PAKISTAN
COUNTRY ASSISTANCE STRATEGY

I. POLITICAL, SOCIAL AND ECONOMIC CONTEXT ¾ A TURBULENT DECADE

A. From Crisis to Growth

1. Pakistan entered the new millennium with more hope. Starting from a position of extreme vulnerability at the end of the 1990s—a financial crisis, domestic tensions, and external isolation—it has achieved a remarkable turnaround. A major factor behind this turnaround is strong leadership in the country with internal cohesion and a clear sense of direction. The latter is manifested in the Interim Poverty Reduction Strategy (I-PRSP) anchored in a comprehensive reform program for poverty reducing growth, human development, and governance improvement. The government is engaged in fundamental political, institutional, economic, social and gender transformation for Pakistan's transition to a modern Islamic state.

2. The current government implemented a far reaching devolution program which led to locally elected officials with the legitimacy and mandate to improve public service delivery. Women were given more voice than in the past (33 percent of the total local governments seats were reserved for them and the number of reserved seats was tripled in the future national and provincial assemblies). Despite severe shocks—including the worst drought in decades—GDP at factor cost grew by 2.7 percent in 2000/01; inflation remained low at 4.4 percent, and reserves have reached US$3.5 billion on March 31, 2002, one third of imports, their highest level in a decade. The government formulated a credible education and health reform strategy. It started also a pro-poor public works program to ease the impacts of the economic shock and the drought.

3. Pakistan, however, still faces formidable challenges (political, attitudinal, and policy) to fully develop human capital, improve the investment climate, and increase productivity growth to bring the economy to the 5-6 percent annual growth rate achieved in earlier decades, or even higher, to significantly reduce poverty.

B. Development Challenges

4. Pakistan's past track record as a reformer has been erratic. Over the previous decade, Pakistan had failed to complete on schedule any of the nine programs supported by Fund arrangements. Progress was made in some areas, particularly on trade liberalization and banking sector reform; and reversal of reforms has been rare. Successive governments started off well with ambitious home grown reform programs but failed to carry through sustained reform. This undermined investors' confidence and prevented lasting improvements in the fiscal and external positions, as well as human development.

5. Pakistan became more inward looking in the 1990s at a time when competing Asian economies were aggressively integrating into the global economy (see Annex II). A large share of Pakistan's private sector was content with operating behind high protective barriers and special tax privileges—rent-seeking behavior often referred to as the Statutory Rule Order (SRO) culture—or "tailor made privileges"—which have prevented it from reaping the benefits of integrating into world markets. This situation created an increasingly unfavorable investment climate which has constrained Pakistan's growth potential by discriminating against exports, SMEs, and productivity growth in the industrial sector.

6. As a result, average annual growth hovered around 4 percent over the 1990s. A falling tax ratio —to 15-16 percent of GDP resulting from a narrow tax base, poor governance, and weak collection and enforcement— limited government's ability to provide critical social services and infrastructure. The fiscal deficit remained well above 6 percent of GDP throughout most of the 1990s, causing a continuous increase in public sector indebtedness which when combined with abuse of the banking sector kept real interest rates high (now at 10 percent). Limited budgetary space for development expenditure and inefficiency—if not outright corruption—in expenditure management resulted in poor social indicators (see Table 1). On the external front, protectionism and an uncompetitive foreign exchange regime discouraged export diversification and resulted in unsustainable current account deficits. Low private investment inflows and the recourse to short-term debt and foreign currency deposits only delayed an external debt crisis, which was eventually triggered by economic sanctions following Pakistan's nuclear test in 1998. Thus, the economy grew increasingly vulnerable, balance of payments crises recurred, leaving Pakistan with debt indicators higher than those of the HIPC group of countries (see Pakistan Development Policy Review, April 3, 2002. Report No.23916-PAK).

Table 1. Social and Economic Indicators

	1990-97	1998	2001	I-PRSP 2004 Targets	Low Income 2000
Headcount Poverty Index (%)	28.2	32.6*	..	..	..
Illiteracy rate, adult female (% of females 15+)	75.6	71.1	67.7	..	47.2
Illiteracy rate, adult male (% of males 15+)	46.4	42.0	39.2	..	28.5
Illiteracy rate, adult total (% of people 15+)	60.4	56.0	52.9	40.0	37.8
Life expectancy at birth, total (years)	60.1	61.7	63.9	64.4	59.1
Mortality rate, infant (per 1,000 live births)*	103.7	90.0	85.0	77.0	77.3
Growth Rates			%		
GDP at market prices	4.1	2.5	3.4	5.5	5.1
GDP at factor costs	4.6	3.5	2.7	5.5	..
Per capita GDP at market prices	1.6	0.1	0.9	3.7	1.3

* The head count index is for 98/99. Infant mortality rate for 2001 is from Pakistan Reproductive Health & Family Planning Survey.

Source: PRSP page 6. World Development Indicators 2001.

7. There are also significant gender gaps in both literacy and health status in Pakistan which are compounded by outright discrimination against women (due to institutional and attitudinal factors) in access to education, health, employment and other productive assets, and justice. These These gaps present a stark picture of gender inequity. These gaps present a stark picture of gender inequity.

Box 1: Who Are the Poor?

In urban and rural areas, the poor are wage laborers in farm and non-farm sectors or self-employed indicating the importance of small household enterprises for livelihood. According to the 1998/99 household survey, poverty incidence is highest (47 percent) among the illiterate, especially the rural (more so for women) illiterate. Only 6 percent of those with college education are poor. In addition, as much as 43 percent of total population is concentrated within a small range of 75 to 125 percent of the poverty line. This implies that unanticipated shocks, such as illness, death, drought, have the potential to drive large numbers into poverty.

In addition to the social and gender gaps, a highly skewed pattern of distribution of land (see Box 2), contributes to poverty and vulnerability of a large number of rural households. Rural poverty incidence is highest and most severe among the landless (who represent more than 50 percent of the rural population) and falls steadily as ownership of land increases. Close to 75 percent of Pakistan's poor are landless and constitute 70 percent of the rural poor, while less than 3 percent of households owning 10 acres or more are poor.

Of the four provinces, NWFP stands out with the highest rural (46.5 percent) and urban (31 percent) poverty incidence while Sindh has the lowest urban poverty incidence (19 percent). Sindh comes next with a higher rural poverty (37 percent) followed by Punjab (34.7 percent) and Balochistan (24 percent).

8. After rapid growth during the 1980s that led to sharp reductions in poverty, lower and volatile growth in the 1990s has led to stagnation of poverty measured in consumption terms. Differences across regions and provinces persisted or widened. While urban poverty fell between 1990-91 and 1998-99 (from 28 percent to 24 percent), rural poverty stayed at 36 percent (see Box 1). This shows a weak link between rural growth and reduction of rural poverty due in part to a skewed land distribution and low agricultural productivity (see Box 2). This is of particular concern since more than two-thirds of Pakistan's population live in rural areas.

Box 2: Land Ownership and Productivity

Inequity in land ownership also explains why overall agricultural yields in Pakistan remain below those of other countries with similar resource endowments. The impact on productivity can occur in various ways. ***First***, there is evidence from developing countries, and Pakistan, that as farm size increases, productivity falls. One reason for this is high labor supervision costs that encourage large farmers to reduce cropping intensity. ***Second***, while land rental markets increase access to land, the form of tenure on land can have a significant impact on productivity, the incomes of tenants, and investment incentives. Share tenants are likely to be less productive than owner or fixed rent tenants, since any productivity gains must be shared with the landlord. Also, the prevalence of share tenancy, especially in Sindh, reduces the incentives to invest in land improvement and resource conservation.

Distribution of Land Ownership in Pakistan, 1990

Farm Size (acres)	Percent of Owners	Percent of Total Farm Area
5 or less	54.0	12.0
5 – 25	39.0	39.0
25 – 50	5.0	15.0
50 – 150	2.0	17.0
150 and above	0.5	17.0
All sizes	100.0	100.0

Source: Government of Pakistan, Agricultural Census (1990).

A Turbulent Political and Social History

9. Pakistan's turbulent political and social history has also contributed to limit its growth potential. This in turn has constrained its ability to develop its human capital. ***First***, the country's wrenching social change since its independence, vast influx of refugees, and its increasing internal schisms (result of a difficult economic situation exacerbated by the impact of Afghanistan's conflict) have contributed to social fragmentation. Discord between its diverse ethnic groups, sectarian and ethnic schisms, and the continued political dominance of large landowners (Box 2), have all contributed to deteriorating law and order and have kept much of Pakistan relatively backward both socially and economically.

10. Another factor which may have contributed to the social and political turmoil in recent years is the growing power of militant Madaris (Muslim religion-based seminaries). The radicalization of some of these institutions started with their politicization during the 1980s. With active support from the Zia regime (1977-1988), Madaris with extremist administrations were established along the Pakistan-Afghan border. The objective was to form a cadre of religiously motivated "*Mujahideen*" to fight in Afghanistan and provide political support to Zia's regime. Madaris degrees were made equivalent to degrees obtained from formal universities. This facilitated recruitment of Madaris students into the civil service, leading to the state's accommodation of activities encouraging religious intolerance and sectarian divides.

11. The contribution of these "Mujahideen" to the Afghan victory, poverty, falling standards of public education, and weak governance, account for much of the success of the Madaris in the 1990s. Since they provided free boarding and lodging, they became popular with the parents of poor children and a steady stream of Afghans fleeing the factional fighting in Afghanistan. Marginalized, the graduates from the non-mainstreamed Madaris (those which did not include the formal education curricula) with no career-oriented education, resorted to violence to influence the country's policies. Successive governments did little to restrain them or bring them into the mainstream education system. It is estimated that 15–20 percent of the Madaris are involved in military related teachings and training.

12. ***Second***, the continuing tensions in the region starve Pakistan of crucial resources (while reduced from over 6 percent in the 1980s, defense spending still absorbs 4.7 percent of GDP) and reduce opportunities for closer regional integration. While over the medium-term Pakistan's growth potential may be enhanced by Afghanistan's reconstruction plan, in the short-run, the war in Afghanistan, and its spillovers to Pakistan, and tensions along the border with India, are adding to the political turmoil and raising the risk of doing business in Pakistan.

13. ***Third,*** Pakistan's poor and deteriorating governance has accentuated the political and social turmoil. Since 1990 four democratically elected governments have been dismissed, three of them on corruption charges. The frequent changes of government over the 1990s and the ensuing unpredictability of the policy stance undermined business confidence. At the core of the governance problem is the abuse of the state's institutions, widespread corruption, and disregard for the separation of powers and respect for the rule of law.

Service Delivery in Crisis

14. Pakistan is a federation of 4 provinces—Punjab, North West Frontier Province (NWFP), Balochistan, and Sindh—seven tribal areas (excluding five tribal areas adjoining settled areas called as Frontier regions); and the Northern Areas. Pakistan's 1973 constitution grants major responsibility to the provinces for regulatory oversight, provision of infrastructure (including irrigation and agricultural extension services) and social services. The provinces account for 80 percent of total government spending on health, education, and irrigation. In contrast, and contrary to experience with other federal countries, tax authority is concentrated at the federal level. The federal government revenue transfers account for as much as 84 percent of provincial resources, weakening the accountability of provincial governments to taxpayers, as expenditure and revenue decisions are made at two different levels of government.

15. As a result, and like the country as a whole, Pakistan's provinces have been facing a crisis of public finances, public service delivery, and public institutions and governance. The provinces suffer from large and worsening "deficits" (shortfalls of spending and service delivery relative to needs) in the funding, delivery, and quality of social services (education, health, rural water supply and sanitation). Similar provincial infrastructure deficits (roads, irrigation and drainage, and municipal services) increase the cost of doing business and impose a heavy burden on the economy and the general public. Vital irrigation water services are unreliable and controlled by antiquated, non-transparent and unresponsive departments. The multiplicity of provincial regulatory agencies harass the private sector and discourage entrepreneurship and economic activity. The police is widely perceived as ineffective and corrupt, while the judicial services are subject to long delays and are also seen as sometimes corrupt and out of reach of the average citizen, let alone the poor.

16. There is a tremendous opportunity for the provinces to turn around the performance of their public sector. The following factors are conducive to reform.

- There is a reforming government at the federal level, which has put at the heart of its poverty reduction strategy a program of reforms to foster growth and reduce poverty.

- The provinces—particularly Sindh and NWFP—have already initiated a number of promising reforms to restore good governance, improve their public finances and public service delivery.

- Pakistan's devolution plan represents a major opportunity to reverse decades of over-centralization of public sector management by creating more accountable elected local governments, which would be responsible for the provision of local public services.

17. The policy reform record of the military government which took over on October 12, 1999, has gradually led to renewed optimism that these development challenges can be seriously tackled. This optimism has been reconfirmed in the recently published Interim Poverty Reduction Strategy (I-PRSP). There are also signs of an economic revival.

C. Recent Economic Developments

18. Prior to September 11, 2001, Pakistan was already reforming for nearly two years and showing signs of an economic recovery. In 2000/01, despite a severe drought, total GDP at factor cost grew by 2.7 percent while CPI inflation remained low at 4.4 percent, notwithstanding large increases in fuel and electricity prices and a significant depreciation of the rupee. Although the program's tax collection targets were not achieved, the Central Bureau of Revenue (CBR) tax ratio increased by 0.4 percentage points of GDP. The budget deficit was contained at 5.3 percent of GDP compared with 6.5 percent the previous year (Table 2). Low inflation and successful reserves accumulation—US$3.5 billion by March 31, 2002, the highest level in a decade—reflected responsive monetary management supported by the introduction of a floating exchange rate regime. The tightening of anti-money laundering measures in US, Europe, and the official banking channel since end-September.

Table 2 : Pakistan: Macroeconomic Indicators, 1998/99 - 2003/04

			Estimate	Projections		
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Output and Prices (annual changes in percent)						
Real GDP at factor cost	4.2	3.9	2.7	3.3	4.7	5.2
Consumer Prices	5.7	3.6	4.4	3.0	3.9	4.0
Savings and Investment (percent of GDP)						
Gross National Savings	11.9	13.5	12.8	15.4	15.4	15.8
Government	-3.0	-3.6	-1.8	0.2	0.8	1.4
Non-Government*	15.0	17.2	14.6	15.2	14.6	14.3
Gross Capital Formation	15.6	15.6	14.7	15.2	16.6	17.5
Government	3.7	3.2	2.7	3.4	3.6	3.9
Non-Government*	11.9	12.4	12.0	11.8	13.0	13.6
Public Finances (percent of GDP)						
Budgetary Revenue	16.2	16.5	15.7	16.9	17.3	17.3
Budgetary Expenditure	22.2	23.0	21.0	22.7	21.5	20.6
Budgetary Balance	-6.0	-6.5	-5.3	-5.7	-4.2	-3.3
Primary Balance	1.3	1.1	1.5	1.2	2.1	2.4
Net Public Debt	93.6	91.6	100.9	94.2	90.5	83.6
Interest Payments	7.3	7.6	6.8	7.0	6.3	5.7
External Sector (percent of GDP)						
Merchandise Exports	12.8	13.3	15.0	14.9	15.4	15.8
Merchandise Imports	16.4	15.6	17.1	16.4	16.9	17.1
Current Account Balance excluding official transfers	-4.6	-3.6	-3.3	-2.3	-2.7	-2.1
Current Account Balance including official transfers	-3.6	-2.1	-1.9	0.2	-1.2	-1.7
Total External Debt (percent of current receipts)	328.1	307.0	302.4	294.1	280.5	259.1
Total Debt Service (percent of current receipts)	41.7	38.9	32.5	33.9	30.4	26.8
Gross Reserves (US$ million)	1672.0	908.0	1681.0	2797.0	3677.0	4555.0
(in weeks of next year imports)	7.7	3.9	7.5	11.6	14.4	17.0
Financing Gap (US$ million)	..	..	..	..	100.0	200.0

* Including Public Enterprises.
Sources : World Bank and IMF staff Estimates.

19. the Gulf countries has also triggered a large repatriation of holdings abroad by Pakistani residents through

20. The recovery is now threatened as perceptions about security risks due to the war in Afghanistan, tensions with India, together with the global economic slowdown, have worsened prospects for growth, exports and FDI inflows. The external financing gap for fiscal year 2001/02 increased by at least US$1 billion (or 1.7 percent of GDP) after the September 11 shock.

21. On September 26, 2001, the IMF's Board agreed that performance under the program supported by a SDR 465 million Stand-By Arrangement (approved on November 29, 2000) established a good track record of macroeconomic policy and structural reform implementation. This laid the ground for a three-year support program under the Poverty Reduction and Growth Facility (PRGF), approved in November 2001. The first review of the PRGF program was successfully completed in end-March 2002.

22. The international community's response post September 11 helped reduce the financing gap. The US provided direct budgetary support of US$600 million to protect spending on health, education, and anti-poverty programs and cover some of the cost due to the increased number of Afghan refugees. Other donors (Japan, UK, EU, Canada and European countries) also contributed. The external financing package which is supported by the IMF (PRGF—US$1.25 billion over FY02-04) includes US$3.3 billion in debt relief from the Paris Club over the next three years. However, despite these favorable developments, the external and domestic public debt are both quite large and hence there are still concerns over the fragility of the external position and future growth prospects. The September 11 shock has also increased the longer term risks to the balance of payment position by making more uncertain an early resumption of long-term private capital inflows as well as increased access to international capital markets.