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# **A Growth and Adjustment Strategy for Pakistan**

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## **Introduction**

1. The last few years have been a difficult time for Pakistan. A growing militancy at home, very serious floods, severe power outages, shortage in supply of natural gas, weakening exports on account of continuing slowdown in the main markets for the country's merchandise, and a weak foreign exchange position, have dealt a serious blow to investor confidence. This has led to a sharp reduction in investment and a slump in the rate of economic growth that has now lasted for four years—the longest downturn in the country's history. There is also anecdotal evidence of considerable amounts of capital flight from the country. Policy responses to these challenges have not been effective; noticeably in the area of tax collection, management of public enterprise losses and handling of energy predicament. Federal-provincial relations have also become difficult. This has resulted in persistence of large fiscal deficits which financed largely by bank borrowing have led to high rates of inflation.

2. In contrast to an economic situation that remains very challenging, there has been considerable progress in developing a new political order that is likely to be more durable than those that preceded it. With the settling of a number of outstanding political structural issues there are good prospects that a real democratic system can develop under a genuine federal setup. The test of the leadership that will emerge following the next elections will be to ensure that the new political freedoms and stability are used to strengthen the state and revive the economy.

3. At this time Pakistan faces two immediate problems: the longest downturn in its history and serious macroeconomic imbalances, and the absence of consensus on how to place the economy on a plane of higher and sustainable rate of GDP growth. The policymakers must address these inter-related problems simultaneously. Growth needs to become the basis of a new development paradigm. At the same time, large macroeconomic imbalances must be eliminated. Progress on one front will improve the prospects on the other. Improved macroeconomic situation will improve the investment climate for both foreign and domestic investors. The increased confidence and recovery in growth will lay the basis of both expanded revenues and exports. This paper provides some ideas that could help develop a comprehensive, consistent and credible economic strategy that is urgently needed. Such a 'home grown' program could also assist in negotiations with the Fund that could become necessary to relieve the pressure of repayments of over USD 5 billion due to the institution in the next eighteen months.

4. Many of the problems and issues that constrain steady progress towards sustained high growth and financial stability are deep seated and have persisted for decades. While there are no silver bullets or magical formulae for solving structural problems, a broad agreement on the nature of the problems, a strong political will to undertake reforms and initiation of critical first steps would have significant pay-off. This will be the case even in the short and medium term, defined as the next two to three years.

5. This paper is divided into four sections. The first provides a quick overview of the current political and economic situation, focusing in particular on the stagnation of growth and deepening macroeconomic imbalances, and a fast approaching balance of payments crisis. The second section focuses on ways to improve macro-economic balances especially public finances not only by increasing revenues but restructuring expenditures including

reductions in subsidies to the non-poor and increasing the effectiveness of public spending. The third section focuses on critical elements in reviving growth. The paper argues for a comprehensive growth strategy which focuses on governance as a central issue. Reversing the decline of public institutions and improving the quality of governance will provide confidence in the country's economic future and will result in increasing domestic investment. Other elements of the strategy must involve improving the energy situation; correcting the long neglect of exports and using international trade as a driver of growth (including opportunities that may become available by the intended normalization of trade with India); reversing the decline on growth rate of agriculture both by supporting diversification in the cropping pattern; processing of agricultural products, and more economical use of inputs (especially water); a new push on human development including quality of education in public schools, skills training and a new emphasis on adult literacy; and, a new compact with the private sector that phases out economic rents, reduces the burden of unnecessary or ineffective regulation not excluding labor legislation, and strengthens incentives for investment and productivity improvements especially in moving up the value added chain. Finally, the fourth section presents a summary of key actions that government could take along with a timeline for implementation.

## **Current Political and Economic Situation**

### ***Political Backdrop***

6. The last five years represent somewhat of a paradox. On one hand, governance has declined further, corruption has been on the rise and effective decision making has suffered as merit has not been the key criteria for senior appointments. Militancy and terrorism have risen and there was foot dragging on the establishment of appropriate mechanisms for ensuring accountability of senior public officials both from the political and bureaucratic sides. On the other, the higher judiciary—especially the very independent minded Supreme Court—became very proactive in governance issues and the free media especially electronic media came to play an important role in highlighting public policy issues and exposing wrong doings.

7. Furthermore, some basic constitutional changes were instituted that augur well for the future of democracy in a meaningful federal setting. The 18th Amendment to the Constitution passed in April 2010 restored in letter and spirit parliamentary democracy and the relationship between the federation and the provinces as originally envisaged in 1973 Constitution. The Amendment also laid down the procedures for nominating judges to the higher judiciary and made the office of Chief Election Commissioner autonomous of both the executive and the parliament. The Amendment also laid down the procedure for appointing the head of National Accountability Bureau (NAB). Through the subsequent 19th and 20th Amendments, procedures for appointments of High Court and Supreme Court were clarified and the arrangements for putting in place a caretaker government to oversee elections were prescribed. The final authority for the appointment of the caretaker prime minister was given to the Chief Election Commissioner in case the outgoing prime minister and the leader of the opposition could not agree on a nominee.

8. These changes should move the country towards a durable political structure which should ensure democracy and stability. The stage has been set for providing the next set of political leaders to effectively cope with the large looming problems of large macroeconomic imbalances, slow growth and poor governance. The government will be well served to prepare a credible strategy that addresses all the three interlinked issues: stabilization, reviving growth and improving governance. This paper discusses some of the key elements that need to be accommodated in such a strategy.

### ***Salient Features of the Current Economic Situation***

9. GDP growth averaged less than 3 per cent per annum over 2008-12 and is expected by to be at roughly the same level in 2012-13. This low rate of growth was due in part—but only in part—to the impact of floods that did a great deal of damage in 2010 and 2011. Some of it was also due to the slowdown in global economic expansion. But the relatively sluggish performance of the economy was also the result of a number of policy failures. One of these resulted in serious power shortages that became a major constraint on economic activity. Rough estimates of loss of output due to energy shortages are as high as 2 per cent of GDP per annum.

10. In the critical power sector, there has been further deterioration. First, the line losses have not shown any decline in the last few years and remain high at 21 per cent. Second, load



shedding, 35-40 per cent at present, has worsened and is not expected to show a decline in the next few years as the imbalances between supply and demand are likely to persist. Third, even though electricity tariffs have risen by 75 per cent in recent years, power subsidies are large and including arrears reached a peak of 2.2 per cent of GDP in 2011-12—continuing in 2012-13.

11. Equally important gross fixed capital formation has dropped more than 30 per cent in real terms over 2008-12 and the ratio of fixed investment to GDP at around 11 per cent in FY 2012 was lowest over half a century. If proper allowance is made for normal depreciation of capital—wear and tear and obsolescence of machinery and running down of infrastructure—the net additions to nation's capital stock is small right now—this against the background of loss of capital due to a major earthquake in 2005 and devastating floods in 2010 and 2011.

12. It is also worth mentioning in this context that disruption and hardship caused by power outages apart, private consumption has not suffered at all in the last three or four years: according to Pakistan Statistical Bureau, private consumption expenditures in real terms were 13.7 per cent higher than in 2008-09 and 27.7 per cent higher than in 2007-08 which was a depressed year due to sharp increases in international prices of oil and food grains. But even in the last three years there was an increase of around 8 per cent in the average real per capita consumption. Two factors have made this possible. On one hand, the Gross National Income (GNI) has risen faster than GDP because of large influx of worker remittances and generally better terms of trade compared to 2007-08. The other explanation is worrisome. As investment climate deteriorated for a number of reasons, there was a switch from investment to consumption. Real investment is now much lower than it was at its peak in 2006-07. The declining trend in investment needs to be reversed if growth is to be revived. Fiscal policy must play a key role in this respect. But more generally, political leadership can set an example for the nation by avoiding conspicuous consumption and extravagant life styles.

13. Agricultural growth which averaged nearly 4 per cent per annum over the 40 year period from 1960 to 2000 slowed down to around 2.5 per cent in 2001-12. This occurred notwithstanding a buoyant livestock sector and sharply rising level of milk production. Availability of water—mostly surface irrigation—which trebled between 1960 and 1990 is no longer increasing. Also there has not been any major breakthrough in major crop yields which remain low.

### ***Macroeconomic Imbalances***

14. Slow economic growth has been accompanied by large macroeconomic imbalances, and Pakistan for the first time in its history faces the danger of stagflation. Public finances have deteriorated very significantly and external finances are largely being kept afloat as a result of very large worker remittances, both through official channels and money market companies.

15. Driven by a stagnant tax-to-GDP ratio, despite a large increase in tax revenue in 2011-12, mounting public enterprise losses, and persistent subsidies for the power sector, overall fiscal deficit was over 7 per cent of GDP during the last three years FYs 2009-12: the reported deficit figure including large settlement of arrears was 8.5 per cent in 2011-12 and is

likely to exceed 8 per cent in 2012-13. The problem, however, is not only the large size of the deficit but what it finances and also how it is financed. Because of the stagnation of the tax-to-GDP ratio at around 10 per cent, government revenues do not cover current expenditures, the revenue account deficit—negative savings on general government account—have averaged 3.5 per cent of GDP in FYs 2010-12 and have been responsible for half of the overall fiscal deficit.

16. The financing of the overall fiscal deficit has relied heavily on inflationary means. Total bank financing during the FYs 2011 and 2012 averaged over 3.5 per cent of GDP, more than half the fiscal deficit. The direct financing of the fiscal deficit by the State Bank of Pakistan has been curtailed, but the financing of the government operations, by large commercial banks, has been possible only through huge liquidity infusion by the State Bank of Pakistan. Consequently, consumer price inflation averaged 12 per cent annually during the three years FY 2010-12 but has moderated to 8.0 per cent in the first nine months of FY 2013. This was partly due to a change in base year of Consumer Price Index (CPI) from 2000-1 to 2007-08 and reportedly a substantial underreporting in the inflation of house rent and gas prices.

17. While the large fiscal imbalances have persisted, constrained foreign exchange is becoming increasingly critical. The current account balance of payments deficit was USD 4.3 billion or 2 per cent of GDP in FY 2012. In relative size, a 2 per cent of GDP current account bop may not appear large but in Pakistan's case it must be viewed against the background of potentially volatile external flows. The sharp increases in the flow of remittances—18 per cent in FY 2012, increasing to a total of USD 13.2 billion—may not be sustainable. Loss of confidence in economy's future may discourage some of the remitters to send money to the homeland preferring to wait out the difficult period. Indeed the growth in worker remittances slowed down in the first nine months of FY 2013 to only 6 per cent over the same period last year. Exports which contracted 2.8 per cent last year have not shown any signs of recovery so far this year due both to supply bottlenecks and competitiveness issues. Exports of goods in first nine months of FY 2013 were flat compared to the corresponding period a year ago.

18. The most serious and urgent problem is that the capital account is under great pressure. Because of large repayments to IMF (USD 1.15 billion) in FY 2012—a 50 per cent decline in direct foreign investment to USD 800 million—and only modest inflows of long-term loans (USD 500 million), liquid foreign exchange reserves held by the State Bank of Pakistan (SBP) dropped by USD 4 billion in FY 2012. With a further repayment of USD 1.8 billion during first eight months of 2012-13, SBP net reserves had fallen to USD 7.5 billion by mid March 2013. The present level of reserves is less than 2 months' of imports of goods and services; and its continuous decline is putting pressure on the Rupee which is depreciating at close to 1 per cent a month. More importantly, repayments including interest of USD 3 billion are due to IMF in the remaining part of calendar 2013 (March-December) and another USD 2.1 billion in calendar year 2014.

## **Reducing Macro-economic Imbalances**

### ***Improving Public finances***

19. Improving public finances is an immediate and critical need. This, however, is not only an issue of an orderly reduction in fiscal deficit through improving revenues and cutting back of expenditures but must also involve undertaking a substantial restructuring and reprioritizing of expenditures to support economic growth. An objective should also be to eliminate the sizable negative general government savings—in recent years, as indicated above, was as high as 3 per cent of GDP—by requiring that government revenues cover all current expenditures in two to three years. At the same time, it is important that dependence on bank financing of the deficit be curtailed and much greater efforts should be made by mobilizing resources through non-bank sector and liquidation and sale of considerable state assets both at the federal and provincial levels. Consideration should be given for the sale of landholdings of some of the public sector enterprises through public auctions—there is a lot of land owned by the railways, some of it in large cities across the country. The proceeds from such sales should be sequestered in a special fund for future generations.

20. A balanced approach is needed—which reduces fiscal imbalances but at the same time improves economic efficiency and growth orientation of the economy, helps reduce income inequalities, and moderates the rate of inflation. If adopted, it would avoid the mistakes of the past that have resulted in uneven growth and inequitable distribution of growth benefits. A major restructuring of public expenditures from defense to development, from wasteful administrative expenditures and subsidies to non-poor would be a substantial undertaking and in some cases may yield results only slowly. But a move towards a comprehensive reform is urgently needed if economic stability is to be restored, confidence of investors, both foreign and domestic, is to be revived and recovery of economic growth is to be assured.

### ***Tax Revenue***

21. Pakistan has one of the lowest tax-to-GDP ratios among developing countries of any size. Yet periodic efforts to make tax machinery more effective have not succeeded. More than a decade ago an effort was made to reform Federal Board of Revenue (FBR). This was done under President Pervez Musharraf, however the results were disappointing. The tax-to-GDP ratio of 9.9 per cent in 2011-12, though representing a significant improvement over the previous year, was lower than the ratio a decade earlier.

22. There are several structural problems with the Pakistan tax system. First, the income tax, which should be a source of progressive taxation, is ineffective and has very limited reach. Second, proposals for expenditure taxation in the form of a comprehensive value added tax, to replace the outmoded sales tax, has met political resistance. The fact that there is only very limited capital gains tax and no estate tax means that the burden of tax falls lightly on the rich and thus fiscal policies contribute to income inequalities. Finally, provincial taxes mobilize barely 0.5 per cent of GDP because property tax is light and agricultural income tax—a provincial subject—is practically non-existent.

23. Over the medium term, gradually raising the tax-to-GDP ratio would require actions on a broad front. This would require removing major weaknesses in the present system as

noted above. In the short-run, two to three years, the greatest pay off appears to be in three areas: an appropriate structure of income tax at the federal level, an increase in property tax and an increase in the levy agricultural tax at the provincial level.

### ***Individual Income Tax***

24. The biggest problem area and the one that has perhaps the greatest potential for yielding quick results is individual income tax. Even though income tax receipts are shown as direct taxation, a very large part of these collections come from withholding taxes, which are essentially indirect levies. According to available data, in 2008-09 less than 700,000 non-salaried households paid only PKR 40 billion or 0.3 per cent of GDP (or on average a tax of PKR 60,000 on an estimated average declared income of PKR 300,000). This group of non-salary individuals, professionals, small businesses, traders, service providers, is at the root of income tax evasion problem and should be targeted for improving income tax collections.

25. According to a recent head of FBR, less than one per cent of Pakistan's 180 million citizens pay income tax and no one is believed to have been prosecuted for tax evasion in 25 years. Reportedly, FBR is determined to force the rich little to pay their fair share by using both a carrot and a stick approach. To instill fear, FBR plans policy of 'name and shame' and the wrong doers will be threatened with freezing of assets and a ban on travel. Apparently National Data and Registering Authority (NADRA) has profiled over 2 million possible offenders based on use of cars, houses, bank accounts and overseas travel.<sup>1</sup>

26. Basing the estimation of the incidence of income tax on the size of the population estimated at 181 million in 2012 is misleading. The unit that pays or should pay income tax is the household. Pakistan has about 30 million households. The six million top 20 percent households by income who receive roughly 50 percent of the national disposable income, with an estimated average income of close to PKR 1.5 million per household, should be the main focus of the income tax administration. Excluding say a million households who can claim exemption because of agricultural income, would still leave 5 million households with a minimum income equal to or more than the average national household income, at present around half a million annually. The present coverage appears to be around 1.5 million households or 33 per cent of the total. Looking at the problem of tax avoidance or underpayment from the perspective of households makes the problem seem more manageable.

27. Developing a medium term plan to cover most persons who are liable but at present do not pay income tax thus deserves the highest priority. However, any such plan cannot succeed without strong political will and a well-paid but honest tax collection service.

### ***National Tax strategy***

28. On the technical level and given the need for a coherent national tax strategy, a National Tax Policy Office (NTPO) is required that would do all the ground work for policy directions and choices for all taxes at the federal and provincial levels. Such an office was recommended by the Taxation Committee as far back as 2002. It should be located in the Ministry of Finance and should have the responsibility for coordinating policy analysis and approaches with the provinces as well. The NTPO should be supported by Tax Policy

<sup>1</sup> Dawn Newspaper 4th October 2012

Research Institute to be funded jointly by the government and the private sector. The ad hoc approaches are clearly not working. At the same time, consideration should be given to the establishment of high level Tax Reform Commission which could provide guidance for not only tax policy but tax administration issues.

29. The casualness with which the goal of increasing the tax-to-GDP ratio to 15 per cent in four or five years is suggested or agreed to is worrying. It should be recognized that it will take an average economic growth rate of 6 per cent per annum over the next five years and an economy wide marginal tax rate of close to 20 per cent to achieve that target. If the average growth remains sluggish, say 3-4 per cent per annum, rapid improvement in tax ratio would be even more difficult. This does not argue for setting less ambitious targets but merely to stress the critical importance of accelerating growth and launching a serious effort to mobilize revenue.

30. The potential for increasing tax revenue in the provinces is considerable because at present they collect a mere 0.5 per cent of their combined GDP. As mentioned above, both increased property taxation and a meaningful agricultural tax should be pursued. As discussed below there is also a strong economic efficiency case for sharply increasing water rates and earmarking the revenue for land leveling and canal improvements. Overall, a target of increasing provincial tax revenue from 0.5 per cent of to 1.5 per cent of GDP would appear quite feasible to be realized over a period of three years. Reaching the target should be made retroactively as a condition for a larger provincial share in the federal divisible pool. The Council for Common Interest (CCI) could be used for arriving at this agreement.

31. A discussion of Pakistan's tax issues must touch on the large informal sector. This sector has never been fully captured in the GDP statistics. Incorporating it would suggest a faster GDP growth in recent years as service sectors, small scale industry, and non-crop agriculture have accounted for much of the growth in economic activity. It is not clear that the income tax authorities have sufficient outreach to these sectors most notably the flourishing and very successful fashion and 'IT cottage' industries. In general the escaping of the tax net especially by small scale industrial enterprises not only deprives the government of revenue but also acts against achieving economies of scale, a factor that inhibits export competitiveness. The tax authorities thus need to give more attention to taxation of high end luxury goods as well as small scale industry and service sector providers.

32. The Seventh National Finance Commission (NFC) increased the share of the provinces in the divisible pool. Apart from the larger provincial share, Baluchistan and Khyber Pakhtunkhwa (KPK) provinces were given additional resources; the former for reasons of its size and the latter because of the expenditure related to combating insurgency. The Ministry of Finance is concerned that with only 30 per cent of the total revenues available to it, it is highly constrained in financing some of the high priority programs that still remain its responsibility after the passage of the 18th Amendment. It believes that the award did not create incentives for the provinces to raise resources of their own. One result of this is that the share of provincial revenues in the total raised nationwide is declining.



### ***Level and Effectiveness of Public Spending***

33. Public sector spending accounts for about 20 per cent of Pakistan's GDP. This proportion is unlikely to rise in the medium term: the much needed increase in the tax-to-GDP ratio would be largely offset by the necessary reduction in the very high overall fiscal deficits.

34. The effectiveness of public spending is therefore a central issue. At present there are several problems with the structure of spending: considerable waste in administrative expenditures, high levels of defense outlays, provision of generous subsidies to non-poor, large losses made by major public enterprises and a greatly overextended development program—involving both low priority projects and long gestation periods—which yield sub-optimal economic impacts.

35. Comprehensive public expenditure reviews both at the provincial and federal level should be undertaken and completed by the end of March 2013. The objectives should be to:

- introduce a strict austerity regime for at least the next two years for administrative expenditure and discretionary spending other than high priority social spending items,
- improve the balance between development and defense spending,
- ensure that critical infrastructure gaps begin to be reduced, and
- maximize the short- and medium-term impact of development projects in the pipeline.

36. Surprisingly even though growth has been slow during the last four years, there are few signs of a pullback of spending either in the public sector or in the private sector. In the public sector, pressure for expanding security-related spending, large energy subsidies and inability to control losses of large public enterprises are the principal reasons for overall fiscal deficit. These are at a high level given the relative stagnation of tax revenues. But it is also true that no real effort has been made to control discretionary spending at either the federal or the provincial levels. Public salary and pension increases have been generous and miscellaneous expenditure has been increasing. Excluding defense spending, interest payments and subsidies, federal current expenditures in nominal terms more than doubled over the three years from FY 2009 to FY 2012 and a similar increase was recorded in provincial non-development spending. Allowing for inflation, the increase in general government expenditures including subsidies but excluding defense and interest payment has been of the order of 30-35 per cent over the three year period.

37. Against this background, the institution of an austerity regime for a couple of years and strict control of salaries and other discretionary spending seems not only absolutely necessary but also quite feasible.

### ***Adjustment Path and Financing of Budget Deficits***

38. There is need for full transparency in budget-making. Counting of buildup of arrears and circular debt or temporary parking of public enterprise losses elsewhere should not become parts of the budget-making exercise as has been the case in the past. These practices have reduced the credibility of the government in its dealings with foreign governments and development and financial institutions.

39. Given the severity of the budgetary situation and the depressed state of private sector investment, it is felt that a gradual reduction of fiscal deficit from 8 per cent to 4 per cent of GDP over the three-year period from FY 2014 to FY 2016 would be justified provided:

- strong actions are taken to increase tax revenue both at the federal and provincial levels;
- plans are initiated to eliminate revenue deficit and negative government savings by FY 2016
- the dependence on financing of the budget deficit from bank borrowing (including from the SBP) is reduced immediately to no more than one per cent of GDP per annum. There seems to be no particular advantage in limiting borrowing from SBP while it provides liquidity to the commercial banks so that they can make substantial loans to the public sector.

40. In the interim, before fiscal deficits can be financed from non-inflationary means, the government must aggressively push the sale of public assets including share of state-owned public companies and step up efforts to mobilize private savings including the development of a market for long-term government paper for individuals and small businesses. At present because investment is sluggish, a lot of private money is taking the form of capital flight.

41. The Sixth NFC in January 1997 made the larger share in divisible pool provided to the provinces contingent on their taxing of agricultural incomes. The provinces committed themselves to taxing agricultural incomes at the rate 2 per cent per annum. This was to be done by using a production price index for estimating incomes from agriculture. However, the index to be used was not linked to the rate of inflation. Consequently the tax rate related to agriculture income has declined to less than one per cent of combined provincial product in 2011-12. Restoring—preferably increasing—the incident of tax on agricultural incomes should be taken up by the Federal Government in the Council of Common Interests, a constitutional arrangement meant to resolve issues between the provinces or between the provinces and the Federal Government. A revenue mobilization program to be adopted by the provinces should be developed by the Federal Government with targets fixed for the next five years in terms of the proportion of the provincial product that would be realized in terms of tax revenues. Such a program should include incomes from agriculture, services and property.

### ***Strengthening Balance of Payments***

42. Regardless of whether another program with the IMF would be necessary or can be agreed, serious attention must, therefore, be given to strengthening the underlying balance of payments position which remains weak. After a spurt, mainly due to higher prices, exports have essentially stagnated. The trade deficit running at USD 20 billion annually is now being financed almost entirely by huge worker remittances. Furthermore, the future of fairly sizable coalition forces support is uncertain. Moreover, the capital account is under pressure not only because large payments are due to the Fund but also foreign investment flows have declined sharply and the net inflow on account of long terms loans has also become modest.

43. A large part of the pressure on the imports side is emanating from large petroleum payments which totaled USD 14.4 billion in FY 2012 and are running at about the same level in the first four months of the current year. But because of Pakistan's energy situation and

the likely course of international oil prices, Pakistan cannot expect much relief on this account.

44. The strengthening of the current account balance payments must, therefore, come mainly from rapid expansion in exports. As discussed later in detail, Pakistan has progressively lost market share to almost all major developing countries during the last several decades. It is imperative that this trend be reversed if growth is to be revived and the balance of payment has to become viable. In the absence of strong exports, the desired revival of investment from the present low level would intensify the current account difficulties.

45. The various elements that would help develop exports rapidly are also discussed as a part of revival of growth strategy. Here it is enough to mention that foreign private investment in directly productive sectors would not only help in finding markets, improving technologies, and upgrading worker skills but would also greatly strengthen the capital account of the balance of payments.



## **Strategy for Reviving Growth**

### ***Need for a Comprehensive Growth Strategy***

46. The above discussion noted the deep fiscal and foreign exchange crises that the country faces and provides both general and specific recommendations for sharply reducing macro-economic balances and reviving confidence in the economy. These will require difficult choices for the new leadership who in order to avoid a collapse of the economy would have to ask for sacrifices and cooperation of the population; especially the well-to-do sections—something that the people of Pakistan have rarely been asked to do.

47. But in order to win public support for tough economic choices, the new government must present an economic vision and a strategy of inclusive development in which future rewards become available to all segments of the population and to all parts of the country.

48. The past pattern of economic growth and developments in Pakistan has been deeply flawed: economic rents, along with public corruption rather than genuine entrepreneurship and initiative have too frequently been the source of economic gain with the state as the benefactor: the distribution of growth benefits has been inequitable as job creation has lagged, as education of the masses has been neglected and fiscal policy has failed to play a role in redistributing income: and too heavy a reliance on external assistance and flows has meant that periods of high growth have rarely been sustainable.

49. So avoiding a financial meltdown, runaway inflation, and sharply declining value of the rupee would be a necessary but not a sufficient condition for economic revival with a new face. To aim at least doubling the GDP growth rate, from the present level of 3 per cent or so over the next four or five years, with more balanced sharing of benefits of growth would require major structural shifts in both governance and economic policies.

50. Hopefully the political order would continue to change towards greater sharing of power among state institutions and levels of government, greater accountability of public officials enforced by a rule of law, vigilant judiciary, informed and free media, and increasingly robust civil society. This will facilitate a greater acceptance of austerity and a national discourse on development approaches and strategy.

### ***Planning Commission's Framework for Economic Growth***

51. In what it called the 'Framework for Economic Growth (FEG)', the Planning Commission came up with what amounts to a new theory of development for Pakistan. The Commissions' work on growth started with a criticism of the approaches adopted in the past. It believes that in the past the emphasis on investment—particularly by the public sector—created a number of growth-retarding distortions in the economy. "An unintended consequence of our policies has been the stifling of internal markets, cities and communities which play a critical role in fostering productivity, innovation and entrepreneurship and ultimately promote growth, and prosperity and development" wrote the authors of the report. "The Planning Commission has been involved in the formulation of Perspective, Medium and Annual Development Plans based on a savings-driven approach where growth rates are arbitrarily set and incremental capital (investment) to output ratios are used to generate investment requirements in key sectors of the economy. Public investment across

sectors is allocated according to the planners' priorities. It is assumed that public sector development program will not crowd out private investment". After offering this criticism of the past, the Planning Commission promised a strategy that would factor in Pakistan's situation in 2010-11 and also the development in economic thought. "Never has there been a more pressing need in Pakistan's history to search for a new model". It suggests that the country needs to move from 'hard' to 'soft' growth<sup>2</sup>.

52. 'Hard' approach means large public sector investments in brick and mortar development—building roads, bridges and dams and, yes, building buildings. What was needed were a combination of efforts that would improve the quality of governance, less interference by the government in the working of the private sector, encouraging greater innovation within the economy, and greater focus on the activities that would produce higher rates of growth with low rates of development. Implicit in this strategy was the recognition that it will take a long time to increase the rate of investment, in particular by the public sector. For this to happen, it will require some fundamental changes in the tax system, something for which there was no or little political appetite. Nonetheless, the economy could be made to perform better by improving its efficiency. In the jargon of economics the policymakers should work to lower the incremental capital output ratio.

53. However, the Commission did not recognize that the 'soft' approach would take a long time to become embedded in the structure of the economy. Following it would not help the country climb out of the low growth trap into which it had fallen. Recognizing, albeit implicitly, that the existing institutional structures and the prevalent style of governance could not place the economy on a higher growth plane, the FEG put its faith in the private sector. This is a throwback to the approach advocated in the late 1980s and the early 1990s by a number of Washington-based think tanks and development institutions. This was the reason why the policies they advocated came to be called The Washington Consensus.

54. The Planning Commission has rightly emphasized the importance of governance and private sector and has rightly criticized over-emphasis on Public Sector Development Programme (PSDP) in past strategies. However, it is believed that by pursuing the strategy proposed by the Commission, Pakistan will not rescue the economy from its current slump. The role of state and public policies in accelerating growth and ensuring greater fairness in the society cannot and should not be ignored. No doubt the incoming governments would face the major challenge of restoring public institutions, enforcing the rule of law and strengthening public accountability mechanisms. But the political order is moving in the direction of facing these challenges under pressure by an active judiciary, a free media and civil society.

### ***Need for a Comprehensive Development Strategy***

55. Beyond tackling the immediate and urgent problems of macro-economic imbalances, there is need for a longer-term vision and a comprehensive long term strategy which aims not only at reviving strong sustained growth but also making it more equitable. It is not the purpose here to present such a strategy but merely to highlight the following key elements that have been relatively ignored in the past and deserve renewed focus and priority.

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<sup>2</sup> Planning Commission. *Towards a New Growth Strategy*. Islamabad, The Planning Commission, January 2011.

- Improving Governance
- Increasing Export Orientation
- Renewed focus on Human Resource Development
- Moderating Population Growth
- Reviving Savings and Investments but focusing especially on productivity growth
- Managing the Energy Crisis
- Reinvigorating both agricultural and industrial growth

### ***Improving the Quality of Governance***

56. One important theme that runs through this paper is that the Pakistani state—which means the numerous institutions that support the working of the government and guide the interaction of the citizenry with them—has been weakened over time. This weakening was the result of many factors, most notably the political roller-coaster ride Pakistan has been on ever since it became an independent state 65 years ago. With frequent changes in the political order, the state’s institutional structure did not have the time to develop. There is now an opportunity for the political order to develop towards a genuinely representative system of government. There is now consensus in the country that Pakistan should be governed by a system that gives voice to its diverse population. This implies the establishment of a durable political order.

57. This raises an important question: how should the state improve the functioning of the institutions of governance? Our approach would not result in expanding the role of the state in the economy but by improving it. A number of small steps should be taken that would incrementally improve the working of the government. The focus should be on close collaboration between the public and the private sectors.

58. In a real sense, improving governance must be key element in a growth strategy. If the quality of governance had not deteriorated as much as it did in the last several years, if the strength of public institutions had not eroded over time, if adequate resources had been mobilized through taxation to provide basic public services especially law and order and education, the growth challenge would have been less severe. Over time, growth and governance problems became increasingly intertwined. Because growth benefits were not widely shared, the quality of public services especially education deteriorated and the pace of poverty reduction slowed. Consequently, there was a palpable increase in social tension, with increasing frequency in ethnic, sectarian and random violence.

59. Now, the biggest threat to the country and the economy comes from the militants and Jihadists who would like to impose their narrow version of Islam on the society. Only belatedly is there a realization that the ‘Pakistani Taliban’ poses an existentialist threat to the county. It was reported in the press that the military, following an exceptionally bloody December 2012, changed its strategy, recognizing militancy as the most important threat the country faced at this time. The new doctrine was added to the Army’s ‘green book’ under the chapter ‘sub-conventional warfare’. According to one newspaper report, the Green Book says that “some organizations are out to annihilate Pakistan and their terrorist activities in tribal and urban areas are aimed at achieving the same target. These attacks are planned very

skillfully and can be countered through a matching expertise.”<sup>3</sup> The perceived threat from India had been central to the military’s strategy up to this point. Now that the military is fully on board, new political leadership would have to prepare the country for strong actions both against sectarian violence and Talibanization. If the country cannot counter the threat from the extremists, its future as a modern, moderate, and prosperous society will be at great risk.

60. Without necessarily increasing the role of the state, governance can be improved significantly through: 1) the erection of a firewall between executive authority and the accountability mechanisms and strengthening the deterrents to prevent the abuse of power and breaking of the law. It would be fair to say that Pakistan has one of worst records in punishing wrong doers, whether politicians, bureaucrats, businessmen or military leaders; (2) taking effective steps to de-centralize authority to the local government level initially at least for social services; (3) making serious efforts to reform the civil service and restore the independence of public institutions through autonomy, proper selection of top management and professional staff, and adequate pay; and (4) encouraging and respecting civil society at all levels of government.

### ***Accountability***

61. Pakistan has tried several institutional mechanisms for ensuring that public officials, both elected and those belonging to the various administrative services, will be accountable for carrying out the duties entrusted to them. Each institution ultimately was politicized, losing the confidence of the citizenry. Three improvements in the existing system should help to restore confidence. Following the approach adopted in India, Pakistan too should pass a law that would allow citizens to obtain information about the actions taken by government officials and the practices followed by various ministries and departments. It was access to this information that led to the discovery of a number of malpractices by various Indian government agencies including the sale of G2 mobile phone licenses and grant of coal mining concessions to private operators.

### ***De-centralization***

62. Under President Musharraf there was introduction of a genuine—albeit ambitious—devolution plan transferring several powers from the federal and provincial governments to the local level.<sup>4</sup> The lynchpin of the plan was the elected office of District Nazim (head) with substantial authority and responsibilities for economic and social development functions. It is not clear, however, whether the local government system devised by President Musharraf will survive. The provincial government in general and members of national and provincial assemblies in particular regard elected local district heads as competitors for influence in their respective domains.

63. The Sindh Government seems particularly opposed to the transfer of much authority to elected local representatives. There is a political divide in the province. Although the PPP and the MQM are coalition partners in both the federal and provincial governments, the two parties have very different agendas. The MQM’s main constituency is urban Sindh, in particular the city of Karachi. The PPP appeals to the countryside. A decentralized system of government with power in the hands of elected mayors suits the MQM; the PPP prefers a

<sup>3</sup> The Nation. *New Army Doctrine declares guerrilla activities, bombings as biggest threat*. 3 January 2013, p. 1.

<sup>4</sup> For details see Chapter 8 of 2010 Annual Report of IPP.

more centralized political order. Under pressure from MQM the coalition government in Sindh has proposed a hybrid system of local government in which only major urban centers will have de-centralized authority.

64. The danger of elite capture and further increase in corruption are often cited as arguments against devolving too much authority to local governments. These dangers are real but can be mitigated by instituting the office of independent provincial prosecutors for all districts who will be responsible only to the Federal or Provincial Ombudsman depending on the nature of crimes being investigated. In addition, the provincial government in making budgetary allocations should remain responsible for oversight, regulation and monitoring of the quality and quantity of services delivered.

65. On the positive side, healthy competition among districts could improve their performance as Nazims attempt to burnish their reputations and attempt to showcase their administrative skills.

66. Also, without devolution much needed improvements in public service delivery especially education will not take place. Public expenditure on education at 2 per cent of GDP is woefully inadequate. However, some political promises to treble or quadruple this level of expenditure are totally unrealistic because of the financial constraint the country faces. The fact is that, as discussed later, public schools are steadily losing ground to private schools even in the rural areas where private schools do not charge very high fees. The quality of public sector education remains a critical concern—there is evidence of the presence of ‘ghost schools’ and ‘phantom teachers’ in the system that claim scarce resources without providing the needed services. These failings require structural solutions such as transfer of authority to local bodies, public-private partnerships, and even school vouchers that can be used in private schools.

67. The public sector can and should play leadership and catalytic roles. Shahbaz Sharif’s (Punjab’s Chief Minister) initiative, called the *Danish* schools, can produce positive results including creating pride in the excluded communities studying in excellent institutions located in their midst. But these schools are expensive to establish and manage. One approach would be to involve the private sector in this initiative. Civil society in the districts could be encouraged through promotion, land grants and selective subsidies to establish such schools countrywide on a scale and speed that is not likely to be possible otherwise.

### ***Civil Society***

68. Pakistan needs to draw lessons from countries where the state’s weakness was compensated for by the development of various institutions in private space. Bangladesh is a notable example of a country that founded several non-government organizations to provide the citizens the services that are normally in the domain of the state. The same trend is evidenced in Pakistan. The void left by the state has been filled by private institutions that operate in a number of different areas. It has been noted by a number of analysts that Pakistan is now one of the more ‘giving’ societies in the world financed by donations from the citizens in the country as well as those of its people who live and work abroad. These charitable organizations are doing impressive work in the sector of education that could become the basis of a new approach to increasing the extent of literacy as well as improving the skill base of the population. Microfinance is another area where, with the active



involvement of the private sector, Pakistan has outperformed even Bangladesh where this form of lending was institutionalized. It is worth noting that women have been very active in developing this part of finance. Mobile telephone banking is another important area of economic activity.

69. **Intellectual Back Up and Public Education:** There is an intellectual vacuum in Pakistan on economic matters which hurts informed public debate and limits the impact of what would be a more balanced and less biased media reach. The level of academic research and economic literacy is low. This is partly because Pakistan has relied for long periods on analysis done by international financial institutions notably the World Bank and the IMF. Many of the domestic policy institutes remain dependent on foreign funding.

70. Major organs of the state require more intellectual backup and analysis. For instance, the Council of Common Interest has become critically important for resolving disputes among provinces and between the provinces and center, and coordinating economic policies between center and the provinces, especially now that the provinces are at the forefront of development activity. The Council needs to be supported by a permanent secretariat.

### ***A New Compact with the Private Sector***

71. Pakistan's relations with the private sector have been through several iterations. The present system remains flawed. On one hand, the private sector continues to look to government for opportunities for creating economic rents through devices such as SROs. On the other, public sector presence and involvement in economic activity in many cases is either excessive or unnecessary and is source of inefficient use of resources that could be employed more effectively in fields such as infrastructure development.

72. This may be a good time to dispel the ambiguity and define a relationship in which both—the state and private entrepreneurs—will have the confidence that will endure. The present government made an effort in this context when the Private Sector Development Task Force (PSDTF) was convened in the winter of 2009. It comprised both senior public officials as established business people. The task force was co-chaired by a Pakistan economist based in Washington with deep knowledge of development in many parts of the world and a Lahore-based businessman who was also actively involved in developing institutions of learning aimed especially at producing business leaders. The PSDTF met several times and was called upon on several occasions to brief President Asif Ali Zardari and then Prime Minister Yusuf Raza Gilani. The Task Force prepared a report and presented it to the government. It had a detailed policy matrix with an accompanying time line for taking actions in the recommended areas. As has been the case with several other such efforts, the government took no action, keeping the report on its crowded shelf. In several places in this paper suggestions have been provided on how the government could work with the private sector to add to the amount of resources that need to be committed for developing the economy and improving citizen's welfare. Specific suggestions can be summarized as follows:

- Issue of a policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector;
- Issue of policy frameworks for the involvement of private sector in the development of education, health and vocational training;
- A thorough examination of the regulatory landscape with the aim of weeding out those regulations that have lost their relevance. Some of them such as those

pertaining to agricultural processing and marketing are redundant and are in place since they have created rent-seeking for some vested interests. At the same time existing regulatory agencies like SECP, CCP, OGRA, NEPRA should be strengthened and made more autonomous.

- Formulation of a program for the privatization of some of the economic assets that remain under the control of the public sector. These include PIA, National Shipping Corporation and Karachi Steel Mills. The funds generated by these sales should be put in the aforementioned Future Generations Fund.

73. The Governments both at the federal and provincial levels also need to deepen their involvement with private sector bodies but especially independent institutions like the important Pakistan Business Council. Among the existing institutions, the role of the Planning Commission needs to be redefined and its function of liaison and coordination with provincial planning authorities needs to be considerably strengthened in light of the new distribution of powers. At the same time the Planning Commission needs to become a leaner outfit discarding some of the functions not central to the planning processes.

### ***Making Exports a Major Driver of Growth***

74. An important feature of Pakistan's history is that it has continued to fall behind other developing countries in export development by not exploiting tremendous opportunities offered by international developments. Development strategies followed by various administrations in the country did not pay attention to having the export sector become one of the drivers of growth as was very successfully done by the 'miracle economies' of East Asia.

75. The remarkable expansion in international trade in manufactures has been the engine of global growth and leading edge of globalization over the past several decades. Manufactured goods exports increased almost steadily from less than USD 200 billion in 1970 to a peak of USD 11.5 trillion in 2011, showing an average annual growth of 10 per cent. While the nature of international trade in manufactures has changed quite significantly from finished goods to intermediate products or components, the growth trend was sustained till 2008. However, there was a fairly sharp decline in 2009 due to the deep international recession but there was a quick recovery in 2010 and in 2011 where the earlier peak was exceeded.

76. The biggest economic story of recent times is the rise of China in substantial part due to its spectacular success in expanding exports. Chinese manufactured exports have risen nearly two hundred fold over the last three decades and their share in world trade has grown from less than 1 per cent to 15 per cent over 1980-10. However, China is not the only country to have benefitted from the expansion and restructuring of global trade. Other major developing countries have also increased their share in world manufactured exports from 7 per cent to 22 per cent over the period. In contrast Pakistan's share has improved only marginally from 0.12 per cent to 0.16 percent and probably is lower now than it was in 1970.

77. The ratios of total exports of goods and services to GDP also presents clear evidence of how far Pakistan has fallen behind in the export market. China and most other East Asian countries are in a class by themselves but traditionally inward looking economies like India, Turkey and Bangladesh have increased their export orientation remarkably in the last thirty years. In 1980, India had an export-to-GDP ratio (6 per cent) half that of Pakistan (12 per

cent) but in 2010 its ratio was 23 per cent—double that of Pakistan. Even Bangladesh with an export-to-GDP ratio of 18 per cent has moved ahead in this respect.

78. There are several reasons why Pakistan has not succeeded in the export field. First, export growth was never a central pillar of development strategy unlike Korea, Malaysia and China, and more recently Turkey and Vietnam. Second, Pakistan has the least diversified manufactured exports among major developing countries because there was an excessive focus on its principal manufactured exports, textiles and clothing, and this sector was artificially supported for a long period through the domestic price of cotton set well below the international price. Furthermore, because of slow growth in productivity, insufficient investments in moving up the value chain in textiles and clothing, and lack of sufficient diversification in promising areas such as other manufactures and high valued added agricultural products, Pakistan's export competitiveness has suffered. Last but not least, because of political tensions trade with its large neighbor India, which should be the country's natural trading partner, is quite limited. Pakistan has also not availed fully the potential of close relationship with China to promote exports: indeed it has a large trade deficit with its big neighbor.

### ***Opening to India***

79. The gravity model of trade suggests that Pakistan should trade more with the large countries in its immediate neighborhood—China and India. The recent thawing in the relations between these two South Asian nations should add significantly to their trade and growth. The possibilities of expanding trade with India need to be followed up urgently and diligently. While there may be losers and winners resulting from this trade expansion, the overall impact on Pakistan will most certainly be very positive.

80. At the same time to deal with the large negative balance with China, public policy should aim to develop supply chains that will link up with China's large industrial sector. These chains should take advantage of the entrepreneurship that exists in the sector of small and medium engineering.

81. Some will argue that the boom in world exports is over and in any case Pakistan has now a very steep hill to climb in terms of competitiveness. But the pessimism about further globalization is not justified. International comparative advantage will continue to shift. Like Japan earlier, the share of many East Asian countries in labor intensive manufactured goods has been declining. Recently the rate of exports from China has also slowed reflecting cost pressures emanating from higher wages; Pakistan's exports of cotton yarn and fabrics have trebled in the last three years. Pakistan has the further advantage that its share in manufactured goods other than textiles and clothing is miniscule. So even with the slowing in international trade Pakistan can hope to gain market share provided it follows policies that strengthen competitiveness, improve the base of technology, diversify the product mix, and move up the value chain.

82. As discussed later, in the foreseeable future, Pakistan cannot catch-up with its competitors in the rate of capital formation. It must rely on sharper gains in factor productivity to get to a high growth path. Rapidly rising exports can be an important instrument for improving productivity and keeping capital requirements for growth low.



83. The specific policy actions that should be taken to promote exports are:
- An exchange rate which fully reflects the differential between the movements in Pakistan prices and the international price level,
  - A review of all SROs and their gradual elimination in three years because they essentially increase domestic protection and thus increase the anti-export bias.
  - Strong incentives for new investments and skill upgrading in textiles that increase scale and update technology while encouraging the exit of enterprises with low productivity and profitability
  - A determined push aimed at small and medium industries for expansion and export diversification in areas outside textiles
  - Joint public and private sector efforts to promote foreign investment in textiles, clothing and other promising export sectors from countries like Korea, Hong Kong, Malaysia, Taiwan, and also China which are losing ground in labor-intensive industries due to high and rising wage costs. The focus of these efforts should be to encourage foreign investment that will help to upgrade skills and technology and make use of established export channels.
  - A special focus on expanding exports to regional partners especially China and India, the two fastest growing economies in the world. The large negative trade balance with these countries can provide some leverage.
  - A special and speedy implementation review of the free trade agreement and establishment of freed trade zone with China and assessment of their likely impact on exports in the near term.
  - A similar review of key constraints and principal opportunities for expanding trade with India
  - Focus on the development of export supply chains using the work being done in the context of the National Trade Corridor Improvement Project (NTCIP).
  - Strengthening monitoring mechanisms including quarterly meeting of the high level Export Board
  - Implementing recommendations in the Strategic Trade Policy Framework 2009-12 to reduce anti export bias through the withdrawal of protection from inefficient industries, minimization of taxation at investment stage, and elimination or zero rating of customs duty on important inputs to textiles and clothing exports.
  - Closer coordination of commerce ministry policies and activities not only with textile ministry but all other production-related ministries appears to be sorely needed.

### ***Human Resource Development***

84. By now it is fully recognized that Pakistan has neglected the development of its large human resources. Most indicators point to human under-development. This may be an appropriate time to do some out-of-the-box thinking. A suggestion in this context can be more aggressive public-private partnership in the areas of education and health, and giving special attention to having women make a larger contribution to the development of the economy.

### ***Role of Private Sector***

85. A recent Financial Times article draws the world's attention to the role the private sector and private enterprise is playing in delivering a variety of services to the poorer segment of the population. "...at the grassroots, Pakistan is in perpetual motion, with

ceaseless activity as people find affordable solutions to their basic needs. These largely hidden forces of resilience offer the best hope for the country's future. In Pakistan, the state may be fragile but society is far stronger than many think."<sup>5</sup> The article also points out the important role private charity is performing in helping the poor. This was evident at the time of two floods that hit the country in 2010 and 2011 respectively.

86. The private sector has done extremely well in the sector of education. Low-cost private sector schools, charging perhaps USD 2 a week, are booming in slums and villages. Many such schools work in the homes of families that have girls who have received decent education and are prepared to put it to use to earn a living. A number of charitable organizations are active in building and managing schools in the country's poorest areas. Each large organization follows its own business plan. To take one example: the Karachi-based Citizens Foundation has built 900 high quality schools in the country's poorest areas. The buildings that house these schools are modern and well designed. This is done to create community pride in the school, often located in a slum area. The teaching staff is entirely female, many of them graduates of the schools established by the charity.

87. There are other models that are working equally well. In other words, while demand for education is outpacing the state's financial and organizational capacity to meet such basic needs as education, the private sector has shown the capacity to fill the void. The state should take advantage of this. As a practical matter the state should come up with a program for inviting the private sector to participate in the development of neglected sectors of education and health. To begin with, the provinces should be encouraged to privatize some of the educational facilities in the public sector that are, at best, providing indifferent education.

88. The same approach could be followed in the health sector with the provincial governments selling some of the district hospitals to private operators.

#### *Public Education*

89. Despite a remarkable growth in the role of private education, it is a matter of great concern, as discussed earlier, that the improvement in social indicators witnessed over most of the past decade appears to have slowed down in last two or three years presumably under financial pressures and slow economic growth: 44 per cent of school age children were still not in school in 2011, the literacy rate among 15 years and older which had improved from 44 per cent in 1998 to 57 per cent in 2009 was only 58 per cent in 2011—this despite a continued rise in female literacy that now stands at 46 per cent. Pakistan will miss the millennium goals in education and literacy.

90. Public clamor for greater access to education and deep concerns with the quality of public education have led to all major parties putting stress on education in their election platforms. However, promises being made to raise the public expenditure from a paltry 2 per cent of GDP to 5-6 per cent are totally unrealistic. Given financial constraints, an increase to 3 per cent in the next few years would be quite an achievement. A substantial part of the improvement in education must come from improving the efficiency of public expenditures. Eliminating fictitious expenditures, steps to increase teacher training, reducing teacher absenteeism and greater teacher accountability are largely in the domain of improved

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<sup>5</sup> Charles Leadbeater. Time to look again at Pakistani Society. *Financial Times*. November 07, 2012.

governance—transfer of responsibilities to local governments remains as important as increasing public funding for the sector.

### ***Moderating Population Growth***

91. It is true that Pakistan's large population—in a world where most of the developed countries begin to see a fairly steep decline in working age population—in less than two decades can be a potential asset provided it has the right education and work skills. But it is also true that rapid population growth continues to hamper growth in incomes and employment. Therefore, population control issues deserve more attention than they are receiving. Fortunately, population transition has begun: the growth rate of population has come down to 1.8 per cent per annum. However, fertility rate is still high 3.6 compared to Bangladesh (2.4) and India (2.6) and so is the desired family size. This accounts for the much lower growth rate of population in these two countries than in Pakistan. In terms of policy action, focus should be on the high fertility rate of 4.5 in rural areas through continued acceleration of women's education, employment opportunities for them and availability of family planning services. In general and especially in rural areas, continued policy efforts to encourage reduction in birth rates will help increase savings, reduce poverty and make it easier to improve social indicators.

### ***Focusing on Productivity Growth***

92. Reviving economic growth will require a significant increase in rate of fixed capital formation which touched a low of 11 per cent of GDP in 2011-12. But because of the financial constraints it may be difficult to raise the rate beyond say 15 per cent of GDP by 2018, much less than the 20 per cent required for a sustained 6-7 per cent annual growth rate. So in the near future a large part of the revival of growth would have to come from exploiting unused capacity and productivity gains.

93. There are a number of ways in which economic policies can encourage productivity growth and disperse economic benefits without enormous amounts of investment while serving other objectives like raising revenues, improving wage income, and reducing economic rents.

94. As mentioned above, promotion of labor intensive exports both manufactured goods and agricultural products like fruits and vegetables could have a large payoff in terms of a unit of investment. Similarly moving up the value chain in textiles and clothing, Pakistan's principal exports, and other exports would yield productivity gains.

95. One way to make sure that economic incentives do not protect low value added sectors would be to review and phase out SROs. This will not only improve government revenue but also improve equity in the society and encourage entrepreneurial behavior. As noted above, most SROs provide domestic protection which increases the anti-export bias. On the other hand under-invested areas like agricultural processing, marketing and storage could be provided investment incentives. There are major gains to be had in improving the use of inputs in agriculture notably water, fertilizer and seeds. Nothing in this area is quite as important as improving the efficiency of irrigation water use.

*Efficiency of Water Use*

96. Without immediate attention given to the proper use of water, Pakistan will face a serious problem in the not too distant future. Water availability has declined from about 5,000 cubic meters (cm) per capita in the early 1950s to less than 1,500 cm in 2010. According to 2008 data from the Food and Agricultural Organization (FAO), Pakistan ranked last in a list of 26 Asian countries in terms of water availability. The country is expected to become ‘water scarce’ which is defined as a country with annual availability of below 1,000 cm by 2035—though some experts project that this could happen as soon as 2020<sup>6</sup>. Much of the decline is because of global warming. Few areas in the world are suffering as much from climate change as are the Himalayas that are estimated to be experiencing a thinning of the glacier cover by as much as a meter a year. A recent report by IFPRI has reached a number of worrying conclusions based on productivity declines for most major South Asian crops. It projects that wheat yields could decline by as much as one-half in the next quarter century.

97. Where there is water there is corruption. This is evident in both rural and urban areas. In the countryside powerful politicians who are also large landowners have no desire to push for a real overhaul of farming practices. In the large cities—Karachi in particular—‘water mafias’ charge exorbitant amounts to supply water to the parched communities. Most of the water they bring by trucks is stolen from the pipes in the extensive public system. Those responsible for managing the public water supply infrastructure are paid by the mafia to look the other way while water is being stolen.

98. Pakistan uses most of its available water for agriculture, which is quite high as compared to its development counterparts. History has a lot to do with the pattern of water use. An estimated 90 per cent of available water is used on the farms, leaving only 10 per cent for other purposes. Consequently, “anywhere from around 40 to 55 million Pakistanis—about a quarter to a third of the country’s total population—do not have access to safe drinking water.”<sup>7</sup>

99. The solutions to the water problem are as well-known as the problem itself. The two important ones are worth recalling. The first is proper pricing of water that would reflect its scarcity; the second, better management of the vast irrigation system to reduce wastage. The two solutions should be taken together: the amount of resources generated from increased water charges could be earmarked for system maintenance. While ‘ear-marking’ is not favored by economists it helps to create constituencies for raising additional incomes from taxation.

100. Proper pricing of water will also create an incentive structure that will impact the pattern of cropping and also bring in new water-saving technologies. Cheap water has meant that Pakistan has allowed extensive cultivation of high water-intensive crops such as sugar cane. These need to be replaced by the crops that use less water. A changed water-pricing structure should also create incentives for the farming community to start using technologies such as drip irrigation. According to Adrien Couton, a water expert who works for an NGO with experience in Pakistan, “...drip irrigation has particularly attractive characteristics. It

<sup>6</sup> The data are from Asia Society, *Asia’s Next Challenge: Setting the Region’s Water Future*, New York, 2009.

<sup>7</sup> Michael Kugelman and Robert M. Hathaway, *Running on Empty: Pakistan’s Water Crisis*, Woodrow Wilson Center for Scholars, Washington Dc, 2009.

generates massive increase in the efficiency of water use (the increase in yield as compared to conventional irrigation methods is from 20 to 100 per cent while saving in water ranges from 40 to 70 per cent). It offers much more granularity than typical infrastructure intervention, since no heavy capital investments are involved, and investments can be easily spread geographically and over time. Drip irrigation also delivers immediate benefits. Finally the system is to educate the end users about the immediacy of the water issue and the urgent need for more water efficiency”.<sup>8</sup>

### ***Role of Women***

101. Helping women to become active participants in developing and modernizing the economy has to be an important part of the long-term growth strategy. Women’s assigned roles serve as drags on the economy. They affect the rate of growth in output, keeping it at a lower rate than would be the case if women participated more actively in the labor force. Pakistani economists have not factored into their analyses the role Pakistani women can play in developing their country if their participation in the work force was to increase and if their productivity increased through better education. If women figure in economic writings on Pakistan at all it is usually to highlight how far they have been left behind in social development and how this could serve as a drag on economic growth. Not enough attention has been paid to the fact that the real economic role of women is underestimated, particularly their participation in the workforce. Most of the work they do in their homes or the time they spend looking after the animals owned by the families is either not reported or not fully counted. In the writings on Pakistan both the negative and the positive consequences of the lack of progress in improving the wellbeing of women have not been fully investigated.

102. Encouraging and enabling greater participation of females at all levels of society would not only help improve labor productivity but also work against the extremist forces that aim at diminishing the role of women in modern society.

### ***Skill Upgrading***

103. Finally much more active policies to improve literacy and upgrading labor skills are needed especially in information technology. This is another area in which private and public sector should work closely to develop appropriate policies and incentives.

### ***Managing Energy Crisis***

104. Over the years Pakistan’s energy sector has been studied from several different angles. It was looked at by the World Bank and the Asian Development Bank in some detail. Both institutions provided technical advice as well as finance for developing the sector. More recently the energy problem has received the attention of the USAID. The Americans have identified the sector as one of their priority areas under the Kerry-Lugar initiative. They have concentrated their efforts on the supply side of the equation, offering assistance for several electricity generation projects. The Planning Commission was given the mandate to come up with a solution for easing the shortage in electricity supply that is causing enormous amount

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<sup>8</sup> Adrien Couton. “Tackling the water crisis in Pakistan: What entrepreneurial approach can do”, in Michael Kugelman and Robert M. Hathaway (editors), *Running on Empty: Pakistan’s Water Crisis*, Woodrow Wilson Center for Scholars, Washington Dc, 2009.



of discomfort to the people and badly hurting the economy. Building upon these analyses some ideas are discussed that could bring about both short term easing of the situation as well as setting the stage for a long-term development of the sector.

105. It is clear from the way the sector has developed that the problems it now faces are the product of poor public policy. At no time in its history, has Pakistan developed a consistent approach towards the development of a sector that is critical for the health and growth of the economy especially taking into account the sharp rise in international oil prices and the country's large energy deficit. The result is that the sources used for augmenting the supply of electric power did not reflect the country's comparative advantage. Each time the country faced a crisis it turned to whichever source of generation was available with little attention given to the long-term cost to the economy of the choice that was being made.

106. At this time the sector faces three problems. Each of these needs a different solution. To begin with there is the problem of 'circular debt', now estimated at PKR 872 million, which is the consequence of the type of contracts that were negotiated with independent power producers (IPPs) to solve the crisis the country faced in the 1990s. The private entrepreneurs who came into sector were given several guarantees, the most important of which was the commitment to purchase the power they produced at a pre-agreed price. These 'take or pay' contracts shifted the financial burden to Water and Power Development Authority (WAPDA) and by default to the government. Since the government lacked the political will to levy appropriate tariffs from the end-users, timely payments were not made to the IPPs. The circular debt became 'circular' when the IPPs failed to make payments to the suppliers of fuel to their plants.

107. The second problem concerns the organizational structure of the sector. For several decades generation, transmission and distribution of power were the responsibility of one public sector entity—WAPDA. Then, advised by the World Bank, the sector was split into several quasi-autonomous institutions, each with its own responsibility. This was done to prepare some parts of the sector—distribution in particular—for privatization. That has not happened and the advantages available because of aggregation were lost. This advice was in line with the thinking of the time at which it was given—a strong belief in the ability of the private sector to do both economic and social good. There is no longer that blind faith in the working of the private sector.

108. The third problem relates to sources used for generating power. These don't appropriately reflect Pakistan's endowments. The country should have relied much more on hydro and power produced from coal. However, the largest source is imported oil which accounts for 35.1 per cent of total supply. Hydel-power accounts for another 33.6 per cent. The share of natural gas—a dwindling resource—is 27.3 per cent. The share of nuclear power is 6 per cent. Coal accounts for a minuscule amount—only 0.1 percent. A central long term challenge is to mobilize large resources needed for Diamer-Bhasha Dam (USD 8.5 billion) or standalone hydro-projects. In light of reservations expressed by international development banks about some of these projects, alternative sources such as the prosperous Pakistani Diaspora or friendly countries like China, Turkey and Saudi Arabia, if necessary can be offered a part of the likely high return on hydro-electric power.

109. In order to solve both the short- and long-term problems faced by the energy sector the government could explore the possibility of shifting the management and part ownership

of some thermal plants operating in the public sector to an entity which can sell a part of its share to the private sector. The entity should also issue bonds backed by its assets in order to liquidate the accumulated circular debt. The private sector should also be invited to participate in the development of renewable sources of energy, in particular solar energy.

110. Under the 18th Amendment the provinces have the authority to invest in the development of the energy sector. This could be encouraged by the assurance that power supply to them from the national grid would not be reduced if they generated significant amounts of own supply. A market for trading powers could be developed in which the provinces can buy and sell electricity to each other. The implication of this for various provincial interests should be examined.

111. As mentioned earlier, the need for further power tariff adjustment is also clear. But the consumer resistance to tariff increases is very real because they do not see any progress in reducing load shedding or reducing line losses. Simply pushing for power rate adjustments could be counterproductive in terms of line losses. Aggressive effort to control electricity, oil and gas theft must be undertaken because they will help both to improve revenues and to improve the image of the electric power supply companies.

### ***Reinvigorating Agricultural Growth***

112. In sectoral terms, revival growth would require major acceleration in growth rates of major sectors, agriculture and industry. Industrial growth should be led by exports and use of unutilized capacity due to energy shortages.

113. Pakistan's agriculture, despite its large potential, continues to underperform. Agricultural growth which averaged nearly 4 per cent per annum over the 40 year period from 1960 to 2000 slowed down to around 2.5 per cent in 2000-12. This occurred notwithstanding a buoyant livestock sector and sharply rising level of milk production. A part of the reason is the availability of water—mostly surface irrigation—which trebled between 1960 and 1990 and is now no longer increasing. Also there has not been any major breakthrough in major crop yields which continue to remain low.

114. The reasons for the above are well known but no systematic attempt has been made to address them in public policy. The areas that need the state's immediate attention are (a) increased efficiency in the use of water (discussed above); (b) improvement in the use of modern technologies and basing them on Pakistan's circumstances; (c) changing the system of incentives in order to have a cropping pattern that conforms to the country's comparative advantage; (d) modernizing agricultural marketing; and (e) increasing agricultural exports to the food-deficit as well as high-income countries in the neighborhood.

115. In terms of crops, it is doubtful whether Pakistan would have any special comparative advantage in export of wheat except to Afghanistan. However, it should remain a marginal exporter in good years in order to ensure domestic food security. Cotton exports would be more promising, especially by switching to genetically modified cotton, but the bulk of future agricultural exports would probably come from fruits and vegetables and milk and meat. Detailed studies on possibilities of agricultural exports are needed.

116. Pakistan needs to invest more in improving the technological base of the agricultural sector. The country inherited a fairly well developed system that combined agriculture education, research and extension. Not much was done after independence to keep the system current and expand its scope. This is one reason why agricultural productivity has fallen so far behind that of India. This is another area where a partnership with the private sector could help. The government should invite the private sector—especially that part of the sector that is now involved in processing and marketing of agricultural products—to join hands with the government to set up institutions devoted to research and extension.

### ***Inclusive Growth and Poverty Reduction***

117. A strong revival of growth on the lines suggested above would help reduce poverty and contribute to a fairer share of growth benefits. Development experiences of China and India over the last few decades suggest that high growth through tightening of labor market and increasing real wages has been a major factor in lifting millions out of poverty. Pakistan cannot of course hope to achieve annual growth rates of 8-9 per cent in the near term. But much greater emphasis on job creation through expansion of labor intensive exports, small, industry and agriculture could dramatically transform the employment situation especially for women and educated but un-employed youth. On the other hand, strictly controlling economic rents and corruption practices that benefit the few would improve government revenues and enable access to good quality social services for the poor and middle classes. This does not necessarily mean that there would be no scope for increasing direct income support programs for the poor. For the present, however, the priority should be to improve the Benazir Income Support Program (BISP) that seems to be generally working well but is, nonetheless, marred by some corruption and favoritism. In any case, it would be a mistake, however, to try to abolish the program or change its name for political reasons.



## **Summary & Key Policy Actions**

### ***Public Finances***

118. In order to improve the fundamental weaknesses of public finances Pakistan needs a National Tax Policy and a strong political will to enforce effective implementation. The establishment of a National Tax Policy Office should be initiated.

119. In the meanwhile, a three year fiscal framework needs to be developed in the next three months. The goals should be to reduce the overall fiscal deficit to 4 per cent of GDP by FY 2016, eliminating the large revenue account deficit, and improving the tax-to-GDP ratio from 10 per cent in FY 2012 to 13 per cent. The main improvement in tax revenues should be planned from personal income tax collections at the centre and property and agricultural taxation in the provinces, as discussed earlier.

120. Both in the medium and long run much larger collections from the Federal Income Tax from individuals not yet in the tax net must be a critical pillar of a sound fiscal policy. Specifically, the Federal Board of Revenue should be given the target of bringing into the tax net a million non-salary households with a tax payment of at least 1 per cent of GDP over the next three years and should be asked to provide a credible plan to achieve this target.

121. A resource mobilization program for the provinces, the raising of provincial tax-to-GDP ratios from 0.5 to 1.5, should be agreed in the Council of Common Interest and should become the condition for meeting the resource transfer targets set out in the Seventh National Finance Commission Award.

122. In order to improve the effectiveness of public spending, comprehensive public expenditure reviews both at the provincial and federal level should be undertaken and completed by the end of March 2013. The immediate objectives should be to introduce a strict austerity regime for at least next two years for administrative expenditure and to maximize the short and medium term impact of development projects in the pipeline.

123. The dependence on financing of the budget deficit from Bank borrowing (including from the SBP) is reduced immediately to 1 per cent of GDP per annum. At the same time, the government must aggressively push the sale of public assets including state land and share of state-owned public companies.

124. A 'Fund for Future Generations' (FFG) should be established from the revenues received by the sale of public land and public sector enterprise. The FFG should be independently managed with its own expert staff doing investment analysis.

### ***Revival of Growth***

125. The revival of growth strategy should aim initially at restoring the growth rate of the economy to 6 per cent of GDP by FY 2016. In the current circumstances of widespread energy shortages and a low rate of investment, much of the acceleration of growth must come largely from higher productivity in factor use—more efficient use of capital and labor, and inputs like water and energy. The four key but inter-related elements that are the focus of economic revival in this paper are:

- i. Improved Governance
- ii. A clearer policy framework for the Private Sector and closer Private-Public Partnership
- iii. Much greater attention to trade strategy and priorities and induction of private foreign investment in support of exports, and
- iv. Quick resolution of serious power and gas shortages

### *Improving Governance*

126. Without necessarily increasing the role of the state, governance can be improved significantly through:

- Erection of a firewall between executive authority and the accountability mechanisms and strengthening the deterrents to prevent the abuse of power and breaking of the law. It would be fair to say that Pakistan has one of worst records in punishing wrong doers whether politicians, bureaucrats, businessmen or military leaders.
- Appointment of the Chairman of the National Accountability Bureau for non-renewable six year term. The process set in place for the appointment of the Chief Election Commission could be replicated in this case.
- Taking effective steps to de-centralize authority to the local government level initially at least for social services.
- Making serious efforts to reform the civil service and restore the independence of public institutions through autonomy, proper selection of top management and professional staff and adequate pay
- Encouraging and respecting civil society at all levels of government.
- Since the Council of Common Interest has become critically important in coordinating federal and provincial policy actions, a strong independent secretariat needs to be set up to support and assist Council's work.

### *New Compact with the Private Sector*

- Issue a policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector;
- Issue policy frameworks for the involvement of private sector in the development of education, health and vocational training;
- A thorough examination of the regulatory landscape with the aim of weeding out those regulations that have lost their relevance. Formulation of a program for privatization of some of the economic assets that remain under the control of the public sector—these include PIA, National Shipping Corporation and Karachi Steel Mills. The funds generated by these sales should be put in the Funds for Future Generations.
- The Commerce Ministry should publish all the SROs that have been adopted to-date by the government. These SROs should be withdrawn within a period of three years, to be incorporated in the General Trade Policy.

*Trade and Foreign Investment*

127. Pakistan has progressively lost market share to almost all major developing countries during the last several decades. It is imperative that this trend be reversed if growth is to be revived and the balance of payment has to become viable. In the absence of strong exports, the desired revival of investment from the present low level would intensify the current account difficulties. Expanded trade with the neighbors especially India and China, and induction of foreign private investment in directly productive sectors, would not only help in finding markets, improving technologies and upgrading worker skills but would also greatly strengthen the capital account of the balance of payments.

128. Some suggestions are as follows:

- India should be granted the most favored nation status.
- A permanent committee to watch over the development of trade between India and Pakistan should be set up with members drawn from both the public and private sectors. The committee should be provided with a secretariat of its own so that it can do the analysis that will be needed. The Committee should be required to table a report every year for discussion and adoption by the National Assembly.
- A quarterly meeting of the Export Board should be held every quarter
- A special effort be made in collaboration with the private sector to attract foreign investment in export field from newly industrialized friendly countries notably China, Korea and Malaysia.
- A quick review should be undertaken why some international agreements on trade and investment notably with China have suffered implementation delays and their execution should be speeded up.

*Energy*

129. The factors that constrain the use of existing power generation capacity should be effectively dealt with including the annual build up of circular debt.

130. There is general agreement that relieving the energy shortages is the most critical need for the economy. The need for further power tariff adjustment is also clear. But the consumer resistance to tariff increases is very real because they do not see any progress in reduction of load shedding or line losses. The near term plans must promise reduction of theft though early installation of proof meters and institution of strong penalties.

131. The organizational structure of the sector with heavy concentration of authority and responsibility directly or indirectly needs to be revisited. The involvement of provincial governments and the private sector on a range of activities including generation should be pursued on a priority basis and the freedom to delegate final pricing decisions to private sector, local government should also be explored.