IPP's Second Annual Report
2009

# State of The Economy: Emerging from the Crises

**Institute of Public Policy**
Beaconhouse National University

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# Institute of Public Policy
# Beaconhouse National University

Institutional backing is absolutely essential to policy makers of today, to guide their actions in promoting development and peace. These are times of change and challenge. There is a need for policy makers to base the policies on sound analytical work. Therefore, The Beaconhouse National University established the Institute of Public Policy as an independent, private sector think tank for research on economic, social, political and foreign policy issues.

IPP's mission is to; "work in the areas of importance for improving the welfare of the citizenry. Its work will focus in particular on public policies in areas of economics, social and political development, as well as on foreign policy".

Key activities of the institution include: independent and objective analysis of the economy; strategic analysis of the concepts and doctrines in selected areas of public policy; research in the areas that are important for regional cooperation; conduct seminars and workshops to bring together policy makers, experts and other members; undertake funded research projects and disseminate research findings with the view to enhance public awareness and contribute to debate on issues of public policy.

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| ■ Mr. Sartaj Aziz | Ex-officio Member, Vice Chancellor, BNU |

Dr. Aisha Ghaus-Pasha is Director of Research.

# PREFACE

This is the second Annual Report of BNU's Institute of Public Policy on the state of the Economy. In the first Annual Report, released in May 2008, the focus was on macro economic stabilization to correct serious imbalances in fiscal and external accounts, which the new government had inherited from the previous regime.

With some improvements in the macro economic indicators, following the sharp decline in the international oil and commodity prices and support from the IMF, the focus of the second Annual Report is on economic recovery and accelerated growth. Sub-sectors which can spearhead the process of recovery have been identified along with policy interventions that will be necessary to stimulate growth. The Report also outlines certain specific proposals for making the process of growth more inclusive and pro poor. I hope these proposals will be useful to policy makers in the Federal and Provincial Governments as they prepare their respective budgets for 2009-10.

The Report also emphasizes the close linkages between economic, political and security issues. Unfortunately, the deteriorating security situation has become the most serious impediment to political stability and economic revival. Separately, each of these crises could have been handled with strong political will and good governance but taken together, the security challenge, the political polarization and the economic crisis, are threatening the very foundations of the state of Pakistan. We therefore desperately need a national consensus on security issues, greater political reconciliation to strengthen democratic institutions and a strong and effective government to handle different dimensions of the economic crises.

I would like to thank Mr. Shahid Javed Burki, Dr. Hafiz A. Pasha, Dr. Parvez Hassan, Dr. Akmal Hussain, Mr. Shahid Kardar, and the IPP research team led by Dr. Aisha Ghaus-Pasha, for their valuable contributions in preparing and publishing this Report. I also wish to thank other members of Executive Council of the IPP for their guidance and support.

**Sartaj Aziz**
Vice Chancellor
Beaconhouse National University

# FOREWORD

This is the second annual report to be issued by the Beaconhouse Institute of Public Policy. When the institution was launched in the fall of 2006 we decided that the preparation, publication and the public launch of the annual report will be the institution's most important activity. It would be the collective effort of the senior people associated with the Institution and they would bring to the report the expertise they had on a variety of subjects. This effort has called for an enormous amount of commitment of time and energy on the part of the authors. It is gratifying that they were able to come together last year and again this year to reflect on some of the more important economic, social and security problems faced by Pakistan.

The 2008 report was also written at a moment of crisis. The country's economy had been destabilized because of the poor judgments on the part of the policymakers in the period 2005-08. The budget and the external account were managed poorly. At the same time the leadership had intervened in the running of the judiciary which created a backlash that was not anticipated. Coming on top of this was a sudden change in the country's terms of trade as a result of unprecedented increases in the prices of commodities - in particular oil and edible oil - of vital interest to the country's economy. These developments produced enormous pressures on the economy. That notwithstanding, the 2008 report presented a scenario of hope if the direction of public policy could be changed to address the crisis. We were of the view that there were opportunities present which the policymakers would exploit and set the country on a trajectory of economic growth and social development that would parallel those followed by other rapidly growing and transforming economies of Asia.

The hope on which we built the scenario for the future was also reinforced by the successful start of a process towards returning the country to representative democracy. Elections to the national and provincial assemblies had been held in February, three months before we launched the 2008 report, and coalition governments had been formed at the center and the provinces. There was an expectation that the country was on the path of developing viable political institutions to bring stability to the country. Factoring all these in our analysis, we came to the conclusion that with appropriate choices made by policymakers the country could return to the path of reasonable growth and also ensure that the fruits of growth were shared more widely among different segments of the citizenry.

Unfortunately our hopes were not realized because of a number of adverse developments. Political uncertainty remained as the country's external situation deteriorated as a result of the severe global economic downturn. This is taking a heavy toll on the economy in spite of the improvement in the country's terms of trade. Most worrisome is the increase in violence in the country associated with the rise of extremism. Pakistan has come to be viewed as the most dangerous place on earth. This, of course, hurts the economy, dependent as it is on external financial flows and foreign direct investment.

It is with this as the somber background that we have written the Institution's second annual report. We have, in this report, extended the scope of our analysis. We have suggested that the nexus between the lack of security, poor development of political institutions, and stress on the economy has produced a vicious cycle. This has to be broken into. Improving the security situation is the place to start. As was the case last year, we have once again provided a detailed overview of the macroeconomic situation upto 31st of March 2009. We are concerned that complacency may return to policymaking in Islamabad as a result of some positive developments. There has been a significant improvement in the terms of trade. We are about to see an increased availability of official development assistance (ODA) as the attention of the international community gets riveted on Pakistan. As has happened before, this may cause the policymakers to ignore the need for structural reforms that have made the country's situation so vulnerable to both external and internal shocks.

We have also incorporated analysis of the economic costs associated with the continuing shortage of electric power for industry and agriculture and also of terrorism. The costs of power loadshedding are high, at Rs 210 billion in 2008 and demand action from the government to moderate the demand for power by using the structure of tariffs as well as increasing supply. The cost of terrorism, estimated at Rs 380 billion in 2008 needs to be brought down by educating the citizenry as to the hurt that is being caused to them, to the economy, to the political system and to the society by not taking an unambiguous position on this deepening scourge.

We have drilled down deeply into the need for reforms in the sectors we had identified for greater attention by the makers of public policy. We have identified a dozen areas for focus by the government, suggesting action in some and further analytical work in others.

We finally provide a detailed reasoning of why the problem of poverty - in particular poverty in the countryside - needs to be addressed by the introduction of new and reform of old institutions that would make it possible for the underprivileged to take command over the lives and their economic and social future. In keeping with the substance in the growing literature on the subject, we call this participatory development.

We offer this report as a contribution of our young institution to public discourse on a number of issues of vital concern for our country at this delicate time. We hope that our analysis and our suggestions will invite the attention of the policymakers as they begin to formulate ideas for the budget of 2009-10; the development plan, also for that year; and trade policy. Pakistan at this time faces about the most difficult period in its history. The resolution of the crisis in which the country finds itself today will require resolute and imaginative action by policymakers. We hope we have provided some material that could help them in this difficult task.

Shahid Javed Burki

**Shahid Javed Burki**
Chairman
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IPP expresses its gratitude to Jehangir Karamat, Shahid Hamid and AZK Sherdil, for their intellectual insights and guidance. The Report has also benefited from the Interm Report of the Panel of Economists, the Report of the Task Force on Food Security and the deliberations of the Private Sector Development Task Force, Planning Commission.

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## BOXES:

# ACRONYMS

| | |
|---|---|
| AKRSP | Aga Khan Rural Support Programme |
| AMUL | Anand Milk Union Limited |
| AMCS | Automatic Milk Collection System |
| ANP | Awami National Party |
| BIMSTEC | Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Corporation |
| BISP | Benazir Income Support Program |
| BNU | Beaconhouse National University |
| BMVSS | Bhagwan Mahaveer Viklang Sahayata Samiti |
| BOP | Balance of Payments |
| BRICS | Brazil, Russia, India and China |
| CBOs | Community Based Organizations |
| CCB | Citizen Community Board |
| CIC | Central Information Commission |
| CEO | Chief Executive Officer |
| CFCs | Common Facilities Centers |
| CPD | Center for Policy Dialogue |
| CPI | Consumer Price Index |
| CSP | Communicating Sequential Processes |
| DA | District Administration |
| DCO | District Coordination Officer |
| DFI | Direct Foreign Investment |
| DFPI | Direct Foreign Private Investment |
| EIU | Economist Intelligence Unit |
| EOBI | Employees Old Age Benefit Institution |
| ERRA | Earthquake Reconstruction & Rehabilitation Authority |
| EU | European Union |
| FATA | Federally Administered Tribal Area |
| FBS | Federal Bureau of Statistics |
| FDI | Foreign Direct Investment |
| FIA HQ | Federal Intelligence Agency, Headquarter |
| FPI | Foreign Private Investment |
| GCMMF | Gujrat Cooperative Milk Marketing Federation |
| GB | Grameen Bank |
| GDP | Gross Domestic Product |
| GDR | Global Depository Receipt |
| GFCF | Gross Fixed Capital Formation |
| GNI | Gross National Income |
| GNP | Gross National Product |
| GOP | Government of Pakistan |
| GPO | General Post Office |
| GST | General Sales Tax |

| | |
|---|---|
| HSBC | Hong Kong and Shanghai Banking Corporation |
| HSD | High Speed Diesel |
| ICORs | Incremental Capital-Output Ratios |
| IDP | Internally Displaced Persons |
| IMF | International Monetary Fund |
| IPP | Institute of Public Policy |
| IPPs | Independent Power Producers |
| IPO | Initial Public Offering |
| ISC | Industrial Support Center |
| JF | Jaipur Foot |
| KSE | Karachi Stock Exchange |
| Kwh | Kilowatt Hour |
| LDA | Lahore Development Authority |
| LDO | Light Diesel Oil |
| LFS | Labour Force Survey |
| LIC | Low Income Countries |
| LUMS | Lahore University of Management Sciences |
| MAF | Ministry of Agriculture and Forestry |
| MAF | Multi Fiber Arrangements |
| MDGs | Millennium Development Goals |
| MIS | Management Information System |
| MMA | Muttahida Majlis-e-Amal |
| MNA | Member of National Assembly |
| MoF | Ministry of Finance |
| MW | Megawatts |
| NATO | North Atlantic Treaty Organization |
| NDMA | National Disaster Management Authority |
| NEC | National Economic Council |
| NFC | National Finance Commission |
| NGO | Non-Governmental Organization |
| NHDR | National Human Development Report |
| NPL | Non Performing Loans |
| NRSP | National Rural Support Program |
| NSS | National Savings Schemes |
| NWFP | North West Frontier Province |
| OPEC | Organization of Petroleum Exporting Countries |
| PDC | Pakistan Dairy Corporation |
| PDL | Petroleum Development Levy |
| PES | Pakistan Economic Survey |
| PFC | Provincial Finance Commission |
| PIA | Pakistan International Airline |
| PIBs | Public investment Bonds |
| PIEDAR | Pakistan Institute for Environment-Development Action Research |

| | |
|---|---|
| PIHS | Pakistan Integrated Household Survey |
| PIPS | Pakistan Institute of Peace Studies |
| PLSMS | Pakistan Living Standards Measurement Survey |
| PML (N) | Pakistan Muslim League (Nawaz) |
| POF | Pakistan Ordinance Factory |
| POL | Petroleum Oil and Lubricant |
| PPAF | Pakistan Poverty Alleviation Fund |
| PPP | Pakistan Peoples Party |
| PRGF | Poverty Reduction and Growth Facility |
| PRSP | Poverty Reduction Strategy Papers |
| PRSP | Punjab Rural Support Program |
| PSDP | Public Sector Development Program |
| REER | Real Effective Exchange Rate |
| R&D | Research & Development |
| RSPs | Rural Support Programs |
| ROZs | Reconstruction Opportunity Zones |
| SAPNA | South Asian Perspective for New Alternatives |
| S&P | Standard and Poor’s |
| SBFC | Small Business Finance Corporation |
| SBA | Stand-By-Arrangement |
| SBP | State Bank of Pakistan |
| SE | Social Enterprise |
| SEA | School Education Authority |
| SMEDA | Small and Medium Enterprise Development Authority |
| SME | Small and Medium Enterprise |
| SPDC | Social Policy and Development Center |
| SSEs | Small Scale Enterprises |
| SSI | Small Scale Industries |
| TFP | Total Factor Productivity |
| TMA | Tehsil Municipal Administration |
| TOT | Terms of Trade |
| UDF | University Development Foundation |
| UNDP | United Nations Development Program |
| UNIDO | United Nations Industrial Development Organization |
| USAID | United States Agency for International Development |
| VOs | Village Level Organizations |
| VAT | Value Added Tax |
| VTIs | Vocational Training Institutes |
| WAPDA | Water and Power Development Authority |
| WTO | World Trade Organization |

# Executive Summary: Dealing with a Perfect Storm

# Executive Summary: Dealing with a Perfect Storm

The Second Annual Review of the Institute of Public Policy (IPP) is focused on *Emerging from the Crises*; a multi-faceted crises which essentially involves a vicious cycle arising from the nexus of a security breakdown, economic downturn, governance failure and lack of political stability. What Pakistan is experiencing today is ‘the Perfect Storm’ when all negative factors have come together and are reinforcing each other. The question before policy makers is how to stop this vicious cycle that is virtually carrying us to a point of no return.

## THE VICIOUS CYCLE

On the economic side we face the possibility of a prolonged slow down in activity that will probably imply a decline in the real incomes of the bottom 60 to 75 per cent of the population. The only segments of the population that may still see some improvement in their economic situation are the rich and the relatively well-to-do. This will further exacerbate the maldistribution of income, with an addition of 10 million new poor to the 50 million who already suffer from abject poverty and deprivation. This will increase the social restiveness in concentrated pockets in cities adding not only to the general level of crime and violence but also to the problems posed by the rise of extremism and militancy. The economic downturn can lead to a loss of 'effectiveness' of the incumbent government and radicalization of politics, contributing to the environment of political confrontation and instability.

The aggravating security conditions, in turn, further lead to economic difficulties and governance failure. When an increasing number of people believe that the present structure of the society is not serving their interests, they may be willing to resort to extreme means to disturb the existing social order. As mentioned earlier, failure of the economy to provide adequately for the people at the bottom end of the income scale or living in the more backward regions of the country accelerates the rise of extremism. The failure of the political system which does not have the institutions the disaffected can use to voice their discontent further increases the sense of alienation and marginalization. The resultant rise in the acts of terrorism lead to loss of life and property and negatively impacts upon the investment climate. The cost of doing business increases, reflected in the higher transaction costs, adversely affecting the country's competitiveness and economic growth. Security breakdown can potentially aggravate the political situation also. Challenges to the 'writ' of the government can destabilize the incumbent government and damage its credibility and reliability, both nationally and internationally

The third pillar of the nexus is political instability/governance failure as reflected by the inability of the political institutions to develop a system that would allow voice to the people, make it possible for the people to resolve their differences without resorting to the politics of the street, and create a structure that will be able to sustain the shocks inevitable in a politically volatile situation. Such a situation negatively affects the investment climate, especially for foreign investors. Further, public agitation on the streets leads to short-run economic dislocation, bulk of the burden of which falls on the lower income segments in society. Needed government attention to tackle the security challenge is not forthcoming and the extremist elements get an opportunity to strengthen their capabilities and expand their influence.

The nexus of economic, politics and security discussed above is further reinforced by two other dimensions of crises facing Pakistan: foreign involvement in the domestic affairs, which the world thinks is necessary because of the impact on them if the Pakistani state weakens and several developments in external environment, especially the on-going global recession, over which it has no control. These developments introduce a number of downside risks for Pakistan’s external accounts and sustainability.

Overall dealing with the five crises enumerated above would have been less difficult if they had occurred separately. However, by all coming together at the same time, the country has been drawn into a vicious cycle. The fundamental question is: what strategic interventions are required to break into this cycle?

## STRATEGIC INTERVENTIONS TO BREAK THE NEXUS

It is our considered view that in order to break into this vicious cycle of economy, security and politics, we should first address the problem posed by the continuing deterioration in the state of security. A strategy focused on improving security has many dimensions. The state must first create an awareness among the people that battling extremism is in their interest. It is important for the people to recognize that the extremist elements are doing harm to the economy, to the development of the political system and to Pakistan's standing in the world. The message will be better received if the state commits significant amount of its resources to improving the social and economic well being of the people who reside in the areas most affected by the rise of extremism. Simultaneously, institutions that provide voice to the people and help them to resolve disputes not only among themselves but also with the state need to be strengthened. It will mean putting in place a judicial system in which the people have confidence.

In order to deal with extremism, Pakistan will also need a combination of targeted development programs, including an ambitious program of social protection focusing especially on youth skill development and employment. It will require ensuring that people, no matter how disaffected they are, do not question the authority of a legally constituted state. It is only when the institutions put in place by the state to help the common citizen are not violated by any one element in society that Pakistan will be able to convince the world that it is serious about dealing with the problem of extremism and mobilize more support from the international community for the 'War on Terror' necessary to cushion against the negative impact of the downturn in the global economy. A detailed counter-terrorism strategy is presented in Chapter 4.

On the economic front, the report presents a set of stabilization policies which are consistent with early revival of growth. The emphasis is on pursuing a pro-poor and inclusive growth strategy. This requires focus on agriculture, small-scale enterprises, labor-intensive industry and services alongwith a move towards decentralizing economic decision making by devolving greater authority to the provinces and to the institutions of local government and thereby bring government closer to the people.

On top of all this, Pakistan needs strengthening the institutions of governance, including the national parliament, the provincial assemblies, the legal and judicial systems. The Charter of Democracy can provide the basis for a new political compact.

## STATE OF THE ECONOMY: PROGRESS ON STABILIZATION

There was an almost catastrophic deterioration in the macroeconomic situation over the three years 2005-08 that has had profound adverse impact on growth rates, poverty incidence, and confidence in Pakistan's ability to manage crises and its future economic outlook. The most alarming signs of growing economic imbalances were very sharp increases in the current account deficit of the balance of payments and fiscal deficit and an unprecedented pickup in inflation, especially food price inflation.

Both the deficits in 2007-08 turned out to be significantly larger than was expected at any level. The current account deficit shot up to $14 billion in 2007-08 or 8.4 percent of GDP, while the fiscal deficit was 7.4 percent of GDP. These aggravations, in part, led to a rise in inflation. 'Core' rate of inflation, in particular, has persisted at 18 to 19 percent during the last five months while consumer inflation peaked at 25 percent at the end of October 2008, and has as yet not shown any significant tendency to decline despite softening of international commodity prices and tightening of monetary policy.

The current account deficit was financed by a rundown of foreign exchange reserves which fell from the relative comfortable level of $15.4 billion in October 2007 to $6.5 billion by mid November 2008, equal to less than two months of foreign exchange payments. This is the background against which Pakistan had to seek emergency assistance from the IMF to avoid a total melt-down of the foreign exchange position and a major disruption in economic activity.

The scale and speed of recent deterioration in macroeconomic balances especially the current account deficit in balance of payments was both a consequence of external shocks and policy neglect: especially the sharp rise in oil prices and continuation of expansionary fiscal and monetary policies. The deterioration of terms of trade meant a loss of national income of as much as 2.4 per cent in 2005-06 (or a loss equal to 40 per cent of otherwise strong GNP growth of 6 per cent in that year). The rapidly worsening current account deficit in the balance of payments should also have alerted the authorities that domestic demand was substantially outstripping productive capacity.

Though, the deficits in 2005-06 and 2006-07 were not excessive, but the way they were financed triggered further monetary expansion. The government resorted to the low cost borrowing from the central bank that continued and reached a peak in 2007-08. This created large amounts of reserve money, leading to excess liquidity in the banking system.

As such, by the time the new democratically elected government took office in March 2008, the macroeconomic situation was becoming quite worrisome. There was no attempt to adjust energy prices and public expenditures to bring the fast deteriorating balance of payments position and growing inflationary pressures under control. The domestic absorption of resources continued to increase, widening the imbalance with respect to the GNP. There was an imperfect understanding and analysis of the macroeconomic situation, overemphasis on GDP growth rates, and political expediency resulting in little appetite to put burden of energy and other price adjustments on the consumer.

Undoubtedly the new government inherited a most difficult economic situation. It started the painful process of major energy price adjustments and scaling back of public expenditures especially on development side clearly recognized the need for fiscal deficit reduction. The Government also saw the need for strengthening incentives for agriculture and boldly increased the wheat support price. When it became clear that an IMF agreement was necessary not only for meeting the large resource gap but also to underpin bilateral support, it ignored those who argued against the agreement on grounds that IMF conditionalities would bring great economic hardship on general masses and would slow down investment and growth unnecessarily.

On the fiscal side, the government failed to undertake any major effort to mobilize tax revenues from the well to do sections of the population -a tax effort that was sorely needed to reduce the large fiscal deficit and would have been fully justified in view of the growing income disparities in the last few years and the need to fund income support and food subsidies for the poor who were extremely hard hit by recent economic developments. A part of the problem was political issues faced by the new coalition government. The decision in May 2008 by a major partner, Muslim League (N), to quit the Federal Government and growing insurgency in the country. There was no clear economic leadership for several months which delayed policy response on the part of the government. Though belatedly, the government has constituted a panel of eminent economists to suggest to the policy makers a short-term policy package to restore macroeconomic stability which is efficient and equitable. The Panel interim report argued for strong macroeconomic adjustment and outlined a number of measures that could cushion unfavorable effects of stabilization on growth and equity.

Following these policy initiatives, what is the likely outcome in 2008-09? There is a general expectation now that the GNP growth would be less than 3 per cent during 2008-09. This is lower than expected but not a bad outcome considering the deep international recession and financial crisis that have engulfed the world, developments that were clearly not foreseen a year ago. On the domestic front, due to a number of factors outlined in the subsequent sections, there has been an actual decline in large-scale manufacturing output. We expect that there will be a reduction in fiscal deficit from 7.4 per cent of GDP in 2007-08 to about 5 per cent in 2008-09. Some slippage in the IMF suggested target is likely due particularly to the loss of momentum in tax revenues in the second half of the year. It is a good thing that the government has recently moved to retire circular debt of Rs. 80 billion related to the oil payments and energy. But it has involved additional borrowing equal to about 0.6 percent of GDP. Meanwhile, other public enterprise losses have continued to mount. In other words, the underlying fiscal deficit is significantly higher than the deficit on a cash flow basis.

Year to year inflation will probably come down to 10-12 per cent by the end of June. Government hopes to bring the rate down to single digit within the next twelve months, assuming some further fiscal deficit reduction, improvement in investment climate and law and order situation and resolution of power shortage problem.

Though fiscal adjustment has been significant, two-thirds of it has been borne by a cut in public investment- a strategy that should have been avoided. On the external finance side, the current account deficit is also expected to fall to 6 per cent of GDP.

Can Pakistan hope to revive its growth to a sustained level of 6 percent per annum without raising saving and investment levels, narrowing the saving-investment gap and reducing the high dependence on external resources? This will require a broad range of policies, critical elements of which are presented in Chapter 2.

To avoid future balance of payments difficulties, an external finance strategy that complements the Fiscal Sustainability Law should be prepared and could include the adoption of a few specific guidelines such as: ceiling of 20 percent of total investment to be financed from foreign savings; limits on total external debt and foreign investment obligations in relation to total foreign exchange earnings at close to the present level of 100-110 per cent; balance between equity and debt financing of, say, 2:1, to meet a given balance of payments gap.

## Proposals for the 2009-10 Budget

The report presents specific proposals for the forthcoming budget of 2009-10. The first important consideration is the setting of fiscal targets for next year. According to the IMF program, the fiscal deficit target for 2008-09 is 4.2 percent. As highlighted above, this is likely to be closer to 5 percent. Given the higher base of 2008-09, the same reduction in fiscal deficit as envisaged in the SBA with the IMF of 0.9 percent of the GDP, implies that the deficit target for 2009-10 should be 4.1 percent of GDP. In order to provide some space for the crucially needed social protection program, for a higher PSDP, especially on priority sectors like agriculture, water, power, education, health etc, and for security expenditures to implement an effective counter-terrorism strategy, we recommend that the fiscal deficit target for 2009-10 be fixed at 4.5 percent of the GDP. While Pakistan is unable to provide a fiscal stimulus to its economy in the face of a global recession like other countries, including China and India, it must not be put into a straightjacket, with the process of growth being suffocated, given the multi-faceted nature of its problems. A deficit reduction of 0.5 percent of GDP in 2009-10 while sustaining the process of stabilization will provide some fiscal space for expansion.

But, how is the deficit reduction of 0.5 percent of the GDP to be achieved? Total public expenditure should largely remain unchanged as a share of the GDP, but, as emphasised in Chapter 2 of the report, there should be significant expenditure-switching from current to development expenditure of at least 0.5 percent of the GDP. The tax-to-GDP ratio must be raised by about 0.5 percent of the GDP. This is achievable without impacting too adversely on the process of production and investment at a time when the economy is growing slowly. The increase in the tax-to-GDP ratio will essentially contribute to reduction in the fiscal deficit.

As such the key elements of the strategy for 2009-10 are as follows:

(i) implementation of part of the unfulfilled reform agenda (especially in the fiscal area and social protection)

(ii) focus on strategy for revival of growth (especially of the industrial sector)

(iii) contingency planning against downside risks (especially adverse developments due to global recession)

The implied policy actions for the Budget of 2009-10 are given below:

**Fiscal Policy**

(i) Tax effort involving improvements in tax administration and laws, withdrawal of tax exemptions and broad-basing of taxes

(ii) Strong curtailment of current expenditure

(iii) Prioritization and scaling up of development expenditure

~ Raise PSDP from about 2½ percent (down from target of 4 percent of GDP) in 2008-09 to 3 percent of GDP in 2009-10

~ Prioritization of allocations on the basis of well-defined criteria

(iv) Borrowings from SBP and commercial banks in 2009-10 limited to 2 percent of the GDP

(v) Keep returns on NSS unchanged in 2009-10, following the recent reduction.

**Monetary Policy**

(i) Bring the SBP policy rate down in line with the fall in the 'core' rate of inflation

(ii) SBP to focus on issues arising from big increase in NPLs, especially of small private banks

(iii) Special tax credit to banks for lending to 'preferred sectors' [SMEs, agriculture, exports] and for recapitalization.

**Policy on Administered Prices**

(i) Keep Petroleum Development Levy (PDL) unchanged for motor spirit but bring down PDL on HSD to say Rs. 10 per liter and eliminate PDL on LDO and Kerosene Oil

(ii) The procurement price of wheat at Rs. 950 per 40 kgs is higher than the import parity price of about Rs. 850 per 40 kgs. Divert the saving (of Rs. 20 billion annually) on imported wheat subsidy to reduce issue/release price. Regulate private sector imports of wheat.

**Social Safety Nets**

(i) Full scale Implementation of BISP

(ii) Special Youth Skill Development and Employment (with Micro Credit) Program

(iii) Special Development Programs in FATA, Baluchistan and South Punjab.

### Macroeconomic Projections for 2009-10

The report presents tentative forecasts for 2009-10, which may be useful in the finalization of the Annual Plan by the NEC as follows: GDP growth rate of 4 to 4½ percent; average rate of inflation in CPI of 9 - 10 percent; fiscal deficit of 4½ percent of the GDP; and current account deficit of 4½ - 6½ percent of GDP. In view of uncertainties about the global economy forecasting the current account deficit is problematic.

The report emphasizes the need for proper policy coordination. Three areas require urgent attention: development of effective fora for dialogue and consensus building with the private sector; reinvigorating planning processes to monitor progress and deal effectively with economic crises and handling of economic shocks; close coordination of economic policies across ministries, agencies, and provincial governments and clear delineation of responsibility for top economic leadership.

## HOW SHOULD PAKISTAN DEAL WITH GLOBAL ECONOMIC DEVELOPMENTS?

There is near agreement among most economists as to the causes of the current economic and financial crisis. Its primary reason was the highly skewed distribution of global savings and their misallocation among different economic activities. Global savings got skewed because some three-fourths of the American national income is accounted for by consumption. This resulted in growing balance of trade deficits which were financed almost entirely by the countries that accumulated large foreign exchange reserves, especially China and the oil exporting countries. These were invested, mostly, in the United States' government paper - the treasuries - which helped to finance the country's trade deficit. A lot of the capital found its way in the United States' housing markets which went through a boom because of the easy money policy followed for too long by the Federal Reserve System, the Fed. The Fed's complacency about the possible consequences of the housing boom was based in its belief that financial engineering had found ways for distributing the risk that were involved in fueling the sector with ever more capital. These, international economic developments are likely to impact on the Pakistani economy in multiple ways as summarized below:

## Impact on Pakistan's Economy

Pakistan's economy today is under a severe stress, as discussed above. This has been caused by both external events as well as those that are unfolding within the country. Pakistan does not have any control over external events and does not have a say, as it is not represented, in the international bodies devising strategies to counter the global developments.

There are several ways of showing how Pakistan has been affected by the global crisis. The first is by comparing the situation in Pakistan with that of some other countries at comparable level of development. Such a comparison reveals the deterioration in some of the macroeconomic variables over the last 12 months, like GDP growth rate, trade deficit, pressure on the exchange rate, inflation, changing perceptions in the international markets about Pakistan's creditworthiness and its ability to service foreign obligations resulting in the flight of capital.

Further the analysis of some key vulnerability indicators-current account deficit as percentage of GDP, short-term debt as percentage of reserves, banks' loan deposit ratios-reveals that Pakistan has the fourth highest rank (higher score indicates higher risk) among the seventeen countries listed in Chapter 3. IMF also has used a set of indicators to assess the vulnerability of low income countries. It divided the countries into three categories - highly vulnerable, those with level of medium vulnerability and those with low vulnerability. Pakistan falls in the middle category for three of the five variables. It is highly vulnerable to an increase in the price of oil and has a low vulnerability to a decline in the rate of growth in international trade. Overall, it appears that Pakistan's economy is fragile. It would plunge into a crisis if public policy is not directed towards putting in place programs and measures that could help in the recovery of the economy.

Despite the above analysis of the vulnerability of Pakistan's economy to external shocks, the last few months have been characterized by a visible improvement in Pakistan's balance of payments position with respect to the rest of the world. The first round impact of the global economic crisis and the worsening demand conditions has been a precipitous fall in international commodity prices, especially of oil. This has led to a major reduction in the overall import bill for Pakistan in excess of any fall in export earnings. The sharp reduction in import prices is reflected in an over 36 percent fall in imports during January and February 2009. Exports have fallen less, by about 13 percent, in relation to the corresponding period of the previous year. Meanwhile, home remittances have held up remarkably well, showing growth of over 20 percent. The consequence has been an extremely large improvement in the current account deficit of almost 88 percent. In fact, Pakistan enjoyed a surplus in the current account in February 2009.

There has, however, been some deterioration in the surplus on the financial (capital account).

While foreign direct investment has continued to show some positive growth, despite negative developments on the political and security fronts, there have been significant portfolio outflows and a large redemption in February of a maturing GDR. Net inflows of foreign aid have also been smaller. But the improvement in the current account has more than compensated for the worsening of the capital account and Pakistan was able to build up its foreign exchange reserves over and above the support provided by the IMF since November 2008. The consequence has been stability in the exchange rate, the real value of which has shown no depreciation over the last one year despite the intervening crisis.

Does the recent improvement in the balance of payments indicate that Pakistan's problem of stabilization of its external account has been resolved? If import prices, especially of oil, remain at current levels and the buoyancy demonstrated by home remittances and FDI persists then there is the likelihood of a moderation in the current account deficit to about 4.5 percent of the GDP next year, which can be financed by the surplus on the financial account and further (potential) inflows from the IMF SBA. Foreign exchange reserves could even show some increase.

But, there are many serious 'downside risks' and the underlying structural vulnerabilities of Pakistan's economy to external shocks of the type identified above need to be seriously kept in account. There are no grounds for complacency. If exports fall, which in March 2009 are down by 26 percent over the level in the corresponding month of the previous year, foreign direct investment dry up in coming months, remittances fall in response to global unemployment increases, as is already visible in transfers from the USA, the balance of payments position may rapidly deteriorate. The report develops two BOP scenarios for 2009-10, one a more optimistic scenario based on continuation of recent trends and the other which incorporates the 'downside risks'. In the latter scenario, Pakistan could be left with a large financing gap of $ 4.2 billion. This may be reflected in a precipitous fall once again in foreign exchange reserves and in the value of the rupee.

Therefore, in view, of the downside risks associated with the continuing and deepening global recession this year and possibly in 2010, it is clear that Pakistan will have to maintain a constant surveillance of monthly movements in its balance of payments. Contingency plans of the type described below have to be put in place to guard against this eventuality.

## Policies to Manage External Vulnerability and Risks

Contingency planning against these risks will involve the following:

***Building a cushion of foreign exchange reserves:*** Pakistan should insure itself against the risks of another financial crisis by seeking concessional assistance, either in the form of grants or in the form of long term loans with a large effective grant component, from donors and the Friends of Pakistan. To the extent possible, however, commercial loans have to be avoided because the position of external debt and liabilities (at over $ 50 billion as of end 2008) is reaching a position where issues of debt sustainability are becoming important.

The costs of the 'War on Terror' to Pakistan are in excess of $ 6 billion annually (as quantified in Chapter 4) and concessional assistance (both military and civilian), especially from the USA, is only about one third of this cost. Pakistan has to make a persuasive case for more support over and above that recently promised by President Barack Obama (of about $ 900 million above the existing level of support) in order to more effectively counteract terrorism and its negative effects on the economy. If, as a last resort, Pakistan has to go back to IMF for enhanced support, then the preference should be for a PRGF facility rather than an SBA.

***Protecting Exports:*** Pakistan's exports have started plummeting in response to the on-going decline in world trade. As mentioned above, the real effective exchange rate (REER) at the end of March 2009 was back to the level a year ago. Meanwhile, there has been a major depreciation in the REER of competitors like India (of about 15 percent by December 2008). This is leading to a major loss of competitiveness of Pakistani exports, at a time when export markets are very tight and Pakistan has a relatively high rate of inflation. Exporters need to be helped with a more favourable exchange rate for their exports. Also, in seeking international support, Pakistan must emphasise greater market access and trade preferences.

The policy stance on the exchange rate has to be to link the value of the rupee to the change in purchasing power parity and to shift earlier the imports of oil fully to the inter-bank market, especially if in the next few months the balance of payments position starts deteriorating once again. Over and above this, supply-side problems with respect to exports also need to be tackled, like compensation for higher cost of non-tradables including power and gas in the duty-drawbacks.

***Compressing Imports:*** If imports start rising once again due to some increase in oil prices (already up by about $ 10 per barrel in March 2009) or because of the need for large imports of power generating equipment then the issue of compressing non-essential imports may have to be taken up once again. In such an eventuality, Pakistan may have to impose a cascaded regulatory duty on all non-essential imports (other than wheat, pulses, edible oil, fertilizer, POL and medicines) alongwith more aggressive moves on the exchange rate.

***Sustaining Foreign Private Investment:*** Pakistan must formulate a comprehensive counter-terrorism strategy based on a broad-based political consensus and in collaboration with its international partners. Also, there is need for a well-formulated Investment Policy which clearly identifies profitable investment opportunities for foreign investors and specifies carefully the terms of public-private partnerships in infrastructure which could attract foreign investment. Investments in real estate and housing schemes, with numerous incentives, could also become a way of channellising more home remittances.

We believe that while the first round impact of the global recession has been largely favourable because of the large containment in the import bill due particularly to the sharp fall in international prices, especially of oil and not due to policy interventions, there are no grounds for complacency. In structural terms, Pakistan remains vulnerable to external shocks. Also, in coming months there are many 'downside risks'. There is need, therefore, to formulate a contingency plan against these risks of the type described above.

## OVERCOMING DOMESTIC IMPEDIMENTS TO GROWTH

While we prepare ourselves for external downside risks, the country also has to tackle domestic impediments to growth, which in a major way take their roots in infrastructural constraints and governance failures. The report highlights that 2008 experienced a fundamental deterioration in some key problem areas which attained unprecedented heights during the course of the year. Two of these problems, which have been focused on in Chapter 4, relate to power shortages and security specifically related to terrorism and breakdown of law and order. These issues point out the diversified nature of domestic challenges currently faced by the country and highlight that domestic issues are no less important than the external challenges.

## Power Shortages: Cost to the Country

An important reason for the slowdown in manufacturing sector has been the unprecedented increase in power shortages, manifested in the rise in loadshedding. In this report we estimate the economic costs of power outages in the industrial sector of Pakistan, which accounts for about 28 percent of total power consumption. The magnitude of cost is a basic indicator of the benefits that could be realized from investment and improved management of the power sector.

Major factors contributing to increased power shortages in Pakistan include: growth in demand for electricity, particularly domestic demand fuelled in part by subsidized tariffs; inadequate policy response to the increased demand, reflected in the lack of expansion and up gradation of power plants and the low priority to public sector expenditure on the power sector; lack of improvement/up gradation by the IPPs, partly because of the uncertainty created by the adhocism in the government's privatization policy earlier; overall mismanagement of the power sector, reflected both in the accumulation of over Rs.370 billion of circular debt and the heavy line losses and large scale theft; and short-term supply-demand imbalances due to the seasonality in particular in hydel power generation.

### *Costs of Outages*

Costs of outages consist of direct costs which primarily comprise the spoilage cost and net value of lost production and indirect costs incurred by firms to recover at least some of the output lost during and immediately after outages. The particular mechanisms chosen for recovering output lost, will, of course, be based on cost minimization considerations. Typically, types of adjustments made by a firm include: acquiring self-generation capacity; more intensive utilization of capacity; working overtime; working additional shifts, and; changing shift timings. A pattern of response by industrial units increasingly observed in Pakistan, is that of development of own sources of energy supply through investment in generators.

Some of the key parameters required to estimate the cost of loadshedding for this report have been collected through a survey of a pre-designed and tested questionnaire on a purposive sample, stratified (by city and industry group) of 65 industrial units. The survey reveals that the average annual hours of outages per unit was 1379 in 2008. The average duration per day was 4 hour and 36 minutes. The highest incidence of outages in 2008 was between the months of December and January and in June. Industries which have been affected more by outages are textiles, machinery and equipment, food, glass and allied products. Also, continuous-process industries appear to have been less exposed to outages than batch-making industries.

Our analysis shows effective time losses- time losses during the outage plus restart time- were over 20 per cent. About 84 percent of the sample units did make an effort to recover part of the lost production time. The highest proportion, 75 percent, have done so through self-generation of electricity. Wherever generators have been installed, the extent of substitution has been high, at 85 percent of the normal power consumption. Firms which do not have self generation capacity, either because it is not economically feasible or affordable, have tried to recover some of the lost output through other adjustments identified earlier. However, their level of recovery of lost output is lower, at 29 percent.

The recovery of lost output is at a higher cost. The average cost of self-generation is almost two and a half times more than the cost of acquiring electricity from power utilities. Therefore, the extra cost to the industrial sector due to self-generation of electricity is about Rs. 32 billion. This is also an indicator of the extent to which profitability of firms is lower because of load shedding. Also, since such firms recovered about 84 percent of the output, the cost of output permanently lost is estimated at Rs 42 billion.

Firms adjusting through other mechanisms also incur additional costs which include overtime/ shift/changing working days premia to labour, additional wear and tear of machinery and spoilage of raw material/inputs in process. These costs aggregated to Rs. 6 billion at the national level. For such firms the cost of value added lost is Rs. 77 billion. Therefore, aggregate cost to the industrial sector of loadshedding is estimated at Rs 157 billion. This is equivalent to 9 percent of the industrial value added. The loss of industrial output is estimated at 7 percent.

Over and above the direct costs on the industrial sector, a change in value added in the industrial sector has secondary or multiplier effects on the rest of the economy. Adjusting for these forward and backward linkages increases the overall costs of industrial loadshedding to the country by Rs. 53 billion.

Overall, power loadshedding in the industrial sector has cost the country Rs 210 billion or over two percent of the GDP, over US$ 1 billion of export earnings and potential displacement of 400,000 workers. Costs could be even higher if impact on other sectors like agriculture and services are allowed for, which account for almost the same share in power consumption as industry.

### Strategy to Overcome Power Shortages

The Report presents a strategy for the development of the power sector in the country. A summary of key recommendations is as follows:

***Investment in Power Sector:*** The high economic cost of unsupplied electricity justifies a case for expanding power generation capacity in the country. In fact, there is a stronger case for upgrading existing power generation facilities, which can be accomplished at almost one-third the cost of new plants. This will require development and quick implementation of an accelerated generation investment program, which includes the project to import 1000 MW electricity from Iran and a comprehensive program to reduce technical losses and improve the reliability of the distribution system. Simultaneously, the enabling environment has to be improved so that IPPs investment plans can be encouraged and the problem of circular debt has to be resolved on a priority basis.

***Load Management Strategy:*** Such a strategy should focus on a loss-minimizing policy. The loadshedding schedule should reflect clear and transparent priorities, in consultation with all stakeholders, and be predictable. Sectors that deserve priority, in particular should include export industries.

***Information Flows and Customer Education:*** There is a strong case to develop and implement customer outreach programs to encourage energy conservation measures, steps to improve the power factor, and methods of limiting peak demand. It is also important that alternative sources of energy, in particular solar energy be explored. Pakistan should enhance its capacity to follow international developments on alternative sources and promote greater use of renewable energy for light, heating, agriculture and small-scale enterprise.

We turn next to our other case study which focuses on the failure of security. The question posed is what has been the economic cost to the country of participating in the global "War on Terror" since 2001 which has led to the rise of insurgency and terrorism inside Pakistan?

## Costs of The 'War on Terror'

Until recently, the focus on the ‘War on Terror’ has largely been on highlighting the benefits in terms of increased support from the international community, especially the USA. Since 2001-02, Pakistan has cumulatively received $ 12.2 billion funding from the USA, 70 percent of which has been reimbursement for military expenditure. The consequence was not only the alleviation of the foreign exchange constraint to growth but also the associated rapid expansion in money supply which led to a precipitous fall in interest rates and stimulated aggregate demand in the economy. The economy resumed, after a long time, the path of rapid growth from 2003-04 onwards, averaging a GDP growth rate almost of 7 percent.

But the large inflows of aid, alongwith higher remittances and, more recently, foreign direct investment, led to symptoms of 'Dutch Disease' in the Pakistani economy. The currency appreciated in real terms promoting import-based consumption-led growth, which soon became unsustainable. The current account deficit in the balance of payments reached 5 percent of the GDP. Following the sharp increase in oil prices, Pakistan found itself confronted with a full-blown financial crisis in 2007-08, plummeting the growth rate to probably less than 3 percent in 2008-09. Increasingly, the benefits of participation in the 'War on Terror' appear to have been declining and temporary in character. These benefits have largely been frittered away in rising consumption levels, especially of the richer sections of Pakistani society.

There are growing concerns that the costs of participation in the ‘War on Terror’ are rising exponentially and leading to severe dislocation of economic activity and unacceptably high losses of life and property. Conceptually, costs of the 'War on Terror' can be classified as direct and indirect. Direct costs include: value of human lives lost or of injuries; value of property or infrastructure destroyed or damaged; costs of enhanced spending on security. There are, of course, conceptual issues relating to the valuation of the human cost, either in terms of loss of life or injuries. Indirect costs are diverse in nature and include: costs to local economies; costs of greater uncertainty and risk perceptions; higher transaction costs; and, psychological costs.Those costs that are short run are more clearly identifiable and potentially less difficult to measure. Estimates covering longer periods of time and focused mainly on indirect costs require numerous assumptions concerning counter factuals and hence are on less firm ground.

The costs crucially hinge on the level of incidence of the acts of terrorism in the country. The trend in the number and incidence of these acts is also a basic indicator of the success of the counter-terrorism strategy. The incidence clearly is on the rise, both in terms of frequency and intensity of damage. In 2008, 2267 people were killed in various attacks and 4558 were injured. In addition, 'operational attacks' (security force's operations against terrorists) have led to 3182 deaths and 2267 injured (mostly 'collateral' damage). According to some estimates, missile attacks by US drones have killed almost 1000 innocent civilians in 2008.

The Ministry of Finance of the GOP has prepared estimates of the cost of the 'War on Terror' to Pakistan in the PRSP-II document. These costs (direct and indirect) aggregated to Rs 678 billion (approximately $8.4 billion) in 2008-09, equivalent to over 5 percent of the projected GDP. Cumulatively, since 2001, the costs of the ‘War on Terror’ are estimated at over $ 31 billion.

Estimating first the direct costs, given the number killed and injured in 2008, the total potential compensation cost is estimated at over Rs 3 billion. This is, of course, a low estimate compared to the present value of the lifetime income stream lost either due to death or injury. As far as the damage to property and infrastructure is concerned, no systematic data is available except for 'mega attacks' like the bombing of the Marriott Hotel. A notional estimate of loss of property due to terrorist attacks can be made at about Rs 1 million per person killed. This is equivalent to about one sixth of the damage per person killed in a high value property bombing like Marriott hotel. Accordingly the loss of property and infrastructure due to attacks in 2008 is approximately Rs 8 billion.

Turning next to expenditure on security, defence expenditure has been higher because of the need to place the armed forces at the Western borders and for undertaking counter-terrorism operations especially in the North. It appears that defence expenditure is about 62 percent higher than what it would have been in the absence of the 'War on Terror' while expenditures on law and order and public safety by provincial governments, primarily on police, are higher by about 48 percent.

Another aspect of enhanced security is the development of private security arrangements in the country. Overall, out estimate of direct costs of terrorism to Pakistan are *Rs 150 billion*. Despite the conservative and incomplete nature of these estimates, they work out to be significantly greater than government's estimate of direct costs in 2007-08 of about Rs 109 billion (see Chapter 4).

The indirect costs include: first, the cost to local economies, essentially NWFP and FATA, in the form of lost growth is estimated at Rs 40 billion in 2007-08. We also estimate a fall in employment of 100,000 persons in 2006-07. Added to this is the cost of internally displaced persons (IDPs), the annual costs of relief and rehabilitation are estimated at about Rs 2 billion.

Second, cost of greater uncertainty and risk perceptions are reflected primarily in falling investment by both domestic and foreign investors. Terrorism in Pakistan is responsible for a fall in private investment of 0.5 percent of the GDP in 2007-08, equivalent to Rs 52 billion. Beyond this, the enhanced level of risk has affected the stock market capitalization. The extreme sensitivity of stock prices to mega-terrorist attacks is demonstrated by the market collapse of 696 points or almost 5 percent following the assassination of Mohtarma Benazir Bhutto. Market capitalization of Rs 213 billion was wiped out overnight. As per the details specified in Chapter 4, we estimate this cost of terrorism at Rs 120 billion.

The next cost of higher risk and uncertainty arising from acts of terrorism is the negative impact on tourism and associated services performed by hotels, restaurants, etc. The indirect cost of loss of travel and tourism and downstream activities due to terrorism is about Rs 10 billion. Finally, in the area of indirect costs we have to factor in the higher costs of insurance. We estimate that the cost of higher insurance premia is about Rs 3 billion on an annualized basis. Therefore, the overall indirect costs of terrorism are estimated to be *Rs 230 billion* for 2007-08. These are less than the government estimate of indirect costs of *Rs 376 billion* for the same year.

### Policy Recommendations

The total costs (direct and indirect) of terrorism in Pakistan are high, estimated at Rs 380 billion, (above $ 6 billion) at the 2007-08 base, with adverse distributional consequences. The analysis in Chapter 4 in the report leads to a number of important conclusions. First, as the incidence of terrorist acts and counter-terrorism operations has increased rapidly, the benefits of participation in the 'War on Terror' are falling while the costs are rising sharply. In 2007-08, the cost is over three times higher than the inflow of assistance. There has, therefore, been substantial undercompensation for Pakistan's participation in the 'War on Terror', which partly explains the lack of some ownership of the war effort. It is important that the full costs of the 'War on Terror' are highlighted to donors in the subsequent meetings of the Friends of Democratic Pakistan.

Second, the past experience with utilization of the concessional support is not very positive. From the viewpoint of achieving sustainable higher growth and promoting employment, especially for alleviating poverty, it is perhaps better if Pakistan is also given preferential access to markets, especially for textiles, in the USA, EU and Japan. While the proposal for Reconstruction Opportunity Zones (ROZs) in the affected areas, enjoying preferential access, is worthy of consideration, it is unlikely that in the short run much investment will be diverted to these areas despite the incentive given the prevailing situation. It is important that as an alternative fast-track concessional assistance is provided for public investments in infrastructure and basic services and employment-intensive public works in affected areas which are cleared up either through military operations or peace agreements in order to provide an early 'peace dividend'. At the national as well as local level, the problem of militancy can be tackled effectively by fast implementation of a Youth Skill Development and Employment Program, which aims to absorb the over 1.5 million unemployed youth in the country.

Finally, the Report highlights the ineffectiveness of the current strategy being followed in the 'War on Terror'. There is need for a comprehensive review of the strategy, preceded by the development of a stronger political consensus and broad-based public commitment to participation in this war.

## MOVING FROM STABILIZATION TO REVIVAL

### Short-term Industrial Revival: Cornerstone of the Strategy

As highlighted above the process of stabilization, especially on the external account, has gone further then was perhaps originally anticipated, aided particularly by the sharp fall in import prices (especially of oil) but the growth process in the economy has been affected more than was implied by projections at the beginning of the year. Not only is this the consequence of tighter aggregate demand management, reflected, for example, in high interest rates and a big cutback in development expenditure, but also in the emergence of supply-side bottlenecks, especially of power, water and gas, and in the rise of terrorism, discussed earlier. The fall in growth momentum is most acutely manifest in the large-scale manufacturing sector of Pakistan which is likely to show a negative growth rate (-6 percent in first 7 months) for the first time after 1996-97 during the current financial year. Output of 43 out of the 71 industrial products on which data is available have experienced negative growth.

Broadly speaking, the negative growth is due to: extraordinary increase in prices, as in the case of vegetable ghee, petroleum refining and automobiles, fall in construction activity, for industries like iron and steel and cement; decline in export demand, for cotton yarn and cotton cloth; decline in domestic consumer demand, for industries producing consumer durables including automobiles, motor cycles, bicycles and sewing machines; power shortage, which has reduced the demand for electrical goods like deep freezers, electric bulbs, TV sets, air conditioners and refrigerators; and decline in private investment, for industries producing capital goods.

As such it appears that demand factors have been more operative than supply-side constraints in explaining the drop in industrial production. Within demand factors up to now fall in domestic demand has probably been more instrumental in curbing output than external demand in export markets. This may, of course, change as global trade shrinks further. Therefore, revival of industry appears to be contingent on recovery of aggregate demand in the economy, especially since a large component of Pakistani industry is import-substituting in character. But an abrupt increase in aggregate demand runs the risk of jeopardizing the process of stabilization. Therefore, we suggest that management of the exchange rate in particular, can help both in stabilization and revival. Ensuring that the currency does not get overvalued, as has happened in recent months, will not only ensure higher profitability and ability to compete of export-oriented industries, like textiles, but will also provide for greater protection to import substituting industries. If there is evidence of a fall in import prices due to under-invoicing or dumping, then a return to the regime of International Trade Prices (ITPs) and / or regulatory duties may have to be contemplated.

Beyond this, as highlighted earlier, changes in the level of interest rates (especially the SBP policy rate) should be pegged to changes in the underlying 'core' inflation rate and consumer financing may be made more attractive and affordable by allowing longer maturity periods for repayment. A crucial element in fostering future growth will have to be a recovery in the size of the PSDP by at least 0.5 percent of the GDP in 2009-10. Infrastructural shortages have to be addressed. Measures for reducing the quantum of loadshedding in the industrial sector have already been described in detail above. Fiscal incentives may also be considered for specific industries like automobiles, vegetable ghee and power self- generation.

### Domestic Demand vs Export-Led Growth

A number of countries are bringing life back to their economies by spending public money to build the much needed physical infrastructure. Spending is being encouraged along with establishment of safety-nets. Across Asia, economies are being advised to shift away from increasingly capital-intensive manufacturing towards labor-intensive services, so that a bigger share of national income goes to households, so as to increase domestic demand rather than rely on earnings from export. This new model has only a limited application to Pakistan. The country does not have the option since its fiscal deficit is large and there is no cushion of large foreign exchange reserves. That said, it must not use the conventional ways of restraining demand by a severe contraction in public expenditure, in particular on development expenditure, and a very tight monetary policy. This is already being done to some extent; continuing it would send the economy in to a deep recession, if not into a depression. What is required is an innovative approach.

The policymakers need to restructure aggregate demand not increase it as is being done in the countries that are not faced with the fiscal problem and inflationary pressures. Instead, the first order of business for the government - in fact governments at all levels - should be to review and restructure public sector expenditure not to reduce greatly development spending but to drastically curtail non-development spending as indicated in Chapter 2. Public works programs should be instituted for the development of public infrastructure, which will provide some relief to the unemployment situation and thereby poverty, while simultaneously addressing the issues of infrastructure bottlenecks. Restructuring government would reduce the level of employment in the public sector. A special training and skill development program could be launched to help the workers made redundant in the public sector find jobs elsewhere in the economy.

## The Sectoral Interventions

There is some debate in the country on what is the most appropriate model of growth for Pakistan and also about what kind of strategy should be pursued by the country in order to sustain high rates of uninterrupted growth as has been done successfully in a number of Asian countries. Should Pakistan be guided by the experience of other countries or should it adopt an entirely different route and opt for agriculture, agro-processing and the various labor-intensive service sectors as the engines of growth? In order to find answers to these questions we should examine both Pakistan's endowments on which the country can build its economic future as well as develop a good understanding of the changes that have occurred and are occurring in the country's external economic environment.

The process of globalization has changed the structure of production and trade in the world economy. There are a number of new opportunities that have opened up for countries such as Pakistan that have large and young populations and are physically close to some of the more rapidly growing and dynamic countries in the global economy. The country inherited a well developed sector of agriculture that could have become the engine of growth and also a significant earner of foreign exchange had the attention of the first generation of policymakers not been turned towards industrialization. Pakistan's other economic inheritance was the small-scale industrial and commercial sectors. The first was based on the presence of skills that were developed over centuries; the second was connected with the need to supply agricultural surpluses to several distant parts of British India. The same kind of neglect was visited upon small-scale commerce and retail trade.

Building Pakistan's economic future on the development of these sectors offers a viable opportunity for the country. Had this been done in the past, Pakistan would have chartered a different economic course for itself, different from those pursued by other more successful Asian countries. What kind of public sector interventions are needed to develop these essentially neglected parts of the economy is the subject discussed in detail in the report.

However, before turning to specific strategies, an understanding of the the state of the Pakistani firm would be useful. Economists working in the area of development reached the conclusion a couple of decades ago that the sustained growth of backward economies required an environment that provided the right set of incentives for the various economic players. What were the right sets of policies to be pursued? The most important part of the advice given to the developing world was to open the economies by allowing relatively - if not totally free - flow of goods and capital across their borders. Policymakers were advised to move away from import substitution, towards export promotion. The governments were advised to create a business-friendly environment.

Pakistan today has 3.3 million economic establishments, 90 per cent of which are sole proprietorships and another 2 per cent are partnerships. Pakistan's economy is dominated by small and medium-sized establishments. Almost 90 per cent employ 78 per cent of the non-agricultural workforce and contribute 30 per cent of the GDP. Ninety five per cent of the 3.3 million economic establishments employ less than 5 workers, another 4 per cent employ between 6 and 50 workers. If an industrial policy were to be developed and followed by the government to promote growth, to increase the amount of incremental resources flowing to the poorer segments of the population, to obtain a larger share in the global economy, Pakistan will need to look carefully at the structure of establishments operating in the economy. In other words, an important part of the industrial policy will have to be a policy aimed at developing enterprises.

In particular, focus would have to be on reducing the cost of doing business for such firms. In the *World Bank Indicators of cost of doing business*, Pakistan ranks 77th out of the 181 countries. For Pakistan the best ranking among the ten indicator sets is for "protecting investors". Enforcement of contracts is an area Pakistan has the worse score among the ten used by the Bank. It is obvious that this is one of the areas where Pakistan has to put in real effort in order to reduce the cost of doing business. The report describes a number of areas in which action by the government will increase the productivity of the establishments operating in various parts of the economy, including: human resource development; construction industry; trade facilitation; retail trade; agricultural marketing; urban development; fiscal decentralization and the use of fiscal policy for influencing inter-personal and inter-regional income distribution; private health insurance; pension funds; developing a supporting legal framework; and, tackling technological backwardness.

The report makes the basic point that improving the performance of the enterprises will improve the functioning of its economy and set it on the path of a high rate of economic growth that could be sustained over time.

## INSTITUTIONAL IMPERATIVES FOR BROADENING THE BASE OF GROWTH AND POVERTY REDUCTION

Economic growth in the past 60 years has failed to make a substantial dent into the poverty problem. This is because of an institutional structure within which high economic growth has been neither sustainable nor equitable. At this time the battle for Pakistan is being conducted against the extremists. The economic dimension is a vital element in prosecuting this war. Establishing the institutional structure for inclusive growth in which the people of Pakistan could participate in the process of growth would enable a higher sustained growth with equity. A shift in the paradigm for understanding both the determinants of growth as well as the nature of poverty is required.

The institutional structure of inclusive growth would enable all citizens of Pakistan rather than only a small elite to participate as subjects of economic growth as well as the recipients of its fruits. Key elements of this new approach to poverty proposes that: first, neither handouts to the poor nor economic growth per se, can resolve the poverty problem. This is because the poor are locked into a nexus of power within an institutional structure that gives them insufficient access to productive assets and to health, skill development and education through which they could develop their human potential. They also lack access over justice and over governance decisions that affect their immediate social, economic and environmental conditions. There is, therefore, the need to establish an institutional framework for the provision of productive assets to the poor as well as the capacity to utilize these assets efficiently. Such an institutional framework could have four broad dimensions:

(1) A process of localized capital accumulation through participatory development.

(2) A small and medium farmer strategy for accelerated agriculture growth through the provision of land ownership rights to the landless and institutional arrangements for yield increases.

(3) Accelerated growth of small and medium scale industrial enterprises through an institutional framework for increasing the production and export of high value added products in the light engineering and automotive sectors.

(4) An institutional framework for providing productive assets to the poor through equity stakes in large corporations owned by the poor and managed by professionals.

The institutional structure for endemic poverty is such that the poor face markets, state institutions and local power structures, which discriminate against access of the poor over productive assets, financial resources, public services and governance decisions which affect their immediate existence. A substantial proportion of the potential as well as actual income of the poor peasantry is lost to the increasingly adverse tenancy arrangements and the obligation to sell labour at less than market wage rates or without any wages at all, to the landlords. This is because of the social and economic leverage that the landlords exercise over the poor peasants. At the same time there is unequal access over both the input and the output markets. Poor peasants have to pay a higher price on their inputs and get a lower price on their outputs compared to the large farmers. As a consequence the poor are losing over 20 percent of their income in the major crops alone due to asymmetric markets.

In the small farm households the most significant constraint to increasing income is lack of ownership rights and the income losses associated with land use within the structure of dependence. Amongst the non rural farm households the principal constraint to poverty alleviation is the limited possibility of remunerative jobs and the low ability to start self employment projects. In the urban areas the employment status, informalization of the work force and the low level of productivity of micro enterprises constrain income levels and give rise to poverty.

## Growth through Participatory Development

An essential feature of inclusive growth is to provide access to the poor over productive assets through a variety of institutional mechanisms so that they can become both the subjects as well as the beneficiaries of growth. One of the ways to achieve this is through participatory development. Participatory development in its broadest sense is a process which involves the participation of the poor at the village/mohalla levels to build their human, natural and economic resource base for breaking out of the poverty nexus. It specifically aims at achieving a localized capital accumulation process based on the progressive development of group identity, skill development, and local resource generation. It has three key elements: process, empowerment and participation. The process of participatory development proceeds through a dynamic interaction between the achievement of specific objectives for improving the resource position of the local community and the sense of community identity. Collective actions for specific objectives such as a small irrigation project, fertilizer manufacture through organic waste, clean drinking water provision, or production activities such as fruit processing, can be an entry point for a localized capital accumulation process, leading to group savings schemes, reinvestment and asset creation. The dynamics of participatory development are based on the possibility that with the achievement of such specific objectives for an improved resource position, the community would acquire greater self confidence and strengthen its group identity.

Operationalization of this can take the form of autonomous community organization (COs). Through these COs the poor can identify income generating projects, initially at the household level, acquire skill training from a variety of sources such as government line departments, autonomous institutions, private sector firms, NGOs. and donors; and access credit for micro enterprise projects through apex organizations such as the PPAF, Khushali Bank, Small Business Finance Corporation (SBFC), and commercial banks. Institutionalization of links between these autonomous organizations of the poor and local government bodies at the Village, Union Council, Tehsil and District levels can enable more participatory and equitable processes of project identification, design and implementation for local level development also.

The issue of some significance in the case of such COs is of taking them to scale. NGOs in Pakistan have had some success in enhancing their scale of operations. Some factors contributing to their success include the quality of leadership,fostering of village level activities, development of second level management and, acquisition of proper accounting and financial skills.

### Small and Medium Farmer Agriculture Growth Strategy

The current economic burden of food imports can be converted into a strength through food exports. To bring about this transformation a new policy framework is required to shift from the earlier elite farmer strategy to a new small farmer growth strategy.

This requires a three pronged strategy, detailed in Chapter 6 of the report, including:

1) land reforms for sustainable growth with equity
2) land for the landless
3) enabling tenant households to buy land

However, provision of land to the landless will not be sufficient to achieve the objective of equitable growth. These landless rural poor will have to be strengthened through input supply, technical training and credit availability for micro enterprise projects.

### Growth of Small-Scale Industries Enterprises (SSEs)

A large number of small-scale enterprises (SSEs), as mentioned earlier, have a considerable potential for growth and high value added production such as components for engineering goods or components of high quality farm implements for the large scale manufacturing sector. Yet they are in many cases producing low value added items like steel shutters or car exhaust pipes resulting in low profitability, low savings and slow growth. Major constraints to their growth include:

(i) Inability to get vending contracts
(ii) lack of expertise in production management and quality control
(iii) Lack of specific skills like advanced mill work, metal fabrication, precision welding and accounting and management skills
(iv) Getting good quality raw materials from distant large cities
(v) Lack of specialized equipment
(vi) Absence of fabrication facilities such as forging, heat treatment etc. which are are too expensive for any one small unit to set up
(vii) Lack of capital.

Overcoming these constraints would involve providing institutional support in terms of credit, quality control management, skill training and marketing. This could be done by facilitating the establishment of Common Facilities Centers (CFCs) located in the specified growth nodes in selected towns where the entrepreneurial and technical potential as well as markets already exist. Such support institutions (CFCs) while being facilitated by the government and autonomous organizations such as SMEDA can and should be in the private sector and market driven.

### Growth Through Equity Stakes For The Poor In Large Corporations

The poor can be included in the process of investment and economic growth not merely through micro enterprises, but can be engaged into the mainstream corporate sector as well. What is required is financing the entry of the poor into the capital market. These clearly involve issues of risk assessment, as well as how such groups of the poor can be mobilized into sufficient numbers to empower them to become partners in the corporate sector. The methodology of group formation of the poor and its dynamics, have been discussed in an earlier section.

Also, corporate enterprise owned by the poor is yet another mechanism for promoting inclusive growth. There are three sectors which have considerable potential for stimulating GDP growth, poverty reduction and increasing Pakistan's foreign exchange earnings: (i) milk and dairy products, (ii) livestock and the production of meat and meat products, (iii) marine fisheries. The report contains detailed discussions on developing these sectors.

In conclusion, Pakistan finds itself in a ‘perfect storm’ of a multi-faceted crises involving a nexus of security breakdown, economic downturn and political instability and governance failure. A strong, united and committed political leadership is a pre-requisite for breaking out of this cycle with primary focus initially on improving security and broad-based institutional change. On the economic front, transition has to be made from stabilization to revival of growth, especially of the industrial sector. Beyond this, the report highlights that there are immense possibilities of development with many potentially leading sectors and institutional innovations that can promise high, sustainable and inclusive growth in the future.

# Chapter - 1

# The Current Situation: Breaking the Nexus of Economy, Governance and Security

# Chapter - 1
# The Current Situation: Breaking the Nexus of Economy, Governance and Security

## INTRODUCTION

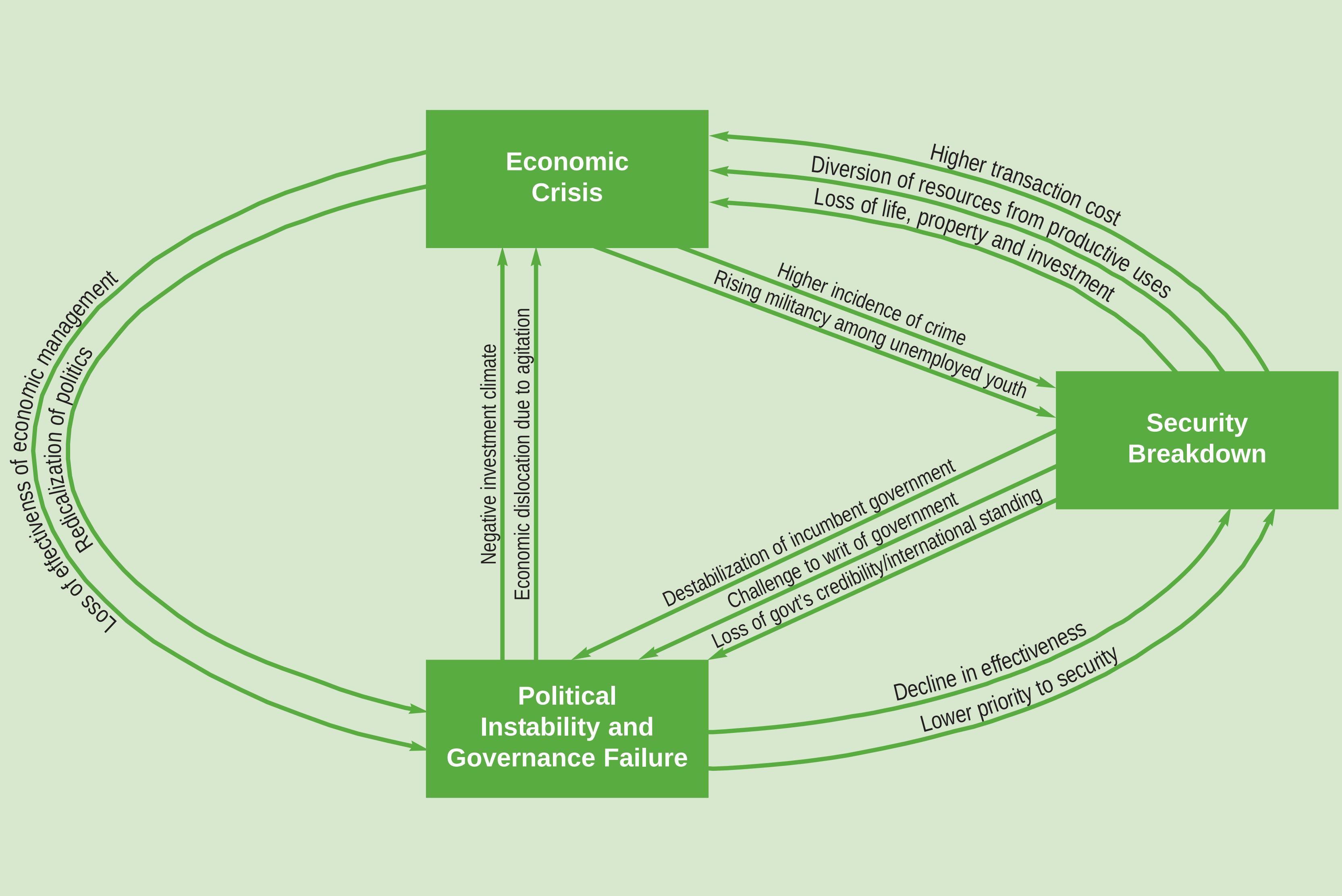
The second State of the Economy report of the Institute of Public Policy broadens the scope of analysis by factoring in concerns about political and security situations to those that pertain to economics. The fact that Pakistan is currently faced with a crisis that in terms of its scope, reach and likely consequences has no precedent even in our exceptionally turbulent history cannot be disputed. There are many dimensions to the problem. The current situation can be defined as a nexus among economic, political and security developments. Each factor feeds into the other. Public policy initiatives pertaining to the economy alone will not bear fruit unless a comprehensive approach at tackling all dimensions simultaneously is devised. The question before the policymakers, therefore, is how to break into the vicious cycle that grips the country and is carrying us virtually to a point of no return.

## THE VICIOUS CYCLE

The vicious cycle is illustrated in Box 1.1. On the economic side we face the possibility of a prolonged slow down in activity that will probably yield a GDP growth rate of no more than 2½ per cent this year. This will mean practically no increase in income per head of the population. That, in turn, will imply a decline in the real incomes of the bottom 60 to 75 per cent of the population. The only segment of the population that may still see some improvement in its economic situation are the rich and the relatively well-to-do. This will further exacerbate the maldistribution of income. By the end of the year the country may add 10 million new poor to the 50 million who already suffer from abject poverty and deprivation. A sizeable proportion of these will be in the urban areas, in particular in the large cities. This will increase the social restiveness in concentrated pockets in cities adding not only to the general level of crime and violence but also to the problems posed by the rise of extremism and militancy. The economic downturn can lead to a loss of 'effectiveness' of the incumbent government and radicalization of politics, contributing to the environment of political confrontation and instability.

Another dimension of Pakistan's problem is posed by the growing presence of extremist elements in the society. An increasing number of people in the country believe that the present structure of the society is not serving their interests and presents to them a future they are not prepared to accept. They are willing to resort to almost any means, even to limitless violence and extreme cruelty, to disturb the existing social order and usher in a new one. The recent developments in Swat which have resulted in a move towards the adoption of a legal system that stands apart from the one followed in the other parts of the country is one manifestation of the growing influence of the extremist forces. The reach of these extremist elements in the society may expand further. As mentioned earlier, failure of the economy to provide adequately for the

## BOX 1.1
## THE VICIOUS CYCLE OF ECONOMY, POLITICS AND SECURITY



people at the bottom end of the income scale or living in the more backward regions of the country accelerates the rise of extremism. The failure of the political system which does not have the institutions the disaffected can use to voice their discontent further increases the sense of alienation and marginalization.

The security breakdown as demonstrated by acts of terrorism, in turn, further aggravates the economic stress by leading to loss of life and property. Also, acts of terrorism negatively impact upon the investment climate, driving away both domestic and foreign investors. Higher need for security raises private and public sector security expenditures, diverting them from "productive" uses. Historically, a rise in defense expenditure has largely been financed through a diversion of public spending on basic social and economic services. The cost of doing business increases, reflected in the higher transaction costs. Security breakdown can potentially aggravate the political situation also. Challenges to the 'writ' of the government can destabilize the incumbent government and damage its credibility and reliability, both nationally and internationally

The third pillar of the nexus is political instability/governance failure as reflected by the inability of the political institutions to develop a system that would allow voice to the people, make it possible for the people to resolve their differences without resorting to the politics of the street, and create a structure that will be able to sustain the shocks inevitable in a politically volatile situation. Pakistan's plunge into deep political chaos and possible destabilization of the state was narrowly averted on March 16 by the eleventh-hour agreement between two contending forces.

Political uncertainty/instability negatively affects the investment climate, especially for foreign investors, which in the present global environment, as discussed subsequently, have limited resources to invest anyway. Further, public agitation on the streets leads to short-run economic dislocation. Inadvertently, bulk of the burden of this falls on the lower income segments in society, especially the daily wage or casual workers. In the presence of political confrontation and instability, the kind of government attention required to tackle the security challenge is not forthcoming and the extremist elements not only get an opportunity to strike to get public attention and show strength but can also use the hiatus to strengthen their capacities and capabilities.

That said, following the recent resolution of political grievances, it is now believed that the events leading to and following March 16 have created a situation that may result in the politics of reconciliation and move towards constitutional changes within the framework of the Charter of Democracy. The withdrawal of Governor's Rule and restoration of the Government of Punjab have contributed significantly to a lowering of the political temperature.

## OTHER DIMENSIONS OF THE CRISES

The nexus of economic, politics and security discussed above is further reinforced by two other dimensions of crises facing Pakistan. The rise of extremism in a country of Pakistan's size and the use of its territory by terrorist elements for operations elsewhere, by many in the more developed Western societies, is seen as an existential threat. This poses another challenge to the country, the fourth in our list. The people of Pakistan may consider possible foreign involvement to be interference in their domestic affairs, but the world, concerned about the impact on them if the Pakistani state fails, will not allow the country to go down. The political and economic order they may seek to impose on the country may not be to the liking of most of the people.

It is in this context that we should view the recent policy stance adopted by the administration of President Barak Obama to deal with what the Americans' view as the worsening situation in Afghanistan and Pakistan. The Americans have come to the conclusion that force alone will not solve the problems they confront in this part of the world. This new approach also focuses on economic and social developments on both sides of the border. The new American policy towards Afghanistan and Pakistan announced recently was endorsed by the NATO summit in early April.  The important question here is adequacy of the level of engagement proposed.

The fifth crisis Pakistan faces is the result of several developments in its external environment over which it has no control. The first IPP report "State of the Economy: Challenges and Opportunities" factored in some of the changes in country's external environment. Our argument was that Pakistani policymakers should take full cognizance of the changes occurring outside the country's borders. Our focus then was on the restructuring of the global economy as well as in international division of labour. We argued that these developments posed some challenges for the country as well as provided it with a number of opportunities that could help it to achieve a high sustainable rate of growth and also better serve the general citizenry. However, we did not then anticipate the developments in global economy which have had an adverse effect on Pakistan's economy. For most of 2008, the country's balance of payments was under considerable stress because of an unprecedented increase in commodity prices, particularly of oil, which led to haemorraging of the foreign exchange reserves. By the fourth quarter of 2008 as the downturn of the world economy worsened, the prices of oil and several commodities fell as sharply as they had risen, thus providing some relief to the policymakers in Islamabad. But other problems appeared. There has been a contraction in export markets for developing countries, including Pakistan. At the same time severe stress in international finance resulted in the flight of capital, in particular portfolio investments, from Pakistan. There is the likelihood that in the face of the global credit crunch private capital inflows to Pakistan will dry up.

## BREAKING OUT OF THE PERFECT STORM

There is, in other words, a perfect storm which has hit Pakistan at this time. Five different crises have emerged, more or less, simultaneously, and are reinforcing each other.  Will the country and its political leadership be able to deal with them? We know how to deal with each of these storms separately. The objective of this report is to suggest ways in which these difficulties can be resolved, focusing especially on the economy. The economy's recovery requires a set of stabilization policies which are consistent with revival of growth. Stabilization on both fiscal and external accounts should be undertaken without disturbing the medium-term growth prospects. This was the focus of IPP's First Annual Report. We emphasized the importance of pursuing a pro-poor and inclusive growth strategy. This requires turning of agriculture, small-scale enterprises, and modern services into the leading sectors of the economy. To adopt the approach we suggested that it is essential to move towards decentralizing economic decision making by devolving greater authority to the provinces and to the institutions of local government and thereby bring government closer to the people by giving more power to sub-national institutions of governance.

In this report we drill down further into these sectors, suggesting public policy initiatives in a number of areas. We also focus on highlighting some serious impediments that stand in the way of reviving the faltering economy and moving it on to a trajectory of growth that will parallel those followed by several Asian countries. We have quantified the costs to the economy of the 'War on Terror' and by the severe shortages that have developed in the supply of power. Our estimates suggest that an enormous amount of damage has already been done by these two factors. These costs must be contained, and for that, the state will have to develop an effective response.

In order to deal with extremism, Pakistan will need a combination of targeted development of the areas that have become vulnerable to it. It will require the launching of an ambitious program of social protection including the setting up of a large youth skill development and employment program. It will also require ensuring that people, no matter how disaffected they are, do not question the authority of a legally constituted state. It is only with the adoption of a comprehensive approach involving economic and social development on the one side and clear demonstration that the state's authority must be respected on the other side that the problem of extremism can be addressed. It is only when the institutions put in place by the state to help the common citizen are not violated by one element in the society that Pakistan will be able to convince the world that it is serious about dealing with the problem of extremism. This will enable us to mobilize more support from the international community for the 'War on Terror' and provide a cushion against the negative impact of the downturn in the global economy.

The stresses on the economy because of the global economic downturn would require making the country more reliant on domestic resources for development. It will also need the accumulation of foreign reserves to absorb the shocks delivered from abroad. Finally, the propensity to use the street and of the coercive power of the state to settle disputes, can only be dealt with by strengthening the institutions of governance. These include the national parliament, the provincial assemblies, the legal and judicial systems. The Charter of Democracy can provide the basis for a new political compact.

In other words, we know how to deal with the five crises enumerated above if they occurred separately. However, by coming together all at the same time, the country has been drawn into a vicious cycle. How does public policy break into this cycle?

It is our considered belief that in order to break into this vicious cycle of economy, security and politics, we should first address the problem posed by the continuing deterioration in the state of security. A strategy focused on improving security has many dimensions. The state must first create an awareness among the people that battling extremism is in their interest. It is important for the people to recognize that the extremist elements that are operating in the country, sometimes with impunity, and doing harm - to the economy, to the development of the political system, to Pakistan's standing in this world. The message will be better received if the state commits significant amount of its resources to improving the social situation and economic well-being of the people who reside in the areas most affected by the rise of extremism. A concerted effort at economic and social development should be accompanied by the establishment of institutions that provide voice to the people and helps them to resolve their disputes not only among themselves but also with the state.  This will require bringing government nearer to the people through devolution of authority to the bodies on which the citizens are fully represented. It will also mean putting in place a judicial system in which the people have confidence. Development of skills for both men and women resident in the troubled areas must be an important part of the strategy for improving security. The economies of the areas that are, at this time, most severely affected should be better integrated into the country's economy.

Once the environment of security has been improved, Pakistan will be better equipped to handle the two other branches - political and economic development - in the nexus it confronts. The first step in moving towards a more durable and representative system of government may have been taken on March 16. If this step takes the country towards greater political stability, the state will be able to concentrate its full attention towards achieving sustainable economic development.

# Chapter - 2

# State of the Economy: Progress on Stabilization

# Chapter - 2
# State of the Economy: Progress on Stabilization

There was an almost catastrophic deterioration in the macroeconomic situation over the three years 2005-08 that has had profound adverse impact on growth rates, poverty incidence, and confidence in Pakistan's ability to manage crises and its future economic outlook. The most alarming signs of growing economic imbalances were very sharp increases in the current account deficit of the balance of payments and fiscal deficit and an unprecedented pickup in inflation, especially food price inflation.

Both the deficits in 2007-08 turned out to be significantly larger than was estimated at the time of the preparation of the IPP's First Annual Report in the spring of last year. The current account deficit shot up to $14 billion in 2007-08 or 8.4 percent of GDP, the highest level in four decades (See Table 2.1). The reported fiscal deficit (excluding grants) rose to Rs. 779 billion or 7.4 percent of GDP. We believe, however, that the reported fiscal deficit was seriously understated because of the large build up of arrears to oil marketing companies (the so called circular debt), the unfunded losses of public enterprises and the suspected large rise in contingent liabilities.

**TABLE 2.1**
**MAJOR MACROECONOMIC INDICATORS**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 (E) |
|---|---|---|---|---|---|
| GNP growth per annum (%) | 7.1 | 6.0 | 5.9 | 6.2 | 3.0 |
| Fiscal Deficit (as %of GDP) | -3.3 | -4.3 | -4.3 | -7.4 | -5.0 |
| Current account Deficit (as % of GDP) | -4.0 | -3.9 | -4.9 | -8.4 | -6.0 |
| GDP deflator change (%) | 7.0 | 10.5 | 7.9 | 13.4 | 20.0 |
| Consumer Price Change (%) | 9.3 | 7.9 | 7.8 | 12.0 | 20.0 |
| Change in Net Domestic Assets of Monetary System (%) | 17.1 | 12.4 | 11.3 | 23.2 | 17.0[a] |
| M2 change (%) | 19.3 | 14.9 | 19.3 | 15.3 | 2.3[b] |
| Level of Foreign Exchange Reserves (Millions of US Dollars - at the end of the period) | 12,597.6 | 13,122.4 | 15,647.2 | 11,369.4 | 10,500.0 |
| Gross Investment (As %of GDP) | 17.5 | 20.5 | 21.3 | 20.0 | 18.5 |
| Gross National Savings (As %of GDP) | 17.5 | 17.7 | 17.8 | 13.3 | 14.0 |

(E) Estimated

[a](Up to February 2009)

[b](Up to February, 2009)

**Source:** Refer to Statistical Appendix of Report.

Year over year consumer inflation that had risen to 20 percent at the end of June 2008 increased further to 25 percent by the end of October 2008, and has as yet not shown any significant tendency to decline despite softening of international commodity prices and tightening of monetary policy. The 'core' rate of inflation, in particular, has persisted at 18 to 19 percent during the last five months.

The current account deficit during July-October 2008 remained at record levels. Almost all this deficit was financed by a further rundown of foreign exchange reserves which fell from the relatively comfortable level of $15.4 billion in October 2007 to $6.5 billion by mid November 2008, equal to less than 2.0 months' of foreign exchange payments. This is the background against which Pakistan had to seek emergency assistance from the IMF to avoid a total melt-down of the foreign exchange position and a major disruption in economic activity.

**TABLE 2.2**
**INTERNATIONAL COMMODITY PRICES**

| | Annual Averages | | | | Quarterly Averages | | | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | Jan-Feb 2009 | Jan-Mar 2008 | Apr-Jun 2008 | July-Sep 2008 | Oct-Dec 2008 |
| Crude oil, avg, spot a/ $/bbl | 64.3 | 71.1 | 97.0 | 42.9 | 95.3 | 121.0 | 115.7 | 56.0 |
| Wheat, Canada,$/mt | 216.8 | 300.4 | 454.6 | 329.3 | 621.7 | 484.4 | 390.2 | 322.1 |
| Wheat US,$/ mt | 159 | 238.6 | 271.5 | 189.2 | 384.1 | 277.8 | 241.5 | 182.7 |
| Fertilizer DAP $/mt | 260.3 | 432.5 | 967.2 | 359.4 | 860.2 | 1191.6 | 1153.7 | 663.3 |
| Fertilizer Urea $/mt | 229.9 | 309.4 | 492.7 | 268.3 | 357.6 | 575.7 | 745.4 | 292.2 |
| Palm Oil $/mt | 478 | 780 | 949 | 567 | 1156 | 1198 | 928 | 512 |
| Soybean Oil $/mt | 599 | 881 | 1258 | 769 | 1384 | 1466 | 1353 | 830 |

**Source:** World Bank Commodity Price Data.

## EXTERNAL SHOCKS AND POLICY FAILURES

The scale and speed of recent deterioration in macroeconomic balances especially the current account deficit in the balance of payments (a swing of 10 percent of GDP in four years) was totally unprecedented and was the cumulative result of large negative external shocks, failure to develop an appropriate response to terms of trade deterioration, especially the sharp rise in oil prices (See Tables 2.2 and 2.3), and continuation of expansionary fiscal and monetary policies, well after danger signals had emerged.

In retrospect, the fiscal and monetary policies remained excessively expansionary even though warning signals had emerged in 2004-05 and 2005-06. Inflation, as measured by the GDP deflator, rose to 7 per cent in 2004-05 and exceeded double digit level in 2005-06, for the first time in a decade. The deterioration of terms of trade that meant a loss of national income of as much as 2.4 per cent in 2005-06 (or a loss equal to 40 per cent of otherwise strong GNP growth of 6 per cent in that year) (Table 2.4) and rapidly worsening current account deficit in the balance of payments should also have alerted the authorities that domestic demand was substantially outstripping productive capacity.[1]

On surface, the actual deficits of 4.3 per cent of GDP (including earthquake related spending) in 2005-06 and 2006-07 might not appear excessive. But the way they were financed triggered further strong monetary expansion. The government has had difficulty after 2005-06 in meeting growing domestic borrowing requirement from the market on longer term Public investment Bonds (PIBs) without offering higher interest rates. It thus resorted to the low cost alternative of borrowing huge amounts from the central bank that continued and reached a peak in 2007-08. This moderated the cost of government borrowing (thus helping to keep interest payments on domestic debt in the budget low) but it also created large amounts of reserve money, leading to much excess liquidity in the banking system.

**TABLE 2.3**
**PAKISTAN'S OIL IMPORT BILL**

| | POL Imports ($ in Billion) | Average Crude Oil Price ($ per Barrel) |
|---|---|---|
| 2002-03 | 3.1 | 26.9 |
| 2003-04 | 3.1 | 30.3 |
| 2004-05 | 4.5 | 41.5 |
| 2005-06 | 6.7 | 58.5 |
| 2006-07 | 7.3 | 65.0 |
| 2007-08 | 11.5 | 108.2 |
| 2008-09 IMF (Nov. 2008) | 10.8 | n.a. |
| 2008-09 (Estimated) | 9.5 | n.a. |

**Source:** Foreign Trade Statistics, FBS.

As outlined in some detail in IPP's last year's report, the worsening of economic balances had already started in 2006 but gathered great momentum during 2007 and 2008. Oil prices continued to rise steeply, and international commodity price inflation spread to grains and edible oils. Indeed, 2007-08 was the worst year from the point of view of negative external shocks, precisely when Pakistan's political situation was unraveling and initially at least was thrown into total turmoil with the assassination of Mohtarma Benazir Bhutto, the head of PPP, at the end of 2007. Needed economic adjustments especially in energy prices were not made. The fiscal and monetary policies remained expansionary as Pervez Musharraf-Shaukat Aziz government remained preoccupied with pushing short-term growth through large public spending in preparation of elections. Meanwhile, the neglect of emerging structural problems in three key sectors - energy, agriculture and exports, began to hamper productivity, competition, and growth. The lack of energy investment and large scale power shortages have seriously hurt the economy (as highlighted in Chapter 4), export growth has slowed and the long term agriculture growth rate appears to have declined from 4 percent to 2.5-3.0 percent per annum.

In the last few months of Prime Minister Shaukat Aziz's tenure, the growing economic concerns were totally pushed aside as attention focused entirely on the political future of President Musharraf. Unfortunately the technocratic caretaker government that came into office in late 2007, unlike some previous caretaker governments, also took little decisive action to stabilize the economic situation. An important opportunity was thus missed to start the economic adjustment process even though fiscal and balance of payments deficits had widened, the energy subsidy bill was growing and the inexorable rise in the international oil prices was continuing (see Table 2.3).

By the time the new democratically elected government took office in March 2008, the macroeconomic situation was becoming quite desperate. The cumulative energy subsidies had approached Rs 400 billion. The gap between domestic and international prices of petroleum products had widened to almost 40 percent and the losses of WAPDA were mounting. Even more importantly, the current account deficit approached $4 billion in the first quarter of 2008 and was financed to a large extent by a record decline of $2.2 billion in the foreign exchange reserves during the quarter.

**TABLE 2.4**
**GNP GROWTH, TERMS OF TRADE LOSS, AND NATIONAL INCOME INCREASE**

| | GNP Growth per annum (%) | Terms of Trade (TOT) Loss (As % of GNP) | Gross National Income (GNI) Growth (%) (adjusted for TOT loss) |
|---|---|---|---|
| 2004-05 | 7.1 | 1.2 | 5.9 |
| 2005-06 | 6 | 2.4 | 3.6 |
| 2006-07 | 5.9 | 0.9 | 5.0 |
| 2007-08 | 6.2 | 3.2 | 3.0 |

**Source:** See Annex A of the Chapter.

There was not enough recognition of the fact that the large terms of trade loss over 2004-08 reduced Pakistan's national income, as distinct from Pakistan's Gross National Product, by over $ 10 billion, roughly 8 per cent or on average 2 per cent per annum over 2004-08.[2] This means that the healthy looking GNP growth rate of 6.3 per cent per annum during this period was reduced by nearly a third to a relatively modest growth in Gross National Income (GNI) of 4.3 per cent per annum (See Table 2.4).

## Handling External Shocks

Faced with a large negative external shock, there is no alternative in the very short term to finance the foreign exchange loss from reserves. But over the medium term national expenditures have to be reduced to bring them in line with the reduced availability of real resources. This did not happen in Pakistan though the oil prices had started rising in 2003 and spending from domestic resources for the 2005 earthquake reconstruction had also become an additional charge on resources.[3] It should be added, however, that impact of the negative shocks was most severe in 2007-08 when Pakistan was undergoing a particularly messy political transition. However, even before any real political difficulties had emerged, there was no attempt to adjust energy prices and public expenditures to bring the fast deteriorating balance of payments position and growing inflationary pressures under control.

The domestic absorption of resources (consumption plus investment) increased by 21 per cent over 2005-08 while GNP adjusted for terms of trade loss increased by only 12 percent (See Table 2.5). This imbalance symbolizes the need for deep economic adjustment the new government had inherited but moved only slowly to address.

Pakistan is not unique in ignoring the timely handling of major negative economic shocks. Indeed, one often finds an asymmetry in countries' response to negative and positive shocks. Positive shocks are

**TABLE 2.5**
**DOMESTIC ABSORPTION OF RESOURCES**
**In 1999-2000 prices**
**(Rs Billion)**

| | 2004-05 | 2007-08 | 2008-09[a] |
|---|---|---|---|
| Consumption of which | 4068 | 4774 | 4909 |
| (private) | (3671) | (4214) | (4333) |
| Investment including stocks | 780 | 1102 | 1050 |
| **Total** | **4848** | **5876** | **5459** |

**Source:** Pakistan Economic Survey
[a]For 2008-09 the assumptions are that:
(i) GDP growth during 2008-09 would be 3.0 percent,
(ii) the current account balance of payment deficit will be 6 percent of GDP in 2008-09
(iii) terms of trade improvement gain would be equal to 1% of GDP during 2008-09 as against a loss of 3.2 percent of GDP in 2007-08
(iv) investment during 2008-09 will fall by about 5 per cent in real terms

considered long lasting and therefore often frittered away while negative shocks are considered transitory and thus are ignored and costs mount up. This is what happened in Pakistan.

But as mentioned above, there were other factors at play, including an imperfect understanding and analysis of the macroeconomic situation, overemphasis on GDP growth rates, and political expediency resulting in little appetite to put burden of energy and other price adjustments on the consumer.

### Policy Progress

Undoubtedly the new government inherited a most difficult economic situation. It started the painful process of major energy price adjustments and scaling back of public expenditures especially on development side during April - June 2008. The Federal Budget for 2008-09 clearly recognized the need for fiscal deficit reduction and indicated forcefully that economic adjustments especially in energy prices would continue. The Government also saw the need for strengthening incentives for agriculture and boldly increased the wheat support price.

Despite warnings[4], however, it did not recognize the seriousness of the foreign exchange position and failed to develop a clear plan to deal with rapidly declining foreign exchange reserves. It seemed that for nearly six months, April-September 2008, the government was either in denial about the huge foreign exchange crisis it faced or unrealistically hopeful about very large financial support it could receive from friendly governments notably, USA, Saudi Arabia, China and Japan, to tide over its foreign exchange difficulties.

When it became clear that an IMF agreement was necessary not only for meeting the large resource gap but also to underpin bilateral support there was a largely futile public debate. Those that argued against the agreement felt that IMF conditionalities would bring great economic hardship on general masses and would slow down investment and growth unnecessarily. But there was never a clear presentation of alternatives.

Even on the fiscal side it failed to undertake any major effort to mobilize tax revenues from the well to do sections of the population -a tax effort that was sorely needed to reduce the large fiscal deficit and would have been fully justified in view of the growing income disparities in the last few years and the need to fund income support and food subsidies for the poor who were extremely hard hit by recent economic developments. Though in the Federal Budget for 2008-09 ambitious target was set for fiscal deficit reduction (from 7.4 to 4.6 per cent of GDP), the axe fell and is falling largely on development spending but without a thorough review of expenditure priorities, commitments and off-budget items. Another opportunity was missed to activate tax on capital gains and mop up some of huge windfall gains that had accrued to asset holders during 2004-08. Instead the exemption from capital gains was extended for two years under pressure from vested interests.

A part of the problem was once again the political issues faced by the new coalition government notably the decision in May 2008 by a major partner, Muslim League (N), to quit the Federal Government and growing insurgency in the country. There was no clear economic leadership for several months after Finance Minister Ishaq Dar of PML(N) resigned after being a couple of months in office. Naveed Qamar was Finance minister till September 2008 when Shaukat Tareen was appointed as Adviser Finance. At the bureaucratic level, four Federal Finance Secretaries have changed in a little more than a year. The coordination with Planning

Commission and Provincial governments remains weak and there are serious capacity constraints in all major economic ministries.

The Government and the Planning Commission must, however, be congratulated on setting up, though somewhat belatedly in mid-September 2008, a panel of eminent economists headed by Dr. Hafiz A. Pasha to suggest to the policy makers a short-term policy package to restore macroeconomic stability which is efficient and equitable. The Panel worked hard on achieving great speed and produced an interim-report already by the middle of October 2008.[5] A final report is expected shortly.

The Panel interim report argued for strong macroeconomic adjustment but outlined a number of measures that could cushion unfavorable effects of stabilization on growth and equity. It is heartening to note that though the Panel made many more detailed recommendations than the IPP 2008 report, the broad thrust of the two reports on the scale of macroeconomic adjustment and structural reforms for sustained growth and protecting the poor essentially overlapped a great deal --- not altogether surprising considering Dr. Pasha was a leading member of both teams.

Possibly a recourse to IMF could have been avoided if the caretakers and the new government would have taken bold and urgent actions to restore confidence among domestic and international investors. But it must also be stressed that unexpected further steep rise in international prices of oil and the persistence of high other commodity import prices notably wheat, palm oil, and fertilizers, made the external gap extremely large during April-September 2008 and basically unmanageable.

In any case, the IMF program did not have any significant tough conditionality while promising a substantial package of financial support of $7.6 billion over a period of 23 months of which $3.1 billion was provided upfront in November 2008. Essentially, the IMF at least initially accepted the key parameters of the government's own program that was largely developed with the help of the Economists' Panel. It aimed at major reductions in levels of fiscal and current account deficits while striving for a GDP growth of 3.4 per cent during 2008-09 and 5 percent in 2009-10. The IMF fiscal deficit target (excluding grants) of 4.2 percent of GDP for 2008-9 was a bit more stringent than the Government's own goal of 4.7 percent. But in contrast, the proposed current account adjustment suggested in the balance of payments, a reduction in deficit from a record deficit of 8.4 per cent of GDP in 2007-08 to 6.5 percent in 2008-09 and to 5.7 percent in 2009-10 assumed only relatively modest adjustment, partly because of the assumption that the oil import bill will decline only moderately. (See Table 2.2)

The IMF endorsed a gross external financing need of $ 13.3 billion for 2008-09 and $12.2 billion for 2009-10, a total of $25.5 billion, about the same amount that was available without emergency financing in the previous two years.

### Likely Outcomes in 2008-09

There is general expectation now that the GNP growth would be around 3 per cent during 2008-09, lower than expected but not a bad outcome considering the deep international recession and financial crisis that have engulfed the world, developments that were clearly not foreseen a year ago. On the domestic front, acute power shortages, slowing exports and domestic demand and civil strife have brought about an actual decline in large-scale manufacturing output in the first half of 2008-09, a decline that is likely to extend to the year as a whole. A detailed discussion on industrial performance is presented in Chapter 5.

We expect that there will be a reduction in fiscal deficit from 7.5 per cent of GDP in 2007-08 to about 5 per cent in 2008-09. Some slippages in the IMF suggested target are likely due particularly to the loss of momentum in tax revenues in the second half of the year. It is a good thing that the government has recently moved to retire circular debt of Rs. 80 billion related to the oil payments and energy. But it has involved additional borrowing equal to about 0.6 percent of GDP. Meanwhile, other public enterprise losses have continued to mount. In other words, the underlying fiscal deficit is significantly higher than the deficit on a cash flow basis.

Large public sector borrowing (see Table 2.6) remains a fundamental cause of high inflation, capital flight, and pressure on the balance of payments, although restraint has been exercised in recent months. There are expectations that inflation will slow in coming months but average inflation during 2008-09 will be 20 percent. High inflationary expectations remain a major threat to financial stability. Year to year inflation will probably come down to 10-12 per cent by the end of June and the Government hopes to bring the rate down to single digit within the next twelve months. But this progress assumes that further fiscal deficit reduction will take place and there will be improvement in investment climate for both foreign and domestic investors. At present investors are fearful not only because of growing insurgency and worsening law and order situation but also because of extreme power shortages.

As mentioned earlier, though fiscal adjustment has been adequate, the burden of adjustment has fallen on development spending. Excluding Benazir Income Support Program which is essentially an income transfer program for the poor, development expenditures could drop this year by close to 40 percent, from 4.3 percent of GDP in 2007-08 to 2.5 percent in 2008-09.

**TABLE 2.6**
**MONETARY AGGREGATES**

| | 2006-07 | 2007-08 | 2008-09 upto February |
|---|---|---|---|
| ***M2 (Broad Money)*** | | | |
| Change | +19.3 % | +15.4 % | + 2.3 % |
| Stock Net | - | Rs. 4689 billion | +Rs. 105.8 billion |
| Domestic Assets | + 14.0 % | + 30.5 % | + 10.2 % |
| ***Private Sector Credit*** | | | |
| Stock | End of June 2008, Rs. 2888 billion | | |
| Change (Rs. Billion) | + 365 | + 408 | + 133.1 |
| ***Credit to Public Enterprises*** | | | |
| Stock | End of June 2008 Rs. 1373 billion | | |
| Change (Rs. Billion) | + 20.0 | +33.0 | +62.0 |
| ***Reserve Money*** | | | |
| Stock | End of June 2008 Rs. 1480 billion | | |
| Change | + 20.9 % | + 22.3 % | - 2.47 % |
| ***Government Borrowing*** | | | |
| Stock | Stock at the end of June 2008, Rs. 1052 | | |
| Change (Rs. Billion) | - 58.6 | + 689.3 | + 297.5 |

**Source:** State Bank of Pakistan.

Two-thirds of the fiscal adjustment has been borne by public investment. Equally serious, as mentioned above, the drastic adjustment has taken place without any serious attempt either to restructure the large project portfolio in light of changed situation or to move responsibility closer to provincial/district level or giving weight to projects helping the poor.

On the external finance side, the current account balance of payments deficit is also expected to fall from $14 billion last year to around $10 billion this year or 6 per cent of GDP. A pleasant surprise as is discussed in the next chapter was the small surplus in the current account in February. However, bulk of the improvement is due to fall in oil and other commodity prices. Also, there has been a substantial recovery in the level of foreign exchange reserves due largely to higher external borrowing. But the position is far from satisfactory, as highlighted in the next chapter, in the event inflows are affected by the on-going world recession.

Going forward, even with further orderly reduction in current account deficit over the next four years the needs for gross inflows of foreign grants, loans and private investment capital will be huge--- rising from $ 12 billion in 2009-10 to $15 billion in 2012-13, totaling about $ 70 billion over the next five years, if the economy is to recover to robust and sustained growth. These levels of flows will not materialize if economic management does not improve and major structural reforms are not adopted.

## STABILIZATION, CONSUMPTION AND INVESTMENT

Is the stabilization effort supported by the program with the Fund excessive?

In the context of current stabilization efforts, it is important to stress that during 2005-08 there was a 17 per cent growth in overall consumption and 15 per cent growth in personal consumption. On a per capita basis, private consumption in 2007-08 was nearly 20 per cent higher than in 2003-04. Even with a much lower growth rate of GDP of 3 percent, we estimate that total consumption would grow by 2.8 per cent in 2008-09 (1.0 per cent per capita) reflecting improvement in terms of trade and declining investment (See Table 2.5).

It cannot therefore be argued that, at the macro aggregates level, consumption is being squeezed. The general public discontent about falling living standards, however, seems to contradict the macroeconomic numbers. There may be several explanations. The sharp rise in average consumption levels of the last few years may have raised expectations to unduly high levels. A more probable explanation lies in the skewed distribution of incomes and consumption. There is general agreement that disproportionate economic gains accrued to the top 20 per cent of the consumers during the last several years. Unfortunately the burden of high inflation especially fuel and food inflation has fallen most heavily on the bottom half of the population

Still overall consumption levels are high and savings rates are low. Total consumption is nearly 87 percent of GDP, with private consumption about 68 per cent of GDP. In China private consumption is one third of GDP. Even with a very large current account deficit (foreign saving of over 8 percent of GDP), the ratio of gross fixed capital formation to GNP was only 20 per cent in 2007-08 and is set to drop this year.

It is also disturbing that the rise in investment goods prices has been faster than the GDP deflator in recent years. As a result, the ratio of gross investment to GDP in constant prices has risen more slowly than the same ratio in current prices. In 1999-2000 prices gross fixed capital

**TABLE 2.7**
**GROSS FIXED CAPITAL FORMATION**
**(At constant prices of 1999-2000 and at current prices)**

| Year | GFCF as % of GDP at 1999-2000 Prices | GFCF as % of GDP at Current Prices |
|---|---|---|
| 1999-2000 | 15.9 | 15.9 |
| 2000-01 | 16.3 | 15.7 |
| 2001-02 | 15.7 | 15.3 |
| 2002-03 | 15.6 | 15.1 |
| 2003-04 | 13.6 | 15.0 |
| 2004-05 | 14.4 | 17.5 |
| 2005-06 | 16.2 | 20.5 |
| 2006-07 | 17.8 | 21.3 |
| 2007-08 | 17.3 | 20.0 |

**Source:** Economic Survey of Pakistan 2007-08

**TABLE 2.8**
**INTEREST PAYMENTS**

| | Rs in Billion | % of GDP |
|---|---|---|
| 1999-2000 | 262 | 6.9 |
| 2003-2004 | 203 | 4.0 |
| 2004-05 | 210 | 3.4 |
| 2005-06 | 237 | 3.4 |
| 2006-07 | 369 | 4.4 |
| 2007-08 | 490 | 4.7 |

**Source:** Ministry of Finance, GOP

formation in 2007-08 was only 17.3 per cent of GDP compared to 20 per cent in current prices. (See Table 2.7)

The national saving rate touched a low of 13 per cent of GDP in 2008-09 and is not likely to recover this year. Negative public savings (general government only) are now exceeding 3 per cent of GDP due to both rising interest payments (see Table 2.8) and growing defense and security spending.

The bunching of large interest and repayments on ten year Defence Saving Certificates issued a decade ago became due and were either deliberately or unintentionally not provided for in the previous budgets as they should have been. But on the other hand, the domestic financing of deficits almost entirely by borrowing from the State Bank of Pakistan has not only kept nominal borrowing costs low but has also meant that the repatriation of State Bank net profits to Treasury as non-tax revenue has kept the net burden of interest payments on the budget low. But the increased insurgency especially in NWFP and Tribal areas has definitely increased security costs as highlighted in Chapter 4.

The sad thing is that Pakistan's deep economic and security crises required a sense of urgency and quick action both in a scaling back of all unnecessary expenditures and a truly motivated effort to mobilize tax revenue especially from the elite that have been the very disproportionate beneficiaries of the economic boom in 2003-07. Instead the government was almost apologetic about reducing energy subsidies and passing on some of the cost of higher wheat and edible prices to the consumers. Income support program for the poor was desperately needed and could have and should have been larger if those with ability to bear extra burden would have been tapped. Implementation of even the modest protection program has been weak to date.

## SAVINGS, INVESTMENT AND EXTERNAL FINANCE

As highlighted above, Pakistan cannot hope to revive its growth to a sustained level of even 6 per cent per annum without raising saving and investment levels, narrowing the saving-investment gap and reducing the high dependence on external resources to around 20 percent of investment. It will take most determined efforts and a broad range of policies to attain, say, an investment rate of 25 percent of GDP and a national saving rate of 20 percent in four to five years, the goals to which we have long aspired but never attained.

Critical elements of this strategy would require:

- A fundamental change in incentives for savings and investment
- Raising much higher tax revenue but with great attention to equity and consequences on production and investment
- Broad basing of tax system and fully utilizing the considerable potential of Income tax, capital gains tax, property taxation, agriculture income tax, sales tax on services and followed by a value added tax
- Aiming at making personal income tax an important instrument of fairness in tax and expenditure policies. Right now income tax collections on non- salaried individuals (excluding corporate tax, withholding and salaried individuals) total only Rs. 40 billion or 0.3 percent of GNP. The number of filers is less than 700,000
- A better burden sharing between the formal and informal business sectors
- Tax incentives for investment in high pay-off sectors, like oil and gas exploration, agro-processing and other manufactured goods exports need to be strengthened
- Attention to and analysis of rise in the price of capital goods
- Scrutiny of all public expenditure, including defence, by creating a culture of austerity that is needed
- Reversing private capital flight, caused by loss of confidence in the currency, resulting both from an uncertain political future and weakening of foreign exchange position.

The big political economy question is whether the elite, say top 10-20 percent of households accept a stagnation in their living standards of three or four percent annually to transfer resources to government equal to 3-4 percent of GDP over next three years and shift 2-3 percent of national income from savings to investment?

## NEED FOR AN EXTERNAL FINANCE STRATEGY

The external debt and foreign investment obligations have risen sharply in the last few years. As of 31st December 2008 external debt and liabilities have increased to over $50 billion, with an annual growth rate of over 18 percent. A framework of foreign assets and liability management is needed which must be underpinned by an explicit External Finance Strategy. As highlighted earlier, even with a major national savings effort, Pakistan would need gross capital inflows of over $70 billion over the next five years. The present efforts to mobilize large resources have not been placed in a medium-term framework and implications of terms of assistance on future burden of debt servicing and investment income repatriation on the balance of payments have not been worked out.

To avoid future balance of payments difficulties, an external finance strategy that complements the Fiscal Sustainability Law (sadly being violated in default) should be prepared and could include the adoption of a few specific guidelines such as:

(i) Ceiling of 20% of total investment to be financed from foreign savings

(ii) Limits on total external debt and foreign investment obligations in relation to total foreign exchange earnings at close to the present level of 100-110 percent

(iii) Balance between equity and debt financing of, say, 2:1, to meet a given balance of payments gap.

## PROPOSALS FOR THE 2009-10 BUDGET

Based on the above, we turn now to specific proposals for the forthcoming budget of 2009-10. The first important consideration is the setting of fiscal targets for next year. According to the IMF program, the fiscal deficit target for 2008-09 is 4.2 percent. As highlighted earlier, this likely to be closer to 5 percent. The sharp fall in the rate of growth in revenues in the second half of the year and the faster growth in interest payments are likely to be only partially compensated for by the cut back in PSDP and higher revenues from the Petroleum Development Levy (PDL).

Given the likely higher base of 2008-09, the same reduction in fiscal deficit as envisaged in the SBA with the IMF of 0.9 percent of the GDP, implies that the deficit target for 2009-10 should be 4.1 percent of GDP. In order to provide some space for the crucially needed social protection program, for a higher PSDP, especially on priority sectors like agriculture, water, power, education, health etc, and for security expenditures to implement an effective counter-terrorism strategy, we recommend that the fiscal deficit target for 2009-10 be fixed at 4.5 percent of the GDP. While Pakistan is unable to provide a fiscal stimulus to its economy in the face of a global recession like other countries, including China and India, it must not be put into a straightjacket, with the process of growth being suffocated, given the multifaceted nature of its problems. A deficit reduction of 0.5 percent of GDP in 2009-10 while sustaining the process of stabilization will provide some fiscal space for expansion.

But, how is the deficit reduction of 0.5 percent of the GDP to be achieved? Total public expenditure should largely remain unchanged as a share of the GDP, but, as emphasised elsewhere in the report, there should be significant expenditure-switching from current to development expenditure of at least 0.5 percent of the GDP. This is achievable without impacting too adversely on the process of production and investment at a time when the economy is growing slowly. The envisaged increase in the tax-to-GDP ratio will essentially contribute to reduction in the fiscal deficit.

As such the key elements of the strategy for 2009-10 are as follows:

(i) implementation of part of the unfulfilled reform agenda
(especially in the fiscal area and social protection)

(ii) focus on strategy for revival of growth
(especially of the industrial sector)

(iii) contingency planning against downside risks
(especially adverse developments due to global recession)

The implied detailed policy actions in the Budget of 2009-10 are as follows:

BOX 2.1
STRATEGY FOR MOBILIZATION OF ADDITIONAL RESOURCES

The resource mobilization strategy for the 2009-10 budget should principally focus on additional revenue generation through improvements in tax administration and broadening of the tax net to undertaxed sectors. We are of the view that any escalation on the tax rates will be counter to the objective of revival of growth and should, therefore, be avoided. Also, we feel that there is enough potential to mobilize the revenue target for the year through these mechanisms. A recent World Bank and FBR (2008) study estimates the tax gap - measure of tax evasion - for corporate income tax at 4% of the GDP. Though the figure appears to be on the higher side, the point made is valid and requires attention of policymakers.

SUMMARY OF TAX EXPENDITURE 2007-08

| | Rs in Billion |
|---|---|
| Income Tax | 28 |
| Sales Tax | 18 |
| Customs | 44 |
| Total | 90 |

**Source:** PES

We recommend that half a percent of GDP can potentially be mobilized initially through a value added tax (Services Tax of the Indian type) on key services ---- import cargo handling services, custom house services, general insurance, banking and other financial services etc. India levies this tax on about 90 odd services. We can start with a dozen services and gradually expand. The tax may be levied by the federal government and shared on the basis of collection with the provincial governments. The other key source is a tax on tobacco. Currently tobacco, particularly the intermediate range cigarettes, is undertaxed and the structure of taxation is leading to distortionary pricing over certain price ranges. There is need to enhance the tax to curb consumption while ensuring that the incidence of the tax becomes progressive. Upto Rs 10 billion could be generated.

Another area of tax reform is the withdrawal of tax concessions and exemptions. As highlighted in IPP's First Annual Report granting of concessions/exemptions alongwith reduction in tax rates was a major cause for the stagnation of the tax-to-GDP ratio earlier in times of high economic growth. Though we do not recommend restoration of tax rates, as mentioned above, we do suggest withdrawal of exemptions and concessions. Pakistan Economic Survey, 2007-08, quantifies the costs of these exemptions to be Rs 89 billion for 2007-08 as shown above. Though the list of tax expenditures is not exhaustive and excludes the revenue cost of concessions like accelerated depreciation allowance, lack of coverage of sales tax on wholesale and retail trade, effective exemption of a large number of services from GST, effective zero-rating of domestic sales of export-oriented sectors etc, it is a good starting point for public action.

## Fiscal Policy

(i) Tax effort involving improvements in tax administration, withdrawal of tax exemptions and broad-basing of taxes (detailed in Box 2.1)

(ii) Strong curtailment of current expenditure (detailed in Box 2.2)

(iii) Prioritization and scaling up of development expenditure

~ Raise PSDP from about 2½ percent (down from target of 4% of GDP) in 2008-09 to 3 percent of GDP in 2009-10

~ Prioritization of allocation on the basis of well-defined criteria

(iv) Borrowings from SBP in 2009-10 limited to 1% of the GDP (given the likely extent of 'seignorage')

(v) Net borrowings from commercial banks limited to 1% of GDP (to prevent 'crowding out' of the private sector)

(vi) Keep returns on NSS unchanged in 2009-10, following the recent reduction (to provide significant real rates of return and stimulate savings)

**BOX 2.2**
**RESTRUCTURING OF GOVERNMENT: SUMMARY OF DOWNSIZING REPORT**

The federal Government is characterized by the following: (a) organizations that are no larger needed; (b) new organizations added to an antiquated system rather than improving the core organizations to be more skill oriented, performance oriented and management oriented in accordance with the needs of fast moving times; (c) hierarchical Divisions with vertical chain of command; (d) monopolies with no incentive to improve; (e) presence of public sector in areas which should have been left to the private sector and; (f) increasing centralization of functions which are best handed over to lower levels of government.

Adopting the Zero-based budgeting approach, the Pasha's Downsizing committee [1997] recommended in 1997 the following with regard to the 31 Divisions, 422 attached departments and 105 autonomous bodies/corporations:

- Abolition/Winding up of 23 organizations
- Privatization of 22 corporations
- Merger and Transfer of attached Departments/Organizations
- Substantial downsizing and strengthening
- A combination of the above

Many of these recommendations remain valid after over a decade, except possibly for privatization where progress has been made.

The rationalized structure of the federal government proposed by the committee consisted of 18 Ministries and 24 Divisions. These recommendations are in line with the following objectives:

a) allocate functions to the federal government more in line with the Constitution of Pakistan, with Concurrent List largely delegated to provincial jurisdiction
b) Promote 'synergy' between different parts of the government and ensure stronger coordination
c) Change the character of the government from that of a provider to that of a regulator and enabler.

Proposals for rationalization of the ministries included the following:

- Ministry of Trade and Industry by merging Industries, Production and Commerce.
- Ministry of Communication by merging Communications and Railways.
- Ministry of Energy and Natural Resources by merger of Water and Power and Petroleum and Natural Resources.

Ministries recommended either fully or partially for abolition or provincialization included the following: Railways, Industries and Production, Culture, Sports, Tourism and Youth affairs, Population welfare, Housing and Works, Science and Technology, Women Development, Social Welfare and Special Education, Local Government and Rural Development, Health, Education, Food and Agriculture.

Similarly, according to the report, rationalization of the 422 attached departments and 105 autonomous bodies/corporations could lead to a sizeable savings of upto 15 percent reduction in staff and a 25 percent reduction in wage bill.

The more recent report by the Commission on Administrative Reforms headed by Dr. Ishrat Hussain has made similar recommendations, although not in such a detailed manner.

The following steps need to be undertaken by government on a priority basis:

(i) undertake a 'zero-base' budgeting exercise of each attached department, autonomous body and corporation under Parliamentary supervision.

(ii) Implement the Prime Minister's target of 40% cut in establishment cost initially for allocations in 2009-10 for non-salary operational expenses and grant greater flexibility in levying user charges for services with retention of proceeds.

### Monetary Policy

(i) Bring the SBP policy rate down in line with the fall in the 'core' rate of inflation

(ii) SBP to focus on issues arising from big increase in NPLs, especially of small private banks

(iii) Special tax credit to banks for lending to 'preferred sectors' [SMEs, Agriculture, Exports] and for recapitalization

### Policy on Administered Prices

(i) Incomplete transmission currently of fall in POL prices internationally. PDL has risen to Rs. 19.13 per liter on motor spirit; Rs. 17.77 per liter on HSD; Rs. 13.09 per liter on LDO and Rs. 15.89 per liter on Kerosene Oil, in addition to sales tax. Keep PDL unchanged for motor spirit but bring down PDL on HSD to say Rs. 10 per liter and eliminate PDL on LDO and Kerosene Oil.

(ii) The procurement price of wheat at Rs. 950 per 40 kgs is higher than the import parity price of about Rs. 850 per 40 kgs. Divert the saving (of Rs. 20 billion annually) on imported wheat subsidy to reduce issue/release price. Regulate private sector imports of wheat.

### Social Safety Nets

(i) Full scale Implementation of BISP

(ii) Special Youth Skill Development and Employment (with Micro Credit) Program

(iii) Special Development Programs in FATA, Baluchistan and South Punjab.

As far as management of downside risks, due to possible adverse developments in the balance of payments arising from the global recession, is concerned, detailed proposals are presented in the next chapter.

## MACROECONOMIC PROJECTIONS FOR 2009-10

We now present macroeconomic projections for 2009-10. These are fraught with a considerable amount of uncertainty due, first, to how long and deep the world wide recession will be and what impact this will have on the Pakistan economy (see Chapter 3), second, the extent to which domestic economic activity and the investment climate will be affected by acts of terrorism, bottlenecks in access to infrastructure and any future political instability (see Chapter 4).

At this stage, we make tentative forecasts for 2009-10, which may be useful in the finalization of the Annual Plan by the NEC as follows:

***GDP Growth:*** The GDP growth rate could rise somewhat next year primarily on the basis of a recovery of industrial output due to a potential fall in interest rates, some stimulus provided by higher development spending, easier access to bank credit by the private sector, reduction in power loadshedding due to fast track implementation of some on-going schemes and investments and a possible recovery in export markets towards the and of the year.

Following the likely big jump in wheat output this year, it is unlikely that the agricultural sector will show high growth again next year. As such, the sectoral growth rate is likely to below 3 percent. With industry growing at about 6-7 percent and services at 4 ½ to 5 percent, an overall growth rate of 4 to 4½ percent looks attainable next year.

***Rate of Inflation:*** The year-to-year rate of inflation in the CPI has been declining slowly since the peak rate of over 25 percent attained in August 2008. With an average monthly inflation rate of about 1 percent during the remaining four months of the year, the year-to-year rate could fall to about 13 percent by June 2009. We project a relatively high monthly inflation rate in the coming months as wheat flour prices at the retail level respond to the big increase in procurement price. However, the impact on the year to year inflation rate is reduced by a 'base effect', that is, a rapid increase in the rate of inflation from March 2008 onwards, due especially to the upward adjustment in retail prices of POL products. For the year as a whole, as indicated earlier, the average rate of inflation in CPI is projected at 20 percent.

Turning to 2009-10, continuation of a 1 percent inflation rate monthly, will imply that by June 2010 the Y to Y rate could fall to about 11.5 percent. But we expect that the rise in the price level beyond June 2009 will be moderated by the restricted monetization of the fiscal deficit due to limits placed on government borrowings from SBP, little or no imported inflation and a gradual lowering of inflationary expectations. Both the average and the Y to Y rates of inflation could come down to 9 - 10 percent by June 2010.

***Fiscal Deficit:*** Based on the strategy described above, we project the fiscal deficit to fall to 4 ½ percent of the GDP from the expected level of 5 percent in 2008-09.

Details of the fiscal projections are given in the table 2.9. A summary of the macroeconomic projections is given in Table 2.10.

**TABLE 2.9**
**FISCAL PROJECTIONS FOR 2009-10**

**(% of GDP)**

| | Likely Outcome 2008-09 | Projected 2009-10 | Change |
|---|---|---|---|
| ***Total Revenues*** | ***14.0*** | ***14.5*** | ***+0.5*** |
| Tax Revenues | 9.3 | 10.2* | +0.9 |
| Non-Tax Revenues | 4.7 | 4.3* | -0.4 |
| ***Total Expenditure*** | ***19.0*** | ***19.0*** | ***0.0*** |
| Current Expenditure** | 16.5 | 16.0 | -0.5 |
| Development Expenditure | 2.5 | 3.0 | +0.5 |
| ***Fiscal Deficit*** | ***-5.0*** | ***-4.5*** | ***-0.5*** |

*including the effect of conversion of part of the PDL into an excise duty

**including the unidentified but booked expenditure

**Source:** IPP estimates

***Balance of Payments:*** the detailed balance of payments projections, including the size of the current account deficit, are given at the end of the next Chapter. These projections have the maximum degree of uncertainty and depend crucially on developments in the world economy.

Overall, a summary of the macroeconomic projections for 2009-10 is given in the Table 2.10.

## POLICY COORDINATION

We take up the issue of policy coordination in this final section. Pakistan has had in its history some major economic policy failures, in the form of a lack of sufficient attention to exports, shifting attitudes to the private sector, totally inadequate investment in human capital, neglect of

**TABLE 2.10**
**MACROECONOMIC PROJECTIONS* FOR 2009-10**

| | IMF SBA | IPP Projections |
|---|---|---|
| GDP Growth Rate (%) | 5 | 4 - 4½ |
| Rate of Inflation (Average) | 13 | 9 - 10 |
| Fiscal Deficit (% of GDP) | 3½ | 4½ |
| Current Account Deficit (% of GDP)** | 5½ | 4½ - 6½ |

*Projections are rounded off to the nearest ½ percentage point.
**Projections of the Balance of Payments are given in the next Chapter.

population control, and last but not the least a persistent and excessive reliance on external resources for its development. But if we look at country's past plans and policies, the rhetoric was often right in terms of goals for higher savings rates, higher level of educational attainments, reduced dependence on external assistance etc. Big problems have been in the lack of effective implementation, follow up and monitoring --- simply learning what is going on and what is working-and adjusting policies accordingly and consequently learning from own and others' experience. This is where the contrast with countries like Korea is most striking.

How can implementation, monitoring, policy coordination be made more successful than in the past? Three areas desperately require urgent attention:

(i) Development of effective fora for dialogue and consensus building with the private sector.

(ii) Reinvigorating planning processes to monitor progress and deal effectively with economic crises and handling economic shocks.

(iii) Close coordination of economic policies across ministries, agencies, and provincial governments and clear delineation of responsibility for top economic leadership. Improved macroeconomic management should be a key priority.

There are no cases of development where economic progress has proceeded smoothly. Economic crises occur regularly either because of overheating of the economy or large external shocks like energy price increases. Successful countries are able to quickly recognize changed economic circumstances and show flexibility, but poor performing countries postpone adjustment often at a great ultimate cost.

The lesson of history is that a crisis should not be allowed to go to waste and should be considered as a challenge to tackle deep seated problems. Better planning processes and closer economic coordination cannot substitute for economic will but can certainly improve the chances of more rational decision making.

# Chapter - 3

# Global Economic and Financial Developments: Implications for Pakistan

# Chapter - 3
# Global Economic and Financial Developments: Implications for Pakistan

## INTRODUCTION

A degree of schizophrenia has prevailed among the economists who have investigated the consequences of globalization for the countries of the developing world. Some think -we believe rightly - that the freer flow of capital, trade, technology and information had created a structural transformation of the global economic system. One element of this change was the transmission of the impact of developments in one (or a few) place(s) in the global system to other places. Globalization was meant to have a very positive impact on emerging countries if they allowed their economies to open to the outside world.[1] That this would indeed happen led to the advice given to the emerging world by development experts as a part of the framework of policy reform that went under the title of *The Washington Consensus*. This was so called because the package of recommended policies was formulated by the development and finance institutions operating out of that city.

The Washington consensus policies had a profound impact on the countries of Latin America many of which had to contend with a severe debt crisis in the 1980's. It also influenced policy making in the countries that were forced into the arms of the IMF in order to obtain quick infusion of capital to tide over balance of payments difficulties. Both India and Pakistan had to go to the Fund to deal with external crises - India in 1991 and Pakistan repeatedly in the 1990's. Partly as a result of the pressure from the IMF and partly because the countries had begun to draw lessons from their own experience, they began to partially open their economies. However, they did not open as much as did the countries of East Asia and Latin America.

While the virtues associated with the process of globalization were generally being lauded, it was also recognized that its effect could be negative.[2] Those who factored in the possibility of the negative consequences of globalization for emerging markets suggested exercise of caution as the countries in that part of the world opened their economies. The thinking of these experts was based in part on the experience of a number of countries during what came to be known as the Asian financial crisis. This hit the region in 1996-97. The economic systems of a number of Asian countries that had once been called the "miracle economies" were laid to waste by the speed with which foreign capital flowed out of them once there was doubt about the sustainability of the economic model they were pursuing. The area's banking system came under heavy pressure; the rates of economic growth declined rapidly, unemployment increased as did the incidence of poverty. Multilateral financial and development institutions got engaged in rescuing these countries but some well known economists, among them the Nobel Prize winner Joseph Stiglitz who worked at that time at the World Bank as that institution's Chief Economist, questioned the wisdom of the approach followed by the multilaterals to help the stricken countries.[3] Stiglitz and other critics of the Fund believed that the institution was wrong to advocate drastic adjustment through fiscal retrenchment and monetary restraint for getting the effected countries out of the crisis.

The East Asian crisis did not spread much beyond the region. Some countries were affected in Latin America but South Asia was totally spared. It did not reach the South Asian shores for the simple reason that their economies were not as closely linked with those of the West as were those of East Asia. The South Asians had not integrated as much into the financial system of the developed world as was done by the East Asians. Not being leveraged they did not feel the impact of deleveraging that took the East Asians to the edge of the economic precipice. But that began to change as *The Washington Consensus* approach to economic management acquired universal acceptance.

It is useful to recall this recent episode in world economic history to provide a context for the discussion of the present economic and financial crisis that has hit the global economic system in a way that was not anticipated. The crisis had its origin in the United States but spread first to Western Europe and, after a brief pause, to the emerging markets. It has now reached some unlikely places, including Pakistan. The speed with which the crisis spread surprised most experts.

There is a reason why there was the belief that the crisis would not engulf the emerging world. Some economists had come to believe that a variety of linkages had developed among regional economies that effectively decoupled them from the industrial world. Globalization had restructured the global economic system in such a way that close links had developed among countries within one region. Thus China had emerged as an anchor economy in Asia (more accurately East Asia), Brazil in Latin America and South Africa in the southern parts of Africa. Only India, one of the two largest and most rapidly growing economies in the emerging world, had not developed its own regional sphere of economic influence on account of its political problems with Pakistan, the largest economy in its immediate neighborhood.

The decoupling hypothesis, therefore, saw the economic globe structured in the fashion of airline hubs. Large economies in the emerging parts of the world were acting as economic poles for the countries that were physically close to them. If there were negative shocks in the global system - in particular if these shocks emanated from the richer parts of the world - the hubs would absorb them much as airplanes tend to cluster at the hubs during storms and other disruptive events. These buffers would thus dull and contain the impact of the event on the world's smaller economies. The decoupling hypothesis seemed to have been vindicated for a little while as the world began to tumble into an economic and financial crisis in the summer of 2008. Its impact was not felt initially beyond the United States, where it had originated, and Western Europe which was closely linked with the American economy. But this relief proved to be short lived. Now the crisis has reached all parts of the globe.

With this as the background this chapter we will look at the way the severe downturn in the global economy has affected Pakistan. How the global economic system got transformed as a result of the current economic and financial crisis is the subject of the first section following this introduction. The second section provides a brief overview of the Pakistani economic situation in the spring of 2009 and examines how the still developing crisis affected the Pakistani economy and made it to be one of the more vulnerable ones in the emerging world. The potential implications of global developments on the outlook for the balance of payments of Pakistan in 2009-10 are also highlighted. The third deals with the public policy response in Pakistan as the negative impacts become more visible.

## THE SUDDEN SHOCKS TO THE GLOBAL ECONOMIC SYSTEM

There is now near agreement among most economists as to the cause of the current economic and financial crisis. Its primary reason was the highly skewed distribution of global savings and their misallocation among different economic activities. Global savings got skewed because of the United States' propensity to consume a dominant proportion of its national income. By now some three-fourths of the American national income is accounted for by consumption. This resulted in growing balance of trade deficits which were financed almost entirely by the countries that accumulated large foreign exchange reserves. This was the case with several East Asian countries, especially China. The oil exporting countries - in particular those in the Middle East - also accumulated large foreign exchange reserves. These were invested, mostly, in the United States' government paper - the treasuries - which helped to finance the country's trade deficit. According to classical economics, well functioning capital markets allocate capital to wherever the highest returns are available. These were available in the United States' housing markets which went through a boom because of the easy money policy followed for too long by the Federal Reserve System, the Fed, under its long-serving Chairman, Alan Greenspan. Prices of houses increased rapidly, much beyond their intrinsic value, which drew in more capital. This set up a classic spiral of expectations - a boom. This was not recognized as such by the policy makers, especially those working in the Fed.[4]

The Fed's complacency about the possible consequences of the housing boom was based in its belief that financial engineering had found ways for distributing the risk that were involved in fueling the sector with ever more capital. New products were developed by the banking industry that used mortgages for back-up. Aggregated, these products were rated by the rating agencies and sold mostly to the financial institutions such as insurance companies and pension funds. High ratings ware given because of the way the products were structured. The financial institutions that bought the products insured them with large insurance companies. Almost all parts of the American and European financial system thus got caught up in this kind of financial engineering.

This description of the causes of the crisis highlights the two ways in which globalization helped to spread it so quickly around the globe. Most of the world's large economies were linked in the way the US housing boom developed and the way its collapse was felt around the world. Since much of the boom was financed indirectly by the savings of the countries that had, for one reason or other, large trade surpluses the large losses incurred by the sector were felt around the globe. The effect of the collapse of the boom was transmitted in two steps. First, by the weakening of the financial system that was involved in housing finance through financial products of increasing complexity. Second, by the withdrawal of capital from even those countries whose financial institutions were not involved in the complex structure of securitized debt that supported the financial system. As losses began to surface in the American and European financial systems, they began to withdraw capital from all over the world to strengthen their deteriorating balance sheets.

## THE EFFECT ON PAKISTAN OF THE GLOBAL ECONOMIC CRISIS

### Indicators of Vulnerability

Pakistan's economy today is under a severe stress. This has been caused by both external events as well as those that are unfolding within the country. Pakistan does not have any control over external events. It is excluded from the deliberations of the Group of 20, that has been tasked by the international community to restructure the global economic and the global financial system. The group has already met once in Washington shortly after the United States held its general elections and elected a new president. It will meet again in London in early April when it will begin to interact with the new American administration. Pakistan will be absent from that meeting while a number of other emerging economies - Brazil, China, Egypt, India, Indonesia, Mexico, South Africa, South Korea included - will have a voice. With no voice in the international system, where the leadership in the country does have a say is in the way it manages the situation at home. However before discussing the main elements of public policy designed to deal with the difficult economic situation the country faces today, we will assess Pakistan’s vulnerability in relation to other large emerging economics.

There are several ways of showing how Pakistan can be affected by the global crisis. We will do this by assembling two types of data for the country and comparing the situation in Pakistan with that of some other countries. The first table, Table 3.1, shows the deterioration in some of the macroeconomic variables over the last 12 months. In the 12 month period up to December 2008, Pakistan's trade deficit had increased to $20.9 billion which had a very negative impact on the current account balance. In the third quarter of 2008, it reached 6 per cent of GDP, the highest level among the countries represented in the table. The prospects of relief in the immediate future are constrained by the fact that expansion of traditional exports to traditional markets is unlikely to be forthcoming given the downturn in these economies. The situation is compounded by increase in unemployment in these countries which can result in lay off of Pakistanis employed and thereby a reduction in remittances. The deterioration in current account has put pressure on the exchange rate which fell by close to 30 per cent, one of the most precipitous falls in nominal terms among the countries of the emerging world. The fiscal deficit proved to be stubborn inspite of the severe expenditure reductions undertaken by the federal government, in

**TABLE 3.1**
**TRADE, EXCHANGE RATES, BUDGET BALANCES AND INTEREST RATES**

| | Trade balance* latest 12 months $ billion | Current Account Balance: Last 12 months $ billion | Current Account Balance: % of GDP 2008+ | Currency units, per $: February 25th | Currency units, per $: Year Ago | Budget balance % of GDP 2008+ | Interest rates (%): 3 months latest | Interest rates (%): 10 year government bonds, latest |
|---|---|---|---|---|---|---|---|---|
| India | -114.5 Dec | -28.5 Q3 | -3.6 | 49.9 | 39.8 | -6.0 | 4.74 | 7.09 |
| Indonesia | +8.7 Dec | +3.9 Q3 | +0.4 | 11,945 | 9,053 | -1.2 | 9.88 | 11.07# |
| Malaysia | +42.7 Dec | +38.3 Q3 | +11.4 | 3.67 | 3.20 | -5.1 | 2.09 | 4.08# |
| Pakistan | -20.9 Dec | -15.6 Q3 | -6.0 | 79.9 | 62.5 | -6.8 | 13.61 | 23.26# |
| South Korea | -12.6 Jan | -6.4 Dec | -0.7 | 1,516 | 941 | 0.3 | 2.52 | 5.08 |
| Thailand | +0.2 Dec | -0.2 Dec | -0.1 | 35.8 | 32.1 | -0.6 | 2.05 | 2.88 |

* Merchandise trade only
+ The Economist poll or Economist Intelligence Unit forecast
# Dollar-denominated bonds
**Source:** EIU

particular in development spending. This was done in part in the context of the Standby Agreement entered with the International Monetary Fund in November 2008 that provided some short-term relief to the country. The very sharp increase in domestic prices - inflation in Pakistan in the second half of 2008 touched historic highs - led the State Bank to tighten credit. Interest rates on government paper were close to 14 per cent, one of the highest levels in the emerging world. The negative changes in the macroeconomic variables led to a changing perception in the international markets about Pakistan's creditworthiness and its ability to service foreign obligations. The spread on government bonds increased enormously.

Table 3.2 below compares the performance of the Pakistani economy in recent times with that of some other Asian countries. The data drawn from The Economist Intelligence Unit suggests a sharp down turn in the economy in 2009, much sharper than that suggested by the government in Islamabad, in fact even by the International Monetary Fund. According to this assessment, the GDP growth rate will see a downward adjustment of 4.8 percentage points, from 6.0 per cent in 2008 to only 1.2 per cent in the current year. The Fund forecasts a growth rate of 2.5 per cent; the government even higher at 3 - 3.5 per cent. Of the countries listed in the table, the sharpest decline in percentage terms will be in South Korea that will see an adjustment of 8.5 percentage points, from a growth rate of 2.6 per cent in 2008 to a decline in GDP of 5.9 per cent in 2009. The least amount of change is likely to be in India with the increase in GDP adjusting downward by only 0.3 percentage point.

**TABLE 3.2**
**EXPECTED CHANGES IN OUTPUT, PRICES AND JOBS**

| | Gross domestic product | | | | Industrial | Consumer prices | | | Unemployment |
|---|---|---|---|---|---|---|---|---|---|
| Country | Latest | Qtr* | 2008+ | 2009+ | production latest | latest | ago | 2008+ | rate# (%) |
| India | +7.6 Q3 | Na | +5.3 | +5.0 | -2.0 Dec | +9.7 Dec | +5.5 | +8.2 | 6.8 2008 |
| Indonesia | +5.2 Q4 | Na | +6.1 | +1.9 | -2.8 Dec | +9.2 Jan | +5.6 | +10.3 | 8.4 Aug |
| Malaysia | +4.7 Q3 | Na | +5.1 | -0.3 | -15.6 Dec | +3.9 Jan | +2.3 | +5.5 | 3.1 Q3 |
| Pakistan | +5.8 2088** | Na | +6.0 | +1.2 | -1.2 Nov | +20.5 Jan | +11.9 | +20.3 | 5.6 2007 |
| South Korea | -3.4 Q4 | -20.8 | +2.6 | -5.9 | -18.6 Dec | +3.7 Jan | +3.9 | +4.7 | 3.3 Jan |
| Thailand | -4.3 Q4 | -22.2 | +3.0 | -1.8 | -18.8 Dec | -0.4 Jan | +4.3 | +5.5 | 1.4 Dec |

* percentage change on previous, annual rate.
+ The Economist poll or Economist Intelligence Unit estimate/forecast
# national definitions
** Year ending months
**Source:** EIU

As shown in Table 3.3, the crisis has had a deep impact on the valuations in the capital markets. This has happened in Pakistan for both external and internal reasons. The global financial turmoil resulted in portfolio flows in most emerging markets turning negative, going from net recipients to net providers of capital. As capital flew out of the countries, stock markets plunged. One of the severest falls was in Pakistan where the KSE-100 index of stocks declined from over 15,500 to 5,500 in less than a year. While most other countries allowed the markets to operate, regulators in Pakistan panicked and put a floor under the prices of individual stocks. This practically halted trading in the capital markets. Trading was eventually restored and the stocks continued their fall, perhaps at a rate that would have been less had the regulators not intervened. This intervention

**TABLE 3.3**
**PERFORMANCE OF THE CAPITAL MARKETS**

| Country | Index February 25th | % CHANGE ON One week | in local currency | in $ terms |
|---|---|---|---|---|
| India | 8,902.6 | -1.2 | -56.1 | -65.4 |
| Indonesia | 1,300.1 | -2.3 | -52.7 | -62.8 |
| Malaysia | 896.5 | +0.1 | -38.0 | -44.1 |
| Pakistan | 5,580.8 | -5.1 | -60.4 | -69.4 |
| South Korea | 1,067.1 | -4.1 | -43.8 | -65.3 |
| Thailand | 434.2 | -1.2 | -49.4 | -52.4 |

* Total return index
+ Credit-default swap spreads, basis points
**Source:** EIU

will leave an impact on the market as it will inhibit the arrival of fresh foreign capital into the market. For investors both the ease of entry and exit are important factors determining their interest in particular markets. That exit is possible is an important part of investor confidence. This has been seriously compromised.

The expected economic slowdown will take a heavy toll on the poorer segments of the population. The most important way of transmitting slowdown to the poor is in the level of unemployment. Pakistan's employment data is notoriously poor and needs to be treated with a great deal of caution. And it is not updated on a regular basis. The number reported in Table 3.2 is for 2007 when the economy was performing very well in terms of aggregate rates of growth. More recent estimates are available for other Asian economies. India, for instance, has already reported a rise in the rate of unemployment to 6.8 per cent, Indonesia to 8.4 per cent. We would expect the rate in Pakistan to increase to more than 9 per cent with the bulk of the change happening in the large urban centers such as Karachi and Lahore and some in the poorer parts of the country such as southern Punjab. This should worry the policymakers since it is precisely from these areas that extremists are recruiting foot soldiers for their operations in various parts of the country.

How vulnerable is Pakistan to the crisis in the international economy that Pakistan confronts today? There are several ways of answering this question. One of them is to examine some areas of vulnerability for emerging economies and rank Pakistan among other large countries. This is done in Table 3.4 which, using the analysis done by HSBC and The Economist, ranks the large emerging economies according to an estimated degree of vulnerability. Three indices are used. The first looks at current account as a percentage of gross domestic product. Large deficits have to be financed but capital flows - institutional, portfolio and foreign direct investment - have become scarce. As well as financing the deficit countries have also to finance existing debt. If external finance is not readily available, countries must run down official reserves. This is precisely what Pakistan did before the arrival of help from the International Monetary Fund in November 2008. On this score, Pakistan ranks the third most vulnerable, after South Africa and Poland among the seventeen countries listed in Table 3.4. The least vulnerable is Malaysia followed by Taiwan and China.

The second vulnerability index measures short term debt as a proportion of reserves. This reflects the ability of a country to service debt. After the Asian crisis of 1996-97, the most important lesson drawn by the affected countries was to build large external reserves. These in a way contributed to the crisis that currently affects the global economy. Pakistan has a relatively

TABLE 3.4
VULNERABILITY OF EMERGING COUNTRIES

| Countries | Current-account as % of GDP[a] | Short-term debt as % of reserves | Banks' loan deposit ratio | Overall risk ranking[b] |
|---|---|---|---|---|
| South Africa | -10.4 | 81 | 1.09 | 17 |
| Hungary | -4.3 | 79 | 1.30 | 16 |
| Poland | -8.0 | 38 | 1.03 | 14 = |
| South Korea | 1.3 | 102 | 1.30 | 14 = |
| Mexico | -2.5 | 39 | 0.93 | 12 = |
| Pakistan | -7.8 | 27 | 0.99 | 12 = |
| Brazil | -1.5 | 22 | 1.36 | 10 = |
| Turkey | -2.3 | 70 | 0.83 | 10 = |
| Russia | 1.5 | 28 | 1.51 | 9 |
| Argentina | 0.2 | 63 | 0.74 | 8 |
| Venezuela | 0.8 | 58 | 0.75 | 7 |
| Indonesia | 1.2 | 88 | 0.62 | 6 |
| Thailand | 0.3 | 17 | 0.88 | 5 |
| India | -2.4 | 9 | 0.74 | 4 |
| Taiwan | 7.9 | 26 | 0.87 | 3 |
| Malaysia | 11.3 | 15 | 0.72 | 2 |
| China | 5.2 | 7 | 0.68 | 1 |

**Source:** HSBC, Economist Intelligence Unit
**a** 2009 forecast
**b** higher score implies higher risk

low level of vulnerability on this score. The most secure by this measure are China and India; the least South Korea, Indonesia, South Africa and Turkey.

The third indicator looks at the health of the banking sector. This is measured by the ratio of bank loans to bank deposits. Russia, Brazil and South Korea are the most vulnerable according to this measure; Indonesia and China being the least. The generally accepted wisdom is that if the ratio crosses one - if the amounts loaned by the banking system are equal to amounts of deposits it has received, the system is entering the red zone. The data of Table 3.4 suggests that Pakistan stands at the edge of the zone.

The IMF has used a different set of indicators to assess the vulnerability of low income countries, the LICs. In a report issued in March 2009,[5] it used five variables - trade, oil prices, remittances, foreign direct investment, aid - to assess the vulnerability of the LICs. It divided the countries into three categories - highly vulnerable, those with level of medium vulnerability and those with low vulnerability. According to its assessment, Pakistan fell in the middle category for three of the five variables. It is highly vulnerable to an increase in the price of oil and has a low vulnerability to a decline in the rate of growth in international trade. Overall the IMF revised its growth target for Pakistan by 4.7 percentage points compared to its estimate in the *World Economic Outlook* issued in the spring of last. Then it had the Pakistani economy growing at a rate of 6.7 percent in 2009 compared to 6.0 percent in 2008 and reserves were projected to decline slightly from 3,2 to 3,1 months of imports. However, as shown in Table 3.5, all these projections have been significantly revised downwards. GDP growth rate is expected to decline to only 2 per cent which would mean close to zero increase in income per head of the population. Given the deteriorating income distribution, this would mean a significant increase in the incidence of poverty and large additions to the ranks of the unemployed particularly in the urban areas.

**TABLE 3.5**
**CURRENT IMF PROJECTIONS**

| GDP growth | | (months of imports) | | Current account balance in % of GDP | |
|---|---|---|---|---|---|
| 2008 | 2009 | 2008 | 2009 | 2008 | 2009 |
| 5.8 | 2.0 | 2.4 | 2.8 | -8.4 | -4.7 |

**Source:** IMF (2009)

The conclusion we draw from this analysis of vulnerability is that Pakistan's economy is fragile. It would plunge into a crisis if public policy is not directed towards putting in place program and measures that could help in the recovery of the economy.

## Recent Developments in the Balance of Payments

Despite the above analysis of the vulnerability of Pakistan's economy to external shocks, of the type being observed today, the last few months have been characterized by a visible improvement in Pakistan's balance of payments position with respect to the rest of the world. The first round impact of the global economic crisis and the worsening demand conditions has been a precipitous fall in international commodity prices, especially of oil. This has led to a major reduction in the overall import bill for Pakistan in excess of any fall in export earnings. Table 2.2 in the previous Chapter gives the evolution of import prices faced by Pakistan.

The sharp reduction in import prices is reflected in a over 36 per cent fall in imports during January and February 2009. Exports have fallen less, by about 13 per cent, in relation to the corresponding period of the previous year. Meanwhile, home remittances have held up remarkably well, showing growth of over 20 per cent. The consequence has been an extremely large improvement in the current account deficit of almost 88 per cent, as shown in Table 3.6. In fact, Pakistan enjoyed a surplus in the current account in February 2009.

**TABLE 3.6**
**QUARTERLY TRENDS IN BALANCE OF PAYMENTS, 2008-09**
**(% growth over corresponding quarter of 2008-09)**

| | 1st Quarter | 2nd Quarter | 3rd Quarter* | Cumulative |
|---|---|---|---|---|
| ***Current Account Deficit*** | ***65.8*** | ***-6.0*** | ***-87.9*** | ***-13.8*** |
| Exports (f.o.b) | 25.1 | -4.0 | -13.2 | 4.3 |
| Imports (f.o.b) | 41.8 | -6.1 | 36.2 | 0.7 |
| ***Trade Deficit*** | ***74.0*** | ***-8.6*** | ***-77.6*** | ***-4.6*** |
| ***Invisibles Deficit*** | ***-8.6*** | ***-14.2*** | ***-30.4*** | ***-15.4*** |
| ***Current Transfers*** | ***0.4*** | ***-17.0*** | ***9.8*** | ***-3.8*** |
| Home Remittances | 25.2 | 12.5 | 20.5 | 19.2 |
| ***Financial Account Surplus*** | ***-96.5*** | ***17.7*** | ***-53.6*** | ***-50.0*** |
| FDI + FPI | -9.1 | 7.3 | -159.5 | -27.7 |
| Foreign Aid (Net) | -99.9 | -39.8 | -38.1 | -69.4 |
| Others | | | | |
| ***Overall Deficit in BOP*** | ∞[a] | ***8.3*** | ***-109.9*** | ***68.6*** |
| Memo Items ($ million):** | | | | |
| Current Account Deficit | -3767 | -3555 | -133 | -7455 |
| Financial Account Surplus | 77 | 1869 | 457 | 2403 |
| Overall BOP Deficit(-) / Surplus(+) | -3690 | -1686 | 324 | -5052 |

* for two months, January and February
** in 2008-09
[a] very large deterioration

**Source:** SBP for BOP statistics

**TABLE 3.7**
**FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE**

| Year / Month* | Foreign Exchange Reserves ($ Million) | Change | Nominal Exchange Rate (Rs / $) | Change (Rs) | Real Effective Exchange Rate (2000 = 100) |
|---|---|---|---|---|---|
| June 2008 | 11369 | | 67.26 | | |
| July 2008 | 10282 | -1087 | 70.59 | 3.33 | 91.48 |
| August 2008 | 9111 | -1171 | 74.29 | 3.70 | 91.02 |
| September 2008 | 8211 | -900 | 77.17 | 2.88 | 90.54 |
| October 2008 | 6716 | -1495 | 80.43 | 3.26 | 92.71 |
| November 2008 | 9056 | -2340[b] | 79.92 | -0.51 | 96.04 |
| December 2008 | 9955 | 899 | 78.92 | -1.00 | 95.09 (95.59) |
| January 2009 | 10176 | 221 | 79.08 | 0.16 | 95.31 (94.54) |
| February 2009 | 10138 | -38 | 79.76 | 0.68 | (93.69) |
| March[a] 2009 | 10052 | -86 | 80.45 | 0.69 | (92.52) |

[a]as of 20th March 2009
[b]After receipt of 1st tranche of IMF loan of $ 3.1 billion.
**Source:** SBP

There has, however, been some deterioration in the surplus on the financial (capital account). While foreign direct investment has continued to show some positive growth, despite negative developments on the political and security fronts during January and February 2009, there have been significant portfolio outflows and a large redemption in February of a maturing GDR. Net inflows of foreign aid have also been smaller. But the improvement in the current account has more than compensated for the worsening of the capital account and Pakistan was able to build up its foreign exchange reserves over and above the support provided by the IMF since November 2008 as shown in Table 3.7.

The consequence has been a new found stability in the exchange rate. Between October 2008 and March 2009 the nominal exchange rate has remained, more or less, unchanged and the real effective exchange rate has, in fact, shown no depreciation over the last one year despite the intervening crisis.

The improvement in the balance of payments position, due primarily to a fall in import prices and not due to any significant acts of policy internally, has led to some projected improvement in the overall balance of payments outcome for 2008-09. The expected current account deficit for the year in the IMF program was 6.5 per cent of the GDP. This is now expected to fall to about 6 per cent of the GDP, with exports at about $ 19 billion and imports at $ 31 billion, both below the levels of 2007-08.

## BOP Projections for 2009-10

Does the recent improvement in the balance of payments herald that Pakistan's problem of stabilization of its external account has been resolved? If import prices, especially of oil, remain at current levels and the buoyancy demonstrated by home remittances and FDI persists then there is the likelihood of a moderation in the current account deficit to about 4.5 percent of the GDP next year, which can be financed by the surplus on the financial account and further (potential) inflows from the IMF SBA. Foreign exchange reserves could even show some increase.

But, there are many serious 'downside risks' and the underlying structural vulnerabilities of Pakistan's economy to external shocks of the type identified above need to be seriously kept in account. There are no grounds for complacency. The positive developments upto now are the consequences of a fall in import prices, especially of oil. But as the global crisis persists and even deepens there is the likelihood of a major fall in exports. This has started to happen and exports in March are down by 26 per cent over the level in the corresponding month of the previous year. Also, given in particular the security conditions in the country, foreign direct investment may increasingly dry up in coming months. Furthermore, the recessionary conditions in labor markets of countries with Pakistani expatriate labor indicate that sooner or later remittances will start falling, as is already visible in transfers from the USA. Overall, the balance of payments position in 2009-10 is very vulnerable to downside risks.

We have developed two BOP scenarios for 2009-10, one a more optimistic scenario based on continuation of recent trends and the other which incorporates the 'downside risks'. In the latter scenario, we allow for monthly exports in 2009-10 to fall by 10 per cent in relation to the monthly average for January and February 2009. Imports are projected to increase by 5 per cent in relation to the monthly level in January and February 2009, due particularly to some rise in oil prices, which have already risen to $ 50 per barrel from the low of $ 40, and as a potential outcome of further OPEC production cuts. Further, a drop in remittances of 10 per cent is projected alongwith a 20 per cent drop in foreign private investment (direct + portfolio) over the 2008-09 level.

The plausible declines in inflows and rise in import bill in 2009-10 in the 'downside risk' scenario dramatically change the outlook for the balance of payments, as shown in Table 3.8. Even after more tranches of support from the IMF (subject, of course, to meeting the performance criteria or obtaining waivers) Pakistan could be left with a large financing gap of $ 4.2 billion. This may be reflected in a precipitous fall once again in foreign exchange reserves and in the value of the rupee.

**TABLE 3.8**
**BOP SCENARIO FOR 2009-10**
**(Under different assumptions)**

**($ Million)**

| | | 2009-10 | |
|---|---|---|---|
| | 2008-09 Projected | Scenario based on Recent Trends | Downside Risk Risk Scenario |
| ***Current Account Deficit*** | ***-9900*** | ***-7500*** | ***-11400*** |
| Exports (f.o.b) | 19100 | 18300 | 16500 |
| Imports (f.o.b) | 31000 | -27800 | 29200 |
| ***Trade Deficit*** | ***-11900*** | ***-9500*** | ***-12700*** |
| ***Invisibles and Transfers*** | ***2000*** | ***2000*** | ***1300*** |
| ***Financial Account Surplus*** | ***4500*** | ***6500*** | ***4800*** |
| FDI + FPI | 3000 | 4000 | 2800 |
| Foreign Aid (Net) | 1500 | 2500 | 2000 |
| Others | 0 | 0 | 0 |
| ***Overall Deficit in BOP*** | ***-5400*** | ***-1000*** | ***-6600*** |
| IMF SBA | 4700 | 2400 | 2400 |
| Reserves | -700 | +1000 | -4200 |

**Source:** IPP estimates

In view, therefore, of the downside risks associated with the continuing and deepening global recession this year and possibly in 2010, it is clear that Pakistan will have to maintain a constant surveillance of monthly movements in its balance of payments. The improvement in recent months may not be sustained and we could have a repeat of the situation we saw in the first few months of the current financial year. Contingency plans of the type described below have to be put in place to guard against this eventuality.

## POLICIES TO MANAGE EXTERNAL VULNERABILITY AND RISKS

Given the potential 'downside risks' of a protracted and deep global recession, contingency planning against these risks will involve the following:

***Building a cushion of foreign exchange reserves***

Following the signing of the IMF SBA and release of the first two tranches alongwith the recent improvement in the underlying balance of payments position, as highlighted above, Pakistan's foreign exchange reserves have crossed the level of $ 11 billion, enough to finance over three months of imports of goods and services. But the situation remains fragile in view of the downside risks as indicated in a BOP scenario for 2009-10, and reserves could start falling once again.

Pakistan should insure itself against the risks of another financial crisis by seeking concessional assistance, either in the form of grants or in the form of long term loans with a large effective grant component, from donors and the Friends of Pakistan. To the extent possible, however, commercial loans have to be avoided because the position of external debt and liabilities (at over $ 50 billion as of end 2008) is reaching a position where issues of debt sustainability are becoming important, as discussed in the previous Chapter.

We quantify in the next Chapter that the costs to Pakistan of the 'War on Terror' are in excess of $ 6 billion annually and concessional assistance (both military and civilian), especially from the USA, is only about one thirds of this cost. Pakistan has to make a persuasive case for more support over and above that recently promised by President Obama (of about $ 900 million above the existing level of support) in order to take more effective measures to counteract terrorism and cover its negative effects on the economy. If, as a last resort, Pakistan has to go back to IMF for enhanced support then the preference should be for a PRGF facility rather than an SBA.

***Protecting Exports***

Pakistan's exports have started plummeting in response to the on-going decline in world trade. The fall in particular of textile exports is beginning to have adverse implications on the domestic level of employment. But due to the recent favourable developments in the balance of payments, the currency is beginning to appreciate once again in real terms. In fact, as mentioned above, the REER at the end of March 2009 was back to the level a year ago. Meanwhile, there has been a major depreciation in the REER of competitors like India (of about 15 per cent by December 2008). This is leading to a major loss of competitiveness of Pakistani exports, at a time when export markets are very tight and Pakistan has a relatively high rate of inflation. Exporters need to be helped with a more favourable exchange rate for their exports. Also, in seeking international support, Pakistan must emphasise greater market access and trade preferences.

The policy stance on the exchange rate has to be to link the value of the rupee to the change in purchasing power parity and not allow the currency to become overvalued at any time. One option is to shift the imports of oil fully to the inter-bank market earlier than envisaged in the IMF

SBA, especially if in the next few months the balance of payments position starts deteriorating once again and reserves come under pressure.

Beyond this, supply-side problems with respect to exports also need to be tackled. Higher costs of power and gas have to be compensated for by including in the duty-drawbacks provision for higher costs of such non-tradeables. Such incentives may need to be put in place especially for value added textiles and emerging manufactured exports, especially if the decline continues and possibly intensifies in coming months.

***Compressing Imports***

The need for compression of imports was emphasized earlier as the cornerstone of the strategy for restoring stability in the balance of payments. But the sharp fall in the import bill, due largely to the fall in international prices, has put this issue on the back burner. But if imports start rising once again due to some increase in oil prices (already up by about $ 10 per barrel in March 2009) or because of the need to import power generating equipment (in excess of $ 1 billion already in first eight months of 2008-09) then the issue of compressing non-essential imports may have to be taken up once again. In such an eventuality, Pakistan may have to impose a cascaded regulatory duty on all non-essential imports (other than wheat, pulses, edible oil, fertilizer, POL and medicines) alongwith more aggressive moves on the exchange rate.

***Sustaining Foreign Private Investment***

The stock market has once again started showing some buoyancy following the collapse in 2008. This has, no doubt, been facilitated by the recent improvement in the political environment following the restoration of the Supreme Court judges and the Punjab Government. This could be consolidated further if there are substantive moves for implementation of the Charter of Democracy. But there are downside risks here too. The rising incidence of major acts of terrorism in the country, the unraveling of the peace agreement in Swat and civil disturbances in Balochistan can damage significantly once again the investment climate. Both portfolio and direct investment flows could be affected by the heightened risk and uncertainty.

Pakistan must formulate a comprehensive counter-terrorism strategy based on a broad-based political consensus and in collaboration with its international partners as discussed in Chapter 1. Also, there is need for a well-formulated Investment Policy which clearly identifies profitable investment opportunities for foreign investors and specifies carefully the terms of public-private partnerships in infrastructure which could attract foreign investment. Investments in real estate and housing schemes, with numerous incentives, could also become a way of channelising more home remittances.

Overall, this chapter has highlighted that the first round impact of the global recession has been largely favourable because of the large containment in the import bill due particularly to the sharp fall in international prices, especially of oil. The balance of payments position has improved significantly in recent months. But, we have emphasized that there are no grounds for complacency. In structural terms, Pakistan remains vulnerable to external shocks. Also, in coming months there are many 'downside risks' in the form of falling exports, home remittances and foreign private investment, which could lead once again to a dramatic worsening of the balance of payments. There is need therefore to formulate a contingency plan against these risks by building a cushion of foreign exchange reserves, protecting exports, compressing imports and sustaining foreign private investment.

# Chapter - 4

# Domestic Environment: Impediments to Growth

# Chapter - 4
# Domestic Environment: Impediments to Growth

Since independence Pakistan's average annual growth rate has been a little over 5 percent per annum, much below the 8 or 9 percent growth enjoyed by East Asian countries. Even in periods of high growth the average growth never exceeded 7 percent per annum. As highlighted in IPP's first Annual report *State of the Economy: Challenges and Opportunities* and in the previous chapters there is little dispute that Pakistan was unsuccessful in reaching the high growth trajectory because of fundamental demographic, governance and supply side problems. These problems have had long roots and had their origins in: a high population growth rate; low rate of savings and consequently inadequate investment particularly in human capital, infrastructure, industry and agriculture; a weak industrial and export structure; an ambivalent attitude towards the private sector; a major neglect of human development; an inability to develop viable democratic political institutions and effective governance structures; over centralized decision making, weakening public institutions and rule of law; public corruption and lack of accountability.

Though there may be an effort at tackling some of these deep rooted constraints, 2008 has witnessed a quantum deterioration in some key problem areas which attained unprecedented heights during the course of the year. Two of these problems, which will be the focus of this chapter, relate to infrastructural shortages and security failure specifically related to law and order. These very different types of issues have been chosen for further analysis in this report to point out the diversified nature of domestic challenges currently faced by the country and to demonstrate that the domestic environment, alongwith global environment, is grave with far reaching consequences and therefore require immediate public policy attention.

Currently, Pakistan is in the grip of major infrastructural shortages impeding growth in all sectors including industries, agriculture and services. The industrial sector faces energy shortages both in electricity and gas; the agricultural sector is faced with water shortages alongwith critical input shortages like improved seeds and fertilizer. These shortages not only have constrained growth in terms of GDP foregone, but have had their implications on employment, exports and development in general. An analysis of water shortage, for example, shows that inadequate water availability has cost the country as much as Rs 70 billion in 2007-08 (see Box 4.1). Likewise, governance failure as reflected in inappropriately designed and implemented public policy in general has contributed to an increase the cost of doing business in Pakistan, (see Chapter 5) seriously undermining Pakistan's competitiveness and growth prospects. According to the worldwide governance indicators. Pakistan's indicators are comparatively poor relative to many other countries at similar levels of development. Within institutions, Pakistan ranks the worst on security indicators.

A detailed identification and analysis of all such constraints impeding Pakistan's development will

**BOX 4.1**
**COSTS OF WATER SHORTAGE**

| Year | Loss (Rs in Billion) | % of Agricultural Value Added |
|---|---|---|
| 2002-03 | 38.7 | 0.81 |
| 2003-04 | 16.9 | 1.47 |
| 2004-05 | 23.5 | 2.01 |
| 2005-06 | 29.3 | 2.01 |
| 2006-07 | 45.6 | 2.86 |
| 2007-08 | 70.2 | 3.48 |

**Source:** IPP estimates

The annual growth in real agricultural value added has faltered to 2.8 percent in the current decade from over 4 percent in the previous two decades. This is despite the higher increase the current decade in some key inputs into agriculture like tubewells and tractors. The noticeable fall, however, has been in the increase in water availability, at about 0.3 percent as compared to the historic growth rate of 1.3 percent. An important reason for this has been underinvestment in water. Share of PSDP on water has averaged at 11 percent in the current decade. In earlier plan periods it averaged at about 20 percent. An analysis of the contribution of water to agricultural growth reveals that the elasticity of agricultural growth to water is 0.48. Therefore, if water availability had grown at trend rate, of about 1.3 percent, the agricultural value added would have been higher. The loss in 2007-08 due to underinvestment in water in the current decade has been as much as Rs 70.3 billion, equivalent to 3.5 percent of the agricultural value added as shown in the enclosed table.

require a full report. The case studies identified to symbolize these constraints in this report are power shortages and terrorism. Specifically the question being posed is what has the country paid for inappropriate policies or policy neglect/ deficiency and implementation failure in the power and security sectors in 2008?

## ECONOMIC COST OF POWER SHORTAGES IN THE INDUSTRIAL SECTOR OF PAKISTAN

As mentioned above, an important adverse domestic development has been the upsurge in power shortages. The year 2008 witnessed a major increase in the frequency and intensity of power loadshedding or outages generally in Pakistan and in particular in the industrial sector. A manifestation of this problem can be seen in the large number of reports in the popular press of high incidence of outages and protests, by not only the domestic and commercial, but also industrial consumers. We have also seen, during the course of the year, complaints by the various chambers of commerce and industry and other industrial associations in the country that the level of production in a number of industries has been reduced due to the persistence of outages which apparently have fundamentally disturbed the normal rhythm of the production cycle in a large number of industrial units, especially in electricity-intensive sectors like textiles, non-metallic mineral products, basic metals, leather products, rubber and plastic products, paper and paper products, etc.

Casual empiricism supports their claim. At the macro level, the industrial sector of Pakistan has shown a decline of about 6 percent during the first seven months of 2008-09. Further, at the micro level, there is some evidence of shortages in various manufactured goods as indicated by a big double digit increase in prices over the course of the year. Clearly, there is need to undertake research to quantify, in more precise terms, the impact of outages on the national economy. This exercise was last done in 1989, when the problem of power loadshedding was also significant. Following an appreciation of the gravity of the power outage problem, the government promoted the establishment of Independent Power Plants (IPPs) later in the mid-90s.

In this section we estimate the economic costs of power outages in the industrial sector, which accounts for about 28 percent of total power consumption. The magnitude of the cost is a basic indicator of the benefits that could be realized from investment and improved management of the power sector.

### Causes of power outages

One major long-term factor which has contributed to increased power shortages in Pakistan was the growth in demand for electricity during the last decade of over 7 percent per annum. In particular, there was a high growth in domestic demand for electricity, averaging about 10 percent per year. Growth in energy demand increased more rapidly in the current decade after some moderation in the decade of the 1990s (4 percent per annum) following the spurt in the 1980s (11 percent per annum). This growth in energy demand was fuelled by subsidized tariff rates and the phenomenal increase in the use of electrical appliances like air conditioners, refrigerators, televisions, etc. As a result, the share of domestic consumers in total power consumption has increased from 23 percent in 1980-81 to 46 percent in 2007-08. The growth in demand in the current decade was clearly not fully anticipated and adequate provisions, therefore, were not made to cater for this increased demand. This is reflected in the lack of expansion and up gradation of power plants (which could have been accomplished at one-thirds of the cost of expansion). The share of public sector expenditure on the power sector, which averaged at about 28 percent since the 1980s, fell to less than 3 percent in the current decade.

Furthermore, the IPPs also did not invest in improvement/up gradation partly because of the uncertainty caused by the adhocism in the government's privatization policy earlier. On top of this, appropriate tariff reforms, which may have suppressed somewhat the growth of domestic demand, were not made in a timely fashion. It, therefore, appears that public policy neglect and public mismanagement over the years have contributed to the power sector shortages. An example of the overall mismanagement of the power sector is the accumulation of over Rs.370 billion of circular debt. The inability of federal and provincial government agencies and semi-autonomous corporations to timely pay their dues to power generating entities has in turn weakened their ability to pay for their inputs, in particular fuel, resulting in reduced power supply by IPPs. Heavy line losses, large scale theft are other examples of the overall mismanagement of the sector.

Factors which explain short-term supply-demand imbalances are, on the supply side, power system generation capacity is lower at particular times of the year, particularly in late December and January, when hydel generation capacity is at a seasonal trough because of water reserves/flows. The thermal capability also fluctuates somewhat due to seasonal changes in ambient temperature, fuel supply (calorific value and availability) and maintenance requirements.

### Quantifying Outage Costs

Costs of outages consist of direct costs which primarily comprise the spoilage cost and net value of lost production, also referred to as 'idle factor cost'. Costs of loadshedding also consist of adjustment costs. Firms frequently make adjustments in their operations to recover at least some of the output lost during and immediately after outages. These are referred to as indirect costs of outages. The particular mechanisms chosen for recovering output lost, will, of course, be based on cost minimization considerations. Accordingly, firms would opt for a particular strategy up to the point where it is cheaper than the other options. It is possible, therefore, for a firm to make multiple types of adjustments in response to outages. Typically, types of adjustments made by a firm include: acquiring self-generation capacity; more intensive utilization of capacity; working overtime; working additional shifts and; changing shift timings. The costs associated with these adjustments are briefly discussed below.

A pattern of response by industrial units, which is being increasingly observed in Pakistan, is that of development of own sources of energy supply through investment in generators. The case for such investment becomes greater the larger the time losses due to outages and the stronger the expectation that relatively high levels of power interruptions will persist in the long run. In practice, however, the extent of substitution of the conventional power source will depend upon the energy-intensity of operations, the extent of access to and cost of capital, on the possibility of making other cheaper adjustments and the ability of the firm to transfer the higher costs in the form of higher prices. Therefore, both partial and complete substitution of the standard power source by generators could be observed during periods of outages. The cost of operating generators also crucially depends on the type of fuel used (diesel or gas).

Firms generally report higher repair and maintenance costs due to more intensive utilization of machinery when there is no power outage. This represents the adjustment cost of moving to a higher rate of capacity utilization during the period not affected by outages. As far as overtime costs are concerned, if the firm does not operate a 24 hour production schedule daily, then there exists some opportunity for overtime. Whether or not overtime is actually resorted to will depend upon the magnitude of overtime differential, the importance of labour costs in total costs of production and the extent to which the firm has the market power to transfer the higher costs on to consumers. Likewise, if a firm operates one or two shifts only, adequate slack time may be available to alter the shift timings in order to avoid or work around periods of maximum outages during a particular day. However, given the fixity of contractual arrangements with labour any major changes in shift timings are likely to result in additional labour costs for payment of shift differentials. Costs associated with changing work days are, more or less, similar in character.

## Estimating Outage Costs

Some of the key parameters required to estimate the cost of loadshedding have been collected through a survey of a pre-designed and tested questionnaire on a purposive sample, stratified (by city and industry group) of 65 industrial units. As highlighted in Box 4.2, the sample included units from textiles, cement, engineering, chemicals, fertilizer, paper and paper board, food and consumer care and miscellaneous industrial categories. The survey was conducted in four principal industrial centres of Pakistan and was spread over both continuous and batch-making industries. Though the sample is relatively small, the nature of underlying costs and adjustments made by firms has yielded some important insights into the costs of outages.

**BOX 4.2**
**SAMPLE DISTRIBUTION BY INDUSTRY GROUP, PROCESS AND LOCATION**

| | *% of Sample* |
|---|---|
| ***Industry Group*** | |
| Textile | 27 |
| Chemicals and Products | 17 |
| Engineering | 28 |
| Paper and Board | 5 |
| Cement | 9 |
| Food and Consumer Care | 5 |
| Miscellaneous | 9 |
| ***Process*** | |
| Continuous | 36 |
| Batch-Making | 64 |
| ***Location*** | |
| Karachi | 39 |
| Lahore | 31 |
| Faisalabad | 20 |
| Sialkot | 10 |
| **Total Sample (number)** | **65** |

**Source:** IPP Survey

**TABLE 4.1**
**INCIDENCE OF LOADSHEDDING, 2008**

| | *Average Hours per Month* |
|---|---|
| January | 166.5 |
| February | 167.1 |
| March | 112.2 |
| April | 103.8 |
| May | 104.2 |
| June | 116.6 |
| July | 85.3 |
| August | 88.8 |
| September | 89.2 |
| October | 97.7 |
| November | 96.4 |
| December | 151.1 |
| Annual in 2008 | 1379 |
| Average per day | 4.6 |

**Source:** IPP Survey

***Incidence of Outages.*** As shown in Table 4.1, the average annual hours of outages per unit in the sample was 1379 in 2008. The average duration per day was 4 hour and 36 minutes. The duration of loadshedding varied widely, from a low of no loadshedding, in priority industries (like cement), to a maximum of over thirteen hours a day. The highest incidence of outages in 2008 was between the months of December and January and in June.

Industries which have been affected more by outages are textiles, machinery and equipment, food, glass and allied products. Also, continuous-process industries appear to have been less exposed to outages than batch-making industries. This could be attributed at least partially to efforts by WAPDA to protect the former.

***Pattern of Direct Costs.*** Effective time losses, corresponding to time losses during the outage plus restart time, were over 20 per cent. That is, 20 per cent of the time firms could have been in production, but was lost due to loadshedding.

**TABLE 4.2**
**TYPES OF ADJUSTMENTS TO LOADSHEDDING**

| | % of Sample | Extent of Recovery (%) |
|---|---|---|
| Self-Generation of Electricity | 75 | 85 |
| Working Overtime | 18 | 30 |
| Working Additional Shifts | 15 | 33 |
| More Intensive Utilization of Machinery | 10 | 28 |
| Changing Shift Timings | 6 | 30 |
| Changing Working Days | 5 | 6 |
| Firms making some adjustment to Loadshedding | 84 | 60 |

**Source:** IPP Survey

***Types of Adjustments to Outages.*** As shown in Table 4.2, about 84 percent of the sample units have responded to outages by making some changes in their operations. The highest proportion, 75 percent, of the sample units, have gone in for self-generation during outages by investment in stand-by generating capacity. Industries with a relatively high proportion of firms with generators are chemicals and petrochemicals and machinery and equipment. It is also of interest to note that wherever generators have been installed, the extent of substitution has been high, at 85 percent of the normal power consumption. Further, another 17 percent of the sample firms had plans to invest in generators. Therefore, industrial units in Pakistan probably feel that loadshedding is a phenomenon that will persist for several coming years. The potential demand for generators continues to rise, with the import bill of generators rising to about $ one billion in the first eight months of 2008-09.

Of the sample firms surveyed 65 per cent have diesel generators, 22 per cent have gas generators and about 12 per cent have multiple fuel i.e. both diesel and gas generators. It appears that such firms prefer self-generation using gas, presumably because of lower operating costs, but because of unreliability of gas supply (Pakistan experiences gas loadshedding also), sole reliance on gas generators is not a preferred option for them.

Firms which do not have self generation capacity, either because it is not economically feasible or affordable, have tried to recover some of the lost output with 18 percent working overtime, and

10 percent achieving more intensive operation of machinery. 15 percent have worked additional shifts while 6 percent have changed shift timing. About 5 percent have changed working days. These figures are surprisingly low. The principal reason for a lack of response in terms of a change in timings is that power distribution companies have been unable to announce well in advance scheduled timings for outages and to adhere to these schedules over time. The resulting uncertainty has prevented firms from changing shift timings or working days.

***Extent of Recovery of Output.*** Adjustments made by firms in response to outages have meant that a significant proportion of output lost during the outage and the subsequent restart time has eventually been recovered. For the sample as a whole, the extent of recovery of output is approximately 60 percent. Highest recovery rates have been observed in industries which have acquired self-generation capabilities, at 85 percent. Units which are unable to acquire generators lose about 73 percent of the output.

***Total Outage Costs to the Industrial Sector.*** One of the key objectives of the research is to estimate the overall magnitude of economic costs of outages in the industrial sector at the national level. Given that average industrial value added per Kwh of electricity supplied during the last year is Rs 81.25 and time lost due to load shedding, as revealed by the sample firms, was 20 percent, about Rs. 350 billion of value added would have been lost. However, our estimates shows that about 84 percent of the firms made an effort to recover part of this lost output through various adjustments. The highest proportion was recovered through self-generation. The recovery was, however, at a higher cost. The average DISCO tariff was Rs 7.94 per Kwh. According to Sheikh (2008) the average cost of self-generation is almost two and a half times more than this, i.e. Rs. 19.85 per Kwh, implying that self generation costs an extra Rs. 11.91 per Kwh. Therefore the extra cost to the industrial sector due to self-generation of electricity is about Rs. 32 billion (See Box 4.3). This is also the extent to which profitability of firms is lower because of load shedding. Also, since such firms recovered about 84% of the output, the cost of output permanently lost is estimated at Rs 42 billion. Therefore for firms which acquired self-generation capabilities, the cost of loadshedding is estimated to be Rs 74 billion.

**BOX 4.3**
**TOTAL COSTS OF LOADSHEDDING TO THE INDUSTRIAL SECTOR**

| | |
|---|---|
| ***For Firms with Self-Generation*** | |
| Additional Cost of Power Self-Generation | Rs 32 Billion |
| Value Added Loss | Rs 42 Billion |
| **Total Costs** | **Rs 74 Billion** |
| ***For Firms Without Self-Generation*** | |
| Additional Costs of Adjustments | Rs 6 Billion |
| Value Added Loss | Rs 77 Billion |
| **Total Costs** | **83 Billion** |
| Overall Costs to the Industrial Sector | Rs 157 Billion |
| Cost as % of Industrial Value Added | 9 |
| % Loss of Production | 7 |
| Loss of Industrial Employment | 300,000 workers |

**Source:** IPP estimates

Firms also recover output lost through other mechanisms, as indicated earlier. The extent of recovery is, however, limited to only 29 per cent. Also this recovery is made at additional costs which include overtime/ shift/changing working days premia to labour, additional wear and tear of machinery and spoilage of raw material/inputs in process. These costs aggregated to Rs. 6 billion at the national level. For such firms the cost of value added lost is Rs. 77 billion. The aggregate cost to firms which have not been able to self- generate power is, therefore, Rs. 83 billion. The costs of firms which have not been able to supplement their energy need through generators is higher than those which have done so. Overall, the cost to the industrial sector of loadshedding is estimated at Rs 157 billion. This is equivalent to 9 percent of the industrial value added. The loss of industrial output is estimated at 7 percent. Further, lower industrial activity leads to a contraction in industrial employment, particularly in the case of daily wage and part-time workers. Given the employment elasticity of industrial production of about 0.65, the reduction in industrial value added has led to a likely loss of industrial employment of about 300,000 workers. This magnitude of retrenchment can have significant consequences on the level of poverty in the country, where already poverty is on the rise due to escalating prices and lower growth.

**National Costs of Load Shedding.** Over and above the direct costs to the industrial sector, a change in the value added in the industrial sector has secondary or multiplier effects on the rest of the economy. Therefore, outages in the industrial sector by reducing the value added in that sector cause a decline in the level of economic activity in other sectors of the national economy like wholesale and retail trade, transport and communications, banking and insurance, etc. Pasha et.al. (1989) derived the short-run magnitude of the multiplier at 34 percent. Allowing for the multiplier effects, the overall costs of industrial loadshedding to the rest of the country is estimated to be Rs 53 billion (See Box 4.4). Therefore, the total cost to the economy of power loadshedding in the industrial sector is estimated to be Rs. 210 billion. This is equivalent to two percent of the Gross Domestic Product ( GDP). In turn, exports have also been affected. The loss of exports is estimated at Rs. 75 billion, equivalent to about US $ 1.2 billion in 2008.

**BOX 4.4**
**NATIONAL COSTS OF LOADSHEDDING**

| | |
|---|---|
| Cost to the Industrial Sector | Rs 157 Billion |
| Cost to the Other Sectors of Industrial Loss of Value Added | Rs 53 Billion |
| Total Cost of Industrial Load Shedding to the Economy | Rs 210 Billion |
| Cost As % of GDP | 2 |
| Loss of Employment in the Economy | 400,000 |
| Loss of Exports | Rs 75 Billion equivalent to over $ 1 billion |

**Source:** IPP Estimates

In summary, power loadshedding in the industrial sector has cost the country Rs 210 billion or over two percent of the GDP, over US$ 1 billion of export earnings and potential displacement of 400,000 workers. Costs could be even higher if impacts on other sectors like agriculture and services are allowed for which account for almost the same share in power consumption as industry.

***Comparison with Earlier Estimates of Outage Costs.*** The other national study in Pakistan on outage costs was conducted in 1984-85, a year of high power shortages. The study, [Pasha et. al (1989)] was based on a larger sample of 843 units. A comparison of results indicates the gravity of the power shortage the country currently faces.

**BOX 4.5**
**COMPARISON OF ESTIMATES WITH THE EARLIER RESULTS (1984-85 STUDY)**

| | 1984-85 | 2008 |
|---|---|---|
| Average Hours of Loadshedding (Annual) | 175 | 1379 |
| % of Sample Making Adjustment through Self Generation | 12 | 75 |
| Extent of recovery of Output (%) | 44 | 60 |
| Impact on Value Added (%) | 8 | 9 |
| Impact on Production | 2.6 | 7.0 |

**Source:** IPP estimates, Pasha (1989)

Box 4.5 compares the key results. Clearly loadshedding is a graver problem now then it was in the mid-80s. Also, firms now have developed expectations of power shortages and have adjusted to minimize losses. This is revealed both by the percentage of firms acquiring self-generation capabilities and the extent of recovery of output. However, the cost of power outages is significantly higher to the economy as is indicated by the percentage of loss of value added and production. Clearly, the country has not faced a power crisis of the magnitude it currently does. Also, the urgency to address the problem has never been historically higher.

**BOX 4.6**
**POLICY RECOMMENDATIONS BY SAMPLE UNITS**

- Build more dams
- Reduce industrial tariffs
- Reduce gas tariffs
- Priority to Industry at times of peak
- Change outage times to night
- Conserve electricity
- Reduce theft
- Develop other sources of energy
- Uniform tariff
- Improve load management
- Reduce diesel prices
- Improve management of power transmission and distribution

**Source:** IPP Survey

## Policy implications

Policy recommendations identified by the industrial units surveyed are presented in Box 4.6, ranked by frequency. A number of public policy initiatives can be taken regarding the development of the power sector, regulation and pricing of electricity and its management. Some of these are identified below:

***Investment in Power Sector.*** As mentioned earlier, the economic cost of unsupplied electricity is one of the key indicators of returns to expansion in the generation capacity and enhancement of the reliability of a power system. The results indicate that the cost of outages is relatively high in comparison to current tariff levels for power supply to the industrial sector. There is thus a strong case for expanding power generation capacity in the country. Given the high outage costs, our analysis shows that any investment in the sector will pay-off in a short span of time. In fact, there is a stronger case for upgrading existing power generation facilities, which can be accomplished at almost one-third the cost of new plants. This will require development and quick implementation of an accelerated generation investment programme both in thermal power plants, which will provide firm generation capability throughout the year, and in smaller hydel plants. Gas based and inefficient WAPDA plants should be replaced by new more efficient combined cycle plants.  The hydel projects in the pipeline, like Neelum-Jhelum (969 MW), Tarbela 4th Extension (960 MW), Suki Kinari (840 MW), Munda Dam (700 MW), Khan Dubar (130 MW), Allai (126 MW), and Jinnah Hydro (96 MW), should be executed on fast track. Also, the project to import 1000 MW electricity from Iran should be followed up.

Such expansion in capacity will need to be supported by the implementation of a comprehensive programme to reduce technical losses and improve the reliability of the distribution system. WAPDA and its thermal arm, need to be given autonomy to prepare, market and construct new projects, as happened in the 1960s and 1970s. Simultaneously, the enabling environment has to be improved so that IPPs investment plans can be encouraged. The distribution companies should also be provided adequate resources to modernize the overloaded transmission and distribution systems. The required investment can be recovered in less than three years through savings in transmission and distribution losses. The problem of circular debt has to be resolved on a priority basis. The payment should also be linked to higher capacity utilization to ensure that thermal stations will increase their generation to at least 75 percent of their capacity.

***Load Management Strategy.*** There appears to be a major variation among different types of industries in the outage costs. Our survey was limited and therefore we were constrained to draw conclusions on the magnitude of variation by type and size of industry. Earlier study on outages clearly brings out the differences and our survey also points it out. This indicates that there is scope for pursuing a loss-minimizing strategy rather than following a policy of equal curtailment. In particular, it has been highlighted that losses are high in continuous-process industries and more generally in those units which are especially vulnerable to spoilages. Also, they are high in export-oriented industries like textiles and leather. To the extent that power feeders can be distinguished by type of consumers an order of priority may be evolved regarding the extent of their curtailment during periods of energy shortages. The loadshedding schedule should reflect clear and transparent priorities, in consultation with all stakeholders and be predictable. Sectors that deserve priority should include, in particular, export industries.

***Information Flows and Customer Education.*** Responses to the survey questionnaire indicated that the distribution companies, do not announce loadshedding schedules well in advance which constrains a firm's ability to adjust to loadshedding. Also, there is a strong case to develop and implement customer outreach programmes to encourage energy conservation measures, steps to improve the power factor, and methods of limiting peak demand. It is also important that alternative sources of energy, in particular solar and wind energy, be explored, as recommended by our survey respondents. Internationally, new and renewable sources of energy such as wind power and solar energy, are a focus of research and development. Pakistan should enhance its capacity to follow these developments and promote greater use of renewable energy for light, heating, agriculture and small-scale enterprise.

***Pricing Policy.*** The scope for variation in tariffs intertemporally needs to be examined in line with the level of demand and the associated marginal costs of providing service. Given the seasonal character of incidence of outages in Pakistan with the highest frequency of occurrence during the winter and early summer months there is a strong case for a corresponding seasonal variation in the level of tariffs generally. On top of this, the difference between daily peak and off-peak tariffs may also be enhanced with the help of appropriate metering systems.

Some of the policy recommendations enunciated above can be implemented immediately while others have a medium term perspective, given the gestation period required for completion/execution of investments. The recommendations which can potentially be implemented in the short run are identified in Box 4.7.

**BOX 4.7**
**SHORT-TERM POLICY RECOMMENDATIONS**

- Up-gradation of Existing Power Plants
- Resolution of Circular Debt
- Reduction in transmission and distribution system's losses
- Import of Electricity from Iran
- Development / Implementation of Load Management Strategy
- Development/Implementation of Energy Conservation Strategy
- Consumer Education

**Source:** IPP Survey

We next turn to our other case study focusing on the failure of security, symbolized by the emergence of terrorism, reflecting the breakdown of basic institutions of governance. As mentioned in Chapter 1 such a breakdown, besides its other socio-political-economic consequences, directly affects the domestic and foreign investment climate, compromising growth and economic development. The question is what has been the economic cost to the country of participating in the global ‘War on Terror’ since 2001 which has led to the rise of insurgency and terrorism inside Pakistan?

## ECONOMIC COST OF THE 'WAR ON TERROR'

Until recently, the focus on the "War on Terror" was largely on highlighting the benefits in terms of increased support from the international community, especially the USA. But increasingly there is concern that the costs of participation are rising exponentially and leading to severe dislocation of economic activity and unacceptably high losses of life and property. In this section we attempt to quantify the net costs of terrorism. Conceptually, these costs can be classified into a number of categories, largely depending on their nature (direct and indirect) and on the time period examined (immediate, medium-term or long-term). Those costs that are short run are more clearly identifiable and potentially less difficult to measure. Estimates covering longer periods of time and focused mainly on indirect costs require numerous assumptions concerning counter factuals and hence are on less firm ground.

### Benefits of Participation in the 'War on Terror'

The decision to participate in the 'War on Terror' did lead to a major outpouring of international support to Pakistan. In 2001 Pakistan was emerging from a tough stabilization program with the IMF which in the process of reducing macroeconomic imbalances had, more or less, 'suffocated' the process of growth. Per capita income was stagnant and there been a substantial increase in unemployment and poverty. Foreign exchange resources were scarce and at the beginning of FY 2001-02, foreign reserves stood at $ 3,231 million, enough only to finance three months of imports of good and services.

Participation in the war effort led to a substantial increase in the inflow of concessional assistance, especially in the form of grants from the USA. As shown in Table 4.3, since 2001-02 Pakistan has cumulatively received $ 12.2 billion funding from the USA. This has consisted primarily (almost 70 percent), of reimbursement for the costs incurred by the military in counter-terrorism operations in the North of the country. Development and economic assistance has aggregated to $ 3.2 billion during the period. Therefore, the direct contribution to the growth process in the country has been limited. However, the overall assistance, including the funding of military operations (mostly incurred in local currency), contributed to a rapid buildup in the foreign exchange reserves of the country. These reserves increased to $ 12,389 million by the end of 2003-04.

**TABLE 4.3**
**US FUNDING TO PAKISTAN SINCE 2001**

**[$ million]**

| Purpose | FY 2002 | FY 2003 | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | Cumulative |
|---|---|---|---|---|---|---|---|---|
| Military | 1465 | 1473 | 782 | 1273 | 1218 | 1095 | 1387 | 8694 |
| Law Enforcement | 100 | 32 | 36 | 40 | 46 | 31 | 31 | 318 |
| Development & Economic | 665 | 258 | 304 | 405 | 677 | 442 | 445 | 3194 |
| Diplomacy | 3 | 4 | 7 | 6 | 9 | 9 | 1 | 39 |
| Total | 2232 | 1767 | 1129 | 1724 | 1951 | 1578 | 1866 | 12245 |

**Source:** US Government Accountability Office, Securing, Stabilizing and Developing Pakistan's Border with Afghanistan, February 2009.

The consequence was not only the alleviation of the foreign exchange constraint to growth but also the associated rapid expansion in money supply this led to a precipitous fall in interest rates and stimulated aggregate demand in the economy. The economy went back, after a long time, on to the path of rapid growth from 2003-04 onwards, averaging a GDP growth rate almost of 7 percent.

But the large inflows of aid, alongwith higher remittances and, more recently, foreign direct investment, led to symptoms of 'Dutch Disease' in the Pakistani economy. The currency appreciated in real terms which promoted import-based consumption-led growth (see Chapter 2). By 2006-07, the process of rapid growth was beginning to look increasingly unsustainable, with the current account deficit in the balance of payments reaching 5 percent of the GDP. Following the sharp increase in oil prices, Pakistan found itself confronted with a full-blown financial crisis in 2007-08. This will lead to the plummeting of the growth rate to less than 3 percent in 2008-09. Increasingly, the benefits of participation in the 'War on Terror' appear to have been declining and temporary in character. These benefits have largely been frittered away in rising consumption levels, especially of the richer sections of Pakistani society.

## The Incidence of Terrorism

We turn to the costs, which hinge on the level of incidence of the acts of terrorism in the country. The trend in the number and incidence of these acts is also a basic indicator of the success of the counter-terrorism strategy.

The Pakistan Security Report prepared by the Pakistan Institute of Peace Studies (PIPS) quantifies carefully the incidence of terrorism in the country on the basis of day-to-day monitoring of the national and local print and electronic media. The estimated number of attacks in 2008 alongwith the numbers killed and injured is given in Table 4.4. Bulk of the incidents were in the nature of terrorist attacks in 2008. An estimated 2267 people were killed in these attacks and 4,558 were injured. In addition, 'operational attacks' (security force's operations against terrorists) have led to 3182 deaths and 2267 injured (mostly 'collateral' damage). According to some estimates, missile attacks by US drones have killed almost 1,000 innocent civilians in 2008.

**TABLE 4.4**
**NATURE AND INCIDENCE OF ATTACKS IN 2008**

| Attacks/Clashes | Number of Incidents | Killed | Injured |
|---|---|---|---|
| Terrorist attacks | 2148 | 2267 | 4558 |
| Operational attacks | - | 3182 | 2267 |
| Clashes between security forces and militants | 95 | 655 | 557 |
| Political violence | 88 | 162 | 419 |
| Inter-tribe sectarian clashes | 55 | 395 | 207 |
| **Total** | | **6661** | **8008** |

**Source:** PIPS (2008)

The highest number of attacks were reported in NWFP at 1009, followed by Balochistan at 682 and the Tribal Areas at 385. As many as 35 attacks took place in Punjab, 25 in Sindh, 7 in Islamabad and 4 in Azad Kashmir. The major attacks in 2008 in which more than 25 people lost their lives are listed in Table 4.5. The striking conclusion is that these 'mega-attacks' have occurred throughout the country including in high-security locations like the capital city, Islamabad. Such major acts of terrorism disproportionately magnify general perceptions of risk throughout the country and demonstrate the lack of success of counter-terrorism efforts to date.

One of the most devastating incidents, widely publicized in both the national and international media, was the bombing of the Marriott Hotel in Islamabad on the 20th September 2008, which claimed 80 lives and injured 230 people, alongwith extensive damage to property and vehicles. Other events which have left an indelible mark on peoples minds include the attack on FIA headquarters in Lahore on 11 March, on Pakistan Ordinance Factory in Wah Cantt on 21 August, on a Tribal Jirga in FATA on 10th October and on a PPP Rally in Parachinar Khurram Agency, on

**TABLE 4.5**
**MAJOR ACTS OF TERRORISM IN 2008**

| Date | Place | Target | Casualties | Injured |
|---|---|---|---|---|
| **N W F P** | | | | |
| 9 February | Shabqadar, Charsada | ANP's Rally | 31 | 51 |
| 29 February | Swat | Funeral | 50 | 80 |
| 2 March | Dara Adamkhel | Peace Jirga | 53 | 56 |
| 19 August | D.I. Khan | Shia Gathering | 33 | 54 |
| 6 September | Budh Beer, Peshawer | Police Station | 39 | 80 |
| 28 December | Shalbandai,Buner | Girls School | 44 | 19 |
| **P U N J A B** | | | | |
| 10 January | GPO, Lahore | Police | 27 | 70 |
| 11 March | Lahore | FIA HQ | 31 | 217 |
| 21 August | Wah Cantt | POF | 85 | 109 |
| 6 October | Bhakkar | MNA meeting | 26 | 62 |
| **F A T A** | | | | |
| 16 February | Parachinar, Khurram Agency | PPP Rally | 51 | 93 |
| 10 October | Khadeezai, Orakzai Agency | Tribal Jirga | 120 | 200 |
| 6 November | Bajaur Agency | Tribal Jirga | 25 | 50 |
| **I S L A M A B A D** | | | | |
| 6 July | Islamabad | Police | 25 | 54 |
| 20 September | Islamabad | Marriott Hotel | 80 | 230 |

**Source:** PIPS (2008).

the Sri Lankan cricket team in Lahore on March 3, 2009, and on a police academy on March 31, 2009. The people of Pakistan were earlier shocked by the assassination of Mohtarma Benazir Bhutto in Rawalpindi by a terrorist, which shook the foundations of the country and led to a carnage of violence and destruction. Ms. Bhutto was assassinated on December 27.

The inescapable conclusion from Table 4.6 is that the incidence of terrorism is increasingly exponentially in Pakistan. These estimates indicate that the costs of terrorism are rising very

**TABLE 4.6**
**TERRORIST AND OTHER ATTACKS FROM 2005 TO 2008**

| Years | Total Attacks | % Increase | Number Killed | % Increase | Number Injured | % Increase |
|---|---|---|---|---|---|---|
| 2005 | 254 | | 216 | | 571 | |
| 2006 | 675 | 159 | 907 | 320 | 1543 | 170 |
| 2007 | 1503 | 129 | 3448 | 280 | 5353 | 247 |
| 2008 | 2386 | 59 | 6661 | 93 | 8008 | 50 |

**Source:** PIPS (2008).

rapidly in the country due not only to the increasing number but also because of the rising intensity and widespread nature of this activity.

## Government Estimates of Costs of Terrorism

The Ministry of Finance of the GOP has prepared estimates of the cost of the 'War on Terror' to Pakistan in the PRSP-II document. The following indirect costs have been identified in addition to the direct costs:

(i) Delay in implementation of development projects in affected areas, like NWFP and FATA, leading to cost overruns.

(ii) Increasing uncertainty leading to capital flight and affecting FDI.

(iii) Slowing down of domestic economic activity.

(iv) Excessive increase in the country's credit risk, making borrowing very expensive.

(v) Increased unemployment in affected regions.

(vi) Costs of displacement of local population.

According to Table 4.7 above, costs of the 'War on Terror' are expected to approach Rs 678 billion (approximately $8.4 billion) in 2008-09, equivalent to over 5 percent of the projected GDP. Indirect costs on account of loss of exports, foreign investment, industrial output, etc, represent bulk of the costs, with a share of over 83 percent. Cumulatively, according to government the cumulative cost of the 'War on Terror' since 2004-05 is $ 31.4 billion, substantially in excess of

**TABLE 4.7**
**COSTS OF 'WAR ON TERROR' TO PAKISTAN**

**[Rs billion]**

| | FY 2004-05 | FY 2005-06 | 006-07 | FY 2007-08 | FY 2008-09[a] | Growth Rate (%) |
|---|---|---|---|---|---|---|
| Direct Cost (Rs Billion) | 67.1 | 78.1 | 82.5 | 108.5 | 114.0 | 14.1 |
| Indirect Cost* (Rs Billion) | 192.0 | 222.7 | 278.4 | 375.8 | 563.8 | 30.9 |
| Total (Rs Billion) | 259.1 | 300.8 | 360.9 | 484.4 | 677.8 | 27.2 |
| Total ($ Billion) | 4365 | 5025 | 5752 | 7744 | 8368 | 17.7 |
| % of GDP | 4.0 | 3.9 | 4.1 | 4.6 | 5.1 | |

[a] Assumed exchange rate 1$ = 81.00 Rs.
* On account of loss of exports, foreign investment, privatization, industrial output, tax collection, etc.

**Source:** Finance Division, Government of Pakistan, September, 2008, PRSP II.

the flow of concessional assistance estimated at about $ 1.7 billion annually, but this will still remain substantially less than the costs of the 'War on Terror'.

The government estimates reveal very rapid growth in costs of over 27 percent per annum since 2004-05. This is consistent with the sharply rising incidence of attacks highlighted in the previous section. But in the absence of a detailed technical statement it is difficult to judge the reliability of the government estimate of the magnitude of the costs.

The literature is replete with attempts at quantification of the costs of the 9/11 terrorist attacks on the US economy. [See Chan (2002), The Milken Institute (2004), J. Brauer (2002), Warshawsky (2001)] According to the Institute for Analysis of Global Security [2003] the total cost was $244 billion, with the share of direct and indirect costs being 44 percent and 56 percent respectively. This is equivalent to about 2.5 percent of the US GDP in 2001. If the loss in stock market wealth is included, then the costs rise substantially. A recent book by Bruce Reidel puts the cost of 9/11 for the US economy at over 1 trillion. According to the Milken Institute if losses to the global stock markets are included, the costs approach $2 trillion.

## Typology of Costs

Costs of terrorism, as highlighted above, are both direct and indirect as well as of a short-term and more long-term nature. [See Saxton Report of US Congress (2002), Looney (2002), Frey, Luchinger and Stutzer (2007), Paul Krugman (2004)]

Direct costs include the following:

(i) Value of human lives lost or of injuries

(ii) Value of property or infrastructure destroyed or damaged

(iii) Costs of enhanced spending on security.

Here, the major conceptual issue relates to the valuation of the human cost, either in terms of loss of life or of injuries. In order to avoid controversy over any assumed value, we simply compute the cost as the (potential or actual) compensation due to affected families as per a prescribed government formula (if available).

Indirect costs are diverse in nature and include the following:

***Costs to local economies:*** areas which are severely impacted by terrorism, like NWFP and FATA, are likely to experience dislocation of economic activity resulting in loss of output and employment. In addition, due to the heightened sense of insecurity, loss of livelihood, and damage to shelter, terrorism may lead to internally displaced persons (IDPs) on whom costs will need to be incurred in the form of relief and rehabilitation.

***Costs of greater uncertainty and risk perceptions:*** The first cost incurred is in terms of lost investment, both foreign and domestic, due to heightened risk perceptions, especially arising from 'mega-attacks' like the assassination of Mohtarma Benazir Bhutto and the bombing of Marriott Hotel, both of which have happened within the last eighteen months. The enhanced uncertainty may also be reflected in decline in share market capitalization. In addition, travel and tourism to the country is likely to be adversely affected leading to decline in associated services by hotels, restaurants, tourist guides, transport operators, etc. Finally, an important category of costs relates to the higher costs of insurance premia for coverage against acts of terrorism.

***Higher transaction costs:*** These costs are associated with delays in the movement of goods and consignments. Firms may also incur costs of higher inventories to avoid the possibility of disruption in supplies. In addition there are enhanced time costs, arising, for example, at airports due to greater security checks, immigration restrictions, etc.

***Psychological costs:*** These are relatively hard to measure costs of terrorism like added anxiety, stress and even mental disorders.

In attempting a quantification of the costs, deliberate effort has been made to keep the estimates on the conservative side for the latest year, 2007-08. For this year, the counter-factual in the case of direct costs is the projection of the trend observed up to 2000-01 while in the case of indirect costs the counter-factual assumed is the projection of trend estimated up to 2006-07.

## Direct Costs

Starting with the damage to human lives and property, as mentioned above, we focus only on the cost of compensation for loss of life or injury. The Prime Minister has announced a compensation formula to affected families following the Wali Bagh suicide attack on October 3, 2008 of Rs 300,000 per deceased and Rs 100,000 per injured person. Given the number killed and injured in 2008, as shown in Table 2, the total potential compensation cost is estimated at about Rs 3 billion. This is, of course, a low estimate compared to the present value of the lifetime income stream lost either due to death or injury.

As far as the damage to property and infrastructure is concerned, no systematic data is available except for 'mega attacks' like the bombing of the Marriott Hotel, in which case the renovation cost is estimated at over Rs 500 million. Also, an inventory has been made of the damage caused by the riots following the assassination of Mohtarma Benazir Bhutto. A notional estimate of loss of property due to terrorist attacks can be made as about Rs 1 million per person killed. This is equivalent to about one sixth of the damage per person killed in a high value property bombing like Marriott hotel. Accordingly the loss of property and infrastructure due to attacks in 2008 is approximately Rs 8 billion.

Turning next to expenditure on security, defence expenditure has been higher because of the need to place the armed forces at the Western borders and for undertaking counter-terrorism operations especially in the North. This is demonstrated by the numbers in Table 4.8. Between 1993-94 and 1999-2000 there was a gradual drop in real current defence expenditure (at 1999-2000 prices) of about 2 percent per annum. From 2001-02 onwards, at the time of the onset of the 'War on Terror', the trend in real defence expenditure is one of positive growth of over 5.5 percent per annum. It appears that defence expenditure is about 62 percent higher than what it would have been in the absence of the 'War on Terror'. This implies that at current prices the cost of engaging in the war in 2007-08 is Rs 109 billion. This, of course, does not include the cost of acquisition of specialized military equipment for the war, on which no information is available. As such, the overall cost is understated. The upward pressure on defence expenditure is highlighted by the fact that in recent years actual expenditure has consistently exceeded budget estimates.

Turning to expenditure on law and order and public safety by provincial governments, primarily on police, we also observe a distinct change in the trend after 2001-02, as shown in Table 4.8.

**TABLE 4.8**
**DEFENCE EXPENDITURE* AND EXPENDITURE ON LAW AND ORDER****

**[Rs billion]**

| | Defence Expenditure | | | Expenditure on Law and Order | | |
|---|---|---|---|---|---|---|
| Years | at current prices | at constant prices[a] | Growth Rate (%) | at current prices | at constant prices[a] | Growth Rate (%) |
| 1993-94 | 91.8 | 171.3 | | 5.6 | 10.4 | |
| 1994-95 | 104.5 | 161.8 | -5.5 | 7.4 | 11.5 | 10.0 |
| 1995-96 | 119.7 | 156.9 | -3.0 | 9.5 | 12.5 | 8.8 |
| 1996-97 | 127.4 | 158.7 | 1.1 | 11.0 | 13.7 | 9.5 |
| 1997-98 | 136.2 | 161.4 | 1.7 | 11.9 | 14.1 | 3.1 |
| 1998-99 | 143.5 | 159.8 | -1.0 | 13.2 | 14.7 | 4.2 |
| 1999-2000 | 150.4 | 150.4 | -5.9 | 15.6 | 15.6 | 6.1 |
| 2000-01 | 131.2 | 125.7 | -16.4 | 17.5 | 16.8 | 7.7 |
| 2001-02 | 149.3 | 138.1 | 9.9 | 19.5 | 18.0 | 7.1 |
| 2002-03 | 159.7 | 144.8 | 4.9 | 23.7 | 21.5 | 19.4 |
| 2003-04 | 184.9 | 158.3 | 9.3 | 32.1 | 27.5 | 27.9 |
| 2004-05 | 211.7 | 165.8 | 4.7 | 35.5 | 27.8 | 1.1 |
| 2005-06 | 241.1 | 176.4 | 6.4 | 46.7 | 34.2 | 23.0 |
| 2006-07 | 277.3 | 188.3 | 6.7 | 57.1 | 38.8 | 13.4 |
| 2007-08 | 297.0 | 184.1 | -2.2 | 65.0b | 40.3 | 3.9 |

* by federal government.
** by provincial governments.
**a** of 1999-2000.
**b** budget estimate.
**Source:** MoF, Pakistan Economic Survey.
FBS, Statistical Year Book.

Prior to 2001-02, the trend growth rate in real law and order expenditure was 7 percent, which doubled to 14 percent after 2001-02. It thus appears that law and order expenditure is higher by about 48 percent in the presence of the 'War on Terror' than it would have been without the war. This implies a higher cost of Rs 21 billion in 2007-08. Here again, no provision is made for higher expenditure on special equipment for police. However, the faster increase in police expenditure in recent years may also be due to a general deterioration in the law and order situation not necessarily linked to rising levels of terrorism in the country. Given the deteriorating situation, the government of NWFP has increased the police budget by 28 percent in the current financial year. Actual expenditure may be even higher, Higher costs of operations of para-military forces, intelligence agencies like ISI and FIA have not been estimated due to lack of data.

Another aspect of enhanced security is the development of private security arrangements in the country. There has, in fact, been a mushroom growth in this service in recent years. According to an informal survey carried out by the newspaper, *Daily Times*, the number of men employed by private security companies in Lahore is about 50 percent more than the number of policemen stationed in the city. The enactment of the Private Security Companies Regulation and Control Ordinance by the Punjab government in 2002 has facilitated the establishment of such companies, of which there are over 200 alone in Lahore. Currently it is estimated that there are over 30,000 security guards in Lahore and probably over 200,000 in the country. With the total cost (wages plus overheads) per guard of about Rs 7,000 per month, the total cost of private security services is estimated at Rs 16.8 billion. We assume that about half, or Rs 8 billion, is attributable to the 'War on Terror'.

Overall, a summary of the direct costs of terrorism is presented in Box 4.8.

**BOX 4.8**
**DIRECT COSTS OF TERRORISM**

| | [Rs in Billion] |
|---|---|
| ● (Potential) costs of compensation to victims | 3 |
| ● Costs of damage to property and infrastructure | 8 |
| ● Higher costs of defence | 109 |
| ● Higher costs of police | 21 |
| ● Higher cost of private security | 8 |
| **Total Direct Cost** | **149** |
| **SAY** | **Rs 150 Billion** |

Despite the conservative and incomplete nature of these estimates, they work out to be significantly greater than government's estimate of direct costs in 2007-08 of about Rs 109 billion.

### *Indirect Costs*

We first take up the impact of the war on terror on local economies.

### *Costs to Local Economies*

The local economies in the Pakistani context are NWFP and FATA, where bulk of the terrorist attacks have occurred and where military operations (including the drone attacks) are concentrated. The shares of the two regions in the national population, according to the 1998 Census, are 13.4 percent and 2.4 percent respectively.

**TABLE 4.9**
**GDP AND SECTORAL GROWTH TRENDS IN NWFP AND PAKISTAN**

[%]

| | 1995-96 to 2000-01 | 2001-02 to 2003-04 | 2004-05 |
|---|---|---|---|
| ***GDP*** | | | |
| NWFP[a] | 2.8 | 6.8 | 6.2 |
| Pakistan | 3.5 | 4.8 | 8.6 |
| ***NWFP Sectoral Growth*** | | | |
| Agriculture | 3.5 | 3.4 | 2.9 |
| Industry | 1.8 | 7.5 | 10.2 |
| Services | 3.0 | 7.9* | 5.7 |

*fast growth in transport and communications, public administration, wholesale and retail trade.
[a] share of NWFP in national GDP is 9.6% in 2004-05.
**Source:** World Bank (2006).

Estimates of the Gross Regional Product of NWFP have been made by the World Bank [2006] upto 2004-05. No such estimates are available for FATA. Table 4.9 gives a comparison of the growth trends in the regional and national economies. Some interesting conclusions emerge from the table. It appears that in immediate aftermath of the war, there was actually greater buoyancy in the NWFP economy due to the 'war multiplier' of an enlarged military presence and the stimulus provided to services like transport in the process of supplies to the NATO forces in Afghanistan. Consequently, between 2001-02 and 2003-04, the regional growth rate approached 7 percent. However, as the incidence of acts of terrorism increased, especially in Peshawar, and military operations became more intense and widespread, there has been much greater dislocation of economic activity. In 2004-05, the differential in the growth rates of Pakistan as a whole and NWFP in particular was almost 2½ percentage points. By now, it has probably exceeded 3 percentage points.

**TABLE 4.10**
**EMPLOYMENT TRENDS IN NWFP AND PAKISTAN**

| | NWFP | | PAKISTAN | |
|---|---|---|---|---|
| | Employment (000s) | Annual Growth Rate (%) | Employment (000s) | Annual Growth Rate (%) |
| 2001-02 | 3851 | | 51262 | |
| 2003-04 | 4193 | 4.3 | 42859 | -8.6 |
| 2005-06 | 4743 | 6.3 | 48005 | 5.8 |
| 2006-07 | 4635 | -2.3 | 48812 | 1.7 |

**Source:** LFS, FBS

Employment trends can be extracted from the Labor Force Surveys and are presented in Table 4.10. These trends confirm the initial impetus to the NWFP followed more recently by falling employment, with over 100,000 persons losing jobs in 2006-07. Even though data is not available on FATA it is likely that there has been a massive displacement of economic activity from the region.

We estimate that the growth rate of the NWFP economy has been about 3 percentage points less than the national economy in recent years. This implies that in 2007-08, the growth rate of NWFP was less than 3 percent and, in 2008-09, the regional economy is likely to exhibit little or no growth. Given that NWFP accounts for about 10 percent of the national GDP, the implication is that the cost of lower growth in the local economy due to the 'War on Terror' is about 0.3 percent of Pakistan's GDP, equivalent to Rs 31 billion in 2007-08. We notionally add about 30 percent to this cost to incorporate the impact on the economy of FATA. Therefore, the indirect cost on local economies of the 'War on Terror' is estimated at about Rs 40 billion.

There is need also for inclusion of costs of internally displaced persons (IDPs) in terms of the potential relief and rehabilitation costs. The National Disaster Management Authority (NDMA) has already registered 337,772 people who have left their homes because of the security situation in parts of NWFP and FATA, of which about 70 percent belong to FATA. The estimate of Amnesty International of IDPs is higher at 500,000.

We assume that the level of relief and rehabilitation required is about Rs 1000 per month per adult corresponding to the level of transfer proposed in the Benazir Income Support Program. The annual cost is estimated at about Rs 2 billion for about one-thirds of the IDP population.

***Cost of Greater Uncertainty and Risk Perceptions***

These costs are reflected primarily in falling investment by both domestic and foreign investors. Between 2003-04 and 2006-07 as the economy exhibited high growth, private investment was, in fact, quite dynamic. It increased from 10.9 percent of the GDP in 2003-04 to reach a peak of

15.7 percent in 2005-06. Since then, however, there has been a declining trend and it stood at 14.2 percent in 2007-08. A similar decline is observed in foreign private investment in 2007-08 of 25.7 percent.

A number of factors explain the sharp decline in private investment in 2007-08. These are as follows:

(i) Deterioration in the investment 'climate' due to the emergence of large macroeconomic imbalances and a sharp rise in the rate of inflation following the oil price shock, coupled with enhanced political instability in the lead up to the elections and formation of government thereafter.

(ii) High incidence of power loadshedding and other supply bottlenecks which have substantially raised the cost of doing business in Pakistan.

(iii) As highlighted earlier, a sharp increase in the number and intensity of acts of terrorism and risk perceptions being heightened following particularly the assassination of Mohtarma Benazir Bhutto.

Therefore, there are essentially three sets of factors responsible for the plummeting of private investment. We assume that the contribution of the factors is, more or less, the same to the fall of private investment of about 1.5 percent of the GDP from the peak level attained in 2005-06. As such, the enhanced perception of risk and uncertainty due to terrorism in Pakistan is responsible for a fall in private investment of 0.5 percent of the GDP in 2007-08, equivalent to Rs 52 billion.

Beyond this, the enhanced level of risk has affected the stock market capitalization. In fact, the Karachi Stock Exchange had shown remarkable buoyancy since 2003 and had emerged as one of the best performers in emerging markets. But in 2007-08 a process of decline set in, not only due to local factors but also because of the incipient global financial crisis which led to a fall in most markets in share values. Between the 1st of July 2007 to 30th June 2008 the share price index in KSE fell by 10.8 percent.

The extreme sensitivity of stock prices to mega-terrorist attacks is demonstrated by the consequences of the assassination of Mohtarma Benazir Bhutto. Prior to the 27th of December 2007, the day she was killed by a terrorist, the stock market had been showing an upward trend. The first day after the event the market collapsed by 696 points or almost 5 percent. Market capitalization of Rs 213 billion was wiped out overnight.

Given the fact that global factors are responsible for the fall in stock values in most markets, we estimate the differential between the fall of the market in Pakistan and elsewhere in Asia. It is assumed that local factors are responsible for this differential. Within the local factors, terrorism is assumed once again to have contributed one-third to the incremental fall. The composite regional index (S&P ASIA 50 INDEX) fell by 1.8 percent between end-June 2007 and end-June 2008. Therefore, the differential in rate of decline of KSE was 9 percent. With a market capitalization at the beginning of 2007-08 of Rs 4019 billion, this implies that the loss of value was about Rs 362 billion, of which one-third can be attributed as the cost of terrorism, amounting to about Rs 120 billion.

The next cost of higher risk and uncertainty arising from acts of terrorism is the negative impact on tourism and associated services performed by hotels, restaurants, etc. This is particularly relevant as some of the most attractive tourist locations are in the North of the country. There had, in fact, been buoyancy in travel expenditures to Pakistan as indicated by the balance of payments statistics maintained by the SBP. Between 2000-01 and 2006-07 income from travel to Pakistan had increased at the annual rate of almost 22 percent. But there was a significant drop in 2007-08. We estimate that in relation to the level projected on the basis of the past trend of growth, there was a fall of $71 million. This is primarily attributable to the greater reluctance to travel to Pakistan because of higher risk associated with acts of terrorism. Therefore, the indirect cost of less travel to Pakistan is Rs 4 billion. This, of course, does not factor in the decline in domestic tourism. It is not surprising that losses of the national carrier, PIA, have been rising from Rs 4.4 billion in 2005 to Rs 13.4 billion in 2007, due to loss of market and higher fuel prices.

Combined with the fall in tourism is the negative impact on the hotel industry and other linked service activities. During 2008, the Pakistan Hotels Association indicates a sharp drop in hotel occupancy rates, especially after the bombing of Marriott Hotel. In addition, there are less hotel events like conventions, marriages, etc., due to excessive security arrangements. A conservative estimate is that occupancy rates in 2007-08 have declined from about 60 percent earlier to close to 40 percent.

The Tourism Division of the GoP estimates that there are about 38,000 lettable rooms in hotels in Pakistan. The average tariff per room is estimated at Rs 2000 per day. A fall in occupancy of 20 percentage points implies a loss in income of over Rs 5 billion. We double this estimate to allow for the loss in other hotel income and in the income of associated services like restaurants, tour operators, transport, etc. Therefore, the indirect cost of loss of travel and tourism and downstream activities due to terrorism is about Rs 10 billion.

Finally, in the area of indirect costs we have to factor in the higher costs of insurance. With the rise in terror related acts, premia for providing insurance cover on such acts has skyrocketed. Following the destruction of property in the riots in the aftermath of assassination of Mohtarma Benazir Bhutto, general insurance companies had to honor claims of over Rs 3 billion, which wiped out the premium income for more than a year. There has, in fact, been a big increase in demand for terrorism insurance following the Marriott bombing. However, domestic insurance companies are limited by the reluctance of foreign companies to provide reinsurance to Pakistani companies.

Some companies have started to provide cover of upto Rs 100 million against acts of terror but the premium rate has gone up to a high of 4 percent, as compared to the past rate of about 1 percent. We estimate that the cost of higher insurance premia is about Rs 3 billion on an annualized basis.

Overall, the indirect costs of terrorism can be aggregated to Rs. 230 billion (See Box 4.9).

The implications of higher transaction costs due to terrorism in the form of delays in the movement of consignments, costs of maintaining higher inventories and larger time costs at airports, etc., have not been quantified due to lack of data. These represent areas for further research.

**BOX 4.9**
**INDIRECT COSTS OF TERRORISM**
**[Rs in Billion]**

| | |
|---|---|
| ***Costs to Local Economies*** | |
| Loss of economic growth in NWFP and FATA | 40 |
| Cost of IDPs | 2 |
| ***Costs of Higher Risk Perception and Uncertainty*** | |
| Fall in Private Investment | 52 |
| Fall in Stock Market Capitalization | 120 |
| Decline in Travel and Tourism | 4 |
| Fall in Hotel Occupancy and Income from Associated services | 10 |
| Rise in Insurance Costs | 3 |
| **Total Indirect Costs** | **231** |
| **SAY** | **Rs 230 Billion** |

***Policy Recommendations***

The total costs of terrorism in Pakistan are high, estimated at Rs 380 billion, at the 2007-08 base. The distributional consequences of these costs on the 'War on Terror' need to be highlighted. Higher security expenditures run the risk of 'crowding out' other expenditures related to the provision of basic social and economic services and thereby having on adverse impact especially on the lower income groups. This is mitigated partly by the reimbursement from the USA of the additional military expenses but remains a real threat in the context of higher expenditures on law and order (especially police) by the provincial governments.

Beyond this, the negative implications for the relatively poor include the loss of property and livelihoods in the affected areas which are among the most backward regions of the country, primarily as a consequence of dislocation of economic activity, including in the labor-intensive sector of tourism. The human dimension is manifested most acutely not only in the loss of life but also in the emergence of large numbers of IDPs.

For the relatively well-off, the costs consist of foregone investment opportunities and decline in wealth associated with the fall in share values, due to heightened levels of risk and uncertainty. There are also higher costs to the corporate sector in the form of larger premia for insurance coverage and increased transaction costs.

A number of important conclusions emerge from the analysis of the costs of terrorism. First, as the incidence of terrorist acts and counter-terrorism operations has increased rapidly, the benefits of participation in the 'War on Terror' are falling while the costs are rising sharply. In 2007-08, the inflow of concessional assistance from the USA was about $ 1.9 billion, whereas the cost is over three times higher at $ 6 billion. There has, therefore, been substantial undercompensation for Pakistan's participation in the 'War on Terror', which has been limited largely to reimbursement only for the costs of military operations. This, at least, partly explains the lack of some ownership of the war effort. The recent commitment by President Barak Obama that the USA will pass a bill in Congress to authorize economic aid to Pakistan of $ 1.5 billion per year for the next five years, will raise the quantum of concessional assistance from USA to Pakistan but the level of support will still remain at less than half the costs of the 'War on Terror'. It is important that the full costs of the 'War on Terror' are highlighted to donors in the subsequent meetings of the Friends of Democratic Pakistan.

Second, the past experience with utilization of the concessional support is not very positive. From the viewpoint of achieving sustainable higher growth and promoting employment, especially for alleviating poverty, it is perhaps better if Pakistan is also given preferential access to markets, especially for textiles, in the USA, EU and Japan. While the proposal for Reconstruction Opportunity Zones (ROZs) in the affected areas, enjoying preferential access, is worthy of consideration, it is unlikely that in the short run much investment will be diverted to these areas despite the incentive given the prevailing situation. It is important that as an alternative fast-track concessional assistance is provided for public investments in infrastructure and basic services and employment-intensive public works in affected areas which are cleared up either through military operations or peace agreements in order to provide an early 'peace dividend'. At the national as well as local level, the problem of militancy can be tackled effectively by fast implementation of a Youth Skill Development and Employment Program, which aims to absorb the over 1.5 million unemployed youth in the country.

Finally, the higher direct costs being incurred on the military and police operations against counter-terrorism of almost Rs 130 billion per annum and the concomitant increase in acts of terrorism, highlight the ineffectiveness of the current strategy being followed in the 'War on Terror'. There is need for a comprehensive review of the strategy, preceded by the development of a stronger political consensus and broad-based public commitment to participation in this war.

To conclude, the analysis in this section amply demonstrates that the country is paying a heavy price for the delay in the effective resolution of these enormous challenges facing it. Potentially, GDP could have been higher by almost Rs. 590 billion if the problems of security and power shortage alone were not adversely impacting on the economy. The concomitant repercussions for exports, employment and poverty are also sizable. Any further inaction or inadequate/inappropriate policy action can further frustrate the country's growth potential, which it can ill afford in these times of increasingly unfavorable global developments.

# Chapter - 5

# From Stabilization to Recovery of Growth: Drilling Down to the Specifics

# Chapter - 5
# From Stabilization to Recovery of Growth: Drilling Down to the Specifics

This chapter builds on the public policy suggestions made in the first IPP annual report. In that we proposed concentrating public policy on some of the sectors that had potential for contributing to the growth of the Pakistani economy and ensuring that its rewards were more equitably distributed. This chapter drills down deeper into the sectors and examines some of the areas for concentration by the state functioning at the federal, provincial and local levels. It focuses first on the causes of the negative growth in the industrial sector in the current financial year and what measures need to be taken to revive the sector next year. It then discusses the appropriateness of the development model for a country in Pakistan's situation. The chapter then focuses on the development of the Pakistani firm as a catalyst of economic change in the country. We conclude with the identification of a dozen areas for analytical work and policy advice, each with enormous bearing on improving the competitiveness of the Pakistani economy and enhancing the prospects of growth.

## PROMOTING INDUSTRIAL REVIVAL IN THE SHORT RUN

The previous chapters have highlighted on the one hand that the process of stabilization, especially on the external account, has gone further then was perhaps originally anticipated, aided particularly by the sharp fall in import prices (especially of oil) but on the other hand the growth process in the economy has been affected more than was implied by projections at the beginning of the year. Not only is this the consequence of tighter aggregate demand management, reflected, for example, in high interest rates and a big cutback in development expenditure, but also in the emergence of supply-side bottlenecks, especially of power, water and gas, and in the rise of terrorism, which has disturbed economic activity in the country. The fall in growth momentum is most acutely manifest in the large-scale manufacturing sector of Pakistan which is likely to show a negative growth rate (-6 percent in first 7 months) for the first time since 1996-97.

The basic questions are: Which particular industries have been hit the most? How much of the negative impact is due to external and to internal factors respectively? Within internal factors, what is the relative contribution from the demand-side and from the supply-side respectively? What policy measures need to be adopted urgently (possibly as the key priority in the 2009-10 Budget) to revive industry without jeopardizing the gains that have been achieved with regard to stabilization so far?

### Industrial Performance in 2008-09

Overall growth rate of the large-scale manufacturing sector during the period, July to January, of 2008-09 is estimated at about -6 percent according to the FBS. This masks wide variation in performance of individual industries during the period. 43 out of the 71 industries on which data is available have experienced negative growth, as shown in Table 5.1. Some industries like automobiles, iron and steel, electrical goods and engineering goods have shown very sharp declines. These are generally industries which fluctuate most with the stages in the business cycle. As opposed to the industries producing basic consumer goods like tea, matches, soaps and detergents, cigarettes, etc., continue to show positive growth.

Broadly speaking, the negative growth industries can be classified into the following categories:

***Due to extraordinary increase in prices:*** these are industries which have a large import content and are, therefore, vulnerable either to a rise in import prices or devaluation of the

**TABLE 5.1**
**GROWTH RATE OF OUTPUT OF SELECTED INDUSTRIAL PRODUCTS IN 2008-09***

| Less than -20% | -20% to -10% | -10% to -5% | -5% to 0% | 0% to 5% | 5% to 10% | 10% to 20% | 20% & above |
|---|---|---|---|---|---|---|---|
| Billets (-43) | Pig Iron (-12) | Petroleum Refining (-8) | Cotton Yarn (-1) | Paper & Board (1) | Jute Goods (6) | Cigarettes (13) | Coke (55) |
| R. Sheets / Strips/etc. (-27) | Motor Cycle (-18) | Cooking Oil (-5) | Cotton Cloth (-1) | LCVs (2) | Fertilizer (6) | Glass Plates & Sheets (19) | Footwear (21) |
| Trucks (-28) | Vegetable Ghee (-12) | Beverages (-5) | Soda Ash (-1) | Tea (4) | Cement (5) | Sole Leather (15) | Plywood (43) |
| Buses (-52) | Wheat Milling (-10) | Chlorine (-10) | Caustic Soda (-4) | Liquid Syrups (1) | Tractors (8) | Paints & Varnishes (20) | Motor Tubes (38) |
| Jeeps & Cars (-46) | Wollen Yarn (-17) | Man-Made (-8) | Upper Leather (-2) | Capusles (1) | Starch (10) | Razor Blades (14) | Wheat Threshers (80) |
| Cycle Tyres (-40) | Knitting Wool (-14) | Sewing (-7) | Tablets (-1) | Ointments (2) | Injections (5) | | |
| Cycle Tubes (-36) | Toilet Soaps (-20) | Refrigerators (-7) | Sulphuric Acid (-5) | Polishes & Creams (1) | Soaps & Detergents (7) | | |
| Sugarcane Machines (-43) | Chaff Cutters (-11) | Electric Fans (-8) | | Matches (4) | Hydrochloric Acid (9) | | |
| Power Looms (-37) | Bobbies & Shuttles (-20) | Electric Meters (-10) | | Motor Tyres (4) | | | |
| Deep Freezers (-22) | Air Conditioners (-16) | Electric Transformers (-8) | | Diesel Engines (3) | | | |
| Electric Bulbs (-22) | Switch Gears (-16) | | | | | | |
| Electric Tubes (-20) | | | | | | | |
| Electric Motors (-22) | | | | | | | |
| TV Sets (-38) | | | | | | | |
| Bicycles (-28) | | | | | | | |

*July to January
**Source:** Federal Bureau of Statistics

currency. Major industries in this category are vegetable ghee (-12 percent), petroleum refining (-8 percent) and automobiles (-27 to -52 percent).

***Due to fall in construction activity:*** there has been a visible decline in construction activity both in the private sector because of the slump in real estate market and rise in interest rates and in the public sector because of the sharp cutback in releases for PSDP projects. Major industries impacted negatively by this factor are iron and steel (-12 to -43 percent) and cement, domestic sales of which have fallen but positive growth has been achieved by higher exports.

***Due to decline in export demand:*** The largest industry, textiles, has declined with negative growth in cotton yarn (-1 percent) and in cotton cloth (-1 percent). However, the impact is likely to have been larger on the small-scale segment of the industry, especially garments.

***Due to decline in domestic consumer demand:*** industries producing consumer durables have been particularly vulnerable, especially as there has been less resort to consumer financing due to stagnant or falling real incomes and higher interest rates. Industries impacted by the fall in demand mostly by households include automobiles, motor cycles (-18 percent), bicycles (-28 percent) and sewing machines (-7 percent). An additional factor affecting demand has been power shortages which has reduced the demand for electrical goods like deep freezers (-22 percent), electric bulbs (-22 percent), TV sets (-38 percent), air conditioners (-16 percent) and refrigerators (-7 percent).

***Due to decline in private investment:*** the fall in private investment, partly due to difficulties in accessing credit and higher costs of capital, has adversely impacted on a number of domestic industries producing capital goods like power looms (-37 percent), bobbies and shuttles (-20 percent), chaff cutters (-11 percent), etc.

***Due to power shortages:*** As demonstrated in the previous chapter, a large proportion of large-scale units have been able to largely avoid production losses by installation of self-generation capacity. The impact has been felt more in rising costs and lower profitability. As such, the impact has been more on electricity-intensive industries like textiles, paper and board, non-metallic products, iron and steel.

Therefore, from the above analysis it appears that demand factors have been more operative than supply-side constraints in explaining the drop in industrial production. Within demand factors up to now fall in domestic demand has probably been more instrumental in curbing output than external demand in export markets. This may, of course, change as global trade shrinks further. Also, it is likely that supply-side factors, like shortage of power and gas, have impacted more severely on the small-scale manufacturing sector.

## Policies for Industrial Revival

Revival of industry appears to be contingent on recovery of aggregate demand in the economy, as highlighted above, especially since a large component of Pakistani industry is import-substituting in character. But an abrupt increase in aggregate demand runs the risk of jeopardizing the process of stabilization. Therefore, as outlined in Chapters 2 and 3, we suggest that management of the exchange rate in particular, can help both in stabilization and revival. Ensuring that the currency does not get overvalued, as has happened in recent months, will not only ensure higher profitability and ability to compete of export-oriented industries, like textiles, but will also provide for greater protection to import substituting industries. Beyond this, if there is evidence of a fall in import prices due to under-invoicing or dumping, especially of Chinese products (now the largest source of imports of Pakistan) then a return to the regime of presumptive International Trade Prices (ITPs) and / or regulatory duties may have to be contemplated.

Beyond this, changes in the level of interest rates (especially the SBP policy rate) should be pegged to changes in the underlying 'core' inflation rate and consumer financing may be made more attractive and affordable by allowing longer maturity periods for repayment. A crucial element in fostering future growth will have to be a recovery in the size of the PSDP by at least 0.5 percent of the GDP in 2009-10 as recommended in Chapter 2. Measures for reducing the quantum of loadshedding in the industrial sector have already been described in detail in Chapter 4.

The general policy measures for industrial revival may not be adequate for specific industries. For industries like automobiles and vegetable ghee the level of indirect taxation (customs duties and excise duties) may have to be adjusted downwards in the event of a depreciation in the value of the rupee so as to reduce the impact on domestic prices. Also, special fiscal incentives may be given to industry for investment in power self-generation and in domestically produced capital goods.

We turn now to issues of the type of medium-run development strategy that a country in Pakistan's situation may consider adopting.

## A DIFFERENT MODEL OF ECONOMIC GROWTH

### Domestic Demand vs Export-Led Growth

A number of countries are bringing life back to their economies by spending public money to build the much needed physical infrastructure. This is being done on a large scale by China and in a limited way by India. There is near-consensus amongst economists that China - and to a lesser extent India - must change the development model. "Asian governments must introduce structural reforms that encourage people to spend and reduce the need for them to save", advised *The Economist* in a recent issue." Governments need to establish safety-nets that ease worries about the cost of children's education and healthcare. And across Asia, economies need to shift away from increasingly capital intensive manufacturing towards labor-intensive services, so that a bigger share of national income goes to households," the magazine continued in its leading article. In other words, the Asians were being asked to move away from the much lauded export-oriented economic growth models that had produced so many "miracle economies" in the continent's eastern part. Instead, they were now being advised to obtain economic dynamism by increasing domestic demand. Rather than have the earnings from export far exceed import expenditure and squirrel away the difference as national savings that bloated national reserves, the Asians were being told to significantly increase domestic expenditure. There was one added advantage to this approach. It would not only provide the Asian economies with a new engine of growth. It would also produce a relative balance in global savings and expenditure. A mirror image of this approach would be to increase domestic savings in the Western economies, in particular the United States.

This new model has only a limited application to Pakistan. The country does not have the option since its fiscal deficit is large, already way beyond the estimated sustainable level of about 4 percent of GDP and it has a very small cushion of foreign exchange reserves. That said, it must not use the conventional ways of restraining demand by a severe contraction in public expenditure, in particular on development expenditure, and a very tight monetary policy. This is already being done to some extent; continuing it would send the economy in to a deep recession, if not into a depression. What is required is an innovative approach.

The policymakers need to restructure aggregate demand not increase it as is being done in the countries that are not faced with the fiscal problem and inflationary pressures that currently afflict the Pakistani economy. Instead, the first order of business for the government - in fact governments at all levels - should be to review and restructure public sector expenditure not to reduce greatly development spending but to drastically curtail non-development spending as indicated in Chapter 2. The focus is on eliminating waste from the government without compromising the quality of delivery of functions. Also, this will require removing duplication of effort between different levels of government and passing on to the private sector the functions it can perform more efficiently and more effectively than the state. In addition there is need, wherever possible, to leverage development spending by the formation of public-private partnership in infrastructure projects.

Public works programs also should be instituted for the development of infrastructure, which will provide some relief to the unemployment situation and thereby poverty, while simultaneously address the issue of infrastructure bottlenecks. Restructuring the government would reduce the level of employment in the public sector. A special training and skill development program could be launched to help the workers made redundant in the public sector find jobs elsewhere in the economy alongwith the possibility of access to microcredit.

### The Sectoral Composition of Growth

There is some debate in the country on what is the most appropriate sectoral model of growth for Pakistan and also about what kind of strategy should be pursued by the country in order to sustain high rates of uninterrupted growth as has been done successfully in a number of Asian countries. Should Pakistan be guided by the experience of countries such as South Korea and now India that have relied on industrialization by focusing on the development of large industries? Should industrial growth be left to medium-sized enterprises as was done by Taiwan? Should industrialization be left to foreign companies who will bring in capital and associated technologies in order to supply external markets? This is essentially the route taken by China. Or should Pakistan adopt an entirely different route and opt for agriculture, agro-processing and the various modern service sectors as the engines of growth? Should the country encourage the development and modernization of the enterprises operating in these sectors of the economy? In order to find answers to these questions we should examine both Pakistan's endowments on which the country can build its economic future as well as develop a good understanding of the changes that have occurred and are taking place in the country's external economic environment.

The process of globalization has changed the structure of production and trade in the world economy. With the extraordinary development of information and communication technologies, economists have given up classifying the "products" of the service sector as non-tradeable. There are a number of new opportunities that have opened up for countries such as Pakistan that have large and young populations and are physically close to some of the more rapidly growing and dynamic countries in the global economy. The country inherited a well developed sector of agriculture that could have become the engine of growth and also a significant earner of foreign exchange had the attention of the first generation of policymakers not been turned towards industrialization. This happened largely as a result of a number of actions taken by India in 1947-49 to economically cripple Pakistan. These included the refusal to release funds that were due to Pakistan from the compensation provided by Britain for British India's war effort; the attempt to divert water from the rivers that flowed into Pakistan from India; and, finally, a trade embargo imposed on Pakistan by New Delhi when Karachi (then the capital of Pakistan) refused to devalue its currency with respect to the US dollar as was done by all countries of the British Commonwealth. These Indian actions were to have profound consequences for Pakistan's economic development. Of these two were particularly important.

The first was the neglect of agriculture which, at the time of independence, was by far the most important part of the Pakistani economy. The second was to make the economy less trade-oriented. At the time of independence trade accounted for more than 50 per cent of the country's economy. India was the most important trading partner accounting for nearly two-thirds of the new country's exports and imports. All this changed as a result of the initial Indian hostility towards its neighbor. Had India not forced Pakistan to opt for industrialization as a way out of the problems the country faced right after gaining independence, the structure of the economy as well as trade would have been very different from what is today. In both, agriculture would have played a more important role.

Pakistan's other economic inheritance was the small-scale industrial and commercial sectors. The first was based on the presence of skills that were developed over centuries; the second was connected with the need to supply agricultural surpluses to several distant parts of British India. Several small towns in the Punjab and the North-West Frontier Province had metal working and basic engineering skills that could have become the basis for both industrialization and exports. The Punjab also had wood-working skills; there were skilled workers in Sindh producing ceramic tiles and stone works; the people of the NWFP had built up small businesses in processing the area's abundant forestry resources; the Kashmiris, some of whom were to become the citizens of Pakistan, were known for their weaving and wood-working skills. However, for several decades Pakistan's policymakers made no effort to develop the small-scale sector as a major contributor to economic growth and poverty alleviation. It was only in the late 1990s, that the government turned its attention to this part of the economy.

The same kind of neglect was visited upon small-scale commerce and retail trade. It remained burdened with regulations that had lost their meaning after the partition of India. In addition to this, as we will discuss later in this chapter, import into the urban areas of agricultural commodities and livestock products remained controlled by the institutions of local government that created all manner of rent-seeking opportunities for the functionaries of the state while inhibiting the modernization of this important part of the economy.

Building Pakistan's economic future on the development of these sectors offers a viable opportunity for the country. Had this been done in the past, Pakistan would have chartered a different economic course for itself, different from those pursued by other more successful Asian countries. According to one Pakistani economist, the main components of an appropriate economic strategy for Pakistan are the "knowledge economy, biotechnology driven agriculture growth and strong support for development of a modern retailing sector. There are obvious linkages between these three, but more important are the linkages between them and other growth areas in the economy". *What kind of public sector interventions are needed to develop these essentially neglected parts of the economy is the subject of the last section of this chapter. However, before we get to that point, we will discuss the state of the Pakistani firm and enterprise in all parts of the economy.

## THE STATE OF THE PAKISTANI FIRM

Economists working in the area of development reached the conclusion a couple of decades ago that the sustained growth of backward economies required an environment that provided the right set of incentives for the various economic players. "Set the policies right" became their mantra. What were the right sets of policies to be pursued? This was defined at some length within a framework that was given the name of *The Washington Consensus* refered to earlier.

The most important part of the advice given the developing world was to open the economies by allowing relatively - if not totally free - flow of goods and capital across their borders. This meant reduction in tariffs and other barriers to trade. It also meant easing controls on the movement of capital. The governments were also advised to reduce fiscal and balance of trade deficits - to bring their economies in balance. It was recognized that opening the country to trade would initially increase imports to the point where serious balance of payments deficits would occur. To deal with this problem, the policymakers were advised to adopt export promoting policies, to move away from import substitution and move towards export promotion. Also, under this consensus, the state's role had to be reduced and the private sector given the role of the leader in the economy.

Later, when some of the economies to which this prescription was applied did not grow as rapidly as the authors of the *Consensus* had hoped, another set of policies came to be advocated. These were aimed at the development of the private sector. To achieve this objective, the governments were advised to create a business-friendly environment. This required the governments to reduce the regulatory burden on the enterprises operating in the economy, to ease the entry of new enterprises and to make it easier for them to exit if they failed, to make it easier for enterprises to obtain finance, to facilitate the hiring of new workers by them and let the workers go if they had to reduce their operations, to improve the legal and judicial systems so that the contracts into which enterprises entered could be readily and cheaply enforced.

To give substance to this advice, the World Bank started a program to evaluate how various countries were doing with respect to these indicators. The purpose of this exercise was to alert the policymakers where their country stood compared to other countries in the region and in the developing world. These results are reported every year in a document titled *Doing Business*, most recently in a report published in late 2008. Along with this work, the World Bank is in the process of completing its second *Investment Climate Assessment* for Pakistan. Most of the data used below on the economic enterprises in Pakistan are drawn from the latter document.

Pakistan has 3.3 million economic establishments, 90 per cent of which are sole proprietorships and another 2 per cent are partnerships. The distribution of the enterprise sector, in other words, is heavily skewed towards informality. Punjab, with 67 per cent of the total, has the largest share of these enterprises followed by Sindh with 17 per cent, the NWFP 14 per cent and Balochistan 2 per cent. A significant number of those in Punjab are small while a much larger share of the large enterprises is in Sindh. In fact Sindh, having had an earlier start in the process of industrialization, has much older enterprises compared to those in the Punjab. Pakistan is different from other developing countries in the sense that the older enterprises are more efficient and productive than those that are relatively new. This is one indication of the important fact that newer enterprises were not technologically more advanced, as would be expected, compared to those that were established earlier. For the country to move forward economically it is the small enterprises in the informal sector that must become the focus of public policy.

For a country of its size and the stage of development, Pakistan's economy is relatively dominated by small and medium-size establishments. Almost 90 per cent of the enterprises are SMEs which employ 78 per cent of the non-agricultural workforce and contribute 30 per cent of the GDP. Ninety five per cent of the 3.3 million economic establishments employ less than 5 workers, another 4 per cent employ between 6 and 50 workers. Only 1,617 enterprises employ more than 50 workers. A handful of the enterprises can be considered to be big, employing more than 1,000 workers. More than one half of the large enterprises are in the textile sector. Most of the smaller enterprises are in retail trade and simple manufacturing, the two sectors we have identified as holding potential for quickening the pace of economic change in Pakistan.

These facts about the structure of the enterprise sector raise an important issue with respect to public policy. If Pakistan is to opt for the adoption of an industrial policy - something we believe it should do - should its emphasis be on the development of the SME sector, should it aim to encourage the establishment of large enterprises, or should it follow a strategy that aims to develop both types of enterprises? This is an important question. If an SME- oriented approach were to be adopted, there would be the need to develop linkages with the large corporations operating in the global field. One consequence of this approach would be to focus on the development of the vendor industry which would supply parts and components not only to the domestic industry but, more importantly, to the large transnational corporations. Since the most rapidly growing part of international commerce is the growth of "parts and components" in trade, such an approach may yield high dividends.

The sectoral distribution of Pakistan's establishments provides one more evidence of the relatively underdeveloped structure of the country's economy. A little over half of the enterprises operating in the country are in wholesale and retail trade. This is the semi-formal part of the enterprise economy which needs to be developed to gain size and efficiency. That would not only contribute to increasing the rate of growth in GDP but also help to reduce poverty and narrow income distribution in the country.

About one fifth of the enterprises are in the manufacturing sector. That some 660,000 establishments are engaged in manufacturing is one more indication of the relative backwardness of the economy. The activities in which they are engaged are relatively low cost, low technology, and low skill. An important part of the strategy aimed at increasing the efficiency of the economy would be to improve the scale and technological base of at least the top 20 per cent of these enterprises. The state should get actively involved in improving the working of 125,000 enterprises in the manufacturing sector. In order to do this would not mean providing them with financial support. It would mean a number of interventions by the state of the type discussed in the financial section of this chapter.

If an industrial policy were to be developed and followed by the government to promote growth, to increase the amount of incremental resources flowing to the poorer segments of the population, to obtain a larger share in the global economy, Pakistan will need to look carefully at the structure of establishments operating in the economy. In other words, an important part of the industrial policy will have to be a policy aimed at developing enterprises.

## COSTS OF DOING BUSINESS

Should Pakistan's policymakers, worried as they must be about security, also be concerned about the cost of doing business in the country? It is well known that this is an important determinant of the decision to invest. For foreign investors stories about kidnapping, demands for ransom, and the killing of some hostages pose serious issues in their decisions to bring capital to Pakistan. Security concerns must also weigh heavily with the domestic investors particularly in the troubled areas in Balochistan and the North-West Frontier Province. While these are weighty concerns, the government should be mindful of the fact that the cost of business is an important factor in investors' calculus. This is one reason why the World Bank is spending a significant amount of its resources on estimating the cost of business in the developing world and publishing it findings in annual reports titled *Doing Business*. The report for 2009 has recently been released and has some interesting findings for Pakistan.

The first *Doing Business Report* was published in 2003. It covered five indicator sets in 133 countries. The more recent report has a wider country coverage. It has data on 181 countries. It has also expanded the issues of likely concern for the investors. The Bank has looked at ten indicator sets. These include the ease of starting a business, the cost of obtaining construction permits, the cost of employing workers, the ease (or conversely difficulties faced) in registering property, availability of credit and the cost of obtaining it, what kind of protection is available to the investors, how difficult (or easy) is it pay taxes, what are the problems encountered in cross-border trade, can contracts be enforced and what are the costs of closing businesses. The Bank's work is focused on small and medium-size industries since it is this type of entrepreneurship that ultimately determines the pace and scope of economic growth in the developing world.

How does Pakistan fare in this exercise and how does it compare with other countries in the region and with the countries that are its competitors in the global market place? There are some surprising conclusions concerning Pakistan, especially when we compare the various elements in the perceived cost of doing business with those in India and Bangladesh. Pakistan ranks 77th compared to Bangladesh's rank of 110th and India's 122nd out of the 181 countries studied by the Bank. India's relative low rank is particularly surprising considering the strong interest in the country shown in recent years by the community of international investors.

There are two other areas in which Pakistan does relatively well. These are ease of closing businesses and obtaining credit for business. The country's ranks in these areas are respectively 53 and 59 out of 181 countries. Once again the question of the cost of closing business is relevant for the formal sector of the economy. For the informal sector which accounts for the vast majority of the enterprises in the country, shutting down a business is not problematic. The burden falls on the family and is not too difficult to bear. Most often, the entrepreneurs set up industries producing another line of products or providing another kind of business. Access to credit, however, is important for businesses of all sizes. In most developing countries the formal financial sector - banking as well as non-banking - is open to large businesses. Small enterprises have to make do with informal parts of the financial sector. The cost of obtaining capital from these sources may be high but the time and cost of enforcing informal contracts can be quite low. This is one reason why small and medium-size industries may not be keen to graduate in size in the search for capital generally available to the formal part of the financial sector.

For Pakistan the best ranking among the ten indicator sets is for "protecting investors". This set has four indicators, all concerning the way publicly listed companies are managed. This is an important indicator. A recent study suggests that the presence of legal and regulatory protections for investors explain up to 73 per cent of the decision to invest. In contrast, company characteristics explain only between 4 per cent and 23 per cent. Thus both government and businesses have an interest in reforms strengthening investor protections. However, much of the small and medium-size sector in Pakistan is outside the formal capital markets in Pakistan. Consequently a relatively high ranking in terms of investor protection is of limited consequence for the country.

What is of great consequence is the relative ranking on another score - enforcement of contracts. For this indicator, Pakistan has the worse score among the ten used by the Bank for the purpose of evaluation. Contract enforcement has three elements - number of procedures that have to be followed, the time it takes to enforce a contract, and the cost of enforcement. The three are assigned the same weight in the rating for this indicator. In Pakistan's case 47 procedures have to be followed for the enforcement of contracts compared to 21 in the case of Singapore that has the top ranking in terms of ease of doing business. In Pakistan it takes an average of 976 days to reach a settlement on a contract dispute compared to 150 in Singapore. The cost of settlement of a contract in Pakistan is 23.8 per cent of the total value, a bit lower than Singapore's 25.8 per cent. Justice may be rapid in Singapore but it is costly. India does considerably worse than Pakistan in two of the three elements of contract enforcement. It has 46 procedures that need to be followed, it takes 1420 days for the courts to enforce contested contracts and the cost of enforcement is 39.6 per cent of the value of the contract.

It is obvious that this is one of the areas where Pakistan has to put in real effort in order to reduce the cost of doing business. As the World Bank report puts it: "In many countries only the rich can afford to go to court. For the rest, justice is out of reach. In the absence of efficient courts, firms undertake fewer investments and business transactions. And they prefer to involve only a small group of people who know each other from previous dealings." Problems associated with contract enforcement not only inhibit investments they also work as disincentives against scaling up. Firms prefer to remain small, fearing that by growing in size they will invite more legal problems.

Employing workers for businesses is another area where Pakistan does poorly. This indicator has five elements - difficulty in hiring, rigidity in the number of hours worked, difficulties in firing, the cost of firing, and the rigidity in employment. This can be traced to the 1970s when fairly stringent labor laws and regulations were adopted by the first Pakistan People's Party government headed by Prime Minister Zulfiqar Ali Bhutto. While these laws empowered workers they contributed to greater rigidity in the workings of the labor market.

Some obvious conclusions flow from this analysis. The most important is that while Pakistan may be placed relatively high in terms of its rank in the group of 181 countries studied by the World Bank in its latest *Doing Business* report, not much comfort should be drawn by the policymakers from this conclusion. The high ranking scored by Pakistan is on account of the factors that are less relevant for the success of the businesses that dominate the real sectors of the country's economy. In the case of those that really matter, the country does relatively poorly. That is where the policymakers have to concentrate their attention.

As we will suggest below there are a number of areas in which action by the government will increase the productivity of the establishments operating in various parts of the economy. We list and briefly discuss a dozen of these and raise a series of questions that need to be answered to identify specific elements of the development strategy. It is by improving the performance of the enterprises that the country will be able to improve the functioning of its economy and to set the economy on the path of a high rate of economic growth that could be sustained over time.

## AREAS FOR SPECIFIC ATTENTION IN THE DEVELOPMENT STRATEGY

There is one common element in the areas proposed below for public policy focus. It is only with attention given to increasing the productivity and competitiveness of the economy that Pakistan will succeed in dealing with the current crisis and securing a better future for its growing population. In focusing our attention on these areas we have kept in view some of the main characteristics of the Pakistani economy and society. These include a large and very young population; a society with a very weak institutional base; an economy that is technologically even more backward than is the case for the countries at its level of development; a number of significant endowments that have been largely ignored by successive generations of policymakers and a poorly developed enterprise sector.

***Demographic asymmetry and demographic window of opportunity:*** Pakistan has one of the youngest populations among the world's more populous countries. The population's median age is 17 years which means that some 80-85 million people are less than 17 years old, assuming that the country's population is between 160 and 170 million at this time (i.e. the middle of 2009). This young population could become a burden for the economy. It could also be turned into an asset. With the population in several developing countries declining there is at this moment a demographic asymmetry - declining population in some rich countries and rapidly increasing population in many of those that are less developed. This provides Pakistan a window of opportunity to use its population as an asset for the domestic economy. It could, properly husbanded, also become a major source of foreign exchange earnings. That this can happen has been demonstrated by countries such as India and the Philippines. Both countries earn sizeable amounts of foreign exchange through the export of IT services and through the remittances sent by their citizens working abroad. Pakistan also earns foreign exchange from both sources but the amounts are relatively small. Could these be increased? What are the possible areas of public policy which are pertinent for turning Pakistan's young population into an economic and social asset? What kind of public-private partnership helps in this respect? Some ways this could be accomplished are discussed below.

***Human Resource Development:*** Related to the above is the question of human resource development. The fact that the public sector has done poorly in terms of educating the citizenry is well known. What is also well known is the positive role played by both for-profit and non-profit private organizations successfully operating in the education sector. The private sector is involved at all levels - primary, secondary and tertiary. It is also present in the rural areas. However, skill development is a neglected area by both public and private sectors. There are serious shortages of skilled workers in almost all sectors of the economy. The normal recourse to meet this gap is to rely on "learning by doing" which is a costly way of bringing efficiency and productivity to the economy. Most enterprises that need skilled work force can't go to the labor market. Instead, they have to develop their own system for imparting skills to the employees. This is an expensive - both for the enterprises as well as the economy - way for doing business. How could this situation be remedied and what are the respective roles for the public and private sectors in this context?

***The Construction Industry:*** There are a number of sectors that could play an important role in providing employment to a rapidly growing work force. One of these is the construction industry. The fledgling construction industry could absorb significant numbers of workers, particularly in the urban areas. But the industry remains backward made up mostly of artisans-turned-contractors, particularly for the housing sector. The small modern component of the sector developed in several phases. Opportunities were created by the massive Indus Water Replacement works in the 1960s and the construction of the motorways in the 1990s. While some entrepreneurs successfully took advantage of these opportunities, the industry did not develop for a variety of reasons. The development of some firms that have acquired scale has occurred without a supporting policy framework. The question for policymakers is how to improve the competitiveness of the firms that are already operating in the field; how to facilitate the entry of new players into the sector; what kind of public policy support is needed to help the construction firms to enter the international market place; what kind of standardization is needed to develop industries to support the construction industry, particularly in the housing sector; how can the supply of finance be improved to develop the modern construction industry?

An important factor hindering the growth of housing is the high cost of registering property transfers. All related instruments are either wielded by or within the control of the provincial and local governments. In Punjab and Sindh the costs in urban areas include a 1 percent registration fees, a 3 percent provincial stamp duty and transfer fees on the value of the property (plus a 2 percent Capital Value Tax levied by the Federal Government), compared with a nominal transfer fee of Rs.150 per sq. yard (and no stamp duty) payable to the Capital Development Authority in Islamabad. In the case of a loan, there is a 0.25 percent charge for registering mortgage documents.

The building by-laws are outdated and do not reflect realties or the needs of major urban centers and leave discretion in the hands of officials. For instance, residential zones only cover single family homes and not greater urban density through say apartment blocks. For constructing apartment blocks developers are liable for commercialization charges. Moreover, there are multiple agencies, Development Authorities, Cantonment Boards, Tehsil Municipal Administrations, each administering its own, non-uniform, zoning and building by-laws (including those relating to height restrictions) with little coordination between them on these matters.

Some local government taxes and fees overly load the cost of investment for the construction sector. For instance, the Lahore Development Authority (LDA) levies a commercialization fee equivalent to 20 percent of the value of the plot in case of change of use of property, even in areas declared as commercial zones. In Karachi, the flat rate commercialization fee of Rs.8,000 per sq. yd. is approximately equivalent to 10 percent of the value of the plot in case of change of use of property in prime commercial areas of the city. As a result, commercially zoned property is inadequate, explaining the lack of hotels and shopping malls in major urban centres.

Moreover, commercialization is generally restricted in the form of strip development. In Karachi it is along 17 roads of the city (where commercialization had already taken deep roots) instead of promoting the development of commercial and business districts in the city, resulting in the uneconomical utilization of scarce developed land.

A major issue is the slow colonization of the housing schemes, even when all associated infrastructure has been provided. The levies/charges on leaving plots vacant do not serve as effective instruments for deterring speculation in land and ensuring better utilization of installed infrastructure and more efficient land markets. Also, private developers of housing and related schemes require a host of separate approvals from a variety of agencies, rather than have access to a one-window processing facility. Developers also complain: (a) of the high charges or rates of penalties for modifying building plans, even when the variations do not result in any increase in the covered area of the building; and (b) the demands of the Employees Old Age Benefit Institution (EOBI) and the Provincial Employees Social Security Institutions for contributions at 5 percent and 7 percent of wages respectively even for casual workers, which make up most of the labor force in the construction industry. The latter is a particularly contentious issue in NWFP where the bulk of the labor force in the sector comprises Afghan refugees.

A key factor constraining the expansion of the housing sector is the rent control legislation that is biased in favor of the tenant, creating a disincentive for construction of property for rental purposes. The most important provisions of the legislation relate to conditions governing the eviction of tenants. For getting the tenant to vacate his property not only is the landlord required to establish his bonafides of the stated need, he also has to demonstrate that the premises are more suitable for his needs than the one he is currently occupying. The process of eviction is slowed down appreciably (and may even take several years) over disputed questions of fact that require submission of evidence and accounts of witnesses before they can be resolved. Moreover, the law makes the tenancy relationship even more complicated by allowing tenancy rights to automatically pass onto the legal heirs of the dead tenant.

Other major factors that serve as disincentives for renting out properties are:

a) the high rate of stamp duty (e.g. in Sindh 3 percent of value of contract) and registration fee (1 percent of contract value) on the compulsory registration of lease documents covering a period of 1 year and above; and

b) the structure of property tax in Punjab under which rented-out properties pay ten times the tax paid by similar owner-occupied properties, even though they have similar access to facilities like roads and street lights and to services like solid waste disposal. This differential is much higher than in Karachi where the ratio is 1:2 and in Islamabad where both categories pay the same rate of property tax. The NWFP government on the other hand has put in place a better policy for taxing commercial properties. Both owner-occupied and rented commercial properties pay the same rate of property tax.

As the forgoing discussion suggests, a thorough review of the regulatory regime that is in place is needed in order to commercialize the housing sector and encourage the development of the construction industry to meet the enormous shortage of housing in the country. However, increased domestic demand is not the only way for encouraging the development of the construction industry. Enormous opportunities exist in the geographical area in which Pakistan is located for its expansion. There were two construction booms in the Middle East in the last 30 years which could have provided opportunities for the Pakistani construction industry. These opportunities were largely missed by the Pakistani industry. There has been significant amount of reconstruction activity in Afghanistan which is likely to gain momentum as a result of the increased American investment in the country. There are also opportunities within Pakistan - in the early 2000s, capital from the Middle East flowed into the housing and trading sectors. This activity may be renewed once the global economy stabilizes.

***Trade facilitation:*** The realization that Pakistan has not benefited from the enormous expansion of international trade was slow in coming. It was only after the current balance of payments crisis that policy makers have turned their attention to export promotion as an important element of economic strategy aimed at putting the country on a growth trajectory that parallels those followed by the more successful countries of Asia. Export promotion is a vast subject. Among some of the specifics that need to be addressed is the development of the logistics side of export promotion. Taking cognizance of the fact that the private sector has turned its attention towards the development of a multipronged approach towards the movement of goods and material should be the starting point of this exercise.

The demand on logistics created by the need to supply the NATO and US troops in Afghanistan has created a new industry that has been built on the Karachi-based forwarding agencies and the Peshawar-based long-haul trucking companies. The old and new firms are significant employers; the number of employees could increase significantly if this industry were to be developed along modern lines. There are a number of questions the policymakers should ask. Among them: How could this be done; what role could the public sector play in this endeavor; what are the other aspects of service sector that could be developed to support the growth and modernization of this relatively new industry?

***Retail trade:*** Also neglected by public policy is the important sector of domestic commerce, one of the largest providers of employment to the large work force. By and large the sector is inefficient and the low level of worker productivity results in limiting the incomes the enterprises provide to the workforce. The sector is underdeveloped in part because of the lack of attention from public policy makers. Its development has also been inhibited by the presence on the books of such antiquated laws as the Agricultural Marketing Acts in various provinces that continue to involve the government in price fixing and control over markets down to the small town level. These laws date back to the 1930s and were promulgated largely for political reasons in order not to allow the non-Muslim traders from extending their economic hold over the Muslim peasantry. This is no longer a concern for today's policymakers. The sector has also not been helped by land use policies in the urban areas. There is an urgent need, therefore, for the provincial governments to review the existing legislations and rationalize their content given the requirements of a modernizing economy.

The retail sector may have begun the process of radical change as a result of the arrival of large multinationals into the country. In countries that have allowed the entry of the multinational retail companies, a significant proportion of trade in agro-processed products is now accounted for by them. The firms demand quality products, quality packing, quality ware-housing, and quality transport. There is, in other words, considerable externalities associated with the operations of these companies. Metro (a German retail company now operating in Pakistan), for instance, has contracted out warehousing to smaller operators. It is also contracting the supply of meat to livestock producers. Since multinational retail companies buy and sell goods across borders, successful operations by them in the domestic market could increase exports of non-traditional products Also retail goods produced by women such as fashion garments will find markets through these multi-national firms. Their operations could, therefore, help female entrepreneurs and female workers. What kind of public policy framework needs to be put in place in order to develop and modernize the sector of retail trade? What changes need to be made in the existing legal framework - some of which is based on societal needs that no longer apply - for this sector to develop? What are the technological needs of a modern retail sector?

***Agricultural Marketing:*** Relating to the item discussed above is the important question of agriculture marketing. In addition to the inhibiting impact of antiquated rules and regulations on the development of this aspect of marketing discussed above, this sector suffers from the absence of relatively large sized firms. The most negative impact of this was on the development of livestock sector which accounts for significant female employment. One example of the distortions that have crept into this part of the economy is that animals arrive in the major cities on hoof, thus losing a lot of body weight. Lahore has primitive and unhygienic slaughter facilities to serve a city of perhaps more than 10 million people. The same is the case with other major cities. Slaughter houses should be located in the areas which have large concentrations of animal population and meat and meat products should be transported via a cold chain to major centers of consumption.

Another example of poor marketing of agricultural commodities is the way Pakistan exports basmati rice, a commodity that fetches premium prices in many foreign markets. A significant quantity of rice is sold to Dubai which is then packaged by Indian firms for exports to the places where there are large ethnic markets. Indian traders therefore, capture a good part of the value addition that should normally go to the Pakistani producers. In what way should agricultural marketing be improved and what are the technological needs of this activity that the state could help provide?

For maximizing the returns of farmers for their agricultural produce easing constraints that impede the marketing of these products need to be removed. The government has significant control over markets for fruits and vegetables and livestock. Farmers can only sell their produce in markets established and approved by provincial or local governments. This is detrimental to the interests of growers which results in the intermediaries, who have captured these government regulated markets, pocketing 2/rds to 3/4ths of the price paid by the final consumer.

There is no reason why trade in fruits and vegetables and livestock cannot be deregulated by allowing private parties to set up and operate bulk/wholesale markets and manage product-grading and standardization processes. There is, therefore, a need for creating more competitive, non-monopolistic, structures that will ensure better returns to farmers, including permissions to retailers to buy directly from the farmer by-passing the markets and the intermediaries.

Such an arrangement will enable organized retailing (e.g Metro/Macro type organized retailers/wholesalers) directly sourcing from the farmer-eliminating at least two intermediaries from among the arthi, commission agent and the wholesaler, with the need for central storage and reliance on wholesalers also being eliminated in the process. The resulting overall economies from the shortening of the supply chain would be 20 - 25 percent of the consumer price. Farmers will get higher prices and if warehouses and cold storages are constructed spoilage of farm produce would be reduced significantly and provide an incentive to increase farm productivity through improved technology.

The reforms in the area of agriculture marketing should also aim to strengthen market related information systems. To this end there is a need to improve the information providing network comprising websites and electronic boards in markets to make data real time.

***Urbanization, urban employment, and urban services:*** Not unlike other developing countries, Pakistan tends to underestimate the size of its urban population, the size of its large and medium cities and the proportion of the population that should normally be classified as urban. Other than the usual reasons for this underestimation, there are also political reasons for giving a smaller weight to the urban population. Pakistan was a rural place and a largely rural economy at the time of its birth. Since then, starting with the movement of the population that accompanied the partition of British India into the independent states of Pakistan and India, the size of the urban population has increased at rates between two and half times to three times the rate of increase in population. Pakistan has had one of the highest rates of the urbanization in the developing world. This should have resulted in the flow of greater political power from the countryside to towns and cities. That did not happen as the powerful landed interests succeeded in preventing the urban areas from gaining a larger space in the political system. This is one reason why population censuses have not been held on a regular basis as provided by the Constitution of 1973.

By underestimating the size of the urban population and the size of the major urban areas the country has not properly provided the needed urban services. Pakistan urgently needs an urban economic and social development strategy that can provide employment and economic security to its young and growing population.

For designing an urban strategy it may be appropriate to reflect on the economic and social dynamism that shapes urban areas. Policymakers may distinguish among four different types of urban communities: the large cities; the peripheries of large cities; the medium-sized cities and small towns. Each of these urban centers has its own dynamic. There are also differences among the large cities. The strategy that might well serve the city of Karachi, Pakistan's largest, may not be the same as the one that would be relevant for Lahore, the country's second largest city. Nonetheless, both cities need better supply of water and sanitation, better transport, better education and health care, more focused attention to providing employment to the people who are constantly moving into the cities from the areas outside, more technological advance to increase the incomes of the employed and better integration with the global economy.

While the metropolitan city centers of Karachi and Lahore and other large cities may need the same kind of public services, their peripheries are very different from one another. Karachi has expanded into its hinterland by extending itself into the essentially empty and desert areas to its south and east. Those who have arrived in the city in search of jobs, have found or developed slum-like housing in the numerous "katchi abadis" that are located in the city's periphery. Hundreds of thousands of Pathans are living in these cities making Karachi the world's largest city for this particular ethnic group, larger than Peshawar and Kabul. There are "katchi abadis" in Lahore as well but its expansion has occurred largely by the assimilation of long-settled towns that were all around its ever-expanding periphery. Public policy designed to address the problems faced by the peripheral areas of the two cities, therefore, will have considerable differences in their content and objectives.

The medium-sized cities are the product of economic and social dynamics that are altogether different from those that are operating in large cities. Most medium-sized cities have grown in size for three different reasons. They were either important links in the system of transport and communication; they were centered on some local small enterprises; they were supplying important services to the sector of agriculture as it developed in the surrounding countryside. Two medium size cities, both in the Punjab, illustrate very well how different approaches towards industrialization can influence the shape and growth of urban areas. Rahim Yar Khan in the province's south drew a number of large transnational corporations that, taking advantage of the import substitution bias in the first forty years after independence established their operations in and around the city. The city's choice as a location was influenced by the impressive agricultural potential in the surrounding countryside. Lever Brothers, a prominent multinational that specialized in the manufacture of basic consumer goods, chose to locate its plant in the city. Engro established a fertilizer plant. But the city failed to develop as an industrial hub especially after the economy was opened to trade and import-substitution lost some of its luster.

On the other hand Sialkot in the province's center was able to become a vibrant urban center by opting for what economists now call "cluster development". By this is meant the location of relatively small enterprises in one area producing same types of goods and services. Being clustered together makes it possible for them to obtain the inputs, services, physical infrastructure they need. Clustering also allows access to the markets that, working individually would be expensive and, therefore, uneconomical for the small enterprises. Sialkot is an example of the success of this type of cluster development. The medium-sized cities located in the city built a strong export business based on traditional skills that were abundantly available in the area. The city's entrepreneurs also decided not to rely on the government for serving their area with the needed infrastructure. Instead they taxed themselves and raised sufficient resources in a highly innovative way to improve roads and even build an airport. A single urban development approach, therefore, would not work for all medium-sized cities.

Until the mid 1990s, the private sector had neglected the skill gap, because production technology tended to be rather simple, industry being heavily protected from both internal and external competition. However, with the opening up of the economy, more complicated technology has been introduced in the production process. The induction of modern technology is rapidly altering the nature of the skills requirement. There is therefore a need to provide skills required by the emerging industrial and services sectors.

To improve the productivity of the young labour force, we recommend skill development initiatives through public private partnerships, instead of expanding the operations of the technical and vocational training institutes and skill development centres with training courses that the market considers inadequate. To this end, we propose a two pronged approach to improve the employment capability of the potential target age group that comprises both those with limited educational qualifications and those having completed at least secondary level mainstream education.

Two possible instruments could be used to assess their individual efficiencies and efficacies in achieving the objectives of the intervention before opting for either or a combination of these skill enhancement channels. The first could be a supply side intervention in the shape of technical training grants to institutions (managed by either the public or the private sectors) that meet eligibility criteria for such support while the second could be a demand side intervention in the form of training vouchers to those seeking technical training in disciplines of their choice.

An average laborer is generally poorly educated with limited or no skills to get gainful employment. The unskilled landless, casual workers can be assisted by teaching them decent quality basic skills. Therefore, for those with up to elementary level education received in the schooling system providing education of at best indifferent quality we propose vocational training to develop skills say related to masonry, carpentry, catering and, perhaps, animal husbandry, etc. For the lower level simpler, practical skills like driving, masonry, carpentry, repairs of agricultural implements, animal husbandry and related extension work, Traditional Birth Attendant and Lady Health Worker training for women, etc. we propose partnerships with private sector associations like the Association of Builders, the Farmers Associations, the associations of Doctors, etc., as well the departments of Agriculture, Livestock and Health for approving the training course content, joint designing of the curriculum and the setting of standards, and for directly certifying the quality of the training or for mandating any other authority/agency they deem as credible for the purposes of certification.

For the skill development of those with secondary level schooling and above, a wider variety of well-structured and effective technical and vocational training could be on offer. However, to ensure demand driven training, the skills communicated under the programme should have market relevance-to match market opportunities and needs. So that the training is of the level and quality demanded by the private sector (especially those engaged in the exports of services and manufactured goods) we strongly recommend the adoption of a system of international certification of these skills. In a globalized world only those skills will have market value, and are likely to be sought by the private sector, that have been certified by an internationally recognized organization.. Such an approach will provide employability to graduates in line with emerging market needs, and strengthen their capability to earn a higher and steady stream of earnings in markets in Pakistan or abroad.

To facilitate the growth of SMEs and SME clusters there is a need for a carefully designed programme for the development of secondary/intermediate cities/towns (the design will have to ensure that these towns/cities will have the revenues/resources to maintain this newly installed or rehabilitated infrastructure) by adopting a cluster based approach (with the cities/towns to be connected, if necessary, through expressways) on the basis of economic potential (in terms of available markets and commercial centres), returns to the economy and pay back period, rather than select individual cities in different parts of a province. Initially, for instance in Punjab, this may result in the selection of clusters in the central districts of the province with basic infrastructure (supplemented/upgraded by infrastructure to be provided under this project/programme), with markets having strong forward and backward linkages, because of readily available supply chains, skills, population concentrations with purchasing power and entrepreneurial talent.

Such an approach will keep the additional investment costs low for both the government and the private sector. For foreign investors in particular the costs of investment or doing business and locating assets will become lower for each new venture as more clusters are developed in other geographical areas of the province. These investments could attract large foreign retailers like

Metro, Makro, Carrefour, etc. to locate in these areas creating opportunities for the development of high quality supply chains and related skills. The experience and expertise gained by those supplying to such franchises and by those trained by such branded outlets in managing the entire range of services linked to retailing would enable them to market their products and services internationally, especially in similar wholesale and retail outlets operating in the Middle East.

Finally, small towns have their own social and economic characteristics. They are much more integrated with the economic and social situations of the surrounding countryside than the other these types of urban communities. They will be affected much more by the policies aimed at the development of agriculture and by promoting trade in agricultural commodities.

Pakistan's urban future will depend to some considerable extent on how the country builds its economy and how it makes it more productive and competitive. For instance, by encouraging the development of retail trade and by facilitating the entry and expansion of multilateral retail chains, the country may be able to develop a number of centers of agricultural processing. This will create new urban poles of economic activity which, in turn, will reduce the pressure on the large cities by holding back some of the surplus workers from the countryside that would have inevitably migrated to the large cities, further crowding them and further putting pressure on already weak urban services. Given this way of disaggregating the urban economy, in what way should public policy respond to the separate needs of each of these four urban areas?

***Fiscal decentralization and the use of fiscal policy for influencing inter-personal and inter-regional income distributions:*** Over the years, Pakistan has become a more centrally managed economic and political system than provisioned by the Constitution of 1973. Not only does the constitution require greater functional autonomy for the provinces (now as well for the system of local government established in 2001), it is also an important part of the strategy for improving fiscal management. Reshaping of fiscal policies could help to spread economic development more evenly among different regions of the country. It will also arrest the worsening inter-personal income distribution. Of the several elements in fiscal policy that would help in the realization of these objectives, two are particularly important: distribution of the tax and other revenues of the central government and allowing more fiscal space to the governments at lower levels.

The 1973 constitution mandated the constitution of the National Finance Commission every five years for apportioning central revenues, both tax and non-tax, to the provinces. This provision was not followed. The last time an NFC award was given by the government was in 1997, a dozen years ago, and that too was written by an interim administration put into office to conduct elections after the dismissal by the president of an elected government. In other words, the political process has not been able to resolve some of the fundamental differences among the several provinces on the question of how best to distribute federal resources.

The question of allowing greater fiscal space to the provinces and perhaps to the large cities also needs to be addressed. Allowing greater fiscal role and responsibility to sub-national governments could simultaneously serve several important objectives. It would increase consolidated tax to GDP ratio allow more development resources at the local level, and move some responsibility for economic and social development to the governments physically closer to the people.

***Private health insurance:*** Health services are being poorly delivered to the populations in both urban and rural areas. It might be appropriate to increase the flow of public funds to the countryside while encouraging the establishment of private health insurance to cover towns and cities. In the cities, the provincial governments should continue to provide basic health care to the poor while encouraging the relatively well-to-do to obtain insurance for themselves from private operators. The state could subsidize the poor to obtain insurance coverage. The development of a health insurance system should also help the growth of urban services as the cost of coverage is spread over a wider circle of potential users and also over time. Given the rapid growth in medical education in the country in recent years when a number of private entrepreneurs entered the field, Pakistan may be in a position to move into the area of export of health services following the successes already achieved in such countries as Thailand and India. Given the significance of the health sector in improving human development and also the possibility of using the young population to become providers of health services to foreign customers, this would be an appropriate area for public sector intervention. What form should it take?

***Pension funds:*** There is a very limited pension funds activity in the country. The public sector has funds that resemble pension funds; there is very little presence of such instruments in the private sector. Encouraging the establishment of pension funds would help as it has been done in several Latin American countries to increase the rate of domestic savings. Again, as the experience of many developing countries indicates, such funds have a positive demographic impact on rapidly growing populations. Those who seek protection for old age by relying on large families will be less inclined to take that route if a viable pension fund industry was developed. However, as was done in Latin America, the development of pension funds will have to be carefully regulated by the state. Without appropriate regulation a lot of people can lose a lot of money if pension fund owners and managers become adventurous at the cost of policyholders. The challenge before the policymakers, therefore, is to design a system of regulation that encourages the development of this industry while protecting the consumers. What shape should government regulations take is an important issue for policymakers?

***Developing a supporting legal framework:*** Based on a considerable amount of analytical work done at the development institutions such as the World Bank and the Asian Development Bank, economists have begun to focus their attention on the need for legal and judicial systems that support efficient economic activity and not distort it. For the last two years - from March 9, 2007 when then President Pervez Musharraf attempted to dismiss Chief justice Iftikhar Chaudhry to March 16, 2009 when Prime Minister Raza Shah Gillani agreed to restore the judge to his position on the Supreme Court - the civil society in the country conducted an extraordinary public campaign aimed at improving the functioning of the judiciary. The movement was led by the community of lawyers. The legal community became increasingly concerned with the politicization of the judiciary; with the increasing propensity of the executive branch of the government to browbeat the judiciary to serve its purpose.

While the lawyers were campaigning to have the government bring back the judges who were removed from their benches as a result of the emergency rule briefly imposed by President Musharraf on November 3, 2007, an entirely different campaign gathered momentum in the Swat district in the North-West Frontier Province. There a group loosely associated with the Taliban movement sought to force government to bring shariah to the area. While the Swat campaign was couched in the new idiom of the Taliban movement in Pakistan, its purpose was to restore the legal and judicial systems that had existed before 1969. In that year the semi-autonomous states of Chitral, Dir and Swat were merged to form the administrative unit of Malakand. With this merger also come the legal and judicial systems that were prevalent in the "settled districts" of the NWFP. However, the new system had all the characteristics that had come to dominate the rest of Pakistan. It was a slow and cumbersome process and those who administered it were often corrupt. The people were generally very unhappy, something that was successfully exploited by the forces of extremist Islam. In early 2009, Islamabad reached an agreement with the religious leaders of Swat to restore the old system under the guise of Islamization.

These two episodes - the campaign to restore Chief Justice Chaudhry and the campaign to bring sharia to Swat - illustrate the growing sentiment in the country that the legal and judicial systems need to be reformed and modernized. The same conclusion was reached by development economists. How should this be done and who should be entrusted are important issues in this context?

***Technological backwardness:*** As discussed in the previous section, firms (enterprises, establishments) form the bedrock of all the economies. This is also the case for Pakistan. There are more than 3 million of them in Pakistan, most of them are very small and most of them are technologically very backward. The economist Paul Romer developed a new (endogenous) model of growth in which acquisition of knowledge and its applications was one of the factors of production. How does a developing country such as Pakistan acquire and apply knowledge? This can be done in several ways of which four are particularly important. There are: process innovation, new equipment, foreign direct investment and "research and development" or R & D. On all these scores, Pakistan's performance is poor. Smaller firms that dominate the Pakistani landscape are less innovative than large and medium size firms. Only 6 percent of the Pakistani manufacturing firms had introduced new or significantly improved products in the last three years. Majority of the firms (78 percent) finance new technology with internal funds and 21 percent of them use bank loans for this purpose. Among the various ways of acquiring new technology, the most important is the purchase of new technology and equipment from abroad. This emphasizes the role of foreign trade and foreign direct investment in improving the technological base of the Pakistani economy. Research suggests that there is a high correlation between those countries that have shown significant economic improvement and countries that have made substantial investment in R & D. Pakistan's record in this area is poor. R & D investment increased from 0.13 percent of GDP in 2006 to 0.44 percent in 2005 but is still lower than in most comparable countries. It is 0.7 percent in India and 0.8 percent in Brazil and Turkey. Until 2003, 100 percent R & D expenditure was by the government. In 2005, the government's share declined to 87 percent, most of it the consequence of the work done in higher education institutions. There is currently no business expenditures on R & D in Pakistan.

This brief analysis poses some obvious public policy issues pertaining to the role of the government, association between public and private sectors, and what kind of encouragement can be provided to the smaller firms to improve the technological base.

The dozen areas of public policy listed and briefly discussed above are some of those that are particularly important for addressing the many economic and social problems Pakistan currently faces. The main point for highlighting them was to identify a checklist of areas for public policy interventions where the returns to the economy, in terms of GDP growth and its better distribution, are high. Simultaneous focus on all these areas would, of course, stretch institutional and financial capacity to the limits. Pakistan's politicians and planners in developing a new long term vision of the country at this critical stage in the nation's history and operationalizing this vision into medium term plans will need to prioritize and sequence the process of development of the above mentioned areas. No doubt the immediate priority is to break the vicious cycle of security breakdown, economic crisis and governance failure, as emphasized in Chapter 1. The objective of this chapter has been to demonstrate the immense possibilities that exist for Pakistan's development once the vicious cycle is broken.

# Chapter - 6

# An Institutional Framework for Inclusive Growth

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## INTRODUCTION
### An Alternative Policy Paradigm

Economic growth in the past 60 years has failed to make a substantial dent into the poverty problem. This is because of an institutional structure within which high economic growth has been neither sustainable nor equitable. If growth is to be sustained and poverty is to be overcome quickly, a shift in the paradigm for understanding both the determinants of growth as well as the nature of poverty is required. The literature of the New Institutional Economics shows that the most important determinant of sustained growth is the institutional structure within which it occurs. If Pakistan is to embark on a path of sustained growth it would be necessary to establish an institutional structure for inclusive growth. Such a growth process would enable a transition to economic democracy which would sustain political democracy[1]. The institutional structure of inclusive growth would enable all citizens of Pakistan rather than only a small elite to participate as subjects of economic growth as well as the recipients of its fruits.

### The Elements of Inclusive Growth

The new approach to poverty proposes that neither handouts to the poor nor economic growth per se, can resolve the poverty problem. This is because the poor are locked into a nexus of power within an institutional structure that gives them insufficient access to productive assets and to health, skill development and education through which they could develop their human potential. They also lack access over justice and over governance decisions that affect their immediate social, economic and environmental conditions. This approach to inclusive growth could be adopted by establishing an institutional framework for the provision of productive assets to the poor as well as the capacity to utilize these assets efficiently. In this way the poor by engaging in the process of investment, innovation and productivity increase could become the active subjects of economic growth rather than being merely recipients of a "trickle down" effect: Thus a sustained high growth could be achieved through equity. Inclusive growth so defined can become both the means and the end of GDP growth.

The institutional framework of such an inclusive growth could have four broad dimensions:

(1) A process of localized capital accumulation through participatory development.

(2) A small and medium farmer strategy for accelerated agriculture growth through the provision of land ownership rights to the landless and institutional arrangements for yield increases.

(3) Accelerated growth of small and medium scale industrial enterprises through an institutional framework for increasing the production and export of high value added products in the light engineering and automotive sectors.

(4) An institutional framework for providing productive assets to the poor through equity stakes in large corporations owned by the poor and managed by professionals.

**THE INSTITUTIONAL STRUCTURE OF ENDEMIC POVERTY**

The poor in Pakistan cannot be simply seen as individuals with certain adverse 'resource endowments', making choices in free markets. Poverty occurs when the individual in a fragmented community is locked into a nexus of power which deprives the poor of their actual and potential income. The poor face markets, state institutions and local power structures, which discriminate against access of the poor over productive assets, financial resources, public services and governance decisions which affect their immediate existence.

In this context some of the questions that arise are: How do distorted markets for inputs and outputs of goods and services result in the loss of the actual or potential income of the poor? If this is indeed the case then what is the magnitude of the income loss?; how do power structures adversely affect tenancy contracts of the poor peasants?; how do local structures of power with respect to landlords, local administrative officials, and institutions for the provision of health, credit and dispute resolution, deprive the poor of their income, assets and the fruits of their labour?

Various forms of dependencies of the peasant on the local power structures and the distortions in the input and output markets functioning against the poor, constitute the elements of the process of poverty generation amongst the peasantry.

A substantial proportion of the potential as well as actual income of the poor peasantry is lost to the increasingly adverse tenancy arrangements and the obligation to sell labour at less than market wage rates or without any wages at all, to the landlords. This is because of the social and economic leverage that the landlords exercise over the poor peasants. Data show that 50.8 percent of the extremely poor peasants have taken a loan from the landlord and of these peasants 57.4 percent worked for the landlord without wages and 14 percent worked for the landlord at a daily wage rate of only Rs.28, compared to the typical market daily wage rate of about Rs.150.

At the same time there is unequal access over both the input and the output markets. Poor peasants have to pay a higher price on their inputs and get a lower price on their outputs compared to the large farmers. As a consequence the poor are losing 20.5 percent of their income in the major crops alone due to asymmetric markets.

In the small farm households the most significant constraint to increasing income is lack of ownership rights and the income losses associated with land use within the structure of dependence. The evidence shows that the contribution of tenants to input costs in the case of tractor rental, labour, seeds and fertilizers has increased during the period 1990-91 to 2000-01. For example, in the case of wheat the contribution of tenants in the provision of tractors increased from 63 percent to 74 percent, labour from 47 percent to 60 percent, seeds from 51 percent to 67 percent and fertilizers from 47 percent to 57 percent over the period, 1990-91 to 2000-01. Poor owner farmers and owner cum tenant farmers in the small size category instead of buying additional land have been forced to sell their land over the period 1991-2001. As many as 76.5 percent of the extremely poor farmers and 38.9 percent of the poor farmers sold their land for urgent consumption needs, marriage expenditures and health expenditures. As a consequence the productive assets of the poor peasants have been further depleted, thereby adversely impacting their future streams of income and reducing the probability of getting out of poverty.

Amongst the non rural farm households the principal constraint to poverty alleviation is the limited possibility of remunerative jobs and the low ability to start self employment projects. In the urban areas the employment status, informalization of the work force and the low level of productivity of micro enterprises constrain income levels and give rise to poverty[2].

## INCLUSIVE GROWTH THROUGH PARTICIPATORY DEVELOPMENT

Establishing the institutional basis for enabling the poor to increase their incomes, savings and investment, would not only constitute a direct attack on poverty but would also contribute to a faster and more equitable economic growth process. In this section we will begin by specifying the participatory development paradigm.

Participatory Development in its broadest sense is a process which involves the participation of the poor at the village/mohalla levels to build their human, natural and economic resource base for breaking out of the poverty nexus. It specifically aims at achieving a localized capital accumulation process based on the progressive development of group identity, skill development, and local resource generation.

At this level of generalization the concept has three key elements:

(a) Process: The process whose moving force is the growth of *consciousness*, of *group identity* and the realization in practice of the creative potential of the poor.

(b) Empowerment: The process of reconstructing a group identity, of raising consciousness, of acquiring new skills and upgrading, their knowledge base, progressively imparts to the poor a new power over the economic and social forces that fashion their daily lives.

It is through this 'power' that the poor shift out of the perception of being passive 'victims' of the process that reproduces their poverty. They become the vital subjects in initiating interventions that progressively improve their economic and social condition, and overcome poverty.

(c) Participation: The process of acquiring power to break the vicious circle of poverty, based on *participation* within an organization in a series of projects. This participation is not through 'representatives' who act on their behalf but rather, the actual, involvement of each member of the organization in project identification, formulation, implementation and evaluation. It is in open meetings of ordinary members at the village/mohalla level organization that decisions are collectively taken, and work responsibilities assigned on issues such as income generation projects, savings funds, conservation practices in land use, infrastructure construction and asset creation.

The process of participatory development proceeds through a dynamic interaction between the achievement of specific objectives for improving the resource position of the local community and the sense of community identity. Collective actions for specific objectives such as a small irrigation project, fertilizer manufacture through organic waste, clean drinking water provision, or production activities such as fruit processing, can be an entry point for a localized capital accumulation process, leading to group savings schemes, reinvestment and asset creation. The dynamics of participatory development are based on the possibility that with the achievement of such specific objectives for an improved resource position, the community would acquire greater self confidence and strengthen its group identity.

Since the term empowerment has been loosely used in much of the literature on development it may be helpful to specify its meaning. Empowerment means enabling the poor to build their human capabilities and economic resource base for breaking out of the poverty nexus. It is a process of reconstructing a group identity, of raising consciousness, of acquiring new skills and of achieving better access over markets and institutions for a sustainable increase in incomes. Such a process progressively imparts to the poor a new power over the economic and social forces that fashion their daily lives. It is through this power that the poor shift out of the perception of being passive victims of the process that perpetuates their poverty. Thus they become active subjects in initiating interventions that progressively improve their economic and social condition to overcome poverty.

The economic strategy requires a national campaign to empower the poor at the level of village/mohallah, Union Council, Tehsil and District. The idea is to facilitate the growth of autonomous community organizations of the poor at the village/mohallah level to be able to break out of the poverty. Through these community organizations (COs) the poor can identify income generating projects, initially at the household level, acquire skill training from a variety of sources such as government line departments, autonomous institutions, private sector firms, Non-governmental Organizations (NGOs). and donors; and access credit for micro enterprise projects through apex organizations such as the Pakistan Poverty Alleviation Fund (PPAF), Khushali Bank, Small Business Finance Corporation (SBFC), and commercial banks. Special organizational arrangements would need to be made in these apex institutions to take credit to poor women and women's COs, since poor women have even lesser access over institutional credit compared to poor men.

It is important that such village level COs be autonomous and be permitted to form cluster apex organisations with other. Autonomous COs by means of social mobilisation, skill training, increased productivity, increased income, savings and investment would begin a process of localised capital accumulation. Such a process, which we have called participatory development would be integrally linked with the emergence of a new consciousness of empowerment. The poor can begin to take autonomous initiatives to improve their material conditions of life. They would thus break out of the poverty nexus and shift from being victims to active subjects of social and economic change. Such a process of village level increases in productivity, incomes and savings would not only constitute a direct attack on the poverty problem but would also contribute to a faster and more equitable macro economic growth.

Such autonomous organizations of the poor could not only become a framework for grassroots economic growth, but would also constitute countervailing power to that of the power structures of local elites. At the same time, these autonomous organizations of the poor would enable the individual poor household to get better access over input and output markets.

Facilitating the emergence of autonomous organizations of the poor particularly organizations of poor women, could enable the newly established local government institutions to function in a more equitable and effective manner. The equity would be with respect to class as well as gender. This would require establishing institutionalized links between autonomous organizations of the poor and local government bodies at the Village, Union Council, Tehsil and District levels. These institutional links between organizations of the poor and elected local bodies would enable more participatory and equitable processes of project identification, design and implementation for local level development.

Over the last three decades the tightening financial constraints on the government[3] and growing awareness of the limitations of top-down development programmes to alleviate poverty, have created the space for non-governmental organizations and an alternative approach to development action. During this period a variety of NGOs have established support programmes aimed at developing community organizations at the village level, institution building, providing training and accessing credit and technical support.

Compared with the other South Asian countries the development NGO sector in Pakistan has been slow to mature. Until well into the 1980s the bulk of NGOs in Pakistan were small charitable or social welfare oriented bodies. Of these, a distinct segment were rural cooperatives, registered under the Cooperative Act. These would have merited attention in as much as the Cooperatives Act is one of the possible, indeed one of the logical means of constitution of a non-profit NGO. There are historical reasons however, why cooperatives in the form in which they have existed in Pakistan with Government support, are distrusted by the bulk of the rural population. Apart from the tendency of rural cooperatives to be dominated by rural elites which manipulated their policies and monopolized their resources and benefits, there has been generalized outright fraud in the cooperative sector. This has led development professionals to explore other possible means of NGO formation, such as a charitable trust (the form chosen by NGOs such as Orangi Pilot Project) and non-profit private limited companies (which is the form chosen by Rural Support Programs (RSPs)) or a society under the Societies Act, (the form chosen by PIEDAR).

Development NGOs exist in a variety of sizes and forms, from large centralized bodies spanning a number of districts and provinces, such as the RSPs to smaller organizations operating in a number of regions within the same province (such as SUNGI). Finally there are COs which operate on a very local scale either at the village level or a cluster village level.

Development NGOs range from multi-functional ones that support a wide range of activities in fields such as income generation, natural resource management and the social sector, (e.g. PIEDAR, SUNGI and RSPs) to a particular limited set of operations such as KASHF (which is essentially a micro-credit support NGO), or which target a particular disadvantaged group such as women through innovative and multi sectoral interventions (e.g. Shirkatgah, Aurat Foundation).

### Taking Small NGOs to Scale

Some large NGOs such as AKRSP, PRSP and PPAF have achieved impressive results. At the same time, in the case of other large government created NGOs, questions continue to remain with respect to five issues: (i) Lack of financial self sufficiency and continuing dependence on government/donor support. (ii) The problem of cost effectiveness. (iii) The problem of accuracy in targeting the poor population. (iv) The problem of speed and scale of coverage of the poor population. (iv) Lack of autonomy of village level community organizations within the centralized command structure of the National Rural Support Program (NRSP).

The success and limitations of existing large government supported RSPs not-withstanding, an approach of letting "a hundred flowers bloom", may enable greater innovation, rapid growth and success of the endeavour of development through NGOs.

Of the large number of multi-sectoral NGOs with small beginnings, using the participatory development methodology, at least three can be said to have grown to a significant size and achieved national prominence. These are SUNGI, PRSP, KASHF and BANH BELI. Three questions arise in the context of their success: (a) What are the common factors in their success? (b) At this stage of their growth, what are the constraints they face to further up-scaling and/or rapid replication? (c) What are the elements of an enabling environment at the national level which could let a "hundred flowers bloom", in the sense of nurturing the rapid growth/replication of development NGOs, enable mutually catalyzing interaction and yet maintain the unique character of each of them?

Apart from the efficacy of the participatory development methodology adopted by the above mentioned NGOs, perhaps the single most important factor in their success is the quality of leadership. It is to build a team which while being internally coordinated, at the same time, enables each member to become a centre of thought and action. The successful NGO leader creates the team synergy to develop innovative responses to each new problem on the ground. Yet, he/she ensures that each action by the team contributes to reinforcing the process of the poor taking charge of their own development. The effective leader focuses the team to experience the potential of the poor and to grasp the specific dynamics of how they can organize, take responsibilities and initiate change. Thus the challenge for the NGO leadership is to so relate with the poor and the team, that every act, every word, every moment of silence, contributes to fertilizing the other, rather than establishing control: Liberating rather than inducing dependency.

The second factor in the success of small NGOs is the identification, training and fostering of village level activists who gradually begin to manage existing COs, thereby, enabling NGO staff to give more time to develop new COs. This process of devolution of management responsibility from NGO staff to village level activists is a crucial factor in the enlargement of NGO coverage in a situation where funds are limited and rapid expansion of staff financially infeasible. The converse of this dynamic is that if too much money becomes available too early, it undermines discipline, initiative and energy of the NGO.

The third factor in the success of small NGOs which have reached significant scale is the development of second level management and the ability of top level leadership to devolve responsibility, acknowledge their achievements and to learn from them just as much as it is necessary for the leadership to learn from the poor. An inner wakefulness that comes from transcending the ego is necessary to be always open to learning from the poor, and from each member of one's team. It is this openness to learning from others that constitutes the basis of the organization's dynamism, its innovation and its sense of being a community.

The fourth factor in the success of small NGOs in reaching significant scale is the development of credible accounting procedures, and a regular monitoring and evaluation exercise on the basis of which donor funding can be sought when it is required. In each case the successful NGO, apart from devising efficacious modes of reflection and action with the village communities, also develops formalized recording and reporting systems.

Those NGOs which started small and through certain specific features, discussed above have reached a medium-size are now faced with the challenge of up-scaling to a much larger size. Typically, the successful NGOs started work in one hamlet a decade ago, are now working in scores of villages and in three or four districts. The question is what are the key changes within the organization which could enable them to reach a large size. In this context, seven key changes may be required:

i) The single leader at the top (variously called Chairman, President or Chief Executive Officer) would need to build a team of at least three or four leaders who can work independently at the top level. This is necessary in a situation where programme operations become so geographically diversified that overall programme management would need to get regionally decentralized, such that each regional programme would be operating in three or more districts. At the moment, each of the heads of the three successful NGOs mentioned above are taking all strategic decisions and many tactical ones and have a hands on presence in each area of operation. In addition, they are also devoting part of their time to doing consultancy work or other private business to supplement their meagre salary from NGO funds. Consequently, the leadership is so over-stretched, that it is difficult for them to consider making a quantum leap of up-scaling. Yet, they have acquired the consciousness of relating with the poor necessary to train and develop a larger top level leadership.

ii) For a major up-scaling of successful medium-sized NGOs, it would be necessary to receive grant funding for institutional strengthening and growth. PPAF could provide such funding after careful evaluation of the concerned NGOs and assessment of their expansion plans.

iii) As the organizational structure of the NGO changes from a centralized to a geographically decentralized one, the methodology of work would also have to change to enable introduction of procedures for monitoring and strategic planning. As full autonomy is granted to regional programme heads, each of them would be expected to report and evaluate on programme performance within an agreed format and in consultation with community organizations and the regional programme team. This evaluation could be done on a monthly basis and could feed into the process of developing regional programme plans on a quarterly and annual basis. These regional programme plans prepared initially at regional programme offices, would include issues such as the number and locations of new COs to be formed and the deepening of existing COs. In would also include facilitating the preparation of participatory village development programmes for infrastructure, social sector services, and off-farm enterprises, as and when such services are identified by COs. The deepening of existing COs in the regional programme plans would include devolution of organizational responsibilities to village activists for managing village level or village cluster level apex organizations of the poor. Such devolution of responsibility would, on the one hand, enable self-managed community organizations to develop, and on the other hand, enable the NGO to keep its overheads low as it enlarges its coverage. The regional planning exercise could be conducted at the regional office on a quarterly basis. However, this process could also involve annual plenary planning sessions at head office where village activists, key members of regional teams and head office personnel in planning, monitoring and human resource development, would interact with each other.

iv) One of the necessary conditions for successful NGOs that up-scaled to medium-sized level, was the development of a nascent middle level management in their team, although still tightly supervised by the top leadership. As such NGOs up-scale to large size and achieve geographic diversification, such middle level management would have to be brought to maturity, allowed greater autonomy and considerably increased in number. Such middle level management would play a key role in coordinating social mobilization, training of village level activists, and accessing technical support and credit. The middle management cadre by virtue of its proximity to the field would also be important in collecting data necessary for monitoring, evaluation and planning.

v) The challenge to NGO up-scaling is that, they must keep overheads costs to a minimum level. In order to achieve this, it is necessary for the NGO to be able to withdraw from those villages where COs have achieved adequate maturity and have developed the capacity to form apex support organizations of their own. The critical factor for enabling NGOs to devolve organizational responsibilities to apex organizations of COs, is the development of a cadre of village activists with training in the following fields: (a) community management skills, (b) ability to interact with donor organizations and government line departments, (c) expertise in a range of basic skills such as, livestock management, agriculture, soils, irrigation, natural resource management and micro-enterprise development. Such a cadre could constitute a core management team in an independent apex support organization.

vi) As the NGO up-scales to a large size it would generate a variety of training needs for CO members at the village level, as well as career development and professional training needs of NGO personnel. Consequently, a human resource development programme within the NGO may be necessary to identify the human resource and career development needs specific to the internal dynamics of the NGO's work. The human resource development section within the NGO would need to be a lean unit which should network with diverse specialized institutions to access the required training services.

vii) As the NGO reaches a large scale, there would be a quantum leap in the range and complexity of financial flows within the NGO programmes and also between the NGO and macro level institutions (such as PPAF, commercial banks, donor agencies and government departments). It would, therefore, be essential for the NGO to have a high quality professional finance and accounts division, with the ability to develop and operate MIS, finance, accounting and statistical software packages. Members of this division, while having the best available skills as chartered accountants and finance managers would need to be sensitized to the methodology of participatory development and their work integrated with field operations. It would be necessary to develop accounting procedures that while meeting the auditing requirements at the most rigorous level, would also have the innovativeness and flexibility to cater to the unique nature of development NGOs credit operations.

Box 6.1 shows the key features of NGOs at each stage of their growth from small to large size. The features specified at the small size and transitional stages, actually prevail in successful NGO that have grown to a significant size. The features in the third stage (large size), however, are indicative in nature, for large NGOs to be sustainable, cost-effective and genuinely participatory.

**BOX 6.1**
**NGO GROWTH AND CHANGING PROFILE OF KEY FEATURES**

| | Key Features | Small NGO (Prevalent Features) | Transition to Upscaling (Prevalent Features) | Large NGO (Indicative Features) |
|---|---|---|---|---|
| 1. | Leadership | Single, dedicated leader usually without formal management training. | Emergence of one or more field officers as Regional programme Heads. Hiring of specialists at senior management level. | Hiring and training of professional and dedicated leaders for regional programs. Elevation of talented middle management field officers to top leadership positions. |
| 2. | Management Systems | Absence of formalized procedures, multi-function role of staff members, intense synergy and team work. An openness to learning from the poor and from each other. | Institutional regulations and job specifications emerge; yet, emphasis on participatory decision making; collective reflection in regular staff meetings. | Formalized management systems, functional division of roles, systematic, periodic collective reflection to ensure participatory decision making and planning. In house research capacity and link up with specialized research institutions. |
| 3. | Accounting and Finance Systems | Rudimentary, operated by non-specialists. Maximum emphasis on keeping costs at lowest level. | Hiring of professional accountants emergence of financial analysis, computerized accounts and formal auditing | Hiring of top level finance manager with professional finance & accounting team, sensitized to participatory development approach, development of customized software for MIS and credit operations. |
| 4. | Devolution of Responsibility to Independent Apex Support Organizations of VOs | Social mobilization and support functions performed only by NGO staff. | Emergence of cadre of village activists, who share support role; emergence of independent multifunction support organizations at village level. | Large experienced cadre of village activists, matured multifunction VOs; emergence of independent apex multifunction support organizations at village cluster or tehsil level. They enable redeployment of NGO field staff and hence NGO overheads kept low. |
| 5. | Relationship with Funding Agencies | Funding usually from single foreign donor, covering function specific operational costs hence occasional donations from friends of leader. | Funding from multiple donor sources for both operations and institutional capacity building. Application to PPAF for institution building grant and credit line. | Establishment of an endowment fund, project specific and region specific funding from multiple donor sources, link up with banks and PPAF for financing credit operations. |
| 6. | Relationship with Government | Government departments usually hostile, avoiding pressure from lower echelon government officials a significant preoccupation. | Nascent links with government line departments to access technical support for VOs, good working relationship with district officials and selected provincial secretaries. Interference by vested interests amongst senior government officials and politicians a major hazard particularly due to fragility of NGO at this stage. | Systematic working relationship with government Line departments at the provincial, district, and tehsil level. Systematic working relationship with specialized institutions for technical support and training in government, autonomous and private sectors. Unwarranted government interference through senior officials and politicians could be a significant hazard. |

## INSTITUTIONAL FRAMEWORK FOR A SMALL AND MEDIUM FARMER AGRICULTURE GROWTH STRATEGY

Pakistan's fragile democracy is threatened by an economic crisis combined with growing poverty that fuels terrorist organizations. An important factor in the economic crisis is the food deficit and the underlying stagnation in yields per acre of major crops. (In the year 2007-08, crop sector growth was negative). It can be argued that if the yield potential of the medium and small size farm sector is achieved, food shortages can be converted into food surpluses. Such a shift can enable Pakistan to convert its weakness into its strength: The current crippling economic burden of food imports can be converted into a strength through food exports. To bring about this transformation a new policy framework is required to shift from the earlier elite farmer strategy to a new small farmer growth strategy.

The rural poor once liberated from the shackles of feudal power and provided with ownership rights can become a major driving force in accelerating agriculture growth and in achieving both political and economic democracy in Pakistan.

At an economic level the existence of a powerful landed elite is indicated by the fact that according to the Agriculture Census of 2000, as much as 30 percent of total farm area is owned by land owners with ownership holdings above 50 acres, and yet they constitute only 2 percent of the total number of land owners. Elements of this landed elite dominate the major political parties, local governments, institutions and markets for credit and agriculture input distribution.

When the 'Green Revolution' technology became available in the late 1960s it was possible to substantially accelerate agriculture growth through an elite farmer strategy which concentrated the new inputs on large farms. Now the crucial determinant in yield differences became not the labour input per acre in which small family farms had been at an advantage in earlier decades, but the application of the seed-water-fertilizer package to which the large landlords with their greater financial power had superior access. Thus the 'Green Revolution' had made it possible to accelerate agriculture growth without having to bring about any real change in the rural power structure. Today, after almost four decades of the elite farmer strategy, the imperative of land reform is re-emerging, albeit in a more complex form than before. As the large farms approach the maximum yield per acre with the available technology, further growth in agricultural output increasingly depends on raising the yield per acre of small farms and reversing the trend of land degradation brought about by improper agricultural practices.

The small and medium farm sector whose yield potential remains to be fully utilized, constitutes a substantial part of the agrarian economy. Farms below 25 acres constitute about 94 percent of the total number of farms and about 60 percent of the total farm area. From the viewpoint of raising the yield per acre of small and medium farms (i.e. farms of less than 25 acres) the critical consideration is that 15.7 percent of the total farm area in the less than 25 acre farm category is operated by landless tenants. Another 13 percent of the farm acreage in less than 25 acre farms is operated by owner cum tenant farmers. Since tenants lose half of any increase in output to the landlord, they lack the incentive to invest in technology which could raise yields per acre. Because of their weak financial and social position they also lack the ability to make such investments. Their ability to invest is further eroded by a nexus of social and economic dependence on the landlord which deprives the tenant of much of his investible surplus.

This problem is further exacerbated by the absence of an efficient land market where productive land can move to the more efficient operator. Flexible and secure tenancy contracts, and a competitive land market which can allow efficient operation of farm land, can only emerge if the extra economic power currently enjoyed by the feudal elite is constrained. Thus the objective of raising yields in the small farm sector is inseparable from removing the constraints to growth arising out of the institutional structure of tenancy. A policy initiative that enables the tenant to acquire land is therefore an essential first step in providing the small farmers with both the incentive and the ability to raise their yields/acre.

Thus the imperative of land reform today arises not only from the need to accelerate agricultural growth and alleviate rural poverty, but also from the need to build a sustainable democracy. A society based on tolerance, merit and the supremacy of law would require overcoming feudal forms in the conditions of production, in society, and in the very functioning of the State.

A policy of enabling tenant farm households to acquire ownership rights together with access to the markets for inputs could play a vital role in making the small farm sector the leading edge of a faster and more equitable agriculture growth. Such a policy could have two main elements: (a) transferring the existing 2.6 million acres of state owned land to landless peasants together with an institutional framework for providing them with access over high quality seeds, fertilizers, water and extension services. (b) institutional changes to open up the land market together with the provision of credit to tenant farm households for enabling them to purchase land.

An initial step in providing productive assets to the rural poor could be to allot the available 2.6 million acres of State owned land to the landless. According to the Census of Agriculture 2000, there are about 5.0 million acres of private farm area under pure tenant cultivation in farms below 25 acres. Transfer of 2.6 million acres (assuming that all of it is cultivable) could make a significant contribution to the reduction of rural poverty. For example if the 2.6 million acres of state owned land were to be transferred to landless farm households in holdings of 5 acres each, then as many as 520,000 tenant farmers would become owner operators. This means that out of the total number of tenant farmers (about 897,000) in the less than 25 acre category, as many as about 58 percent would become owner operators.

However, it is important to recognize that providing ownership of land to the landless is a necessary but not a sufficient condition for alleviating their poverty. Enabling the landless to make the transferred land cultivable, to actually settle on the new land and to achieve a sustainable increase in their income, productivity and savings are equally important factors in making the scheme successful.

The achievement of sustainable livelihoods for the landless rural poor through the provision of state owned land would involve the following steps to be undertaken by relevant departments of provincial governments in partnership with NGOs, private sector and international donor agencies:

1. Undertake a diagnostic survey of the areas in which the beneficiaries and the lands to be transferred to them are located. The objectives of these diagnostic surveys would be:
    - (a) To evaluate the cultivable status of the land and the potential uses for which the land could be utilized.
    - (b) Identification of the main physical constraints to utilizing the land for the purpose of achieving a sustainable livelihood for the poor. (Examples of such constraints are: saline soils, poor quality of ground water, poor management of torrent water or an absolute non availability of water).

(c) Identification of physical infrastructure interventions that could be made through participatory development projects involving partnership between government departments, NGOs and organizations of the landless poor in the concerned areas (examples of such interventions could be, minor land reclamation schemes, provision of tube wells where possible, check dams, water lifting devices and water harvesting schemes).

(d) Identification of micro enterprise projects which individual households or groups of households of the poor could undertake in order to achieve a diversified economic base for their livelihoods. For the identification of such micro enterprise schemes the survey would involve consultations with organizations of the poor and with individual poor households from amongst the potential beneficiaries.

(e) Estimates of credit needs of those poor households who are targeted as beneficiaries of the newly allotted lands.

(f) Socio economic profiles of the landless poor in the specific areas where they are expected to acquire the land under the scheme. This profile would identify the mechanisms through which poverty of the concerned households is reproduced, their current major sources of income, debt and actual or potential skills.

2. The provincial governments would facilitate the local governments in the specific areas where the relevant state lands are located to initiate a process of social mobilization of the landless poor. This mobilization would be essential to enabling the landless poor households to begin using the newly acquired land in a productive way and to position themselves for acquiring skill training, credit and technical support from both government departments and NGOs.

   This social mobilization could be conducted by local governments through partnership with community based organizations at the local level, NGOs at the district and provincial levels and with support from apex organizations such as the PPAF and also from donor agencies.

3. Training of social mobilisers/catalysts could be undertaken by specialized NGOs such as the South Asia Partnership, NRSP, PRSP and SAPNA (South Asian Perspective for new Alternatives).

4. After specific local level infrastructure projects for improving the productivity of state allotted lands have been identified, the provincial governments in collaboration with Pakistan Agricultural Research Council could mobilize the technical expertise for implementing the projects through organizations of the poor. The financial resources necessary for these infrastructure projects could be mobilized from Asian Development Bank, World Bank, SBFC, The Khushali Bank, PPAF.

5. The provision of technical training and credit for micro enterprise projects could be undertaken by networking the following organizations: (a) PPAF and Khushhali Bank for credit. (b) For organizing technical training and technical support for micro enterprise projects of the poor the following organizations could be networked: NGO Federation (BINGOF), Punjab NGO Coordination Council, Sarhad NGO Ittehad , Sind NGO Federation, the Pakistan NGO Forum and SUNGI.

The scheme of providing state lands to the landless poor can lead to a sustainable increase in incomes of the beneficiaries if the provision of state land is combined with the following elements: (1) social organization of the poor, (2) development of local infrastructure for increasing land productivity, (3) development of micro enterprise projects of the poor and (4) provision of training, technical support and micro credit to the poor in order to develop a diversified economic base for overcoming their poverty. If such a scheme for participatory development of poor landless households could be undertaken then the government could set a new example not only for Pakistan but for developing countries as a whole, that could demonstrate how the landless poor can be enabled to overcome their poverty.

While the transfer of state owned land could provide land to 58 percent of the existing tenant farmers, the remaining 42 percent could be enabled to buy land through credit and institutional changes in the land market. Thus all the existing tenant households could become owner operators who could play a strategic role in generating a faster and more equitable agriculture growth.

Out of a total of 897,000 pure tenant farmers, 377,000 households could be enabled to acquire ownership rights over 5 acre farms through purchase of land. This would create the institutional basis of providing both the incentive and the ability to tenant farmers to increase yields per acre. This objective could be achieved through four sets of policy actions:

(a) Through a consortium of government, donors and commercial banks a credit fund for providing land to the landless amounting to about Rs.332 billion (US$ 4.24 billion) could be created. The purpose would be to: (a) provide targeted credit to enable about 377,000 tenant farm households to purchase 5 acres per household of cultivable land with a total cost of approximately Rs.283 billion (US$ 3.62 billion), (b) allocate Rs.50 billion (US$ 0.64 billion) for follow up extension services to enable efficient cultivation of purchase land.

(b) Update, systematize and computerize the land revenue records. The objective would be to establish clear ownership rights of existing owners/claimants such that owned land could become legally transferable without the market transactions being subject to crippling litigation.

(c) Facilitate the formation of small farmer associations at the union council and tehsil levels with a view to providing small farmers with the leverage to get equitable access over the markets for seed, fertilizer, tube well water and pesticides. At the moment markets for these inputs are asymmetric with respect to the large and small farmers respectively. Local power structures mediate local markets so that the small farmers get poorer quality of seeds, fertilizer and pesticides, and have to pay relatively high prices for these inputs compared to the large farmers.

(d) Strengthen extension service organizations of the provincial governments at the union council and tehsil levels and re-orient their operations to provide high quality support to small farmers for: (i) soil testing to enable the farmer to determine the precise composition of the chemical fertilizers that is congruent with the nutrient requirements of the soil, (ii) improved on farm water management to increase water use efficiency, (iii) improved agricultural practices based on new scientific knowledge to reduce salinity and improve the organic profile of the top soil.

## INSTITUTIONAL FRAMEWORK FOR FASTER GROWTH OF SMALL SCALE INDUSTRIAL ENTERPRISES (SSEs)

Since small scale industries have higher employment elasticities, smaller Incremental Capital Output Ratios (ICORs), and shorter gestation periods, therefore an increased share of investment in this sector could enable both a higher GDP growth for given levels of investment as well as higher employment generation for given levels of growth. At the same time if the institutional conditions could be created for enabling small scale industries to move into high value added components for both import substitution in the domestic market and for exports, Pakistan's balance of payments pressures could be eased. The key strategic issue in accelerating the growth of SSEs is to enable them to shift to the high value added, high growth end of the product market. These SSE's. include high value added units in light engineering, automotive parts, moulds, dyes, machine tools and electronics and computer software.

Training of a large number of software experts with requisite support in credit and marketing could quickly induce a significant increase in software exports from Pakistan. Pakistan could build a pool of software experts for a large increase in export earnings. This would of course require a proactive government to establish joint ventures between large software companies such as Microsoft and Pakistan's private sector institutions such as LUMS and INFORMATICS. The Ministry of Science and Technology is already moving rapidly in facilitating the growth of information technology in Pakistan.

A large number of small scale enterprises (SSEs) in the Punjab and the NWFP have a considerable potential for growth and high value added production such as components for engineering goods or components of high quality farm implements for the large scale manufacturing sector. Yet they are in many cases producing low value added items like steel shutters or car exhaust pipes resulting in low profitability, low savings and slow growth.

Small scale enterprises in small towns of Pakistan face the following major constraints:

(i) Inability of small units to get vending contracts for the manufacture of components from the large-scale manufacturing sector.

(ii) Due to lack of expertise in production management and the frequent inability to achieve quality control it becomes difficult to meet tight delivery schedules.

(iii) Lack of specific skills like advanced mill work, metal fabrication, precision welding, all of which are needed for producing quality products with low tolerances and precise dimensional control. In other cases accounting and management skills may be inadequate.

(iv) Difficulty faced by small units in getting good quality raw materials, which often can only be ordered in bulk (for which the small entrepreneurs do not have the working capital), and from distant large cities.

(v) Lack of specialized equipment.

(vi) Absence of fabrication facilities such as forging, heat treatment and surface treatment which are required for manufacture of high value added products, but are too expensive for any one small unit to set up.

(vii) Lack of capital for investment and absence of credit facilities.

Overcoming the aforementioned constraints would involve providing institutional support in terms of credit, quality control management, skill training and marketing. This could be done by facilitating the establishment of Common Facilities Centers (CFCs) located in the specified growth nodes in selected towns where the entrepreneurial and technical potential as well as markets already exist. Such support institutions while being facilitated by the government and autonomous organizations such as SMEDA can and should be in the private sector and market driven.

The concept of the Common Facilities Centers is based on the fact that small scale industrialists in Pakistan have already demonstrated a high degree of entrepreneurship, innovation and efficient utilization of capital. The CFCs would provide an opportunity for rapid growth to SSEs through local participation in extension services, prototype development, and diffusion of improved technologies, equipment, and management procedures. The CFCs would constitute a decentralized system which ensures continuous easy access to a comprehensive package of support services such as credit, skill training, managerial advice and technical assistance. The CFCs could also be linked up with national research centres, and donor, agencies for drawing upon technical expertise and financial resources of these agencies in the service of small scale industries (SSI).

The Common Facilities Centres could have the following functional dimensions:

***Marketing***

Provision of orders from the large scale manufacturing sector for components, and from farmers for farm implements. These orders would then be sub-contracted to the cluster of SSI units that the CFC is supposed to serve. The individual order would be sub-contracted to the SSI on the basis of the skills and potential strengths of the unit concerned.

***Monitoring and Quality Control***

Having given the sub-contract, the CFC would then monitor the units closely and help pinpoint and overcome unit specific bottlenecks to ensure timely delivery and quality control of the manufactured products. These bottlenecks may be specialized skills, equipment, good quality raw material or credit.

***Skill Training and Product Development.***

Skill training for technicians could be provided by the new good quality vocational training institutes (VTIs) established by the Vocational Training Council of Punjab. Similar VTIs could be established in other provinces. The CFC would provide specialized supplementary skill training on its premises to workers in the satellite SSI units when required. At the same time, it would provide advice on jigs, fixtures, special tools and product development where required.

***Forging and Heat Treatment Facilities***

The CFCs would establish at their premises plants for forging, heat treatment and surface treatment. The SSI units could come to the CFC to get such fabrication done on the products they are manufacturing on sub-contract, and pay a mutually agreed price for this job to the CFC.

***Credit***

The CFC would provide credit to the SSE's for purchase of new equipment and raw materials. In cases where raw materials are available in bulk supply, the CFC could buy it from the source, stock it on its premises and sell at a reasonable price to units as and when they need them.

## INCLUSIVE GROWTH THROUGH EQUITY STAKES FOR THE POOR IN LARGE CORPORATIONS

The hallmark of underdevelopment or what North calls a Limited Access Social Order, is an institutional structure which systematically excludes the majority of the people from the process of investment, economic growth and access over basic services for human development. If economic growth and political democracy are to be sustainable it is necessary to move towards an institutional framework which provides opportunities to all of the people rather than a small elite to participate in the process of investment, growth and human development. In this section we will examine some of the innovative new institutional forms that have been tried and tested in a number of South Asian countries for mainstreaming the poor into the economy.

The concept of enabling ownership rights to the poor in the mainstream large scale corporate sector has not yet been addressed in the literature on development policy. The poor can be included in the process of investment and economic growth not merely through micro enterprises, but can be engaged into the mainstream corporate sector as well.

Investments in the capital market have often been made by pledging the stocks being purchased. A down payment of say 20 percent of the value of the asset is usually made by the investor and the residual amount of the stock purchased is covered by the bank which then holds the stock as collateral.

There is no reason why such loan financing for under writing investment in the capital market should not be made available to organizations of the poor. Their small savings can be pooled and then used as down payments on investments in the corporate sector. The poor can thereby become eligible for bank loans to buy into the initial public offering by the corporate sector. They can also be directly inducted as equity partners in existing large corporations.

There are clearly issues of risk assessment, as well as how such groups of the poor can be mobilized into sufficient numbers to empower them to become partners in the corporate sector. The methodology of group formation of the poor and its dynamics, have been discussed in an earlier section.

## INSTITUTIONAL INITIATIVES FOR INCLUSIVE GROWTH THROUGH CORPORATE ENTERPRISES OWNED BY THE POOR

There are three sectors which have considerable potential for stimulating GDP growth, poverty reduction and increasing Pakistan's foreign exchange earnings: (i) milk and dairy products, (ii) livestock and the production of meat and meat products, (iii) marine fisheries.

With over 177 billion rupees worth of milk being produced annually in Pakistan, milk is Pakistan's largest product in the agriculture sector. Unlike agriculture crops the production of milk can be accelerated sharply within a couple of years. Currently Pakistan's milch cattle yield per animal is one fifth the European average. Demonstrable experience in the field has shown that the milk yield per animal in Pakistan can be doubled within two years through scientific feeding, breeding and marketing. What is required is an institutional framework for training the farmers in scientific feeding and breeding, and for establishing the logistics to collect milk from the farm door by means of refrigerated transport, domestic marketing as well as arrangements for refrigerated storage at airports and subsequent airfreight to export markets. Such an initiative could have a significant impact not only on the incomes of poor peasants but also on exports and overall GDP growth.

Marine Fisheries, also provide a significant potential for improving foreign exchange earnings although not as large as the potential for milk. Here again, what is required is improved institutional support and better management rather than huge investments by the Government.

The expansion in the export of marine fisheries is constrained because the storage facilities for transportation do not match the international quality standards. Currently alternate layers of fish and hard sharp edged ice are placed in containers on the boats. Under the weight of upper layers of fish and the sharp edged ice, fish at the lower layers are crushed, and the resultant bleeding causes putrefaction. To avoid this, it is necessary to provide shelves for layered storage of fish in boats, topped by dry ice, with fiberglass covers to maintain the European Union standards of minus 7ºC temperature during transportation. An export potential of 300 million dollars exists over the next three years if such improved management of the marine fisheries industry could be achieved.

It is proposed that the PPAF, its NGO partner organizations at the district level and provincial Dairy Development Boards be brought together into a consortium to establish a Pakistan Dairy Corporation (PDC). The institutional framework for the PDC could be as follows:

- This corporation should be a public limited company, run by a professional management with poor peasants as its shareholders.
- International donors, and the government of Pakistan can contribute to establishing a special fund within the PPAF which can be used to give either grants or loans to poor peasants to enable them to buy the equity in the PDC and also to acquire additional milch animals.
- The objective of the corporation should be to generate profits through establishing milk collection centers in each Union Council to collect milk, from its shareholders, arrange refrigerated transport, establish milk pasteurizing and packaging facilities at the provincial level, and a marketing and export infrastructure.
- The PDC should also establish an infrastructure at the village level for directly collecting milk from poor peasant milk producer shareholders, testing the milk and immediate payment to the milk producers.
- A computerized data base platform should be established at the Union Council level to keep a record of the profile of each milk producer with respect to the following data: percentage of milk that passes the quality test; payments for milk supplied; extension services provided; increases in yields per milch animal; changes in the stock of milch animal, initial level of and changes in household income resulting from increased milk sales.
- The profits of the corporation should be used partly for re-investment and growth and partly for disbursing dividends to the poor peasant shareholders.
- The PPAF should develop new partner organizations at the Union Council, Tehsil and District levels which would be exclusively devoted to forming special purpose COs of poor peasants. The objective of the COs would be to enable its members to increase production and sale of milk, access credit for increasing the stock of milk animals at the household level and undertake scientific feeding and breeding of milch animals for increasing milk yields.
- The PPAF could also be tasked to provide credit to the milk producer share holders of PDC, arrange for extension services to the community organizations of milk producers for testing and inoculating animals against disease, scientific feeding and breeding practices.

## CONCLUSION

At this time the battle for Pakistan is being conducted against the extremists. The economic dimension is a vital element in prosecuting this war. Establishing the institutional structure for inclusive growth in which the people of Pakistan could participate in the process of growth would enable a higher sustained growth with equity.

An essential feature of inclusive growth is to provide access to the poor over productive assets through a variety of institutional mechanisms so that they can become both the subjects as well as the beneficiaries of growth. In this context four main institutional mechanisms were discussed: (i) A process of localized capital accumulation involving micro enterprise development, sustainable livelihoods and local infrastructure construction through the participatory development methodology. (ii) A small and medium farmer strategy for accelerated growth through the provision of land ownership rights to the landless with supportive institutional mechanisms for increasing yields per acre. (iii) Accelerated growth of small and medium scale industrial enterprises through an institutional framework for increasing production and export of high value added goods in high growth sectors. (iv) Provision of productive assets to the poor through equity stakes in large corporations owned by the poor and managed by professionals in the fields of milk production, livestock, and marine fisheries.

The institutional structure for inclusive growth would enable growth through the provision of economic citizenship to the people of Pakistan and thereby constitute a vital element in national security.

# Annexure Key Indicators

# Annexure
# Key Indicators

**TABLE A-1**
**LEVEL AND PATTERN OF GROWTH**

| | GDP Growth Rate (%) | Incremental Capital Output Ratio | Volatility of Growth[a] (%) | Extent of Balanced Growth[b] | Relative Growth Rate of Labor Intensive Sectors[c] |
|---|---|---|---|---|---|
| 2000-01 | 2.0 | 9.05 | -2.2 | 7.18 | 0.78 |
| 2001-02 | 3.1 | 5.59 | -0.2 | 4.79 | 1.01 |
| 2002-03 | 4.7 | 3.72 | 1.2 | 4.04 | 1.68 |
| 2003-04 | 7.5 | 2.10 | 3.9 | 13.27 | 0.16 |
| 2004-05 | 9.0 | 1.86 | 4.8 | 9.09 | 0.72 |
| 2005-06 | 5.8 | 3.15 | 0.5 | 11.83 | 0.72 |
| 2006-07 | 6.8 | 2.94 | 0.8 | 4.85 | 0.82 |
| 2007-08 | 5.8 | 3.36 | -1.0 | 6.15 | 1.11 |
| **Average** | **5.6** | **4.0** | **1.0** | **7.65** | **0.86** |

**Source:** Pakistan Economic Survey, various issues.

[a] Difference in the growth rate of GDP during a year minus the trend growth rate (as approximated by the average growth rate during the previous five years).

[b] Computed as the weighted (share of value added in 1999-2000) standard deviation of the growth rates of individual sectors during a particular year. The larger the magnitude of this indicator the less the extent of balanced growth.

[c] Labor-intensive sectors of the economy are identified as agriculture, small scale manufacturing, construction, whole sale and retail trade, public administration and defence and social services.

**TABLE A-2**
**LEVEL AND PATTERN OF INVESTMENT**

| | Gross Domestic Capital Formation (% of GDP) | National Savings as % of Investment (%) | Private Investment as % of Total Fixed Investment (%) | Share of Private Investment in Labor Intensive Sectors (%) |
|---|---|---|---|---|
| 1999-2000 | 17.4 | 91.0 | 65.0 | 40.3 |
| 2000-01 | 17.2 | 95.8 | 64.0 | 37.5 |
| 2001-02 | 16.8 | 110.7 | 72.7 | 33.7 |
| 2002-03 | 16.9 | 123.1 | 73.8 | 31.6 |
| 2003-04 | 16.6 | 108.0 | 72.4 | 34.4 |
| 2004-05 | 19.1 | 91.5 | 74.3 | 36.0 |
| 2005-06 | 22.1 | 82.3 | 75.6 | 30.5 |
| 2006-07 | 22.9 | 77.7 | 72.0 | 31.4 |
| 2007-08 | 21.6 | 71.0 | 70.2 | 32.9 |
| **Average** | **19.0** | **93.8** | **71.1** | **34.2** |

**Source:** Pakistan Economic Survey, various issues.

## TABLE A-3
## AGRICULTURAL GROWTH AND PROFITABILITY

| | Growth Rate (%) | Share of Growth in Crop Sector (%) | Volatility in Agriculture Growth[a] (%) | Change in Ratio of Output Prices to Fertilizer Prices (%) | Change in Agriculture Terms of Trade with Manufacturing (%) |
|---|---|---|---|---|---|
| 1999-2000 | n.a. | n.a. | 1.1 | 6.6 | n.a. |
| 2000-01 | -2.2 | n.c. | -7.1 | -3.1 | 4.6 |
| 2001-02 | 0.1 | n.c. | -2.0 | -5.4 | 0.0 |
| 2002-03 | 4.1 | 60.8 | 2.0 | -0.7 | -0.8 |
| 2003-04 | 2.4 | 44.6 | 0.4 | 0.4 | 0.2 |
| 2004-05 | 6.5 | 95.7 | 4.4 | -4.5 | -2.1 |
| 2005-06 | 6.3 | n.c. | 4.1 | -4.9 | -8.0 |
| 2006-07 | 3.7 | 54.7 | -0.2 | 13.7 | 6.4 |
| 2007-08 | 1.5 | n.c. | -3.1 | -12.8 | -9.1 |
| **Average** | **2.8** | **n.c.** | **0.0** | **-1.2** | **-1.1** |

n.c. = not computed, n.a. = not available

**Source:** Pakistan Economic Survey, various issues.

[a]The difference in the growth rate of agriculture during a year minus the trend growth rate (as approximated by the average growth rate during the previous five years).

## TABLE A-4
## LEVEL AND PATTERN OF MANUFACTURING GROWTH

| | Growth Rate (%) | Growth Rate of Export Oriented Industries (%) | Growth Rate of Import Substituting Industries (%) | Share of Growth in Large-Scale Manufacturing (%) | Growth Rate of Manufactured Exports (%) |
|---|---|---|---|---|---|
| 1999-2000 | 1.5 | | | | |
| 2000-01 | 9.3 | 27.6 | 4.6 | 76.3 | 6.2 |
| 2001-02 | 4.5 | 9.7 | 3.1 | 52.0 | 1.5 |
| 2002-03 | 6.9 | 4.3 | 7.6 | 68.2 | 22.2 |
| 2003-04 | 14.0 | 8.0 | 15.5 | 84.6 | 11.6 |
| 2004-05 | 15.5 | 26.5 | 12.7 | 87.0 | 15.6 |
| 2005-06 | 8.7 | 5.9 | 11.1 | 75.2 | 14.4 |
| 2006-07 | 8.2 | 9.9 | 7.5 | 74.3 | 3.4 |
| 2007-08 | 5.4 | 3.2 | 6.3 | 78.2 | 12.2 |
| **Average** | **8.2** | **11.9** | **8.6** | **74.5** | **10.9** |

**Source:** Pakistan Economic Survey, various issues.
State Bank of Pakistan, Annual Report, various issues.

## TABLE A-5
## GROWTH IN EMPLOYMENT BY SECTOR

| | Employment (000) | | | Employment Growth Rate (%) | Value Added Growth Rate (%) | Employment Elasticity |
|---|---|---|---|---|---|---|
| | 2001-02 | 2005-06 | 2006-07 | | | |
| Agriculture | 20474 | 19075 | 20775 | 0.3 | 4.6 | 0.07 |
| Manufacturing and Mining | 4982 | 5421 | 6433 | 5.2 | 11.3 | 0.46 |
| Electricity and Gas | 299 | 296 | n.a | -0.3 | 3.9 | -0.07 |
| Construction | 2757 | 3579 | 3145 | 2.7 | 7.8 | 0.35 |
| Wholesale and Retail Trade | 5090 | 6635 | 6862 | 6.2 | 8.7 | 0.71 |
| Transport and Communication | 2216 | 2452 | 2573 | 3.0 | 6.3 | 0.48 |
| Finance and Insurance | 247 | 491 | n.a | 18.7 | 17.9 | 1.05 |
| Public Administration and Community Services | 7151 | 8405 | 6862 | -0.8 | 8.4 | -0.10 |
| **Total** | **43286** | **46365** | **47650** | **1.7** | **7.4** | **0.23** |

**Source:** Household Integrated Economic Survey, Federal Bureau of Statistics.

## TABLE A-6
## INFLATIONARY TRENDS

| | Rate of Inflation (Consumer Prices) (%) | Rate of Inflation (Food Prices) (%) | Core Rate of Inflation (Non-Food Non-energy) (%) | Rate of Inflation in Import Prices (%) | Rate of Monetary Expansion less GDP Growth (%) |
|---|---|---|---|---|---|
| 1999-2000 | 3.6 | - | n.a | 16.0 | 5.5 |
| 2000-01 | 4.4 | 3.6 | n.a | 15.2 | 7.2 |
| 2001-02 | 2.5 | 2.5 | n.a | 0.0 | 12.3 |
| 2002-03 | 3.1 | 2.8 | n.a | 3.7 | 13.3 |
| 2003-04 | 4.6 | 6.0 | 3.9 | 14.8 | 12.1 |
| 2004-05 | 9.3 | 12.5 | 8.8 | 10.4 | 10.1 |
| 2005-06 | 7.9 | 6.9 | 7.0 | 17.3 | 9.3 |
| 2006-07 | 7.8 | 10.3 | 6.9 | 7.6 | 12.5 |
| 2007-08 | 12.0 | 17.6 | 10.2 | 27.7 | 9.5 |
| **Average** | **6.1** | **7.8** | **7.4** | **12.5** | **10.2** |

**Source:** Pakistan Economic Survey
State Bank of Pakistan, Annual Report
International Monetary Fund

## TABLE A-7
## FISCAL POLICY

(%of GDP)

| | Revenues[a] | Expenditure[b] | Non-Interest Current Expenditure[c] | Budget Balance[d] | Revenue Deficit/Surplus[e] |
|---|---|---|---|---|---|
| 1999-2000 | 13.4 | 18.5 | 9.5 | -4.6 | -3.0 |
| 2000-01 | 13.1 | 17.1 | 9.4 | -4.3 | -2.2 |
| 2001-02 | 14.0 | 18.6 | 9.6 | -5.5 | -1.7 |
| 2002-03 | 14.8 | 18.4 | 11.4 | -3.8 | -1.5 |
| 2003-04 | 14.1 | 16.9 | 9.5 | -2.3 | 0.3 |
| 2004-05 | 13.8 | 17.2 | 9.9 | -3.3 | 0.5 |
| 2005-06 | 14.1 | 18.4 | 10.2 | -4.3 | 0.5 |
| 2006-07 | 14.9 | 20.6 | 11.3 | -4.3 | -0.9 |
| 2007-08 | 14.3 | 21.7 | 13.1 | -7.4 | -3.4 |
| **Average** | **14.1** | **18.6** | **10.5** | **-4.6** | **-1.3** |

**Source:** Pakistan Economic Survey
State Bank of Pakistan, Annual Reports
Ministry of Finance, Fiscal Operations

[a] Total revenues of federal and provincial governments
[b] Revenue and development expenditure of federal and provincial governments
[c] Current expenditure minus interest payments
[d] Total revenue minus total expenditure
[e] Revenue receipts minus current expenditure of federal and provincial governments

## TABLE A-8
## FISCAL POLICY

| | Primary Balance[a] (% of GDP) | Total Government Debt[b] (% of GDP) | Effective Interest Rate on Domestic Debt[c] (%) | % of Deficit Financed by Bank Borrowing (%) |
|---|---|---|---|---|
| 1999-2000 | na | 83.7 | 14.1 | 19.3 |
| 2000-01 | 1.3 | 88.8 | 11.3 | -18.4 |
| 2001-02 | 0.1 | 81.4 | 12.4 | 7.4 |
| 2002-03 | 0.4 | 74.5 | 10.2 | -30.5 |
| 2003-04 | 1.2 | 67.8 | 9.4 | 47.4 |
| 2004-05 | 0.0 | 62.9 | 8.5 | 27.7 |
| 2005-06 | -1.2 | 57.3 | 10.2 | 21.8 |
| 2006-07 | -0.1 | 57.9 | 13.8 | 37.5 |
| 2007-08 | -2.5 | 61.3 | 16.5 | 80.5 |
| **Average** | **-0.1** | **70.6** | **11.8** | **21.4** |

**Source:** Pakistan Economic Survey
State Bank of Pakistan, Annual Reports
Ministry of Finance, Fiscal Operations

[a] Estimated as revenue receipts minus total expenditure net of interest payments
[b] Includes domestic and external debt.
[c] Defined as the ratio of domestic interest payment to outstanding domestic debt.

## Table A-9
## EFFECTIVE TAX RATES
### (Tax Revenues as % of Tax Base[a])

| | Income Tax (%) | Customs Duty (%) | Excise Duty (%) | Sales Tax (%) | Total FBR Taxes (%) |
|---|---|---|---|---|---|
| 1999-2000 | 4.3 | 19.1 | 6.4 | 11.6 | 9.1 |
| 2000-01 | 4.2 | 17.8 | 4.7 | 13.1 | 9.3 |
| 2001-02 | 4.5 | 12.0 | 4.3 | 14.1 | 9.1 |
| 2002-03 | 4.4 | 14.8 | 3.6 | 14.8 | 9.4 |
| 2003-04 | 4.0 | 14.3 | 3.1 | 12.7 | 9.2 |
| 2004-05 | 3.8 | 11.2 | 2.9 | 10.0 | 9.1 |
| 2005-06 | 3.9 | 12.1 | 2.4 | 10.3 | 9.4 |
| 2006-07 | 5.0 | 10.5 | 2.7 | 9.9 | 9.7 |
| 2007-08 | 4.3 | 7.6 | 2.9 | 10.0 | 9.6 |
| **Average** | **4.3** | **13.3** | **3.7** | **11.8** | **9.3** |

**Source:** Pakistan Economic Survey, various issues
Federal Board of Revenue

[a] Tax bases for various taxes are as follows:
Income tax: Non-agricultural GDP
Custom Duty: Value of imports
Excise Duty: Value of manufacturing
Sales Tax: Value of Imports plus value of manufacturing

## TABLE A-10
## MONETARY POLICY

| | Net Foreign Assets (% Change of broad money) | Net Domestic Assets (% Change of broad money) | Private Credit Growth (%) | Interest Rate on Six Month Treasury Bill (%) | Broad Money Growth (%) | Interest Rate Spread[a] (%) |
|---|---|---|---|---|---|---|
| 1999-2000 | 2.0 | 7.4 | 1.4 | 8.8 | 9.4 | 8.0 |
| 2000-01 | 5.1 | 3.9 | 4.0 | 10.4 | 9.0 | 8.3 |
| 2001-02 | 13.4 | 2.0 | 4.8 | 8.2 | 15.4 | 9.6 |
| 2002-03 | 17.5 | 0.5 | 18.9 | 4.1 | 18.0 | 7.8 |
| 2003-04 | 2.1 | 17.5 | 29.8 | 1.7 | 19.6 | 6.3 |
| 2004-05 | 2.2 | 17.1 | 33.2 | 4.7 | 19.3 | 7.4 |
| 2005-06 | 2.5 | 12.4 | 23.2 | 8.5 | 14.9 | 8.7 |
| 2006-07 | 8.1 | 11.3 | 17.2 | 8.9 | 19.3 | 9.0 |
| 2007-08 | -7.8 | 23.2 | 16.4 | 9.6 | 15.3 | 8.4 |
| **Average** | **6.3** | **9.1** | **16.6** | **7.4** | **15.6** | **8.2** |

**Source:** State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases
[a]Difference between the interest rate on advances and deposits.

## TABLE A-11
## LEVEL AND PATTERN OF TRADE

| | Merchandise Export Growth (US $; %) | Extent of Product Diversification of Exports[a] | Extent of Market Diversification of Exports[a] | Merchandise Import Growth (US $; %) |
|---|---|---|---|---|
| 1999-2000 | 11.2 | 0.801 | 0.230 | 13.1 |
| 2000-01 | 12.5 | 0.798 | 0.221 | 14.3 |
| 2001-02 | 2.3 | 0.786 | 0.221 | -7.5 |
| 2002-03 | 20.1 | 0.791 | 0.223 | 20.1 |
| 2003-04 | 13.5 | 0.782 | 0.232 | 21.2 |
| 2004-05 | 16.2 | 0.778 | 0.218 | 38.3 |
| 2005-06 | 14.3 | 0.769 | 0.229 | 31.7 |
| 2006-07 | 3.2 | 0.737 | 0.230 | 8.0 |
| 2007-08 | 16.5 | n.a | n.a | 31.2 |
| **Average** | **12.2** | **0.780** | **0.226** | **18.9** |

**Source:** Pakistan Economic Survey
International Monetary Fund
United Nations Conference on Trade and Development

[a]This is estimated by UNCTAD as the Herfindahl Index, which ranges from a value of 0 to 1. The greater the extent of diversification the lower the value of the index.

## TABLE A-11 (CONTD.)
## LEVEL AND PATTERN OF TRADE

| | Change in Terms of Trade (%) | Share of Essential Imports[a] (%) |
|---|---|---|
| 1999-2000 | -15.3 | 39.3 |
| 2000-01 | -7.1 | 39.3 |
| 2001-02 | -0.2 | 36.7 |
| 2002-03 | -9.6 | 35.0 |
| 2003-04 | -4.1 | 28.8 |
| 2004-05 | -6.5 | 25.0 |
| 2005-06 | -11.7 | 30.7 |
| 2006-07 | -3.7 | 29.1 |
| 2007-08 | -11.7 | 39.1 |
| **Average** | **-8.6** | **33.7** |

**Source:** Pakistan Economic Survey, various issues
State Bank of Pakistan, Annual Report, various issues

[a] Essential imports are of wheat, edible oil, fertilizers, medicines and POL products.

## TABLE A-12
## BALANCE OF PAYMENTS

| | Current Account Balance (% of GDP) | External Debt as a % of Exports of Goods and Services | Net Reserves (US $ Million) | Gross Reserves (In months of next years imports of goods and services) | Change in Value of Pakistani Rupee per US $ (%) | Change in Real Effective Exchange Rate (%) |
|---|---|---|---|---|---|---|
| 1999-2000 | -1.6 | 322.1 | 908 | 0.9 | 3.0 | -0.6 |
| 2000-01 | -2.7 | 309.4 | 1679 | 1.7 | 12.8 | -2.5 |
| 2001-02 | 3.9 | 282.0 | 4337 | 3.7 | 5.1 | -2.6 |
| 2002-03 | 4.9 | 229.0 | 9529 | 6.5 | -4.7 | -0.1 |
| 2003-04 | 1.8 | 209.5 | 10564 | 5.0 | -1.5 | -1.8 |
| 2004-05 | -1.4 | 183.7 | 9805 | 3.5 | 3.1 | 0.3 |
| 2005-06 | -3.9 | 167.2 | 10760 | 3.7 | 0.8 | 5.3 |
| 2006-07 | -4.9 | 169.2 | 13345 | 4.5 | 1.3 | 0.5 |
| 2007-08 | -8.4 | 169.7 | 8577 | 2.7 | 3.2 | -0.8 |
| **Average** | **-1.4** | **226.8** | **7723** | **3.6** | **2.6** | **-0.3** |

**Source:** State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases

## TABLE A-13
## TERMS OF TRADE LOSSES

**(Million $)**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| ***Exports*** | | | | |
| Current Year Prices | 14,401 | 16,388 | 17,278 | 20,122 |
| Adjusted for Previous Year Prices[a] | 13,942.8 | 15,814.7 | 16,680.6 | 17,803.7 |
| ***Imports*** | | | | |
| Current Year Prices | 18,753 | 24,647 | 26,989 | 35,417 |
| Adjusted for Previous Year Prices[a] | 16,984.0 | 21,010.3 | 25,084.7 | 27,744.9 |
| ***Trade Deficit*** | | | | |
| Current Year Prices | 4,325 | 8,259 | 9,711 | 15,295 |
| Adjusted for Previous Year Prices[a] | 3,041.2 | 5,195.6 | 8,404.1 | 9,941.3 |
| Tems of Trade Loss[b] | 1,310.8 | 3,063.4 | 1,306.9 | 5,353.7 |
| GNP (Billion Dollars) | 109.6 | 127.5 | 144.0 | 167.8 |
| Terms of Trade Loss (As % of GNP) | 1.2 | 2.4 | 0.9 | 3.2 |

[a]These numbers are author's calculation adjusted for price change. The price change is adjusted for the previous year price to see how it makes a difference on the exports and imports, and the trade deficit using the Federal Bureau of Statistics Data. The adjustment is made by dividing the current year exports (imports) by the current year exports price index (imports price index) then multiplied by the previous year exports price index (imports price index).

[b] Terms of trade loss is the difference between the trade deficit at the current year prices and the trade deficit that is adjusted for the previous year prices.

## TABLE A-14
## TREND IN INCOME INEQUALITY
### Growth in Real Household Income by Quintile
### (Annual Growth Rate, %)
### 2001-02 to 2005-06

| | QUINTILE | | | | | |
|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | Total |
| **Pakistan** | **4.8** | **6.0** | **6.7** | **7.7** | **9.6** | **7.8** |
| Urban | 0.5 | 1.7 | 3.0 | 2.1 | 5.0 | 4.4 |
| Rural | 5.7 | 7.2 | 8.0 | 10.6 | 14.2 | 9.2 |

**Source:** Household Integrated Expenditure Survey, Federal Bureau of Statistics

## TABLE A-15
## TREND IN REGIONAL INEQUALITY
### Growth in Employment by Province

| | Number of Employed (000) | | | Annual Growth |
|---|---|---|---|---|
| | 2001-02 | 2005-06 | 2006-07 | Rate (%) |
| Punjab | 25224 | 27292 | 29130 | 2.9 |
| Sindh | 10819 | 11043 | 11300 | 0.9 |
| NWFP | 5208 | 5881 | 5080 | -0.5 |
| Balochistan | 1931 | 1988 | 2140 | 2.1 |
| **Pakistan** | **43286** | **46365** | **47650** | **1.9** |

**Source:** Labor Force Survey, Federal Bureau of Statistics.

## TABLE A-16
## TREND IN REGIONAL INEQUALITY
### Growth in Real Household Income by Province

| | (Annual Growth Rate, %) 2001-02 to 2005-06 | | |
|---|---|---|---|
| | Urban | Rural | Total |
| Punjab | 5.9 | 10.5 | 9.0 |
| Sindh | 1.8 | 8.9 | 6.1 |
| NWFP | 9.0 | 9.0 | 9.0 |
| Balochistan | -3.1 | -3.0 | -2.5 |
| **Pakistan** | **4.4** | **9.2** | **7.8** |

**Source:** Household Integrated Economic Survey, Federal Bureau of Statistics.

**TABLE A-17**
**TREND IN REGIONAL INEQUALITY**
**Coverage of Education and Health Services**

| | 1998-99 | 2001-02 | 2006-07 |
|---|---|---|---|
| **Gross Primary Enrolment Rate** | | | |
| Punjab | 75 | 76 | 100 |
| Sindh | 64 | 63 | 79 |
| NWFP | 70 | 77 | 82 |
| Balochistan | 64 | 62 | 72 |
| **Max/Min Ratio** | **1.172** | **1.242** | **1.389** |
| **Net Primary Enrolment Rate** | | | |
| Punjab | 44 | 45 | 62 |
| Sindh | 41 | 40 | 50 |
| NWFP | 39 | 41 | 49 |
| Balochistan | 36 | 32 | 41 |
| **Max/Min Ratio** | **1.222** | **1.406** | **1.512** |
| **Gross Middle Enrolment Rate** | | | |
| Punjab | 43 | 45 | 55 |
| Sindh | 38 | 34 | 43 |
| NWFP | 37 | 38 | 53 |
| Balochistan | 29 | 33 | 34 |
| **Max/Min Ratio** | **1.483** | **1.364** | **1.618** |
| **Net Middle Enrolment Rate** | | | |
| Punjab | 19 | 18 | 20 |
| Sindh | 17 | 14 | 17 |
| NWFP | 11 | 12 | 16 |
| Balochistan | 9 | 8 | 9 |
| **Max/Min Ratio** | **2.111** | **2.250** | **2.222** |

**Source:** Pakistan Social and Living Standard Measurement Survey, Federal Bureau of Statistics.

**TABLE A-17 (CONTD.)**
**TREND IN REGIONAL INEQUALITY**
**Coverage of Education and Health Services**

| | 1998-99 | 2001-02 | 2006-07 |
|---|---|---|---|
| **Gross Matric Enrolment Rate** | | | |
| Punjab | 37 | 44 | 51 |
| Sindh | 51 | 42 | 45 |
| NWFP | 36 | 41 | 45 |
| Balochistan | 41 | 29 | 33 |
| **Max/Min Ratio** | **1.244** | **1.517** | **1.545** |
| **Net Matric Enrolment Rate** | | | |
| Punjab | 12 | 12 | 11 |
| Sindh | 10 | 13 | 10 |
| NWFP | 6 | 10 | 6 |
| Balochistan | 3 | 6 | 5 |
| **Max/Min Ratio** | **4.000** | **2.000** | **2.200** |
| **Literacy Rate (10 +)** | | | |
| Punjab | 46 | 47 | 58 |
| Sindh | 51 | 46 | 55 |
| NWFP | 37 | 38 | 47 |
| Balochistan | 36 | 36 | 42 |
| **Max/Min Ratio** | **1.417** | **1.306** | **1.381** |
| **Full Immunisation** | | | |
| Punjab | 55 | 57 | 83 |
| Sindh | 38 | 45 | 65 |
| NWFP | 54 | 57 | 76 |
| Balochistan | 34 | 24 | 54 |
| **Max/Min Ratio** | **1.618** | **2.375** | **1.537** |

**Source:** Pakistan Living Standard Measurement Survey, FBS

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# Notes

## CHAPTER - 2

1. For details see, 2008, *State of The Economy: Challenges and Opportunities*. Institute of Public Policy, Beaconhouse National University, Lahore.
2. See Annex Table A-13 for details.
3. Even though donors have been generous in their support for earthquake reconstruction. According to the Earthquake Reconstruction & Rehabilitation Authority (ERRA), most of the foreign assistance is in the form of grant assistance, but there is some loan element. Conservatively, the burden on Pakistan is likely to be in the range of $1- 1.5 billion.
4. See IPP's First Annual Report, 2008, *"State of The Economy: Challenges and Opportunities."*
5. *"Interim Report on Economic Stabilization with Human Face"*, Panel of Economists, Planning Commission, 2008.

## CHAPTER - 3

1. The most articulate exponent of this belief was Jagdish Bhagwati, an Indian-American economist at Columbia University, New York. See him in *Defense of Globalization*, Oxford, Blackwell, 2005.
2. The subject of globalization is one of the more studied about and written among recent developments in economic thought. For a very thorough treatment of the subject see Martin Wolf, *Globalization*, New York Penguin Books, 2007.
3. See Joseph E. Stiglitz (2002) *"Globalization and its Discontents"*, London, Allen Lane.
4. For a detailed analysis of the theoretical underpinnings of the model of monetary management followed by the US Fed see the former chairman's autobiography: Alan Greenspan, *The Age of Turbulence: Adventures in a New World*, New York, The Penguin Books, 2007.
5. International Monetary Fund (2009) *"The Implications of the Global Financial Crisis for Low Income Countries"*, Washington DC.

## CHAPTER - 6

1. For a discussion on Economic Democracy and case studies of action, see Ponna Wignaraja, Susil Sirivardana, Akmal Hussain (eds), *"Economic Democracy through Pro Poor Growth"*, SAGE Publications, Delhi, 2009.
2. For a case study based on implementing the Participatory Development approach in nine districts of Punjab Province, see, Akmal Hussain, Honory Chief Executive Officer, Punjab Rural Support Program (PRSP), The First Four Months report to the Board of Directors, PRSP, 1998.
3. The government's annual development programme as a percentage of GDP has declined from seven percent in the 1970s to 2.5 percent this year.