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INTERNATIONAL DEVELOPMENT ASSOCIATION

AND THE

INTERNATIONAL FINANCE CORPORATION

COUNTRY ASSISTANCE STRATEGY

FOR

THE ISLAMIC REPUBLIC OF PAKISTAN

FOR THE PERIOD FY06-09

April 4, 2006

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CURRENCY AND EQUIVALENTS

Currency Unit = Pakistan Rupee
US\$1 = PKR 59.40

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ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	IDI	Long Distance and International
ADB	Asian Development Bank	LL	Local Loop
ADR	Alternative Dispute Resolution	MDG	Millennium Development Goals
AIDS	Acquired Immunodeficiency Syndrome	MIGA	Multilateral Investment Guarantee Agency
AJK	Azad Jammu Kashmir	MTBF	Medium Term Budget Framework
BMOs	Business Membership Organizations	MTDF	Medium Term Development Framework
CAE	Country Assistance Evaluation	NBP	National Bank of Pakistan
CAS	Country Assistance Strategy	NEPRA	The National Electric Power Regulatory Authority
CAS-PR	Country Assistance Strategy Progress Report	NEAS	National Education Assessment System
CBR	Central Board of Revenue	NGOs	Non-Governmental Organizations
CFAA	Country Financial Accountability Assessment	NWFP	North West Frontier Province
CGA	Controller General of Accounts	PDF	Pakistan Development Forum
CWIQ	Core Welfare Indicators Questionnaire	PEP-MENA	Private Enterprise Partnership for Middle East and North Africa
DCC	Donor Coordination Cell	PFM	Initial Public Offering
DFID	Department for International Development (UK)	PIFRA	Project to Improve Financial Reporting and Auditing
DPL	Development Policy Loan	PIHS	Pakistan Integrated Household Survey
EAD	Economic Affairs Division	PPAF	Pakistan Poverty Alleviation Fund
EBP	Enterprise Benchmarking Program	PPPS	Public-Private Partnerships
ERRA	The Earthquake Reconstruction and Rehabilitation Authority	PRSC	Poverty Reduction Support Credit
FSAP	Financial Sector Assessment Program	PRSP	Poverty Reduction Strategy Paper
GDP	Gross Domestic Product	PSCB	Public Sector Capacity Building
GEF	Global Environment Facility	PTCL	Pakistan Telecommunications Limited
GoP	Government of Pakistan	PSLSM	Pakistan Social and Living Standards Measurement Survey
GTZ	German Agency for Technical Cooperation	QAG	Quality Assurance Group
HIES	Household Income and Expenditure Survey	SAC	Structural Adjustment Credit
HIV	Human Immunodeficiency Virus	SME	Small and Medium Enterprise
IBRD	International Bank for Reconstruction and Development	TATF	Technical Assistance and Trust Funds
ICR	Implementation Completion Report	TMA	Tehsil Municipal Authorities
IDA	International Development Association	USAID	United States Agency for Int'l Development
IEG	Independent Evaluation Group	WAPDA	Water and Power Development Authority
IFC	International Finance Corporation	WEF	World Economic Forum
IMF	International Monetary Fund	WHO	World Health Organization
IPO	Initial Public Offering	WTO	World Trade Organization
IPP	Independent Power Producer	WSS	Water Supply and Sanitation
JBIC	Japan bank for International Cooperation		

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EXECUTIVE SUMMARY

i. The FY06-09 Country Assistance Strategy (CAS) has been prepared at a time of great opportunity for Pakistan. Since the beginning of the new millennium, Pakistan has managed a remarkable turnaround. During the 1990's Pakistan's progress in reducing poverty and improving the welfare of its people was not very encouraging as economic growth slowed and progress in improving social indicators stagnated. Beginning in 2000, the Government initiated a wide-ranging and ambitious reform program resulting in a dramatic turnaround. The FY03-05 CAS period witnessed the consolidation and acceleration of this turnaround with sustained implementation of a program of stabilization and wide-ranging structural reforms. Yet Pakistan's development challenges remain formidable. While provisional poverty estimates suggest that poverty declined between 2001 and 2005, the proportion of the population below the poverty line remains high. And despite recent indications of improvement, social and living standards remain well below countries with similar incomes and growth rates.

Development Challenges

ii. The key challenge for Pakistan is now to sustain its recent growth performance in order to generate significant poverty reduction. Sustained growth will require continued sound macroeconomic management along with further improvements in the investment climate. Pakistan's infrastructure platform needs significant investment in order to support Pakistan's growth and service delivery goals. For the poor to participate in and benefit from growth Pakistan needs to accelerate human development. While Pakistan is making progress, analysis suggests that it will be challenging to achieve the MDGs for infant mortality, child malnutrition, primary completion, and elimination of the gender gap in primary enrolment. Looking beyond the MDG's, enhancing competitiveness in an increasingly globalized and technology driven world economy will require a growing pool of workers with leading edge skills pointing to the need for increases in the level and quality of secondary, vocational and higher education. Thus, continued concerted efforts to address poor human development outcomes are important not only to improve equity but also as an integral part of achieving Pakistan's growth objectives.

Pakistan's Poverty Reduction Strategy

iii. Pakistan's poverty reduction strategy paper (PRSP) sets forth a broad-based strategy for addressing poverty in its various dimensions including human development, governance, and vulnerability and builds on the economic program first articulated in the fall of 1999 and further elaborated in the I-PRSP of 2001. The PRSP emphasizes policies to sustain rapid growth as the main vehicle for poverty reduction and is grounded on four pillars: (i) achieving and sustaining a high growth rate while maintaining macroeconomic stability, translating this higher growth into lower poverty, and bridging the social gap; (ii) improving governance and consolidating devolution, both as a means of delivering better development results and ensuring social and economic justice; (iii) investing in human capital, with a renewed emphasis on effective delivery of basic social services; and (iv) targeting the poor and vulnerable to bring marginalized sections of the population and backward regions into the mainstream of development, and to make marked progress in reducing existing inequalities. The PRSP's targets are fully aligned with the MDGs.

Bank Group Assistance Strategy

iv. In line with Pakistan's recent performance and the Government's request for increased Bank Group support, this CAS proposes a substantial increase in the volume of lending to Pakistan during the next four years.¹ The immediate priority will be to assist in addressing the impact of the October 2005 earthquake – up to US\$1 billion in IBRD/IDA commitments will be used to support reconstruction and recovery (US\$840 million in new commitments have already been approved). In addition, based on the

¹ In this report, the "Bank Group" refers to IBRD, IDA, IFC, and MIGA while the "Bank" refers to IBRD/IDA.

Government's priorities for sustaining growth and accelerating poverty reduction, the CAS envisions an expansion in lending in **infrastructure** (primarily energy, water, and transport) and **human development**. Bank Group program priorities will retain considerable continuity with the FY03-05 CAS, focusing on the areas which are most critical for poverty reduction. The three inter-linked and mutually reinforcing pillars of the CAS correspond to the strategic priorities of the PRSP: (i) sustaining growth and improving competitiveness; (ii) improving government effectiveness and service delivery; and (iii) improving lives and protecting the vulnerable.

Pillar I: Sustained Growth and Improved Competitiveness

v. The focus of this pillar of the CAS will be to support the investments and reforms needed sustain rapid, private sector-led growth. To help maintain the hard-won benefits of macroeconomic stability the Bank will provide support to help the Government strengthen economic management through improving the composition and effectiveness of public expenditures and supporting tax reforms. In agriculture, the focus of the Bank's work will initially be to support the preparation of a rural strategy, integrating issues related to agriculture, natural resource management, the rural non-farm economy, infrastructure, rural finance and the need for targeted interventions. In irrigation the Bank will support a combination of institutional reforms and investments throughout the system including major investments in rehabilitation of critical assets and reforms to improve the quality, efficiency, and accountability with which irrigation services are delivered. Recognizing that sustaining the current high rates of economic growth requires globally competitive production in an increasingly demanding world market, the Bank Group will also support reforms to improve the business environment.

vi. Infrastructure bottlenecks pose a significant threat to Pakistan's ability to sustain rapid growth. In the power sector the Bank Group will support further strengthening of sector governance to improve performance and attract private investment while at the same time helping to address a significant backlog in investment, particularly to address technical losses. In telecommunications the Bank will support adoption of measures to strengthen the policy and regulatory environment and possible investment support for accelerating the provision of rural telecommunication infrastructure. In transport, the Bank and the government will adopt a strategic approach focusing first on the National Trade Corridor linking Pakistan's major ports in the south with its major cities and trade corridors to the North. The key outcome sought would be significant reductions in the time and cost of moving goods through the Indus corridor. Investment and policy-based lending for highways, trade facilitation, ports and railways will be considered, with an emphasis on increasing private sector participation in operation and management. In the financial sector, the Bank Group will support further financial sector reforms to increase access to finance (especially for microcredit borrowers) and support further reforms with the aim of increasing the availability of longer term savings instruments.

Pillar II: Strengthened Governance and Service Delivery

vii. Improving government effectiveness is a central theme of the PRSP. Priorities in this area will be to support further reforms and investment to increase efficiency, transparency and accountability in the use of public resources. In public financial management, full implementation of the Project for Improved Financial Reporting and Auditing (PIFRA) will be the focus along with analytical support to assist in defining the agenda for further reforms in financial management at the federal and provincial levels. The Bank will also support the achievement of transparent and efficient public procurement through development policy lending, policy dialogue and capacity building. Working across sectors, the Bank Group will continue to support cross-cutting reforms to increase capacity and accountability of those responsible for service delivery; empower communities and clients through enhanced access to information on finances and performance; and build the capacity of both communities and governments. Work will also include support to further civil service reform and devolution as well as a stepped-up engagement in the urban sector to improve municipal service delivery, especially in the larger cities.

Pillar III: Improved Lives and Protection of the Vulnerable

viii. The PRSP recognizes that increased investment in human capital leading to significant improvements in education and health will be necessary to build the skilled, healthy work force necessary to sustain recent growth performance. The Bank strategy in education will continue to be focused on the provinces, using development policy credits to support policy and systemic changes as well as the other areas linked to education reform including decentralization and governance reforms. In health, at the national level, the Bank will concentrate on encouraging the Government to focus on public health functions (such as surveillance, quality control, monitoring and evaluation, and public information) while supporting the development and implementation of program and management reforms in the Lady Health Worker program as a way of expanding access to primary health care and family planning. The Bank Group will also support the piloting and evaluation of new approaches for service delivery and demand side interventions. Recognizing that a major focus of efforts in health must be at the provincial and local level, we will support major system reforms through planned provincial Development Policy Credits, beginning in NWFP.

ix. The PRSP recognizes that protection for the poor and vulnerable is a cornerstone of any poverty reduction program. The Bank's assistance for social protection will include support for safety nets that help the chronic poor cope with and, where possible, escape poverty, and help families and individuals cope with seasonal shocks and natural disasters. The Bank will also provide support for social security via improving formal sector pensions and consider innovative approaches to micro-insurance to address life cycle risks. Pakistan's PRSP recognizes that while rapid growth will be the main driver of poverty reduction, targeted interventions and community-based approaches to rural development are also required to address the immediate needs of the poor and vulnerable, especially in drought prone and flood stricken areas, and help them share in economic growth. The Bank will continue to support implementation of the Community Investment Programs in NWFP and AJK and look for possible expansion and replication opportunities. The Bank will also support the Government's newly announced program for rural poverty alleviation through social mobilization.

Delivering the World Bank Group Program

x. ***IBRD/IDA Lending.*** Pakistan's demand for World Bank financial support has grown to meet the needs of its growth and poverty reduction strategy and to address the impact of the October earthquake. To meet this demand a flexible IBRD/IDA lending program of up to US\$6.5 billion (approximately US\$3.1 billion IDA and US\$3.4 billion IBRD) is proposed in order to support implementation of the PRSP. Pakistan's IDA allocation has been increased under IDA 14, with the three-year envelope set at SDR 1.5 billion (equivalent to about US\$725 million per year). In addition Pakistan will have access to additional IDA on hard terms estimated at SDR 130 million. The scale of IBRD financial support will be determined by the strength of the GoP's policy performance and macroeconomic management. The upper bound of the proposed IBRD lending range for FY06-09 is \$3.4 billion of which up to \$1.3 billion could take the form of development policy loans. Annual lending could increase to as much as \$1 billion per year with up to \$500 million in DPLs within this envelope.

xi. ***The IFC and MIGA Programs.*** In the upcoming CAS period, IFC will be increasing its investment with the target range of US\$500-600 million for the period. IFC will also explore opportunities in pre-privatization investment. It furthermore plans to make more equity investment and intends to be a catalyst for and mobilize private equity in the country. IFC activity will focus on three main sectors: financial, SME and infrastructure. With the recent creation of Private Enterprise Partnership for Middle East and North Africa region (PEP-MENA), IFC has initiated a substantial TA program in Pakistan to build capacity and address constraints of the SME, infrastructure and financial sectors. MIGA's outstanding portfolio in Pakistan consists of 10 contracts of guarantee with a total gross exposure of US\$136.8 million and a net exposure of US\$106.8 million. An application seeking coverage for a US\$20.8 million equity investment in a hydropower project in Pakistan is currently pending.

xii. **Partnerships and Harmonization.** The Bank Group's work in Pakistan is coordinated with and reinforced by the efforts of other donors in a wide variety of areas. The international response to the October earthquake has also served as an opportunity to substantially deepen donor harmonization and coordination. The Government leads coordination of policy dialogue and donor support within the framework of the PRSP, using the Pakistan Development Forum (PDF), held annually in Islamabad, as the principal forum for discussion with and among donors. A Donor Coordination Cell (DCC) has been created in the Economic Affairs Division (EAD). Formal donor group meetings are also held, at least two to three times a year, to discuss implementation of the government's PRSP. Under the leadership of the Government of Pakistan, the Bank Group is increasing efforts to strengthen partnerships and improve harmonization of activities among donors in line with the Paris Declaration on Aid Effectiveness. During the next four years we expect an increasing share of analytical activities to be carried out jointly with partners.

Managing Risks

xiii. The proposed CAS program poses a number of risks, the greatest of which is that of possible **policy reversal** due to shifting priorities or political changes. There are also **implementation risks** relating to both the Bank and Pakistan. The Bank will seek to pro-actively manage these risks by actively addressing capacity constraints while seeking to build and sustain support for further reforms. We will continue to rely on the self-regulating nature of the programmatic approach wherein the volume and pace of lending will match the pace of reforms.

Issues for Board Discussion

xiv. The following issues are suggested for Board discussion:

- a) Does the proposed program adequately support Pakistan's strategy for poverty reduction and achievement of MDGs?
- b) Is the planned increase in the scale of World Bank Group support for Pakistan appropriate?
- c) Is mix of instruments and activities consistent with the focus of the strategy?

I. COUNTRY CONTEXT AND DEVELOPMENT CHALLENGES

A. Political and Social Context

1. The FY06-09 Country Assistance Strategy (CAS) has been prepared at a time of great opportunity for Pakistan. Since the beginning of the new millennium, Pakistan has managed a remarkable turnaround. During the 1990's Pakistan's progress in reducing poverty and improving the welfare of its people was not very encouraging. Economic growth slowed and progress in improving Pakistan's social indicators stagnated. Successive governments initiated reforms, but with only modest results. Beginning in 2000, the Government initiated a more wide-ranging and ambitious reform program resulting in a dramatic turnaround. The FY03-05 CAS period witnessed the consolidation and acceleration of this turnaround with sustained implementation of a program of stabilization and wide-ranging structural reforms. Economic growth accelerated from the average of 3.3 per cent during 1997-2002 to 6.4 per cent in 2003/04 and 8.4% in 2004/05. Public debt fell to 61% of GDP from almost 90% in 2000/01. Improved fiscal performance and growing fiscal space resulting from savings on interest expenditures, generous external support and improved revenue administration have enabled the government to exceed targets for education spending. In short, Pakistan moved from crisis to growth, laying the groundwork for sustained growth and significant poverty reduction.

2. Yet Pakistan's development challenges remain formidable. While provisional estimates for 2004-05 suggest that poverty has declined compared with 2000-01, the proportion of the population below the poverty line remains high. And despite recent indications of improvement, social and living standards remain well below countries with similar incomes and growth rates. For example Pakistan's gross female primary enrolment rate is 33 percent below and its infant mortality rate is 27 per thousand above that of countries with the same per capita income. Moreover, there remain substantial disparities in opportunity, particularly for the rural poor and women.

3. Politically, Pakistan is benefiting from a period of relative stability compared with the turmoil of the last decade. The past six years have been marked by consistent policies and sustained implementation of the government's reform program. Elections in 2002 restored the National and Provincial Assemblies and despite occasional slowdowns in implementation, the reform program has been carried forward under the elected government. The prospects are good for continued stability and maintenance of the government's pro-reform orientation. General elections are due to be held in 2007. The decentralization initiative has started the process of transferring responsibility and resources for public service delivery to local governments, laying the groundwork for more responsive and accountable government at the local level as well as improved services. Recent local government elections in 2005 were an important milestone in the institutionalization of the new local government system.

4. Internationally, relations with India have steadily improved over the past two years, although the conflict in Afghanistan and international terrorism continue to have serious repercussions for Pakistan. Relations with India have improved markedly under the comprehensive dialogue launched in early 2003 and trade between the two countries is growing strongly, although from a low base. President Musharraf visited India in late April 2005, and he and the Indian Prime Minister, Manmohan Singh, agreed to increase transport links between the divided parts of Kashmir. The response to the October 8 earthquake has served as an opportunity to expand peaceful interaction across the divided territory, demonstrating the potential for cooperation and constructive engagement in the region. However, Pakistan's efforts to deal with the spillover of post-9/11 conflict in Afghanistan and to cooperate in international efforts to combat terrorism continue to bring it into conflict with militant groups, particularly in remote border region. Clashes between law enforcement agencies and militants—many of them foreign—have resulted in significant casualties.

B. Social Progress and Poverty Profile

5. The most recent household survey from which poverty estimates can be derived is now 4 years old, dating from 2000/01, when economic growth was depressed and much of the country's rural areas were suffering severe drought conditions. A definitive evaluation of whether the economic turnaround of the past few years has translated into lower poverty will have to await the release and analysis of the results of the Household Income and Expenditure Survey which is expected in 2006; however, provisional estimates released by the Government indicate that the incidence of poverty which rose above 30% in 1998/99, and rose further in 2000/01, fell to below 30% in 2004/05.² The results of the 2000/01 Pakistan Integrated Household Survey (PIHS) convey the characteristics of poverty in Pakistan and highlight the challenge of attaining the Millennium Development Goal of halving the proportion of population below the poverty line between 1990 and 2015.

6. Based on the PIHS, disaggregated poverty headcounts by province (using the official poverty line) show that NWFP and Balochistan are the poorest provinces and that poverty is far more widespread in rural areas. Poverty is highest among unskilled labor in the informal sector and their condition became worse between 1998-99 and 2001-02. Ownership of livestock and agricultural land are also closely associated with rural incomes. While the poorest quintile of the rural population accounted for only 10 percent of the total estimated value of livestock in 2001-02, the top quintile accounted for 36 percent. Households with no land constituted 60 percent of the rural population in 2001-02, but accounted for 76 percent of those in the bottom quintile; and poverty incidence among landless households actually increased from 1998-99 to 2001-02. Vulnerability is a key feature of poverty; approximately 41 percent of the population is concentrated in a small range of 75 to 125 percent of the poverty line implying that, for a very large share of Pakistan's population, unanticipated shocks such as illness/disability, death, or natural disaster can result in poverty.

7. Poverty is also characterized by low level of human capability, manifested in poor outcomes in education, health and lack of connectivity to basic services and facilities. Here there is recent data to suggest that Pakistan's reform program is beginning to pay off. Preliminary findings from the recently completed Pakistan Social and Living Standards Measurement survey, measuring outcomes as well as access, satisfaction and usage of public services both at the household and facility level, are encouraging. The preliminary results show significant improvement in a range of indicators including primary enrolment and immunization coverage (See Table 1). Nevertheless, across a range of indicators, Pakistan's social indicators continue to lag behind those of similar countries.

C. Development Challenges

8. ***The key challenge for Pakistan is now to sustain its recent growth performance in order to generate significant poverty reduction.*** Pakistan's recent growth performance is encouraging, but its continuation is by no means assured. Sustained growth will require continued sound macroeconomic management along with further improvements in the investment climate. Notwithstanding the economic recovery, investment rates are insufficient to sustain high rates of growth needed to reduce poverty. Foreign direct investment, while recovering from the very low levels of the late 1990's remains low compared to more dynamic economies in Asia. Sluggish rates of investment reflect continued weaknesses in the investment climate; despite the recent successes in reducing state intervention in the economy and improving the regulatory framework for private business, firms continue to face significant policy, regulatory, and infrastructure constraints. Security concerns and political uncertainty have also combined to deter investors, both foreign and domestic. The impact of these constraints is reflected in the results of

² The government has established a joint committee made up of donors, experts and officials to evaluate and analyze the most recent data and carry out a detailed analysis of poverty incidence. The provisional estimates are subject to change based on the results of this analysis.

the World Economic Forum's (WEF) 2005-2006 Competitiveness Report which indicate that in 2005, of the 116 countries covered, Pakistan ranked 66th in 'business competitiveness' (see Table 2).³

Table 1: Progress on Selected Social Indicators

Indicator	Reported data		
	1998-99	2001-02	2004-05
Poverty			
Poverty incidence (%)	30.6	32.1	
Demographics			
Population (millions)	135	141	151
Education			
Adult literacy rate: 15+ years (%)	43	43	50
Female literacy rate as percent of male literacy (%)	48	51	57
Net enrollment rate (NER): grades 1-5 (%)	50	51	60
Female NER as a percent of male: grades 1-5 (%)	75	79	85
Health			
Life expectancy at birth (year)		64	65
Infant mortality rate 0-12 months (per 1000 live births)	90	82	na
Under-five mortality rate (per 100,000 live births)	116	114	na
Fully immunized children, age 12-23 months (%)	49	53	77
Percentage of pregnant women using pre-natal care	31	35	50

Sources: PIHS 1998-99, 2001-02, Preliminary estimates from PSLM 2004-05.

* Provisional estimate.

9. Pakistan's infrastructure platform needs significant investment in order to support Pakistan's growth and service delivery goals. Infrastructure services including electricity, paved roads, municipal services, and telecommunications reach a relatively low proportion of the population. Moreover, inefficient operations in key sectors, like power and transport, adversely affect competitiveness. The power sector is characterized by high losses and unreliable supply, forcing many large firms to invest in captive generators. Much of the road network is in poor condition and the railways are carrying only a small fraction of the nation's freight due to inefficiency. Delays at Pakistan's ports are also hurting cost competitiveness of Pakistan's exports. Each day of delay in shipment is currently raising unit costs, on average, by over 0.5 percent of f.o.b. prices of exports.⁴ At the same time, improvements in basic infrastructure are critical to improving

Table 2: Competitiveness Rankings

Countries	Business Competitiveness Index		
	2005 (116 countries)	2004 (103 countries)	2003 (102 countries)
Singapore	5	10	8
Malaysia	23	23	26
India	31	30	37
Thailand	37	37	31
Turkey	51	52	52
China	57	47	46
Pakistan	66	73	75
Philippines	69	70	65
Sri Lanka	72	68	57
Bangladesh	100	95	91

Source: World Economic Forum, *Global Competitiveness Report: 2005-2006*; World Economic Forum, *Global Competitiveness Report: 2003-2004*

³ WEF's 'Business Competitiveness' index incorporates indicators of the 'quality of the national business environment' and of the 'company operations and strategy'. For details, see: World Economic Forum, *Global Competitiveness Report 2005-2006*.

⁴ The World Bank, *Global Economic Prospects: Trade, Regionalism, and Development- 2005*, page 80.

human development outcomes. Approximately 40 percent the population lacks access to power and about 75% of all rural health, education and market facilities are accessible only by earth tracks. Similarly, water and sanitation services which are critical to achieving human development outcomes suffer from poor quality and limited availability.

10. The infrastructure challenge is particularly acute with respect to water as Pakistan relies on the largest contiguous irrigation system in the world for 90% of food production and 25% of GDP. Agriculture is the single most important source of employment and irrigation represents more than 95% of the total consumptive use of water. However, this massive infrastructure is deteriorating and in need of rehabilitation along with reforms to improve the allocation of water as well as the efficiency of its use. The capacity of existing reservoirs is diminishing as the result of siltation and no new reservoirs have been built since 1976. Moreover, competition for water is growing among the provinces and across the varied needs for irrigation, industrial and domestic use, and the environment. Pakistan has already begun ramping up its investments, beginning with the urgent rehabilitation of barrages. Yet there remains a need for significant new investment, not only in irrigation but in other uses of water as well, including power generation and urban-industrial and domestic supplies (50% of the population is not served by a formal supply system and sanitation and water treatment reaches less than 10% of the population). At the same time there is uncontrolled pollution of surface and groundwater from agriculture, industry and rapidly growing cities.

11. For the poor to participate in and benefit from growth Pakistan needs to accelerate human development. International experience suggests that no country can hope to compete in the global economy without an educated and healthy work force. Indeed, the lack of skilled manpower and lower labor productivity are often cited as constraints to raising productivity, strengthening competitiveness, and achieving sustained high economic growth by both business leaders and policymakers in Pakistan. While Pakistan is making progress, analysis suggests that it will be difficult to achieve the MDGs for infant mortality, child malnutrition, primary completion, and elimination of the gender gap in primary enrolment.⁵ Looking beyond the MDG's, enhancing competitiveness in an increasingly globalized and technology driven world economy will require a growing pool of workers with leading edge skills pointing to the need for increases in the level and quality of secondary, vocational and higher education. Thus, continued concerted efforts to address poor human development outcomes are important not only to improve equity but also as an integral part of achieving Pakistan's growth objectives.

12. Pakistan's poor social indicators are not due solely to poverty or lower rates of economic growth; Pakistan significantly underperforms when compared to other countries at similar levels of per capita income, and when compared to countries at similar levels of development. For example, Pakistan has 36 percent fewer births attended by trained personnel, an infant mortality rate that is 27 per thousand higher, and a gross primary enrollment rate that is 20 percent lower than countries with similar income levels. Similarly, growth in Pakistan appears to have less of an impact on social indicators than in other countries—between 1960 and 1998, as per capita GDP more than doubled in Pakistan, infant mortality declined by 43 percent, as compared to a decline of 73 percent in a group of low income countries that on average grew at the same rate.

13. Pakistan's relatively slow progress in improving human development reflects both low public expenditures on education, health, water and sanitation and other key sectoral expenditures as well as weaknesses in public service delivery which limit the effective use of scarce resources. As a result of the debt burden, which reached a peak in the late 1990's, social sector spending was squeezed, with education and health expenditures declining from 2.2 and 0.7 percentage of GDP in 1987/88 to 1.7 and 0.5 percentage of GDP by 1999/00. Despite having risen since then, public expenditure on health and education remain low by international standards. Within sectors, resources have been poorly allocated

⁵ World Bank, *Attaining the MDGs in Pakistan* (Washington, DC, 2005).

with emphasis on spending for new hiring and facilities at the expense of providing resources for operations and maintenance. Weaknesses in management of public services also stem from capacity constraints and in some cases lack of clarity about the roles and responsibilities of various levels of government. Moreover, social services are subject to, inter alia, high absenteeism rates of service professionals (25 percent for teachers), poor quality of inputs and materials, low community involvement and limited participation of the poor.

14. It is also important to note that a number of factors weaken the link between growth and poverty reduction in Pakistan. One such factor is the skewed structure of ownership and access to factors of production (land, water and credit) in rural Pakistan, which limits the impact of agricultural growth on the incomes of the rural poor. Landless agricultural laborers and non-agricultural rural poor households account for 61 percent of the rural poor (and nearly 30 percent of the rural population). Another factor is the ineffective targeting and delivery of government programs which reduces the benefits of increased government spending. Strong social and cultural norms restrict access to public services and reduce the economic opportunities of women and girls. Together these factors create obstacles for the poor and vulnerable to partake in the benefits of economic growth, highlighting the importance of interventions that address chronic poverty and vulnerability, and help the disadvantaged groups, including women, participate in economic growth.

15. Large gender inequalities represent a critical constraint to improvements in human development outcomes. Since the late 1990s, the Government of Pakistan has launched programs designed to increase girls' school enrollments, enhance female access to health care, and facilitate women's participation in the public arena. Some progress has been made, but much more is needed. For example, legislation mandating reservation of seats for women in local governments, as well as in provincial and national assemblies, has substantially increased women's political representation. However, although more girls are in school, a substantial gender gap in enrollment remains and worsens significantly as girls transition from primary to middle school. Although gender differentials in child immunization have declined, considerable gender differentials persist in other aspects of health care. The use of reproductive health services is low, and maternal mortality ratios remain high. In the labor market, lower educational attainment coupled with social norms that restrict mobility confine women to a limited range of employment opportunities and low wages. The achievement of Millennium Development Goals (MDGs) will require significant reductions in these gender gaps. Policy interventions directed specifically at gender inequality in these public domains are needed.

16. Pakistan's population is predominantly rural and dependent on agricultural lands, rangelands and forests. Natural resources and their sustainable management are therefore central to Pakistan's economic growth and to people's livelihoods. Salinization and waterlogging of land, increasingly polluted agricultural drainage (partly due to excessive pesticide use), and loss of important ecosystem functions from diversion of flows and from pollution are reflected in disappointing development outcomes and compromised agricultural yields. Degradation of rangelands continues and the rate of deforestation is relatively high (although the level of remaining forest cover is already low). The poorer rural dwellers suffer most from these trends. Urbanization is increasing at a rapid rate and the provision of basic environmental services in these areas has not matched the pace of growth. In both rural and urban areas there are problems of public health related to the lack of water, sanitation and other services and also to high levels of air pollution (in rural areas, this is related mainly to indoor air from use of poor quality fuels). Addressing these problems is a necessary adjunct to a sustainable growth and poverty alleviation strategy.

Box 1: Impact of the October 8 Earthquake

The October 8, 2005 earthquake left widespread destruction in its wake, killing at least 73,000 people, severely injuring another 70,000, and leaving 2.8 million people without shelter. The affected areas suffered extensive damage to economic assets and infrastructure, with social service delivery, commerce, and communications either severely weakened or destroyed. Beyond the human toll, the overall costs associated with the earthquake are significant. A Joint Damage and Needs Assessment put the value of the direct damage sustained due to the earthquake at US\$2.3 billion while resulting indirect losses are estimated at US\$576 million. The estimated costs for relief, livelihood support for victims, and reconstruction cost are estimated at approximately US\$5.2 billion.

The earthquake is expected to have an adverse impact on the economy, most notably on the fiscal deficit. The impact on economic growth will be modest as the affected regions account for a very small part of the country's GDP; growth at the national level is expected to decline by 0.4 percentage points in 2005/06. However, a large share of reconstruction costs, including restoration of social and physical infrastructure and government assistance to households to rebuild livelihoods and homes, will fall on the Government. Fiscal deficits during FY06-08 are expected to increase by 0.5 to 0.9 percent of GDP per year. While the impact on exports is projected to be limited, relief and reconstruction needs have increased import demand due to higher demand for fuel and steel.

These pressures could pose difficulties for Pakistan's macroeconomic balances and have the potential to compromise the achievement of its long-term development goals. Whether and to what extent this occurs will depend on the response of the Government and the international community. The Government intends to absorb a part of the budgetary impact of the earthquake by making cuts in low-priority expenditures and by raising additional domestic revenue while protecting priority expenditures needed to improve health, education, and public infrastructure. The decision to delay the purchase of new military aircraft indicates the Government's seriousness in this regard. Implementation of outstanding revenue and spending measures also need to be accorded high priority. However, even with such measures (which are needed in any case), given the magnitude of resources needed for rehabilitation of earthquake-affected areas, it is unlikely that the government will be able to fully absorb the fiscal impact of the earthquake without significantly affecting public sector development activities. Moreover, it is important that the poor in areas not affected by the disaster (the vast majority) not lose out due to increased allocation of public resources to the earthquake-affected areas at the expense of the rest of the country. Ensuring the dual objectives of rehabilitating and rebuilding earthquake affected communities and accelerating Pakistan's development will require additional resource mobilization by Pakistan and the international community.

For the country assistance strategy, the main impact is on the lending program, particularly the use of IDA resources. While Pakistan's long-term development challenges and poverty reduction strategy have not been fundamentally changed by the earthquake, its immediate financing needs have greatly increased. To help meet these needs while protecting implementation of the PRSP reform program, the Bank has already made available \$740 million in new IDA commitments and \$100 million in IBRD lending. Overall earthquake-related financing may reach \$1 billion. This has significantly front-loaded the use of IDA 14 resources with expected FY06 IDA commitments totaling over half of the three-year IDA allocation. In consultation with the Government, the CAS lending program has been re-prioritized accordingly; some planned IDA operations have been reduced in size and additional IBRD lending is planned, consistent with creditworthiness considerations. To the planned AAA program we have added dialogue and advisory activities to assist the Government in the development of a comprehensive hazard risk management strategy.

17. ***Addressing governance challenges and combating corruption are critical for improving the investment climate and strengthening the delivery of public services.*** Public institutions delivering social services, law and justice and economic services suffer from inadequate capacity and ineffective internal and external accountability. Moreover, while reliable data is scarce, surveys cited in the Government's

National Anti-Corruption Strategy indicate that corruption is a serious challenge.⁶ The civil service suffers from weak capacity as a result of many years of rapid turnover, patronage-based employment at lower levels and inadequate compensation at senior levels. Accountability has been further weakened by lack of effective client voice, made worse by the over-centralization of power at higher levels of government. Together these weaknesses represent a major impediment to improving service delivery and the investment climate.

18. Improving governance and combating corruption is one of the pillars of Pakistan's poverty reduction strategy. Key elements of the strategy include: (i) reducing opportunities for corruption by redefining and refocusing the role of the state through privatization and de-regulation; (ii) reforming the civil service; (iii) establishing local government as an effective system of governance, participation and accountability; (iv) supporting reforms in public financial management and procurement in order to promote prudent and accountable management of public resources while reducing opportunities for corruption; and (v) strengthening enforcement mechanisms and the administration of justice.

19. Significant progress has been made in these areas. Local governments have been created to increase responsiveness and accountability for provision of key public services. The tax administration system has been redesigned to reduce interaction between taxpayers and tax officials. The Government's privatization program accelerated during the previous CAS period; over the last two years the government realized US\$4.35 billion in proceeds through 27 transactions compared with US\$600 million during the previous three years. Privatization of state-owned banks coupled with stronger regulation under a revitalized State Bank of Pakistan has reduced politically-motivated lending and non-performing loans. Progress has been made in improving public financial accountability through modernization of financial reporting systems and auditing, while the institutions of accountability like the Auditor General and the Parliamentary Public Accounts Committees have been revitalized. The national power utility is being unbundled to de-monopolize the industry, improve its transparency and efficiency and prepare for privatization. The National Accountability Bureau was created, successfully prosecuting cases of high-level corruption. Nevertheless while this progress has been encouraging, most observers believe that a great deal more needs to be done to address the deep governance challenges faced by Pakistan.

D. Economic Developments and Outlook

Recent Economic Developments and Prospects

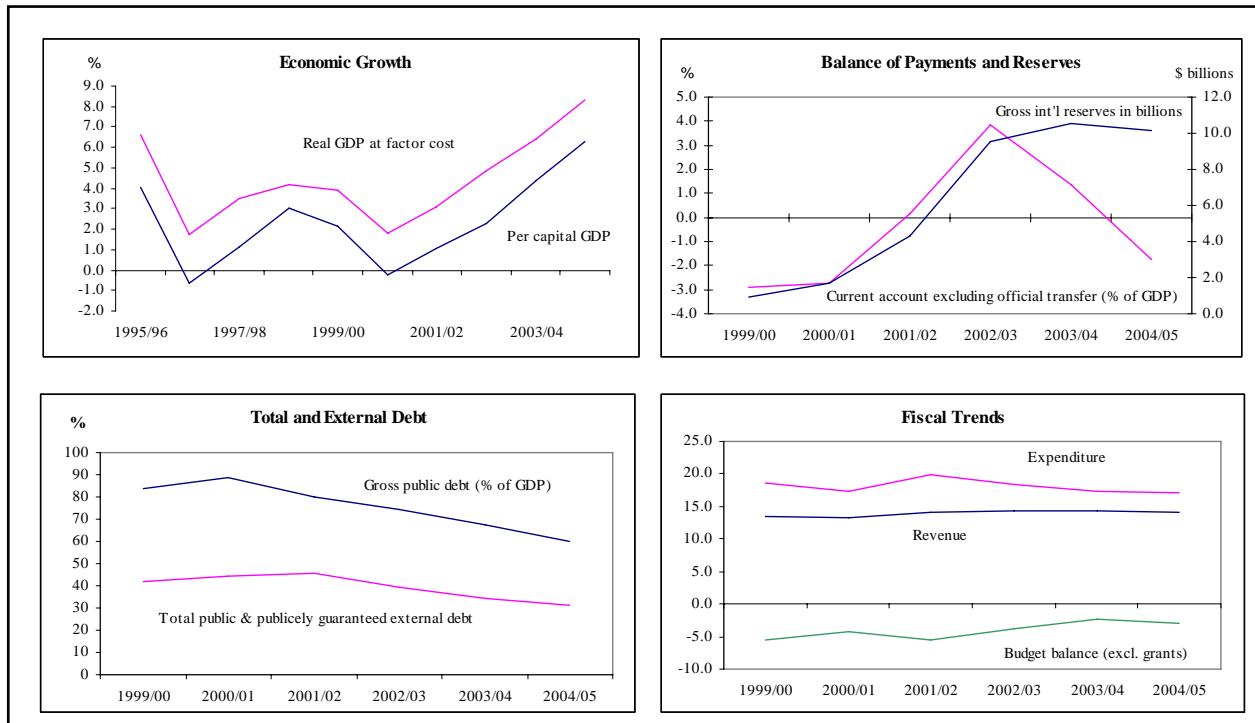
20. Since the last CAS, Pakistan's economy has continued its strong recovery. Growth has accelerated from 3.1 percent in FY2001/02 to 8.4 percent in 2004/05. The recovery was driven by a strong rebound in exports of manufactures and, more recently, favorable weather conditions leading to a strong pick up in agricultural production. Large scale manufacturing grew by 18.2% in FY2003/04 and by 15.4% in 2004/05. Fiscal performance has been sustained, despite limited progress in improving revenue collections and reducing power sector losses. Due primarily to increases in non-tax revenues and savings on the interest bill, the overall fiscal deficit (excluding grants) declined from 6.6 percent of GDP in 1999/2000 to about 3 percent of GDP in 2004/05. Moreover, despite this rapid fiscal adjustment, social- and poverty-related expenditures were raised by over 1 percentage point of GDP over the last three years, or by over 30 percent in real per capita terms, although they remain low in comparison with other developing countries.

21. The balance of payments turned around with strong export growth and sizable remittances, and international reserves were rebuilt to cover about five months of imports of goods and nonfactor services and over 250 percent of short term external liabilities (up from 11 percent in 1999/2000) at end 2004/05.

⁶ Government of Pakistan, *National Anti-Corruption Strategy*, Islamabad Pakistan, 2002 (<http://www.nab.gov.pk/Downloads/Doc/NACS.pdf>).

However, the external situation has deteriorated somewhat over the past 18 months. Exports and workers' remittances have performed well, but with imports growing even faster, the current account moved into deficit in 2004/05. The trade deficit during FY05 rose sharply to US\$ 4.3 billion and is projected to increase further to over US\$7 billion in FY06. This reflects the rapid increase in imports which rose by nearly 38% to US\$18.8 billion due to strong import demand for a wide range of consumer and investment goods (including automobiles and machinery), agricultural and chemical goods (fertilizer), and to high oil prices. Exports increased by 13.8% to US\$14.1 billion. Gross reserves fell by about US\$800 million in 2004/05 to US\$9.8 billion at end-June 2005. The current account deficit is projected to reach 3.9% of GDP in FY06.

Figure 1: Recent Economic Performance



22. Pakistan's public debt burden has declined sharply in the past four years. Although the stock of debt remains high, it has declined faster than expected, and its net present value has been reduced. Thanks to rapid growth, availability of grants and concessional finance, debt cancellation and fiscal consolidation, total government debt as a percent of GDP declined from 80% in 2001/02 to 61% in 2004/05. Total external public and publicly guaranteed debt declined from 296 percent of exports of goods and services in FY2001/02 to 203 percent in FY2004/05 while debt service fell from 34 to 19 percent of exports of goods and services. Interest payments have fallen from 5.6% of GDP in 2001/02 to 3.2% in FY2004/05.

23. The response to the October earthquake—arguably the most debilitating natural disaster in Pakistan's history—is expected to have an impact on fiscal outcomes during the current fiscal year and for at least the next 3 years. The deficit, which had already been projected to grow as the result of increases in civil service salaries and a growing public investment program, is expected to rise further, reflecting the costs of rebuilding infrastructure and government services and of subsidies to restore livelihoods and housing in the earthquake-affected areas. The FY06 fiscal deficit before grants is expected to increase by around 0.6% of GDP, to 4.4% of GDP (see Table 3), which remains consistent with a stable macroeconomic framework and the Fiscal Responsibility and Debt Limitation Law. However, the increase in public expenditures due to the earthquake may result in a slowdown in the pace of debt reduction. The extent to which it does depends not only on the Government's efforts to reprioritize

expenditures, but also the pace at which grants pledged at a November 2006 donors' conference materialize. The government has indicated that it is reprioritizing expenditures and strengthening revenue efforts so as to minimize the impact of the earthquake on fiscal balances. The latter is particularly important since revenue performance suffered in FY05 due to a reduction in petroleum taxes (a move designed to cushion consumers from the impact of rising international oil prices), reductions in customs duties and special regimes for particular sectors. Some administrative reforms also may have contributed to a temporary dip in collections. However, collections during the current fiscal year are improving markedly.

Table 3: Medium Term Outlook – Key Indicators

	2002/03	2003/04	2004/05	Projections			
				2005/06	2006/07	2007/08	2008/09
	(in percent of GDP, unless indicated otherwise)						
Output and Prices							
Real GDP at factor costs (percent change)	4.8	6.4	8.4	6.3	6.5	6.6	6.8
Consumer prices (period avg. percent change)	3.1	4.6	9.3	8.2	6.5	5.5	5.0
Consolidated Government Budget Balance							
Excluding grants	-3.8	-2.3	-3.3	-4.4	-4.4	-3.9	-3.6
<i>Net of Earthquake Impact</i>				-3.6	-3.5	-3.3	-3.1
Public Debt							
Total government debt	74	68	61	57	54	51	49
Domestic debt	39	36	33	32	28	25	23
External debt	35	31	28	25	26	26	26
External Sector							
Current Account Balance	5.1	2.0	-1.3	-3.9	-4.3	-4.3	-4.1
Gross Reserves (US\$ millions. IMF definition)	10,251	10,621	9,985	10,549	12,157	13,117	14,079
Reserve cover to imports of GNFS (months)	6.9	5.0	3.7	3.4	3.4	3.2	3.0

Sources: 2002/03 to 2004/05 – Government of Pakistan; 2005/06 to 2008/9 projections - World Bank Staff estimates.

24. ***The Government's fiscal policy aims to contain the deficit and continue to reduce the debt burden while increasing public investment and social spending.*** These commitments are embodied in the Fiscal Responsibility and Debt Limitation Bill approved by the National Assembly and subsequently passed into Law in 2005. The Law specifies that the revenue deficit be reduced to zero by June 30, 2008, and a surplus maintained thereafter; that total public debt be reduced by 2.5% of GDP per year; that PRSP expenditures be at least 4.5% of GDP in any year; and that debt guarantees be limited to 2 percent of GDP. An additional important clause introduced in the Law by the Assembly is the requirement that education and health expenditures, as a percentage of GDP, be doubled over the next ten years. Meeting these targets will depend in large part on the government's ability to improve revenue collection while continuing to reduce the losses of state-owned enterprises, particularly in the power sector. The Government fiscal framework for 2006 through 2009 is expected to remain consistent with the Fiscal Responsibility and Debt Limitation Law.

25. Prospects for rapid growth to be sustained over the next 3 years are good, provided that political and macroeconomic stability are maintained, that the momentum of structural reforms and investments to reduce the cost of doing business is sustained, and that domestic savings and public and private investment continue to increase. The Government is targeting a more ambitious growth path than the Medium Term Outlook table estimates, with growth projected to rise gradually to 7.8% of GDP by 2009. Emerging risks on the external sector can be mitigated by gradually reducing demand pressures. The Medium Term Outlook presented above assumes that the measures necessary to reduce inflationary pressures and the growing external and fiscal imbalances will be taken by the central bank and the Government of Pakistan. Economic growth for FY06 is projected to remain strong and broad-based. Led

by strong domestic demand, industrial growth remains strong in the automobiles and consumer durables sub-sectors. The textile sector continues to perform well, in spite of the end of the Multi-Fiber Agreement, and exports of textile products have remained strong. Agricultural output in FY06 is projected to be average, below last year's record-breaking levels. Foreign Direct Investment is continuing to increase, as investor confidence is strengthening.

II. PAKISTAN'S POVERTY REDUCTION STRATEGY

26. The positive developments outlined above have set the stage for accelerating poverty reduction in Pakistan. Pakistan's poverty reduction strategy paper (PRSP), which was presented on December 31, 2003, sets forth the broad-based strategy for addressing poverty in its various dimensions including human development, governance, and vulnerability and builds on the economic program first articulated in the fall of 1999 and further elaborated in the I-PRSP of 2001.⁷ Since the PRSP was prepared, the Government has continued to develop and refine its program for implementing the PRSP agenda which is embodied in the five-year Medium Term Development Framework 2005-2010 (MTDF), adopted along with the FY2005/06 Budget. While the PRSP continues to serve as an overall framework for the poverty reduction strategy, the MTDF refines the strategy, taking into account recent developments, and updates the targets while providing further details on implementation strategies. The Government is also in the process of preparing a new PRSP which is expected to be finalized in 2006.

27. Taken together, the PRSP and the MTDF constitute a comprehensive poverty reduction and growth strategy. The PRSP emphasizes policies to sustain rapid growth as the main vehicle for poverty reduction and is grounded on four pillars: (i) achieving and sustaining a high growth rate while maintaining macroeconomic stability, translating this higher growth into lower poverty, and bridging the social gap; (ii) improving governance and consolidating devolution, both as a means of delivering better development results and ensuring social and economic justice; (iii) investing in human capital, with a renewed emphasis on effective delivery of basic social services; and (iv) targeting the poor and vulnerable to bring marginalized sections of the population and backward regions into the mainstream of development, and to make marked progress in reducing existing inequalities. The PRSP's targets are fully aligned with the MDGs (see Table 4:).

A. The PRSP Strategy

28. ***Pillar One: Accelerating economic growth while maintaining macroeconomic stability.*** The PRSP focuses on accelerating poverty reduction and improving social indicators through rapid, private-sector and export-led growth and more effective and equitable delivery of health, water and sanitation, and education services. The PRSP also emphasizes enhancing competitiveness in the era of globalization through higher investment and knowledge inputs. It recognizes that, while a great deal has been accomplished in terms of restoring growth and addressing external vulnerabilities, considerable challenges remain to improve the efficiency of resource use and raise factor productivity. The key source of poverty reduction and employment is expected to be rapid growth and job creation in the manufacturing and service sectors, which are already responding well to economic reforms. The PRSP projects a substantial increase in private sector investment and the continued expansion of private sector activity in order to sustain growth. To increase private investment, the PRSP outlines a set of structural reforms to increase productivity and reduce the cost of doing business in Pakistan. Overall, the strategy aims to expand the role of the private sector in the development process by the strengthening the enabling role of the government through policy direction and creation of a supportive regulatory environment.

⁷ The Bank-Fund Joint Staff Assessment (JSA), discussed by the Board on March 11, 2004, endorsed the PRSP and indicated it provides a good policy framework for the implementation of a strong reform program. *Pakistan, Joint Staff Assessment of the Poverty Reduction Strategy Paper*, Report 27625-PK, February 12, 2004.

29. **Pillar Two: Improving governance.** The PRSP recognizes that continuing to improve governance in Pakistan matters critically for economic growth and the development of human capital. The MTDF reinforces this emphasis. Key elements of the Government's strategy include accelerating civil service reform, furthering devolution, improving access to justice, police reforms, accelerating improvements in public procurement and financial management, and additional measures to accelerate progress on fiscal and financial transparency and reduce opportunities for corruption. In addition to these areas, the MTDF also highlights the importance of strengthening corporate governance, enhancing the quality and coverage of data and statistics, and making greater use of participatory approaches in order to improve program and project outcomes. Regarding civil service reform, the government's strategy highlights a flatter structure, merit-based recruitment and promotion criteria, performance based compensation, and incentives to innovation. There is also a proposal to restructure the civil services in order to break free of some of the structural rigidities resulting from the current cadre system. The government also indicates its intention to implement further pay and pension reforms.

Table 4: Pakistan's PRSP Targets and Alignment with Millennium Development Goals

Goals and Indicators	1990-91 actual	2000-01 actual	2005-06	2011	2015
1. Eradicate Poverty and Hunger					
- Overall poverty level (% of population)	26.1	32.1	28	22	16
- Poverty gap ratio	4.53	6.84			
2. Achieve Universal Primary Education					
- Literacy rate of 15-24 years old (%)	49	58	59.5	78	86
- Gross Enrollment*	73	87	104	104	100
3. Promote Gender Equality and Empower Women					
- Ratio of literate females to males of 15-24 years (%)	0.61	0.65	0.65		0.93
- Proportion of Seats held by women in the Parliament:					
National Assembly (%)	0.9	21			
Senate (%)	1.0	17			
Local Councils (%)		33			
4. Reduce Child Mortality					
- Infant mortality rate	120	77	63	50	40
- Proportion of fully immunized children 12-23 months	25%	53%	82%	90%	>90%
- Under five mortality rate	140	105	80	65	52
5. Improve Maternal Health					
- Maternal mortality rate/100,000	550	450	350	180	140
- Total fertility rate	5.4	4.1	4.0	2.5	2.1
- LHW coverage of target population	n/a	45%	77%	90%	100%
6. Combat HIV/AIDS, Malaria and Other Diseases					
- Incidence of TB/100,000	n/a	177	133		45
7. Ensure Environmental Sustainability					
- Sustainable access to safe water	82%	86%	90%		93%
- Population with access to sanitation		28%	51%	55%	

Source: Government of Pakistan, Poverty Reduction Strategy Paper, 2003.

*A sub-committee headed by Director, PIDE is engaged in reconciling PIHS and NEMIS data.

30. **Pillar Three: Investing in human capital.** In Pakistan, social development lagged even when growth was robust and the incidence of income poverty declined. The Government's PRSP acknowledges that without a considerable improvement in social indicators, especially for women, Pakistan will be unable to sustain high rates of economic growth. Education is seen as the most important factor

distinguishing the poor from the non-poor. The PRSP, therefore, includes increased allocations for education, health, water and sanitation, and rural infrastructure. The MTFDF reflects a large increase in resources for education with the total public allocation for education expected to increase to 3.6 percent of the GDP by 2010 with private sector expenditure adding another 1.5 percent.

31. In health, the PRSP recognizes the need to increase financing and enhance efficiency of spending through organizational and management reforms. Furthermore, the PRSP focuses on reorganization of district health structures, strengthening of district and tehsil hospitals, improving hospital administration through greater autonomy, and regulation of the private sector. On the programmatic front, the strategy is to continue and strengthen the shift from curative services to preventive and primary health care. The strategy prioritizes control of communicable diseases, reproductive health, child health and nutrition. In health, the Federal Ministry would focus on development of a public health surveillance system and on gradually devolving preventive care programs, which would increasingly be designed and not only implemented by provincial and local governments. The PRSP acknowledges that the achievement of key PRSP goals in health depends also on policies and developments outside of the health sector such as literacy, access to drinking water and adequate sanitation.

32. ***Pillar Four: Targeting the poor and the vulnerable.*** Targeting the poor and the vulnerable through social protection programs is one of the integral pillars of the strategy. There are several social protection programs in Pakistan, which have as their objective improving the welfare of the poor and vulnerable groups. The programs include cash transfers through the Zakat and Bait-ul-Maal programs, in-kind assistance through, for example, the school meals pilot program (Tawana Pakistan), and programs to reduce the prevalence of child labor (stipend/schools for working children and their families). In addition to cash and in-kind transfers, Khushali Bank and a number of NGOs provide microfinance to low-income households. There is also a social security system for workers in the formal sector. A modest number of facilities provide institutionalized care or special education to specific vulnerable groups such as the disabled or child laborers.

III. BANK GROUP ASSISTANCE STRATEGY

A. Implementation of the Last CAS and Lessons Learned

FY03-05 Actual lending, portfolio management, and IFC program

33. While *new lending* slowed during FY03 following the October 2002 elections, it picked up thereafter and overall CAS lending volume was close to that envisioned in the high-case lending scenario of the FY03-05 CAS. New lending commitments during the CAS period totaled US\$2.033 billion, including US\$404 million of IBRD, or 15% below the CAS high case lending scenario of US\$2.4 billion including US\$600 million in IBRD borrowing. The shortfall in IDA commitments was due in large part to delays in development policy lending for the provinces of Sindh and NWFP as well as a shortfall in overall IDA 13 resources. Total IBRD commitments were one-third less than the high-case scenario total. A detailed comparison of planned and actual lending is included in the CAS Completion Report. Just over half of IDA and IBRD commitments were fast disbursing development policy loans, compared with the 65% share projected in the CAS, again reflecting the delay in planned development policy lending for the provinces.

34. With respect to the ongoing portfolio, performance throughout the CAS was generally good (see Table 5). Starting from a low point at the beginning of the CAS period, the portfolio has grown from 12 to 16 projects reflecting the increase in lending over the previous CAS. Despite the growing volume of lending, the portfolio remains relatively small, a reflection of the substantial proportion of single tranche development policy credits in the program (about one-third of the operations approved during the CAS period). Performance indicators showed sustained strong performance with 100 percent realism and

pro-activity and a disbursement ratio well above regional and Bank-wide averages. The percentage of projects at risk remained low, although it rose somewhat in FY05. This increase is being watched closely and managed intensively in consultation with the GoP (see para. 106).

Table 5: Bank Portfolio Indicators

Indicator	FY02	FY03	FY04	FY05
Number of Projects	12	15	18	16
Projects at Risk (%)	8.3	6.7	5.6	12.5
Commitments at Risk (%)	0.0	23.2	19.6	7.2
Realism (%)	100.0	100.0	100.0	100.0
Proactivity (%)	100.0	100.0	100.0	100.0
Disbursement Ratio	37.0	28.0	24.7	40.7

35. The CAS emphasis on knowledge transfer was reflected in the *AAA program*. Core diagnostic reports completed include a Public Expenditure Review (rated highly satisfactory by QAG), a Poverty Assessment, CFAA (complemented by three provincial financial accountability assessments), an FSAP, and a Country Gender Assessment. Customized, high impact informal AAA such as the trade policy notes and power sector policy notes were used to support high level policy dialogue and catalyze implementation of reforms. A series of in-depth provincial economic reports was launched, beginning in FY04 with the Punjab Economic Report, followed by the NWFP Economic Report in FY05. By design, the AAA program has put less emphasis on delivery of discrete outputs and teams have been encouraged to transfer knowledge through policy dialogue and non-lending TA. Major (or flagship) ESW Reports have been limited to no more than three a year to ensure quality and adequate managerial attention.

36. *The IFC Program* over the previous CAS period included investments and significant increases in technical assistance and advisory service. Commitments during the three year period totaled US\$187 million. Total exposure now stands at US\$314 million in 32 companies including US\$62 million in equity, down from US\$442 million in 48 companies at the time of the CAS. Liquidity in the local financial markets led IFC to reassess its approach and provide more value-added instruments and put greater emphasis on TA. The focus during this period was on the financial sector, SMEs infrastructure, and targeted industrial interventions. IFC's investments supported expanded container capacity in Karachi's port, the first investment in information technology, Islamic financing in the leasing sector, and a linkage initiative in the textiles sector. TA included initiatives in all major pillars of the Private Enterprise Partnership for the Middle East and North Africa (PEP-MENA) facility: financial sector, SMEs, business enabling environment, and privatization or public-private partnerships. IFC's TA program in Pakistan included a corporate governance program for banks, institution building in housing finance, and SME and microfinance, training in alternative dispute resolution, support for business membership organizations, and advice in the water sector. Moreover, during the last CAS period, IFC Technical Assistance and Trust Funds Program (TATF) completed a feasibility study in the health sector as well an analysis of the competitive positions of the country's leasing companies and investment banks. IFC's Environmental Opportunities Facility (EOF) completed a study to help optimize a wastewater treatment facility in the textile manufacturing industry.

Lessons learned from IEG evaluations, client survey, and the CAS Completion Report

37. The Country Assistance Strategy (CAS) for FY2006-09 builds on the lessons learned during implementation of the FY03-05 CAS and the messages heard during consultations with stakeholders as well as the results of a client survey. In addition, recent formal reviews of the Bank's work in Pakistan include (i) the Independent Evaluation Group (IEG) Country Assistance Evaluation covering FY94-FY03; (ii) the FY03-05 CAS Completion Report; (iii) Recent IEG Project Performance Assessment Reports; (iv) ICRs of projects closed during the CAS period; and (v) a QAG review of AAA work.

38. **Results of the Client Survey.** The survey of 351 stakeholders drawn from government, national and provincial assemblies, the private sector, media and academia yielded a number of insights on the Bank's contribution to Pakistan's development. Stakeholders reported that the greatest development challenges are poverty reduction, education and law/justice, with education emerging as a critical issue consistently throughout the survey—and an area where respondents believe the Bank can play a more profound role. In addition, stakeholders emphasized infrastructure as an area that is critical for successful development—and an area where the Bank's work receives some of the highest ratings from stakeholders. The Bank's role as a provider of knowledge was also particularly valued. The Bank's greatest weaknesses were considered to be imposing technocratic solutions without regard to political realities and not exploring alternative policy options. A consistent and important message from both the survey and consultations is that the Government of Pakistan values its partnership with the World Bank.

39. **Lessons from the CAS Completion Report.** The CAS Completion Report (Annex 2) reviews the Bank Group's effectiveness over the past three years and indicates that the Bank's strategy was appropriate and succeeded in making a significant contribution toward the achievement of some of the outcomes targeted in the FY03-05 CAS. In particular, targets for macroeconomic stabilization (including debt reduction) and increases in poverty-related expenditure were met and milestones in governance reforms in financial management and tax administration were achieved. While outcomes in several areas were not met, the Bank program helped in the development and implementation of reform programs to which the government remains committed, even if the pace of reform has not been as rapid as envisioned in the CAS. With respect to development outcomes, there is now preliminary data to suggest that the reforms of the past three years are beginning to yield measurable improvement, although in some cases less than targeted in the CAS. Taken together these reviews and feedback suggest that while the Bank has made a valuable contribution to Pakistan's development, there is significant potential to increase our development impact. The chief lessons relevant to formulation of the CAS are:

- *A programmatic approach provides the flexibility to support reforms while managing risk.* The use of annual single tranche adjustment operations at both the provincial and national level helped to support reforms while providing a mechanism to adjust the lending program to match the pace of reforms. This approach strengthened the link between borrower performance and the Bank lending program.
- *Projects need to be focused and scaled to fit the capacity of the implementing agency, in terms of both project scope and the pace of implementation.* While reinforcing the emphasis on the key role of "client pull," the experience of a number of projects that closed during the CAS, especially the multi-province umbrella projects, highlights the need for focused projects that are readily "implementable" with realistic schedules and clear ownership. In particular, governance reforms often took longer than planned. Realistic assessment of technical and political implementation challenges need to be reflected in project designs which should exhibit a strong bias towards simplicity.
- *Greater attention to capacity building is needed.* As indicated above, weak implementation capacity is a widespread concern affecting project design and implementation. The Bank has begun to increase its capacity building programs with the approval of the Public Sector Capacity Building (PSCB) project in FY04 and the designation of Pakistan as a focus country for WBI programs beginning in FY05. The Bank will also continue its support for civil service reforms through policy dialogue, the PSCB project and PRSCs. During the coming CAS, projects will have a greater emphasis on building institutional capacity.
- *The program needs to continue to strengthen its focus on results.* To address weak M&E systems and capacity within the GoP and implementing agencies, the Bank needs to support the strengthening of statistical capacity and monitoring and evaluation as part of institution strengthening. At the same time, the Bank needs to do a better job of focusing on developing

solid project-level results and indicators and incorporating the monitoring of these results into the supervision process. The results-based CAS offers an opportunity to identify and focus on key strategic outcomes at the country level and provide a framework for joint monitoring and evaluation of the overall country program with the Government.

40. ***The IEG Country Assistance Evaluation.*** IEG's Country Assistance Evaluation (CAE) rates the overall outcomes of the Bank's assistance program as moderately unsatisfactory.⁸ During the period covered by the IEG review (1994-2003), IEG found that the outcomes of Bank support for macroeconomic management and growth achieved success, especially in the last few years. However, outcomes of the Bank's assistance were found to be unsatisfactory in poverty reduction and social sector development, governance, agriculture and natural resource management, fixed infrastructure, and revenue mobilization and expenditure management. Taken together, therefore, IEG rated the overall outcomes of the Bank's assistance program as moderately unsatisfactory. Although the CAE primarily covers the decade prior to the beginning the FY03-05 CAS, some of its findings and recommendations are applicable to the new CAS and have been discussed by the Country Team and are reflected herein. The key recommendations of the CAE are: (i) the Bank should continue its strong support of analytical work while translating analysis into implementable actions taking into account political economy constraints; (ii) Bank interventions should have a greater focus on building sustainable institutional capacity; (iii) projects should be more focused and scaled to fit the capacity of implementing agencies; and (iv) the Bank should invest additional effort into improving donor relations.

41. A more recent IEG Project Performance Assessment⁹ drawing lessons from the provincial development policy loans for Sindh and NWFP has also informed the development of this CAS. In particular, the PPAR notes that sub-national development policy lending can make a significant contribution in terms of improving service delivery. In the context of devolution, the PPAR also notes the importance of clarifying the respective roles and financial relationships of various levels of government. Finally like the CAE, the PPAR notes the importance of taking capacity constraints into account—especially at the local level—and recommends greater attention to capacity building in future operations.

B. Context and Engagement Principles

42. While highlighting areas in need of strengthening, the review of our assistance and lessons learned outlined above also confirm the value of the Bank's strategic partnership with Pakistan. The Bank has come to be seen by the Government as a trusted development partner, valued not only as a major source of development finance but also as a source of global knowledge based on international experience. At the same time, the Bank has gained significant credibility as a catalyst for reform through its willingness to exercise selectivity, lending only in the presence of strong ownership of, and commitment to, reform and where there is clear evidence that the Bank adds significant value. The Bank is therefore uniquely positioned to play a key role in helping Pakistan to sustain its recent strong performance and accelerate poverty reduction. Moreover, in light of its recent successes, Pakistan is well positioned to make real progress in poverty reduction and has requested a significant increase in the scale of Bank financial support. For the Bank, this represents an important opportunity to increase the impact of our work in Pakistan by significantly scaling up our program over the FY06-09 period.

43. In this context, the Bank's work will continue to be guided by the following strategic engagement principles:

⁸ Pakistan - Country Assistance Evaluation (CODE2005-0058; /1), June 29, 2005. The Pakistani authorities agree with the CAE's analysis in some areas, but note that the report did not emphasize adequately recent improvements and was too critical of outcomes in agriculture and privatization.

⁹ IEG, Project Performance Assessment Report. Report No. 33612, December 19, 2005.

- The Bank will commit resources only in the presence of strong “**client pull**” to ensure that scarce resources are applied only where there is a high probability of success. Evidence of client demand for Bank support will include the leadership of committed reform champions who have demonstrated the willingness and ability to carry out needed reforms. At the project level, client demand will be reflected in the establishment of adequate institutional arrangements and readiness for prompt implementation.
- The Bank’s program will reflect **strategic selectivity**, targeting Bank resources where they can be most effective. A principle consideration will be demonstration of client pull as outlined above. In addition, while the program will span a wide range of instruments and sectors, we will maximize impact by seeking replicate or scale-up approaches that have already been shown effective. We will continue to maintain a close dialogue with the Government and other partners to harmonize and reinforce our efforts and to target our activities in the areas where the Bank has the greatest comparative advantage.
- This new CAS will have an even greater focus on **outcomes**. The Bank’s program for Pakistan will be guided by the CAS results framework (Annex 1) which identifies: (i) long-term national development goals; (ii) associated CAS outcomes that the Bank can directly help to realize; and (iii) the mix of Bank Group products and services that best contributes to these CAS outcomes. An integral part of the shift toward a results-based CAS will be the strengthening of the CAS M&E architecture. The CAS results framework also identifies indicators to monitor progress toward the achievement of CAS outcomes as well as implementation of World Bank Group CAS programs and will therefore serve as a mechanism for monitoring progress in CAS implementation.
- **Programmatic approaches** will continue to form the core of the Bank program. The experience of the FY03-05 CAS supports the continued use of a programmatic approach to provide sustained, flexible, and predictable support to medium-term reform programs. Experience has also shown that programmatic approaches are effective in strengthening ownership while accommodating the uncertainties inherent in medium-term reforms. Increasingly we will provide a range of services—a combination of dialogue, capacity building, expenditure review and technical assistance along with IDA resources—aimed at building effective service delivery systems at the local government level. Programs will seek to link inputs to outputs, be integrated into medium-term budget frameworks and include an effective monitoring system.

44. In line with Pakistan’s recent performance and request for additional Bank support as well as application of the strategic principles outlined above, the Bank will seek to deliver a substantial increase in its volume of lending to Pakistan during the next four years. The immediate priority will be to assist in addressing the impact of the October 2005 earthquake; up to US\$1 billion in IBRD/IDA commitments will be used to support reconstruction and recovery (US\$840 million in new commitments have already been approved). In addition, based on the Government’s priorities for sustaining growth and accelerating poverty reduction, the expansion in lending will be primarily in **infrastructure** (primarily energy, water, and transport) and **human development**. Cross-cutting reforms, both at the national and provincial level will remain a key focus and a substantial share of IDA lending will take the form of PRSCs and provincial development policy credits to support, inter alia, fiscal/financial management improvement, transparent and efficient public procurement, power sector reforms, actions to improve the investment climate and cross-cutting initiatives to improve service delivery. Investment lending devoted to strengthening and reform of the key governance institutions (e.g., tax administration, financial management, land records, and statistics) will also continue to make up a significant portion of the lending program.

45. While the Government's request for additional financing for infrastructure will lead to an increase in investment lending, policy-based fast disbursing lending will continue to account for a significant share of total lending. Policy-based lending instruments are well-suited to supporting the Government's poverty reduction strategy which emphasizes second generation policy and institutional reforms. The experience of the FY03-05 CAS has demonstrated the effectiveness of flexible, performance-based assistance in supporting policy reforms and crosscutting actions needed to improve service delivery. Annual PRSCs will form the core of the Bank's support for implementation of Pakistan's poverty reduction strategy at the national level. Province-level development policy operations will feature prominently where medium-term reform programs have advanced to the stage where Bank support can assist in their implementation. As in the previous CAS province level development policy operations will couple fiscal and financial management reforms to improve financial sustainability with actions to improve the effectiveness of service delivery. IBRD development policy lending will be considered to support reforms in urban management, irrigation, and transport, in conjunction with investment lending, policy dialogue and technical assistance. In each case, the choice of development policy instruments will be driven by the strength of medium-term reform programs and the capacity and track record of counterparts.

46. The proposed assistance program will be aligned with the respective responsibilities of national and provincial governments in Pakistan and tailored to meet the needs of the individual provinces. Provinces and local governments bear most of the responsibility for delivering public services including irrigation, education, health, and water supply and sanitation, but have very limited "fiscal space" to provide these services. In the FY03-05 CAS, the Bank's strategy was to focus on those provinces—Sindh and NWFP—that had embarked upon comprehensive reform programs to support those programs through a series of development policy credits. In addition the Bank provided programmatic support for education reforms in Punjab, beginning in FY04. Provincial reform programs in Punjab and Balochistan were supported through the Asian Development Bank's Resource Management Program loans. During the coming CAS period we will continue to support provincial reform programs in these provinces and maintain a dialogue with all provinces based on in-depth provincial economic reports for each province. We will seek a balanced approach with lending and analytical services geared to the specific challenges and unique opportunities (e.g., the mineral sector in Balochistan) in each province.

47. At the national level, policy-based and investment lending will focus on areas that are the mandate of the federal government. The PRSC program will focus on the critical policy and institutional reforms to improve governance and the investment climate. Much of the planned increase in investment lending will be for national-level programs, including national highways, ports, railways, power, and water.

C. World Bank Group Program Priorities

The Strategic Framework

48. The Bank Group' program priorities will retain considerable continuity with the FY03-05 CAS. The World Bank program for FY06-09 will support the continuation and consolidation of many of the reforms initiated in previous years including cross-cutting governance reforms initiated in current and earlier CASs (financial management, procurement, tax administration, devolution and civil service reform). We will also assist in strengthening the institutions governing the market economy and continue to encourage reforms in the incentive and regulatory regimes for infrastructure, finance, trade and manufacturing to further improve the business climate. Working with the federal government and the provinces we will seek to improve the quality of and expand access to basic services for the poor, including health, education and safety nets.

49. The Bank Group will focus its program on the areas which are most critical for poverty reduction. The three pillars of the CAS correspond to the strategic priorities of the PRSP: (i) sustaining growth and

improving competitiveness; (ii) improving government effectiveness and service delivery; and (iii) improving lives and protecting the vulnerable. The pillars of the CAS are inter-linked and mutually reinforcing. Sustaining high and broad-based growth is necessary to create employment and income-generating opportunities. Addressing poor human development outcomes is a critical element of the strategy to enable the poor to take part in and benefit from growth. Improving governance cuts across the entire strategy – it is important both to improving the investment climate to support growth and to strengthening the delivery of services to the poor. Within the three pillars of the CAS, the Bank has identified a selected number of outcomes that will be pursued during the CAS period. The rest of this section explains the main issues and constraints in the areas of the CAS pillars and how the proposed outcomes to be supported by the Bank Group program will assist Pakistan in tackling these constraints.

Pillar I: Sustained Growth and Improved Competitiveness

50. ***Strengthened macroeconomic management and allocation of resources.*** Maintaining the hard-won benefits of macroeconomic stability will be critical to sustaining growth during the CAS period. While recent performance has been good, particularly with respect to growth, rising inflationary pressures and limited progress in improving revenue mobilization represent challenges. With the increased spending made necessary by the costs associated with earthquake recovery, there is an even more acute need for further prioritization of expenditures to maximize the benefit of available fiscal space. Key priorities include reducing the drain on the budget caused by losses of state-owned enterprises, improved management of the public investment program, and strengthened debt management.

51. With the conclusion of the IMF poverty reduction growth facility program, the Bank's macroeconomic monitoring and advice will occupy a more central role in our dialogue¹⁰. In addition, the Bank will continue to provide support to help the Government strengthen macroeconomic management through (i) improving the level and composition of expenditure; (ii) improving the effectiveness and impact of public expenditures through the preparation of a Medium Term Budget Framework (MTBF) and the formulation of sector strategies and sector investment programs; and (iii) continuing ongoing tax reforms aimed at improving tax payer services while increasing the tax-to-GDP ratio. PRSCs and province-level development policy lending will help to bolster these reforms while planned AAA will include reviews of the Public Sector Development Program, a Public Expenditure Review, technical assistance in pension reform, and analytical support for tax policy reforms.

52. Improving Pakistan's low tax-to-GDP ratio will continue to be a major focus of our work aimed at addressing weaknesses in the current system including: (i) inefficient tax administration; (ii) a narrow tax base – only 1.53 million taxpayers out of 39.4 million employed; (iii) a complex and cumbersome tax system; and (iv) corruption and tax evasion. Recent reform initiatives have had a positive impact on tax management and in improving revenues – for the first time over the last two years, the Government was able to achieve its revenue targets, although this cannot be attributed to tax administration measures alone as strong growth has also contributed to rising revenue. Successful implementation of the FY05 Tax Administration Reform project will be the centerpiece of our efforts. The main challenges will include implementing organizational and management reforms, re-engineering of operational processes that are likely to affect staffing levels and introducing automated risk-based systems that reduce contact between tax payer and tax officials to minimize corruption. In addition, with the end of IMF program, ad-hoc and inconsistent tax policy changes have started to constrain expansion of the tax base. Tax policy support,

¹⁰ A 3-year PRGF arrangement was approved in November 2001 and concluded in December 2004. All PRGF disbursements were made available upon completion of program reviews although the GoP elected not to draw the final tranche in light of its improved external position. Compliance with structural performance criteria and macroeconomic conditionality was better than average for Fund-supported programs. See, IMF, *Pakistan 2005 Article IV Consultations and Ex Post Assessment of Longer-Term Program Engagement*, November 2005.

including a Tax Policy Study, is planned and PRSC III will support tax policy measures to increase revenue mobilization.

53. ***Increased diversification and exports in agriculture.*** The Government intends to accelerate agricultural growth by promoting the diversification of agricultural production into high value products (including crops, livestock and fisheries) and agro-processing, improvement in factor productivity, and better integration of supply chains. The Government has made good progress over the last couple of years with respect to liberalization of the domestic wheat trade (removing restrictions on transport), liberalizing wheat imports and maintaining a reasonable level of strategic reserves. However, the Government remains involved in the procurement of some 20% of local production at a heavy cost. Long-term agricultural growth and poverty reduction are constrained by the structure and performance of key rural factor markets including land, water, and credit as well as a degrading resource base, in particular soil and water. Given the constraints on land and productivity, the poor will benefit from agricultural growth only if the increase in productivity is translated into lower real prices of food and higher employment—to include the rural non farm poor, who together account for 61% of the rural poor—and higher rural wages.

54. The focus of the Bank's work in this area will initially be to support the preparation of a rural strategy, integrating issues related to agriculture, natural resource management, the rural non-farm economy, infrastructure, rural finance and the need for targeted interventions. The strategy will also include analytical work on supply chains and World Trade Organization (WTO) issues, to understand the potential market access for agriculture through the opening up of international markets and agribusiness networks. It will analyze and discuss the potential for increased public support through agricultural research, extension services, and technology transfers with an emphasis on adapting technology for rainfed areas and livestock. The Bank will also support policy and institutional reforms in land administration beginning with the Punjab Land Records Management Project. In addition we will seek to support reforms in the research and extension system to introduce more demand-driven participatory approaches based on public-private partnership.

55. ***Irrigation and drainage.*** Pakistan's extensive irrigation system is under growing stress as the result of growing demand, deteriorating infrastructure and poor governance. Building on the recently completed water strategy, the Bank will support a combination of institutional reforms and investments including: (i) major investments in rehabilitation of critical assets (including barrages), and will help put in place Asset Management Plans which will set priorities for asset rehabilitation and maintenance, make explicit the requirements for public and user financing, and develop institutional arrangements for rehabilitating and maintaining this infrastructure; (ii) development of capacity at the provincial and federal levels for improving water and associated natural resource management; (iii) efforts to improve the quality, efficiency, and accountability with which irrigation services are delivered; and (iv) investments in on-farm services (land leveling, watercourse lining, introduction of new technologies) for increasing the productivity of water use. Bank support will be provided through a range of instruments including development policy lending in support of key reforms as well as through investment lending to finance infrastructure and institutional development. Governance and communication improvements will be a central theme as poor governance and low trust are among the key underlying factors behind the poor performance of the irrigation system and low productivity. Finally, given the major scientific, policy and implementation challenges ahead, the Bank, with support from the Government of the Netherlands, will provide analytical and technical support to the federal and provincial governments.

56. While Pakistan recognizes the importance of improving the efficiency of water use, the Government's water strategy also assigns high priority to augmenting water storage capacity, both to offset the declining capacity of existing reservoirs (due to siltation) and to meet growing demand. Indeed, compared with other countries Pakistan has relatively little water storage capacity and substantial untapped hydropower potential, indicating a potentially high payoff from new reservoirs. The GoP has recently announced a Presidential initiative under which it intends to build up to five new dams by 2016.

Given the importance of such an investment for addressing long-term water issues, the Bank will consider providing technical assistance for this work. Looking further ahead, should the proposed project prove technically and economically sound, the Bank would be prepared to respond favorably to a government request to help finance construction, provided the project is designed and implemented in conformance with international standards for social and environment safeguards.

57. ***Improving the business environment for trade and investment*** Recognizing that sustaining the current high rates of economic growth requires globally competitive production in an increasingly demanding world market, policy makers are focused on strengthening international competitiveness through rising productivity to support higher wages, a strengthened currency and increased returns to capital. Macroeconomic stability and the removal of price distortions have eliminated impediments to productivity growth but will only translate into rising productivity if accompanied by a more conducive business environment. There is consensus among policy makers, academics and the business community that improvement in Pakistan's competitiveness derives in part from success in three "second generation" areas which impact firm-level productivity and thus have become important priorities for Pakistan. First, *economic governance* to instill market discipline and provide certainty in investment returns poses a particular challenge, encompassing such entrenched factors as efficiency and effectiveness of government and autonomous institutions, quality of regulation, policy uncertainty, and the rule of law. Second, efficiency of factor markets to foster flexibility and fluidity represents a major constraint to good resource allocation and ease of entry, particularly in the case of land and labor. Third, the degree to which entrepreneurs find it easy to do business has a major impact on international competitiveness. Many reforms were initiated in these areas in recent years, and a number of indicators of 'doing business' have improved as a result.

58. During the CAS period, the Bank Group will support the following: (i) strengthening the institutions and legal/regulatory frameworks in support of a competitive market economy by updating corporate law and building the capacity of courts and monopoly control authorities; (ii) lowering the burden of government bureaucracy and regulation to ease entry and business operations, particularly for SMEs; (iii) improving labor market flexibility through legislative reform (employment and industrial legislation is currently being revised); (iv) improving tax administration; and (v) further reduction of trade protection. In addition, as provincial governments have a role in improving their local investment climate, the Bank Group will work with provincial authorities to address areas within their domain such as improving management of industrial estates and improving the functioning of land markets.

59. Ongoing analytical work in this area includes studies on 'Growth and Competitiveness', 'Value Chain Analysis', and 'The Labor Market.' This work will be followed by National and Sub-national Doing Business & Investment Climate Assessments and additional Provincial Economic Reports. The Public Sector Capacity Building Project (PSCBP) will be implemented along with an IDF grant for the Securities and Exchange Commission of Pakistan. Capacity building for other institutions charged with government markets will also be deployed, such as efforts to strengthen the framework for fair and open competition. Annex 7 outlines in greater detail the World Bank Group Private Sector Strategy.

60. ***Improved infrastructure to Support Rapid Growth.*** Infrastructure bottlenecks pose a significant threat to Pakistan's ability to sustain rapid growth. During the next CAS period the Bank will focus on three areas: (i) supporting reform processes, including privatization and private sector participation in public utilities, technical assistance and capacity building to strengthen institutions in specific sectors; (ii) working closely with the IFC and MIGA to increase private investment in infrastructure; (iii) developing the legal and institutional framework to encourage private-public partnerships and (iv) undertaking IBRD investment operations where reforms have advanced sufficiently to make public investment effective.

61. At present, the **power** sector is not up to the challenge of meeting growing electricity demand efficiently and reliably and extending service to underserved areas and poorer segments of the population.

Challenges include high technical and commercial losses (over 20 percent in a number of distribution companies and in some cases as high as 40 percent), bottlenecks in transmission and distribution, substandard quality of supply, underinvestment, high costs, and inadequate tariffs. About 30 percent of population has no access to power. There are large cross-subsidies in the tariff structure, with industrial and commercial consumers subsidizing residential ones. Government subsidies to the sector total about US\$1 billion annually.

62. In recent years the Government has made significant progress in implementing its power sector program first initiated in the late 1990s. The reform program includes unbundling, corporatization, commercialization, and privatization of the industry,¹¹ establishment of an independent regulatory agency; institutional strengthening in policy, governance, and corporate management; and mobilization of resources from the private sector to meet the power sector's technical, financial and human resource needs. Although much remains to be done, progress has been made: a new legal framework for the sector was adopted, an independent regulatory agency (NEPRA) established, WAPDA was unbundled, privatization of several companies in generation and distribution has been completed or is underway, and a Policy and Implementation Cell in the Ministry of Water and Power established.

63. The Bank has been deeply engaged in the power sector. Strategic and policy advice, supported by development policy lending including SAC II and PRSC I, was instrumental in restructuring the sector. Although progress in improving financial performance has been disappointing, implementation of the overall restructuring strategy for the sector has laid the groundwork for improved performance and opened the way for investment lending. Further strengthening of sector governance is required to improve performance and attract private investment. There is a significant backlog of investment, particularly in reducing the high technical and commercial losses in the distribution systems. In addition to continued support for policy, governance and regulatory reforms through the PRSC, planned investment lending includes support for distribution and transmission, investment in hydropower (including possible large-scale hydropower), and the expansion of rural access. A programmatic approach is planned, with a sequence of investment loans and guarantees to address investment priorities as implementation of the reform program proceeds. In the context of expanding rural access, there is good potential for the mobilization of Global Environment Facility (GEF) and carbon finance to support "low-carbon" growth in the sector. In developing options for affordable and sustainable provision of power in rural areas—and in particular in NWFP and Balochistan where grid penetration is currently limited—the Bank will consider alternative investment and institutional approaches to rural electrification, including options for decentralized autonomous grids.

64. During the previous CAS period, the Bank supported Pakistan's **telecommunication** reforms through policy dialogue and lending, including PRSC I and the Telecommunication Regulation and Privatization Support project. As a result of the reforms, sector performance has begun to improve markedly as indicated by the increase in aggregate telecommunications density (fixed and mobiles) from 4.6 telephones lines per 100 inhabitants in June 2003 to about 17.8 by December 2005. Key reforms included (i) strengthened institutional and regulatory arrangements under the Ministry of IT and Telecommunications and the Pakistan Telecommunications Authority; (ii) full liberalization of the local loop (LL) and long distance and international (LDI) markets resulting in numerous new companies providing services at competitive rates; (iii) approval of a new cellular mobile policy in January 2004 leading to licensing two new additional cellular mobile operators, rapid growth in penetration, and a dramatic reduction in prices; (iv) successful privatization of Pakistan Telecommunications Limited (PTCL) generating US\$2.6 billion in proceeds and leaving the telecommunications sector fully managed

¹¹ The Water and Power Development Authority (WAPDA) has been responsible for electricity generation, transmission, and distribution in all areas of Pakistan with the exception of Karachi, where Karachi Electricity Supply Company (KESC) has played that role. The unbundling and restructuring elements of the reform program applied to WAPDA only, as the dominant monopoly; the other elements of the reform applied to the entire industry.

by the private sector. IFC made a very successful investment in TRG, (a call center company), with a strong demonstration effect.

65. In spite of this success, telecommunications services fall well short of their potential compared to comparator countries. One important gap is between rural and urban users; as of March 2005 about 50% of Pakistan's 50,000 villages have no access to telecommunications services and very few villages have access to the Internet. The Bank will support over the CAS period (i) adoption of additional measures to strengthen the policy and regulatory environment, including establishing pro-competitive licensing, interconnection and tariff regimes, addressing quality of service and other consumer issues, and improving the management of limited resources such as the radio spectrum and numbers; (ii) policy dialogue and advice; and (iii) investment support for accelerating the provision of rural telecommunication infrastructure including e-services and broadband connectivity. In addition, IFC will support the expansion of services by the private sector.

66. Pakistan's **transport sector** is inefficient, imposing additional costs on Pakistani business and threatens to become a serious obstacle to sustained growth, as well as an impediment to achievement of the MDGs. It is estimated that this inefficiency already costs 4-6% of GDP per annum, constrains economic growth and diversification, reduces export competitiveness, and hinders social development. Key issues are: (i) poor rural mobility with 75% of all rural health, education and market facilities accessible only by earth tracks; (ii) urban congestion and inadequate public transport which are raising the cost of doing business, crowding out the urban poor, and increasing the health and safety hazards faced by passengers, pedestrians and residents; (iii) Pakistan Railways' financial and operating performance remains weak and as a result it carries barely 5% of total cargo traffic, far less than its potential; (iv) costly port systems and inadequate trade facilitation are imposing high costs and delays on shippers.

67. Reflecting the high priority assigned to supporting growth and competitiveness, the Bank and the government are in the process of developing a strategic approach to the transport sector focusing first on the National Trade Corridor linking Pakistan's major ports in the south with its major cities and trade corridors to the North. Together the ports, road and railways along this corridor handle 95 percent of external trade and 65 percent of total land freight serving the regions of the country which contribute 80-85% of GDP. Corridor utilization is more than 80% of existing capacity and projected growth will double demand by 2015, and require much higher levels of service. The objective is to develop an integrated approach to planning, investing and managing the National Trade Corridor transport logistics system. The key outcome sought would be significant reductions in the time and cost of moving goods through the Indus corridor. The GoP has already initiated reforms, reducing entry fees at Karachi port while seeking to reduce port dwell times. The Government is also targeting improved trade and transport connectivity with China, Central Asia and Western Europe as a means of promoting economic activity throughout the region and is seeking World Bank support in this endeavor. The Bank has provided and will continue to provide analytical support to develop the frameworks to guide sub-sector policies (for highways, railways, ports and trade facilitation), including pricing, regulation and enforcement, medium term budgetary frameworks, restructuring and progressive commercialization of public entities and strengthening of institutions (NHA, Pakistan Railways, etc.). An ongoing transport competitiveness study will help highlight priorities for investment lending and institutional reforms.

68. Pakistan's investment needs in transport are enormous. There is a significant maintenance backlog and current government investment in the sector is as much as 5 times less (as percent of GDP) than countries in East Asia. It is estimated that modernization of the Indus Trade Corridor alone will require investment of about US\$1 billion per year over the medium term. In addition, critical road links were destroyed or damaged in the October earthquake and their repair is an urgent priority. The Bank is currently supporting rehabilitation of the national highway network through the Highways Rehabilitation Project (with additional financing to address the effects of the earthquake) and assisting in modernizing trade and transport facilitation under the Trade & Transport Facilitation Project. There is strong demand

from government for increased lending in the transport sector during the coming CAS period. Follow-on investment lending for highways and trade facilitation is expected along the Indus Trade Corridor with an emphasis on increasing private sector participation in operation and management. In railways, a combination of development policy lending and investment projects may be considered should the government commit to a medium term reform program to revitalize Pakistan Railways by creating a separate, professionally managed, commercial freight business with its own rolling stock and staff. In the port sector the Bank will support a move towards port corporatization and professional management combined with a modern institutional and legal framework for port operations that would open the way for investment lending to upgrade port infrastructure.

69. While the emphasis is on supporting growth, the Government also recognizes that transport, especially in rural areas is important to improving development outcomes. Surveys have shown that healthcare for all, and above-primary educational opportunities for girls are particularly hard hit by mobility constraints. During FY03-05 the Bank prepared a Rural Access and Mobility Study focusing on options for the sustainable provision of a core rural access network at the district level under the country's devolution framework. During the coming four years we will continue to explore options for providing assistance to this sub-sector including possible implementation of pilot projects through the Pakistan Poverty Alleviation Fund.

70. Support for reform and development of the **oil and gas sector** has been a strategic priority for the World Bank assistance program since 1999. During the last CAS, the Bank continued to provide policy advice and technical assistance supported by development policy lending (SAC II and PRSC I). Good progress has been made in the deregulation of the petroleum market, pricing and regulation of natural gas, conversion of power plants from fuel oil to natural gas, and acceleration of exploration activities. However, gas tariffs continue to be distorted by cross subsidies among different classes of consumer (particularly the very large and poorly targeted "lifeline" tariff slab and the low cost of gas for the fertilizer sector) and implementation of the gas price adjustment mechanism has been erratic. Similarly, in 2004 the government elected only partially to adjust domestic petroleum product prices to reflect international oil prices, resulting in a fiscal cost of Rs. 8 billion (US\$130 million).

71. Looking ahead, a key priority is to address looming gas shortages; while all gas is currently domestically produced, given the combination of rapid growth in demand and depleting reserves, gas imports will become necessary, possibly as soon as 2009. With this in mind, the Bank will continue to provide policy and technical advice and encourage further appropriate de-regulation and privatization in the industry while helping the government to build necessary capacity to engage in international gas import transactions. Possible investment lending or guarantees would support the expansion of infrastructure for the importation, storage and distribution of gas. In addition, IFC is expected to support private participation in the oil, gas and mining sectors.

72. Pakistan's infrastructure investment needs are as high as US\$3.5 billion per year, far greater than can be financed by the public sector. The Government recognizes that **public-private partnerships** (PPPs) can play a key role in increasing resources and improving efficiencies by helping the country access not just finance, but also managerial expertise, new technology, better project design and implementation, and more efficient use of resources. Past efforts to attract private investment, in particular in the power sector, have shown both that these investments can be realized, but also that strong oversight is needed to ensure that these are priority projects and that consumers and the government have the capacity to pay for them.¹² Regardless of sector or level of government, PPPs should be pursued where they represent priority projects, are affordable to the government and consumers, and represent value-for-money, i.e. a better approach than would be delivered through public procurement.

¹² Fraser, Julia M. *Lessons from the Independent Private Power Experience in Pakistan*. Energy and Mining Sector Board Discussion Paper No. 14. May 2005.

73. The Bank Group will support the government's efforts to encourage PPPs through: (i) advisory support in developing the national PPP policy and, where needed, provincial policies and legal frameworks for PPPs; this would also cover strengthening oversight of the fiscal costs of PPPs; (ii) technical assistance for the development of the institutional framework (including financial and subsidy support to PPPs) and to develop pilot PPPs ready for procurement and implementation within the next 12-18 months; and (iii) lending to support subsidies to address affordability issues for PPPs and for long-term finance for PPP service providers.

74. ***Improving access to market-based finance.*** Pakistan has undertaken major reforms in recent years in the financial sector that have resulted in a sound and more efficient system. A major achievement has been the transformation of a pre-dominantly state-owned and weak banking system into a healthier, market-based system, owned primarily by the private sector (nearly 80% percent of sector assets are now under private ownership compared with 34 percent in 1999, and just 8% percent in 1990). This has been facilitated by the restructuring of major banks, ongoing consolidation of the sector, strengthening of regulatory capacity, and improvements in transparency, corporate governance, and credit culture. This has helped improve access, and credit to the private sector has grown significantly over the past three years. These achievements have been endorsed by the findings of a joint Bank-IMF Financial Sector Assessment that was concluded in 2004.

75. Despite these impressive accomplishments, important reforms remain to be done, and a large segment of the economy continues to operate with little formal credit. A significant number of financial institutions are still under government control including the National Bank of Pakistan (NBP), State Life Insurance, the largest open end mutual fund, and a few large specialized banks. The legal framework needs to be strengthened to address banking laws, the Public Debt Act, the Insurance Ordinance, as well as laws pertaining to insider trading and take over of companies, bankruptcy/insolvency, payments systems, credit information and Anti-Money Laundering. Enforcement of financial contracts remains weak pending clarification of the Financial Recoveries Ordinance 2001. While there have been extensive reforms of capital markets, under-development of contractual savings has inhibited development; insurance penetration remains very low relative to other countries at Pakistan's income level, reflecting weak consumer protection and awareness. The pension system is also weak – both civil service system and Employees Old Age Benefits Institution are fiscally unsustainable. Finally, the stock market has performed well but it remains shallow and narrow with inadequate investor protection systems. Leveraged financing of share transactions coupled with weak supervision of market intermediaries pose a threat to systemic stability.

76. During the next CAS period the Bank Group will support further financial sector reforms in the following areas: increasing the number of microcredit borrowers (especially in rural areas), restructuring and privatization of the remaining state owned financial institutions, non-bank financial companies and other specialized institutions; continuing the revision of the legislative framework to facilitate effective regulation and enforcement; aligning rates on National Savings Scheme (NSS) instruments more closely with market yields; strengthening and further deepening capital markets (including equities, bonds and swaps) with the aim of increasing the availability of longer term savings instruments, e.g. by establishing a comprehensive legal and regulatory framework for private pensions, reviewing the role and strategy for state owned insurance companies; and improving financial markets infrastructure and legal framework. New areas of involvement will include expanding financial services—consumer financing, mortgage loans, SME financing, agriculture credit—through expansion of banks' retail. Following on the recent Financial Sector Assessment and the approval of the Banking Sector Development Policy Credit, future work will center on policy dialogue, and technical assistance, particularly to provinces as well as economic and sector work on access to finance. Lending operations to support technical assistance for the State Bank of Pakistan and for capital market development will also be considered. The IFC will

selectively invest in the financial sector to support the development of housing finance, SME finance and microfinance, in addition to providing TA through its PEP-MENA facility.

Pillar II: Strengthened Governance and Service Delivery

77. Improving government effectiveness remains a hallmark of the Government of Pakistan's reform program. As discussed earlier, inadequate and poorly targeted government spending on services and investment are only part of the problem; delivery of government services is hampered by the weak capacity and lack of accountability of service providers. Addressing these weaknesses is critical for achieving most if not all of the Government's poverty reduction goals. Far reaching reforms to improve the performance of key government institutions including financial management, tax administration, and the civil service are underway in parallel with the government's decentralization initiative. Many of these have been and will continue to be supported by the Bank Group.

78. ***Greater efficiency transparency and accountability in use of public resources.*** The government has been pursuing far-reaching reforms in **public financial management** since 1996. The Bank has been deeply engaged in this process and significant progress was made during FY03-05 CAS period. Under the Bank-funded Project for Improved Financial Reporting and Auditing (PIFRA), a new computerized accounting system and a new chart of accounts is being implemented nationwide. The new systems being introduced under PIFRA will eventually allow for the automated consolidation and reconciliation of all the civil accounts of the government, thereby greatly improving the timeliness, comprehensiveness, and accuracy of financial data. Legislative oversight has improved with the re-establishment of Public Accounts Committees at the federal level (a PRSC 1 prior action), as well as in the provinces. The federal Public Accounts Committee has made good progress in reviewing audit reports, and in tracking and monitoring cash recoveries from public officials in government departments and other public institutions. The Controller General of Accounts (CGA) organization has been strengthened, and the timeliness of reporting and reliability of public accounts and audit reports has improved substantially.

79. Remaining challenges include full implementation of the PIFRA system. In addition, the backlog in the review of audit reports and audited accounts remains substantial, due in large part to the poorer quality of the older audit reports that resulted in a large number of audit paragraphs being placed before the Committee. In the case of accounting, the Government needs to clarify the roles, responsibilities and reporting relationships of various players (e.g., Controller General (Accounts), Provincial Accountant Generals, District Accounts Officers and Treasury Officers) in the light of devolution. Support for these reforms will continue to be a priority. The follow-on PIFRA-2 project, which was approved in September 2005, will extend the computerization to remaining sites across the country. An IDF Grant has recently been approved to strengthen the capacity of the Public Accounts Committee at the federal level. The Bank will also work on supporting the improvement of the accounting and auditing oversight arrangements following up on the Accounting and Auditing ROSC exercise, conforming corporate accounting and auditing practices to international standards. IFC's PEP-MENA facility will launch a comprehensive corporate governance project in Pakistan to support private sector companies.

80. Building on the 2003 CFAA, the Bank will continue to provide analytical support to assist in defining the agenda for further reforms in financial management. The Bank will work with the Government and international partners (including DFID and ADB) to carry out public financial management and accountability assessments based on the PEFA PFM performance measurement framework approved in 2005. A similar exercise, using the December 2004 PEFA Consultative Draft was conducted in FY 2005 for Punjab. The assessments will be carried out at the federal and provincial levels in order to identify the strengths and remaining weaknesses in the accountability framework and provide the basis for drawing up comprehensive action plans that focus on areas most in need of action to mitigate shortcomings. The action plan will not only aim at further improving public financial management but will also support transparency, competition, value for money and controls in procurement.

81. **Procurement** irregularities have been a significant problem in Pakistan, in large part due to a weak regulatory framework that discouraged due diligence in contract awards and stifled open competition. Specific problems have included inadequate bidding documents, inadequate response time to bidders, prequalification as a means of restricting competition, price negotiations, lack of independent complaints handling process, and irregularities in inspections or measurements. During the CAS, the Bank will support the achievement of transparent and efficient public procurement at federal and autonomous bodies levels. The Bank will support the Government in: (i) developing a implementing regulations for the recently notified public procurement rules; (ii) developing credible complaints handling process; (iii) developing rules for the selection of consultants; (iv) introducing reporting requirements and a credible enforcement mechanism; and (v) capacity building for the Pakistan Public Procurement Regulatory Authority; and (vi) harmonizing audit and procurement procedures. Procurement will also be an integral part of the PFM Performance Measurement assessments planned during the CAS period.

82. **Enhanced service delivery.** The need to dramatically improve service delivery to Pakistan's citizens—with particular attention to programs in health, education, water and sanitation, and safety nets—is essential to the achievement of Pakistan's poverty reduction goals. Working across sectors, the Bank Group will continue to support reforms to increase capacity and accountability of those responsible for service delivery; empower communities and clients through enhanced access to information on finances and performance; and build the capacity of both communities and governments.

83. Improving the quality of public administration is critical for making public expenditures more effective, and for improving service delivery. While the size of the **civil service** in Pakistan is not problematic, improving its performance is recognized by the Government as a key challenge for improving service delivery. The key problems are: (i) systemic rigidities that make it difficult to recruit and move staff between departments as needed; (ii) compensation is insufficient to attract skilled entrants at the higher levels but may be too generous at lower levels; (iii) inadequate training which has led to an erosion in the quality of civil service and critical gaps in technical skills. Implementation of a comprehensive civil service reform is proceeding slowly, although there are very important pieces of the reform going forward. The best progress has been made on merit recruitment, training, pay and pensions and capacity building of selected government line and regulatory agencies. However, improvements in overall public service delivery require progress across a broader front in the civil service program as well as in the devolution agenda. Over the coming CAS period, the Bank will continue to support development and implementation of a long-term strategy for public sector employment, which would include: further implementation of merit-based recruitment and promotion; structural changes to support devolution; further pay and pension reforms; and continued capacity building through effective national and international training.

84. Pakistan's **devolution** initiative is a cornerstone of the government's strategy for improving service delivery by making the public sector more accountable to citizens and more efficient at delivering basic services. Creation of the political structure for devolution began in 2001 with the creation of a new local government structure consisting of over 6,400 new elected local governments. New local governments were sworn in following local government elections in August 2005. However, while political devolution has moved rapidly, fiscal and administrative devolution have not advanced as well, creating obstacles for local governments and weakening incentives of local government staff to improve service delivery. Local governments are also facing a number of problems linked to capacity constraints, including lack of strategic planning, poor financial management, lack of skills and finance. Decentralization reforms need to be completed through a meaningful devolution of administrative and fiscal powers and supported with capacity building assistance. This needs to include a greater share of resources going to the provinces through National Finance Commission (NFC) awards—and to the districts—through the Provincial Finance Commissions and, to a lesser extent, conditional grants;

reassignment of tax bases from the center to local governments (e.g. agriculture income tax); and the transfer of functions and administrative authority to local governments. Pakistan's PRSP also recognizes that devolution will not be complete until there is some transfer of responsibility from the federal to the provincial governments as well. The January 2006 Amendment to the NFC award was a positive step in this regard as it increased the provinces' share of revenues and should alleviate some of the fiscal pressures being faced by provincial and local governments.

85. The Bank has worked to support of devolution, both at the provincial and local levels, through analytical and capacity building support. A major study on progress in implementing devolution was undertaken jointly with the ADB and DfID. During the next four years, Bank support for devolution, much of which will be provided in the context of ongoing operations, will feature: (i) analytical support to assist in the rationalization and clarification of roles and responsibilities under the devolved framework; (ii) support for citizens participation through social mobilization, community driven approaches, and other mechanisms to strengthen the linkages between local governments and communities in order to increase their responsiveness and accountability; (iii) capacity building support for local governments. We will also ensure that the design of lending operations reinforces the local government system.

86. With over a third of its population living in **urban** areas, Pakistan is currently the most urbanized country in South Asia and urbanization growth rates are twice the rate of the overall population increase. But cities suffer from severe infrastructure bottlenecks, service deficiencies (roads, water, and waste removal), poor local governance, and distortions in land and housing markets. While the urban sector was an area of limited engagement during the previous CAS, devolution has created opportunities for deeper engagement and the Government of Pakistan has accorded greater priority to urban development with a particular focus on the "mega-cities" of Karachi and Lahore. Devolution has transferred to municipalities (Tehsil Municipal Authorities – TMAs) the responsibility for services such as water supply, sewerage, sanitation, waste collection, urban transport and land management.

87. The Bank's strategy is to assist the Government's urban reform agenda by helping to address the weaknesses in policies and administrative structures that undermine service delivery in cities. Recent analytical work has highlighted the fragmentation of service provision, weak financing and management of urban service delivery, especially water and sanitation, and dysfunctional land and housing policies. Two projects are currently being prepared. The Punjab Municipal Services Improvement Project (PMSIP) will build capacity and provide for grants for investments to improve service delivery in the smaller municipalities of the Punjab Province. The Punjab Large Cities Development Policy Loan (DPL) will support implementation of reforms to improve the functioning of the Punjab's seven large cities. Reforms will focus on four broad areas: (i) governance and institutional reform; (ii) municipal finance and service delivery; (iii) urban planning and land management; and (iv) urban transport. The Bank is also conducting economic and sector work to help shape our future involvement in the urban sector. With the support of PPIAF/GPOBA financing, the Bank is undertaking a detailed study of eight major cities in Punjab to investigate options for improving the efficiency of WSS service providers. A variety of alternatives are being considered, including public-private contractual mechanisms (management contract, concession), financial incentives, and regulatory reform with possible downstream Bank and IFC project financing. A similar investigation of solid waste management issues is also underway. Finally, building on preliminary work carried out with the support of the Italian Government through the Italian Trust Fund for Culture and Sustainable Development, the Bank will support development of Pakistan's cultural heritage and tourism.

88. Experience in Pakistan has shown that there is considerable potential for improving access to and quality of public services through the adoption of alternative service arrangements and by empowering communities to monitor providers and influence resource allocation. In health, Pakistan has begun to experiment with contracting of public services to private providers to circumvent weak administrative capacity of the public sector and expand coverage. Initial results of contracting out management of

primary health facilities in twelve districts of Punjab to an NGO (the Punjab Rural Support Program) indicates significant improvement in utilization of services. The Punjab education program has begun to expand public-private partnerships to tap into low cost private schools while strengthening School Councils to increase parental involvement and influence. In Balochistan, the planned Primary Education Project will focus on strengthening community-run schools. During the CAS we will continue to pilot and scale up such initiatives.

89. Policy makers have also fostered private provision of services in Pakistan in order to allow greater provider choice (and competition) to the population, and this has enabled the better off (but also the poor) to bypass the low quality public system. In education, the private sector has already demonstrated its potential with private schools accounting for a growing share of total enrolments, in many cases with higher quality and lower costs than government schools. However, private sector providers need to be held accountable to particular standards (e.g., in education) and may need to be regulated (e.g., in the case of health).

Pillar III: Improved Lives and Protection of the Vulnerable

90. During the next 5 to 10 years, in addition to the measures outlined below, improving social indicators is likely to require strong economic growth, effective public sector management, a motivated and well managed civil service, increased pro-poor spending and more effective allocation of resources. At the same time increased investment in human capital leading to significant improvements in education and health will be necessary to build the skilled, healthy work force necessary to sustain recent growth performance.

Improved delivery of health and education services

91. The achievement of universal primary education, with a particular emphasis on promoting girls' schooling, has been a government priority since the early 1990s. Resources for education have increased by over 60% over the past four years and a range of programs to increase enrolments, especially for girls, have been put in place. These efforts appear to be starting to bear fruit; preliminary results of a national household survey are encouraging and show an increase in the net primary enrolment rate from 42% in 2001/02 to 52% in 2004/05. Nevertheless, meeting Pakistan's goal of increasing the net primary enrolment rate to 100% by 2015 remains a major challenge. The issues affecting the performance of the sector include inadequate resources, systemic weaknesses in public service delivery including over-centralization and weak public sector management, and poor performance of the education system in terms of access, governance and quality.

92. Reflecting the lessons of the Social Action Program of the 1990s and the requirements of devolution, the Bank strategy has focused efforts at the provincial level using development policy credits to support policy and systemic changes as well as the other areas linked to education reform including decentralization and governance reforms. Under the Punjab Education program the Bank is supporting free tuition and books, upgrading school facilities, stipends for girls in backward areas and public funding of the rapidly growing non-government—-independent low-cost private—education sector. Results so far have been promising. The Bank will continue to support these reforms through education development policy credits in Punjab with annual tranches linked to outcomes; annual Development Policy Credits in other provinces, beginning in NWFP, with a special focus on education; and investment projects for regions where sector investment projects are a more viable option such as Balochistan. Gradually the focus of reforms will shift from primary to higher levels of education.

93. At the national level, policy dialogue on financing, governance, demand side interventions, improvements in quality of learning, inclusive education for the disabled, and service delivery issues, will be backed by analytical work, including an education sector review and evaluations of the impact of

different education sector reforms and policies. Annual PRSCs will continue to support reform in education. The ongoing National Education Assessment System (NEAS) project will develop a baseline and monitoring system for measurement of learning outcomes. We will also provide advice and technical support to the government’s vocational/technical and higher education reforms which are needed to provide the skilled labor force needed to support sustained growth.

94. Given its far-reaching importance for reaching all of the MDGs, gender equity in education will remain a high priority. Building on the findings of the recent Gender Assessment, the Bank will assist the government in developing strategies to address gender gaps in education. Recent analysis suggests that the practice of restricted female mobility plays a large role in perpetuating gender gaps in school enrollments. As a result, school attendance for girls is very sensitive to school proximity. Girls are much more likely to attend school if a school is available within the settlement they reside in. This sensitivity to school proximity worsens as girls grow into adolescence. Qualitative studies suggest that concerns over safety and norms of female seclusion are the primary factors behind the precipitous drop in enrollment beyond age 12. This concern is also evident in the rising expenditure on transportation to school reported for older girls. A similar concern makes it difficult to attract female teachers to schools in remote areas.

95. While Pakistan has made some progress in improving **health** outcomes for the poor, the pace has been slow. Poor health outcomes and high fertility remain obstacles to economic growth and contribute significantly to high levels of poverty. In particular reducing fertility rates would contribute to: (i) improved

Table 6: Selected Health Indicators

	Fertility rate 2003	Infant Mortality 2003	Child Mortality 2003	Maternal mortality 2000
Pakistan	4.1	77	103	500
Bangladesh	2.9	46	69	380
India	2.9	63	87	540
Sri Lanka	2.0	13	15	92

Sources: World Development Indicators (2005), except MM: WHR 2005.

women’s health and reduced overall maternal mortality by reducing the number of high order births; (ii) reduced infant mortality rates by increasing the time between births; (iii) helping empower women by providing them choices about when and how many children to have; and (iv) providing a necessary condition for sustained and rapid economic growth. Recent research has found quite a large impact on economic growth from lower dependency ratios brought about by lower adult mortality and fertility rates. There is a continuing burden of malnutrition and increasing burden of hepatitis infections. Utilization of essential maternal health services is low, especially in rural areas. Pakistan also faces a real threat from AIDS; recent assessments found HIV epidemic among certain populations; for example, 27% of injecting drug users and 7% of male sex workers in Karachi were found to be HIV-positive. The government is committed to increasing public health expenditure and has taken steps in that direction but the overall strategic allocation of public resources should be focused towards achieving better health for the poor and addressing the most urgent priorities, such as maternal and child health. In addition key constraints to effective utilization of increased resources include: (i) limited management capacity; (ii) lack of high quality data and program impact evaluation for decision making; (iii) lack of a well-developed human resource development strategy; (iv) inadequate use of the private sector for national goals; (v) lack of focus on quality of care; and (vi) lack of clarity on the roles and responsibilities of the three levels of government.

96. During the past three years, IDA lending to the health sector consisted of an HIV/AIDS Prevention Project and US\$41 million to support polio eradication. Multi-sectoral policy-based loans (a PRSC and provincial structural adjustment credits) have supported HNP policy reforms as well. Recent analytical work has highlighted the potential for public-private partnerships (e.g. contracting with NGOs to deliver services) to improve basic health services. For example, one district in the Punjab (Rahim Yar Khan) contracted the management of its 104 health units to an NGO and witnessed a doubling in the number of outpatient visits and increased client satisfaction. Such successful efforts must be scaled up.

97. Looking ahead, at the national level, the Bank will concentrate on: (i) encouraging the Government to focus on public health functions (such as surveillance, quality control, monitoring and evaluation, and public information), through analytical support and national level development policy lending; (ii) supporting the development and implementation of program and management reforms in the Lady Health Worker program as a way of expanding access to primary health care and family planning; (iii) supporting increases in overall health expenditures as envisioned in the PRSP; and (iv) supporting the piloting and evaluation of new approaches for service delivery and demand side interventions. Recognizing that a major focus of efforts must be at the provincial and local level, we will support major system reforms through planned provincial Development Policy Credits, beginning in NWFP. Initially, the focus of these credits will be on increasing access and coverage of maternal health services, improving the functioning and utilization of first level care facilities, and targeting underserved areas. Overall, Bank lending and analytical support in health will be guided by the following principles: (i) a focus on the poor and underserved areas; (ii) promoting testing and rigorous evaluation of innovations by local governments; (iii) increased accountability, particularly at the district level; and (iv) increased integration of services at the grassroots level.

98. Improving the health outcomes of the poor will also depend on complementary interventions outside of the health sector. Recent research has highlighted the strong effects on infant and child mortality from improved maternal education and basic infrastructure services, such as access to sanitation, piped water, clean cooking fuels and electricity. The Government has recently announced a major initiative to expand access to clean water by building water treatment facilities at the local level. In light of this, **water supply and sanitation** will continue to feature in the Bank's lending and analytical work, in both the urban sector and through support for community infrastructure, especially in rural areas.

99. Current analytical work on the health and economic costs associated with air and water pollution has confirmed the high impacts, with losses estimated to be more than 2% of GDP. The Bank is deepening its engagement with the Government on environmental management to address these issues. The recently approved National Environment Policy provides the framework and the Bank is supporting the Government at federal and provincial levels in the identification and preparation of priority interventions. Key areas for action in relation to health issues will be urban air quality in the major cities, protection of water supplies and management of increasing amounts of industrial and hazardous waste.

Reducing vulnerability and poverty through effective safety nets and targeted programs to reach the poor

100. The PRSP recognizes that protection for the poor and vulnerable is a cornerstone of any poverty reduction program and Pakistan has a range of programs which aim to improve the welfare of the poor and vulnerable including microfinance, old age security, public works, cash and in-kind transfers, and programs for child laborers, the disabled, and other highly vulnerable groups. However, these programs are severely under-funded, covering only a very small fraction of the poor and vulnerable (see Table 7 for details). Total spending is equivalent to 0.5% of GDP, substantially lower than the levels found in other developing countries. Moreover, there are severe shortcomings in the existing safety net programs: (i) there is no program (such as workfare) to help the rural poor cope with chronic or seasonal under-employment; (ii) formal social security covers only the small minority employed in the formal sector; (iii) existing programs do too little to protect the human capital of the vulnerable--efforts to use safety net measures to support health, nutrition, and education of the poor are in their infancy; and (iv) the size of benefits is often negligible. Other issues include the weak administration, targeting, and delivery mechanisms, lack of coordination between agencies, and poor monitoring and evaluation.

101. The Bank's assistance for social protection will include support for **safety nets** that (i) help the chronic poor (e.g. widows, disabled, and the elderly with no means of livelihood) cope with

Table 7: Public Spending on Select Safety Net Programs

	Budget / spending (in Rs. Billion)	Number of Beneficiaries
Wheat subsidy	8.00	(untargeted)
Bait-ul-Mal (Food Support and other)	4.50	1,250,000
Tawana (mid-day meals for girl students)	0.70	530,000
Zakat (cash transfers and other)	5.86	1,733,000
Employees Old Age Benefits (EOBI)	1.74	850,000
Total	20.80	4,363,000

poverty, and, where possible, (ii) help the poor escape poverty, e.g., via conditional cash transfers and other demand side interventions, (e.g., inclusive education) aimed at increasing access to basic social services for the poor and marginalized; and (iii) help families and individuals cope with seasonal shocks and natural disasters (e.g., via workfare). We will also provide support for **social security** which helps mitigate risks, via improving formal sector pensions, and consider innovative approaches to micro-insurance to address life cycle risks. Building on ongoing analytical work and policy dialogue, the Bank is helping the government develop a comprehensive social protection strategy to guide policy reform in this area over the medium and long term. Reforms will be supported through the PRSCs, a stand alone Social Protection operation, support for persons with disabilities in the earthquake affected areas as well as social protection components in provincial DPCs and emergency operations. Technical assistance will include support for strategy development, design of new social protection interventions (workfare, demand-side incentives for health and education, etc), program implementation, e.g. improved targeting methods, administration, and evaluation. The Bank will also broaden its work on pensions to cover old-age security mechanisms in their entirety, and continue and deepen its work on inclusive education that seeks to mainstream disability in the education sector.

102. Pakistan's PRSP recognizes that while rapid growth will be the main driver of poverty reduction, targeted interventions and community-based approaches to rural development are also required to address the immediate needs of the poor and vulnerable, especially in drought prone and flood stricken areas, and help them share in economic growth. The Bank is supporting the Government through a series of analytical and advisory services in the definition of a rural development strategy that would look in an integrated way at farm and non-farm opportunities as well as policy and institutional issues. The Government has announced a major increase in its pro-poor public works program and has asked for Bank's support for the continuation of a drought/flood assistance program (DERA). The Bank will continue to support implementation of the Community Investment Program in NWFP and AJK and look for possible expansion and replication opportunities. A major focus of these efforts will be to strengthen the partnership between communities and local governments by supporting citizen participation in identifying priorities for public investment and by building the capacity of local governments. At the same time, the Bank would support the Government's newly announced program for rural poverty alleviation through social mobilization. Such program would be critical in fostering organizations of the poor and their access to income generating activities as well as in enhancing accountability mechanisms and the effectiveness of Government programs. These investments yield not only better project outcome but also help in the longer term to build communities that are better organized and in control of their own development. The Bank will seek to build on the successful experience of the Pakistan Poverty Alleviation Fund (PPAF) which has already reached 6,500 communities through micro-credit and community driven physical infrastructure projects. The experience of the PPAF has also shown that the impact of targeted interventions is enhanced through up-front investments in social capital formation that build ownership and increase sustainability.

Reducing Pakistan's Vulnerability to Natural Disasters

103. The Government, with support from the international community has responded capably to the October earthquake and its aftermath. The Army, with support from UN agencies and bilateral donors, led a massive and largely successful relief campaign to provide shelter and food for the displaced. Despite the extremely difficult conditions with many affectees in inaccessible regions subject to severe winter a feared "second disaster" of mass freezing and starvation did not materialize. By mid-February the government had managed to provide immediate cash relief to some 543,000 households (over 90 percent of those declared eligible), with payments made through individual bank accounts to reduce potential for leakage. Arrangements for assisting households with housing reconstruction are progressing with government partnering with local NGOs to mobilize assistance and inspection teams to administer relief and provide technical support. Reconstruction of major highways commenced in mid-March with the onset of favorable weather. Donors pledged a total of US\$6.5 billion at the November 19th donor's conference. Of this total, US\$3.1 billion has been committed and US\$1 billion disbursed as of mid-February. A key challenge now is to complete institutional arrangements linking The Earthquake Reconstruction and Rehabilitation Authority (ERRA) with local and provincial governments and to complete detailed reconstruction strategies in some sectors, particularly for education, health and public administration.

104. The October earthquake highlighted the vulnerability of the poor to natural disasters and the importance of hazard risk management. This is an issue of continuing concern since in addition to being in an earthquake prone area, Pakistan frequently experiences weather-related hazards, resulting in significant economic losses from localized and seasonal floods, landslides and droughts. Pakistan has been identified as being among the more vulnerable countries in the world on the basis of mortality and economic risks induced by such hazards.¹³ Lack of enforcement of building codes, unsafe land use patterns, and poor construction practices contribute to high economic and human losses. To address such issues, hazard prevention and mitigation strategies are relevant and integral to Pakistan's national development framework.

105. Effective hazard risk management should be mainstreamed as part of Pakistan's poverty reduction strategy with the purpose of reducing future losses of lives and livelihoods, protecting infrastructure and investments and promoting a stable foundation for private sector investment. At present, Pakistan has an ad hoc approach to hazard risk management. Interventions are primarily focused on relief and response with insufficient ex ante mitigation measures. Given its social and economic vulnerability to natural disasters, it is essential that Pakistan improve its approach to hazard risk management. Following the relief period, Pakistan needs to develop a strategic approach to hazard risk management based on five key pillars: risk identification, risk reduction, capacity building, emergency preparedness, and risk transfer mechanisms, to achieve a sustainable recovery program and build in-country capacity for hazard risk management. Beginning with the ongoing Emergency Recovery Credit the Bank will assist in the process of developing Pakistan's hazard risk management strategy. The Bank plans to continue to work with government and other partners to develop the capacity to carry out this strategy and to integrate risk management into development programs.

¹³ Dilley, Maxx and others. 2005 *Natural Disaster Hotspots: A Global Risk Analysis*. Washington, D.C: The World Bank.

IV. DELIVERING THE WORLD BANK GROUP PROGRAM

A. The World Bank Program

Portfolio management strategy

106. The key to maintaining strong portfolio performance will be continued attention to good quality at entry and timely attention to implementation issues through joint portfolio monitoring. The planned increase in investment lending, especially in large-scale infrastructure projects, will pose a challenge in sustaining current good portfolio performance. To meet this challenge we will continue to closely scrutinize new lending and apply “readiness filters,” screening new projects for ownership, adequacy of institutional and policy frameworks, and implementation capacity. This is being reinforced by Regional management by requiring a formal “decision meeting” prior to project appraisal in order to institutionalize a formal review of project readiness. For projects that have already been approved, we will jointly establish with the GOP key portfolio indicators for each year (e.g., portfolio riskiness; disbursement etc.) which will be jointly monitored on a regular basis. Quarterly joint portfolio review meetings will continue to serve as a forum for discussing portfolio performance and for elevating and resolving project issues. The CAS results framework will also serve as the foundation for monitoring the portfolio for outcomes. Starting in FY07, we will undertake a yearly joint review of progress in achieving CAS outcomes and adjust the lending and AAA programs accordingly.

107. ***Portfolio Fiduciary Risk Management.*** Taking into account the result of reforms implemented over the past five years, including recommendations from the CFAA and provincial financial accountability reviews and implementation of PIFRA, overall Bank portfolio fiduciary risk has fallen from an average rating of ‘substantial to high’ during the 2002-05 CAS to an average of ‘moderate to substantial’. The strategy for managing this risk will emphasize project design and capacity building. Projects will be designed with increased participation of beneficiaries in projects (e.g., CDD projects and enhancing the role of school management committees in education projects) and generation and public dissemination of project performance information including information generated through third party validation exercises. Project readiness filters will include assessment of the adequacy of fiduciary arrangements. A risk-based approach to financial management and procurement will guide the Bank’s fiduciary team, both in project design and supervision. Intensive supervision and enhanced procurement arrangements will be put in place in selected projects where fiduciary risks are deemed to be highest.

108. Continued strengthening of government financial management and audit capabilities will be a key element of the strategy. The Bank recognizes the Supreme Audit Institution (Office of the Auditor General of Pakistan) as the independent auditor for Bank-financed operations implemented by most government entities.¹⁴ Bank financing is fully integrated into federal and provincial budgets and disbursements for Bank-financed operations flow through the State Bank of Pakistan to the nominated account of the projects and programs to ensure that Bank funds are accounted as part of the overall funds flow of the Government. Successful roll-out of PIFRA to the provinces will enable the timely preparation of reliable and comprehensive financial reports as well as timely, high quality audits, not just for Bank projects but also for the entire government. We will also continue to work with government to strengthen procurement practices at the federal and provincial level (see paras. 78-81). Supporting the improvement of country systems and the overall control environment will support planned development policy lending and enable mainstreaming of investment lending operations using government PFM systems. While over 90% of project financial statements are received on time, due to uneven quality of presentation and content of the statements, about 25% of the statements are unacceptable at first submission. Capacity

¹⁴ Bank-financed projects that are implemented by corporatized entities are audited by independent firms of Chartered Accountants whose acceptability will continue to be assessed by the Bank on a case-by-case basis.

building of project financial management teams in financial reporting will therefore also be an important area of Bank intervention during the CAS.

FY05-09 lending scenarios and triggers

109. ***IBRD/IDA Lending.*** As indicated above, Pakistan's demand for World Bank financial support has grown to meet the needs of its growth and poverty reduction strategy and to address the impact of the October earthquake. To meet this demand a flexible IBRD/IDA lending program of up to US\$6.5 billion (approximately US\$3.1 billion IDA and US\$3.4 billion IBRD) is proposed in order to support implementation of the PRSP.¹⁵ In light of the extraordinary demands posed by the earthquake and the need to protect implementation of the PRSP program, the Government of Pakistan is seeking additional concessional financing from the donor community. The proposed program is consistent with Pakistan's financing requirements, IDA allocation, debt management strategy, and the Bank's exposure guidelines.

110. IDA will account for about half of Bank Group support to Pakistan. Pakistan's IDA allocation has been increased under IDA 14, with the three-year envelope set at SDR 1.5 billion (equivalent to about US\$725 million per year). In addition Pakistan will have access to additional IDA on hard terms estimated at SDR 130 million.¹⁶ Annual IDA availability is therefore expected to be in the range of an average of \$785 million per year. It is expected that the full IDA allocation would be utilized provided Pakistan continues to maintain a policy environment conducive to growth and PRSP implementation while making further progress in implementing reforms. A dramatic deterioration in performance including, for example, failure to maintain a sound macroeconomic framework, reversal of governance reforms in public financial management and procurement, and inappropriate reductions in poverty-related expenditure would warrant a review of the overall strategy and could preclude full utilization of the IDA 14 allocation. In assessing performance, the Bank will focus on progress in achieving key outcomes tied to PRSP reforms and CAS program priorities.

111. Priorities for IDA resources include support for second generation structural reforms to facilitate private sector growth, improve governance and continue to expand PRSP-related expenditures. In addition, the demands placed on IDA have risen dramatically as a result of the October 8 earthquake with incremental IDA commitments of \$740 million already approved. As a result, utilization of IDA will be front loaded; over half of the three year IDA allocation will be committed by end-FY06 and the full IDA allocation could be exhausted by end FY-07. Other priorities for IDA support include support for policy reforms and institution building to help reach MDG targets as well as financing for pro-poor targeted programs such as micro-credit, social protection and community-driven infrastructure. Annual Poverty Reduction Support Credits will serve as the foundation of our support for PRSP implementation at the national level. These will be complemented by development policy lending for the provinces to support service delivery and improve human development outcomes. IDA will also continue to be used to finance governance-related institution building (tax administration, financial management, land administration).

112. The scale of IBRD financial support will be determined by the strength of the GoP's policy performance and macroeconomic management. Continued good policy performance and sound macroeconomic management leading to continued improvements in IBRD creditworthiness would form the basis for IBRD lending of up to \$400 million per year, of which no more than \$200 million would be in the form of development policy loans. The upper bound of the proposed IBRD lending range for FY06-09 is \$3.4 billion of which up to \$1.3 billion of IBRD lending could take the form of development policy loans. Annual lending could increase to as much as \$1 billion per year with up to \$500 million in

¹⁵ Four-year IDA access is estimated on the basis of IDA 14 allocation.

¹⁶ IDA hard-term lending allocations are additional to regular allocations under IDA14. The hard-term IDA allocation for Pakistan in FY06 is SDR 62 million. The allocation for FY07/08 is indicative and subject to change based on implementation of the IDA 14 grant component.

DPLs within this envelope. Reaching this upper bound would take place only in the context of strong performance as demonstrated by reaching the key benchmarks set forth in Table 8. In the event of policy reversals resulting in the macroeconomic framework going off-track, the Bank would seek to limit its exposure by suspending IBRD lending. Although recent macroeconomic performance has been good, rising inflation, earthquake-related increases in the fiscal deficit, and a growing current account deficit reflect increased pressure and the need for continued vigilance.

Table 8: Key Policy Performance Benchmarks for IBRD Lending

Lending	IBRD lending up to \$1.6 billion (\$400 million per year)	Total IBRD lending up to \$3.4 billion (up to \$1 billion per year)
Macroeconomic Management and Debt Reduction	<ul style="list-style-type: none"> Maintenance of a sound macroeconomic framework and no substantial decline in fiscal discipline. <i>[as demonstrated by public debt to GDP ratio at or below FY05 level and foreign exchange reserves equivalent to at least 3 months of following fiscal year's projected imports of Goods and Nonfactor Services]</i> 	<ul style="list-style-type: none"> Continued improvement in fiscal performance and debt management as demonstrated by achieving in each year all targets for the revenue deficit and debt reduction in the Fiscal Responsibility and Debt Limitation Act of 2005.
Promoting private sector-led growth	<ul style="list-style-type: none"> No substantial deterioration in the business environment. <i>[as evidenced by no substantial moves toward protectionist or interventionist policies or reversal of financial sector reforms]</i> 	Continued improvement in the business environment through approval by Government of legislation governing employment conditions and a competition law.
Governance	<ul style="list-style-type: none"> Continued commitment to financial management reforms. 	<ul style="list-style-type: none"> Implementation of modernized accounting and auditing systems capturing 65% of the federation's expenditure budget by June 2007 and 80% by June 2009
	<ul style="list-style-type: none"> Notification of regulations to support implementation of the national procurement rules. 	<ul style="list-style-type: none"> Satisfactory implementation of national procurement rules to reduce procurement irregularities.

113. The level of IBRD lending will also reflect the extent to which sectoral policies and governance arrangements are conducive to effective Bank engagement. The Government of Pakistan's priorities for IBRD financing are in infrastructure, primarily water, power, transport and urban development. In each of these areas the viability of investment lending will depend on the establishment of a policy environment conducive to project implementation and to the achievement of targeted outcomes. In some cases, the conditions necessary for increased lending have already been met while in others key policy actions are required before expanded investment lending can take place. Reaching the upper end of the proposed lending range would require strong progress across the board in implementing the sector reforms necessary to ensure that IBRD investments lead to the achievement of CAS outcomes. Annex 7 summarizes key sector reforms that would serve as indicators to guide IBRD lending.

114. Actual lending amounts will also depend on the ability to prepare high quality operations as well as continued satisfactory portfolio performance. As indicated in the CAS Progress Report, work has already begun to meet the demand for stepped-up IBRD support and the pipeline of IBRD projects is growing. Nevertheless, given the fact that this new lending is in sectors where Bank has lending has been limited in the recent past, the scale-up will take some time. At present, with concerted effort on the part of both the Bank and GoP counterparts, we expect IBRD lending to reach US\$850 million in FY07.

However, reaching this level would require a considerably strengthened pace of project preparation and strong implementation capacity.

115. The level of policy based lending will depend on several factors. Continued sound macroeconomic management will continue to be a pre-condition for development policy lending as will satisfactory implementation of PRSP reforms. Similarly, development policy operations at the province level will take place in the context of fiscal and financial management reforms aimed at increasing fiscal space and ensuring sustainability of reform programs. Within the context of a sound macroeconomic environment, the use of DPOs will be driven primarily by the appropriateness of the DPO instrument vis-à-vis alternatives (see para. 45). In addition, the share of IDA-funded development policy lending in the overall IDA lending program will be managed in the context of commitments on the Bank-wide share of policy-based lending under the IDA 14 agreement.

116. Due to its rapid economic turnaround, Pakistan is far more creditworthy than at the time of the last CAS. Total government debt outstanding is 61 percent of GDP in 2004/05 (compared with 74 percent in 2002/03) and is projected to decrease to 47 percent by 2008/09. Debt service has fallen from 26 percent of exports of goods and services in 2002/03 to 15 percent in 2004/05. Recent debt sustainability analysis suggests that public and external debt are projected to continue to decline over the medium term and sensitivity analysis indicates that this downward trend is not likely to deteriorate significantly under a variety of shocks to the baseline scenario. Pakistan's improved creditworthiness is also reflected in improved ratings on its sovereign bonds (Table 9), although the country's rating remains several grades below minimum investment grade.

The Government of Pakistan's first international Islamic 'Sukuk' bond offering (this is the GoP's second bond offering, following last year's Eurobond US\$500 million issue) attracted subscriptions worth US\$1.2 billion for a bond issue of US\$600 million on January 18, 2005. The authorities have also indicated that they intend to initiate further bond offerings on an annual basis.

Table 9: Pakistan Credit Rating by Standard & Poor's

Date	Local Currency Sovereign Credit Rating	Foreign Currency Sovereign Credit Rating
July 9, 1999	B/Stable/B	SD/NM/SD
Dec. 21, 1999	B+/Stable/B	B-/Stable/B
Dec. 12, 2002	BB-/Stable/B	B/Stable/B
Dec. 2, 2003	BB-/Positive/B	B/Positive/B
Nov. 22, 2004	BB/Stable/B	B+/Stable/B

Source: Standard & Poor's.

117. IBRD lending of up to the maximum of US\$3.4 billion over the FY06-09 CAS period would increase total IBRD exposure to Pakistan from the current US\$2.5 billion, or 2.3% of the portfolio to US\$3.3 billion in FY10, about 3% of the IBRD portfolio. Bank Group exposure guidelines limit the ratio of IBRD debt service to public debt service to no more than 20%, and the ratio of IBRD debt service to exports of goods and services to no more than 4%. Even if total IBRD lending reaches US\$3.4 billion over the CAS period—the upper end of the proposed range—neither of these limits would be breached. Pakistan does have a high share of external debt owed to preferred creditors and the preferred credit ratio (debt service to preferred creditors as a percent of total public debt service) is above the 35% recommended by IBRD exposure guidelines. But this risk is mitigated by bilateral debt rescheduling and Pakistan's debt reduction strategy which has emphasized the retirement of expensive short term debt and increased reliance on multilateral concessional debt, including IDA. In combination these factors have served to reduce both the stock of external public debt and the associated debt service.

Table 10: Maximum Projected IBRD Exposure

	Projected					
	FY05	FY06	FY07	FY08	FY09	FY10*
IBRD Debt Disbursed and Outstanding	2,464	2,149	2,192	2,571	2,835	3,293
Preferred creditor ratio	61.3	60.4	57.1	52.7	42.8	45.6
Share of Total IBRD Portfolio (%)	2.3	2.1	2.2	2.5	2.7	3.0
IBRD Debt Service as % of Total Debt Service	17.7	19.9	16.5	15.1	11.6	10.8
IBRD Debt Service as % of Exports of GNFS	1.8	1.6	1.3	1.2	1.0	0.8

* FY10 Exposure projected on the basis of continued lending at the upper end of the FY06-09 CAS lending range.

Knowledge Services: AAA and Building Capacity

118. AAA and capacity building will be integral to the Bank Group program. Consistent with our focus on outcomes, ESW and TA will be programmed on the basis of their contribution to achieving CAS outcomes, recognizing that knowledge transfer, often without financing, can be instrumental in achieving results. The AAA program will also provide the analytical underpinning of the lending program. Based on the FY04 QAG review of the Pakistan AAA program, we will invest more in dissemination and outreach.

Table 11: AAA – Indicative Key Outputs by CAS Theme

	FY06	FY07	FY08	FY09
<i>Sustained Growth and Improved Competitiveness</i>	<ul style="list-style-type: none"> • Sindh Economic Report • Growth and Export Competitiveness • Rural Development Report • Transport Competitiveness 	<ul style="list-style-type: none"> • Balochistan Economic Report • Investment Climate Assessment • Poverty Update • Tax Policy Study 	<ul style="list-style-type: none"> • Banking Sector NLTA • Development Policy Review • PPP for Agric. Technology and Services 	<ul style="list-style-type: none"> • Access to Finance • Skill Development & Labor Market TA
<i>Strengthened Governance and Service Delivery</i>	<ul style="list-style-type: none"> • Provincial Procurement Assessment • Urban NLTA • Civil Service Pension Report 	<ul style="list-style-type: none"> • Monitoring and Evaluation NLTA 	<ul style="list-style-type: none"> • Land Market Administration NLTA • Devolution TA 	<ul style="list-style-type: none"> • Statistical Strengthening TA
<i>Improved Lives and Protection of the Vulnerable</i>	<ul style="list-style-type: none"> • Safety Net Report 	<ul style="list-style-type: none"> • Public-Private Partnerships in Education • Health Sector Review 	<ul style="list-style-type: none"> • Education Sector Review • Pension Reform NLTA 	<ul style="list-style-type: none"> • Education TA
<i>Crosscutting/Core Diagnostic</i>	<ul style="list-style-type: none"> • Strategic Country Environment Assessment 		<ul style="list-style-type: none"> • Integrated Public Financial Management and Accountability Assessments (CFAA/CPAR/PER) 	<ul style="list-style-type: none"> • Poverty Assessment

119. Based on the lessons learned in implementing the last CAS as well as the recommendations of the CAE, the FY06-09 CAS has been designed with greater emphasis on capacity building and ensuring that capacity constraints are adequately addressed in project design. The Public Sector Capacity Building

project, approved in May 2004, is revitalizing civil service training and building the capacity of key ministries and regulatory agencies that are in the forefront of design, implementation and monitoring of reforms. With the designation of Pakistan as a focus country, the World Bank Institute will also play a greater role in building capacity in support of operations. For example WBI has provided training in municipal management feeding directly into the capacity building component of the Punjab Municipal Services project. The partnership between WBI and country operations has been strengthened with the appointment of regional coordinator located in Dehli. WBI activities are expected to focus primarily on governance, including decentralization, urban management and parliamentary oversight of spending.

120. At the project level, projects will have a stronger emphasis on building institutional capacity. Projects will be designed with capacity issues in mind and capacity considerations will play a greater role in appraisal of projects' readiness with an explicit requirement that projects not proceed to negotiation unless institutional issues are resolved and project management capacity is in place. The proposed guidelines for IBRD lending address capacity constraints as well as policy reforms and therefore will help serve as a "capacity filter" for judging project readiness. Capacity building will also increasingly be incorporated in project design with provision for associated technical assistance included in projects.

Country Financing Parameters

121. The country financing parameters pursuant to the Bank's policy OP-BP 6.00, *Bank Financing* were established in November 2004, and reviewed during the preparation of this CAS (see Annex IV). This framework allows the Bank to finance expenditures needed to meet the development objectives of the operations it supports within a framework that addresses country risks related to fiscal sustainability and appropriate use of Bank resources. The policy has added flexibility in the use of Bank financing for a number of expenditures. To implement this policy, the Bank and Government have agreed upon country financing parameters for Pakistan. Under these financing policy parameters, the Government of Pakistan will have flexibility in allocation and management of resources in the following areas: overall cost sharing; local cost financing; recurrent expenditures; and financing of taxes and duties. Application of the policy is not expected to have an adverse impact on fiscal sustainability. The above policy is based the Government's five-year track record of stable and prudent fiscal management and debt reduction coupled with a sound medium term fiscal framework, approval of a Fiscal Responsibility and Debt Limitation Bill, and commitment to implement its development program with all donor assistance fully integrated into the budget.

122. The financing parameters for cost sharing, local and recurrent costs, and taxes and duties will be applied on a project-by-project basis, depending upon the type of operation, to ensure efficient implementation and sustainability after project closure. This will not impact the overall cost sharing of the Bank, and the magnitude of financing in any individual project would be limited by the total available IDA and IBRD resource envelope; the flexible financing arrangements in some projects will be offset by other projects, depending upon the nature, type and sectoral intervention. Periodically, the financing parameters and cost sharing for individual projects, will be reviewed with the Government and the Bank to ensure that overall Bank financing remains within the total IDA/IBRD envelope and funding is consistent with the Government's PRSP and availability of local resources. Details can be found in Annex IV.

B. The IFC Program

123. Over the last CAS period, IFC helped existing clients to restructure and strengthen their financial position and provided financing for new projects in infrastructure, manufacturing, and the financial sector to support small and medium enterprises (SMEs). IFC committed a total of US\$187 million in 16 projects in Pakistan from FY03 to FY05. IFC's committed portfolio in the country as of July 31, 2005 was US\$314 million in 32 companies, including US\$62 million in equity. The largest exposure is in the power

sector, representing 37% of the portfolio in five independent power producer (IPP) projects, with the remaining portfolio spread across the financial and industrial sectors.

124. During the previous CAS period, local banks became active providers of longer term financing at competitive rates, driven by strong liquidity inflows and the increased efficiency of the recently privatized commercial banks. The business environment in the country also benefited from recent government private sector policies (visible in the improvements in the Doing Business indicators), which have spurred investment activity. Therefore, IFC was selective in its investments during this period and did not compete with local banks.

125. In the upcoming CAS period, IFC will be increasing its investment with the target range of US\$500-600 million for the period. IFC will also explore opportunities in pre-privatization investment. It furthermore plans to make more equity investment and intends to be a catalyst for and mobilize private equity in the country. In addition IFC will increase technical assistance (TA) activity in Pakistan. IFC activity will focus on three main sectors; financial, SME and infrastructure. With the recent creation of Private Enterprise Partnership for Middle East and North Africa region (PEP-MENA), IFC has initiated a substantial TA program in Pakistan to build capacity and address constraints of the SME, infrastructure and financial sectors.

126. In the financial sector, opportunities include: microfinance; SME lending; support for recently privatized banks and those expected to consolidate; and long term lending and securitization for housing finance. IFC will also continue to support the expansion of trade finance for SMEs, and expansion of the asset management sector where it has played a pioneering role in the country. TA will complement the investment program. PEP-MENA will focus on strengthening financial markets and on expanding access to finance for micro, small and medium-sized enterprises, improving corporate governance practices, and expanding access to affordable housing for low and middle-income citizens. PEP-MENA will launch a training and advisory project for the housing sector and will work with individual banks to improve internal credit and risk systems, policies and procedures to promote affordable housing finance.

127. IFC expects to support innovative financing to promote funding to SMEs from local banks and to help meet the funding needs of SMEs, specifically in health and education. To help enhance the country's business enabling environment, PEP-MENA is supporting commercial dispute settlement through its alternative dispute resolution (ADR)/mediation pilot project in Karachi. The project will establish a pilot mediation center for SMEs to provide training on mediation for judges, lawyers and the private sector. It is expected that the pilot will result in a decline in court litigation, which is particularly burdensome for SMEs, and could eventually be replicated in other provinces. PEP-MENA is also providing support to business membership organizations (BMOs) to improve services and support to their SME members. PEP-MENA will also launch its business management training tool, Business Edge, in Pakistan to support business development service providers through train-the-trainer workshops. This management training tool is to provide SMEs greater access to business development, management training and advice.

128. IFC intends to increase its investments in infrastructure and housing finance activities in order to address financing gaps in these sectors. In the infrastructure sector, the country is addressing constraints in power generation and distribution. IFC is developing a number of investment proposals to address these challenges. IFC is pursuing opportunities to further develop the country's natural gas resources, where clients value IFC's political risk mitigation. In addition, IFC lending and advisory services are expected to support the expansion of the private telecom industry, which is growing strongly after the privatization of Pakistan Telecommunications Limited (PTCL) and after the rapid expansion in mobile telephony and value added telecommunication services.

129. As to the development of housing finance sector, a key driver for stimulating the growth in the mortgage market would be for originators to have access to long term local currency financing. This

would be led by the development of the local capital market, via securitizations and other capital market instruments, which mobilize domestic capital to support funding for mortgage finance. Some legal and regulatory framework needs to be changed to ensure that the environment for securitization is enhanced. PEP-MENA is exploring ways to support the GoP to enhance the legal regulatory framework. IFC will explore ways to support pilot securitization efforts with some local financial entities that could be developed in tandem with some of the changes in the legal and regulatory infrastructure.

130. In privatization and public-private partnership (PPP) development, PEP-MENA will support the GoP's regulatory bodies and its infrastructure privatization efforts. IFC currently has two advisory mandates in Pakistan: (i) structuring a PPP for Lahore Water and Sewerage Agency; and (ii) privatization of Faisalabad Electric Supply Company. IFC is working with Global Partnership on Output Based Aid (GPOBA) and Infrastructure Department of the Bank on other PPP-related transactions and on the institutional framework in support of PPPs.

C. MIGA Portfolio and Program

131. MIGA's outstanding portfolio in Pakistan consists of 10 contracts of guarantee—four in the financial sector, five in the infrastructure sector and one in the services sector—with a total gross exposure of US\$136.8 million and a net exposure of US\$106.8 million. An application seeking coverage for a US\$20.8 million equity investment in a hydropower project (Laraib Energy Ltd.) in Pakistan is currently pending. In FY07 MIGA intends to implement an Enterprise Benchmarking Program (EBP) Survey in South Asia, and Pakistan is expected to be one of six or seven countries that will participate. The EBP will provide detailed investor-focused information to assist Pakistan's investment promotion efforts.

D. Partnerships and Harmonization

132. The Bank Group's work in Pakistan is coordinated with and reinforced by the efforts of other donors in a wide variety of areas. The Government leads coordination of policy dialogue and donor support within the framework of the PRSP, using the Pakistan Development Forum (PDF), held annually in Islamabad, as the principal forum for discussion with and among donors. The PDF has allowed the Government (federal and provincial) to actively participate and present their policy reforms to the donor community. This has enabled the development partners to learn first hand from key policy makers and implementers, about the country's economic reforms and to experience the ownership of the program at all levels of the government. To follow-up on the PDF in a systematic manner, a Donor Coordination Cell (DCC) has been created in the Economic Affairs Division (EAD). Formal donor group meetings are also held, at least two to three times a year, to discuss implementation of the government's PRSP. Provincial governments have also continued to engage development partners in the implementation of their provincial reform programs. Building on the positive experience of the provincial development forum meetings in Sindh and NWFP, a Punjab development Forum was held in 2005, and another NWFP Development Forum is planned in 2006.

133. Under the leadership of the Government of Pakistan, the Bank Group is increasing efforts to strengthen partnerships and improve harmonization of activities among donors in line with the Paris Declaration on Aid Effectiveness. Analytical activities are increasingly being prepared jointly; during the last CAS five ESW reports were prepared as joint products with the support and participation of the Bank, IMF, ADB, the EC and the UK Department for International Development. During the next four years we expect an increasing share of analytical activities to be carried out jointly. A comparison between the World Bank's and ADB procurement rules was undertaken in 2004 as part of the harmonization exercise and as a result, harmonized procurement documents are available for use. A similar exercise is underway in the area of financial management where DFID and ADB will be working jointly together on the planned PFM Performance Measurement assessments for the federal government, Punjab and NWFP. A

similar PFM assessment for Punjab was carried out jointly by the World Bank, DFID, and the EC in 2005. Discussions are underway with a number of donors including the US, UK and EC to harmonize program support and we will continue to seek opportunities for harmonization of budget support, both at the national and provincial level, under common policy frameworks. Details of partner activities can be found in Annex V.

134. The international response to the October earthquake has served as an opportunity to substantially deepen donor harmonization and coordination. The Preliminary Damage and Needs Assessment was the product of a multi-agency mission led by the Asian Development Bank (ADB) and the World Bank including experts from the government as well as international organizations, including the European Union, the United Kingdom's Department for International Development (DFID), the German Agency for Technical Cooperation (GTZ), the German KfW, the Japan Bank for International Cooperation (JBIC), the Japan International Cooperation Agency (JICA), the United States Agency for International Development (USAID), the World Health Organization (WHO), and UN Agencies.¹⁷ A core group of seven donors including the ADB, DFID, the European Union, Japan, UN, USAID, and the World Bank has continued to meet on a near-weekly basis to coordinate activities by designating lead agencies and develop common approaches, including assisting in development of sector reconstruction strategies to guide government and donor efforts over the coming months. During the CAS we will seek to build on this mechanism to institutionalize and deepen donor coordination.

E. Communications and Outreach

135. An important complement to partnership and coordination efforts is the Bank Group's overall outreach. Accordingly, the Bank has increased its interactions with the different levels of government, the media, civil society, and business community to establish partnerships based on a shared vision for Pakistan's development. The Bank Group has intensified efforts to build the local media's capacity, and will continue to conduct training programs for business and economic journalists in collaboration with local universities and WBI. In keeping with the Bank's goal of sharing knowledge, increasing transparency, and enhancing accountability, the Bank Group's web site not only provides information about Bank operations in Pakistan but also provides real time access to stakeholders all over the world on annual events like the Pakistan Development Forum. The web site and other web-based communications channels like virtual meeting rooms and discussion space have played a great role in donor coordination during the recent earthquake in Pakistan. Additional efforts will be made to extend the Bank Group's outreach through more periodic dialogue with stakeholders. This will be done through wider dissemination of the Bank Group's reports and disclosure of project documents (especially in local languages), greater engagement with civil society organizations and opinion makers. The Bank will continue also its highly effective consultative process in the preparation of specific projects.

F. Monitoring and Evaluation

136. Successful implementation of the results-based CAS will require further improvements in monitoring and evaluation. At the level of the country program, the CAS results framework establishes the specific results which the Bank Group aims to assist the Government to achieve (Annex 1). Progress toward the achievement of these objectives will be monitored and jointly reviewed on an annual basis. This process will be supported by activities to improve government systems to collect, analyze and disseminate data. To supplement the data available from household surveys, beginning in 2005, the Federal Bureau of Statistics (FBS) has begun conducting a Pakistan Social and Living Standards Measurement Survey (PSLM). This survey consists of a Core Welfare Indicators Questionnaire (CWIQ), which for the first time is gathering data at the district level, and a Household Income and Expenditure

¹⁷ *Pakistan: 2005 Earthquake Preliminary Damage and Needs Assessment*. SecM2005-0585/IDA/SecM2005-0588, November 18, 2005.

Survey (HIES), which is provincially representative. Together with household surveys, the CWIQ and the HIES provide information on intermediate and final development outcomes as well as on satisfaction with government services and provide decision makers with annual feedback on the results of government programs which can be used to assess effectiveness and make needed adjustments. The Bank will also support the strengthening of administrative reporting systems with independent cross-checks provided by third party validation surveys, an approach that is already being implemented in the Punjab Education program.

137. Like several other South Asian countries, Pakistan boasts a strong statistical system with a long time-series of household surveys with extensive data on economic, demographic, and social trends. Already a participant of the General Data Dissemination System, the GoP has announced its intention to adopt the Special Data Dissemination Standard. Further, as the country moves forward in implementing its poverty reduction strategy, increasing information demands are being placed on its statistical system. Recognizing the importance of timely and reliable statistics for policy analysis and public debate, the GoP has embarked on an ambitious plan to restructure existing statistical agencies and develop a long-term plan to strengthen its system of official statistics to meet these challenges. The World Bank is providing technical assistance to the GoP to help prepare a strategic plan for the merger of the various statistical agencies into one organization, to help draft a new statistical law specifying the respective roles and responsibilities of various actors in the revamped statistical system, as well as to develop an implementation plan to strengthen the overall system, including training and motivation of staff and the strengthening of the statistical infrastructure. In addition, the Bank has also helped the Federal Bureau of Statistics carry-out the CWIQ survey in 2004/05.

138. Improvements in monitoring and evaluation will also be a focus of efforts at the project and portfolio level. Based on the results of a recent portfolio monitoring and evaluation review, there is scope for improving the M&E focus of projects by enhancing projects-level results frameworks, strengthening the selection of measurable outcome indicators, and strengthening M&E information channels at the project level. We will continue to build the capacity of the Planning Commission for evaluation and monitoring of development projects. Further support, including lending and technical assistance for implementation of the statistical restructuring plan, will also be considered during the CAS period.

G. Managing Risks

139. The greatest risk faced in the new CAS is the risk of **policy reversal** due to shifting priorities or political changes. While the government has shown itself able to sustain its reform program over an extended period, the period leading up to elections in 2007 could bring greater uncertainty. In this context, a slowdown in decision making is possible as are shifts in government policies and priorities. While the Bank's ability to mitigate this risk is limited, we will seek to build and sustain support for further reforms, using our AAA work as appropriate to help make the case for reform in public and to strengthen the hand of reformers in policy debates. The government is also sensitive to this risk and has launched a variety of initiatives which aim to spread the benefits of growth and reform as widely as possible, particularly among the poorer regions in the country. In this way, the government seeks to build popular support for continued reform. We will support these efforts. Finally, we will continue to rely on the self-regulating nature of the programmatic approach: the volume and pace of lending will match the pace of reforms.

140. Recent macroeconomic developments including rising inflation and a growing current account deficit suggest an increase in the risk of **macroeconomic slippage**. On the fiscal front, expenditure pressures are evident due in part to the October 2005 earthquake and associated claims on the federal government's finances. Disbursement of grant donor funding pledged at the November 19, 2005 Conference in Islamabad has been slower than planned. There is also a risk of increased external vulnerability as shown by the rapid increase in the current account deficit during FY05 and the first half

of FY06. These risks are offset to some extent by the Government's track record over the past five years in managing the economy coupled with its strong commitment to sound macroeconomic management as embodied in the Fiscal Responsibility Law. The Bank will seek to further mitigate this risk through its engagement in macroeconomic policy dialogue and in the context of the PRSCs and other development policy operations, as well as technical assistance and capacity building.

141. Despite some favorable trends over the past several years, Pakistan will remain vulnerable to **security risks** which may affect implementation of the strategy. While the peace process with India remains on track, the threat of violent conflict persists. Some episodes of violence in Balochistan and in the border regions near Afghanistan over the past year have caused disruption in project or program implementation. Moreover, it is likely that security concerns have acted as a constraint on the effectiveness of Pakistan's reform program by dampening somewhat the private sector's response to the rapidly improving investment climate. While the Bank cannot address security issues directly, its engagement can have a demonstration effect and help to "crowd in" private investment. We will mitigate the security risk to Bank operations by continuing to closely monitor developments and by responding quickly to safeguard staff while maintaining our engagement.

142. The October earthquake has highlighted Pakistan's vulnerability to **exogenous shocks**, including natural disasters. Pakistan is subject to earthquakes as well as weather-related hazards including floods, landslides and droughts, all of which were experienced during the last CAS period. The response to the earthquake has also demonstrated Pakistan's capacity to weather such shocks, as well as the need to improve hazard risk management practices in Pakistan. This risk will be mitigated by ensuring the Bank's readiness to provide necessary support—resources, AAA and leadership—to assist in responding to emergencies. In addition we will work with the Government to strengthen hazard risk management strategies and capacity.

143. The **IBRD exposure risk** is deemed to be acceptable based on Pakistan's improving debt sustainability indicators and growing access to international financial markets. Nevertheless, IBRD lending at the upper end of the proposed range will take place only in the context of further improvements in creditworthiness. In consultation with the IMF, the macroeconomic situation will be monitored closely and IBRD lending adjusted accordingly. Moreover, application of the guidelines for IBRD lending will serve to modulate the lending program based on policy performance at the sector level.

144. There are **implementation risks** relating to both the Bank and Pakistan. As outlined earlier technical and institutional capacity constraints, particularly at the local level, could delay implementation of reforms or slow the preparation of new projects. On the Bank side, the planned increase in infrastructure lending poses risks related to the timeliness and effectiveness of Bank support as we re-engage in sectors where there has been little or no lending during the previous CAS. Portfolio risks will also be more prominent as we scale up infrastructure lending. As outlined above, we will aim to increase our support for capacity building, both through stand-alone operations and as an integral part of new activities. We will also apply a "capacity filter" to new operations to ensure that projects proceed only with adequate capacity in place or with a clear strategy for building it. To address the environmental and social risks associated with scaling-up and programmatic support, particularly in the infrastructure and water/irrigation sectors, the Bank will increase efforts, working with our clients, to identify at an early stage the critical issues affecting the potential sustainability of the programs and to put in place appropriate mechanisms to address them. To mitigate the implementation risks on the Bank side will require a concerted effort to streamline project preparation and ensure timely attention to implementation issues on the part of both the Bank Group and GoP.