COUNTRY PRIVATE SECTOR DIAGNOSTIC

# CREATING MARKETS IN PAKISTAN

Bolstering the Private Sector

May 2021

WORLD BANK GROUP
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# ACKNOWLEDGMENTS

This Country Private Sector Diagnostic (CPSD) was prepared by a World Bank Group (WBG) team led by Michael Engman (Senior Economist) and Bushra Ghulam Mohammad (Strategy Officer) and comprising Rami Mikko Ahmed Galal (Young Professional), Rafay Khan (Economist) and Faryal Nazir (Private Sector Specialist). The team benefited from contributions from Stefan Apfalter (Senior Evaluation Officer), Shahjahan Hashmani (Consultant), Peter Kusek (Senior Economist), Yan Liu (Young Professional), Camilo Mondragon-Velez (Principal Research Economist), Jan Olivier Imhof (Research Officer), Shoghik Hovhannisyan (Research Officer), Santosh Ram Joshi (Research Officer), and Kersten Kevin Stamm (Consultant). Mubashar Awan (Team Assistant), Zulfiqar Ali Shah (Program Assistant), provided administrative support.

The team is grateful for comments provided by the peer reviewers Moazzam Mekan (Principal Investment Officer), Massimiliano Cali (Senior Economist) and Fatima Zehra Shah (Senior Operations Officer). It also benefited from the insights and guidance shared by colleagues in the International Finance Corporation (IFC) and the World Bank: Kiran Afzal (Senior Private Sector Specialist), Aijaz Ahmad (Senior Public Private Partnerships Specialist), Anjum Ahmad (Senior Energy Specialist), M. Said Amlaiky (Principal Investment Officer), Mirza Khurram Baig (Investment Officer), Amjad Bashir (Senior Economist), Sabine Cornieti (Young Professional), Jean Saint-Geours (Senior Economist), Tania Khan Jamal (Investment Officer), Willem Janssen (Lead Agriculture Economist), Oliver Knight (Senior Energy Specialist), Guo Li (Senior Agriculture Economist), Shabih Mohib (Lead Country Economist), Zunee Muhtashim (Principal Investment Officer), Vincent Palmade (Lead Economist), Saadia Qayyum (Energy Specialist), Navaid Qureshi (Chief Industry Specialist), Silvia Redaelli (Senior Poverty Economist), Charles Schneider (Senior Private Sector Specialist), Sarmad Shaikh (Financial Sector Specialist), Panayotis Varangis (Lead Financial Sector Economist), Gonzalo Varela (Senior Economist), Marius Vismantas (Lead Financial Sector Specialist), Muhammad Waheed (Senior Economist), Namoos Zaheer (Senior Financial Sector Specialist) and Hasan Afzal Zaidi (Senior Transport Specialist). The analysis and conclusions were informed by consultations with industry associations, business leaders, civil society leaders and civil servants in federal and provincial government departments and autonomous agencies.

The work was prepared under the supervision of Mona Haddad (Director), Nadeem Siddiqui (Senior Manager), Rolf Behrndt (Practice Manager), Shabana Khawar (Principal Country Officer) and John Nasir (Practice Manager) of IFC; and Zoubida Kherous Allaoua (Regional Director), Najy Benhassine (Country Director), Illangovan Patchamuthu (Country Director), Nabila Assaf (Practice Manager) and Melinda Good (Operations Manager) of the World Bank.

The CPSD makes extensive use of the existing body of work prepared by the World Bank for the Pakistan@100: Shaping the Future (2019). It also relies on and integrates the findings of several recent World Bank publications, including: (i) *Pakistan Systematic Country Diagnostic* (2020), (ii) *Pakistan Jobs Diagnostic: Promoting Access to Quality Jobs for All* (2020); (iii) *Pakistan Unlocking Private Sector Growth Through Increased Trade and Competitiveness* (2018); and (iv) *Pakistan Financial Sector Assessment Program—Development Module* (forthcoming). The World Bank Open Data website, the World Integrated Trade Solutions database and the State Bank of Pakistan provided much of the data.

# ACRONYMS

| | |
|---|---|
| AEDB | Alternative Energy Development Board |
| ASEAN | Association of Southeast Asian Nations |
| BBRI | Better Business Regulation Initiative |
| BOI | Federal Board of Investment |
| BOT | Build-Operate-Transfer |
| CAA | Civil Aviation Authority |
| CCP | Competition Commission of Pakistan |
| CMC | Collateral Management Companies |
| CPEC | China Pakistan Economic Corridor |
| CPSD | Country Private Sector Diagnostic |
| EFF | IMF-Extended Finance Facility |
| EoDB | Ease of Doing Business |
| EWR | Electronic Warehouse Receipt |
| FDI | Foreign Direct Investment |
| FTA | Free Trade Agreement |
| GDP | Gross Domestic Product |
| GoP | Government of Pakistan |
| GVC | Global Value Chain |
| LNG | Liquified Natural Gas |
| LPI | Logistics Performance Index |
| MNO | Mobile Network Operator |
| MSME | Micro, Small and Medium-sized Enterprises |
| NEPRA | National Electric Power Regulatory Authority |
| NFIS | National Financial Inclusion Strategy |
| NPCC | National Power Control Center |
| NSS | National Savings Scheme |
| ODA | Overseas Development Assistance |
| OECD | Organization for Economic Cooperation and Development |
| PIA | Pakistan International Airlines |
| PMEX | Pakistan Mercantile Exchange Limited |
| PPP | Public Private Partnership |
| PSC | Private Sector Credit |
| R&D | Research and Development |
| SAM | Social Accounting Matrix |
| SBP | State Bank of Pakistan |
| SCADA | Supervisory Control and Data Acquisition System |
| SECP | Securities and Exchange Commission of Pakistan |
| SEZs | Special Economic Zone |
| SME | Small and Medium-sized Enterprise |
| SMEDA | Small and Medium Enterprise Development Authority |
| SOE | State Owned Enterprise |
| SPS | Sanitary and Phytosanitary |
| TFP | Total Factor Productivity |
| VRE | Variable Renewable Energy |
| WEF | World Economic Forum |

# EXECUTIVE SUMMARY

**1. Pakistan has tremendous untapped economic potential.** Built upon one of the world's oldest civilizations, Pakistan is strategically located as it borders energy rich Iran and the world's two largest emerging economies: China and India. Pakistan has the world's fifth largest population with two-thirds under the age of 30. The country boasts a diaspora of nine million residing mainly in the Middle East, the United States and Europe. The east of the country is endowed with fertile land and great rivers that have rendered Pakistan among the world's top producers of cotton, dates, mangoes and oranges. The textiles and garment industry has been a major source of export earnings for decades. Yet despite these endowments and the demographic dividend, Pakistan's economy has stagnated relative to its regional and aspirational peers, and this divergence in economic fortunes has accelerated in the last decade. A history of political turbulence, regional insecurity and macroeconomic instability have shaped the economy and investment decisions. A relatively slow growth in both human and physical capital accumulation coupled with restrictive and distortive policies maintained by special interest groups have left the country unable to realize its economic potential.

**2. This Country Private Sector Diagnostic (CPSD) analyzes and synthesizes cross-cutting and sectoral impediments to private sector development in Pakistan.** It also proposes a policy reform agenda that would be transformational for the growth and competitiveness of the private sector. It complements the World Bank's Systematic Country Diagnostic (SCD, 2020) and aims to contribute to the national dialogue by focusing specifically on private sector issues. The Pakistan@100 body of work is the base and it draws on recent thematic World Bank reports and consultations with business leaders and public officials. Technical solutions to Pakistan's institutional constraints and policy distortions are readily available, but the implementation of these solutions requires committed political leadership. This has proven hard to muster in Pakistan's young and noisy democracy. Successive administrations have been humbled by vocal public opposition or internal resistance to change influenced by special interest groups. Maintaining political stability has been challenging with frequent transfers of power between civilian and military administrations. The devolution of powers to the provinces and local governments has resulted in an institutional footprint with sometimes overlapping or unclear mandates that give rise to uncertainty for businesses. The question is therefore what it would take for Pakistan's policymakers—and its elites and informal decision makers—to step up to address the multitude of issues as Pakistan falls behind its peers. Or, in other words, what would enable the government to break the economy's many sub-optimal equilibria.

**3. The reforms identified in this CPSD can be transformative in catalyzing private investments and creating new market opportunities, with or without the COVID-19 pandemic.** The reforms and policy recommendations presented in the action matrix summarize core constraints faced by the private sector and link them to concrete solutions that could be implemented within the next five years. The core of this work was prepared in the fall of 2019 and the beginning of 2020 before the COVID-19 pandemic reached Pakistan. Consequently, while the fundamental policy issues that inhibit the private sector will remain as relevant in a post-COVID-19 world, this exogenous shock to the Pakistani economy will have profound negative effects on many sectors and exacerbate structural issues. The Government of Pakistan (GoP) may thus find itself under stronger pressure to tackle structural issues that distort and impede private sector growth to promote an economic recovery. This medium- and long-term agenda will need to complement short-term initiatives to mitigate the demand and supply shocks resulting from the COVID-19 pandemic such as the rescue and recovery efforts of businesses.

***Pakistan is in urgent need of a more sustainable and equitable growth model that can help create jobs and offer better opportunities for the more than two million youth who join the labor force every year.***

**4. Pakistan's economic growth rate has been on a downward trajectory for four decades with comparatively low human and physical capital accumulation contributing to low productivity growth.** In the decade ending in 2018, the gross domestic product (GDP) per capita grew by less than 2 percent per year. Periods of growth have generally been fueled by consumption and financed by debt, which has resulted in boom-bust cycles. Public spending today is mostly servicing debt and maintaining a strong security complex. There are few resources left for investment in enabling infrastructure, health and education. For example, in 2017, health expenditure per capita was US$45, or approximately 10 percent of the amounts in neighboring China and Iran. In 2017, government expenditure on education per capita was 2.9 percent of GDP (US$43) compared to an average of 4.6 percent in lower-middle income countries. The implications of underinvestment in human capital are stark as it depresses labor productivity and reduces life expectancy—only Afghanistan has a lower life expectancy than Pakistan in South Asia. Without a reorientation toward investment in human and physical capital it will be difficult to raise the economic growth potential and improve economic performance.

**5. Pakistan needs to nearly double its investment-to-GDP ratio to 25-30 percent to become an upper middle-income country by its centenary (World Bank, 2019a).** Pakistan's total investment-to-GDP ratio has remained below 20 percent over the last four decades, of which private investment has remained around 10 percent of GDP over the last decade. This is roughly half of regional peers and only one-third of more dynamic emerging markets in Asia. Capital deepening, or the rate at which the stock of capital per worker grows, has been declining in Pakistan and it has impeded growth in labor productivity. The net inflow of foreign direct investment (FDI) has averaged 0.8 percent of GDP since 2010, with much of the FDI targeting oil and gas exploration, telecoms and the financial sector. Market seeking FDI currently accounts for 94 percent of total FDI while efficiency seeking FDI accounts for less than 1 percent of FDI. Despite some highly successful clusters in for example textiles and sport equipment, Pakistan has not benefitted as much from globalization as most other countries, and it has largely been a spectator amidst the rapid expansion of global value chains (GVCs). Consequently, the economy is not benefiting from the capital, technology, knowledge and business networks that tend to accompany FDI in many sectors.

**6. The level of competition in many local markets is muted and it has adversely affected the dynamism of local businesses.** Pakistani businesses are significantly older on average than comparable businesses in South Asia and beyond. Weak competition reduces investments in innovation and technology and inhibits creative destruction, which in turn impede growth in productivity. There are seemingly few incentives to invest in, and adopt new, technologies and diversify products, as captured by relatively low levels of R&D expenditure and use of technologies licensed from foreign companies. An inward oriented and protectionist trade policy, with an anti-export bias, shields some domestic producers from external competition. And while Pakistan is a relatively open economy to foreign investment, the country has a relatively modest record of attracting FDI. The state's sizable footprint in key economic sectors and ineffective implementation of the competition legal framework deter market entry. There is also a risk that the economic fallout from the COVID-19 pandemic may lead to market concentration in some sectors if publicly owned or politically connected businesses benefit more from emergency programs and policy initiatives than the large small and medium-sized enterprise (SME) community and the many dynamic startups that are exposed to the economic downturn. A World Bank enterprise survey conducted in the summer of 2020 found that large enterprises are indeed much more likely to benefit from early government COVID-19 relief programs than are micro enterprises.

**7. Pakistan's export competitiveness is declining, the export profile is concentrated in terms of products and markets, and few businesses are integrated in the global economy.** Between 2005 and 2019, Pakistan's exports as a share of global exports dropped from 0.15 percent to 0.12 percent. Exports of goods and services as a proportion of GDP is at its lowest level since 1971. Besides China, with which bilateral trade grew 200 percent in 2008-18 on the back of the Pakistan-China Free Trade Agreement (FTA), Pakistan's trade and investment with neighbors and within its greater region are modest. Textiles and clothing accounts for 55 percent of exports, and leather and rice jointly make up another 15 percent. This share has remained unchanged for over a decade. The exports of information technology-enabled services are growing but from a relatively modest base. The value of foreign inputs in Pakistan's exports has dropped to 8 percent, or one-fifth of the value in emerging markets such as Malaysia and Vietnam. It illustrates Pakistan's relative exclusion from global supply chains. The national trade policy has been used as a tool to generate public revenue and protect select industries rather than as a force for increased competition, global value chain participation, product diversification and productivity growth. Pakistan is currently the world's seventh most protected economy as measured by the Overall Trade Restrictiveness Index. The complexity of the tariff structure is relatively high with tariff lines augmented with para tariffs such as additional duties, regulatory duties and special regulatory orders (Varela et al., 2020). The complexity of the tariff structure leads to resource allocation towards highly protected sectors, which affects economic performance. Despite GoP efforts in recent years to simplify the trade policy, including by reducing the average level and dispersion of custom duty rates, the pace of change is low, and Pakistan's producers have been slow to adapt to changes in the global economy.

***Pakistan's greatest achievement over the last few decades has arguably been the rapid reduction in extreme poverty. The COVID-19 pandemic may result in a temporary reversal of this positive trend.***

**8. Pakistan has made impressive strides in reducing poverty, but most citizens remain economically vulnerable and many struggle as a result of the COVID-19 pandemic.** In 2001–2015, the World Bank Group's poverty headcount ratio at US$1.90 a day (2011 purchasing power parity) dropped from 29 percent to 4 percent. This reduction is largely attributed to the expansion of economic opportunities outside the agricultural sector, such as growth in male off-farm employment in the informal sector, and the increase in out-migration and associated remittances, which helped boost domestic consumption and demand for goods and services. Despite the progress toward poverty reduction, many citizens are still economically vulnerable, with more than three-quarters of the population estimated to live on less than US$5.5 a day in 2015 (2011 purchasing power parity). Gains made in recent decades in reducing absolute poverty will be challenged in the coming years as economic growth slows at home and abroad as a result of the COVID-19 pandemic. The economy had started to slow down even before the COVID-19 pandemic struck the country and it came to a near halt during the imposition of COVID-19 outbreak containment measures, including partial lockdowns, limitations to travel, and closures of non-essential businesses in 2020.

**9. The COVID-19 pandemic has led to a deterioration in the economic outlook despite the GoP's bold macroeconomic reforms initiated in 2019.** SMEs have been particularly hard hit with little public support or access to formal finance. .Prior to the onset of the pandemic, Pakistan had made considerable progress towards macroeconomic stability supported by the IMF-Extended Finance Facility (EFF), with the GoP moving to a market-based exchange rate regime, expenditure consolidation, increased revenue mobilization, energy price adjustments and the tightening of monetary policy to control inflation. But COVID-19 containment measures have adversely affected most businesses. Temporary fiscal stimulus measures and an expansion of the social safety net have helped mitigate some of the economic effects.. The GDP is projected to grow by 1.5 percent in FY21 following a contraction of 0.4 percent in FY20. A World Bank enterprise survey conducted in June-July 2020 found that only 28 percent of the surveyed businesses were fully operational. 51 percent were operating under reduced hours, 12 percent were temporarily closed, and 9 percent were permanently closed. More than two-thirds of the businesses reported a drop in sales of an average 27 percent. 13 percent of the businesses had laid off staff and 41 percent of remaining staff were employed in vulnerable businesses. Small businesses and those operating in the services sector—in particular retail services—were most adversely affected. The Pakistan Economic Survey 2019-20 cites preliminary estimates that the COVID-19 pandemic may adversely affect employment by between 1.4 million and 18 million depending on the length and severity of restrictions (GoP, 2020).

***Pakistan's policymakers need to address critical cross-cutting and sectoral constraints to promote economic recovery and private sector-led growth. A private sector-led growth agenda needs to be equitable and benefit Pakistan's many SMEs.***

**10. This CPSD assesses several cross-cutting constraints to private sector-led growth that the GoP will need to address if it wants to arrest the decline and foster a more innovative and entrepreneurial economy.** First, the GoP needs to promote greater competition in the economy by reducing the cost of doing business and removing policy distortions to trade and investment. Second, the GoP needs to reduce its footprint of largely inefficient and often loss-making state-owned enterprises (SOEs), including in sectors such as electricity, transport and industry. This would not only free up public resources that could be invested in social services and public infrastructure, but also remove distortions from the preferential treatment of SOEs. Essential reforms include a clear separation and fair competition between the private sector operated by civilians and companies controlled and/or operated by the state complex. In addition, the government could scale up the design and implementation of public-private partnerships (PPP) in critical enabling sectors. A robust PPP agenda could help strengthen private participation with more capital investment, more advanced technology and prudent management. Third, deepening the financial sector and expanding its reach to SMEs and more households is essential to promote equitable growth and to increase private investment. Treasury operations, as opposed to lending operations, have become the mainstay of the sector. The GoP needs to create a more conducive environment for long-term financing, help leverage private capital and ideas through strategic partnerships, and divest the state from what are natural private markets.

**11. A private sector-led growth agenda needs to be equitable and benefit Pakistan's many SMEs.** Most businesses in Pakistan operate in the informal sector. Estimates of informality indicate that between 25 and 35 percent of economic activity is undocumented. The pandemic has led millions of daily wage earners in the undocumented sector to lose their livelihoods. An estimated 67 percent of urban employment is in the informal sector, including 92 percent of employed women. Entrepreneurship is often driven by necessity rather than opportunity with more than one-third of the active labor force defined as self-employed. Pakistan also has a large SME sector, which by some estimates accounts for 90 percent of all businesses in the country, and roughly 80 percent of the non-agricultural labor force. Despite its size and importance, the sector accounts for only 7 percent of the credit extended by the financial sector. Of the formal businesses, the great majority are family-owned businesses registered as sole proprietorships, which exposes the household to full liability of the business and limits risk taking and investment.

***Pakistan's policymakers can increase private sector participation and investment by implementing a reform agenda focused on three broad policy objectives: (i) to enhance institutional capacity and policy coordination; (ii) to strengthen competition and level the playing field; and (iii) to facilitate development of a diversified and inclusive financial sector. This reform agenda would generate higher returns if complemented by other initiatives to address systemic macroeconomic fragilities and to increase both public and private investments in human capital.***

(i) **Enhance institutional capacity and policy coordination:** The strengthening of public institutions and governance are long-term objectives. The GoP could help remove constraints for private businesses in the short- to medium-term by reforming the commercial judicial system, clarifying federal and provincial mandates, and modernizing administrative procedures in the public-private interface. Priority reforms to improve commercial justice include: (i) the enactment of Commercial Courts Acts at the provincial level to provide specialized fora for dispute resolution, and (ii) the development of an insolvency registry and introduction of special simplified procedures for SME insolvency. The latter would be especially useful for the COVID-19 recovery phase. The GoP could help address overlaps in federal and provincial mandates and reduce transaction costs through: (i) the modernization of administrative records and processes, including the digitization of land records, construction permits and property registration; and (ii) the simplification of tax administration, including the harmonization of the general sales tax on goods and service, the adoption of an electronic portal for tax submissions and payments, and the merger of the sales tax registration number and the national tax number. Lastly, it has been ten years since the 18th Amendment to the Constitution was approved and it would be timely to assess its impact on the private sector with the view to provide guidance on how to improve interprovincial and federal coordination.

(ii) **Strengthen competition and level the playing field:** A short- to medium-term reform agenda to promote more competitive markets would seek to reduce the judicial backlog of competition cases, reform the policy for foreign investment, reduce anti-export bias in the national trade policy, and rein and limit the state's role in markets. Priority actions would be to (i) introduce investor relationship management and grievance management systems; (ii) promote transparency by launching a virtual one-stop information portal that identifies laws and regulations affecting market entry at both federal and provincial levels; and (iii) develop pro-competitive principles in sectoral regulations at both tiers of government. Reducing anti-export bias in the trade policy entails (i) the implementation of a National Tariff Policy with tariff reductions on intermediate goods and machinery, and a gradual tariff reduction on final goods; (ii) simplifying procedures and documentary requirements and automating the process of refunds for sales and import-duty for exporters; and (iii) lowering tariffs on digital goods included in the World Trade Organization's Information Technology Agreement, and reducing taxes levied on data. The GoP should also advance fair competition principles and restructure its SOEs, including through the adoption of an SOE ownership policy and SOE Law as well as amend the corporate governance rules for SOEs. Initiatives that increase transparency at all levels of the public administration would offer some of the most effective—and sometimes game changing—reforms to reduce the waste of public resources, improve public services and render economic sectors shielded by government policy more competitive. Reforms to increase transparency generally consume few, if any, public resources.

(iii) **Facilitate development of a diversified and inclusive financial sector:** The GoP is absorbing much of the credit generated by the domestic market. The situation is not sustainable in the long run and it has seriously impaired access to finance for businesses and particularly for SMEs and women. Besides adopting a more prudent fiscal policy, the GoP could help increase SME finance by operationalizing the SME Credit Guarantee Company and promote the development of alternative financing methodologies to substitute traditional collateralized lending for SMEs. To increase the uptake of digital finance and promote innovation and private investment in this space, the GoP could adopt a sandbox approach that allows for a risk-based regulatory, supervisory and oversight framework for the fintech sector. SBP has announced the launch of instant digital payment system 'Raast', a micropayment gateway. Operationalization of this initiative would allow merchants, businesses, individuals, fin-techs and government entities in Pakistan to send and receive near real-time payments through the internet, mobile phones and agents. The mobilization of more long-term finance is critical to help meet infrastructure investment needs. Priority reforms would align KYC requirements of the National Savings Scheme (NSS) with those of financial institutions and harmonize taxes between NSS and financial institutions. It would also entail limiting NSS access to retail investors to support capital market development and alignment of the issuance feeds and processing times for non-government securities with international standards. Medium-term reforms to increase long-term finance would include the development of a sovereign Sukuk issuance program for a wide range of maturities, and the consolidation of government owned and managed development finance institutions into a single development bank.

***Pakistan exhibits high GDP multipliers across most sectors in the economy in comparison to other countries. It signifies a relatively high impact of investment on economic growth and employment, and it captures chronic public and private underinvestment in many areas of the economy.***

**12. The CPSD also assesses some sectors where sector-specific reforms could help unleash private sector growth and attract investment in the near- to medium-term.** The IFC Country Strategy identified, among others, fintech/digital finance, port logistics, renewable energy and agribusiness as sectors of high potential and where a coordinated effort is needed to implement the IFC 3.0 strategy that aims to create new private sector opportunities. These four sectors and sub-sectors are priority sectors for the GoP and score high in social accounting calculations that estimate the impact on overall output of an increase in investment in each sector through backward and forward business linkages. Pakistan exhibits relatively high GDP multipliers across most sectors, which signifies the high impact of investment on economic growth and employment. The sectors are highly relevant in the COVID-19 context given for example the rapid increase in the demand for digital payments and better storage and distribution in the agribusiness sector, whereas energy and ports logistics will contribute to the economic recovery phase. There are other sectors with high growth potential such as pharmaceuticals, auto and auto-parts, and specialty textiles that could be explored in future sectoral analyses.

**13. The key cross-cutting constraints highlighted above affect the select sectors to varying degrees, and thereby create distinct limitations for greater private sector participation and investments.** However, there are some common challenges, for instance, the lack of inter-agency coordination at the federal and provincial levels in the fintech/digital payments and agribusiness sectors. Similarly, policy distortions and poorly functioning markets impede development of the renewable energy and agribusiness sectors. The development of the port logistics sector is constrained by weak governance and a lack of clarity of mandates and responsibilities by the governing entities.

(i) **Fintech and digital finance:** Enhanced financial inclusion is at the core of Pakistan's long-term sustainable and inclusive growth agenda. Digital finance and digital transactions can also help improve health outcomes and build a more resilient economy during a pandemic. Digital finance powered by fintech can both broaden and deepen the financial sector, especially for women. Intentional design of digital finance platforms that meet the specific needs of women, focusing on convenience, security, reliability and privacy can go a long way in reducing gender disparity in the access to finance. Unlocking sector growth would require, first, better access for the fintech industry to citizen identification infrastructure, which should include rationalizing the cost structure and making eligibility criteria transparent. Second, the digital landscape would expand greatly if government payments were digitized. Third, updating the legal framework for digital payments would entail operationalizing micropayment gateways and automated transfer systems, and enabling interoperability of retail payment systems with automated clearing houses. Finally, the fintech sector would benefit from the setting up of 'sandboxes' and adopting a 'test and learn' approach to allow for a risk-based regulatory, supervisory, and oversight framework.

(ii) **Port logistics:** The development of seaports and the modernization of the customs administration are vital to facilitate trade, increase Pakistan's export competitiveness and establish stronger links to GVCs. The country's location offers its traders easy access to markets in the Middle East, East Africa, Central Asia, and Western China. The investments in port and transport logistics associated with the China-Pakistan Economic Corridor (CPEC), which is part of China's Belt and Road Initiative, coupled with the Quadrilateral Traffic Transit Agreement could help turn Pakistan into a transit hub for sea-bound traffic with Central Asia and Western China. International trade currently goes through two ports: Karachi Port, which accounts for around 60 percent of marine shipments, and Port Qasim, which accounts for 35 percent. Two big challenges are to improve the management of port operations and to facilitate trade through customs modernization. The GoP alongside the respective trust/authorities must reform port governance structures, including by promoting professional management and professional boards with private sector representation. Karachi Port could improve efficiency by fully embracing the landlord model and outsource operational activities to private specialists, while attracting private investors to help upgrade and rehabilitate existing berths, to optimize capacity utilization, etc. Implementation of an automated processing system for border management will be essential to address customs and border delays, which cause congestion and add high indirect costs especially for small traders.

(iii) **Renewable energy:** Demographic changes and economic growth will drive energy demand in the coming decades. To meet this demand, the GoP has set bold targets for expanding the share of renewable energy in the production mix. Pakistan is well-equipped to do so given its wind, solar and hydro energy potential. To realize this potential, the GoP will need to tackle three broad sets of challenges. First, it must raise competitiveness and financial viability in the sector. Key priorities are to initiate competitive auctions for renewable energy capacity additions and private transmission projects; and ensure proper pricing and payment mechanisms in the sector. Second, technical and regulatory obstacles need to be addressed to facilitate greater integration of renewable energy in the system. This involves amending the grid code, installing modern monitoring and forecast systems, and refurbishing infrastructure. Third, off-grid solutions warrant support to overcome early-stage risks. This could be done in the form of a rural electrification fund that may provide grants to solar systems providers, as well as the establishment of strong quality standards.

(iv) **Agribusiness:** The agriculture sector employs nearly two-fifths of the labor force and generates one-fifth of GDP. It has experienced declining productivity growth for decades. The production of low-value crops is relatively inefficient and there is little value-addition along supply chains. Transforming agribusiness will require, first, the removal or at least a significant reduction of distortionary policies such as flat rates on water and fertilizer gas subsidies. Similarly, phasing out public procurement of wheat and reducing strategic reserve requirements are essential to crowd in private participation. Second, the GoP should seek to strengthen the enabling environment with better-functioning wholesale markets, collateral systems and physical infrastructure. A third set of initiatives should seek to improve food safety and raise the quality of produce through reforms at the farm and market levels. Establishing a complete warehouse receipts system is key to improving storage and facilitating post-harvest financing. Enhancing food testing lab capacity and outreach are key to raise compliance with SPS standards. Farmers require better extension services and better research would help raise the quality of inputs and facilitate the adoption of more efficient technologies.

**14. Reforms in one sector often have positive spillover effects in other sectors.** A more efficient logistics sector would for example support exports of agricultural produce and manufactured products. More reliable, cleaner and affordable energy would be advantageous for all sectors, including by improving health outcomes and living standards. Greater financial inclusion through fintech would facilitate transactions and investments for consumers and SMEs, render society more resilient to pandemics and help modernize tax administration.

**15. The two-tiered Action Matrix that is presented below summarizes key constraints, recommended reforms or actions to address the constraints, and the expected outcomes as identified in this paper.** **Tier 1** recommendations cover seven of the most critical, or "game changing", policy reforms that could help break the status quo of low investment levels, declining exports and private sector competitiveness. There is no single reform that would turn the economy around and the list of reforms should be viewed as a package with one reform often reinforcing the outcome of another one. The recommendations are synthesized from a rich body of analytical work produced by the World Bank Group in recent years and they are anchored in the continuous dialogue with public and private sector representatives.

**16. Tier 2 recommendations cover fifteen other priority reforms that would help address specific constraints to boost private investment and competitiveness.** The Matrix includes an indicative timeframe and the perceived difficulty to implement the reforms ('+' as "less challenging" or low hanging fruit; '++' as "moderately challenging"; and '+++' "challenging"). There are also action matrices presented for each of the four individual sectors under the sectoral sections towards the end of the paper.

# ACTION MATRIX: POLICY PRIORITIES TO PROMOTE PRIVATE INVESTMENT AND ENTERPRISE

### Tier 1—Game Changing Reforms to Boost Private Investment and Competitiveness

| CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | OUTCOME | RESPONSIBILITY |
|---|---|---|---|---|---|
| Lengthy and uncertain commercial justice | 1. Introduce Commercial Courts Acts at the provincial level to provide for a permanent and exclusive specialized forum and procedure for commercial dispute resolution. | ++ | 18-36 months | Faster and fairer commercial justice | Provincial Industries, Law Departments |
| Uncertainty and high transaction costs for businesses | 2. Modernize administrative records and processes; and digitize urban land records, land administration, construction permits and property registration. | +++ | >36 months | Greater transparency, less uncertainty, less discretion, lower transaction costs | Provincial BORs, FBR, Land Record Management Authorities |
| High transaction costs for businesses | 3. Simplify tax administration: (i) harmonize the General Sales Tax on goods and services; (ii) adopt an electronic tax payment system that allows for e-filing, e-payments and e-invoicing; and (iii) merge the Sales Tax Registration Number and the National Tax Number, and introduce a unique business identification number. | +++ | >36 months | Greater transparency, lower transaction costs, more efficient tax collection | Provincial Revenue Authorities, FBR |
| Anti-export bias | 4. Implement a national tariff policy with tariff reductions on intermediate goods and machinery, and a gradual tariff reduction on final goods. | ++ | 12-24 months | Fairer competition, removal of anti-export bias | MoC, National Tariff Commission |
| Public sector crowding out private participation | 5. Adopt an SOE ownership policy and an SOE Law to streamline regulations governing SOEs and safeguard principles for public ownership. Create a central SOE ownership entity with mandate to oversee financial and operational performance of the portfolio. | +++ | 24-36 months | Greater transparency, fairer competition, stronger corporate governance | MoF |
| Uncertainty, high cost of capital, underdeveloped banking and financial sector | 6. Strengthen the institutional framework underlying fiscal management to support macroeconomic stability through: (i) the establishment and operationalization of a Macro-Fiscal Policy Office; and (ii) tasking the NFC Monitoring Committee to set, review and monitor national fiscal policy decision. | ++ | 12-24 months | Policy certainty, lower inflation, less public borrowing from banking sector | MoF |
| Uncertainty, high cost of capital, underdeveloped banking and financial sector | 7. Implement a robust debt management strategy and improve primary and secondary market operations. | ++ | 12-24 months | Depth and function of capital markets | MoF |

# ACTION MATRIX:
# POLICY PRIORITIES TO PROMOTE PRIVATE INVESTMENT AND ENTERPRISE

## Tier 2—Other Priority Reforms to Boost Private Investment and Competitiveness

| | CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | OUTCOME | RESPONSIBILITY |
|---|---|---|---|---|---|---|
| **Public institutions and governance** | Lack of clarity on federal and provincial mandates | 1) Evaluate the impact of the 18th Amendment to the Constitution on the private sector and strengthen the capacity and collaboration of key constitutional organs such as the National Finance Commission Secretariat, the Council of Common Interests, and the Council of Ministers, to effectively support devolution. | + | 36 months | Stronger coordination and clarity on priorities | EAD and CCI |
| **Public institutions and governance** | Uncoordinated regulatory process with little consideration of impact on business | 2) Establish a National Regulatory Delivery Office (NRDO) under the PMO as part of the Better Business Regulatory Initiative to instill coordinated approach to business regulation. Formulate a Regulators' Code as framework of principles for new regulation to be proportionate, risk-based, targeted and cost-effective. | ++ | 18-24 months | Stronger coordination and formulation of more business-friendly regulation | PMO, NRDO |
| **Public institutions and governance** | Inefficient commercial dispute resolution and insolvency administration | 3) Introduce a new Arbitration Act based on United Nations Commission on International Trade Law to repeal the application of the Arbitration Act (1940). | ++ | 18-36 months | Faster and fairer commercial justice | MoLJ |
| **Public institutions and governance** | Inefficient commercial dispute resolution and insolvency administration | 4) Create an insolvency registry and introduce special simplified procedures for SME insolvency and corporate restructurings. Improve the distressed assets resolution framework to promote secondary market creation. Incorporate a pre-packaged restructuring option to the Corporate Rehabilitation Act to enable swift court processing of out of court restructurings. | +++ | 18-36 months | More effective firm exit and utilization of private capital | SECP and SBP |
| **Promoting competitive markets** | High trade transaction costs and anti-export bias | 5) Simplify procedures and document requirements and automate the processing of refunds for sales and import-duty for exporters. | + | 12-24 months | Lower trade transaction costs, predictability | MoC and FBR |
| **Promoting competitive markets** | High trade transaction costs and anti-export bias | 6) Lower tariffs on digital goods, included in the WTO Information Technology Agreement, and reduce taxes levied on data. | + | 12-24 months | Greater tech and knowledge diffusion | MoC and FBR |
| **Promoting competitive markets** | Opaque SOE governance and use of public subsidies | 7) Amend corporate governance rules for SOEs to ensure that Board members and senior management are selected based on merit; and enforce the publication of annual financial statements and external audit reports. | +++ | 12-24 months | Transparency, fairer competition, less waste of public resources | MoF and SECP |

# **ACTION MATRIX:** POLICY PRIORITIES TO PROMOTE PRIVATE INVESTMENT AND ENTERPRISE

**Tier 2—Other Priority Reforms to Boost Private Investment and Competitiveness,** *continuation*

| | CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | OUTCOME | RESPONSIBILITY |
|---|---|---|---|---|---|---|
| Promoting competitive markets | Opaque and uncoordinated investment policy & administrative interface discouraging market entry and impeding competition | 8) Establish an Investor Relationship Management System at the Board of Investment and deploy an investor grievance management system. | + | <12 months | Fairer competition, more market entry | Board of Investment |
| | | 9) Create a virtual one stop information portal that identifies all the laws and regulations affecting investors entry. | + | <18 months | Information symmetry | Board of Investment |
| | | 10) Develop pro-competition principles in sectoral regulation through greater collaboration between the CCP and sectoral regulators and ensure consistency between the Competition Act (2010) and sectoral acts and regulation. | ++ | 12-24 months | More market competition | CCP |
| | | 11) Improve competition enforcement through advocacy with the judiciary. | + | 18-36 months | More market competition | CCP |
| Promoting private participation | Poor use of public assets and barriers to private participation | 12) Identify risks and develop effective PPP modalities. | + | <12 months | Stronger public capacity | Provincial and Federal PPP cells |
| | | 13) Develop a bankable framework with concession agreements, risk allocation, and standardized legal agreements aimed at promoting private sector investments in water, waste management, tourism, urban transport, etc. | + | 12-24 months | Stronger public capacity | Prov. and Fed. PPP cells + relevant departments |
| | | 14) Empower municipalities, cities and local governments to undertake and implement PPP projects in primary healthcare, education, waste-water treatment, water supply, etc. | ++ | 12-24 months | More market competition and private solutions | Local Government Department |
| | | 15) Develop a realistic pipeline of bankable infrastructure projects that can be effectively developed and maintained through private participation. | ++ | 18-36 months | Improved service delivery, reduced public investment | Provincial and Federal PPP Authority |

# 1. COUNTRY CONTEXT

**1. The GoP has since March 2020 been trying to control the outbreak of the coronavirus and the economic fallout from the COVID-19 pandemic.** The economy contracted somewhat in 2020 but it is expected to grow by 1.5 percent in 2021. The economic downturn was softened by fiscal stimulus measures, an expansion of the social safety net, monetary policy support and targeted financial initiatives to the private sector. However, income and job losses have adversely affected millions of vulnerable families. Many businesses and entire industries are in distress, including those in the labor-intensive textiles and apparel sector, which accounts for most of Pakistan's exports. For example, an enterprise survey conducted in Pakistan by the World Bank in June-July 2020 found that 68 percent of the businesses had experienced an average decline in sales by 27 percent (Khan and Bashir, 2020). Fiscal pressures remain high due to lower than normal tax collection and rising public expenditures to respond to the economic downturn. Strong inflows of remittances, a reduction in imports, and a mild export recovery have helped strengthen Pakistan's current account balance. The COVID-19 pandemic will most likely have long-term consequences for the economy and the government's reform agenda.

## 1.1 ECONOMIC CONTEXT

**2. Pakistan's economic growth pattern displays regular boom-bust cycles with a slow, long-term decline in both the actual and potential growth rates.** The economy did reasonably well in 2014-18 as GDP per capita expanded annually by 3.0 percent; up from 0.8 percent in 2009-13, but down from 3.2 percent in 2004-08 (see Figures 1-2). A long-term growth assessment concluded that economic reforms and political stability with high inflows of overseas development assistance (ODA) were associated with high growth in the 1960s and 1980s whereas political disruption, economic uncertainty and regional tensions were accompanied by slow economic growth during other periods. Macroeconomic turbulence has been a defining characteristic of Pakistan's economy: between 1958 and 2019, Pakistan availed itself of 22 IMF stabilization and budget support programs, to address balance of payments crises and other macroeconomic issues. A chief cause of the regular boom-bust cycles of the economy is its very high dependency on consumption rather than investment and exports. Periods of high economic growth witnessed in recent years were driven to a large extent by consumption financed by foreign debt and financial remittances. Higher consumption led to an increase in imports, which in turn depleted the reserves of foreign currency, which triggered a balance of payments crisis. Figure 3 shows consumption expenditures in Pakistan to exceed 90 percent of GDP—a much higher share than in peer countries.

**3. Real output growth has been driven more by employment growth than output-per-worker growth and labor productivity growth has remained low for some time.** The growth in labor productivity steadily declined from an average of 4.0 percent in the 1980s to 0.8 percent in the 2000s, before improving to 1.7 percent in 2011-17. A decomposition of the output-per-worker growth into its contributing factors shows that since 2000, it has been driven by human capital (0.4 percent) and total factor productivity (0.6 percent) with physical capital accumulation being literally irrelevant (0.1 percent) and arable land slightly negative. In a World Bank assessment of labor productivity growth in Asia in 2003-14, Pakistan averaged 1 percent, with Bangladesh above 4 percent, India and Sri Lanka around 6 percent, and China at 9 percent. And while urbanization at first sight may seem to imply that the economy will benefit from the relatively higher labor productivity growth experienced in the services sector compared to in agriculture and industry, few women work in urban environments. Roughly one-in-three women work in rural areas, but only one-in-ten women work in urban areas. The trend is that an increasing share of women work in rural communities whereas the low share of women working in urban areas has remained constant.

**4. Persistently low and falling saving and investment ratios undermine the country's long-term growth potential.** The investment-to-GDP ratio has remained below 20 percent over the last four decades and fluctuated around 15 percent over the last five years (see Figures 4-5). This is roughly half the ratio of Pakistan's regional peers and only one-third of the most dynamic emerging markets in Asia. The savings and investment ratios are suppressed by constraints both on the supply and demand side, including a relatively high dependency ratio, low financial sector intermediation, an underwhelming investment climate and generally low returns on investment. The result is a reduction in the potential growth rate that is already affected by low investment in human capital formation. Public investment is critical to crowd in private investment and catalyze private enterprise and it has typically been half of private investment. According to the World Economic Forum's (WEF) Global Competitiveness Index, Pakistan ranks 110 out of 141 countries in terms of the quality of its overall infrastructure,

**Figure 1: Growth in GDP per capita**

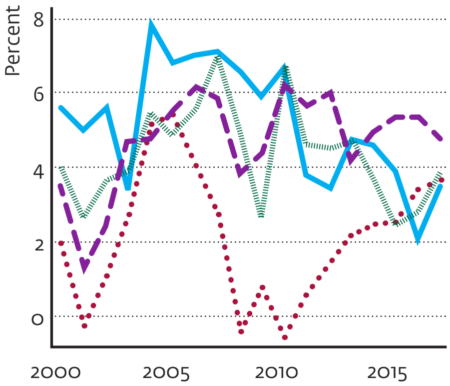



**Figure 2: GDP purchasing power parity**

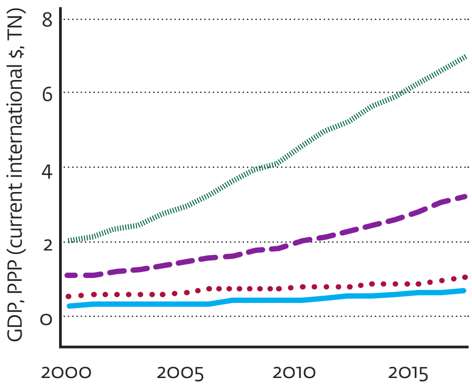
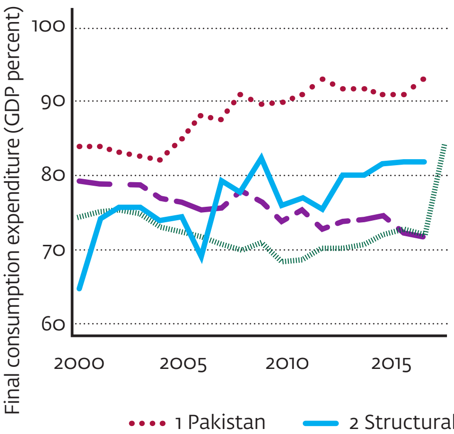



**Figure 3: Final consumption expenditure**




The CPSD benchmarks Pakistan with three comparator/peer groups:

1.) *Structural* group: Egypt, Ethiopia, Myanmar, Nigeria;

2.) *Regional* group: Bangladesh, India, Sri Lanka; and

3.) *Aspirational* group: Brazil, China, Indonesia, the Philippines

Annex 1 presents information about how these countries were selected.

1 Pakistan | 2 Structural | 3 Aspirational | 4 Regional

Source: World Development indicators

**Figure 4: Gross fixed capital formation**

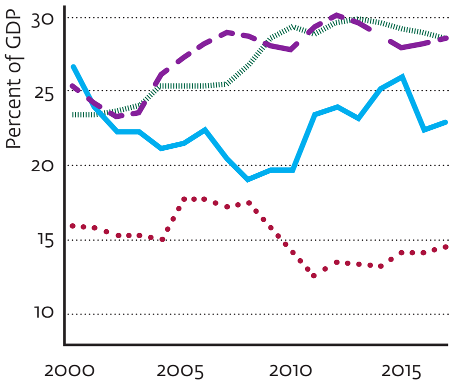
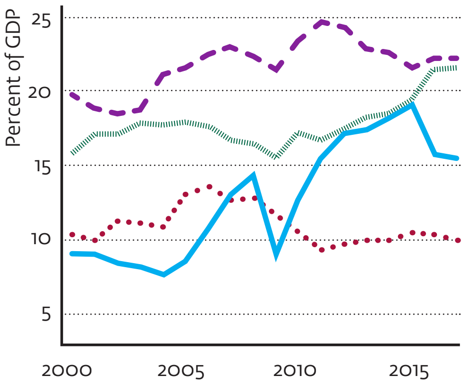



**Figure 5: Gross fixed capital formation, private sector**




1 Pakistan 2 Structural 3 Aspirational 4 Regional

Source: World Development indicators

which includes transport and utility infrastructure, such as road connectivity, electricity access, electricity supply quality and reliability of water supply. Successive governments have been unable to break out of the low-investment-low-growth equilibrium. And the COVID-19 pandemic will likely put even further downward pressure on the investment to GDP ratio: the GoP will raise less tax income and many businesses will lose money.

**5. Foreign investors have shown limited appetite for investing in Pakistan.** Since 2010, net inflows of FDI averaged 0.76 percent of GDP, which was significantly lower than Pakistan's regional peers. As the critical source for technology and management spillovers, this inflow is too low to have a marked impact on total factor productivity and to accelerate the modernization and structural transformation that the country needs to move to a higher growth trajectory. In 2018, FDI inflows accounted for 4.3 percent of the total inflow of FDI in South Asia, even though Pakistan accounted for 9 percent of the GDP in South Asia (see Figure 6). The FDI that Pakistan attracts to date is concentrated in oil and gas exploration, telecoms and the financial sector, which make up 60 percent of the total over the last 15 years. The United States, UK and the United Arab Emirates account for approximately 60 percent of FDI. The knowledge spillovers generated by the FDI has also dropped: between 2005 and 2015, the share of FDI in services that went to low value-added services increased from 11 percent to 63 whereas the share of FDI in manufacturing that went to low-value added manufacturing increased from 61 percent to 94 percent. UNCTAD (2020) estimates that global FDI flows will contract 30-40 percent in 2020-2021 as a result of the pandemic so Pakistan's record of attracting FDI will likely worsen before the situation can be turned around.

**6. Structural transformation has slowed over recent decades and stalled in recent years.** The share of value added in agriculture, forestry and fishing to GDP roughly halved between 1960 and 1993 and it has since then fluctuated between 20 percent and 25 percent (Figure 8). The employment in agriculture as a share of total employment has remained remarkably stable at around 43 percent over the last two decades. In 2000-18, there has been a clear reduction in the employment in agriculture as a share of total in the regional (-18 percentage points), structural (-9 percentage points), and aspirational (-15 percentage points) comparator groups. The share of value added in industry, including construction, to GDP was 18 percent in 2018 and it has not been this low since the 1960s (Figure 9). Pakistan's industry is relatively small compared to other countries with

**Figure 6: Net inflows of FDI**

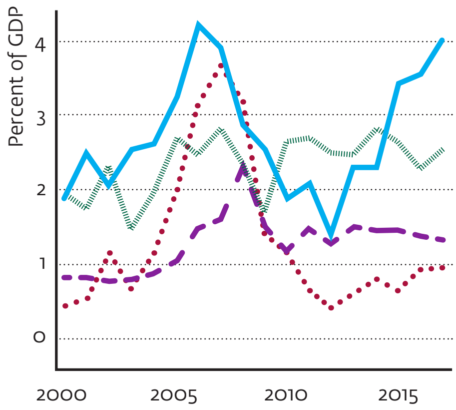



**Figure 7: Net outflows of FDI**

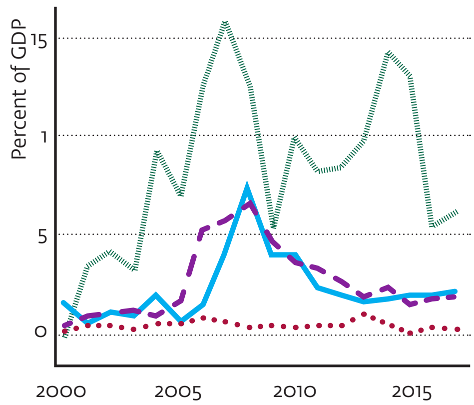



**Figure 8: Value added-to-GDP in agriculture, forestry, fishing**

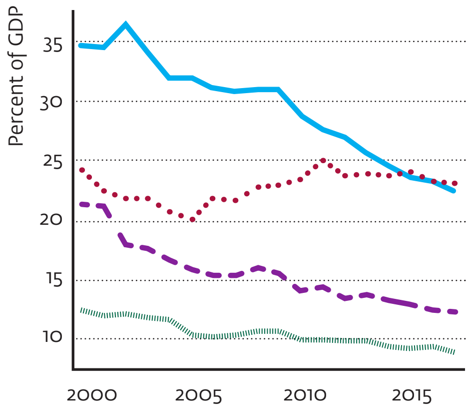
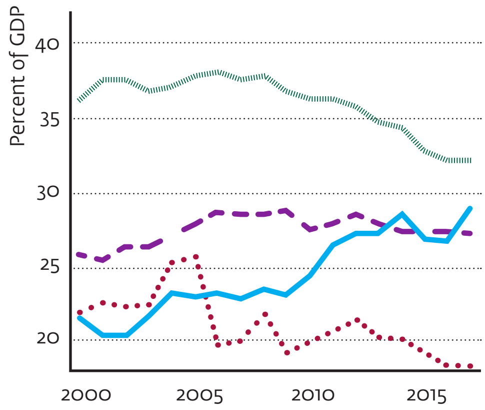



**Figure 9: Value added-to-GDP in industry**




Source: World Development indicators

an economy of similar size. Premature deindustrialization has negative long-term growth implications as manufacturing in the formal sector tends to be relatively technologically advanced (Figure 10). And while the share of value added in industry to GDP dropped by 4-5 percentage points in 2000-18, employment in industry as a share of total employment increased from 21 percent to 24 percent. The share of value added in services to GDP has expanded to 54 percent in 2018, which is high in comparison to similar economies, and much of this expansion has been in services dependent on low-skilled labor such as wholesale and retail trade, and public administration (Figure 11). In 2000-18, the employment in services as a share of total employment was flat in Pakistan (35-37 percent) whereas it increased rapidly in regional (11 percentage points), structural (6 percentage points) and aspirational (13 percentage points) comparator groups. Productivity in the agricultural sector improved little over the last 30 years. In 2000-18, capital per worker did increase but significantly less than in the structural comparator group and much less than in the regional and aspirational comparator groups.

**Figure 10: Value added-to-GDP in manufacturing**

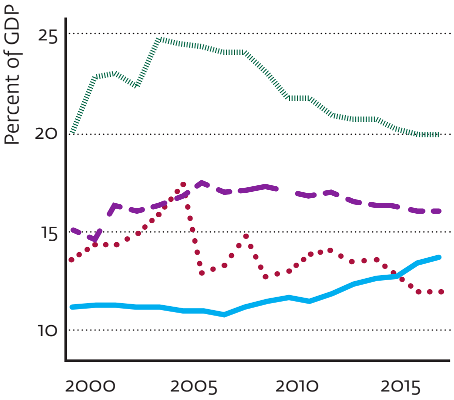



**Figure 11: Value added-to-GDP in services**

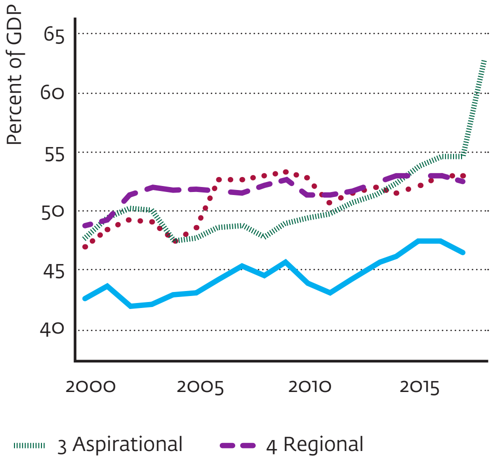



**Figure 12: Exports of goods and services**

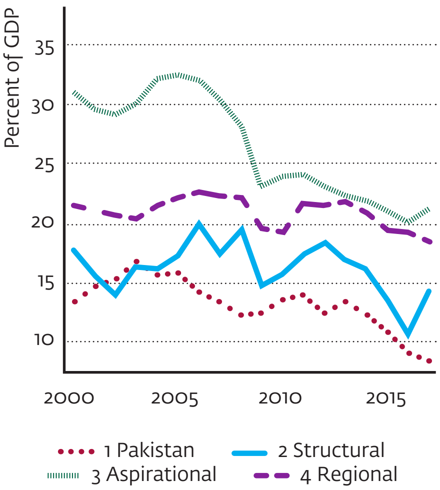
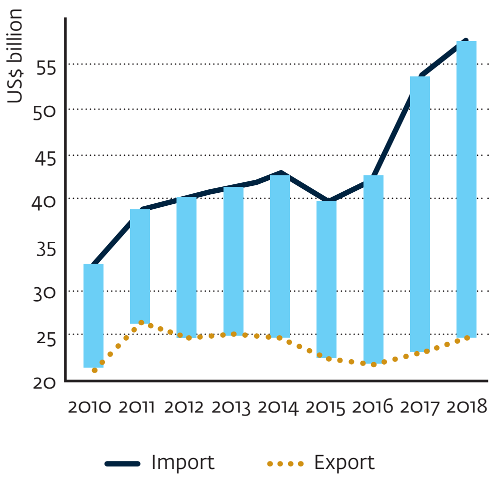


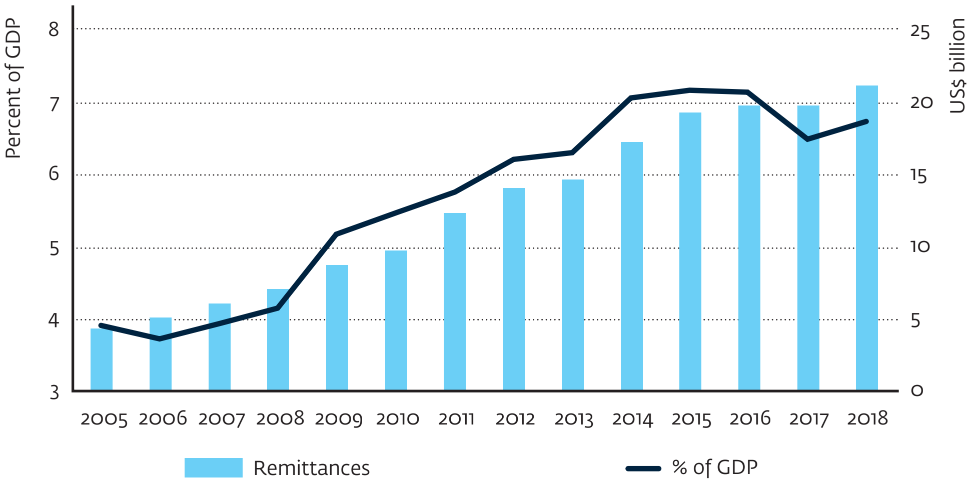

**Figure 13: Trade balance in 2010-18**




Source: World Development indicators

**7. Pakistan's trade deficit has grown large over the last decade, but it has narrowed slightly more recently.** In 2017, exports of goods and services as a proportion of GDP was at its lowest level since 1971 (see Figure 12). Between the peak in 1992 and 2018, exports as a share of GDP more than halved to 8.5 percent of GDP. At the same time, imports of goods and services was 19.4 percent of GDP, which was near its average of the last decade or two. Imports surged in 2017-18 with increases across product categories and especially of oil and natural gas as well as machinery and capital goods (see Figure 13). A strong anti-export bias in the trade policy has encouraged inward orientation. The net barter terms of trade index shows that the price of Pakistan's goods exports compared to the price of its goods imports dropped from 100-150 in 1980-2000 to 55-65 in 2010-18, of which the lowest recorded share was in 2018. Thus, the price of product categories for which Pakistan has a comparative advantage has declined markedly over the years compared to the product categories which the country buys from abroad. Pakistan's export value and export volume have both fallen behind regional, structural and aspirational peers quite drastically since

**Figure 14: Inflow of remittances in 2005-2018**




Source: WDI

2000. The COVID-19 pandemic will likely make matters worse in the short run: a survey of exporters in June-July 2020 found that half operated under reduced hours, 10 percent had temporarily closed, and 5 percent had gone out of business. Three out of five exporters reported a decline in sales in the first half of 2020 (Khan and Bashir, 2020).

**8. Pakistan is increasingly relying on support from abroad to finance its structural imbalances at home.** Personal financial remittances are replacing ODA as the major source of financial support. Inflows of ODA has fluctuated between 0.7 and 1.6 percent of gross national income in the last decade. The 0.7 percent received in 2017 was the lowest number on record since 1960. However, inflows of personal remittances were on average 7 percent of GDP in 2014-18. (see Figure 14). This transfer of wealth from the Pakistani diaspora, the sixth largest in the world, has increased since the turn of the century when it was below 2 percent of GDP. Between 2003 and 2019, the inflow of remittances increased five-fold, or from US$4.2 billion to US$21.3 billion in 2019. The inflow of remittances has also helped cushion the adverse effects of the pandemic as Pakistan has seen a surge in remittances in 2020. For example, Pakistan received US$2.8 billion in July alone and it was the highest monthly amount recorded. Net migration data are reported on a five-year basis and the numbers for 2007, 2012 and 2017 show that on balance between 1.1 and 1.4 million people leave Pakistan every year. While some of those leaving in the last decade may have been former refugees returning to Afghanistan, it is still a high number, with many Pakistanis opting to exit the domestic labor market and seek opportunities abroad. Some of these migrant workers are now returning home due to the pandemic and the surge in remittances in 2020 is partly linked to workers remitting their savings in this process.

**9. A more vibrant private sector is needed to offer more and higher quality jobs to the 2.1 million youth (ages 15-24) who enter the labor force every year.** The quality of many jobs as reflected in sector and type of employment in addition to earnings is low. Most of the labor force are stuck in low productivity, agricultural and unpaid work while the composition of employment has changed little despite an improvement in educational attainment. Pakistan's workforce has 5.6 years of schooling on average and it is an improvement from 3.8 years fifteen years ago. In 2017, the proportion of the employed (57 million), which includes informal employees, out of the total population of the country (208 million) was only 27 percent. Thus, one breadwinner provides on average for 3.6 individuals in Pakistan. The number of individuals supported by each employed person is much higher than in comparable countries such as Bangladesh (2.7) and Vietnam (1.9). This is in part because almost half of the working-age population is out of the labor force due to factors such as the very low female labor force participation rate and a high percentage of youth who are not in education, employment or training. It is also a reflection of Pakistan's high fertility rate.

**10. Women have a disadvantage in the labor market as they face restricted access to some jobs and there is a persistent gender wage gap.** Access to quality jobs is determined by age, educational attainment and gender. Most women have informal jobs with more than half occupied in unpaid family work and three quarters occupied in the agriculture sector. Getting women to join the labor force is key to Pakistan's growth prospects. Female labor force participation has increased in recent years but at 26 percent—compared to 82 percent for men—it is much lower than in regional, structural and aspirational peers (see Figure 15). For example, unlike in most South and East Asian countries, Pakistani women have hardly entered sectors such as travel and hospitality, which often rely on women workers. Only one in four women are in wage or salaried employment (Figure 16). The reasons behind Pakistan's low female labor force participation include social norms, women's mobility, urban security and a large and persistent gender wage gap. Controlling for age and educational attainment, the monthly salary of men exceeds that of women by approximately 60-70 percent. The male wage premium is the highest in the manufacturing sector (86 percent) and lowest in the agriculture sector (34 percent).

**11. Women led businesses perform relatively well on some measures.** There is some evidence that female led businesses are inclined to invest more in fixed assets score well on management metrics. According to the World Bank enterprise survey in 2013, 73 percent of women led businesses had an internationally recognized certification, as opposed to 33 percent of male led businesses. Similarly, 54 percent of women led businesses had financial statements reviewed by external auditors, as opposed to 37 of male led businesses. 44 percent of women led businesses directly or indirectly exported 10 percent or more of their sales, as opposed to 16 percent of businesses led by men. Women led businesses also had a higher capacity utilization rate and offered more formal training to their employees.

**Figure 15: Female labor force participation (ages 15-64)**

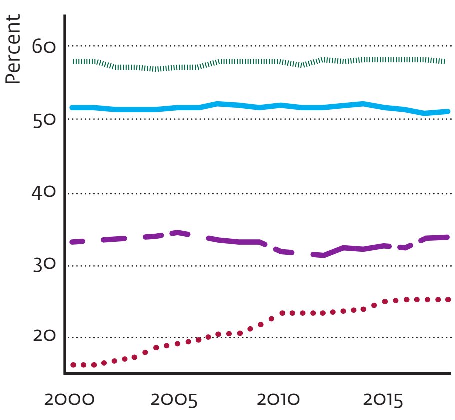
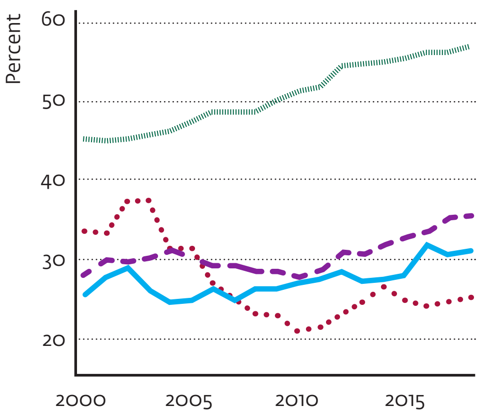



**Figure 16: Female wage and salaried workers of female employment**




1 Pakistan · 2 Structural · 3 Aspirational · 4 Regional

Source: World Development indicators

## 1.2 PRIVATE SECTOR CHARACTERISTICS

***Pakistan's private sector is dominated by SMEs that are often informal and mostly family run. Data on new business registrations show that Pakistan has a much lower incidence of entrepreneurship per capita than its peers. Innovative and growth-oriented businesses are rare.***

**12.Most Pakistani businesses operate in the informal sector because of the transaction costs of dealing with the public administration and few formal SMEs are growth oriented.**[1] Estimates of the degree of informality vary significantly between researchers depending on the definitions they use, the assumptions they make, and the data sources they cite. The World Bank's Pakistan@100 refers to relatively old estimates that span anywhere from 20 percent to 70 percent of GDP. But informality is high when studied as a proportion of total employment. The share of formal workers (i.e. wage workers with a written contract) out of the total number of wage workers in Pakistan is 27 percent. If all non-wage workers are assumed to have informal jobs, the share of formal jobs out of all jobs is 12 percent. Formal workers earn on average 120 percent more than informal workers. Pakistan's SME sector, by some estimates, accounts for around 90 percent of all businesses and it accounts for roughly 80 percent of the non-agricultural labor force, 30-40 percent of GDP, and 25 percent of exports. The average SME in Pakistan has been in operation for around 20 years while the average large business has been in operation for around 30 years. Growth oriented business are rare, and most businesses do not grow over their life cycle. SMEs in other South Asian countries and around the world tend to be younger, whereas the large businesses in the same countries tend to be about same age as large Pakistani businesses. The relatively old age of SMEs suggests that they do not have the resources or do not have the incentives to invest and grow. The GoP has prepared a draft SME Policy that would help strengthen the enabling environment for SMEs. It was pending final approval at the end of February 2021.

**13. Data on new business registration and new business density highlight that Pakistan is way behind its regional, structural and aspirational peers (see Figures 17-18).** The number of new business registrations per capita is particularly low compared to structural and aspirational peers but it is even low compared to Pakistan's regional peers. Nearly half of formal companies report that they faced unfair competition from unregistered or informal companies (World Bank, 2013). Thirteen percent complained that the practices of their informal competitors acted as a major constraint. This was lower than the average in South Asia (20 percent) but during a recent business roundtable discussion in Islamabad with large manufacturers, some business leaders admitted off-the-record that they operated three or four informal plants for every formal plant. They argued that it was necessary to stay beyond the reach of confiscatory tax officials and inspectors. They also argued that any enterprise that broke this pattern would go out of business with operating profits seldom exceeding ten percent, and taxes and official fees often exceeding 40 percent.

**14. Most formal businesses are family run and operate as sole proprietorships.** In 2013, the WBG Enterprise Survey found that 74 percent of the surveyed businesses operated as a sole proprietorship compared to a global average of 41 percent It means that the enterprise is owned and managed by one person without legal distinction between the owner and the business entity. This structure curbs the expansion potential of said entities by limiting access to finance and other advantages that come with other structures that separate the legal obligations of the owner and the enterprise. It also leaves individuals, and families, exposed to the risks of bankruptcy. A lack of dynamism and competitiveness means that the private sector has not been able to attract much needed efficiency enhancing FDI, which through knowledge spillovers can boost productivity across supply chains. Only 1.5 percent of all firms surveyed as part of the enterprise survey indicated to having 10 percent or more foreign ownership, in comparison to 12.3 percent average globally.

**15. Entrepreneurship provides livelihood opportunities to a large share of the workforce but is driven by necessity rather than opportunity.** More than one-third active in the labor force are self-employed. However, most of the self-employed are self-employed for want of other opportunities. The incidence of 'growth-oriented' entrepreneurship is low. Growth-oriented entrepreneurship, defined as businesses with the potential to grow and generate employment, contrasts with 'necessity' entrepreneurship, which provides livelihoods to those who opt for self-employment for lack of other opportunities and do not necessarily have the skills or aspirations to grow their business. Only 1 percent of the active labor force are employers and this share is only slightly higher in urban areas (3 percent). Women represent 2 percent of all employers and 14 percent of own-account workers. While starting a business and engaging in entrepreneurial activity is difficult to begin with, it is more so for women. Social norms curtail the autonomy and decision-making power of women and the lack of access to business networks makes it harder for most women to grow a business. As a result, women are grossly underrepresented in self-employment.

**16. The COVID-19 pandemic will exacerbate gender inequalities and put more pressure on the already precarious position of female entrepreneurs.** Economic uncertainty resulting from the pandemic is especially challenging for informal workers, and thus affecting women disproportionally. Over a quarter of Pakistan's working women have either temporarily or permanently lost their jobs and have had to take up additional household responsibilities (Quresh, 2020). The consequences of the pandemic may also have long-term effects on female entrepreneurship. Based on a World Bank survey in Karachi, the quality of managerial practices and levels of education are strong predictors of entrepreneurial success (World Bank, 2019b). Global findings show that in the face of disasters, girls in low-income households engage in household and other informal work at the expense of schooling.

**Figure 17: New businesses registered**

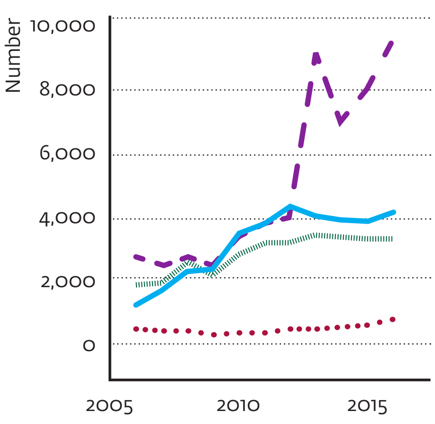
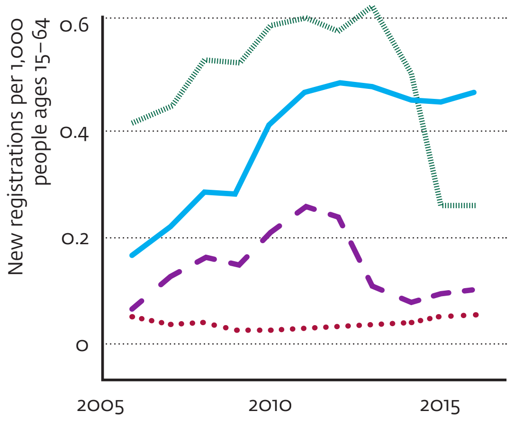



**Figure 18: New business density**




Source: World Development indicators

### *Weak adoption of standard corporate governance structures, low levels of technology absorption and innovation, and low private investment contribute to low productivity growth across sectors.*

**17. Low and falling productivity growth has impeded competitiveness.** Growth in labor productivity has declined in recent years and averaged 1.5 percent since 2001, which is less than one third of the level observed in the 1980s). In contrast, and over the same period, labor productivity grew on average by 4.4 percent in Bangladesh and 6 percent in India. TFP growth has displayed a similar negative pattern in recent years. One reason for these productivity outcomes is the lack of private investment through its impact of capital deepening. The stock of capital per worker has been declining in recent years whereas it has risen in countries such as Bangladesh and India. And productivity growth is expected to suffer further as a result of the pandemic. Weak managerial practices, inward oriented investment and trade policies, low human capital, and policy induced distortions are some of the other factors that have played a role in keeping productivity growth subdued. A recent study on firms in Pakistan's Punjab province and capital territory showed that a one standard deviation improvement in the management score of firms in Pakistan was correlated with a 21 percent improvement in labor productivity (Lemos et al., 2016). Pakistani businesses on average display low management scores and a high level of dispersion. Underinvestment in human capital taking a toll on the competitiveness of businesses. Pakistan ranks 134th out 157 countries in the World Bank's Human Capital Index and it has one of the highest stunting rates in the world (38 percent of the children under the age of 5 are stunted) with stark implications for productivity growth.

**18. The average level of technology adoption and innovation at the firm level is low in Pakistan.** The World Bank Enterprise Survey in 2013 found self-reported rates of innovation to be low in comparison to peers. Only 20 percent of the firms surveyed reported spending on research and development (R&D), and similarly, only 22 percent of all firms reported using technology licensed from foreign companies. Innovation, or lack thereof, in the textiles and clothing sector reinforces this point. While there are some large, technologically advanced producers in this industry, the average business in the textile industry is still using 30-year-old technology. Low levels of technology adoption and innovation have also manifested in the composition of the country's export basket. The technological content of Pakistan's exports is low: high-technology exports constituted less than 1 percent of all exports over the period 2010–17, and low-technology exports constituted more than 60 percent of exports. This share of low- and high-tech exports in the total export basket has not changed much over time. However, the COVID-19 pandemic is accelerating digitization and technology adoption in some sectors. More than half (54 percent) of the businesses surveyed in June-July 2020 reported that they had increased or started to use digital platforms for their operations and sales as a result of the pandemic (Khan and Bashir, 2020).

### *Relatively few Pakistani businesses have integrated in the global economy with export performance deteriorating and concentrated to a few product categories of modest value addition.*

**19. Pakistan's export competitiveness has seen a slow but steady decline.** Between 2005 and 2019, Pakistan's exports as a share of global exports dropped from 0.15 percent to 0.12 percent. There are many reasons for the decline in export competitiveness, including the lagging state of infrastructure at large and modest labor productivity, but also drivers linked to trade policy and trade logistics such as a complex and discretionary trade policy, high transaction costs associated with trade logistics and customs clearance, inadequate export intelligence, and an overvalued exchange rate. Between 2008 and 2018, the simple average tariff rate was reduced from 14.1 percent to 12.6 percent, but it is still higher than in South Asia (11.0 percent) and in East Asia (4.8 percent). In addition, while the country has moved towards a more free-floating exchange under the aegis of the IMF-EFF, which has led to significant depreciation, it has yet to translate into a significant increase in exports. The exchange rate depreciated from 105 PKR/US$ in early December 2017 to 150 PKR/US$ in May 2019, and it has since then fluctuated around 153-166 PKR/US$. But there was no surge in exports partly due to the lack of export promotion, supply constraints aggravated by tight credit markets, and the high pricing power of large international buyers.

**20. Pakistan's export profile is concentrated in terms of products and markets and there are few new growth industries with revealed comparative advantage (Figures 19-20).** The three largest export categories are textiles and clothing, leather and rice and they make up over 70 percent of total exports. This share has remained unchanged for over a decade. Textiles have over the last decade accounted for 50-60 percent of exports. Pakistan's export market base, much like its product base, has remained static over time. Six markets account for over 60 percent of exports. The European Union and the United States absorb 22 percent and 17 percent, respectively. The share of exports to China has declined from a peak of 11 percent in 2012-13 to 8 percent in 2018-19. It follows a similar pattern for exports to Afghanistan, which is not far behind China.

**21. Pakistan has relatively few industries integrated in GVCs (World Bank, 2020a).** Participation in GVCs is fundamentally dependent on components of final goods being able to move seamlessly and at a low cost between countries. Successful integration and upgradation within GVCs thus require supporting infrastructure and policies that maintain low, or reduce, restrictions in factor markets, tariffs and non-tariff barriers; and improve logistics and customs performance. Pakistan has made progress on all fronts but still lags most peers. The trade policy is a significant deterrent to the integration in GVCs. Pakistan's tariffs on intermediates—on average 8 percent—are four times as high as the average in East Asia. Pakistan compares unfavorably in its logistics performance with a ranking of 122 out of 160 countries in the WBGs Logistics Performance Index (LPI) 2018. Around 40 percent of the gross value of exports in countries like Malaysia and Vietnam are made up of foreign inputs. In comparison, Pakistan uses 8 percent and this share has decreased over time. It highlights the limited integrated in international production networks. Trade policy has been used more as a tool for revenue mobilization and protection than as a policy tool to facilitate Pakistan's integration in international production networks.

**22. The increasing use if information technology, mobile services and internet technology are putting increasing pressure on established industries to improve their services and raise productivity.** It has also created a thriving export sector of high-tech services. In 2010-17, internet access among individuals more than doubled to 16 while the share of households with internet access increased fourfold to 22 percent. During the same time, exports of IT services has grown by 11 percent per year and now exceeds US$1 billion. This industry is strong in enterprise planning, application development, and systems integration, which is an indication that it could expand into higher value-added activities. Pakistan maintains relatively restrictive digital trade policies, particularly through policies around domestic taxation, customs duties, trade defense and subsidies. There is no tax harmonization for services industries across provinces. Exporters face challenges in meeting regulatory requirements abroad. Electricity shortages raise capital investment requirements and intellectual property rights are inadequate. But overall, the IT services industry is a promising segment of the economy and one that grows rapidly.

## 1.3 THE LONG-TERM OUTLOOK FOR PRIVATE SECTOR GROWTH

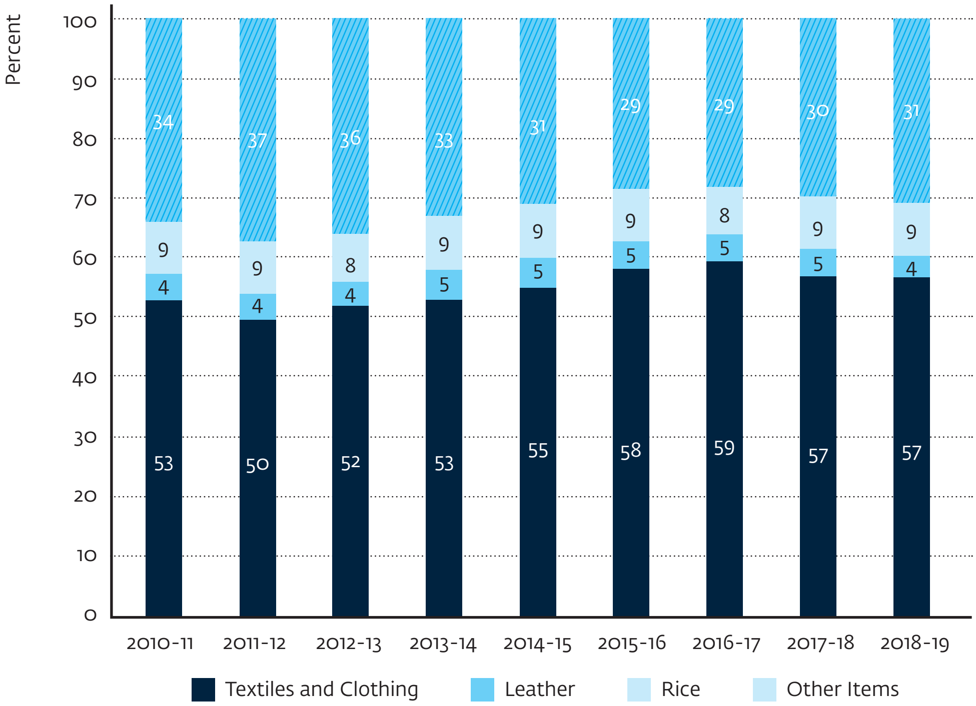
**23. This section highlights four long-term growth opportunities that Pakistan's private sector is facing: urbanization, the development of the CPEC, the scope to increase regional trade and integration, and a steady improvement in national security.** It also covers three long-term challenges to growth that Pakistan's private sector is facing: climate change, unsustainable water management practices, and the risk of increased regional tensions. The following discussion is not an attempt to cover all risks and opportunities, of which some are interrelated, but rather highlight some of the more important ones in the current context.

***The pace of urbanization and demographic change, the state of national security and the development of the CPEC will influence economic outcomes in coming decades. A breakthrough in political relations in the region has the potential to significantly boost regional integration and economic prosperity.***

**24. Pakistan's increasing rate of urbanization is expected to move tens of millions of people from low-productivity activities in rural areas to higher productivity activities in cities over the coming generation.** Pakistan is already one of South Asia's more urbanized countries with approximately 37 percent of the population living in urban areas and generating more than half of the GDP. The United Nations expects the urbanization rate to exceed 50 percent at some point between 2040 and 2050. Urbanization offers improved economic prospects through its effect on agglomeration economies. Cities like Karachi, Lahore, Sialkot and Faisalabad are engines of growth and economic dynamism. By some estimates, ten cities account for 95 percent of all tax revenue in Pakistan. The rapid growth of cities is offering business opportunities linked to the construction of essential infrastructure, an increase in the demand for consumer products and professional services, and an increase in the supply of labor available for manufacturing and new services industries. It requires leadership, skilled management, new sources of financing for infrastructure and services, and long-term investment in basic services to reap the benefits of this great domestic migration. However, unplanned urbanization has its challenges that if left unaddressed will reduce the potential benefits due to congestion, lagging provision of basic services, an increase in urban informal settlements, rising land prices and a decline in land for industrial use.

**25. CPEC is a unique opportunity to address power shortages and improve trade and transport logistics that will benefit many industries for decades to come.** The 3,000 km CPEC is a sub-project of the Chinese Government's Belt and Road Initiative, which seeks to connect China to Europe, the Middle East and Africa through infrastructure investments primarily in the transport and energy sectors. Approximately 70 percent of the CPEC investments in Pakistan target the energy sector. CPEC also envisions investments in logistics and transport infrastructure, including roads, ports, mass transit, railways, along with the development of nine special economic zones (SEZs) due to open by 2030. Transport and logistics development would facilitate regional integration with Central Asia and offer opportunities for local companies to integrate in regional value chains. It will offer China's western provinces an alternative entry and exit point for their trade. For example, a five percent diversion of Chinese international cargo from its western provinces could generate up to US$6 billion in revenue for Pakistan every year (World Bank, 2019c). The CPEC is an integral part of the larger Belt and Road Initiative, which over time will create new opportunities for Pakistani businesses, and the GoP to attract FDI in manufacturing and other industries, especially in the new SEZs.

**Figure 19: Export concentration by product**

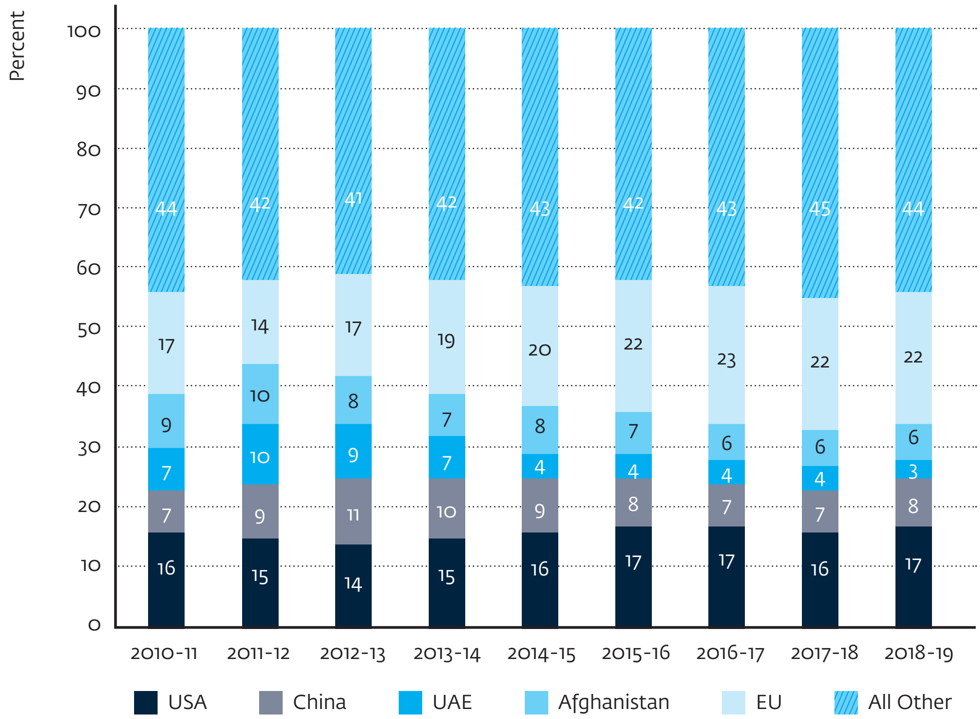



Source: Economic Survey of Pakistan

**26. Trade and regional integration remain Pakistan's greatest (untapped) growth potential.** South Asia is the world's least integrated major region in terms of investment, tourism, energy and trade. Intra-regional trade accounts for roughly 5 percent of South Asia's total trade whereas intra-regional trade in the Association of Southeast Asian Nations (ASEAN) and in the European Union make up around 25 percent and 60 percent, respectively. As in much of South Asia, Pakistan has been unable to leverage regional trade and connectivity as an engine of growth. But if tariffs, para-tariffs and non-tariff barriers for intra-South Asian trade were to be reduced, and geopolitical tensions reduced, Pakistan's producers would have better access to a market of nearly two billion consumers. It is anyone's guess if, and when, it may happen. Economic models find that intra-regional liberalization of trade in goods could result in additional economic growth of 30 percent by 2047 (World Bank, 2019c). Trade with India alone has the potential to increase from roughly US$2 billion in recent years to US$35 billion. Pakistan currently faces higher levels of protection from regional countries such as Bangladesh, China and India than it does from the European Union, the United Arab Emirates and the United States.

**27. A sustained improvement in the security environment would boost private investment, commerce and tourist arrivals.** Investors, especially foreign ones, have refrained from investing in Pakistan due to an unpredictable and volatile security environment, especially post-2007. FDI has been negatively affected when local security has deteriorated. But investment, trade and tourism can bounce back rapidly if there are clear signs of a permanent improvement in the security environment. Pakistan may be short of extractive natural resources but the size of its markets for consumer goods and services indicate that there is significant potential for market-driven investment opportunities. The challenge for Pakistan's policy makers is to reform the investment climate, revise the trade

**Figure 20: Export concentration by geography**




Source: Economic Survey of Pakistan

policy and improve the logistical infrastructure to attract more efficiency-driven investment aimed at serving foreign markets. Improvements in domestic security and reduced regional tensions are essential in this process.

***Pakistan's private sector and by extension the overall economy would benefit greatly from more proactive climate change adaptation, policy reform and improvement of water management practices, and improvements in regional political relations.***

**28. Climate change is expected to add to Pakistan's environmental and development challenges and have profound implications for economic development in Pakistan.** Pakistan is ranked as the fifth most vulnerable country in Global Climate Risk Index 2020 (Eckstein, 2019). Economic and climatic models point to annual GDP losses that could reach 1.2 percent by 2050 (Davies et al, 2016). Climate change may push between 5 million and 22 million people into poverty over this timeframe. It is the biggest long-term and currently unmitigated external risk to Pakistan's water security as it increases variability in water inflows between and within years. For example, by 2050, between 16 percent and 32 percent of the increase in the demand for water may be attributable to climate change. Climate change will adversely affect agriculture with yields, ceteris paribus, of staple crops projected to decrease by up to 20 percent, and livestock production predicted to decline by as much as 30 percent. Pakistan is especially vulnerable to hydrological and meteorological hazards, including floods and droughts. Climate change is expected to increase the occurrence and severity of extreme weather events, with high human and economic costs. A national response that promotes good conservation practices, sustainable development and investments in green infrastructure would help reduce the cost of climate change.

**29. The demand for water is projected to grow by more than 40 percent over the next 30 years and the current water policy and management practices are unsustainable.** Demographic change and economic growth are the main drivers of the rise in the demand for water. Furthermore, climate change is expected to accelerate the increase in the demand for water, especially in the agriculture sector. While agriculture continues to represent most of the demand, much of the new consumption will come from other sectors of the economy. Current withdrawal levels are nearly 60 percent of the renewable water supply, making a large increase in water demand unsustainable. The rise in demand cannot be met with groundwater harvesting. Compounding the challenge of increasing demand is the inefficiency of water use, driven by low water prices and poor management of the irrigation network. Pakistan uses 93 percent of its water resources for irrigation. Pricing of water is subsidized and occurs on a flat-fee basis per acre of land. The price is not only low but also independent of the quantity used. Distortive pricing is perpetuating spatial inequalities through a misallocation of resources as downstream farmers receive less than one-third of the water than farmers at the head of canals. A new National Water Policy was passed in 2018 to give impetus to reforms in the sector. To date, however, no price reform has been implemented.

**30. Regional tensions continue to shape economic outcomes.** The GoP spends 32 percent of its annual budget on defense (3.6 percent of GDP), curtailing the fiscal space to invest in human and economic development. These regional dynamics have had a direct bearing on economic growth and private enterprise by hampering public and private investment. A recent escalation in tensions with India had an immediate impact on investor sentiment as manifested by the country's stock market performance.

**31. The preceding analysis highlighted Pakistan's urgent need for a new growth paradigm that is less reliant on consumption and more driven by competition, public and private investment, and outward orientation.** A move towards such a growth model would require a committed effort to address three constraints to private sector growth. First, the GoP needs to improve the coordination of policy formulation and both streamline and strengthen the public institutions that are meant to enable private enterprise, including with regards to commercial justice. Second, a GoP reform agenda promoting competition and the leveling of the playing field for businesses should reduce the regulatory and administrative burden especially for SMEs, reduce the heavy presence of state actors in private markets, and address policies that protect incumbents and discourage outward orientation. Finally, the financial sector is serving a small and shrinking number of wealthy business houses and families with investments made primarily in government securities. The promotion of financial inclusion and the deepening of financial markets could help catalyze private investment and job creation, and set Pakistan on a more sustainable and resilient growth trajectory.

# 2. CROSS-CUTTING CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

## 2.1 INSTITUTIONS AND POLICY COORDINATION

***The GoP could greatly improve the public-private interface by completing the devolution of powers initiated by the 18th amendment, strengthening inter-agency coordination, reforming the commercial justice system, and streamlining and digitizing regulations and public administration.***

**32. Over the past two decades, Pakistan has made significant progress toward security, democratic consolidation, and devolution.** The Constitution of Pakistan 1973 (the "Constitution") is based on a trichotomy of powers with the state comprising a legislature, an executive and a judiciary branch of government. The federal system covers four provinces with independent legislatures or provincial assemblies. The center, or federation, has a bi-cameral legislature with the Parliament comprising the National Assembly and the Senate. The members of the National Assembly are directly elected through general elections whereas the members of the Senate are indirectly elected. The legislative powers of the federal and provincial legislatures are set out in the Constitution. The executive head of the government is the Prime Minister who takes decisions in consultation with the cabinet, which comprises the ministers of the state who are advised and supported by the civil bureaucracy on administrative matters. Likewise, at the provincial level the executive head is the Chief Minister who functions in consultation with the provincial cabinet. The judiciary has an independent appointment process and the Supreme Court and the High Court are constitutionally established offices.

**33. The provinces gained expansive legislative powers under the 18th Constitutional Amendment of 2010.** The devolution of powers has exposed provincial capacity constraints that are slow to bridge. The 18th Amendment to the Constitution led to a gradual transition towards increased executive and legislative autonomy for the provinces. It enhanced the scope of fundamental rights in the Constitution such as introducing the right to fair trial, the right to information, and the right to education. It changed the electoral college composition and increased the share of provinces in net proceeds of taxes. The devolution of powers to the provinces has had profound implications for businesses. Before the amendment, the provinces had limited legislative competence and in case of conflict between federal and provincial laws, the federal law generally prevailed. After the amendment, there are only select subjects enlisted in the Constitution for which the federation has power to legislate. For all residuary matters the provinces are empowered to legislate as well as regulate administrative affairs. Moreover, the provinces have also been granted powers to raise domestic and international loans, and to provide guarantees on the security of the Provincial Consolidated Fund subject to limits and conditions specified by the National Economic Council. Thus, while the provinces now have the exclusive power to legislate on subjects such as agriculture, land, health, education, tourism, contracts, procedural laws, they often lack the administrative capacity to effectively manage these affairs. At the time of devolution there was only modest effort from the federal government to harmoniously handover matters to provincial counterparts. For instance, before devolution, the Ministry of Agriculture, Food and Livestock at the federal level oversaw the cotton sector. After devolution of agriculture to the provinces, the federal government, instead of entrusting it to the provincial authorities, transferred the cotton wing to the Ministry of Textile Industry at the federal level (Bokhari, 2016). It has led to ambiguity and in some cases excessive regulation of the private sector.

**34. The federal government is prevented from implementing reforms and undertake development projects due to the lack of consensus and coordination between the federation and the provinces, and provincial governments are weakened by their lack of fiscal resources.** The challenges are exacerbated by the fact that the federal government may not be aligned with provincial governments, leading to delays in the execution of development projects (see Box 1 on public infrastructure). It has led to weak inter-provincial coordination on issues of economic importance such as taxation, housing regulations and renewable energy policy, and occasionally divergent policies, which increase the compliance cost for businesses. For example, a business with nation-wide operations may be subject to four different types of environmental, safety and quality standards and licensing regimes. Businesses in the food and agribusiness sectors have faced legal challenges due to different food and quality standards across the provinces (Ali, 2019). The tourism sector is another example of an industry that requires joint efforts of federal and provincial governments. The federation retains the taxation powers on almost all subjects except sales tax on services, which has been devolved to the provinces. Unsurprisingly, the provinces have significantly increased the sales tax on services following the amendment. Most of the legislative subjects related to human indicators, including health, education and infrastructure, are fully devolved to the provinces but they are not allowed to collect or levy taxes other than sales tax on services, which exacerbates the problem of an unbalanced fiscal structure.

**35. The 18th Amendment also included the devolution of powers from the provincial level to the local government level.** To date, this devolution has not happened in practice. The amendment envisioned the establishment of local governments by the provinces and the delegation of political, administrative and financial authority to elected representatives of the local governments. Presently, the local governments have either been dissolved or completed their term without announcing new elections. The local governments are therefore not yet fully functional, and the civil bureaucracy has been delegated the powers of the local governments (Khan, 2020).

**36. Public administration is associated with long lead times, excessive bureaucracy and opaque processes.** Manual, slow and complicated regulations increase compliance costs for businesses. The process of the purchase of land requires visits to multiple offices to effectuate the transaction. The procedure of obtaining a construction permit in some metropolitan areas can take more than four months to complete in ordinary cases. Land records remain largely manual. In addition, the businesses are required to register individually with several government departments in order to start operations, including company registration, sales tax registration, income tax registration, labor department and social security registrations. There are seldom timelines for the approval of applications and administrative processes. An example is the delay in the clearance of invoices in public procurement or PPP projects (Siddiqui, 2019). Even if procurement laws or contracts provide a timeline there is no effective and expeditious remedy against delay. Besides, the National Accountability Bureau recently launched an accountability drive and many civil servants who managed procurement of large projects are under investigation. The accountability drive is viewed by the media as a vindictive tool for settling political scores and has reportedly led to reluctance on part of civil servants to process and sign files, adversely impacting the business community as well (Raza, 2019).

### Box 1: The state of infrastructure—public infrastructure as a driver of private investment

**Publicly provided infrastructure is needed to stimulate and crowd in private investment.** Better public infrastructure such as roads, power, transport and general logistics could help mobilize private investment. It is an important element of private sector competitiveness. Access to serviced land close to urban centers, for instance, is needed to allow firms to leverage agglomeration economies. Efficient and well-maintained transport and logistical infrastructure reduces transport transaction costs. Uninterrupted power supply is essential in most industries and in manufacturing. Returns associated with the effective provision of public infrastructure can be large. If Pakistan were to improve its electricity, transport and telecom sector infrastructure to the corresponding levels of Malaysia, for instance, the GDP per capita growth rate could increase by an estimated 3.7 percent.

**Pakistan's public infrastructure is improving but it is not keeping pace with the demands from a rapidly growing and urbanizing population.** According to the World Economic Forum's Global Competitiveness Index, Pakistan ranks 105 out of 140 countries in terms of the quality of its overall infrastructure, which includes transport and utilities such as road connectivity, electricity access, electricity supply quality and reliability of water supply. In comparison, India ranks 70, Sri Lanka 71 and Indonesia 72. For example, only 74 percent of the population has access to electricity in comparison to 88 percent in India, 98 percent in Indonesia and 100 percent in Sri Lanka. Pakistan's SEZ policy hasn't been effective owing to deficient infrastructure both within and outside the SEZs. Energy costs remain the highest in South Asia. Old infrastructure, faulty metering and power theft lead to the loss of one fifth of the electricity output. Transport and logistics infrastructure accounts for 25-30 percent of the GoP's development budgets but it is still lagging. Pakistan ranks 122 out of 160 countries on the WBGs LPI, ranking 121 on the 'infrastructure' sub indicator, which quantifies the state of the trade and transport related infrastructure in the country.

**Infrastructure investments under CPEC will help to bridge some of the gaps.** While some infrastructure investments under the umbrella of CPEC will address gaps especially in power generation and logistics, other gaps remain and keep widening. Infrastructure financing requirements of Karachi alone—Pakistan's largest city—amount to US$10 billion over the next 10 years. The estimated investment requirements in infrastructure are estimated at over US$30 billion (10 percent of GDP) annually in order not to fall behind.

**37. The judicial backlog and weak contract enforcement have led to a distrust of the judicial system that has adverse effects on private enterprise.** The dispensation of justice in Pakistan is cumbersome, time consuming and expensive. A backlog of millions of cases pending at all levels of the judicial system discourage private investment and risk taking (Iqbal, 2019). The cases remain in the court system for years and due to multiple forums of appeal, it can take decades to conclude a matter. In the absence of finality to a judgement, a business is prevented from executing the court decree and recover its losses. In this regard, micro, small and medium-sized enterprises are particularly vulnerable as they often lack the resources to pursue the litigation and meanwhile continue operations with outstanding debt and receivables. Nearly 25 percent of Pakistan's SME credit portfolio comprises non-performing loans. And once the State Bank of Pakistan (SBP) moratorium placed on the principal amount repayments in response to COVID-19 pandemic expires, the number of non-performing loans particularly among SMEs is expected to rise quickly (Fitch Solutions Group, 2020). GoP has in the past few years updated the legal framework to support insolvency and distressed assets restructuring reforms. Besides enforcement of Pakistan Corporate Rehabilitation Act 2018, GoP has, earlier in 2020, amended the Corporate Restructuring Companies Act 2016 which sets out the process of licensing and regulatory framework of Corporate Restructuring Companies. SECP has recently issued a license to Pakistan Corporate Restructuring Company Limited (PCRCL) which is formed as a consortium of ten banks representing both public and private sector financial institutions. The mandate of PCRCL is to acquire, restructure and resolve the non-performing assets of financial institutions and ultimately rehabilitate and revive financially distressed companies or sick units. However, judicial capacity remains an important area on which reform and collaboration among stakeholders is required. In the past, cognizance of public interest cases in exercise of suo motu jurisdiction of the Supreme Court of Pakistan were largely deemed as judicial interference in the executive's domain of political and economic decision making (Siddique, 2015). On the one hand, owing to judicial activism, the Supreme Court of Pakistan imposed hefty fines on corporate entities without undergoing complete trial; and on the other hand, it ordered crowd funding for construction of public infrastructure (Bilal, 2018). For expeditious disposal of commercial cases, enactment of a specialized commercial law and the establishment of commercial courts are essential. In addition, the judicial system would benefit from systematic training of judges, court automation, a modern case management system, changes to procedural law, the setting out of time standards for cases, the reorganization of the bar council, and the appointment of judges and the promotion of a performance management system based on data and quality of judgements.

**38. The delays in the disposal of cases on the district judiciary level are mostly due to insufficient staffing and disruptions due to strikes.** The local bar councils routinely announce strikes and prevent lawyers from appearing in cases (Liaquat, 2017; Saleem, 2019; Naseer, 2019). As there are no rules governing capping the number of adjournments, judges frequently grant adjournments, which allow the litigation to prolong unnecessarily. Interim injunctive (stay or maintenance of status quo) reliefs are presently discretionary remedies and once a party obtains an injunctive relief it usually delays the proceedings and has no interest in quick disposal. In civil matters, courts commonly grant injunctive reliefs for an unlimited time period in matters ranging from public procurement to encashment of performance guarantees in contractual disputes. Disputes of billions of US$ pertaining revenue collection to loan repayments are held up due to litigation. Commercial contracts have lost their sanctity owing to protracted litigation and complex processes prescribed by courts. Many investors and private parties have little faith in the judicial system due to inordinate court delays and conflicting precedents (Husain, 2016).

### 2.1.1 Business regulations and public administration

***The GoP has made great progress over the last few years in reforming the regulatory and administrative environment faced by businesses. This reform momentum must be maintained in the coming years to make a lasting impact on the investment climate in the country.***

**39. Running a formal business in Pakistan demands patience and perseverance as it requires much engagement with the country's public administration, but the situation is rapidly improving.** A typical business deals with 40 regulatory entities that manually administer over 1,000 regulations without horizontal or vertical integration. However, the GoP adopted several reforms in 2018-2019 that were captured in the WBG's Ease of Doing Business (EoDB) indicators. The reforms covered the administration of starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders. Pakistan was consequently recognized as a top-10 reformer in the EoDB 2020. The SECP has created a virtual one stop shop for business registrations that integrates administrative procedures of federal and provincial agencies on a single portal. The reforms to issue construction permits included amendments to the Lahore Development Authority by-laws and the integration of the Sindh Building Control Authority with landowning agencies that simplified procedures and reduced the time and cost of compliance. Reforms adopted by provincial departments cover the automation of the revenue department, process reengineering, and the reduction in stamp duties, capital value tax and registration fees. In 2020, a revision of the Consumer Service Manual 2005 by the National Electric Power

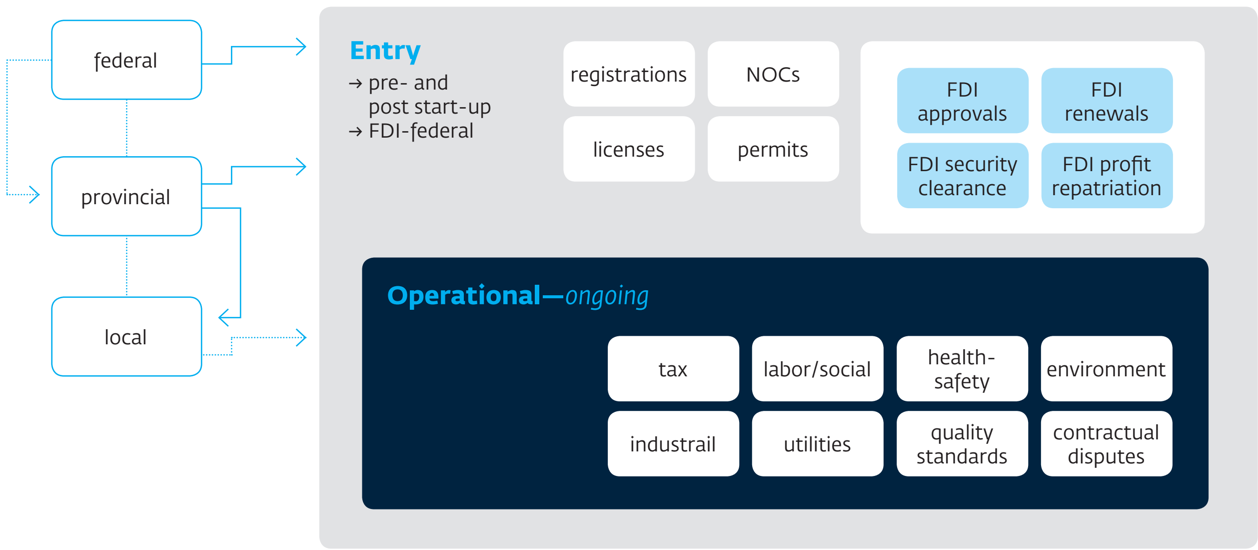
Regulatory Authority mandated the provision of electricity connections within 58 days for electricity distribution companies. The Financial Institutions (Secured Transactions) Act of 2016 was amended to comply with the UNCITRAL model law and an electronic secured transactions registry has been established to maintain records of charges relating to moveable assets of unincorporated entities.

**40. Reforms have been undertaken and championed by both federal and provincial entities.** The improvement in the investment climate is the outcome of reforms undertaken both at the federal and provincial levels. A National Coordination Committee headed by the Prime Minister has strengthened coordination between the provinces and the federal government. The GoP has adopted the 'Pakistan Regulatory Modernization Initiative' (PRMI) to identify and institutionalize a second generation of investment climate reforms beyond those captured by the EoDB. PRMI entails the mapping of all the national rules, regulations, licenses and permits that govern the operations of the private sector. It is then followed by efforts to simplify, streamline and automate them. This is an agenda that will help build investors' trust in the public administration. It will be supported by the National Regulatory Deliver Office under the Prime Minister's Office to ensure a coordinated approach to the design and enforcement of business regulations. The effort will also be supported by a Regulators' Code to ensure that new business regulations are proportionate, risk-based, targeted and cost effective and can be enforced in a consistent and transparent manner. This agenda has gained public attention owing to the GoP's recognition of the impact of the pandemic on the private sector.

**41. Inefficient land markets limit access for greenfield investors to a critical factor of production.** Land in Pakistan has been used more as a vehicle for speculative investment than as a factor of production. In urban areas, years of high levels of investment in land facilitated by low taxation has priced land out of the reach of businesses seeking to start, relocate or expand operations. In rural areas, a high concentration of land holdings within local and political elites means that private producers struggle to acquire land. While federal and provincial governments have invested heavily in industrial estates and SEZs, especially under CPEC, mismanagement and a lack of basic services and infrastructure mean that these estates have produced modest agglomeration economies. The issue of tight land markets for productive use is compounded by the opaque and complex way they are administered. Ownership of land remains highly fragmented with different levels and arms of the government—federal, provincial, local, government departments, etc.—staking claim to prime real estate across the country. Property or land registration is also onerous. Registration of property often involves multiple agencies, or at least 17 in Karachi.

**42. Surveys of domestic and foreign investors have highlighted political instability, a fragmented regulatory environment and corruption as major impediments to doing business in Pakistan.** This includes results from regular surveys of foreign investors administered by the Overseas Investors Chambers of Commerce and Industry, the World Bank's enterprise survey from 2013 and the annual EoDB report. There are at least twelve different categories of general regulatory layers, which are applicable to all businesses, and four additional administrative processes for foreign companies (see Figure 21). The administration of business regulations is mostly based on manual processes with irregular enforcement. The multiplicity of regulations, their fragmentation across different levels of the government, and *adhoc* and manual administration have left the system open for rent seeking. For example, the regulatory regime governing the manufacturing sector covers 50 laws and a multitude of secondary regulations enforced by over 40 national and subnational agencies and departments through manually processed 'no objection certificates', permits and licenses. Compliance requirements are neither clearly defined nor published in an easily accessible format. A more transparent and simplified business regulatory and administration interface would reduce the scope for rent seeking.

**Figure 21:** **Complexity of public administration**




## 2.2 COMPETITION AND LEVELING THE PLAYING FIELD

***Many sectors in the economy are protected from foreign competition by restrictive investment and trade policies. Domestic competition is also obstructed by the heavy presence of SOEs, weak enforcement of competition rules, and distortive policies maintained to protect special interest groups.***

### 2.2.1 Investment and trade policy

***Domestic competition is stymied by institutional weaknesses. Rules and principles of fair competition are not upheld, including legal recourse in the case of grievance, and distortionary factor and product market policies that curtail incentives to invest and innovate.***

**43. Domestic competition is stymied by the weak implementation of competition rules.** The Competition Commission of Pakistan (CCP) is mandated to enforce the Competition Act of 2010. The Commission, however, has been more successful in enforcing the Act's provisions on consumer protection and deceptive marketing than those related to the abuse of market dominance or collusion to stifle competition. Its ability to enforce decisions has been suppressed by long delays in the courts' adjudication of appeals. By some estimates, fines worth PKR30 billion imposed by the CCP are currently pending in court. These fines have been imposed for various anti-competitive behavior, including deceptive marketing, price fixing, misrepresentation, and cartelization. In 2019, fines worth PKR1.25 billion were imposed by the CCP on entities operating in the agriculture, education, construction and food services sectors.

**44. Limited economy-wide competition owing to distortionary factor and product market policies curtail incentives to invest, innovate and upgrade technology and management practices.** In 2018, Pakistan ranked 120th out of 137 countries in terms of 'intensity of competition' in the WEF's Global Competitiveness Report. Weak competition is primarily attributed to protectionism and sector policies that deter competition and accord direct or indirect advantages to connected incumbents. This holds especially true for sectors in which the GoP has a significant footprint, such as in aviation, insurance, energy, transportation and industrial and engineering sectors. Anti-competitive practices are also prevalent in agricultural markets, the mainstay of a sizable proportion of the labor force. This is especially true for subsectors and markets dominated by large land-owners and a few dominant players such as in the sugar and wheat markets. The fusion of politics, the state administration and product markets is not unique for Pakistan but the implications for the economy and the functioning of markets are stark.

**45. The provinces gained a considerable regulatory responsibility in the 18th Amendment but they lack the tools and mechanisms to promote and enforce competition on provincial subjects such as agribusiness and food processing.** The provinces have archaic profiteering and anti-hoarding laws that are insufficient to combat price fixing and other anti-competitive behavior. The spirit and requirements of the 18th Amendment are not adequately reflected in the existing legal framework on competition. It undermines the jurisdiction of the Competition Commission to collect penalties. As a quasi-judicial body, the Competition Commission needs to clarify its role in imposing and collecting penalties, which should not be construed as a mere revenue generating activity but instead as a tool to enforce antitrust laws. At the same time, the appellate process for competition cases needs to be strengthened. The final appellate authority for competition cases should be entertained by a specialist appellate mechanism and the decisions of such appellate forums should have finality. Appeals and other jurisdictional matters of competition cases from the appellate forum set up by the Competition Commission are currently dealt with by the provincial high courts, which are overloaded and lack technical capacity to handle this subject. Frequently, the courts issue restraining orders against proceedings of the Competition Commission. As a result, decisions on competition cases get delayed, which undermine the enforcement of competition rulings. The analytical capacity of the Competition Commission to identify anti-competitive tendencies across all sectors of the economy should be strengthened.

**46. Poor governance accentuates the ambiguities and gaps in the law.** Ambiguities and gaps are filled through different regulations and practices within different agencies. Some of these regulatory practices are not subject to good regulatory governance, which results in high transaction costs and uncertainty for investors. Although there is an obligation by law to solicit comments on proposed regulations from the general public, it is not done in a systemic way and investors do not have a direct channel of communication with the administration. Moreover, there is no requirement for regulations to be periodically reviewed to assess if they remain relevant. Ministries and regulatory authorities also do not conduct impact assessments of proposed new regulations. There is no specialized governmental body tasked with reviewing and monitoring regulatory impact assessments conducted by other individual agencies or government bodies. This is captured in Pakistan's Regulatory Governance Index rating, which puts Pakistan behind most peers.

**47. Pakistan investment laws do not provide investors with adequate recourse or redress in case of grievances.** Pakistan scores poorly in the contract enforcement indicator of the EoDB compared to its aspirational peers. Over 1.8 million cases are pending in courts and it takes on average more than 1,000 days to resolve a dispute (LJCP, 2020). The two acts that govern investment are silent on the issue of dispute settlement, which leaves it to local courts as the only recourse unless otherwise agreed by contract or investment treaty. Most international investors are reluctant to rely on local courts as their only recourse in case of dispute especially vis-à-vis the state. Pakistan's official stance is yet increasingly averse to the risk of investment disputes in international fora. A grievance redress and dispute prevention mechanism could help mitigate these differences in preferences between the GoP and investors. Despite a plethora of complaint mechanisms in various agencies such as the Board of Investment (BOI), they do not serve investors well, and lack monitoring, evaluation and escalation systems.

***Foreign competitors are discouraged by the ambiguity and inconsistencies in the legal framework that regulates foreign participation and draconian security clearance procedures.***

**48. The legal framework for investment is fragmented and incomplete, leaving space for ambiguity and inconsistent application.** Foreign investment in Pakistan is regulated by the Foreign Investment Protection and Promotion Act 1976, and the Protection of Economic Reforms Act 1992. In 2013, the BOI adopted a new investment policy, which presented a more liberal approach to FDI than the one adopted by the two acts governing FDI. It also affirmed broader protections and guarantees for investors. The relationship between these various instruments is confusing to investors as the Investment Policy is not a legally binding instrument and the framework for investment entry and protection is unclear (World Bank Group, 2018). The Foreign Private Investment Act of 1976 imposes an economic needs test that makes foreign investment conditional on the need for the proposed economic activity and its contribution to development. It leaves a fair deal of discretion to the GoP in the approval process. The Investment Policy of 2013, on the other hand opens most sectors and uses a negative list approach. This is more consistent with good practice.

**49. Long security clearance processes leave foreign companies in legal limbo and deter investment.** Companies with foreign shareholders and/or foreign directors need to obtain a No Objection Certificate from the Ministry of Interior as part of the company incorporation process. This process is lengthy and lacks a predetermined timeframe. To mitigate this, companies incorporated with foreign shareholders and/or directors are now issued a Certificate of Incorporation so they can start their business activities pending security clearance. Foreign shareholders and directors must, however, provide an undertaking that they have subscribed shares and/or agreed to be directors and will immediately step down if security clearance is denied. Basic investment protection guarantees vary in scope across instruments and fall short of good practice. For example, Pakistani law guarantees investors the right to repatriate assets freely. However, different instruments define the scope of assets differently. The same applies to guarantees against expropriation. But the definition of what constitutes expropriation is unclear and the guarantees do not extend to indirect or regulatory expropriation.

***Pakistan's trade policy does not only shield domestic producers from foreign import competition, but it has also maintained a strong anti-export bias that encourages inward orientation. The result is a less competitive domestic market and the survival of underperforming businesses.***

**50. High tariffs on imported inputs, high tariff rate differentials, and uncompetitive logistics services lead to high production costs and an anti-export bias.** Local producers struggle with competition from manufacturing juggernauts such as China. Pakistan's simple average tariff rate has been consistently higher than in regional, aspirational and structural peers independent of product category and method of measurement (see Figures 22-23). But it is not only a high and complex tariff schedule that impede trade but inferior logistics. Pakistan fares poorly in the LPI, which measures the state of logistical infrastructure and policy, and therefore offers an indicator of a country's readiness to integrate in GVCs. As of 2018, Pakistan ranked 122nd out of 160 countries in the LPI, having dropped from 68th in 2007. Pakistan compares unfavorably to most peers and performance is particularly weak on: (i) the efficiency of the clearance process by border

**Figure 22: Applied tariff rate, simple mean manufactured products**

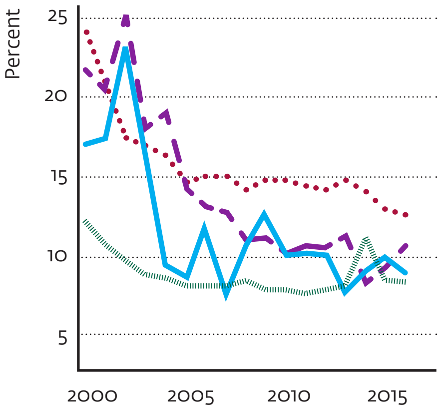
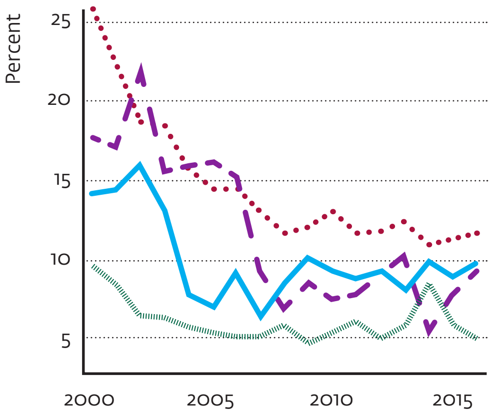



**Figure 23: Applied tariff rate, weighted mean manufactured products**




1 Pakistan 2 Structural 3 Aspirational 4 Regional

Source: World Development indicators

control agencies, including customs; (ii) the quality of trade and transport related infrastructure such as ports, railroads, roads and information technology; and (iii) the ability to track and trace consignments.

**51. Exporters are not diversifying into new products or markets partly due to a policy that encourages inward orientation.** Pakistani businesses are sheltered from competition with the help of a regressive investment policy and a trade policy with a strong anti-export bias. For example, Pakistan has one of the highest weighted average tariff rate differentials (differential between consumer goods and raw materials was 10.4 percent in 2016) in South Asia and the world. The tariff differential encourages domestic businesses to cater primarily to the domestic market. Companies that want to innovate and diversify are discouraged because they are priced out of more competitive international markets. Inputs generally, and imported inputs specifically, are too expensive. Only 27 percent of producers use material of foreign origin and foreign origin inputs account for only 12 percent of total inputs. There are several duty exemption schemes in place to ease access to imported raw material and intermediates. However, these schemes do not benefit all businesses and their impact is skewed towards large companies. The GoP has decided to reform the National Tariff Policy to remove some of these distortions and the adoption of the revised policy started under the Finance Act FY21 with the reduction of duties on 1,600 tariff lines.

**52. The national trade and investment policy would need to shed its inward-orientation and anti-export bias to gradually open sectors to competition and expose incumbents to nimbler entrepreneurs.** First, the tariff policy needs to be revised to promote a transparent tariff structure with lower average tariffs, minimal dispersion and less discretion. Second, the duty exemption schemes should be streamlined and be more accessible to all businesses regardless of their size. Third, the customs administration would need to improve trade facilitation to reduce the time and cost of importing and exporting. Interagency coordination could be much enhanced in the development and implementation of a coherent and pro-export trade policy. The investment policy could also be tailored to attract investment in more sophisticated and higher value-added goods and services.

### 2.2.2 State owned enterprises

***Pakistan's SOE portfolio has made large aggregate losses in recent years and SOE debt and GoP guarantees to SOEs have risen rapidly. Private investors have shunned sectors where SOEs distort competition and investors are not interested in buying SOEs with opaque finances and operations.***

**53. The level of competition is low in some sectors because of the state's footprint in the economy and the financial performance of many SOEs is dismal.** In FY19, the federal budget financing for SOEs equaled 2 percent of GDP, 9 percent of total consolidated expenditure, and 23 percent of the fiscal deficit. In the same year, SOE debt with sovereign guarantee was 3.3 percent of the GDP. SOE debt and losses have grown rapidly in recent years with SOE debt equaling 5.3 percent of GDP (PKR2.0 trillion) in FY19. An estimated 49 SOEs are financially unviable (*i.e.* 58 percent of the SOEs excluding subsidiaries) with 17 SOEs having negative equity. Four SOEs remain *de facto* but lack operations, including in steel production and energy. Another 17 SOEs have negative equity and accrued losses in sectors such as air transport, banking, broadcasting, printing, metals, power, telecom and tourism. And 13 SOEs made losses in the three last consecutive years (FY16-18) that were reported in sectors as wide ranging as highways, postal services, power, railways, SME banking, television and textiles. The state-owned power sector comprising numerous businesses is a liability to the GoP. The exception to this meagre financial picture was the oil and gas industry, which made handsome profits, and there were also profitable companies in banking, insurance and ports and shipping.

**54. State patronage has protected incumbents from competition and come at a high cost to taxpayers.** Pakistan's aviation sector illustrates the impact of state patronage on competition, sectoral dynamics and investment. Pakistan international airlines (PIA), the state carrier, controls 60 percent of all seats on the domestic routes it operates, and 20 percent of all seats on international routes. The state carrier has been able to realize this dominance despite its key operational and financial indicators having shown signs of distress for many years. PIA lost PKR77 billion in FY16 alone and has only managed to stay afloat owing to direct capital injections and guarantees by the government (Rana, 2019). The carrier is not paying for airport services provided by the Civil Aviation Authority (CAA), and it is not honoring or delaying payments to other government or state-owned entities, such as PKR42 billion accumulated in payables for fuel, airport and ATC charges provided by the CAA. PIA's private competitors have no such benefits.

**55. SOEs enjoy superior access to finance and favorable regulation.** Various forms of loans, grants and subsidies are often offered to cover operational costs in addition to capital investments. Sovereign guarantees are used to ensure preferential access to bank credit at the expense of credit to private firms. There has been a marked increase in banking sector credit to SOEs despite their mounting losses in recent years: or from PKR380 billion (1.5 percent of GDP) in June 2014 to PKR1.4 trillion (3.6 percent of GDP) in FY19. SOEs are granted favorable treatment by regulators with lax enforcement for SOEs. In the air transport sector, for instance, the Aviation Division (policy maker) is the line ministry for PIA (the SOE) as well as the Civil Aviation Authority (CAA, the regulator for all civil aviation activities). The Federal Secretary of the AD is also the Director General of the PCAA and a member of PIA's Board of Directors. This institutional setup breaches principles of competitive neutrality and discourages private participation. For instance, the financial standing criteria for air carriers that is needed to maintain the validity of their Air Operator Certificate is enforced unevenly with PIA benefitting from the application of lower financial standards compared to privately owned operators.

**56. A serious attempt to restructure the SOE portfolio could reduce fiscal leakages, promote competition and revitalize important sectors of the economy.** In the short-term, the GoP should seek to contain the liabilities of SOE debt, close non-essential, unviable

## Box 2: PPPs in Pakistan—Managing the risks and opportunities

**The private sector could play a much more prominent role in the financing and provision of physical and social infrastructure.** The GoP needs to raise investments by an estimated US$165 billion in order to reach the universal access goals of the Sustainable Development Goals over the next two decades. A high level of public indebtedness calls for private participation to accelerate the development and maintenance of infrastructure. Private participation could help improve service quality and instill budget discipline. But Pakistan's track record of structuring PPPs has been mixed and there are concerns about contingent liabilities. Noteworthy transactions in a relatively modest portfolio of 68 PPP transactions are found in the power and port sectors. But guarantees in support of underused infrastructure built through PPPs have given rise to fiscal liabilities of yet unknown magnitude. The practice of providing state guarantees and viability gap funding needs to follow a transparent process based on value for money considerations. The lack of capacity to assess, manage and report fiscal implications is relatively low according to the World Bank's latest PPP benchmarking.

**The Government needs to strengthen PPP frameworks and methodically build capacity.** It needs to identify true PPP champions at the federal and provincial levels. High-level leadership is essential to address challenges of coordination. Pipeline development needs to be part of an enhanced public investment management system to ensure that only economically sound investments that fit with the overall infrastructure plan are prioritized. This would require better methods and guidelines for value for money assessments and a clearer process to handle unsolicited bids. Furthermore, contract award and renegotiations need to be transparent to promote fair competition and avoid the favoring of politically connected entities. The GoP needs to build a stronger transaction advisory capacity and provide ring-fenced funding so projects can engage qualified advisors.

**High potential PPP engagements are found in the renewable energy, ports, bus-based mass transit/BRTs, highways, rail freight/bulk terminals, water, transmission and telecoms.** Given the challenges of low administrative capacity, a difficult political economy, and internal coordination, the GoP would be well advised to take a pragmatic approach and focus on model transactions that can showcase the feasibility of the PPP concept. Cabinet-level ownership for such an agenda is required and a list of potential transactions need to be endorsed and monitored with clear accountability and responsibility assigned. PPP transactions with explicit and material user charges that produce foreign currency denominated cash flows are arguably most realistic. Such a list could include seaports, airports and rail fright/bulk terminals, which tend to generate revenue, and mass transit/BRTs or highways.

**Pakistan's PPP agenda would eventually develop once issues of long-term finance and demand from domestic sponsors are addressed.** The country lacks long term debt financing and hedging products (currency and interest rate swaps) to bridge the mismatch between long-term forex financing and local currency revenues, and the conversion of variable rates to fixed rates. This explains the country's reliance on FX finance, which given that many PPPs receive cash flows in local currency leads to contingent liabilities and hence further fiscal risks. An ambitious PPP agenda would therefore need to be complemented by efforts to strengthen debt and capital markets that can support long-term local currency finance. Islamic finance and its various instruments have been used for infrastructure/PPPs in Pakistan in the past and represents a large untapped potential in the provision of long-term finance.

and defunct SOEs while divesting assets when possible. This would require stricter rules and conditions for budget financing and guarantees to SOEs, a redirection of subsidies from SOEs to consumers, stronger cost and performance metrics and agreements, divestiture of minority stakes, and the voluntary separation or re-deployment of staff. In the medium-term, the GoP should start to actively manage the SOE portfolio, restructure essential, unviable SOEs, and reduce the negative impact of SOEs on competition. It would require a centralized ownership function in a single entity through a SOE Act or the establishment of one or more holding companies with a portfolio management mandate. Some of this work is in progress but far from finalized. The GoP would need to convert commercial SOEs into companies through the SOE Act or amendments to other acts. Conflict of interest could be better controlled by the divestiture of SOEs with a dominant market share, the separation of sector ministries' regulatory function and supervision function, and the prohibition of government preferential treatment for SOEs in market regulations, access to finance and public assets, taxation and public procurement. Future efforts to realize the value of dormant public assets or the achievement of public objectives may be better served by a robust approach to develop a portfolio of PPPs as presented in Box 2.

### 2.2.3 Elite capture and policy distortions

***Pakistan's entrepreneurs are facing competition from entrenched special interest groups that benefit from the status quo, maintains unfair and distortive economic policies, and use state patronage to gain an advantage in public procurement.***

**57. Pakistan's complex history has given rise to different factions with different agendas that help undermine effective governance.** The Pakistani elite configuration is heterogenous and includes the public administration, the military complex, industrial conglomerates, business houses religious groups, large landowners or other local elite groups. Some elites straddle all the clusters, but each category of the elites is strong and affects development in different ways. The influence of these special interest groups has made it very difficult to implement far-reaching reforms. Elections are viewed by urban powerbrokers and regional elites as an extension of age-old systems of kinship and intertribal rivalry, which offer an opportunity to gain access to government largesse (Lieven, 2011). The landowning class dictates economic policy for its own benefit through political channels. Rural landowners in some areas still dictate the political choices of their tenants, and key elites, including business houses, use all means to influence election outcomes.

**58. Excessive government interventions and failed sector policies have resulted in economic distortions maintained by special interest groups.** The GoP has traditionally intervened in agricultural input and output markets through subsidies and procurement prices. In the 1990s, the National Agricultural Policy was passed to reverse this practice and liberalize agricultural markets. However, reforms fell short of eliminating major sources of distortion, especially price floors for wheat, sugarcane and fertilizer subsidies, which continue to distort crop choices, uphold entry barriers and constrain competition. Some analysts argue that members of the landowning class successfully resist the implementation of reforms as they benefit from the status quo (Lieven, 2011; Speakman and Rysova, 2015). In the water sector, irrigation water tariffs are subsidized and occur on a flat-fee basis per acre of land. Pakistan uses 95 percent of its water resources for irrigation according to the Pakistan National Water Policy 2018. Various reforms and agricultural strategies, including the National Water Policy of 2018 and the GoP economic policy program for 2005-10 (MTDF 2005-10), proposed appropriate pricing mechanisms to achieve cost recovery and sustainability. To date, no major reform of the irrigation water-pricing system has been implemented. Large landowners benefit disproportionately from the low water rates and preferential access (Pasha, 2014).

**59. The military is an active stakeholder in economic policymaking and controls various businesses.** Direct and indirect participation of the military and its affiliated institutions in commercial activities is widespread in Pakistan. In a report presented to the Pakistani Senate in 2016, fifty commercial entities were reported to be run by the military and welfare organizations established for retired army officers (see Wasim, 2016 and Siddiqa, 2016). These manage business ventures in port and marine terminals, dry ports, logistics, power plants (wind, coal, thermal), construction, real estate, food processing (cereals, meat, dairy etc.), manufacturing (fertilizer, cement, pharmaceutical), banking, banquet halls, etc. An estimate from 2019 suggests that military's equity in businesses in the country exceeds US$100 billion (Shakil, 2019). These organizations are not formally defined as state-owned entities and they are hence free to participate in tenders for public procurement and PPPs.

## 2.3 FINANCIAL EXCLUSION

**60. The financial sector should play a much more effective role as an intermediary of capital and facilitator of investment and growth.** The domestic credit-to-GDP ratio, which includes credit extended both to the private and public sectors, is a barometer

**Figure 24: Domestic bank credit to private sector**

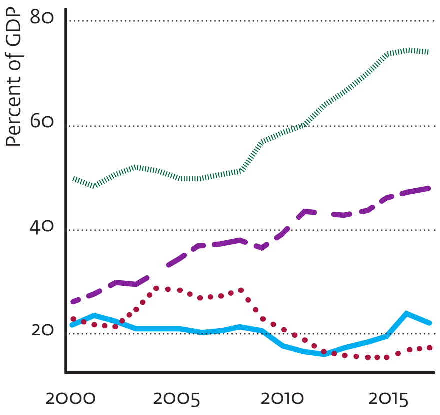
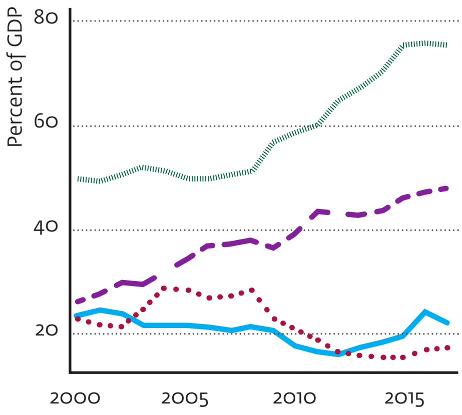



**Figure 25: Domestic credit to private sector**




1 Pakistan 2 Structural 3 Aspirational 4 Regional

Source: World Development indicators

of the depth of the financial sector and therefore a measure of its role and potential. In 2018, it was 58 percent in Pakistan. In comparison, a South Asian country like Nepal (102 percent), and middle-income countries like Malaysia (142 percent), Thailand (123 percent), Turkey (77 percent) and Vietnam (141 percent), had significantly higher ratios. Pakistan compares less favorably still in studies of the private sector credit (PSC)-to-GDP ratio: between 2008 and 2018, it dropped from 29 percent to 19 percent. Figure 24-25 illustrates how the ratio has remained low over time in comparison to other countries. A mature financial sector, as measured by a high proportion of bank credit to the private sector, is a robust predictor of long-run economic growth (Levine and Zervos, 1998).

**61. Few businesses can access external finance so they tend to rely on retained earnings to finance investments. Women are particularly affected.** Only 7 percent of the Pakistani businesses surveyed in the World Bank Enterprise Survey 2013 had a bank loan or a line of credit. But 43 percent said they needed a loan. The number is lower for SMEs with 3.4 percent of them having a loan or a line of credit. In general, businesses that are not credit constrained grow faster than those that are credit constrained (Fowowe, 2017). The businesses that do access finance need to present collateral equal to approximately 150 percent of the loan value. Consequently, 88 percent of the investments undertaken by the surveyed companies were financed through retained earnings. And this is particularly challenging for women and women owned businesses. According to the SBP, 18 percent of women have a financial account in Pakistan compared to 51 percent of men. The SBP adopted the Banking on Equality (BoE) Policy in December 2020 as a framework to promote gender parity in financial access. It seeks to build consensus around key public and private sector actions to promote gender equality and covers product diversification and development capability, customer acquisition and facilitation approaches towards women segments, collection of gender disaggregated data, and prioritizing gender issues in the policies of the SBP.

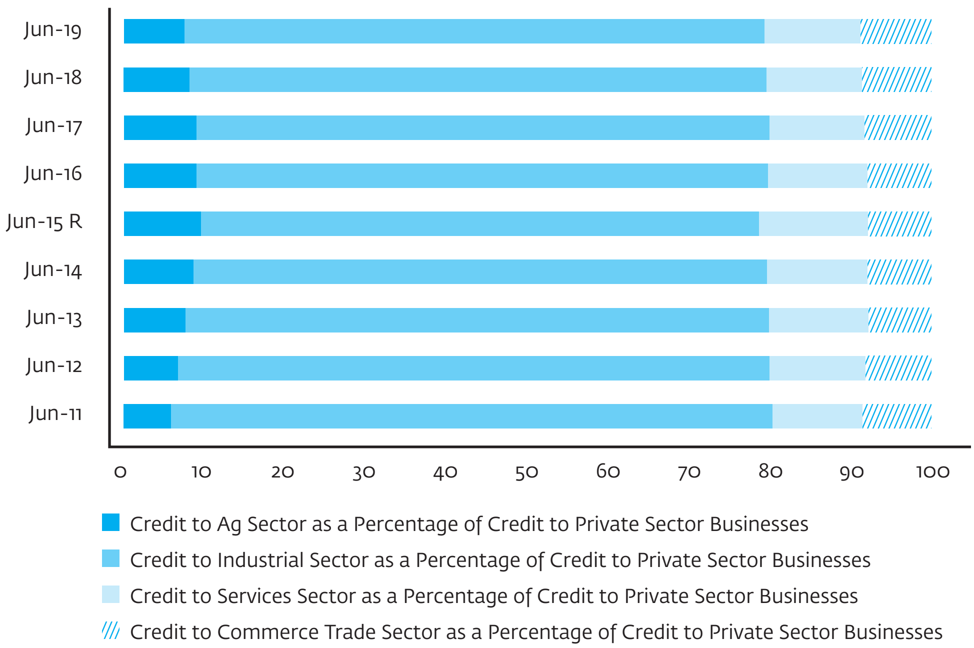
**62. Credit is concentrated and primarily intermediated to the corporate segment.** The corporate segment accounts for 71 percent of the private sector credit extended by the banking sector and this share has been trending upwards in recent years (SBP, 2015). In 2017, twenty business groups accounted for thirty percent of the banking sector's private sector lending portfolio. There are only about 1,000 corporate borrowers active in the market. The industrial sector and the agricultural sectors absorb 70 percent and 8 percent, respectively, of the credit extended by the banking sector. The services sector, which accounts for 60 percent of GDP, made use of 12 percent of bank finance in the past decade. Key segments of the economy, including the SME segment of the market, and the infrastructure and housing sectors, are underserved. The GoP's own financing schemes for the private sector have primarily benefitted a relatively small number of established businesses. In 2017, for example, the Export Finance Scheme of the SBP provided 62 percent of its loan disbursements and 68 percent of its Long-Term Finance Facility for Plant & Machinery to the country's 100 leading exporters. The eligibility criteria have been revised more recently to make the schemes more accessible to all exporters.

**63. The economic downturn triggered by the COVID-19 pandemic is putting additional stress on the banking sector.** Many SMEs did not have significant savings at the onset of the crisis and therefore depleted working capital and even sold productive assets to survive the lockdown. Businesses surveyed in June-July 2020 reported liquid means to remain open for an average duration of 66 days, but 60 percent had only cash to cover operational expenditures for 30 days or less if the situation remained unchanged. Small businesses reported considerably lower buffers than large businesses.

## a) SME Finance

**64. The SME sector is severely underserved from a regional perspective.** In 2019, credit extended to SMEs accounted for 7 percent of the total private sector credit portfolio of banks and DFIs. In the mid-2000s, SME financing accounted for 17 percent of total private sector financing by banks. SME financing accounts for 1.2 percent of GDP in Pakistan. In comparison, it accounts for 6 percent of GDP in India, 9 percent in Bangladesh, 15 percent in

**Figure 26: Credit by sector FY11-19**




Source: State Bank of Pakistan

**Figure 27: Corporate and total advances**

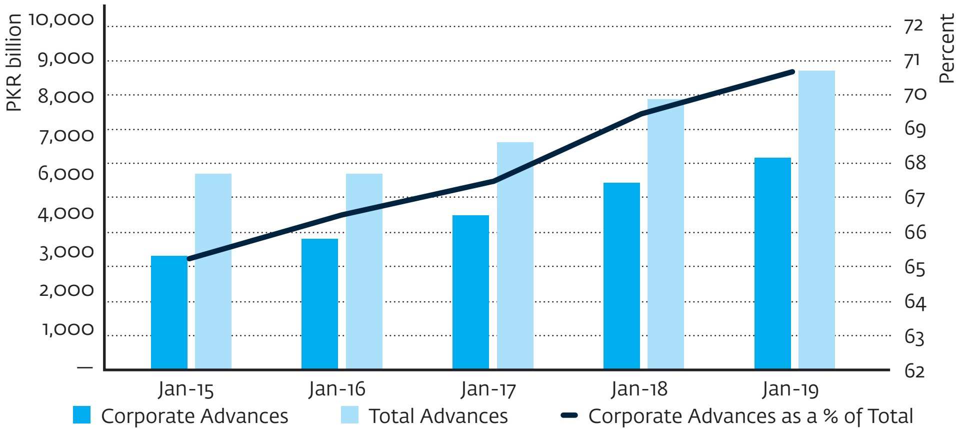
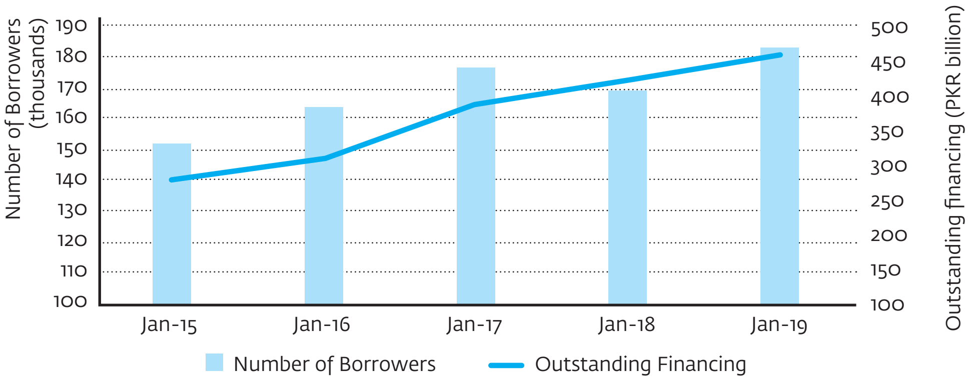
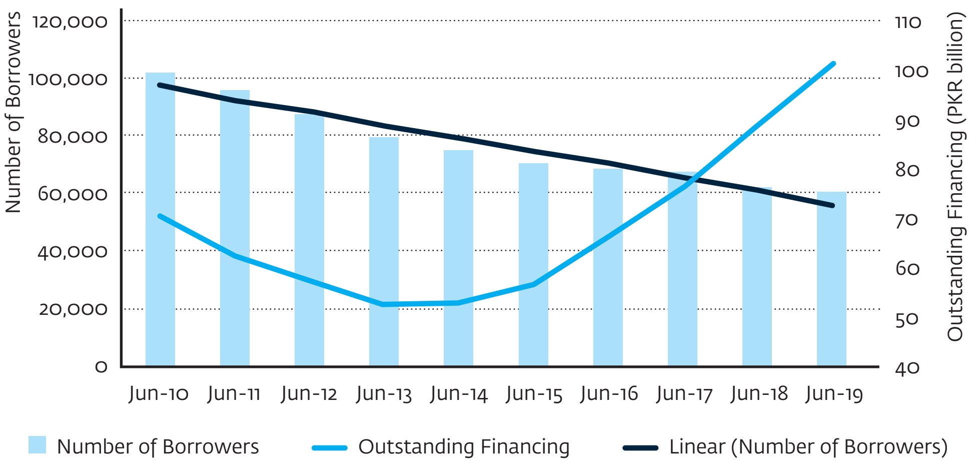



**Figure 28: SME credit in FY15-19**




Source: State Bank of Pakistan

**Figure 29: Housing finance in FY10-19**



Turkey and 21 percent in Malaysia (IMF, 2018). While the volume of financing has grown in absolute terms in recent years, it has decreased slightly as a percentage of total private sector financing—or from 8.3 percent in 2016 to 6.9 percent in 2019. The demand of the sector far exceeds the current portfolio of financing. According to a recent study commissioned by Karandaaz Pakistan, as of 2018, the demand for SME financing was estimated at PKR3.2-PKR4.6 trillion. In contrast, the SME financing portfolio of banks and DFIs amounted to PKR422 billion in September 2019, or 8-11 percent of estimated demand. Some SMEs can now secure financing from capital markets through the creation of an alternative board for SMEs on the Pakistan Stock Exchange, but SME financing remains low. Banks and DFIs are catering to the needs of 182,000 SMEs, or 0.05 percent of the total, based on data from the last economic census. This is a drop of nearly 50,000 SMEs since 2007. Most of the outstanding financing is directed towards medium-sized enterprises.

## b) Housing Finance

**65. At 0.3 percent of GDP, Pakistan's housing finance market pales in comparison to regional and structural peers.** In June 2019, there were 60,441 mortgage loans worth PKR101 billion outstanding in the system serving a population of 220 million. In 2010, the value of the mortgage portfolio was PKR70 billion serving 101,632 debtors. The portfolio is heavily concentrated, and the market is primarily catered to by the publicly owned House Building Finance Company, which accounts for 72 percent of outstanding

**Figure 30:** **Gross savings**

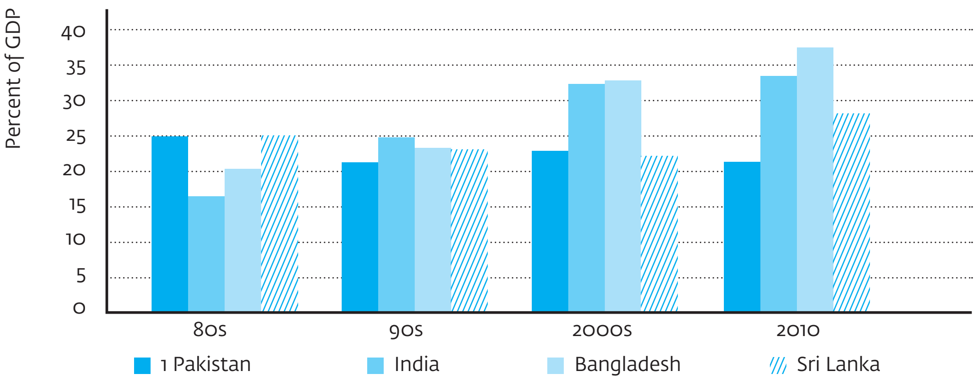
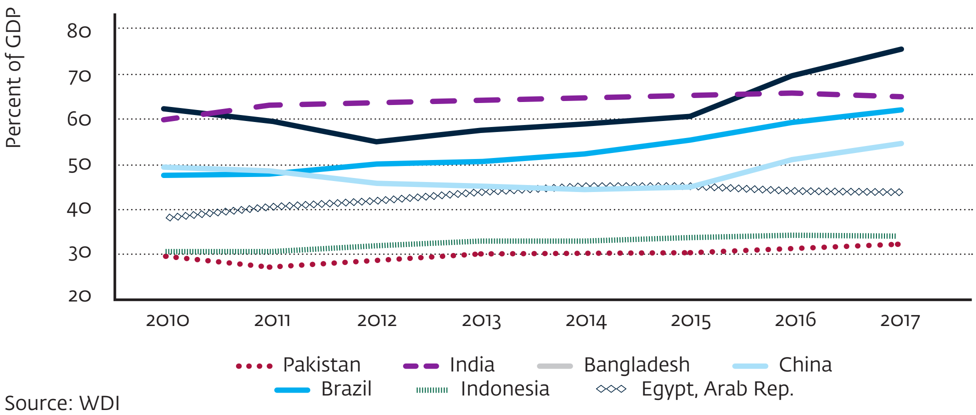



**Figure 31:** **Bank deposits**




Source: WDI

mortgages in terms of the number of borrowers, but 14 percent in terms of the volume of financing. The fact that 28 percent of the total number of mortgages account for 86 percent of the outstanding mortgage finance highlights that it is predominantly the higher income groups who have access to housing finance.

**66. The GoP has introduced policy and sectoral reforms to support the revival of affordable residential mortgage lending.** In 2016, the Parliament amended the mortgage recovery law (i.e. the Financial Institutions Recovery Ordinance Amendments) although a 'stay' order on this law in the Lahore High Court limited its applicability until March 2020 when it was vacated. In 2016, the GoP also created the Pakistan Mortgage Refinance Company, which is a mortgage refinancing facility. The housing finance policy agenda has gained prominence in the last few years following the announcement that the government would launch an affordable housing program in 2018 (i.e. the Naya Pakistan Housing Program) to provide 5 million affordable housing units in 5 years' time. The first phase of the program seeks to create 100,000 affordable housing units. The government also announced a construction sector stimulus package entailing tax and regulatory incentives specific to affordable housing to meet the targets. In addition, the SBP mandated commercial banks to reach at least 5 percent of their outstanding private sector credit devoted to housing and construction loans by December 2021. Two subsidy programs were operationalized: an up-front subsidy program and an interest rate subsidy program. Under the interest rate subsidy program, the government has announced fixed rates for borrowers for 10 years and the difference between this fixed rate and the market rate will be covered by the SBP.

**66. The growth of the housing sector is depressed by the lack of developer finance.** Financing for developers through commercial banks and other financial institutions is low and most developers fund their projects from their own equity, investor advances and customer installments. Limited access to finance dampens the overall interest of investors and developers in undertaking projects in the housing sector. Land for housing projects is typically purchased using the equity of one or a pool of developers, while the construction costs are covered through advance payments and installments by buyers. As the developers are unregulated, the funding of construction through installments by buyers has consumer protection implications, with numerous cases of developers absconding before completing the construction. The abovementioned initiatives, in addition to unlocking housing finance more generally, are also expected to increase developer finance.

## c) Infrastructure Finance

**67. Infrastructure financing, much like SME and housing financing, accounts for a small percentage of the financial sector's already modest lending portfolio.** Infrastructure project finance volumes have averaged US$300 million per year and the outstanding stock of infrastructure financing, as of December 2016, amounted to PKR471 billion, which was an increase by 58 percent from December 2010. This financing is concentrated in the power sector, which accounts for 66 percent of outstanding infrastructure financing. Long-term, fixed-rate financing, which is critical for infrastructure finance, is currently available only for the GoP, both in the credit and capital markets. Short maturities expose the private sector borrowing for long-term infrastructure projects to re-financing risks.

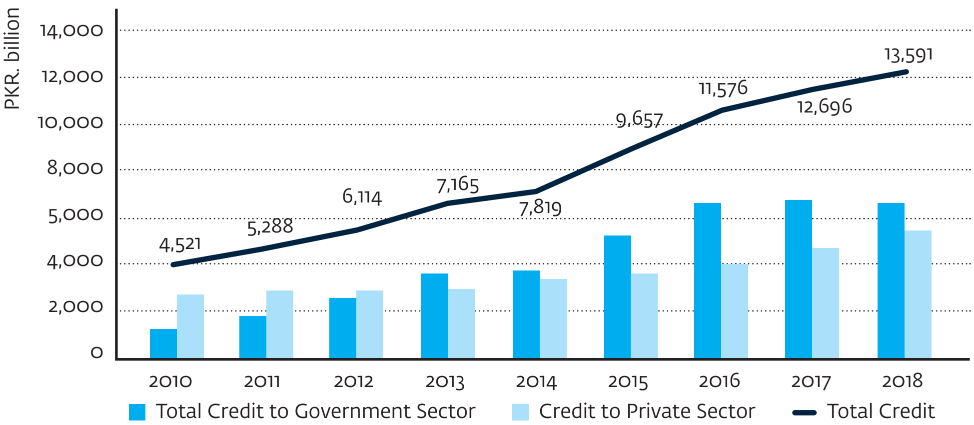
**68. Pakistan needs to invest an estimated US$30 billion, or around 10 percent of GDP, in backbone infrastructure to sustain growth.**[2] Public investment in backbone, enabling infrastructure such as energy, transport and communication, averaged 0.8 percent of GDP in FY08-17, while private investment averaged 1.7 percent of GDP.

Low investment in infrastructure is the outcome of several constraints of which the lack of financing and especially long-term financing is a serious one.

**69. Several supply side constraints affect the inclination and the ability of the financial sector to play its role in the market.** First, stringent capital requirements imposed by the SBP after the adoption of the Basel Framework have curtailed risk appetite in the banking sector. Banks are required to hold capital no less than 8 percent of their risk weighted assets. The requirement has incentivized banks to increase exposure to the public sector, which carries a zero-risk rating, at the expense of credit to other sectors, which carry higher risk weights. Second, legal uncertainty and weak contract enforcement are unfavorable to market development. Contract enforcement is a slow and opaque process. The Law and Justice Commission of Pakistan estimates the number of pending cases in special courts/tribunals, which include customs, labor, and banking courts, to exceed 130,000 cases. Contract resolution takes more than 30 months on average. Third, low domestic savings and a modest deposit base reduce the financial sector's intermediation potential. In the last decade, domestic savings made up 21 percent of GDP on average compared to 37 percent in Bangladesh, 28 percent in Sri Lanka and 33 percent in India. Only 21 percent of the population also holds a bank account. By some estimates less than 30 percent of domestic savings find their way to the financial sector.

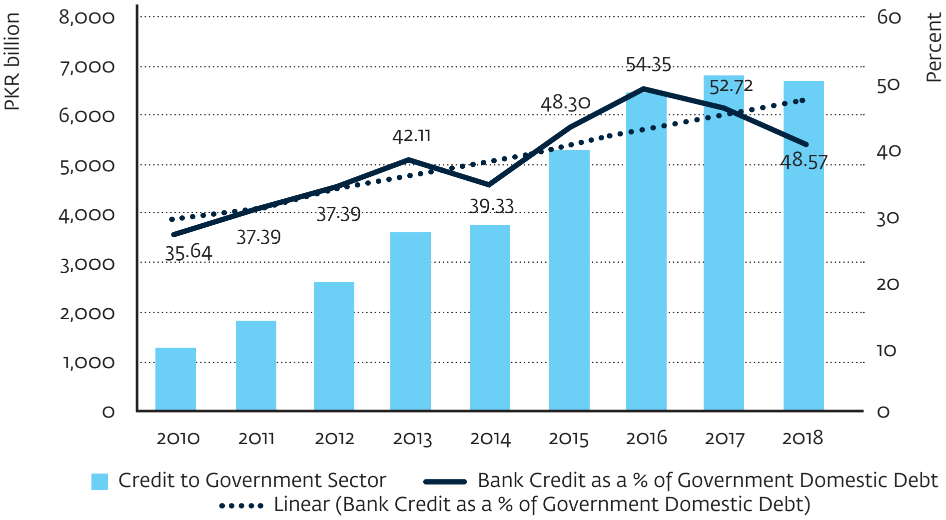
**70. Private sector credit as a share of GDP has declined in recent years owing to increasing government borrowing from the domestic financial system.** The GoP is the dominant borrower in the country's financial sector. Recurrent and large public deficits have significantly increased borrowing from the domestic financial system. Credit to the government sector in Pakistan, including non-bank public sector enterprises, has increased drastically both as a share of total credit extended by the banking sector and in absolute terms. Credit extended by the banking sector to the GoP increased from PKR2.8 trillion to PKR9.4 trillion in FY11-19 (or +223 percent). The rapid expansion in the government's borrowing from the financial system has crowded out the private sector. In FY19, financing to the GoP amounted to 60 percent of all financing extended by the banking sector, which was still a reduction from a high of 68 percent in FY16. The increase is reflected in the composition of the public debt. Borrowing from the financial sector increased as a percentage of the government's total domestic debt i.e. from 27 percent in FY10 to 41 percent in FY18, after peaking at almost 50 percent in FY16.

**Figure 32: Credit breakdown**




Source: State Bank of Pakistan

**Figure 33: Government borrowing & financial sector**




**71. The financial sector has been unable to originate long term finance.** Long-term funds are critical because they allow governments and businesses to finance large long-term investments and reduce rollover risks. The capital market is underdeveloped despite recent reforms which have streamlined the public offering process for debt and equity securities. This has resulted in very limited access to long-term finance. Banks account for 74 percent of total assets of the financial system. Banks are not natural conduits for long-term finance as they are unable to originate requisite financing since tenors of deposits have gravitated towards shorter maturities. Regulatory requirements limit asset liability mismatches and banks cannot use short-term deposits to fund long-term debt. In the past five years, medium-term deposits of 1-5-year tenors have declined from 13 percent to 9 percent of total deposits. Long-term deposits of 5 years and above tenors have declined from 3 percent to 1 percent of deposits, resulting partly from low deposit rates and distortions associated with the National Savings Scheme (NSS) etc. In comparison, medium- and long-term deposits accounted for 55 percent of total deposits in India and 63 percent in Malaysia. Even where long-term funding is available, it is not transformed into long-term loans. Long-term maturity transformation measured by the ratio of long-term loans to long-term deposits plus shareholder funds is low in Pakistan.

**72. Government borrowing has also affected the functioning of the debt capital market.** Debt capital markets—the main conduit for long-term finance and private investment—are also dominated by Government securities. The total outstanding amount of bonds (Pakistan Investment Bonds, Ijara Sukuks and Treasury Bills) was 46 percent of GDP in 2019 (up from 30 percent of GDP in 2009). A well-functioning government securities market is essential for growth of the broader debt capital market. Owing to the risk-free nature of government securities, they serve as a reference for pricing other fixed income securities. Historically, however, due to the GoP's reliance on short-term borrowing (treasury bills), the long-term yield curve has remained underdeveloped. The government's borrowing dominance and a lack of a long-term yield curve, in addition to lack of confidence in the debt recovery regime and judicial enforcement, the limited number of public and private sector enterprises considered to have a sufficiently strong credit rating, have directly led to the crowding out of long-term corporate debt. As of 2020, corporate outstanding debt amounted to PKR788 billion issued by 95 distinct entities. In contrast, investments in government securities as of April 2020 amounted to PKR9.79 trillion.

### Box 3: Building on the WBG engagements in Pakistan

Many of the proposed recommendations highlighted in this CPSD build on the existing WBG portfolio and especially engagements aimed at strengthening the business environment, improving competitiveness, expanding investment and trade, and enhancing inclusion. Since FY15, the WBG country program has been guided by the Pakistan Country Partnership Strategy (CPS), which focuses on four pillars: energy, private sector development, inclusion and service delivery.

Support under the private sector development pillar has yielded some notable achievements. The WBG support to implement a national multi-year Doing Business reform strategy at the federal and provincial levels resulted in several reforms in the public administration to reduce transaction costs for businesses. The SOE reform agenda has largely stalled due to political headwinds in recent years but WBG advise helped in the formulation of the Strategic Trade Policy Framework 2018-2023. This CPSD Action Matrix covers SOE reforms to enhance fair competition principles, including adoption of a SOE ownership policy and SOE Law, to streamline regulations governing the different SOEs. It also covers the implementation of the National Tariff Policy with tariff reductions on intermediate goods and machinery and a gradual tariff reduction on final goods. It also supports the simplification of procedures and document requirements, and the automation of the processing of refunds for sales and import-duty for exporters.

The WBG has helped develop and implement the National Financial Inclusion Strategy (NFIS), strengthen the financial infrastructure, produce credit information on MSME borrowers, and support the establishment of a secure transaction registry. These efforts have been complemented with building capacity programs, outreach to financial institutions serving MSMEs and help to set industry standards for SME banking. The portfolios of these financial institutions have grown by 10 to 20 percent on loans outstanding. Yet access to finance and overall finance inclusion remain low. The CPSD therefore recommends prioritizing operationalization of the SME Credit Guarantee Company and development of alternative financing methods to substitute traditional collateralized lending for SMEs. In addition, creating an insolvency registry and introducing special simplified procedures for SME insolvency is critical, especially in the COVID-19 environment.

A WB Development Policy Credit helped trigger amendments in the SECP Act and the Companies Act, 2017, that have strengthened capital market practices and auditing and accounting standards in the corporate sector. However, these were preliminary steps. The CPSD places strong emphasis on developing long-term finance instruments to help meet the large infrastructure needs. Some priority reforms include implementing a robust debt management strategy and improve primary and secondary market operations; and develop a sovereign Sukuk issuance program for a wide range of maturities.

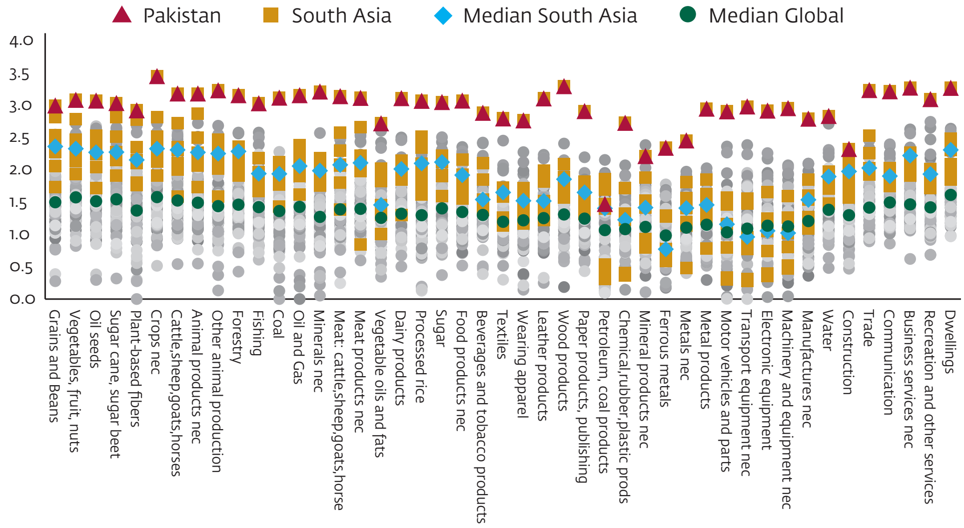
**73. Growth in long term finance to the private sector has also been dampened owing to the very small size of the institutional investor base in Pakistan.** Institutional investors (insurance funds, mutual funds, and pension funds), as of 2017, only account for 7 percent of the total assets of the financial sector. The NSS, which is a government vehicle that mobilizes the largest pool of retail savings and channels this capital to the government budget has been detrimental to the growth and development of the institutional investor landscape in Pakistan. NSS has distorted the savings market through subsidized returns, thus cannibalizing institutional investor savings products and vitiating the institutional investor base. Institutional investors, while being small to begin with, have also tilted their portfolios towards government securities. The three largest institutional investors in Pakistan are State Life Insurance worth PKR 497 billion, the mutual fund industry worth PKR 450 billion and Employees Old-age Benefits Institution worth PKR 298 billion all of which have most of their portfolios invested in government securities. 92 percent of the portfolio of the SLIC, 45 percent of the portfolio of mutual funds and 65 percent of EOBI's investments are in government paper.

# 3. ASSESSMENTS OF SECTORS WITH HIGH GROWTH POTENTIAL

**74. This section presents brief assessments of select sectors where targeted reforms could unleash private sector growth and attract investment in the near- to medium-term.** These sector are part of IFC's strategic areas of focus for Pakistan, and cover areas where an integrated approach is needed to implement the IFC 3.0 strategy that seeks to create new opportunities for the private sector.

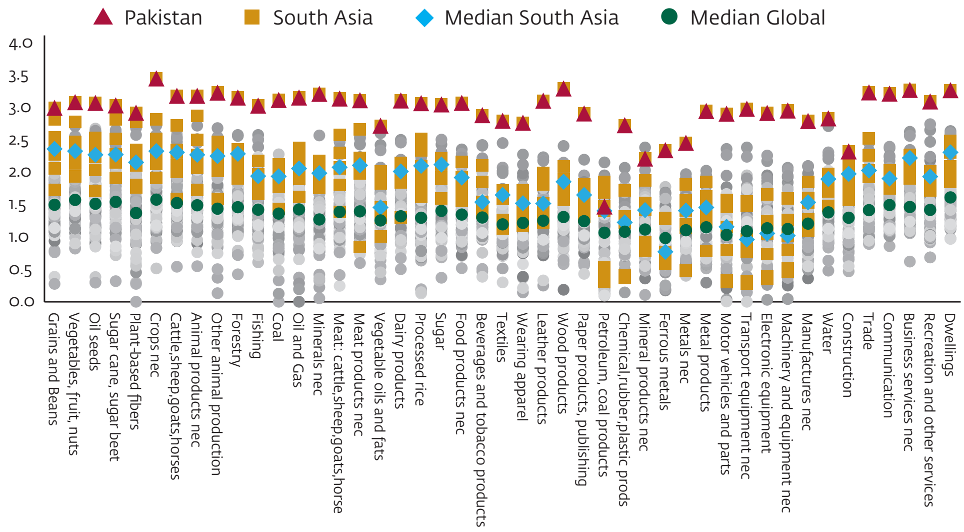
**75. The social accounting matrix (SAM) presented in Figures 34-35 estimates the impact on overall output of increased investment in each sector through forward and backward linkages.** Pakistan exhibits relatively high GDP multipliers across most sectors, which signifies the high impact of investment on economic growth and employment. The selected sectors—the financial sector, renewable energy, port logistics and agribusiness—have high scores in the SAM. The Pakistani economy is diverse with many sectors demonstrating economy-wide effects in terms of the impact of investment on GDP compared to median IFC client countries in South Asia and beyond. The increases in output under the SAM are the sum of direct and indirect effects. As shown in Figures 34-35, Pakistan's GDP and employment multipliers across numerous sectors compared to other countries are significantly higher than the median of WBG client countries and in the South Asia region.

**Figure 34: GDP multipliers across countries and sectors**




Source: Global Trade Analysis Project and World Development Indicators.
Note: Each dot indicates a country in the list of top 100 IFC clients. Red triangles indicate Pakistan, yellow triangles indicate IFCX client countries in SAR, blue diamonds indicate the median of IFC client countries in SAR, and green dots indicate the median multiplier for a given sector in IFC top 100 client countries.

**Figure 35: Employment multipliers across countries and sectors**




Source: Global Trade Analysis Project and World Development Indicators.
Each dot indicates a country in the list of top 100 IFC clients. Red triangles indicate Pakistan, yellow squares indicate IFC client countries in SAR, blue diamonds indicate the median of IFC client countries in SAR, and green dots indicate the median multiplier for a given sector in IFC top 100 client countries.

**76. While, the CPSD highlights fintech/digital finance, port logistics, renewable energy and agribusiness, there are other promising sectors in high-value adding manufacturing sectors (e.g. pharmaceuticals, auto-parts and agro-processing) that could be explored in the future.** The sectors presented here are relevant in the COVID-19 context given increased demand for services in the fintech/digital finance and agribusiness sectors, while renewable energy and ports logistics will be important to build a more resilient and competitive economy for the recovery phase.

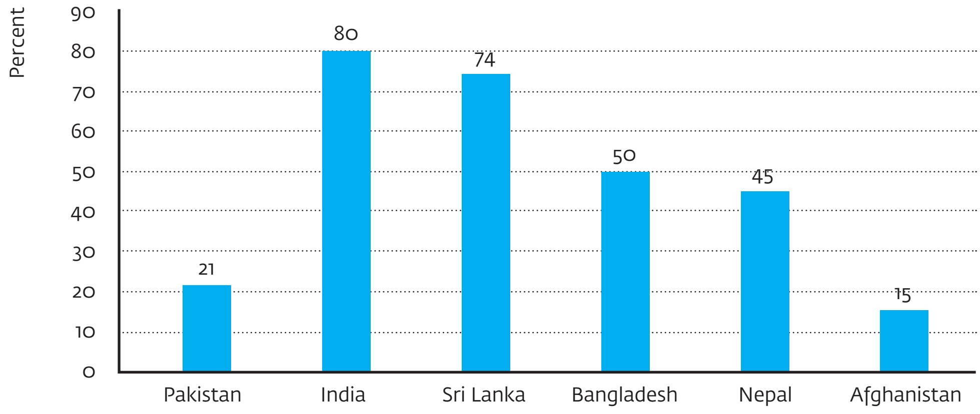
## 3.1 FINANCIAL INCLUSION, FINTECH AND DIGITAL FINANCE

***Digital finance could boost GDP by 7 percent through the mobilization of US$260 billion in deposits and associated increases in investment and productivity.[*] It could also help create an estimated 4 million jobs, promote formalization and empower SMEs and households.***

**77. The financial sector is hardly serving the large SME sector.** The implementation of the GoP's financial inclusion agenda would promote more sustainable and inclusive economic growth. Greater depth and inclusion of the financial sector would facilitate investment, smooth consumption and support economic mobility. The GoP launched Pakistan's National Financial Inclusion Strategy (NFIS) in 2015 to implement coordinated reforms targeting: (i) the scale and viability of digital transactions accounts, (ii) the expansion of access points, (iii) the diversification of financial service providers, and (iv) the knowledge of prospective clients. A key objective is to promote digital services to better serve SMEs, rural communities, women and youth who are generally unable to access finance through conventional channels. The NFIS aims to increase the share of adults with a transaction

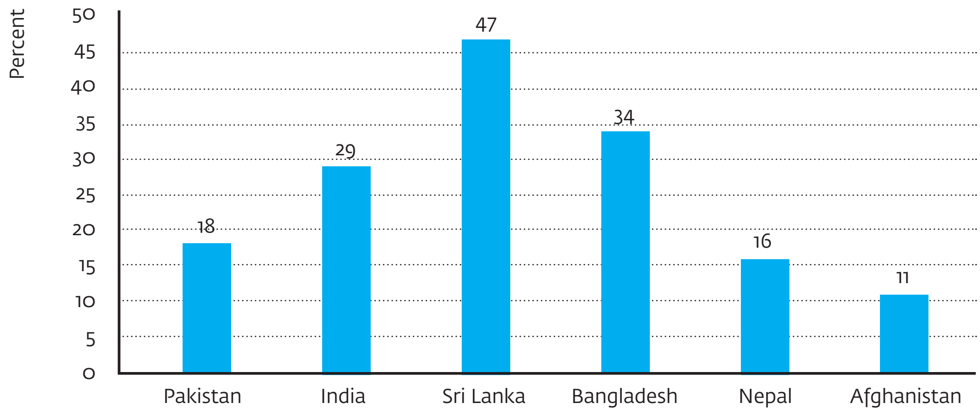
[*] McKinsey Global Institute (2016), *Digital Finance for All: Powering Inclusive Growth in Emerging Economies*, September 2016

**Figure 36: Account ownership**




Source: Findex (2017)

**Figure 37: Use of digital payments**




Source: Findex (2017)

account to 50 percent (25 percent women), double the credit extended to the SME sector to 17 percent of the total lending portfolio, increase the use of digital payments to cover 65 million active digital transaction accounts (of which 20 million held by women) and serve 6 million farmers with digitalized solutions.

**78. The COVID-19 crisis has highlighted the importance of financial inclusion and digital finance.** Few businesses can avail of credit lines and bank loans during the crisis. And digital finance could have played a more important role in channeling emergency cash transfers and social security support to the poorest.[3] Digital finance reduces the dependence on physical interaction and need for cash, which allows for secure and effective delivery of support to the most vulnerable. The integration of information technology in the delivery of services may ultimately be one positive outcome of the pandemic.

## Sector Specific Challenges

**79. Pakistan has among the lowest levels of financial inclusion in South Asia.** Sustained efforts to promote financial inclusion in Pakistan have yielded mixed results. Only 21 percent of the population has access to an account compared to a regional average of 70 percent. There are also large gaps with vulnerable segments having limited access at high prices. For example, microfinance clients often pay 30-40 percent interest. 7 percent of adult women have an account compared to 35 percent of adult men. There are about 7 million microfinance clients and digital payments account for less than 1 transaction per person per year compared to 5 in India and 7 in Indonesia.[4]

**80. The enabling infrastructure and policies have improved in recent years.** Pakistan has made strides in the development of an enabling infrastructure for financial inclusion, including the introduction of a citizen ID infrastructure and growing telecom penetration. In 2008, it became one of the first countries to adopt a branchless banking regulation, which paved the way for digital financial services. The SECP has issued regulatory sandbox guidelines for new products, services and business models, which have not been addressed under existing laws and regulations. Yet these initiatives are insufficient to generate significant change. Private sector interest is modest due to behavioral biases and information asymmetries. Central bank-led initiatives to promote digital platforms, fintech, an innovation office and sandboxing would help to achieve greater financial inclusion. In the absence of an enabling environment and coordination among stakeholders, the potential for a rapid increase in financial inclusion remains low.

**81. The digital financial ecosystem is underdeveloped with regards to the issuance and acceptance side.** Cash still dominates the Pakistan economy and there is very little use of electronic payments, regardless of the value of the transaction, especially by small retailers. Consumer behavior has not adopted digital payments for retail transactions. Most merchants have also proved reluctant to adopt digital payments due to concerns such as settlement and fraud risk, formal transaction costs, and fear of the tax administration.

**82. The telecom distribution networks need to consolidate to become more efficient and capable of providing financial services.** The telecom distribution network was established over a decade ago at a time of strong subscriber growth. Each mobile network operator (MNO) had its own proprietary distribution network, made up of sales offices and franchise offices, where the proximity to the access point was a comparative advantage. The telecom market has since matured: customer churn and new customer acquisition rates for MNOs have dropped in part due to the introduction of mandatory biometric verification for SIM cards in 2015. The sale of airtime credit offers modest margins for distributors and it is gradually shifting to digital channels. At the same time, the operating costs to maintain a distributor network (mainly rent and salaries) are increasing. Thus, these trends are changing the distribution model.

**83. The branchless banking network, with 200,000 agents, is fragmented and dominated by two large mobile money operators.** These two operators hold 85 percent of active mobile banking accounts and 77 percent of active agents. Six other providers have smaller market shares. The branchless banking networks provide basic financial services to the mass market, such as handling financial transfers and bill payments. However, the branchless banking networks were built on the inefficient MNO distribution networks, which have a relatively high cost structure. All mobile wallets are closed loop—that is transactions cannot be made between operators—and all agents are proprietary to its wallet providers. Mobile money usage is also limited to agent-based domestic remittances for the low-income mass market. There is hence need for independent merchant acquirers to provide consolidated solutions to all.

## Realizing sector potential

**84. Improve the coordination of reform efforts.** There is a need for a more sustained, high-level commitment and coordination of reform efforts. Reform efforts on financial inclusion require dedicated policymaking and coordination between financial sector development objectives, tax measures, telecom sector development and citizen ID infra-

### Recommendations to Boost Private Investment and Competitiveness in Digital Finance, Fintech and Financial Inclusion

| CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | RESPONSIBILITY |
|---|---|---|---|---|
| Limited SME use of digital finance | 1) Design and adopt regulations to mandate the use of digital payments for public invoices. | ++ | 18-24 months | MoF, SBP |
| High verification cost | 2) Provide the digital finance/fintech sector access to the citizen identification system by rationalizing the cost structure and making eligibility criteria transparent. | + | 18-24 months | SBP and NADRA |
| Limited regulatory facilitation and missing core infrastructure | 3) Operationalization of micropayment gateway and automated clearing house/transfer system; and update the PSEFT Act 2007 and Payment Services Provider/ Payment System Operator (PSP/PSO) Regulations allowing for interoperability of retail payment systems and automated clearing house. Modernize the regulatory and supervisory framework applicable to e-payments, fintech startups and platforms and update Foreign Exchange Manual to facilitate start-ups. | ++ | 24-36 months | SBP, MoF |
| | 4) Establish an innovation office, adopt a sandbox approach that allows for a risk-based regulatory, supervisory and oversight framework for the fintech sector and promote regtech & suptech solutions. | + | 12-24 months | SBP |
| Underdeveloped SME, housing and infrastructure financing markets | 5) Operationalize the SME Credit Guarantee Company and develop alternative financing methods to substitute traditional collateralized lending for SMEs. | + | 12-24 months | SBP and MoF |
| | 6) Adopt and implement the Real Estate Regulatory Authority Act, strengthen the foreclosure framework and issue implementing regulations for developers. | ++ | 24-36 months | Provincial and Federal Housing Deps, SBP |
| | 7) Adopt a strategy for public financial sector institutions and consolidate public development finance institutions into a single development bank. | +++ | 24-36 months | MoF and SBP |
| Limited mobilization of long-term finance | 8) Align KYC requirements of the National Savings Scheme (NSS) with those of financial institutions; harmonize taxation between NSS and financial institutions; and limit NSS access to retail investors to support capital market development. | +++ | 12-24 months | MoF |
| | 9) Align issuance fees and processing times for non-government securities with international standards. | ++ | 12-24 months | SECP |
| | 10) Develop a sovereign Sukuk issuance program for a wide range of maturities. | ++ | 24-36 months | MoF |

structure. A more coordinated approach, both within the government and between the government and the private sector, would allow for convergence on reforms and incentives required to make digital financial transactions more effective than cash across the economy. Notable progress has been made in enhancing coordination of reform efforts in recent months, led by the SBP. A National Payments System Strategy was launched in November 2019 and it includes an action plan for the development of a robust digital payments network. The strategy was prepared in coordination with relevant public and private stakeholders. The GoP has also recently launched a 'Digital Pakistan' program to harmonize the cross-cutting digitization initiatives in the country.

**85. Update legal framework for digital payments, including interoperable retail payments with low-cost biometric verification charges.** A modern retail payment systems infrastructure, legal and otherwise, needs to be put in place to enable seamless and low-cost payment services. Receipts and payments are the largest use case within the financial sector and have widespread usage across all population segments. In order to make these seamless, affordable and safe, they need to be processed through a micro-payment gateway, that is an interbank system for retail electronic funds transfers.

**86. Adopt 'sandboxes' and 'test and learn' regulatory approach for the promotion of fintech.** The regulatory environment needs to foster more innovation in the financial sector through fintech business models that combine data, connectivity and financial services. SBP and SECP should enhance capacity and knowledge of the fintech ecosystem by creating a cross-cutting fintech regulatory team, followed by regular consultations with emerging fintech businesses. This should be complemented with the adoption of a 'sandbox' or 'test and learn' regulatory approach and a periodic review of the licensing and regulatory framework to harness private sector innovation. This would promote innovation in account opening, payment switches, payment service providers, card processing platforms and other fintech solutions driving usage of digital payments (e.g. e-commerce platforms, bill aggregators, e-ticketing, etc.).

**87. Digitize government transactions.** Government transactions need to be digitized by facilitating, mandating and incentivizing receipts and payments through accounts/wallets and through the development of digital infrastructure for e-invoicing and payments. For receipts, the government needs to ensure that digital payments are (i) behaviorally encouraged (i.e. incentive for digital payments for utility bills, motor registration, business registration, other fees), and (ii) technically feasible (i.e. back-end government systems enable digital receipts and payments). On payments, government payments to individuals, businesses and vendors need to be made digitally into accounts/wallets without exception. This would also entail changing financial rules and regulations that require paper-based documentation.

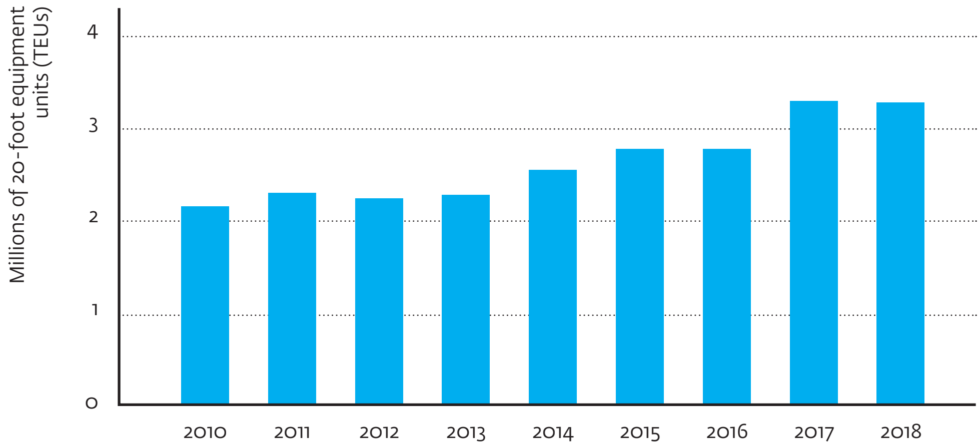
## 3.2 PORT LOGISTICS

***Seamless trade and cargo facilitated through Pakistan's ports can serve as the main gateway for increasing domestic and international trade. Shifting Pakistan towards a more export-oriented economy can help break the boom-bust cycles of growth and encourage global integration.***

**88. Efficient and integrated transport and logistics networks are critical arteries for a robust economy.** In Pakistan, transport and logistics contribute to 13 percent of GDP and represent 5.4 percent of jobs. Reducing trade costs, upgrading service quality, and improving connectivity between domestic and foreign markets are essential in increasing export competitiveness. Specifically, countries with a more efficient port sector incur lower maritime transport costs for their trade. A 0.1 unit increase in the average efficiency score of a country's port sector (on a scale on which 0 is least efficient and 1 is most efficient) would reduce the maritime transport cost of its exports by 2.3 percent, leading to a 1.8 percent increase in exports (World Bank, 2016).

**89. Pakistan's strategic location offers it the potential to reap significant economic gains from becoming a hub for regional trade.** Pakistan has three ports: Karachi Port, Port Qasim, and Gwadar. These ports could increasingly help connect markets especially

**Figure 38: Container port traffic in 2010-2018**




Source: World Bank

**Figure 39: Logistics Performance Index, 2018**

in the Middle East with markets in Central Asia and Western China. 95 percent of Pakistan's international trade goes through two ports: Karachi Port, which accounts for around 60 percent of marine shipments, and Port Qasim, with 35 percent of maritime shipments. The development of Gwadar (driven primarily by CPEC investments) offers an opportunity to increase the volume of marine cargo in a long-term objective.

**90. Traffic in the ports are increasing and the outlook is positive due to rising imports for domestic household consumption and for bulk cargo for infrastructure investments.** Over the last five years, the cargo and container traffic moved through Pakistani ports increased every year on average by 8.3 percent and 7.2 percent, respectively. At the same time, the number of container cargo ships grew by an average of 10 percent per year.[5] The COVID-19 pandemic drastically reduced containerized cargo traffic during the first half of 2020.

**91. Pakistani seaports are attracting increasing interest from domestic and foreign investors.** Unlike other segments of the transport and logistics market (e.g. highways, roads, railways), ports offer a more attractive investment proposition as the revenue stream is relatively predictable, secure and less susceptible to external shocks. Since 1995, US$2.8 billion have been invested through PPPs on a mostly build-operate-transfer (BOT) basis. However, despite the port authorities' commitment to operate on a landlord model, the Karachi Port Trust concession process has been slow. The Karachi International Container Terminal was the first private terminal concession in 1998. It was followed by the Pakistan International Container Terminal in 2004 and the South Asia Pakistan Terminal in 2016. Port Qasim has three terminals: the Qasim International Container Terminal, a liquified natural gas (LNG) terminal, and a coal-cement terminal called the Pakistan International Bulk Terminal. The port functions well as a landlord port with nearly all terminals outsourced to private stevedoring companies. In December 2019, the Port Qasim Authority selected five consortia for building five LNG terminals, including ExxonMobil and Energas, Trafigura Group and Pakistan GasPort, and Royal Dutch Shell and Engro Corporation. The GoP will finance a US$2 billion pipeline and storage facilities to distribute the new gas according to official statements.

**92. The development of port logistics is integral to the plan to increase trade and strengthen export competitiveness.** More than 90 percent of world trade is carried at sea and Pakistan's weak logistics performance is a constraint to traders and for the integration in global value chains. Despite several initiatives to facilitate trade and upgrade logistical policies and infrastructure, Pakistan's ranking in the LPI has fallen from 110th in 2010 to 122nd in 2018. Logistics costs linked to time and service fees have fallen but remain considerably higher in Pakistan than in regional peers. Inadequate investment in upgrades and maintenance of port infrastructure has resulted in underutilization of capacity and heightened operational inefficiencies.

## Sector specific challenges

**93. Governance and management challenges are cross-cutting issues in the Karachi Port and Port Qasim but there are some unique characteristics and challenges associated with them too.**

**94. Karachi Port:** The port has lower handling costs, including tariffs and terminal handling charges, than leading Asian ports such as Singapore Port and the Jebel Ali Port in Dubai. However, indirect costs associated with delays and uncertainty have a detrimental effect on its competitiveness. Dwell times for containers are high. It is often more cost effective for traders to leave the consignments at the port than find external storage for

### Recommendations to Boost Private Investment and Competitiveness in Port Logistics

| CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | RESPONSIBILITY |
|---|---|---|---|---|
| 1. Poor operations and management practices | 1) Reform Karachi Port and Port Qasim governance structures by installing professional Boards with private participation and rationalize staffing, induct professional staff and implement Enterprise Resource Planning. | +++ | 18-36 months | Ministry of Maritime Affairs, KPT, PQA |
| | 2) Develop and start implement a strategic plan to concession out terminal development and operations, dredging, tuggage and other operational activities. | ++ | 18-36 months | KPT |
| 2. Border processing delays | 3) Implement the Pakistan National Single Window System. | + | 18-24 months | Pakistan Customs |
| | 4) Improve the Customs risk management system to expedite export and import. | ++ | 18-30 months | FBR |

the goods. In addition, complex customs procedures and slow customs clearance give rise to high trade transaction costs. In 2017, border and documentary compliance to export from Karachi took 130 hours compared to 15 hours on average in Organization for Economic Cooperation and Development (OECD) member states. The equivalent time to clear imports was 272 hours compared to 12 hours on average within OECD members. The customs authority could improve valuation and address under-invoicing issues through the adoption of good valuation practices and data exchange with major trading partners. It should also adopt a modern risk management system. The share of cargo that undergo physical inspections has dropped but smaller traders face great scrutiny.

**95. Weak governance and fragmented management produce operational inefficiencies and sends a negative signal to private partners.** While the Karachi Port Trust has committed to the landlord model and vows to *"lease out port infrastructure, land, access and assets to private port operators on a long-term basis while retaining regulatory functions"*, staffing increased by more than 40 percent between 2007 and 2014 to 5,700. In contrast, the Port of Rotterdam—the largest port in Europe—employs 1,100 people. Labor unions in Karachi Port have resisted rationalization programs and there is no Enterprise Resource Planning system.

**96. Port Qasim:** The main infrastructure challenge at Port Qasim relates to dredging. The main fairway suffers from high levels of silting, which requires frequent and costly dredging, and there are short windows in which the tide permits entry into the approach channel. Port Qasim has outsourced much of the activities to the private sector. However, the governance structure is weak as exemplified by the uncertainty on concession awards and prolonged delays in decision making.

## Realizing Sector Potential

**97. Connectivity is a key pillar of the GoP's Vision 2025.** A new National Freight and Logistics Policy aims to integrate key stakeholders of logistics under one policy to facilitate efficient multimodal domestic and international cargo movement. It builds on the National

Transport Policy 2018. In the area of seaports, the main authority is the Ministry of Maritime Affairs, which oversees the Karachi Port Trust, the Port Qasim Authority, and the Gwadar Port Authority. The port sector could be significantly strengthened and if the following eight recommendations were adopted. First, reform port governance structures, including by adopting professional management reporting to professional boards with adequate private sector representation. For instance, the Karachi Port Trust Board should act as a policy board and not be involved in operations. Second, rationalize staffing numbers, induction of professional staff, and implement the enterprise resource planning system.

**98. Third, implement an automated border management system. Pakistan Customs is striving to replace its old clearance system ("One Customs") with the web-based customs software WeBOC, which provides a portal for filing and processing export and import-related documents.** Fourth, install 3D imaging technology to expedite a reliable container inspection process. Fifth, expand the PPP agenda to dredging, tuggage, etc. Sixth, rehabilitate existing berths rather than construct new ones given enough berth capacity. Seventh, upgrade environmental and social safety standards and adopt eco-friendly initiatives to reduce the use of energy and avoid costly hazardous spills. Finally, strengthen planning and coordination between government agencies to improve connectivity links between seaports, dry ports, industrial estate, roads and railways.

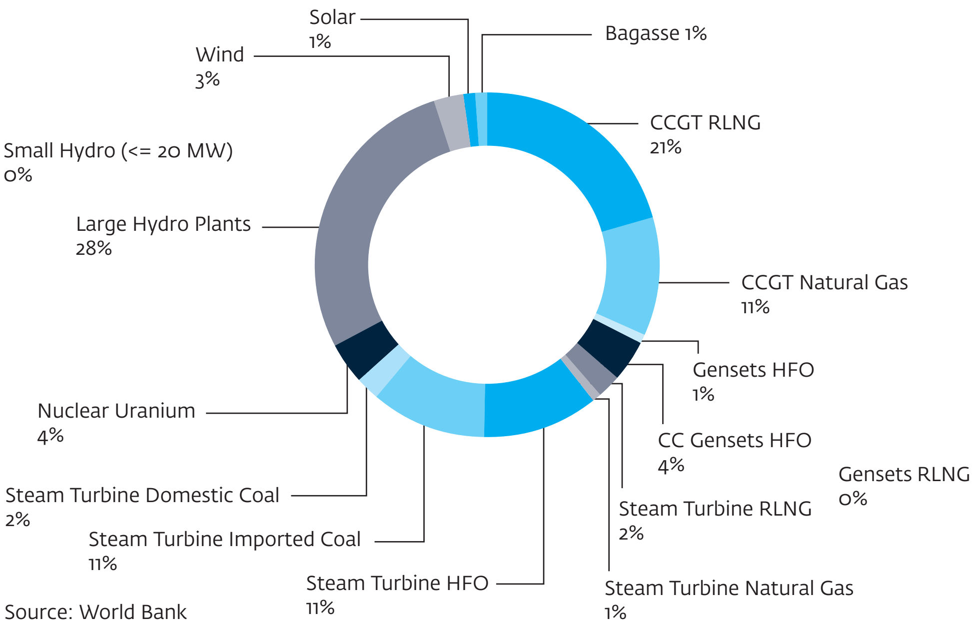
## 3.3 RENEWABLE ENERGY

***As the world decarbonizes and cutting-edge technologies become mainstream, supporting the transition to renewable energy is more important than ever in Pakistan. This is not only from the perspective of meeting ambitious renewable energy targets, but ensuring greater economic growth, fiscal sustainability, and inclusive development.***

**99. New technology, declining unit costs of production, and private solutions in the renewable energy sector could revolutionize the energy industry in Pakistan in the coming decades.** The benefits would be improved reliability, less pollution and a more affordable energy mix to benefit households and producers alike (World Bank, 2020b). The GoP has set bold goals for the energy sector and particularly renewable energy. The Alternative and Renewable Energy Policy of 2020 presents a framework for establishing the foundations of a long-term sustainable development agenda for the power sector, including the necessary steps to improve the transmission network and encouraging private investment in the rehabilitation and augmentation of transmission and distribution infrastructure. It targets the installed capacity for renewable energy to reach 20 percent of total capacity by 2025 and 30 percent of total capacity by 2030. Furthermore, it encourages distributed solar power projects and wind measurement campaigns to identify potential sites for the establishment of wind farms. It proposes a 'clean energy' levy on the revenue of oil, gas, and coal fuel marketing companies. The levy would go to a Clean Energy Fund that would invest in renewable energy projects.

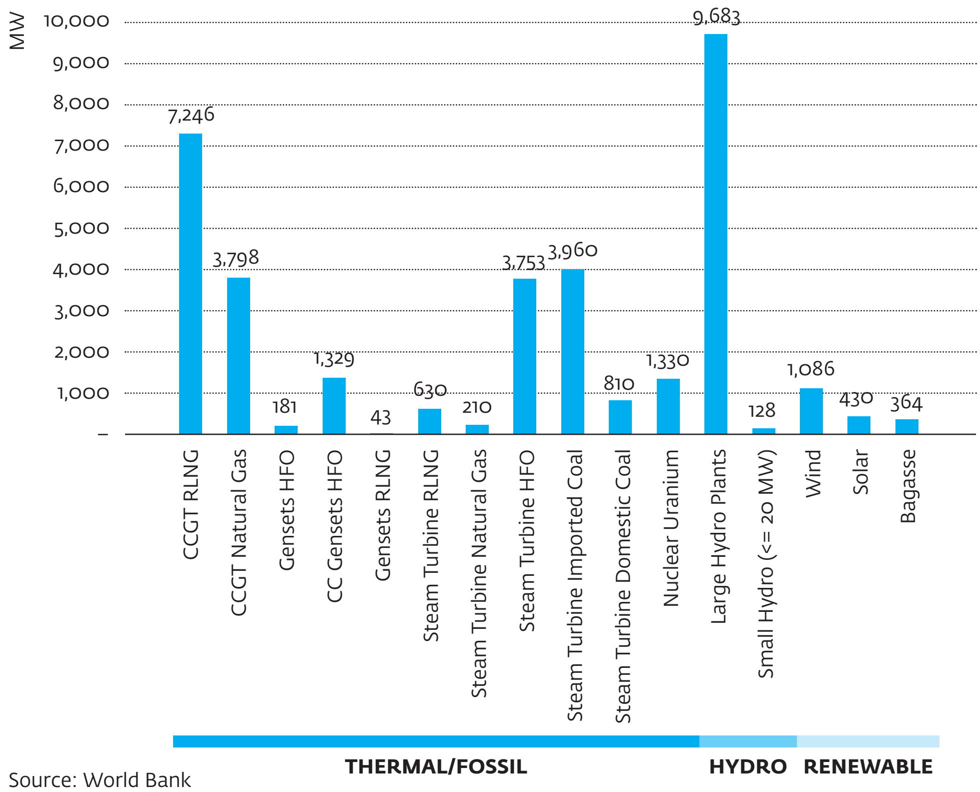
**100. The demand for energy is expected to increase in line with population and economic growth.** The current energy mix is dominated by fossil fuels (63 percent of installed capacity) with hydropower accounting for 28 percent and variable renewable energy (VRE) of mainly wind and solar adding another 4 percent. Demand is expected to increase from 118 TWh in 2018/19 to 178 TWh in 2024/25 TWh and to 249 TWh by 2029/30 under a normal scenario, and to 184 TWh and 226 TWh under a low scenario in the same years, which may be more likely due to the COVID-19 impact. Given dwindling domestic gas reserves and the increasing dependency on fossil fuel imports, the expansion

**Figure 40: Existing power generation capacity by technology and fuel in 2019**




Source: World Bank

**Figure 41: Existing power generation capacity by technology and fuel in 2019**




Source: World Bank

of renewable energy generation could help reduce the reliance on fossil fuel imports, reduce electricity price volatility, and meet the country's climate change mitigation targets. The cost of solar and wind generation has come down considerably and is in some markets as competitive or even more competitive than fossil fuel generation.

**101. Pakistan's renewable energy potential for hydro, wind and solar is large and far beyond currently installed capacity.** According to the Private Power and Infrastructure Board, the estimated total hydropower resource in Pakistan amounts to 60 GW with promising areas in the Khyber Pakhtunkhwa, the Northern Areas, Punjab and elsewhere. Pakistan's Alternative Energy Development Board (AEDB) has also identified additional potential for small hydropower amounting to 3.1 GW of which 1.5 GW are available for development. For wind generation, the US National Renewable Energy Laboratory estimated potential resources amounting to 340 GW. In 2013, the Pakistan Meteorological Department estimated the economically feasible wind farm potential to 43 GW, with the Gharo-Jhimpir wind corridor in Sindh as the most profitable area with a potential of 11 GW. In addition, solar energy is one of the most abundant sources of renewable energy in the country. It can be harnessed through both photovoltaics and concentrated solar power. For example, Sindh and Baluchistan experience 7 to 8 hours of sunshine per day or roughly 2300-2700 hours per year.

## Sector specific challenges:

**102. The energy sector in Pakistan has slowly undergone substantial transformation that is far from complete.** Alongside the launch of an independent power producer program in 1994, the national vertically integrated power and water utility, the Water and Power Development Authority, was unbundled into separate corporate entities: thermal generation through four generation companies, hydropower through WADPA Hydel, transmission through the National Transmission and Despatch Company, and distribution through eight electricity distribution companies, of which there are now ten. Privately financed generation by independent power producers was introduced as well and it now makes up approximately half of the country's electricity generation. In 1997, and in parallel with the unbundling process, the National Electric Power Regulatory Authority (NEPRA) was established as a separate regulatory entity and in 2005 Karachi Electric was privatized. Since 2015, a single buyer model is the standard with the Central Power Purchasing Agency separated from transmission and dispatch. Since 2010, private investments exceeding US$15 billion in 47 projects have been sunk mostly in thermal coal, hydro and gas. A continued government commitment to renewable energy will be needed moving forward. Moreover, the prevailing institutional and market structures, some regulatory shortcomings, and inadequate infrastructure and technical capacity impede private participation and investment in the supply of VRE.

**103. There are limitations in appetite and coordinative capacity to secure policy-commitments to expand renewable energy capacity.** The capacity shortages that plagued the energy sector in Pakistan have been largely overcome leaving some concern for over-supply if new renewable energy capacity is purchased today, especially as COVID-19 will result in decreased demand growth forecasts. Nonetheless, newly produced capacity would take several years to come online and there remains a risk of falling behind the curve. This requires a long-term view of the energy sector, which is further complicated by some fragmentation in the energy policy-making process. The current process involves the Ministry of Finance, the Planning Commission, provincial governments, and state energy organizations. Moreover, energy policies and investment are reviewed and approved by the Economic Coordination Committee chaired by the Prime Minster. The Prime Minister has also created a new Task Force on Energy Reform, headed by an energy adviser.

**104. Limited coverage and technical limitations of the power grid suppresses demand and the grid code is unfavorable to VRE.** Grid expansion is constrained by limited financial capacity of regional distribution companies, especially in rural and sparsely populated areas like Baluchistan and the tribal areas where risk of non-payment is high. Much of the rural population have no access to reliable or affordable energy. Poor grid infrastructure contributes to the poor security and quality of power supply, especially during peak hours. This has led to a system of self-supply of electricity and the adoption of energy substitutes. The degree of suppressed demand is difficult to estimate, however, data from a World Bank Enterprise surveys from 2007 to 2013 suggests the situation had worsened with increases in outage duration, losses in sales, and greater acquisition and reliance on own generators. NEPRA has amended the grid codes traditionally developed for thermal power projects to facilitate interconnection and power evacuation from wind and solar power plants, but these remain below international standards. There are no favorable regulatory incentives or support measures for off-grid renewables.

**105. Technical and commercial losses and public sector arrears discourage greater private participation more generally.** A major underlying cause of the challenges in the sector has to do with the “circular debt” crisis, where distribution utilities that struggle to collect revenues and meet regulatory targets for transmission and distribution losses default on payments to generators. Due to the persistent shortfalls in bill collection leading to losses and subsequent government bailouts, loss-making distribution companies have been able to maintain their inefficient operations (Bacon, 2019). Late payments made to suppliers by distribution companies discourage new entrants in the market. To alleviate supply shortages, the GoP has prioritized domestic hydrocarbon production and increased natural gas imports. Also, as a result of the growing stock of arrears, distribution companies engage in load shedding. This controlled reduction in electricity provision is used as a demand management measure and results in suppressed demand. Load management by distribution companies amounted to approximately 3 GW in 2018/19.

## Realizing sector potential:

**106. Realizing the potential of renewable energy resources and attracting more private investment would require market, institutional and technical reforms.** These reforms would not only support the expansion of renewable energy, but also improve the functioning of the energy sector at large.

**107. At the sector level, several reforms could strengthen performance and financial viability.** There is broad consensus that the circular debt overhang and government non-payment represent a serious threat to the sector. Tariff rationalization, improved metering, and the enforcement of collection are essential to reduce losses. It can be achieved with the implementation of the Circular Debt Reduction Strategy and the adoption of policy-measures to minimize the flow and gradually eliminate the stock of circular debt and improve the efficiency of DISCOs. Alongside these reforms, vulnerable populations should be compensated through targeted subsidies.

**108. Power purchase agreements for renewable energy generation should follow a least-cost approach moving towards a competitive bidding process and international benchmarks for ramp rates.** This would create a system where suppliers compete on price and provide innovative solutions to meet energy needs. Direct contracts between the government and private sector companies have resulted in higher costs of power generation and contributed to the circular debt. These power purchase agreements have also been linked to the USD, which has further raised power costs in the face of a depreciating

### Recommendations to Boost Private Investment and Competitiveness in Renewable Energy

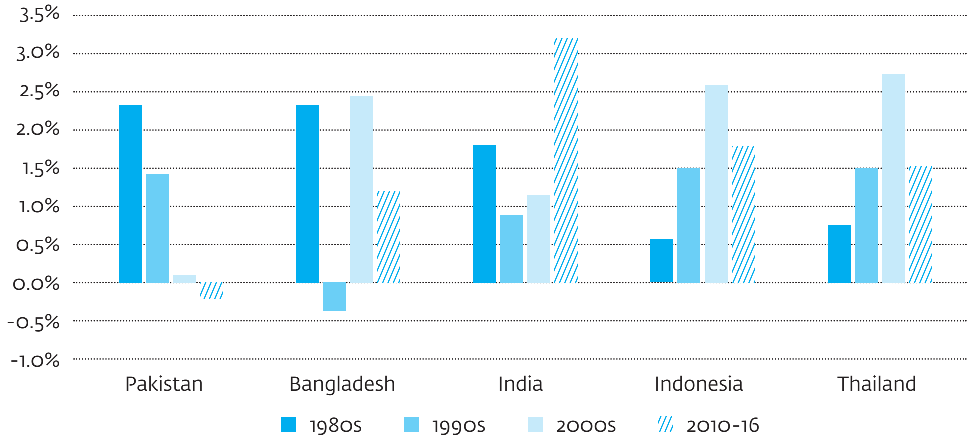
| CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | RESPONSIBILITY |
|---|---|---|---|---|
| 1. Weak financial viability and sector competitiveness | 1) Launch RE auctions and revise ramp rates to be up to international standards. | ++ | 18-24 months | CCI, AEDB |
| | 2) Amend the Distributed Generation & Net Metering Regulations of 2015 phasing in tariff rationalization, better metering, and enforcement of collection. | +++ | >36 months | NEPRA |
| | 3) Initiate and auction private transmission projects under the Policy Framework for Private Sector Transmission Line of 2015. | ++ | 12-24 months | PPIB |
| | 4) Provide legislative support to off-grid renewables and establish a rural electrification fund. | ++ | 12-24 months | AEDB |
| 2. Grid code limitations | 5) Review and amend the grid code to define, update and reinforce variable RE requirements to international standards. | ++ | 12-24 months | NEPRA |
| 3. Technical and infrastructural limitations | 6) Install the Supervisory Control and Data Acquisition system (SCADA) with Automatic Generation Control to enable monitoring, control and analysis of performance and facilitate VRE integration. | ++ | 12-24 months | NPCC |
| | 7) Adopt high accuracy central forecasting systems for VRE, preferably at a central level to increase accuracy, and conduct extended network studies to ease VRE integration. | + | 12-24 months | NEPRA |

PKR. The contractually agreed maximum ramp rates for existing and committed plants should be renegotiated up to international benchmarks. This would enhance the flexibility with which energy is dispatched from conventional power plants, which is essential for the integration of volatile VRE.

**109. The renewable energy sector would benefit from greater coordination and centralized planning in the context of an integrated national energy plan.** The Alternative and Renewable Energy Policy of 2020 is a step in the right direction. Public procurement of renewable energy should be forward looking to ensure overall energy capacity remains sufficient and prioritizes renewables over alternatives that make less economic sense. Plans for the adoption of new substations along with regular integrated transmission and generation expansion should include VRE integration. Consideration of geographical distribution of photovoltaics and wind power plants is also key to reduce variability. Conducting least-cost electrification studies would also be key to inform decisions of whether grid expansion or alternative off-grid solutions are best to extend electrification to remote areas.

**110. Expanding off-grid renewables requires incentives and supportive legislation.** The limitations in coverage create scope for renewable energy applications like solar home systems or mini grids that could provide access to electricity in remote areas. Such systems have expanded rural electrification in many countries. Solar energy has become increasingly cost-effective as prices of photovoltaics and batteries have come down, and new business models using mobile payments have made such systems more affordable. The GoP may take steps to facilitate cooperation between solar system providers and regional distribution companies, especially on technology interface for mini- or micro-grids. With support from the World Bank, the Sindh Solar Energy Project, which is supporting the commercial provision of 200,000 households by private sector solar solution providers (SSPs) by providing partial grants, a public awareness-raising campaign, and extensive monitoring and evaluation to ensure adherence to high quality standards. In doing so, the project is expanding solar home system providers and encouraging additional SSPs to enter the market and can serve as a template to follow in other parts of the country.

**Figure 42: Annual average TFP growth**




Source: USDA (2019).

**111. New technologies need to be adopted to facilitate integration of a larger share of renewable energy and maximize the capacity of the existing system.** The SCADA enables the monitoring, control and analysis of energy system performance. It is key for VRE integration and it would support the efficient use of other energy sources. VRE can be expanded without it, but it could cause technical problems threatening security and quality of supply, as well as commercial problems if network capacities are not maximized to meet needs. The adoption of High Accuracy Central Forecasting systems for VRE, preferably at a central level to increase accuracy, along with extended network studies would ease VRE integration. Refurbishing and reinforcing the grid would help guarantee a steady-state and transient stability.

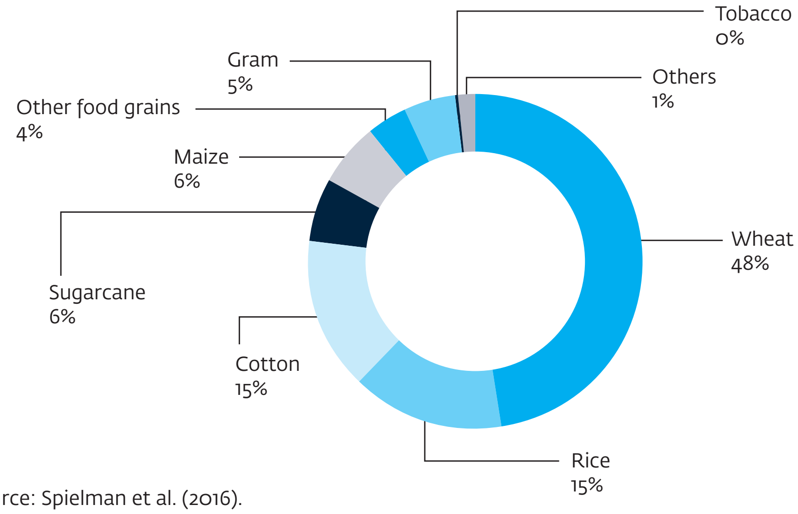
**112. Grid codes should be updated to integrate more renewable energy sources and operate the power system effectively.** A first step would be to undertake a grid code review to define, update and reinforce VRE requirements to international standards. In addition to changes already adopted by NEPRA, further amendments to the grid code would improve integration of solar and wind energy to optimize the benefits of renewable power generation, as well as minimize technical and planning risks both for independent power producers and grid operators.

## 3.4 AGRIBUSINESS

***The benefits of transformation in the agribusiness sector go beyond meeting the rising needs and changing tastes of a growing population. The returns from catching up with foregone productivity gains and realizing export-potential can bear fruit through their impact on health, sustainability and growth.***

**113. The agriculture sector employs nearly two-fifths of the labor force and contributes around one-fifth of GDP, but value-addition remains low.** Pakistan's growth in TFP in the agriculture sector stagnated in the 1980s and turned negative in the 2000s (see Figure 42). Output growth had been driven primarily by increased use of factor inputs, rather than technical change, a more efficient product mix, or upgraded processing of crops (Spielman et al, 2016). Agribusiness considers the value-addition that derives from efficient supply chains that can deliver fresh produce to export markets in a timely manner, the production of higher value produce, as well as value-addition through either

**Figure 43: Share of area cultivated by crop, 2014**




Source: Spielman et al. (2016).

the processing or marketing of agricultural output. On the pattern of crops, despite the potential of higher value varieties like fruits and vegetables for domestic and export markets, agricultural output is dominated by food staples like wheat, rice and maize, in addition to the production of water-intensive produce like cotton and sugarcane (see Figure 43). This pattern of production has hardly changed since the 1990s. At the same time, the development of the agribusiness sector in the form of activities beyond the farm, including logistics, processing and retail, has remained modest, despite the fact that post-farm activities contribute about 55 percent of the total global value of the sector (Chodavarapu et al, 2016). Catching up with the pace of productivity improvements in regional peers, like Bangladesh, or aspirational peers, like Indonesia and Thailand, would unlock substantial economic and developmental benefits to Pakistan.

**114. The untapped potential of the agribusiness sector in Pakistan is large and well assessed.** First, the average yields for crops like wheat, cotton, rice, maize and sugarcane amount to 18 to 47 percent of the yields in leading producing nations (Aslam, 2016). For example, the yields from horticulture could be increased by up to 40 percent with improved production techniques (Bajwa, 2011). Second, the International Trade Center estimates that Pakistan has an untapped export potential of US$2.6 billion, which represents 40 percent of actual exports of agriculture products.[6] Third, the domestic market for fruits and vegetables is large and the versatile climate and rich genetic diversity are well-suited to produce a more varied product mix.

**115. The potential benefits of growth in the agribusiness sector can have important developmental effects.** A more efficient and competitive agribusiness sector that is more connected to global value chains would enhance the sector's ability to meet food demand of a growing population, improve nutritional outcomes, support poverty reduction, and provide new business opportunities. Conversely, a weak agribusiness sector, and by association the contribution of the agricultural sector to GDP and other developmental objectives, lead to greater reliance on imports, and lower livelihoods in rural areas. The costs of undernutrition in Pakistan are substantial, leading to losses from higher mortality, greater incidence of illness, lower productivity, and poorer educational performance. In 2015, the total cost of undernutrition to the economy was estimated at as much as PKR0.7 trillion because of losses of earnings, productivity and health and education costs (IFPRI, 2018).

## Sector specific challenges

**116. The agribusiness sector faces many of the challenges that the agriculture sector faces, but it has its own challenges as well.** Among the issues facing the agriculture sector more broadly are challenges related to water management, smallholder issues, limited mechanization, and risks of environmental unsustainability. These challenges merit reforms and would undoubtedly benefit the agribusiness sector as well. The focus here is on the agribusiness sector more specifically, and the most notable challenges include the spillover effects of distortionary policies in the agriculture sector, inefficiencies in the wholesale markets for non-traditional products, the absence of warehouse receipt systems and storage capacity, poor physical infrastructure, non-tariff barriers, limited knowhow of producers, and a lack of modern seed research. Each of these undermine the cultivation of higher value-added crops and limit opportunities for value-addition along the supply chain.

**117. The dominance of traditional crops at the expense of higher value produce owes its continuation in part to the distortionary impact of subsidies and the pricing of water, fertilizer and wheat.** Water charges (*abiana*) do not reflect the actual cost of maintenance and repair and typically represent under 0.2 percent of crop budgets. In 2003/04, a fixed water rate per acre was implemented undermining incentives for efficient water use. It is unsustainable given the growing demand for water, along with environmental risks. The production and use of fertilizer are indirectly subsidized through low natural gas prices used in the production of urea. Similarly, the public procurement of wheat at inflated prices encourages overproduction, which in turn discourages the production of alternative crops with potential for downstream value addition. These subsidies are costly: in Punjab, provincial and federal costs of agricultural subsidies amounted to US$1.25bn in FY17 (World Bank, 2017). The distortions also create negative externalities and undermine sustainability through increasing salinity, sodicity and waterlogging resulting in soil degradation for instance of 25 percent of formerly fertile land in Punjab.

**118. Poorly functioning wholesale agricultural produce markets hamper price discovery and inhibit the production of higher value-added output.** Historically, producers and traders have met in wholesale markets where farmers bring samples and produce is sold to the highest bidder. Over the years, these markets have grown significantly in trade volume, but not in capacity. They have continued to operate without the aid of IT and web-based platforms, keeping markets local. These markets are also administered by provincially appointed market committees, and producers are required to use these wholesale markets or sell to licensed buyers—both of which raise concerns about efficiency and perverse incentives. As such, these markets have created imbalances in market power, undermined transparency, and limited direct purchase and contracting between agro-processors and farmers. Notable progress in improving markets has taken place. Sindh adopted the Wholesale Agricultural Markets Act in 2010, which abolished notified market areas and market committees, and allowed private markets and direct buying. More recently, the Punjab Agriculture Marketing Regulatory Authority Act 2020 establishes a new and more transparent legal regime to market agricultural produce in one of Pakistan's provinces (Janssen and Li, 2020). While these are positive developments, implementation across the country has been uneven and the impact remains unknown.

**119. The limited availability of pre- and post-harvest financing opportunities hamper investments in agribusiness.** Reliable collateral can enable both farmers, traders, processors and other holders of inventory to acquire financing and reduce trade costs. For farmers, systems of movable collateral are well-suited to do this. Post-harvest financing would benefit from a well-functioning warehouse receipts system. Recently, the Securities and Exchange Commission of Pakistan (SECP) initiated a mechanism for collateral management, and the Naymat Collateral Management Limited company was launched in early 2020. The Punjab Agriculture Marketing Regulatory Authority act in Punjab will also expedite bulk warehousing services in the private sector and promote the development of electronic warehouse receipts.

**120. Poor infrastructure supporting storage and farm-to-market transport and modern supply chains including cold storage facilities cause substantial losses and limit the growth potential of agribusiness.** Fruits, vegetables, and other produce with a limited shelf-life require modern storage and handling facilities with appropriate warehouses, silos, and cold storage along the supply chains. While internationally comparable estimates are scarce, the scant evidence from Pakistan suggests the absence of such facilities comes at a great cost. Pakistan's post-harvest losses for fruits and vegetables are 30-50 percent of vegetables, and 10-30 percent of cereals. The comparable losses in Bangladesh are 10-30 percent and 5-10 percent, respectively, which highlight the scope to improve (COMCEC, 2016). In Pakistan, most food grain is stored in gunny bags not well suited for large bulk storage. In addition, the limited capacity to maintain inventory contributes to price volatility, hurting producers and consumers.

**121. Inadequate SPS and food safety regulations that do not meet international standards have limited access to foreign markets and export-led productivity growth.** The domestic food processing industry also has one of the highest effective rates of protection. In Pakistan, regulatory authorities covering food safety are spread across ministries with overlapping responsibilities and limited coordination for example between the ministries of agriculture and health. Enforcement of regulations is weak and food safety labs are not internationally recognized and lack the capacity to test for pesticides, mycotoxin and antibiotic residues (Chodavarapu et al, 2016). The efficient trade of products, especially high value perishable goods, would require quality storage infrastructure and efficient processing as delays may spoil the produce. Pakistan lacks up-country customs clearance and container sealing, and procedures at the Karachi Port are cumbersome. A recent World Bank assessment of the national quality infrastructure ecosystem reveals that Pakistan has some way to go to improve supporting services that could facilitate trade, such as beef exports of to China which faces challenges around foot-and-mount disease (World Bank, 2020c). The GoP drafted a national quality policy already in 2014 that captures good practices, yet the policy was not reviewed or approved.

**122. The limited adoption of higher value-added crop types and more efficient production technologies owes to limited know-how of producers and low effectiveness of extension services.** Agriculture departments could play a more important role in diffusing productivity enhancing technology and production processes. They do provide some extension services covering technical knowledge, farm management, and information systems, but there are wide gaps in access and support is not customized to location- and crop-specific needs. Simply put, without more knowledge and training, farmers may be reluctant to grow new crops.

**123. The lack of modern seed research inhibits farmers ability to use higher value-added inputs, especially of new crop types needed to foster growth in horticulture.** The industry is increasingly dependent on imported seeds, which are not tailored to maximize productivity in local climatic conditions, and sometimes risk the introduction of foreign diseases and pests, especially given limitations in the public seed certification system. Plant breeding and agroeconomic research are considered public goods that motivate public subsidy. The absence of local seeds owes in part to the fact that public expenditure on agricultural research amounts to 0.18 percent of GDP, which is the lowest in the region (World Bank, 2017). There is also a disconnect between public sector seed research organizations and private sector seed companies and seed labs. Although Pakistan recently passed The Seed (Amendment) Act of 2015 and the Plant Breeders' Rights Act 2016, there is a need to improve the seed development policies for the protection of breeder marketing and intellectual property rights.

## Realizing sector potential

**124. Realizing the potential of the agribusiness sector and attracting greater private investment will require policy and institutional reforms to align the incentives of the farmers and businesses.** The range of reform areas to promote the business sector correspond to the challenges highlighted in the section above.

**125. Rationalizing the pricing of public procurement of some products (wheat) and input subsidies (water and fertilizer) would go a long way towards shifting the crop pattern in favor of a more optimal mix.** The current inflation of the price of wheat and the artificial price of water and fertilizer encourage farmers to produce crops that may not be in demand or carry high value to the economy. They may also lead to the exports of water intensive products, with benefits accruing to other countries. The removal of subsidies would lead to a more optimal output mix and facilitate charging the true cost of water and other inputs. If the government were to take this route, the reforms would require a clear and gradual subsidy removal plan, as well as targeted support to vulnerable groups.

**126. The development of online portals for wholesale agricultural markets would help connect producers with traders and sellers and improve market efficiency.** This is an action that only the GoP could undertake to overcome the problem of collective action among individuals and the public benefits would outweigh the costs. Pakistan could for example follow India's Electronic National Agricultural Markets (e-NAM) model adopted in 2016 or the models adopted by Kenya or Turkey. e-NAM covers 18 states, over 100,000 traders, over 70,000 commission agents, nearly 1,000 FPOs and 17 million farmers. The development of a similar market in Pakistan could provide an electronic trading terminal for online sale and purchase of agro-commodities.

**127. Establishing a well-functioning regime for warehousing would enhance post-harvest financing.** A well-functioning warehouse receipt system requires a supportive legal framework (Wehling and Garthwaite, 2015). Success stories include those from Turkey, where the Licensed Warehousing Law passed in 2005 has warehouses licensed by the Turkish Grain Board. . Pakistan has made progress in the same direction. In order to promote electronic trading and warehouse receipt financing of agricultural commodities, the SECP issued the Collateral Management Companies (CMC) Regulations of 2019 to provide an ecosystem for storing, preserving, trading and financing of a range of agricultural commodities. The CMC Regulations provide the necessary framework for commodities placed in warehouses to be used as collateral for bank loans and trading of electronic warehouse receipts on the futures exchange. To this extent, the SECP provides accreditation services to warehouses and issues electronic warehouse receipts. The Pakistan Mercantile Exchange Limited (PMEX) has selected certain commodities for which EWRs will be eligible for trading on the PMEX. So far, specifications for commodity futures contracts based on EWRs of maize have been approved.

**128. Investments in physical infrastructure such as modern bulk storage or silos and in supply chains would reduce losses and support trade.** Adequate transport infrastructure is important for timely transfer of fresh commodities from the farm-to-market to limit post-harvest losses. Investments are needed to support the supply chain of perishable goods, including cold chain development.

## Recommendations to Boost Private Investment and Competitiveness in Agribusiness

| CONSTRAINT | RECOMMENDED REFORM OR ACTION | DIFFICULTY | TIME | RESPONSIBILITY |
|---|---|---|---|---|
| 1. Distortive policies in water, fertilizer and wheat markets | 1) Remove flat rates on water use and roll back fertilizer gas subsidies. | +++ | >36 months | Fed. and Prov. Food Deps |
| | 2) Strengthen water management systems and encourage an expansion of high efficiency irrigation systems. | ++ | >36 months | Fed. and Prov. Irrigation Deps |
| | 3) Phase out public wheat procurement and reduce the government's strategic reserve requirements. | ++ | 12-24 months | Min of NFS&R, Fed. and Prov. Food Deps |
| 2. Poorly functioning wholesale agricultural markets | 4) Promote more inclusive representation in the governing authorities of wholesale markets, and allow the private sector to expand into alternative marketing channels | + | 12 months | Fed. and Prov. Agriculture Deps |
| | 5) Transition towards electrotonic settlement and e-auction systems. | + | 12 months | Fed. and Prov. Agriculture Deps |
| 3. Weak product standards, non-tariff barriers, slow border clearance | 6) Enhance food testing labs capacity to test for pesticides, mycotoxin, and antibiotic residues, expand regional and mobile labs, and provide training in standards to producers to raise compliance with international SPS. | + | 12-24 months | Min of NFS&R, Agriculture Deps |
| 4. Limited use of effective farming methods and techniques | 7) Strengthen extension services for farmers to provide advice in areas such as soil tests, fertilizers, pesticides, mechanization, irrigation and water management. | ++ | 12-24 months | Fed. and Prov. Agriculture Deps |
| | 8) Increase public investments in agroeconomic research tailored to local conditions and promote collaboration between processors, farmers and academia. | + | 12-24 months | Fed. and Prov. Agriculture Deps |

**129. Raising quality standards is key to enhancing export of agricultural produce.** Phytosanitary requirements should be brought up to international standards and regulatory coordination between relevant government agencies is needed to ensure full and consistent coverage. Reforms should also aim to expedite the processing times of agricultural produce at ports to limit losses. Building the capacity of relevant government departments would enable them to better serve farmers and support the adoption of productivity enhancing technologies and production systems. Agriculture departments may consider teaming up with stakeholders from the private sector and civil society institutions that also provide extension services and other support to producers.

**130. Building and disseminating research is key to improving inputs and providing better knowledge of production practices.** To this end, the GoP may consider the establishment of a collaborative research center engaging members across the private sector, researchers and farmers. It may also consider greater investments in agroeconomic research that tailors advice to local climatic conditions and crops.

# 4. CONCLUSION

**131. The development of a more competitive and dynamic private sector is essential to create jobs for a young and rapidly growing labor force and for Pakistan to attain upper-middle income status by its centenary.** The economy has been on a downward trajectory for some time with a steady deterioration in major macroeconomic indicators. Private investment is at a very low level compared to regional, structural and aspirational comparator countries and it has remained stagnant for decades. Pakistan's export competitiveness has also dropped over time and few domestic companies integrate in global value chains and production networks. In the face of fiscal constraints and the stress from the COVID-19 pandemic, the GoP could help turn the situation around if it adopts the right set of reforms to promote private enterprise.

**132. The GoP will need to maintain its reform momentum of recent years and tackle critical constraints to growth that are highlighted in this report.** The CPSD proposes a series of practical reforms across three cross-cutting areas that would stimulate a more robust private sector and help Pakistan realize its largely untapped economic potential. The summary of the proposed reforms presented in the Action Matrix under the Executive Summary may seem daunting. However, most of them require strong political commitment rather than public investments. And inaction would be costly. Successful implementation of the proposed reform agenda aimed at boosting the private sector would strengthen Pakistan's prospects for sustainable growth and job creation.

# ANNEX 1: ECONOMIC AND PRIVATE SECTOR BENCHMARKING

The CPSD Private Sector Scan benchmarks Pakistan's economic, policy, and sector-specific indicators against peer countries. It seeks to provide an overview of the private sector, identify main cross-cutting policy constraints, and highlight sector-specific policy barriers to a country's private sector competitiveness. The scan includes a comparator selection tool that identifies structural and aspirational comparators, in addition to regional comparators, to identify the country's areas of comparative under-performance. The method of selecting structural and aspirational comparators seeks to embed maximum flexibility in a standard, automated algorithm while ensuring comparability and stability.

For structural comparators, the user chooses a benchmarking timeframe, selects multiple dimensions that comparator countries should resemble the country of interest, adds categorical restrictions, and adjusts weight of each dimension. For aspirational comparators, the user chooses the aspirational dimensions that the country of interest seeks to emulate, and how aspirational it wants to be. In the data below we use a comparator selection timeframe to be 2016 to 2018.

Structural comparators were selected based on the following five criteria with equal weight: (i) GDP per capita (current US$), (ii) population, total, (iii) total natural resources rents (% of GDP), (iv) employment in agriculture (% of total employment) (modeled ILO estimate), and (v) human capital index (HCI) (scale 0-1). Aspirational comparators are based on the list of countries that have higher GDP per capita and structural relevance.

These criteria produced the following list for the following benchmarking exercise:

**Structural comparators:** Nigeria, Egypt, Ethiopia, Myanmar

**Aspirational comparators:** Indonesia, China, Philippines, Brazil

**Regional comparators:** India, Bangladesh and Sri Lanka

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# Endnotes

[1] Informality is defined as those activities which are productive and legal but are deliberately concealed from the public authorities to avoid payment of taxes and social security contributions or complying with regulations.

[2] SMEs are those enterprises which employ between 10-250 employees and have annual sales turnover between Rs 75 million to Rs 400 million. Data cited is from the Economic Census (2003).

[3] State Bank of Pakistan – Financial Sector Stability and Soundness Indicators

[4] Financial Sector Assessment Program Development Module – Technical Note on Infrastructure Finance (2016)

[5] Under the government's Ehsaas emergency cash program, the government intends to support over 10 million households around Pakistan through grants equivalent to PKR3,000 for a period of 4 months. The grants are to be given through a bullet payment of PKR12,000.

[6] World Bank Universal Financial Access data.

[7] Insights of Warehousing & E-Commerce. PIBT http://pbit.gop.pk/system/files/Insights%20of%20Warehousing%20%26%20Ecommerce%20.pdf

[8] Agri-products included in the analysis are rice, fruits, fish & shellfish, sugar, vegetables, cereals (processed), other food products, vegetal residues & animal feed, spices, and vegetable oils & fats. Source: ITC Export Potential Map https://exportpotential.intracen.org/en

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