**Third Annual Report**
**2010**

# State of the Economy: Pulling Back from the Abyss




INSTITUTE OF PUBLIC POLICY
BEACONHOUSE NATIONAL UNIVERSITY, LAHORE

# IPP's Third Annual Report
# 2010

# State of The Economy: Pulling Back From the Abyss

**Institute of Public Policy**
Beaconhouse National University

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# Beaconhouse National University

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Dr. Aisha Ghaus-Pasha is the Director of the Institute.

# PREFACE

This is the third Annual Report of BNU's Institute of Public Policy on the State of the Economy.

The first Annual Report was released in May 2008, only two months after the new democratic government took over in the midst of a serious economic crisis marked by record trade deficit, high fiscal imbalances and double digit inflation for the third year in a row. The focus of the Report was therefore on short term macro economic adjustments to bring down inflation and to reduce the fiscal and current account deficits. It also addressed the issue of making the growth process more sustainable and more inclusive.

The second Annual report released in May 2009, was strongly influenced by the deteriorating security situation and its impact on the economy. Chapter 4 of the Report presented a detailed overview of "the economic cost of the War on Terror". The Report also presented, in the wake of the serious energy crisis, estimates of the "Economic Cost of Power Outages in the Industrial Sector of Pakistan". Another important component of this Report was its analysis of the global economic and financial crisis of 2008-09, and its impact on the Pakistan economy along with suggested policies for "Managing External Vulnerability and Risks". These recommendations were supplemented by policies for industrial revival emphasizing the need for exploring a different model of economic growth.

This Third Annual Report is built on some very positive political developments: the passage of the 18th Constitutional Amendment which will strengthen the Parliament and the federal structure, the unanimous 7th NFC Award, which will significantly increase the financial resources of the Provinces to carry out the additional functions being transferred to them under the 18th Amendment, and the successful military operations against extremism in Swat and South Waziristan.

But the economic picture presented in this Report is not equally hopeful. Despite improvements in the balance of payments and the buildup of foreign exchange resources, largely through short term IMF loans, the fiscal situation has worsened further, the energy crisis has deepened and continuing high inflation, in the wake of virtual stagnation in per capita incomes, has further increased poverty and unemployment in the country.

The Report presents a summary of the negative and positive facets of the current security, economic, institutional, social, and political situation in the country to explore if the country is about to fall into an abyss or will it muddle through. It then outlines the strategy for the transition to a better future provided we can correct three major fault-lines: (i) closing the fiscal hole through better governance, (ii) defusing the poverty bombshell through a different homegrown strategy of economic revival and (iii) reducing ethnic and provincial polarization through democratic decentralization.

I hope, like the previous two Reports, this Report will also be useful for the policy makers and other stakeholders, inside and outside the government, as they grapple with these momentous issues.

**Sartaj Aziz**
Vice Chancellor
Beaconhouse National University

The Institute of Public Policy is grateful to the Asia Foundation for its financial support for the preparation, publication and dissemination of this Report.

# FOREWORD

The third annual report is the continuation of the program launched by the Institute of Public Policy to prepare and publish an annual assessment on the state of the Pakistani economy. The reports have been prepared with two intents in mind: to use the tools of economic and other social sciences to read the Pakistani situation at the time the work is done. This way with each report we have advanced the state of our knowledge about the structure and the character of the Pakistani economy and society. Since the effort was begun three years ago we have, we believe, broken a number of new grounds. Four of these are important and hence worth noting.

We have made attempts first to estimate the sustainable levels of fiscal and current account deficits for a country in Pakistan's situation. This analysis and the conclusions it has reached has been useful to the policymakers as they engage in dialogue with the I.M.F. and the two development banks, the World Bank and the Asian Development Bank. As targets are established for public policy to pursue, it is important to have a reasonably accurate idea of the absorptive capacity of an economy for adjustment. Making serious mistakes on either side can be very costly as several members of the European Union are discovering in the summer of 2010 and as several East Asian countries came to understand in 1996-97. Squeezing too hard in the process of adjustment to reduce the twin deficits can stall the economy and hurt the poor. This was the East Asian experience. Being too accommodating can throw the economies and the markets that support them completely out of balance. This is what the Europeans are finding now at a great cost to some of their weaker economies.

The second area of analysis that has developed new analytical insights and provided some ideas about how the economy is being hurt by a number of exogenous factors is to estimate the cost of three shortages - of electricity, gas and water - as well as terrorism. We began this exercise with the second report and advance it further in this one. These costs have many dimensions, not just economic. They are also producing social tensions and grievances that a still-developing political system may find hard to absorb. Understanding the scale of these problems should help to focus the attention of the authorities.

The third area of focus which is not customary in country economic analysis is to explain what is meant by the loosely used term "provision of good governance". In most accounts - in particular those produced by multilateral and bilateral aid agencies - the term is a euphemism for widespread corruption. Our understanding of the term goes beyond that notion. We have emphasized also institutional support that must be available to the policymakers to provide them with the wherewithal to serve people. This needs to be done from several different levels - the national, the provincial, the local. This also means bringing in the civil society into the decision-making process. For us decentralization of decision-making and devolution of authority have become important instruments for promoting both development and social change.

The fourth and final part of the development process we have emphasized in our reports is to understand Pakistan's problems and its prospects in the context of the region in which it is placed as well as the perspective of the extraordinary changes occurring in the global economy and the political structure that supports it. For a country that remains so dependent on external flows, the incident involving a person of Pakistani origin in an attempt to set off a bomb in Times Square, the busiest area in Manhattan, is not just one episode in the war against terrorism. For Pakistan it is much more than that: it strengthens the negative image of the country that reduces foreign interest in it and makes it even more isolated from the world at large.

One of the important reasons for producing these reports is to generate informed debate in the country on a number of policy issues critical for Pakistan's future. There is not enough of it at this time; some of which is taking place is based on strong biases or poor knowledge of our economic and social circumstances. We are deliberately attempting to fill this gap. Accordingly, the reports have three distinct audiences: (a) makers of public policy at the federal and provincial levels, (b) the academia and other think tanks interested in analyzing the country's economy and (c) the general public. We have attempted to reach these audiences through direct contacts as well as through the electronic and print media.

The tone of the reports has become increasingly pessimistic from year to year reflecting the changes in the state of the economy. Although in 2008, when the first report was written, the growth spurt of the previous few years had petered out leaving the country faced with serious macroeconomic imbalances, even then we expressed a degree of optimism provided the policy makers were prepared to undertake a program of serious macroeconomic adjustment as well as reforms in the real sectors of the economy. While accepting that there would be some loss of growth momentum, we were confident that the economy would revert to the trajectory of a sustainable rate of growth - ranging between 5 to 6 percent a year, if the government adopted the set of recommended policies.

The second report, written in 2009, analyzed some of the shocks the economy received in 2008-09. These included a serious deterioration in terms of trade, a sharp disruption in the supply of electricity and rise of extremism and terrorism in the country. As already indicated we began estimating the costs of these shocks. The authors lowered their expectation about growth prospects in the second report. The policy agenda that was recommended had three components: (a) adjustment policies aimed at taking the economy through a transition period that was estimated to last over a longer period than envisaged in the previous report; (b) sectoral policies aimed at dealing with the shocks to the economic system; and (c) improving the quality of governance through greater decentralization of economic policy making.

The present report has been prepared at an even more difficult time for the country. After a brief period of recovery, the fiscal balance has deteriorated again, growth has stalled, the incidence of poverty has grown, terrorism has increased and to power outages have been added shortages in the availability of natural gas and water. All these supply constraints are taking a heavy toll on the economy. This report assesses the impact of these changes and builds upon the reform agenda as presented in the previous reports by suggesting a series of policy options for decision makers.

Once again - as was the case with the first and second reports - the main message of this report is one of considerable concern about the future of the economy and about the deterioration in the welfare of the citizenry. We are of the view that people's patience is running out and they have begun to seriously question the resolve of the elite for improving the well-being of the people. However, the situation can still be avoided but that would only be ensured if today's policy makers fully realize that the alternative for not taking appropriate actions is not only an extension in the period of economic stagnation but also possibly social chaos. As suggested in the chapter that discusses positive and negative aspects of the present situation, those that have the power to take decisions must mitigate the negatives and build on the positives. The cost for not doing that is simply too great even to contemplate.

As was the case with the previous reports, this is a collective effort by the same group that produced the earlier documents. It has become a custom for us to gather in Lahore for brain-storming sessions to review each other's chapters and to ensure that they support the overall theme of the report and the message that is being sent out. This year we met for such a session in mid April. We do not identify the authors of the various chapters by name so that our readers see this as a collective effort rather than as a collection of individual thinking. The authors are identified in one of the following pages with their names presented in alphabetical order. That said, as the Chairman of IPP, I would like to thank in particular one member of the team - Aisha Ghaus-Pasha, Director of IPP - who, in addition to the enormous intellectual effort made to the preparation of this report, has also taken on the additional responsibility for seeing it through the process of production and distribution. Our thanks is also due to Asia Foundation for providing financial support for the preparation, production and distribution of the report.

**Shahid Javed Burki**
Chairman
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| | |
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| ADP | Annual Development Programme |
| AKRSP | Aga Khan Rural Support Programme |
| BISP | Benazir Income Support Programme |
| BMCFT | Billion Cubic Feet |
| BOP | Balance of Payments |
| CBOs | Community Based Organizations |
| CCI | Council of Common Interests |
| CO | Community Organisations |
| CPI | Consumer Price Index |
| CPI | Corruption Perception Index |
| CSF | Coalition Support Fund |
| CSO | Central Statistical Office |
| DFID | Department for International Development |
| DG | District Government |
| DISCOs | Distribution Companies |
| EDOs | Executive District Officers |
| FATA | Federally Administered Tribal Areas |
| FBR | Federal Board of Revenue |
| FCR | Frontier Crimes Regulations |
| FDI | Foreign Direct investment |
| FoDP | Friends of Democratic Pakistan |
| GDP | Gross Domestic Product |
| GDS | Gas Development Surcharge |
| HESCO | Hyderabad Electric Supply Company |
| HIES | Household Integrated Economic Survey |
| ICRG | International Country Risk Guide System |
| IMF | International Monetary Fund |
| IPD | Inverse Population Density |
| IPP | Institute of Public Policy |
| KESC | Karachi Electric Supply Corporation |
| LG | Local Government |
| LGOs | Local Government Ordinances |
| LNG | Liquefied Natural Gas |
| MAF | Million Acre Feet |
| MDGs | Millennium Development Goals |
| MIS | Management Information System |
| MMCFD | Millions of Cubic Feet Per day (of Gas) |
| MTDF | Medium Term Development Framework |
| MW | Mega Watt |
| NATO | North Atlantic Treaty Organization |
| NEPRA | National Electric Power Regulatory Agency |

| | |
|---|---|
| NFC | National Finance Commission |
| NGOs | Non-Government Organizations |
| NRSP | National Rural Support Programme |
| OECD | Organization for Economic Co-operation and Development |
| OGDC | Oil and Gas Development Corporation |
| PACRA | Pakistan Credit Rating Agency Limited |
| PEPCO | Pakistan Electric Power Company |
| PFC | Provincial Finance Commission |
| PRGF | Poverty Reduction and Growth Facility |
| PHCL | Pepco Holding Company Limited |
| PIA | Pakistan International Airlines |
| PMPIU | Project Management and Policy Implementation Unit |
| POL | Petroleum, Oil and Lubricants |
| PPAF | Pakistan Poverty Alleviation Fund |
| PRSP | Poverty Reduction Strategy Paper |
| PSDP | Public Sector Development Programme |
| PSEDF | Public Sector Energy Development Fund |
| REER | Real Effective Exchange Rate |
| RFO | Request for Offer |
| SBA | Stand by Arrangement |
| SBFC | Small Business Finance Corporation |
| SBP | State Bank of Pakistan |
| SMEs | Small and Medium Enterprises |
| SNGPL | Sui Northern Gas Pipelines Limited |
| SSGCL | Sui Southern Gas Company Limited |
| TCF | Trillion Cubic Feet |
| TCP | Trading Corporation of Pakistan |
| TMA | Tehsil/ Town Municipal Administration |
| TMO | Tehsil/ Town Municipal Officer |
| UA | Union Administration |
| UN | United Nations |
| UNDESA | United Nations Department of Economic and Social Affairs |
| UNDP | United Nations Development Programme |
| USA | United States of America |
| USAID | United States Agency for International Development |
| VAT | Value Added Tax |
| WAPDA | Water and Power Development Authority |
| WTO | World Trade Organization |

# Executive Summary: Pulling Back From the Abyss

# Executive Summary: Pulling Back From the Abyss

## ARE WE EDGING TOWARDS THE ABYSS?

Pakistan today presents a picture of stark contrasts. Take one day, for example, the 19th of April 2010. This day witnessed the historic signing of the Eighteenth Amendment to the Constitution by the President of Pakistan at an impressive ceremony. At the same time, less than 300 miles away, there were two major terrorist attacks in the city of Peshawar, killing 25 people including a bomb explosion in a procession of people protesting against power loadshedding. On this particular day, we saw major positive political developments coupled with evidence of increasing cracks in the economic and social fabric and a breakdown of law and order.

Therefore, we need to identify the positives and the negatives relating to the contempory situation of Pakistan in the areas of security, economy, society, politics and institutions. This will enable an assessment of where we are going as a nation and as a people.

### Security

The major negative development on the security front is the retaliation in the form of terrorist attacks throughout the country to the military operations in the North and drone attacks. The frequency and intensity of these attacks has increased greatly over the last few years. Beyond terrorism, the level of human security has been adversely affected by the virtual breakdown of law and order in the country. Some of the root causes of the increase in crime are rising levels of unemployment and poverty which have alienated a larger section of society.

Perhaps one of the more disturbing and negative developments is the loss of trust and faith of a large section of the population in the ability of the government to address the problems they face in their day-to-day lives. This has resulted in mass protests against problems like loadshedding and rising prices.

On the positive side, military operations in Swat and North Waziristan have apparently gone well and large tracts of land have been cleared. Intelligence agencies have been successful in apprehending various important militant leaders and their accomplices. This will contribute to weakening the terrorist networks and reducing their ability to undertake suicide and other attacks.

## Economy

The economy today is replete with a large number of negatives. Of prime concern is the near total breakdown in the delivery of basic public services like power, gas and water. As highlighted above, this has already led to large-scale public agitation and violence on the streets. The next factor impacting severely on the living standards of the people is the high cumulative inflation in prices of essential items, since 2006. Coupled with this, the low rate of economic growth since 2007-08 has implied stagnation of real incomes and rising levels of unemployment, which may have doubled in the last three years. The combination of high prices and high unemployment in the presence of constant or declining household real incomes has inevitably led to a big increase in the incidence of poverty in Pakistan.

Alongwith the faltering rate of growth of the national economy, there is evidence that regional disparities are widening further fuelling agitation by various ethnic and nationalist groups. The largest province, Punjab, has shown some dynamism, but incomes have fallen in Balochistan and in rural Sindh, fanning nationalist tendencies. This reflects a failure of the federal government in investing relatively more in infrastructural development in the lagging regions of the country.

Prospects for economic revival and renewed dynamism of the economy have been dampened by a big fall in private investment, both domestic and foreign, which has fallen by 7 percent in 2008-09 and is likely to show a further decline in 2009-10.

The financial sector has remained largely insulated from the global financial crisis due to the absence of strong international links of Pakistani banks. But domestic factors, primarily linked to the on-going recession in the real sector, have contributed to a big increase in the volume of non-performing loans which have reached 13 percent of outstanding advances. Smaller banks, in particular, have been exposed to the risk of default by borrowers, especially SMEs, farmers and households.

The financial sector is also suffering from liquidity problems, even though credit demand by the private sector is slack. This is due primarily to large-scale borrowing by the public sector. The pressure on the banking system could increase further in the coming weeks as the financial year comes to an end, and the government has to finance a larger than anticipated fiscal deficit.

The large and rising levels of government borrowing can also be attributed to the substantially lower than anticipated aid inflows. The budget for 2009-10 was framed on very optimistic assumptions about the level of support from the international community. For example, Friends of Democratic Pakistan were expected to contribute over $ 2 billion during the year, whereas only $ 174 million has come in to date. US bilateral assistance has not commenced yet and there is lack of clarity as to the extent to which this will finance the government's development program.

The budget deficit for 2009-10 is expected to be significantly larger than originally anticipated depending upon the magnitude of shortfall in the achievement of FBR's target of revenues and the extent of reimbursement of military expenditures in the North from the CSF. If the borrowings from the market to reduce the circular debt in the power sector are included, then the size of the fiscal deficit could approach Rs 1000 billion (almost 7 percent of the GDP). This is despite a large cutback in the PSDP of almost 40 percent to a critically low level of less than 3 percent of the GDP at a time when infrastructural bottlenecks are crippling the economy.

There are also apprehensions that the level of public debt is once again approaching unsustainable levels close to 65 percent of the GDP. The large on-going SBA from IMF will require repayment within the next five years and Pakistan could find itself back in a 'debt trap'.

On the positive side, there has been a substantial improvement in the balance of payments position of the country. During the first nine months of 2009-10 the deficit on the current account has declined by as much as 68 percent compared to the corresponding period of last year. The primary reason for the improvement is the fall in the import bill due not only to the lower cost of POL imports but also the saving in food imports due to the bumper wheat crop, alongwith some decline in machinery imports due to the depressed private investment.

Remittances are up by 16 percent. More recently, exports are beginning to show some dynamism as the world economy recovers. Exports grew by 38 percent in March 2010 with textiles exports rising by 30 percent. There is also evidence of an incipient recovery in the manufacturing sector. The stock market has shown a rising trend.

Overall, the economy exhibits a mixed picture. There is slow growth, high persistent inflation and the fiscal situation has deteriorated significantly, while unemployment and poverty continue to rise. As opposed to this, there has been a spectacular improvement in the balance of payments, the agricultural sector has performed relatively well and there are some signs of recovery in the manufacturing sector.

## Politics and Institutions

Perhaps one of the areas of greatest concern is the perceived large-scale breakdown in the quality of governance in the country. This is acutely reflected in the burgeoning losses (approaching Rs 200 billion) of state enterprises and public utilities. There are also frequent media reports of 'grand corruption', some of which has been taken notice of, on a suo moto basis, by the Supreme Court.

The bureaucracy is demoralized and ineffective, with limited implementation capacity. Reports by the Transparency International indicate that Pakistan is beginning to approach once again the peak levels of corruption attained in the mid-90s. There exists no independent and impartial accountability mechanism to apprehend people in high places for acts of corruption. The consequence is a decline in the writ of the State and a breakdown in the rule of law. The delivery of services by public agencies is abysmal. Overall, since delivery of services is the prime interface between government and the people, it is not surprising that there is a general disillusionment with the quality of governance in the country.

While there are serious problems at the local level, there are some positive developments on the political and constitutional fronts which highlight that the functioning of democracy, howsoever imperfect, can still achieve major results. Historical signing of the 18th Amendment incorporating fundamental changes in the Constitution has been achieved by a consensus of the political parties, seen for the first time after 1973. The Balochistan Package announced by the Government is also a major attempt at removing the longstanding grievances of the province. The generous dispensation to the provinces in the Seventh National Finance Commission (NFC) Award alongwith transfer of the Concurrent List of functions should go a long way in strengthening the process of provincial autonomy.

Other major developments which auger well for the future of democracy are a strong, independent and assertive superior judiciary and a vibrant media. On the social side, the democratically elected government has shown more concern for the plight of poor people. A more comprehensive social protection program has been developed through targeted income transfers under the BISP.

The contrasting developments highlighted above with many serious concerns on the one hand and some promising and positive developments on the other hand, raise the fundamental question: Is Pakistan on the edge of the abyss?

In subsequent chapters we discuss issues related to the future stance of macroeconomic policies for promoting economic revival, costs of infrastructural shortages and solutions thereof, implications of decline in the quality of governance and key areas where improvements are required, and prospects for greater provincial autonomy and resulting benefits to the people arising from the eighteenth amendment and the NFC award. If we are to pull back from the abyss actions on all these fronts are required.

## POLICY PRIORITIES: FURTHER MACROECONOMIC STABILIZATION OR REVIVAL?

In the next few days as the government finalizes its budget for 2010-11, it faces some hard choices. The Federal government would have to be particularly prudent in expenditure allocations because the NFC award has reduced its fiscal space. How should it proceed?

Here are a number of suggestions. First, be honest with the public on the nature of the challenges that the country faces that are the cumulative result of policy neglect or failures for decades. Second, try to appeal to the enlightened self- interest of the elite that sacrifices and tax compliance are absolutely necessary to avoid economic disaster or worse. This, however, can work only if political leaders can restore trust and confidence in government by showing high standards of integrity, avoid parochialism and favoritism and set a real example of austerity which a situation of war demands. At the same time, issues of deteriorating governance have to be addressed frontally.

Working more closely with the provinces in the coordination of economic policy actions is now a necessity. In view of the devolution of authority and resources to the provinces, the coordinating role of the National Economic Council has become even more important. It must meet frequently and should be supported in its staff functions both by the Planning Commission, the NFC Secretariat and the planning departments of the provinces.

In the immediate future, the macroeconomic imbalances especially the large and persistent fiscal deficit and the relationship with the Fund are going to be a central challenge for the government. While strong tax mobilization efforts, both at the central and provincial levels, are necessary and there is need for a close scrutiny of all public expenditures to achieve savings, a rapid fiscal adjustment on the scale envisaged by the original IMF medium term framework of a reduction of deficit to less than 3 per cent of GDP by 2012-13 may be neither feasible nor desirable. This could fundamentally jeopardize prospects for revival of the economy.

As discussed later, a somewhat slower fiscal adjustment path, say a reduction in overall public sector deficit from an estimated 6.5-7.0 percent of GDP ratio in 2009-10 (including borrowings for circular debt reduction and public enterprise losses) to 5 percent by 2012-13 would have credibility. But only if tax-to-GDP ratio can be raised by about 2 per cent over the next three years, the quality of public spending can be improved, and losses of public enterprises largely eliminated.

A successful introduction of the value added tax in the coming months would be a test for government's will to collect additional taxes. In the medium run, the VAT would help to raise tax revenues by 1.5- 2 per cent of GDP. Other reforms like a restructuring and broad-basing of the income tax regime also appear urgent. Exemptions of agricultural income and capital gains need to be reviewed. The present tax collections particularly from non-salary individuals and private companies are small and must be enhanced. The Revenue Advisory Council should be entrusted with the task to develop a comprehensive resource mobilization strategy, with the objective of not only enhancing the tax-to-GDP ratio but also to rationalize the tax structure, strengthen tax administration and make the tax incidence more progressive.

## SHOULD PAKISTAN GO FOR ANOTHER IMF PROGRAM?

Pakistan has had a long history of going on and off IMF programs since 1988. During the decade of the 90s, Pakistan sought IMF assistance at different times when foreign exchange reserves were depleted and had fallen to critically low levels. From 1999 to 2003, this program was successful in bringing down sharply the current account deficit from over 4 percent of the GDP in 1998-99 to a virtual surplus in 2001-02. The inflation rate also remained low, at below 4 percent, while the fiscal deficit was contained at about 4.5 percent of the GDP. But the process of severe contraction of aggregate demand in the economy implied a very low growth rate of the GDP of only 3 percent. Consequently, there is evidence that unemployment and poverty rose sharply during this period. In December 2004, the then government announced that Pakistan would never go once again with a 'begging bowl' to the IMF.

But history has a nasty tendency of repeating itself. The large oil price shock in 2008 along with the rise in commodity prices, especially of food items like wheat and edible oil, led to a severe haemorraging of the foreign exchange reserves in the first ten months of 2008. The newly elected government had hoped initially to mobilize large-scale support on a bilateral basis from "Friends of Pakistan" following the return to democracy and the on-going War on Terror but it soon became clear that this would be forthcoming only under the umbrella of a comprehensive Fund program. Fortunately, the Fund largely accepted the 'home grown' program prepared by the Government with the help of the Advisory Panel of Economists to the Planning Commission. The Program, relatively speaking, was soft and initially Pakistan has performed relatively well in meeting the macroeconomic targets.

Once again, however, of great concern is the impact of the Fund Program on the rate of growth of the economy. There was a quantum decline in the growth rate of the economy from an average of 6.8 percent from 2002-03 to 2006-07 to 2 percent in 2008-09, with the likely outcome of just over 3 percent growth in GDP in 2009-10.

Though it is difficult to disentangle the impact of various factors on the loss of dynamism of the Pakistan economy, like the global financial crisis, and the emergence of major infrastructural bottlenecks, there are elements in the Fund program which may have contributed to the slowing down of the rate of growth. The steep reduction in the fiscal deficit, which meant curtailment of the PSDP, and the rise in interest rates, which may have dampened private investment, are examples.

What should be the optimal fiscal framework for 2010-11 and how should the medium term macroeconomic framework be modified in light of the experience in 2008-09 and 2009-10? We develop in this report a 'homegrown' macroeconomic and fiscal framework which is consistent with the ground realities of Pakistan at this time. The Government may use this framework in its forthcoming discussions with the IMF on the coming budget and for any extension of the tenure of the Fund program beyond December 2010 when the current SBA comes to an end. The basic conclusion is that if Pakistan is to remain on the original fiscal framework agreed with the IMF then there is very little 'fiscal space' left for executing the development program, which will have to fall to about 2-3 percent of the GDP and show a drop in real terms of over 19 percent in relation to the already depressed level in 2009-10. This is despite a significant increase expected in the tax-to-GDP ratio of 0.6 percent of the GDP.

As mentioned earlier, we are of the view that a smaller adjustment in the fiscal deficit is warranted for 2010-11. As such, the fiscal deficit may be brought down to 5.0 percent of the GDP, rather than 4 percent or so, and the additional fiscal space be used to raise the size of the development program by one percent of the GDP (equivalent to about Rs 170 billion), for high-priority projects and programs in the Federal PSDP focusing on removing the infrastructural bottlenecks. Such a move is justified on a number of grounds: the need to preserve the 'human face' of the structural adjustment process, and creation of more jobs as unemployed youth could be driven to crime and militancy in the absence of their productive absorption in the economy. A fiscal stimulus to facilitate recovery has already been implemented in a much bigger way by other countries like India and China with some success. Given the slump in private investment, the only option for a counter-cyclical policy is to push up public investment to revive the economy. Of course, this must be accompanied by sharper prioritization of the PSDP and better implementation of projects.

What are the principal differences between our 'homegrown' medium term macroeconomic framework and the proposed IMF framework? First, there is the difference in choice of policy instruments over the next five years. As highlighted above, the 'homegrown' framework envisages a bigger build up in public investment. Second, the current account deficit is significantly smaller in the 'homegrown' framework when debt repayments peak after 2011-12. The strategy of import compression and promotion of exports is critical to the achievement of greater self-reliance. This is proposed to be achieved by imposition of regulatory duties on imports (excluding essential imports) and a somewhat faster depreciation of the exchange rate.

Third, the inflation rate is somewhat higher in the 'homegrown' scenario, at about 7 percent by 2014-15, due primarily to the more aggressive use of the exchange rate instrument. Fourth, the 'homegrown' framework envisages a significantly faster growth of the economy, from 4.4 percent to 6 percent by 2014-15. In the IMF framework, GDP growth rate will remain below 5 percent upto 2013-14. Finally, with a higher GDP growth the prospects for employment and thereby lower poverty are unambiguously better in the 'homegrown' strategy. Estimates show that there are likely to be about 2.5 million less poor people in Pakistan in 2014-15 if the 'home grown' strategy is resorted to.

Therefore, should Pakistan stay in or exit out of the IMF program? This will hinge crucially on discussions with the Fund over the next few weeks on the forthcoming budget and updating of the medium term macroeconomic and fiscal framework in light of the expected outcome in 2009-10. If the Fund accepts the need to push for higher public investment next year as a means of reviving the economy and thereby relaxes the fiscal deficit target then Pakistan should continue the relationship with the Fund upto the end of the present SBA in December 2010 hopefully under better terms of repayment (SAF or ESAF). As far as getting on to new program thereafter is concerned this must hinge on acceptance of a medium term macroeconomic and fiscal framework like the 'homegrown' framework presented in the Report, which enables a process of sustained recovery of the economy. The costs of continued breakdown in the provision of public services and of rising unemployment and poverty are becoming too high to be contemplated.

## REMOVAL OF INFRASTRUCTURAL CONSTRAINTS

The year 2009 has witnessed an escalation in power outages and water shortages as well as an emergence of gas shortages to further compound the supply-side constraints on all sectors including industry, agriculture and services. These shortages not only constrain growth in terms of GDP foregone, but have impact on employment, exports and development in general.

Despite a commitment by government, the incidence of power loadshedding increased by over 30 percent during the course of the year. As highlighted earlier, the problem has aggravated to the extent that people in various cities have resorted to street protest against loadshedding.

Recent analysis, based on a survey of industrial units, shows that the cost to the economy of power outages in the industrial sector in 2008-09 was Rs 230 billion. This is equivalent to 11 percent of industrial value added. The reduction in industrial value added has led to a loss of industrial employment of about 535,000 workers. This magnitude of retrenchment can have significant consequences on the level of poverty in the country, where poverty is already on the rise due to escalating prices and lower growth. Allowing for the multiplier effects the total cost to the economy of power loadshedding in the industrial sector is estimated to be Rs. 315 billion. This is equivalent to two and a half percent of the GDP. The loss of exports is estimated at about US $ 1.3 billion in 2008-09. Compared to 2008, the costs to the economy of power outages in 2009 are probably 40 percent higher.

Policy actions taken more recently by the government include the following: establishment of Debt Co. (PHCL) and transfer of debt stock of over Rs 30 billion from power utilities; financing of debt servicing (Rs. 40 billion) through tariff increases; 48 percent increase in power tariff from March 2008 and institution of performance contracts with DISCOs aimed at efficiency improvement, loss reductions and improved recoveries. The government has also held last month a high-level Energy Summit which agreed on a number of steps for energy conservation and short and long term proposals to improve energy security in the country.

Ensuring energy security will however require a more structural solution to the circular debt problem; upgradation of existing power plants; expansion in capacity through the implementation of a comprehensive programme to reduce technical losses and improve the reliability of the distribution system and formulation of load management strategy. It is also important that alternative sources of energy, in particular solar and wind energy, be explored.

After electricity, there is an incipient crisis in gas supplies which is likely to strike the country with equally far reaching impact in the coming years if corrective policy actions are not taken with some urgency. It is projected that the demand for gas in Pakistan, over the next five years, will increase at about 5.5-6 percent per annum. The gap in demand and supply is likely to increase to between 342 and 405 bmcft by 2014-15, depending on the supply position of gas. The annual cost to the economy of this shortfall could be as high as Rs. 110 billion by 2014-15.

Overall, Pakistan needs to develop and implement a comprehensive energy strategy with the objectives to: (a) enhance the exploration and production activities of oil, gas and coal resources, (b) encourage the utilization of the country's hydel potential and other indigenous resources to reduce dependence on imported fuel: (c) create an environment conducive to the participation of the private sector and (d) develop the local energy scenario in the context of a regional perspective.

Turning next to the water sector, Pakistan is now one of the world's most arid countries with an annual rainfall of less than 240mm and virtually total reliance on a single river system with no additional injections into the system. According to the UN Report (2009), total water renewable resources in Pakistan have decreased from 2,961 cubic meters in 2000 to 1,420 cubic meters per capita in 2005. It is estimated that by 2025, not more than 1,000 cubic meters will be available per person in Pakistan making it a water-scarce country.

Over 80 percent of the cropland is irrigated in Pakistan. The country receives an inflow of 104 Million Acre Feet (MAF) from the Indus Basin out of which 64 MAF are consumed by crops and the remaining is lost to the Arabian Sea and seepage. The flows in the three rivers is declining at the rate of 6.6 percent per year. The other main source is ground water which accounts for 40 percent of irrigation. There is evidence of over exploitation as ground water pumping has increased from 3.34 MAF in 1959 to 55 MAF by 2009.

An important issue in recent years has been under-investment in water. Recent analysis has demonstrated that, if water availability had grown at the trend rate, of about 1.3 percent, the agricultural value added would have been higher. The loss of GDP in 2008-09 due to underinvestment in water in the current decade has been as much as Rs 125 billion, equivalent to 4.8 percent of the agricultural value added.

Quick actions are required in order to avoid a drought situation in the country which will severely impact the lives of millions of people in Pakistan. An ecologically sound and sustainable strategy would include: construction of dams; improvement in operation and maintenance of the irrigation system; private sector involvement to improve performance and efficiency in the water supply and other infrastructure; implementation of strict laws for industries with respect to water contamination and pollution; introduction of water efficient cropping system; new technologies such as drip and sprinkler irrigation; proper water pricing and improvement in cost recovery to both reduce stress in financial position of water providing agencies and wastage; introduction of a water credit system with the involvement of the private sector and based on the principles of microfinance and lastly introduction of measures to reduce water theft in the irrigation network.

Overall, the analysis in the report demonstrates that the country is paying a heavy price for the delay in the effective resolution of the enormous infrastructural challenges facing it. Potentially, GDP could have been higher by almost Rs. 450 billion, or about 3 percent, if the shortages of power and water shortage alone were not adversely impacting on the economy. The concomitant repurcussions for exports, employment and poverty are also sizable. Any further inaction or inadequate/inappropriate policy action can severely frustrate the country's growth potential.

## ISSUES OF GOVERNANCE

Governance is a very broad concept that encompasses the form of political regime, the process by which authority is exercised in the management of economic and social resources of a country and the capacity of governments to design, formulate, and implement policies and discharge functions. It includes formal institutions and regimes empowered to enforce compliance as well as informal arrangements that people and institutions either have agreed to or perceive to be in their interests.

The current governance problems in Pakistan, of worsening security and law and order situation, widespread corruption and declining public authority and institutions, threaten future investments and growth as well as political and social stability. However, to a considerable extent, the present governance problems have also their roots in the pattern of economic development over the last fifty years. The uneven distribution of growth benefits and the increasing dualism in the society are reflected in the sharp contrast between the growing numbers of poor and illiterate, on the one hand, and increasing sophistication and wealth of the elite and upper middle classes, on the other hand.

However, in contrast with the familiar litany of governance problems noted above, there have been some positive recent developments that hold at least the potential of improving the quality and the effectiveness of governance structures. These major developments have greatly enhanced the prospects of a free, stable, and decentralized democratic order. First, the passage of the 18th amendment to the Constitution as already noted transfers greater powers and authority to the provinces and lays the basis of healthy competition as well as direct negotiations among provinces and the centre on matters of common interest. Second, the Seventh NFC Award provides the financial underpinnings of greater provincial autonomy and equity by not only significantly increasing the share of the provinces in the divisible pool of revenues but also considerably expands the share of smaller provinces. Third, the restored and reinvigorated higher judiciary has shown great independence in asserting the rule of law and has been fearless in pursuing wrong doing thus increasing public confidence in this important third pillar of the state.

How does Pakistan fare in international rankings of governance? Numerous international sources which follow different methodologies in constructing indicators and cover different dimensions of governance have been analysed in this report to determine Pakistan's ranking in governance indicators. It turns out that Pakistan is in the lowest quintile (bottom 20 percent) in two thirds of the rankings. The conclusion follows that Pakistan performs poorly in governance in relation to most countries, and has the lowest ranking among South Asian countries. There are only 11 rankings in which Pakistan is in higher (first and second) quintiles which relate to economic governance like business regulatory environment and quality, debt policy, structural policies and size of government. There is no other indicator of governance in any international assessment in which Pakistan performs relatively well.

Cross-country regressions indicate that if governance in Pakistan had approached the average for the countries of South Asia, then the GDP growth rate during the period, 1996 to 2008, could have been higher by 0.66 percentage points annually (that is, at 5.3 percent per annum instead of the observed 4.6 percent). In other words, the GDP today could have been 8.3 percent higher, equivalent to about Rs 820 billion. These results also demonstrate the impact of the quality of governance on progress on the Millennium Development Goals (MDGs) and human development. Clearly, Pakistan has sacrificed growth and human development due to poor governance.

There is no doubt that Pakistan can make a major headway with improved governance, for example, by learning from international experience. Some key lessons on successful implementation of governance reforms are as follows: national ownership—by governments and communities—is key; continued political will and support throughout all phases of reform is vital; creating broad coalition of support for reform is important; change agents or reform champions are needed to anchor the reforms; support and engagement of multiple stakeholders is essential; change management is an integral part of any reform process; there is no one-size-fits-all programme design; strategic incrementalism may be a more pragmatic and feasible option; setting realistic and well-defined targets can be useful; ensuring financial and institutional sustainability of reforms is crucial; projection of "good results" and provision of incentives for continued progress are useful.

The report presents a ten-point governance reforms agenda. A pre-requisite is for the political leadership at both the federal and provincial levels to try to regain the trust and confidence of the public. Several steps can help to alleviate the present mistrust. Among them are: less arbitrariness and greater transparency in decision making, a clear respect for the rule of law, adoption of austerity measures to curb wasteful and low priority public spending, and finally strong accountability mechanisms that reward good performance and punish wrong doing. At the same time, the capacity for governance must be improved by the appointment of highly capable and honest individuals.

Specific areas of governance reform in Pakistan must include the following: better policy framework, civil service reform, improved delivery of services, emphasis on curbing corruption by enhanced transparency and accountability, strengthening the rule of law and the role of civil society institutions. Detailed proposals are presented in Chapter 5 of the report.

## ENHANCEMENT OF PROVINCIAL RIGHTS AND RESPONSIBILITIES

The passage of the 18$^{th}$ Amendment to the Constitution is a momentous development in the direction of enhanced provincial autonomy. Decentralization of policymaking as well as the implementation of the policies made would be some of the important outcomes of this amendment.

Most of the press coverage of the 18$^{th}$ Amendment has been concerned with the division of powers between the president and the prime minister. What has escaped notice by most analysts and commentators is another part of the amendment, a significant increase in the powers of the federating provinces. Granting provincial autonomy was also the intention of the original constitution. The constitution had two lists, one for federal subjects and the other that were to be the joint responsibility of the federal government and the provinces. The concurrent list included matters - 47 in number - such as civil and criminal law, population planning, electricity, tourism, trade unions, and other matters of common interest. The concurrent list was to be removed from the constitution ten years after its promulgation. That, of course, did not happen and the country continued to be run from the center at Islamabad. Under the eighteenth amendment there is once again a promise that decentralization will be achieved not just on paper but also in practice.

The country has also attempted to bring government closer to the citizenry by constituting local bodies, directly elected by the people. A number of different systems have been tried since independence but did not survive long enough to provide services effectively. Had one system been allowed to remain in place with changes introduced from time to time, Pakistan would possibly have developed an effective system of local governance. This has not happened.

There cannot be any doubt that the eighteenth amendment will have a profound impact on the way Pakistan's economy is managed. If the federating units receive additional powers as a result of the abolition of the concurrent list put into the 1973 constitution by its framers, it will mean transferring large amounts of economic authority to the provinces. They will, for instance, have the right to manage labor laws, environmental impact of development in both the public and the private sectors of the economy, generation of much larger amounts of electricity than currently permitted, development of infrastructure, movement of goods and commodities within their own boundaries, improving the level of education and providing for the acquisition of usable skills by the populace. This will happen only if the provinces find a way of financing these activities. If they remain dependent on the central government for funds, the autonomy promised by the amendment will remain illusory.

The Council of Common Interests (CCI) has also been greatly strengthened. Some of the subjects which will now be under the purview of the CCI include major ports; electricity, presumably all aspects of it including generation, transmission and distribution; all regulatory authorities; national planning; public debt; census; legal, medical and other professions; higher education standards; and inter-provincial matters and coordination.

The eighteenth amendment has also removed the sixth schedule to the constitution that had given protection to 35 laws. Included in these was the Devolution Plan of 2001.This leaves open the question whether the provinces would continue the systems that were in place as a result of the 2001 Ordinance. It is essential that the process of decentralization is further deepened and local governments are strengthened.

There are a number of provisions pertaining to strengthening the finances of the provinces, They will have the right to raise domestic or foreign loans with the approval of the National Economic Council, a body chaired by the Prime Minister with a secretariat in the Ministry of Finance. Future NFCs cannot issue awards that reduce the combined share of the provinces in the central "divisible pool".

Will the 18$^{th}$ Amendment deliver decentralization? For this to happen the military will have to come under the control of the civilian authority. The country may also be moving towards the creation of a federal system in which there is sharing of power between governments at different levels - between the federal and provincial governments and between provincial and local governments. Also, it is essential that the lower levels of government have the capacity and wherewithal to effectively perform their functions. This involves allocation of resources including financial resources. Currently the distribution of fiscal powers is highly skewed in favour of the federal government.

All in all, while the 18$^{th}$ Amendment to the constitution has taken a major step forward in moving Pakistan towards a federal system, the real test of the efficiency will come once the envisaged system begins to take shape. The passage of the amendment and its signing into law has not resolved the controversy that surrounds many aspects of governance in Pakistan. Another test will come in terms of providing services for which the provinces will have the responsibility with the abolition of the concurrent list by the 18$^{th}$ Amendment. There is general agreement that decentralization of government's authority should help in addressing the problem the country faces as the number of people living in absolute poverty increases. But will the provinces have the capacity and the resources to carry out this mandate? We turn in this context to the implications of the recent NFC Award.

## MOVING TOWARDS FISCAL DECENTRALIZATION

Inter-governmental revenue transfers are the lifeline of provincial governments in Pakistan. These transfers account for over 80 percent of sub-national revenues. This dependence is a consequence of the imbalance in the allocation of functional responsibilities and fiscal powers between the federal and provincial governments in Pakistan, whereby the federal government collects as much as 92 percent of tax revenues and the provinces, only 8 percent. Since partition, eight revenue sharing awards have been announced in Pakistan for determining transfers which have historically taken three forms, "divisible pool" transfers, straight transfers and grants / subventions.

Overall, it appears that, inter-governmental transfers between the federation and federating units have evolved within the broad philosophy of promoting a degree of fiscal decentralisation and by strengthening the resource base of the provinces making them more dynamic as service delivery agents. There has been a rise in federal transfers as a proportion of federal tax revenues. However, the change in the nature of fiscal transfers has accrued to the advantage of natural resource rich provinces. The share of Sindh has increased significantly in the late 90s and in the earlier part of the current decade. Khyber-Pakhtunkhwa's share peaked following the 1990 NFC award and transfer of hydel profits and has declined thereafter. Both NFCs of 1990 and 1996 enhanced the share of Balochistan in federal transfers but this trend was not maintained by the 2006 Presidential Order. Punjab shows a steady decline in its share of the transfers.

Factors which justify a further increase in the provincial share in the divisible pool include: the security conditions prevailing in the country which have increased the 'fiscal needs' of the provinces in the war against militancy. Provinces also need more resources for skill development and employment creation to reduce the propensity of youth towards extremism; for achieving the Millennium Development Goals (MDGs), which are the principal responsibility of the Provincial governments; and for financing transfer of Concurrent List functions and vertical programs by Federal government.

The 7th NFC Award has, in fact, made a major headway in transferring more resources to provinces. It has enlarged the size of the divisible pool through a reduction in collection charges from an average of 5.2 percent to 1 percent. It has provincialized sales tax on services and has increased provincial share in vertical transfers from 46.25 percent to 56 percent in the first year of NFC and 57.5 percent in the subsequent years. It has also diversified the bases of distribution of revenues among provinces. Punjab showed accommodation to the longstanding demand of other provinces to have multiple indicators for horizontal distribution. Provincial shares are now derived on the basis of poverty, inverse population density (IPD) and revenue contribution (both proxy collection and generation) and, of course, population.

The seventh NFC award is also unique as it takes into account special considerations which impact on the fiscal requirements of the provinces. First, the federal government and provinces recognized the role of Khyber-Pakhtunkhwa as a frontline province against the 'war on terror'. As a gesture of support, all provinces joined the federal government to allocate 1 percent of the divisible pool to the province. Second, the federation and all the provinces accepted the special development needs of Balochistan and agreed to raise its share in the divisible pool to over 9 percent. Also, the Award enhanced straight transfers by accepting the provincial demand of payment of arrears from profits of hydel power electricity and gas development surcharge.

All in all, the 7th NFC award is unique in its design and its sensitivity to the needs of the federating units. It is also an award which has made big changes in the status quo and therefore, has substantial and varying implications both on the federal government and four provincial governments.

Total divisible pool transfers to the provinces in 2010-11 are projected at Rs 883 billion, Rs 58 billion higher than the transfers if the current revenue-sharing arrangements had continued. Other transfers will also be higher at Rs 244 billion, due to, first, transfer of the entire proceeds of the sales tax on services to the provinces, and second, payment of arrears of hydel electricity profits and GDS to the smaller provinces. There will, however, be some reduction in grants. Overall, transfers to provinces are estimated to be Rs 1077 billion in 2010-11, higher by Rs 283 billion as compared to the present distribution formula. The larger transfer to provincial governments implies that the federal budget deficit could approach 6 percent of the GDP.

As opposed to the federal government, the provincial governments will witness a substantial improvement in their fiscal position. Assuming that the provincial governments maintain the level of fiscal effort and expenditure growth envisaged in the IMF agreed fiscal framework, the provinces of Sindh, Khyber-Pakhtunkhwa and Balochistan will carry surpluses ranging from Rs 22 to 35 billion. Overall, these estimates indicate that the provinces combined could initially generate a budget surplus of Rs 115 billion, of about 0.7 percent of the GDP, due to limitation of absorption capacity, especially in the smaller provinces.

Perhaps for the first time, there will a shift of development focus from the federal government to the provinces. The provinces combined could carry out development programs approaching Rs 370 billion in 2010-11, thereby exceeding the federal PSDP. The fast growth in development spending will require enhancement in provincial capacity to design, execute and manage a larger portfolio of projects.

Of course, since the provincial governments are primarily responsible for the social sectors, prospects for 'investing in the people' have improved. For the medium term consequences to be favourable provinces must not slacken their own fiscal effort, so that additional transfers essentially supplement and not substitute for provincial own revenues and avoid profligacy in current expenditures. Additional resources should be used for development and largely routed towards backward regions and pro-poor sectors. It is recommended that the provinces may prepare their own Medium Term Development Frameworks (MTDF) to help strategize and prioritise their development priorities and facilitate proper planning and management of spending.

As highlighted above, the Award has reduced the fiscal space for the federal government. Sharper prioritization and pruning of federal PSDP has become indispensable. Also, the linchpin in the strategy to keep the federal fiscal position from becoming unsustainable is to enhance the level of resource mobilization of the type described earlier.

In conclusion, the 7th NFC award has major implications for both the federal and provincial governments in Pakistan which will require well thought out, coherent policy responses by the two levels of government. Its real accomplishment is that in one of the most difficult times in the history of the country, it has rekindled the spirit of national solidarity, consensus building, cohesion and unity.

## STRENGTHENING OF LOCAL GOVERNANCE

The argument in favour of local governments is based on a simple proposition: that the allocation of public resources at the local level is more likely to conform to public welfare priorities, and the delivery of basic services is likely to be more efficient, in a situation where these administrative functions are being performed by elected government officials, close to and in full view of the electorate. Thus, proximity to the electorate and accountability to them, are more likely to impel local government officials to seek the public good.

The most recent experiment with devolution in Pakistan is the introduction of the ambitious Devolution Plan in 2001. This was based on a template developed by the National Bureau of Reconstruction, which meant the adoption of a "one size fits all" approach to creating governmental units at the local level. Working under the direction and control of elected councils and Nazims, the local government system attempted to create institutions and mechanisms for public participation in design, management, monitoring and control of social service delivery and development activities. There were 31 decentralized departments with management control and functional responsibility transferred from provincial government under Part A of the First Schedule to LGOs, 2001.

Devolution reforms, also envisaged large-scale fiscal decentralization to follow the administrative and political decentralization. This, however, did not happen. While a fiscal relationship was forged between the provinces and the districts, an extensive reorganisation of resources did not take place and the vertical financial imbalance stayed in place with the major financial collections being made at the federal, and to a lesser extent, at the provincial level, and transferred to the local tiers under semi-institutionalised arrangements.

Many studies have been conducted on the decentralization experience in Pakistan. Some have emphasised the gains to be made from a decentralized system, particularly in terms of allocative efficiency and participation of the people at the grassroots, while others cast doubt on some of these gains, and raise concerns about possible negative consequences, particularly related to local elite capture and poor quality of service delivery.

Admittedly, there is a strong case for strengthening the local government system through deepening of reform. These reforms are warranted in political, institutional, legal, fiscal and administrative areas. The report presents a number of structural reforms related to province-district/tehsil relations; local institutional capacity; transparency and accountability; fiscal equalisation through transfers, etc.

In conclusion, local governments in Pakistan in the future can take one of three routes: (1) The district level governments may be rendered so dysfunctional that Nazims or Chairmen may begin to resign and in the subsequent elections genuinely popular local figures may lose interest in local government altogether. Such a process could ultimately result in the failure of the "devolution of power programme". (2) The local government system as it presently exists may continue to function at such a low level of efficiency that the efficiency gains conceived in the programme may become low or even negative. (3) The current situation where local government (LG) elected officials have responsibility without appropriate authority and where they are starved of financial resources may be changed. In this case local government officials may be granted authority over appointments, promotions and transfers of all personnel in the district administration. At the same time, adequate technical and financial resources could be made available to elected LG officials. In such a case the power of the provincial bureaucracy to establish personalized patron-client relations and the tendency to appropriate economic rent could be transformed into efficiency gains associated with effective decentralization. We strongly support the third option.

There is also enough evidence from around the globe to suggest that decentralization through the creation of local government works better for the poor where it is supported by strong community mobilization. This will require a national campaign to empower the poor at the level of village/mohallah, Union Council, Tehsil and District levels. The idea is to facilitate the growth of autonomous community organizations (CBOs) of the poor at the village/mohallah level to be able to break out of the poverty. These autonomous CBOs should be permitted to form cluster apex organisations with other CBOs. By means of social mobilisation, skill training, increased productivity, increased income, savings and investment these organizations would begin a process of localised capital accumulation.

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

In conclusion, Pakistan today is poised at the knife edge. We could fall into the abyss or progress towards a better future. There is no doubt a myriad of problems existing today on the security, economic, political and institutional fronts. But the return to democracy has led to big actions

# Chapter - 1

# Are We Edging Towards The Abyss? The Positives and The Negatives

# Chapter - 1
# Are We Edging Towards The Abyss? The Positives and The Negatives

Pakistan today presents a picture of stark contrasts. Take one day, for example, the 19th of April 2010. This day witnessed the historic signing of the Eighteenth Amendment to Constitution by the President of Pakistan at an impressive ceremony in Islamabad where all leaders of the major political parties were present. At the same time, less than 300 miles away, there were two major terrorist attacks in the city of Peshawar, killing 25 people. One of the bomb explosions was in a procession of people protesting against the high level of power outages which had impacted on their livelihoods. Therefore, on this particular day, we saw major positive political developments coupled with evidence of increasing cracks in the economic and social fabric and a breakdown of law and order.

The objective, therefore, of this Chapter is to identify the positives and the negatives relating to the contempory situation of Pakistan in the areas of security, economy, society, politics and institutions. This will enable an assessment of where we are going as a nation and as a people.

## SECURITY

### Negatives

Pakistan today is effectively a war economy, fighting against militants in the North who pose a threat to the institutions and norms of the State as they currently exist. The negative consequence of this is the retaliation in the form of terrorist attacks throughout the country on both the security apparatus as well as 'soft' targets like markets, mosques and schools.

The frequency and intensity of these attacks have increased over the last few years. According to the Institute of Peace Studies [2009] the number of terrorist attacks has increased by 48 percent to 3816 in 2009, while the number of people killed has risen by 58 percent to 12632. Simultaneously, a large number of people have been injured and there have been major losses to property. IPP [2009] estimated the direct and indirect costs of the War on Terror to Pakistan as aggregating to $ 6 billion in 2008-09, over three times the funds received as support from the international community for the War on Terror. These costs are imposing an increasingly heavy burden on the economy.

Beyond terrorism, the level of human security has been adversely affected by the virtual breakdown of law and order in the country. According to the official crime statistics, from 2006-07 to 2008-09, the number of murders has increased by 20 percent, kidnappings by 49 percent and thefts by 45 percent. Some of the root causes of the increase in crime are rising levels of unemployment and poverty which have alienated a larger section of society. On top of this, the breakdown in law and order is also a reflection of growing problems of governance arising from a police force, which is both ill trained and corrupt and now focused more on controlling terrorism.

Perhaps one of the more disturbing and negative developments is the loss of trust and faith of a large section of the population in the ability of the government to address the problems they face in their day-to-day lives. This has resulted in widespread agitation against the extremely high levels of power load shedding, rising prices of basic items of consumption like food and energy and for basic rights. With power load shedding reaching 12-16 hours a day at some locations, there is, for example, on-going street protest in almost 40 cities and towns of Punjab.

For people living in the Northern part of the country, especially in Waziristan, insecurity has been maximized by drone attacks. Although the US justifies this external intervention into Pakistani soil on the grounds that they are targeting known terrorists and leaders of militancy, but there has been collateral damage and innocent lives have also been lost. The Parliament had passed an unanimous resolution earlier against the drone attacks. The Government must convey in unambiguous terms the opposition of the elected representatives of the people to these violations of national security.

## Positives

On the positive side, military operations in the North have apparently gone well and large tracts of land have been cleared. The large number of IDPs from Swat have mostly returned to their homes. This is perhaps one of the most undocumented examples of a temporary movement of the people and their successful return. Full credit must go not only to the government agencies handling the operation but also to the host families. Steps that need to be taken to restore normalcy and economic activity in the areas cleared up are identified in Chapter 5 of the report.

Similarly, intelligence agencies have been successful in apprehending various important militancy leaders and their accomplices. This will contribute to weakening the terrorist networks and reducing their ability to undertake suicide and other attacks.

In the domain of foreign policy, an important high level Strategic Dialogue took place recently in Washington, with Pakistan being jointly represented by both the civilian and military leadership. The outcome appears to be not only greater coordination and collaboration in the area of security but also appreciation of the need to enhance and fast track economic support to Pakistan. One of the more immediate consequences has been payment of dues from the Coalition Support Fund of $ 656 million, although a large amount still remains pending. It is also reassuring to note that initial dialogue with India has commenced once again and there is some willingness of India to begin to look beyond the Mumbai incident of terrorism.

## THE ECONOMY

### Negatives

The economy today is replete with a large number of negatives. Of prime concern is the near total breakdown in the delivery of basic public services like power, gas and water. As highlighted above, this has already led to large-scale public agitation and violence on the streets. The causes, costs thereof and solutions to these shortages are discussed in depth in Chapter 4 of the Report.

The next factor impacting severely on the living standards of the people is the high cumulative inflation in prices of essential items, especially since 2007. For example, food prices on the average have increased by over 31 percent since December 2007, when international commodity prices started rising and Pakistan undertook large-scale deficit financing by printing of money to mitigate against the oil shock. Coupled with this, the low rate of economic growth since 2007-08 has implied stagnation of real incomes and rising levels of unemployment, which may have doubled in the last three years.

The combination of high prices and high unemployment in the presence of constant or declining household real incomes must inevitably have led to a big increase in the incidence of poverty in Pakistan. Although no recent poverty surveys have been undertaken, the joint UN Mission led by the WFP indicated as far back as mid 2008 that following the big increase in food prices, especially of wheat, almost 66 million people (equivalent to almost 40 percent of the population) had become food insecure.

Alongwith the faltering rate of growth of the national economy, there is evidence that regional disparities are widening in character and providing a basic cause for agitation by various ethnic and nationalist groups. According to the latest HIES [2007-08] during the period, 2001-02 to 2007-08, the largest province, Punjab, has shown exceptional dynamism and average real household income has increased annually on average by almost 6 percent. As opposed to this, the smallest and most backward province, Balochistan, has actually experienced a decline in average household income of 1 percent annually during this period. This testifies to the failure of the federal government in achieving greater fiscal equalization in transfers and investing relatively more in infrastructural development in the lagging regions of the country. It is not surprising that nationalist forces in Balochistan have gained strength in their demands for greater autonomy and larger share in the distribution of national resources.

On the front of sources of growth, prospects for renewed dynamism of the economy have been dampened by a big fall in private investment, both domestic and foreign, which has fallen by 7 percent in 2008-09 and is likely to show a corresponding decline in 2009-10. Foreign direct investment, in particular, has slumped with an almost 50 percent decline in the first nine months of 2009-10.

Turning to the financial sector, this remained largely insulated from the global financial crisis due to the absence of strong international links of Pakistani Banks. But domestic factors, primarily linked to the on-going recession in the real sector, have contributed to a big increase in the volume of non-performing loans which have reached the level of Rs 432 billion by December 2009, equivalent to 13 percent of outstanding advances. Smaller banks, in particular, have been exposed to the risk of default by borrowers, especially SMEs, farmers and households.

The financial sector is also suffering from liquidity problems, even though credit demand by the private sector is slack. This is due primarily to large-scale borrowing by the public sector, including, as of 23rd of April 2010, of Rs 286 billion for budgetary support, Rs 77 billion to public sector enterprises and Rs 280 billion in commodity operations due, in particular, to the carry over of large wheat stocks. The pressure on the banking system could increase further in the coming weeks as the financial year comes to an end, and the government has to finance a larger than anticipated fiscal deficit. It is not surprising that interest rates have remained high and monetary policy has been held largely hostage to fiscal policy.

The large and rising levels of government borrowing can also be attributed to the substantially lower than anticipated aid inflows. The budget for 2009-10 was framed on very optimistic assumptions about the level of support from the international community especially in view of the high costs to Pakistan of being a frontline state in the War on Terror. For example, Friends of Democratic Pakistan were expected to contribute over $ 2 billion during the year, whereas only $ 174 million has come in to date. Bilateral assistance from the US through the Kerry-Lugar bill has not commenced yet and there is lack of clarity as to the extent to which this will finance the government's development program.

The budget deficit for 2009-10 is expected to be significantly larger than originally anticipated depending upon the magnitude of shortfall in the achievement of FBR's target of revenues and the extent of realization of funds from the CSF in the nature of reimbursement of military expenditures in the North. If the borrowings from the market to reduce the circular debt in the power sector are included, then the size of the fiscal deficit could approach Rs 1000 billion (almost 7 percent of the GDP). This is despite a large cutback in the PSDP of almost 40 percent to a critically low level of less than 3 percent of the GDP at a time when infrastructural bottlenecks are crippling the economy.

There are also apprehensions that the level of public debt is once again (like the late 90s) approaching unsustainable levels close to 65 percent of the GDP. Of particular concern is the growth in external debt which has risen by 38 percent from $ 39 billion in June 2007 to $ 54 billion by December 2009. The large on-going SBA from IMF will require repayment within the next five years and Pakistan could find itself in a 'debt' trap.

### Positives

On the positive side, there has been a substantial improvement in the balance of payments position of the country. During the first nine months of 2009-10 the deficit on the current account has declined by as much as 68 percent in relation to the level attained in the corresponding period of last year. In fact, there was hardly any deficit in the months of February and March

2010. The primary reason for the improvement is the fall in the import bill due not only to the lower cost of POL imports but also the saving in food imports due to the bumper wheat crop, alongwith some decline in machinery imports due to the depressed private investment. Remittances are up by 16 percent, although the deterioration in labor market conditions in Middle East are beginning to limit future growth.

More recently, exports are beginning to show some dynamism as the world economy recovers. Exports grew by 38 percent in March 2010 with textiles exports rising by 30 percent. There is the likelihood that the overall export target for 2009-10 may be met. Foreign exchange reserves are showing a rising tendency and are expected to be up by almost $ 5 billion to over $ 15 billion in 2009-10, enough to finance five months of imports. The rupee has remained stable despite the transfer of the financing of oil imports to the inter-bank market.

There is also evidence of an incipient recovery in the manufacturing sector. On a month-to-month basis the sector has shown a growth rate above 6 percent during the months of December 2009 to February 2010, after many months of decline. Some industries like tractors, motorcycles, cars and fans have exhibited high double-digit growth rates due to the buoyancy, in particular, in rural demand following the rise in incomes in the wake of higher procurement/support prices. This recovery has taken place despite the severe supply-side constraints due to power and gas shortage.

The stock market has shown a rising trend. After the, more or less, catastrophic drop from the peak of over 16000 in early 2008, and following temporary closure it has risen to 10500 by May 2010. The Karachi Stock Exchange has emerged as one of the better performers among emerging markets. Some portfolio inflows have also started flowing in the last few months.

Overall, the economy exhibits a mixed picture. There is slow growth, high persistent inflation and the fiscal situation has deteriorated significantly, while unemployment and poverty continue to rise. As opposed to this, there has been a spectacular improvement in the balance of payments, the agricultural sector has performed relatively well and there are some signs of recovery in the manufacturing sector.

## POLITICS AND INSTITUTIONS

### Negatives

Perhaps one of the areas of greatest concern is the perceived large-scale breakdown in the quality of governance in the country. This is the most acutely manifest in the burgeoning losses (approaching Rs 200 billion) of state enterprises and public utilities like Pakistan Railways, PIA, WAPDA, Pakistan Steel Mills, TCP, etc., due not only to 'crony' appointments in top managerial positions but also because of unwarranted expansion in the labor force and large-scale leakages. On top of this, there are frequent media reports of 'grand corruption', some of which has been taken notice of, on a suo moto basis, by the Supreme Court.

The bureaucracy is demoralized and ineffective. Implementation capacity is at an all time low. The recent reversion of the appointment of 54 Federal Secretaries by the Supreme Court has shaken up Islamabad. Reports by the Transparency International indicate that Pakistan is beginning to approach once again the peak levels of corruption attained in the mid-90s. There exists no independent and impartial accountability mechanism to apprehend people in high places for acts of corruption.

The consequence is a decline in the writ of the State. Not only have non-state actors including militant groups become more active in different parts of the country but there is also a breakdown in the rule of law. The lower courts, in particular, are characterized by long delays and high levels of corruption. Regulatory agencies have failed to ensure the proper operations of markets. Cartelization, profiteering and hoarding are the order of the day and explain the artificially high prices of many basic consumer items. Tax administration is weak and riddled with corruption. Smuggling and under invoicing of imports are flourishing and hundreds of thousands of tax payers do not even file returns.

The delivery of services by public agencies is abysmal. For example, there are large transmission losses in the delivery of electricity. Combined with large scale theft and non-payment of bills this has destroyed the commercial viability of power distribution companies. Similar problems are beginning to be observed in the supply of other services like gas and water. Social services have declined so much in quality that even the lower middle classes have been forced to search for alternatives in the private sector. Overall, since delivery of services is the prime interface between government and the people, it is not surprising that there is a general disillusionment with the quality of governance in the country.

## Positives

While there are serious problems at the ground level, there are larger developments on the political and constitutional fronts which highlight that the functioning of democracy, howsoever imperfect, can still achieve major results. This includes the historical signing of the 18th Amendment incorporating fundamental changes in the Constitution, achieved by a consensus of the political parties, seen for the first time after 1973. The Balochistan Package announced by the Government is also a major attempt at removing the longstanding grievances of the province. The generous dispensation to the provinces in the Seventh NFC award alongwith transfer of the Concurrent List of functions should go a long way in strengthening the process of provincial autonomy.

Other major developments which auger well for the future of democracy are a strong, independent and assertive superior judiciary and a vibrant media. These institutions are emerging as pillars of the state and contributing to the development of effective checks and balances in the system. Supporting this process is a resurgent civil society which is advocating for basic rights and has already played a critical role, for example, in the return of Supreme Court judges removed by the military dictator.

On the social side, the democratically elected government has shown more concern for the plight of poor people. A more comprehensive social protection program has been developed through targeted income transfers under the BISP, subsidized prices of basic consumer items and an improvement in conditions of workers, through enhancements in minimum wages and improved access to benefits. Gender concerns have also been highlighted by the recent passage of the Sexual Harassment Bill by the National Assembly.

## CONCLUSION

The contrasting developments highlighted above with many serious concerns on the one hand and some promising and positive developments on the other hand, raise the fundamental question: Is Pakistan on the edge of the abyss and close to becoming a 'failed state' or are we likely to 'muddle' along like a 'soft state'. Or have some of the larger developments, especially on the constitutional front, laid the basis for a transition to a better future? We leave the readers to form their own judgment about the future of Pakistan.

# Chapter - 2

# Preventing Further Deterioration in Macroeconomic Imbalances

# Chapter - 2
# Preventing Further Deterioration in Macroeconomic Imbalances

## ECONOMIC TRENDS

In sharp contrast to the precariousness of the macroeconomic situation in 2008-09-- that was typified by the almost freefall in foreign exchange reserves in July-October 2008 and a year to year inflation that peaked at 25 percent in August 2008 — 2009-10 was a year of relative financial calm, though the security situation worsened, the costs of terrorism rose, and the real economy remained sluggish. The growth of GDP was only 2 percent for 2008-09. The estimated growth rate of 3.5 percent for 2009-10 is likely to be revised downwards partly because of a somewhat disappointing wheat crop. It would appear, therefore, that there was little improvement in per capita income taking the two years together, making this period among the worst in Pakistan's economic history.

Taking the two years (2008-09 and 2009-10) together the GNP growth has been less than 2.5 percent per annum (see Table 2.1). Improvement in terms of trade during 2008-09, representing mainly a fall in international oil prices, added another 0.5 percent to the growth rate of real

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

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 (E) |
|---|---|---|---|---|---|---|
| GNP growth per annum (%) | 7.1 | 6.0 | 5.9 | 6.2 | 2.5 | 3.0 |
| Fiscal Deficit (as % of GDP) | -3.3 | -4.3 | -4.3 | -7.4 | -5.2 | -5.8 |
| Current account Deficit (as % of GDP) | -4.0 | -3.9 | -4.9 | -8.4 | -5.6 | -2.9 |
| GDP deflator change (%) | 7.0 | 10.5 | 7.8 | 16.2 | 22.6 | - |
| Consumer Price change (%) | 9.3 | 7.9 | 7.8 | 12.0 | 20.8 | 11.0 |
| Change in Net Domestic Assets of Monetary System (%) | 17.1 | 12.4 | 11.3 | 23.2 | 12.8 | 9.0 |
| M2 change (%) | 19.3 | 14.9 | 19.3 | 15.3 | 9.6 | 12.0 |
| 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 | 12,425 | 14786[a] |
| Gross Investment (As % of GDP) | 17.5 | 20.5 | 21.3 | 22.0 | 19.7 | 17.7[b] |
| Gross National Savings (As % of GDP) | 17.5 | 17.7 | 17.8 | 13.5 | 14.3 | 14.2[b] |

(E) Estimated

**a** (Up to February 2009)

**b** Numbers for these in two indicators are in current prices. Numbers for Gross Capital Formation excluding inventories (as % of GDP) in 1999-2000 prices are as follows:

| 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
|---|---|---|---|---|---|
| 15.3 | 17.3 | 18.4 | 18.3 | 15.0 | 14.7 |

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

national income. Still, because of the need to sharply shrink the totally unsustainable current account balance of payments deficit of 8.4 percent of GDP in 2007-08, to the current level below 3 percent of GDP the increase in availability of domestic resources has been very small and negative on a per capita basis.

Nonetheless, even with the sharp reduction in government energy and other subsidies since 2007-08, average private consumption per head appears to have been sustained, indeed may have grown by as much as 1 percent between 2005-06 and 2007-08 (see Table 2.2). Major gains apparently have accrued to wheat farmers with large marketable surpluses. However, as unemployment has risen and food inflation has remained very high, it is difficult to avoid the impression that the low income groups who typically are net purchasers of food even in the rural areas have been squeezed. The incidence of poverty is thus likely to have risen. The reason why consumption gains per capita, however modest, have been possible is mainly due to a fairly sharp decline in gross fixed capital formation.

**TABLE 2.2**
**DOMESTIC ABSORPTION OF RESOURCES IN 1999-2000 PRICES**

| | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
|---|---|---|---|---|---|
| Consumption of which | 4297 | 4415 | 4571 | 4671 | 4802 |
| (Private) | (3708) | (3883) | (3831) | (4031) | 4130 |
| Investment including stocks | 924 | 1043 | 1084 | 1016 | 968 |
| (Of which gross capital formation) | (841) | (955) | (992) | (927) | (873) |
| Total domestic absorption | 5221 | 5458 | 5653 | 5687 | 5770 |

**Source:** Economic Survey, Government of Pakistan.

The current account balance of payments deficit during 2009-10 is expected to come down sharply to $ 5 billion or below 3 percent of GDP, a vast improvement over the totally unsustainable deficits of 8.4 and 5.6 percent of GDP during 2007-08 and 2008-09 respectively. Meanwhile, due mainly to the continued large support from the IMF and further allocation of SDRs, the foreign exchange reserves that had touched the low of $ 6.5 billion in November 2008 increased to $ 15 billion by April 2010. Meanwhile, year over year headline CPI inflation after bottoming out at 8.9 percent in October 2009 has risen to 13 percent in February-March 2010, though it is well below the peak of 25 percent in November 2008.

The resurgence of inflation in recent months suggests that the macroeconomic stability remains fragile. A more detailed analysis of the both the external and domestic finances adds to the worry that the macroeconomic stability would continue to require stabilization efforts and tight monetary and fiscal policies. Three issues thus arise. In what respect is the financial situation most vulnerable? How can the macroeconomic situation be kept from deteriorating? How best to protect the real economy, growth, and investment from the consequences of an extremely constrained financial situation in the near future?

## THE EXTERNAL ACCOUNT AND DEBT BURDEN

The improvement in current account of the balance of payments is mainly due to a continuous sharp rise in worker remittances and a steep drop in imports. Even though there has been a strong pickup in recent months, exports during 2009-10 are likely to be only moderately higher than their level in 2007-08. Pakistan's recent export trends show two somewhat contrasting developments On the one hand Pakistan does not seem to have been that badly affected by the very sharp drop of over 12 percent in the volume of world trade in calendar year 2009. On the other hand, WTO manufactured export figures show that Pakistan lost serious market share in 2005-08.Overall, it appears that despite some improvement in market share in 2009, for which data is not yet available, Pakistan is losing its competitive edge especially in its principal textile and clothing exports.

As Table 2.3 indicates, world manufactured exports expanded by well over 40 percent during the years 2005-08. China of course made the largest gain in the wake of the end of the international Multi-Fiber agreement. Its manufactured exports grew by more than 75 percent over a short three year period and it captured 20 percent of the world increment in exports. Major developing countries including India, Bangladesh, Vietnam made huge gains ranging from 100 percent in the case of Viet Nam to more than 50 percent for India and Bangladesh. Pakistan's gain in this period was a modest 14 percent and its market share that was already low dropped further from 0.18 to 0.14 percent.

**TABLE 2.3**
**WORLD MANUFACTURED EXPORTS**

| | Total Exports, 2008 [in US $ Billion] | Manufactured Exports [in US $ Billion] | | | Manufactured Exports Market Share (%) | | |
|---|---|---|---|---|---|---|---|
| | | 2000 | 2005 | 2008 | 2000 | 2005 | 2008 |
| China | 1430.7 | 219.9 | 700.3 | 1329.6 | 4.7 | 9.6 | 12.7 |
| Hong Kong | 329.7 | 192.4 | 279.9 | 348.0 | 4.1 | 3.8 | 3.3 |
| Korea | 422.1 | 154.9 | 258.2 | 365.0 | 3.3 | 3.5 | 3.5 |
| Singapore | 338.2 | 117.7 | 185.2 | 236.9 | 2.5 | 2.5 | 2.3 |
| Taipei, Chinese | 255.6 | 141.0 | 171.7 | 222.3 | 3.0 | 2.4 | 2.1 |
| Mexico | 291.3 | 138.6 | 165.0 | 212.3 | 3.0 | 2.3 | 2.0 |
| Malaysia | 199.5 | 78.9 | 104.9 | 129.9 | 1.7 | 1.4 | 1.2 |
| Thailand | 177.8 | 51.7 | 84.3 | 127.2 | 1.1 | 1.2 | 1.2 |
| India | 194.8 | 32.8 | 70.4 | 112.2 | 0.70 | 0.96 | 1.07 |
| Brazil | 197.9 | 31.7 | 61.8 | 86.4 | 0.67 | 0.85 | 0.83 |
| Turkey | 132.0 | 22.3 | 59.8 | 103.8 | 0.47 | 0.82 | 0.99 |
| Philippines | 49.1 | 34.8 | 36.7 | 40.5 | 0.74 | 0.50 | 0.39 |
| Vietnam | 62.7 | 6.2 | 16.2 | 32.7 | 0.13 | 0.22 | 0.31 |
| Pakistan | 20.3 | 7.6 | 13.0 | 14.9 | 0.16 | 0.18 | 0.14 |
| Bangladesh | 15.4 | 5.9 | 8.5 | 13.5 | 0.13 | 0.12 | 0.13 |
| Total for Above Countries | 4117.1 | 1236.3 | 2215.9 | 3375.1 | 26.3 | 30.3 | 32.3 |
| World Exports | 15800.0 | 4698.2 | 7303.8 | 10458.1 | 100.0 | 100.0 | 100.0 |

**Source:** Author's calculations using the WTO Statistics.

The major reason was the poor relative performance of only a modest increase in its clothing and textile exports over 2005-08.

As Table 2.4 shows this that rise compared very unfavorably with some other major exporters of textiles and clothing notably China, India, Bangladesh, Viet Nam and Turkey. Though power shortages and lack of new investment due to the security situation have added to the problems of the textile industry, lack of competitiveness remains its major problem.

**TABLE 2.4**
**TEXTILES AND CLOTHING EXPORTS OF MAJOR DEVELOPING COUNTRIES**

***($ billion)***

| | Textile Exports | | Clothing Exports | | % Change in | % Change in |
|---|---|---|---|---|---|---|
| | 2005 | 2008 | 2005 | 2008 | Textile Export | Clothing Exports |
| China | 41.1 | 65.3 | 74.2 | 120.0 | 59.0 | 61.8 |
| Hong Kong | 13.8 | 12.3 | 27.3 | 27.9 | -11.2 | 2.3 |
| Korea | 10.4 | 10.4 | 2.6 | 1.7 | -0.2 | -32.5 |
| Mexico | 2.1 | 2.0 | 7.3 | 4.9 | -6.8 | -32.8 |
| Malaysia | 1.4 | 1.5 | 2.5 | 3.6 | 14.2 | 46.2 |
| Thailand | 2.8 | 3.2 | 4.1 | 4.2 | 16.2 | 3.8 |
| India | 8.3 | 10.3 | 8.6 | 10.9 | 23.9 | 26.3 |
| Turkey | 7.1 | 9.4 | 11.8 | 13.6 | 32.8 | 14.9 |
| Indonesia | 3.4 | 3.7 | 5.0 | 6.3 | 9.6 | 26.7 |
| Philippines | 0.3 | 0.2 | 2.3 | 2.0 | -27.9 | -13.5 |
| Vietnam | 0.7 | 1.6 | 4.7 | 9.0 | 126.1 | 91.6 |
| Pakistan | 7.1 | 7.2 | 3.6 | 3.9 | 1.4 | 8.4 |
| Bangladesh | 0.7 | 1.1 | 6.9 | 10.9 | 54.6 | 58.5 |
| Total for Above Countries | 99.0 | 128.1 | 160.8 | 218.9 | 29.4 | 36.2 |
| World Exports | 204.3 | 250.2 | 277.1 | 361.9 | 22.4 | 30.6 |

**Source:** Author's calculations using the WTO Statistics.

Much of the improvement in the balance of trade during the last two years has been the result of a decline in imports. A part of this reflects the drop in petroleum imports that reached a peak in 2007-08 due to exceptionally high international oil prices. Excluding petroleum imports which remain high at $ 10 billion, imports have come down from $25 billion in 2007-08 to an estimated $ 20 billion in 2009-10, a drop of 20 percent. The virtual elimination of wheat imports and a reduction in raw cotton imports have contributed to this decline. But a significant decrease of nearly 30 percent has been in the machinery group from $ 5.7 billion in 2007-08 to an estimated $ 4.1 billion in 2009-10. Some of it is the slowdown in mobile phone and telecommunications imports, but other machinery imports have also dropped sharply confirming the impression of a serious slowdown in new investment.

Thus improvement in the current account balance of payments is being achieved, in part, at the cost of future growth. Moreover, even the smaller deficit is being financed from external flows that are not totally sustainable. The financing of the balance of payments deficit during the last two years has added considerably to its relatively short-term debt obligations and substantially worsened the foreign asset and liabilities position. More specifically, repayments obligations to IMF have become large and would beginning with 2011-12 involve large net repayments to IMF.

Pakistan external debt and liabilities have risen from $ 40 billion in mid 2007 to $ 55 billion at the end of 2009 and are expected to rise to $ 57 billion by mid 2010 (see Table 2.5). The ratio of external debt and liabilities to total foreign exchange earnings has risen from the low of 139 percent in 2005-06 to an estimated 175 percent in 2009-10. However, the rise in external debt, serious as it is, does not provide a full picture of Pakistan's total external obligations because a very large part of the deficits during the last few years have been financed through foreign private investment both direct and portfolio.

**TABLE 2.5**
**EXTERNAL DEBT BURDEN**

***($ billion)***

| | External Debt and Liabilities | Foreign Exchange Earnings* | External Debt as a Percentage of Foreign Exchange Earnings |
|---|---|---|---|
| 2005-06 | 35.7 | 25.7 | 138.8 |
| 2006-07 | 39.5 | 27.9 | 141.9 |
| 2007-08 | 44.5 | 32.1 | 138.6 |
| 2008-09 | 50.8 | 31.8 | 159.5 |
| 2009-10 (E) | 57.0 | 32.5 | 175.2 |

*Includes Exports(f.o.b.), Services (credit), Income (credit) and Workers Remittances

(E) Estimated

**Sources:** Authors calculations using SBP numbers.

According to State Bank of Pakistan's data, Pakistan's total foreign liabilities increased rather dramatically from $ 47 billion at the end of 2005 to $ 87 billion at the end of 2008 reflecting a much faster growth in equity flows than in loans (see Table 2.6). A rough estimate suggests that total foreign liabilities would exceed $ 100 billion by mid 2010. After taking into account Pakistan's foreign exchange reserves and other foreign assets, net foreign liabilities have risen from $ 29.2 billion at the end of 2006 to $ 69.9 billion at the end of 2009 and are estimated to reach $ 75 billion in mid 2010. As a percentage of total foreign exchange earnings, net foreign liabilities are now at 231 percent compared to 110 percent at the end of 2006.

**TABLE 2.6**
**INTERNATIONAL INVESTMENT POSITION**

***($ billion)***

| | Assets | Foreign Liabilities | Net Liabilities | Foreign Exchange Earnings | Net Liabilities as % of Foreign Exchange Earnings |
|---|---|---|---|---|---|
| 2004 | 17.0 | 43.6 | 26.6 | 20.2 | 131.6 |
| 2005 | 17.1 | 44.9 | 27.8 | 24.0 | 115.6 |
| 2006 | 17.7 | 46.9 | 29.2 | 26.5 | 110.0 |
| 2007 | 19.7 | 55.2 | 35.5 | 29.3 | 121.0 |
| 2008 | 22.7 | 73.5 | 50.8 | 33.8 | 150.3 |
| 2009 | 16.8 | 87.0 | 70.2 | 31.6 | 222.3 |
| 2010 (mid) | 26.0 | 101.0 | 75.0 | 32.51 | 230.7 |

**Source:** State Bank of Pakistan.

Pakistan needs to move to an asset- liability framework for managing its external accounts in formulating an external finance strategy. The rising importance of investment inflows makes a focus on external debt obligations alone less meaningful. For instance, in terms of debt service obligations in the current account, interest payments on external debt at $ 1.5 billion in 2009 were only a fraction of the total investment income payments of over $ 4 billion representing profit and dividends of foreign companies.

The State Bank of Pakistan carries out an annual survey of Pakistan's International Investment Position annually which includes detailed information on foreign assets as well as liabilities. There is however, a substantial time lag in the compilation and availability of this information. The latest provisional numbers are available only for the end of 2008. There is need for speedier production of this data and its greater integration with analysis of both Pakistan's current account balance of payment position and its net debtor position.

## THE FISCAL POSITION

The underlying fiscal position is even more challenging. The fiscal deficit target of 4.9 percent of GDP for 2009-10 is not likely to be met. The deficit in the first half of the year was 2.7 percent and according to the State Bank, even with proposed cutbacks in development spending in the second half could be in the range of 5.0-5.5 percent of GDP. As we have argued in the previous reports, there is a tendency to understate the actual deficit by not including the full losses of the public enterprises and obligations already incurred. A most unfortunate consequence of this has been not to fully resolve the problem of circular debt related to payments on account of oil purchases. This has resulted in the situation that some capacity for electricity generation has not been used while very extreme power shortages continue to exist. The taking of one off charge to accommodate past obligations would no doubt increase the notional deficit but would not have any negative economic effects. Indeed by ensuring greater transparency and eliminating the circular debt it would help in a much better functioning of the economy and greater accountability of public enterprises.

The tax revenue performance remains a matter of serious concern. FBR tax revenues in July-December 2009 were only 8.6 percent higher than in the same period last year. Since average inflation remained over 10 percent during the period, there has been a decline in real tax revenues. Inflation is now on the rise and is expected to grow by 11-12 percent for the full year 2009-10. Unless revenue collection improves markedly in the coming months, the tax to GDP ratio which was at the low level of 10.2 percent in 2008-09 will drop further.

Government's current expenditure is clearly on the rise driven by higher security spending, recent power subsidies and expenditure on internally displaced persons. The year over year increase in expenditure during the first half of 2009-10 was 15 percent in nominal terms and about 5 percent in real terms. Apparently the rise in security spending has not been offset by cuts in non- essential expenditure. The country is at war but there is no reflection of it either in tax collections or any visible sign of austerity in public spending.

Even though there was a surge in non-tax revenues reflecting State Bank of Pakistan profits, total revenues fell short of current expenditure by nearly Rs. 150 billion. At this rate, the revenue deficit for the year would touch a new record and negative government savings would exceed 2 percent of GDP.

The planned large increase in development spending during 2009-10 Budget is not likely to materialize as the development budget has been cut back because of slippages in tax revenue and revenue expenditure. Our best estimate based on figures for July- December 2009 is that development spending in 2009-10 is likely to decline in real terms and certainly would not match the rate of 3.7 percent of GDP attained last year.

The financing of the fiscal deficit has not improved much. The reliance on borrowing from the central bank has been reduced but the reliance on commercial banks remains high partly because external assistance under Tokyo pledges has not materialized to the extent expected. The government has, however, been able to raise money from non- bank sources, mainly savings schemes, during July-December 2009 in excess of target. Non- bank financing sources provided nearly half of the financing of the overall deficit during the first half. Under the present circumstances when new investment is being constrained not so much by financial constraints but by security considerations, it makes sense to mobilize private savings for budgetary purposes reducing further the reliance on bank financing.

## CONSUMPTION AND INVESTMENT

Despite the government's ongoing stabilization efforts under the IMF program, inflation remains high and could accelerate in coming months. To an extent the rise in prices is inevitable because it represents necessary adjustment in energy prices and pass- through of exchange rate depreciation. The recent rise in international oil and other commodity prices would intensify the cost push pressures. This points to the importance of keeping demand pressures under control, to remove the structural rigidities in domestic commerce and to exercise special regulatory vigilance against cartels and price fixing. Reducing the inflation rate to below double digit level should be a paramount objective.

More fundamentally, the economy needs to strike a better balance among key economic aggregates, consumption, savings, investment and tax collections. Total consumption in Pakistan in 2008-09 was 90.1 percent of GDP at current market prices while private consumption was over 79.4 percent. In China the latter ratio is was only about 38 percent. This suggests that though China had a per capita income ($6600), in purchasing power parity terms, of more than double the level of Pakistan ($2600) in 2009, the average per head private consumption in China in 2008, was only 22 percent or so higher than in Pakistan. This conclusion might seem hard to believe but it is the direct result of the Chinese as a nation saving a large part of their income.

The Indian numbers indicate that while per capita income is about 10 percent higher than in Pakistan private consumption per head is actually lower than ours.

The Pakistan society has suffered a great deal during the last three years due to terrorist attacks that threaten the state and power shortages and load shedding that are destroying economic activity. Still, while the government expenditure on fighting terrorism has gone up sharply, private consumption has continued to grow through the recent crisis years notwithstanding the sharp losses in income due to higher oil prices. Increases in consumption are of course very desirable and are a major objective of development but in Pakistan they have come during the last three years at the cost of lower investment, lower tax revenues and persistent high budget deficits. Notwithstanding average increases in consumption levels, the poverty incidence has continued to increase mainly because inflation especially food inflation has hurt the poor the most.

Gross fixed capital formation declined by 6.5 percent during 2008-09. The sharp drop in machinery imports and very high prices of construction materials, notably cement and steel, suggest that there would be a further drop in real terms of 6-7 percent in the current year. In 1999-2000 prices, the rate of gross fixed capital formation is down to 14.7 percent of GDP, lower than a decade earlier and clearly not high enough to support a strong revival of growth in the very near future.

There are serious problems also with the pattern of investment. The neglect of energy investments during 2000-08 is well known. It is less clearly realized that investment in agriculture and manufacturing were also not at all adequate during the last decade. The investment boom between 2002-03 and 2007-08, an average increase of 12 percent per annum in real gross capital formation, was led by service related activities notably

**TABLE 2.7**
**GROSS FIXED CAPITAL FORMATION**
**(Excluding General Government)**
**BY ECONOMIC ACTIVITY**
**(At constant prices of 1999-2000)**

***(Rs. Billions)***

| | 2002-03 | 2006-07 | 2007-08 | 2008-09 |
|---|---|---|---|---|
| Private & Public Sector | 577.3 | 776.7 | 806.6 | 746.5 |
| Agriculture | 66.8 | 70.9 | 64.5 | 59.5 |
| Mining and Quarrying | 66.7 | 32.6 | 36.2 | 45.9 |
| Manufacturing | 149.3 | 179.5 | 165.6 | 148.5 |
| Large Scale | 121.0 | 142.4 | 125.0 | 104.1 |
| Small Scale | 28.3 | 37.1 | 40.6 | 44.4 |
| Construction | 6.6 | 26.8 | 21.3 | 19.8 |
| Electricity & Gas | 50.1 | 32.8 | 35.1 | 24.6 |
| Transport and Communication | 74.2 | 197.2 | 203.2 | 168.0 |
| Wholesale and Retail Trade | 11.7 | 22.6 | 23.8 | 23.1 |
| Finance & Insurance | 21.3 | 48.5 | 81.0 | 74.4 |
| Ownerships of Dwellings | 83.2 | 94.2 | 96.7 | 99.4 |
| Services | 50.0 | 71.8 | 79.1 | 83.4 |

**Source:** Economic Survey of Pakistan, Government of Pakistan.

telecommunications and finance and public sector development spending. Real investment in financial sector grew by nearly fourfold and growth in cellular phone investments was truly spectacular (see Table 2.7). But investment in large scale-manufacturing and agriculture grew relatively little. In 2008-09 manufacturing investments shrank by about 9.0 percent and were only 2.5 percent of GDP. Indications are for a further significant decline in the current year.

In the short- run, it is not the capacity but the power availability and weak demand that are the most binding constraints on industrial growth. Large-scale manufacturing which showed a drop last year would show only a modest growth of 5 percent in the current year, Agricultural growth was boosted in 2008-09 by the high support prices for wheat that considerably improved agricultural terms of trade. But the prospects for agricultural growth this year do not appear to be favorable even though last year's high support prices for wheat have been maintained for the 2010 crop. Meanwhile, international prices of wheat have dropped and the government is having to export a large surplus of 3.5 million tons at a considerable loss. Diversion of acreage to wheat from sugarcane was reportedly a factor in accentuating sugar shortages this year.

## CONSTRAINTS TO GROWTH

Pakistan's faces several major and inter-linked constraints on growth, a continued difficult security situation which is undermining the investor confidence in the economy and probably encouraging capital flight, a considerable loss of competitiveness in manufactured exports that is accentuated by lack of adequate investments in industry and human capital and still sizable macroeconomic imbalances that limit the options for public spending and credit expansion.

In the face of these multi-dimensional challenges, future growth path is uncertain and revival to a desired high growth rate of 6-7 percent per annum is not yet in sight. But the period of slow (but hopefully rising) growth and the overhang of financial problems can and must be used to address the structural problems of quality of governance, effectiveness of resource use, incentives for innovation and high productivity, reward for merit, and accountability and punishment for wrong doing.

What are needed are not brave new economic policies but a determined national endeavor to improve the quality of public and private efforts that can help to improve the quality of life for most citizens while laying the foundations for sustained long term growth.

Much would depend on improved governance in a decentralized setting. There have been three historic changes during the last year that have greatly improved the chances for a stronger and more prosperous Pakistan. The determined military action against the very serious threat to the state from the extremists, a new National Finance Commission award that transfers more resources to the provinces especially to Baluchistan, and the 18th Amendment to the Constitution that fully restores a parliamentary democracy while devolving much more authority to the provincial governments.
All are steps that would strengthen the Federation and create conditions for a shared exercise

of power.

Still, the current economic and political situation remains difficult. The trust in the government and the political leadership is not high. The political leadership can gain greater confidence of the public only by greater transparency and accountability, control of corruption, and a strong commitment to avoid waste and ostentatious behaviour. Pakistan's economic problems would not be solved without greater restraint on both private and public consumption. But the leadership must be both courageous and credible if it is to appeal effectively to the public to join the war against extremists by restraining wasteful consumption and being more responsible in paying taxes. There are as yet no signs that less essential public expenditure, either current or developmental, is being curtailed or any hard choices are being made.

## AGENDA FOR REFORMS

A successful introduction of the value added tax in the coming months would be a test for government's will to collect additional taxes. It does not appear that the public and the principal economic agents have been adequately prepared. In the longer run the VAT would help to raise tax revenues by 1.5-2 percent of GDP. But the introduction of VAT should not be treated just as an issue of IMF conditionality.

A total restructuring of the individual income tax regime appears urgent. The present collections from non-salary individuals are small. Most of the tax is collected through withholding taxes on exports, bank interest etc. It is necessary to make income tax a more progressive instrument of taxation considering the rising income inequalities that are exacerbating social tensions. The Revenue Advisory Council should make recommendations for the overhaul of the system. Examining the present structure of taxation should be a part of its work.

One area where the tax efforts have been lagging is provincial taxation which is now less than 0.5 percent of the GDP, less than half the level three decades ago. The low property taxation in a situation where real estate values have been climbing steadily is a direct subsidy to the rich and upper middle classes who are the main beneficiaries of the municipal services. With greater delegation of functions to the provincial governments, the political case for greater provincial tax effort has also become stronger.

We have argued in earlier reports for full transparency in the fiscal deficit. All expenditures that have already been made should be reflected in the budget numbers. Hiding of public enterprise losses either as arrears or by recourse to short-term borrowing from the banks does not help sound fiscal management. In our circumstances when public enterprise losses are reportedly running at around 1.5 percent of GDP, it would make a great deal of sense from a policy point of view to adopt a broader definition of fiscal deficit to include public enterprise losses As discussed earlier, this would increase both transparency and accountability by indicating clearly what progress was being made to eliminate public enterprise losses.

Once it is recognized that the full fiscal deficit is at least around 7 percent of GDP, the adjustment path could be somewhat less steep than indicated by the IMF. A realistic policy goal would be to reduce the overall deficit by 0.5 percent per annum over the next three years to say 5 percent of GDP.

There are no compelling reasons to reduce the fiscal deficit to less than 3 percent of GDP by 2012-13 as suggested by IMF provided the revenue deficit is eliminated over this period i.e. the deficit almost entirely finances development expenditure. Because of the low level of private investment, the scope for raising funds through non- bank borrowing appears substantial (perhaps as much as 2 percent of GDP annually). The foreign loans and grants disbursements under Tokyo pledges have been very slow this year but could pick up in the next two years. As inflation will at best come down slowly, below 10 percent per annum, the inflationary tax seignorage would yield at least 1.5 percent of GDP.

With the suggested deficit levels, the ratio of public debt to GDP would remain somewhat above 65 percent for a few years. However, a more relevant criterion for the public debt burden is, the ratio of total revenues to total public debt, which should improve provided additional tax efforts are successful. It should also be noted that the real cost of government borrowing i.e. nominal interest rate paid adjusted for inflation are still low. It is not the level of deficit but the raising of the ratio of taxes to GDP which is the most critical fiscal issue for the near term.

The endorsement of a somewhat larger fiscal deficit and a strong push for growth in development spending comes with another very important caveat-the need for much greater attention to the quality, economic impact and the timeframe of benefits of the project outlays. During 2002-07, the development program expanded very substantially in real terms - in the range of 60-70 percent and in view of expanding fiscal space, the standards were relaxed and effectiveness of spending suffered. Under political pressures, many new projects have been added under the new government and thus the resources are spread too thinly.

Even with our recommendations, the development spending is unlikely during the next few years to exceed the peak of 5 percent of GDP reached in 2006-07. With constrained resources on the one hand and pressing needs for water, power, agriculture and education on the other, a re-prioritization and restructuring of the development program appears essential A thoroughgoing review of the existing programs should be undertaken at both the Federal and Provincial levels. The objective should be a better focus and clearer delineation of priorities and the weeding out of low priority spending.

In the balance of payments field, the links between the two priority goals, export development and revival of foreign private investment, need to be recognized more clearly than was done in the past. As is well known, very little of the surge in foreign private investment during 2006-08 (See IPP 2008 Report p.32) benefited either the export or the manufacturing sectors. Though it might not be easy to elicit foreign private interest in these areas because of the security situation, private efforts and public policy must explore promising sources of financial and technical assistance.

Unfortunately, the very ambitious textile sector strategy for 2009-14 does not stress the role foreign investment can and must play in upgrading and expansion and skill development in this important sector. In the absence of large foreign investment flows, it would be almost impossible even to approach much less reach the target of increasing textile sector exports from $10 billion in 2008-09 to $ 25 billion in 2013-14.

The foreign private investment in textiles should be targeted from countries where textile exports are weakening (Hong Kong, Korea, Turkey). Even foreign investment from China should not be ruled out. Even though Chinese textile exports are still expanding strongly, these exports are becoming less important for China and would face a declining trend a few years down the road.

The aim should be to scale up the textile mills to international standards. But this would not happen if the inefficient and sick textile mills are not allowed to die and periodically receive government bailouts. As a matter of principle, future support to textile and other industries should be limited to incentives for new investment and skill upgrading and development

The changes required to stimulate manufacturing and exports with the help of foreign investors would not happen without strong government diplomatic support for the private sector initiatives. Large and persistent trade deficits with China and India can form a basis for exploring the possibilities of much larger exports to these two fast expanding economies. Implementation issues in agricultural exports to China and Chinese trade zone also deserve close attention.

The present government has been rightly stressing the critical importance of reviving the agricultural growth rate, from the underlying growth rate of less than 3 percent to 4 percent per annum. The very sharp increase in the support price of wheat in late 2008 was a bold step and has delivered results but at a cost. There are obvious limits to government price interventions that add to the fiscal burden. Provincial governments must look for areas that can raise productivity in the short term without huge costs.

Four areas appear specially promising. First, the strengthening of the links between agricultural research and extension. With a large majority of farmers being illiterate, well organized campaigns supported by political efforts to improve the effective use of agricultural inputs, seeds, fertilizer and pesticides could have an important pay off. Second, the adulteration in the supply of inputs, seeds, fertilizer, and pesticides remains a major problem. Effective regulation in this area could also yield important dividends. Third, the optimal use of available water resources remains a critical and strategic long term issue. But as past experience has shown, even in the short term public and private sector efforts to level land and line water courses can yield high economic returns. Restructuring of public sector programs to find resources for quick yielding short-gestation projects would make sense. The political resistance to low water rates which accentuate the waste of water must be overcome. Finally, agricultural export potential especially in fruit and vegetable remains greatly under-exploited. Here again, state efforts in removing bottlenecks is considered very important.

There cannot be a quick turn around in the investment climate unless there is a marked improvement in the security situation. However, it is not too early to give serious attention to long term issues that have kept Pakistan's savings and investment ratios so low historically- there has not been much improvement in these ratios for the past several decades even though there have been brief spurts of saving and investment growth.

On the investment side, several areas require analysis and policy action. The increase in the relative prices of investment goods compared to the general price level in recent years is disturbing. This faster rate of inflation in investment goods prices simply reduces the value of a given level of savings. The reasons for this trend need to be examined and rectified to the extent possible.

As noted earlier, the incentive structure should be tilted towards new technology enhancing investment rather than keeping the outmoded technologies and uncompetitive capacity alive especially in the textiles, the country's largest industry and the most important export sector.

The great imbalance that has developed between investment in manufacturing and in services needs to be reversed. This imbalance has been partly the product of foreign investment inflows that have heavily favoured the finance and telecommunications sectors. The government must play a major role in attracting foreign investors into export oriented manufacturing and agricultural development. Our twin problems of a lag in exports and low competitiveness cannot be resolved without a substantial injection of foreign capital and know-how especially in the textile sector. If necessary, the government should be willing to goad five or six major industrialists to seek partnership with interested parties in China, Korea, Hong Kong and Turkey while using diplomatic efforts to advance the country's interests.

On the savings side, determined political leadership can send strong signals for frugal behavior by setting examples of avoiding ostentatious behavior and practicing genuine austerity that have been sadly lacking even in these difficult times.

The instruments for personal savings do not offer attractive choices. The real returns on bank saving deposits remain substantially negative. The saving schemes are cumbersome, do not have wide reach, and offer only locked in returns for longer maturities. The switch to tradable packaged smaller denomination public investment bonds of various maturities is long overdue but assumes that the government is willing to borrow on market determined rates.

On a broader level, since Pakistan is a very open economy with not very effective capital controls, the maintaining of a market determined exchange rate is crucial for confidence in the currency and avoiding capital flight. In the absence of the confidence that the rupee will continue to lose real value, even housewives will opt for keeping their savings in US dollars bought from the exchange dealers.

The inter-related issues and balance of payments viability and exchange stability are also very important for the foreign investor. As discussed earlier, Pakistan's external debt has grown sharply during the last few years and the net foreign investment position has deteriorated greatly. Even on the assumption that the current account balance of payments can be kept in the range of 3 percent of GDP annually, the gross inflows needed would be $ 10billion a year for the next several years. This would require large loan as well as equity inflows, sources of which are not clear as yet. The foreign exchange reserves have risen to a more adequate levels but it is also well known that large repayments to the IMF will begin in 2012 and will average $ 2.7 billion over the four years 2011-12 to 2014-15.

The foreign investors are well aware of the difficult road ahead for Pakistan's balance of payments. This adds to the concerns they have about the immediate security position. The government can help remove uncertainty about the future foreign exchange position only by recognizing the magnitude of the problem and presenting a credible medium term framework for balance of payments management. We have argued in the previous reports for the need for developing a clearly formulated external finance strategy which would have the goals of keeping balance of payments within sustainable limits and gradually bring down the relatively high exposure to external debt and foreign equity.

Until such time that exports show a clear rising trend, Pakistan should try to keep the current account deficit including external grants at around 3 percent of GDP. The aim should also be to bring down the net foreign investment position from 230 percent of annual foreign exchange earnings to 200 percent over a five year period. This would be broadly consistent with an annual average current account deficit of $ 6-8 billion over the next five years depending on the growth rate of foreign exchange earnings. Hopefully, Pakistan can obtain another $ 500 million annually in external grants.

The external finance strategy should have an explicit foreign exchange reserve policy. Substantial volatility in the payments position is unavoidable because of uncertainty about the future and growing openness of the Pakistan economy. In order to deal with risks, there is a need to build up foreign exchange reserves to even more adequate levels to deal with unexpected shocks and shortfalls. The foreign exchange reserves are currently only a little over 4 months of foreign exchange payments. The goal should be to maintain this ratio and if possible to increase it over time to 5-6 months' of foreign exchange payments. The making of large repayments to IMF during 2010-11 to 2013-14 could compromise this goal. This would be unfortunate because it is likely to adversely affect foreign confidence. However, as outlined in the Executive Summary, Pakistan should be willing to walk away from the IMF if an agreement on a fiscal framework that slowly but surely revives growth and keeps the incidence of poverty from rising.

But regardless of IMF conditionality, it would be economically disastrous if Pakistan cannot reverse the declining trend of tax revenues to GDP. There is plenty of scope for raising revenues through expenditure, capital gains and more effective income taxation. By all indications the consumption levels of the elite and well to do have not been adversely effected by the national crises which the country has faced during the last three years, while the poor have suffered greatly. At the same time there is great room for increasing the effectiveness of public spending by weeding out low priority and largely politically motivated spending. What is needed is a strong political will. But a strong will alone cannot be exercised unless government regains the confidence of the people and the trust of the populace through better governance and high standards of probity. The passage of the 18th amendment to the Constitution and the new National Finance Commission award are historic changes which can spell a genuine transfer of public authority and functions closer to the people. However, to translate the potential of these changes into a better quality of life, one would need politicians and public servants that enjoy high reputation for competence and integrity and are willing to subordinate narrow personal interests for sake of bringing fundamental changes in society.

# Chapter - 3

# The Relationship with the IMF: Stay in Or Exit?

# Chapter - 3
# The Relationship with the IMF: Stay in Or Exit?

Pakistan has had a long history of going on and off IMF programs since 1988. During the decade of the 90s, Pakistan sought IMF assistance at different times when foreign exchange reserves were depleted and had fallen to critically low levels. After the nuclear explosions and the imposition of sanctions on Pakistan by the US a particularly tough program was negotiated with the IMF involving a sharp process of adjustment in the economy focusing on the rapid elimination of macroeconomic imbalances.

This program was successful in bringing down sharply the current account deficit in the balance of payments from over 4 percent of the GDP in 1998-99 to a virtual surplus in 2001-02. The inflation rate also remained low at below 4 percent while the fiscal deficit was contained at about 4.5 percent of the GDP. But the process of severe contraction of aggregate demand in the economy implied a very low growth rate of the GDP of only 3 percent. Consequently, there is evidence that unemployment and poverty rose sharply during this period. In other words, it can be said that 'the operation was a success but the patient (nearly) died.'

Following the rescheduling of debt and the large inflow of bilateral concessional assistance in the aftermath of Pakistan joining the War on Terror in 2002, the diminished need for IMF support enabled the government to make an exit from the on-going PGRF program in December 2004, with the proud announcement that Pakistan would never go once again with a 'begging bowl' to the IMF. This policy proved successful over the next three years as Pakistan was able to finance its growing current deficits with larger inflows of FDI, privatization receipts and concessional bilateral assistance.

But history has a nasty tendency of repeating itself. The large oil price shock in 2008 along with the rise in commodity prices, especially of food items like wheat and edible oil, led to a severe haemorraging of the foreign exchange reserves in the first ten months of 2008.By October 2008, reserves of the SBP had fallen from $13.1 billion in December 2007 to $3.3 billion. The rupee had started declining rapidly and had depreciated already by over 30 percent. The newly elected government had hoped initially to mobilize large-scale support on a bilateral basis from donors following the return to democracy and the on-going War on Terror but it soon became clear that this would be forthcoming only under the umbrella of a comprehensive Fund program, with well-defined macroeconomic targets, policy conditionalities and structural benchmarks.

## THE IMF SBA

The SBA reached with the IMF in November 2008 can be considered as 'soft' by historical standards. Not only was the quantum of credit promised very large, initially at $7.6 billion and then augmented to $11.4 billion, in relation to programs earlier which were generally below $2 billion in size but the process of structural adjustment was also expected to be more gradual in character. Most of the policy conditionalities were 'backloaded' in character and to be implemented in the latter part of the program period. The Fund largely accepted the 'home grown' program prepared by the Government with the help of the Advisory Panel of Economists to the Planning Commission. The only significant move expected initially was a hike in interest rates, of two percentage points, in the policy rate of the Central Bank.

On top of this, the program had a focus on social protection so as to soften the impact of the process of adjustment on the poorer sections of society. Consequently, the program supported the up-scaling of the Benazir Income Support Program, subject, of course, to its effective implementation.

The schedule of flow of funds from the program is given in Table 3.1. Each successive tranche was to be subject to a periodic review, with a gap of about three months each time. In mid-2009 the Fund took the unprecedented step of providing for a fiscal augmentation of $1.4 billion to enable Pakistan to tide over liquidity problems in the budget of 2009-10, arising from any delays in the inflow of funds committed by the Friends of Democratic Pakistan (FoDP) as part of the Tokyo pledges.

**TABLE 3.1**
**FUNDING FROM IMF-SBA**

***($ Million)***

| Amount Received | Funding** | Amount Due | Funding |
|---|---|---|---|
| Following Board Approval (November 2008) | 3170 | Following Fourth Review (February 2010) | 1541* |
| Following First Review (March 2009) | 871 | Following Fifth Review (May (2010) | 1176 |
| Following Second Review (August 2009) | 1907* | Following Sixth Review (August 2010) | 1176 |
| Following Third Review (November 2009 | 1541* | Following Seventh Review (November 2010) | 1176 |
| **Total Received** | **7489** | **Total Due** | **5069** |
| | | **Total*** ** | **12558** |

* Including fiscal augmentation
** 1 SDR = 1.5338$
***700% of quota
**Source:** IMF (2009)

Given the softness of the Program initially, Pakistan has performed relatively well in meeting the macroeconomic targets, performance criteria and structural benchmarks. Four reviews have been completed successfully and Pakistan has received installments adding up to $8.3 billion, including the initial payment of $3.2 billion following the signing of the Program. The fourth review was completed in February 2010 with the agreement to enhance the fiscal deficit target to 5.1 percent of the GDP from 4.9 percent. But the IMF Board meeting to release the amount due has been delayed, given growing apprehensions about implementation of conditionalities relating to the introduction of the VAT and a rise in power tariffs.

## EVALUATION OF THE PERFORMANCE UNDER THE IMF PROGRAM

Any evaluation of the Fund program since late 2008, over the last eighteen months or so, is rendered difficult by the absence of a 'counterfactual', that is, the economic situation that would have prevailed in the absence of the Program. There is no doubt that in the immediate aftermath of the signing of the Program in November 2008, considerable stability was restored to the markets, especially in the value of the rupee, which has shown only a relatively small change in nominal terms up to now. In fact, the immediate impact was some appreciation in the real effective exchange rate.

### Growth

Of much greater concern is the subsequent impact on the rate of growth of the economy. As highlighted earlier, the experience with earlier IMF programs in Pakistan is that while they help in macroeconomic stabilization they are generally detrimental to growth prospects. In fact, there was a quantum decline in the growth rate of the economy from an average of 6.8 percent from 2002-03 to 2006-07 to 4.1 percent in 2007-08 and 2 percent in 2008-09, with the likely outcome of just over 3 percent growth in GDP in 2009-10 (see Table 3.2).

**TABLE 3.2**
**ORIGINAL* MACROECONOMIC FRAMEWORK OF THE IMF PROGRAM**

| | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 |
|---|---|---|---|---|---|---|
| GDP Growth Rate (%) | 3.0 | 4.0 | 4.5 | 5.0 | 5.5 | 6.0 |
| Investment (% of GDP) | 18.5 | 20.9 | 21.5 | 21.7 | 22.7 | 23.2 |
| Of which: | | | | | | |
| Government | 3.3 | 4.4 | 4.7 | 4.8 | 5.1 | 4.9 |
| Non-Government* | 15.2 | 16.5 | 16.8 | 16.9 | 17.6 | 18.3 |
| Current Account Deficit (% of GDP) | -4.2 | -4.6 | -4.5 | -4.2 | -3.8 | -3.5 |
| National Savings (% of GDP) | 14.3 | 16.3 | 17.0 | 17.5 | 18.9 | 19.7 |
| Fiscal Deficit (% of GDP) | -4.9 | -4.1 | -3.2 | -3.0 | -2.08 | -2.3 |
| Public Expenditure (% of GDP) | 19.5 | 19.3 | 19.1 | 19.1 | 19.2 | 19.1 |
| Current Expenditure (% of GDP) | 16.0 | 14.9 | 14.4 | 14.3 | 14.1 | 14.2 |
| Development Expenditure (% of GDP) | 3.4 | 4.4 | 4.7 | 4.8 | 5.1 | 4.9 |
| Revenues (% of GDP) | 14.6 | 15.2 | 15.9 | 16.1 | 16.4 | 16.8 |
| Tax Revenues (% of GDP) | 10.7 | 11.4 | 12.2 | 12.7 | 13.0 | 13.4 |
| Non-Tax Revenues (% of GDP) | 3.9 | 3.8 | 3.7 | 3.4 | 3.4 | 3.4 |
| Rate of Inflation (%) | 11.0 | 7.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| MEMO ITEM | | | | | | |
| Current Account Deficit ($ billion) | -7.5 | -8.6 | -9.0 | -8.9 | -8.7 | -8.5 |
| FE Reserves** ($ billion) | 14.1 | 17.2 | 17.8 | 16.8 | 15.4 | 15.4 |

* Private Sector plus non-state enterprises
** End of Period
**Source:** IMF (2009)

How much of the decline in growth since 2007-08 is attributable to policies adopted as part of the Fund program? Disentangling the impact of various factors on the loss of dynamism of the Pakistan economy is, of course, a difficult exercise especially in view of the operation of a large number of factors. First, there was the global financial crisis and a slowdown in world trade which impacted negatively on most economies. For example, Pakistan's exports also declined in 2008-09 by as much as 6 percent.

Second, the intensification of military operations in the North and concomitant increase in terrorist attacks at various locations in the country inevitably led to some disruption in economic activities and heightened risk perceptions on the part both of foreign and domestic investors. In fact, there has been a sharp fall in private investment in 2008-09 of almost 9 percent, with the likelihood of another large decline in 2009-10. It is clear that the umbrella of a large IMF program has not been able to build investor confidence due particularly to the on-going War on Terror and growing problems of governance in the country, referred to elsewhere in the Report.

Third, the emergence of major infrastructural bottlenecks has created major supply-side constraints to growth. This is most acutely manifested in the high incidence of power outages alongwith more recently, water shortage in agriculture and gas load shedding. Chapter 4 of this report quantifies the loss to the economy of power outages. The industrial sector, in particular, was severely hit with negative growth for the first time after near double-digit growth for many years.

In the presence of the above factors, a substantial fall in the GDP growth rate was probably inevitable, but there are elements in the Fund program which have contributed further to the process of retardation of growth. First, the reduction in the fiscal deficit by almost 2.5 percentage points of the GDP in 2008-09 meant that the size of the PSDP had to be curtailed from 4.1 percent of the GDP in 2007-08 to 3.5 percent. Public sector development expenditure is directly needed at this time not only to remove the growing infrastructure deficits and thereby 'crowd in' private investment, but also in playing a multiplier role in stimulating employment and incomes.

Second, the rise in interest rates in the early days of the Fund program may have also dampened private investment especially when combined with high levels of risk perception. Overall, the potentially positive impact of macroeconomic stabilization on private investment has been largely non-existent, while the resort to a restrictive fiscal policy has limited the scope for rapid growth.

### Inflation

At the time of the commencement of the IMF program inflation had reached high levels, especially in energy and food prices. The rate of increase in the CPI peaked at over 25 percent in August 2008 on a year-to-year basis and has shown a decline to 9 percent by October 2009. This has, of course, been facilitated by the precipitous fall in commodity prices, especially of oil. In addition, the resort to a tight monetary policy has limited growth in M2 to only 9.6 percent in 2008-09 and to 5.5 percent in the first ten months of 2009-10.

But the worrying recent development is the upsurge in prices since October 2009. The year-to-year inflation rate is back to a double-digit rate of over 13 percent and there are fears that high inflation is becoming entrenched in the economy. The major contributory factor to recent inflation is the rise in administered prices of POL products, power and gas. As part of the conditionalities in the IMF program the government is committed to a sharp rise in power tariffs, two thirds of which has already been implemented.

Therefore, while the program has helped in containing aggregate demand through contractionary monetary and fiscal policies and thereby limiting demand-pull inflation, the opposite effect has been exerted through cost-push inflation, especially by the hike in energy prices.

## Macro Economic Imbalances

### *Fiscal situation*

There was a phenomenal increase in the fiscal deficit in 2007-08 to 7.6 percent of the GDP due primarily to the lag in adjustment of domestic POL prices to the jump in oil prices globally. This had led to record levels of borrowing from the Central Bank of over Rs 688 billion and exacerbated inflationary pressures in the economy.

The newly elected government moved decisively following takeover to adjust POL prices and eliminate the large oil subsidy. Current expenditure was brought down by over 2 percent of the GDP in 2008-09. Simultaneously, as highlighted above, entry into the Fund program implied a scaling down of development expenditure from 4.1 percent of the GDP to 3.5 percent. But here was a sizeable shortfall in the attainment of the FBR tax revenue target of almost Rs 100 billion, due primarily to contraction in the two major tax bases in the economy - large-scale manufacturing and imports. Consequently, the reduction in the fiscal deficit was restricted to less than 2.5 percent of the GDP.

The fiscal targets agreed with the IMF for 2009-10 involved a relatively minor decline in the fiscal deficit from 5.2 percent to 4.9 percent of the GDP. This enabled the government to target for an almost 26 percent increase in the national PSDP on the back of an expected increase in tax revenues of almost 20 percent. Assumptions about financing the deficit were also optimistic based on a jump in net aid inflows, especially from the FoDP.

As the year has progressed, it is becoming increasingly clear that most of the targets in the current budget will not be met. To start with, current expenditure could be almost Rs 250 billion higher than envisaged due, first, to larger costs of military operations in the North and, second, the need to carry a larger subsidy to the power sector. On top of this, FBR revenues could fall short of target by over Rs 50 billion due to a slower recovery in manufacturing and continued fall in dutiable imports. Non-tax revenues have been limited by the delayed disbursement of funds from the Coalition Support Fund (CSF) of Rs 128 billion.

The deficit could approach 5.5 percent of the GDP in 2009-10 depending upon the extent to which CSF funds are received in the second half of the year. This is after a draconian cut of over

40 percent in the PSDP. Not only is the fiscal deficit likely to be larger but financing it will prove to be more difficult due to the failure of FoDP commitments of aid to materialize. Almost Rs 600 billion of domestic borrowing may have to be resorted to that would put enormous pressure on the banking system.

The lessons learned already regarding fiscal management during the tenure of the IMF program include, first, the need to avoid over-ambitious targets for growth of tax revenues at a time of relatively slow growth in the economy, second, appreciation of the fact that Pakistan is effectively a war economy and a policy of business-as-usual cannot be followed at this time especially in terms of the degree of fiscal adjustment, third, recognition of the high costs in terms of future growth of drastic scaling down of the development program (to a low of below 3 percent of the GDP in 2009-10), fourth, that the initial assumption that larger bilateral aid inflows will come under the umbrella of a Fund program is not valid.

***Balance of Payments***

The major good news on the economic front is the sizeable improvement in the balance of payments of the country. The current account deficit which attained a peak of $13.9 billion in 2007-08 declined to $9.3 billion in 2008-09 and is expected to fall further to about $5 billion (2.8 percent of the GDP) in 2009-10. During the months of February and March 2010 the deficit has been virtually eliminated. Even though the capital account of the balance of payments has worsened due to reduced FDI, there has been a build up of foreign exchange reserves to about $ 15 billion currently, equivalent to about five months of imports.

Why has there been such a large improvement (of almost 5.5 percent of the GDP) in the current account of the balance of payments? Clearly, the decline in commodity prices from peak levels of 2008 has helped in reducing the import bill by 10 percent in 2008-09 and by a further 9 percent in the first nine months of 2009-10.The policy of substitution of food imports by an aggressive domestic (procurement) pricing policy has also worked and wheat imports of almost one billion dollars have been eliminated.

It needs to be recognized, however, that the process of macroeconomic adjustment has also contributed to improving the balance of payments position. The massive depreciation initially in 2008 in the exchange rate has played an important role in bringing about import compression in the economy. The import bill of Pakistan had been artificially inflated by years of virtual nominal exchange rate stability. On top of this, the management of aggregate demand through contractionary fiscal and monetary policies under the aegis of the IMF program has also reduced the pressure on the balance of payments. The consequence is that one target in the Fund program which will be overachieved in 2009-10 relates to the balance of payments. The current account deficit will be almost $2.5 billion less than the level projected for the year.

The question that will be asked is how has Pakistan achieved such a spectacular improvement in the balance of payments while experiencing at the same time a deterioration in the fiscal deficit. The answer lies in applying the Keynesian identity, according to which the private sector has generated a larger surplus, measured by the difference between its savings and investment. The latter has fallen in 2008-09 and (likely in) 2009-10. Therefore, in macro terms, the bigger public sector deficit is being financed by the larger surplus generated by the domestic private sector on the one hand and smaller foreign savings (equivalent to the current account deficit) on the other. This position could change somewhat as private investment recovers in the economy.

## FUTURE OF THE IMF PROGRAM

Transitional difficulties are currently being experienced in the relationship with the IMF. For the first time the release of a tranche that was due following review of performance (upto December 31st 2009) has been delayed. The IMF Board is now scheduled for May 14 to discuss the release of funds to Pakistan. Apparently, the government has removed the apprehensions of the Fund during the recent negotiations about implementation of the VAT by July 1, 2010 and enhancement in power tariffs. Therefore, it can be expected that the amount due will be released.

In view of the worsening of the fiscal situation, the Government had requested for an enhancement in the fiscal deficit target from 4.9 percent of the GDP to 5.1 percent of the GDP for 2009-10. It is clear now, as highlighted above, that the fiscal deficit could be even higher due to delayed releases of CSF funds and to some shortfall in tax revenues. It remains to be seen if these slippages will also be condoned by the Fund, especially in view of the improved performance on the BoP front.

The future of the on-going IMF program, which ends in December 2010, will hinge crucially on agreement on fiscal targets for 2010-11. If the original fiscal framework set up with the IMF is followed then the fiscal deficit target will have to be 4.1 percent of the GDP in 2010-11. Given the higher deficit likely in 2009-10, this will imply a sharp fiscal adjustment of almost 1.5 percent of the GDP, especially when the scope for cutting development spending has already been taken up during the current fiscal year.

What should be the optimal fiscal framework for 2010-11 and how should the medium term macroeconomic framework be modified in light of the experience in 2008-09 and 2009-10? We develop in the subsequent sections a 'homegrown' macroeconomic and fiscal framework which is consistent with the ground realities of Pakistan at this time. This framework is similar to that contained in the final report presented recently by the Advisory Panel of Economists to the Planning Commission. We believe that the Government may use this framework in its forthcoming discussions with the IMF on the coming budget and for any extension of the tenure of the Fund program beyond December 2010 when the current SBA comes to an end.

## A 'HOMEGROWN' MACROECONOMIC FRAMEWORK

### Short-Term Framework

Before we present an alternative medium-term macroeconomic framework we first highlight the consequences of sticking, more or less, to the original budgetary framework for 2010-11 involving the attainment of a fiscal deficit target of 4.1 percent or so of the GDP, as shown in Table 3.3.

**TABLE 3.3**
**BUDGETARY PROJECTIONS FOR 2010-11***

*(% of GDP)*

| | 2009-10 | | | 2010-11 | |
|---|---|---|---|---|---|
| | Original Program Projection | Budget | Likely Outcome | Original Program Projection | Revised Projection* |
| **A. REVENUES** | **14.6** | **14.5** | **13.8** | **15.2** | **14.2** |
| **A-1. Tax Revenues** | **10.7** | **10.7** | **10.3** | **11.4** | **10.9** |
| FBR | 9.3 | 9.3 | 9.0 | 10.1 | 9.6 |
| Others | 1.4 | 1.4 | 1.3 | 1.3 | 1.3 |
| **A-2. Non-Tax Revenues** | **3.9** | **3.8** | **3.5** | **3.8** | **3.3** |
| **B. EXPENDITURE** | **19.5** | **19.4** | **19.3** | **19.3** | **18.3** |
| **B-1. Current Expenditure** | **16.0** | **15.2** | **16.4** | **14.9** | **16.0** |
| Federal | 12.1 | 11.3 | 12.4 | 10.5 | 11.8 |
| Provincial | 3.9 | 4.0 | 4.0 | 4.4 | 4.2 |
| **B-2. Development Expenditure** | **3.5** | **4.2** | **2.9** | **4.4** | **2.3** |
| **C. FISCAL DEFICIT** | **-4.9** | **-4.9** | **-5.5** | **-4.1** | **-4.1** |

*If the deficit target of 4.1 percent of the GDP is to be achieved
**Source:** IPP Estimates

The basic conclusion is that if Pakistan is to remain on the original fiscal framework agreed with the IMF then there is very little 'fiscal space' left for executing the development program, which will have to fall to about 2.3 percent of the GDP and show a drop in real terms of over 19 percent in relation to the already depressed level in 2009-10. This is despite a significant increase expected in the tax-to-GDP ratio of 0.6 percent of the GDP, achieved largely through the (likely) introduction of a broad-based VAT and a reduction of 0.6 percent of the GDP in federal current expenditure due largely to the reduction in power subsidy following the hike in tariffs, although defence expenditure will remain high due to continued military operations in the North and the full year impact of the increase in salaries of defence personnel. Also, debt servicing costs will rise because of the high level of bank borrowing in 2009-10 and the liabilities created by retirement of the circular debt of the power sector.

On top of all this, there is the prospect that greater resource constraints will now be operative on the federal government. This is the consequence of the new NFC Award. As discussed in Chapter 7 of the Report, the Award could involve an additional transfer of over Rs 283 billion to the provincial governments. Therefore, net revenue receipts of the federal government will be correspondingly lower. Consequently, the revenue deficit after meeting current expenditure obligations will be substantially larger and this will strongly limit the size of the PSDP directly executed by the federal government. As opposed to this, provincial governments will be in a position to rapidly expand both their current and development budgets. Perhaps for the first time we may witness a higher share of the national PSDP being executed by the provincial governments.

We are of the view that a smaller adjustment in the fiscal deficit is warranted for in 2010-11. As such, the fiscal deficit may be brought down to 5.0 percent of the GDP, rather than 4.1 percent or so, and the additional fiscal space be used to raise the size of the development program by one percent of the GDP (equivalent to about Rs 170 billion), for high-priority projects and programs in the Federal PSDP.

What are the arguments in favour of a larger fiscal deficit and a corresponding larger public outlay on development in 2010-11? The first justification is the need to preserve the 'human face' of the structural adjustment process. The people of Pakistan have had to face extremely difficult conditions over the last two years with stagnant real incomes, substantial increases in prices (especially of food items), growing unemployment, shortages of power, water and gas, and acts of terror creating not only loss of life and property but also psychological trauma. The anger and frustration is beginning to spill over into large-scale public agitation on the streets of most of the cities and towns of Pakistan.

It may also be noted that while militarily Pakistan may be winning the war it is losing the war on another front. The propensity towards militancy is rising with growing unemployment and poverty. In particular, the number of unemployed male youth has crossed half a million and number is rising by over 100,000 ever year. These youth could be driven to crime and militancy in the absence of their productive absorption in the economy.

Therefore, at this time we have no other option but to follow more expansionary policies so as to revive the economy and improve the prospects for employment and higher incomes of the people. A key element in the fiscal domain of expansionary policies is an escalation in the size of the public sector development program, especially in priority areas for removing deficits in vital infrastructure and services. Reliance can no longer be placed only a social protection program, including the BISP and other mechanisms of food support. Much more needs to be done with a sense of urgency if a large-scale social breakdown is to be averted.

The higher fiscal deficit in 2010-11 can also be justified on 'sustainability' grounds. As highlighted earlier, there has been great success, partly through management of the aggregate demand, in drastically bringing down the deficit in the current account of the BOP beyond the original projections in the Fund program. This means that somewhat more expansionary fiscal and monetary policies can be adopted now without seriously exacerbating the problem of the external balance of payments. With relatively high level of foreign exchange reserves once again, a fiscal stimulus can be provided to the economy to facilitate recovery of the type that has already been implemented in a much bigger way by other countries like India and China.

In fact, the years, 2010-11 and 2011-12, represent a 'window of opportunity' when the economy can be kick started once again in light of the projected external debt servicing obligations. The flow of funds under the on-going SBA of the IMF are due for debt repayment primarily from 2012-13 onwards when almost $ 11 billion will have to be repaid by 2014-15, as shown in Table 3.4.

**TABLE 3.4**
**REPAYMENT OF IMF-SBA + PAST CREDITS**

| | $ Million |
|---|---|
| 2009-10 | 379 |
| 2010-11 | 377 |
| 2011-12 | 1394 |
| 2012-13 | 3244 |
| 2013-14 | 4641 |
| 2014-15 | 2788 |
| 2015-16 | 468 |
| **TOTAL** | **13291** |

**Source:** IMF (2009)

Therefore, during the intervening period the economy can sustain somewhat larger deficits in the current account of the BOP.

## Medium Term Framework

We have developed a medium term macroeconomic framework for Pakistan on the basis of the IPP Macroeconomic Model. Salient features of the model are described in Boxes 3.1 and 3.2. This model also enables changes in the original framework developed with the IMF on the basis of likely outcome of key variables in 2009-10.

**BOX 3.1**
**FEATURES OF THE IPP MODEL***

Short-Run / Medium-Run - Keynesian
- Long-Run - Harrod-Domar

18 Equation Model
- Based on Consistent National Income Accounts from 1980-81 to 2008-09

Models Consequences of
- o Fiscal Policy
- o Monetary Policy
- o Trade Policy
- On Macroeconomic Imbalances, Inflation, Growth, Employment and Poverty

Models Impact of Changes in World Economy
- Handy Tool for Policy Analysis

*The specification and estimated equations of the model are available from IPP on request.

**BOX 3.2**
**SOME KEY ELASTICITIES IN THE MODEL**

The various equations in the model estimated on data from 1980-81 to 2008-09 yield the following elasticities:

| | WITH | ELASTICITY |
|---|---|---|
| Private Consumption | Income | 1.003 |
| Private Investment | Interest Rate | -0.790* |
| Private Investment | Price of Capital Goods (imported) | -0.117 |
| Imports | Income | 1.093 |
| Imports | Interest Rate | -1.340* |
| Imports | Import Prices | -0.262 |
| Exports | World Trade | 0.693 |
| Exports | Export Prices | 0.079 |
| Price Level | Money Supply | 0.248 |
| Price Level | Import Prices | 0.504 |
| Revenues | Income | 1.029 |
| Revenues | Imports | 0.138 |
| (Money Supply) | Fiscal Deficit | 3.394 |
| ∆(Money Supply) | Interest Rate | -0.167 |
| ∆(Money Supply) | Income | 0.088 |
| Employment | Real Wage | -0.467 |
| Poverty | Per Capita Income | -1.308 |
| Poverty | Relative Food Price | 3.546 |

*Percentage change in variable due to one percentage point change in interest rate
**Source:** IPP Model.

What are the principal differences between our 'homegrown' medium term macroeconomic framework and the revised IMF framework? First, the difference in choice of policy instruments over the next five years, upto 2014-15, is presented in Table 3.5. The 'homegrown' framework envisages a bigger build up in pubic investment over the next five years. As such, total public investment (budgetary and non-budgetary) is pushed up by 15 percent in real terms in 2010-11, followed by 12.5 percent in 2011-12, 10 percent in 2011-12 and 7.5 percent thereafter. This is in contrast with the IMF framework, where in lieu of the need to bring down the fiscal deficit sharply, real public investment will grow only modestly on average over the next five years by about 5 percent per annum. The initial 'big push' in public investment is considered necessary, as highlighted earlier, to jump start the economy at a time when private investment is shy. This will also enable earlier removal of the supply-side constraints to growth.

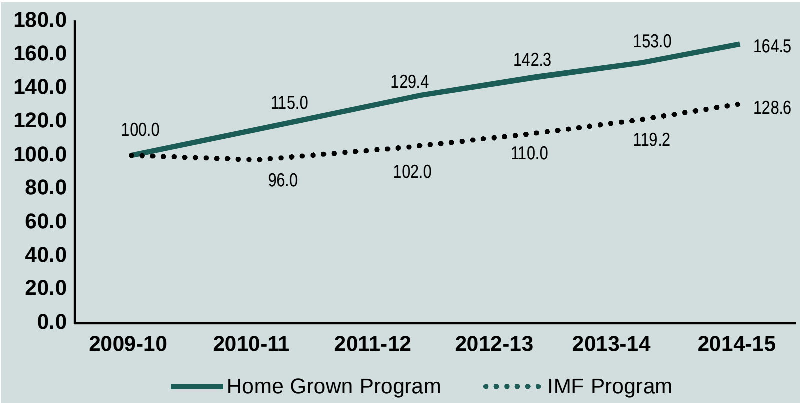
**TABLE 3.5**
**CHOICE OF POLICY INSTRUMENTS IN DIFFERENT SCENARIOS**

| | With IMF Program | 'Homegrown' Program |
|---|---|---|
| Increase in Tax-to-GDP Ratio | High | High |
| Increase in Public Investment | Low | High |
| Increase in Government Current Expenditures | Low | Low |
| Level of Interest Rates | High | Moderate |
| Rate of Expansion in Money Supply | Low | Moderate |
| Rate of Depreciation in REER* | Low | High |

*Real Effective Exchange Rate

The resulting path of public investment in the two frameworks is highlighted in Chart 3.1. Over the next five years the cumulative increase in public investment is 65 percent in the 'homegrown' framework as compared to 29 percent in the IMF framework. It needs to be emphasized that the success of the recommended strategy hinges crucially on proper prioritization of the PSDP whereby only those projects/programs receive allocation which are either at a mature stage of execution or belong to key sectors like power, water, gas, education and health.

**CHART 3.1**
**LEVEL OF REAL PUBLIC INVESTMENT**
**(Index 2009-2010 = 100)**




Beyond the difference in levels of public investment, both frameworks envisage a strong containment of government current expenditure and rise in the tax-to-GDP ratio. The former will be accomplished by transfer of Concurrent List Functions, discussed in Chapter 6 of the report, and by reduction in the subsidy bill and grants to various entities. In addition, costs of administration will need to be restrained by recruitment bans, freezing of non-salary expenditure and adoption of a culture of austerity.

Both frameworks involve an increase in the revenue-to-GDP ratio of over 2 percent of the GDP over the next five years with the tax-to-GDP ratio going up by almost 2.5 percent of the GDP. According to the Revenue Advisory Council of the FBR implementation of the VAT has the potential of raising 1.5 percent of the GDP over the next few years. In the 'homegrown' program, a large part of the residual increase in tax-to-GDP ratio will be achieved after 2011-12 by the levy of regulatory duties on non-essential imports as described in Box 3.3. The strategy of levying regulatory duties is considered as an essential part of the strategy, alongwith somewhat faster depreciation in the real effective exchange rate, to achieve import compression and stimulate exports so as to reduce the current deficit at a time when external debt repayments (especially to the IMF) begin to peak.

**BOX 3.3**
**THE CASE FOR REGULATORY DUTIES ON IMPORTS**

After 2011-12 Pakistan will have to repay over $11.5 billion to the IMF in a short period of three years as servicing of debt acquired during the on-going SBA. This will require a large reduction in the current account deficit to create the requisite debt repayment capacity. Alongwith promotion of exports this will necessitate fairly severe import compression. The advantage of regulatory duties is that they can be used selectively to cut back non-essential imports and impact less on the domestic level than resort to exchange rate depreciation. Simultaneously, these duties contribute to higher tax revenues. Also, they can be treated as temporary in character and withdrawn at an appropriate time when debt servicing obligations come down to more normal levels.

Essential imports of Pakistan include wheat, pulses, edible oil, POL products, fertilizer and medicines. These items have a large weight in the consumer price index, either directly or indirectly. Therefore, they should be exempted from the levy of regulatory duties. Other imports carry duty rates ranging from 5 percent to 35 percent. The average rate on duitable imports, excluding the essential items, is low at about 10.5 percent. In fact, import policy of Pakistan today is more liberal than that of other countries like India and Bangladesh, according to the Trade Restrictiveness Index of IMF. The actual level of tariffs is also substantially below the tariff bindings of WTO.

The regulatory duty will be levied on non-essential imports in a cascaded manner, reflecting the existing structure of duties. That is, items carrying a duty of 5 percent will pay an additional duty of 2 percent, items at 10 percent will pay the regulatory duty at 4 percent, and so on. At this rate, the regulatory duty could fetch additional tax revenue of about Rs 40 billion, including the consequential effects on general sales tax and presumptive income tax on imports.

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The regulatory duty will be levied on non-essential imports in a cascaded manner, reflecting the existing structure of duties. That is, items carrying a duty of 5 percent will pay an additional duty of 2 percent, items at 10 percent will pay the regulatory duty at 4 percent, and so on. At this rate, the regulatory duty could fetch additional tax revenue of about Rs 30 billion, including the consequential effects on general sales tax and presumptive income tax on imports.

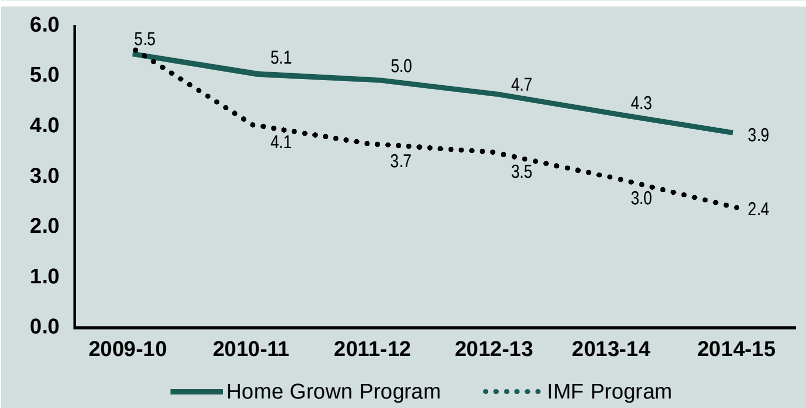
The difference in key macroeconomic outcomes in the two frameworks is presented qualitatively in Table 3.6, while the quantitative magnitudes are highlighted in Chart 3.2 to 3.5. Some of the principal conclusions are as follows:

**TABLE 3.6**
**OUTCOMES IN DIFFERENT SCENARIOS**

| | IMF Program | 'Homegrown' Program |
|---|---|---|
| Budget Deficit | Low | Moderate |
| Current Account Deficit | Moderate | Low |
| Growth Rate of GDP | Low | Moderate |
| Rate of Inflation | Low | Moderate |
| Growth Rate of Employment | Low | Moderate |

(i) The fiscal deficit falls from 5.5 percent of the GDP in 2009-10 to 5 percent in 2010-11, as discussed above, in the 'homegrown' fiscal framework and declines to just below 4 percent of the GDP by 2014-15 (see Chart 3.2). As compared to this, in the IMF framework the fiscal deficit is limited to 4.1 percent or so of the GDP in 2010-11 and continues to fall sharply to 2.4 percent of the GDP by 2014-15.

**CHART 3.2**
**FISCAL DEFICIT**
***(As percentage of GDP)***




(ii) The current account deficit is significantly smaller in the 'homegrown' framework especially after 2011-12 when debt repayments peak. The strategy of import compression and promotion of exports is critical to the achievement of greater self-reliance. In absolute terms (see Chart 3.3) the cumulative size of the current deficit is smaller in the 'homegrown' framework by $11.7 billion. This is adequate to cover the additional debt servicing obligations.

(iii) The inflation rate is somewhat higher in the 'homegrown' scenario, with the annual rate falling to about 7 percent by 2014-15 as compared to 5.4 percent in the IMF framework (See Chart 3.4). The difference is due primarily to the more aggressive use of the regulatory duties and the exchange rate instrument in the former framework.

(iv) The 'homegrown' framework implies significantly faster growth of the economy over the next five years (See Chart 3.5). In 2010-11, the growth rate rises to 4.4 percent, to 5.1 percent in 2011-12 and reaches 6 percent by 2014-15. In the IMF framework, there is unlikely to be any significant improvement in the GDP growth rate in 2010-11 and the growth rate will remain below 5

**CHART 3.3**
**CURRENT ACCOUNT DEFICIT**

***($ Billion)***

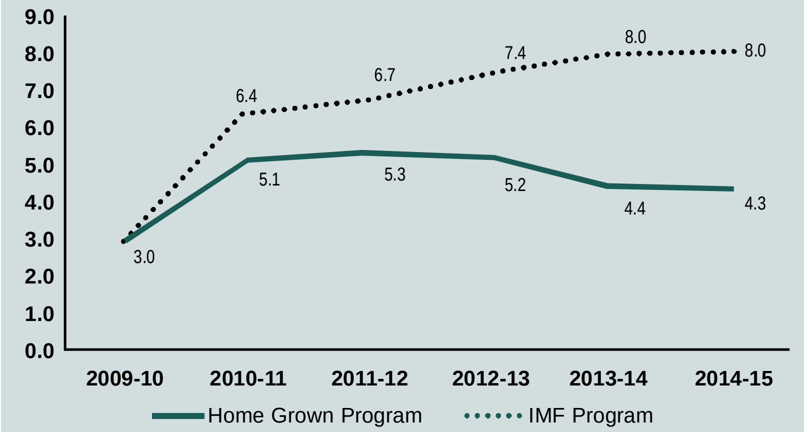



**CHART 3.4**
**RATE OF INFLATION**

***(Percentage)***

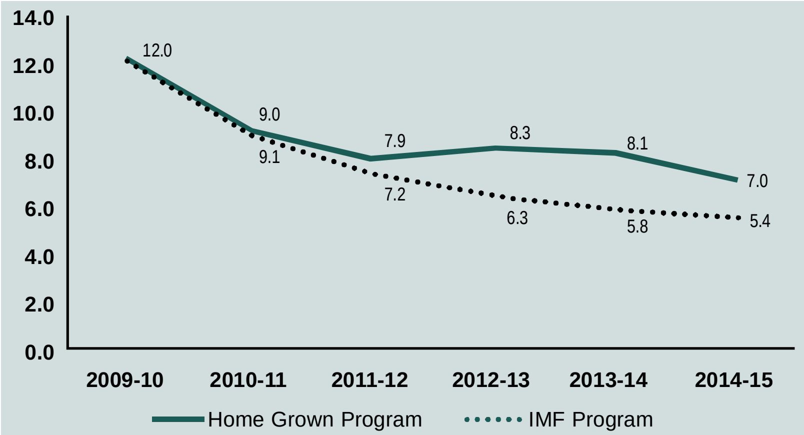
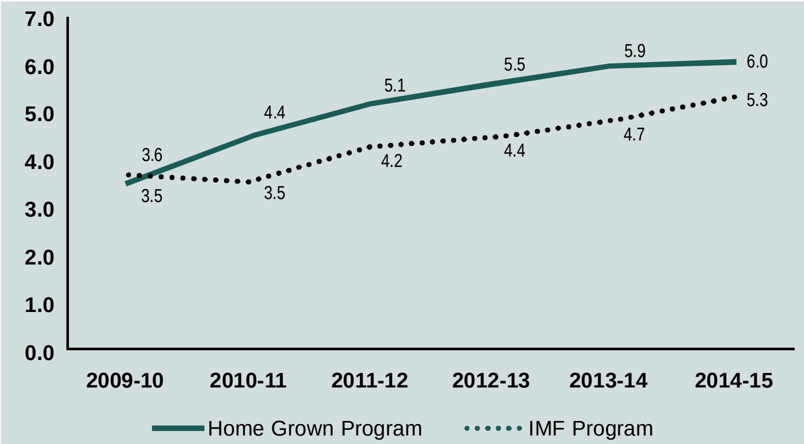



**CHART 3.5**
**GDP GROWTH RATE**

***(Percentage)***



percent upto 2013-14. A summary of the differences in the macroeconomic variables is given in Table 3.7.

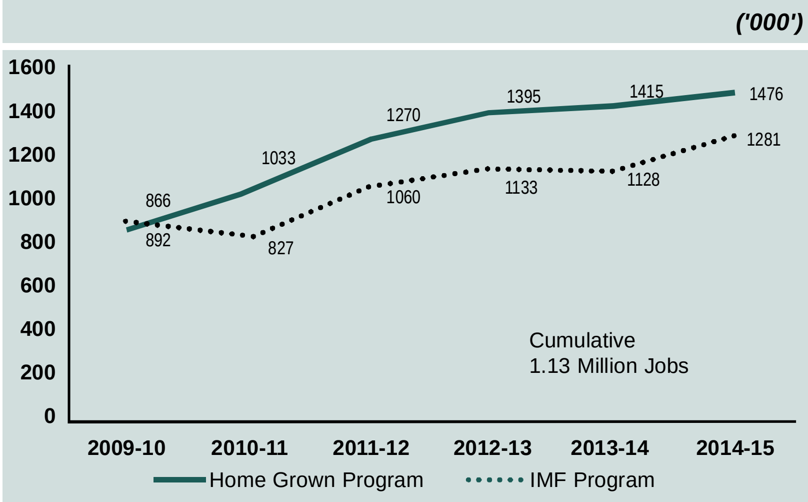
**TABLE 3.7**
**COMPARISON OF THE TWO SCENARIOS**

| | IMF Program | 'Homegrown' Program |
|---|---|---|
| **GROWTH RATES (%)** | | |
| **GDP** | **4.4** | **5.4** |
| Private Consumption | 4.1 | 4.8 |
| Public Consumption | 1.4 | 3.0 |
| Private Investment | 8.3 | 6.7 |
| Public Investment | 6.3 | 10.5 |
| Exports* | 4.7 | 5.2 |
| Imports* | 4.7 | 3.1 |
| **Employment (No)** | **56.8**[a] | **57.9**[a] |
| **Incidence of Poverty (%)** | **34.0**[a] | **32.6**[a] |
| **Budget (% of GDP)** | | |
| Revenues | 15.1a | 15.1[a] |
| Expenditure | 17.5 a | 19.0[a] |
| **Fiscal Deficit** | **3.3** | **4.6** |
| **Money Supply (%)** | **10.2** | **12.4** |
| **Rate of Inflation (%)** | **6.7** | **8.1** |
| Exports | 15.1[a] | 16.1[a] |
| Imports | 20.0[a] | 19.6[a] |
| **% Change in REER** | **0.8** | **2.7** |
| **Current Account Deficit** | **-3.2** | **-2.2** |

*of goods and services
**a** In 2014-15
**Source:** IMF (2009) and IPP Estimates.

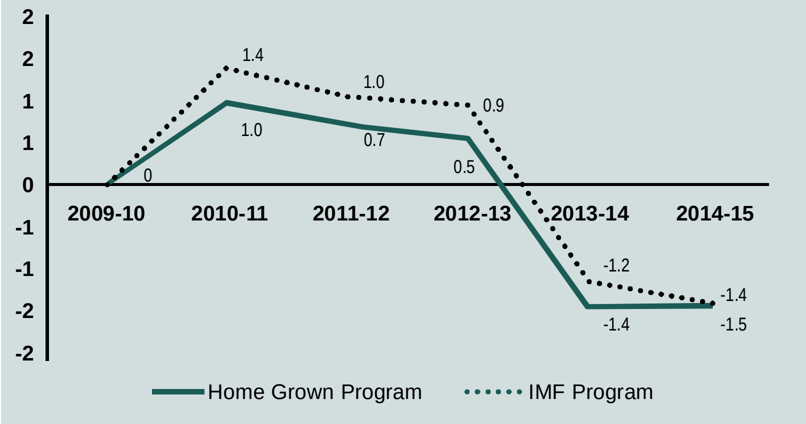
The difference between the two frameworks highlights the sharp policy trade off between a 'homegrown' strategy which offers more growth at the cost of somewhat higher inflation and the strategy supported by the Fund which brings down the inflation rate at the expense of lower growth in the economy.

**CHART 3.6**
**ADDITIONAL JOBS CREATED**




The litmus test of the two strategies has to be which strategy promises more employment and less poverty. With a higher GDP growth the prospects for employment are unambiguously better in the 'homegrown' strategy. As shown in Chart 3.6, this strategy creates an additional 1.13 million jobs over the five year period.

**CHART 3.7**
**CHANGE IN INCIDENCE OF POVERTY**
***(Percentage of Population)***




The issue is whether poverty is higher / lower with higher / lower real per capita income and high / lower price level. This impact of the two strategies hinges on the relative importance of different determinants of poverty. According to the poverty equation in the IPP Macroeconomic Model it appears that the projected incidence of poverty is lower if the 'homegrown' macroeconomic framework is implemented by about 1.4 percent of the population (see Chart 3.7). In other words, there are likely to be about 2.5 million less poor people in Pakistan in 2014-15 if the 'home grown' strategy is resorted to.

## CONCLUSION

We are now in a position to suggest if Pakistan should stay in or exit out of the IMF program. This will hinge crucially on discussions with the Fund over the next few weeks on the forthcoming budget and updating of the medium term macroeconomic and fiscal framework in light of the expected outcome in 2009-10. If the Fund accepts the need to push for higher public investment next year as a means of reviving the economy and thereby relaxes the fiscal deficit target to 5 percent of the GDP for the year, then Pakistan should continue the relationship with the Fund upto the end of the present SBA in December 2010 in light of injection of additional funds. As far as getting on to new program thereafter is concerned, this must hinge on acceptance of a medium term macroeconomic and fiscal framework like the 'homegrown' framework developed by us, which enables a process of sustained recovery of the economy. The costs of continued breakdown in the provision of public services and of rising unemployment and poverty are becoming too high to be contemplated.

# Chapter - 4

# Infrastructural Shortages: Cost to The Economy

# Chapter - 4
# Infrastructural Shortages: Cost to The Economy

IPP's Second Annual Report unambiguously established that Pakistan is unsuccessful in reaching the high growth rate trajectory largely because of fundamental domestic impediments which include factors like demographic dynamics, governance issues and supply side problems. These problems have long roots and originate 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; and ambivalent attitude towards the private sector; a major neglect of human development; an inability to develop viable democratic political institutions and effective governance structure; over centralized decision making, weak public institutions and rule of law; public corruption and lack of accountability.

The report quantified the cost of power outages to illustrate the damage infrastructural shortages are causing to the economy. The year 2009 has witnessed an escalation in power outages and emergence of gas shortages also, to compound the damages conferred on all sectors including industries, agriculture and services. The industrial sector faces energy shortages both of electricity and gas; the agriculture sector is faced with water shortage. These shortages not only constrain growth in terms of GDP forgone, but have implications on employment, exports and development in general.

In this chapter we update the costs to the economy of power outages in the industrial sector and also attempt to quantify the cost of gas and water shortages.

## THE ECONOMIC COST OF INDUSTRIAL LOADSHEDDING

The year 2009 witnessed a major increase in the frequency and intensity of power loadshedding generally in Pakistan and in particular in the industrial sector. This was despite the government claims that there will be a substantial decline in loadshedding in the country during the course of the year. Come 2010, the problem aggravated bringing the people in various cities on the streets to protest loadshedding in scorching heat. Public reaction motivated the leadership in the country which included the Prime Minister and the four Provincial Chief Ministers, to hold a two day Energy Summit in Islamabad. Therefore, for the first time since the commencement of the problem, policy makers gave the kind of attention the problem deserved, at the domestic level.

Also, the gravity of the problem has forced the national leadership to seek international assistance for its resolution. In the strategic dialogue held between the Pakistani and American leadership in Washington, energy crises was top on the agenda. IPP's Second Annual Report was consulted by PEPCO to prepare its working papers for the dialogue. We are therefore motivated to update the economic cost estimates of power outages for the year 2009.

The diagnosis of the problem is by and large the same. 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 commercial demand for electricity, averaging over 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) (See table 4.1) 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 almost 46 percent in 2007-08 (See Table 4.2). 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.

**TABLE 4.1**
**GROWTH RATES OF ELECTRICITY DEMAND AND SUPPLY**
**(ACGR %)**

| | ELECTRICITY | | |
|---|---|---|---|
| | | Supply | |
| | Demand | Installed Capacity | Generation |
| 1972-1980 | 8.6 | 8.3 | 8.9 |
| 1981-1990 | 10.9 | 6.8 | 9.9 |
| 1991-2000 | 4.2 | 8.5 | 5.4 |
| 2001-2008 | 6.1 | 1.5 | 5.0 |

**Source:** Pakistan Economic Survey (various issues)

**TABLE 4.2**
**ELECTRICITY CONSUMPTION BY TYPE OF CONSUMER**
***(Percent)***

| Sector | Share in Total (%) (2007-08) | Growth Rate (%) (2000-2008) |
|---|---|---|
| Household | 45.9 | 5.7 |
| Commercial | 7.6 | 10.4 |
| Industrial | 28.2 | 5.4 |
| Agricultural | 11.5 | 8.0 |
| Street Light | 0.6 | 9.9 |
| Other Govt | 6.1 | 3.4 |
| Total | 100.0 | 6.0 |

**Source:** Pakistan Economic Survey (2008-09)

Furthermore, the Independent Power Producers 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. In 2009, the government retired about Rs 100 billion of this circular debt, which currently stands at Rs 187 billion. The inability of the federal and provincial government agencies and semi autonomous corporations to pay their dues to power generating entities in time, has in turn weakened their ability to pay for their inputs, in particular fuel, resulting in reduced power supply by the Independent Power Producers. One of the key decisions taken in the Energy Summit was to retire circular debt to the extent of Rs 116 billion. 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, that the power system’s 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.

**What has been the Cost of Industrial Power Outages to the Economy in 2009?** Essentially replicating the methodology used in the IPP's Second Annual Report and using parametric values of costs and adjustment in response to loadshedding, the details of which are presented in the Annual Report, we have updated the cost of loadshedding. The incidence of outages has increased in 2009 as compared to 2008, on the average by about 30 percent. Therefore, the overall damage to the economy in terms of foregone output and GDP is going to be higher. Our analysis shows that the cost to the economy of outages to the industrial sector in 2009 was Rs 230 billion. This is equivalent to 11 percent of industrial value added. 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 535,000 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.

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 causes 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 total cost to the economy of power loadshedding in the industrial sector is estimated to be Rs. 325 billion (see Box 4.1). This is equivalent to two and a half percent of the Gross Domestic Product (GDP). In turn, exports have also been affected. The loss of exports is estimated at about US $ 1.3 billion in 2009. Compared to 2008, these costs to the economy in 2009 are over 40 percent higher.

**BOX 4.1**
**COST OF INDUSTRIAL POWER OUTAGES TO THE ECONOMY, 2009**

| | |
|---|---|
| Cost to the Industrial Section | Rs 230 Billion |
| • Loss of Industrial Value Added | 11 percent |
| Total Cost of Industrial Load Shedding to the Economy | Rs 325 Billion |
| • Cost as % of GDP | 2.5 percent |
| Loss of Employment in the Economy | 535,000 |
| • Loss of Exports | $1.3 Billion |

**Source:** IPP Estimates.

## Policy Action

Given the high level of damage which power outages continue to cause to the economy, has there been any policy action in 2009? Yes, 2009 did witness some important government interventions. These include:

- Establishment of Debt Co. (PHCL) and transfer of debt stock of Rs 301 billion from power utilities;
- Financing of debt servicing (Rs. 40 billion) through tariff increase affected to catch up the deficit of 2003-07;
- NEPRA Act amended to provide Monthly Fuel Price Adjustments and quarterly tariff determination;
- Moving towards zero subsidy regime, cumulative increase in tariff from March 2008 is 48.1 percent;
- Federal Adjuster appointed for 'at source' deductions against government receivables;
- Performance contracts executed with DISCOs aimed at efficiency improvement, loss reduction and recoveries.

In the high level Energy Summit held in Islamabad, a number of resolutions were also passed which are presented in Box 4.2.

Clearly, there has been some government action. These actions coupled by an improvement recently in the water position in the dams has led to some improvement in the outages situation, which had reached the peak of upto 20 hours a day in some parts of the country. However, enough has not yet been done to resolve the problem on a sustainable basis. Policy action required include: first, resolution of the circular debt problem. Though action has been take on this front but the reemergence of the problem in less than six months highlights the need for a deeper look and more structural solutions.

As an immediate action payment should be linked to higher capacity utilization to ensure that thermal stations will increase generation to atleast 75 percent of capacity. Second, upgradation

## BOX 4.2
## RECOMMENDATIONS OF THE ENERGY SUMMIT

After two days of extensive debate, the First Energy Summit formulated the following set of recommendations for adoption by the Government of Pakistan.

**CONSERVATION MEASURES:**

Conservation measures are the most convenient and short term method of ensuring power savings. According to the consensus achieved in the Energy Summit, nearly 500 MW can be saved through variety of conservation efforts agreed upon as follows:

- Reduction of lights up to 50% in all public offices including President, Prime Minister's Secretariats.
- Use of Air Conditioners by authorized officers only after 11 a.m
- Conservation in street lights
- Ban on commercial decorative lights
- Staggering of weekly holiday for Industry
- Non-supply of power to irrigation dominated tube-wells feeders during peak hours.
- Closure of markets and shops at sun-set.
- Evening marriage hall usage restricted to three hours.
- Five day week for Government Departments and affiliated Institutions.

**IMMEDIATE AND SHORT TERM MEASURES:**

Diversion of 183 MMCFD of additional gas for PEPCO. This gas shall result in additional power generation of 740 MW.

- KESC shall generate additional 300 MW on RFO which is not being utilized because of paucity of gas.
- About 400-600 MW shall be made available from IPPs commissioning. A policy guideline shall be issued from the Ministry of Water and Power.
- A total of 10 IPPs with a capacity of 1305 MW shall be commissioned by December 2010.
- A total of 5 Rental projects with a capacity of 605 MW shall be commissioned by December 2010.

**FINANCIAL MEASURES:**

- The problem of circular debt will be resolved: Government of Sindh shall clear its arrears amounting to Rs. 21 billion to HESCO; Government of Punjab will pay Rs. 6.1 billion; Government of Khyber Pakhtunkhwa will pay Rs. 14.2 billion; Government of Balochistan will pay arrears of Rs. 9.5 billion and the AJK Government will pay its arrears of Rs. 3.1 billion;
- KESC agreed to pay their arrears to PEPCO through adjustment of subsidy and GST refund which will be provided to them by Ministry of Finance;
- In support of the Power Sector, the Ministry of Finance shall provide Rs. 116 Billion to bail out PEPCO and its entities from the financial crunch during the current financial crunch.

**MEDIUM AND LONG TERM MEASURES:**

- In the medium and long term, the demand is expected to grow by about 8% resulting in a total demand of nearly 36,000 MW by 2015 and 114,000 MW by 2030. The energy summit drew a road map to achieve the required capacities in times to come
- In the long term, 105,000 MW additional capacities will have to be inducted out of which 25,000 MW will be from Hydro and 30,000 MW from coal. Renewable and captive power will contribute up to 15,000 MW.
- An ambitious action plan to generate power from the sugar/textile captive power shall be drawn up in the next fortnight.
- Public Sector Energy Development Fund (PSEDF) will have to be established to finance additional generation project, especially based on coal and hydro.

of existing power plants alongwith investment in new power generating capacities can pay-off in a short span of time given the high costs of outages. Assistance from the donor community like the $ 125 million committed by U.S.A. following the strategic dialogue, is a welcome step but a very small one. This amount can fill up only one-fourth of the existing energy gap. The country requires development and quick implementation of an accelerated generation investment programme both in thermal power plants, which will provide generation capability throughout the year, and in smaller hydel projects. 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.

Third, 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.

Fourth, there is scope for pursuing a loss-minimizing strategy rather than following a policy of equal curtailment. In particular, 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.

Finally, information flows and customer education is an important area. 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. 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.

## GAS SHORTAGE: AN IMMINENT CRISIS

After electricity, gas supply is a crisis which is likely to strike the country with almost as far reaching impact and damages in coming years if corrective policy actions are not taken with some urgency. The beginning of the problem is already visible. The country is experiencing not only electricity but also gas loadshedding, highlighting major concerns of energy security.

The annual consumption of gas has been increasing at the annual rate of 7 percent over last four decades. The demand for gas has increased more rapidly in this decade, at 7.5 percent, than in the previous one, at 4.9 percent (See Table 4.3). Highest increase appears to be in the case of CNG for transport consumers, of almost 49 percent, even though their share in consumption is still low, at about 5½ percent. Major share in consumption is of power plants, 33 percent, industries, 24 percent, and domestic consumers 16 percent (See Table 4.4).

**TABLE 4.3**
**GROWTH RATES OF GAS DEMAND AND SUPPLY**

***(ACGR %)***

| Year | Demand | Supply |
|---|---|---|
| 1972-80 | 9.4 | 9.6 |
| 1981-90 | 5.9 | 5.8 |
| 1991-2000 | 4.9 | 5.2 |
| 2001-2008 | 7.5 | 7.8 |

**Source:** Pakistan Economic Survey (various issues)

**TABLE 4.4**
**GAS CONSUMPTION BY TYPE OF CONSUMER**

| Sector | Share in Tota (2007-08) | Growth Rate (%) (2001-08) |
|---|---|---|
| Domestic | 16.0 | 5.4 |
| Commercial | 2.6 | 7.3 |
| Industries | 24.0 | - |
| Pak Steel Mills | 1.3 | - |
| Cement | 1.0 | 8.9 |
| Fertilizer ( as feed stock) | 15.6 | - |
| Fertilizer(as fuel use) | 15.6 | 1.8 |
| Power | 33.7 | 6.2 |
| Transport (CNG) | 5.6 | 48.6 |

**Source:** Pakistan Energy Yearbook (2008)

Siddique [1999] estimates elasticities of demand for gas by type of consumer. She concludes that the overall income elasticity of gas demand is high, at 0.86, while the price elasticity is low, minus 0.05 (see Table 4.5). This implies the gas is highly income elastic commodity. With 10 percent increase in income, the consumption of gas is likely to increase by 8.6 percent. These results also imply that the demand for gas is inelastic, i.e. it will contract insignificantly in the event of an increase in prices.

**TABLE 4.5**
**ELASTICITIES OF GAS DEMAND**

| Type of Consumer | Income Elasticity | Project Elasticity |
|---|---|---|
| Domestic | 0.01 | -0.05 |
| Commercial | 1.39 | -0.07 |
| Industry | 0.14 | -0.01 |
| Cement | 0.79 | -0.96 |
| Fertilizer | -0.81 | -0.18 |
| Power | 0.45 | -0.27 |
| Overall | 0.86 | -0.05 |

**Source:** Siddiqui (1999)

Given the elasticities, we can project the demand for gas in Pakistan over the next five years. It is likely to increase at a cumulative rate of 5.5-6 percent per annum. The gap in demand supply is likely to increase by 342 mmcft by 2014-15 if the supply increases at an annual rate of 1 percent (see Table 4.6). If

**TABLE 4.6**
**PROJECTION OF DEMAND FOR GAS**

*(bmcft)*

| | Demand for Gas | Constant Gas Supply | 1 percent Growth Rate | Constant Gas Supply | 1 percent Growth Rate |
|---|---|---|---|---|---|
| 2009-10 | 1291 | 1291 | 1991* | - | * |
| 2010-11 | 1351 | 1291 | 1304 | -60 | -47 |
| 2011-12 | 1411 | 1291 | 1317 | -120 | -94 |
| 2012-13 | 1491 | 1291 | 1330 | -200 | -161 |
| 2013-14 | 1586 | 1291 | 1343 | -295 | -243 |
| 2014-15 | 1699 | 1291 | 1357 | -408 | -342 |

*1 percent growth in gas supply
**Source:** IPP Estimates.

on the other hand, there is no increase in gas supply, the gap will increase to 408 mmcft over the next five years. The cost to the economy of this shortfall could be as high as Rs. 110 billion.

The Medium Term Development Framework (MTDF) developed by the Government of Pakistan has projected a decline in the supply of gas as shown in Table 4.7. According to their estimate, the gas supply shortfall will increase to 1834 bmcft in the next ten years.

**TABLE 4.7**
**MEDIUM TERM DEVELOPMENT FRAMEWORK:**
**PROJECTIONS OF DEMAND AND SUPPLY OF GAS**

*(bmcft)*

| | Demand | Supply | Gas |
|---|---|---|---|
| 2009-10 | 1370 | 1327 | -43 |
| 2019-20 | 2734 | 900 | -1834 |

**Source:** Medium Term Development Framework, 2005-10. Planning Commission, Government of Pakistan.

Why is there an emergence of a gas crises? The key issues include:

- Low pace of exploration and drilling activities
- Coal development, which can provide a potential substitute if the energy-mix is changed, has been neglected for over 50 years despite major finds at Thar, Lakra and Sonda Jherak due to lack of capability and proper institutional set up.
- Lack of realization that indigenous gas will be in short supply by 2010 if domestic potential not fully exploited.
- Absence of indigenous design engineering technology and manufacturing inputs.
- Slow development of deeper reservoir at Sui (1 TCF of gas) and slow pace of work at Tal Block near Kohat (5 to 30 TCF).
- Lack of focus on gas conservation.
- 16 gas fields having estimated reserve of 2 TCF lying dormant (majority in Sindh).

Pakistan needs to develop and implement a fuel sector strategy with the objectives to: (a) enhance the exploration and production activities of oil, gas and coal resources, (b) encourage the utilization of the country's indigenous resource base and reduce dependence on imported fuel: (c) create an environment conducive to the participation of the private sector and (d) develop the local energy scenario in the context of regional perspective.

The following policy measures can be envisaged:

To encourage oil and gas exploration in the country especially in off-shore areas, policy should be reviewed and impediments in the way of private sector should be removed;

- To encourage investment in gas pipelines, necessary policy incentives should be evolved for private investment in the gas pipeline system;

Consider the import of gas by 2010 to fill in the supply demand gap consistent with the envisaged economic growth of the country. In particular, the import of gas form Turkmenistan, Qatar, and Iran should be considered. The deal with Iran has been finalized recently.

- Incentives should be provided for expediting exploration and exploitation of huge coal reserves of the country, and alternate technologies like coal gasification should be promoted for expanding the utilization of the coal.

A plan for Liquefied Natural Gas (LNG) imports needs to be developed.

- The policy to disinvest / privatize public sector companies/ corporations such as Sui Northern Gas Pipelines Ltd (SNGPL). Sui Southern Gas Company Ltd (SSGCL) and Oil and Gas Development Corporation (OGDC) and other energy sector entities to improve their efficiency should be studied.
- A comprehensive plan for the development of solar products like, solar fans, solar cookers and solar geysers by the participation of private sector should be developed.

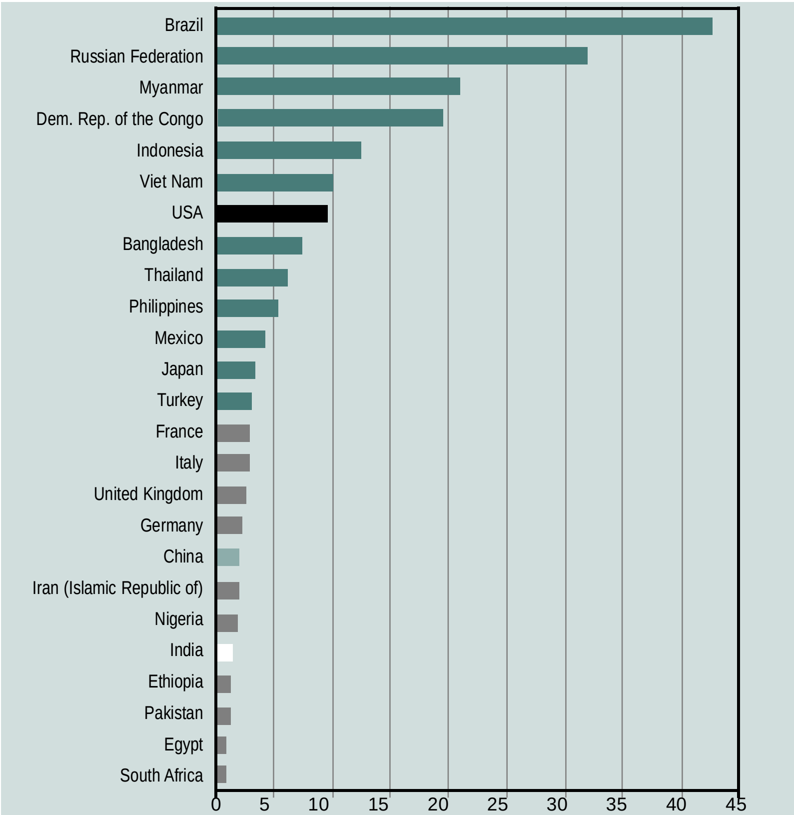
## WATER SHORTAGE: A MAJOR THREAT TO THE ECONOMY

Pakistan is one of the world's most arid countries with an annual rainfall of less than 240mm. The population and the economy are heavily dependent on an annual influx into the Indus river system of about 180 billion cubic meters of water that emanates from India and is mostly derived from snow-melt in the Himalayas. But the single river system on which Pakistan entirely relies on has been heavily used and there is no additional water injected into the system.

The availability of water is crucial for Pakistan as being an agrarian economy it relies heavily on water for its agriculture. According to the latest Economic Survey, agriculture contributes 21 percent to the GDP and employs 45 percent of the labor force. Clearly, it is imperative for Pakistan to provide water for agriculture to help alleviate poverty, reduce unemployment levels and boost the economy. In addition, crops such as cotton are a major contributor to the country's foreign exchange earning and require water. Also, hydro-power plants are Pakistan's main tool for generating electricity which, as highlighted in the previous section, is itself a scarce resource in the country.

According to UN (2009), total water renewable resources in Pakistan decreased from 2,961 cubic meters in 2000 to 1,420 cubic meters in 2005. This places Pakistan in the most water-limited nations along with South Africa and Egypt (See Chart 4.1). India and China are not far behind with dwindling water resources per capita of only 1,600 and 2,100 cubic meters respectively. In relation to that, major European countries have twice as much renewable resources per capita ranging from 2,300 (Germany) to 3,000 (France) cubic meters per capita per year. It is estimated that by 2025, not more than 1,000 cubic meters will be available per person in Pakistan making it a water-scarce country [World Bank (2005)]. The situation is a cause for concern.

**CHART 4.1**
**TOTAL WATER RENEWABLE RESOURCES IN VARIOUS COUNTRIES**




**Source:** World Bank (2005)

In Pakistan, over 80 percent of the cropland is irrigated. According to a report on water conservation by the Project Management and Policy Implementation Unit (PMPIU), Pakistan receives an inflow of 104 Million Acre Feet (MAF) from the Indus Basin out of which 64 MAF is consumed by crops and the remaining is lost to the Arabian Sea. The flows in the three rivers are declining at a rate of over 6 percent per year. This is mainly due to the climatic changes and other field applications.

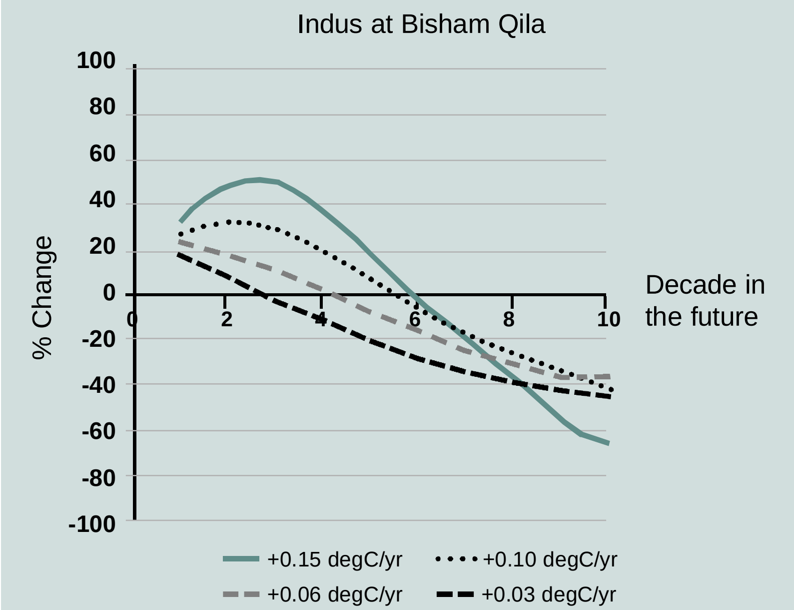
Pakistan's other main source of water, ground water, accounts for 40 percent of irrigation. Ground water even consists of water from the Indus Basin which has been recharged or absorbed by the ground. Ground water is utilized through pumping of the tube wells which further disturbs the water table beneath the ground. According the World Bank estimates, as compared to the 3.34 MAF in 1959, ground water pumping is estimated to have reached 55 MAF by 2009. As a result of this over-pumping, about 70 percent of Pakistan's half a million tube wells produce hard or brackish water which introduces the problem of salinity.

Whereas Pakistan's irrigation system is vast, it is managed in an extremely inefficient manner. Seepage from irrigation canals has resulted in water-logging in low lying areas, reducing the delivery efficiency of the canal system to hardly 40 percent.

### Issues of Water Management

The Indus basin relies heavily on the glaciers of the western Himalayas which acts as a reservoir capturing snow and rain, holding the water and releasing it into the rivers which feed the plain. It is clear that climate change is already affecting the western glaciers. Chart 4.2 shows estimates of changes in the river flow just above the Tarbela dam over the next few decades. It is clear that there will be a glacier retreat, during which the river flows will increase resulting in flooding and drainage. But after a few decades the glacier reserve will significantly decrease by 40 to 50 percent and the country will endure a barren spell [World Bank (2005)].

**CHART 4.2**
**PREDICTED CHANGES IN INDUS FLOWS JUST ABOVE TARBELA**




**Source:** World Bank (2005)

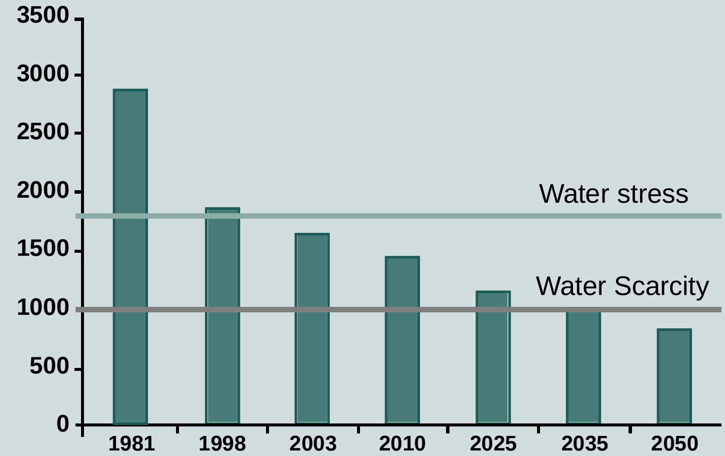
The initial release of water flow will require Pakistan to invest heavily in its water storage facilities. Currently Pakistan lags behind in terms of its storage capacity. According the World Bank (2009) United States and Australia have over 5000 cubic meters of storage capacity per inhabitant, China has 2200 cubic meters. Pakistan has only 150 cubic meters of storage capacity per capita. The dams of the Colorado and Murray-Darling rivers can hold 900 days of river runoff. South Africa can store 500 days in its Orange river, and India between 120 and 220 days in its major peninsular rivers. By contrast, Pakistan can barely store 30 days of water in the Indus Basin.

Another problem is the leakages and wastage of water to the Arabia Sea. Pakistan's irrigation network is not well maintained and therefore inefficient. The average annual inflow of the Indus and its tributaries is 141 MAF, of which 97 percent is used in agriculture and the remaining 3 percent for domestic and industrial use. Out of the 141 MAF, around 106 MAF is annually diverted into one of the largest but inefficient irrigation systems. The remaining 36 MAF is lost to the sea. Also, out of the 106 MAF diverted to the Irrigation network more than 50 percent is lost due to field application.

**CHART 4.3**

**DECLINING PER CAPITA AVAILABILITY OF WATER IN PAKISTAN**

***(cubic meters per capita per year)***




**Source:** World Bank (2005)

Also, the Indus River System carries about 43,500 hectares meters of silt every year, about 40 percent of the silt load settles before reaching the Indus mouth and erodes the storage capacity of the three main dams, Tarbela, Mangla and Chashma dam. Increasing population, urbanization and industrialization have also reduced the availability of water per person and the country is on the path to become a water scarce country by 2025 (see Chart 4.3). Also, urbanization and industrialization play their part in the contamination and wastage of water. Factories and cities discharge mostly untreated sewage and pollutants in the country's lakes and sea. Some billion tons was discharged in 2008 alone. This leads to problems such as diseases, an imbalanced ecosystem and affects the economy as a whole. Inadequate operations and maintenance expenditure recovery through water charges, which is at only about 44 percent, is also an issue.

**TABLE 4.8**

**SURFACE WATER AVAILABILITY**

***(MAF)***

| | Kharif | Rabi | Total | % Change over the Average |
|---|---|---|---|---|
| Average System Usage | 67.1 | 36.4 | 103.5 | - |
| 2002-2003 | 62.8 | 25.0 | 87.8 | -15.2 |
| 2004-2005 | 59.1 | 23.1 | 81.2 | -20.6 |
| 2006-2007 | 63.1 | 31.2 | 94.3 | -8.9 |
| 2008-09 | 66.9 | 24.9 | 91.8 | -11.3 |

**Source:** Economic Survey 2008-09

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. This is despite the higher increase the current decade in some key inputs into agriculture like tube wells 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. Table 4.8 shows that average decline in water availability for kharif and rabi crops in 2008-2009 was 11.3 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 2008-09 due to underinvestment in water in the current decade has been as much as Rs 125 billion, equivalent to 4.8 percent of the agricultural value added as shown in Table 4.9.

**TABLE 4.9**
**COST OF WATER SHORTAGES**

| Years | Loss (Rs in Billion) | % of Agriculture Value added |
|---|---|---|
| 2002-2003 | 38.7 | 0.81 |
| 2003-2004 | 16.9 | 1.47 |
| 2004-2005 | 23.5 | 2.01 |
| 2005-2006 | 29.3 | 2.01 |
| 2006-2007 | 45.6 | 2.86 |
| 2007-2008 | 70.2 | 3.48 |
| 2008-2009 | 125.0 | 4.8 |

**Source:** IPP's Second Annual Report

## Policy Action

Quick action is required in order to avoid a drought situation in the country which will severely impact the lives of millions of people in Pakistan. Water strategy must be based on essential elements covering both water development and water management. Construction of dams is of primary importance. In the face of declining water supply, it is imperative for Pakistan to increase their storage capacity which will be beneficial in times of drought which are expected due to climatic changes. As mentioned earlier, the current capacity of Mangla, Tarbela and Chashma dams is reducing due to excessive sedimentation, which is hampering Pakistan's storage capacity as well as generating electricity. Controlling the population growth rate is also important. Over the years, development of water resources have not kept pace with population growth and therefore, the increase in the demand for water.

Another important step by the government will be to minimise loss of water due to seepage, infiltration and leakages. Seepage results in water logging and these losses can be reduced or eliminated by improving the canal system. The kacchi canal project is being undertaken currently and it is hoped that it will reduce water leakages and wastages.

Also government should introduce water efficient cropping system by introducing new technologies such as drip and sprinkler irrigation. These reduce wastage of water and are more productive in terms of yields. Low tariffs and an inadequate cost recovery system has led to, both a stressful financial position of water providing agencies and wastage. It has to be realized that water is a scarce resource and therefore its use has to be made efficient.

Private Sector involvement can improve performance and efficiency in the supply of water. Private sector has a role to play in ensuring water supply to the urban as well as the rural community. The Private sector should also be encouraged to invest in water purification techniques.  Saline water in the seas and underground can be treated and this can add to the supply of water significantly. The efficient desalination could produce more usable water and competition between private firms will ensure that consumers get water at affordable prices.

A water credit system should be introduced with the involvement of the private sector and based on the principles of microfinance. Small loans should be provided for the poor to address their water needs and the repaid loans can go back into a revolving fund. Lastly, water theft in the irrigation network has been a chronic issue in Pakistan. Big farmers use more water than they actually pay for. As a result, small farmers do not get adequate water and hence refuse to pay for it. However, Pakistan, is trying to curb these problems by forming organizations such as the Punjab Irrigation and Development Authority (PIDA) which functions as a regulatory body. This has improved the situation in water theft generally but requires further strengthening.

To conclude, Pakistan is rapidly reaching the limit of surface water diversion and ground water abstraction. Declining water levels is having an adverse effect on the country's vast agrarian economy. Underinvestment in water has cost Pakistan Rs 125 Billion in 2008-2009 which is almost 4.8 percent of the agriculture value added. The need to develop additional storage capacity is therefore, of paramount importance.

This shortfall of water availability has many causes ranging from the changing climatic conditions in the Himalayas and leakages and wastage from the Indus Water System to rising population, urbanization and industrialization. The country needs a water development and management strategy which needs to be developed and implemented with a sense of urgency. Also, Pakistan needs to look out for its interest vis-a-vis its neighbor India. The general perception that India is stealing Pakistan's water is open to debate. Under the Indus Water Treaty, India would take the three eastern rivers - Ravi, Sutlej, and Beas and Pakistan would take three western rivers-Chenab, Jhelum and Indus. The treaty also gives India, which is the upper riparian country, certain rights over the western rivers including domestic use, navigation, limited agriculture and generation of hydropower.

But the treaty allows this permission on the strict condition that this use of water for the generation of power, does not affect either the quantity of water reaching Pakistan or the natural timing of the water flows into Pakistan. The threat posed by India's control over the timing of river flows became apparent when India chose to fill the Baglihar dam, built on the Chenab river, during the critical planting season. The severely diminished flows of the Chenab had disastrous consequences for downstream farmers in Pakistan. India is now constructing and planning to construct a series of dams on the Jhelum and Chenab rivers - the Kishanganga, Sawalkot, Pukuldul, Bursar, Dal Huste, etc.

Since the treaty gives India the right to "live storage" (the storage that matters for changing the timing of flows) India is in a position to use this option as a means to deny Pakistan its legitimate right over the flows of these rivers (as downstream riparian) by filling them when water is most needed for agriculture. The cumulative storage capacity that India would acquire by building all these dams will give it such hegemony over their waters as to pose an existential threat to Pakistan.

Overall, the analysis in this chapter demonstrates that the country is paying a heavy price for the delay in the effective resolution of the enormous infrastructural challenges facing it. Potentially, GDP could have been higher by almost Rs. 450 billion if the infrastructural problems of power and water 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 and domestic developments.

# Chapter - 5

# Governance: Nexus of the Crisis

# Chapter - 5
# Governance: Nexus of the Crisis

"Good governance is essential for sustainable development; that sound economic policies, solid democratic institutions responsive to the needs of the people and improved infrastructure are the basis for sustained economic growth, poverty eradication and employment creation; and that freedom, peace and security, democratic stability, respect for human rights, including the right to development, the rule of law, gender equality and market oriented policies and an overall commitment to just and democratic societies are also essential and mutually reinforcing". This is a declaration of world leaders in the UN General Assembly 2005 in the World Summit.

The reasons for the above declaration is a global consensus that while there are many reasons as to why economic development continues to bypass many of the world's poorest people and places, a common cause is poor governance. Poor governance has also been identified as the linchpin in the nexus of crises the country is currently facing as highlighted in IPPs Second Annual Report. In this chapter we briefly discuss the issues of governance and present a way forward.

## WHAT IS GOVERNANCE?

Governance is a very broad concept that encompasses the form of political regime, the process by which authority is exercised in the management of economic and social resources of a country and the capacity of governments to design, formulate, and implement policies and discharge functions. It includes formal institutions and regimes empowered to enforce compliance as well as informal arrangements that people and institutions either have agreed to or perceive to be in their interests.

DESA (2007) identifies three main types of governance, as follows:

***Political or public governance:*** whose authority is the state, government or public sector, relates to the process by which a state organizes its functions and manages itself.

***Economic governance:*** whose authority is primarily the private sector, relates to the policies, the processes or organizational mechanisms that are necessary to produce and distribute goods and services.

***Social governance:*** whose authority is civil society, includes citizens and non-profit organizations, relates to a system of values and benefits that are necessary for social behavior to happen and for public decisions to be taken.

In this framework, social governance provides the moral foundation, economic governance gives the material foundation and political governance guarantees the order and cohesion of a society.

Mimicopoulos (2006) emphasizes that in the political or public domain five dimensions of governance are crucial, as follows:

***Efficiency:*** is the government's ability to establish predictability in the institutional and policy environment through an economically efficient system of production and distribution. Efficiency is also the correct prioritization of government services with respect to citizens needs and preferences.

***Equity:*** is the existence of a fair and just legal system which provides access to all. It also includes the equitable distribution of public services, especially to underprivileged groups.

***Transparency:*** is the availability and clarity of information provided to the general public about government activity. A lack of transparency creates opportunities for government corruption and reduces public sector efficiency.

***Accountability:*** rests on the establishment of criteria for evaluating the performance of public sector institutions, including financial accountability. The focus is on internal and external audit of operations.

***Participation:*** is the essential element for an engaged civil society, through the workings of an active and free media, establishing an electoral management body, improving access to information on government procurement and contracting and promoting public discussion on policy and budget making. The role of civil society is broadly to act as a bridge between the industry and the state and as such it is a very important agent for promoting good governance.

Therefore, in the final analysis, governance boils down to the delivery and effectiveness of all public services, their efficiency, equity, transparency, accountability and participation. In a sense, governance is not an easily divisible concept. The political regime determines the extent of participation, fairness in provision of public services and transparency of the system of government. The strength of institutions, depends also on the willingness of the rulers to accept the rule of law and create service cadres of capable public servants who are recruited on merit, paid adequately, and allowed to function independently in performing their routine duties.

Economic growth and governance agendas are also often intertwined. The current governance problems in Pakistan, worsening security and law and order situation, widespread corruption, declining public authority and institutions threaten future investments and growth as well as political and social stability. However, to a considerable extent, the present governance problems have also their roots in the pattern of economic development over the last fifty years. The uneven distribution of growth benefits and the increasing dualism in the society are reflected in the sharp contrast between the growing numbers of poor and illiterate, on the one hand, and increasing sophistication and wealth of the elite and upper middle classes, on the other hand.

The divergence in the lifestyles between the rich and the poor is normal in the early stages of capitalist development. In Pakistan, however, this divergence appears to have become especially pronounced over time as economic growth spurts have not been enduring, youth unemployment has become a major problem under the pressures from rapidly rising labor force situation, real wages have not shown a clear upward trend in last two decades, and the incidence of poverty, at about 33 per cent, has not shown a decline since 1990.

Equally important, the government policies which have neglected the social sectors and bestowed unearned benefits on industrialists and entrepreneurs have aggravated income disparities. It is not, therefore, altogether surprising that tensions within the society were growing over time and were beginning to erupt with increasing frequency in ethnic, sectarian, and random violence even before the extreme militancy that now threatens the state.

Paradoxically, the state of governance in Pakistan has touched both a high and a low level in the past twelve months. For many ordinary citizens, security threats, and costs of terrorism including large scale displacement of persons in Swat and tribal areas increased further, Mismanagement of the power sector shortages have played havoc with daily life of all except the elite and the government's response to the problem has come very late. Economic growth remains very low and unemployment and poverty are increasing. The government's revenue base continues to erode making needed fiscal adjustment very difficult. Consequently, the trust in political leaders and confidence in the government's ability to deliver basic services is perhaps at an all time low. There is a widespread perception of persistence of corruption and abuse of power at high levels. The higher bureaucracy, weakened as it has been over time by an all round deterioration in service conditions and failure to attract highly talented individuals, appears further demoralized because policy directions are not always clear and there is frequent unnecessary political intervention.

However, in contrast with the familiar litany of governance problems noted above, there have been some very positive developments that hold at least the potential of improving the quality and the effectiveness of governance structures. For virtually the first time, a very effective military action has been initiated against militants and extremists. Swat has been freed from the control of the violent extremists who wished to impose their narrow interpretation of Islam against popular will. Public sympathy for terrorists is waning. Further military successes in South Waziristan and other parts of FATA have greatly weakened the Pakistan Taliban and other extremist groups though the War on Terror is far from being won. Box 5.1 presents the contours of governance structure in the liberated areas.

Three further major developments have greatly enhanced the prospects of a free, stable, and de-centralized democratic order in which personalised rule and military interventions become relics of the past. First, the passage of the 18th amendment to the Constitution which transfers greater powers and authority to the provinces and makes the Prime Minister as the Executive head of government under a parliamentary democracy clearly strengthens the foundations of the

## BOX 5.1
## GOVERNANCE IN LIBERATED AREAS

The military has conducted numerous operations of varying scale, intensity and duration (719) and such operations continue but the two biggest operations have been to retake the lost Swat valley and the Taliban strongholds of South Waziristan and Bajaur. The military operations have been successful and the lost areas have been retaken and liberated. A very heavy cost has been paid—30,457 killed and wounded—8785 military personnel and 21672 civilians. Of these there were 10000 casualties in 2009 alone with almost 10 military casualties per day-a consequence of the military's silent unpublicized surge. 86 percent of the military casualties were in the period 2007-2009 with 2273 killed and 6512 wounded. These figures plus the statistics on displaced persons indicate the magnitude of the overall human tragedy that has been part of the entire 'liberation 'process. Governance in liberated areas is an absolute imperative otherwise this great sacrifice would have been in vain and what has been gained could easily be lost.

The military is holding cleared areas with a deployment of over 147000 personnel---the 43 nation force in Afghanistan is not more than 100000. The military is manning 821 posts on the Pakistan-Afghanistan border with only 112 such posts on the Afghan side. The military has articulated command arrangements and these include the Frontier Corps that is now a fully trained and equipped force for counter insurgency operations. The military has helped to rehabilitate over 2.2 million internally displaced persons even distributing over 12000 tons of soldiers' rations. It has undertaken rebuilding of mosques in Swat and has reconstructed 120 schools, 22 solar energy projects and is working on 228 kms of road construction in Waziristan. It has rehabilitated power, completed survey work for dams in Mehsud and Wazir areas and implemented health, water supply and education projects. This is part of the military's holding strategy in the area and points to the direction that civil governance must take as soon as possible.

Civil governance must now take over so that the moral ascendancy obtained and the favorable public opinion is not lost as the militants will aim once again at eroding the writ of the government through terror. The capacity of the civil administration and law enforcing agencies capacity should continue to be built up with local militias raised and supported to defend their own areas. An effective police and human intelligence network must be put in place to fore stall any impending militant inroads or actions. The people must be supported and secured so that normalcy is restored and the people can resume work. Effective planning should be done to create jobs and develop infrastructure. Health care, water supply, education facilities and power must be arranged and above all there is an immediate need to respond to the grievances of the people especially in the delivery of services and justice. This has to be done as part of an urgent crash plan in all liberated areas in conjunction with the military and this is the minimum that will make the governments' writ sustainable. Political leaders and civil administration officials have to be visible and accessible to the people. The people must feel that they are a priority for governance.

Longer term measures must focus on plans for mainstreaming areas and extending political control. The contours of future political and administrative arrangements should be debated, discussed and evolved so that it does not take a catastrophe to give a wake up call. The situation in Afghanistan has to be a major consideration for future security measures. The current fluidity in the environment should not hamper planning and discussion of alternatives to evolve a plan. Such a blue print is important if we are to present a suitable environment for aid plans like the Reconstruction Opportunity Zones, support for local small entrepreneurs and businesses, vocational training initiatives, capacity building and infrastructure development projects. The world may be waiting to help us but will do so only when they see feasible projects and the capacity to implement them. Effective governance is, therefore, the key.

Federation and lays the basis of healthy competition as well as direct negotiations among provinces and the centre on matters of common interest. Second, the completion, without rancour, of the seventh NFC award provides the financial underpinnings of greater provincial autonomy and equity by not only significantly increasing the share of the provinces in the divisible pool of revenues but also considerably expands the share of smaller provinces, Baluchistan and Khyber-Pakhtunkhwa, in total revenues transferred from the centre. Third, the restored and reinvigorated higher judiciary has shown great independence in asserting the rule of law and has been fearless in pursuing wrong doing thus increasing public confidence in this important third pillar of the state.

Nevertheless, it would be fair to say that the common man has yet to feel any impact from these historic changes because a lot of work has to be done before the changes in the political framework translate into better governance for the populace.

## RANKING OF PAKISTAN IN GOVERNANCE INDICATORS

We have identified as many as 61 international sources which follow different methodologies in constructing indicators, cover different dimensions of governance and have either global or regional coverage of countries. Desirable properties of such indicators are presented in Box 5.2. Among the earliest sources and publications on governance are the Global Competitiveness Scale by the World Economic Forum starting in 1980 and the International Country Risk Guide System (ICRG) in 1982. The number of sources has increased sharply since 2000.

It appears that the greatest interest internationally is in the measurement of the broad area of political governance, especially since many countries embarked on the path of democratic governance during the last two decades. Economic governance is also of importance especially from the viewpoint of acting as a guide to private investors and aid-giving agencies. Thirty one international sources quantify political and twenty sources the economic dimensions of governance (See Table 5.1).

**TABLE 5.1**
**DISTRIBUTION OF INTERNATIONAL SOURCES* BY AREA OF GOVERNANCE COVERED**

| Governance Dimension | Number of |
|---|---|
| Political | 37 |
| Economic | 20 |
| Law and Order and Regulatory Quality | 16 |
| Public Administration | 13 |
| Control of Corruption | 5 |
| Freedom of Media | 4 |

*One source may cover more than one area of governance

A number of sources are performing more specialized functions. For example, the Transparency International focuses, more or less exclusively on corruption and brings out the ranking of countries in the Corruption Perception Index (CPI), which is widely used. The Heritage Foundation and Wall Street Journal give an assessment of economic freedoms, Freedom House looks at political and civil rights, and so on.

## BOX 5.2
## GOVERNANCE INDICATORS: DESIRABLE PROPERTIES AND TYPES

OECD (2005) has identified the desirable properties of governance indicators and the data set from which is generated as follows:

**Relevance:** when the indicator satisfies particular demands and needs of users

**Reliability:** when it adequately measures the concepts or characteristic that it is designed for and when users can trust it, due to the integrity of the information collecting process, independent from any pressure, especially political or ideological; and there are no serious aggregation problems

**Timeliness:** when its availability and frequency are compatible with assessment for quick action, if necessary, to be undertaken.

**Transparent:** when it is easily and correctly used and understood by users, due to precise definitions, identification and clear indication of limitations

**Coherent/Consistent:** when it is comparable over time and across countries

**Accessible:** when the source is well located and its easily accessable (like a website with unrestricted access).

**Types of Governance Indicators**

Governance indicators may be single or aggregate. A single governance indicator focuses on one particular and specific aspect of governance, for example, whether a country has ratified a particular international convention or not or measure a specific input into or output from a particular public service. The characteristics of electoral systems, corruption, human rights enforcement, public service delivery, etc. can be studied by sets of single indicators. A wide and balanced range of single indicators is necessary to provide an adequate diagnosis of public governance.

Aggregate governance indicators are the consequence of efforts of practitioners to combine the information from numerous sources into aggregate or composite governance indicators. OECD (2006) defines a composite indicator as a compilation of "individual indicators into a single index on the basis of an underlying model". It has been argued that aggregate indicators provide more precise measure of governance than single indicators. However, adoption of aggregate indicators leads to the sacrifice of the richness and scope of the original individual indicators, which provide much better guidance for policy action. Also, the basic problem with aggregation in the absence of an adequate and generally acknowledged 'theoretical framework'.

Indicators can be divided into objective and subjective indicators. The former are generally referred to as quantitative indicators and the latter as qualitative indicators. Objective indicators of governance can be constructed from data from standards, codes and various administrative documents. Examples are quantifiable outputs or inputs, such as, the size of government.

On the other hand, subjective indicators rely on perceptions of people. Data for construction of such indicators are essentially qualitative in nature and are gathered through more complex processes, like polls, surveys of households or from responses of national or international experts. Concepts, time coverage, sampling methodology, nature and order of questions are key issues concerning the reliability of subjective data sets. Interpretation of concepts relating to governance may differ among local cultures and traditions. Also, there is the danger of ideological biases entering into the measurement process, especially in terms of the implicit governance model.

International sources include multilateral development agencies like World Bank, UNDP and the Asian Development Bank; bilateral development / aid giving agencies like USAID, DIFID, etc; international NGOs like Transparency International, Civicus, Social Watch, academic institutions like Universities of Maryland and Santa Barbara; media related entities like the Economist Intelligence Unit, the Wall Street Journal; and private institutions like the Business Environment Risk Intelligence, Political Risk Service Group, etc. Therefore, there is great diversity in the nature of international sources on governance.

The number of countries currently covered by different sources also varies, depending upon whether global or regional rankings are being presented. The Governance Matters data base of the World Bank Institute covers more than 175 countries and Transparency International ranks 180 countries. As opposed to this the ADB, with a regional focus, covers only 28 countries.

What is the State of governance in Pakistan? Annexure Table A-17 gives the ranking of Pakistan in 45 categories from international sources including Freedom House, World Bank Institute (Governance Matters) and Transparency International and so on. Pakistan's ranking for the earlier year and the latest year for which information is available is presented to highlight the nature of change over time. Table 5.2 presents a summary of Pakistan's ranking in different indicators. According to the Table, Pakistan is in the lowest quintile in almost two-thirds of the rankings. The conclusion follows that Pakistan performs poorly in governance in relation to most countries.

**TABLE 5.2**
**DISTRIBUTION OF PAKISTAN'S RANKING AMONG COUNTRIES**

| | Number of Ranking | Percentage |
|---|---|---|
| Highest Quintile | 2 | 1.6 |
| 2nd Highest Quintile | 9 | 7.2 |
| 3rd Highest Quintile | 10 | 8.1 |
| 4th Highest Quintile | 27 | 21.8 |
| Lowest Quintile | 76 | 61.3 |
| **TOTAL** | **124** | **100.0** |

**Source:** IPP Estimates.

There are only 11 rankings in which Pakistan is in highest first and second quintile which relate to economic governance like business regulatory environment and quality, debt policy, structural policies and size of government. There is no indicator of political governance in any international source in which Pakistan performs relatively well.

Focusing on the six governance indicators in the Governance Matters database, namely voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and corruption control, Pakistan's ranking in a sample of Asian countries is presented in Table 5.3. In a sample of fourteen countries,

**TABLE 5.3**
**PAKISTAN'S RANKING IN SAMPLE OF ASIAN COUNTRIES**
***(Average for 1996 to 2008)***

| Ranking | Country | Ranking | Country |
|---|---|---|---|
| 1 | Malaysia | 8 | China |
| 2 | Thailand | 9 | Nepal |
| 3 | Turkey | 10 | Vietnam |
| 4 | India | 11 | Bangladesh |
| 5 | Sri Lanka | 12 | Iran |
| 6 | Philippines | 13 | Pakistan |
| 7 | Indonesia | 14 | Yemen |

*According to the Six sets of Governance Indicators in World Bank Data Base, Governance Matters.

Pakistan ranks thirteenth, just above Yemen. Malaysia stands at the top of the list followed by Thailand and Turkey. India ranks fourth while the rank of Bangladesh is eleventh.

Pakistan's ranking in some key international sources is also presented in Table 5.4. Clearly its ranking is low and has generally deteriorated over time. In Transparency International, out of 180 countries analyzed Pakistan ranked 139th. Likewise in the World Bank dataset, Pakistan's rank declines to 140-209 out of 212 countries in 2009 in different indicators. In the governance indicators ranking of DIFID also Pakistan's rank fell to 162-195 out of 211 countries. In some of the indicators measured by Gallup World Poll, Index of Economic Freedom and Business Environment Risk Intelligence, though generally Pakistan's ranking is low but it is not unambiguously declining in all indicators.

**TABLE 5.4**
**PAKISTAN'S RANKING IN SOME KEY INTERNATIONAL SOURCES**

| Source | Year | Number of Countries | Pakistan Ranking | Trend |
|---|---|---|---|---|
| Transparency International (CPI) | 2009 | 180 | 139 | ↘ |
| World Bank Institute (Governance Matters) | 2009 | 212 | 140-209 | ↘ |
| Governance Indicators (DIFID) | 2008 | 211 | 162-195 | ↘ |
| Gallup World Pool | 2008 | 143 | 53-102 | ↗ ↘ |
| Index of Economic Freedom (HF/WSJ) | 2009 | 183 | 23-146 | ↗ ↘ |
| Business Environment Risk Intelligence | 2008 | 119 | 52-92 | ↗ ↘ |

↗ Indicates improvement; ↘ Indicates deterioration

From the viewpoint of tracking in which areas of governance there has been a significant worsening over time, Pasha and Pasha et. al. (2009) present a time series of scores for over a decade in various dimensions of governance given in the World Bank Governance Matters data. They conclude, among the different areas of governance, the relatively worse scores in 2008 is in Political Stability ,Absence of Violence and in Voice and Accountability (see Table 5.5). Clearly, the recent peaking of the War on Terror and the large number of suicide bombings have led to a severe deterioration in the score in the absence of

**TABLE 5.5**
**PAKISTAN'S GOVERNANCE SCORES* IN DIFFERENT DIMENSIONS OVER TIME**

| | 1996 to 2002 | 2002 to 2008 |
|---|---|---|
| Voice and Accountability | ↘ | ↘ |
| Political Stability and Absence of Violence | ↘ | ↘ |
| Government Effectiveness | ↘ | ↘ |
| Rule of Law | ↘ | ↘ |
| Control of Corruption | ↗ | ↗ |
| Regulatory Quality | ↘ | ↗ |
| Overall | ↘ | ↘ |

↗ Indicates improvement; ↘ Indicates deterioration

**Source:** Governance Matters, WDI

violence. It is significant to note that Pakistan's score in Voice and Accountability declined sharply in 2000 after the military takeover.

The only area of governance in which Pakistan does relatively well is in regulatory quality, especially after 2002 (see Table 5.4). The worst score in the control of corruption was observed in 1996, when Pakistan was declared as one of the most corrupt countries in the world by Transparency International. Since then, there has been some improvement up to 2008.

## COSTS OF POOR GOVERNANCE

The progress of developing countries is retarded by a number of factors including lack of natural resources, excessive population pressure, low levels of literacy, limited savings and investment, lack of competiveness in export markets, etc. As already mentioned, since the 90's the development literature has begun to identify the role of institutional factors in placing limits to growth in poor countries.

While the importance of good governance has been recognized there is still debate as to whether countries with functioning democracies generally perform better in economic terms. Examples are frequently quoted from the East Asian experience that countries like South Korea (in the early years), China and more recently Vietnam have shown high rates of economic growth for long periods of time in the presence of autocratic governments. Even Pakistan's experience testifies to the fact that during periods of military governments the rate of economic growth has been somewhat higher.

Therefore, the basic empirical question is does governance matter in influencing the rate of economic growth and progress in human development and poverty reduction? Analyzing data from 55 countries over the period 1976 to 2008, our analysis shows that controlling for difference in the economic structure, captured through variables like per capita income, degree of openness of the economy and level of investment, the quality of governance in a country has a significant long-term impact on the rate of economic growth.

It appears from the cross-country regression results that if governance in Pakistan had approached the average for the countries of South Asia then the GDP growth rate during the period, 1996 to 2008, could have been higher by 0.66 percentage points annually (that is, at 5.3 percent per annum instead of the observed 4.6 percent). In fact, with improved governance, the increase in per capita GDP in Pakistan between 1996 and 2008 could have been as much as 27 percent larger. In other words, the GDP today could have been 8.3 percent higher, equivalent to about Rs 820 billion. Clearly, Pakistan has sacrificed a lot of growth due to poor governance.

The results also show a one-way causality between governance and growth with the direction of causation being from improved governance to higher growth. The conclusion that good governance leads to higher growth but not vice verse is not unique to our analysis and has two important implications. First, the strategy of waiting for improvements in governance to come automatically as the country becomes richer is unlikely to succeed. Second, we are unlikely to observe a "Virtuous Circle" of better governance improving income and this in turn leading to further automatic improvement of positive and sustained interventions to improve governance. Indeed the fact that good governance is not a 'luxury good" that a country automatically acquires when it become wealthier means in practical terms that leaders, policy makers and civil society need to work hard and continuously at improving governance in their country.

Our results also indicate that once growth is controlled for, the relationship between the quality of governance and progress on MDGs is also significant. Good governance not only contributes to the achievement of the MDGs by promoting growth and the trickle down to poverty reduction but also more directly by enabling a better allocation of public resources and more efficient provision of basic services. It appears that one percent improvement in governance leads to 0.26 percent increase in index of progress on MDGs. Overall, the relationship between governance and human development is also significant.

Improving governance is a difficult but not an impossible task. Many countries have made headway and have achieved success in their reform initiatives. We next turn to some lessons that can be derived from global experience for improving governance.

## INTERNATIONAL EXPERIENCE WITH IMPROVING GOVERNANCE

Identification of underlying facilitating factors for improving governance can be useful for Pakistan prior to embarking on a reforms agenda. UNDESA (2007) identifies some key common factors that contribute to success and extracts some lessons for design of governance reform initiatives. Pakistan can benefit from this international experience. The key lessons are as follows:

***1) National ownership—by governments and communities—is key***

Issues of governance can foster debate, and leaders are more likely to take action when there is pressure from engaged populations. The reforms must become a national reality, embraced by the main stakeholders—people and governments. They should be seen as a set of benchmarks for assessing progress—and for enabling poor people to hold political leaders accountable. They should enable people to fight for the kind of policies and actions that will create decent jobs, improve access to basic services and root out corruption. They must represent commitments by national leaders, who must be held accountable for the fulfillment of the promises in elections.

***2) Continued political will and support throughout all phases of reform is vital***

Political support from the highest levels of government and ministries is of extreme importance for creating momentum for reform and driving the implementation process from conception to completion. Reform efforts are long-term processes and require commitment throughout the process. This commitment must continue even in the case of change of governments.

***3. Creating broad coalition of support for reform is important***

Institutional reforms require change in power relationships among actors. They upset entrenched interests, which have the advantage of inertia, history, organizational capability, and knowing exactly what is at stake. They are generally more organized, informed, and influential than the body of common citizens. But reform is possible, even against these odds. Coalitions of people for better services, in particular, increase the odds for success. In most instances making services work for poor people means making services work for everybody—while ensuring that poor people have access to those services. Therefore, what is required is a coalition that includes poor people and significant elements of the non-poor. There is unlikely to be progress without substantial "middle-class buy-in" to the proposed reforms.

***4) Change agents or reform champions are needed to anchor the reforms***

Episodes of reform depend on reform champions who act as the entrepreneurs of public sector reform. They can emerge from various sources. Politicians can often pursue service improvements even when the conditions are not propitious. They must act to create and sustain pressures for reform. Professional associations are often both the source of pressure for, and resistance to, major innovations. Dissatisfied with the progress in their field—education, policing, public health, sanitation—professionals emerge as champions for reform, putting pressures on politicians and policymakers for reform. Linking the efforts of these "insiders" and "technocrats" to broader coalitions of citizens is often a key element of success.

***5) Support and engagement of multiple stakeholders is essential***

Active civil society participation-including bottom-up initiatives through NGOs, community-based organization, public interest groups, private sector, media and human rights organizations-is crucial from the beginning in programme planning, design, policy implementation and monitoring. The involvement of 'non-state sector' in policy implementation has been an important element in improving its speed and effectiveness. Also, political leaders and public institutions frequently lack the political will to reform on a sustained basis. The experience suggests that a small group of civil society and NGO leaders can play an important role in mobilizing support for reforms. All stakeholders should be prepared for long-term engagement if they seek to change the mindset on desirability of a reform. Mobilization empowers people to articulate themselves in decision-making and ensures transparency and accountability.

***6) Change management is an integral part of any reform process***

Successful change management is an integral part of any reform process. Engaging and consulting staff early in the stages of reform, providing incentives and learning opportunities to use new technologies, adapting to new business re-engineering systems, and acquiring new skills and knowledge to cope with the new business environment, will pave the way for a smoother administrative reform process and organizational transition. Failing to manage a process of change successfully and effectively will lead to resistance, jeopardize achievements accomplished and the process will suffer delays and inefficiency as a result of power struggle.

***7) There is no one-size-fits-all programme design***

There is no one model of public sector delivery or management reform that suits all situations. Reform designers should pay attention to the political, legal and socio-cultural context of the proposed interventions. There is the need for an interdisciplinary approach to better understand socioeconomic and political factors that facilitate or impede the success of reforms. For the reforms to succeed, many systemic variables are important, including a homogeneous culture, an institutional framework that is conducive to organization level reform, and the involvement of stakeholders in program design and implementation.

***8) Strategic incrementalism may be a more pragmatic and feasible option***

Sweeping or fundamental reform of institutions is rare and difficult to achieve. It requires the right conditions. Most "modern" institutions of political and economic governance that are recommended today emerged late in the history of developed countries. Institutional reforms that change the nation's outlook move at a slow pace, they require patience and perseverance.

However, the improvement of services, always pressing, cannot wait for the right conditions. Some arrangements, such as enclave approaches to delivering services to poor people, may not be sustainable in the long run, even if they improve outcomes in the short run. Often driven by donors, these actions can undermine national relationships of accountability. Sometimes the desirable arrangement is to strengthen the weakest link. If the policymaker-provider accountability link is weak, contracting out services—such as the use of nongovernmental organizations for primary health services—may be the preferred arrangement. But incremental activities—pragmatic improvisation to make services work even in a weak institutional environment—should be used to create more favorable conditions for reform in the longer run. Temporary work-arounds cannot and should not substitute for creating the conditions for fundamental reform.

***9) Setting realistic and well-defined targets can be useful***

The approach has to focus on setting and delivering discernable and manageable short term and intermediate goals that can be reached in the existing context, while building towards the 'bigger' goals in the longer term. This approach has been effective in generating and maintaining motivation and political support.

***10) Learning from ones own and others' experience can lead to significant value added***

Best practices are useful tools to share experience and knowledge. They highlight some of the common reform issues discernible in most situations, relationships between systematic variables—the extent of political support at the highest level and the resource base of the country, for example—and the various elements of the civil service reform. Furthermore, knowledge of global experience and best practices facilitates a critical review by national and local development practitioners.

***11) Ensuring financial and institutional sustainability is crucial***

Most of the governance reforms - whether relating to public administration, civil services, decentralization or delivery of services or upholding of the rule of law and human rights- need adequate financial resources and a predictability in the flow of funds. If there is a serious gap between the quantum of the resources required to meet the hardware and staffing needs and expenditure allocation actually made or if there is disruption in the timely flow of resources an otherwise good initiative can turn into a failure.

Many view capacity constraints as barriers to scaling up of their financial commitments. Initially, in such cases, the focus should be on capacity building. Capacity for service delivery can be increased through investments in human resources, physical infrastructure and management systems. In the medium-to-long term, people can be trained, infrastructure can be built, and new management systems –consisting of effective processes and structures for service delivery – can be put in place to enable a country, to deliver and manage the services at the scale required to meet its goals.

***12) Show and publicize "good results" and provide incentives for continued progress***

Publicizing good results and providing incentives and awards to successful implementers and users of the new systems, will encourage others to join in, forge change in attitudes towards reform, and ease the fear and perceptions of threat that is usually experienced when change in introduced.

***13) Role of international organizations should be supportive***

Reforms should be driven by actors at the national level. International agencies can act only as international advisors and facilitators of resource mobilization to achieve national objectives. Global policy advice is useful as long as it is in tune with national realities and facilitates cross-fertilization of experiences and ideas. International partnership with local civil society should be enhanced through support to their internal governance structures as well as capacity building to ensure that they are capable and have the resources and autonomy required to advocate and support the reform effort. Successful private sector partnerships, particularly in e-governance, suggest an opportunity for more systemic outreach to the domestic private sector.

Overall these lessons can be instrumental in helping Pakistan design and implement a governance reform agenda, some elements of which are described in the next section.

## THE REFORM AGENDA

A pre-requisite for improved governance is for the political leadership at both the Federal and Provincial levels to try to regain the trust and confidence of the public. Several steps can help to alleviate the present mistrust. Among them are, less arbitrariness and greater transparency in decision making, a clear respect for rule of law, and adoption of austerity measures to curb wasteful and low priority public spending, and finally strong accountability mechanisms that reward good performance and punish wrong doing.

At the same time, the capacity for governance must be improved by the appointment of highly capable and honest individuals, paying them better and providing them leeway in implementation. The recommendations of the Pay Commission deserve special attention in that the top management ranks are rapidly thinning in terms of competence and expertise. The move to consolidated pay and perks is long overdue.

If the government puts its own house in order and sets high examples of financial restraint and greater integrity, it would be in a stronger position to be honest with the public on the nature of the challenges that the country faces, that are the cumulative result of policy neglect or failures for decades and are not a fault of any particular party or regime. It must also try to appeal to the enlightened self- interest of the elite that sacrifices and tax compliance are absolutely necessary to avoid economic disaster or worse.

Some specific areas of governance reform in Pakistan include the following:

### Framework of Policies

1) Proper and timely design of policies, their coordination is an essential pre-requisite for improved management of the economy. What is of utmost importance is that policy framework should be widely debated and should involve academia, think tanks and research organizations in the country context. Public discourse should focus on pros and cons of possible alternatives. In particular, advise from multilateral organizations should be openly debated and the policies like the priorities in national/local budgets should be open to debate and public discourse.

2) A policy to encourage the private sector, which has hitherto received little attention has to be emphasized. Important ingredients include: provision of supportive macroeconomic framework– which minimizes uncertainty and promotes stability; favourable legal and regulatory environment– which reduces costs to business; adequate physical and social infrastructure– which enhances productivity; and developed markets – for inputs and outputs.

### Public Administration and Civil Service

3) There are four 'building blocks' to improve public sector capacity in developing countries: first, strong central capacity for formulating and coordinating policy; second, reforms of institutions for the delivery of products and services especially by the state enterprises and public utilities like PIA, Pakistan Railways, WAPDA, Pakistan Steel Mills, etc. third, motivated and capable staff selected on merit basis at the entry point, intensive training, a system of merit-based promotions and incentives and leadership development; and finally, effective mechanisms for interface between the public sector agencies and people. An incremental approach to capacity building might be essential

in some cases to sustain reforms. These will require heavy investments in both personnel (increase in salaries/rewards, training, capacity building etc.) and physical infrastructure (ICT hardware and software, one stop shops etc). Donor's financial and technical support may be sought in this context.

### Decentralization and Delivery of Services

4) A move towards decentralized local governance is the most effective mechanism of achieving sustainable improvements in service delivery. Many factors determine the success of decentralization, including: a clear and coherent set of rules delineating the powers, responsibilities and resources of each level of government; appropriate government policies including enabling legal framework, increase in local autonomy, with proper checks and balances and institutional structures; partnership among different actors at the local level; leadership at local level; and adequate administrative capacity.

5) Specific / targeted interventions in critical areas like education, child and maternal health care, water supply and sanitation, slum improvement etc aiming to expand coverage, improve quality and enhance affordability are essential. Besides, increasing physical infrastructure (schools/health facilities), this involves better trained staff, which is accountable to communities and adequate and better quality materials and inputs (relevant curricula and textbooks in schools, vaccines and medicines in health facilities etc.)

### Accountability and Transparency

6) Accountability requires the presence of quasi-judicial independent mechanisms that can prevent concentration of power and encourage an accountable political system. The first step is free and fairly conducted elections which should be consolidated through further strengthening of representative and responsive governance institutions, opening up of media and giving a voice to the people. Accountability, in practice, depends on citizens' awareness of their rights and information about government action and this requires openness, free flow of information and transparency of government rules, procedures and processes, including planning, procurements, expenditure reviews and project level details. Civil society's 'watchdog' role needs to be strengthened and encouraged.

7) Corruption is a systemic challenge confronting many developing countries, for which there are no quick fixes and piecemeal reforms are not likely to make a big difference. Combating corruption requires a comprehensive strategy which combines: first, prevention – simplifying government programs and procedures and eliminating discretion, enforcing code of conduct, modifying laws that leave loopholes for corrupt practices, privatization of appropriate institutions with reforms to remove rent-seeking

opportunities; second, enforcement – formal statutes effectively enforced by independent authorities, with independent investigation, prosecution and adjudication; third, public awareness and support – easy access to information, free press, a dynamic civil society and freedom of information laws; and finally, institution building - establishment of independent commissions against corruption with broad investigative, prosecutorial and public education powers.

8) The Accountability Commission should have top political support, operational independence, and adequate resources. In addition, other institutions like the Auditor General, Ombudsman, Election Commission and Public Accounts Committee of the Parliament need to strengthened. On top of this, regional initiatives for combating corruption like the Africa Union Convention on Preventing and Combating Corruption and ADB/OECD Anti-Corruption Initiative can be fruitful and therefore, should be implemented.

### Rule of Law

9) Strengthening the legal system is essential. Separation of the power of different branches of government, through outlining their roles and responsibilities is important alongwith the provision of sufficient financial resources and adequately trained and accountable personnel. Enhancing societal respect for the role of an impartial judiciary–through judicial independence, efficient and fair decisions on judicial cases, and appearing unbiased with respect to economic, social and political status – is essential. Reforming the institutional structure is the key to ensuring the independence of the judiciary. This involves a transparent selection process, security of tenure of legal professionals, effective procedures for evaluation and promotion and proper financial resources. Besides, there is need to undertake pro-poor legal reforms – elimination of laws with a distinct anti-poor component, reforming legal procedures to create greater access for individuals and CSOs acting in public interest and reducing legal technicalities and simplifying the legal language. There is also need for appropriate legal system and business and commercial laws for the private sector to conduct its activities efficiently.

### Role of Civil Society

10) Governments should create legal, political and institutional space for civil society to express its views, organize and participate in the development process; participate in the planning and review of development based strategies; deliver services; train communities; play the 'watchdog' role on public sector activities, network, build coalitions, share advise and exert pressure for resource mobilization, foster political will, campaign and monitor the progress on social development; initiate livelihood programmes; and socially mobilize particular communities - especially the vulnerable and the marginalized. For civil society to effectively perform these functions it is

important that its capacity is strengthened, financial sustainability is ensured, internal accountability and transparency is enhanced and the mistrust between government and CSOs is removed through enhanced dialogue, partnership, collaboration and transparency.

In conclusion, the overall message of this chapter is that Pakistan has paid a heavy price for poor governance which has worsened over time. However, governance has many dimensions - it is a complex terrain where easy and simple fixes may not yield effective and sustainable results. In some cases difficult political choices are major obstacles while in other cases complex operational strategies may be difficult to implement. Governance reforms fundamentally need political will and commitment. But one thing is clear, they are essential if Pakistan is to achieve sustainable and inclusive development and if the writ of the State is not to be questioned.

# Chapter - 6

# Eighteenth Amendment: Provincial Rights and Responsibilities

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# Eighteenth Amendment: Provincial Rights and Responsibilities

## INTRODUCTION

The main purpose of this chapter is to suggest that Pakistan needs a different development paradigm to deal with its many economic, social and political problems. It needs to be different from the one followed in recent years that, after several years of high growth, plunged the country into a deep crisis. As mentioned earlier, this manifested itself in many different ways. The rate of economic progress slowed down and the incidence of poverty increased. Domestic terrorism grew to the point that most contacts with the outside world have been affected by it. The last was particularly troubling since Pakistan depends to such an extent on external capital flows were severed. Any slack in their quantity has a deadening impact on the economy. Economy's poor performance accompanied by palpably poor governance has created an environment in which inter-regional, intra-provincial, inter- economic classes, and sectarian conflicts have risen to the surface and to the point at which they threaten the very integrity of the Pakistani state. These have come with heavy economic, social and political costs that will further set back progress on a number of different fronts[1].

As has been said by a number of people who have influence over world affairs, Pakistan faces an existential threat. Dealing with it must be a high priority for those who hold the reins of power in the country today. A new development paradigm must, therefore, work to restore not only the confidence of the domestic players in the economy, it must also revive external interest in the country's economic future.

An important part of the suggested paradigm is the notion that one way of rebalancing the economy and the social and political systems is to bring government closer to the people. The Award made by the 7th National Finance Commission in late 2009, is a step in the right direction. This, however, is the subject of another chapter in this report. The other is the passage and signing into law on April 19, 2010 of the 18th Amendment to the Constitution by President Asif Ali Zardari. Notwithstanding these momentous developments and the comprehensiveness with which the drafters of the 18th Amendment carried out their assignment, does not mean that further tinkering may not be required to make the Constitution more meaningful for the times. The Constitution was so thoroughly disfigured by a number of authoritarian rulers that governed the country for long periods of time that making it an effective instrument of governance may need even more changes. But a good start has been made.

Decentralization of policymaking as well as the implementation of the policies made are some of the important outcomes of the 18th Amendment but it will need much more than that to address the problems the country faces today. Highlighting these and suggesting some ways of dealing with them is the main theme of this chapter. The chapter will first provide a quick overview of the situation in the country to lay the context for the discussion of the recently enacted Eighteenth Amendment. It will then briefly discuss the history of constitution making in the country, suggesting that the tendency towards having a highly centralized system of governance has deep historical roots. It will then go to discuss the 18th Amendment, focusing on both the process used for arriving at a consensus among different political parties on the substance of the Amendment and then go on to analyze its content. Finally the chapter, using experience of other countries, will examine how effective the Amendment to the constitution will be in bringing about effective decentralization and providing services to the people for which the government must take full responsibility.

## HISTORICAL BACKGROUND

Most of the press coverage of the 18th Amendment concerned the division of power between the President and the Prime Minister. Since the Constitution of 1973 established a parliamentary form of government in the country, it has been the contention of those who favored the reduction in the authority of the President, that executive authority must reside in the Parliament. That was the intention of the framers of the Constitution. However the Parliament's powers were repeatedly usurped by the governments dominated by the military. Through constitutional amendments or simply by practice, the President became the chief executive of the Pakistani State. The military leaders introduced changes in the constitution through the 8th Amendment inserted by President Ziaul Haq and the 17th Amendment by President Pervez Musharraf to provide legal covers to their efforts to monopolize power. The 18th Amendment seeks to correct that anomaly by restoring the powers given to parliament under the 1973 Constitution. At this point it might be useful to pause a bit and provide a brief historical background to the evolution of Pakistan's constitution with respect to provincial rights.

What has escaped notice by most analysts and commentators is another part of the amendment, a significant increase in the powers of the federating provinces. Granting provincial autonomy was also the intention of the original constitution. This became a political necessity when East Pakistan was part of the Pakistani federation. It was larger in size in terms of the population compared to the combined population of the four provinces in the country's western wing. In the mid-1950s a political solution was found by merging the four western provinces into the One Unit of West Pakistan which led to the adoption of what came to be called the system of "parity" – or simply "fifty-fifty". Under it East and West Pakistan were assigned equal number of seats in the national parliament created in the Constitution promulgated in 1956. This was the first of three Constitutions Pakistan was to adopt in a period of only 17 years, one indication of the political turmoil through which the country has passed at various times in its history. However, the principle of parity meant depriving East Pakistan the representation it deserved on account of its larger population. The Bengali acquiesced to this arrangement in the expectation that it would bring to an end the system of politics that had been dominated by the civil and military bureaucracies working with one powerful group - the landed aristocracy of the Punjab and Sindh. The Punjab also had a large presence in the bureaucracies which gave it enormous power in the political and economic systems.

The arrangement did not work to the satisfaction of the Pakistani military which, seeing the yo-yo style of politics the Constitution of 1956 had set in motion, decided to intervene. The men in uniform had become apprehensive that political turmoil would damage the economy and create problems for national security. They struck on October 7, 1958 and put the country under martial law. National and provincial assemblies were dissolved, the Constitution was abrogated and, eventually, a military presidency was established. Nearly four years after assuming power, the military gave the country another Constitution, promulgated in 1962. It set the pattern of extreme centralization of authority that was to be followed for the next several decades not only when the country was under the direct rule of the military. Civilian rulers also continued with this tradition of centralization.

President Ayub Khan was pushed out of power in March 1969 by General Yahya Khan following a movement that focused on the outcome of his economic policies that produced high rates of economic growth but some income inequality. Under the new leader, the military opted for another spell of political engineering. The 1962 Constitution was abrogated, the One Unit of West Pakistan was dissolved and replaced by four provinces; a Legal Framework Order was promulgated under which a new assembly was to be created, elected on the basis of adult franchise and charged with the task of providing the country with yet another constitution; and East Pakistan was given a share in the assembly proportionate to its population. Elections were held in December 1970, the first time the people of Pakistan were allowed to vote directly for their representatives in the National Assembly. The script, however, was not played out on the political stage the way it was written. West Pakistanis under the leadership of Zulfikar Ali Bhutto refused to grant power to East Pakistan's Awami League that under Mujibur Rahman had won all but one seat from that wing of the country and an outright majority in the National Assembly. The stand-off eventually led to a civil war, the departure of East Pakistan from the Pakistani federation and the emergence of Bangladesh as an independent state. The military in West Pakistan – now Pakistan – lost power and was replaced by Zulfikar Ali Bhutto as the Chief Martial Law Administrator and President.

Bhutto began the process of providing Pakistan with another constitution. He and the framers of the new Constitution recognized that the failure to run a federal system, allowing significant provincial autonomy was the main reason for the break-up of Pakistan in 1971 and the emergence of Bangladesh as an in independent state. They were also concerned with the fact that the country that emerged after 1971 had one very large province – the Punjab – in the federation. It could – and perhaps would – dominate the federation even more than was the case in the 1947-1971 period when Bangladesh, as East Pakistan, was a part of Pakistan. Then in terms of the country's total population the share of the Punjab was about 30 per cent. It was slightly more than that in terms of its contribution to the country's gross domestic product. With the departure of East Pakistan, these ratios had climbed to 60 per cent. Accordingly, the smaller provinces demanded that their rights should be protected in the new state that was being organized after the break-up of original Pakistan.

This was ensured in the form of several provisions in the 1973 constitution. Without these it is unlikely that Zulfikar Ali Bhutto would have won the support of all the provinces to the Constitution that he and his advisors put in front of them. One important provision in the draft was the inclusion of a "Concurrent List" that included the subjects that will be the joint responsibility of the federal government and the provinces. The Constitution had two lists, one for federal subjects and the other that were to be the joint responsibility of the federal government and the provinces. The Concurrent List included matters – 47 in number – such as civil and criminal law, preventive detention, arms and explosives, drugs, marriage and divorce, adoption, bankruptcy, arbitration, trusts, transfer of property and registration of property, population planning, electricity, tourism, trade unions, and other matters of common interest.

The Constitution also had provisions for the settlement of disputes between the governments at federal and provincial levels. The Chief Justice was assigned the responsibility for arbitrating these disputes. The President could establish a Council of Common Interests, the CCI, to deal with the matters identified in both the federal as well as the concurrent lists. According to Hamid Khan, a prominent constitutional authority, "this was meant to be an important body for the provinces to air their grievances. If the federal government or a provincial government was dissatisfied with the decision of the Council, it could refer the matter to Parliament for a joint sitting [of the two houses], whose decision would be final."

There was no list of subjects for the provinces, the assumption being that all the residual areas will be taken care of by them. Bhutto and his colleagues reached an understanding that the Concurrent List will be removed from the Constitution ten years after its promulgation. That, of course, did not happen and the country continued to be run from the center at Islamabad. Under the Eighteenth Amendment there is once again a promise that decentralization will be achieved not just on paper but also in practice.

The country has also attempted to bring government closer to the citizenry by constituting local bodies, directly elected by the people. A number of different systems have been tried since independence but did not survive long enough to provide services only local governments can effectively deliver. Had one system been allowed to remain in place with changes introduced from time to time, Pakistan would possibly have developed an effective system of local governance. This did not happen. The most elaborate of the previous systems was designed by President Ayub Khan as a part of the 1962 constitution. It was to perform two functions – provide a mechanism for the people to have representation at six different levels of government and to deliver a number of basic services to the people at these levels. The six levels were the Union, a large village or a cluster of smaller ones; the Tehsil; the District, the Division; the province; and, finally, the nation. Each of the bottom four jurisdictions had councils made up of elected representatives of the people and government functionaries. The top two tiers had assemblies. The people directly elected only the Union Councilors; members of other councils were elected indirectly by the members of the bottom tier. The Union Councilors, 80,000 in all – 40,000 from each wing of the country – also served as the electoral college for the office of the president[2].

Called the system of "Basic Democracies" the new structure was successful in bringing development to the country's villages and to create the economic and administrative environment for the launch of Pakistan's first green revolution in the late ‘sixties’ and early 'seventies. But the structure was not accepted by the political establishment as an appropriate system of representation. It was not representative enough, particularly for electing the President and the members of the provincial and national assemblies. As already indicated, the system was dissolved in 1969.

The most recent of the attempts to create a system of local government was made by the administration headed by President Pervez Musharraf that provided the stool of governance with its third leg – governments at the local level. The design that was incorporated in the ordinance issued in 2001, by the president, drew inspiration from the system of "basic democracies". The provinces were instructed to issue their own local government laws as long as the basic construction proposed by Islamabad was not tampered with.

There is a default constitutional condition in Pakistan; the country reverts back periodically to a highly centralized system of management. It has happened during the periods of military rule as well as when politicians with strong popular backing were in power. The military accustomed to a centralized command and control system of management, was not willing to devolve power to other institutions that could possibly challenge its authority. Strong political men and one politically powerful woman who have governed Pakistan were equally reluctant to share power. This trend started with Zulfikar Ali Bhutto who did not fully subscribe to the spirit of the Constitution he had helped write and was responsible for having it accepted by all major parties. He began to subvert it the moment it was promulgated. The provisions that came under attack were precisely those that were meant to create a functioning federal state. Once the constitutional dust had settled down, the Prime Minister turned his attention to removing the administrations that were not in the control of his political party, the Pakistan People's Party, the PPP. These were in Balochistan and the Khyber-Pakhtunkhwa.

## THE EIGHTEENTH AMENDMENT

The Eighteenth Amendment does more than repeal the Seventeenth Amendment that had given enormous authority to the President. It also removes the clutter that had accumulated in the constitution as a result of the tinkering by two military leaders, first President Ziaul Haq and then President Pervez Musharraf. Will the passage of this Amendment ensure Pakistan's move towards making parliament sovereign and introducing genuine federalism in the country? Only time will answer this question. As has been shown by the experience of several other federal systems, decentralization of power to governments at the sub-national level takes more than provisions in the Constitution. Ultimately it depends upon how the various parts of the government structure act out their roles.

There cannot be any doubt that the Eighteenth Amendment will have a profound impact on the way Pakistan's economy is managed. If the federating units – the provinces – receive additional powers as a result of the abolition of the concurrent list put into the 1973 Constitution by its framers, it will mean transferring large amounts of economic authority to the provinces. They will, for instance, have the right to manage labor laws, environmental impact of development in both the public and the private sectors of the economy, generation of much larger amounts of electricity than currently permitted, development of infrastructure, movement of goods and commodities within their own boundaries, improving the level of education and providing for the acquisition of usable skills by the populace. This will happen only if the provinces find a way of financing these activities. If they remain dependent on the central government for funds, the autonomy promised by the Amendment will remain illusory. What is the meaning of the Eighteenth Amendment for economic decentralization? We will take up this matter in a later part of the chapter. For the moment we will discuss the process adopted to write the Amendment and its content. Both are worth noting in some detail.

## The Process

The Amendment has as its source the Charter of Democracy, the COD, signed in London by Benazir Bhutto, Chairperson of the Pakistan People's Party, the PPP, and Mian Nawaz Sharif, President of his faction of Pakistan Muslim League, the PML(N). The signing took place in 2006 when President Pervez Musharraf was at the peak of his power and was engaged in creating circumstances that would help to prolong his tenure. At the time of signing, the Charter seemed like a hope that would take a miracle to realize. But miracles happened. These included the decision by President Musharraf to allow the two former Prime Ministers to return home from exile; his decision to withdraw the emergency under which he had placed the country in November 2007 after dismissing the Supreme Court Chief Justice for the second time in less than eight months; to hold free and fair elections in February 2008; and to resign from his office in August 2008. Normalcy did not return immediately after the departure of the military President. President Asif Ali Zardari who succeeded Musharraf, resisted the effort to restore the Chief Justice to his position and to cleanse the Constitution of the distortions introduced by the military Presidents. However, he finally agreed to set into motion a process that would result in the incorporation of the COD in the Constitution by way of the 18$^{th}$ Amendment.

A 26 member Constitutional Reforms Committee was constituted in 2008 under the chairmanship of Raza Rabbani, a PPP member of the national assembly who had shown the ability to act independently of his party's leadership. This became evident when the lawyers launched a movement in the country to restore Chief Justice Iftikhar Ahmed Chaudhry from which he had been fired twice by President Pervez Musharraf. The composition of the Committee deviated considerably from the party composition in the national assembly. Only 13 of its 26 members were from the four large parties – the PPP; the PML(N); the PML(Q), a faction of the Muslim League that had supported Musharraf while he was in power; and the Mutahida Qaumi Movement, the MQM. The PPP had five members, the two Muslim League factions three each and the MQM two. The remaining 13 belonged to ten different parties and groups. This composition was meant to provide confidence to the smaller parties that their wishes would not be ignored.

The Committee assigned itself an ambitious mandate. The most important objective was to strengthen Parliament as well as the provincial assemblies. The chief executives – the Prime Minister and the provincial Chief Ministers – would be guided by their respective assembles and would be accountable to them. This would ensure government transparency and also reduce individual discretion. The Constitution would also revert to its original intent: accommodate provincial autonomy. Fundamental rights will be strengthened by expanding their reach. Judiciary would be strengthened.

The Committee conducted its business in relative secrecy in order not to have a national debate while it was deliberating the various clauses in the amendment draft. The members agreed not to give public statements and speak to the press on the issues that were being discussed even when the Committee was not in session.

The amendment was voted by the Committee after a slight hiccup when Nawaz Sharif and his party refused to give ground on two issues: the renaming of the Northwest Frontier Province, the NWFP, as Pakhtunkhwa and the mechanism for appointing judges to the superior courts. The Committee made some accommodations in the final draft to keep the party on board. The draft Amendment was placed first before the National Assembly and then before the Senate. The vote in the Assembly was 292 in favor and none against. The vote in the Senate was 90 in favor and none against. This represented an enormous display of confidence in both the process that was followed by the drafting Committee in producing the Amendment, as well as in its content.

### The Content

The Amendment met the long-standing demand of the Pakhtun population of the NWFP to rename their province by identifying it with the main ethnic group living in the area. The group would have preferred the province to be named Pakhtunkhwa but this was resisted by other ethnic groups in particular the Hindkoh speakers who live in the areas bordering Punjab. A compromise was truck and the province was given the unwieldy, hyphenated name of Khyber-Pakhtunkhwa. That did not satisfy the Hindkoh speakers; there were riots in the area after the Amendment was passed leaving several people dead. Giving the NWFP a long name may have stalled the move that is gaining some momentum in the country to create a number of new provinces to accommodate different linguistic groups. If that move is to succeed, Pakistan will follow the example of neighboring India that reorganized the country essentially on linguistic grounds soon after achieving independence.

One of the more important changes in the Constitution pertains to the powers of the President. All the authority bestowed on this office by General Ziaul Haq's 8$^{th}$ Amendment and General Pervez Musharraf's 17$^{th}$ Amendment were withdrawn. While the President retains the right to be informed on all matters pertaining to domestic and external policies, he cannot now require reports on any administrative or legislative matters to be submitted to him. These reports were the basis of one dismissal of the Prime Minister of the day by President Ziaul Haq, two dismissals by President Ghulam Ishaq Khan and one by President Farooq Leghari. In other words, the notorious section 58.2(b) that allowed the President to dismiss the Prime Minister on such vague charges as incompetence and poor governance was used more frequently by civilians than by military leaders. This clause was inserted in 1985 by the 8$^{th}$ Amendment brought in by Ziaul Haq when he began the process of sharing power with politicians. It was removed by the 13$^{th}$ Amendment piloted by Prime Minister Nawaz Sharif who wanted to become the chief executive of the State by diluting the powers of the President. It was reinserted by Pervez Musharraf in 2002 when the National assembly, at his urging, passed the 17$^{th}$ Amendment. The need for this arose after Musharraf held elections and was in the process of transferring some executive authority to an elected Prime Minister. The 18$^{th}$ Amendment has removed the clause once again.

Further limits have been placed on the powers of the President. Time limits have been fixed for the President to act on the advice given to him by the Prime Minister and his cabinet. President's discretionary powers to dissolve the National Assembly or to refer a matter to referendum have been removed. Referendums were conducted by both Presidents Ziaul Haq and Pervez Musharraf to win legitimacy for their rules. In both cases the results were massively rigged. The President is now to appoint the provincial governors and service chiefs on the advice of the Prime Minister, which is binding.

The Amendment has several provisions to give more power to the smaller provinces. The Constitution had created a bicameral legislature in which the Senate, the upper house, was to have equal representation of all provinces. The Amendment seeks to strengthen the Senate. The membership of the Senate has been increased to 104 from 100; the Prime Minister and his cabinet will be responsible to both the National Assembly as well as the Senate; the body must meet for at least 110 days a year rather than only 90 days; the President cannot issue an ordinance when the Senate is in session; the Senate can discuss money bills (budget etc.) for 14 rather than seven days; and the government's annual report on implementation of principles of policy must be placed before both houses of the Parliament.

The Amendment strengthened Article 6 of the Constitution that was originally inserted to deter military takeovers. In the original Constitution, any effort to dislodge a duly constituted government was made a capital offense punishable by death. This did not, however, prevent the coups staged by Generals Ziaul Haq in 1977 and Pervez Musharraf in 1999. In both cases, when challenged, the acts were given legal cover by the Supreme Court. The amended article expands the definition of high treason by including in it an act of suspending the Constitution or holding it in abeyance. Further the Supreme Court or the High Courts cannot validate assaults on the Constitution.

The number of fundamental rights have been increased to include the right to fair trial, the right to information and the right to education. It is now compulsory for children between the ages of 5 to 16 years to be in schools and for the state to provide them with free education. This provision will have enormous implications for a resource-strapped state that spends just under 2 percent of the gross domestic product on education. Meeting this condition could quadruple this proportion.

For the appointment of judges – a contentious area that held up the final agreement on the draft for a few days – the Amendment appoints a seven member Judicial Commission headed by the Chief Justice of the Supreme Court. The recommendations of the Commission will be sent to an eight member Parliamentary Committee with the authority to reject the nomination by no less than 3/4$^{th}$ majority. This section of the Amendment has been challenged in the Supreme Court by some members of the legal community who believe that it will politicize the judicial system and not necessarily make it independent of executive control. Whether it remains a part of the amended Constitution will be decided by the Supreme Court. The Amendment has created a new High Court – at Islamabad, the federal territory – and has established two additional benches of the High Courts, at Mingora in Khyber-Pukhtunkhwa and at Turbat in Balochistan. The motives for this were to accommodate the wishes of the people of these two provinces. The Taleban led rebellion in Swat of which Mingora is the capital was prompted in part by people's unhappiness with the time it took the courts to settle disputes and render justice. There is an expectation that by reducing the physical distance between some of the far-flung areas in some of the more backward provinces and setting up judicial centers would help to take care of some of the grievances of the people.

For our purpose – the need to bring government closer to the people – the most important changes in the Constitution relate to the assigning of responsibilities to governments at different levels. The Concurrent List in the original document that gave joint responsibilities to the federal as well as provincial governments has been removed. However, criminal laws and criminal procedure and the rules of evidence remain subjects on which both Parliament and Provincial Legislatures can make laws. The Council of Common Interests has been greatly strengthened. It shall now be chaired by the Prime Minister, shall meet at least once a quarter, and have a permanent secretariat. It shall comprise the Prime Minister, three Federal Ministers and the four Chief Ministers. The list of subjects that will fall within the purview of the CCI has been substantially expanded including some of the subjects that were on the abolished concurrent list. Some of the subjects which will now be subject to deliberation by the CCI include major ports; electricity, presumably all aspect of it including generation, transmission and distribution; all regulatory authorities; national planning; public debt; census; legal, medical and other professions; higher education; and inter-provincial matters and coordination. The federation will not be allowed to build hydroelectric stations in any province without consultation with that province.

The Amendment has removed the Sixth Schedule to the Constitution that had given protection to 35 laws and ordinances promulgated during the Musharraf period. These could only be amended with the consent of the President. Included in these was the Local Government Ordinance of 2001.This leaves open the question whether the provinces would continue the systems that were in place as a result of the 2001 Ordinance. However, the provision inserted by the 17th amendment by President Musharrraf relating to the devolution of power to local governments has been retained and expanded to provide that elections should be held to local councils by the Election Commission.

An effort has been made to strengthen the Election Commission and make it autonomous. The term of office of the Chief Election Commissioner has been increased from three to five years and the number of Commissioners has been fixed at five. The CEC will be appointed by the President after he has received a binding recommendation from a Committee of the Parliament. A panel of three members will be sent to the Committee by the Prime Minister and the Leader of the Opposition in the National Assembly working together. The Committee will select one person from the panel and forward his (or her) name to the President for appointment. The Commission's powers have been expanded to include the preparation of electoral rolls, holding elections to the seats that fall vacant, and appointment of election tribunals to handle complaints. The Commission will be responsible for recruiting its staff.

There are a number of provisions pertaining to strengthening the finances of the provinces, They will have the right to raise domestic or foreign loans with the approval of the National Economic Council, a body chaired by the Prime Minister with secretariat in the Ministry of Finance. They will collect the entire amount generated by excise duty on oil and natural gas. Future National Finance Commissions cannot issue awards that reduce the combined share of the provinces in the central "divisible pool". In other words, the amount given to the provinces by the 7th Award has been frozen in time. The only discretion they have is to change the proportions allocated to the provinces.

There are some other amendments to the Constitution that that warrant some mention. These pertain to political matters. As a nod to the peculiar political circumstances in Pakistan, with the heads of the three of the four major political parties – the PPP, the PML(N), and the MQM – not present in the Parliament, disqualification on the basis of defection will be undertaken only on the initiative of the party head and not by the parliamentary leader. That the members of the assembly who cross the floor can lose their seats was inserted in the Constitution by the 13th Amendment to deal with horse-trading that had marked politics in the 1990s. The new provision means that the absent leaders will be able to rule over their parties from outside the parliament or the provincial assemblies. Also the clause in the 17th Amendment that limited the tenure of the

Prime Minister to two terms has been removed thus enabling Nawaz Sharif to aim for that position, held twice in the 1990s, once again. These changes will have intended or unintended consequences of strengthening the hold of some of the powerful families over the political process[3].

## Will the 18th Amendment Deliver Decentralization?

With the passage of the 18th Amendment, Pakistan may be on the way towards establishing a fully democratic system with political authority vesting in a directly elected parliament. For that to happen, the military will have to come under the control of the civilian authority. The country may also be moving towards the creation of a federal system in which there is sharing of power between governments at different levels – between the federal and provincial governments and between provincial and local governments. If this happens, what will be the impact on the economy and on delivering services to the people? The answer to this question has been provided by many theoretical and empirical studies done over the years by scholars from both developed and developing countries. While many benefits have been claimed for federalism, it is "paradoxical that that we observe so few countries in the world which posses all the attributes of a strong federalist structure", writes Dennis C. Mueller of University of Vienna. "There are two possible explanations for this paradox. First, there may also be several disadvantages associated with federalism, so many that for most countries the disadvantages outweigh the advantages. Thus full blown federalism may be rare, because in fact it is undesirable. The second possible explanation for federalism's rarity is that it is somehow inherently unstable. When it is chosen, it fails to survive, not because of any fundamental difficulty in the outcome it produces, but because of the existence of forces in a democracy which undermine it.

To explain the case for federalism we should perhaps start with the reason why the state is involved in economic matters in the first place. The main reason for this is made in the public choice literature according to which markets fail in many situations particularly when public goods such as defense of the borders or police protection or a bridge connecting two places across a river are to be provided or where what economists call externalities become important. There are positive (when educated people work together to bring about positive change) and negative externalities (when industrialization produces air and water pollution). Markets are less efficient providers in both cases; the governments, at least in theory, do a better job. But what type of government? There are three possibilities: a unitary state, a federalist system, or a confederation. We will concern ourselves with the first two.

A unitary system need not be distant from the people especially when the state is decentralized with government departments organized to reach people where they are located. This was the system used by the British during their long rule of India and was the one that Pakistan inherited when it became an independent state. But it was not a federalist system in the sense that elected representatives of the people were not responsible for providing public goods to the people. That responsibility rested with the officials appointed by a highly centralized state. In British India the responsibility for providing public services rested with the members of the powerful Indian Civil Service, the ICS. The ICS was variously called the "steel frame" of the British raj in India or the "mai bap" of the people over whom its members ruled.[4] In a unitary system, responsibility to the people is only at the central level. In a federal system people through elections have control over those who serve them. That in theory is the system that Pakistan attempted to establish following the adoption of the 1973 Constitution.

Once the decision is made to establish a federal system the next question concerns its optimal design. How many levels of government should there be is one of these questions? What should be the division of responsibility among them? How should the governments at various levels finance their activities? The 1973 Constitution established two tiers of government, one at the central level and the other at the provincial level. The 17$^{th}$ Amendment introduced into the constitution by President Pervez Musharraf effectively introduced a third tier into the structure. This was done by devolving various state responsibilities to an elaborate system of local government, patterned, to some extent on Ayub Khan's multi-tiered system of "Basic Democracies". A new position was created to assign responsibility for delivering public services to an elected official called the "Nazim". This official was to be elected by the people and the bureaucracy at the local level was made responsible to him (or her). The Nazim effectively replaced the Deputy Commissioner who was the anchor of the administrative system Pakistan had inherited from the British.

The 1973 Constitution – even when amended by President Musharraf – did not provide many resource generation responsibilities to the governments at the sub-national levels. They were mostly dependent on the central government for financing their activities. The provincial governments were given some say in the amount of resources they obtained from the center by their representation in the National Finance Commission. The NFC was to be convened every five years. According to Section 160 of the Constitution, "Within six months of the commencing day and thereafter at intervals not exceeding every five years the President shall constitute a National Finance Commission consisting of the Minister of Finance of the Federal Government, the Ministers of Finance of the Provincial Governments, and such other persons as may be appointed by the President after consultation with thy Governors of the Provinces.[5]" The NFC would decide on the formula to be followed for allocating the resources available in what was called the divisible pool. However, this provision like so many other in the Constitution, was largely ignored. For instance the most recent NFC Award was signed in 2009, almost 13 years after the one it replaced. Whatever shares were agreed upon were provided to the provinces in the form of grants. According to many economists this way of providing resources to the federating units introduces serious distortions.

More than a hundred years ago, the economist Knut Wicksell established what has come to be called the Wicksellian connection. According to this, each public expenditure should be coupled with a tax to finance it so that the voting public knows how much it is paying for the services being provided. Some experts go a step further. They suggest that the people receiving services from the State no matter where the State is located, should be charged for the services they are being provided. This approach serves several purposes. It forces the State to be efficient in the business in which it is involved. It also makes it possible for the people to bypass the State and go to the private sector if they are not happy with the services being made available by the State. This is what has happened in the case of education and health services for the more well-to-do segments of the Pakistani society. The people who can afford to go to the private sector have largely abandoned the State in these areas.

There is a virtual consensus among economists that intergovernmental grants lead to an expansion of the public sector – there is empirical evidence to suggest that a local government generally spends a far larger fraction of an unconditional grant from a higher level of government than its citizens would consider to be optimal. Applying this finding to Pakistan where financing for the provinces will come mostly from the NFC Awards, Eighteenth Amendment induced autonomy will not necessarily lead to economic efficiency. The provinces must be given a way to finance most of their own development and take full responsibility for the resources they mobilize, including servicing them if they were obtained through borrowing.

## CONCLUSION

While the 18th Amendment to the Constitution has taken a major step forward in moving Pakistan towards a federal system, the real test of the efficiency will come once the envisaged system begins to take shape. The passage of the Amendment and its signing into law has not stilled the controversy that surrounds many aspects of governance in Pakistan. Many petitions have been moved in the Supreme Court challenging the Parliament's right to bring about such a major change in the original structure. Some legal experts contend that Parliament, even when voting unanimously, as was the case with the votes in favor of the amendment, cannot bring about a fundamental change in the original structure. Others maintain the opposite[6].

Another test will come in terms of providing services for which the provinces will have the responsibility with the abolition of the concurrent list by the 18th Amendment. Most economists agree that basic services are better provided by the governments that are closer to the intended beneficiaries. Decentralization of government's authority should help in addressing the problem the country faces as the number of people living in absolute poverty increases. But will the provinces have the resources to carry out this mandate? The Amendment has largely left this as an open question. That is a mistake. It is only when the devolution of responsibility is coupled with the responsibility of raising resources that the real test of the new system will come. Preceding the passage of the amendment was the announcement of the 7th National Finance Commission Award which has broken new ground in increasing the combined share of the provinces in the resources generated by the federal government. The NFC also provides a much larger share to Balochistan, the country's most backward province. However, grants made as part of the NFC rewards don't necessarily produce fiscal efficiency.

Then there is a lesson Pakistan's history has to teach. The process of centralization within a federalist structure Pakistan has seen in its history is so pervasive worldwide that it has come to be referred to as the Popitz law, named after the German economist who in the early part of the previous century identified the tendency toward centralization in state revenues and expenditures. According to a 2004 study by Alberto Diaz-Cayeros it is suggested that this law is correct. His conclusion is based on a study of 20 countries. "Starting from highly decentralized tax systems in 1930s, unitary and federal countries alike concentrated fiscal authority in the hands of the national governments." Will Pakistan once again revert to that situation? Again only time will tell.

Then there is the question of the impact of globalization on regional development within federalist structures. It has been noted by several scholars that with the easy movement of capital across national frontiers, there is intense competition among federating units within federal structures. This has been seen in federalist systems in both developed (Australia, Canada, the United States) as well as in the emerging (Brazil, China, India, South Africa) parts of the developing world. Economists call it "competitive federalism". We did not touch upon this aspect of decentralization in this brief presentation .

# Chapter - 7

# Fiscal Decentralization: Strengthening Provincial Finances

# Chapter - 7
# Fiscal Decentralization: Strengthening Provincial Finances

## INTRODUCTION

The members of the National Finance Commission (NFC), in the presence of the Chief Ministers of the four provinces, signed the seventh NFC Award on 30th December, 2009. The signing ceremony held at Gwadar, a recently developed port in Balochistan, was witnessed by Prime Minister Yusuf Raza Gilani. The award will come into force on 1st July 2010. The venue was chosen to reflect the desire of all provinces to end years of deprivation of the country's largest province by area, Balochistan.

The Constitution provides for the convening of the NFC every five years to apportion the funds collected by the federation but assigned to the "Divisible Pool" since they are meant to be shared with the provinces. The last NFC Award was announced in February 1997. Since then, two NFCs were constituted, in 2000 and 2005, but an award could not be announced on both occasions due to the lack of consensus among the members.

Given the deadlock in 2006, the provincial Chief Ministers vested the authority to the President to announce an ad-hoc award. As a consequence the President under Article 160(6) of the Constitution of the Islamic Republic of Pakistan, made amendments through Ordinance No.1 of 2006 to the "Distribution of Revenues and Grant-in-Aid Order of 1997". The new revenue sharing arrangements took effect from 1st July 2006.

Inter-governmental revenue transfers are the lifeline of provincial governments in Pakistan. These transfers account for over 80 percent of sub-national revenues. As mentioned in the earlier chapter, this dependence is a consequence of the imbalance in the allocation of functional responsibilities and fiscal powers between the federal and provincial governments in Pakistan, which has given rise to large vertical imbalances. Such vertical imbalances exist in other federations also, as shown in Table 7.1.

The vertical imbalance is high in Pakistan due to the skewed allocation of fiscal powers, whereby the federal government collects as much as 92 percent of tax revenues and the provinces, only 8 percent. Also, there is relatively greater centralization of functions and the share of the federal government in public expenditure is one of the highest in Pakistan, at 72 percent. *Prima facie*, there appears to be a case for decentralization from the federal to the provincial governments in Pakistan of both functions and fiscal powers.

Existence of vertical imbalances has necessitated establishment of elaborate revenue sharing arrangements in the different Federations. The transfers should be designed not only to remove

**TABLE 7.1**
**IMBALANCE BETWEEN REVENUES AND EXPENDITURES IN COUNTRIES, 2000-2001**

*(Before Transfers)*

| | Revenue Share (percent) | Expenditure Share (percent) | Surplus (+)/ Deficit (-) |
|---|---|---|---|
| **AUSTRALIA** | | | |
| National Government | 69 | 54 | +15 |
| Sub-National Governments | 31 | 46 | -15 |
| **BRAZIL** | | | |
| National Government | 69 | 54 | +15 |
| Sub-National Governments | 31 | 46 | -15 |
| **CANADA** | | | |
| National Government | 44 | 37 | +7 |
| Sub-National Governments | 56 | 63 | -7 |
| **INDIA** | | | |
| National Government | 66 | 45 | +21 |
| Sub-National Governments | 34 | 55 | -21 |
| **SOUTH KOREA** | | | |
| National Government | 95 | 50 | +45 |
| Sub-National Governments | 5 | 50 | -45 |
| **GERMANY** | | | |
| National Government | 65 | 37 | +27 |
| Sub-National Governments | 35 | 63 | -27 |
| **PAKISTAN** | | | |
| National Government | 92 | 72 | +20 |
| Sub-National Governments | 8 | 28 | -20 |

**Source:** Adopted from Watts (2005).

the imbalances but also be efficient and equitable. Box 7.1 presents the criteria that ought to be satisfied in the design of inter-governmental transfers. While current federal transfers in Pakistan do fairly well on the criteria of efficiency, predictability and simplicity, as will be demonstrated in this chapter, they do relatively poorly on the criteria of revenue adequacy, equity and incentives for sound fiscal management by sub-national governments. As such, there was need for the new NFC Award to make a special effort to address these inadequacies.

Before we discuss the newly announced Award and its implications, it will be useful to briefly see how inter-governmental transfers have evolved in Pakistan as the design has had a significant impact on the fiscal position of the provincial governments, both collectively and individually.

## EVOLUTION OF REVENUE SHARING IN PAKISTAN

Since partition, eight revenue sharing awards have been announced in Pakistan, the Riesman award of 1951 and the NFC awards of 1961-62, 1964, 1970, 1974, 1990, and 1996 and the Presidential Order of 2006. The 1990 award was delayed for a period of eleven years. Similarly, an award was due in 2001 but was not announced despite the constitution of two NFCs. Therefore, the need for the Presidential amendment to the Ordinance in 2006.

**BOX 7.1**
**CRITERIA FOR THE DESIGN OF INTER-GOVERNMENTAL FISCAL ARRANGEMENTS**

Criteria for the design of inter-governmental fiscal arrangements include:

***Autonomy.*** Ideally transfers should honor the independence of sub-national governments in setting their own expenditure priorities.

***Revenue adequacy.*** Transfers should be adequate to cover both vertical and horizontal imbalances of sub-national governments.

***Equity.*** Allocated funds should vary directly with fiscal need of each sub-national government.

***Incentives.*** Transfers should create appropriate incentives for sound fiscal management and promote fiscal effort and control over expenditure.

***Efficiency.*** Transfers should be neutral with respect to choice of resource allocation among functions by sub-national governments.

***Predictability.*** The quantum of funds to be transferred should be known in advance so that recipient governments can plan with a degree of certainty.

***Simplicity.*** A sub-national government's allocation should be based on objective factors over which individual units have little control.

The lack of consensus can potentially be due to the following issues: (i) which taxes are to be included in the divisible pool; (ii) magnitude of respective shares of federal and provincial government (combined) in the 'divisible pool'; and (iii) the distribution of the overall provincial share among the four provinces. The last issue relates to the extent to which there should be fiscal equalization, that is, the extent to which the more developed provinces should subsidize the development of the backward provinces.

Inter-governmental transfers have historically taken three forms, "divisible pool" transfers, straight transfers and grants / subventions. The composition of the divisible pool alongwith the combined provincial share is given in Table 7.2. Clearly, the trend has been to increase the share of the provinces. Initially, this was achieved by including more taxes in the divisible pool and then subsequently by increasing the provincial share in the shareable taxes. In terms of distribution of revenues among the provinces, population has continued to be the sole criterion uptil 2006. Thereafter, one-sixth of general sales tax in lieu of abolition of octroi/zila tax, has been distributed on the basis of origin of the revenues.

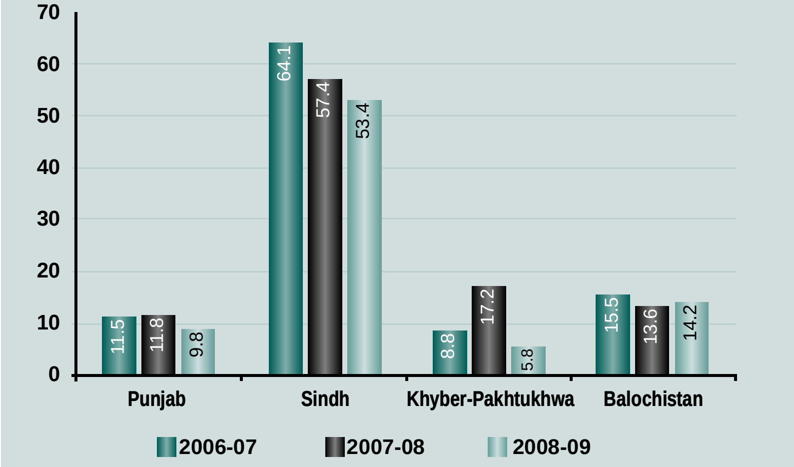
**TABLE 7.2**
**EVOLUTION OF DIVISIBLE POOL AND SHARING**

| Divisible Pool | (Percent Transferred to Provincial Governments) | | | |
|---|---|---|---|---|
| | NFC 1974 | NFC 1990 | NFC 1996 | Presidential Order 1 2006 |
| A. Income Tax | 80 | 80 | 37.5 | 41.5 - 46.25 |
| B. Sales Tax | 80 | 80 | 37.5 | 41.5 - 46.25 |
| C. Excise Duties[a] | | 80[a] | 37.5 | 41.5 - 46.25 |
| D. Customs Duties | - | - | 37.5 | 41.5 - 46.25 |

*Transfer only of excise duty on tobacco and sugar

Besides divisible pool transfers, the federal government also makes straight transfers to the provinces. Straight transfers from the federal to provincial governments were initiated in the 1990 award. They now include the development surcharge, royalty and excise duty on natural gas and royalty on crude oil. In addition, Khyber-Pakhtunkhwa also receives net hydel profits from WAPDA at a currently capped level of Rs 6 billion. As shown in Chart 7.1, straight transfers are a significant source of revenue for the provinces, with the exception of Punjab. As a proportion of transfers, straight transfers have increased from about 5 percent in 1990-91 to almost 15 percent in 2008-09.

**CHART 7.1**
**STRAIGHT TRANSFERS TO PROVINCES**




Inter-governmental transfers have also taken the form of unconditional grants to the provinces. Under the Raisman Award, subventions of Rs 12.5 million were given to the province of Khyber-Pakhtunkhwa. The 1974 NFC awarded an annual grant of Rs 50 and Rs 100 million respectively to Balochistan and Khyber-Pakhtunkhwa governments to compensate them for their relatively weak financial situation. The 1990 NFC further expanded the principle of subventions based on fiscal stress to all provinces while the 1996 Award included large special grants for Balochistan and Khyber-Pakhtunkhwa only to achieve greater fiscal equalization. In the 2006 Presidential order, total subvention/grants for provinces were enhanced from Rs 8.7 billion to Rs 27.8 billion. Punjab and Sindh were also given a share of 11 and 21 percent respectively, while the shares of Khyber-Pakhtunkhwa and Balochistan were determined to be 35 and 33 percent respectively.

Overall, it appears that, inter-governmental transfers between the federation and federating units have evolved within the broad philosophy of promoting a degree of fiscal decentralisation and by strengthening the resource base of the provinces making them more dynamic as service delivery agents. Table 7.3 clearly shows the rise in federal transfers as a proportion of federal tax revenues.

**TABLE 7.3**
**TREND IN SHARE OF TOTAL TRANSFERS IN FEDERAL TAX REVENUES**

*(Rs. in Billion)*

| | | Percent Share in Federal Taxes of | |
|---|---|---|---|
| | Total* Transfers | Total Transfers | Divisible Pool Transfers & Special Grants |
| 1990-91 - Pre 1990-NFC | 33.8 | 30.2 | 28.7 |
| 1991-92 - Post 1990-NFC | 65.8 | 46.4 | 34.9 |
| 1996-97 - Pre1996-NFC | 139.4 | 49.4 | 43.0 |
| 1997-98 - Post 1996-NFC | 131.7 | 44.9 | 37.9 |
| 2005-06 - Pre 2006 Order | 316.0 | 41.2 | 33.0 |
| 2007-08 - Post 2006 Order | 490.8 | 50.2 | 41.5 |
| 2008-09 - Post 2006 Order | 606.0 | 51.4 | 43.9 |

* Including hydro-electricity profits to Khyber-Pakhtunkhwa and other straight transfers

**Source:** Federal Budget Document

However, the change in the nature of inter-governmental fiscal transfers has accrued to the advantage of natural resource rich provinces. This has changed the flow of transfers among provinces (see Table 7.4).

**TABLE 7.4**
**SHARE IN TOTAL TRANSFERS BY PROVINCES**

*(percent)*

| | 1990-91 (pre-1990 NFC) | 1991-92 (post-1990 NFC) | 1996-97 (pre-1996 NFC) | 1997-98 (post-1996 NFC) | 2005-06 (pre-2006 Order) | 2007-08 (post-2006 Order) | 2008-09 |
|---|---|---|---|---|---|---|---|
| Total Federal Transfers (Rs in Billion) | 33.8 | 65.8 | 139.4 | 131.7 | 316.0 | 490.8 | 606.0 |
| Punjab | 55.3 | 45.1 | 51.3 | 47.0 | 47.1 | 47.3 | 46.5 |
| Sindh | 24.0 | 23.9 | 24.9 | 23.8 | 30.1 | 29.8 | 30.2 |
| Khyber-Pakhtunkhwa | 12.7 | 19.0 | 15.9 | 17.8 | 14.4 | 14.8 | 14.7 |
| Balochistan | 7.9 | 12.0 | 7.9 | 11.4 | 8.4 | 8.0 | 8.6 |
| **Pakistan** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

**Source:** Federal and Provincial Budget Documents.

The share of Sindh has increased significantly in the late 90s and in the earlier part of the current decade. Khyber-Pakhtunkhwa's share peaked following the 1990 NFC award and has declined thereafter. Both the NFCs of 1990 and 1996, enhanced the share of Balochistan in federal transfers but this trend was not maintained by the 2006 Presidential Order. Punjab shows a steady decline in its share of transfers.

## CASE FOR A FURTHER INCREASE IN PROVINCIAL TRANSFERS

Factors which justify a further increase in the provincial share in divisible pool include the following:

(i) The security conditions prevailing in the country have increased the 'fiscal needs' of the provinces, especially of Punjab and NWFP, for higher expenditure on public order and safety affairs.

(ii) An important cornerstone of the war against militancy is also to reduce the propensity of youth towards extremism. Punjab is relatively vulnerable to the disproportionately large share of unemployed male youth in the province and needs more resources for skill development and employment creation.

(iii) Pakistan is falling behind in achieving the MDGs. Provincial governments play a key role in providing MDG related services. Therefore, there is need for transferring more resources to enable provinces to invest more in social services to attain MDG-targets.

(iv) Expenditure implications of potential transfer of Concurrent List functions and vertical programs by the Federal government.

(v) The low level of expenditure on social and economic services has restrained provinces' capacity to provide basic services to their residents.

(vi) All provinces are likely to run into fiscal deficits in 2009-10, implying generally the need for higher transfers to cover these deficits.

There is a strong case for a higher share of provinces in federal revenues which preserves the historic trend and promotes the spirit of decentralization initiated in the country two decades ago. Fortunately, the new NFC Award realizes the importance of the above factors and as discussed in the subsequent sections, substantially enhances vertical transfers.

## THE 7TH NFC AWARD

The 7th NFC, reconstituted by the President of Pakistan on July 24, 2009 deliberated over six meetings before reaching a consensus in Lahore over the vertical and horizontal sharing of the divisible pool. Important differences between the current and new revenue-sharing arrangements are present in Box 7.2. The key salient features of the 7th Award are as follows:

**BOX 7.2**
**DIFFERENCE BETWEEN CURRENT AND NEW REVENUE SHARING ARRANGEMENTS**

| | Presidential Order 1 2006 | 7th NFC Award 2009 |
|---|---|---|
| **A. DIVISIBLE POOL [DP]** | | |
| **1. Composition:** | | |
| Taxes on Income | | ✓ |
| Wealth Tax | | ✓ |
| Capital Value Tax | | ✓ |
| Taxes on Sales and Purchases | | ✓ |
| Sales Tax on Services (CE Mode) | | Devolved to Provinces |
| Export Duties on Cotton | ✓ | |
| Customs Duties | ✓ | |
| Federal Excise Duty Execluding on Gas | ✓ | ✓ |
| **2. Collection Charges:** | **5%** | **1%** |
| **B. VERTICAL DISTRIBUTION** | | |
| **1. Provincial Share in DP** | **46.25%** | **56% increasing to 57.5%** |
| **2. Grants and Subventions** | **3.75%** | **-** |
| Distribution: Punjab | 11% | - |
| Sindh | 21% | Rs 6 billion |
| Khyber-Pakhtunkhwa | 35% | - |
| Balochistan | 33% | - |
| **C. HORIZONTAL DISTRIBUTION** | | |
| **1. Indicators and Weights** | | |
| Distribution Formula of DP among Provinces [Excluding 1/6th of Sales Tax] | Population [100%] | Population [82%] Poverty [10.3%] Revenue [5%] IPD [2.7%] |
| 1/6th of Sales | Ad-hoc - collection | Merged in above |
| **2. Provincial Shares in DP** | | |
| Punjab | 53.01%* | 51.74% |
| Sindh | 24.94%* | 24.55% |
| Khyber-Pakhtunkhwa | 14.88%* | 14.62% |
| Balochistan | 7.17%* | 9.01% |

*Including Grant

***Enlargement of the Divisible Pool:*** The size of the divisible pool is enhanced because of a reduction in collection charges from an average of 5.2 percent to 1 percent.

- ***Provincialisation of the Sales Tax on Services:*** NFC recognized that sales tax on services is a provincial subject and accepted the demand of the provinces to devolve services taxed under the ambit of federal excise duties to the provinces. There is provision for GST on services to be collected by the provinces, if they so desire.

- ***Higher provincial share in Vertical Transfers:*** The 7th NFC Award increases the provincial share in the divisible pool from the current 46.25 percent to 56 percent in the first year of NFC and 57.5 percent in the subsequent years. The award also does away with the existing system of subventions, the derivation of the distribution formula for which is not known and replaces it with fiscal equalization among provinces through a non-discretionary and transparent revenue sharing formula, discussed next. The only exception is a Rs 6 billion grant to Sindh.

***Diversification of the Bases of Horizontal Transfers:*** Punjab showed accommodation to the longstanding demand of other provinces to have multiple indicators for horizontal distribution. Currently, divisible pool (excluding 1/6$^{th}$ of sales tax) is distributed on the basis of population. The distribution of one-sixth of sales tax, in lieu of octroi zila tax, transferred to district governments, is distributed on the basis of collection shares determined in the 1996 revenue-sharing arrangements. Accordingly Punjab gets a share of 50 percent, Sindh, 34.85 percent, Khyber-Pakhtunkhwa, 9.93 percent and Balochistan 5.22 percent. This distribution basis has, however, remained disputable.

- Under the 7$^{th}$ NFC Award, all revenue will be distributed according to the agreed upon provincial shares which are derived using multiple criteria of poverty, inverse population density (IPD) and revenue contribution (both collection and proxy generation) and, of course, population. The formula builds in horizontal fiscal equalization through explicit recognition of backwardness (poverty) and cost of provision differentials (IPD) while allowing provinces some benefit of revenues collected and generated. Population, however, continues to be the principal basis of distribution with a weight of 82 percent.

***The Special Considerations:*** The 7$^{th}$ NFC is also unique as it takes into account special considerations which impact on the fiscal requirements of the provinces. First, the federal government and provinces recognized the role of Khyber-Pakhtunkhwa as a frontline province against the 'war on terror'. The federal government undertakes to bear all expenditures incurred on the war. As a gesture of support, all provinces also joined with the federal government to earmark one percent of the total divisible pool for Khyber-Pakhtunkhwa. Second, the federation and all the provinces recognized the special development needs of Balochistan and agreed to not only raise the share of the province in the provincial divisible pool to 9.01 percent, but to underwrite revenue transfers of Rs 83 billion to the province. Any shortfall in this amount would be made up by the federal government from its own resources. Punjab contributed the largest share by accepting a cut of 1.27 percent in its share, followed by Sindh, 0.39 percent and Khyber-Pakhtunkhwa, 0.26 percent.

- ***Enhancement in Straight Transfers:*** Royalty on natural gas and gas development surcharge (GDS) are notionally clubbed into one and rate per MMBTU would be worked out. Royalty would be distributed on the existing basis while GDS would be distributed by making adjustments based on this effective rate. Consequently, the share of Balochistan and Punjab provinces will go up at the cost of Sindh. Also, the federal government has resolved the longstanding dispute with Khyber-Pakhtunkhwa on arrears of hydel electricity profits and with Balochistan on arrears of GDS. According to the agreement, Khyber-Pakhtunkhwa will receive arrears of Rs 110 billion over a period of five years, while Balochistan will get Rs 10 billion over the same period.

All in all, the 7th NFC Award is unique in its design and its sensitivity to the needs of the federating units. It is also an Award which has made big changes in the status quo and is therefore, likely to have substantial and varying implications both on the federal government and four provincial governments. We next turn to examine the impact of the award on the federal and provincial fiscal position.

## FISCAL POSITION OF THE FEDERAL AND PROVINCIAL GOVERNMENTS

As mentioned in the previous section, the 7th NFC Award envisages significant enhancement in the transfer to the provinces. Table 7.5 presents projections of transfers to provinces in 2010-11 both under the 7th NFC Award and in the absence of the award, that is, under current arrangements. With a gross FBR collection of Rs 1667 billion, as envisaged in the Medium Term Budgetary Framework, the net divisible pool under the new arrangement will be Rs 1477 billion, lower than the net divisible without the award, due to exclusion of sales tax on services which will not be shared but will be transferred now to the provinces essentially as straight transfer. The decline is estimated at Rs 73 billion in 2010-11.

**TABLE 7.5**
**TRANSFER TO PROVINCES**
**WITH AND WITHOUT 7TH NFC AWARD, 2010-11**
***(Rs. in Billion)***

| | Without New NFC Award | With New NFC Award | Change |
|---|---|---|---|
| Federal Receipts | 2294.6 | 2294.6 | - |
| Net Divisible Pool | 1550.78 | 1477.3 | -73.5 |
| Total Divisible Pool Transfers to Provinces | 775.3 | 833.3 | 58.0 |
| Straight and other Transfers to Provinces | 68.9 | 244.1 | 175.2 |
| Total Federal Transfers | 844.2 | 1077.4 | 283.2 |

**Source:** IPP Estimates.

Despite this decline, the total divisible pool transfers to be provinces will be Rs 883 billion, Rs 58 billion higher than the transfers if the current revenue-sharing arrangements had continued. Besides, straight and other transfers will also be higher, at Rs 244 billion. The increase in these transfers of over Rs 175 billion is primarily because of, first, inclusion of sales tax on services, and two, payment of arrears of hydel electricity profits and GDS to the smaller provinces. Overall, transfers to provinces are estimated to be Rs 1077 billion, higher by Rs 283 billion due to the 7th NFC Award as compared to the present distribution formula.

The higher magnitude of transfers from the federal to the provincial governments is bound to have an adverse effect on the fiscal position of the federal government. Table 7.6 presents the federal fiscal position in 2010-11, both with and without the new NFC award. The net federal receipts are projected at Rs 1167 billion, Rs 283 billion lower than in the absence of the new NFC award. If expenditures increase at that same rate as this year, the federal government will have a budget deficit of 6.1 percent of the GDP, 1.4 percentage points higher than without the 7th Award. This implies that if federal government maintains its current expenditure policy, the underlying deficit will increase to 6 percent of GDP, substantially above the level envisaged in the fiscal framework agreed with the IMF at around 4 percent of the GDP in 2010-11.

**TABLE 7.6**
**FEDERAL FISCAL POSITION WITH AND WITHOUT 7TH NFC AWARD, 2010-11**

***(Rs. in Billion)***

| | Without New NFC Award | With New NFC Award | Change |
|---|---|---|---|
| Federal Receipts | 2294.6 | 2294.6 | - |
| Net Federal Receipts | 1450.4 | 1167.2 | -283.2 |
| Total Federal Expenditure | 2251.5 | 2251.5 | - |
| Current | 1847.0 | 1847.0 | -50.0 |
| Development | 404.5 | 404.5 | - |
| Budget Deficit | 801.1 | 1084.2 | +283.2 |
| As % of GDP | 4.7 | 6.3 | - |

**Source:** IPP Estimates.

As opposed to the federal government, the provincial governments will witness a substantial improvement in their fiscal position. Assuming that the provincial governments maintain the level of fiscal effort (of 11 percent growth in tax and 8.5 percent in non-tax revenues) and expenditure growth (17.5 percent in current expenditure and 22 percent in development expenditure) envisaged in the IMF agreed framework, the provinces of Sindh, Khyber-Pakhtunkhwa and Balochistan will carry surpluses ranging from Rs 22 to 35 billion. Punjab, on the other hand, given its current tight fiscal position, will generate a surplus if it maintains its development spending to the level projected under the provincial Medium Term Development Framework (MTDF) at about Rs 194 billion. Overall, our estimates indicate that the provinces combined will generate budgeting surpluses of Rs 115 billion, of about 0.7 percent of the GDP. It is, of course, possible that some or all provinces may target for an even faster growth in expenditure in lieu of the enhanced availability of resources. Overall, the consolidated budget deficit is likely to be above 5 percent of the GDP in 2010-11, unless almost draconian attempts are made by the federal government to cut back expenditure, especially the PSDP. Therefore, the 7th NFC Award will necessitate greater mobilization of resources and economy in expenditure, especially by the federal government, if the fiscal deficit is to be contained. In a perhaps more medium run setting, this may lead to containment of defence expenditure and cost of administration.

**TABLE 7.7**
**PROVINCIAL FISCAL POSITION IN 2010-11**

***(Rs. in Billion)***

| | Punjab | Sindh | Khyber-Pakhtunkhwa | Balochistan |
|---|---|---|---|---|
| Provincial Own Revenues | 91.5 | 47.2 | 10.2 | 4.1 |
| Straight Transfers | 69.1 | 114.2 | 58.1 | 18.3 |
| Total Provincial Resources | 157.6 | 161.4 | 68.3 | 22.4 |
| Total Provincial Expenditures | 561.3 | 336.9 | 154.0 | 83.6 |
| Federal Transfers | 428.0 | 209.1 | 120.9 | 83.0 |
| Surplus | +24.3 | +33. | +35.5 | +21.8 |

**Source:** IPP Estimates.

## IMPLICATIONS OF THE 7$^{TH}$ NFC AWARD

Clearly the nature of public finances of Pakistan will change substantially due to the 7$^{th}$ NFC Award. It constitutes a level of fiscal decentralization which can be viewed as a great "opportunity" for the provinces to improve the well-being of their residents. However, it is important to realize that this opportunity has been created by the federal government at a high cost to the state of its own finance. Therefore, it is essential that this 'opportunity" really gets translated into welfare gains and is not wasted. For this to be achieved, the onus is on the four provincial governments. Behavioural consequences over time are likely to be the following:

(i) There will a shift of development focus from the federal government to the provinces. The provinces combined will carry out development programs approaching Rs 370 billion in 2010-11, perhaps for the first time exceeding the federal PSDP. The fast growth in development spending will require enhancement in capacity to design, execute and manage a larger portfolio of projects. The absorption capacity of the provinces, particularly the smaller provinces, will need to be significantly strengthened. Also, given that social services are mostly in the provincial domain, prospects for higher outlays on education and health have improved. This could confer more direct benefits to the people.

(ii) Vertical programs in all likelihood will be transferred to the provincial government after the 18$^{th}$ Amendment. Provinces will have to make a choice to continue with them. Given the paucity of resources at the federal level there should be no expectation of federal funding of special packages.

(iii) Provinces, particularly the government of Punjab, are likely to use the additional funds to eliminate their overdrafts and thereby improve their financial solvency.

(iv) For the medium term consequences to be favourable, the following conditions need to be fulfilled:

   (a) It is important that given the higher transfer from the federal government, provinces do not slacken their own fiscal effort. The additional transfers should essentially supplement and not substitute for provincial own revenues. Provinces, particularly the bigger provinces, have two large and buoyant tax bases under their fiscal jurisdiction, real estate and agricultural income. Proper exploitation is essential not only to enhance the overall federal and provincial consolidated tax-to-GDP ratio but also to make the burden of tax system more equitable.

   (b) Provinces must avoid profligacy in current expenditures. Prudent spending strategy is an important pre-requisite for the realization of the "opportunity" that the 7th NFC has opened up. Punjab has set a precedent in this regard whereby the Provincial Chief Minister in the immediate aftermath of the NFC announced that additional resources will only be used for development and will be largely routed towards backward regions and pro-poor sectors. This appears to be a good strategy which the other provinces may wish to follow.

(c) The provinces may develop MTDFs, taking into account the additional funding available. These will help the provinces strategize and prioritise their development priorities, facilitate proper planning and management of spending and very importantly route spending in accordance to the development needs of their province thereby avoiding ad-hocism and populism. Also, the MTDF's should feed into the 10th Five Year Plan which the Planning Commission is in the process of preparing. Proper dovetailing of the planning exercises at the federal and provincial level will enhance the credibility of the exercise and ensure development outlays which are essential to enhance the growth potential of the country.

(d) It is also important that the provincial governments should vigorously take on newly acquired autonomy which the 7th NFC Award and the 18th Amendment has bestowed on them, by taking over the Concurrent List functions sooner rather than later. In particular the basic functions of education, health and social welfare should be devolved without much delay.

The 7$^{th}$ NFC Award also has significant implication for the federal government, as follows:

(i) It is clear that following transfer to the provinces, the federal fiscal positions becomes unsustainable. The increase in the underlying structural deficit by 1.4 percent to 6 percent of GDP its clearly untenable. The structural deficit has to be brought down. The first thing that has to be done is to cutback in federal current expenditures. There is, of course, a non-discretionary component in the federal current spending like debt servicing and basic defence. While protecting the base, the federal government will have to pose some very important but unavoidable strategic questions like following the passage of the 18$^{th}$ Amendment, how quickly should the functions be devolved to the provinces and how best to achieve some savings in federal spending?

(ii) Sharper prioritization of the federal PSDP has become indispensible. Given that the focus for development has largely shifted to the provinces, pruning of development program at the federal level is essential. Currently the throw forward of federal projects is over Rs 3 trillion. With an annual development expenditure of around Rs 300 billion, projects on an average will take ten years to complete. New projects approval should be stopped for some time unless such projects have very high priority.

(iii) The linchpin in the strategy to keep the federal fiscal position sustainable is to enhance the level of resource mobilization. The country is stuck at a tax-to-GDP ratio of less than 10 percent, even at times when the tax bases grew in real terms in excess of 7 percent. The tax-to-GDP ratio has shown a tendency to decline in recent years. As mentioned in Chapter 2, the strategy of resource mobilization has to focus on base broadening and improvements in tax administration.

(iv) Effective functioning of the NFC Secretariat is also necessary. The provinces now have to play a very strong role in the national development scenario. The NFC Secretariat will not only have to keep a database of provincial finance but be pro-active in communicating best practices, special policies and innovations taken by state governments both nationally and internationally. The purpose is, of course, not to step in on provincial autonomy but to support and strengthen the federating units. The NFC Secretariat has to play a supportive role to the National Economic Council in matters pertaining to national development.

In conclusion, the 7$^{th}$ NFC Award has major implications for both the federal and provincial governments in Pakistan which will require well thought out, coherent policy responses by the two levels of government. Also, some elements that should have been sorted out in the NFC still remain pending. Provincial distribution of sales tax on services, discussion on measures to ensure financial discipline, mentioned in the terms of reference of the NFC, and incentives for higher fiscal effort by provincial governments are part of the unresolved agenda. While the euphoria of the NFC Award still exists, these are issues that can be taken by the federal and provincial governments in the spirit of national solidarity.

All in all, the 7$^{th}$ NFC Award by recognizing the case for higher resource allocation to the provinces, constitutes a big step forward in fiscal devolution. The award demonstrates the federal resolve of devolving and strengthening government at the level closer to the people. But its real accomplishment is that in one of the most difficult times in the history of the country, it has rekindled the spirit of national solidarity, consensus building, cohesion and unity. It also demonstrates that the prosperous provinces are willing to share their achievements with their not so prosperous brothers – the smaller provinces, to quicken their pace of development, and all are wiling to accommodate the view point of each other to strengthen Pakistan.

# Chapter - 8

# Pursuing the Logic of Decentralization: Strengthening Local Governance

# Chapter - 8
# Pursuing the Logic of Decentralization: Strengthening Local Governance

## INTRODUCTION

The idea of decentralizing governance is drawn from social science theory stretching back to the age of enlightenment. In recent times, economists such as Oates (1972) and Teibot (1956) have propounded the welfare gains of decentralization. The argument is based on a simple proposition: The allocation of public resources at the local level is more likely to conform to public welfare priorities, and the delivery of basic services is likely to be more efficient, in a situation where these administrative functions are being performed by elected government officials, close to and in full view of the electorate. Thus, *proximity* to the electorate and *accountability* to them, impel the local government officials to seek the public good. By contrast, un-elected bureaucrats in a centralized administrative system are disciplined through the less effective device of service rules.

The theory of course looks at centralized and decentralized governance as alternative options. It does not take account of the transition process of moving from one to the other. More importantly it ignores the issues of *power* involved in the transition to effective local government. Pakistan's case constitutes a vivid illustration of the dynamics of power in the transition process.

In an important study on decentralization in Pakistan, Cheema, Khwaja and Qadir (2003), make two noteworthy propositions which are relevant for our discussion: (1) In Pakistan historically, decentralization measures in terms of local government have always been undertaken by military governments which while centralizing political power in their own hands, seek political legitimacy through local government. (2) While such "non-representative governments" have undertaken reforms for "representative" local government, they have at the same time sought to establish control over local governments through the bureaucracy.

## EVALUATION OF THE DEVOLUTION PLAN, 2000

Pakistan introduced the ambitious Devolution Plan in 2000, which was implemented in 2000—2001 through the promulgation of Local Government Ordinances (LGOs) in all the four provinces. These were based on a template developed by the National Bureau of Reconstruction (NBR), operating out of Islamabad. This meant the adoption of a "one size fits all" approach to creating governmental structures at the local level. Devolution reforms provided a three-tier local government (LG) system consisting of District Government (DG), Tehsil/Town Municipal

Administration (TMA) and Union Administration (UA). Working under the direction and control of elected councils and Nazims, the local government system attempted to create institutions and mechanisms for public participation in the design, management, monitoring and control of social service delivery and development activities. Many of the functions previously performed by the local offices of provincial government departments fell within the domain of DGs/TMAs. There were 31 decentralized departments with management control and functional responsibility transferred from provincial government under Part A of the First Schedule to LGOs, 2001.

Devolution reforms, as originally conceived and articulated, also envisaged large-scale fiscal decentralization to follow the administrative and political decentralization. This, however, did not happen. While a fiscal relationship was forged between the provinces and the districts, an extensive reorganisation of resources was not undertaken and the vertical financial imbalance stayed in place with the major financial collections being made at the federal, and to a lesser extent, at the provincial level, and transferred to the local tiers under institutionalised arrangements.

An important assumption in the devolution paradigm was that it would bring decision making closer to the grassroots through effective electoral institutions, by creating new alignments at the local level, by catalysing the process of democracy via the creation of a vibrant civil society, by creating locally accountable and efficient bureaucracy, and by adopting local accountability mechanisms to fight corruption.

Many studies were conducted on the decentralization experience in Pakistan. The studies attempted to identify the merits and demerits of decentralization. Some authors emphasised the gains to be made from a decentralized system, particularly in terms of allocative efficiency and participation of the people at the grassroots, while others cast doubt on some of these gains, and raised concerns about possible negative consequences, particularly in relation to macroeconomic policy and income redistribution. Concerns were raised about the potential dangers of decentralization (e.g. elite capture) in a socially stratified society such as Pakistan. Widespread corruption in the devolved dispensation was also an important area of concern in these studies.

Information gleaned from our interviews with local government officials at various tiers in Lahore and Multan respectively, suggests that a contention for power is taking place between elected district government officials and the provincial bureaucracy. This contention threatens to paralyze the effective functioning of local government even for the limited objective of providing more efficient service delivery. This contention flows directly from the history of the patron-client model of governance in Pakistan. The latest "Devolution of Power" program threatens the terrain of resource gratification and discretionary appointments and transfers, on the basis of which the bureaucracy and the elected politicians in provincial governments had constituted their domains of pelf and privilege. Therefore, a contention for power has ensued between the provincial bureaucracy and the local governments. This contention was intensified with the recent establishment of elected provincial governments, in which elected members of parliament at the provincial level contend with local governments for control over development funds and discretionary appointments of officials.

The provincial bureaucracy was able to appropriate the authority to appoint key officials, Executive District Officers (EDOs). Yet it is through these officials that the elected local governments were supposed to administer the allocation of development funds and provision of basic services such as health, education, sanitation and drinking water. Moreover, all officials in various public service departments in the district administration from grade 11 to 18, are also appointed by the provincial bureaucracy. Thus, while the elected local government officials have responsibility, they do not have authority. Their ability to improve the delivery efficiency of public services is severely constrained by the fact that they can neither transfer, nor appoint most of the officials who operate these services. To make matters worse, the resources made available to local governments and the professional expertise at their command are so inadequate, that they are unable to take even a minimal initiative to fulfill their election mandate of widening the coverage and quality of basic services. Elected local government officials (Nazims) are reduced to 'requesting' the provincial bureaucracy to fill vacant posts in various schools and health care facilities or to transfer employees who fail to perform their duties. The resultant delays, the lack of control over EDOs, the severe shortage of resources and expertise combine to severely constrain the effective functioning of local governments. As a consequence of this contention for power, efficiency in the provision of public services instead of increasing may, in fact, have been reduced. According to one Tehsil Nazim, in Multan district, the dominance of the provincial administration over the functioning of district governments has created a hybrid creature which is preventing efficient service delivery and limiting the effectiveness of elected members of the local government.

Admittedly, there were a number of important issues influencing service delivery through the local government system. For example, working of the police and its accountability to political institutions at the local level was a critical concern that figured in most debates on decentralization.

In the future, local governments in Pakistan can take one of three routes: (1) The district level governments may be rendered so dysfunctional that Nazims may begin to resign and in the subsequent elections genuinely popular local figures may lose interest in local government altogether. Such a process could ultimately result in the failure of the "devolution of power programme". (2) The local government system as it presently exists may continue to function at such a low level of efficiency that the efficiency gains conceived in the programme may become low or even negative. (3) The current situation where local government elected officials have responsibility without appropriate authority and where they are starved of financial resources may be changed. In this case, local government officials may be granted authority over appointments, promotions and transfers of all personnel in the district administration. At the same time, adequate technical and financial resources could be made available to elected local government officials. In such a case the power of the provincial bureaucracy to establish personalized patron-client factions and the tendency to appropriate economic rent could be transformed into efficiency gains associated with effective decentralization. We are of the view that there is a strong case for strengthening the local government system through deepening of reform. These reforms are warranted in political, institutional, legal, fiscal and administrative areas. We present below some proposals that will be instrumental in putting local governments on the path of being effective service delivery agents.

## THE LOCAL GOVERNMENT REFORM AGENDA

Local government is a provincial subject and each province should amend, modify and reform the system in terms of its social, economic and political situation. It is not appropriate to force the same structure on so many different socio-economic situations. The following recommendations are offered:

### Structural Reforms

The local government system should be extended to all parts of Pakistan without any exception. This shall bring the cantonment areas as well as the Islamabad Capital Territory under the same local governance as in other areas.

- Local government elections should be held on party basis to promote a democratic culture at the grassroots and to provide a nursery for the development of future political leaders.

In the present scheme of things, there is a poor link between the district government and TMAs. This is not only administratively undesirable but also creates anomalies in the development of infrastructure. TMAs should be integrated more effectively with local governments.

- The mandate of the local governments should be expanded through appropriate changes in the Local Government Ordinance, 2001, and the Police Order, 2002, to include part of the regulatory functions and law and order, which are presently outside their jurisdiction. This will not only increase political control of the essential functions at the local level, but will also strengthen the local government system. However, such expansion of their mandate should be preceded by institutional strengthening of the local government system through direct elections.

Recent amendments in LGO, 2001 empowering the Chief Minister to suspend a district Nazim, needs to be revisited since it is against the spirit of bringing democracy to the local areas. Such powers for extreme action belong to the legitimate realm of an independent Local Government Commission.

### Province-District/Tehsil Relations

- Local Government Commissions have an important role under the Local Government Ordinance 2001. These have become all the more important after certain amendments in the LGO. For instance, the Chief Minister has been empowered to suspend a district

Nazim. But if he does so, the matter is to be referred to the Commission. Similarly, if any resolution or decision of the District Council or Tehsil Council is suspended by the Chief Minister that, too, is to be referred to the Commission. It is, therefore, recommended that the Commission should be made more autonomous and broad based. It may, perhaps, be headed by a retired judge of the High Court or by distinguished retired civil servants, and should also include two to three appointees selected in consultation with the leader of the opposition in the provincial assembly.

There are reservations at the provincial level against the transfer of some of its functions, responsibilities and resources to the local level. This would not be the case, if the federal government had, in turn, transferred some of its powers and resources to the provinces. Since this did not happen (although it was intended initially), the provinces lost in this zero-sum game of exercise of authority. It is, therefore, important that the federal government transfers functions and resources to the provincial governments in sectors like education, health and agriculture, which are essentially in the provincial domain. The stage has been set for this after the passage of the 18$^{th}$ Amendment.

- In the context of human resource, a short list of officials from different cadres eligible for particular positions should be made available by the provincial government to the Nazims. Once the selection is made, the officials should be given fixed tenures.

## Local Institutional Capacity

In order to make the local governments functionally independent, it is necessary to establish district cadres for different service groups.

- Elected representatives and the bureaucracy, at provincial and local levels, may be trained for performing in the new administrative structures.

It is necessary to address capacity constraints particularly at the TMA level, by enhancing staff and strengthening technical capacity, and not reverting the functions to provincial line departments.

- Administrative and human capacity requirements and strategies in local governments should be separately assessed and developed for supporting their regulatory and enforcement functions. The administrative and human capacity of local governments for regulatory functions may be enhanced at two levels. Firstly, issues concerning the absence of an enabling policy or legal framework which could strengthen the regulatory capacity of local governments may be addressed from the provincial level. Secondly, the issues relating to dearth of training opportunities for relevant EDOs, TMOs, Tehsil Officers and Union Council Secretaries may be addressed on a priority basis.
- Priority must be given to strengthening local capacity through technical training such as use of modern tools for drafting, project management, planning, audit, as well as in the efficient maintenance of infrastructures.

### Transparency and Accountability

- The monitoring and supervisory committees, as stipulated in the LGO, should be made effective and their functioning improved through training and the requisite resource allocation.
- A mechanism for active external monitoring of local governments by media and civil society should be developed.
- The local governments should be required to engage reputable (pre-vetted) auditing firms to conduct the audit of accounts on an annual basis.
- A Management Information System integrated at the provincial level, should be set up for greater transparency in the affairs of local governments.

### Local Resource Mobilisation

- There is a strong case for enhancing fiscal powers of the local governments. These are currently rather limited. Collection of municipal taxes like the urban property tax should be transferred initially to local councils. Besides, the local governments may explore the possibility of levying service related taxes, as provided in the LGO.
- There is also a need to provide incentives to local governments for enhancing local fiscal effort. A separate criterion capturing local fiscal effort can be built into the formula for revenue transfers to local governments.
- Some of the more creditworthy jurisdictions may be authorised to tap the capital markets for raising resources for commercially viable projects. This approach could be tested on a pilot basis in a few districts that have already demonstrated the ability to raise and earmark resources for development. Sialkot in Punjab is an example of self-taxation for the purpose of improving infrastructure in the district. This is how the city was able to improve municipal roads and build an international airport.

### Fiscal Equalisation through Transfers

- There is a case for higher development transfers to local governments, which have over the last few years declined as a share of provincial PSDPs.
- An analysis of local expenditure priorities indicates relative neglect of some important sectors. While education has shown a marked improvement during the last few years, improvement in health indicators has lagged behind. There is a case for introduction of conditional transfers to ensure minimum standards for provision of health services.
- The weight of backwardness in the revenue sharing criteria for current and development needs to be increased. The broad parameters and apportionment formulae may be made simpler. Sindh Provincial Finance Commission award is an example where many criteria, which in some way cancel each other were used. This needs to be avoided.

In conclusion, the process of evolution of local governments in Pakistan has been characterised by a path of uneven development rather than a progressive one. The policies have lacked continuity and every time when the institution was revived it was essentially a new experiment without real linkage with past practice and experience. Also, the importance of this institution in the overall government structure has varied depending upon the type of regime at the centre.

With the newly elected governments in power we are again in some state of uncertainty. Will these governments resort to the same course of action as their predecessor elected governments? Or will they demonstrate more vision and wisdom and let the process of decentralization of governance flourish in an effort to genuinely bring government closer to the doorsteps of the people. It is important to emphasise that for the deepening of the local government structures, their operation has to continue in an uninterrupted manner and their role has to be explicitly provided for. Also, it is necessary that the elections to local governments should be held periodically.

## PROMOTING PARTICIPATORY DEVELOPMENT

There is enough evidence from around the globe to suggest that decentralization through the creation of local government works for the poor – certainly for the very poor – where it works in juxtaposition with community mobilization.

(i) *The Meaning of Empowerment:* Since the term empowerment has been loosely used in much of the literature on development it may be helpful to specify its meaning in the context of this section. 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[1].

(ii) *Empowering the Poor:* 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, the 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. 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 to institutional credit compared to poor men.

It is important that such village level community based organisations (CBOs) be autonomous and be permitted to form cluster apex organisations with other CBOs. Autonomous CBOs 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[2] 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[3].

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.*

# 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 | 4.1 | 3.36 | -2.7 | 6.15 | 1.11 |
| 2008-09 | 2.0 | 9.80 | -4.6 | 4.04 | n.c |
| **Average** | **5.0** | **4.60** | **0.2** | **7.25** | **0.86** |

n.c. = not computed

**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 | 22.5 | 77.7 | 72.0 | 31.4 |
| 2007-08 | 22.0 | 71.0 | 70.2 | 32.9 |
| 2008-09 | 19.7 | 72.8 | 71.8 | 36.9 |
| **Average** | **19.0** | **92.4** | **71.2** | **34.5** |

**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 | 1.1 | n.c. | -3.5 | -12.8 | -9.1 |
| 2008-09 | 4.7 | 31.2 | 0.7 | -1.0 | 5.8 |
| **Average** | **3.0** | **n.c** | **0.0** | **-1.2** | **-0.3** |

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 | 8.3 | 9.9 | 7.5 | 74.3 | 3.4 |
| 2007-08 | 4.8 | 3.2 | 6.3 | 78.2 | 12.2 |
| 2008-09 | -3.3 | 0.9 | -5.2 | n.c. | -8.0 |
| **Average** | **7.0** | **10.7** | **7.0** | **74.5** | **8.8** |

n.c. = not computed

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

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

| | Employment (000) | | | | 2001-02 to 2007-08 | | |
|---|---|---|---|---|---|---|---|
| | 2001-02 | 2005-06 | 2006-07 | 2007-08 | Employment Growth Rate (%) (%) | Value Added Growth Rate (%) (%) | Employment Elasticity |
| Agriculture | 20474 | 19075 | 20775 | 21894 | 1.1 | 4.1 | 0.28 |
| Manufacturing and Mining | 4982 | 5421 | 6433 | 6382 | 4.2 | 10.4 | 0.40 |
| Electricity and Gas | 299 | 296 | n.a | n.a | -0.3 | 3.9 | -0.07 |
| Construction | 2757 | 3579 | 3145 | 3093 | 1.9 | 6.4 | 0.30 |
| Wholesale and Retail Trade | 5090 | 6635 | 6862 | 7167 | 5.9 | 5.8 | 1.02 |
| Transport and Communication | 2216 | 2452 | 2573 | 2700 | 3.3 | 4.3 | 0.78 |
| Finance and Insurance | 247 | 491 | n.a | n.a | 18.7 | 17.9 | 1.05 |
| Public Administration and Community Services | 7151 | 8405 | 6862 | 6725 | -1.0 | 6.6 | -0.15 |
| **Total** | **43286** | **46365** | **47650** | **49090** | **2.1** | **6.5** | **0.33** |

**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 |
| 2008-09 | 20.8 | 23.7 | 19.2 | 25.1 | 7.6 |
| **Average** | **7.6** | **9.5** | **9.3** | **13.8** | **9.9** |

**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 |
| 2008-09 | 14.1 | 19.1 | 9.9 | -5.2 | -1.9 |
| **Average** | **14.1** | **18.7** | **10.4** | **-4.7** | **-1.4** |

**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 | 13.7 | 80.5 |
| 2008-09 | -0.3 | 63.0 | 14.3 | 54.2 |
| **Average** | **-0.1** | **69.8** | **11.7** | **24.7** |

**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 |
| 2008-09 | 4.2 | 6.0 | 5.2 | 9.6 | 8.8 |
| **Average** | **4.3** | **12.5** | **3.9** | **11.6** | **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 |
| 2008-09 | -3.2 | 12.8 | 0.7 | 12.0 | 9.6 | 9.8 |
| **Average** | **5.4** | **9.5** | **15.0** | **7.9** | **15.0** | **8.4** |

**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 |
| 2008-09 | -6.4 | n.a | n.a | -10.3 |
| **Average** | **10.3** | **0.780** | **0.226** | **16.0** |

**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 |
| 2008-09 | 3.0 | 35.1 |
| **Average** | **-7.4** | **33.8** |

**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 |
| 2008-09 | -5.6 | 212.9 | 9118 | 2.8 | 25.5 | -1.0 |
| **Average** | **-1.8** | **225.4** | **7863** | **3.5** | **4.9** | **-0.4** |

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

## TABLE A-13
## TREND IN INCOME INEQUALITY
### Growth in Real Household Income by Quintile
### (Annual Growth Rate, %)

| | Total | QUINTILE 1st | 2nd | 3rd | 4th | 5th |
|---|---|---|---|---|---|---|
| | **2001-02 to 2005-06** | | | | | |
| **Pakistan** | **7.8** | **4.8** | **6.0** | **6.7** | **7.7** | **9.6** |
| Urban | 4.4 | 0.5 | 1.7 | 3.0 | 2.1 | 5.0 |
| Rural | 9.3 | 5.7 | 7.2 | 8.0 | 10.6 | 14.2 |
| | **2005-06 to 2007-08** | | | | | |
| **Pakistan** | **-1.4** | **-1.9** | **-1.1** | **-2.8** | **-2.4** | **-0.9** |
| Urban | -0.3 | 5.6 | 3.2 | -1.4 | 1.0 | -0.6 |
| Rural | -2.2 | -3.3 | -2.5 | -3.4 | -4.2 | -1.0 |
| | **2001-02 to 2007-08** | | | | | |
| **Pakistan** | **4.7** | **2.5** | **3.6** | **3.4** | **4.2** | **5.9** |
| Urban | 2.8 | 2.2 | 2.2 | 1.5 | 1.7 | 3.1 |
| Rural | 5.3 | 2.6 | 3.9 | 4.1 | 5.4 | 8.9 |

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

**TABLE A-14**
**TREND IN REGIONAL INEQUALITY**
**Growth in Employment by Province**

| | Number of Employed (000) | | | | Annual Growth Rate 2001-02 to 2007-08 |
|---|---|---|---|---|---|
| | 2001-02 | 2005-06 | 2006-07 | 2007-08 | (%) |
| Punjab | 25224 | 27292 | 29130 | 28970 | 2.3 |
| Sindh | 10819 | 11043 | 11300 | 12260 | 2.1 |
| Khyber-Pakhtunkhwa | 5208 | 5881 | 5080 | 5730 | 1.6 |
| Balochistan | 1931 | 1988 | 2140 | 2130 | 1.6 |
| **Pakistan** | **43286** | **46365** | **47650** | **49090** | **2.1** |

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

**TABLE A-15**
**TREND IN REGIONAL INEQUALITY**
**Growth in Real Household Income by Province**

| | (Annual Growth Rate, %) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2001-02 to 2005-06 | | | 2005-06 to 2007-08 | | | 2001-02 to 2007-08 | | |
| | Urban | Rural | Total | Urban | Rural | Total | Urban | Rural | Total |
| Punjab | 5.9 | 10.5 | 9.1 | -1.3 | -0.6 | -0.9 | 3.4 | 6.7 | 5.6 |
| Sindh | 1.9 | 8.9 | 6.1 | 2.2 | -9.6 | -2.9 | 2.0 | 2.3 | 3.0 |
| Khyber-Pakhtunkhwa | 9.0 | 8.8 | 9.1 | -7.3 | -1.5 | -2.7 | 3.3 | 5.3 | 5.0 |
| Balochistan | -3.0 | -3.0 | -2.5 | 8.1 | -1.6 | 3.2 | 0.5 | -2.5 | -0.6 |
| Pakistan | 4.4 | 9.3 | 7.8 | -0.3 | -2.2 | -1.4 | 2.8 | 5.3 | 4.7 |

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

**TABLE A-16**
**TREND IN REGIONAL INEQUALITY**
**Coverage of Education and Health Services**

| | 1998-99 | 2001-02 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| **Gross Primary Enrolment Rate** | | | | |
| Punjab | 75 | 76 | 100 | 97 |
| Sindh | 64 | 63 | 79 | 80 |
| Khyber-Pakhtunkhwa | 70 | 77 | 82 | 83 |
| Balochistan | 64 | 62 | 72 | 75 |
| **Max/Min Ratio** | **1.172** | **1.242** | **1.389** | **1.293** |
| **Net Primary Enrolment Rate** | | | | |
| Punjab | 44 | 45 | 62 | 61 |
| Sindh | 41 | 40 | 50 | 51 |
| Khyber-Pakhtunkhwa | 39 | 41 | 49 | 49 |
| Balochistan | 36 | 32 | 41 | 41 |
| **Max/Min Ratio** | **1.222** | **1.406** | **1.512** | **1.488** |
| **Gross Middle Enrolment Rate** | | | | |
| Punjab | 43 | 45 | 55 | 59 |
| Sindh | 38 | 34 | 43 | 46 |
| Khyber-Pakhtunkhwa | 37 | 38 | 53 | 52 |
| Balochistan | 29 | 33 | 34 | 35 |
| **Max/Min Ratio** | **1.483** | **1.364** | **1.618** | **1.686** |
| **Net Middle Enrolment Rate** | | | | |
| Punjab | 19 | 18 | 20 | 19 |
| Sindh | 17 | 14 | 17 | 18 |
| Khyber-Pakhtunkhwa | 11 | 12 | 16 | 14 |
| Balochistan | 9 | 8 | 9 | 12 |
| **Max/Min Ratio** | **2.111** | **2.250** | **2.222** | **1.583** |

**Source:** Pakistan Social and Living Standard Measurement Survey, Federal Bureau of Statistics.

**TABLE A-16 (CONTD.)**
**TREND IN REGIONAL INEQUALITY**
**Coverage of Education and Health Services**

| | 1998-99 | 2001-02 | 2006-07 | 2007-08 |
|---|---|---|---|---|
| **Gross Matric Enrolment Rate** | | | | |
| Punjab | 37 | 44 | 51 | 54 |
| Sindh | 51 | 42 | 45 | 44 |
| Khyber-Pakhtunkhwa | 36 | 41 | 45 | 48 |
| Balochistan | 41 | 29 | 33 | 34 |
| **Max/Min Ratio** | **1.244** | **1.517** | **1.545** | **1.588** |
| **Net Matric Enrolment Rate** | | | | |
| Punjab | 12 | 12 | 11 | 13 |
| Sindh | 10 | 13 | 10 | 11 |
| Khyber-Pakhtunkhwa | 6 | 10 | 6 | 6 |
| Balochistan | 3 | 6 | 5 | 5 |
| **Max/Min Ratio** | **4.000** | **2.000** | **2.200** | **2.600** |
| **Literacy Rate (10 +)** | | | | |
| Punjab | 46 | 47 | 58 | 59 |
| Sindh | 51 | 46 | 55 | 56 |
| Khyber-Pakhtunkhwa | 37 | 38 | 47 | 49 |
| Balochistan | 36 | 36 | 42 | 46 |
| **Max/Min Ratio** | **1.417** | **1.306** | **1.381** | **1.283** |
| **Full Immunisation** | | | | |
| Punjab | 55 | 57 | 83 | 76 |
| Sindh | 38 | 45 | 65 | 67 |
| Khyber-Pakhtunkhwa | 54 | 57 | 76 | 74 |
| Balochistan | 34 | 24 | 54 | 57 |
| **Max/Min Ratio** | **1.618** | **2.375** | **1.537** | **1.333** |

**Source:** Pakistan Living Standard Measurement Survey, FBS

## TABLE A-17
## TREND IN PAKISTAN'S RANKING IN DIFFERENT GOVERNANCE INDICATORS

| | | INDICATORS | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | EARLIEST YEAR[a] | | | LATEST YEAR[b] | | | |
| Source | Type | Year | Number of Countires | Ranking[d] (Quintile)[c] | Year | Number of Countries | Ranking[d] (Quintile)[c] | Trend |
| 1 Transparency International (TI) | Corruption Perception Index (CPI) | 1995 | 41 | 39 (1st) | 2009 | 180 | 139 (1st) | |
| 2 Freedom House (Freedom in the World) | Political Rights Score | 2002 | 151 | 131 (1st) | 2009 | 193 | 142 (1st) | |
| | Civil Liberties Score | 2002 | 151 | 135 (1st) | 2009 | 193 | 162 (1st) | |
| | Status | 2002 | Not Free | - | 2009 | Partly Free | - | |
| 3 Freedom House (Countries at the Crossroads) | Civil Liberties | 2004 | 30 | 28 (1st) | 2006 | 30 | 30 (1st) | |
| | Rule of Law | 2004 | 30 | 27 (1st) | 2006 | 30 | 29 (1st) | |
| | Anticorruption and Transparency | 2004 | 30 | 22 (1st) | 2006 | 30 | 24 (1st) | |
| | Accountability and Public Voice | 2004 | 30 | 27 (1st) | 2006 | 30 | 28 (1st) | |
| 4 Freedom House (Countries at the Crossroads) | Voice & Accountability | 1996 | 191 | 123 (1st) | 2008 | 197 | 138 (1st) | |
| 5 Freedom House (Press Freedom Survey) | Status | 2002 | Not Free | - | 2009 | Not Free | - | No Change |
| | Legal Environment | 2002 | 187 | 172 (1st) | 2009 | 195 | 174 (1st) | |
| | Political Environment | 2002 | 187 | 177 (1st) | 2009 | 195 | 178 (1st) | |
| | Economic Environment | 2002 | 187 | 176 (1st) | 2009 | 195 | 172 (1st) | |
| | Total Score | 2002 | 187 | 172 (1st) | 2009 | 195 | 175 (1st) | |
| 6 World Bank Institute (Governance Matters) | Voice & Accountability | 1996 | 194 | 139 (1st) | 2008 | 212 | 172 (1st) | |
| | Political Stability and Absence of Violence | 1996 | 180 | 162 (1st) | 2008 | 212 | 209 (1st) | |
| | Government Effectiveness | 1996 | 182 | 120 (2nd) | 2008 | 212 | 158 (1st) | |
| | Regulatory Quality | 1996 | 183 | 130 (2nd) | 2008 | 212 | 140 (1st) | |
| | Rule of Law | 1996 | 171 | 105 (2nd) | 2008 | 212 | 172 (1st) | |
| | Control of Corruption | 1996 | 154 | 127 (1st) | 2008 | 212 | 161 (1st) | |
| 7 World Bank - World Development Indicators [Country Policy and Institutional Assessment (CPIA) | CPIA Building Human Resources Rating | 2005 | 76 | 46 (1st) | 2006 | 78 | 47 (1st) | |
| | CPIA Business Regulatory Environment Rating | 2005 | 76 | 15 (4th) | 2006 | 78 | 12 (4th) | |
| | CPIA Debt Policy Rating | 2005 | 76 | 12 (4th) | 2006 | 78 | 12 (4th) | |
| | CPIA Economic Management Cluster Average | 2005 | 76 | 15 (4th) | 2006 | 78 | 28 (3rd) | |
| | CPIA Efficiency of Revenue Mobilization Rating | 2005 | 76 | 40 (2nd) | 2006 | 78 | 40 (1st) | |
| | CPIA Equity of Public Resource Use Rating | 2005 | 76 | 38 (2nd) | 2006 | 78 | 37 ((1st) | |
| | CPIA Financial Sector Rating | 2005 | 76 | 1 (5th) | 2006 | 78 | 1 (5th) | |
| | CPIA Fiscal Policy Rating | 2005 | 76 | 41 (2nd) | 2006 | 78 | 40 (2nd) | |
| | CPIA Gender Equality Rating | 2005 | 76 | 75 (1st) | 2006 | 78 | 77 (1st) | |
| | CPIA Macroeconomic Management Rating | 2005 | 76 | 17 (4th) | 2006 | 78 | 39 (2nd) | |
| | CPIA Policies for Social Inclusion/Equity Cluster Average | 2005 | 76 | 54 (1st) | 2006 | 78 | 52 (1st) | |
| | CPIA Policy and Institutions For Environmental Sustainability Rating | 2005 | 76 | 22 (4th) | 2006 | 78 | 24 (3rd) | |
| | CPIA Property Rights and Rule-Based Governance Rating | 2005 | 76 | 41 (2nd) | 2006 | 78 | 42 (2nd) | |
| | CPIA Public Sector Management and Institutions Cluster Average | 2005 | 76 | 39 (2nd) | 2006 | 78 | 39 (2nd) | |
| | CPIA Quality of Budgetary and Financial Management Rating | 2005 | 76 | 34 (3rd) | 2006 | 78 | 32 (3rd) | |
| | CPIA Quality of Public Administration Rating | 2005 | 76 | 19 (4th) | 2006 | 78 | 17 (4th) | |
| | CPIA Social Protection Rating | 2005 | 76 | 55 (1st) | 2006 | 78 | 53 (1st) | |
| | CPIA Structural Policies Cluster Average | 2005 | 76 | 2 (5th) | 2006 | 78 | 7 (5th) | |
| | CPIA Trade Rating | 2005 | 76 | 37 (3rd) | 2006 | 78 | 36 (3rd) | |
| | CPIA Transparency, Accountability, and Corruption In The Public Sector Rating | 2005 | 76 | 63 (1st) | 2006 | 78 | 64 (1st) | |

## TABLE A-17 (CONTD.)
## TREND IN PAKISTAN'S RANKING IN DIFFERENT GOVERNANCE INDICATORS

| | | INDICATORS | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | EARLIEST YEAR[a] | | | LATEST YEAR[b] | | | |
| Source | Type | Year | Number of Countires | Ranking[d] (Quintile)[c] | Year | Number of Countries | Ranking[d] (Quintile)[c] | Trend |
| 8 UNDP Human Development Report | Gender Empowerment Measure | 1996 | 104 | 101 (1st) | 2007 | 109 | 99 (1st) | |
| 9 Overseas Development Institute (World Governance Assessment) | Civil Society | 1996 | 16 | 15(1st) | 2000 | 16 | 16 (1st) | ↗ |
| | Political Society | 1996 | 16 | 16 (1st) | 2000 | 16 | 16 (1st) | No Change. |
| | Government | 1996 | 16 | 15 (1st) | 2000 | 16 | 16 (1st) | |
| | Bureaucracy | 1996 | 16 | 14 (1st) | 2000 | 16 | 12 (1st) | ↘ |
| | Economic Society | 1996 | 16 | 15 (1st) | 2000 | 16 | 13 (1st) | |
| | Judiciary | 1996 | 16 | 16 (1st) | 2000 | 16 | 16 (1st) | No Change. |
| | Total | 1996 | 16 | 15 (1st) | 2000 | 16 | 15 (1st) | No Change. |
| 10 Human Rights Commitment (Danish Centre for Human Rights) | CPR Violations | 2000 | 72 | 30 (3rd) | na | | | |
| | Formal Commitment | 2000 | 72 | 15 (4th) | na | | | |
| | Social Commitment | 2000 | 72 | 41 (2nd) | na | | | |
| | Gender Commitment | 2000 | 72 | 42 (2nd) | na | | | |
| 11 Data on Governance Indicators (IADB/DIFID) | Freedom of the Press | 1993 | 92 | 80 (1st) | 2008 | 211 | 180 (1st) | ↗ |
| | Political Rights | 1993 | 92 | 85 (1st) | 2008 | 211 | 162 (1st) | |
| | Political Stability and Absence of Violence | 1993 | 92 | 72 (1st) | 2008 | 211 | 195 (1st) | ↘ |
| | Voice and Accountability | 1993 | 92 | 60 (1st) | 2008 | 211 | 185 (1st) | |
| 12 Center for Global Development | Commitment to Development Index | na | na | na | na | na | na | na |
| 13 Democracy Index Economist Intelligence Unit (EIU) | Overall Score | 2006 | 167 | 113 (2nd ) | 2008 | 167 | 108 (2nd) | ↘ |
| | Electoral Process and Pluralism | 2006 | | | 2008 | | | |
| | Functioning of Government | 2006 | | | 2008 | | | |
| | Political Participation | 2006 | | | 2008 | | | |
| | Political Culture | 2006 | | | 2008 | | | |
| | Civil Liberties | 2006 | | | 2008 | | | |
| 14 Polity IV Country Reports (University of Maryland - Center for International Development and Conflict Management) | Polity | 1972 | 154 | 112 (1st) | 2007 | 163 | 145 (1st) | |
| | Democracy | 1972 | 154 | 121 (1st) | 2007 | 163 | 129 (1st) | ↘ |
| | Autocracy | 1972 | 154 | 110 (1st) | 2007 | 163 | 134 (1st) | |
| | Durable | 1972 | 154 | 135 (1st) | 2007 | 163 | 148 (1st) | ↘ |
| | Tentative | 1972 | Not | - | 2007 | Yes | - | |
| 15 Business Environment Risk Intelligence (BERI) | Political Stability and Absence of Violence | 1996 | 101 | 47 (3rd) | 2008 | 101 | 92 (1st) | ↘ |
| | Government Effectiveness | 1996 | 101 | 84 (1st) | 2008 | 119 | 87 (1st) | |
| | Rule of Law | 1996 | 119 | 87 (1st) | 2008 | 119 | 52 (3rd) | ↘ |
| | Control of Corruption | 1996 | 119 | 59 (3rd) | 2008 | 119 | 57 (3rd) | |
| 16 Gallup International (Gallup World Poll) | Voice & Accountability | 2006 | 122 | 80 (2nd) | 2008 | 143 | 102 (1st) | |
| | Government Effectiveness | 2006 | 122 | 61 (2nd) | 2008 | 143 | 53 (3rd) | ↗ |
| | Rule of Law | 2006 | 122 | 62 (2nd) | 2008 | 143 | 94 (2nd) | |
| | Control of Corruption | 2006 | 122 | 75 (2nd) | 2008 | 143 | 62 (3rd) | ↗ |
| 17 Index of Economic Freedom (Heritage Foundation and Wall Street Journal) | Business Freedom | 1995 | 101 | 88 (1st) | 2009 | 183 | 65 (3rd) | |
| | Trade Freedom | 1995 | 101 | 87 (1st) | 2009 | 183 | 140 (1st) | ↗ |
| | Fiscal Freedom | 1995 | 101 | 63 (2nd) | 2009 | 183 | 72 (3rd) | |
| | Government Size | 1995 | 101 | 35 (3rd) | 2009 | 183 | 23 (4th) | ↘ |
| | Monetary Freedom | 1995 | 101 | 48 (3rd) | 2009 | 183 | 125 (2nd) | |
| | Investment Freedom | 1995 | 101 | 33 (3rd) | 2009 | 183 | 118 (2nd) | ↗ |
| | Financial Freedom | 1995 | 101 | 21 (4th) | 2009 | 183 | 128 (2nd) | |
| | Property Rights | 1995 | 101 | 32 (3rd) | 2009 | 183 | 131 (1st) | ↘ |
| | Freedom from Corruption | 1995 | 101 | 90 (1st) | 2009 | 183 | 146 (1st) | |
| | Labor Freedom | 1995 | 155 | 88 (2nd) | 2009 | 183 | 122 (2nd) | ↘ |
| | Overall Index | 1995 | 101 | 52 (2rd) | 2009 | 182 | 102 (2nd) | ↘ |

## TABLE A-17 (CONTD.)
## TREND IN PAKISTAN'S RANKING IN DIFFERENT GOVERNANCE INDICATORS

| | | INDICATORS | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | EARLIEST YEAR[a] | | | LATEST YEAR[b] | | | |
| Source | Type | Year | Number of Countires | Ranking[d] (Quintile)[c] | Year | Number of Countries | Ranking[d] (Quintile)[c] | Trend |
| 18 Voter Turnout: Global Report | Vote to Registration Ratio, Parliamentary Elections | 1945-2004 | 169 | 164 (1st) | | | | |
| 19 Inter-Parliamentary Union (Women in National Parliaments -Statistical Archive) | Lower or single House Upper House or Senate (Women's weight) | 1997 | 102 | 95 (1st) | 2008 | 136 | 46 (3rd) | |
| | Lower or single House Upper House or Senate (Women's weight) | 1997 | 102 | 95 (1st) | 2008 | 136 | 46 (3rd) | ↗ |
| 20 The Opacity Index (Price Waterhouse Coopers) | Corruption | 2004 | 48 | 42 (1st) | | | | |
| | Efficacy of the Legal System | 2004 | 48 | 36 (1st) | | | | |
| | Deleterious Economic Policy | 2004 | 48 | 44 (1st) | | | | |
| | Inadequate Accounting and Governance Practices | 2004 | 48 | 29 (2nd) | | | | |
| | Detrimental Regulatory Structures | 2004 | 48 | 19 (2nd) | | | | |
| | The Opacity Index | 2004 | 48 | 28 (2nd) | | | | |
| 21 Reporters without Borders (Press Freedom Barometer) | Press Freedom Index | 2002 | 139 | 119 (1st) | 2009 | 175 | 159 (1st) | |
| 22 University of California Santa Barbara (Stohl) | Political Terror Scale Amnesty International | 1977 | 101 | 89 (1st) | 1977 | 152 | | ↘ |
| | US State Department | 2008 | 111 | 96 (1st) | 2008 | 179 | | |
| 23 Governance-III (USAID) | Voice & Accountability | 1996 | 192 | 151 (1st) | 2002 | 199 | 168 (1st) | ↘ |
| | Political Stability and Absence of Violence | 1996 | 186 | 165 (1st) | 2002 | 186 | 157(1st) | |
| | Government Effectiveness | 1996 | 180 | 108 (1st) | 2002 | 195 | 123 (1st) | ↘ |
| | Regulatory Quality | 1996 | 182 | 138 (1st) | 2002 | 195 | 151 (1st) | |
| | Rule of Law | 1996 | 167 | 104 (2nd) | 2002 | 195 | 140 (1st) | ↘ |
| | Control of Corruption | 1996 | 151 | 127 (1st) | 2002 | 195 | 140 (1st) | |
| 24 Bertelsmann Transformation Index (Bertelsmann Stiftung) | Voice & Accountability | 2002 | 116 | 85 (1st) | 2008 | 125 | 93 (1st) | ↘ |
| | Government Effectiveness | 2002 | 116 | 53 (3rd) | 2008 | 125 | 81 (1st) | |
| | Regulatory Quality | 2002 | 116 | 61 (2nd) | 2008 | 125 | 78 (1st) | ↘ |
| | Rule of Law | 2002 | 116 | 80 (1st) | 2008 | 125 | 97(1st) | |
| | Control of Corruption | 2002 | 119 | 63 (2nd) | 2008 | 125 | 86 (1st) | ↘ |
| 25 Cingranelli-Richards (CIRI) Human Rights Database (CIRI Human Rights Data Project) | Voice & Accountability | 1996 | 159 | 136 (1st) | 2008 | 192 | 156 (1st) | |
| | Political Stability and Absence of Violence | 1996 | 174 | 152 (1st) | 2008 | 192 | 186 (1st) | ↘ |
| | Rule of Law | 1996 | 159 | 109 (2nd) | 2008 | 192 | 176 (1st) | |
| 26 International Fund for Agricultural Development (IFAD Rural Sector Performance Assessments) | Voice & Accountability | 2004 | 124 | 21 (1st) | 2008 | 90 | 59 (1st) | ↘ |
| | Government Effectiveness | 2004 | 124 | 27 (1st) | 2008 | 90 | 68 (1st) | |
| | Regulatory Quality | 2004 | 124 | 71 (2nd) | 2008 | 90 | 28 (3rd) | ↘ |
| | Rule of Law | 2004 | 124 | 106 (1st) | 2008 | 90 | 62 (1st) | |
| | Control of Corruption | 2004 | 124 | 45 (2nd) | 2008 | 90 | 59 (2nd) | ↘ |
| 27 Institutional Profiles (Institutional Profiles Database) | Voice & Accountability | 2006 | 85 | 63 (1st) | 2008 | 85 | 63 (1st) | No change. |
| | Political Stability and Absence of Violence | 2006 | 85 | 81 (1st) | 2008 | 85 | 81 (1st) | No change. |
| | Government Effectiveness | 2006 | 85 | 75 (1st) | 2008 | 85 | 75 (1st) | |
| | Regulatory Quality | 2006 | 85 | 59 (2nd) | 2008 | 85 | 59 (2nd) | No change. |
| | Rule of Law | 2006 | 85 | 69 (1st) | 2008 | 85 | 69 (1st) | No change. |
| | Control of Corruption | 2006 | 85 | 49 (2nd) | 2008 | 85 | 49 (2nd) | No change. |
| 28 International Budget Project Open Budget Index | Voice & Accountability | 2005 | 59 | 19 (3rd) | 2008 | 85 | 47 (2nd) | No change. |
| 29 Global Insight Business Conditions and Risk Indicators | Voice & Accountability | 1998 | 181 | 127 (1st) | 2008 | 203 | 170 (1st) | |
| | Political Stability and Absence of Violence | 1998 | 181 | 142 (1st) | 2008 | 203 | 194 (1st) | ↘ |

## TABLE A-17 (CONTD.)
## TREND IN PAKISTAN'S RANKING IN DIFFERENT GOVERNANCE INDICATORS

| Source | Type | INDICATORS: EARLIEST YEAR[a] Year | EARLIEST YEAR[a] Number of Countires | EARLIEST YEAR[a] Ranking[d] (Quintile)[c] | LATEST YEAR[b] Year | LATEST YEAR[b] Number of Countries | LATEST YEAR[b] Ranking[d] (Quintile)[c] | Trend |
|---|---|---|---|---|---|---|---|---|
| | Government Effectiveness | 1998 | 181 | 157 (1st) | 2008 | 203 | 176 (1st) | |
| | Regulatory Quality | 1998 | 181 | 159 (1st) | 2008 | 203 | 199 (1st) | ↘ |
| | Rule of Law | 1998 | 181 | 133 (2nd) | 2008 | 203 | 185 (1st) | |
| | Control of Corruption | 1998 | 181 | 150 (1st) | 2008 | 203 | 179 (1st) | ↘ |
| 30 Country Security Risk Ratings (IJET Country Security Risk Ratings) | Political Stability and Absence of Violence | 2004 | 167 | 149 (1st) | 2008 | 185 | 183 (1st) | |
| 31 Cerberus Corporate Intelligence Gray Area Dynamics [Merchant International Group (MIG)] | Political Stability and Absence of Violence | 2002 | 118 | 118 (1st) | 2008 | 164 | 162 (1st) | ↘ |
| | Government Effectiveness | 2002 | 118 | 118 (1st) | 2008 | 164 | 145 (1st) | |
| | Regulatory Quality | 2002 | 118 | 107 (1st) | 2008 | 164 | 57 (3rd) | ↘ |
| | Rule of Law | 2002 | 118 | 113 (1st) | 2008 | 164 | 87 (2nd) | |
| | Control of Corruption | 2002 | 118 | 118 (1st) | 2008 | 164 | 148 (1st) | ↗ |
| 32 Country Policy and Institutional Assessments (Asian Development Bank) | Government Effectiveness | 2005 | 25 | 6 (4th) | 2008 | 28 | 12 (3rd) | |
| | Regulatory Quality | 2005 | 25 | 6 (4th) | 2008 | 28 | 7 (4th) | ↘ |
| | Rule of Law | 2005 | 25 | 16 (2nd) | 2008 | 28 | 19 (2nd) | |
| | Control of Corruption | 2005 | 25 | 19 (1st) | 2008 | 28 | 16 (2nd) | ↘ |
| 33 Brown University's Center for Public Policy | Government Effectiveness | 2002 | 194 | 127 (2nd) | 2008 | 196 | 109 (2nd) | |
| 34 Trafficking in People Report (United States Department of State) | Rule of Law | 2000 | 82 | 74 (1st) | 2008 | 153 | 76 (3rd) | |
| 35 World Economic Forum | Global Competitiveness Scale | 2008 | 131 | 92 (1st) | 2010 | 133 | 101 (1st) | ↗ |

[a] The earliest year denotes the year for which the data of the indicator is available.

[b] The latest year is the most recent year for which the data of the indicator is available.

[c] Note that the Pakistan's ranking is divided into quintiles. These are given in the braces against each indicator and measures the indicators performance as follows:

the 1st quintile is the lowest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the lowest 20% of the countries.

- the 2nd quintile is the second lowest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 21-40% of the countries.

the 3rd quintile is the middle quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 41-60% of the countries.

- the 4th quintile is the second highest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 61-80% of the countries.
- the 5th quintile is the highest quintile of the five quintiles, which means that the Pakistan's performance in that indicator falls in the 81-100% of the countries.

[d] The most we are away on the most bad in terms of performance in that indicator.

**Source:** IPP estimates from the various sources of governance indicators mentioned in Table 3.1 of Chapter 3 of this report.

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# Notes

**CHAPTER - 6**

1. Some of the costs to the economy resulting from terrorism and power shortages were estimated by the Institute of Public Policy, Beaconhouse National University, Lahore, in its second annual report issued in May 2009. See *State of the Economy: Emerging from the Crises* (Lahore, 2009). These estimates have been updated in this report while the costs of two other shortages - gas and water - have been added to the calculus.

2. For the reason why the military leaders developed this elaborate structure, see Muhammad Ayub Khan, *Friends not Masters, A Political Autobiography* (London, Oxford University Press, 1967).

3. Pakistan is not the only country in South Asia that has developed the tradition of dynastic politics. It is prevalent in Bangladesh, India and Sri Lanka as well. It has been argued in recent article that new breed of leaders in India have strong family connection to political families that have played important roles in the country. See James Lamont, "The loom of youth" *Financial Times*, May 11, 2010, p. 7.

4. Perhaps the best account of the role performed by the Indian Civil Service is to be found in Philip Woodruff, The Men Who Ruled India, London, W.W. Norton, 1985. The book was initially issued as a two volume study under the title of *The Men Who Ruled India: The Founders and The Men Who Ruled India: The Guardians*. The Author used the pseudonym of Phil Mason to hide his entity when the books were first published since at that time he was still in the service of the government.

5. We have used the text in Yasmeen Rehman, *The Constitution of the Islamic Republic of Pakistan, 1973 as Amended by Constitution (eighteenth Amendment) Act, 2010*. Lahore, Punjab Law Book House, 2010.

6. One example of the sharp dispute on this issue is the exchange outside the Supreme Court between two prominent lawyers, Aitzaz Ahsan and Akram Sheikh. See Nasir Iqbal, "Aitzaz, Akram spar over parliament" Dawn (21 April, 2010), pp. 1 and 5.

7. This subject was covered in an international symposium held in New Delhi in August 2003 and reported in a Indian journal. See *Economic and Political Weekly*, "Federalism in a Global World: Challenges and Responses", 6 September, pp. 1-16.

**CHAPTER 8**

1. For a case study based on implementing the Participatory Development approach in nine districts of the Punjab province, see, Akmal Hussain, Honorary Chief Executive Officer, Punjab Rural Support Programme (PRSP), The First Four Months Report to the Board of Directors, PRSP, 1998.

2. The concept of Participatory Development is formulated in: Akmal Hussain "*Poverty Alleviation in Pakistan*", Vanguard, Lahore, 1994, Pages 26 to 29.

3. For a more detailed discussion of this issue, See: Akmal Hussain "*Poverty, Growth and Governance*", Chapter in, V.A. Pai Panandiker (ed.): Problems of Governance in South Asia, Centre for Policy Research, New Delhi, 2000.

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