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PAKISTAN

SELECTED ISSUES

June 1, 2017

Approved By
Middle East and Central Asia Department

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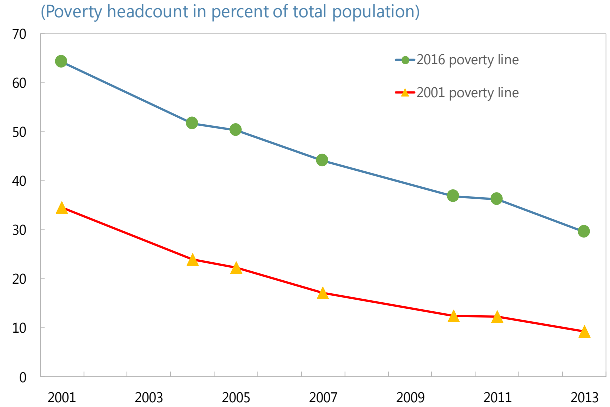
POVERTY, INEQUALITY AND SOCIAL SAFETY NETS IN PAKISTAN[1]

This paper provides an overview of social safety nets (SSNs) in Pakistan and uses a frontier analysis approach to assesses their efficiency in reducing poverty and inequality. SSNs in Pakistan were significantly strengthened over time but remain small against regional and emerging markets' averages. The analysis suggests that stepping up public expenditure in SSNs is needed to alleviate still high poverty and inequality. To this end, finalizing the update of BISP beneficiaries' database, broadening its coverage, and stepping up educational transfers is key. In parallel, continuing the energy subsidies reform would create fiscal space to strengthen SSNs and priority social spending.

A. Poverty and Inequality in Pakistan

1. **Pakistan has made significant improvements in reducing poverty over the last two decades**. Over the period 2000–15, per-capita income nearly tripled, mostly reflecting sustained growth, and the poverty headcount more than halved from 64 percent in 2001 to 29.5 percent in 2013 based on the new poverty line (from 34 percent to about 9 percent based on the 2001 poverty line).[2] Despite these improvements poverty incidence remains high,[3] reaching about 36 percent of the population in rural areas (against 18 percent in urban areas).[4] Poverty incidence also significantly varies across the different provinces, peaking at more than

Pakistan: Poverty has Declined but Remains High
(Poverty headcount in percent of total population)



Sources: WDI (2016); Pakistan Authorities; IMF staff estimates.

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[1] This paper was prepared by Giorgia Albertin.

[2] The government adopted in 2016 a new poverty line, with the World Bank support, which set a higher and more inclusive standard of well-being compared to the poverty line set in 2001. Based on the Cost of Basic Needs method, a PRs 3,032 per adult/per month poverty threshold was identified, leading to a poverty headcount of 29.5 percent of the population in 2013, with about 60 million people in Pakistan classified as poor. Under the former 2001 poverty line based on the Food Energy Intake method, the poverty threshold was at PRs 732.4 per month/per person leading to poverty headcount rate of 34.7 percent in 2001, declining to 9.3 percent in 2013. Back-casting the new 2016 poverty line, the poverty headcount was at 64 percent in 2001, with the same declining trend during 2001–13.

[3] Pakistan has one of the lowest poverty incidence within the South-Asia region, based on the US$1.90 a day poverty line.

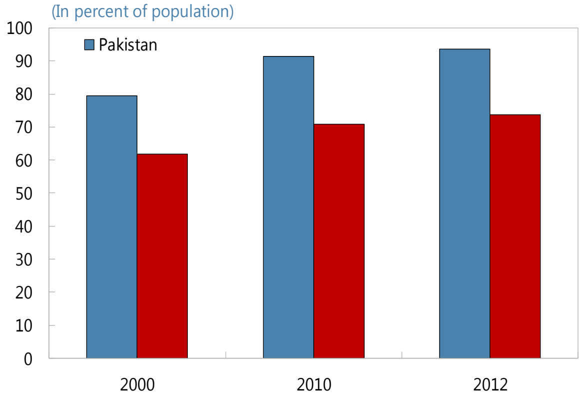
[4] World Bank Development Indicators (2016).

50 percent in the Balochistan region.[5] The multi-dimensional poverty index—measuring achievements in key dimensions of human development—points to a higher incidence of poverty at 38.8 percent of the population (55 percent multi-dimensional poverty incidence in rural areas and 70 percent in the Balochistan region).[6]

2. Access to basic services has significantly improved above South-Asia average and further efforts are underway. The access of the population to basic services has significantly strengthened during 2000–15, and is now well above South Asia average. Access to electricity and improved water sources is close to universal while access to improved water sanitation facilities improved to about 60 percent of the population. Furthermore, local communities' projects are being supported to improve access to basic services in rural areas, under the Sustainable Development Goals (SDGs) program launched in FY 2014/15. These projects aim to strengthen access to improved sanitation, water resources and electricity to achieve the SDGs.

Access to Electricity is almost universal in Pakistan

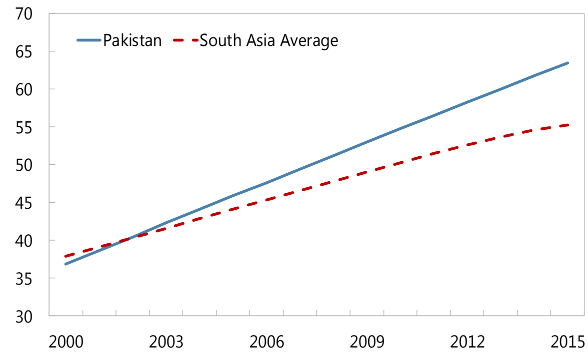
(In percent of population)



Sources: World Development Index (2016)

Access to improved sanitation facilities in Pakistan is above regional average

(access to improved sanitation facilities; in percent of population)



Sources: World Development Index (2016)

3. Children's stunting and malnutrition remains a challenge. The stunting rate among children under five was at 45 percent in 2012, above South Asia average—and the wasting rate among children under-five was at 10½ percent.[7] The incidence of stunting and malnutrition among children varies across different provinces, with the highest prevalence of stunting in the provinces of Balochistan and Sindh where it was above 50 percent (Figure 1).

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[5] The Balochistan region represents 6 percent of the overall population.

[6] The Human Development Index (HDI) is a summary measure of average achievement in key dimensions of human development: a long and healthy life, being sufficiently educated, and have a decent standard of living. The health dimension is assessed by life expectancy at birth, the education dimension is measured by mean of years of schooling for adults aged 25 years and more and expected years of schooling for children of school entering age. The standard of living dimension is measured by gross national income per capita.

[7] Stunting is defined as the percentage of children under five whose height-for-age ratio is two standard deviations or more below the World Health Organization (WHO) Child Growth Standards. Wasting is defined as the percentage of children under five whose weight-for-height ratio is two standard deviations or more below the WHO Child Growth Standards. World Bank Development Indicators used in the analysis are based on the Pakistan Demographic and Health Survey (PDHS) 2012–13. New data on stunting and malnutrition will be released in the PDHS 2017/18.

4. Despite improvements, education and health outcomes remain below the regional average, with public spending in these areas comparatively lower than in other emerging markets. Education and health outcomes have improved during 2000–15, with the primary gross enrollment ratio and youth literacy rate increasing to 94 percent and 73 percent, respectively, and infant mortality declining. Public spending in education and health increased to 2.5 and 0.9 percent of GDP, respectively, but remains well below emerging markets' average, also reflecting capacity constraints at the provincial level in the implementation of development spending (Figure 2). However, education and health outcomes remain below the South-Asia average and Pakistan ranks low on the Human Development Index (147 out of 188 countries in 2015, unchanged from 2009).

5. While income inequality is moderate, sizable gaps in education and health outcomes between the poorest and the richest in the population remain. The Gini coefficient slightly declined over the last two decades and stands at about 30 percent (2010), broadly in line with South Asia average. However, nonmonetary indicators highlight significant inequality along different dimensions. Health outcomes remain unequal among the population, with the rates of under-five mortality and children's stunting in the poorest quintile almost threefold than in the richest one. Furthermore, the gap in education attainment is high, with average years of schooling among young adults (for 20–29 years old) in the richest quintile being more than double than in the poorest quintile and the gross enrollment ratio (for 13–14 years old) being almost four times higher in the richest quintile (Figure 3).[8]

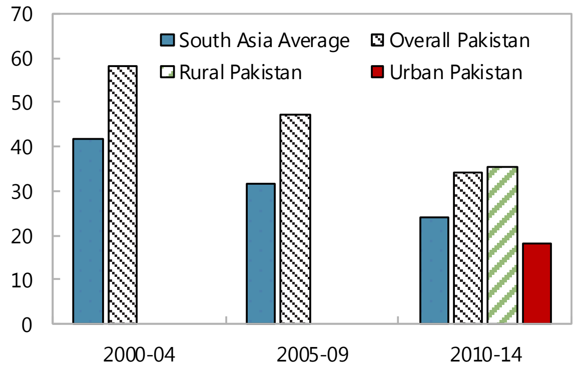
6. Despite some progress, gender inequality continues to be pervasive. Pakistan ranks very low in the Gender Gap Index (143 out of 144 countries in 2016), mostly reflecting poor economic participation and opportunities for women.[9] Women's labor force participation remains very low at 25 percent (against 83 percent for men) while the rate of women's unemployment is almost twice as high as for men, at 9 percent (against 5 percent for men). About 35 percent of young women are illiterate (against 20 percent of young man) and girls are lagging behind boys in primary and secondary education enrollment, with the ratio differential in primary education at 15 percent. Several recent initiatives support women's empowerment, including Gender Responsive Budgeting, a 10 percent women quota in public sector positions; and the Benazir Income Support Program provides cash transfers to women in poor households. Furthermore, women's participation in federal and provincial assemblies increased to 17 percent of seats while in local bodies to one-third.

[8] Data on gross enrollment ratio distribution per quintile is based on Pakistan Social and Living Standard Measurement Survey 2013–14.

[9] The Gender Gap Index (World Economic Forum, 2015) measures the gap between men and women in four categories: economic participation and opportunity, educational attainment, health and survival, and political empowerment.

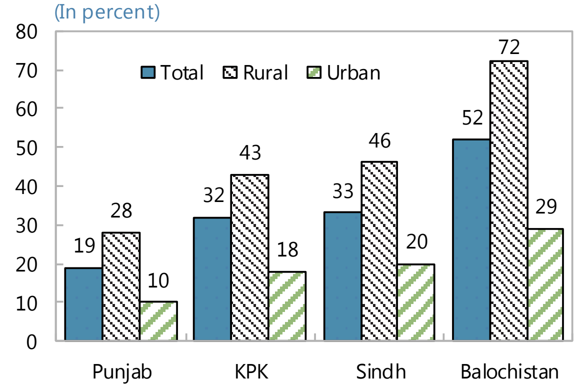
Figure 1. Pakistan: Poverty is High and Children's Malnutrition is Widespread

Poverty Headcount
(In percent, latest data available for each period)



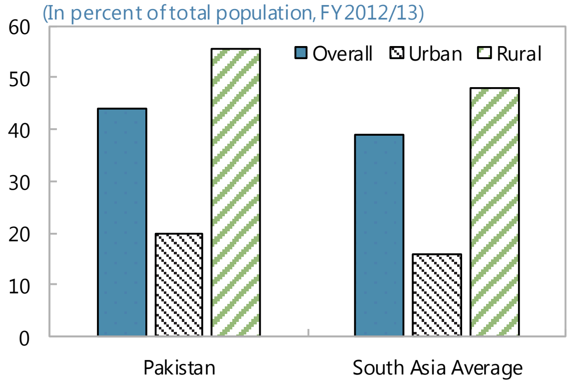
Sources: World Development Index (WDI) (2016).

Poverty Incidence across Provinces
(In percent)



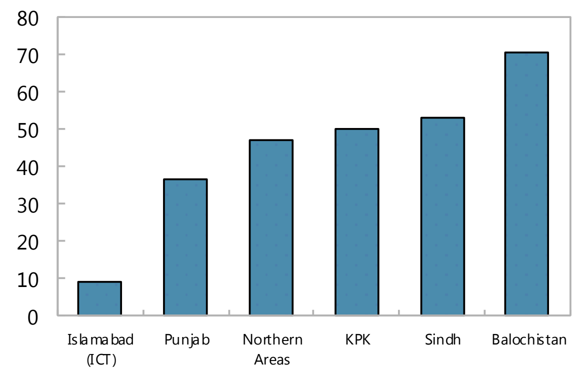
Sources: Sustainable Development Policy Institute (2012).

Multidimensional Poverty Incidence
(In percent of total population, FY2012/13)



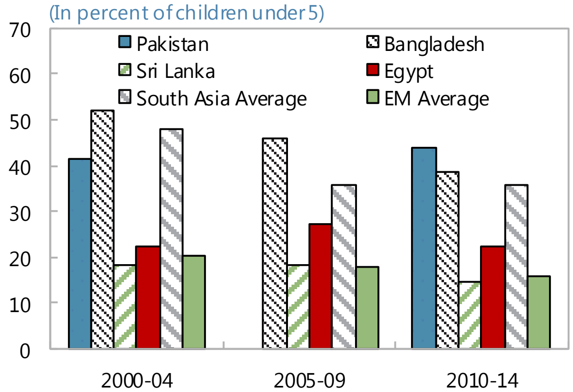
Sources: The Global Multidimensional Poverty Index (MPI) (2016).

Multidimensional Poverty Incidence cross-Provinces



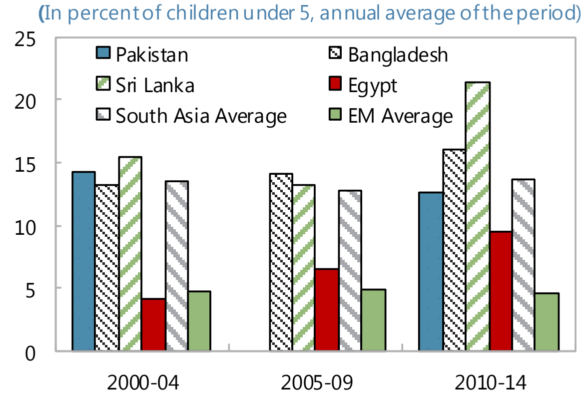
Sources: Global Multidimensional Poverty Index (MPI) (2016).

Prevalence of Stunting, Height for Age
(In percent of children under 5)



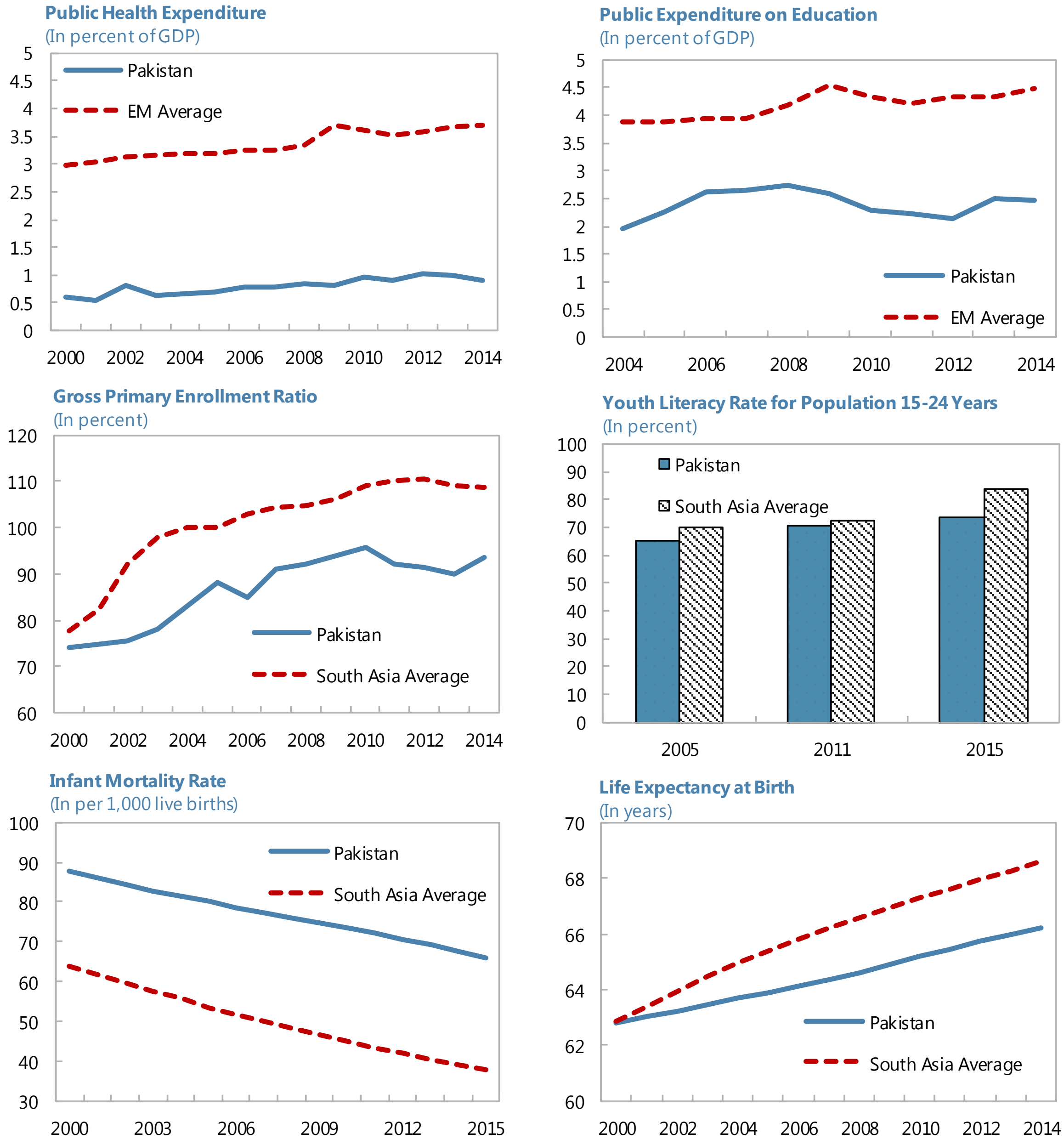
Sources: WDI (2016).

Prevalence of Wasting, Weight for Height
(In percent of children under 5, annual average of the period)



Sources: WDI (2016).

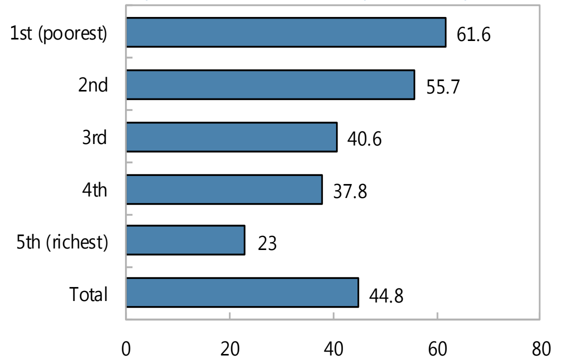
Figure 2. Pakistan: Challenging Education and Health Outcomes amid Limited Public Spending



Source: World Development Index (2016).

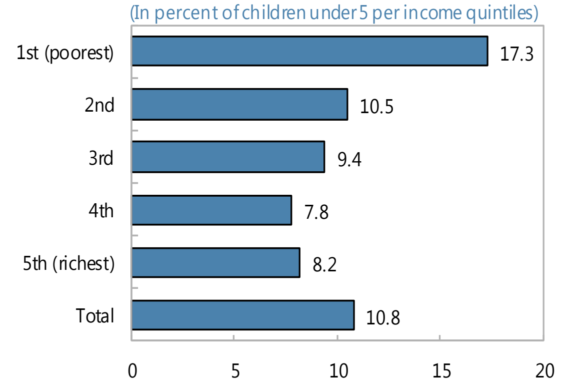
Figure 3. Pakistan: High Inequality Across Many Dimensions

Prevelance of Stunting per Income Quintiles 1/
(In percent of children under 5 per income quintiles)



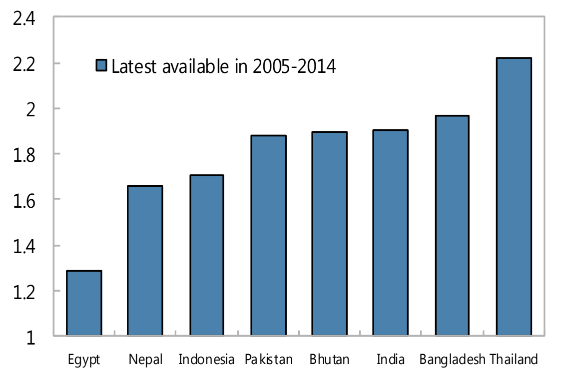
1/ Stunting is the percentage of children younger than 5 years whose height-for-age ratio is two-standard deviations or more below the World Helath Organization Child Growth Standards
Source: Domegraphic and Health Surveys (DHS, 2012-13).

Prevelance of Wasting per Income Quintiles 1/
(In percent of children under 5 per income quintiles)



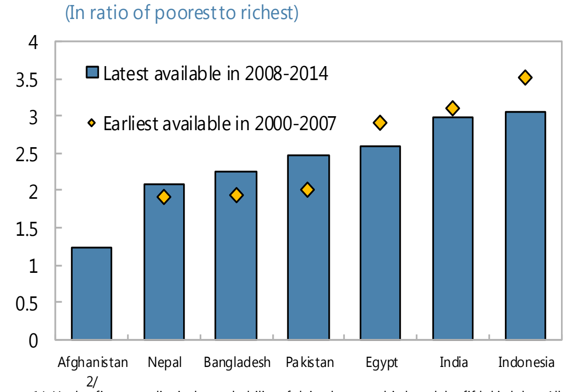
1/ Wasting is the percentage of children younger than 5 years whose weight for height ratio is two-standard deviations or more below the World Helath Organization Child Groth Standard
Source: DHS (2012-13).

Average Years of Schooling among Young Adults
(In ratio of poorest quintile to richest quintile among 20-29 years of age)



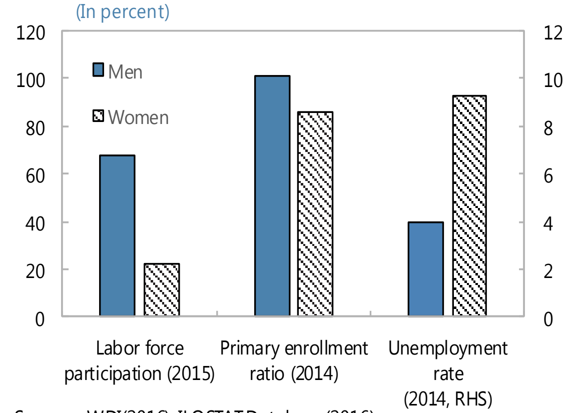
Source: World Bank Education Equality Country Profiles database (2016).

Child Mortality Under 5 by Wealth Quintile 1/
(In ratio of poorest to richest)



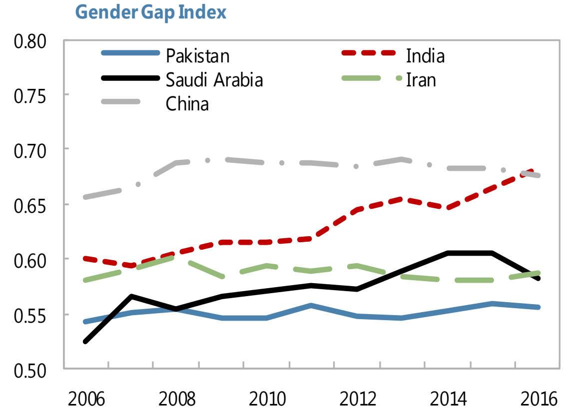
1/ Under-five mortality is the probability of dying between birth and the fifth birthday. All rates are expressed as deaths per 1000 live births.
2/ Data before 2008 is not available for Afghanistan.
Sources: World DataBank Health Nutrition and Population Statistics (World Bank, 2016).

Gender Inequality in Pakistan
(In percent)



Sources: WDI(2016), ILOSTAT Database (2016).

Gender Gap Index

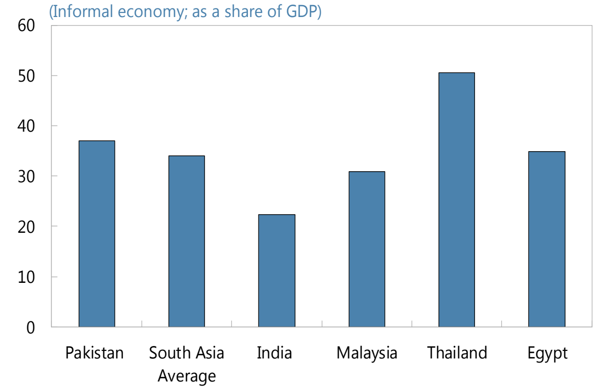


Source: World Economic Forum.

7. Furthermore, the large size of the informal economy constrains inclusiveness by limiting the creation of high quality and durable jobs and upward mobility (Box 1). The size of the informal economy is estimated to be large, in the range of 30–50 percent of the formal economy, above South Asia average. The presence of a large informal sector constrains economic growth and limits the creation of high quality and durable jobs, as workers employed in the informal sectors have no social protection coverage and limited career and upward mobility opportunities.[10]

Pakistan: A large Informal Economy

(Informal economy; as a share of GDP)



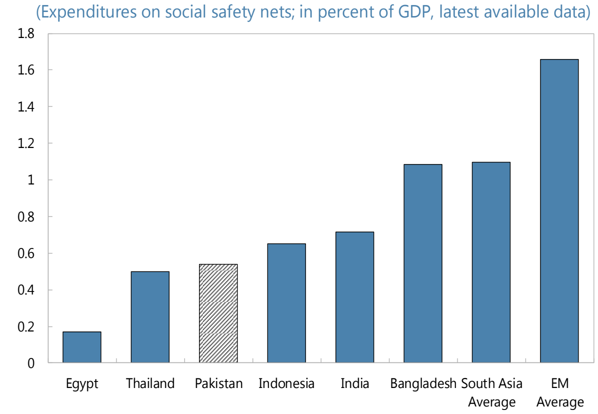
Sources: Friedrich Schneider, "The shadow economy and work in the shadow: what do we (not) know?," (2012).

B. Social Safety Nets, Targeting and Outcomes in Pakistan

8. Social safety nets have a critical role to play to support and protect the most vulnerable in Pakistan.[11] Pakistan has made progress in strengthening social protection programs to reduce poverty. Within this context, several social safety nets programs are in place, both at the federal and provincial level, which differ in terms of size, efficiency and targeted population. At the federal level, the Benazir Income Support Program is the main social safety net, complemented by smaller programs as the Zakat program, the Bait-Ul-Mal program, non-contributory Social Security and Social Welfare programs, and the Workers Welfare Fund.[12] Recently, the new Prime Minister's Health Card Program has been launched to provide free health care services to the poor. In addition to these social safety net programs, electricity and food subsidies and subsidies to foster the development of the agricultural sector are in place. Overall, expenditures

Pakistan: Social Safety Nets are Relatively Small

(Expenditures on social safety nets; in percent of GDP, latest available data)



Sources: Pakistan Authorities; IMF staff calculations; World Bank ASPIRE Database (2016)

[10] Few empirical studies have so far provided an empirical assessment of the impact of the informal economy. Elbadawy and Loayza (2008) show that an increase in informality leads to a decrease in economic growth thus hurting inclusiveness while having a positive impact reducing the incidence of poverty.

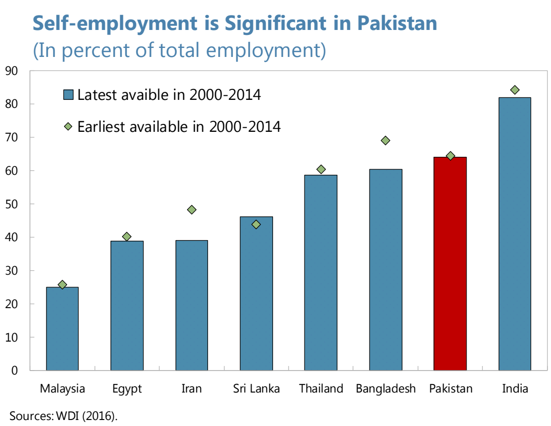
[11] Social safety nets are noncontributory measures designed to provide regular and predictable support to poor and vulnerable people and are a component of larger social protection systems (World Bank, 2015). Social safety nets include noncontributory transfers (unconditional and conditional cash-transfers, food and other in-kind transfers, school feeding programs), noncontributory social pensions, measures to provide access to essential services as education, health and housing through fee-waivers, public works and social care services. Generalized subsidies are typically not considered as part of social safety nets due to their regressive nature.

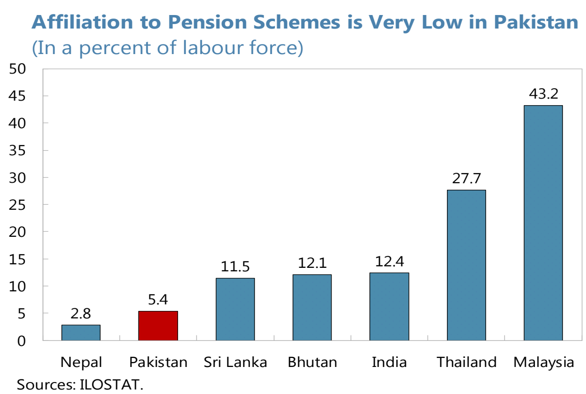
[12] This paper focuses on non-contributory social assistance programs at the federal level. Several provincial initiatives, including the Punjab Khidmat Card, the Insaf Card and low cost provision housing in Sindh also contribute to alleviate poverty. Furthermore, contributory social protection programs are also in place in Pakistan, such as the Employees Old Benefits Initiative and other social security programs.

Box 1. A Large Informal Economy Constrains Inclusiveness in Pakistan

The size of the informal economy is estimated to be large, in the range of 30–50 percent of the formal economy. Schneider (2012), using a cross-countries MIMIC model, estimates the size of the informal economy at about 40 percent of the official GDP in Pakistan, above South Asia average, with about 60 percent of the employed population is the informal economy.[1] Furthermore, the Heritage Foundation Index (2005) points to the informal economy to be large in Pakistan.[2] A significant regulatory burden may contribute to driving firms in the informal economy. Despite having slightly improved, Pakistan's ranking in the World Bank Doing Business remains low (144 out of 190 countries).

The very low affiliation to pensions schemes and high self-employment also point to the presence of a sizable informal economy. Labor market indicators of informality, as the lack of pension coverage and self-employment highlight the large size of the informal economy. In particular, affiliation rate to pension schemes is very low at 5 percent, well below comparator countries, and self-employment is high at above 60 percent.





Large informality may undermine inclusiveness in Pakistan. The presence of a large informal sector may help reduce poverty but is likely to constrain economic growth owing to firms remaining small-scale and having low productivity, and limit job creation. Furthermore, workers employed in the informal sector have no social protection coverage and limited career and upward mobility opportunities. Strengthening the business climate could contribute to reduce informality and raise inclusiveness.

[1] Kemal and Qasim (2012) estimate the informal economy in Pakistan to be at about 90 percent of the formal economy using a consumption-based household survey and calculating the discrepancy to official GDP.
[2] The Heritage Foundation index is based on subjective perception of general compliance with the law, focusing on the role played by corruption.

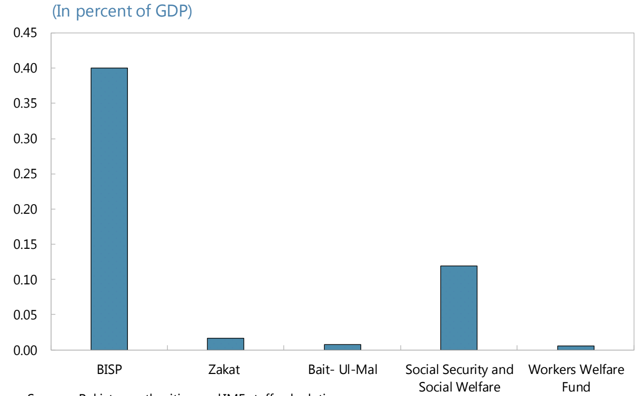
on social safety nets, excluding subsidies and provincial programs, represent 0.54 percent of GDP, well below South Asia average and emerging markets' average.

9. The efficiency of social safety nets has been strengthened over time towards the implementation of best practices.[13] The landscape of social safety nets programs has evolved through time and was significantly strengthened by the launch of Benazir Income Support Program in 2008, which provides targeted cash transfers to the poor. The efficiency of the Benazir Income Support Program was progressively strengthened over time towards best practices. Notably, the program relies on effective and transparent targeting based on proxy means testing. Furthermore, the coverage and size of transfers under the program were gradually strengthened, conditional cash transfers aiming at strengthening human capital accumulation were introduced, and program delivery is effected through modern mechanisms. Efforts to improve the targeting of smaller social safety nets programs, such as the Zakat program, are needed and consolidating them into the Benazir Income Support Program would improve the overall efficiency of social safety nets in Pakistan.

The Benazir Income Support Program

10. The Benazir Income Support Program (BISP) is the main social safety net program, providing targeted cash transfers to the poorest families. The program initially aimed to protect the poor from the negative effects of rising food and fuel prices through the provision of cash transfers, with the broader medium-term objective to provide a minimum income to the poorest and reduce poverty. The key element of BISP is the provision of unconditional cash transfers (UCTs) to poor families, which is paid on a quarterly basis directly to the woman head of the household in order to support women empowerment.[14] Furthermore, education conditional cash transfer (CCTs) started to be rolled-out in 2012 to BISP families with a child (within 5–12 years) to support enrollment, attendance and completion of primary school.[15] Disbursements under BISP have more than tripled since the launch of the program while, in parallel, untargeted energy subsidies were reduced.

BISP is the Largest Social Safety Net in Pakistan
(In percent of GDP)



Sources: Pakistan authorities; and IMF staff calculations.

[13] Efficient social safety nets are characterized by broad coverage and appropriateness of benefits, poverty-based targeting using proxy means testing, consolidation of fragmented programs, unified registry of beneficiaries to be used by different programs, modern service delivery mechanisms, programs to strengthen human capital, strong governance and dissemination of information to the poor on available programs (IMF (2014), World Bank (2012)).

[14] The BISP cash transfer is paid to the adult woman in the household, defined as every ever-married woman in the household with a valid Computerized National Identity Card.

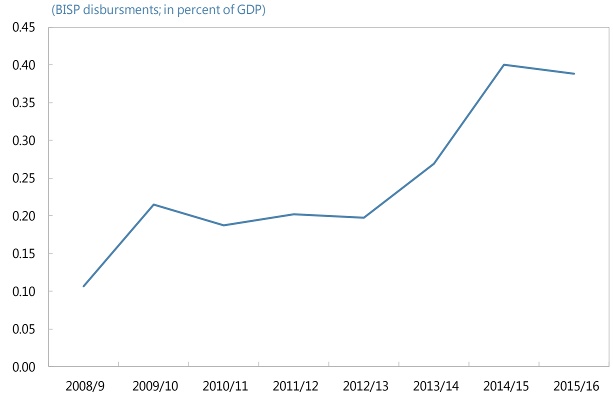
[15] In addition to UCTs and CCTs, other complementary programs are implemented under BISP as Waseela-e-Rozgar providing educational training to the youth, Waseela-e-Haq providing micro-loans to female beneficiaries and Waseela-e-Sehet providing health insurance to beneficiaries.

11. BISP's targeting mechanism has been significantly strengthened over time and relies now on proxy means testing. At the onset of the program, the identification of BISP beneficiaries was entrusted to the members of the National Assembly since no reliable database of the poor was available.[16] A new and more transparent targeting mechanism based on a proxy means test was introduced in 2009, with the support of the World Bank, providing an objective method of approximating households' welfare and poverty status. A poverty scorecard was applied in a door-to-door country-wide survey covering 27 million households (almost the full population of Pakistan) and, based on a cut-off to the resulting poverty score, 7.7 million poor households (about 29 percent of overall surveyed households) were identified as eligible for BISP cash transfers.[17] On this basis, the National Socio-Economic Registry, Pakistan's most comprehensive and reliable database of the poor, was also established. Overall, BISP is perceived to be targeted relatively fairly and protect the poorest households.

12. The coverage and the size of cash transfers to the poor have increased over time. Since 2013, the scope and the coverage of BISP were scaled-up. The budgetary allocation for the program increased from PRs 50 billion in FY2013/14 to PRs 102 billion in in FY2016/17, with PRs 115 billion budgetary allocation for FY2017/18. During 2013–17, the size of UCTs was increased by more than 50 percent, with stipends increasing from PRs 3,000 to PRs 4,834 (about US$46) per beneficiary per quarter.[18] In parallel, while still not reaching the full set of intended beneficiaries, the coverage of the program was significantly broadened to reach to about 5.4 million beneficiary households (17 percent of the national population) in FY 2016/17 (from 3.8 million households in FY 2012/13). Similarly, the coverage of CCTs (PRs 750 per child/per quarter) was gradually expanded from 5 to 32 districts to cover about 1.3 million children in FY 2016/17 (from 52,000 children in 2012).

Disbursments under BISP have streghtened over time

(BISP disbursments; in percent of GDP)



Sources: Pakistan authorities; and IMF staff calculations.

[16] A cut-off income threshold for eligibility to BISP was established (PRs 6,000 monthly income per family), families could apply for income support, and each parliamentarian was assigned to review an equal number of applications, irrespective of political affiliation, and decided on the family's eligibility.

[17] The survey was conducted on the basis of a questionnaire relying on a wide range of questions, including composition and characteristics of household roster, age, education, employment and disability status of household members, nature of dwelling, moveable and fixed assets. The Poverty Scorecard generated a poverty score for each surveyed households (from 1–100) and household below the established cut-off score (of 16.17) were considered eligible to receive cash transfers through BISP.

[18] BISP quarterly stipends were increased from PRs 3,000 at end-June 2013 to PRs 4,700 at end-June 2016. In particular, stipends were increased by 4.5 percent in FY 2015/16 in order to protect the beneficiaries' purchasing power.

13. BISP operations were also significantly strengthened thus improving service to beneficiaries. Despite some remaining delays, the frequency and predictability of payments to beneficiaries has improved substantially, both in terms of number of payments and amounts disbursed, strengthening confidence in the program. The modality of payments delivery was also significantly improved, from the initial money orders through the postal system to the introduction of a dedicated BISP debit card with access to any ATM in Pakistan. Most beneficiaries are now receiving their cash transfers through the BISP debit card while beneficiaries in remote communities with limited financial access still receive transfers via money orders. As a result, transparency improved and the proportion of beneficiaries reporting to have to pay a "fee" to an intermediary in order to collect their transfer has declined. Furthermore, a new biometric-based transaction system was rolled out in September 2016 aimed at reducing fraudulent behavior, and contracts with commercial banks are being strengthened.

14. BISP has contributed to lifting targeted households out of poverty, reducing the poverty gap, and improving welfare of beneficiary households. A recent impact evaluation analysis of BISP assessed outcomes for beneficiaries against key objectives, including poverty reduction, women's empowerment and improved household and child nutrition (Oxford Policy Management, 2015).[19] During 2011–14, BISP cash transfers are estimated to have contributed to reduce poverty, with the proportion of beneficiaries living below the poverty line declining by about 20 percentage points, relative to non-beneficiaries. Furthermore, BISP contributed to reducing the depth of poverty among beneficiaries, leading to a reduction in the poverty gap by 3 percentage points relative to non-beneficiaries. BISP has also strengthened women's empowerment by increasing women's access to cash and reducing dependence on their husbands' support. BISP transfers also contributed to reduce malnutrition amongst girls, with rates of stunting falling by 4 percentage points, relative to non-beneficiaries. Despite increasing primary enrollment of BISP beneficiaries'' children by 10 percent, the impact of BISP on children's education remains limited, since the size of the educational cash transfer remains low compared to the cost of schooling, one of the main reasons cited by BISP beneficiaries for children not to attend school.[20]

15. BISP should be strengthened by updating the beneficiaries' database and broadening coverage, and stepping up educational cash transfers. Challenges include an outdated beneficiaries' database, potential lack of awareness, and beneficiaries not having identification cards which are required to receive the cash transfer. Broadening BISP coverage is important to strengthen the program's impact and make a dent on poverty. Notably, reaching additional 1 million poor households could lift out of poverty about 1.5 million additional people and reduce the poverty rate

[19] A second round impact evaluation analysis was conducted in 2014 to assess the impact of BISP on beneficiaries against key objectives of the program: poverty reduction, women's empowerment, improved household and child nutrition, and increased asset retention. A quasi-experimental method was used, based on a comparison between a treatment group of beneficiaries of BISP against a control group of households' non-beneficiaries of BISP but just above the BISP threshold scorecard (Oxford Policy Management, 2015). This followed the first round evaluation impact analysis conducted in 2013.

[20] The cost of schooling includes costs of uniforms, books, supplies, transports and others (Oxford Policy Management, 2015).

by about 0.7 percent. However, further progress is constrained by several factors, including an outdated beneficiaries database, potential lack of awareness, and beneficiaries not having identification cards which are required to receive the cash transfers. Thus, ongoing efforts to further strengthen the program's targeting and updating the beneficiaries database based on a planned new national survey are important and should be continued. To this end, the poverty scorecard methodology was updated and a pilot for the new survey was finalized in selected districts, with the full national survey expected to be completed by end-2017 and the new BISP beneficiaries' database by mid-2018. To ensure high enrollment, efforts should focus on strengthening awareness among the poor, notably in rural areas, of their eligibility, enhancing capabilities to follow geographical movements of eligible beneficiaries, and helping beneficiaries to obtain identification cards. Finally, increasing the size of educational cash transfers provided under BISP is needed to cover costs of schooling and foster children's school attendance and human capital accumulation.

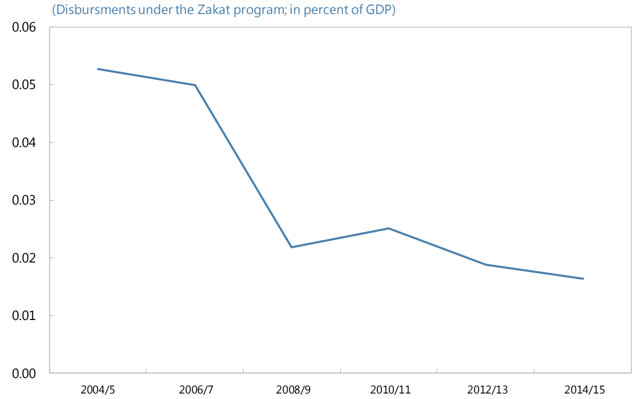
Other Social Safety Nets in Pakistan

16. Several noncontributory social security and social welfare programs, managed by different Ministries, aim at meeting social welfare needs at the level of local communities. These programs include social pensions to the needy, extending social welfare programs in underdeveloped rural areas, and supporting non-profit organizations. Overall expenditures under the Social Security and Social Welfare programs reached about 0.1 percent of GDP in FY 2014/15, covering about 0.4 million beneficiaries.

17. The public Zakat program is a nation-wide social assistance program which supports poor and needy Muslims. The Zakat program, implemented by the Ministry of Religious Affairs, is based on the Islamic injunction of charity which mandates Muslims to give a percent of their wealth to the poor (zakat).[21] Financed by voluntary private contributions, the Zakat program provides financial support to deserving and needy poor Muslims through monthly allowance to households (the Guzara allowance, the program's main component), stipends to students, and health care coverage. Differently from BISP, the Zakat program lacks a formalized targeting mechanism, and the local zakat committees have substantial discretion on eligibility decisions. Disbursements under the public Zakat program have significantly declined over time to

Disbursements under the Zakat program have halved

(Disbursements under the Zakat program; in percent of GDP)



Sources: Pakistan authorities; and IMF staff calculations.

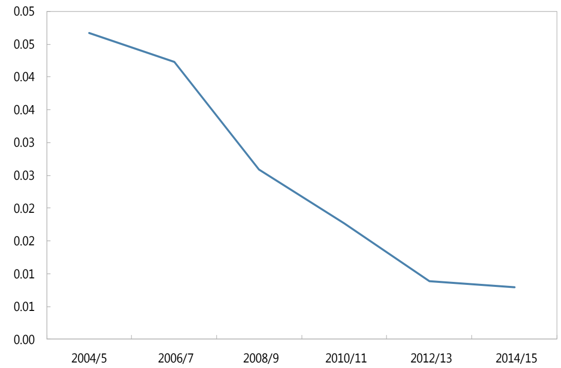
[21] A tax levy (2.5 percent) used to be imposed on financial assets of individuals, including bank deposits above a certain threshold, and collected into the Central Zakat Fund. Since 1999, the supreme court ruled for zakat to be voluntary.

0.02 percent of GDP in FY 2014/15. In parallel, the number of beneficiaries has also declined to 0.8 million from 2.5 million beneficiaries in the mid-2000s. However, zakat contributions outside the governmental program have continued supporting extensive private philanthropic initiatives so that the number of beneficiaries of the Zakat system outside the official program is much higher.

18. The Bait-Ul Mal program and the Workers Welfare Fund are the other main social safety nets programs. Launched in the early 90s, the Bait-Ul-Mal program is a budgetary-funded program which provides housing, financial support and education to orphans as well as financial assistance to widows, elderly and invalids. Disbursements under the Bait-Ul-Mal program have declined over the last decade, reaching 0.01 in percent of GDP in FY 2014/15, with the number of beneficiaries almost halving to 0.9 million. Furthermore, the Workers Welfare Fund, a federally-managed fund governed by a tripartite body—representing the government, employers and workers—and financed by industrial establishment, aims at improving industrial workers' welfare through several initiatives, including the provision of low-cost housing, marriage and death grants, educational scholarships for workers' children, construction of education and health facilities.[22] Disbursements under the Workers Welfare Fund were at 0.01 percent of GDP in FY 2014/15, covering about 21,000 beneficiaries.

Disbursments under the Bait-Ul-Mal have been declining

(Bait-UL-Mal disbursments; in percent of GDP)

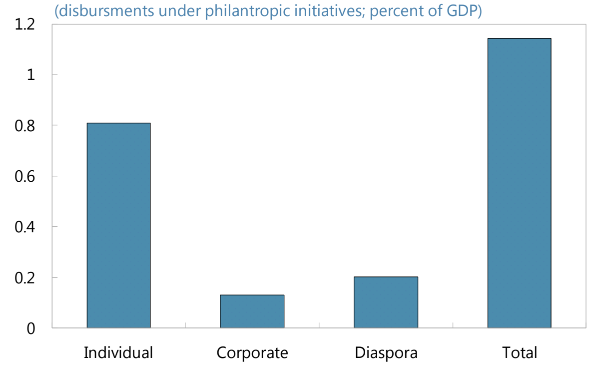


Sources: Pakistan authorities; and IMF staff calculations.

19. In addition to public social safety nets, sizable private philanthropic initiatives aim at reducing poverty and fostering development. Private philanthropy in Pakistan is large, estimated at 1.1 percent of GDP, more than twice the size of the BISP program.[23] In particular, individual philanthropic initiatives reach 0.8 percent of GDP while philanthropy by the diaspora abroad represent about 0.2 percent of GDP.

Philanthropy is sizable in Pakistan

(disbursments under philantropic initiatives; percent of GDP)



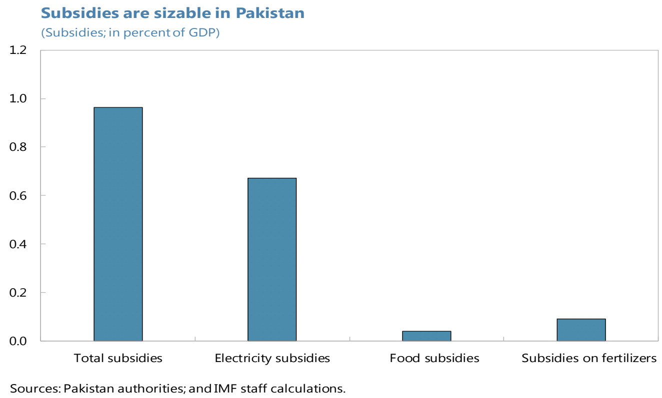
Sources: Pakistan Centre for Philantrophy (2016).

[22] The Workers Welfare Fund is financed by contributions from industrial firms with total income above PRs 5000,000, which have to provide to the Fund two percent of their profits.

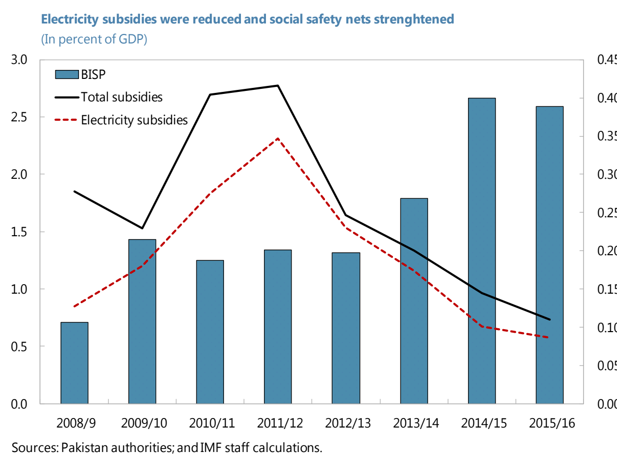
[23] This includes private, corporate and diaspora philanthropy (Pakistan Centre for Philanthropy).

The Role of Subsidies

20. Subsidies remain an important element through which social assistance is delivered in Pakistan. Overall subsidies at the federal level have significantly declined over the last years, from about 3 percent of GDP in FY 2011/12 to close to 0.8 percent in FY 2015/16. Electricity subsidies represent the bulk of subsidies, at about 0.6 percent of GDP in FY 2015/16. On a much smaller scale, a price subsidy scheme on fertilizers for agricultural producers to support the sector and subsidies on some food items, such as wheat and sugar, are in place.



21. Electricity subsidies were significantly reduced owing to reforms efforts while, in parallel, targeted cash transfers to the poor were increased. In an environment of lower oil prices, electricity subsidies were reduced by 1½ percent of GDP during 2013–16, on the back of increases in electricity tariffs, the introduction of surcharges to better reflect costs, and the elimination of untargeted generalized subsidies for commercial and industrial consumers and for the highest-volume residential consumers.[24] The targeting of electricity subsidies was strengthened, with subsidies maintained for selected consumer categories. Notably, a life-line tariff is charged to vulnerable consumers (electricity usage up to 50 kWh/per month) and concessional tariffs are charged for low to moderate consumption levels (usage up to 300 kWh/per month) and for agriculture tube wells to support the agricultural sector. In parallel to the subsidies reform, social safety nets were strengthened and cash transfers to the poor under BISP were increased by about 0.3 percent of GDP.



22. Continuing reform efforts to further reduce electricity subsidies are needed to achieve better targeting of the poor and free up resources for growth-supporting priority spending. The electricity consumption threshold for the concessional tariff remains high, with most households consuming less than 300 Kwh/per month and thus benefiting from subsidies, while subsidies for the life-line tariff for the smallest consumers (up to 50 Kwh/month) account for only about 8½ percent

[24] The Tariff Differential Subsidy (TDS) is the main component of electricity subsidies, a transfer from the government to the power distribution companies (DISCOs) to compensate for the difference between tariff that would allow each DISCO to fully recover their costs and the Uniform Minimum Tariff notified at the national level. In addition, certain categories of consumers are protected by being charged a tariff which is below the determined minimum tariff.

of the overall subsidies envelope. Lowering the consumption threshold for the concessional electricity tariff would contribute to making remaining electricity subsidies less regressive and reducing their level. Also, since many among the poor might not have electricity access, subsidies could be fully eliminated and targeted cash transfers to protect the poor could be stepped up.

C. Frontier Analysis: The Efficiency of Social Safety Nets and Social Programs in Pakistan

23. A frontier analysis approach provides useful insights on the efficiency of Pakistan's public spending on social safety nets and social programs towards achieving their objectives. A cross-country comparison of public spending in social safety nets and in education and health against selected social indicators is used to assess how Pakistan's spending on these programs measures up against progress in reducing poverty and inequality and improving education and health outcomes. However, these results have to be interpreted carefully since many factors contribute to the extent of poverty and inequality as well as education and health outcomes.

Efficiency of Spending in Social Safety Nets in Reducing Poverty and Inequality

24. Public spending on social safety nets in Pakistan remains relatively low amid still high poverty. While many other factors affect poverty outcomes, a cross-country comparison shows that spending on social safety nets, excluding subsidies and provincial outlays, in Pakistan remains relatively low and poverty has remained relatively high compared to other countries (Figure 4).[25] First, most countries have a higher level of spending in social safety nets (in percent of GDP) than Pakistan which, in turn, tends to be associated with lower poverty headcounts and multi-dimensional poverty rates. Furthermore, most countries with a level of public spending on social safety nets close to or lower than Pakistan tend to have lower poverty and multi-dimensional poverty rates.

25. Similarly, the relatively low level of spending on social safety nets in Pakistan is associated with relatively higher inequality. Focusing on non-monetary indicators of inequality such as education and health gaps among the top and the bottom quintile, a cross-country comparison highlights that inequality is relatively high given the level of spending in social safety nets in Pakistan (Figure 4). Notably, countries with spending on social safety nets (in percent of GDP) close to or lower than Pakistan's tend to have smaller gaps in years of schooling and stunting among children between the poorest and the richest quintiles.

[25] To ensure cross-country comparison, poverty incidence data used in the frontier analysis are based on a US$3.1 per day poverty (World Bank Development Indicators). This leads for Pakistan to a poverty rate of 38 percent, higher than under the 2016 national poverty line (29.5 percent).

Efficiency of social spending on education and health outcomes

26. Public spending on education remains relatively low amid weaker outcomes in Pakistan. A cross-country comparison highlights that Pakistan's public spending on education (in percent of GDP) lags behind comparator countries, with most countries having higher public spending in education associated with better education outcomes (Figure 5).[26] Furthermore, most countries with a level of public spending on education close to or lower than in Pakistan tend to have better education outcomes such as higher youth literacy rates and primary school enrollment ratios.

27. Similarly, public spending on health in Pakistan is very low compared to other countries and it is associated with weaker outcomes. Pakistan's public spending on health (in percent of GDP) is among the lowest in the sample, with most countries having higher spending than Pakistan and stronger health outcomes (Figure 5). Furthermore, data suggests that countries with spending on health close to Pakistan's tend to display better health outcomes as higher life expectancy and lower infant mortality rates.

D. Policy Recommendations and Conclusions

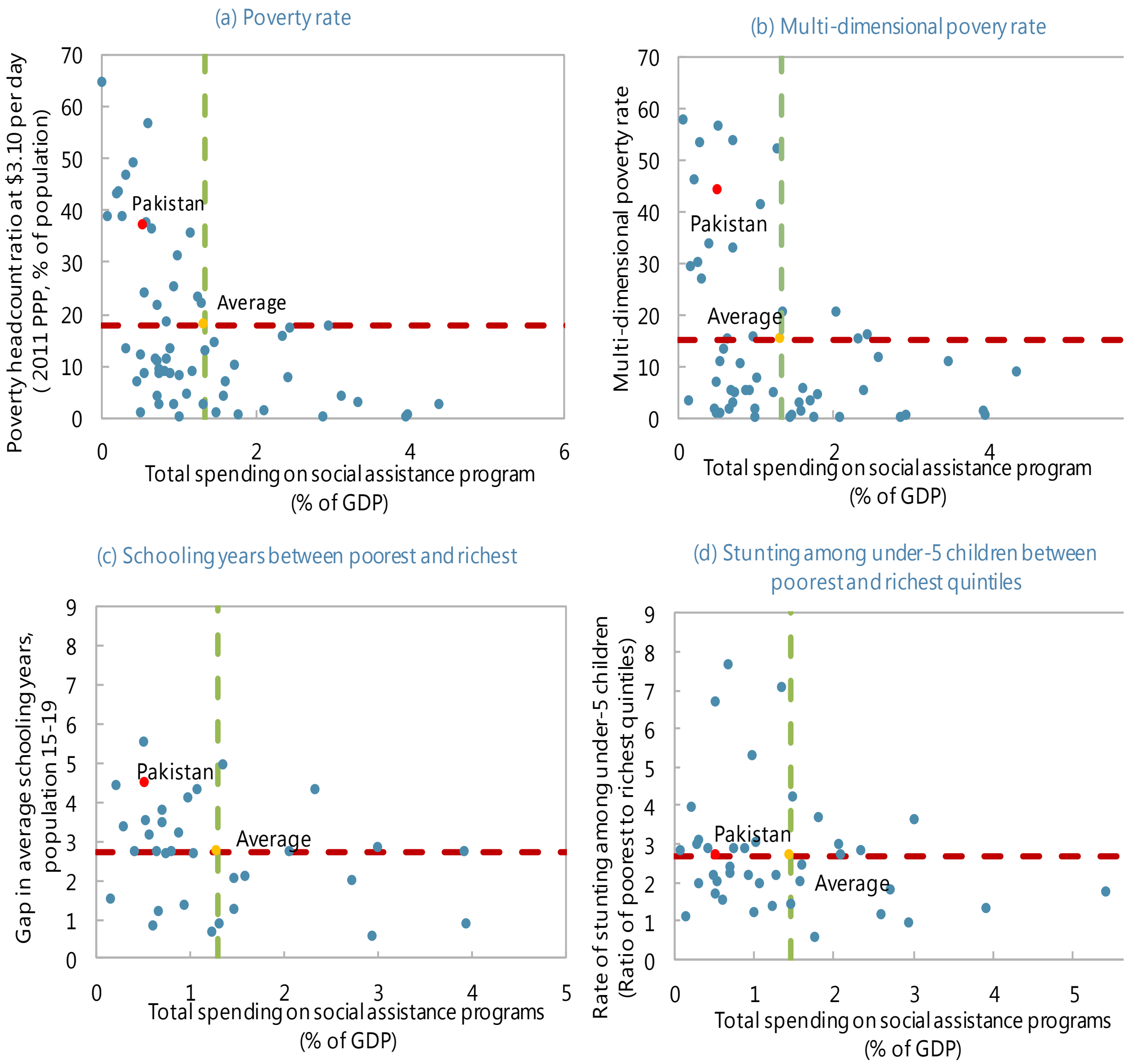
28. Significant progress has been made over the past decades to reduce poverty in Pakistan. However, about 30 percent of the population still lives below the poverty line, about 39 percent experiences multi-dimensional poverty, and children's stunting and malnutrition remain high. Education and health outcomes are weaker than South-Asia average and social spending in these areas remains below emerging markets' average, in part reflecting implementation and capacity constraints at the provincial level. While income inequality is relatively moderate, gaps in education and health outcomes between genders and the richest and the poorest quintiles are sizable. The size of the informal economy is estimated to be large, which is likely to contribute to these outcomes.

29. Generating higher and more inclusive growth is the top priority to make a dent poverty and inequality. Further efforts are needed to raise the living standards of the population, generating sustainable jobs and ensure shared equality. To this end, Pakistan will need to preserve macroeconomic stability, a necessary pre-condition to foster higher private investments and private-sector led growth. Furthermore, moving ahead with key growth-supporting structural reforms is crucial, in particular advancing the energy sector reform, restructuring and privatizing public sector enterprises, improving the business climate and strengthening governance. Dedicated efforts are also needed to strengthen gender equality, including through reforms to boost female labor force participation.

[26] Private schooling is sizable in Pakistan, with enrollment representing more than 1/3 of enrollment in public schools.

Figure 4. Pakistan: Lower Spending on Social Safety Nets and Higher Poverty and Inequality 1/

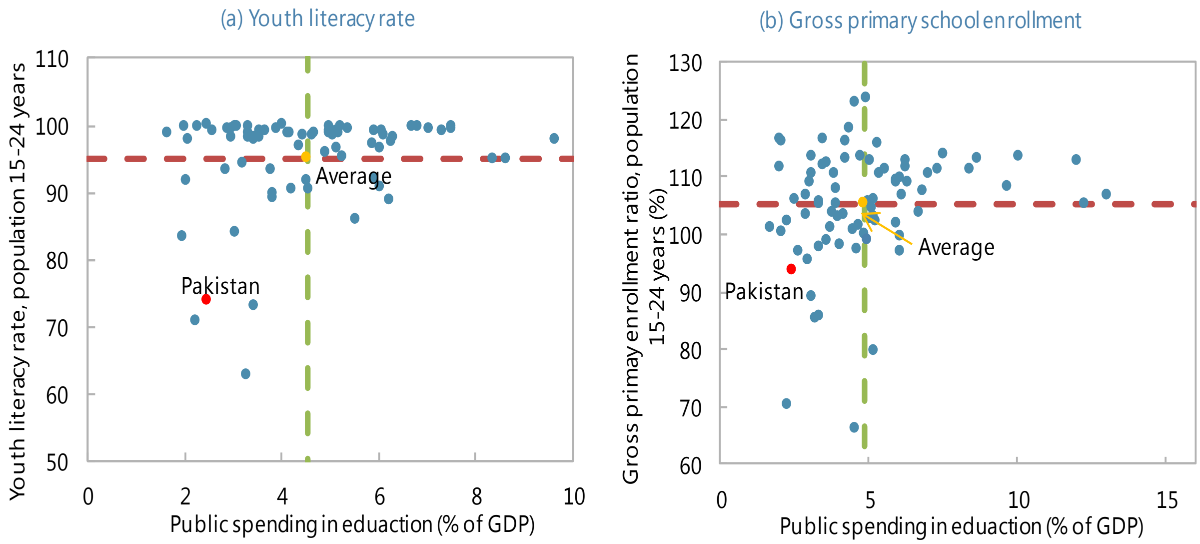
Efficiency of Spending in Social Safety Nets



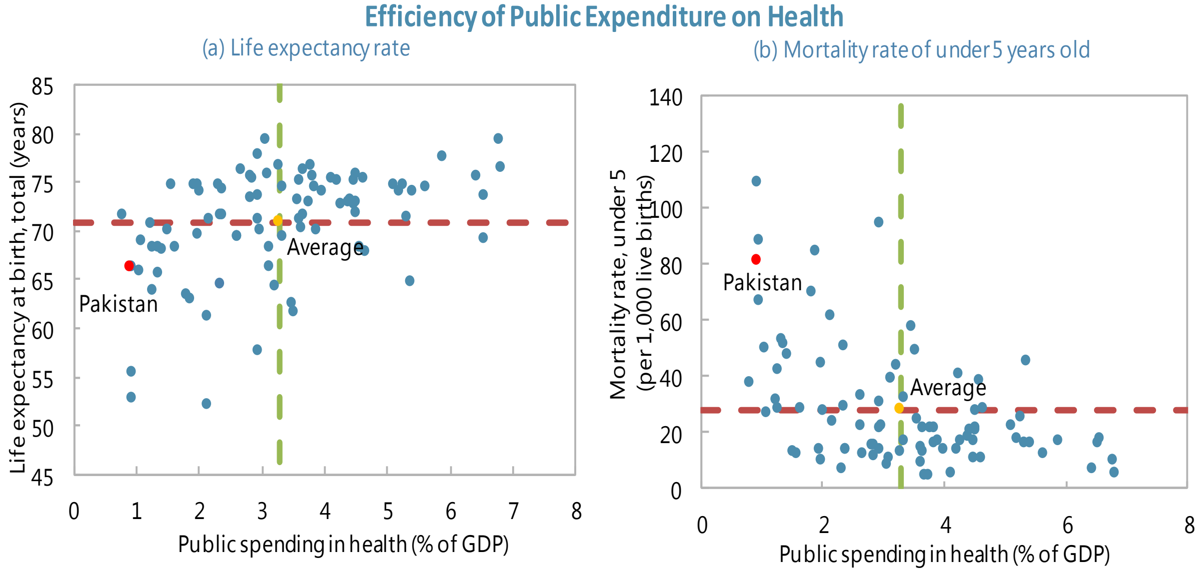
Sources: Human Development Reports (2016), ASPIRE Database (2016), WDI (206), and IMF Staff estimates.
1/ The sample comprises middle income economies (2015 GNI per capital was between US$1,026 and

Figure 5. Pakistan: Lower Social Spending in Education and Health and Weaker Outcomes 1/

Efficiency of Public Expenditure on Education



Efficiency of Public Expenditure on Health



Sources: WDI (2016).

1/ The sample comprises middle income economies (2015 GNI per capital was between US$1,026 and

30. Stepping up expenditures on social safety nets is needed to support the most vulnerable. With high poverty and inequality, social safety nets have a critical role to play to support the poor and protect the most vulnerable. However, despite having strengthened over time, the size of social safety nets remains low against regional and emerging markets' averages. Furthermore, efficiency frontier analysis suggests that low spending on social safety nets is associated with higher poverty and inequality. BISP, the main social safety net program, provides cash transfers to poor households using an effective targeting mechanism and it is underpinned by sound delivery infrastructure. However, it remains small and thus has a limited impact on poverty reduction.

31. Keeping the reform momentum is needed to further reduce electricity subsidies and free up public resources to strengthen social safety nets and growth-supporting priority spending. Subsidies remain sizable, with an overall envelope larger than the combined disbursements under social safety nets programs. Electricity subsidies, representing the bulk of subsidies, were substantially reduced in recent years but remain sizeable and poorly targeted. Further reducing electricity subsidies and improving their targeting are needed to free up public resources and increase targeted social safety nets and growth-supporting expenditures. To this end, reducing the consumption threshold to benefit from the concessional electricity tariff, or fully eliminating electricity subsidies while increasing targeted cash transfers to the poor should be explored.

32. Broadening BISP coverage, updating its beneficiaries' database, and increasing educational transfers will improve the efficiency of social safety nets in reducing poverty and inequality. Swiftly extending BISP coverage to include all eligible poor households, while continuing to protect beneficiaries' purchasing power, will be key to increase the program's impact towards reducing poverty and inequality. In this vein, resources allocated to smaller and poorly targeted social assistance programs could be consolidated into BISP thus increasing overall efficiency. In addition, finalizing ongoing efforts towards strengthening BISP targeting and updating the BISP beneficiary database will allow to better reach the poorest. Finally, increasing educational conditional cash transfers under BISP would allow to better cover children's schooling costs and raise the program's impact on school enrollment, attendance and education outcomes.

33. Furthermore, stepping up public social spending is needed to improve education and health outcomes. Despite having slightly increased, Pakistan's public spending in education and health remains very low compared to emerging markets' average. Efficiency frontier analysis suggests that social spending in Pakistan is low compared to other countries, and is associated with weaker education and health outcomes. Thus, moving forward with reforms to mobilize higher fiscal revenues is needed to create additional fiscal space to increase growth-supporting social spending. Furthermore, strengthening the implementation capacity of the provinces is needed to ensure higher and more efficient social spending in education and health.

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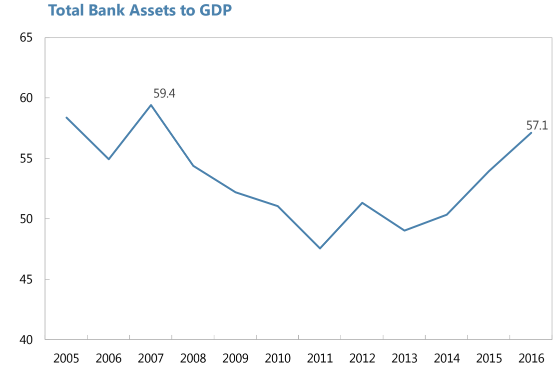
SUPPORTING GROWTH AND INCLUSION THROUGH FINANCIAL DEVELOPMENT[1]

Continuing to foster financial deepening and inclusion in Pakistan will be important to increase the resilience of its economy to shocks and to promote economic growth and equality. It will help channel savings towards productive investment, improve the allocation of resources, foster sharing of information and allow to better diversify risks. Applying recently developed cross-country measures of financial development and inclusion based on Sahay et al., (2015b) and Aslan et al. (2016), the paper finds that financial development trends show a beginning recovery in financial depth following a decade of decline, low yet quickly growing levels of access and financial inclusion, and overall favorable efficiency of the banking system. Despite recent trends and significant efforts, Pakistan still lags behind peers and countries with similar fundamentals, illustrating the large potential for further improvement. Quantifying the effects of progress in financial development on economic growth, the paper finds that raising the level of development of Pakistan's financial institutions to average emerging market levels could generate annual economic growth dividends of about 1 percent. To promote greater financial deepening and inclusion, policies should continue to focus on reinforcing macroeconomic resilience; strengthening institutional and regulatory frameworks; operationalizing the planned deposit insurance; creating conditions that allow for a greater role of private credit; boosting financial coverage of underserved segments such as women, low-income and rural population, and SMEs; and further promoting Islamic finance.

A. Introduction

1. **The financial sector in Pakistan is diverse and growing, but remains small**. Banks dominate the industry, commanding 74 percent of total assets, are predominantly private, with high penetration of foreign ownership and a quickly growing Islamic component. The rest of industry includes a variety of non-bank and other specialized financial institutions (Box 1). The banking system is small relative to regional peers and countries with similar fundamentals. It declined after global financial crisis, but has begun to expand again as a share of GDP.

Total Bank Assets to GDP



Source: IMF International Financial Statistics

[1] Prepared by Maxym Kryshko (MCD) and Abdullah Haron (MCM).

Box 1. Pakistan Financial Sector Snapshot

The financial sector is diverse, but remains dominated by banks. Banks account for 74 percent of total financial sector assets and are classified into five major groups. There are 5 public sector commercial banks (about 19 percent of bank assets) and 21 local private commercial banks (76 percent). The penetration of foreign ownership is high, as more than 50 percent of total banking sector shareholders' capital is foreign owned. Since 2001, the enabling regulatory environment and large Muslim population helped Islamic banking grow very rapidly to get to the current market share of about 12 percent. The remaining categories represent microfinance banks (1 percent of bank assets) and specialized banks, focusing on particular groups of customers such as rural or industrial customers and small and medium enterprises (2 percent).

The rest of the financial sector comprises a variety of non-bank and other specialized financial institutions. The largest is the National Savings Scheme (NSS; 15 percent of assets), a public sector savings program channeling retail savings into government debt. The second largest is insurance industry (5 percent of assets). It includes 36 life, non-life and reinsuring companies and is dominated by three state-owned entities. Other non-bank financial institutions are primarily mutual funds (accounting for two thirds of the non-bank non-specialized financial sector assets), pension funds, development finance institutions, leasing companies, investment banks, real estate investment trusts and Modaraba Islamic funds.

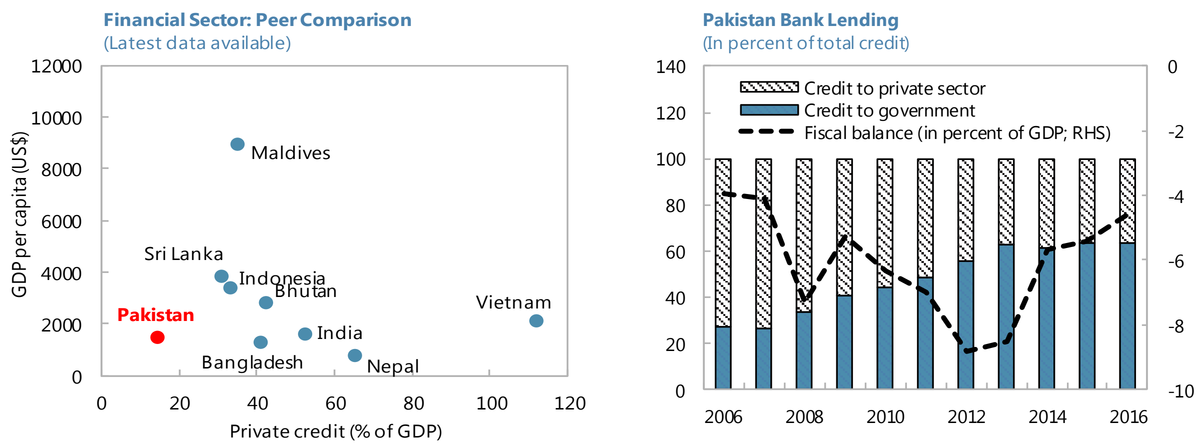
Pakistan: Financial Sector Structure

as of end-December 2016

		Assets	
	Number	PRs billion	Share, %
Banking System	**45**	**16,001**	**74.0**
of which Islamic financial institutions	*21*	*1,853*	*11.6*
Islamic banks	**5**	1,147	7.2
Islamic banking branches	16	706	4.4
Public sector commercial banks	5	2,964	18.5
Private commercial banks, incl. IBs	21	12,226	76.4
Foreign banks' branches	4	391	2.4
Specialized banks	4	250	1.6
Microfinance banks	11	170	1.1
Non-bank and Other Specialized Financial Institutions	**314**	**5,636**	**26.1**
Insurance Companies	36	1036	18.4
Non life	29	177	3.1
Life	6	841	14.9
Reinsurance	1	18	0.3
Asset management companies	22	39	0.7
Mutual funds	175	654	11.6
Pension funds	17	23	0.4
Discretionary and Non-discretionary portfolio management		140	2.5
REIT	1	40	0.7
Leasing companies	8	44	0.8
Modarabas	25	41	0.7
Investment bank and MFIs	21	123	2.2
National Savings Scheme (NSS)	1	3,287	58.3
Development Finance Institutions	8	209	3.7
TOTAL	**359**	**21,635**	**100**

Sources: State Bank of Pakistan, unaudited financial statements of financial institutions. Insurance data is as of September 30, 2016.

Figure 1. Pakistan's Financial Sector: Peer Comparison and Bank Lending



2. While the government has remained large borrower from the banking system, lending to the private sector has begun to recover. Bank private credit significantly contracted after 2008 before beginning to recover over the past few years to 15.1 percent of GDP (2016), but continues to lag behind economies in South Asia and countries with similar income and population (Figure 1). The decline reflected an upsurge in non-performing loans after 2008 and large government financing needs that led banks to increasingly orient their lending activities to the government (Figure 1). NPLs have declined since mid-2011, and, more recently, private credit growth has begun to pick up amid a decline in the fiscal deficit.

3. The efficiency of the financial sector remains favorable. Pakistani banks feature sound profitability, low overhead costs, and a favorable share of non-interest income in total income, as they were able to generate revenue outside traditional financial intermediation.

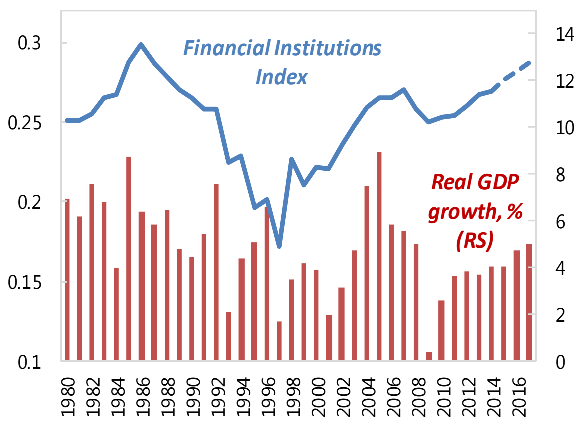
4. Access to finance and the use of financial services in Pakistan have been rising from a low base and have significant potential for further improvement. Despite significant progress, few firms have access to bank loans or enjoy a credit line and, per World Bank's Findex data, less than ten percent of adult population have accounts with formal financial institutions.[2] Very few people use these accounts to receive wages or government transfers or to pay utility bills, and very few people use financial institutions for their saving and borrowing needs. Although the most recent survey by the State Bank of Pakistan indicates that between 2008 and 2015 the share of adults formally served by the financial system has doubled and the share of women has almost tripled (Figure 2), major gaps remain, in particular regarding financial exclusion of women, rural population

[2] According to State Bank of Pakistan's Access to Finance 2015 Survey, around 16 percent of adults have access to formal bank accounts.

and small and medium enterprises. A National Financial Inclusion Strategy, spearheaded by the SBP, has been adopted in 2015 and an action plan to boost financial inclusion is being implemented. These efforts have been recognized internationally as Pakistan has been ranked among the top five countries for its enabling environment for financial inclusion (Economist Intelligence Unit's Global Microscope 2015 and 2016).

Figure 2. Progress in Financial Sector Development and Inclusion

Financial Institutions Index



Source: Sahay et al (2015b). Dashed line is authors' approximation.

Financial Inclusion - Demand Side

Percentage of Adult population	2008	2015
A. Banked	11%	16%
of which women	4%	11%
B. Other formal	1%	7%
Formally Served (A+B)	12%	23%
C. Informally Served	32%	24%
Financially Served (A+B+C)	44%	47%
Financially Excluded	56%	53%

Source: SBP Access to Finance Survey, 2015

5. **A stronger, more developed, deep, and inclusive financial sector would help Pakistan increase the resilience of its economy to shocks and to promote strong economic growth and greater equality**. It will also help channel savings towards productive investment, improve the allocation of resources, foster sharing of information, and allow to better diversify risks. Countries with better functioning banks and markets grow faster and better financial systems ease the external financing constraints that impede firm and industrial expansion (Levine, 2005). Similarly, more inclusive financial systems allow the poor and other disadvantaged groups such as women, youth and rural population to smooth their consumption over time by insuring themselves against many economic vulnerabilities, to build assets and to make business and human capital investments that would improve their livelihood, thereby contributing to reduced poverty and income inequality (Demirguc-Kunt, Klapper, Singer, Van Oudheusden 2015; Demirgüç-Kunt, Levine 2009). At the same time, as the size of the sector and access to bank credit grow, economic and financial stability risks may increase and would require continued adequate focus on proper regulation, supervision and risk mitigation (Sahay et al., 2015a).

6. This paper assesses Pakistan's financial development and inclusion, estimates potential growth gains from further financial deepening, and suggests policies in support of these goals. We first use recently developed measures of financial development and inclusion (Sahay et al., 2015b; Aslan et al., 2016) to document where Pakistan stands relative to regional peer countries and countries with similar fundamentals (Section II). The exponential growth of Islamic banking in Pakistan and its contribution to financial development warrant particular focus in this section. Then, we proceed to quantifying the effects of progress in financial development on economic growth (Section III). Finally, we suggest policies that would help promote greater financial deepening and inclusion and secure safe and sound financial development.

B. Financial Development and Inclusion: Where Do We Stand

7. Financial development and inclusion have made progress over the past decades, with large potential for further improvement. Despite some peaks and troughs reflecting economic crises and political and security uncertainty, the composite index of financial institutions' development (Box 2) has increased by more than 33 percent over the past two decades. The most recent SBP survey indicates that from 2008 to 2015, the number of people formally served by the financial system has increased from 12 to 23 percent (Figure 2). However, major gaps remain, in particular on the financial inclusion side, where Pakistan still ranks very low against peers and where financial exclusion of women, rural population and small and medium enterprises persists.

8. The overall level of financial institutions' development has more than recovered from its post-2008 decline, but remains low. Although the index has recovered and surpassed pre-crisis levels on the back of strengthening economic growth and a conducive regulatory environment (and made sizable progress relative to 1997 trough), it remains just slightly below its 1980s average, underscoring the potential for further improvement.

9. While Pakistan lags behind its peers in the level of development of financial institutions, recent trends show positive momentum. A comparison to regional countries and peers with similar income and population suggests that Pakistan has strong potential to further strengthen the level of development of its financial institutions. In 2014, the indices of financial institutions in Asia and Pacific and in the Emerging Market economies exceeded that of Pakistan by 54 percent and 71 percent, respectively[3].The rankings of South Asian peers such as Bangladesh, India, and Sri Lanka were 7 to 33 percent higher.[4] That said, from 2007, a peak year just before global financial crisis, financial institutions in all peer economies have sizably improved, while Pakistan's index initially fell and by 2014 had just recovered to pre-crisis levels (Figure 3). Since 2014,

[3] 2014 is the latest data point available for comparator countries. Data for Pakistan in 2015 and 2016 are the authors' estimates.

[4] In part, subdued performance is due to particularly difficult challenges that Pakistan—unlike other South Asian nations—has faced, including security issues and terrorist attacks. It may also reflect a more market- and incentives-driven approach to developing – largely private – financial sector, as different from rather direct state intervention.

Box 2. Measuring Financial Development and Inclusion

FINANCIAL DEVELOPMENT

The IMF has recently developed a new measure that captures the level of countries' financial development more comprehensively and systematically. The so called *financial development index* (Sahay et al 2015b, Svirydzenka 2016) provides an aggregated assessment of country's financial institutions such as banks, insurance companies, mutual funds, and pension funds, and of financial markets such as stock and bond markets. It captures well the fact that in many countries markets are relatively underdeveloped, financial systems are bank dominated and that, as they mature, firms and individuals would aim to diversify beyond banks for their financial needs. Financial development is defined as a combination of depth (size and liquidity of markets), access (ability of individuals and companies to access financial services), and efficiency (ability of institutions to provide financial services at low cost and with sustainable revenues, and the level of activity of capital markets), each evaluated separately for financial institutions and financial markets. The overall index of financial development aggregates these sub-indices and covers 183 countries between 1980 and 2014 on annual basis.

Financial Institutions

Depth: Private sector credit to GDP, pension fund assets to GDP, mutual fund assets to GDP, insurance premiums, life and non-life, to GDP.

Access: Bank branches per 100,000 adults, ATMs per 100,000 adults.

Efficiency: Net interest margin, lending-deposits interest spread, non-interest income to total income, overhead costs to total assets, return on assets, return on equity.

Financial Markets

The Financial Markets index combines the depth, access and efficiency sub-indices that reflect level of development of stock and bond markets. However, it is less useful for the purposes of this paper since in Pakistan it is highly correlated with the stock market and business cycle: correlations with the stock trade and stock turnover ratios are 76 and 82 percent, respectively.

In this paper, we therefore focus on the financial institutions component of financial development as the most representative of structural change in Pakistan.

FINANCIAL INCLUSION

Financial inclusion is a multifaceted concept and the index of financial development captures only the access part of it. Following Sahay et al (2015a), we define financial inclusion broadly as the access to and use of formal financial services and consider the providers' and the users' sides of it. For example, on the providers' side, the sub-index of financial institutions access (see above) covers the number of bank branches and ATMs per 100,000 adults. On the users' side, we therefore complement the access sub-indices of the financial development index and examine a number of indicators such as the share of firms and investment financed by bank credit, the share of the population with account at a formal financial institution by gender and by income groups, the share of adults using accounts to receive transfers and wages, and the share of people that saved or borrowed from a financial institution.

We also consider the financial inclusion index, an aggregate measure of financial inclusion recently constructed by the IMF (Aslan et al 2016). Based on World Bank FINDEX 2014 micro-survey data (44 questions, 1,000 people per country), it captures both the access to and the use of financial sector services in 142 countries around the world. In particular, at the individual level, the index captures the common component of survey responses to three groups of financial inclusion questions: (1) whether a person has an account; if he does, whether (over the past year) he made a deposit, made a withdrawal from this account, saved, borrowed, made transaction with mobile phone; whether a person made internet payments; (2) if a person has a debit card, it is in his own name and he used the card in the past year; if he has a credit card, the card has been used in the past year; (3) possibility of coming up with emergency funds; whether a person has a loan from financial institution for house, apartment or land. Individual financial scores are then aggregated by country into a set of country-wide financial inclusion indices. The FI index provides a systematic and useful way to rank countries, but so far lacks time series dimension to track dynamics.

Box 3. Islamic Banking

With a large Muslim population, Islamic banking in Pakistan has significant potential to promote greater deepening and inclusion. About 96 percent of the population is reported to be Muslim, while penetration of financial sector accounts remains low. A 2014 SBP-DfID survey has identified an overwhelming demand for Islamic banking in Pakistan: more than two thirds of households and more than half of corporates have been interested in Shariah-compliant products.[1] More than half of respondents have been prepared to pay more for Islamic products and about 8 percent of respondents said they chose to be financially excluded primarily because of religion. This mirrors survey results showing that Muslims in general are significantly less likely to own a formal account or save at a formal financial institution and that particularly in the Middle East and North Africa region many have a preference for Islamic banking products despite higher costs (Demirguc-Kunt, Klapper, Randall 2013).

Since its re-launch in 2002, Pakistan's Islamic banking industry has been growing rapidly and has contributed to financial development. Between 2002 and 2016, helped by enabling regulatory environment that allowed parallel development of Islamic and conventional banks and large Muslim population, the Islamic banking industry (including Islamic windows at conventional banks) expanded at a compound annual growth rate of nearly 50 percent, and by December 2016 reached a market share of 11.6 percent of total bank assets and 13.3 percent of total bank deposits. [2] Islamic finance has helped financial inclusion, and the authorities have made it an integral part of the National Financial Inclusion Strategy to serve those who prefer Islamic products or who are voluntarily excluded due to their religious beliefs. Islamic finance may also foster greater stability of the sector owing to its risk sharing nature of financing and connection to real assets. To further improve public perception of Islamic banking and ensure strong demand from households and businesses is met, the SBP has devised a strategic plan for the Islamic Banking Industry to reach 15 percent of banking system assets by end 2018.

A high-level Steering Committee for Promotion of Islamic Banking has helped advance reforms in the sector. In 2015, the committee compiled a comprehensive set of recommendations aimed at addressing challenges faced by the industry. In September 2016, an Implementation Committee was formed with subcommittees focusing on swift execution of the recommendations in the areas of the legal and regulatory framework; taxation; capital markets; and awareness, training and capacity building.

The SBP has taken steps to further promote Shariah-compliant products and develop human capital for Islamic finance industry. To encourage participatory-based modes by Islamic Banking institutions on the asset side, SBP has exempted financing provided on the basis of participatory (Musharakah and Mudarabah) and agency (Wakalah) modes from the requirement of using KIBOR as benchmark rate. To improve human resources in the industry and foster research on contemporary issues, the SBP, in collaboration with the government, industry and other stakeholders, has helped establish three fully operational Centers of Excellence in Islamic Finance Education at well renowned business institutes.

As Islamic banks face excess liquidity, financial markets critical for their liquidity management need to be further developed. The domestic Sukūk market has been growing since the first issuance in 2006. The SBP has also played a major role in the issuance of Government of Pakistan Ijārah Sukūk which has paved the way for effective liquidity management of Islamic banks. However, despite witnessing growth over the years, the domestic Sukūk market is still confronted with issues such as lack of short term and long term Sukūk of high quality, absence of a secondary market for trading, and identification of assets for sovereign Sukūk.

The liquidity management has improved, but the holistic framework is still to be operationalized. A number of instruments have been developed for liquidity management by the SBP and banks, including Bai Muajjal of Sukūk, interbank Muḍārabah, Islamic placements, Wakala and others. A liquidity management framework has also been developed that includes development of Shariah portfolio at SBP, Muḍārabah-based facility for Islamic banks at the SBP, development of an Islamic inter-bank money market, and availability of Shari'ah compliant discount window for IBIs. However, this framework has not yet been operationalized.

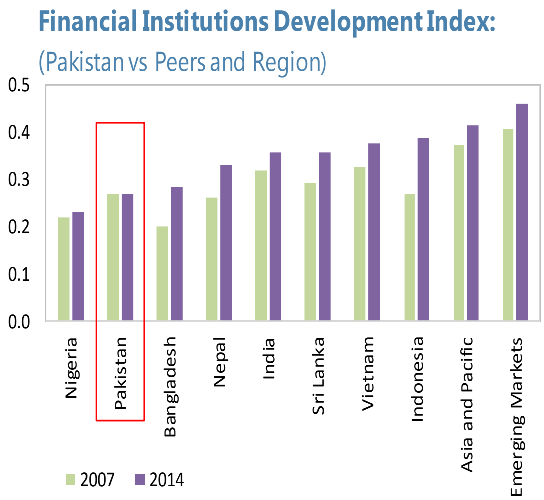
Considerable progress has been made to strengthen corporate and Shariah governance. The SBP has adopted the IFSB-3 on corporate governance, and the IFSB-10 relating to Shariah Governance. The Shariah compliance system is well-structured with a central Shariah board established at the SBP level, and SBs at banks in line with the IFSB and AAIOFI standards, customized according to the market environment in Pakistan. The SBP has developed detailed fit-and-proper criteria for the appointment of Shariah board members of IBIs. However, absence of a unified Shariah Board for the whole financial sector and diversity of Shariah governance practices, across banks and non-banks, remains an issue.

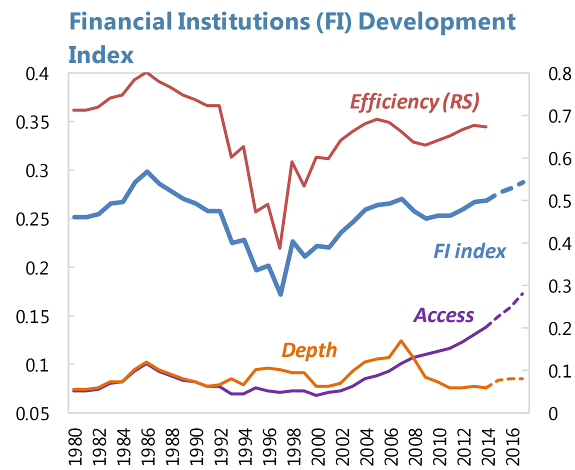
Islamic financial products are less competitive due to inferior tax treatment and should be allowed tax neutrality. Many Shariah-compliant products such as those based on sales, Murabaha and Ijara are subject to double taxation as the Islamic bank has to purchase the asset before selling it to a client and a sales and/or a withholding tax on each asset transfer need to be paid. This raises transaction costs for Islamic products and makes them less attractive compared to instruments used by conventional banks. To level the playing field, tax neutrality regime – currently under active consideration – should be introduced for all Islamic products. The 2016 decision by the Federal Board of Revenue to grant Sukūk transactions similar tax treatment to conventional bonds is a step in right direction.

[1] SBP and DfID, 2014, "Knowledge, Attitude and Practices of Islamic Banking in Pakistan," available at http://www.sbp.org.pk/publications/KAPStudy.pdf

[2] Pakistan has a fairly developed Islamic finance industry that is bank dominated. At present, the Islamic financial services industry of Pakistan consists of Islamic banking institutions (IBIs), Islamic microfinance institutions, Sukūk, Modaraba Islamic funds, Takaful companies, and Islamic Real Estate Investment Trusts (iREITs). The Islamic banking sector dominates and assumes a variety of forms. The Sukūk market, which is the second largest segment, is driven mostly by sovereign issuance followed by Islamic funds which include pension and other mutual funds. The Takaful (insurance and reinsurance) and Islamic micro-finance sector are still very small.

Figure 3. Financial Institutions Index: Pakistan *vs* Peers and Region





Source: Sahay et al (2015b). Dashed lines are authors' approximations.

Pakistan has been able to maintain strong positive momentum in financial institutions' development, benefitting from higher private credit growth and better access to finance. In line with this trend, the Islamic banking component of Pakistan's financial sector has been expanding rapidly and has strengthened its contribution to financial development (Box 3).

10. Pakistan's financial sector development trends over the last decade have shown a beginning recovery from low and shrinking depth, low yet quickly growing level of access, and favorable efficiency relative to peers and benchmarks. Particularly during FY 2015–17, depth has begun to recover and growth in level of access has further accelerated. Below we discuss these aspects, benchmarking Pakistan's performance against (i) peer countries with similar per capita income and population,[5] (ii) regional averages for South Asia, and (iii) statistical benchmarks (expected medians) derived from a regression framework following the World Bank's FinStats 2016 (Feyen, Kibuuka, and Sourrouille, 2015).[6] Statistical benchmarks are estimated based on structural and economic non-policy fundamentals. By excluding policy-driven factors, the benchmarks determine the level at which Pakistan would be expected to perform in a policy-neutral environment. A gap between actual performance indicator and its benchmark can in part be attributed to the quality of financial sector policies.

[5] Peer group countries for Pakistan include Bangladesh, India, Indonesia, Nigeria, and Vietnam.

[6] Each of 46 financial development indicators for over 180 countries is regressed on a set of countries' economic and structural factors, that can be viewed as external to policy, at least in the short run. These factors fall under five types: economic development factors (GDP per capita and its square), population factors (population size and density), demographic factors (age dependency ratio), "special circumstances" (offshore centers, oil exporters, transition economy etc), and global cycle (year dummies).

Depth

11. Despite recent progress, the Pakistani financial sector remains shallow. Empirical evidence suggests that financial depth, capturing the size of financial institutions relative to the economy, is a key aspect of financial development, and bigger and more liquid financial systems facilitate economic growth and help dampen macroeconomic shocks (Rajan, Zingales 1998; Dabla-Norris, Srivisal 2013). Despite its recent recovery, the overall index of financial institutions' depth remains low relative to both South Asian peers and Emerging Markets averages (Figure 4). From its 2007 peak, it has shrunk by about 40 percent, reflecting the declining size of the financial sector and the private credit to GDP ratio.

- Following the global financial crisis, the assets of banks and other depository institutions in Pakistan have declined from 59 percent of GDP in 2007 to 48 percent in 2011, and subsequently recovered to 57 percent of GDP in 2016 in contrast to other countries in the broader region whose banks have been able to expand relative to the size of the economy beyond pre-crisis levels (Figure 4).

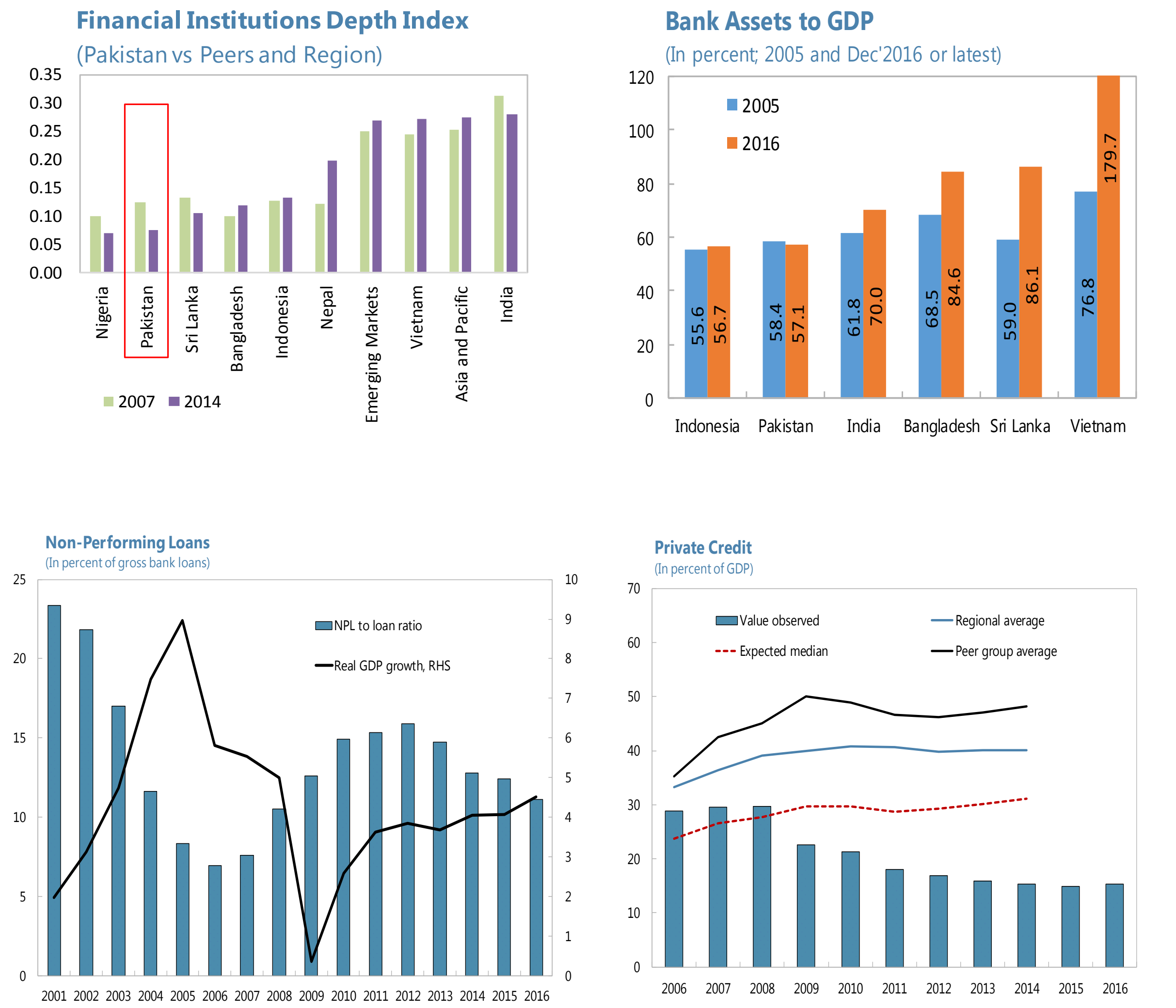
- Bank credit to the private sector has contracted from a peak of 27 percent of GDP in 2008 to 15 percent of GDP in 2015 before beginning to recover. The earlier decline in part reflected a surge in NPLs after 2008[7] and growing government financing needs amid high fiscal deficits that crowded out the resources from the rest of the economy and led banks to orient their lending activities toward the government. The share of government in total bank lending has increased from 38 percent in 2008 to 64 percent in 2016, while fiscal deficit peaked at almost 9 percent of GDP in FY 2011/12 (Figure 1). Since then, fiscal deficits shrank owing to fiscal consolidation efforts, the non-performing loan ratio has declined, and more recently, as interest rates declined, private credit growth has begun to recover.

- Non-bank financial institutions—except pension funds—suffered as well, with mutual fund assets and insurance premiums shrinking relative to GDP.

12. The financial depth index has begun to recover over the past three years. In addition to a growing private credit-to-GDP ratio, this trend has reflected an increase in the pension fund assets and improved insurance life and nonlife premiums collected relative to the size of the economy.

[7] Between 2007 and 2011, the nonperforming loans doubled to 16 percent of gross loans owing to the business cycle, but then improved (particularly in the last few years) to about 10 percent in December 2016. Net nonperforming loans (after provisioning) have been low and manageable (1.6 percent in December 2016).

Figure 4. Depth of Financial Institutions' Development



13. Benchmarking. Compared to peers, bank private credit to GDP in Pakistan is lagging behind the economies in South Asia and countries with similar income and population size (Figure 4). It also remains well below the statistical benchmark (expected median) of about 31 percent estimated based on Pakistan non-policy fundamentals indicating significant room for improvement. The mutual fund industry seems to be relatively well developed and in line with predictions implied by expected median assets to GDP (although being quite lower than regional average), while premiums in insurance industry, in particular non-life, and pension fund assets remain a fraction of what they should be based on Pakistani fundamentals (see footnote 32).

Efficiency

14. The efficiency of the Pakistani financial sector has moved in sync with the business cycle and remains favorable. Most recently, banks in Pakistan have been able to provide financial services at relatively low cost and with sustainable revenues. In 2014, the overall index of financial institutions efficiency has exceeded that of Emerging Markets average by 10 percent, Asia Pacific average by 13 percent and India by 23 percent (Figure 5). However, historically, bank efficiency (driven by profitability) has been following the business cycle, overperforming against benchmarks during boom years (2005–07) and underperforming during decelerations (2008–10). Over the past decade, the ability of banks to generate revenue outside traditional financial intermediation from fees, commissions, trading activities, etc. has strengthened markedly evidenced by rising noninterest income to total income ratio. Profitability has also been supported, however, by ample availability of risk-free lending to the government. More recently, as interest rates have declined, bank profitability has begun to moderate.

15. Benchmarking. Compared to peers, South Asia, and statistical benchmarks, the efficiency of Pakistani banks has improved and is favorable. This has reflected strong profitability measured by return on equity and return on assets, low overhead costs and favorable share of non-interest income in total income against most benchmarks. On the other hand, net interest margin remains high at 4.5 percent, compared to 3.8 percent in Bangladesh and 2.9 percent in India. Lending to government and Public Sector Enterprises is large: in 2014 it was estimated at 20.2 percent of GDP against statistical benchmark of 11.3 percent implied by Pakistani fundamentals and 12.8 percent for South Asia.

Table 1. Pakistan: Benchmarking Non-Bank Financial Institutions

	Pakistan	South Asia Median	Income Group Median	Expected Median
Insurance premiums (life) / GDP (%)	0.5	0.5	0.3	0.5
Insurance premiums (non-life) / GDP (%)	0.2	0.5	0.6	0.6
Mutual fund assets / GDP (%)	1.7	4.1	1.8	1.7
Pension fund assets / GDP (%) 1/	0.02		3.5	2.9

Source: FinStats 2016

Note: All data is for 2014. Pakistani pension fund assets/GDP refer to 2012.

Figure 5. Efficiency of Financial Institutions

Table 2. Pakistan: Benchmarking Efficiency of Banks

	Pakistan	South Asia Median	Income Group Median	Expected Median	Bangladesh	India
Net Interest Margin (%)	4.5	4.2	4.5	4.3	3.8	2.9
Overhead Costs / Total Assets (%)	2.7	2.3	3.4	3.5	2.3	1.7
Credit to Government and SOEs / GDP (%)	20.2	12.8	4.4	11.3	19.1	19.6

Note: All data is for 2014, sourced from FinStats 2016.

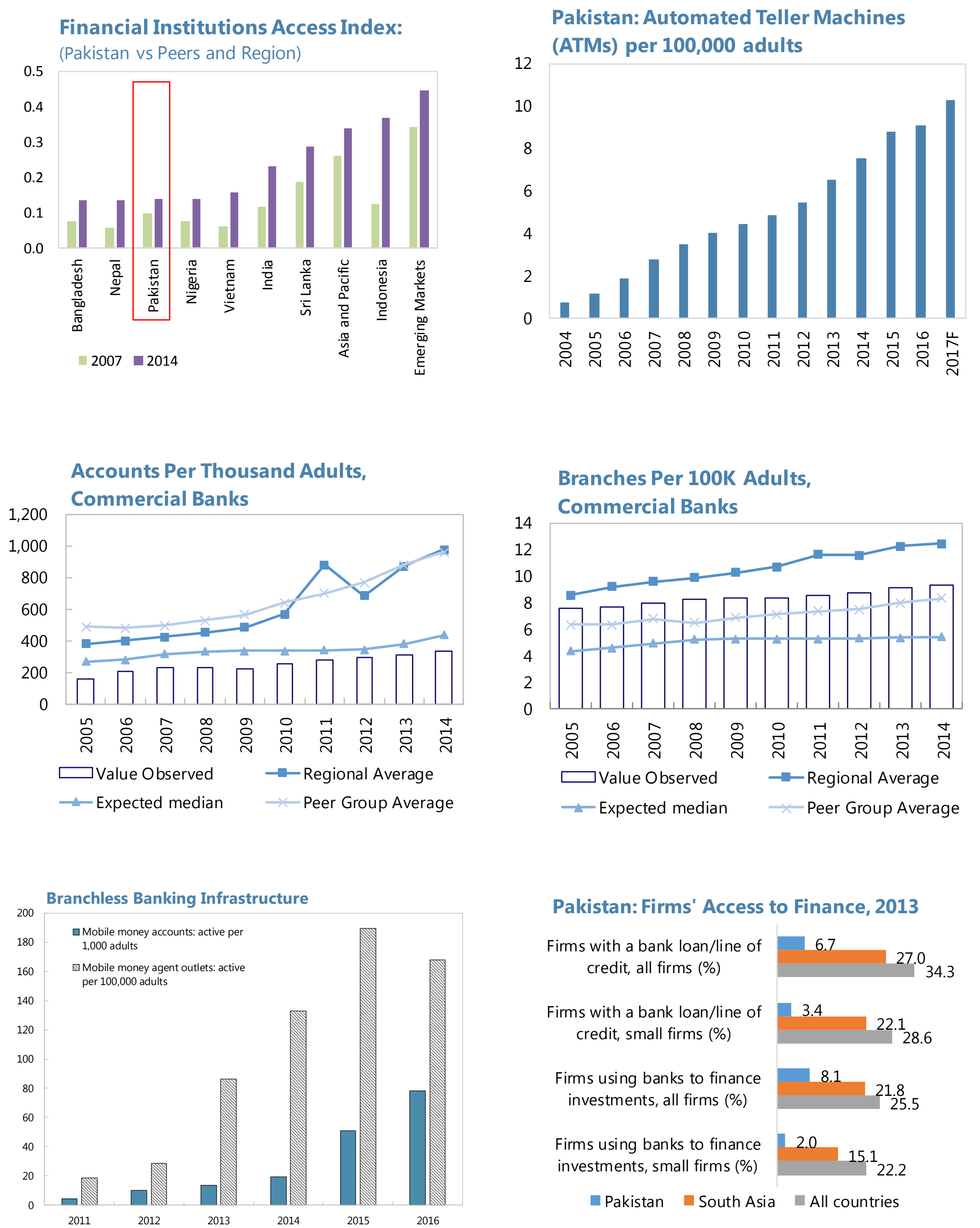
Financial Access and Inclusion

16. The access to financial services has been quickly rising from a low base, with significant potential for further improvement. Pakistan ranks low on the level of financial institutions' access relative to individual peer countries and to the South Asia region and has large potential to improve against Emerging Markets and Asia Pacific averages (Figure 6). From the providers' side, this reflects the moderate coverage by commercial bank branches and low coverage by ATMs as compared to peers and the region. It also reflects the low penetration of bank accounts (in 2014 Pakistan had 333 accounts in banks per 1000 adults compared to 979 accounts for the South Asia region) and limited ability of firms to tap bank resources. According to WB Enterprise Survey, only 6.7 percent of firms (3.4 percent for small firms) had access to bank loans or enjoyed a credit line and only 8.1 percent of firms (2.0 percent for small) used banks to finance investments (Figure 5).

17. That said, sustained efforts led by the SBP ensured that the level of financial access has been growing very quickly in the recent years (Figure 3). For instance, the ATM coverage has increased 5-fold over the last decade and the mobile money infrastructure under branchless banking model has expanded at a fast pace, with penetration of active mobile money agent outlets and active mobile money accounts increasing 9 times and 17 times, respectively, over 2011-2016 (Figure 6). At present, Pakistan enjoys 20 million easy to operate branchless banking accounts and further growth would help boost financial access.

18. Benchmarking. Despite overall low level of financial access, the coverage of population by bank branches is in line with the peer group average and even exceeds the statistical benchmark (Figure 6). However, the rural access to bank branches remains an issue, in part mitigated by about 360,000 branchless banking agents across the country. Bank account penetration remains below peers and the benchmark level of 438 accounts per 1000 adults, and can be further improved by promoting access of underserved segments of society such as small firms, the rural population, and women and by further developing financial sector infrastructure delivered via existing bank branches

Figure 6. Pakistan: Access to Finance



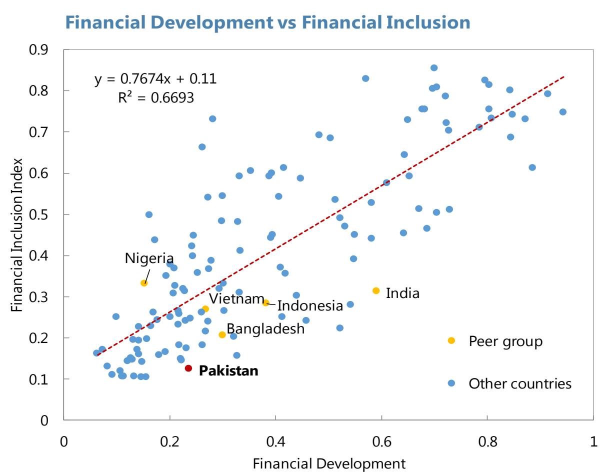
and innovative digital channels. There is also sizable potential for improvement in overall access of firms to bank finance from the current low level to the South Asia average of 27 percent or the statistical benchmark level of 31 percent.

19. Financial inclusion is a multifaceted concept broadly defined as the access to and the use of formal financial services. Following Sahay et al (2015a), in addition to providers' side, we also consider the users' side of financial inclusion and also look at the aggregate measure such as micro-survey based financial inclusion index (Box 2).

20. While Pakistan has made considerable and sustained reform efforts, the level of financial inclusion has remained low. The SBP's Access to Finance Survey 2015 indicates that access to formal financial services has increased from 12 percent in 2008 to 23 percent in 2015 and adult population with a bank account has increased from 11 percent in 2008 to 16 percent in 2015, well below both the South Asian average of 46 percent and the average for all developing countries of 54 percent. Women's access to financial services has expanded considerably, as 11 percent now have access to a bank account, compared with merely 4 percent in 2008, but significant gender gap remains.

21. Despite these improvements, the aggregate index of financial inclusion ranks Pakistan low. The financial inclusion index (Aslan, Deléchat, Newiak and Yang, 2016, see Box 2) that captures common component of both access and use of financial services places Pakistan at 135 out of 142 countries (2014). The positive association between financial development and inclusion (Figure 7) suggests that improvements in financial development to the sample average could potentially lead to significant improvements in financial inclusion.

Figure 7. Pakistan: Financial Inclusion



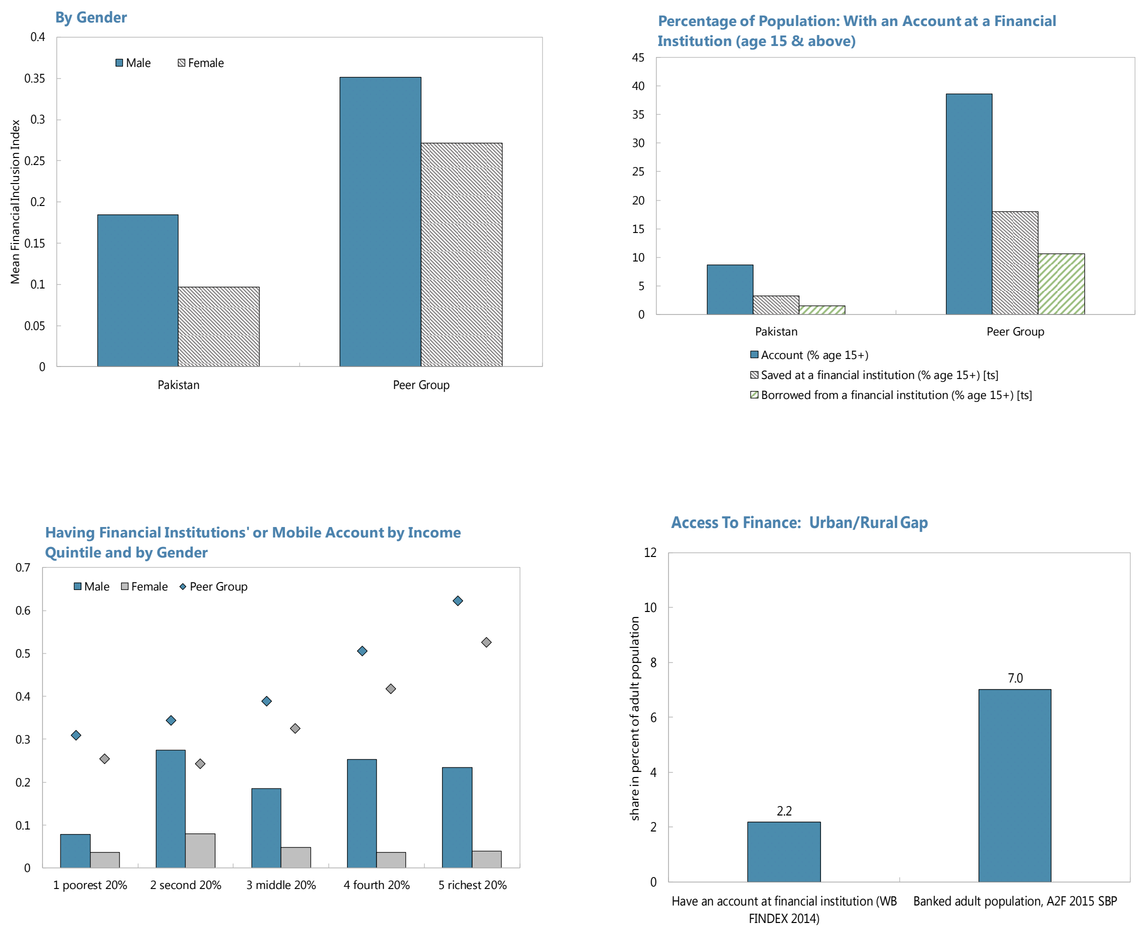
22. The low ranking reflects limited access to financial institutions and limited use of the existing access in everyday activities. According to the World Bank's Findex 2014 survey, just 8.7 percent of adult population in Pakistan have accounts with formal financial institution against 45.5 percent in South Asia and 38.6 percent on average in peer countries (Figure 8).[8, 9] Only 1.4 percent of the population use these accounts to receive wages, 1.8 percent to receive government transfers, and 0.4 percent to pay utility bills.

[8] Although, as per SBP Access to Finance 2015 Survey, the share of adults formally served by the financial system has doubled between 2008 and 2015.

[9] The peer group is the same as before and includes Bangladesh, India, Indonesia, Nigeria, and Vietnam.

Similarly, few people use financial institutions for their saving (3.3 percent) and borrowing (1.5 percent) needs.

Figure 8. Pakistan: Aspects of Financial Inclusion



23. A key challenge is low financial inclusion of women, low income and rural population, as well as agricultural and small and medium enterprises. The mean financial inclusion index for men is twice as high as for women in Pakistan, while the same gap in peer countries is about 30 percent (Figure 8), reflecting strong gender barriers. The poor are more excluded than other income groups as the share of the population in the bottom income quintile having either a bank or a mobile account is disproportionately low relative to higher income quintiles. The urban/rural gap in financial inclusion is less pronounced than the gender gap but remains significant (Figure 8). Although agriculture contributes 23 percent to GDP and employs about 42 percent of the labor force, it accounts for only 8.6 percent of total bank credit to the private sector and heavily relies on cash.[10] SMEs are also underserved by the financial sector. WB Enterprise Survey 2013 suggests that only 3.4 percent of small firms (6.7 percent of all) had access to bank loans or enjoyed a credit line and only 2.0 percent of small firms (8.1 percent for all) used banks to finance investments (Figure 6).

24. Although aggregate inclusion remains low, Pakistan has made fast progress in Islamic Finance, digital finance and branchless banking. Islamic Finance has been rapidly growing in recent years, and further growth could help improve financial inclusion, as survey evidence points to large untapped interest in Shariah-compliant financial products and services (Box 3). Moreover, a conducive regulatory environment created by the SBP, a dynamic private sector, and computerized national identity cards helped pave the way for significant expansion of mobile accounts and branchless banking. As banks were able to leverage mobile phone communication networks to bring their services closer to customers and mobile money infrastructure expanded (Figure 6), penetration of mobile accounts in Pakistan increased to 5.8 percent of adult population in 2014, twice as high as the average in South Asia (2.6 percent). Digital transaction accounts may be more effective in addressing the gender gap in financial inclusion than traditional bank accounts, as difference in access to mobile accounts for men and women is narrower (about 7 percent) than for financial institutions' accounts (11 percent). Recent initiatives to foster branchless banking include the revised regulations to allow remote account opening through biometric verification at agent locations and launching a capacity building program to train more than 100,000 agents. In addition, SBP has also developed an Asaan (Easy) Mobile Account scheme under which the digital finance service providers will join an integrated platform, allowing any person with a basic mobile phone to swiftly open a digital transaction account.

25. Significant progress has also been achieved in promoting SME, agricultural and micro-finance. In agriculture, credit guarantee and insurance schemes, publication of value chain reports and national rollout of value chain financing, streamlining of agri-loan application processes and other measures have resulted in a robust increase of agricultural credit: over 2012-16, it has grown at an average rate of 14 percent per year and its share in total private credit has improved by 2.5 percentage points. Helped by a conducive policy environment, with separate legal and regulatory framework in place (Box 4), the microfinance industry has grown significantly over the past five years and

Performance of the Microfinance Industry

	2012	Dec 2016	% chg
No of borrowers, million	2.0	4.6	130
of which women	1.3	2.5	95
Gross Loan Portfolio, PKR billion	33.1	136.9	314
No of branches	1,460	3,220	121
Deposits, PKR billion	20.8	120.6	480
Depositors, million	1.6	20.2	1191

Source: SBP, Pakistan Microfinance Network

[10] WB Findex 2014 data indicates that 95 percent of people that received payments for agricultural products in the past year have reported to use cash and only 1.7 percent used bank accounts.

continues to maintain a healthy loan portfolio.[11] The number of active borrowers increased from 2 million to 4.6 million, of which more than half were women, the gross loan portfolio quadrupled to PRs 137 billion and deposits of microfinance banks expanded six-fold to PRs 121 billion. Despite small and medium size enterprises being underserved by the financial sector, their access to credit has been gradually improving. During 2012-16, the stock of SME finance and the number of SME borrowers have grown by 51 percent (to PRs 401 billion, 9.2 percent of total private credit) and by 35 percent (to about 178,000 firms), respectively. Amendments to prudential regulations (raising sales and employment thresholds and allowable per party exposures), incentives schemes, such as the Credit Guarantee Scheme for Small and Rural Enterprises and the Prime Minister Youth Business Loan Scheme, and capacity building programs have – among other measures – contributed to this outcome.

26. Despite recent progress, considerable challenges to fostering financial inclusion at both the supply and demand sides remain. Levels of financial literacy and awareness are low, especially with low-income segments, making the demand for financial products and services much lower than optimal. 39 percent of the population consider lack of financial awareness of banking products and services as one of the key barriers.[12] Challenges also exist at the supply side, with considerable infrastructure and strategic commitment needed to cater to the government-to-person beneficiary market segment.[13] Other broad factors inhibiting financial inclusion in Pakistan that often span beyond financial sector policy include:

- Business cycle factors (economic slowdown following global financial crisis),
- Business climate and governance challenges,
- High government financing needs leading to banks' orientation toward lending to government,
- Gender barriers,
- A large and persistent informal economy,
- Challenges in the basic financial infrastructure and in legal and judicial frameworks, and
- Capacity issues on the financial sector providers' side that often focus on the upper end of business and retail markets.

27. Since the launch of National Financial Inclusion Strategy in 2015, Pakistani authorities have implemented several initiatives to boost financial inclusion. The goal is to achieve by 2020 the financial access for at least 50 percent of adults, including at least 25 percent for women, and to increase the percentage of SME loans in bank lending to private sector to 15 percent (Box 4).

[11] The share of NPLs in microfinance banks is about 2.3 percent of gross loans in December 2016.

[12] SBP Access to Finance Survey, 2015.

[13] However, the branchless banking channel is being increasingly used to facilitate social welfare disbursements, including under the Benazir Income Support Program.

Box 4. Progress on Financial Inclusion Initiatives 1/

Since 2001 Pakistan has put in place many policies and initiatives that helped create enabling environment for financial inclusion. These efforts have culminated in the adoption of the comprehensive National Financial Inclusion Strategy (2016–20) to provide a vision, a framework and a roadmap for priority actions aiming to increase the access to and the use of quality financial services. The NFIS strategy focuses on four key drivers: promoting digital transactions and reaching scale through bulk payments, expanding and diversifying access points, improving capacity of financial services providers, and increasing level of financial awareness and capability. To implement the strategy, Pakistan has set up a public-private coordination mechanism that includes the high-level NFIS Council, chaired by Finance Minister, the NFIS steering committee, chaired by SBP Governor, responsible for action plans and monitoring, and technical committees, with participation of more than 160 members from ministries, regulators, associations, and networks.

Recent progress on the financial inclusion initiatives, including on the NFIS, is provided below.

- Creation of a regulatory framework for Microfinance Banks (2001);
- Expansion and modernization of online credit information bureau (e-CIB, 2005);
- Issuance of branch licensing policy mandating banks to open 20 percent of branches in rural areas (2005);
- Establishment of the Pakistan Interbank Settlement System (PRISM) (2008), the development of inter-operable inter-bank card payments platforms;
- A number of credit enhancement facilities aimed at encouraging financing to the underserved sectors including the Microfinance Credit Guarantee Scheme (MCGF, 2008) and the Credit Guarantee Scheme for Small and Rural Enterprises (2010);
- Adoption of Branchless Banking Regulations (2008, amended in 2011);
- Establishment of a specialized Microfinance Credit Information Bureau (MF-CIB, 2011);
- Launch of a National Financial Literacy Program (NFLP) (2012). After its successful pilot, NFLP is being scaled up to the national level with target of one million beneficiaries, and a new component on child and youth financial literacy, is being initiated (2017);
- Issuance of revised SME Finance prudential regulations, with separate sets of regulations for small enterprises and medium enterprises (2013);
- Development of Inclusion, Stability, Integrity, and Protection (I-SIP) methodology in policy making (2014);
- Review of regulatory framework for microfinance banks to promote sustainable growth of microfinance in the country (2014);
- Enhancement of biometric infrastructure to aid real-time account opening (2015);
- Payment Systems Interoperability of MFS platform with Core Banking Accounts through financial switch (1-Link) enabling ATM, POS and Interbank funds transfer facilities through m-wallets (2015);
- Government of Pakistan accepts membership of the UN' "Better than Cash Alliance" (2015);
- Issuance of Guidelines on Low Risk Accounts namely "Asaan Account" with simplified due diligence to expand the outreach of banking services to underserved segments of the society through conventional and innovative channels. Since the launch of the initiative, commercial and microfinance banks have opened more than 1.79 million accounts;
- Establishment of Centers of Excellence in Islamic Finance Education to ensure adequate supply of trained human resource to the industry (2015);
- Incorporating the Pakistan Mortgage Refinance Company to address the long-term funding constraints hindering growth of primary mortgage market (2015);
- Launch of Credit Guarantee Scheme for Small and Marginalized Farmers (CGSMF) with the funding support of Government of Pakistan to share the losses with banks against their collateral-free financing to small and marginalized farmers (2016);
- Approval by the NFIS Council of key strategic actions such as:
  - Development of a National Payment Gateway;
  - Automation of the government collections and disbursements;
  - Introduction of a Warehouse Receipt Financing system;
  - Integration of National Savings Scheme with national payments system;
  - Initiation of new schemes of registered prize bonds;
- Development of Digital Transaction Accounts (Asaan Mobile Account) scheme to support rapid expansion of DTAs, in particular in rural areas. The unified DTA scheme is expected to help design a common technology-led platform for individuals to access and use full range of payment, savings, insurance and credit services (2017).

[1] UNESCAP First High-Level Follow-up Dialogue on Financing for Development in Asia and the Pacific, 30–31st March 2016, Incheon, Republic of Korea.

C. Quantifying the Effects of Financial Development on Economic Growth

28. Given Pakistan's significant potential for financial development, we estimate the potential benefits of accelerated financial development on growth. Following Sahay et al., (2015b), regressions link countries' growth performance with the financial institutions development index and a set of controls. To overcome significant endogeneity between finance and growth documented in the empirical literature (e.g., Levine 2005), we use dynamic panel system generalized method of moments estimator (Blundell, Bond 1998) with lagged variables as instruments. Following Sahay et al., (2015b), we include a standard set of controls such as initial per capita income, educational attainment (secondary school enrollment rate) and the ratio of government consumption to GDP, as well as a banking crisis dummy as suggested by the literature. The generic equation regresses real per capita GDP growth on the level of financial development measured by the Financial Institutions (FI) development index, its square, additional interaction terms ("banking crisis," "emerging markets" and other) and a set of controls. The sample covers 113 countries and includes non-overlapping 5-year averages of the variables over the 1980–2010 period. To better capture Pakistan's and regional peculiarities, we introduce a regional dummy for countries in the Middle East, Central and South Asia (MCDSA) and also estimate a specification with initial GDP per capita interacted with the level of financial development to capture the notion that as country's income grows, benefits from greater financial development may be getting more limited.

29. Empirical results confirm that deeper financial development is associated with higher economic growth and suggest that the growth dividend for Pakistan could be around one percent. The results confirm that there is indeed a positive significant impact of greater financial development on economic growth (Table 3). Given Pakistan's low level of financial development relative to peers and the South Asia region, there is sizable scope for the financial sector to better support growth. Depending on the specification, raising Pakistan's Financial Institutions index (0.269) to the Emerging Market average (0.461) would imply annual growth gains of around 1 percentage point, with some specifications pointing to even higher potential gains (Figure 9). Relatively lower gains are projected by the models with linear impact of FI on economic growth (column 1 and 4 in Table 3). However, the specifications with quadratic FI terms (columns 2 and 5), capturing non-linearities, suggest that for Pakistan whose level of financial development is low, the growth dividend could be higher at about 1 percent. Finally, specifications with interaction between the level of initial GDP per capita and financial development project even larger potential gains of between 1.6 and 1.8 percent, but are perhaps on the upper side of the plausible range. The average across the six specifications would yield about 1.2 percent, a plausible point estimate for the impact of financial development on annual growth.

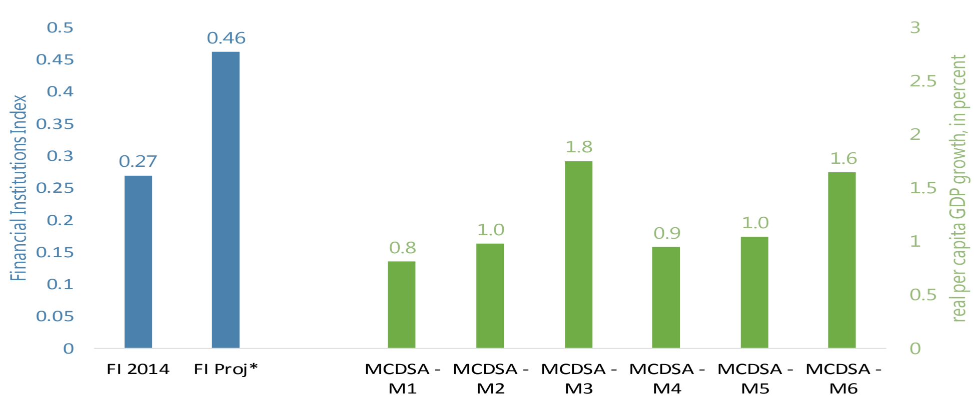
Table 3. Pakistan: Finance and Growth Regressions–GMM Estimation

Dependent variable: *per capita real GDP growth*
Sample: non-overlapping, 5-year period averages covering 1980-2010
excluding offshore financial centers

Explanatory variable	Specifications					
	(1)	(2)	(3)	(4)	(5)	(6)
Financial Institutions (FI) Index	0.042 *	0.161 ***	0.309 ***	0.049 *	0.163 ***	0.296 ***
	[1.708]	[3.312]	[2.731]	[1.954]	[4.018]	[2.944]
MCDSA x FI				0.024	0.039	0.003
				[0.792]	[0.689]	[0.150]
Emerging Market x FI	0.022 **					
	[2.556]					
FI^2		-0.151 ***			-0.149 ***	
		[-3.242]			[-3.825]	
MCDSA x FI^2					-0.089	
					[-0.632]	
y0 x FI			-0.030 ***			-0.029 ***
			[-2.597]			[-2.847]
Crisis x FI	-0.029 ***	-0.013 *	-0.021 ***	-0.030 ***	-0.016 **	-0.025 ***
	[-3.508]	[-1.817]	[-2.716]	[-3.584]	[-2.501]	[-3.564]
Constant	0.086 **	0.072 *	-0.005	0.074 **	0.062 *	-0.011
	[2.180]	[1.749]	[-0.130]	[2.028]	[1.772]	[-0.289]
Observations	548	548	548	548	548	548
No of countries	113	113	113	113	113	113
AR(2)	0.422	0.356	0.385	0.421	0.334	0.372
Hansen	0.202	0.118	0.112	0.146	0.244	0.197
Instruments	90	90	90	90	112	101

Notes:
1. Additional controls included initial GDP per capita, educational attainment, and ratio of government consumption to GDP
2. Z-stats in square brackets, ***: p<0.01 **: p<0.05 *: p<0.1

Figure 9. Pakistan: GDP Growth Dividend from Higher Financial Development and Inclusion



* Financial Institutions index improving to 2014 Emerging Markets average.

D. Policy Implications and Considerations

30. While financial sector development in Pakistan has made significant contributions to economic growth, it remains well below its potential. It has recently been characterized by a beginning recovery after a period of shrinking depth, low yet quickly growing level of access, and favorable efficiency. Regarding financial inclusion, considerable and sustained efforts over the past years are bearing fruit, but there remains large room for further improvement.

31. As potential growth dividends from further progress in financial development are large, Pakistan should continue to formulate and implement policies that will help promote greater financial deepening and inclusion and would also secure safe and sound financial development. In addition to maintaining macroeconomic stability by keeping inflation low and public debt in check, the focus should be on strengthening the legal and institutional framework, enhancing regulation and supervision of the sector, creating conditions that allow for an increased role of private credit with due regard to risks, increasing financial inclusion so that benefits of more finance are widely shared, promoting Islamic finance, encouraging bank competition, and developing debt markets.

32. An appropriate macroeconomic policy mix is key to facilitating further financial development. Pakistan should focus on fiscal consolidation and proactive debt management efforts to reinforce its resilience to shocks and to allow the financial sector to allocate more funds to private sector credit. Prudent monetary policy will ensure low inflation and positive real interest rates that encourage savings.

33. Implementation of the forthcoming deposit insurance would support depth of the financial sector. In 2016, Pakistan has enacted the Deposit Protection Corporation Act to establish a deposit protection scheme that would enhance the stability and soundness of the banking system and help encourage growth in bank deposits. It would be important to swiftly move ahead to make the deposit protection scheme fully operational.

34. Reforming credit information systems would facilitate greater access to finance and reduce exposure to credit risks. To improve the credit information system and help banks extend credit to broader sections of society, in 2015 Pakistan has enacted the Credit Bureaus Act and the SBP has subsequently issued regulatory and operational guidelines to relicense the existing private credit bureaus. Among other things, the Act has improved access to credit information by guaranteeing borrowers' rights to inspect their credit data and existing credit bureaus expanded their borrower coverage. Further steps to implement the improved credit information framework will be key to increase currently low credit bureau coverage.

35. Addressing the still high level of NPLs can help support banks' credit to the economy and private sector-led growth. Enhancing the debt enforcement regime, developing an appropriate bankruptcy framework, and continuing to strengthen the market infrastructure for distressed debt are needed for more efficient NPL resolution. In this context, Pakistan has enacted the Corporate Restructuring Companies (CRC) Act to allow setting up companies that would take over assets of bankrupt firms and passed amendments to the Financial Institutions (Recovery of Finances) Ordinance aimed at enabling out of court enforcement of collateral, which are both welcome steps. The Corporate Rehabilitation Act (CRA) that will establish a mechanism for the organization and rehabilitation of distressed companies has been submitted to parliament. Pakistan should move ahead with the adoption of the CRA to further strengthen the bankruptcy framework, improve NPL recovery and support the provision of credit to the economy.

36. **The legal framework for secured transactions should be strengthened to facilitate SME, micro and agriculture finance**. In 2016, Pakistan has enacted the Financial Institutions (Secured Transactions) Act that provides for a legal regime for the creation, registration, priority and enforcement of security interests over movable property. It further envisages the establishment of an electronic secured transactions registry to be created on a federal level. To bear fruit and increase access to credit, swift implementation of the provisions of the law, including making the collateral registry operational, would be key.

37. **Improving the business climate, enhancing governance, and reducing barriers to private sector development would support growth and financial development**. According to the World Bank's Doing Business 2017, in FY 2015/16 Pakistan was among the 10 economies with the largest improvements in their business climate, notably in the areas of registering property, getting credit and trading across borders. Despite these improvements, Pakistan still ranks low relative to other countries (144/190) and governance indicators are well below emerging markets' average. A new comprehensive strategy to improve business climate has been adopted in 2016 and is being implemented. Progress in the implementation of the business climate strategy and further improvements in rule of law, control of corruption and government effectiveness will support private sector development and help further financial deepening.

38. **Review of the regulatory and taxation structure at different financial market segments would help ensure a level playing field**. Unfavorable tax treatment adversely affects non-bank financial institutions in competing with fixed rate government debt instruments and banks and thus restrains progress in financial development. For example, mutual funds are subject to provincial sales tax, federal excise duty, and Workers Welfare Fund payments, while direct investments in stock market, bank deposits and the National Savings Scheme instruments are not affected by these taxes. The non-bank leasing sector and insurance companies remain tax disadvantaged relative to other segments of financial market or in terms of the federal/provincial corporate taxation regime.

39. **Gradually moving toward registering prize bonds would help avoid currency substitution and promote healthy formal financial sector**. Prize bonds are bearer instruments issued by the government to mobilize retail savings. However, due to their bearer nature, they can effectively be used as medium of exchange and a substitute to Pakistan rupee currency. In FY 2015/16, demand for high-denomination bonds of PRs 40,000 and PRs 25,000 has increased by 60 and 80 percent, respectively, and the outstanding stock of bonds amounted to about 20 percent of currency in circulation.

40. Indicative bank lending targets to particular sectors should be pursued with caution. The SBP and the government should pursue such policies carefully to avoid generating greater access to finance at the expense of financial stability risks. For example, lending to SMEs could be facilitated by more conducive market conditions and better financial infrastructure. In this regard, the operationalization of the EXIM bank, with an appropriate governance structure, could help enhance export credit and reduce the cost of borrowing, notably for SMEs. Similarly, a credit guarantee company, with adequate safeguards and transparent funding arrangements, can provide risk coverage to financial institutions lending to SMEs.

41. Existing incentive schemes to foster flow of credit to the private sector can be reviewed to maximize effectiveness. Current schemes are administered by the SBP and envisage providing to commercial banks and development finance institutions subsidized lines of credit to on-lend to selected segments of the private sector: (i) the Export Finance Scheme, (ii) the Refinancing Facility for Modernization of SMEs, (iii) the Long-Term Financing Facility for Plant and Machinery, (iv) the Scheme for Financing Power Plants Using Renewable Energy, (v) the Financing for Agricultural Storage Scheme, (vi) the Credit Guarantee Scheme (CGS) for small and rural enterprises, (vii) the Microfinance Credit Guarantee Facility, and (viii) Prime Minister's Youth Business Loans Scheme. The performance of these schemes in achieving their objectives should be reviewed to determine whether they constitute the best use of public financing support and to maximize their effectiveness.

42. Further progress on the National Financial Inclusion Strategy Action Plan would help boost financial coverage of underserved segments of society. Recent steps in moving ahead with traditional bank and mobile (DTA) accounts are welcome and will help raise the level of financial inclusion. Other priority areas to boost access to and use of finance include: (i) strengthening financial literacy and awareness, in particular among underserved client groups such as women, low income and rural population, and small and micro businesses; (ii) addressing gender gap in access to finance; (iii) strengthening financial, payments and information and communication technology infrastructure (access points, DTAs, balanced Know-Your-Customer regime, National Payments System); (iv) ensuring that businesses and people have access to full and transparent information on financial products and services and that minimum consumer protection standards are followed for microfinance and Islamic finance providers; (v) enhancing conducive policy environment for development of SME, agriculture and housing finance and pensions.

43. Continuing to promote microfinance would help provide economic opportunities for the smallest businesses and the poor and promote financial development and inclusion. Although the microfinance industry has grown significantly over the past decade, the sector is estimated to serve 4.6 million customers, about 17 percent of the potential borrower pool. Further growth of the microfinance sector would facilitate access to finance, reduce poverty and also help existing businesses to grow and foster employment generation. With women accounting for about 50 percent of gross loan portfolio, microfinance providers promote gender equality and women's empowerment and could help reach the NFIS target of 25 percent of women having formal accounts. The recent launch of rules and regulations governing non-bank microfinance providers by

SECP will create a level playing field in the industry, can catalyze the investor interest, help attract capital and diversify sources of funding.[14] The key challenge going forward will be the effective implementation of the new regulatory and supervisory framework.

44. **Pakistan has made considerable progress in adapting the institutional, legal and regulatory framework to the specifics of Islamic finance, nevertheless significant scope remains for further strengthening**. Additional reforms are needed to address gaps with respect to consolidated supervision, tax neutrality for some products, inadequacies in disclosure requirements, the resolution framework, and the absence of liquid secondary markets. In addition, further development for human capital and financial awareness and literacy of Shariah compliant products and services as part of the consumer protection framework are needed. Ongoing reforms with respect to capital adequacy requirement, liquidity framework and deposit insurance schemes should be expedited. Concentrations in bank financing, maturity mismatches and development of interbank markets warrant attention and further efforts are needed to develop deep Sukūk markets.

45. **Encouraging healthy bank competition should facilitate private sector credit growth**. Although Pakistan's banking system is not overly concentrated, the limited degree of competition among banks is highlighted by system's small size relative to the economy, the large share of assets in government securities, and the low level of advances to assets. Reducing the share of government borrowing from banks should help encourage banks to compete for lending to the private sector, benefitting private investment and growth. To this end, consideration could also be given to encouraging new entry to the system (with adequate safeguards).

46. **Developing the domestic debt market will promote alternative sources of financing, help expand the domestic investor base, and contribute to further financial development**. Although the debt market is dominated by large and liquid government securities market, there is strong potential for private sector issuance as alternative to bank financing. Private fixed-income instruments such as corporate bonds, corporate Sukūk, asset-backed securities, mortgage-backed bonds, and covered-mortgage bonds can be essential pillars, providing long-term financing to the private sector and diversifying the financial sector (IMF, 2014). In this connection, strengthening the Debt Policy Coordination Office capacity to act as central debt manager would help increase the efficiency of government bond markets, while removing tax and other distortions should facilitate diversification of domestic investor base to include insurance companies, mutual funds and pension funds.

[14] Pakistan Microfinance Review 2015, Pakistan Microfinance Network, Islamabad.

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FISCAL DECENTRALIZATION AND MACROECONOMIC CHALLENGES IN PAKISTAN[1]

This chapter discusses economic aspects of Pakistan's fiscal decentralization which followed the 18th Constitutional Amendment and the 7th National Finance Commission Award. The chapter does not discuss the optimality of the 18th Amendment itself, nor does it take a position on the optimal division of resources between various fiscal authorities. The chapter argues that the resulting fiscal framework is unbalanced in several ways and is not sufficiently flexible, which makes macroeconomic management more difficult and may have implications for overall socio-economic outcomes in the long run. In this context, the chapter discusses possible options to increase efficiency, flexibility, and responsiveness of the fiscal framework within the current legal framework for the consideration of policy makers and the next National Finance Commission.

A. Introduction

1. **In 2010, Pakistan embarked on a path of significant fiscal and administrative decentralization**.[2] The 18th Constitutional Amendment significantly curtailed the responsibilities of the federal government and expanded the legislative and executive domain of Pakistan's four provinces—Balochistan, Khyber Pakhtunkhwa (KPK), Punjab, and Sindh. At the same time, it gave a more prominent role to the Council of Common Interests (CCI) in coordinating joint federal-provincial tasks, and tasked provincial governments with further devolution of key functions to local governments, i.e. lower tier governments such as municipal authorities (Box 1). Besides setting the stage for significant fiscal decentralization, this devolution was made more permanent by a stipulation that the revenue share of the provinces in each National Finance Commission (NFC) Award cannot be less than the share given in the previous Award.[3]

2. **Implementation of the 18th Constitutional Amendment was enabled by the Seventh NFC Award, which significantly expanded the provincial share of public finances**.[4] Key features of the 7th Award were: (i) increasing the provincial share in the divisible tax pool from about 47.5 percent in FY2009/10 to 56 percent in FY 2010–11 and to 57.5 percent from FY 2011–12; (ii) expanding the divisible pool of federally collected taxes by reducing the federal government's collection charge from 5 to 1 percent; and (iii) moving the General Sales Tax (GST) on services from

[1] Prepared by Tokhir Mirzoev and Tasneem Alam.

[2] See also Shah (2012) for a comprehensive review of the 18th Amendment.

[3] As per the Constitution, a NFC is constituted by the President at intervals not exceeding five years to decide on the division of resources between the federal and provincial governments.

[4] See also Usman (2011).

Box 1. Main Aspects of Pakistan's Fiscal Framework Post-18th Constitutional Amendment

Division of Responsibilities. The 18th Amendment significantly reduced the list of functions under federal jurisdiction and abolished the list of functions under joint jurisdiction, moving most of the functions to the exclusive domain of the provinces. Several functions from these lists were put under the legislative power of Parliament, but with policies and regulations entrusted to the Council of Common Interests (see below). Among other things, these functions include railways, mineral resources, industrial development, all federal regulation, national planning and economic coordination, electricity, and supervision of public debt management. Finally, the 18th Amendment prescribed to the provincial governments to devolve political, administrative, and financial responsibility to the local governments (Article 140A).

Governance structures.

The eight-member *Council of Common Interests* (CCI), to be appointed by the President, consists of the Prime Minister (Chair), four provincial Chief Ministers, and three members of the federal government, nominated by the Prime Minister. CCI reports to the National Assembly and submits annual reports to both Houses of Parliament. Its primary responsibility is to regulate policies and exercise supervision of institutions under its purview. CCI is to have a permanent Secretariat and to meet at least once every ninety days. Decisions of the CCI are expressed by a majority and any disputes or disagreements can be resolved through a joint session of Parliament.

A twelve-member *National Economic Council* (NEC) consists of the Prime Minister (Chair) and four other federal government appointees, four provincial Chief Ministers and one member from each province to be nominated by its Chief Minister. NEC reviews overall conditions of the country and advises federal and provincial governments by formulating plans with respect to financial, commercial, social and economic policies to, among other things, ensure balanced development and regional equity. NEC is to meet at least twice a year or if convened by the Prime Minister or one half of its members. NEC is responsible to the National Assembly and submits annual reports to both Houses of Parliament.

The *National Finance Commission* (NFC) is constituted by the President at intervals not exceeding five years, makes recommendations on the distribution of resources between the Federation and the Provinces, including tax proceeds, grants-in-aid to provinces, and exercise of borrowing powers. The 18th Amendment has added two new provisions: i) the share of the provinces in each NFC Award cannot be less that the share given in the previous Award; ii) federal and provincial finance ministers shall monitor the implementation of the Award and submit bi-annual reports on its implementation to both Houses of Parliament.

Borrowing powers and limits. Borrowing or extension of loan guarantees by the provincial governments has been allowed within the limits, if any, imposed by provincial legislature (Assemblies). The federal government could also lend to or guarantee loans by provinces subject to its own borrowing/lending limits. However, a province may not raise a loan without the consent of the federal government if there is still outstanding any part of the loan made to the province or guaranteed by the federal government. The 18th Amendment has added a clause allowing provinces to raise domestic or international loans (or extend guarantees) within the limits and conditions specified by the NEC (recently raised from 0.5 to 0.85 percent of GDP).

Source: The Gazette of Pakistan (April 20, 2010) and Constitution of the Islamic Republic of Pakistan.

the divisible pool to the exclusive domain of the provinces.[5] Based on the end-FY 2009/10 budget and GDP outcome, these provisions (ignoring the transition year) corresponded to an additional resource transfer of 1.1percent of GDP.[6]

Resource Transfer to Provinces in the 7th NFC Award

(Based on FY 2009/10 budget outcome and GDP) 1/

	Percent of GDP	PRs bn.
Reduction in collection charge from 5% to 1%	0.20	29
1% of Divisible Pool for KPK 2/	0.04	6
GST on services	0.23	34
Change in provincial share to 57.5%	0.64	96
Total	1.11	165

Source: Pakistani authorities and staff calculations

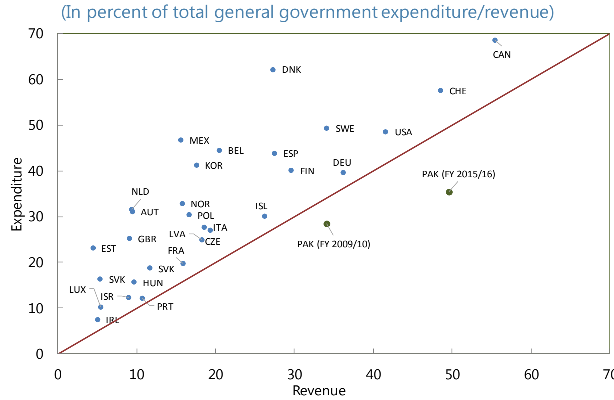
1/ In the transition year FY2010/11 the provincial share was set at 56 percent of the divisible pool.

2/ Calculation based on 0.45 percent reflecting the federal share transferred to the provinces.

3. The 7th Award contributed to substantial vertical fiscal asymmetry. As of FY 2015/16, the provincial share of general government expenditure stood at 35 percent, broadly in line with, for example, average in OECD countries. However, the provinces' share in general government revenue was significantly higher-about 50 percent in FY 2015/16, pointing to a significant structural deficit at the federal level.[7] In this respect, Pakistan's fiscal system is somewhat unique compared to other countries. In all OECD countries, for example, subnational governments' share in revenue is generally lower than their share in expenditure with the resulting gap covered by various forms of transfers. This chapter examines this and other imbalances, as well as economic

Expenditure and Revenue Shares in Selected Countries, 2015

(In percent of total general government expenditure/revenue)



Source: OECD fiscal decentralization database, Pakistani authorities, and staff calculations.

[5] Provincial authorities contend that GST on services was a provincial tax even before the 7th NFC Award. However, in practice, most of it was part of the divisible pool and, therefore, is included in these calculations. Additionally, 7th NFC Award altered the framework for horizontal distribution of resources among provinces from population-based to multiple parameters such as population, poverty, revenue collection and inverse population density. Moreover, one percent of the divisible pool was assigned to KPK to compensate losses incurred due to war on terror.

[6] In addition, Balochistan was guaranteed its projected share of taxes, which subsequently led to additional transfers of PRs 72.5 billion in the following five years; Sindh was awarded 0.66 percent of the provincial share in the divisible pool for the losses on account of abolition of octroi and zilla tax levied on movement of goods within local jurisdiction (PRs 5.7 bn. In FY 2009/10).

[7] Many studies measure provinces' revenue by taking their own revenue collection (e.g. Martinez-Vasquez (2011)), which stood at only 8 percent. However, shared taxes should arguably be included both for purposes of international comparison (Blöchliger and Petzold (2009)) and measuring vertical imbalances (Shah (2012)).

outcomes following the 7th NFC Award, and proposes a number of recommendations for consideration in the context of the next NFC Award discussions.

B. Imbalances in Pakistan's Fiscal Federalism Framework

4. International experience suggests that the design of fiscal federalism, more than the degree of decentralization, affects social and macroeconomic outcomes.[8] In recent decades, fiscal decentralization has been pursued in many countries, often reflecting a desire for more participatory government and greater voice of local constituents in the allocation of budgetary resources, as well as the quest for a more efficient provision of basic services. Among key principles for a successful decentralization, which emerged from these experiences, are: setting clear demarcation of responsibilities between various tiers of government; securing predictable and stable resources for local governments to support increased expenditure responsibilities; building effective and participatory mechanisms (either consensus-based or a more formal institutionalized framework) for coordination and dispute resolution. At the same time, inadequate public finance management systems at the subnational level, moral hazard in the form of weaker incentives to expand provincial tax bases, and procyclical spending patterns by provinces have often resulted in inferior outcomes following fiscal decentralization.

5. The basic design of Pakistan's fiscal decentralization is in line with many principles of successful decentralization. The 18th Amendment provided a clear division of labor between the federal and provincial government and maintained overall checks on provincial borrowing through the limits imposed by the NEC, while the 7th NFC Award ensured a significant additional pool of resources. The CCI has become more prominent and increasingly effective in reaching consensus, notwithstanding various pending issues (UNDP 2015a and 2015b).

6. However, in addition to the vertical imbalance mentioned above, the rollout of fiscal decentralization in the 7th NFC Award has been unbalanced in several important areas:

- **Devolution of fiscal resources was not tied to the devolution of expenditure responsibilities**. While the 7th NFC Award became effective starting in FY 2010/11, the devolution of public functions and full accounting of its fiscal costs took longer.[9] Consequently, the federal government expenditure could not adjust at a pace of the resource transfer, and the

[8] IMF (2009) and Fedelino and Ter-Minassian (2010) provide a comprehensive review of international experiences with fiscal decentralization and IMF's advice on its key aspects.

[9] A Parliamentary Implementation Committee, established to examine the logistical, legal, administrative and international aspects of devolution, completed its work only a year later. Among other things, the new framework of inter-governmental relations abolished 17 federal ministries, which involved reallocating their staff of over 60 thousand, assets, property, etc. as well as establishing effective matching institutions at the provincial level. CCI assigned current expenditure and development projects of devolved institutions to provinces starting FY2011/12 (PRs 49 bn. according to Shah (2012)). Some of the abolished federal ministries did not entirely disappear and still remain in different forms.

NFC Award made no provision for ex post reconciliation of the vertical resource allocation with the actual cost of administrative decentralization. International experience suggests that such an unbalanced devolution of revenue and expenditure generally leads to fiscal difficulties (see Hobdari et al., (2016)).

- **The revenue-sharing arrangement in the 7th NFC Award has posed challenges for fiscal policy-making and may have changed incentives at both federal and provincial levels**. First, with 57.9 percent (after accounting for one percent to KPK) of tax revenue shared with provinces, any revenue adjustment for fiscal policy purposes needed to be substantially larger for the federal government since provinces are free to spend their share. This narrowed the range and effectiveness of fiscal policy instruments. Second, although federal tax revenue has increased substantially in the past several years, incentives for the federal government in raising additional revenue may have become skewed toward revenue areas outside of the divisible pool of tax resources shared with the provinces. Third, provincial incentives to raise revenue may have been diminished by increased availability of revenue from the divisible pool.

- **Devolution of fiscal resources was not synchronized with strengthening public financial management (PFM) frameworks at the provincial level**. Although basic elements of budget formulation process were in place, PFM frameworks, cash management practices, commitment control, and fiscal reporting practices in the provinces varied significantly in their quality and transparency, although provinces have been making effort to improve their efficient spending capacity. Similarly, there is scope to improve the transparency and budgeting practices of quasi-fiscal operations and the operations of provincial public enterprises. The limited and uneven capacity to absorb additional resources and use them efficiently has likely contributed to limited success with improving the provision of basic services and may have increased disparity across provinces.

- **As a multi-year revenue framework, the NFC Award did not adequately account for contingencies**. The NFC Award does not include a strategy to counter unexpected fiscal shocks. The NFC report recommendations include a possibility of federal assistance to provinces in times of unforeseen calamities, but no such provision was made in case of a need for reverse assistance in times of national emergencies (e.g. security-related expenditure). This leaves the federal government more vulnerable to fiscal shocks, especially if affordable borrowing options are limited.

- **The Award is largely silent about sharing the burden of financing joint responsibilities**. The NFC's report did not consider critical functions of national importance which fall under the jurisdiction of the CCI-and hence joint responsibility of the federal and provincial governments-after the 18th Amendment. Most importantly, such areas include public debt and the electricity sector which pose considerable claims on public finances. By default, these functions continue to be financed by the federal government.

- **Ensuring a consistent fiscal stance across the layers of government has also been a challenge**. The NFC Commission's recommendation that the federal and provincial governments develop and enforce a mechanism for maintaining fiscal discipline at both levels remains to be fully implemented. The recently established Fiscal Coordination Committee (FCC), comprising the provincial and federal finance secretaries, helps to synchronize policy coordination and budget implementation, but its decisions are legally non-binding and have not always been implemented.

- **Fiscal decentralization still did not trickle down to local governments**. Implementation of the Article 140A of the Constitution, prescribing to the provincial governments to devolve political, administrative, and financial responsibility and authority to the local governments remains largely incomplete, notwithstanding some progress with provincial finance awards and local government finance legislation adopted in some provinces.

C. Macroeconomic Outcomes Since the 7th NFC Award

7. The original NFC Report laid out an optimistic macroeconomic framework, likely reflecting the intended outcome of the award.[10] After an initial transfer of resources in FY 2010/11, and the corresponding worsening/improvement of the federal/provincial fiscal positions, the framework envisaged:

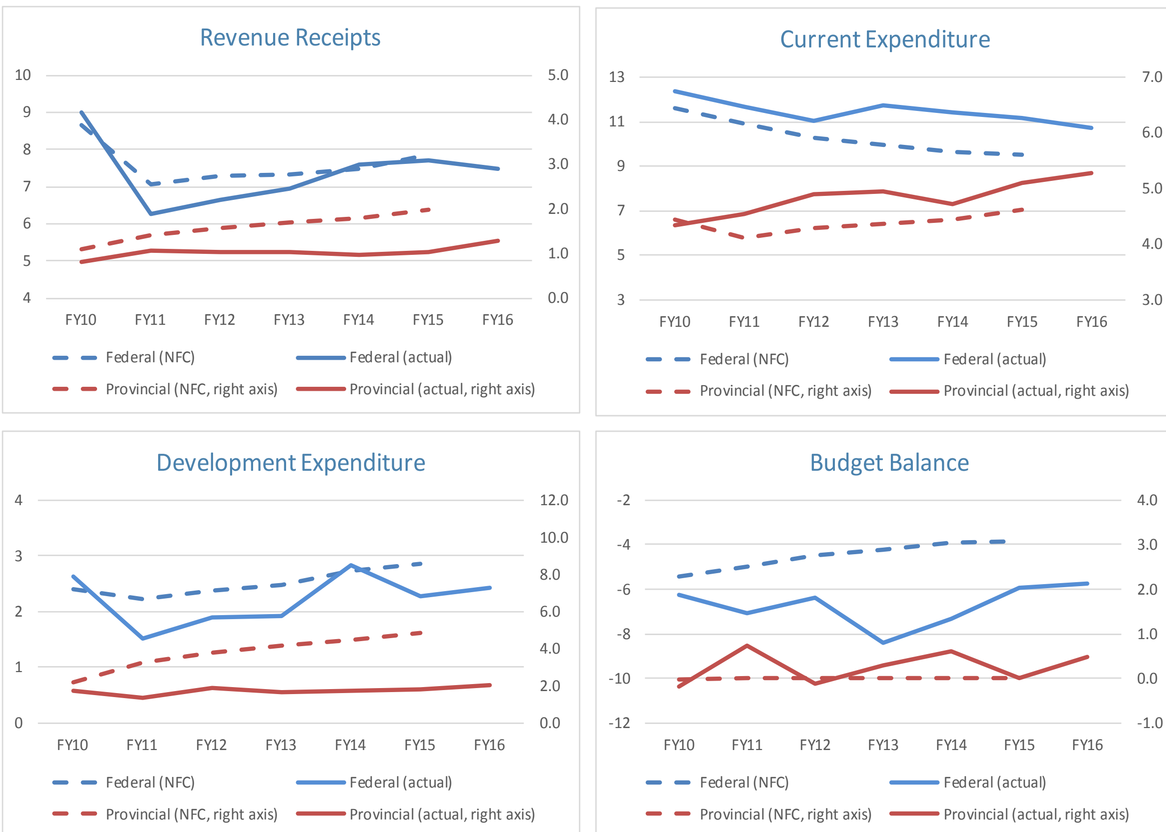
- **Continued fiscal adjustment with increased space for development expenditure by the federal government**. By FY 2014/15, the federal government was expected to bring down its fiscal deficit from 5.5 percent of GDP to 4.1 percent of GDP, on the back of gradual but continuous rationalization of current expenditure and strong revenue growth. Federal development expenditure was expected to increase by 0.6 percent of GDP per year over the next five years.

- **A significant scaling up of development expenditure by the provinces**. Provincial revenue, from both own and federal sources, was expected to increase by 4 percent of GDP between FY 2009/10 and FY 2014/15. The bulk of this increase (3 percent of GDP) was to be used for development expenditure with only a modest increase in current spending (by 0.5 percent of GDP) and balanced budgets.

8. In part linked to the imbalances of Pakistan's decentralization, fiscal outcomes differed markedly from the NFC's vision, despite significant revenue-driven fiscal consolidation during the 2013–16 EFF-supported program and better-than-expected growth of nominal GDP (Figure 1). Specifically:

[10] NFC (2009), Annex IX, Table 1.

Figure 1. Macroeconomic Framework in the NFC Report and Actual Outcomes
(In percent of national GDP, unless indicated otherwise)



Source: Pakistani authorities, NFC Commission (2009), and staff calculations.
Federal revenue receips are net of transfer to provinces.

- **Federal budget deficit was higher than in the NFC framework despite being on a downward trajectory in the past three years**. Federal current expenditure adjusted more slowly than envisaged, owing to delayed and partial transfer of expenditure responsibilities to provinces, slow implementation of key structural reforms, and difficulties in coping with new fiscal shocks. Alongside, growth of tax revenue also underperformed in the initial years. Coupled with additional expenditure shocks, these factors delayed fiscal adjustment at the federal level and, in the absence of automatic stabilizers built into the Award mechanism, kept the budget deficit significantly higher throughout the period.

- **Provincial revenue growth was substantially below expectations, owing both to challenges at the federal level, and the provinces' own tax efforts** (Figure 2, Box 2). Reflecting changed incentives and tax reform challenges, federal revenue increase initially was slower than expected. Meanwhile, provinces' own tax efforts seemed to have focused on improving the collection of GST on services. However, tax collection from other key potential sources (such as real estate and agriculture) largely remained flat in percent to GDP. Having jurisdiction over agriculture and services-which account for 80 percent of Pakistan's GDP-provinces collected a mere 1.3 percent of GDP in taxes in FY2 015/16.

- **The provinces' increased resource envelope went disproportionately into current spending, whereas the expected scaling up of public investment did not materialize**. In the five years of the Award, provincial public investment expanded by only 0.3 percent of GDP, in part reflecting limited absorptive capacity of the provincial governments and PFM-related constraints, and in part owing to slower revenue mobilization.

- **Ultimately, these outcomes translated into very different balance sheet effects**. On one hand, they led to faster increase in public debt despite sizable consolidation efforts. On the other hand, provinces accumulated cash balances of over PRs 600 billion, or 2 percent of GDP during the period of the 7th NFC Award.

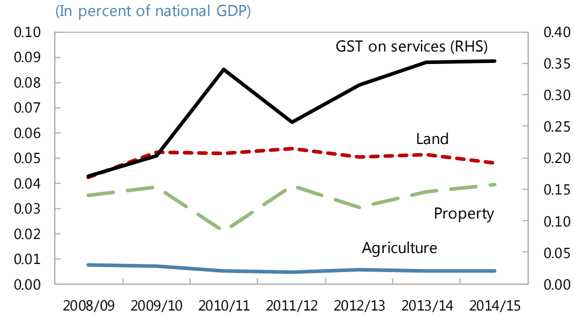
Box 2. Provincial Revenue Mobilization

The 7th NFC Award has assigned the General Sales Tax (GST) on services—a buoyant tax base—to the provinces, in addition to their other tax assignments, which include agricultural income tax, taxes on immovable property, capital gains tax, estate and inheritance tax, motor vehicle tax and charges on services such as water supply, drainage and lighting. Despite significant taxing powers, provinces have collected only 8 percent of the national fiscal revenue in FY 2015/16.

Following the 7th NFC Award, most provincial authorities have established own revenue authorities tasked with the collection of GST on services. These authorities have had some success: tax bases were increased to include a wider range of previously untaxed services and improving administration. As a result, collection has nearly doubled since the NFC award.

At the same time, revenue mobilization from other promising bases such as agriculture and real estate has not shown marked improvement relative to GDP and, in some cases worsened. Tax administration at the provincial level remains fragmented, often with different agencies collecting various taxes. Diminished incentives to expand tax bases following the allocation of higher revenue through the 7th NFC Award may also play a role. Building on the success of revenue authorities and bringing other tax collection responsibilities under "one roof" would help reduce the cost and increase effectiveness of administration. Alongside, building coordination and information-sharing mechanisms both across provinces and with the Federal Bureau of Revenue will be important to make use of complementarities in tax administration (e.g., a nation-wide cadaster of real estate) and promote easier compliance, as well as reduce confusion and resolve disputes in taxation of services traded across provincial borders (such as transport or telecom).

Provincial Tax Revenue
(In percent of national GDP)



Source: Pakistani authorities and staff calculations.
GST on services includes collection by the federal government.

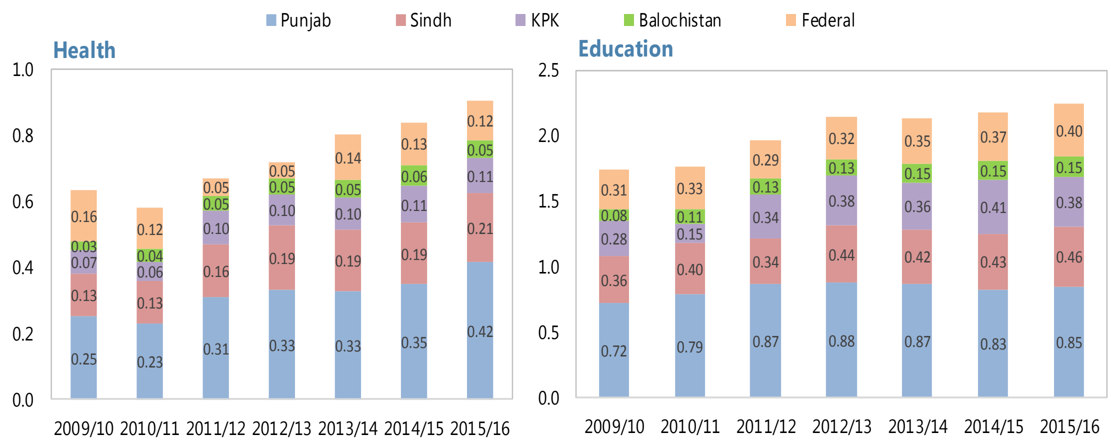
- **Alongside, progress with respect to basic service delivery-one of the key economic justifications for fiscal decentralization-has been mixed**. Notwithstanding some improvements, notably with respect to child immunization rates, overall social outcomes with respect to basic services in some cases did not improve amid gradually increasing but still low levels of spending in these areas (Figures 2 and 3). There were also notable differences across provinces in these outcomes. These observations point to capacity constraints in public administration and public finance management systems which vary across provinces.

Figure 2. Social Outcomes Before and After the 7th NCF Award

Source: Pakistan Social and Living Standards Measurement Surveys, FY2008/09 and FY2014/15

Figure 3. Federal and Provincial Expenditure on Health and Education

(In percent of GDP)



D. Considerations for the Next NFC Award

9. Overall, the 7th NFC Award has resulted in an unbalanced and less flexible intergovernmental fiscal framework. In this context, economic management in addressing macroeconomic imbalances and vulnerabilities has become more constrained. Important revenue sources have been underexploited, fewer instruments are at the disposal for any near-term fiscal policy response to economic shocks, and there is scope for improving the coordination mechanisms between the federal and provincial governments. Overall efficiency of public expenditure and social outcomes were mixed due to a generally lower and uneven quality of PFM frameworks at the provincial level. In more turbulent times, these vulnerabilities could undermine macroeconomic stability.

10. These factors require careful consideration in the next NFC Award. The 18thConstitutional Amendment not only emphasizes the need for greater autonomy of the provinces, but also calls for a more participatory and coordination-based approach to managing aspects of the national economy. Therefore, considering the design aspects of the fiscal framework outlined above in the context of the next NFC Award will be necessary to achieving a well-functioning and effective fiscal system.

11. The next NFC should aim to strengthen macroeconomic stability and increase efficiency, flexibility, and responsiveness of the fiscal framework. Although the Constitutional nature of some parameters of Pakistan's fiscal decentralization framework constrains near-term options, improvements can be considered within the current legal framework. In this context, the NFC may better account for the anticipated consequences of the next Award on public debt, the effectiveness of fiscal policy, nation-wide efficiency of public expenditure across all levels of government in light of the uneven quality of PFM frameworks, as well as strategies to cope with unanticipated shocks. In addition, emphasis could be placed on better incentives and coordination in the area of tax revenue mobilization and overall fiscal stance across all layers of government. To this end, a number of options could be considered, either in the context of the NFC Award or as a subject matter for the CCI:

- **Effective mechanisms for fiscal discipline and coordinating fiscal stance**. International experience with securing fiscal discipline and synchronizing overall fiscal stance varies significantly, from administrative controls (e.g. Greece, Turkey) to reliance on financial market forces (e.g., Canada and the United States).[11] Pakistan's political structure calls for effective institutions of coordination and cooperation, which works best in environments of significant political decentralization (e.g. in Germany). Toward this end, one option is to establish a technocratic fiscal council under the CCI to develop and agree on broad fiscal rules for all levels of governments, with explicit links to a realistic macroeconomic framework, as well as transparent enforcement procedures. Alongside, a uniform framework for transparency, reporting, and accounting of quasi-fiscal liabilities (including public enterprises, public-private partnerships, liabilities from wheat purchases, and special purpose vehicles at all levels of government) will be critical to properly assess the fiscal discipline.

- **Increasing flexibility of the fiscal framework**. At present, the federal government's ability to respond to unexpected expenditure needs of national importance as well as its ability to assist provinces (e.g., in times of natural disasters) is limited. To this end, establishing a jointly funded contingency fund would help enhance the fiscal framework's ability to absorb large and unexpected shocks to expenditure of national importance. Authorization for the use of such a fund could be subject to mutual consent of both federal and provincial authorities and/or sanctioned by the CCI to preserve the participatory approach of the existing federal-provincial relations.

- **Improving incentives for tax revenue mobilization and coordinated administration**. A stronger incentive-based national framework for tax revenue mobilization is needed to avoid over-taxation of compliant taxpayers and facilitate a coordinated expansion of the fiscal space for much-needed development and social spending. A national consensus with specific revenue targets (e.g., set by the CCI) and mechanisms to enforce their attainment could help overcome coordination and political economy issues with respect to policy and administrative aspects of taxation in sensitive areas, such as agriculture and real estate. In addition, improved coordination, both vertically (e.g., in common initiatives to widen the tax net in areas of joint tax jurisdiction) and horizontally (e.g., in harmonizing regulations or implementation of GST on services) will be important to balance the need for increased fiscal revenue and business promotion. To this end, a national tax commission could be established under the CCI.

[11] Joumard and Kongsrud (2003) provide a good discussion of the various approaches.

- **Greater ownership of and burden-sharing with respect to joint tasks**. Consideration should be given to the specific role and contribution of the provinces in areas which, after the 18th Amendment, are under joint federal-provincial responsibility, such as public debt and the electricity sector. Although public debt is mostly contracted by the federal government, such a need is, at least in part, a result of the overall fiscal outcome of the nation-wide fiscal framework, including the existing vertical imbalance. Consequently, the NFC Award structure should minimize federal borrowing needs by reducing the vertical imbalance (e.g., through assumption of additional expenditure responsibilities by the provinces) or consider a burden-sharing arrangement for the impact of its design on public debt, especially given the fiscal surpluses at the provincial level. Similarly, provinces' participation in reforming the power distribution sector as well as sharing the burden of liabilities arising from delays with such reforms should be considered.

- **Improving efficiency of public expenditure**. In addition to improving transparency and fiscal reporting, other aspects of public finance management, such as budget preparation process, project selection, prioritization and procurement procedures, and overall governance structures need to be strengthened and made more uniform across the country. To this end, both the federal government and international partners could be involved to a greater extent in the provision of the necessary capacity building and technical assistance. In addition, saving some provincial funds until the PFM frameworks are improved and allow their efficient spending will help with the overall efficiency of resource allocation over time.

- **Further devolution of expenditure and revenue to local governments over the medium term**. Given the large size of most of Pakistan's provinces, achieving a substantial improvement in the provision of basic services will require effective involvement of local governments. To this end, a clear time-bound framework for improving administrative capacity and public finance systems in local administrations, and transferring basic service delivery functions and the needed resources from provincial to local governments will be key in delivering on the socio-economic promise of decentralization.

12. Initial feedback of the provincial authorities suggests a potentially challenging road ahead (Box 3). Achieving a broad consensus on the specific improvements and modalities of strengthening the fiscal framework will require extensive dialogue to balance the provinces' concerns about preserving their autonomy on one hand, and the need for more coordination and flexibility to improve overall economic outcomes. In this context, closer alignment of provincial and federal economic objectives could help develop common strategies and coordination mechanisms over time.

Box 3. Provincial Authorities' Feedback

In their feedback to an earlier version of this chapter, provincial authorities have emphasized their individual achievements in various areas, such as tax revenue mobilization or devolution to local governments. All provinces strongly underscored the need to respect the constitutional protection of their revenue shares, and, in some cases, argued for additional resources needed to help them meet their social development goals. Some provinces challenged the connection between the 7th NFC Award and tax revenue mobilization incentives, and between social outcomes and the quality of PFM frameworks.

With respect to policy, the provincial authorities expressed a general reluctance to co-finance joint tasks. Some provinces argued that the tasks falling under the jurisdiction of the CCI are not joint in that they remain in the legislative domain of the federal government, and, therefore, should not be co-financed from provincial resources. If this interpretation is correct—i.e. that the constitution only empowers provinces with full participation in national-level policy-making without financial responsibility over the outcome of such policies—a consideration of incentive compatibility in Pakistan's fiscal system is warranted.

Despite some support, there was a similarly reluctant stance by provincial authorities with respect to the financing of large and unexpected shocks out of a jointly funded contingency fund. The provinces' key concern in this area was the potential misuse of such a fund, requiring a robust institutional and operational framework.

Notwithstanding mixed views, the provincial authorities' feedback seemed to recognize the need for improved coordination mechanisms with respect to fiscal stance and tax administration as well as continued strengthening of PFM frameworks. At the same time, there was a general sense of unease about the possibility of such mechanisms to limit the provinces' fiscal autonomy.

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THE MACROECONOMICS OF PAKISTAN'S QUEST FOR ENERGY AND THE CPEC[1]

Pakistan has embarked on a massive investment program in energy and infrastructure sectors, partly in the context of the China-Pakistan Economic Corridor (CPEC). This chapter discusses some of the expected benefits of these investments as well as their potential macroeconomic impact. The planned investments are expected to eliminate Pakistan's energy deficit, improve the economy's fuel mix, reduce energy costs, raise overall business productivity and trade connectivity, and provide a positive boost to output and exports. At the same time, the potential medium-term impact on the balance of payments—through higher loan repayments, repatriation of profits from FDI, and fuel imports—points to the need for a strong policy focus on boosting exports and building external buffers, bringing the distribution sector to full cost recovery, prudent management of project costs and fiscal incentives, as well as careful phasing in of new external commitments.[2]

1. **Over the past decade, Pakistan has faced chronic energy shortages and substantial underinvestment in infrastructure**. The authorities estimate the cost of these challenges to the economy at about 2 percent of GDP per annum. Excessive reliance on furnace oil amid rising oil prices combined with administrative and operational inefficiencies and inadequate tariff setting produced large and persistent losses in the power sector which, in turn, led to the accumulation of power sector arrears (so-called "circular debt"), underutilization of existing capacity, and underinvestment in new energy supply. The resulting gap between demand and supply of energy was manifested in power outages averaging 10–12 hours a day in FY2012/13. Alongside, public investment averaged only about 3.5 percent of GDP-substantially lower than the average of over 6 percent of GDP in other emerging economies.

2. **The authorities' reforms have led to notable improvement in recent years**. Lower oil prices, combined with efforts to bring power tariffs closer to cost recovery as well as improved collections and reduced losses have helped bring power outages to about 6 hours a day on average in the residential sector and less than two hours a day in the industrial sector in FY2015/16. In parallel, accumulation of circular debt has slowed down and efforts to raise tax revenue and rationalize expenditure have created space to expand the public sector development program by 0.5 percent of GDP cumulatively over the last three years.

[1] Prepared by Hiba Zaidi and Tokhir Mirzoev.

[2] Medium-term projections presented in this note represent a preliminary assessment which is likely to change over time. These projections have already been incorporated in the IMF staff's macroeconomic framework balance of payments projections. The calculations are based on available information and, where applicable, staff's own assumptions.

3. Alongside, Pakistan has embarked on a wide-ranging initiative to increase and diversify its energy supply and improve infrastructure to help realize the country's growth potential. The China-Pakistan Economic Corridor (CPEC) is a large package of investment projects, potentially totaling about $55 billion (19 percent of FY2015/16 GDP) over the next decade, aimed at upgrading infrastructure, boosting and diversifying energy supply, and improving regional trade connectivity thereby stimulating investment. The estimated size of CPEC will likely change over time. The analysis below is based on realization of 19 CPEC projects ($17.7 billion in energy sector and $5.9 billion in infrastructure) and several non-CPEC energy sector projects ($25.4 billion), which are either in advanced planning stages or already in the process of implementation. Investments in the energy sector include a combination of generation projects based on coal and liquefied natural gas, hydro power stations, nuclear power plants, and several solar and wind farms. Substantial investment has already taken place and, going forward, inflows are expected to peak at about $12 billion, gradually declining in the following four years.

Summary of CPEC and Other Power Sector Projects 1/

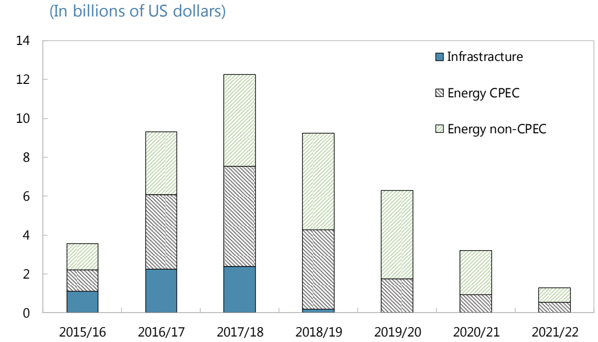
	No. projects	Investment (US$ bn.)
CPEC	19	23.6
Energy	15	17.7
Infrastructure	4	5.9
Non-CPEC energy	13	25.4
Total	32	49.0

Source: Staff estimates based on discussions with the Pakistani authorities.

1/ Includes only projects in implementation or advanced planning stage.

4. The authorities have facilitated a variety of financing modalities for the various investment plans. CPEC infrastructure and transport projects are financed by long term concessional government borrowing from China. CPEC projects in the energy sector involve foreign direct investment and commercial borrowing from Chinese financial institutions, either by majority foreign-owned joint ventures or Chinese investors.[3] Financing of non-CPEC energy projects ranges from private domestic financing to private commercial as well as government concessional borrowing from international financial institutions.

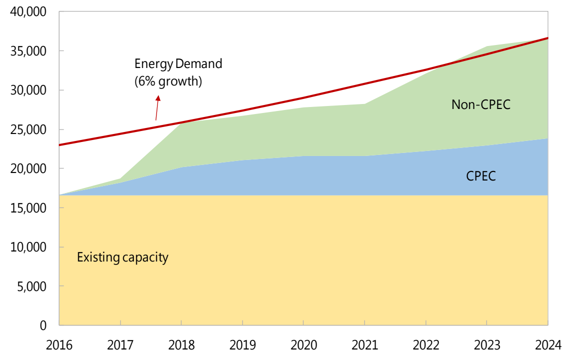
CPEC and Other Power Sector Investment Plans
(In billions of US dollars)



Source: Pakistan authorities, NEPRA, news reports, and staff estimates.
Based on projects in implementation or in advanced planning stages.

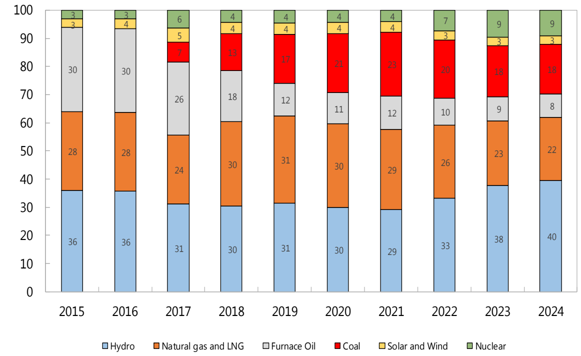
[3] Energy sector projects will operate as independent power producers (IPPs) with guaranteed sales through power purchasing agreements or guaranteed rates of return through energy tariffs.

Projected Power Sector Capacity and Demand
(In MW)



Source: IMF staff estimates based on data from Pakistani authorities, NEPRA, and own assumptions.
Based on projects in implementation or in advanced planning stages. Demand and supply during NTDC's system peak hours.

Projected Evolution of the Fuel Mix
(In percent)

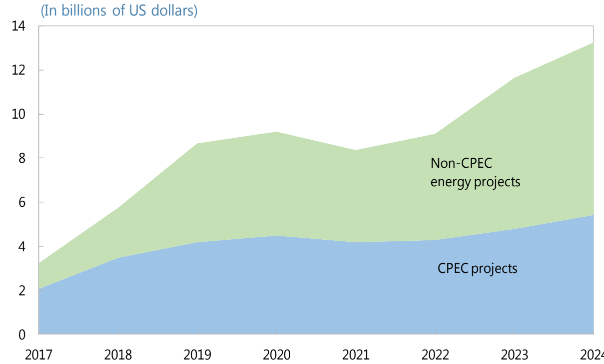


Sources: Pakistan authorities, NEPRA, news reports, and staff estimates.
Based on projects in implementation or in advanced planning stages.

5. **If implemented on schedule, these investments could help close Pakistan's power deficit and significantly improve energy costs and the fuel mix**. The current investment plans envisage an addition of about 24 GW in installed capacity, of which 8.6 GW owing to CPEC, over the next 7–9 years. Assuming annual growth in energy demand of around 6 percent and an average capacity utilization of 85 percent, this expansion will help eliminate Pakistan's deficit of about 6 GW in 2016 to a surplus as early as end-2018. In the process, Pakistan's reliance on furnace oil (30 percent of the fuel mix in 2015) would be significantly reduced, making the energy sector more independent and resilient to abrupt changes in international oil prices.

6. **Alongside, these investments will provide a boost to Pakistan's GDP**. This boost will likely come in three stages: construction, power generation once the installed capacity becomes operational, and-over time-second-round effects on broader economic activity owing to increased productivity, lower costs, and improved trade connectivity owing to improved infrastructure. The first two stages (direct contribution) will likely materialize in the next several years, while the second-round effects will likely accrue more gradually and could lead to a significant contribution in the long run, although the exact impact will depend on many other supportive factors.

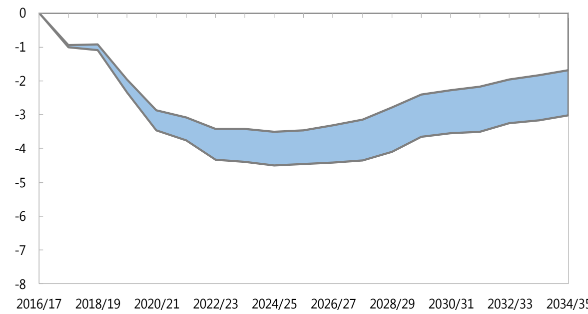
Direct Contribution to GDP from CPEC and other Energy Projects
(In billions of US dollars)



Source: IMF staff estimates based on data from Pakistan authorities, NEPRA, and own assumptions.
Based on projects in implementation or in advanced planning stages. Direct contribution includes impact from construction phase as well as value added in electricity generation (using NEPRA-determined tariffs), and does not include potential second-round effects. Assumes 70% import content during construction. Value added is estimated by subtracting the import content of investment, and the cost of imported fuel.

7. At the same time, Pakistan's investment initiatives will likely create long-term balance of payments outflows. In the medium term, the operation of these projects will require balance of payments (BoP) outflows in the form of loan repayment, profit repatriation, and imports of input fuel. These outflows- which will be moderated by the expected savings from phasing out of the oil-based electricity generation -are expected to rise in the next several years, peaking at about \$3.5–\$4.5 billion by FY2024/25 (1.2–1.6 percent of FY2015/16 GDP) and gradually declining in the long run. A slower growth of energy demand or a faster phasing out of oil-based energy generation capacity, among other factors, will help lower these outflows.

BoP Flows Owing to CPEC and non-CPEC Energy Projects
(In billions of US dollars)



Source: IMF staff estimates based on data from Pakistani authorities, NEPRA, and own assumptions. Based on projects currently in implementation or in advanced planning stages. The range of estimates corresponds to different plausible assumptions about the rate of displacement of furnace oil-based electricity generation, rate of profit repatriation, energy demand growth, fuel prices, and capacity utilization.

8. Exports will need to increase substantially to meet the increased foreign currency financing needs. A positive impact of these projects on exports will further offset the expected outflows in the medium term. However, the effect of these investment initiatives will likely accrue gradually over time given the time required to build up additional export capacity from productivity improvements.

9. These considerations warrant policymakers' attention to two priority areas in order to realize the transformational potential of Pakistan's investment program while maintaining external stability:

- **Generating export revenue and further building the external buffers**. Taking advantage of the still low oil prices to substantially augment the foreign exchange reserves of the State Bank of Pakistan (SBP)will be important to cushion the period of increased BoP outflows. Strong and sustained reform efforts aimed at raising exports by improving competitiveness and the business climate will be critical to maintain long-term external sustainability and realize the potential benefits of CPEC from improved energy supply and transport infrastructure.

- **Bringing the distribution sector to full cost recovery**. Routing the increased generation capacity through a loss-making distribution sector could result in faster accumulation of circular debt and fiscal costs, as well as undermine long-term financial sustainability of the new energy projects. Therefore, despite the recent progress, a significant acceleration of energy sector reforms, including strengthening of governance in the distribution companies (DISCOs), attracting private investment to reduce line losses and improve metering and collection, and maintaining a strong and enabling regulatory framework will be important in the period ahead.

10. Looking ahead, containing fiscal costs, maintaining a supportive environment for all investments, and a gradual phasing in of new external commitments will help maintain macroeconomic stability and strengthen growth sustainability. In this context, it would be important to rationalize and limit tax incentives and exemptions; maintain uniformity of the tax regime with respect to all investments; and synchronize phasing in of new external commitments with the expected balance of payments trends.

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