Sixth Annual Report 2013

THE STATE OF THE ECONOMY:

FROM SURVIVAL TO REVIVAL

INSTITUTE OF PUBLIC POLICY

BEACONHOUSE NATIONAL UNIVERSITY, LAHORE

When Aziz and I started the IPP we wanted to create an institution in the private sphere that would analyze the state of the Pakistani economy without a political bias. I was asked to take up the task of steering the institution during its formative phase even though I lived thousands of miles away in the United States. This has meant spending months away from my family and many hours on the plane. It is a burden I am not able to carry anymore. At one point I had also offered to give the equivalent of $250,000 from the Burki Family Foundation that my wife and I established after I retired from the World Bank. That disbursement could not be made since it required legal work to satisfy the Internal Revenue Service in the United States that the purpose for which the Foundation was set was met by that intended contribution. It is my regret that that contribution could not strengthen the intended mission of the IPP.

I have enormously enjoyed my almost eight years of association with the IPP. My greatest reward was the close relationship I developed with Hafiz Pasha and Aisha Ghaus-Pasha. Without Aisha's diligence and dedication these reports would not have become public. The Pashas are two professionals of exceptional ability and dedication. The two of them are able to put in extraordinarily long hours working on a variety of subjects. Their only motive for this hard labour is love for their country. Their only reward is to see that some of what they have done – and they have done an immense amount – will better the lives of the almost 200 million citizens of Pakistan. I wish them and the institution well.

Shahid Javed Burki
Chairman
Institute of Public Policy

Potomac, Maryland, USA
21st April, 2013

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FOREWORD

The state of the economy is grim today. The external balance of payments has deteriorated because of cessation of capital inflows, although the current account remains manageable, especially in the presence of large home remittances. Low net foreign aid and foreign direct investment and large debt repayments to the IMF have led to a steep decline in foreign exchange reserves, which now stand at $6.4 billion, barely enough to finance one and a half months of imports. Further haemorrhaging of reserves could precipitate a crisis of the type we saw in 2008.

The fiscal situation visibly worsened over the course of the last year, and continues to deteriorate this year, with the budget deficit likely to exceed 8 percent of the GDP in both years. Revenue growth has been sluggish, and debt service payments have acquired an explosive character due to heavy dependence on relatively high cost domestic borrowing. On top of this, the subsidies to the power sector have been vastly in excess of the budget estimates.

But there are some positive developments which need to be built on. The last government successfully completed its full term and the process leading up to the elections has proceeded as planned. The manifestos of the political parties show the same concern for solving the energy problem, improving the quality of basic services like education and health, strengthening governance and institutions for greater accountability, although specific proposals may differ.

While the economy has shown persistently low growth, the impact has been limited by the large inflow of remittances, a buoyant informal economy and a big jump in private consumption expenditure. But the large and growing macroeconomic imbalances, the plummeting of investment, rising militancy and terrorism indicate that the country is presently not on a sustainable path of development.

The basic recommendation of the report is that the newly inducted government will need to focus initially on the stabilization of the economy, by making major reforms in fiscal, monetary and trade policies, in the Budget of 2013-14. Beyond this, the emphasis can gradually shift to the process of revival of the economy, with industry acting as the leading sector.

The report comprises seven chapters. It presents the details of a short-term survival strategy and the contours of a medium- to long-term strategy for sustainable revival of the economy. In addition, an attempt is made to quantify the cost of loadshedding and a series of proposals presented for tackling this problem, which has become one of the biggest impediments to growth today. Other chapters focus on the micro elements of the strategy for industrial revival and on the state of governance, especially in terms of delivery of services, as determined through a Citizen Score Card survey throughout the country.

The members of the Executive Council of IPP have all provided inputs to this report as our humble contribution to the process of transition that is taking place in the country. We hope that policy makers, members of civil society as well representatives of the private sector will find this report of some interest.

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ACRONYMS

ADPs	Annual Development Programmes
AIT	Agricultural Income Tax
AOP	Association of Persons
BERI	Business Environment Risk Intelligence
BHU	Basic Health Units
BISP	Benazir Income Support Programme
BoP	Balance of Payments
BSP	Budget Strategy Paper
CCI	Council for Common Interests
CCP	Competition Commission of Pakistan
CDWP	Central Development Working Party
CEC	Chief Election Commissioner
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CPR	Civil and Political Rights
CSF	Coalition Support Fund
DFID	Department for International Development
DISCO	Distribution Companies
EC	Election Commission
ECC	Economic Committee of the Cabinet
ECNEC	Executive Committee of National Economic Council
EDA	External Development Assistance
EFS	Export Finance Scheme
EIU	Economist Intelligence Unit
FAC	Fuel Adjustment Charges
FBR	Federal Board of Revenue
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FE	Foreign Exchange
FEG	Framework for Economic Growth
FESCO	Faisalabad Electric Supply Company
FIR	First Information Report
FoB	Free on Board
FTA	Free Trade Agreement
FY	Fiscal Year
FYP	Five Year Plan

GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GEPCO	Gujranwala Electric Power Company
GIDC	Gas Infrastructure Development Cess
GNI	Gross National Income
GNP	Gross National Product
GOP	Government of Pakistan
GSP	Generalized System of Preferences
GST	General Sales Tax
GWH	Gigawatt Hour
HESCO	Hyderabad Electric Supply Company
IADB	Inter-American Development Bank
IESCO	Islamabad Electric Supply Company
IFAD	International Fund for Agricultural Development
IFPRI	International Food Policy Research Institute
IMF	International Monetary Fund
IPP	Institute of Public Policy
IPPs	Independent Power Producers
IRPP	Integrated Rehabilitation Project Plan
IT	Information Technology
ITP	International Trade Prices
KESC	Karachi Electric Supply Company
K-PK	Khyber Pakhtunkhwa
KSE	Karachi Stock Exchange
KWH	Kilowatt Hour
LDC	Least Developed Country
LESCO	Lahore Electric Supply Company
LHWs	Lady Health Workers
LMS	Large and Medium Scale
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LTFF	Long Term Financing Facility
MEPCO	Multan Electric Power Company
MIG	Merchant International Group
MMCFT	Million Cubic Feet
MOF	Ministry of Pakistan
MP	Management Pay
MPAs	Members of Provincial Assembly
MW	Megawatt

NAB	National Accountability Bureau
NADRA	National Data and Registering Authority
NATO	North Atlantic Treaty Organization
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NGO	Non-governmental Organization
NIC	National Identity Card
NTCIP	National Trade Corridor Improvement Project
NTDC	National Transmission and Dispatch Company
NTPO	National Tax Policy Office
ODA	Overseas Development Assistance
OGDC	Oil and Gas Development Corporation
OGRA	Oil and Gas Regulatory Authority
OLS	Ordinary Least Square
OMO	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PASMIC	Pakistan Steel Mills Complex
PBS	Pakistan Bureau of Statistics
PES	Pakistan Economic Survey
PIB	Pakistan Investment Bonds
PESCO	Peshawar Electric Supply Company
PIA	Pakistan International Airlines
PIDE	Pakistan Institute of Development Economics
PML-N	Pakistan Muslim League-Nawaz
PML-Q	Pakistan Muslim League-Quaid
POL	Petroleum Oil and Lubricants
PPL	Pakistan Petroleum Limited
PPP	Pakistan Peoples' Party
PPP	Purchasing Power Parity
PSDP	Public Sector Development Programme
PSDTF	Private Sector Development Task Force
PSE	Public Sector Enterprises
PSO	Pakistan State Oil
QESCO	Quetta Electric Supply Company
REER	Real Effective Exchange Rate
RFO	Refined Furnace Oil
RHC	Rural Health Centres
SAARC	South Asian Agreement for Regional Cooperation
SAFTA	South Asia Free Trade Agreement
SBP	State Bank of Pakistan

SDPI	Sustainable Development Policy Institute
SDR	Special Drawing Rights
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprises
SPDC	Social Policy and Development Centre
SROs	Statutory Regulatory Orders
SSGC	Sui Southern Gas Company
TARP	Tax Administration Reform Project
TFPSD	Task Force on Private Sector Development
TI	Transparency International
TOE	Tonnes of Oil Equivalents
TV	Television
UAE	United Arab Emirates
UIPT	Urban Immoveable Property Tax
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UPS	Uninterrupted Power Supply
USA	United States of America
USAID	United States Agency for International Development
VAT	Value Added Tax
WAPDA	Water and Power Development Authority
WDI	World Development Indicators

Executive Summary: From Survival to Revival

Executive Summary: From Survival to Revival*

As we write this report, the nation is preparing for elections. Will the general elections promised for May 11 prove to be an important milestone on the road to greater economic, political and social stability? Can this be a turning point to a better future for Pakistan? The answer to both these questions is a qualified "yes". Pakistan may well be developing a new way of managing the political system and the economy. While we may be accused of some optimism at a time that brings grim news every day, we would like to hope that the new government being elected for the first time after completion of a full term in Pakistan, will come to power with a firm commitment to take the Pakistani citizenry out of its current malaise. An important purpose of this report – the sixth in the series of annual documents by the Institute of Public Policy (IPP) – is to suggest the options that the new policymakers need to consider that will first stabilize the economy and then take it on the path of high growth.

To take stock of the present situation, the most worrisome crises facing the country are the increase in violence, demonstrating limited respect for the rule of law and especially impacting the poorer segments of the population, and severe problems in the economic arena: the longest downturn in its history, serious macroeconomic imbalances, and the absence of consensus on how to place the economy on a trajectory of higher and sustainable rate of (Gross Domestic Product) GDP growth. The policymakers must address these inter-related problems simultaneously. On the economic front, growth and inclusiveness need to become the basis of a new development paradigm. Prior to that, large macroeconomic imbalances must be eliminated. Progress on one front would improve the prospects on the other two fronts. Restoring stability to the macroeconomic situation will improve the investment climate for both foreign and domestic investors. The increased confidence and recovery in growth will lay the basis of both expanded revenues and exports. But a growth strategy must have the people's support, without which it will be hard to implement. It will necessarily involve sacrifices by the relatively well-to-do so that those who have been left behind can begin to benefit from the process of growth.

The deteriorating economic situation clearly requires immediate attention of the policy makers in particular to arrest the dangers on the external financial side. As highlighted in the report the

*The Executive Summary has been prepared by Dr. Aisha Ghaus-Pasha.

pace at which the country has been losing its foreign exchange reserves signals the arrival of yet another balance of payments crisis. Likewise, the challenges on the fiscal side in the area of tax collection, management of public enterprise losses and handling of energy shortages have to be addressed. The previous government was clearly not able to muster enough political will and support to introduce the required reforms.

In the grim environment on the governance side, there are also some silver linings. On the one hand, there has been a precipitous decline in the quality of governance, reflected both in the increase in corruption and decline in the quality of service provision, especially in the public sector enterprises. On the other hand, the higher judiciary especially the independent Supreme Court has become very pro-active in governance issues. The free media has also come to play an important role in highlighting public policy issues and exposing wrong doing. So while there are opportunities there are challenges also. Which way Pakistan goes will depend on the choices the new set of elected leaders/ policymakers make.

Speaking of silver linings, there have been some positive moves on the political front which can provide the foundation for a stronger base for the new legislators. There cannot be a serious discussion of Pakistan's economic future without an equally serious probe into the way its political order is evolving.

Once in the late 1980s and on three occasions in the 1990s, the lives of Parliaments were cut short by the president of the day, using the constitutional authority available at the time. On the fifth occasion, the military intervened directly when General Pervez Musharraf removed Prime Minister Nawaz Sharif from office and took over first as the country's "Chief Executive" and then as President. The infamous Article 58.2 (b) through which these were accomplished, has since been removed from the Constitution by the 18th amendment in April 2010.

Another major area of transition is federal-provincial relations. This is still evolving after the adoption of the 18th amendment. A number of responsibilities that were with the federal government have been devolved to the provinces giving them space to perform a more effective development role.

Furthermore, some basic constitutional changes were instituted that augur well for the future of democracy in a meaningful federal setting. For example, the 18th and the 20th amendment to the Constitution have strengthened the judiciary, the office of Chief Election Commissioner, and laid down the arrangements for putting in place a caretaker government to oversee elections.

In all these developments, what was important to notice in Pakistan's case was the fact that politics was being conducted according to the rule of law. It is also significant that political establishment recognized that there was a need to change the way it managed the political process. This was a major improvement for a country that had lived through so many military interventions in the political process. Also, given the changes one can hope the new government will come in power with full legitimacy and authority. It remains to be seen if it will be able to move the country decisively in the right direction.

THE STATE OF THE ECONOMY

The deterioration in the state of the economy in terms of important fundamentals continues unabated. To cite some examples, the energy and security crises have deepened exhibiting signs of a breakdown of effective governance, economic growth remains slow averaging barely 3 percent per annum over the last five years and real gross fixed investment has fallen steadily to less than 11 percent of GDP which does not portend well for the future rate of growth.

The large and growing macroeconomic imbalances have put Pakistan for the first time in its history in the danger of stagflation. Public finances have deteriorated very significantly. Because of the stagnant tax to GDP ratio (around 9 percent of the GDP), mounting public enterprise losses, and persistent subsidies for the power sector, the real overall fiscal deficit has remained at around 7 percent of GDP during the last three years. The problem, however, is not only the large size of the deficit but what the deficit finances and how it is financed. Since government revenues do not cover current expenditures, the revenue account deficit has averaged 3.5 of GDP in the three years and has been financed heavily by bank borrowings, which are very inflationary.

At the same time, the foreign exchange position is becoming increasingly critical. The current account balance of payments deficit was $4.3 billion or 2 percent of GDP in 2011-12, despite high growth in worker remittances. Exports have not shown any signs of recovery so far this year due both to supply bottlenecks (energy shortages, in particular) and competitiveness issues.

The most serious and urgent problem is that the capital account is under great pressure. Because of large repayments to the International Monetary Fund (IMF) in 2011-12, a 50 percent decline in direct foreign investment to $800 million, and only modest inflows of long term loans ($500 million), liquid foreign exchange reserves held by the State Bank of Pakistan dropped by $4 billion in 2011-12. With a further repayment of $1.8 billion during first eight months of 2012-13, SBP net reserves had fallen to $6.5 billion by end March 2013. The present level of reserves is less than 2 months' of imports of goods and services; and its continuous decline is putting pressure on the Rupee.

Fundamentals Vs Resilience

Despite this long list of negatives, some segments of the economy are showing resilience. The stock market is near an all time peak and was one of the best performing in the world during 2012. Private consumption indicates an increase of 27 per cent over 2008-12, although this is probably overstated. Though there is some capital flight, the rupee is not in a free fall. The initial improvement in agricultural terms of trade and vibrancy of agriculture especially through higher wheat and cotton prices provided for an upsurge in rural incomes.

There are several explanations for the resilience. First, the sharp initial improvement in the agricultural terms of trade helped incomes in the rural areas where the majority of population lives. Second, the large external inflows of remittances recorded and unrecorded have helped sustain per capita income growth well above the rather depressed growth in domestic output of only about 3 percent per annum. Third, and most important, there has been a significant shift from investment to consumption over the last four or five years. While private consumption rose real fixed investment fell by over 30 percent over the same period.

This economic pattern in which present consumption pre-empts future growth and heavy dependence on somewhat exceptional external flows is obviously not sustainable. Thus, the economic fundamentals can no longer be ignored. Moderating the rate of consumption growth to improve public finances and to reverse the decline in public and private investment is absolutely essential but would make for hard choices for the new government. On the other hand, more effective governance reflected in improved security situation, improving energy situation, and stabilization of the economy can restore the confidence in the country. This report presents a detailed analysis of and proposals to address the structural issues in Pakistan's economy.

Towards Structural Reform

On improving the public finances, our view is that it is not only an issue of an orderly reduction in fiscal deficit through improving revenues and cutting back of expenditures but should also involve the undertaking of a substantial restructuring and reprioritizing of expenditures to support economic growth. At the same time, it is important that dependence on bank financing of the deficit be curtailed and much greater efforts should be made by mobilization resources through non- bank sector and liquidation and sale of several state assets both at the federal and the provincial levels. Over and above this, a comprehensive and coherent strategy of higher tax mobilization, both through policy reform and improvement in tax administration, is required which is discussed in the Report. Needless to say, any such strategy cannot succeed without strong political will and a well-paid but honest tax collection service.

Balance of payments challenges pose colossal dangers. The critical long-term need is to reverse the stagnation in exports and recover some of the market share Pakistan has lost to most major developing countries. The immediate issue is whether the foreign exchange reserves with the State Bank of Pakistan can withstand a further unavoidable hit in the next six to eight months without triggering a panic in the foreign exchange market. It seems difficult to reach an agreement with the Fund quickly, even if one is considered desirable and feasible by the policy makers. Short term fixes for the reserves that are apparently been considered include seeking deposits from friendly countries like China, but the real problem is that the underlying balance of payments remains weak.

Investment in human and physical capital is an important pre-requisite for revival and has to figure prominently in any structural reform strategy. The revival of gross fixed capital formation to a modest rate, 15 percent of GDP over the next three years, would require a major turnaround in governance and a broad shift in policies and incentives from consumption to investment. It is also worrying that the decline in investment has been accompanied by shifts in the pattern of investment that do not bode well for improvements in efficiency and productivity. More investment is needed in the large scale manufacturing leading to gains like economies of scale and skill development which are critical to improving the competitiveness of Pakistan's industry and exports. Likewise, investments in power sector including long term and short run measures are the lynchpin in the initial survival and then the revival strategy.

ATTAINING ECONOMIC STABILITY – THE ESSENTIAL REFORMS

The previous sections have highlighted that the newly elected government will have to take urgent policy actions, especially in the Budget of 2013-14, to address the twin problem of deteriorating BoP and falling foreign exchange reserve (by June 2013 foreign exchange reserves could be down to about $6 billion, providing import cover of less than 1.5 months following the lumpy repayments to IMF due in May 2013 of $576 million) and the burgeoning fiscal deficit (which is likely to stand at over 8 percent of the GDP).

A number of steps required to manage the imbalances are described in the report relating to the fiscal policy and tax administration, monetary policy, trade policy and Pakistan's options vis-a-vis the IMF.

On the fiscal side, measures are suggested to make the tax system more equitable while raising significant additional revenues at the Federal and Provincial levels. These include proposals related to Agricultural Income Taxation and property tax at the provincial level and income tax, sales tax and customs duty at the federal level with a focus also on encouraging documentation.

The taxation proposals have the potential of raising additional tax revenues of Rs 503 billion, almost 2 percent of the GDP, over a period of implementation of two years. Federal and provincial tax administrations will have to be improved by increasing automation, simplifying the tax system and introducing greater accountability of tax officials, while publishing a tax directory annually.

The report also suggests immediate measures on the expenditure side which among others include pruning of projects in the Public Sector Development Programme (PSDP) and introduction of zero-based budgeting of new Ministries established at the Federal level following the 18th Amendment, freezing of non-salary expenditure, a recruitment ban and rationalization of subsidies and grants.

With regard to the monetary policy, our view is that on balance, given the problems that are being faced in the raising of medium to long term domestic debt, the SBP may want to contemplate an upward adjustment in the policy rate back to the level of 12 percent in the subsequent two or three Monetary Policy Statements. Also, the widening gap between the inter-bank and open market rate should be a policy concern for the SBP.

The trade policy in the short run will have to implement a policy of import compression to reduce the trade deficit, particularly on non-essential items. However, essential imports including Petroleum Oil and Lubricants (POL), edible oil, medicines, pulses, vegetables, sugar (if any) and fertilizer, which currently account for about 55 percent of total imports, will not be affected. Temporary regulatory duties should be introduced on the remaining imports which are non-essential in character. In a somewhat longer time frame, given currently the limited growth in world trade, policies for export promotion also need to be adopted.

Overall, the above combination of fiscal, monetary and trade policies has the potential of taking the economy out of the period of financial difficulties with an emphasis on self-reliance. Beyond 2013-14, when bulk of the money due to the IMF has been repaid, Pakistan can embark on the path of revival of the economy. Our view is that most of the above-mentioned measures ought to be considered for implementation as part of the survival (stabilization) strategy in the first Budget for 2013-14 of the newly elected Government regardless of whether a recourse to the IMF becomes necessary. As mentioned above, at the same time efforts to line up alternative sources of finance to protect the reserves should be explored and the recourse to the IMF should be only in the nature of the last resort. Meanwhile, Pakistan must develop a ‘home grown’ package of longer term reforms. This will contribute greatly to restoration of confidence in the markets.

DOMESTIC IMPEDIMENT TO REVIVAL – POWER LOADSHEDDING

An important pre-requisite for economic revival will be the effective removal of major hindrances to growth. An overwhelmingly important one is power shortage. As this Report is being written, there are large-scale power riots, especially in the cities and towns of Punjab. The question we pose in this report is: what was the cost the country paid for inappropriate policies or policy neglect/deficiency and implementation failure in the power sector?

Basic Facts

Starting with some key facts about the power sector, compared internationally, Pakistan has both relatively low energy consumption and population with limited access to electricity as compared to India and Sri Lanka in South Asia and virtually all East Asian countries. Also, the fuel mix for electricity generation is different than other countries in the region as China, India and Indonesia mostly rely on coal, Nepal on hydroelectricity, Bangladesh, Malaysia, the Philippines, Thailand, Vietnam and until recently Pakistan on gas while thermal power has emerged as a major source in Sri Lanka and Pakistan. The pattern of sources of electricity of Pakistan exposes the country to two major risks. Dependence on gas at a time when reserves are depleting implies severe constraints in the medium to long run and the need to switch to other sources. The growing reliance on thermal power exposes the economy to ‘oil price shocks’. Furthermore, system losses (a key indicator of efficiency), both India and Pakistan are on the higher side even as compared to an Least Developed Countries (LDC) like Bangladesh.

The long-term trends in power sector indicate a high growth in installed capacity and electricity generation in the 70s and 80, some tapering off in the 90s with a further strengthening of this trend in the last decade. Trend in the growth rate of electricity consumption, however, diverts from this pattern and was over 6 percent during the period 2000-01 to 2007-08 thereafter the overall growth rate has fallen to 2 percent only, due to progressively higher levels of load shedding. Given these trends, the resultant surplus/deficit between potential demand and actual supply during system peak hours for National Transmission and Dispatch Company (NTDC) and Karachi Electric Supply Company (KESC) combined has risen to 27 percent of demand.

Lack of anticipation and proper provision of the long-term growth of electricity demand, imported fuel based energy mix inappropriate pricing policies, inadequate investment in upgradation/improvement, public policy neglect and public mismanagement, reflected in the accumulation of the colossal amount of Rs. 872 billion of circular debt, heavy line losses and large-scale theft, today and over the years have contributed to the power sector shortages.

Quantifying Outage Costs

Costs of outages consist of direct costs which primarily comprise the spoilage cost and net value of lost production, also referred to as 'idle factor cost' and costs incurred on making adjustments to minimize the losses/disruptions due to loadshedding. These are referred to as indirect costs of outages. The particular mechanisms chosen for recovering output lost, will of course, be based on cost minimization considerations.

A number of approaches are used in literature to quantify the cost incurred by different types of consumers as a result of power outages. These rely both on secondary and primary data. Studies undertaken in Pakistan relying on primary data based approaches include Pasha, Ghaus and Malik (1987), IPP (2009) and PIDE (2011). These studies conclude that: levels of load shedding have risen to unprecedented levels in recent years and on average firms have experienced outages between 20 to 30 percent of their working hours; the costs of loadshedding to industry have reached a high level, equivalent to 10 percent or more of national sectoral value added or almost 2 percent of the GDP. These losses have been accompanied by significant declines in profitability, employment and exports, and: the average cost of outages to industry is about 50 cents per kWh.

The approaches which rely on secondary data include: the simple value added approach, the adjusted value added approach, and the consumer surplus approach. Application of the adjusted value added approach yields the total cost of loadshedding of Rs 1228 billion in 2011-12, inclusive of the negative multiplier impact. This is a large magnitude and demonstrates that the economy has had to pay a high cost for the load shedding: 45 percent of the cost has been borne each by the industrial and commercial sectors, and 10 percent by agriculture.

A new variant of the value added approach has been developed for this study for quantification of outage costs which focuses on the relationship between development of infrastructure (electricity generation) and economic growth. It appears that a 1 percent increase in electricity generation per capita leads to a 0.167 percent increase in per capita GDP. The decline in electricity generation and its concomitant impact on GDP growth has implied a lower GDP to the extent of Rs 1347 billion by 2011-12. Application of the consumer surplus approach requires knowledge of the price elasticity of demand. Using the elasticity of demand for developing countries and a tariff of Rs 13 per kWh, the cost of loadshedding is estimated at Rs 1242 billion. Therefore, the average cost of power loadshedding using various secondary data based approaches is estimated at Rs.1247 billion for 2011-12, equivalent to over 6 percent of GDP. This implies that the growth rate of the economy could have been 1.5 percentage points higher, that is, at 4.5 percent if there had not been loadshedding. *The bottom line of the analysis is that the benefit – cost ratio of reduction in loadshedding is very high.*

MOVING FROM STABILIZATION TO REVIVAL: INDUSTRY – THE CORNERSTONE

Like in the case of other developing countries, industry has to be at the forefront of pulling the economy on the revival path. Industry in Pakistan has done this before the 60s, 80s and mid-years of the last decade when the manufacturing sector grew faster than the GDP by over two to three percentage points.

There is need first for a clear identification of the goals of industrial policy, which should includes employment creation, supporting value addition, increasing national exports and promoting faster growth of Small and Medium Enterprises (SMEs). This will give a *consistent* direction to the sector.

The large-scale manufacturing sector led the process of economic revival in the latter part of the Musharraf era. This was facilitated by a supportive business environment and expansionary macroeconomic policies, especially by a sharp reduction in interest rates, increase in bank credit to the private sector and tax cuts. The initial success was due to the considerable excess capacity that existed at the time in key industries like textiles, sugar, fertilizer, cement and automobiles. This essentially meant that the expansionary policies translated more into increases in output and less into higher prices. This pattern cannot be sustained now due to the emergence of supply-side constraints, especially of availability of power and gas.

The collapse in the growth rates of individual industries since 2006-07 is clearly visible. There has been a decline in output growth in 19 out of 23 industries, especially in cement, paints and varnishes, coke, billets, cars and tractors. In fact, as many as 15 industries have experienced an absolute fall in production during the last four years. During the first seven months of the current financial year, eleven industries continue to show negative growth. Historically, there appears to be a high correlation between industrial growth and in electricity consumption, in manufactured exports and in public sector development expenditure.

Can we essentially follow the same strategy of revival as adopted in the Musharaf period? It appears that a significant margin of excess capacity does exist currently. The rates of capacity utilization are 75 percent in sugar, 72 percent in cotton cloth, 68 percent in cement, 34 percent in tractors and 56 percent in motorcycle and so on. Therefore, as in the Musharraf Period, the thrust in the initial stages of industrial revival should be on effective utilization of the excess capacity already available. However, this time the stimulus will have to be achieved by focusing on the supply-side, especially by improving the availability of electricity and gas to industry. Beyond the enhancement of production from existing units, the second stage in the industrial revival will inevitably involve a rise in private sector investment in manufacturing, once after the stabilization goals are achieved.

Pillars of the Industrial Strategy – Revival on the Back of Survival

Energy for industry, the cluster approach, proactive role of the provinces, promotion of Foreign Direct Investment (FDI) and export-led growth, better management of state run or public sector corporations, bringing down costs of doing business and enhancing the role of women entrepreneurs are important prongs of the revival strategy. Some of the measures include:

- Resolving the energy crisis and adopting a policy of power and energy prioritization to industry and other employment generating ventures.
- The option of using Liquefied Natural Gas (LNG) as a fuel in the system must be given priority, as it has many advantages over coal and oil.
- The Water and Power Development Authority (WAPDA) needs to ensure that all the present hydropower projects under implementation are completed on time.
- Power generation by using coal as a raw material should be encouraged and even facilitated by all ways and means possible.
- There is a need to remove the 'disconnect' between various ministries involved in the energy supply chain or merge some of them in order to avoid confusion and conflict of interest. Reforms are needed to tackle issues like deregulation, possible privatization depoliticization of public-sector management in the energy sector.
- Adopting a policy of power and energy prioritization to industry and other employment generating ventures.
- Singapore like initiatives on skill development and direct incentives for sustainable job creation.
- One window facility between the private sector and approval agencies.
- State Bank of Pakistan's oversight to ensure that the public sector borrowings do not crowd out the private sector.
- Incentives for new machinery cum technology investments.
- Revival of limited period tax/duty haven status to underdeveloped and far flung areas to ensure an equitable and even spread of investment in the country.

Implementation of the proposals presented in this report will ensure that industrial revival takes place and the private sector becomes once again the 'engine of growth' in Pakistan.

A COMPREHENSIVE DEVELOPMENT STRATEGY FOR REVIVING GROWTH

To stabilize the economy the politicians will have to make tough choices entailing sacrifices, especially by the well to do sections of the population. But in order to win public support for tough economic choices, the new government must present an economic vision and a strategy of inclusive development in which future rewards become available to all segments of the population and to all parts of the country.

To address the deep-rooted structural problems and a doubling of the GDP growth rate, the new political order will have to bring a major structural shift in both governance and economic policies. The recently adopted "Framework for Economic Growth" (FEG) of the Planning Commission came up with what it suggested was a new theory of development for Pakistan. It suggested that the country needs to move from "hard" to "soft" growth[1]. However, the Commission did not recognize that the "soft" approach would take a long time to become embedded in the structure of the economy. Following, it would not help the country climb out of the low growth trap into which it had fallen. Assuming implicitly that the existing institutional structures and the prevalent style of governance could not place the economy on a higher growth plane, the FEG put its faith in the private sector. However, the role of state and public policies in accelerating growth and ensuring greater fairness in the society cannot and should not be ignored.

Need for a Comprehensive Development Strategy

We believe that the key elements of the long-term strategy should be as follows:

Revival of Growth: This should aim initially at restoring the growth rate of the economy to 6 percent of GDP by 2015-16. Given the low rate of investment, much of the acceleration of growth must come largely from higher productivity in factor and use. The main but inter-related elements that are the focus of economic revival are: improved governance; greater attention to trade strategy and export- orientation including induction of private foreign investment in support of exports; a clearer policy frame work for the private sector and closer private - public partnership; special focus on increasing productivity, and quick resolution of serious power and gas shortages.

Governance: Without necessarily increasing the role of the state, governance can be improved significantly through the erection of a firewall between executive authority and the accountability mechanisms and strengthening the deterrents to prevent the abuse of power and breaking of the law. This report presents a number of proposals in this regard including effective devolution and strengthening of civil society institutions.

[1]Government of Pakistan, *Towards a New Growth Strategy*, Islamabad, The Planning Commission, January 2011.

Trade and Foreign Investment: Pakistan has progressively lost market share to almost all major developing countries during the last several decades. It is imperative that this trend be reversed if growth is to be revived and the balance of payment has to become viable. Expanded trade with the neighbours especially India and China, and induction of foreign private investment in directly productive sectors, would not only help in finding markets, improving technologies, and upgrading worker skills but would also greatly strengthen the capital account of the balance of payments. The report presents some options for achieving these including granting the most favoured nation status to India, followed by India reducing its Sensitive List under South Asian Trade Agreement (SAFTA) to only 100 tariff lines, streamlining of tariffs, institutional strengthening like the setting up of a permanent committee to watch over the development of trade between India and Pakistan with members drawn from both the public and private sectors.

Compact with the Private Sector: A policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector is needed. We believe that regulatory framework of agencies like Securities and Exchange Commission of Pakistan (SECP), Competition Commission of Pakistan (CCP), Oil and Gas Regulatory Authority (OGRA), National Electric Power Regulatory Authority (NEPRA) etc. is also required to make them more effective. Also, privatization of entities like Pakistan International Airlines (PIA), National Shipping Corporation and Karachi Steel Mills should get attention.

Productivity Growth: With supportive public policies and close private-public partnership, areas of substantial productivity gains could come from: labour intensive exports, movement up the value chain in exports, improvement in the efficiency of water use; and, increased participation of women in labour and management.

Managing Energy Crisis: The factors that constrain the use of existing power generation capacity should be effectively dealt with including the annual build up of circular debt and other measures presented in Chapter 5. Over and above these the involvement of provincial governments and the private sector on a range of activities including generation should be pursued on a priority basis. Once the loadshedding incidence is reduced, the policy of tariff adjustments needs to be followed.

PERCEPTIONS REGARDING THE QUALITY OF LIFE: THE CITIZEN SCORE CARD

We would like to conclude the report with the perception of citizens about the quality of service provision by the state. For this, IPP undertook a Citizen Score Card participatory survey of random selected households on the basis of a sample which is nationally representative. Such surveys are undertaken in a number of countries as an instrument to achieve a degree of public accountability.

Access to and Satisfaction with Services

Focusing first on the rural areas, it is not surprising that given the low population density, distances are the largest in Balochistan. In economic services, overall it appears that the province of Khyber-Pakhtunkhwa (K-PK) is relatively better covered by administrative and economic services in the rural areas. Within social services, it is reassuring to note that throughout the country primary schools are located in close proximity to rural households. A surprising and potentially important finding is the emergence of the for-profit and non-profit private sector in the provision of basic education in the rural areas of the country. Almost 40 percent of the sample rural households had a preference for private schools for their children. This is particularly visible in Punjab. Similarly, Basic Health Units are accessible within a distance of 2 to 5 km. Beyond this the distances to other social services are relatively large. Here again, K-PK appears to have achieved a better physical coverage of services.

In terms of quality of service, two services which are rated lowest in terms of level of satisfaction are police and the irrigation department. The highest level of satisfaction is with the basic health and family planning services provided in the villages by the lady health workers. One of the surprising revelations of the survey is the low use and somewhat negative perceptions of a significant percentage of households of public schools in rural areas.

Turning to urban households, as expected, these households are generally better served than their rural counterparts. There is not much difference in access to services in the 10 major cities of Pakistan, although distances are somewhat higher in Sindh. As far as levels of satisfaction with services are concerned, the most highly rated administrative facility is the emergency service (like the 1122 service in Lahore), followed by Excise and Taxation department (mostly for vehicle registration). As in the rural areas, police services are rated poorly. In social services, public hospitals are used by less than half of urban respondents and those who used them majority were dissatisfied. While urban household mostly had access to residential services, one-thirds rated garbage disposal, tap water, sanitation, service quality as ‘bad’ while majority gave this rating to gas and electricity.

Incidence of Bribes

In the rural areas among those who used the service, almost 95 percent of the households paid a bribe for filing a First Information Report (FIR) or a complaint at the local Police Thana. The average amount of bribe paid is Rs 2150. Accordingly, if the sample is blown up to the national level, then the magnitude of corruption by police officials is estimated at over Rs 46 billion in the rural areas of Pakistan. This is at least as much as annual salaries and allowances received by these officials.

In the urban areas, the incidence of corruption by the police is lower and the National Database and Registration Authority (NADRA) has a record of delivering services with the least frequency of ‘speed money’. The sessions courts are more prone to corruption in the rural areas. It appears that among rural households receiving the Benazir Income Support Programme (23 percent of the respondents, least in Punjab), one in six had to pay a bribe to participate in the programme. In terms of targeting efficiency, 57 percent of the households participating in the BISP are the lowest income households (with monthly expenditure less than Rs 15,000 per month).

The incidence of corruption is the highest in Balochistan. Our findings clearly indicate the relatively high presence of corruption in the rural compared to the areas, which is seldom highlighted.

Incidence of Crimes and Disputes

The incidence of crime is surprisingly high, with 42 percent of the sample households being victim of some crime last year. The incidence is the highest in Balochistan followed by Sindh and the most common crime is dacoity/ theft. There is apparently a breakdown of law and order even in the rural areas of the country. For urban households the most frequently reported crimes are snatching/ street theft and theft at home. It is striking that almost 40 percent of respondents in Sindh and 60 percent in Balochistan have been victims of street crime.

Changes in Standard of Living

Households were asked whether they felt that their standard of living was better, same or worse as compared to five years ago. Two thirds of the surveyed rural households indicate that their standard of living has worsened over the last five years. The principal reasons for the deterioration are high prices, law and order situation, corruption and electricity shortages. Likewise, 69 percent of the respondents in urban areas indicate that their standard of living has worsened over the last five years, attributable mostly again to high inflation, corruption, the worsening law and order situation and loadshedding. Our findings clearly indicate the inadequacy of service provision and the deteriorating trend in the quality of provision. The incoming Governments, both at the federal and provincial level will need to focus on improvement of basic services and reducing the incidence of crime and bribes throughout the country.

To conclude, it is our view that today Pakistan has an opportunity to change its future course from economic downturn to stability and sustained revival. This opportunity exists because a new democratically elected government is to take shape in the country which can build on the recent positive political developments. If this new government adopts elements of the reform agenda of the type suggested in this report, then there is reason to believe that the lives of the people of Pakistan will change for the better.

Chapter - 1

On the Path to Revival

Chapter - 1
On the Path to Revival*

The main thrust of this chapter – and of this report – is that Pakistan may well be on its way to developing a new way of managing its affairs. And by "affairs" we mean how the political system is run, how the economy is managed, and how social interactions take place among different segments of the population. This way of thinking about the future may seem too optimistic at a time that brings grim news every day – of an economy stuck in a low growth mode, a balance of payments crisis believed to be just around the corner, and of a country increasingly isolated in a world that is coming together in many different ways. The Gross Domestic Product (GDP) growth rate has been on a declining trend. The average rate of growth has been just 3 percent a year for the last five years.

The most worrisome crisis facing the country is the increase in violence. There is continuous news about it from all parts of the country – urban and rural, tribal and settled. Those who kill, do it for a variety reasons, not always for material gain. Some kill or attempt to kill because they do not accept the basic principles on which the state is run. A small minority, but one that is very well armed and committed to the use of violence, has managed to disrupt the flow of life in many parts of the country. Some resort to violence in a bid to impose their religious beliefs on others. They are averse to co-existing with members of other ethnic groups.

An unsettled economy and limited respect for the rule of law create problems that are largely borne by the poorer segments of the population. This makes the situation unsustainable because the majority of the population gets terribly alienated and begins to search for some other solution to bring order to their lives.

In the first few months of 2013, the various crises faced by Pakistan worsened. This happened on the eve of the elections called by President Asif Ali Zardari for May 11. Undoubtedly, those who will take office following the people's verdict will have to make a number of serious public policy choices. The most important of these will aim to pull the country back from the edge of an abyss. Whether they will be able to reform the economy in order to take it on a higher and sustainable trajectory of growth will depend to a considerable extent on the shape politics will

*This chapter has been contributed by Shahid Javed Burki.

take in the months and years ahead and how the country is viewed by some of the big players in the rapidly changing global system. Pakistan's many problems are interrelated; they feed on one another. We will begin our discussion with economics.

At this time Pakistan faces three immediate problems in the economic arena: the longest downturn in its history, serious macroeconomic imbalances, and the absence of consensus on how to place the economy on a plane of higher and sustainable rate of GDP growth. The policymakers must address the three inter-related problems simultaneously. Growth needs to become the basis of a new development paradigm. At the same time, large macroeconomic imbalances must be eliminated. Progress on one front would improve the prospects on the other two. Restoring stability to the macroeconomic situation will improve the investment climate for both foreign and domestic investors. The increased confidence and recovery in growth will lay the basis of both expanded revenues and exports. But a growth strategy must have the people's support, without which it will be hard to implement. It will necessarily involve some sacrifices by the relatively well-to-do so that those who have been left behind can begin to benefit from the process of growth.

The last five years represent a paradox of sorts. On the one hand, there was a precipitous decline in the quality of governance with corresponding increase in the level of corruption. This was the case especially in the public sector enterprises. Their effectiveness declined as that of the government in general, with merit ceasing to be the key criterion for senior appointments. Militancy and terrorism rose and there was foot dragging by the establishment in implementing appropriate mechanisms for ensuring accountability of senior public officials from both the political and bureaucratic sides. On the other hand, the higher judiciary – especially the very independent Supreme Court – became very pro-active in governance issues and the free media, in particular the electronic media, came to play an important role in highlighting public policy issues and exposing wrong doing.

With all this uncertainty around, can we be hopeful of a better future for Pakistan? Could the general elections promised for May 11 prove to be an important milestone on the road to greater economic, political and social stability? The answer to both these questions is a qualified "yes". This will be a period of great transition – or more accurately, several transitions – since many changes are taking place and they are happening almost simultaneously in a number of areas. Some of these are positive while others are negative. The positives are mostly in the political area; negatives in the area of economics, in the deteriorating domestic security situation and in the worsening of relations with some of the countries that in the past were important in helping with economic development. Which way Pakistan goes will depend on the choices policymakers make. A set of newly elected leaders will be in place after the elections of May 2013. Will they take the country in the right direction? One purpose of this report – the sixth in the series of annual documents by the Institute of Public Policy (IPP) – is to suggest the options that the new policymakers could consider for the next five years.

We will begin by focusing on the deteriorating external financial situation followed by the government's persistent reliance on fiscal deficits to manage its affairs. We will then see whether the country can secure larger international support. This brief discussion about the economic situation will be rounded off by some suggestions about accelerating the rate of economic growth in the future.

The pace at which the country has been losing its foreign exchange reserves signalled the arrival of yet another balance of payments crisis. The reserves reached a peak of $18.29 billion in July 2011, but their haemorrhaging started soon after the setting of this record. The situation was saved somewhat by both the economic slowdown which reduced the current balance of payments deficit and by the release of some blocked funds by the United States (US). In 2011-12, the deficit was $4.6 billion. In the first eight months of 2012-13, it stood at $700 million compared with $3.325 billion in the same eight-month period in 2011-12. But the depletion in the level of reserves has continued. They were only $7.45 billion on March 21, 2013. The payments to the International Monetary Fund (IMF) in May and June will be $785 million, further squeezing the foreign exchange holdings of the State Bank of Pakistan (SBP). The expected fall in foreign exchange reserves would further weaken the rupee which lost 58 percent of its value against the US dollar in the last five years. The rupee's depreciation should help the exporters if they could manufacture the products that have good demand in the global market. However, with supply constraints resulting mostly from severe power shortages, the expected fall in the value of the rupee may not significantly increase the volume of exports or export earnings. It would, however, put some additional pressure on domestic prices which have remained high and uncomfortably so for the poorer segments of the population.

Pakistan's external resource situation became precarious not only because of the large repayments to the IMF; the country's relations with the US soured in 2011 to the point where the flow of desperately needed economic development assistance slowed to a mere trickle. The Kerry-Lugar-Berman bill signed into law by President Barack Obama in October 2009 was meant to ensure uninterrupted flow of economic development assistance from the US at the rate of $1.5 billion a year. This was to start flowing in the financial year 2009-10 and was to last for at least five years. In the US system of governance, what the executive proposes in not necessarily what Congress finally disposes. In Congress, Pakistan was not one of the more popular countries. The little affection there was for the country was dissipated when Islamabad decided in late November 2011 to stop the flow of American material to the US forces fighting in land-locked Afghanistan. This was to retaliate against a number of acts committed by the US on Pakistani soil that Islamabad regarded as hostile and as a series of breaches of the country's sovereignty. This, as we note later, was also the conclusion reached by the United Nations (UN). The US administration was unhappy with this move. Encouraged by Congress, it held back the flow of funds to Pakistan, including the large amount that was owed to Pakistan for the help provided for the American war effort in Afghanistan. Islamabad was not paid from the accumulated resources available in what was called the Coalition Support Fund (CSF).

This constraint on the flow of foreign capital came at a time of declining domestic resource generation which further reduced the already low rate of investment. Given the resource situation, it did not seem possible that Pakistan could lift the economy from the continuing slump. The continuing economic downturn was already impacting the country in several different ways. With relatively low GDP growth rate, there was a palpable increase in the rate of unemployment which only added to the stresses on the political and social structures.

In its annual report issued in early 2013 – later than usual – the State Bank of Pakistan (SBP) wrote candidly about the difficult state of the Pakistani economy in the financial year 2011-12. In particular, it was concerned with the sharp increase in fiscal deficit which it estimated at 8.5 percent of GDP, significantly higher than what the government was prepared to concede. Wrote the Bank: "This outcome is not surprising with the $ settlement of the accumulated circular debt, losses stemming from public sector enterprises, higher interest payments, and floods in the last two years which boosted public works and transfer payments. However, the size of the fiscal deficit is not sustainable as it is contributing to inflation; squeezing out private investment; impacting the balance sheets of commercial banks; and pushing the economy into a debt trap."[1]

The Bank noted that the policy responses to these challenges have not been effective, noticeably in the area of tax collection, management of public enterprise losses and handling of energy shortages. The result has been the persistence of large fiscal deficits which were financed largely by bank borrowing, first from the central bank and then from the commercial banks. The government was not able to muster enough political will to reform the tax code and expand the tax base. Well-entrenched and powerful vested interests were able to thwart some of the efforts that were initiated to improve tax collection and raise government revenues. This way of managing the economy had predictable consequences. The government's persistent demand for resources without a sustainable tax base seriously affected the economy. The government was prepared to pay a high price to borrow from the banking sector. This approach crowded out the private sector and reduced the amount it was investing in the economy. Having the State Bank meet a part of the government's need for capital increased money supply and led to high rates of inflation.

The central bank did not see a significant improvement in the immediate future unless a program of deep structural change was adopted. "The target of GDP growth of 4.3 percent for 2012-13 [set by the Ministry of Finance] appears optimistic: we think Pakistan will grow at about the same rate as the rate last year."[2] As noted below, this confirmed the IMF's pessimism about the rate of economic growth expected in 2013-14.

Pakistan had long been dependent on external flows to finance a significant part of domestic investment. The US was a major source of this capital flow. A significant reduction in this flow will mean reducing the rate of GDP growth to between 3 and 4 percent a year. As the IMF wrote in its "Article IV" consultations, this is about one half of the growth in national product and the country needs to find employment for the 2 million new entrants to the work force. The Fund went on to say: "Pakistan's real GDP growth rate has been on a declining trend and relatively volatile. While there have been GDP growth spurts (most recently in 2004-07 when annual growth rate averaged over 7 percent) overall growth performance has been disappointing especially when compared to other regional economies like India. And in the past four years, real GDP growth has averaged only 3 percent although natural disasters have contributed to this outcome". This level of economic expansion is very worrying. Once again quoting from the Fund's report: "A low official unemployment rate of 6 percent masks deep problems. Underemployment and considerable unpaid employment (the latter estimated at 28 percent of the employed in the 2011-12 Labor Force Survey) remain major problems, as a large young population is not being absorbed due to low growth and despite many Pakistanis finding employment abroad. Indeed it is estimated that average growth needs to around 7 percent per year to absorb about 2 million new labor market entrants annually."[3]

Pakistan has come to rely heavily on "workers' remittances" which crossed $13 billion in 2011-12 and are likely to reach $14 billion in 2012-13. This flow is equivalent to about 7 percent of GDP and accounts for about one-half of the current rate of GDP growth. In other words, Pakistan is in the process of making another transition – from dependence on external development assistance (EDA) for financing a significant part of the needed investment to greater reliance on tapping the incomes of its own citizens. But those citizens do not live within the country's borders and the dependence now is on people of Pakistani origin who live and work outside the country. However, the flow of remittances as shown by past experience is volatile. Excessive dependence on it will not be a prudent course to follow. The country needs another transition: to raising resources for investment from within its own borders. What is needed is a fundamental change in the tax code, and an equally far-reaching restructuring of the tax collection machinery, which will require political will that was in short supply in the past five years. This will have to be area of high-priority for the administration that will take office after the elections of May 11.

Some other factors that have resulted in the deep economic malaise that currently afflicts the economy also have to be addressed. This means going beyond the signs of poor performance we have already noted – large and unsustainable current account and fiscal deficits, sharp reductions in the flow of official development assistance, and continuing slow rate of GDP growth – to those that also harm the economy in difficult-to-quantify aspects of the economic crisis. Three such manifestations are of considerable importance: absence of a well thought-out strategy for the revival of growth, reliance on populism, and a tolerance for corruption and malpractices. It is interesting to note how easily populism slips and slides into widespread corruption, as if policies directed to help the poor provide a licence to collect rents to benefit oneself, one's friends and one's political associates. By all accounts, the five years of democratic rule saw Pakistan at its most corrupt and also the quality of governance was extremely poor. In 2012, Pakistan with a score of 27, ranked 139th in the "corruption perception index" prepared by Transparency International. The organization assessed the situation in 174 countries. India with a score of 36, was ranked 94th; Bangladesh was ranked 144th and Afghanistan 174th.[4] The perception about widespread corruption has increased transaction costs and the cost of doing business in the country.

All this has led to a sharp reduction in investment and a slump in the rate of economic growth that has now lasted for six years, the longest downtown in the country's history. There is also anecdotal evidence that suggested considerable amounts of capital flight from the country. Pakistan's well-to-do citizens are investing in the Middle East as well as in some East Asian countries.

The climate for investment and growth has also been affected by many non economic factors. The most significant of these was the rise of extremism which took several forms. Groups operating from the "no-man lands" on the border with Afghanistan continued to defy the authority of the state. They also challenged the American and NATO operations in neighbouring

Afghanistan, using the sanctuaries they had created in Pakistan's lawless tribal belt. Their activity brought America's decade-long war in Afghanistan into Pakistan by way of attacks by "drones" – unmanned aerial vehicles that fired missiles to eliminate the terrorists on what came to be called the "presidential kill list". Drones entered the war in Afghanistan-Pakistan in 2004 but their use escalated under Obama. These attacks are deeply unpopular in Pakistan and are the reason why a Gallup poll concluded that the US was by far the most unpopular country in Pakistan. The drone attacks were termed as a violation of sovereignty by a report released by the UN in March 2013. According to a statement released by Ben Emmerson, a British lawyer who serves as a special UN human rights envoy, the drone campaign "involves the use of force on the territory of another State without its consent and is therefore a violation of Pakistan's sovereignty." The UN official also accepted the claim made to him by Pakistani officials that "at least 400 civilians had been killed and that an additional 200 individuals killed were probably non-combatants"[5]. The controversy over drones added another element in Pakistan's deteriorating relations with the US. This had immediate economic consequences for Islamabad. As already noted, the flow of economic assistance from the United States was severely impacted from 2011 onwards. Violence related to America's war in Afghanistan spilled over into many parts of the county. Several terrorist groups, most notably, Tehrik-e-Taliban Pakistan carried out attacks on many targets in the country to avenge the American drone operations in the tribal belt. Activities by several groups of extremists took hundreds of lives of innocent people, adversely affecting the already stressed state of the economy.

Extremism also took the forms of sectarianism and violence against religious minorities. There were attacks by Sunni extremists on the Shia communities in the cities of Quetta and Karachi. These resulted in the loss of 250 lives in the months of January and February 2013. In response to two incidents in Quetta, the Shia community launched a political movement, refusing to bury its dead unless the provincial government was removed from office. After some hesitation, Islamabad accepted the demand and President Zardari dismissed the provincial administration, replacing it by rule by the governor.

But Sunni-Shia conflict was not the only religion-based violence the country was experiencing. In March 2013, the Sunni extremists resorted to large-scale arson aimed at a particularly poor community of Christians living in the heart of Lahore, and then Karachi. Some 150 houses were burnt to the ground. The reason: suspicion that a Christian man was engaged in "blasphemy" – a crime punishable by death under the Hudood Ordinance promulgated by General Zia ul Haq, the country's third military ruler.

Without doubt the rise of extremism has unsettled Pakistan and greatly hurt the country's economy. Why a segment of the population – albeit a small proportion of the population but sufficiently large in number to cause a great deal of disruption - turned towards violence as the preferred form of expression will be the subject of academic inquiry for years to come. At the IPP, we have made an attempt to estimate the economic impact of terrorism. The 2009 annual report developed a methodology for determining the extent of economic hurt caused by domestic terror. In its assessment, the report counted not only direct costs, such as those incurred on increasing the presence of security personnel in sensitive places, but also indirect costs, such as the impact on reduction in investments in the economy. "The inescapable conclusion [from the data] is that the incidence of terrorism is increasing exponentially in Pakistan. These estimates indicate that the costs of terrorism are rising very rapidly in the country due not only to the increasing number of activities but also because of the rising intensity and widespread nature of this activity."[6] The total cost, direct and indirect, was estimated at over Rs.909 billion or about 7 percent of the GDP. Investor sentiment has also been hurt by domestic terrorism. Terrorist activities picked up significantly as the country prepared for another election.

The rise of extremism was not the only factor that set the economy back. There were several others: very serious floods, severe power shortages, a serious shortage in the supply of natural gas, weakening exports on account of the continuing slowdown in the global markets for the country's merchandize; and a weak foreign exchange position have combined to deal a serious blow to investor confidence.

THE POLITICAL SILVER LINING

All these negative developments notwithstanding, there were some positive moves. Most of these were in the political arena. There cannot be a serious discussion of Pakistan's economic future without an equally serious probe into the way its political order is evolving. For this reason a discussion of the various transitions through which the country is passing must give considerable importance to the on-going political transformation. It appears that after a great deal of experimentation and trial and error, the country may be on the way to developing a new and durable political order.

Once in the late 1980s and on three occasions in the 1990s, the lives of parliaments were cut short by the president of the day, using the constitutional authority he was given by the 8th constitutional amendment introduced in 1985 by General Zia ul Haq. After having governed for eight years without any meaningful constraint on his authority, President Zia ul Haq was prepared to share some of his power with the civilian political establishment. He held general elections on

February 28, 1985 in which political parties were not allowed to contest. Those wishing to participate in the polls had to do so as individuals, not as the representatives or members of political parties. Once the members of the National Assembly were elected, President Zia went about the task of assembling a cabinet headed by a person he could trust. He chose Muhammad Khan Junejo, a respected politician from Sindh, as prime minister. But before some transition of power could be made to the people's elected representatives, the president wanted to ensure that the prime minister was effectively answerable to him, not necessarily to the parliament. To achieve that purpose he inserted Article 58.2(b) into the Constitution according to which the "President may dissolve the National Assembly in his discretion where, in his opinion…a situation has arisen in which the Government of the Federation cannot be carried on in accordance with the provisions of the Constitution and an appeal to the electorate is necessary". Under the amended Constitution, the president enjoyed enormous power over the parliament, the prime minister and his cabinet. All these could be dismissed by him on the basis of vaguely defined charges of poor governance.

Zia used this authority to remove Prime Minister Muhammad Khan Junejo from office on May 29, 1988, along with his cabinet and the National Assembly. His successor, President Ghulam Ishaq Khan used this constitutional provision twice; the first time to remove Prime Minister Benazir Bhutto on August 6, 1990 and then Prime Minister Nawaz Sharif on April 18, 1993. President Farooq Leghari, once a Benazir Bhutto confidante, dismissed her on November 5, 1996. The Supreme Court held the dismissal of August 6, 1990 and November 5, 1996 to be legal but that on May 29, 1988 and April 18, 1993, as illegal. No relief was however provided to Prime Minister Junejo in 1988 because elections had been called after Zia ul Haq's air crash in August 1988. But the Nawaz Sharif Government was restored on May 26, 1993.

On the fifth occasion, the military intervened directly when General Pervez Musharraf removed Prime Minister Nawaz Sharif from office and took over first as the country's "Chief Executive" and then as President. He stayed in power for almost nine years at the head of the country's fourth military government. This fifth removal - by General Pervez Musharraf of Prime Minister Nawaz Sharif - was in fact the result of the latter's effort to bring the military under civilian control. The infamous Article 58.2(b) had been removed from the Constitution by the 13th amendment introduced in April 1997 but was reinstated by Musharraf in 2002. It took the next democratically elected government more than two years to move the 18th amendment which inter alia struck down Article 58.2(b), in April 2010.

The purpose of this quick overview of the recent political past – the story of the way the system developed since 1985 – is to underscore the important point that even when the country toyed with democracy, real policymaking remained in the hands of the head of the state. Even though the 1973 Constitution had opted for a parliamentary form of government, the president continued to exercise a great deal of authority – more than formally permitted by the country's basic law. He could if he wished, act with impunity, comfortable in the belief that he had the support of the men in uniform.

Another area of transition is federal-provincial relations. This is still evolving after the adoption of the 18th amendment in April 2010. A number of responsibilities that were with the federal government have been devolved to the provinces. The seventh award of the National Finance Commission (NFC) that preceded the adoption of the amendment significantly improved the financial situation of the provinces. But the provinces, having become used to handholding by the federal government, have made little effort on their own to improve their resource base.

These alternating episodes of civilian and military rules created not only political instability but also economic uncertainty. As economists continue to emphasize, investors are not prepared to risk their capital when they are uncertain about the future. Pakistan's political system remained in great turmoil, between August 1988, when President Zia ul Haq died in an air crash, and October 1999, when General Pervez Musharraf put the military back in command of politics. The economy did relatively well in the three long periods of military rule – 1959-1971, 1977-1988, and 1999-2008. This was not because strongman rule is good for economic development as was implied by political economists such as Gunnar Mydral in his seminal work, *Asian Drama*[7] or by the political scientist Samuel P. Huntington in his equally important book, *Political Order in Changing Societies*.[8] Pakistan did well in part because of the stability that resulted when the military was in charge for long periods and its rule was basically uninterrupted by political compulsions. There were also large inflows of foreign capital into the country when the military was in control, especially from the US. It was easier for the military rulers to align their interests with the strategic interests of Washington than is possible under a democratic dispensation. That alignment resulted in the provision of large amounts of official development assistance (ODA) to Pakistan by the US in periods of military rule.

The military's role as a political player started declining from early 2007. After prolonged agitation against his increasingly draconian rule, Musharraf became aware of the narrowing of the space within which he could act. General Pervez Musharraf, Pakistan's fourth military ruler, had to turn over the reins of government to political parties which had won enough seats in the 2008 elections. It is important to briefly recall the series of events that eventually led to Musharraf's fall.

Supported by the liberated media, the legal community came out in the streets after Iftikhar Muhammad Chaudhry, the Chief Justice of the Supreme Court, was summarily dismissed by the military president in March 2007. Both the manner of his dismissal - he was summoned to the Army House in Rawalpindi and asked to resign – and the reasons for which this action was taken – he had shown independence in deciding a number of high profile cases, in particular the case against the privatization of Pakistan Steel Mills – agitated the lawyers. The "black coats" launched a campaign aimed at getting the Chief Justice back on the bench. The pressure from the lawyers increased throughout the summer of 2007. On November 3, General Musharraf made one last attempt to restore his authority. He placed the country under emergency rule. The move backfired. It increased the intensity of the campaign by the black-coats which was widely supported by major political parties, especially Pakistan Muslim League-Nawaz (PML-N). Once General Ashfaq Pervez Kayani, the new military chief, indicated that the army was not behind the president's moves, the die was cast. Elections were held in February 2008 in which the political party that had supported military rule – Pakistan Muslim League-Quaid (PML-Q) – suffered a resounding defeat at the hands of the Pakistan Peoples' Party (PPP) and PML-N. Musharraf refused to see the writing on the wall and made a desperate attempt to hang on to power. He finally resigned when threatened with impeachment, making way for Asif Ali Zardari, the widower of the assassinated Benazir Bhutto, to be elected president. The environment within which the president now had to operate was entirely different from the one existed over the last quarter century. The country's politics settling down into a new order does not mean that economic policymaking will cease to be dominated by political concerns during this period of transition to democracy: the past will inform the future.

The political system has evolved since March 2007 in a way to open it to the citizenry. This is the reason why it is necessary to date the political transition of the last few years to this earlier date rather than to February 2008 when general elections were held. It was the chain of events that began the unravelling of the country's fourth military government. The way the Musharraf government slowly collapsed provides some assurance that the country will not see another military interlude.

Pakistan's economy had performed well in the 2002-07 period, when Musharraf allowed an elected parliament to share some of his power. But he governed as "strong man" within a quasi-presidential form of government. The economy lost its growth momentum in part due to the uncertainty created by the long period of transition from military to civilian rule. Some of the uncertainty remained even after the transition was formally complete. Given the country's history of military interventions at moments of crisis, it was feared that the military could make another comeback. But the environment had changed not only in Pakistan but also abroad. Two years after Zardari had taken over as an elected president, the Arab streets rose first in Tunisia in December 2010 and then in Egypt in January 2011. In both cases, the regimes that had governed for decades were forced out of power by pressure from the street and were replaced by elected governments. Some blood was shed in these two countries but not as much as was the case in Yemen and Libya where the regimes in place resisted for a while by using force. In Syria, however, a civil war has been raging for two years now, leaving 70,000 people dead and two million refugees.

The lesson from the Arab Spring has not been lost on the militaries in other parts of the Muslim world. In Pakistan, the military intervened every time there was some stress on the economy. As noted above, the economy was greatly strained throughout the tenure of the elected government and there was great deal of corruption and poor governance. This time, however, the men in uniform chose to remain in their barracks, leaving most of the governing to elected civilian officials. It appears that the country has finally made the transition from being on a roller coaster to firmer ground, with an evolving political order that should, over time, bring stability. "That ought to be cause for celebration in a country where the army has often stepped in to halt democracy", wrote *The Economist*, in its appraisal of the situation on the eve of the next general election. However, the magazine went on to suggest that this celebration was marred by scores of credible stories about poor governance and general lawlessness that prevailed in the country. "The fact that the government completed its term owes much to the restraint shown by the main opposition leader, Nawaz Sharif, who was wary of playing into the hands of the armed forces, as he did when he was the prime minister in the 1990s".[9]

Furthermore, some basic constitutional changes were instituted that augur well for the future of democracy in a meaningful federal setting. The 18th amendment to the Constitution, passed in April 2010, restored in letter and spirit parliamentary democracy, and the established relationship between the federation and the provinces as originally envisaged in 1973 Constitution. Moreover, the amendment laid down the procedures for nominating judges to the higher judiciary and made the office of Chief Election Commissioner (CEC) autonomous of both the executive and the parliament. The amendment also specified the procedure for appointing the head of the National Accountability Bureau (NAB). Through the subsequent 19th and 20th amendments, detailed procedures for appointments of High Court and Supreme Court judges were laid down and the arrangements for putting in place a caretaker government to oversee elections were prescribed.

The final authority for the appointment of the caretaker prime minister was given to the CEC, in case the outgoing prime minister and the leader of the opposition could not agree on a nominee. The provision came into play in March 2013 when following the dissolution of the national assembly and the announcement that elections would be held on May 11, 2013 the Constitution required that the day-to-day management of government at the federal as well as provincial levels should be handed over to care-taker administrations. As required by law, the government and the opposition had to submit the lists of names of the people to head the federal caretaker administration. This was done with each side proposing three names. There were consultations between the leaders of the treasury and opposition benches which were required by law. If they could not agree on name as they did not, the appointment of the caretaker prime minister was to be done by the Election Commission (EC). This was done on March 24, when the Commission announced the appointment of the 84-year old Mir Hazar Khan Khoso, a retired Chief Justice of the Baluchistan High Court.

The nation held its breadth while these processes were being followed. What was important was not the fact that the political establishment could not find a way to come to an agreement on an issue of some importance. This is not unusual in democracies. In the United States, for instance, the Democrats and the Republicans could not agree on managing the budget deficit. Their differences took the country from one fiscal crisis to another over a period of a few months following the re-election of Barack Obama as President. What was important in Pakistan's case was the fact that politics was being conducted according to the rule of law. This was a major improvement for a country that had lived through so many military interventions and other interferences in the political process.

These constitutional developments and changes were an indication that, on the one hand, the political establishment recognized that serious constraint needed to be imposed on the way it managed the political process. On the other hand, those of the establishment who held the reins of power continued to go beyond what the rules of business allowed them to do. This was particularly the case with senior level appointments. For instance, in two cases the ever vigilant Supreme Court took upon itself the responsibility of correcting what it believed was the exercise of unrestrained executive authority. It took serious note of the way the government had handled the appointment of senior officials of the Pakistan International Airlines and the Executive Director to represent Pakistan on the board of the World Bank.

For the first time in the country's history, an elected government completed its full five-year term in office. A series of constitutional amendments were passed that changed the relationship between the federal administration and provincial governments. Constitutional processes were set in place for making appointments to the judiciary at the senior levels, as well as to the EC. These two institutions were supposed to balance the enormous authority that remained with the executive branch of the government with checks that could be exercised on its use by the Supreme Court and the provincial High Courts. These provisions were tested when caretaker administrations were installed in Islamabad and the provincial capitals to prepare the country for the elections of May 11. There are good prospects that the five-member EC led by a highly respected retired judge of the Supreme Court will ensure free and fair elections. They will give legitimacy to those who will be placed in power. But once in power, will they be able to move the country in the direction in which it should go?

It is pertinent to recall some of the recent events in order to understand how Pakistan's political order is evolving, as it heads towards a general election that will most certainly define its future. On March 16, 2013, Prime Minister Raja Pervez Ashraf dissolved the national assembly. This was five years to the day the national assembly chosen in the elections held in February 2008 was sworn in. It had thus completed the full five-year term in office that was allowed by the Constitution, an event that was celebrated by all political forces in the country – those in the coalition governments as well as those that were in opposition. This had never happened before in the country's turbulent past. On March 19, President Asif Ali Zardari set May 11, 2013 as the date for the next general election. This was the first time in the country's 67-year torrid history that an elected parliament was allowed to complete its full term. For five days the political establishment wrestled with the task of appointing a caretaker prime minister to oversee the holding on the elections in May. It followed the elaborate procedure laid down in the Constitution as amended by the 20th amendment. On March 24, the EC appointed Mir Hazar Khan Khoso as caretaker Prime Minister to oversee the elections. These changes should move the country towards a durable political structure which should ensure democracy and stability. The stage has been set for providing the next set of political leaders to effectively cope with the huge problems of large macroeconomic imbalances, slow growth, and poor governance. These loom large. The government will be well served to prepare a credible strategy that addresses all the three interlinked issues: stabilization, reviving growth, and improving governance. This report discusses some of the key elements that need to be accommodated in such a strategy.

The Sixth Annual Report prepared for the year 2013 by the IPP has seven chapters: keeping with past practise, the report starts with a discussion on State of Economy. A long term picture of Pakistan's economy is presented. Chapter 3 focuses on the latest economic developments and presents an operational strategy for survival. Chapter 4 focuses on a major impediment to revival – power loadshedding. Chapter 5 transits to revival through industry as the leading sector while chapter 6 presents strategy for future to ensure sustainable growth. Finally chapter 7 spotlights citizens' perceptions about the state of governance through presentations findings of a citizens' report card.

Chapter - 2

The State of the Economy

Chapter - 2
The State of the Economy*

FUNDAMENTALS VS RESILIENCE

It is easy to point to the continued weaknesses, and indeed in several cases, to the further deterioration in the economic fundamentals of the Pakistan economy. On the broader level, the energy crisis continues unabated (and is, in fact, deepening), the security situation especially in Khyber-Pakhtunkhwa (K-PK), Balochistan and Karachi has worsened with blatant sectarian killings on the rise once again, and there are very few signs of effective governance. Not surprisingly, economic growth remains slow: the rate of GDP which increased from 3 percent in 2010-11 to 3.7 percent in 2011-12 is likely to drop in the current year (see Table 2.1). For the last five years GDP growth has averaged barely 3 percent per annum–lowest for any period in country's history.

Even as the economy has expanded, albeit modestly, real gross fixed investment has fallen steadily (See Table 2.2), showing a decline of over 30 percent over 2008-12 to 10.8 percent of GDP–again the lowest on record in more than half a century. There are no signs of revival in investment especially given the energy crisis and the security situation. If proper allowance is made for normal depreciation of capital – wear and tear and obsolescence of machinery and running down of infrastructure – the net additions to nation's capital stock is small right now; this against the background of loss of physical capital due to a major earthquake in 2005 and devastating floods in 2010 and 2011. All of this does not portend well for the future rate of growth.

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

Driven by a stagnant tax to GDP ratio, despite a large increase in tax revenue in 2011-12, mounting public enterprise losses, and persistent subsidies for the power sector, the real overall fiscal deficit has remained at around 7 percent of GDP during the last three years. The problem, however, is not only the large size of the deficit but what the deficit finances and how it is

*This chapter has been contributed by Dr. Parvez Hasan financed. Because of the low tax to GDP ratio of around 10 percent, government revenues do not cover current expenditures; the revenue account deficit – negative savings on general government account – have averaged 3.5 of GDP in the three years 2009-10 to 2011-12 and have been responsible for half of the overall fiscal deficit.

The financing of the overall fiscal deficit has relied heavily on what were essentially was inflationary means. Total bank financing during the 2010-11 and 2011-12 averaged over 3.5 percent of GDP, more than half of the fiscal deficit. In the first half of 2012-13 (July-December 2012) bank financing at Rs. 558 billion met nearly 90 percent of the budget deficit. The direct financing of the fiscal deficit by the central bank has been curtailed, but large commercial banks' financing of the government operations has been possible only through large liquidity infusion to them by the SBP. This resulted in significant monetary expansion. Consequently, consumer price inflation averaged 12 percent annually during the three years 2009-10 to 2011-12. However, somewhat surprisingly, consumer inflation moderated to 11 percent in 2011-12 and further dropped to 8.2 percent in (July-February) 2012-13. This is, however, due to a change in base year of Consumer Price Index (CPI) from 2000-1 to 2007-08 with substantial under-reporting in the inflation of house rent and gas prices.

While the large fiscal imbalances have persisted, the foreign exchange position is becoming increasingly critical. The current account balance of payments deficit was $4.3 billion or 2 percent of GDP in 2011-12 (See Table 2.3). Despite a large $1.1 billion disbursement in August 2012 from the Coalition Support Fund (CSF) and continued high growth in worker remittances the current account for 2012-13, is again likely to show a moderate deficit. Exports which contracted 2.8 percent last year have not shown any signs of recovery so far this year due both to supply bottlenecks and competitiveness issues. Exports of goods in first eight months of 2012-13 were at $16.2 billion – slightly lower than in the corresponding period a year ago.

The most serious and urgent problem is that the capital account is under great pressure. Because of large repayments to the IMF ($1.15) in 2011-12, a 50 percent decline in direct foreign investment to $800 million, and only modest inflows of long term loans ($500 million), liquid foreign exchange reserves held by the SBP dropped by $4 billion in 2011-12. With a further repayment of $1.8 billion during first eight months of 2012-13 SBP net reserves had fallen to $7.5 billion by mid March 2013. The present level of reserves is less than 2 months of imports of goods and services; and its continuous decline is putting pressure on the rupee which is depreciating at close to 1 percent a month. More importantly, repayments including interest of $3 billion are due to the IMF in the remaining part of calendar year 2013 (March-December) and another $2.1 billion in calendar year 2014.

Despite this long list of negatives, some segments of the economy are showing resilience. The stock market is near an all-time peak and was one of the best performing in the world during 2012. Private consumption is leading the economic activity; the official statistics indicate a growth in overall private consumption of 27.6 percent over 2008-12, although this is probably overstated. Though there is fairly sizable capital flight, the rupee while weakening is not in a free fall. The gap between the inter-bank rates, however, has widened. The initial improvement in agricultural terms of trade and vibrancy of agriculture, especially through higher wheat and cotton prices, provided for an upsurge in rural incomes.

Table 2.1
Growth Rates of GDP, GNP, GNI

Percent Per Annum

	2007-08	2008-09	2009-10	2010-11	2011-12
GDP	3.7	1.7	3.8	3.0	3.7
GNP	3.7	2.2	5.1	2.9	4.2
GNI	0.7	2.5	5.1	2.9	4.7

Source: Pakistan Economic Survey (Various Issues)

What accounts for rather striking differences in the two narratives?

Table 2.2
Domestic Absorption of Resource in 1999-2000

Rs in Million

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Consumption of which	4415	4518	4746	4929	5094	5657
(Private)	(3883)	(3779)	(4240)	(4412)	(4324)	(4824)
Investment including stocks	1043	1114	1016	910	868	793
(Of which gross fixed capital formation)	(955)	(1025)	(873)	(815)	(769)	(691)
Total	**5458**	**5632**	**5728**	**5845**	**5962**	**6451**

Source: Pakistan Economic Survey (Various Issues)

First, Gross National Product (GNP) growth – a better measure of economic welfare – rose faster than GDP in four years (2007-08 to 2011-12) by 0.6 percent per annum due to doubling of net factor income from abroad (mainly worker remittances). The difference of 0.6 per annum may not seem much but it means that GNP per capita has risen by at least 1.5 percent per annum even in this difficult economic period. Second, there are good indications that the official figures of both GDP and GNP are under-estimated, though rebasing of the national accounts to 1999-2000 had adjusted the series upwards by as much as 19 percent. Pakistan has always had, like many other countries, a substantial informal economy but growing corruption and increasing tax avoidance suggest that the pace of growth of the informal economy has gathered momentum.[1] If the GDP figures do not take account of this recent phenomenon, both official GDP and GNP figures also do not fully capture worker remittances and other transfers from abroad, large spillover of resources from Afghanistan, as Afghans acquire businesses and property and educate their children here, and last but not least, the sizable clandestine transfers of funds from abroad in support of terrorism/ethnic conflicts in Pakistan.

It is difficult to estimate the total resources flowing into Pakistan annually in the form of current transfers over and above the officially recorded worker remittances that are estimated to reach nearly $15 billion during 2012-13. But it is quite possible that total transfers are close to $25 billion or over 10 percent of GDP, though, as suggested earlier, a part of these inflows finance capital flight through informal channels.

Table 2.3
Major Macroeconomic Indicators

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
GDP growth per annum (%)	7.1	6.0	5.9	3.7	1.7	3.1	3.0	3.7
Fiscal Deficit (As % of GDP)	-3.3	-4.3	-4.3	-7.6	-5.2	-6.3	-5.9	-4.3
Current Account Deficit (as % of GDP)	-4.0	-3.9	-4.9	-8.4	-5.7	-2.2	0.2	2.0
GDP Deflator Change (%)	7.0	10.5	7.8	16.2	20.3	12.4	18.2	9.7
Consumer Price Change (%)	9.3	7.9	7.8	12.0	20.8	11.7	13.9	10.8
Change in Net Domestic Assets of Monetary System (%)	17.1	12.4	11.3	23.2	12.8	12.7	13.1	20.2
M2 Change	19.3	14.9	19.3	15.3	9.6	12.5	15.9	8.1
Level of Foreign Exchange Reserves (Millions of US Dollars-at the end of the period)	12,59	13,122	17456	11,510	12,036	16,750	18,244	15,289
Gross Total Investment (as % of GDP)	17.5	20.5	22.5	22.1	18.2	15.4	13.1	12.5
Gross National Savings (as % of GDP)	17.5	17.7	17.4	13.6	12.5	13.1	13.2	10.7
Ratios of Investment and Savings are in current prices: Numbers for Gross Capital Formation excluding inventories (as % of GDP) in 1999-2000 prices are given follows:								
	15.3	**17.3**	**18.4**	**19.0**	**15.9**	**14.4**	**13.2**	**11.5**

Source: Pakistan Economic Survey (Various Issues)

The main reason why the economic activity appears quite buoyant is the fact that private consumption per capita rose by close to 20 percent during the last five years, even on the somewhat overstated official figures. Quite evidently, consumption per head rose at double the rate of growth of per capita income mainly because of the sharp decline in resources allocated to investment. It can also be argued that increasing role of economic rents and corruption also accounts for a boom mentality towards consumption.

What does it all mean for the future? Several points need to be noted. First, the growth rate of GNP has been low per annum. It is totally inadequate to create the needed employment opportunities and a revival in growth to at least 6-7 percent per annum should be a high priority. The IMF has suggested that this level of growth is needed to absorb the new entrants to the workforce. Without a substantial increase in the GDP growth, Pakistan would continue to fall further behind most Asian nations. Second, with US and NATO troops leaving Afghanistan next year, Afghan incomes will decline sharply and with it, outflows to Pakistan. Controlling terrorism could also reduce clandestine resource inflow. Thus the economic fundamentals can no longer be ignored. Moderating the rate of consumption growth to improve public finances and to reverse the decline in public and private investment is absolutely essential but would make for hard choices for the new government. On the other hand, more effective governance reflected in improved security situation, improving energy situation, and better trade and foreign policy relationship with India can relatively quickly restore the confidence in the country and its currency. This will help to improve productivity and competitiveness. In this scenario, foreign investment interest would be restored, capital flight could be reversed and a strong rebound in investment may be possible. We discuss this approach to policymaking in greater detail in a later chapter.

In the remaining part of this chapter, the following four critical areas of the economy are analyzed in some detail, highlighting both the challenges the country faces and the policy responses that could help improve the situation:

- Dire fiscal situation and steps needed to improve public finances
- Dangers lurking in the balance of payments and how to wean ourselves gradually from the IMF
- State of our investment in human and physical capital
- Roots of the deep energy crisis

IMPROVING PUBLIC FINANCES

Table 2.4 summarizes the fiscal position as provided by the official figures over the last five years. As successive IPP reports pointed out, the fiscal deficits figures for the early years did not fully reflect the arrears in the power sector, the build-up of circular debt and losses of the public enterprises (PSEs). According to the SBP annual report 2011-12, the government spent a total of Rs 464 billion (or 2.2 percent of GDP) on power sector subsidies and swap deals in 2011-12 to settle the large outstanding loans of public power companies to the commercial banks. This largely explains why the reported deficit rose to 8.5 percent of GDP. In reality, the overall fiscal deficit has averaged at least 7 percent per annum over the three years – 2009-10 to 2011-12. It also seems likely that the deficit in 2012-13 would be higher than 8 percent of GDP because of substantial shortfall in expected revenues, delays in adjustment of electricity tariffs and the need for immediate payments to tackle the exploding circular debt problem.

Table 2.4
Fiscal Trends

As percentage of GDP

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Tax Revenue	10.2	10.0	9.2	9.3	9.5	9.9
Total Revenue	14.9	14.3	14.1	14.2	12.5	12.4
Total Expenditure	20.7	21.7	19.3	20.5	19.2	20.9
Current Expenditure	15.8	17.7	15.6	16.3	16.1	15.1
Development Expenditure	5.0	4.0	3.5	4.5	2.8	3.6
Overall Deficit	5.8	7.4	5.2	6.3	5.9*	8.5
Revenue Deficit	0.9	3.4	1.5	2.1	3.6	4.6

*Excluding arrears of Electricity Bills

Source: Pakistan Economic Survey (Various Issues)

As mentioned earlier and as discussed in more detail below, the stagnation of tax to GDP ratio at a very low level is at the root of Pakistan's fiscal problems. However, these problems have been greatly aggravated by both an unwillingness and/or inability to rein in power subsidies and public enterprise losses. Equally important, no effort was made to control discretionary spending at either the federal or the provincial levels. Public salary and pension increases were very generous and miscellaneous expenditure increased significantly; public servants' salaries almost doubled over 2009-10 to 2012-13 Excluding defence spending, interest payments and subsidies, federal current expenditures more than doubled in nominal terms over the three years from 2008-09 to 2011-12 and a similar increase was recorded in provincial non-development spending. Adjusting for inflation, real increase in general government expenditures including subsidies, but excluding defence and interest payments has been of the order of 30-35 percent over the three year period. This could only be sustained by the inflation-causing large borrowing from the banking system. Against this background, the institution of an austerity regime for a couple of years and strict control of salaries and other discretionary spending seems not only absolutely necessary, but also quite feasible.

Table 2.5
Price Trends

Percent Per Annum

	GDP Deflator	Consumer Prices
2007-08	16.2	12.0
2008-09	20.6	20.8
2009-10	12.4	11.7
2010-11	18.2	13.9
2011-12	9.7	11.0

Source: Pakistan Economic Survey (Various Issues)

Improving public finances is an immediate and critical need. This, however, is not only an issue of an orderly reduction in fiscal deficit through improving revenues and cutting back of expenditures but should also involve the undertaking of a substantial restructuring and reprioritizing of expenditures to support economic growth. An objective should also be to eliminate the sizable negative general government savings – which as indicated above, averaged 3.5 percent in 2009-10 to 2011-12 and will be even higher in 2012-13 by requiring that government revenues cover all current expenditures in two to three years: this indeed is required by the fiscal sustainability law. At the same time, it is important that dependence on bank financing of the deficit be curtailed and much greater efforts made by the mobilization of resources through the non-bank sector, and liquidation and sale of several state assets both at the federal and the provincial levels. Indeed, during the current fiscal year there has been notable and encouraging mobilization of resources through national savings schemes. Consideration should be given for the orderly sale through public auctions of the landholdings of some of the public sector enterprises. There is a lot of land owned by the railways and cantonments some of it in the centre of large cities in the country. The divesting of government held shares in public corporations is another option. Proceeds from such sales could be sequestered – in the long run – in a special fund for future generations.

A balanced approach is needed: an approach which reduces fiscal imbalances but at the same time, gradually improves growth orientation of the economy, helps reduce income inequalities, and moderates the rate of inflation (See Table 2.5). If adopted, it would avoid the mistakes of the past which resulted in uneven growth and inequitable distribution of growth benefits. A major restructuring of public expenditures, from wasteful current expenditures and subsidies to non-poor to targeted support for social development especially in the poorer areas would be a substantial undertaking, and in some cases may yield results only slowly. But a move towards a comprehensive reform is urgently needed if economic stability is to be restored, confidence of investors, both foreign and domestic, is to be revived and recovery of economic growth is to be assured.

Tax revenue

Pakistan has one of the lowest ratios of tax-to-GDP among developing countries of any size. Yet, periodic efforts to make the tax machinery more effective have not succeeded. More than a decade ago, an effort was made to reform the Federal Board of Revenue (FBR). This was done under President Pervez Musharraf by a team of experts headed by Shahid Husain who had served in several senior positions at the World Bank (WB). However, the results were disappointing since the Husain report was largely ignored by the policymakers. The more recent WB financed Tax Administration Reform Project (TARP) has also not been successful. The tax-to-GDP ratio of 9.9 percent in 2011-12, though representing a significant improvement over the previous year, was lower than the ratio a decade earlier.

There are several structural problems with the Pakistani tax system. First, the tax on income, which should be a substantial source of progressive taxation, is not very productive in terms of yielding revenues and has very limited reach. Second, proposals for expenditure taxation in the form of a comprehensive value added tax to replace the outmoded sales tax, have met political resistance. The fact that there is only very limited capital gains tax and no estate tax means that the burden of tax falls lightly on the rich, but heavily on the salaried classes. Fiscal policies, therefore, contribute to income inequalities. Finally, provincial taxes mobilize barely 0.5 percent of GDP because property tax is light and agricultural income tax–a provincial subject–is practically non-existent. It is one of the aberrations in the Pakistani fiscal system that a major source of income–the agricultural sector–was kept out the purview of the federal tax authorities.

Over the medium term, gradually raising the tax-to-GDP ratio would require actions on a broad front. This would require removing the major weaknesses in the present system noted above. In the short-run of two to three years the greatest pay-off appears to be in three areas: a forceful and politically backed implementation of income tax at the federal level through an overhaul of tax collection machinery; an increase in property tax, particularly in those provinces that have large cities and large urban populations; and a sharp increase in the agricultural tax at the provincial level.

Individual Income Tax

The biggest problem area and the one that has perhaps the greatest potential for yielding quick results is individual income tax. Even though income tax receipts are shown as direct taxation, a very large part of these collections come from withholding taxes, which are essentially indirect levies. According to available data, in 2008-09 less than 700,000 non-salaried households paid only Rs 40 billion or 0.3 percent of GDP (or on average a tax of Rs. 60,000 on an estimated average declared income of Rs. 300,000 or a tax rate of 20 percent). This group of non-salary individuals, professionals, small businesses, traders, service providers, is at the root of income tax evasion problem and should be targeted for improving income tax collections.

According to the recently appointed head of the FBR, less than 1 percent of Pakistan's 180 million citizens pay income tax and no one is believed to have been prosecuted for tax evasion in 25 years. Reportedly, the new chairman is determined to force the rich to pay their fair share by using a carrot and stick approach. The government had proposed an amnesty scheme that would have forgiven past offenses and the new filers would have been charged only $400 for any amount of money they declare next year but in the following year the tax would have gone go up by 10 percent or $40. At the end of second year, the tax rate would have been re-evaluated and could return to the normal rate.

The scheme was controversial because there was fear that it will simply benefit a small number of individuals with large amounts of money that they would like to “whiten” – i.e. move from the informal to the formal sectors of the economy. In any case, the proposed scheme has lapsed because the outgoing parliament did not approve it.

The challenge of a very substantially enlarging the individual income taxpayer base, however, remains. To instill fear, the FBR plans a policy of ‘naming and shaming’ and the wrong doers, who will be threatened with freezing of assets and a ban on travel. Apparently, the National Data and Registering Authority (NADRA) has profiled over 2 million possible offenders based on use of cars, houses, bank accounts and overseas travel.[2]

The ad hoc approaches may work up to a point, though the past record is not encouraging. It is necessary to have a conceptual framework to determine the target group of income tax evaders. In most of the discourse on income tax issues, the number used to highlight the small size of the tax base is the entire population. However, this is at best misleading and actually wrong. The unit that pays or should pay income tax is the household. Pakistan has a population of 180 million but the number of households is about 30 million. According to the income distribution data, the top 20 percent of the households by income, roughly 6 million in number, receive more than 40-45 percent of the national disposable income, with an estimated average income of close to Rs 1.2 million per household. These 6 million households should be the main focus of the income tax administration; leaving the bottom 80 percent of the income receivers effectively exempt from income tax. Excluding say a million households who can claim exemption because of agriculture as the main source of their income, would still leave 5 million households with a minimum income equal to or more than the average national household income, at present around half a million annually. Even though Pakistan’s top marginal rate is low at 25 percent, the effective income taxation of the relatively well to do should yield, in principle, Rs 300-400 billion or roughly 1.5 to 2 percent of GDP over the long-run.

The present coverage of individual taxation appears to be around 1.5 million households or less than 33 percent of the total and individual income tax, including salary individuals, yields only about 1.5 percent of GDP. A medium term target of increasing the complying households to at least 3 million and income tax receipts to 3 percent of GDP by 2017-18 would appear to be quite reasonable.

Tackling the problem of tax avoidance or underpayment by focusing on top 20 percent income households provides a good framework. NADRA’s work in this regard is invaluable. Developing a medium term plan to identify and cover most of the high income households who at present pay little or no income tax thus deserves the highest priority. However, any such plan cannot succeed without strong political will and a well-paid but honest tax collection service.

National Tax Strategy

On the technical level and given the need for a coherent national tax strategy, a National Tax Policy Office (NTPO) needs to be established within the Revenue Division of the Ministry of Finance. This organization should do all the policy work for determining the directions to be taken and the choices to be made for all taxes at the federal and provincial levels. Such an office was recommended by the Taxation Committee as far back as 2002. It should have the responsibility for coordination policy analysis and approaches with the provinces as well. The NTPO should be supported by a Tax Policy Research institute to be funded jointly by the government and the private sector. The ad hoc approaches without appropriate policy work have not worked.

The casualness with which the goal of increasing the tax-to-GDP ratio to 15 percent in four or five years is suggested or agreed to is worrying. This target has been co-opted by some of the political parties in their manifestos for the 2013 elections. It should be recognized that it will take an average economic growth rate of 6 percent per annum over the next five years and an economy wide marginal tax rate of close to 20 percent to achieve that target. If the average growth remains sluggish, say 3-4 percent per annum, rapid improvement in the tax ratio would be even more difficult. This does not argue for setting less ambitious targets but merely to stress the critical importance of accelerating growth and launching a serious effort to mobilize domestic revenue to finance necessary public expenditures. We pick up this subject again in the growth chapter.

The Seventh National Finance Commission (NFC) increased the share of the provinces in the divisible pool. Apart from the larger provincial share, Baluchistan and K-PK provinces were given additional resources; the former for reasons of its size and the latter because of the expenditure related to combating insurgency. The Ministry of Finance is concerned that with only 50 percent of the total revenues available to it, it is highly constrained in financing some of the high priority programs that still remain its responsibility after the passage of the 18th amendment. It believes that the award did not create incentives for the provinces to raise resources of their own. One result of this is that the share of provincial revenues in the total raised nationwide is low.

The potential for increasing tax revenue in the provinces is considerable because at present they collect a mere 0.7 percent of their combined GDP – about half the level a few decades ago. As mentioned above, both increased property taxation and a meaningful agricultural tax should be pursued. There is also a strong economic efficiency case for sharply increasing water rates and earmarking the revenue for land levelling and canal improvements. Overall, a target of increasing provincial tax revenue from 0.7 percent to 1.5 percent of GDP would appear quite feasible to be realized over a period of three years. Reaching the target may be made a condition for continued larger provincial share in the federal divisible pool. The Council for Common Interests (CCI), a constitutional arrangement meant to resolve issues between the provinces or between the provinces and the federal government, should be used for arriving at this agreement.[3]

A discussion of Pakistan's tax issues must touch on the large informal sector. This sector has never been fully captured in the GDP statistics. Incorporating it would suggest a faster GDP growth in recent years as service sectors, small scale industry, and non-crop agriculture have accounted for much of the growth in economic activity according to the official statistics, although the impact of load shedding has not been full captured (See Chapter 4). It is not clear that the income tax authorities have sufficient outreach to these sectors, most notably the flourishing and very successful fashion and other service activities. In general, the escaping of the tax net, especially by small scale industrial enterprises, not only deprives the government of revenue but also acts against achieving economies of scale, a factor that inhibits export competitiveness.

The tax authorities thus need to give more attention to the taxation of high-end luxury goods as well as small scale industry and service sector providers. The report submitted to the government by the Task Force on Private Sector Development emphasized the need for levelling the playing field between large and small industrial and commercial enterprises. By avoiding the taxman as well as many of the regulations that apply to industry, small enterprises have considerable advantage over the larger ones since the latter cannot easily avoid paying taxes or the need to comply with various regulations. This encourages small enterprises to remain small while posing a serious challenge to the larger units. As a member of the TFPSD–the owner of a large textile conglomerate–put it: 'I can compete with other textile producers in international markets but can't beat the challenge posed by the small producers."

Level and Effectiveness of Public Spending

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

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

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

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

Adjustment Path and Financing of Budget Deficits

There is need for full transparency in budget-making. The build-up of arrears and circular debt or temporary parking of public enterprise losses should be fully reflected in the budget figures on a timely basis. The past practices that led to not providing a true picture of the fiscal situation reduced the credibility of the government in its dealings with foreign governments and development and financial institutions.

Given the severity of the budgetary situation and the depressed state of private sector investment, we feel that a gradual reduction of fiscal deficit from 8 percent to about 5 percent of GDP over the three year period from 2013-14 to 2015-16 would be justified and achievable provided:

- Strong actions are taken to increase tax revenue both at the federal and provincial levels.
- Plans are initiated to eliminate revenue deficit and negative government savings by 2015-16
- The dependence on financing of the budget deficit from bank borrowing (including from the central bank) is reduced immediately to no more than one percent of GDP per annum. We also see no particular advantage in limiting borrowing from the central bank while the central bank provides liquidity to the commercial banks so that they can make substantial loans to the public sector.

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

BALANCE OF PAYMENTS CHALLENGE

While the large fiscal deficit is a fundamental source of macro imbalances, the immediate danger to the economy is posed by a possible balance of payments crisis in the next six to eight months. As mentioned earlier, the liquid reserves of foreign exchange reserves which declined by nearly $3 billion in 2011-12 have fallen further by $2 billion in the first eight months of 2012-13. This is despite that fact that the current account balance so far this year (July-February) was only $700 million. According to a government statement the central bank reserves are expected to decline from $7.5 billion at present to $6.8 billion by the end of end of June 2013 and further to 5.2 billion – slightly over a month's imports – a year later.[4]

Table 2.6
Key Components of Capital Account

In billions of US dollars

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13 July-Feb.
Medium and Long-term Term Official Flows Net	1.2	1.6	2.2	0.8	0.6	0.3
Direct Foreign Private Investment	5.4	3.7	2.2	1.6	0.8	0.5
Withdrawals/ Repayments to IMF (Net)	----	3.7	2.2	-0.3	-1.2	-1.8
Memo item Current account BOP	-13.9	-9.3	-3.5	+0.2	-4.6	-0.7
F.E. Reserves(end of Period)	11.4	12.4	16.8	18.2	15.3	13.4

Source: SBP
IMF

As stressed earlier, the main weakness is in the capital account. As Table 2.6 shows, direct foreign investment flows have dried up, long-term net official flows have come down sharply, and large repayments to the IMF, which supplied nearly $8 billons of liquidity during 2008 started in 2011. Excluding interest, $1.2 billion were paid to IMF in 2011-12 and another $1.8 billion were repaid in first eight months of 2012-13. Including interest, another $5 billion are due to the IMF from March 1, 2013 to the end of 2014.[5]

The large fiscal imbalance is, of course, exerting a downward pressure on the current account balance of payments. But on the other hand, the sharp decline in fixed investment from the average of 18 percent of GDP during 2005-06 to 2007-08, to less than 11 percent of GDP in 2011-12, means that the decline in investment imports has been a very positive factor for the balance of payments position. The much needed recovery in the rate of fixed capital formation to say 15 percent of GDP could easily add 2 percent of GDP to the current account deficit.

The critical long-term need is to reverse the stagnation in exports and recover some of the market share Pakistan has lost to most major developing countries. The case for an export oriented strategy, and the elements that should shape it, was argued in all the previous IPP reports. It is again discussed in detail later in the context of growth revival and is linked to promoting foreign investment in areas which have the greatest potential for improving productivity and competitiveness.

The immediate issue is whether the foreign exchange reserves with the SBP which currently are equal to 1.9 months of imports of goods and services can withstand a further unavoidable hit in the next six to eight months without triggering a panic in the foreign exchange market. On the face of it seems difficult to reach an agreement with the Fund quickly, even if one is considered desirable and feasible by the policymakers. This is because the political situation would not be clarified till about June, after the elections in May, and the incoming government would take some time to define its policy positions and approaches. Short term fixes for the reserves that are apparently being considered are (1) to seek deposits from friendly countries like China, Saudi Arabia, and Turkey and (2) to float bonds to invite investment from overseas Pakistanis. These fixes could work for the short term. But the real problem is that the underlying balance of payments remains weak.

The need for IMF assistance and programmes may still be necessary but it should be noted that the IMF money has to be repaid in 3 to 5 years. Even with strong upfront IMF conditionality, simply entering a programme with the IMF would not ensure viability of long-term balance of payments. Pakistan has rarely completed an IMF programme. Therefore, whether or not Pakistan enters into another agreement with the IMF, serious thought must be given to putting not only the country's public finances but also its foreign exchange position on a sound footing on the basis of a strong home-grown program.

Table 2.7
Liquid Foreign Exchange Reserves
In billions of US dollars

End of Period	With SBP	Total
2009-10	12.95	16.75
2010-11	14.78	18.24
2011-12	10.80	15.29
Mid March 2013	7.5	12.4
End March 2013		

Source: SBP

Finally, it must be recognized that Pakistan's balance of payments is especially vulnerable since, on the one hand, there is heavy dependence on worker remittances and, on the other hand, there is little control on private capital outflows. This suggests the need of adopting a strong foreign exchange reserve policy for the long run. The SBP should aim at gradually building liquid reserves (See Table 2.7) to at least four months equivalent of imports of goods and services. Given the imperative of increasing investment levels steadily over time, it is not reasonable to expect current account surpluses so once again it is necessary to stress the encouragement of large well directed inflows of direct foreign investment and long-term official flows while keep the exchange rate at a competitive level.

STATE OF INVESTMENT IN HUMAN AND PHYSICAL CAPITAL

The level of investment in Pakistan, always very low compared to the fast growing economies notably China and India, has suffered a deep blow during the last few years as a result of a number of factors: the security situation, the energy crisis which has led to idle capacity, crowding out of private sector credit by huge government borrowing from the banking system, a shift of resources towards consumption, and last but not least, a slow growing economy. Our estimate is that, given the additional damage done by natural disasters and terrorism, real physical capital stock has risen less than 2 percent a year during the last five years.

The revival of gross fixed capital formation from the present low level of 11 percent of GDP to even a modest rate of 15 percent of GDP over the next three years would require a major turnaround in governance and a broad shift in policies and incentives from consumption to investment.

Table 2.8
Investment in Large Scale Manufacturing in 1999-2000 Prices

	Rs. In Billion	As % of GDP
2006-07	142	2.7
2007-08	124	2.3
2008-09	94	1.7
2009-10	78	1.4
2010-11	59	1.0
2011-12	43	0.7

Source: Pakistan Economic Survey (Various Issues)

It is also worrying that the decline in investment has been accompanied by shifts in the pattern of investment that do not bode well for improvements in efficiency and productivity (See Table 2.8). As our 2010 report pointed out, private investment boom of 2003-08 was led mainly by service related sectors – notably telecommunications and finance. There was only a modest growth in private sector manufacturing investment. Last year's report noted that investment in large and medium- scale manufacturing dropped more than 50 percent between 2007-8 and 2010-11. This trend persisted in 2011-12 and will probably continue in 2012-13. (See Table 2.9)

Table 2.9
Private Sector Investment in Manufacturing
Rs. in billions in 1999-2000 Prices

Year	Large and Medium Scale (LSM)	Small Scale	Total
2007-08	124	41	165
2008-9	92	44	136
2009-10	76	49	125
2010-11	58	53	111
2011-12	43	58	100

Source: Pakistan Economic Survey (Various Issues)

A small part of the decline in LSM investment since 2008-09 has been offset by a rise in investment in small-scale industry. Growth in small industry investment is to be welcomed but what seems to be happening in Pakistan is that the growth in small scale industry is at the cost of larger scale establishments – a phenomenon that does not support either growth in efficiency and productivity or strengthening of the much needed tax net. As discussed in more detail in a subsequent chapter, economies of scale and skill development are critical to improving the competitiveness of Pakistan's industry and exports and, therefore, a substantial and rapid relative decline in the LSM sector in Pakistan does not augur well for growth revival.

In general, as Table 2.10 indicates private investment has declined more sharply than public investment even though the public investment is far from being at an adequate level. This is because of pressing infrastructure needs including not only the thermal power sector, but also somewhat longer run investments required in multi-purpose dams to increase role of low cost hydro power and increase water storage capacity to offset the gradual decline expected in water availability from Tarbela and Mangla Dams.

Table 2.10
Public and Private Investment
In percentage of GDP in 1999-2000 Prices

Year	Private	Public	Public Enterprises	Total
2007-08	13.6	3.2	1.6	18.4
2008-09	11.2	2.7	1.1	15.0
2009-10	10.2	2.1	1.0	13.3
2010-11	9.2	2.2	0.7	12.3
2011-12	7.9	2.1	0.6	10.8

Source: Pakistan Economic Survey (various issues)

Human Capital

It is well known that Pakistan is a laggard in social development especially education, even among South Asian countries. However, it is a matter of even greater concern that the improvement in social indicators witnessed over most of the last decade appears to have slowed down in last two or three years, presumably under financial pressures and slow economic growth.

The literacy rate among 15 years and older which had improved from 44 percent in1998 to 57 percent in 2009 was only 58 percent in 2011 – this despite a continued rise in female literacy that now stands at 46 percent. While the rate of gross enrolment at the primary level improved a little from 91 to 92 percent over 2009-11, the net enrolment over the period actually declined slightly to 56 percent which means that 44 percent of the children of school going age children are not in school.

The more recent numbers of gross enrolment at primary and secondary level available for 2012 confirm that these enrolments have risen less than 10 percent since 2008, only slightly faster than the age cohort. However, the higher education sector appears to be booming, though starting from a low level. The attendance in arts and science colleges grew by 33 percent over

2008-12 and the university enrolment almost doubled. Including professional colleges the tertiary enrolment has grown by nearly 80 percent to 3.7 million or an estimated 15-18 percent of the age group. The female enrolment at the tertiary level exceeds that of male enrolment and continues to grow rapidly. The liberalization of policy towards private colleges and universities appears to be an important factor in the rapid growth, though growing urbanization and widening income disparities have also been contributing factors.

Private sector enterprise has played an important role in increasing the access to education at all levels. However, without an overhaul of the public education system including steps to increase teacher accountability and focus on deteriorating quality, Pakistan will continue to make inadequate progress towards increasing literacy levels and upgrading of worker skills. We believe that improved governance in the sector including transfer of responsibilities to local governments remains as important as increasing public funding for the sector.

The growing number of adult illiterates in society should receive much more attention than they are receiving because both of the need for social cohesion and worker productivity. At present there an estimated 50 million adult illiterates who can be expected to live for another 35-40 years. They will remain a serious drag on both modernization and growth unless special programmes are developed to reduce their numbers.

ROOTS OF ENERGY CRISIS

Pakistan is now in the fifth year of energy crisis which shows no signs of abating. Load shedding in the electricity sector has increased almost steadily over the last several years and reached 44 percent of peak demand in 2011-12. This compared to a gap between peak generation load and peak demand load of 16 percent in 2006-07 and 31 percent in 2007-08. During the last two years, shortages of natural gas have become widespread and this has contributed to a deepening of the problems in the power sector which relies on natural gas for roughly 25 percent of electricity generation.

An analysis in the 2010 IPP annual report suggested that industrial power outages caused a loss of 2.5 percent of GDP, more than half a million jobs and $1.3 billion in exports.[6] More up-to-date research work presented in chapter 4 suggests that the adverse effects continue and have become larger.

Apart from loss of economic activity, power outages of up to 10 to 12 hours in urban areas have caused great disruption in society at large and have been a blow to the quality of life perhaps even more than the security situation and the threat of terrorism.

The many failures in the management of the energy crisis during the last five years, a recurrent circular debt problem leading to existing generating capacity not being fully utilized, an inability to control theft of electricity and thus reduce line losses, little improvements in operational efficiency of the power system, lack of transparency and delayed delivery of power from rental power plants, and political difficulty of undertaking power tariff increases required by the sharp rise in international oil prices, have all made the situation worse than it should have been.

However, it must be stressed that the roots of the energy crisis go well into the past and are attributable to policy decisions taken as early as the 1960s and the 1970s. The find of Sui gas in Baluchistan in the 1950s was a bonanza for the country especially for the well-to-do households. Unfortunately, even though natural gas was a clean, safe, and convenient fuel, the price of gas especially for the household was set very low (well below the unsafe, messy, and inconvenient kerosene oil). The effective large initial subsidy provided not only to the households, but also to the industrial sector especially fertilizer industry made it difficult to adjust prices fully as international gas and oil prices have increased nearly twentyfold during the last four decades.

A result of the domestic structure of gas prices has been the low rate of new gas exploration. At present ‘‘exploratory prices of gas are linked to crude oil, but impact of changes in reference crude prices is not fully passed on to investors, as benchmark prices for compensation are computed on a bi-annual basis only. Furthermore, exploration and production companies accrue only 50 percent of any upside price movements in the price of gas with respect to the aforementioned base level, with the remainder collected by the government in the form of a windfall levy. Producer (well-head) prices of gas therefore do not particularly incentivize exploration of the commodity, and production companies receive prices below import parity levels.’’[7]

The SBP 2011-12 Annual Report has this to say about natural gas shortage: ‘‘Like any other shortage, this is, *fundamentally*, due to mispricing. Natural gas has been too cheap for too long, and this has led to overconsumption and underproduction. The most wasteful of natural gas consumers appear to be households. In 2010-11, households consumed 5.4 million tons of oil equivalents (TOE) of energy in the form of natural gas. This is 72 percent higher than the amount of energy that households consumed in the form of electricity during the same period. The amount of energy consumed by households in the form of natural gas is equal to roughly 63.2 thousand Gigawatt hours (GWh); putting this in perspective, the total amount of electricity generated in the country during 2010-11 was 99.8 thousand GWh. Natural gas consumers also represent a minority in Pakistan: only 23 percent of households have a natural gas connection.’’

Like natural gas, appropriate power pricing has been an issue ever since the early 1970s. The quadrupling of the international oil prices at the end of 1973 by OPEC increased Pakistan's oil import bill by $700 to 800 million, from 1 percent of GDP to 4 percent of GDP. The government headed by Zulfikar Ali Bhutto decided to postpone the needed energy price adjustments relying instead on grants and loans from the friendly Middle–Eastern countries to meet the higher import bill. The growing energy subsidies fuelled a high rate of growth of energy consumption and significantly reduced the resources available to entities like the Water and Power Development Authority (WAPDA) to finance additional investments. This was another example of policy focused on avoiding painful short-term choices. The delayed adjustment of energy prices for nearly a decade was in sharp contrast to the speedy policy response in East Asian countries, notably Korea. Had Pakistan moved quickly, it would have reduced its energy deficit and possibly, saved its well performing public institutions such as WAPDA from financial disaster.

The policy failures in the energy field continued in the last two decades. First, under undue pressure from the WB, a flawed power sector policy was adopted in the mid 1990s, which set the unrealistic goal that the private sector should meet the needs of the power sector, without recourse to public funds except for hydroelectric development and transmission. In the 2003 report on 'Public Expenditure Management' that Parvez Hasan led for the WB, it was made clear that there was a serious mismatch between large national power requirements and the amounts that were in the public sector plans. For instance, the Planning Commission's suggested allocation of Rs 90 billion (0.4 percent of GDP) for the power sector for the five years, 2003–07, stood in sharp contrast to only WAPDA's total requirements of Rs 261 billion: only a small portion of which could be met from WAPDA's own resources. The rest required public funds and/or government guarantees. The Karachi Electric Supply Company (KESC) needs were over and above this. Apparently no body closely followed the fact that private initiatives for power sector investment were not forthcoming and that public sector allocations were not adequate.

Second, while power sector investments were neglected, the international oil prices, having remained relatively subdued in the 1990s, again started rising after 2003 and rose almost inexorably from the average of $30 per barrel in 2003-4 to $108 per barrel in 2007-08: the oil import bill more than quadrupling to $11 billion over four years. Unfortunately the Musharaf government also failed to pass on the full increase in oil costs to the consumers, either on the mistaken assumption that the rise in oil prices would not be lasting or that difficult political decisions could be left for after the elections in 2007-08.

There are several points suggested by this historical perspective. Avoiding short-term pain involved in upward adjustment in energy prices has had high long-term costs. Pakistan has had difficulty in recognizing and dealing with its increasing energy dependence and accepting the reality of high international oil and gas prices that have now persisted for a decade. The natural gas resources of the country have been frittered away by unnecessary and unconscionable subsidies to the household sector and the result has been a low exploration effort. A serious effort to exploit country's hydroelectric resources was not made. On the organizational side, decentralization and privatization of power generation and distribution has moved slowly and hesitatingly.

These long term factors combined with the poor management in recent years of short term issues of circular debt, growing theft of energy resources, and continued non-payment of dues and delays in passing through the steep rise in cost of higher oil prices to consumers have resulted in the country now suffering the record shortage of both power and gas. The bad news is that these shortages are not going to disappear soon though there is general agreement that relieving the energy shortages is the most critical need for the economy.

The need for further power tariff adjustment is also clear. But the consumer resistance to tariff increases is very real because they do not see any progress in reducing load shedding or reducing line losses. Simply pushing for power rate adjustments could be counterproductive in terms of line losses. Aggressive effort to control electricity, oil, and gas theft must be undertaken because they will help both to improve revenues and to improve the image of the electric power supply companies. How long will it take to get the tamper-proof meters to be installed? When is the new electricity act that provides for much stronger penalties for theft likely to be passed?

The problem created by circular debt is essentially man-made. It is necessary to ensure that viable public sector capacity is not left unused due to financial constraint. For the longer term, plans to accelerate hydro-power development at the Federal level, and speedy devolution of thermal generation and distribution to the private sector as well as provincial governments must be actively pursued.

The PPP-led government in Islamabad ended its 5-year tenure by signing a deal with Iran to build the Iran-Pakistan pipeline. This was seen as a political gesture – one that could be identified in the manifesto as an effort to ease the severe gas shortage. Most analysts did not believe that the pipeline which had been constructed by Tehran up to the Pakistan border would be extended into the Pakistani territory. Given the strict UN/US sanctions under which Tehran was operating, it was not likely that Pakistan would be allowed to implement this project.

CONCLUSION

The main message that emerges from an analysis of the current state of the Pakistani economy is that despite continuing deep energy crisis, a worsening security situation, poor governance including generally ineffective economic policy responses, a large part of the population has not suffered any serious economic hardship though, according to the estimates of the Social Policy and Development Centre (SPDC), income poverty had increased from 30 percent in 2005 to 37 percent in 2011 with a larger increase in urban poverty.

There are several explanations for this apparent paradox. First, the sharp initial improvement in the agricultural terms of trade helped incomes in the rural areas where the majority of population lives. Second, the large external inflows – recorded and unrecorded – have helped sustain per capita income growth well above the rather depressed growth in domestic output of only about 3 percent per annum. Third, and most important, there has been a significant shift from investment to consumption over the last four or five years. While private consumption rose 28 percent over the years 2007-08 to 2011-12, real fixed investment fell by over 30 percent over the same period.

This economic pattern in which present consumption pre-empts future growth and there is heavy dependence on somewhat exceptional external flows is obviously not sustainable. Thus the economic fundamentals can no longer be ignored. Moderating the rate of consumption growth to improve public finances and to reverse the decline in public and private investment is absolutely essential but would make for hard choices for the new government. On the other hand, more effective governance reflected in improved security situation, improving energy situation, and better trade and foreign policy relationship with India can relatively quickly restore the confidence in the country and its currency. This will help to improve productivity and competitiveness. In this scenario, foreign investment interest would be restored, capital flight could be reversed and a strong rebound in investment may be possible. We discuss this approach to policymaking in greater detail in a later chapter.

Chapter - 3

The Strategy for Survival

Chapter - 3
The Strategy for Survival*

The objective of this chapter is to highlight the Balance of Payments (BoP) and the fiscal situation as it is unfolding in the on-going financial year, 2012-13. Given the deteriorating position of macroeconomic imbalances,[1] a short term-policy package for survival is also presented.

THE BALANCE OF PAYMENTS SITUATION

The external BoP position of Pakistan is an area of growing concern, in view of issues of debt sustainability and doubts about the ability to meet the high level of debt repayment obligations, especially to the IMF. There is a need to avoid a 2008 type of financial crisis when the 'oil price shock' led to a haemorrhaging of the current account and a rapid depletion of foreign exchange reserves. The rupee depreciated sharply from 60 to 80 per dollar and stability was restored only after the release of a large tranche of over $3 billion by the IMF under a new Standby Facility in November 2008.

This section reviews the recent trends in the balance of payments. The principal finding is that while the current account position has substantially strengthened since 2007-08 and there was actually a surplus in 2010-11, the financial account has weakened considerably and any future BOP problems are more likely to come from this account.

Trends in 2012-13

The balance of payments on a monthly basis are presented for the first eight months of the current financial year. Even within this short period some warning signals are visible, as indicated in Table 3.1.

The current account was in surplus in the first quarter, July to September 2012, and only marginally in deficit in the second quarter, October to December 2012. This was primarily due to a surplus in the services account arising from the large payments from the Coalition Support Fund (CSF) by the USA. Home remittances were also large enough to cover the deficit in the balance of trade.

*This chapter has been contributed by Dr. Hafiz A. Pasha.

Table 3.1
The Monthly Balance of Payments in 2012-13

($ Million)

		July-September (Monthly Average)	October-December (Monthly Average)	January 2013	February 2013
A.	**Current Account Balance**	**115**	**-42**	**-156**	**- 596**
	Trade Balance	**-1224**	**-1326**	**-1122**	**-1236**
	Exports f.o.b	1995	2009	2159	1920
	Imports f.o.b	- 3219	-3335	- 3281	-3156
	Services Balance	**80**	**6**	**-181**	**- 254**
	Credit	719	669	365	331
	Debit	-639	-663	- 546	585
	Income Balance	**-238**	**-351**	**- 204**	**-346**
	Credit	38	52	21	24
	Debit	-276	-403	- 225	-370
	Current Transfers Balance	**1497**	**-1629**	**- 1351**	**1240**
	Credit	1503	1638	1356	1242
	Debit	-6	-9	- 5	- 2
B.	**Capital Account Balance**	**10**	**36**	**42**	**62**
C.	**Financial Account Balance**	**14**	**232**	**-86**	**357**
	Direct Foreign Investment (Net)	**32**	**138**	**-42**	**-11**
	Foreign Aid (Net)	**-7**	**10**	**-55**	**124**
	Disbursements	120	210	13	206
	Amortization	-127	-200	-68	82
	Others	**-11**	**-380**	**11**	**244**
D.	**Errors and Omissions**	**-149**	**67**	**9**	**-14**
E.	**Overall Balance of Payments**	**-9**	**-171**	**-191**	**-191**
F.	**Repayment to IMF**	**-148**	**-270**	**-26**	**-537**
G.	**Change In FE Reserves**	**-157**	**-441**	**-217**	**-728**

Source: SBP

Negative developments can be observed thereafter, with the deficit in the current account rising precipitously to $596 million in February 2013. This is not due to any worsening in the trade balance but to the emergence of a deficit in services and a visible fall in home remittances monthly of over $250 million. First indications are that the current account deficit is again above $500 million in March 2013.

The financial account has been variable in character with a small positive balance, except in the month of January 2013. It is noticeable that net inflows of direct foreign investment have turned negative in January and February indicating some flight of capital by multinational companies from Pakistan but are in the first eight months at, more or less, the same level as last year. Foreign aid inflows in net terms have been small in magnitude and negative in some months.

During the quarter, October to December 2012, there was a large negative outflow largely of non-resident FCAs from banks.

Overall, the balance of payments has been in deficit during the first eight months of 2012-13, with a tendency for the deficit to rise in recent months. The deterioration has been exacerbated by repayments of debt to the IMF of $1817 million in this period. Consequently, foreign exchange reserves have fallen by $2739 million. Two thirds of the decline is due to the payment of debt obligations to the Fund.

Repayment Schedule to IMF

Given the vulnerability of the balance of payments to debt repayments to the IMF, it is necessary to project the future obligations on this account. As shown in Table 3.2, lumpy repayments to IMF are due in May 2013 of $576 million, of $691 million in August and $715 million in November. By the end of 2012-13, Pakistan will have repaid IMF $2922 million. In 2013-14 the liability reaches the peak level of $3116 million. Thereafter, the burden falls sharply to $1271 million in 2014-15.

Table 3.2
Repayment Schedule of IMF Loan*

($ million)

	2012-13	2013-14	2014-15
July		25.9	25.9
August		691.3	293.1
September		144.3	200.4
October		107.1	-
November		714.6	147.2
December		200.4	200.4
January		133.0	-
February		296.7	146.3
March	157.5	200.4	55.9
April	107.1	107.1	0.2
May	576.3	294.4	145.4
June	264.4	200.4	55.9
Total	**1105.3**	**3115.6**	**1270.7**
Cumulative	**(1105.3)**	**(4220.9)**	**(5491.6)**

* From March 2013 onwards
*At the rate of 1 SDR = $

Source: IMF Pakistan

Projected Level of FE Reserves

Projection of the level of foreign exchange reserves up to June 2014 is attempted in Table 3.3 in the 'business as usual' scenario on the basis of the following assumptions:

i) monthly deficit in the overall balance of payments of $200 million for the remainder of 2012-13 and $100 million in 2013-14.

ii) full repayment to the IMF as per the schedule given above.

iii) no disbursements of money from the Coalition Support Fund (CSF) during the remainder of 2012-13 as the inflow has reached the budgeted amount for the year and $1.2 billion in 2013-14.

Table 3.3
Projected Level of Foreign Exchange Reserves upto December 2013
(with ‘business as usual’)

($ million)

	FE Reserves at Start of Month	‘Basic’ BOP Deficit	Repayment to IMF	Reserves at End at of Month	Import Cover (in months*)
April 2013	6500	-200	-107	6193	1.5
May 2013	6193	-200	-576	5417	1.3
June 2013	5417	-200	-264	4953	1.2
July 2013	4953	-100	-26	4827	1.1
August 2013	4827	-100	-691	4036	1.0
September 2013	4036	-100	-144	3882	0.9
October 2013	3882	-100	-107	3675	0.9
November 2013	3676	-100	-715	2860	0.7
December 2013	2860	-100	-200	2560	0.6

*of imports of goods and services
**as of March 22
Source: SBP

Based on these assumptions, foreign exchange reserves are expected to fall to $5.7 billion by the end of June 2013, representing an import (of goods and services) cover of 1.4 months. By October 2013, reserves are likely to decline further to $4452 million, providing import cover of just over one month and by December 2013 to $2560 million, even in the presence of conservative assumptions.

Clearly, before this happens, Pakistan will have to take strong policy actions to arrest the slide in foreign exchange reserves, including possibly renegotiating a new programme with the IMF.

It is appropriate to recount at this time what happened in 2008. From the beginning of the year, foreign exchange reserves started falling rapidly, as shown in Table 3.4. There were months when reserves fell by over $1 billion. After July 2008, when foreign exchange reserves stood at $7 billion, the rupee started plummeting by almost three rupees per month and eventually came down to Rs 80.43 per dollar in October 2008, representing a cumulative depreciation of 29 percent since January 2008. The foreign exchange market stabilized after the signing of the SBA with the IMF and release of a substantial first tranche. The rupee appreciated somewhat by about Rs 1.50 per dollar in the next two months.

Foreign exchange reserves have currently approached the level of $6 billion, when the slide of the currency started in 2008. But market speculation has been very limited, although there were a few days when the open market fell to the ‘psychological’ low level of Rs 100 per dollar. This testifies possibly to greater confidence in the future, with the previous government having

Table 3.4
Recounting What Happened in 2008

($ million)

	FE Reserves	Change*	Exchange Rate (Rs/$)	Change (Rs.)
January	12541	-831	62.37	1.19
February	12032	-509	62.68	0.31
March	11085	-947	62.75	0.07
April	10074	-1011	63.55	0.80
May	8692	-1382	67.60	4.05
June	8577	-115	67.26	-0.34
July	7091	-1486	70.59	3.33
August	5766	-1325	74.29	3.70
September	4883	-883	77.17	2.88
October	3534	-1349	80.43	3.26
November*	5941	2407	79.92	-0.51
December	6616	675	78.92	-1.00
Change		**- 9808** ***(in 10 months)***		**16.55**

*Funding from IMF SBA.
Source: SBP

completed its full term and the election process underway with elections expected on March 11, 2013. There is also the expectation that the newly elected government will make reforms on assumption of office.

But it needs to be emphasized that in the presence of a dangerously low level of foreign exchange reserves, it is difficult to predict exactly the ‘tipping point’ when markets start getting jittery and speculation takes over whereby importers open larger LCs, exporters hold back proceeds and remittances go more through informal channels. This would trigger off faster depreciation of the rupee.

Up to now, between June 2012 and March 2013, the rupee has depreciated by a modest Rs 3.80 per dollar, equivalent to 4 percent, in the interbank market. The corresponding depreciation in the open market is Rs 3.35 per dollar, less than 3.5 percent. This is even less than the underlying rate of inflation. Therefore, there is no evidence of any panic in the foreign exchange market. This testifies to the resilience, especially of the informal economy. It is also likely that some money is coming from abroad through ‘hundi’ to finance the elections.

Indicators of Future Developments

We have highlighted above the resilience of the Pakistan economy which has maintained stability in the foreign exchange market despite the pressure on exchange reserves. But the issue is how long this will last. This question is particularly relevant in 2013-14 when reserves could fall to critically low levels. It is important that the newly elected government monitors and influences developments on the following fronts:

Table 3.5
Fall in Home Remittances
(Year-to-Year)

(%)

	January 2013	February 2013
USA	-5.4	-30.5
UK	18.1	-6.5
Saudi Arabia	-4.3	-3.2
UAE	-10.0	-24.3
Others	-2.1	-6.5
Total	**-1.9**	**-11.1**

Source: SBP

Home Remittances: For the first time remittances have started falling since January 2013. They declined on a year-to-year basis as shown in Table 3.5 by 2 percent in January and 11 percent in February. This is particularly noticeable in the case of remittances from the USA and UAE.

The question is: is this due to a growing spread between the official exchange rate and the 'hundi' rate? This gap has approached Rs 1.50 per dollar and needs to be narrowed.

Foreign Direct Investment (FDI): The previous section has indicated that net FDI inflow has also become negative at $42 million in January and $11 million in February. This raises the issue of flight of capital by multinational companies from Pakistan.

Table 3.6 indicates from which sectors there have been net outflows. These include sectors like chemicals, thermal power, telecom and financial services. Major corporate entities like ICI, Citibank, American Express, etc., have divested their assets from the country. The surprise is the large outflow out of the telecom sector, which over the last decade has been one of the fast growing sectors in Pakistan.

Table 3.6
Sectors with Net Outflow of
FDI in July-February 2012-2013

	($ million)
Chemical	-89
Telecommunications	-320
Financial Services	-203
Thermal Power	-80

Source: SBP

Inflows of Foreign Aid: During July-February 2012-13, the net inflow of foreign aid is only $78 million, as compared to the target for the year of $1800 million. Multilateral agencies are becoming increasingly reluctant to disburse funds in the absence of a positive signal from the IMF and international rating agencies.

Non-Resident FCAs: During the last year, non-residents have withdrawn $500 million from FCAs in Pakistan. If this trend continues, then the remaining balance of $455 million may also exit, with concomitant implications on the BoP.

Foreign Portfolio Investment: One of the major positive developments is the exceptional buoyancy of stock markets in the country. The Karachi Stock Exchange (KSE) Index has risen by over 34 percent since June 30, 2013. However, this attractiveness has not been reflected in large inflows of foreign private investment. Only $158 million has been invested in the last eight months in a market with capitalization approaching $40 billion. Overall, the value of outstanding foreign portfolio investment is estimated at $5 billion, down from the peak of $6.7 billion in December 2007.

A contingent risk is that if the stock market flounders in coming months then some of these sizeable funds may be withdrawn, putting pressure on the BoP. Alternatively, if the currency starts depreciating rapidly then capital losses (in $) may precipitate a flight of capital.

Therefore, there are some ominous signs which need to be guarded in order to prevent the markets from getting increasingly nervous and hastening the period of financial difficulties.

THE FISCAL SITUATION

The budgetary position worsened substantially in 2007-08 in the aftermath of the 'oil price shock' when the government at the time failed to raise domestic prices in line with the increase in international prices, thereby necessitating large subsidies. Since then, up to 2010-11, there has been a visible improvement in the fiscal situation, with the budget deficit declining from 7.6 percent in 2007-08 to 6.6 percent of the GDP. This has been achieved primarily by containing the level of current expenditure. But in 2011-12 the fiscal deficit has risen sharply once again to 8.5 percent of the GDP, as massive subsidies have had to be made to tackle the problem of exploding circular debt in the power sector. Another major development is the drying up of external resources to finance the deficit and increasingly heavy reliance on domestic borrowing including deficit financing (printing of money) by the SBP.

Fiscal Developments in 2012-13

The fiscal deficit in the first months of 2012-13 stands at 2.6 percent of the GDP, more or less, at the same level as observed in the corresponding period of last year, as shown in Table 3.7. Revenues have shown buoyancy with a growth rate of 29 percent, due primarily to the substantial inflow of non-tax revenues from the CSF. Expenditure growth has been somewhat lower at 24 percent.

But the fiscal numbers for the first six months of the current fiscal year already reveal some worrying developments, as follows:

i) Tax revenues have shown only modest growth of less than 9 percent, substantially below the FBR revenue growth target of over 26 percent.

ii) Interest payments, especially on domestic debt, have been unexpectedly high with a growth rate of 39 percent.

Table 3.7
Fiscal Deficit* in First Six Months of 2012-13

(Rs in Billion)

	July - December 2011-12	July-December 2012-13	Percentage Growth
Total Revenue	**1135.3**	**1461.8**	**28.8**
Tax Revenue	904.6	1012.7	12.0
Federal	867.4	942.0	8.6
Provincial	37.3	70.7	89.5*
Non-Tax Revenue	**230.6**	**449.1**	**94.8**
Federal	206.9	414.6	94.8
Provincial	23.7	34.5	45.5
Total Expenditure	**1667.8**	**2066.5**	**23.9**
Current Expenditure	**1399.2**	**1721.7**	**23.0**
Interest Payments	397.2	552.6	39.1
Defence	243.3	256.7	6.5
Others	758.7	912.4	20.2
Development Expenditure	**231.0**	**277.8**	**20.0**
Others**	37.6	87.0	131.4
Budget Deficit	**532.5**	**624.7**	**17.3**
Financing	532.5	624.7	17.3
External	34.0	-1.4	-
Domestic – Bank	302.0	557.9	84.7
Domestic – Non-Bank	196.5	68.1	-65.3
Fiscal Deficit (% of GDP)	2.5	2.6	-

*Consolidated deficit
**Not reconciled
Source: Fiscal Operations, MoF

iii) Other expenditures on the current account have also grown fast, especially on subsidies, by 20 percent.

iv) The entire financing of the budget has been from domestic borrowing. External resources have made no contribution. Within the former, over 89 percent of the contribution has come from bank borrowing, both from SBP and commercial banks.

Looking forward to the second six months of 2012-13, first indications are that the fiscal situation has substantially worsened. The latest estimates have not yet been released up to March 2013 by the Ministry of Finance. As such reliance has been placed on estimates from the financing side below the line.

According to the SBP, as of 6, April 2013, borrowings for budgetary support have reached Rs 926 billion, an increase of 46 percent over the December level, with Rs 69 billion from SBP and Rs 857 billion from commercial banks. The contribution from non-bank sources is estimated at Rs 109 billion. On the assumption that external inflows continue to be marginal, the size of the fiscal deficit in the first nine months of 2012-13 is estimated at Rs 1019 billion, equivalent to 4.3 percent of the projected GDP for the year, close to the targeted level of 4.7 percent of the GDP for the full year.

The issue is what is likely to happen in the remainder of the year. The media has highlighted estimates of up to 9.5 percent of the GDP for 2012-13. This is based on the following:

i) The apparent lack of buoyancy in FBR revenues with a growth rate of less than 5 percent in the first eight months (see discussion on FBR revenues in subsequent section).
ii) Pending huge liabilities of circular debt in the power sector which will require an injection of Rs 150 billion or more in the next three months if record levels of load shedding during the summer are to be avoided.
iii) A burst of spending on the eve of the elections by both federal and provincial governments and a number of populist decisions with downstream negative implications on the budget.
iv) Seasonally, the fiscal deficit on a quarterly basis tends to the highest in the last quarter.

In 2011-12 almost 45 percent of the annual deficit was incurred in the last quarter. But, in our view, the high estimate of the budget deficit represents a significant degree of exaggeration. Our projected estimate is 8.3 percent of the GDP, somewhat below the level of 8.5 percent of the GDP in 2011-12. Nevertheless, it is likely that in both years the fiscal deficit will exceed 8 percent of the GDP. The implication on the financing side is that domestic borrowing will exceed Rs 2 trillion, almost 23 percent above last year's level.

We take up now the issue of slow growth in FBR revenues and the implications of the decisions in the last days of the previous government.

Growth in FBR Revenues

Table 3.8 indicates the monthly growth rate (on a year-to-year basis) of FBR, both in individual taxes and in overall collection from July 2012 to June 2013. As highlighted above, the growth rate of total collection in the first seven months is 4.6 percent, one of the lowest ever. Since September 2012, the monthly growth rate has been declining, actually becoming negative in January.

Among individual taxes, excise duties have declined and the General Sales Tax (GST) has grown by less than 3 percent. Relatively fast growth is observed in customs duties of over 12 percent. Direct taxes have shown an intermediate growth rate of 7 percent, although in this case also there was negative growth in January.

Table 3.8
Monthly Growth Rate of FBR Tax Revenues in 2012-13

(Percentages)

	Direct Taxes	General Sales Tax	Excise Duty (in relation to corresponding month of previous year)	Customs Duty	Total FBR Revenue
July	-24.5	3.6	-37.0	25.8	-4.8
August	0.9	0.5	-13.4	25.3	2.4
September	33.1	16.3	-12.0	19.0	21.9
October	14.2	-3.8	36.2	16.8	6.9
November	6.6	5.6	-6.5	13.1	6.0
December	2.0	-2.8	-28.7	-3.0	0.7
January	-3.4	1.0	-23.7	1.1	-2.5
Cumulative	**6.6**	**2.6**	**-6.6**	**12.5**	**4.6**

Source: Economic Data, SBP

This is an extremely worrying development, especially given the target growth of over 26 percent in FBR revenues in the Budget of 2012-13. What explains the apparent lack of growth in tax revenues? We offer the following possible answers:

i) The Budget of 2012-13, the last budget of the PPP government contained a number of rate reductions and concessions including, first, increase in the exemption limit for personal income tax from Rs 300,000 to Rs 400,000; second, reduction in income tax rates for individuals; third, withdrawal of the 1 percent minimum income tax on turnover of companies, fourth, scaling down of all GST rates above 16 percent to the standard rate of 16 percent; fifth, phasing out of excise duties on a number of industries, including cement; and sixth, reduction in the maximum rate of customs duty from 35 percent to 30 percent. It is likely that the negative impact on revenues of these measures was not factored in the FBR revenue target for 2012-13.

ii) The growth in the tax bases for FBR taxes is given in Table 3.9 during the period July–January 2013 and comparison is made with the corresponding growth in tax revenues. It appears that the growth of tax revenues is less than the growth in the tax bases, with the exception of customs duties. This indicates some slackening in the tax collection effort by FBR, possibly due to the large number of changes in the top management of the Board.

Table 3.9
Growth in Tax Revenues and Tax Bases
July – January 2012-13

(Percentages)

	Growth Rate: Tax Bases	Tax Revenue
Income Tax	12.3[a]	6.6
Customs Duties	7.0[b]	12.5
General Sales Tax	8.3[c]	2.6
Excise Duties	9.5[d]	-6.6

[a] GDP (non-agricultural)
[b] Dutiable Imports
[c] Imports + Value Added in large scale manufacturing
[d] Large-scale manufacturing value added

Source: SBP

iii) Part of the decline in growth of revenues from GST is the transfer of the collection of the sales tax on services to the Provincial Governments of Punjab and Sindh. Against this, refunds in the first quarter of 2012-13 were almost Rs 39 billion less than in the corresponding period of the previous year.

Overall, it is expected that FBR will achieve total tax revenues of a maximum of Rs 2050 billion in 2012-13. This will represent a shortfall of over Rs 330 billion in relation to the original target for the year. Such a large short fall, of almost 14 percent, is the biggest ever.

Cost of Recent Decisions

Towards the end of its tenure, the previous government took a number of decisions which are likely to have implications on the outcome of the current fiscal year and potentially in some cases, in subsequent years. These decisions are listed in Box 3.1.

Box 3.1
Decisions by Outgoing Government* on the Eve of Completion of Tenure

Decisions
• Reduction in Power Tariffs on Tubewells costing Rs 16 billion
• Increase of 20 percent in Salary of Federal Secretariat Employees
• Deferment of Power Tariff Increase recommended by National Electric Power Regulatory Authority (NEPRA)
• Higher Allocation to Peoples' Works Programme
• Regularization of 100,000 Contract workers in Sindh
• Retrospective Increase in Salaries and Perks of Member Provincial Assembly (MPA)s in Sindh Assembly
• Special Support to Pakistan International Airlines (PIA) of Rs 100 billion over the next few years
• Inland Freight Subsidy to Sugar
• Promulgation of 25 Statutory Regulatory Order (SRO)s, mostly in Customs Duties

*both Federal and Provincial, only those which have been covered by the media.

The potentially costly decision is to defer the increase in power tariffs asked for by NEPRA. On the assumption that increase will at least be partially granted by the next government, the cost quarterly comes to approximately Rs 40 billion. The Economic Committee of the Cabinet (ECC) took the decision to reduce the tariff on agricultural tubewells from Rs 10 to Rs 8 per kwh, reducing revenues annually of power distribution companies by Rs 16 billion, thereby necessitating a higher subsidy from the budget.

Other major decisions include the granting of a subsidy of Rs 100 billion to cover losses and costs of acquisition of aircraft by PIA over the next few years and regularization of 100,000 contract workers by the Sindh Government.

On top of all this, an earlier decision that could have significant fiscal consequences is the enhancement in the procurement price of wheat by 19 percent, from Rs 1050 to Rs 1250 per 40 kilogrammes. The current export parity price is close to Rs 1100 per 40 kgs. In effect, this will imply additional borrowing for commodity financing of Rs 30 billion and corresponding liability on both the federal and provincial governments if the retail price of atta is not raised correspondingly.

In the next few weeks, some of the above-mentioned decisions will need to be reviewed. The increase in electricity subsidy to tubewells may be considered for withdrawal. The salary increase will need to be incorporated in the 2013-14 Budget. The regularization of contract employees and the backdated enhancement of salaries and perks to MPAs in Sindh are under judicial review. The recently promulgated SROs will have to be studied from the viewpoint of revenue implications. Importantly, an early decision will have to be taken on implementing an increase in power tariffs.

Indicators of Future Developments

Financing of the Deficit: As quantified above, between April to June 2013 the Government will have to borrow domestically almost Rs 1 trillion. This magnitude of financing has never been attempted before in such a short period. How will this quantum of financing be organized in the face of unfavourable developments?

The basic problem is the increasing reluctance of the capital market to pick up medium – or long-term – government paper. Much of the borrowing is being done by floating short-term treasury bills, the stock of which stands at Rs 2.9 trillion. This implies rapid rollover of domestic debt.

Pakistan Investment Bonds (PIBs) have received no response in the last four auctions during January and February 2013. In the case of National Savings Schemes, the net inflow during the same months has shown declines of 23 percent and 17 percent respectively, with the fall being most pronounced in the case of Prize Bonds and Bahbood Certificates. Clearly, this is the consequence of the fall in the rates of return in line with the sharp reduction of the Policy Rate of the SBP from 14 percent to 9.5 percent by December 2012.

How are the larger purchases of treasury bills by commercial banks being sustained? These are substantially larger than the increase in bank deposits. This has been achieved by massive Open Market Operations (OMOs) by the SBP in the form of injection of short-term liquidity into the banking system. On a, more or less, weekly basis these aggregate to over Rs 2.5 trillion. In effect, this amounts to deficit financing indirectly by the Central Bank.

State of Provincial Governments: The provincial governments have been in a relatively comfortable position since the 7th NFC Award which led to a large increase in federal transfers of over Rs 200 billion in 2010-11, in relation to sharing arrangements prior to the Award.

But the unfolding fiscal developments in 2012-13 do not augur well for the Provinces. The massive shortfall in FBR revenues, referred to earlier, means that transfers could be Rs 180 billion less than budgeted at the start of the year. This will carry some provinces into a position of negative cash balances thereby necessitating higher overdraft from the SBP. Alternatively, the provincial Annual Development Programmes (ADPs) will have to be slashed drastically. This will also render difficult their budgeting exercise for 2013-14.

The Domestic Debt Trap

Pakistan today virtually finds itself in a domestic debt trap for the following reasons:

i) The fiscal deficit has risen substantially and two years running it is likely to exceed 8 percent of the GDP.

ii) External inflows in net terms have become marginal and bulk of financing of the deficit is coming from domestic borrowing, mostly from commercial banks and the National Savings Schemes.

iii) The cost of servicing domestic debt is much higher because external borrowing is generally on concessionary terms.

Projections of the level of domestic and external debt servicing are given in Table 3.10. As observed already in the first six months, the interest costs on outstanding debt are expected to

Table 3.10
The Debt Trap

(Rs in Billion)

Year	Level of Outstanding Debt	Percentage of GDP	Interest Payments on Debt	Percentage of GDP	Interest Rate (%)*	Interest Payments as % of Federal Net Revenue Receipts
2006-07	2610	30.1	368	4.2	14.1	44
2007-08	3274	32.0	490	4.8	15.0	52
2008-09	3861	30.3	637	5.0	16.5	53
2009-10	4654	31.4	642	4.3	13.8	48
2010-11	6012	33.3	698	3.9	11.6	61**
2011-12	7638	37.0	772	3.7	10.1	58
2012-13 (E)	9850	41.6	937	4.0	9.5	65
2013-14 (P)	11868	44.8	1130	4.2	9.4	68

*(interest payments/outstanding Debt) x 100%
**After 7th NFC Award

Source: Fiscal operations, Ministry of Finance (MoF) rise rapidly in 2012-13 by over 21 percent. They are likely to approach Rs 937 billion, equivalent to 4 percent of the GDP, and then rise to Rs 1130 billion in 2013-14. They will eat up over two-thirds of the net receipts of the federal government.

The debt trap can only be broken by herculean efforts to mobilize more revenues, contain current expenditure and diversify the sources of borrowing.

The Budget Strategy Paper

Just prior to the completion of the tenure of the previous Government, a Budget Strategy Paper (BSP) was presented to and approved by the Federal Cabinet. The salient features of the BSP include the following:

i) A FBR revenue target for 2013-14 of Rs 2830 billion. This is unrealistic as it requires a growth of 38 percent on the likely outcome in 2012-13.

ii) The fiscal target for 2013-14 has been fixed at 5.8 percent of the GDP, going down to 4.5 percent by 2015-16. This implies a deficit reduction in one year of as much as 2.5 percent of the GDP. This is very ambitious given the lack of buoyancy in revenues, large stock of circular debt in the power sector and, as highlighted above, rapidly increasing debt servicing liabilities.

iii) The Federal Public Sector Development Programme (PSDP) is set at Rs 450 billion for next year, a growth rate of 25 percent. It is unlikely that there will be enough fiscal space to accommodate this increase, although it is required given the large infrastructure gaps, especially in the power sector.

Overall, the targets embodied in the BSP appear infeasible. A more realistic, although still somewhat ambitious, path of adjustment is one which brings down the fiscal deficit annually by 1 percent of the GDP. As such the achievable target in 2013-14 is close to 7.0 percent of the GDP, down to 4.3 percent of the GDP by 2016-17.

THE SHORT-TERM STRATEGY FOR SURVIVAL

The previous sections have highlighted that the newly elected Government will have to take urgent policy actions, especially in the Budget of 2013-14, to address serious problems on the following two fronts:

i) Deteriorating BOP and Falling Foreign Exchange Reserves: by the beginning of June 2013, soon after the assumption of power by the new Government, foreign exchange reserves could be down to about $6 billion, providing import cover of less than 1.5 months, and there may be some speculative pressures on the Rupee. The policy focus will have to be on restoration of confidence to prevent any flight of capital, weakening in the flow of home remittances, etc. In addition steps will have to be taken to increase the external debt repayment capacity to sustain payments, especially to the IMF, by achieving in the short run a degree of import compression and over time expansion of exports.

ii) Burgeoning Fiscal Deficit: The need to reduce the large fiscal deficit, at over 8 percent of the GDP, will require, first, major changes in tax policy and tax administration to raise the all-time low tax-to-GDP ratio of FBR of 8.5 percent of the GDP in 2012-13, second, important structural moves in the power sector to reduce the tariff differential subsidy and target it better and, third, keep the costs of borrowing within manageable limits.

The steps required to manage the above-mentioned two problems are described below.

Fiscal Policy

The following actions are urgently required in the Budget of 2013-14.

Taxation

The possible measures that will contribute to making the tax system more equitable while raising significant additional revenues at the Federal and Provincial levels respectively are listed below:

1. Effective Agricultural Income Taxation (by Provincial Governments)
2. Curbing tax evasion in non-salaried incomes (see Chapter 2)
3. Taxation of Assets, as the Minimum Alternate Tax in Income Tax
4. Minimum Tax on Turnover of Companies (with carry forward provisions)
5. Withdrawal of Exemptions and Concessions (especially on capital gains, long tax holidays, SROs, etc.)
6. Integration of Income Tax Rates (same for high income persons, AOPs and companies)
7. Moving from Scheduler to Comprehensive Income Taxation
8. Development of the Property Tax (by Provincial Governments)
9. Providing Incentives for Filing of Returns
10. Introduction of a Broad-based Integrated VAT, through reforms in the existing GST
11. Introduction of International Trade Prices (ITPs) for levy of Customs Duties to check under invoicing.

The above taxation proposals have the potential of raising additional tax revenues of Rs 503 billion, over a period of implementation of two years, as given in Table 3.11.

Table 3.11
Revenue Yield* from Tax Reforms
(with tax base 2012-13)

DIRECT TAXES	Revenue Yield (Rs in Billion)
Effective Agricultural Income Taxation	30
Reduction in tax evasion in non-salaried incomes	100
Taxation of Assets	50
Minimum Tax on Turnover of Companies	22
Withdrawal of Tax Expenditures	65
Total	**267**
INDIRECT TAXES	
Introduction of a Broad-based Integrated VAT	140
Withdrawal of SROs in Customs Duties	96
Total	**236**
Overall Total	**503**
% of GDP	2.0

* in one to two years.
Source: Based on calculations by Authors, available on request

Expenditures

The newly elected government will have to review the following:

i) Targeting efficiency and incidence of bribes (see Chapter 7) in operations of Benazir Income Support Programme (BISP) through an independent Third Party Audit.

ii) On-going projects and allocations in the Peoples' Works Program.

iii) The need to build the 20 percent increase in salaries of Federal Secretariat employees into budget estimates for 2013-14.

iv) The size of the portfolio of projects, on-going and new, in the federal PSDP and to take steps to reduce the 'throw forward' of over Rs 2.5 trillion currently on the basis of objective criteria.

In addition, the following steps will need to be considered on the current expenditure side:

i) Imposition of a complete recruitment ban on Federal Ministries and Semi-Autonomous bodies

ii) Freeze of non-salary expenditure at the level prevailing in 2012-13

iii) Zero-based budgeting of new Ministries established at the Federal level following the 18th Amendment and transfer of staff in Ministries to be abolished to the surplus staff pool

iv) Review of all senior contractual appointments in Management Pay (MP) scales

The Planning Commission may also be asked to impose a moratorium on new projects submitted for approval through Central Development Working Party (CDWP) / Executive Committee of National Executive Council (ECNEC), except in priority sectors like power and irrigation.

In the power sector, major actions will need to be initiated to improve governance by, first, zero tolerance of defaulters and recovery of arrears from government entities, especially the Provincial Governments, by deductions at source. Second, through intensive efforts aimed at improving billing recovery rates and reducing transmission losses. The emphasis has to be on reducing costs and raising revenues at existing levels of revenues. Tariff increases of the type recommended by NEPRA may well prove to be very counterproductive if implemented.

As far as subsidies to other public sector entities like Pakistan Railways, Pakistan Steel Mills (PASMIC), PIA, etc., these have to be linked to a business plan prepared by the respective Boards which indicate clearly the improved performance targets to which release of subsidies should be linked.

Monetary Policy

The SBP today essentially faces an important trade off. It can either limit recourse to deficit financing or large OMO injections to Commercial Banks to enable the picking up of government paper and thereby restrict the degree of inflationary pressures and 'crowding out' of the private sector. Or it can following an accommodative monetary policy with low interest rates and put pressure on the rate of inflation and the exchange rate.

On balance, given the problems that are being faced in the raising of medium to long term domestic debt, the SBP may want to contemplate an upward adjustment in the policy rate back to the level of 12 percent in the subsequent two or three Monetary Policy Statements.

In addition, there is evidence of increasing appreciation of the Rupee (as indicated by the Real Effective Exchange Rate (REER)) despite a deterioration in the underlying fundamentals. The gap between the inter-bank and open market rate has widened. The SBP needs to consider if it should continue with its policy of 'overprotecting' the Rupee and thereby losing foreign exchange reserves in the process.

Improvements in Tax Administration

The serious management deficiencies in FBR have already been highlighted. These have become particularly visible this year. The importance of FBR as the prime tax collecting agency of the Government cannot be overemphasized. As such, the next Government will also have to initiate significant improvements in the tax administration at the Federal level, including possibly the following:

Improvements in Federal Tax Administration

a) Conversion of FBR into an autonomous Revenue Authority under a strengthened Board with external members
b) Strengthening of the Revenue Division through creation of a National Tax Police Office in the Federal Ministry of Finance for formulation of tax policy
c) Filing of asset declaration periodically by tax officials
d) Strengthening the Tax Ombudsman and vesting him/her with Judicial Powers
e) Internal strengthening of FBR in the areas of audit and intelligence
f) Development of a Data Warehouse linked particularly to withholding tax payments
g) Streamlining the process of payment of refunds
h) Augmenting the quality of human resources
i) Publishing a Tax Directory annually of payments by tax payers.

Further, the Provincial Governments will require some major improvements in tax administration, listed below, in order to raise their level of fiscal effort.

Improvements in Provincial Tax Administration

a) Reducing multiplicity of taxes with abolition of taxes like entertainment tax, tax on transfer of property, etc., with low yields.
b) Avoiding overlapping of taxes, for example, on property or income by ‘piggy-backing’ on federal taxes.
c) Merger of the Excise and Taxation Department with the Provincial Revenue Board/Authority, following process of screening of officials.
d) Intensive efforts at streamlining of business processes and introduction of information and communications technology, especially to enable e-filing of returns or making of payments.
e) Appointment of a Provincial Tax Ombudsman, also with judicial powers.
f) Augmenting the quality of human resources.
g) Publishing a Tax Directory of Payments of the AIT and UIPT.

Trade Policy

Pakistan’s imports have virtually quadrupled over the last decade and now are equivalent to 164 percent of exports, as compared to 103 percent in 2001-02. This was sustainable as long as remittances and the surplus on the financial account, due to large FDI and net foreign inflows, were adequate to finance the trade deficit. Now, with the financial account drying up and peak repayments due to the IMF, Pakistan has to implement a policy of import compression in the short run to reduce the trade deficit by over $2 billion, or approximately 5 percent.

This is feasible if the following policy is implemented:

i) No action restricting essential imports of petroleum oil and lubricants (POL), edible oil, medicines, pulses, vegetables, sugar (if any) and fertilizer. These items currently account for about 55 percent of total imports.
ii) The remaining 45 percent of imports, which are non-essential in character, should be brought temporarily (till the end of 2013-14 at the minimum) into the regime of regulatory duties.

This measure not only has the potential of reducing non-essential imports by almost $2 billion, it will also yield extra tax revenues of almost Rs 100 billion. This approach is preferred to a general depreciation of the exchange rate because it has less impact on the cost of living of the common man.

There is need to ensure that the regulatory duties on imported inputs are reflected in higher duty drawbacks on exports. Further, an export rebate of about 5 percent may be introduced on value added and emerging exports to compensate for higher domestic costs especially due to the high level of power loadshedding.

Rates of Regulatory Duty on Non-essential Imports

On goods with Satutory Rate	Percentage Points
0% to 5%	1
10%	2
15%	3
20%	4
25%	5
30%	6

In a somewhat longer time frame, given the current limited growth in world trade, policies for export promotion also need to be adopted. The medium term Trade Policy announced by the previous Government contains some useful proposals in this regard which are worthy of implementation.

Overall, the above combination of fiscal, monetary and trade policies has the potential of taking the economy out of the period of financial difficulties with an emphasis on self-reliance. Beyond 2013-14, when bulk of the money due to the IMF has been repaid, Pakistan can embark on the path of revival of the economy.

Dealing with The IMF

The New Government clearly has to first demonstrate its political will to pursue the path of self-reliance and adopt a strong ‘home grown’ package of reforms of the type described above. This will improve the country’s image, inspire more investor confidence and potentially create stability in the markets.

Most of the above-mentioned measures ought to be considered for implementation as part of the survival (stabilization) strategy in the first Budget for 2013-14 of the newly elected Government. Recourse to the IMF should be only in the nature of the last resort.

Chapter - 4

Power Loadshedding: A Major Impediment to Revival

Chapter - 4
Power Loadshedding: A Major Impediment to Revival*

The objectives of this chapter are to present the key trends and facts about the power sector of Pakistan. This will highlight the contribution of different factors to the emergence of high levels of loadshedding in the country and the impact thereof on the economy.

The chapter is organized as follows: Section 1 presents an inter-country comparison of access to electricity in order to highlight the relative level of development of the power sector of Pakistan. Section 2 identifies the long term trends in the sector and the growth in and pattern of electricity consumption, along with the emerging supply gap in the provision of power. Section 3 gives the methodologies that can be used to derive the economic impact of power outages. Section 4 presents earlier estimates and Section 5, our estimates of the national cost of outages as of 2011-12.

INTERNATIONAL COMPARISONS OF THE POWER SECTOR

A comparison is made of key indicators of the power sector in different Asian countries, both in South Asia and East Asia. There is apparently a strong correlation between per capita electricity consumption and the level of development. Pakistan has both relatively low energy consumption and per capita income as compared to India and Sri Lanka in South Asia and virtually all East Asian countries.

The somewhat early stage of development of the power sector in Pakistan is indicated in Table 4.1 by the low share of population with access to electricity at 62 percent, as compared to 66 percent in India, 77 percent in Sri Lanka, 90 percent in the Philippines and 99 percent in Malaysia.

It is also observed that the energy intensity in production increases as development takes place. This is confirmed by Table 4.1 which shows that the GDP per kWh is $2.3 in China as compared to $11.5 in an LDC like Nepal. Pakistan is at an intermediate level at $5.3 per kWh.

The level and sources of electricity generation and magnitude of system losses (in transmission and distribution) are presented in Table 4.2. There is a wide variation among countries in sources

*This chapter has been contributed by Dr. Aisha Ghaus-Pasha and Dr. Hafiz A. Pasha.

Table 4.1
Indicators of Electricity Consumption in Selected Countries
(2009)

	Per Capita GDP, PPP (at Constant 2005 Prices)	Percent of Population with Access to	Electricity Consumption per Capita	GDP per KWh ($)
Bangladesh	1419	41.0	251.6	5.64
China	6206	99.4	2631.4	2.36
India	2813	66.3	570.9	4.93
Indonesia	3696	64.5	590.2	6.26
Malaysia	12526	99.4	3613.5	3.47
Nepal	1048	43.6	91.0	11.52
Pakistan	2357	62.4	449.3	5.25
Philippines	3364	89.7	593.5	5.67
Sri Lanka	4301	76.6	412.9	10.42
Thailand	7160	99.3	2044.8	3.50
Vietnam	2721	97.6	917.6	2.96

Source: World Bank, WDI.

Table 4.2
Level and Sources of Electricity Generation and System Losses
in Selected Countries - 2009

	Per Capita Electricity Production (KWh)	Sources of Electricity (%)					System Losses (%)
		Coal (1)	Hydro (2)	Gas (3)	Nuclear (4)	Oil (5)	
Bangladesh	257.6	1.7	4.1	89.4	0.0	4.8	2.3
China	2776.0	78.8	16.7	1.4	1.9	0.4	5.2
India	744.7	68.6	11.9	12.4	2.1	2.9	23.3
Indonesia	654.9	41.8	7.3	22.1	0.0	22.8	9.9
Malaysia	3759.7	30.9	6.3	60.7	0.0	2.0	3.9
Nepal	106.1	0.0	99.6	0.0	0.0	0.4	14.2
Pakistan	559.2	0.1	29.4	29.4	3.0	38.0	19.7
Philippines	675.3	26.6	15.8	32.1	0.0	8.7	12.1
Sri Lanka	483.3	0.0	39.5	0.0	0.0	60.3	14.6
Thailand	2159.9	19.9	4.8	70.7	0.0	0.5	5.3
Vietnam	967.3	18.0	36.0	43.4	0.0	2.5	5.1

Source: World Bank, WDI.

of power. Countries which rely most on coal include China, India and Indonesia. Hydroelectricity is the dominant source in Nepal, which given its location in proximity to the Himalayas has enormous untapped potential for hydro-electricity, like Pakistan.

Gas is the principal source in Bangladesh, Malaysia, the Philippines, Thailand, and Vietnam until recently, Pakistan. Thermal power has emerged as a major source in Sri Lanka and Pakistan.

The pattern of sources of electricity of Pakistan exposes the country to two major risks. Dependence on gas at a time when reserves are depleting implies severe constraints in the medium to long run and the need to switch to other sources. The growing reliance on thermal power exposes the economy to 'oil price shocks'.

Turning to system losses, a key indicator of efficiency, both India and Pakistan do poorly at 23 percent and 20 percent respectively. Even an LDC like Bangladesh performs much better with only marginal losses. Similarly, other countries like China, Malaysia, Thailand and Vietnam have been successful in containing system losses.

LONG-TERM TRENDS IN POWER SECTOR

The growth in installed capacity and generation of electricity in Pakistan is presented in Table 4.3. The former has been more than doubling every decade up to 2000-01, with annual growth rate over 7 percent. It is only during the last decade that the rate of expansion in capacity has substantially slowed down to less than 3 percent per annum. In the initial years of the decade there was significant excess capacity, due to the hump in investment by the IPPs in the mid-to late-90s. But adequate provisions were not made to cater for the future growth in demand.

The growth in electricity generation was rapid in the 70s and 80s. In particular, the commissioning of the Tarbela Dam in the early 80s enabled a quantum jump in supplies at low cost. During the 90s as the growth rate of the economy slowed down, the demand for electricity was not so buoyant and the rate of increase annually in power generation declined to 5 percent. During the last decade, this has fallen further to only 3 percent.

An index of capacity utilization[1] is constructed in Table 4.3. The rate of capacity utilization exceeded 100 percent by 1990-91 and the loadshedding which occurred in a significant way in the mid-to-late-80s can be attributed to a shortage of capacity. It was during this period that the

Table 4.3
Long-Term Trend in Capacity and Generation in Pakistan of Electricity
1970-71 to 2011-12

	Installed Capacity (MW)	Annual Growth Rate (%)	Electricity Generation (GWH)	Annual Growth Rate (%)	Index of Capacity Utilization (%)
1970-71	1862		7202		81
1980-81	4105	8.2	16062	8.4	82
1990-91	8356	7.4	41042	9.8	102
2000-01	17498	7.7	68117	5.2	81
2011-12	23358	2.7	98664	3.4	88

Source: Handbook of Statistics, SBP, Pakistan Economic Survey, MoF, GoP first study in Pakistan on costs of loadshedding was undertaken by Pasha, Ghaus and Malik [1989]. As opposed to this, the upsurge in loadshedding once again since 2007-08 can be attributed primarily to a lack of full capacity utilization arising from lack of adequate maintenance of older plants and liquidity problems due to the ballooning of circular debt and to the slow expansion in capacity.

The growth in electricity consumption by type of consumer during the last decade is presented in Table 4.4. The analysis is broken up into two sub-periods, the years prior to commencement of significant loadshedding in 2007-08 and the years thereafter. In the latter period, the overall level of power consumption has declined with marginal growth only in the case of industrial consumers.

Table 4.4
Growth in Electricity Consumption from 2000-01 to 2011-12

(GWH)

	Domestic	Industrial	Commercial	Agricultural	Others*	Total
2000-01	22765	14349	1774	4924	3773	48585
2007-08	33704	20129	5572	8472	4923	73400
2011-12	33138	21334	5526	8290	4760	73084
Growth Rate (%)						
2000-01 to 2007-08	5.8	5.4	10.5	8.1	6.7	6.1
2007-08 to 2010-11	2.1	0.8	0.5	1.9	2.2	1.6
2001-01 to 2011-12	-0.4	1.5	-0.2	-0.5	-0.7	-0.2

*mostly government, street lights and traction
Source: Pakistan Economic Survey (Various Issues)

The Supply Gap

The surplus/deficit between demand and supply during system peak hours for NTDC and KESC combined is given Table 4.5. The supply gap was 1912 MW in 2007 which has risen to 6518 MW, equivalent to 29 percent of demand. It is important to note that in 2011-12, NEPRA reports the generation capability as less than 70 percent of the installed capacity.

According to NEPRA, the highest incidence of outages regionally is in the area served by MEPCO, PESCO and LESCO. The least outages are in IESCO. Most areas of Punjab and K-PK are more vulnerable to loadshedding.

Table 4.5
Surplus/Deficit in Demand and Supply during System* Peak Hours

	Generation Capacity	Demand	Supply-Gap	Percent
2007	15575	17487	-1912	11
2008	14707	19281	-4574	24
2009	16050	20304	-4254	26
2012	16104	22622	-6518	29

* NTDC and KESC combined

Source: NEPRA, State of Industry Report

METHODOLOGY FOR ESTIMATING IMPACT OF LOADSHEDDING

Various approaches have been developed in the literature for quantification of the cost incurred by different types of consumers as a result of power outages. The approaches indicated below rely only on secondary data.

The Simple Value Added Approach

A relatively high estimate of the cost of loadshedding is as follows:

V_i = Value added by sector i in absence of loadshedding
E_i = Electricity consumption in the absence of loadshedding

Then the cost C_i, of loadshedding is given by

$$C_i = \frac{V_i}{E_i} I_i \quad \text{...... ....} \quad [1]$$

Where I_i is the quantum of electricity not supplied due to outages. Summing across sectors, the total cost of loadshedding is given by

$$C_i = \sum_{i=1}^{n} \frac{V_i}{E_i} I_i \quad \text{...... ....} \quad [2]$$

Where n is the number of sectors.

This approach can be applied on the production sectors of the economy, viz, agriculture, industry and commerce, but not to domestic consumption of electricity.

The reasons why this approach leads to a high estimate of the cost of loadshedding are as follows:

(i) It does not distinguish between the average and marginal productivity of the electricity input, that is, there could be some economies of scale in the use of energy.

(ii) It assumes that output lost is proportional to the extent of electricity not supplied and the firms do not make adjustments to recover at least part of the output.

As opposed to the above, an approach that yields a low estimate is one which focuses only the wage cost, on the assumption that the idle factor during outages is labour. As such, in this case

$$C_i = \frac{W_i}{E_i} I_i \quad \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \quad [3]$$

Where Wi is the wage bill.

The Adjusted Value Added Approach

This approach postulates that the marginal cost of unsupplied elasticity is different from the average cost as given in (1) above. Accordingly,

$$\frac{\partial V_i}{\partial E_i} = \beta \frac{V_i}{E_i} I_i \qquad \beta > 0 \quad \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \ldots\ldots \quad [4]$$

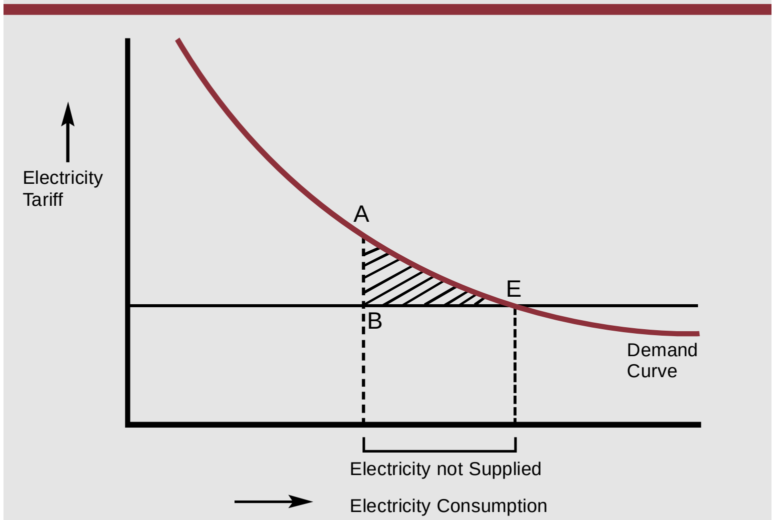
β is estimated on the basis of the historical relationship between value added and electricity consumption. Generally, it is observed that $\beta < 1$.

However, the value added approaches suffer from the defect that they do not allow for spoilage costs arising from damage to mat`erials that takes place at the time when the outage occurs, especially if there is no prior notice.

The Consumer Surplus Approach

This is a relatively popular approach and has been applied by Sanghvi [1982]. The demand curve for electricity captures the willingness to pay for the service and the consumer surplus of electricity supply is represented by the area between the demand and supply curves. The loss of consumer surplus due to supply interruptions is represented by the shaded area, **ABE**, in Box 4.1.

Box 4.1
Loss of Consumer Surplus Due to Outages



The prime magnitude required for application of this approach is the price elasticity of demand, which is not possible to measure in the presence of outages. Also, given a non-linear schedule of power tariffs, as is the case with residential consumers in Pakistan, the magnitude of the consumer surplus lost due to outages becomes difficult to quantify. Further, if AB is large then the consumer may be able to reduce the loss by investing in self-generation. This becomes more attractive the larger the amount of electricity not supplied.

EARLIER ESTIMATES OF COSTS OF LOADSHEDDING

We summarize below the results of various studies in Pakistan undertaken earlier to quantify the costs of load shedding.

The Pasha, Ghaus and Malik Study

This study was undertaken in 1987 when loadshedding first emerged as a problem.The study involved an in-depth survey of 843 units, randomly selected from different locations in Pakistan. Table 4.6 reveals the distribution of costs due to power outages, with differentiation between planned and unplanned outages.

Table 4.6
Break-up of Outage Costs

(% of units)

	Planned Outages	Unplanned Outages
Direct Cost	**87.8**	**89.1**
Spoilage Cost	54.8	54.7
Idle Factor Cost	33.0	34.4
Indirect Cost	**12.6**	**10.1**
Labor Related Cost[a]	3.2	5.3
Capital Related Cost[b]	8.4	5.8
Timing Related Cost[c]	1.0	0.0
Total Cost	**100.0**	**100.0**

[a]Cost of additional overtime or shifts
[b]Cost of generators or more intensive operation of machinery
[c]Cost of changes in shift timings or working days

Source: Pasha, Ghaus and Malik (1987)

The bulk of the costs, as shown in Table 4.6, were in the form of direct costs, including spoilage and idle factor costs. Adjustment (indirect) costs were limited, especially since, at the time of the survey, only 12 percent of the units had acquired self-generation capacity. Other adjustments included overtime work by 26 percent of units, working additional shifts by 8 percent and changing shift timings or working days by 2 percent respectively.

The estimated cost of loadshedding per kWh in different industries is given in Table 4.7, from which emerge a number of key conclusions. First, the outage costs due to unplanned outages were substantially higher, by 75 percent, in relation to costs associated with planned outages. Second, outage costs in continuous process industries were five to six times higher than in batch-making industries. Third, there is substantial variation in outage costs among industries, ranging from a minimum of 24 cents to 185 cents per kWh.

Overall, it appears that in 1987 the average cost of outages to industrial consumers in Pakistan was approximately 50 cents per kWh.

Table 4.7
Cost of Planned and Unplanned Outages per kWh in different Industries

Cents/kWh

	Planned Outages	Unplanned Outages
INDUSTRY GROUP		
Food, Beverages and Tobacco	54	164
Textiles	23	29
Wearing Apparel &Footwear	62	70
Chemicals	57	102
Wood and Paper	69	178
Non-Metallic Mineral Products	23	24
Metal and Metal Products	35	72
Machinery and Equipment	139	185
Other Industries	29	54
BY PROCESS		
Batch-making	20	38
Continuous Process	119	200
TOTAL	**36**	**63**

Source: Pasha, Ghaus and Malik (1987)

The IPP Study

This study was undertaken in 2009, when concerns started being voiced about the alarming rise in loadshedding in the country, especially in Punjab. The sample was substantially lower, due to budget constraints, at 65 and limited only to large–scale industrial units in the major cities of Punjab.

The survey revealed that the level of load shedding were substantially higher at over five times the level prevailing in the mid-80s. It was estimated at an average of 3.8 hours per day, with the peak level being observed during the months of December to March. The sample firms reported that over 20 percent of the time that they could have been in production was lost due to loadshedding.

The incidence of adjustments was greater than in 1987 due to the high level of loadshedding. 75 percent of the firms were engaged in self-generation; 18 percent worked more overtime and 15 percent worked additional shifts.

The value added loss was considerably larger for units without self-generation. The overall cost of loadshedding to industry was estimated at Rs 230 billion equivalent to over 9 percent of national value added by industry.

The implied outage cost per kWh was estimated at approximately at 50 cents. This is close to the 1987 estimate, despite higher incidence of load shedding and more frequent adjustments.

The PIDE Study

This study was undertaken by R. Siddiqui, H. H. Jalil, M. Nasir, W.S. Malik and M. Khalid of PIDE and published in 2011. A survey was undertaken of 339 firms in four cities of Punjab. It excluded small units (employing 10 or less workers).

The study estimated that the sample units on average lost 3.3 hours per day. This is close to the 2009 estimate by IPP. Almost 25 percent of the firms lost more than 5 hours a day.

In terms of adjustments, this survey also revealed a high frequency, with 76 percent of the units having opted for stand-by generators. 69 percent of sample firms reported delays in delivery of orders.

The methodology used for quantifying the cost of loadshedding consisted primarily of deriving the idle factor cost of labour only and excluding spoilage or other adjustment costs. As such, the cost is understated. The cost is estimated on the basis of assumed length of shift at 8, 10, or 12 hours.

The resulting loss in value of production is estimated at Rs 400 billion for Punjab with an 8 hour shift and Rs 267 billion with 12 hour shift. Conversion to value added and blowing up the sample for Pakistan as a whole, the estimate of cost of loadshedding is Rs 176 billion for the large-scale manufacturing sector, equivalent to 12 percent of the total national value added by the sector. As such, this estimate is somewhat higher than that by IPP in 2009.

The above studies enable the following conclusions:

(i) Loadshedding has risen to unprecedented levels in recent years and on average, firms have experienced outages between 20 to 30 percent of their working hours.

(ii) Adjustments of various types have been made by a high proportion of firms, including investment in self-generation by over three-fourths of the units.

(iii) The costs of loadshedding to industry have reached a high level, equivalent to 9 percent or more of national sectoral value added or almost 2 percent of the GDP. These losses have been accompanied by significant declines in profitability, employment and exports.

(iv) The average cost of outages to industry is about 50 cents per kWh. This is high in relation to the existing level of power tariffs. But it is low by international standards.

ESTIMATED IMPACT

Incidence of Loadshedding

The high incidence of power outages is reflected in the sharp decline in electricity consumption by all types of consumers between 2007-08 and 2011-12, as shown in Table 4.8. Cumulatively,

Table 4.8
Percentage Change in Average Annual Electricity Consumption per Consumer
(Cumulatively from 2007-08 to 2001-12)

	Domestic	Commercial	Industrial	Agricultural	Total
PESCO	-20	12	0	-37	-14
IESCO	-8	-12	-17	-12	-12
GEPCO	-13	-11	-17	-15	-12
LESCO	-15	-12	-5	-4	10
FESCO					
MEPCO	-13	-2	-5	-19	-11
HESCO	10	24	4	18	8
QESCO	5	-18	-29	-6	-11
KESC	-2	-6	-1	13	-6
Total PEPCO	**-16**	**-9**	**-12**	**-17**	**-15**
PAKISTAN	**-14**	**-8**	**-10**	**-16**	**-14**

Source: NEPRA

for all consumers, the electricity consumption per consumer has fallen by 14 percent. This compares with an increase between 2003-04 and 2007-08 of almost 16 percent. The latter is an indicator of the normal growth in consumption in the absence of loadshedding. As such, the level of consumption, if there had been no outages, is about 30 percent higher than the observed level of consumption. This is the assumed extent of loadshedding in 2011-12.

Three approaches have been adopted, relying solely on secondary data, to estimate the national cost of power loadhsedding, as follows:

- Adjusted value added approach
- Relationship between growth of GDP and power generation
- Consumer Surplus approach

The resulting estimates are given below.

Adjusted Value Added Approach

This approach has been described above. The magnitude of β is estimated by econometric analysis on historical data for the period when there were no significant outages.

With the adjusted approach, according to Table 4.9 the total cost of loadshedding is estimated at Rs 1228 billion in 2011-12, inclusive of the negative multiplier impact. This is a large magnitude and demonstrates that the economy has had to pay a high cost for loadshedding. 45 percent cost has been borne by the industrial and commercial sectors each and 10 percent by agriculture.

Table 4.9
Cost of Outages with the Adjusted Value Added Approach 2011-12

	β	Outage Cost per KWh (Rs)	Quantity of Electricity not Not Supplied	Cost of Ourage (Rs in Billion)
		With 30 percent time loss due to outages		
Agriculture	0.050	23.90	3495	83.5
Industry	0.196	45.52	9143	416.2
Commerce/Services	0.092	94.20	4424	416.7
Total of above			**10304**	**916.4**
Negative Multiplier effect				**311.6**
			Total	**1228.0**

Source: IPP estimates

Relationship between Growth of GDP and Power Generation

A new variant of the value added approach has been developed for this study for the quantification of outage costs, which focuses on the relationship between development of infrastructure and economic growth. The former includes electricity generation. The relationship is estimated of GDP per capita growth rate with, through on OLS regression, the following explanatory variables:

Agricultural Growth Rate	=	AGR
Private Investment as percent of GDP	=	PRI
Growth Rate of Electricity Generation per Capita	=	EGE
Growth Rate of Water Availability (in agriculture)	=	WAV

It appears that a 1 percent increase in electricity generation per capita leads to a 0.167 percent increase in per capita GDP. The next step in the analysis is to compare the actual growth rate of electricity generation per capita from 2007-08 with the growth rate historically during the period when there was minimal loadshedding. Given the coefficient of 0.167, the impact on the GDP per capita of a slowdown in the process of electricity generation, which has led to outages, can be determined. The divergence in GDP growth rates is presented in Table 4.10.

The difference in the projected and actual GDP is the economic cost of loadshedding. It has risen exponentially according to this approach from Rs 135 billion in 2007-08 to Rs 1347 billion by 2011-12.

Table 4.10
Projected GDP (at factor cost) in the Absence of Loadshedding Compared to Actual GDP

(Rs in Billion)

	Actual per Capita Growth Rate of Electricity Generation (%)	Historical per Capita Growth Rate of Electricity Generation (%)	Difference (%)	Actual per Capita GDP Growth Rate (%)	Projected GDP per Capita Growth Rate (%)	Actual GDP at Current Prices	Projected GDP at Current Prices	Cost of Outages
2007-08	-5.0	4.0	-9.0	1.6	3.1	9922	10067	135
2008-09	-6.1	4.0	-10.1	-0.4	1.3	12110	12490	380
2009-10	1.9	4.0	-2.1	1.0	1.4	14034	14471	437
2010-11	-3.0	4.0	-7.0	0.9	2.1	17093	17910	817
2011-12	-4.1	4.0	-8.1	1.6	3.4	19437	20784	1347

Source: IPP estimates.

Consumer Surplus Approach

The application of the consumer surplus approach requires knowledge of the price elasticity of demand. Box 4.2 presents the estimates of this elasticity for a number of developing countries. The short-run elasticity is taken for the analysis. It appears that the elasticity is generally low, especially in countries like Turkey, Israel, South Africa, etc. The estimate of -0.13 by Jamil and Ahmed [2010] for Pakistan is used for the analysis.

The other assumption that has to be made relates to the demand that would have been observed in the absence of outage at the existing power tariff. Consumers have been exposed to loadshedding for 30 percent of their working hours. As such, it is assumed that unconstrained demand would have been at least 30 percent higher in comparison to the observed level.

Box 4.2
Price Elasticity of Demand for Electricity
(All Consumers Combined) in Different Studies

	Author	Country	Price Elasticity (short-run)
1	Al Faris [2002]	GCC Country	-0.11
2	Bose & Shula [1999]	India	-0.34
3	Narayan [2007]	Seven Countries	-0.06
4	Zchariadis and Pashaurtidou [2006]	Cyprus	-0.02
5	Lin [2003]	China	0.18
6	Erkan [2007]	Turkey	-0.04
7	Beenstock [1999]	Israel	-0.01
8	Ziramba [2008]	South Africa	-0.02
9	Jamil and Ahmed [2010]	Pakistan	-0.13

The existing effective average tariff for all consumers combined is about Rs 9 per KWh. Inclusive of the GST, withholding income tax and FAC raises it to almost Rs 13 per KWh. This is the price used for the analysis.

The estimated magnitude of the consumer surplus is Rs 927 billion in 2011-12. Inclusion of the negative multiplier effect, raises the cost of loadshedding in this approach to Rs 1242 billion. Therefore, secondary data based approaches to quantification of economic cost of loadshedding lead to the following results:

Approach	Cost of Loadshedding, 2011-12
Adjusted value added	1228
Relationship between growth of GDP and power generation	1347
The consumer surplus approach	1242
Average	**1247**
Percent of GDP	**6.1**

The bottom line is that power loadshedding is imposing a large cost on the economy of Rs 1272 billion in 2011-12, equivalent to over 6 percent of economy. This implies that the growth rate of the economy could have been 1.5 percentage points higher, that is, at 4.5 percent, if there had been no loadshedding. The solutions to this problem, both in the short run and in the long run, have been discussed in Chapters 5 and 6.

Chapter - 5

The Revival Strategy: Industry the Leading Sector

Chapter - 5
The Revival Strategy: Industry the Leading Sector*

The experience of developing countries is that in the process of achieving a higher rate of economic growth, the industrial sector has to play a leading role. In the context of the history of Pakistan, decades like the 60s, 80s and mid-years of the last decade when the GDP growth rate rose to above 6 percent, the large-scale manufacturing sector grew even faster by over two to three percentage points.

Therefore, any strategy for revival must focus on the process of achieving faster growth in the manufacturing sector. Pakistan will need to do this as the country makes a transition from survival to revival within the next two years.

This chapter first highlights the key objectives of any future Industrial Policy (IP) of the country. This is followed by a review of the state of industry today. Proposals are then presented for achieving revival of industry, including improving the supply of energy, adopting a cluster based approach, attracting FDI, reducing costs of doing business and enabling a more effective role for the Provincial Governments in the process of industrial development.

GOALS OF INDUSTRIAL POLICY

From the government and the people's perspective, the aims and objectives of the industrial policy need to be very clear, in that the policies should aim to achieve the following:

- Create employment
- Enhance government revenue
- Support value addition
- Reduce the imbalance in foreign trade through focus on increasing national exports
- Achieve the right mix between private and the public sector entities
- Speed up growth of the small and medium size enterprises (SME)
- Strike a balance between governmental oversight and the free (self-regulating) market.
- Ensure compliance with international standards and the required international compliance certification. This can be Pakistan’s strength going forward as our trade enhances within South Asia in general, and with India in particular.

*This chapter has been contributed by Dr. Kamal Mannoo

- Cater for social responsibility
- Be based on good corporate governance
- Promote a fair distribution of return
- Be environmentally friendly (Green)

Looking at our neighbour India, we see that it has been single mindedly promoting industry in all of the last six Five Year Plans (FYP) announced so far. Realizing that the small and medium sized enterprises (considered to be the backbone of industry and employment generation in any economy) can only flourish meaningfully when there is also a commensurate development of the large-scale industry, India has made sure that its latest FYP also focuses mainly on linkages between all sizes of industry in the Indian economy. It is a good example for us to follow and to improve upon, in accordance with our needs and requirements. Perhaps we can also include the following objectives:

- Accelerated growth and optimal realization of economic benefits from the network of industries already in place.
- Rapid industrialization within the provinces, albeit with a conscious effort on diversification.
- Promotion of rural industries for which separate incentives need to be devised in order to ameliorate the economic condition of the weaker section of the society.
- Special incentives for setting up industries per se.

STATE OF INDUSTRY

The large-scale manufacturing sector led the process of economic revival in the latter part of the Musharraf Era, from 2002-2003 to 2007-2008. This was facilitated by a supportive business environment and expansionary macroeconomic policies, especially by a sharp reduction in interest rates and increase in bank credit to the private sector. In addition, tax rates were brought down to promote a supply-side response. Exports of manufactured goods also performed well.

The initial success of this strategy was due to the considerable excess capacity that existed at the time in key industries like textiles, sugar, fertilizer, cement and automobiles. This capacity had been created earlier in the investment boom that had occurred in the first Nawaz Sharif government in response to policies of privatization, liberalization and deregulation. The second jump in investment took place in the late 90s due to the liberalization and enhancement of fiscal incentives in the Investment policy, which encouraged the expansion of capacity, especially in textiles.

Further, the substantial power generation capacity that had been created by Independent Power Plants (IPPs) in the mid-90s under the attractive Power Policy of the second Benazir Bhutto government meant that there was enough electricity available to permit a big spurt in growth initially. This also enabled new investment which pushed capital formation by industry to almost 4 percent of the GDP by 2006-07.

Consequently, in the initial phase of revival, expansionary policies translated more into increases in output and less into higher prices. The danger is that since 2007-08, continuation of such policies would be translated into higher inflation, given the emergence of supply-side constraints, especially of availability of power and gas. Also, initially after entering into a large IMF Standby Facility, Pakistan had to pursue stabilization policies, which meant a hike in interest rates and a squeeze on development expenditure.

The collapse in the growth rates of individual industries since 2006-07 is clearly visible in Table 5.1. In comparison to the annual growth rate between 2003-04 and 2006-07, the growth rate in the latter period, 2007-08 to 2010-12, has fallen in 19 out of 23 industries reported in the Table. The biggest declines in growth rates are observed in recent years in cement, paints and varnishes, coke, billets cars and tractors. In fact, as many as 15 industries have experienced an absolute fall in production during the last four years.

During the first seven months of the current financial year, eleven industries continue to show negative growth, with the sharpest declines in fertilizer, sugar,

Table 5.1
Growth Rates of Output in Selected Industries in Different Periods

Industry	Annual Growth Rate (%) 2003-04 to 2007-08	2007-08 to 2011-12	1st Seven Months 2012-13
1. Cigarettes	5.0	-2.5	5.7
2. Cotton Yarn	9.8	1.4	0.8
3. Cotton Cloth	10.4	0.2	0.0
4. Urea	2.7	-2.5	-9.1
5. Vegetable Ghee	6.4	-0.7	2.2
6. Sugar	4.2	0.4	-9.1
7. Cement	20.1	1.6	5.0
8. Motor Tyres	7.8	-0.1	25.9
9. Soda Ash	6.2	-0.5	-0.2
10. Caustic Soda	7.2	-8.9	9.5
11. Paints and Varnishes	48.5	-5.2	29.4
12. Bicycles	-5.3	-18.3	-0.2
13. Sewing Machines	13.1	-6.7	-24.8
14. TV Sets	-4.0	-17.5	-67.2
15. Electric Bulbs	-1.7	-10.8	-14.3
16. Paper Board	0.2	0.7	32.6
17. Paper	5.3	5.7	n.a.
18. Coke	-22.0	-10.7	n.a.
19. Pig Iron	-4.2	-28.4	-35.4
20. Billets	10.7	-19.2	-1.0
21. Cars	13.5	-3.0	-23.4
22. Motor Cycles	34.0	11.9	-3.0
23. Tractors	10.4	-9.6	104.9

Source: Pakistan Economic Survey

Table 5.2
Trend in Factors Influencing Industrial Growth in Different Periods

Year	Annual Growth Rate of Large-Scale Manufacturing (%)	Electricity Consumption Growth Rate (%)	Manufactured Exports Growth Rate (%)	Public Sector Dev. Expenditure Growth Rate (%)	Interest Rate on Bank Advances (%)
2000-01	11.0	8.3	9.1	7.3	13.1
2001-02	3.5	5.6	2.3	-24.5	13.0
2002-03	7.2	7.3	19.1	0.0	11.8
2003-04	18.1	7.4	13.8	-1.0	8.4
2004-05	19.9	6.9	16.1	5.6	7.0
2005-06	8.3	6.4	13.8	10.5	9.7
2006-07	8.7	6.6	4.4	23.7	11.2
2007-08	4.0	-1.9	18.0	8.2	12.5
2008-09	-8.2	-6.8	-6.4	-19.1	13.5
2009-10	4.4	2.6	2.9	-14.8	12.2
2010-11	1.1	7.0	28.9	-1.8	12.0
2011-12	1.8	-10.3	2.4	-1.6	11.8
Averages Annual (%)					
2001-02 to 2006-07	11.0	6.9	11.2	3.1	10.6
2007-08 to 2011-12	0.6	-1.9	9.2	-5.8	12.4

Source: PES.

electrical appliances, iron and steel and cars. However, industries which are showing the first signs of recovery are cigarettes, tyres, paints and varnishes, paper board and tractors.

The trend in factors which influence industrial growth is presented in Table 5.2. The importance of energy supplies is clearly demonstrated. Between 2000-01 to 2006-07, the annual increase in electricity consumption by industry was almost 7 percent, which has changed to a negative growth rate of 2 percent after 2007-08. Clearly, the supply constraint arising from high and increasing levels of power loadshedding has been a major factor retarding the process of industrial growth.

Other factors include the moderation somewhat in export growth, especially as the world economy and trade have come in the grips of a slowdown. Also, public sector investment levels have fallen steeply and there is evidence that this ‘crowds in’ private investment in Pakistan. Further, interest rates on bank advances have been least two percent points higher.

In the face of slow growth it is not surprising that the level of private investment in large-scale manufacturing has also fallen sharply from peak level of 3.4 percent of the GDP in 2005-06 to a low of 0.7 percent of the GDP by 2011-12. The question is: what is the extent of excess capacity in industry today?

Table 5.3
Rate of Capacity Utilization in Selected Industries

S.No.	Items	Units of Measure	Annual Installed Capacity (000)	2010-11 (July - June) % Capacity Utilization	2011-12 (July - January) % Capacity Utilization
1	Sugar	Th. Tonnes	7	61	75
2	Cigarettes	Mln Nos	96	68	62
3	Cotton Yarn	Th. Kg	3,240	91	92
4	Cotton Cloth	Th. M^2	12,644	71	72
5	Jute Hessian	Tonnes	24	76	78
6	Jute Sacking	Tonnes	120	52	49
7	Jute Others	Tonnes	36	34	34
8-11	Paper & Paper Board	Tonnes	900	48	55
12	Chip Board	Tonnes	95	29	30
13	Sodah Ash	Tonnes	500	76	73
14	Caustic Soda	Tonnes	230	75	74
15-21	Fertilizer	Tonnes	7,264	83	83
22	Glass Sheet	Tonnes	71	19	20
23	Cement	Th.M^2	41	69	68
24	Bicycles	Th. Tonnes	700	49	33
25	Coke	Nos	970	31	19
26	Pig Iron/ H.Metal	Tonnes	1,230	35	22
27	Cast / Rolled Billet	Tonnes	660	1	0
28	Hr. Coils/ Plates	Tonnes	792	45	25
29	Cr. Coils	Tonnes	210	42	14
30	Glav Products	Tonnes	100	3	0
31-33	Cars/LCVs/Jeeps	Tonnes	280	55	58
34-35	Trucks/Buses	Nos	25	13	12
36	Tractors	Nos	75	94	34
37	Motor Cycles	Nos	2,935	56	56

Source: PES

The current rates of capacity utilization, as estimated by the Ministry of Industries and Production, in 37 selected industries are given in Table 5.3. It turns out that a significant margin of excess capacity does exist in many of the major industries. The rate of capacity utilisation is 75 percent in sugar, 62 percent in cigarettes, 72 percent in cotton cloth, 83 percent in fertilizer, 68 percent in cement, 22 percent in pig iron, 57 percent in cars/jeeps, 34 percent in tractors and 56 percent in motor-cycles.

Therefore, as in the Musharraf period, the thrust in the initial stages of industrial revival should be on effective utilization of the excess capacity already available. But unlike the previous period of recovery when reliance was placed on a demand stimulus, this will have to be achieved by focusing this time on the supply-side, especially by improving the availability of electricity and gas to industry.

Beyond the enhancement of production from existing units, the second stage in the industrial revival will inevitably involve a rise in private sector investment in manufacturing. But this will have to wait till there is enough space in the external balance of payments to permit higher imports of machinery. This can only happen from 2014-15 onwards, when the bulk of the large IMF loan will be repaid and the fiscal situation also improves significantly so that more bank credit becomes available to the private sector.

ENERGY FOR INDUSTRY

Solving the Energy/Power Crisis requires resort to an optimization plan of utilization of available resources in the short-term while simultaneously embarking on a comprehensive long-term vision that tackles the crisis from all angles. This entails: adequately covering the cost of generation, arriving at an optimal mix of power generation through different sources, prioritizing supply of existing natural gas in the system to favour power generation, undertaking structural reforms in the power sector to allow more space to the private sector and to encourage private-public partnerships in the sector, introducing other types of gases Liquefied Natural Gas (LNG) in the national system, and supporting alternate and renewable power generation options.

India, for example, has clearly established its priority for the natural gas available at its disposal, which is to use it primarily for generating electricity and producing fertilizer. Bangladesh also tends to follow a similar strategy, with the difference being that it single-mindedly focuses on power generation, which then is supplied on priority to industry and that too at a lower tariff rate when compared to the average power tariff rate in South Asia.

The low priority attached in the load management strategy by Distribution Companies (DISCOs) to industry, even though costs of loadshedding per kWh (see Chapter 4) are relatively high, is shown in Table 5.4. Between 2007-08 and 2011-12, the share of industry in total electricity consumption has fallen from over 28 percent to 26 percent, with diversion of supplies primarily to government and other consumers.

Table 5.4
Share of Different Types of Consumers in Gas and Electricity Consumption

	Share in Gas Consumption (%)		Share in Electricity Consumption (%)	
	2007-08	2011-12**	2007-08	2011-12
Household	16.0	21.5	45.9	44.0
Commercial	2.7	3.1	7.6	6.8
Industry*	42.0	38.5	28.2	26.0
Power	33.7	27.5	-	-
Transport	5.6	9.4	-	-
Agriculture	-	-	11.6	10.4
Others	-	-	6.7	12.8
Total	**100.0**	**100.0**	**100.0**	**100.0**

*including cement and fertilizer in the case of gas consumption
**July to March
Source: PES

In the case of natural gas, the share has fallen even more, from 42 percent to 38.5 percent. In addition, the share of the power sector has declined from 34 percent to 27.5 percent. Much of the gain has accrued to the transport (CNG) sector and households. These allocations clearly do not reflect the differences in value added or foreign exchange savings per Million Cubic Feet (MMCFT) of gas.

Today, corruption and mismanagement, vested interests, outright theft, misallocation of resource (gas) continue to bleed the system and add to the cost of producing power. Quite often the inefficient and more expensive production options get preference over the less costly ones. For example, even during peak summer loadshedding, the larger and more efficient (due to new equipment and owing to economies of scale), IPPs lie closed on account of gas unavailability, while the smaller captive gas power plants installed by individual factories are seen running on gas, at about 35 percent less efficiency. Also, IPPs are either made to run on the expensive furnace oil with the government subsidizing the unit cost differential or simply a capacity commitment payment (as per the agreement) is made to them while they remain closed due to lack of raw material (fuel or gas).

A number of solutions are offered for early resolution of the energy problem.

Import of LNG

The option of using LNG as a fuel in the system must be given priority, as it has many advantages over coal and oil. LNG is environment friendly, has more calorific value and is cheaper than oil. A lot of work in this regard has already been done. Three state-owned oil and gas companies[2] – Pakistan Petroleum Limited (PPL), Pakistan State Oil (PSO) and Oil and Gas Development Corporation (OGDC) – are to acquire shares in a planned liquefied natural gas terminal in an attempt to fast track the import of LNG. Sui Southern Gas Company's (SSGC) Liquefied Petroleum Gas (LPG) Company, PSO, OGDC and PPL are to jointly inject equity of $15 million in this endeavour and the federal government from its side is to provide $10 million through Gas Infrastructure Development Cess (GIDC) being collected from the consumers in their utility bills. For the import of LNG the ECC has constituted a new three-member committee for fresh bidding of the 400 mmcft contract, i.e. in order to ensure that this time the process is transparent and effective.

Perhaps, a better approach is for the government not to get too involved at all in the LNG molecule import business and leave it largely to private sector importers. There is little merit in providing 20 years sovereign guarantees to private companies and that too over a US dollar based risk for covering price fluctuations in the future global prices of gas molecules. Also, why should the Pakistan government be assuming all the risk when the real profits or gains, if any, will be enjoyed by private sector companies/contractors? However, the infrastructure plan to build a gas handling facility at the LPG terminal, owned by the government owned SSGC, at an estimated cost of $150 million, should be implemented as it will provide a common handling and storage platform once the molecules arrive or are liquefied into natural gas.

Development of Hydro-Power

The WAPDA needs to ensure that all the present hydropower projects under implementation are completed on time and any bottlenecks in this regard (e.g. tariff settlement with the Chinese firm demanding 6.7 US cents as against 6.5 US cents being offered) should be removed. Further, the plan to start three more hydropower projects should not be derailed at any cost. These include: Tarbela 4th Extension, Keyal Khwar and Naulong, with combined generation capacity of 1540 MW.

Coal as an Alternative Source

Power generation by using coal as a raw material should be encouraged and even facilitated by all ways and means possible. A drive needs to be launched for conversion of obsolete, fuel guzzling thermal (oil based) plants on to coal. The cost per unit produced through such plants normally goes beyond Rs 14 per unit, whereas, on coal it will come to about Rs 4 to 6 per unit. The pragmatic solution (according to a study carried out by the Pakistan Science Foundation, 2006-07) is to convert these plants of refined furnace oil (RFO) to coal in a way that initially both imported and indigenous coal varieties can be used. To ward off any issues of environmental degradation import of only clean coal technologies should be ensured so as to leave the smallest possible carbon footprint.

Market based Reforms

There is a need to remove the 'disconnect' between various ministries involved in the energy supply chain or merge some of them in order to avoid confusion and conflict of interest. Going forward there needs to be a national consensus on the reality of what needs to be done, especially for power sector structural reforms that allow more space to the private sector and facilitate private-public partnerships in this key economic sector. These reforms are needed to tackle issues like deregulation, possible privatization depoliticization of public-sector management in the energy sector. It is important to realize that when there is a constraint on a resource, its allocation should be made in a manner that optimizes national returns in terms of productivity, growth and job creation.

A Sustainable Development Policy Institute (SDPI) report identifies a number of initiatives to plug the loopholes through, real time web-based monitoring systems, smart metering installations (electronic consumption meters, remote metering, shielded network systems, etc), pre-paid service in areas and to clients with an unhealthy track-record, improvement of maintenance and repair of old and out-dated equipment and cables, etc.

Another innovative proposal is the introduction of the ‘wheeling’ mechanism, as is being practiced in India, whereby peak hour supply is sold to the highest bidder. This ensures revenue optimization for the power grid and the optimal use of a power unit in terms of value addition.

Priority must also be attached to policies, incentives and tariffs to promote alternate energy options, e.g. wind, solar, coal fired boilers and steam based thermo oil heaters, etc. Further, natural gas prices need to be raised to bring them in line with international prices and to make alternate sources more viable. This will also encourage domestic gas exploration.

THE CLUSTER APPROACH

With specialization being the order of the day, unless a systematic and planned cluster approach is followed the development of the industry is not sustainable. An industrial cluster approach carries an inherent advantage in the sense that the infrastructure requirements can be minimized since they cover a large number of industrial units in a given area. Also, the total usage is optimized since the facilities are shared amongst all users. For example, a) an effluent treatment plant that is crucial to a pollution free environment and without which it is difficult to obtain the mandatory international certifications for exports, b) a common infrastructure for material transport, c) collective storage and movement facilities, d) a generic ‘flatted factory system’ to provide more industrial accommodation and factory space, etc.

Pakistan will do well if it can work consciously on developing the cluster approach both at the provincial and the national levels. Moreover, a cluster based development approach can be used to industrialize specific underdeveloped areas that on merit may not be in a position to support isolated cases of industrial investment, but through government support and facilitation can become a hub for a sustainable sized cluster of a chosen/preferred industry and overtime emerge as the ideal production centre for related skills and products.

The other benefits of a cluster approach are as follows:

- Taxes can be levied simply at the entry and exit points, thus enabling the free movement of goods within a cluster.
- Units located within a cluster can be linked through information technology for better sharing and dissemination of information.

- Labour laws within a cluster can be liberalized, or improved.
- Time-and-work study can be conducted within a cluster for achieving higher levels of productivity and efficiency.
- The single-window clearance scheme can be implemented.
- Access of finance to industry through banks and other financial institutions can be improved by physical presence of bank branches.
- Formation of partnerships on human resource development, technology up-gradation, procurement of raw materials, common facility services in production and testing and marketing of products in domestic and international markets.
- The cluster approach has been adopted with great success in countries like China.

ROLE OF THE PROVINCES

Enhanced role of the provincial governments in creating their own opportunities and niche clusters for industrial investment needs to be promoted in Pakistan. States in India strive to specialize in certain areas, which then become their strength both domestically and internationally, e.g. the cities of Hyderabad and Bangalore have emerged as Information Technology (IT) centres. Also, this phenomenon promotes healthy competition amongst the Indian states to lure investment to their respective territories. Good examples are Gujarat quickly wooing Tata's Nano car plant when it was facing problems in Bengal and Bihar, convincing the Kapoor Group to set up their new textile expansion facility (the largest Indian textile expansion plan in 2011-12) in their state instead of Indian Punjab, by offering them extremely attractive terms on finance, taxation and infrastructure support. Such proactive measures are not only helpful to the state itself, but also go a long way in stimulating the national climate of industrial investment. The Pakistani provinces also need to follow suit.

FDI AND THE 'FLYING GEESE' THEORY

In the global economy today, FDI is more often viewed from a "new trade theory" perspective, emphasizing firm-level decisions to marshal proprietary assets and organize production processes across boundaries in either horizontal multi-plant modes or vertically integrated modes. From this perspective, foreign direct investment is frequently viewed as instrumental in promoting industrialization, particularly in host countries that maintain relatively open economies, stable macroeconomic conditions, limited restriction on foreign exchange transactions (and repatriation of investment earnings), and protection for private property rights. Specifically, under such favourable conditions, FDI by multinational firms tends to foster export-oriented production following underlying comparative advantage factors, such as the relative abundance of low-wage labour in developing countries.

This particular notion on FDI also accords well with the “flying geese” theory, according to which the FDI disperses production technology and know-how from a higher wage country to one or more lower-wage countries. Such dispersion ultimately influences trade patterns as the primary location of production is gradually transferred offshore by the high-wage source country to the lower-wage “follower” countries (similar to the pattern formed by flying geese). With its emphasis on differential wage levels between countries and creation of overseas “export platforms” by multinational firms, the flying geese theory of FDI in Asia provides an added explanation for the remarkable performance of East Asian exports. The flying geese theory also points to the nature of the problem faced by many, now, higher-income developing countries in East Asia, namely, the challenge of smoothly adjusting to new products and technologies as the comparative advantage of more advanced Asian countries gradually shifts to the less advanced Asian countries. This holds true not only for the more physically capital-intensive products, but also for more human-capital-intensive and technology-intensive products that are more affected by the higher average wage levels.

Pakistan, given the right policies and good governance at home, can be an ideal destination to attract FDI in manufacturing not only from the West, but also from East Asia (especially from China and South Korea). Of late, we have seen the disturbing trend of multinationals and foreign companies pulling out of Pakistan (e.g. Phillip & Morris, ICI, Citibank, American Express, etc.) and efforts should be made to convince them that Pakistan still remains a viable investment and work destination. The primary issues are of political and macroeconomic stability, continuation of policies, law and order and availability of infrastructure.

EXPORT-LED MANUFACTURING AND GROWTH

Pakistan’s exports of manufactured goods have stopped growing since the last two years at a time when high exports are required to sustain the balance of payments and falling exchange reserves. This is due partly to external factors and partly to internal factors. International markets are in a state of recession while export-oriented industry has suffered severely due to the high level of power loadshedding and shortages of gas.

The Trade Policy for 2012-15 announced by the previous government contains a number of proposals to promote emerging and value added exports, including the following:

1) Mark-up support of 2 percent on Long Term Financing Facility (LTFF) for Import/Purchase Machinery
2) Mark-up support of 1.5 percent on Export Finance Scheme (FES) on the existing concessionary rate
3) Ad hoc relief at 3 percent of FoB to offset the higher cost of utilities (especially electricity)

The emphasis on value added and emerging exports is appropriate and timely. These proposals need to be implemented on a priority basis.

As highlighted above, Pakistan must search strategically for emerging 'niches' opportunities in the evolving global division of labour. China, the world's largest exporter of manufactured goods, is moving up the value added chain in textiles. In the presence of an FTA with China, Pakistan has been able to profit from this opening up. Between 2008 and 2011, Pakistan's exports to China of cotton yarn and fabrics have tripled and have crossed $1 billion. China now meets almost 10 percent of its import of these products from Pakistan and there is scope for much bigger share. Similarly, as the large Indian market opens up after the implementation of SAFTA, Pakistan should attempt to diversify its exports to India.

Other measures required to support the export push are as follows:

- The state to adopt a proactive role in finding new markets, developing different products, improving market access and speedily removing state to state level obstacles.
- FDI in export related ventures be offered special incentives.
- Implementation plans and policies to be closely coordinated with the private sector.
- All-out endeavour to secure the GSP Plus Scheme with the European Union.

STATE RUN OR PUBLIC SECTOR CORPORATIONS

Our PSEs are a serious concern as Pakistan has to provide anywhere between Rs 350 to 450 billion every year to keep them afloat. Not only is a rupee saved a rupee earned, but if you also take into account their underlying potential to instead contribute revenues, the burden appears even more colossal. The solutions are neither simple nor just lie in privatizing these icon identities. State-run or backed enterprises have a significant role to play in any economy and more so in developing and emerging economies. With the might of the state resources, PSEs, if managed efficiently can be crucial to the growth of any developing economy, since they:

- Help in developing areas and sectors, which otherwise may not fall in the outreach of private investors.
- Have the ability to undertake large manufacturing and infrastructure development projects.
- Serve as an incubator for development of industry, human resource and research.
- Help in maintaining market equilibrium and check anti-trust activities.
- Check inflation, cartelization, hoarding, black-marketing of essentials, etc.
- Help the state earn revenues and generate employment.
- Help promote defence and security.

- Can serve as an important tool to ensure equitable distribution of wealth, resources and opportunity.
- Have the ability to lift industrial activity across the board, once they are doing well themselves.

To address the issues confronting our state controlled or state run institutions and in order to turn them around (selling or dilution of interest, at least for now do not appear to be viable options) the government will need to demonstrate a strong will, resolve and maturity to undertake some serious management solutions. The challenge, of course, is to engage professional management, provide them the security and freedom to operate independently and to form governing boards through private-public partnerships that possess the expertise and a reputation for sound oversight. A good learning model to study could be Bangladesh – on how it has set up private-public partnered management structures in not only state run companies, but also in its decision-making corridors. Policy making is done based on national interests rather than under the influence of powerful ruling feudal, pressure groups, lobbyists or politically influential players.

COSTS OF DOING BUSINESS

Pakistan has a relatively low ranking in the Cost of Doing Business Index of the World Bank of 107th out of 185 countries. However, Pakistan does better than India and Bangladesh in this index, but worse than Sri Lanka. Areas where Pakistan needs to focus on, as shown in Table 5.5, are access to electricity, registration of property, payment of taxes and enforcement of contracts. These areas are of particular importance both to domestic and foreign investors.

Table 5.5
Ranking in Costs of Doing Business of South Asian Countries

	Pakistan	India	Bangladesh	Sri Lanka
Starting a Business	98	173	95	33
Dealing with Construction Permits	105	182	83	112
Getting Electricity	171	105	185	102
Registering Property	126	94	175	143
Getting Credit	70	23	83	70
Protecting Investors	32	49	25	49
Paying Taxes	162	152	97	169
Trading Access Borders	85	127	119	56
Enforcing Contracts	155	184	182	133
Resolving Insolvency	78	116	119	51
TOTAL RANKING	**107***	**132**	**129**	**81**

*Out of 185 countries

Source: World Bank

Further, it should be ensured that the benchmarked project implementation time frames can be achieved practically by the potential investors. Time is money and the longer it takes to convert a contract into physical activity, the higher will be the cost. Pakistan with its serious troubles pertaining to power and energy shortages, comparatively high price of power itself, not so attractive interest rates and prevailing red-zone law and orders risks/costs, is becoming an increasingly uncompetitive and unattractive destination for investment. Given the high inflation in the country, implementation delays can often become the difference between the success and failure of a venture. Little wonder that we at home are witnessing a gradual drying up of domestic and foreign investment, and instead a significant outflow of domestic resources into destinations like Sri Lanka and Thailand is taking place. Needless to say that in a country with a high percentage of young population coupled with a high population growth rate, such a lack of adequate employment generation is like a ticking social time bomb. Again, the key to overcoming these issues lies in an autonomous, powerful and professionally run board of investment.

The good news though is that Pakistan, with the right policy measures and governance, still stands a good chance of becoming a preferred global investment destination. The crucial change (directly affecting us) that has taken place over the last decade or so is that wages in other low-cost countries (our competitors) have soared, whereas, in Pakistan when benchmarked in US dollars, they still come out to be amongst the most attractive in the world. According to the International Labour Organization, pay for skilled and senior management in several emerging markets, such as China, Turkey, Brazil and even India to a large extent, now either matches, or in certain sectors exceeds pay in America and Europe. If we can combine this advantage with a sound human resource cum skill development initiative and with English virtually being our second language, our prospects of attracting foreign investment in manufacturing can be very bright.

ROLE OF WOMEN ENTREPRENEURS

Within the South Asian region (SAARC), Pakistan is virtually at the bottom of the table (Afghanistan being the only country lower than us) when it comes to registered women entrepreneurs under the heads of ‘proprietors’, ‘directors’, ‘partners’, ‘chief executive or chief operating officers’, and ‘owners’.

A healthy gender mix is essential to optimize work potential in any society and the economic managers in Pakistan need to concern themselves with the task of shoring up the participation of Pakistani women entrepreneurs in the national industry. Moreover, certain types of businesses/industries are synonymous with female skills and interests and therefore managed by them. Of late, we are seeing a healthy trend in home textiles and fashion wear where our women are not only leading the way in the domestic market, but also seem to be creating a name and niche for themselves in the neighbouring markets. This should be encouraged.

SUMMARY OF OTHER MEASURES FOR REVIVAL

- Need on the part of the government to assume the provision of manufacturing related infrastructure.
- Resolving the energy crisis (covered earlier) and adopting a policy of power and energy prioritization to industry and other employment generating ventures.
- Singapore like initiatives on skill development and direct incentives for sustainable job creation.
- One window facility between the private sector and approval agencies.
- Conscious state efforts to improve management-labour relations.
- SBP's oversight to ensure that the public sector borrowings do not crowd out the private sector.
- Preferential credit and accelerated depreciation programmes for new machinery cum technology investments.
- Providing security on a war footing to key industrial centres.
- Revival of limited period tax/duty haven status to underdeveloped and far-flung areas to ensure an equitable and even spread of investment in the country.
- Encouraging the role of women in industry.
- Development of Good Corporate Governance rules and regulations and their enforcement by SECP and CCP. By instilling a culture and environment of sound corporate governance not only can Pakistan help its own corporate sector to develop meaningfully, but can also become a preferred destination to work in for the multinational corporations.
- The government needs to constructively engage the private sector to adopt the following initiatives within their own ranks: a) strengthen research and development wings in their trade and industrial associations, b) adopt social responsibility and environment friendliness on a voluntary basis, c) use the collective platforms at their disposal for knowledge sharing, innovation and value addition instead of merely using them to indulge in lobbying, d) help improve Pakistan’s perception internationally by promoting a soft image of the country, e) look for energy solutions on a self-help basis, and last but not least f) build intellectual and professional capacity in their ranks to present the government of the day with ‘specific’ projects and ‘concrete’ sector related policy decisions that it can take to help industry at a given time.

Implementation of the above proposals will ensure that industrial revival takes place and the private sector becomes once again the ‘engine of growth’ in Pakistan.

Chapter - 6

Needed: A Comprehensive Development Strategy for Reviving Growth

Chapter - 6
Needed: A Comprehensive Development Strategy for Reviving Growth*

INTRODUCTION

Chapters 2 and 3 have discussed in some detail the deep fiscal and foreign exchange crises that the country faces and provide both general and specific recommendations for sharply reducing macro-economic balances and reviving confidence in the economy most notably through actions in the context of the 2013-14 budget. These will require tough choices for the politicians who in order to ensure avoiding a collapse of the economy would have to ask for sacrifices and cooperation of the population especially the well-to-do sections – something that the people of Pakistan have rarely been asked to do.

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

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

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

Hopefully, the political order would continue to change towards greater sharing of power among state institutions and levels of government, greater accountability of public officials enforced by

*This chapter has been contributed by Dr. Parvez Hasan and Shahid Javed Burki.

a rule of law, vigilant judiciary, informed and free media, and increasingly robust civil society. This will facilitate a greater acceptance of austerity and a national discourse on development approaches and strategy.

Planning Commission's Framework for Economic Growth

In what it called the "Framework for Economic Growth" (FEG), the Planning Commission came up with, what it suggested, was a new theory of development for Pakistan. The Commission's work on growth started with a criticism of the approaches adopted in the past. It believes that in the past the emphasis on investment – particularly by the public sector – created a number of growth-retarding distortions in the economy. "An unintended consequence of our policies has been the stifling of internal markets, cities and communities which play a critical role in fostering productivity, innovation and entrepreneurship and ultimately promote growth, and prosperity and development," wrote the authors of the report. "The Planning Commission has been involved in the formulation of Perspective, Medium and Annual Development Plans based on a savings driven approach when growth rates are arbitrarily set and incremental capital (investment) to output ratios are used to generate investment requirements in key sectors of the economy. Public investment across sectors is allocated according to the planners' priorities. It is assumed that public sector development program will not crowd out private investment." After offering this criticism of the past, the Planning Commission promised a strategy that would factor in Pakistan's situation in 2010-11 and also some developments in economic thought.

"Never has there been a more passing need in Pakistan's history to search for a new model." The Commission was of the view that in the past there was emphasis mostly on developing a public sector development program (PSDP). This was made up of a number of public sector projects with a significant number financed by the donor community. In developing such a model it suggested that the country needs to move from "hard" to "soft" growth.[1]

By the "hard" approach the Commission meant large public sector investments in brick and mortar development – building roads, bridges and dams and, yes, building buildings. What was needed were a combination of efforts that would improve the quality of governance, less interference by the government in the working of the private sector, encouraging greater innovation within the economy, and greater focus on the activities that would produce higher rates of growth with low rates of development. Implicit in this strategy was the recognition that it will take a long time to increase the rate of investment, in particular by the public sector. To have that happen will require some fundamental changes in the tax system, something for which there was no or little political appetite. Pakistan's growing and unsustainable fiscal deficit had brought the economy close to the edge of disaster but it did not result in action by the political establishment. It will also require significant changes in the way the part of the economy that was still under government control was managed. Collectively public sector enterprises, or PSEs, had become a big charge on the budget since most of them were poorly managed. But they were treated as the institutions of "first resort" for providing employment to political associates and supporters. The status quo appealed to the political establishment but drained the economy.

The most important conclusion to be drawn from the way the political system was evolving was that there was not much space for the adoption of economic policies that would help to revive the economy. This was the reason why the Planning Commission chose to adopt a policy stance of least resistance. It took the position that since investment could not be increased to obtain higher rate of GDP growth, economic revival should come from increasing economic efficiency. In the jargon of economics the policymakers should work to lower the incremental capital output ratio, producing a high rate of growth even if there was no increase in the ratio of investment to GDP.

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

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

Need for a Comprehensive Development Strategy

We believe that beyond tackling the immediate and urgent problems of macro-economic imbalances, discussed in Chapter 3, there is need for a longer-term vision and a comprehensive long-term strategy which aims at not only at reviving strong sustained growth, but also making it more equitable. It is not the purpose here to present such a strategy but merely to highlight the following key elements that have been relatively ignored in the past and deserve renewed focus and priority.

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

In addition, the strategy should focus on exploitation of the strategic location of the country and the “youth bulge”.

Improving the quality of governance

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

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

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

Militancy

Now, the biggest threat to the country and the economy comes from the militants and Jihadists who would like to impose their narrow version of Islam on the society. Only belatedly is there a realization that the "Pakistani Taliban" poses an existentialist threat to the country. It was reported in the press that the military, following an exceptionally bloody December 2012, changed its strategy, recognizing militancy as the most important threat the country faced at this time. The new doctrine was added to the Army's "green book" under the chapter "sub-conventional warfare". According to one newspaper report, the Green Book "says that some organizations are out to annihilate Pakistan and their terrorist activities in tribal and urban areas are aimed at achieving the same target. These attacks are planned very skilfully and can be countered through a matching expertise."[2] The perceived threat from India had been central to the military's strategy up to this point. Now that the military is fully on board, new political leadership would have to prepare the country for strong actions both against sectarian violence and Talibanization. If the country cannot counter the threat from the extremists, its future as a modern, moderate, and prosperous society will be at great risk.

Without necessarily increasing the role of the state, governance can also be improved significantly through four major steps: (1) The erection of a firewall between executive authority and the accountability mechanisms, and strengthening the deterrents to prevent the abuse of power and breaking of the law. It would be fair to say that Pakistan has one of worst records in punishing wrongdoers, whether politicians, bureaucrats, businessmen, or military leaders. (2) Effective efforts to de-centralize authority to the local government level, initially at least for social services, need to be taken. There is evidence from other countries that locating government closer to the people improves the sense of accountability of those responsible for providing public services (3) Serious efforts to reform the civil service and restore the independence of public institutions through autonomy, proper selection of top management and professional staff, and adequate pay (4) Encouragement of the development of civil society institutions at all levels of government.

Accountability Mechanisms

Pakistan has tried several institutional mechanisms for ensuring that public officials, both elected and those belonging to the various administrative services, will be accountable for carrying out the duties entrusted to them. Each institution ultimately was politicized, losing the confidence of the citizenry. An independent and strong National Accountability Bureau (NAB) should be the lynchpin of accountability mechanisms. The Chairman of the NAB should be appointed for non-renewable six-year term. The process set in place for the appointment of the CEC could be replicated in this case. Further, following the approach adopted in India, Pakistan too should pass a law that would allow citizens to obtain information about the actions taken by government officials and the practices followed by various ministries and departments. It was access to this information that led to the discovery of a number of malpractices by various Indian government agencies, including the sale of G2 mobile phone licenses and grant of coal mining concessions to private operators.

Devolution

Under President Musharraf, there was introduction of a genuine – albeit ambitious – devolution plan transferring several powers from the federal and provincial governments to the governments at the local level.[3] The lynchpin of the plan was the elected office of District Nazim (head) with substantial authority and responsibilities for economic and social development functions. It is not clear, however, whether the local government system devised by President Musharraf will survive. The provincial government in general and members of the national and provincial assemblies in particular regard elected local district heads as competitors for influence in their respective domains.

The Sindh government seems particularly opposed to the transfer of much authority to elected local representatives. There is a political divide in the province. Although the PPP and the MQM are coalition partners in both the federal and provincial governments, the two parties have very different agendas. The MQM's main constituency is urban Sindh, in particular the city of Karachi. The PPP appeals to the countryside. A decentralized system of government with power in the hands of the elected mayors suits the MQM; the PPP prefers a more centralized political order. Under pressure from MQM the coalition government in Sindh has proposed a hybrid system of local government in which only major urban centres will have de-centralized authority.

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

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

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

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

Some of the gains made during the Musharraf period for bringing government closer to the people are being lost as the future of local government continues to be debated by the various political establishments in the provinces. Using the Council of Common Interest (CCI) as the platform, the federal government should encourage the provinces to keep the local government apparatus created in 2001 in place in some form. The one-size-fits-all approach adopted by the Musharraf government by promulgating the Local Government Ordinance (LGO) of 2001 need not be followed strictly. The provinces can have different systems in place. The important thing to recognize is that the momentum generated by the 2001 Ordinance should not be totally lost.

Civil Society

Pakistan needs to draw lessons from the countries where the state’s weakness was compensated for by the development of the various institutions in private space. It has happened in many other situations where the state’s weakness was compensated for by the development of the various institutions in private space. Bangladesh is a notable example of a country that founded several non-government organizations to provide the citizens the services that are normally in the domain of the state. The same trend is in evidence in Pakistan. The void left by the state has been filled by private institutions that operate in a number of different areas. It has been noted by a number of analysts that Pakistan is now one of the more “giving” societies in the world financed by donations from the citizens in the country as well as those of its people who live and work abroad. These charitable organizations are doing impressive work in the sector of education that could become the basis of a new approach to increasing the extent of literacy, as well as improving the skill base of the population. Microfinance is another area where, with the active involvement of the private sector, Pakistan has outperformed even Bangladesh where this form of lending was institutionalized. It is worth noting that women have been very active in developing this part of finance. Mobile telephone banking is another important area of economic activity.

Intellectual Back Up and Public Education

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

Major organs of the state require more intellectual backup and analysis. For instance, the CCI has become critically important for resolving disputes among provinces and between the provinces and centre and between centre and the provinces, especially now that the provinces are in the forefront of development activity. The CCI should be supported by a permanent secretariat which should facilitate conflict resolution. This function should be distinct from the functions of policy analysis and coordination that must be performed by planning commission and planning departments of the provincial governments.

The above measures will help improve the quality of economic management in the formulation and implementation of public policies both at the federal and provincial level. Formal plans have had very limited success in Pakistan because implementation and monitoring of plans were neglected and with changing circumstances macro-economic frameworks were not revised quickly enough. Going forward, there has to be much greater policy coordination across ministries and between federal and provincial governments. In this, as well as in effective monitoring and impact evaluation, the planning agencies must play a central role.

Making Exports a Major Driver of Growth

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

Beginning in 2008, IRRP reports have pointed to Pakistan's neglect of exports as a major factor in its disappointing economic performance compared to a number of countries. But some salient facts about the remarkable expansion in international trade in manufactures need to be restated because this growth continues to be the engine of global change. World manufactured goods exports which increased steadily from less than $200 billion in 1970 to the peak of $11.5 trillion in 2011, showing an average annual growth of 10 percent. While the nature of international trade in manufactures has changed quite significantly from finished goods to intermediate products or components, the growth trend was sustained till 2008. However, there was a fairly sharp decline in 2009 due to the deep international recession but there was a quick recovery in 2010, and in 2011, the earlier peak was exceeded.

The biggest economic story of recent times is the rise of China in substantial part due to its spectacular success in expanding exports. Chinese manufactured exports have risen nearly two hundred fold over the last three decades and their share in world trade has grown from less than 1 percent to 15 percent over 1980-2010. China is not the only country to have benefitted from the expansion and restructuring of global trade. Other major developing countries have also increased their share in world manufactured exports from 7 percent to 22 percent over the period. In contrast, Pakistan's share has improved only marginally from 0.12 percent to 0.16 percent and probably is lower now than it was in 1970.

The ratios of total exports of goods and services to GDP also presents clear evidence of how far Pakistan has fallen behind in the export field. China and most other East Asian countries are in a class by themselves but traditionally inward looking economies like India, Turkey, and Bangladesh have increased their export orientation remarkably in the last thirty years. In 1980, India had an export to GDP ratio (6 percent) half that of Pakistan (12 percent) but in 2010, its ratio, at 23 percent, was about double that of Pakistan. Even Bangladesh with an export to GDP ratio of 18 percent has moved ahead in this respect.

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

Opening to India

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

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

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

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

The specific policy actions that should be taken to promote exports are:

- An exchange rate which fully reflects the differential between the movements in Pakistan prices and the international price level.
- A review of all SROs and their gradual elimination in three years because they essentially increase domestic protection and thus increase the anti-export bias.
- Strong incentives for new investments and skill upgrading in textiles that increase scale and update technology, while encouraging the exit of the enterprises with low productivity and profitability.
- A determined push aimed at small and medium industries for expansion and export diversification in areas outside textiles
- Joint public and private sector efforts to promote foreign investment in textiles, clothing and other promising export sectors from countries like Korea, Hong Kong, Malaysia, Taiwan, and also China which are losing ground in labour-intensive industries due to high and rising wage costs. The focus of these efforts should be to encourage foreign investment that will help to upgrade skills and technology and make use of established export channels.
- A special focus on expanding exports to regional partners especially China and India, the two fastest growing economies in the world. The large negative trade balance with these countries can provide some leverage.
- A special and speedy implementation review of the free trade agreement and establishment of freed trade zone with China and assessment of their likely impact on exports in the near term.
- A similar review of key constraints and principal opportunities for expanding trade with India.
- Focus on the development of export supply chains using the work being done in the context of the National Trade Corridor Improvement Project, the NTCIP.
- Strengthening monitoring mechanisms including quarterly meeting of the high level Export Board.
- Implementing recommendations in the Strategic Trade Policy Framework (STPF) 2012-15 to reduce anti export bias by the withdrawal of protection from inefficient industries,

minimization of taxation at investment stage, and elimination or zero rating of customs duty on important inputs to textiles and clothing exports.

- Closer coordination of commerce ministry policies and activities not only with textile ministry but all other production related ministries appears to be sorely needed.

A New Compact with the Private sector

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

In several places in this paper, we have suggested how the government could work with the private sector to add to the amount of resources that need to be committed for developing the economy and improving citizen's welfare. Our specific suggestions can be summarized as follows:

- Issue of a policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector;
- Issue of policy frameworks for the involvement of the private sector in the development of education, health, vocational training;
- A thorough examination of the regulatory landscape with the aim of weeding out those regulations that have lost their relevance. Some of them such as those pertaining to agricultural processing and marketing are redundant and are in place since they have recreated rent-seeking for some vested interests. At the same time, existing regulatory agencies like SECP, CCP, OGRA, NEPRA should be strengthened and made more autonomous;

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

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

HUMAN RESOURCE DEVELOPMENT

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

Role of Private Sector

A recent *Financial Times* article draws the world's attention to the role the private sector and private enterprise is playing in delivering a variety of services to the poorer segment of the population: "at the grassroots, Pakistan is in perpetual motion, with ceaseless activity as people find affordable solutions to their basic needs. These largely hidden forces of resilience offer the best hope for the country's future. In Pakistan, the state may be fragile but society is far stronger than many think."[4] The article also points out the important role private charity is performing in helping the poor. This was evident at the time of two floods that hit the country in 2010 and 2011.

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

There are other models that are working equally well. In other words, while demand for education is outpacing the state's financial and organizational capacity to meet such basic needs as education, the private sector has shown the capacity to fill the void. The state should take advantage of this. As a practical matter the state should come up with a program for inviting the private sector to participate in the development of the neglected sectors of education and health.

Public Education

Despite a remarkable growth in the role of private education, it is a matter of great concern, as Chapter 2 indicated, that the improvement in social indicators witnessed over most of the last decade appears to have slowed down in last two or three years presumably under financial pressures and slow economic growth: 44 percent of school age children were still not in school in 2011, the literacy rate among 15 years and older which had improved from 44 percent in 1998 to 57 per cent in 2009 was only 58 percent in 2011 – this despite a continued rise in female literacy that now stands at 46 percent. Pakistan will miss the millennium goals in education and literacy.

Public clamour for greater access to education and deep concerns with the quality of public education have led to all major parties putting stress on education in their election platforms. However, promises being made to raise the public expenditure from a paltry 2 percent of GDP to 5-6 percent are totally unrealistic. Given financial constraints an increase to 3 percent in the next few years would be quite an achievement. A substantial part of the improvement in education must come from improving the efficiency of public expenditures. Eliminating fictitious expenditures and taking steps to increase teacher training, reducing teacher absenteeism, and improving teacher accountability are largely in the domain of improved governance. We continue to believe that improved governance in the sector including transfer of responsibilities to local governments remains as important as increasing public funding for the sector.

MODERATING POPULATION GROWTH

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

FOCUSSING ON PRODUCTIVITY GROWTH

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

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

As mentioned above, the promotion of labour intensive exports both manufactured goods and agricultural products like fruits and vegetables could have a large payoff in terms of a unit of investment.

Similarly moving up the value chain in textiles and clothing, Pakistan's principal exports, and other exports would yield productivity gains.

One way to make sure that economic incentives do not protect low value added sectors would be to review and phase out SROs. This will not only improve government revenue but also improve equity in the society and encourage entrepreneurial behaviour. As noted above, most SROs provide domestic protection which increases the anti-export bias. On the other handed under-invested areas like agricultural processing, marketing, and storage could be provided investment incentives.

There are major gains to be had in improving the use of inputs in agriculture notably water, fertilizer, and seeds.

Nothing in this area is quite so important as improving the efficiency of irrigation water use.

Efficiency of Water Use

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

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

Even more than most countries at its stage development, Pakistan uses most of its available water for agriculture. History has a lot to do with the pattern of water use. An estimated 90 percent of available water is used on the farms, leaving only 10 percent for other purposes. Consequently, "anywhere from around 40 to 55 million Pakistanis – about a quarter to a third of the country's total population – do not have access to safe drinking water."[6]

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

Proper pricing of water will also create an incentive structure that will impact on the pattern of cropping and also bring in new water-saving technologies. Cheap water has meant that Pakistan has allowed extensive cultivation of high water-intensive crops such as sugar cane. These need to be replaced by the crops that use less water. A changed water-pricing structure should also create incentives for the farming community to start using technologies such drip irrigation. According to Adrien Couton, a water expert who works for an NGO with experience in Pakistan, “drip irrigation has particularly attractive characteristics. It generates massive increase in the efficiency of water use (the increase in yield as compared to conventional irrigation methods is from 20 to 100 percent while saving in water range from 40 to 70 percent). It offers much more granularity than typical infrastructure intervention since, no heavy capital investments are involved, and investments can be easily spread geographically and over time. Drip irrigation also delivers immediate benefits. Finally the system is to educate the end users about the immediacy of the water issue and the urgent need for more water efficiency”.[7]

Role of Women

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

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

Skill Upgrading

Finally, much more active policies to improve literacy and upgrading labour skills are needed including in the area of information technology. This is another area in which private and public sector should work closely together in to develop appropriate policies and incentives.

MANAGING ENERGY CRISIS

Over the years Pakistan's energy sector has been studied from several different angles. It was looked at by the World Bank and the Asian Development Bank in some detail. Both institutions provided technical advice as well as finance for developing the sector. More recently, the energy problem has received the attention of the USAID. The Americans have identified the sector as one of their priority areas under the Kerry-Lugar initiative. They have concentrated their efforts on the supply side of the equation, offering assistance for several electricity generation projects. The Planning Commission was given the mandate to come up with a solution for easing the shortage in electricity supply that is causing enormous amount of discomfort to the people and badly hurting the economy. Building upon these analyses, we offer some ideas that could bring about both short term easing of the situation as well a setting the stage for the long-term development of the sector.

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

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

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

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

In order to solve both the short term and long-term problems faced by the energy sector the government could explore the possibility of shifting the management and part-ownership of some thermal plants operating in the public sector to an entity which can sell a part of its share to the private sector. The entity should also issue bonds backed by its assets in order to liquidate the accumulated circular debt. The private sector should also be invited to participate in the development of renewable sources of energy, in particular solar energy.

Under the 18th amendment the provinces have the authority to invest in the development of the energy sector. This could be encouraged by the assurance that power supply to them from the national grid would not be reduced if they generated significant amounts of own supply.

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

REINVIGORATING BOTH AGRICULTURAL AND INDUSTRIAL GROWTH

In sectoral terms, revival growth would require major acceleration in growth rates of major sectors, agriculture and industry. The issues related to industry are discussed in detail in the next chapter. Here we would confine ourselves to a few remarks about agriculture.

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

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

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

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

INCLUSIVE GROWTH AND POVERTY REDUCTION

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

SUMMARY AND KEY POLICY ACTIONS

Revival of Growth

The revival of growth strategy should aim initially at restoring the growth rate of the economy to 6 percent of GDP by 2015-2016. In the current circumstances of widespread energy shortages and a low rate of investment, much of the acceleration of growth must come largely from higher productivity in factor use - more efficient use of capital and labour and inputs like water and energy. The main but inter-related elements that are the focus of economic revival in this paper are:

- Improved Governance
- Much greater attention to trade strategy and export-orientation including induction of private foreign investment in support of exports
- A clearer policy frame work for the Private Sector and closer Private-Public Partnership
- Special focus on productivity growth, especially as investment revival is likely to be slow
- Quick resolution of serious power and gas shortages

Governance

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

- The erection of a firewall between executive authority and the accountability mechanisms and strengthening the deterrents to prevent the abuse of power and breaking of the law. It would be fair to say that Pakistan has one of worst records in punishing wrong doers, whether, politicians, bureaucrats, businessmen, or military leaders.

- The Chairman of the NAB should be appointed for a non-renewable six-year term. The process set in place for the appointment of the CEC could be replicated in this case.
- Taking effective steps to de-centralize authority to the local government level initially at least for social services.
- Making serious efforts to reform the civil service and restore the independence of public institutions through autonomy, proper selection of top management and professional staff and adequate pay
- Encouraging and respecting civil society at all levels of government.
- Since the CCI has become critical important in coordinating federal and provincial policy actions, a strong independent secretariat needs to be set up to support and assist in Council's work.

Trade and Foreign Investment

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

- India should be granted the most favoured nation status, followed by India reducing its Sensitive List under SAFTA to only 100 tariff lines.
- The Commerce Ministry should publish all the SROs that have been adopted to-date by the government. These SROs should be withdrawn within a period of three years, to be incorporated in the general trade policy.
- A permanent committee to watch over the development of trade between India and Pakistan should be set up with members drawn from both the public and private sectors. The committee should be provided with a secretariat of its own so that it can do the analysis that will be needed. It should be required to table a report every year for discussion and adoption by the National Assembly.
- A quarterly meeting of the Export Board should be held every quarter.

- A special effort should be made in collaboration with the private sector to attract foreign investment in export field from newly industrialized friendly countries notably China, Korea, and Malaysia.
- A quick review should be undertaken examine why some international agreements on trade and investment, notably with China, have suffered implementation delays and their execution should be speeded up.

Compact with the Private Sector

- Issue a policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector;
- Issue of policy frameworks for the involvement of private sector in the development of education, health, vocational training;
- A thorough examination of the regulatory landscape with the aim of weeding out those regulations that have lost their relevance and increasing the effectiveness of regulatory agencies like SECP, CCP, OGRA, NEPRA, etc.
- Formulation of a programme for the privatization of some of the economic assets that remain under the control of the public sector. These include PIA, National Shipping Corporation and Karachi Steel Mills. The funds generated by these sales should be put in the Future Generations Fund.
- Pakistan Business Council (PBC) and the Federation of Chambers of Commerce and Industry should become a pivotal point of dialogue with the private sector

Productivity Growth

Because of the financial constraints, it may be difficult to raise the rate beyond say 15 percent of GDP by 2018, much less than the 20 percent required for a sustained 6-7 percent annual growth rate. So in the near future a large part of the revival of growth would have to come from exploiting unused capacity and productivity gains.

With supportive public policies and close private: public partnership areas of substantial productivity gains could come from

- Labour intensive exports
- Movement up the value chain in exports
- Improvement in the efficiency of water use
- Increased participation of women in labour and management

Managing the Energy Crisis

- The factors that constrain the use of existing power generation capacity should be effectively dealt with including the annual build-up of circular debt.
- There is a general agreement that relieving the energy shortages is the most critical need for the economy. The need for further power tariff adjustment is also clear. But the consumer resistance to tariff increases is very real because they do not see any progress in reducing load shedding or reducing line losses. The near term plans must promise reduction of theft though early installation of proof meters and institution of strong penalties.
- The organizational structure of the sector with heavy concentration of authority and responsibility directly or indirectly needs to be revisited. The involvement of provincial governments and the private sector on a range of activities including generation should be pursued on a priority basis and the freedom to delegate final pricing decisions to private sector, local government should also be explored.
- The need for further power tariff adjustment is also clear. But the consumer resistance to tariff increases is very real because they do not see any progress in reducing load shedding or reducing line losses. Simply pushing for power rate adjustments could be counterproductive in terms of line losses.

Chapter - 7

State of Governance: The Citizen Score Card

Chapter - 7
State of Governance:
The Citizen Score Card*

The Citizen Score Card is a participatory survey of random selected households on the basis of a sample which is nationally representative. The survey provides an in-depth feedback, both quantitative and qualitative, on the access, efficiency and quality of public services. It acts also as an instrument to achieve a degree of public accountability.

Citizen Score Cards have been undertaken in a number of countries including the Philippines, Gambia, Malawi and certain states of India like Karnataka. The Pakistan Social and Living Standards Measurement Survey (PSLMS) of the Pakistan Bureau of Statistics (PBS), findings of which are based on a relatively large survey, is a Citizen Score Card, but focuses primarily only on the coverage and access to services.

This chapter highlights the findings of a Citizen Score Card exercise undertaken by IPP, with financial support provided by the Higher Education Commission (HEC). The timing of the survey was considered appropriate as it was at the end of the tenure of five years of a democratically elected government.

THE SURVEY

The Citizen Score Card has been implemented on a sample of 500 households in February 2013. The distribution of the sample among the provinces is based on the respective population shares. Both urban and rural households have been covered. The sample was administered in ten districts including Islamabad/Rawalpindi, Karachi, Hyderabad, Lahore, Faisalabad, Sialkot, Peshawer, Mardan and Quetta. 60 percent of the sample is from urban areas and 40 percent from rural areas. The relative small size of the sample is due to the limited budgetary resources for this research. Confidence intervals at 95 percent level are available from IPP on request.

The survey was administrated on a properly structured questionnaire with the following modules: location, description of respondents, economic status of the household, location of public services (distance from residence), access to line departments, residential services, social safety nets, quality of social services, quality of economic services, level of satisfaction with economic conditions and incidence of crime.

*This chapter has been contributed by Dr. Hafiz A. Pasha

Table 7.1
Average Distances from Facility/Service of Rural Households

(Kms)

	Punjab	Sindh	K-PK	Balochistan	Total
Post Office	3.9	5.5	3.6	8.4	4.5
Police Thana	7.8	5.9	4.3	7.5	7.0
Bank Branch	6.7	7.3	6.0	10.6	7.1
Bus Stop	3.6	3.2	1.8	4.7	3.3
Railway Station	27.3	23.4	25.1	16.3	25.5
Mandi	15.9	6.2	4.6	19.1	16.3
Tractor Repair Shop	9.7	6.7	6.6	7.9	8.6
Outlet for Fertilizer & Seed	9.9	6.7	6.7	7.5	8.6
Primary School	1.0	2.2	1.0	2.2	1.5
Middle School	2.3	5.0	1.4	4.9	3.1
High School	3.2	4.2	3.1	7.1	4.1
College	9.9	9.9	4.9	13.7	9.7
BHU	2.9	3.4	1.8	4.7	3.0
RHC	7.9	5.7	5.3	6.9	7.1
Public Hospital	14.4	8.4	6.7	15.0	12.3
Veterinary Center	4.5	6.2	6.2	7.1	5.3

Source: IPP estimates

The major findings from the Survey are highlighted below. These are presented separately for urban and rural households respectively and wherever there is substantial variation by province.

ACCESS TO SERVICES

Rural

The distances on average of rural households from different facilities/ services are given in Table 7.1. It is not surprising that given the low population density, distances are the largest in Balochistan. In economic services, the low rural penetration of bank branches is observed with average distances from households of 6 to 8 km. It is also somewhat surprising that the distance from a mandi is as high as 16 km in Punjab. This necessitates an extensive network of farm-to-market roads. Overall, it appears that the province of K-PK is relatively better covered by administrative and economic services in the rural areas.

Within social services, it is reassuring to note that throughout the country primary schools are located in close proximity to rural households. Similarly, Basic Health Units (BHU) are accessible within a distance of 2 to 5 km. Beyond this the distances to other social services are relatively large. Here again, K-PK appears to have achieved a better physical coverage of services.

Table 7.2
Average Distances from Facility/Service of Urban Households

(Kms)

	Punjab	Sindh	K-PK	Balochistan	Total
Post Offices	1.7	2.3	2.1	1.2	2.0
Police Thana	2.4	2.5	1.7	0.9	2.3
Bank Branch	1.5	3.4	2.1	1.0	2.2
Bus Stop	1.1	0.7	1.8	0.8	1.0
Railway Station	8.6	16.2	8.1	1.7	11.1
Primary School	0.9	1.3	1.1	1.2	1.0
Middle School	1.3	1.5	1.2	1.0	1.4
High School	1.4	2.2	1.6	1.8	1.8
College	2.4	2.9	1.8	3.0	2.6
Public Hospital	3.3	3.8	3.0	2.8	3.5

Source: IPP estimates

Urban

Turning to urban households, the average distances are presented in Table 7.2. As expected, these households are generally better served than their rural counterparts.

There is not much difference in access to services in the 10 major cities of Pakistan, although distances are somewhat longer in Sindh. This may be a reflection of the larger metropolitan area of the city of Karachi.

LEVELS OF SATISFACTION WITH SERVICES

Rural

The extent of use of different services and levels of satisfaction thereof of rural households are given in Table 7.3. It is clear that the two services which are rated lowest in terms of level of satisfaction are police and the irrigation department. The highest level of satisfaction is with the basic health and family planning services provided in the villages by the lady health workers.

Table 7.3
Extent of Use and Levels of Satisfaction with Services of Rural Households

	% of Households Accessing the Services*	Rating of the Service (%)			
		Excellent	Good	Bad	Total
Police Thana	21	1	39	60	100
Family Planning (LHWs)	22	10	80	10	100
Land Revenue Department	9	3	87	10	100
Session Courts	7	-	80	20	100
Irrigation Department	16	1	47	52	100
NADRA Office**	43	2	55	43	100

*during the last year
**for NIC or Passport

Source: IPP estimates

Table 7.4
Level of Satisfaction of Rural Households with Public Schools and Reasons for Dissatisfaction

	% of children in Public Schools	Rating of the Service (%) Excellent	Good	Bad	Total
Total Sample	**63**	**19**	**37**	**44**	**100**
Reasons for dissatisfaction*:	**(%percent of households reporting*)**				
Teacher Absenteeism		69			
Poor Quality of Teaching		83			
Poor Facilities (water, latrine,etc)		91			

**Among households with a child in a public school. Multiple responses have been given by individual households.

Source: IPP estimates

One of the surprising revelations of the survey is the low use and somewhat negative perceptions of a significant percentage of households of public schools in rural areas, as shown in Table 7.4. The overall percentage of rural households who send their child to a public school is 63 percent. This implies that the percentage of enrolment in private schools has gone up to as much as 37 percent even in rural areas, with the highest percentages being reported from Punjab (43 percent) and K-PK (41 percent). The largest incidence of complaints is with the lack of provision of facilities like tap water and latrines for the children in schools.

Urban

Administrative and legal services

The levels of satisfaction with different services of urban households are given in Table 7.5. The most highly rated facilities are the emergence service (like the 1122 service in Lahore), followed by NADRA. As in the rural areas, police services are rated poorly.

Table 7.5
Extent of Use and Levels of Satisfaction with Services of Urban Households

	% of Households Accessing the Services*	Rating of the Service (%) Good	Bad	Total
Police Thana	18	25	75	100
Excise & Taxation Department	26	49	51	100
Emergency Services	12	73	27	100
Session Courts	5	56	44	100
NADRA Office	28	57	43	100

*during the last year

Source: IPP estimates

Table 7.6
Level of Satisfaction of Urban Households with Public Schools and Reasons for Dissatisfaction

	% of children in Public Schools	Rating of the Quality of Service (%) Excellent	Good	Bad	Total
Total Sample	**32**	**17**	**45**	**38**	**100**
Reasons for dissatisfaction*:	**(%percent of households reporting*)**				
Teacher Absenteeism		62			
Poor Quality of Teaching		97			
Poor Facilities (water, latrine,etc.)		94			

**Among households with a child in a public school. Multiple responses have been given by individual households.

Source: IPP estimates

Public Schools

The survey confirms the high share of children going to private schools in urban areas. For the overall sample it is 68 percent. Reasons for the dissatisfaction of households sending their child to a public school are given in Table 7.6. It is interesting that despite lower rates of enrolment, the levels of satisfaction with public schools are somewhat higher in the urban areas. Lack of proper facilities and poor quality of teaching are the main reasons for dissatisfaction.

Public hospitals

Turning to public hospitals, less than half of the respondents have accessed this facility in urban areas, even in presence of a 'catastrophic' illness. The levels of satisfaction are given in Table 7.7. The majority, 56 percent have rated the services provided as 'bad'. Primary reasons for dissatisfaction are high level of congestion (and long waiting times), no availability of free medicines and no proper testing facilities.

Table 7.7
Level of Satisfaction of Urban Households with Public Hospitals and Reasons for Dissatisfaction

	% of respondents going to Public Hospital	Rating of the Quality of Service (%) Excellent	Good	Bad	Total
Total Sample	**49**	**17**	**45**	**38**	**100**
Reasons for dissatisfaction*:	**(%percent of households reporting*)**				
Absence of Doctor		52			
Poor Nursing Care		63			
Too many Patients		95			
Non-Availability of Free Medicines		91			
No Proper Testing Facility		95			

**Among households with a child in a public school. Multiple responses have been given by individual households.

Source: IPP estimates

Table 7.8
Access to and Levels of Satisfaction of Urban Households with Residential Services

Services	% indicating Access	Rating of the Quality of Service*			
		Excellent	Good	Bad	Total
Gas	96	6	40	54	100
Electricity	100	4	16	80	100
Tap Water	90	17	62	21	100
Sanitation	90	15	59	26	100
Garbage Disposal	48	15	57	28	100

*by households with access
Source: IPP estimates

Residential Services

The levels of access to residential services like garbage disposal, tap water, sanitation, gas and electricity are given in Table 7.8. Urban households generally have access to most residential services, with the exception of garbage disposal, which is a basic municipal function.

The levels of satisfaction are moderate to high in the case of tap water, sanitation and garbage disposal. As expected, the level of satisfaction is the lowest with electricity supply, given the exceptionally high levels of loadshedding.

INCIDENCE OF BRIBES

Rural

The incidence of payment of bribes by the sample rural households in the process of receiving services is given in Table 7.9. Almost 95 percent of the households paid a bribe for filing a FIR or a complaint at the local Police Thana. The average amount of bribe paid is Rs 2150. Accordingly, if the sample is blown up to the national level, then the magnitude of corruption by police officials is estimated at over Rs 46 billion in the rural areas of Pakistan. This is at least as much as the annual salaries and allowances received by these officials.

Table 7.9
Experience with Corruption of Rural Households

	% Accessing the Service	No. of Times Last Year	% Accessing who Paid a Bribe	Average Amount of Bribe (Rs)
Police Thana	21	2.2	95	2150
Sessions Court	7	1.8	35	1130
NADRA	43	3.2	15	280
Revenue Dept	9	2.6	47	1280

Source: IPP estimates

Table 7.10
Experience with Corruption of Urban Households

	% Accessing the Service	No. of Times Last Year	% Accessing who Paid a Bribe	Average Amount of Bribe (Rs)
Police Thana	18	2.0	65	1870
NADRA	28	2.7	4	410
Sessions Court	5	1.6	15	1500

Source: IPP estimates

Urban

The corresponding figures for urban households are given in Table 7.10.

A comparison of the payment of bribes by urban and rural households reveals that, first, the incidence of corruption by the police is lower in the cities and, second, that NADRA has a record of delivering services with the least frequency of 'speed money'. On average, NICs and passports are delivered in about 30 days. Sessions courts are more prone to corruption in the rural areas. The relatively high presence of corruption in the rural areas has seldom been highlighted.

THE BENAZIR INCOME SUPPORT PROGRAMME

Rural

The extent of access of the sample rural households to the BISP is given in Table 7.11. There is significant variation among the provinces in the extent of participation in the BISP. The highest percentage is in Sindh of almost 35 percent followed by Balochistan at 33 percent. Overall, according to the sample, about 3 million rural households are participating in the BISP.

Table 7.11
Experience with BISP of Rural Households by Province

Provinces	% of Household Receiving Payments	% who have paid a Bribe to Participate in BISP
Punjab	20	15
Sindh	35	20
K-PK	19	0
Balochistan	33	60
National	23	17

Source: IPP estimates

It appears that among households receiving the benefit, one in six had to pay a bribe to participate in the programme. The incidence of corruption is the highest in Balochistan. It is significant that no household from K-PK reported any payment of bribe.

Urban

The extent of participation of urban households in the BISP is low in comparison to rural households. As shown in Table 7.12, only 6 percent of the sample households were receiving

BISP payments. However, the incidence of bribes appears to be somewhat higher, at close to one in four households. The highest coverage is in Balochistan and K-PK. According to the survey about 0.5 million households are participating in the BISP in the cities and towns of the country. As such, the BISP appears to have a rural focus with 86 percent of the households benefiting from the Programme living in villages.

Table 7.12
Experience with BISP of Urban Households by Province

Province	% of Household Receiving Payments	% who have paid a Bribe to Participate in BISP
Punjab	5	21
Sindh	3	25
K-PK	17	20
Balochistan	20	50
National	6	23

Source: IPP estimates

In terms of targeting efficiency, 57 percent of the households participating in the BISP are the lowest income households (with monthly expenditure less than Rs 15,000 per month)

INCIDENCE OF CRIME AND DISPUTES

The Citizen Score Card has revealed startling facts about the incidence of crime in the country.

Rural

The incidence of different crimes in the rural areas is given in Table 7.13.

During the year prior to the survey (February 2012 to February 2013) the sample rural households have highlighted a high incidence of crimes and disputes throughout the country, especially in Balochistan. The most frequent crime is dacoity/theft. Almost one in three households in the nationwide sample has revealed that it has been a victim of this crime. While the rise in urban crime has been adequately projected by the media, the spread of crime also in the rural areas merits more attention.

Table 7.13
Crime and Dispute Incidence Reported by Type by Rural Households
(percent of households surveyed*)

% Reporting Crime during last year	Punjab	Sindh	K-PK	Balochistan	Total
Murder	1	0	4	0	1
Dacoity/Theft	23	38	37	54	30
Kidnapping	2	7	0	0	2
Land Dispute	10	16	18	20	13
Water Dispute	2	0	7	0	1

*some households have reported more than one crime last year.
Source: IPP estimates

Table 7.14
Crime Incidence Reported by Type of Urban households
(percent of households surveyed)

% Reporting Crime during last year	Punjab	Sindh	K-PK	Balochistan	Total
Murder	1	1	0	0	1
Dacoity/Theft	15	6	7	60	12
Kidnapping	1	0	0	0	1
Snatching/Street Theft	18	47	5	60	29

*some households have reported more than one crime last year.
Source: IPP estimates

Urban

The corresponding levels of crime reported by urban households are given in Table 7.14.

The incidence of dacoity/theft in urban areas appears to be substantially lower than in the rural areas. The highest incidence of crime is in the case of snatching/ street theft. While the incidence of this crime in Sindh has been highlighted, it appears to be even higher in Balochistan. Overall, street theft has affected more than one in four persons.

The overall incidence of crime revealed by the sample of households is high. It underscores the sharp deterioration of the law and order situation in the country and the failure of police and other agencies to combat crime.

CHANGES IN STANDARD OF LIVING

At the end of the questionnaire, the households were asked whether they felt that their standard of living was better, same or worse as compared to five years ago. Here again, the results are revealing.

Rural

The results on change in standard of living are given in Table 7.15. The only province where some households, 10 percent, have reported an improvement is in Punjab. The reasons given for the improvement are higher crop price, higher crop output or larger remittances.

A significant proportion has indicated no change, ranging from 15 percent in Sindh to 33 percent in K-PK. But the striking finding is the large share of rural households who indicate a worsening in their standard of living compared to 5 years ago. The percentage varies from 67 percent in Punjab and Sindh to 100 percent in Balochistan. Overall, almost three-fourths of the rural households indicated that they are worse off compared to five years ago. This is contrary to the perception that rural households (especially the farming population) are better off because of better crop prices in recent years.

Table 7.15
Comparison of Present Standard of Living with 5 years ago by Rural Households

(Percent)

	Punjab	Sindh	K-PK	Balochistan	Total
Improvement	1	0	0	0	6
Same	23	15	33	0	21
Worse	67	85	67	100	73
Total	**100**	**100**	**100**	**100**	**100**

*some households have reported more than one crime last year.

Source: IPP estimates

Table 7.16
Reasons* for Deterioration in Standard of Living
(percentage of rural households indicating deterioration)

(Percent)

	Punjab	Sindh	K-PK	Balochistan	Total
High Prices	86	85	61	27	74
Unemployment	26	6	28	0	18
Law and Order Situation	22	12	56	93	32
Corruption	38	47	67	87	49
Others (electricity shortages, etc.)	67	52	43	58	57

*Multiple reasons given by households

Source: IPP estimates

There is significant variation regionally in the responses. The principal reason given in Punjab and Sindh is high prices, whereas it is corruption in K-PK and the law and order situation in Balochistan.

Urban

The responses on the standard of living by urban households are given in Table 7.17. The results are different from those for rural households.

The highest proportion of households declaring that their standard of living has fallen is from Punjab at 72 percent followed by Balochistan at 70 percent, Sindh at 65 percent and K-PK at 55 percent. Overall, the proportion of households in this category is, more or less, similar in the rural and urban areas.

Table 7.17
Comparison of Standard of Living of Urban Households with Five Years Ago

(Percent)

	Punjab	Sindh	K-PK	Balochistan	Total
Improvement	11	5	17	20	9
Same	17	30	28	10	22
Worse	72	65	55	70	69
Total	**100**	**100**	**100**	**100**	**100**

Source: IPP estimates

Table 7.18
Reasons* for Deterioration in Standard of Living by Urban Households

(Percent)

Reasons	Punjab	Sindh	K-PK	Balochistan	Total
Inflation	100	100	100	86	98
Unemployment	18	4	0	14	12
Law and Order Situation	22	33	10	43	26
Corruption	53	21	10	71	40

*Multiple reasons given by households
Source: IPP estimates

The reasons given for deterioration in the standard of living over last five years are given in Table 7.18. The predominant reason throughout the country is the rise in prices, followed by corruption and the law and order situation.

SUMMARY OF FINDINGS

A summary of the key findings from the Citizen Score Card of rural and urban households is given below:

Rural

- Relatively high level of satisfaction with LHWs and Revenue Department but low levels of satisfaction with the Police and Irrigation Department.
- By far the highest incidence of bribes is in dealings with the police; almost Rs 46 billion last year.
- Access to services, both economic and social, is generally higher in Punjab and in K-PK
- The private sector has substantial presence in the provision of social services even in the rural areas.
- Approximately 3 million households in rural areas are receiving BISP payments. The incidence of bribes is 17 percent.

- The incidence of crime is surprisingly high, with 42 percent of the sample rural households being victim of some crime last year. The incidence is the highest in Balochistan, followed by Sindh and the most common crime is dacoity/ theft. There is apparently a breakdown of law and order even in the rural areas of the country.
- Two-thirds of the surveyed rural households indicate that their standard of living has worsened over the last five years. The principal reasons for the deterioration are high prices, law and order situation, corruption and electricity shortages.

Urban

- Relatively very low level of satisfaction with the police and high level of satisfaction with NADRA. High incidence of bribes to police, especially in Sindh, amounting to over Rs 10 billion in the country.
- Very strong preference for privately provided social services, especially in Sindh. Households using public facilities voice a high level of dissatisfaction.
- About 6 percent of urban households are receiving BISP payments, equivalent to 0.5 million households. 23 percent had to pay bribes to gain access. The targeting is satisfactory.
- Urban households have reported high incidence of crime. 42 percent have been victims of some crime last year, with the highest percentages in Balochistan and Sindh. The most frequently reported crimes are snatching/ street theft and theft at home. It is striking that almost 40 percent of respondants in Sindh and 60 percent in Balochistan have been victims of street crime.
- As expected, in the presence of extremely high levels of loadshedding, over 80 percent households have expressed a high level of dissatisfaction with electricity supply.
- The majority, 69 percent of the respondants indicate that their standard of living has worsened over the last five years, attributable mostly again to high inflation, corruption, the worsening law and order situation and loadshedding

The Citizen Score Card has indicated services where either the extent of coverage is limited or the level of satisfaction is low. Clearly, these are the services which the incoming Government will have to focus on in the next few years.

Statistical Appendix

Key Indicators

Statistical Appendix
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	1.4	4.04	1.68
2003-04	7.5	2.1	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	2.88	0.8	4.85	0.82
2007-08	3.7	5.18	-3.1	4.07	1.22
2008-09	1.7	9.42	-4.8	4.60	n.c
2009-10	3.1	4.88	-1.6	4.93	1.98
2010-11	3.0	4.49	-2.0	4.62	n.c
2011-12	3.7	3.24	0.0	3.52	1.84
Average	**4.5**	**4.63**	**-0.2**	**6.40**	**1.22**

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	22.1	61.5	73.2	36.0
2008-09	18.2	68.7	74.0	41.8
2009-10	15.4	85.1	73.9	46.0
2010-11	13.1	100.8	72.3	50.8
2011-12	12.5	84.0	72.7	57.8
Average	**17.7**	**91.5**	**72.4**	**37.5**

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
2006-07	4.1	61.0	0.2	13.7	6.4
2007-08	1.0	n.c.	-3.7	-18.8	-0.2
2008-09	4.0	59.1	-0.1	-6.6	14.4
2009-10	0.6	n.c	-3.8	15.3	-0.7
2010-11	2.4	8.8	-0.8	-13.5	-2.8
2011-12	3.1	28.2	1.5	-46.0	-9.8
Average	**2.7**	**n.c**	**-0.3**	**-5.2**	**0.1**

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

Source: Pakistan Economic Survey (various issues)

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

Table A-4
Level and Pattern of Manufacturing Growth

	Growth Rate (%)	Growth Rate of Export Oriented Industries (%)	Growth Rate of Import Substituting Industries (%)	Share of Growth in Large-Scale Manufacturing (%)	Growth Rate of Manufactured Exports (%)
1999-2000	1.5				
2000-01	9.3	27.6	4.6	76.3	6.2
2001-02	4.5	9.7	3.1	52.0	1.5
2002-03	6.9	4.3	7.6	68.2	22.2
2003-04	14	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	12.8	2.3	58.9	12.2
2008-09	-3.6	4.3	-2.4	n.c.	3.3
2009-10	5.5	6.5	14.8	58.4	0.4
2010-11	3.1	4.7	3.8	24.8	20.3
2011-12	3.6	0.5	4.5	32.5	3.9
Average	**6.3**	**10.1**	**4.5**	**62.9**	**9.6**

n.c. = not computed

Source: Pakistan Economic Survey (various issues)
SBP, Annual Report (various issues)

Table A-5
Growth in Employment by Sector

	Employment (000)						2001-02 to 2010-11		
	2001-02	2005-06	2006-07	2007-08	2009-10	2010-11	Employment Growth Rate (%)	Value Added Growth Rate (%)	Employment Elasticity
Agriculture	20474	19075	20775	21894	23945	24228	1.9	3.3	0.58
Manufacturing and Mining	4982	5421	6433	6382	7024	7376	4.5	7.3	0.62
Electricity and Gas	299	296	n.a	n.a	n.a	n.a	-0.3	3.9	-0.07
Construction	2757	3579	3145	3093	3565	3769	3.5	5.6	0.63
Wholesale and Retail Trade	5090	6635	6862	7167	8673	8722	6.2	4.6	1.35
Transport and Communication	2216	2452	2573	2700	2820	2746	2.4	3.5	0.69
Finance and Insurance	247	491	n.a	n.a	n.a	n.a	18.7	17.9	1.05
Public Administration and Community Services	7151	8405	6862	6725	5960	5815	-2.3	6.8	-0.34
Total	**43286**	**46365**	**47650**	**49090**	**53210**	**53840**	**2.5**	**4.9**	**0.51**

n.a = not available

Source: Labour Force Survey, PBS (various issues)
Pakistan Economic Survey (various issues)

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	11.6
2008-09	20.8	23.7	19.2	25.1	7.9
2009-10	10.1	12.6	11.6	6.2	9.4
2010-11	13.7	18.3	9.4	20.7	12.9
2011-12	11.0	11.0	10.6	21.8	9.4
Average	**8.5**	**10.7**	**9.6**	**13.7**	**10.3**

n.a = not available

Source: Pakistan Economic Survey (various issues)
SBP, Annual Report (various issues)
IMF

Table A-7
Fiscal Policy

(*Percentage 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	9.8	-2.3	0.3
2004-05	13.8	17.2	9.7	-3.3	0.5
2005-06	14.1	18.4	10.2	-4.3	0.5
2006-07	15.0	20.8	11.4	-4.3	-0.9
2007-08	14.6	22.2	13.1	-7.6	-3.5
2008-09	14.5	19.9	10.9	-5.3	-1.5
2009-10	14.0	20.3	12.3	-6.3	-2.7
2010-11	12.5	19.2	12.1	-6.6	-3.5
2011-12	12.4	20.9	13.6	-8.5	-4.6
Average	**13.9**	**19.0**	**10.8**	**-5.1**	**-1.7**

Source: Pakistan Economic Survey (various issues)
SBP, Annual Reports (various issues)
MofF, 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	n.a	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	1.1	67.8	9.4	47.4
2004-05	0.3	62.9	8.5	27.7
2005-06	-0.9	57.3	10.2	21.8
2006-07	-1.3	55.4	13.8	37.5
2007-08	-2.6	59.0	13.7	80.5
2008-09	-0.2	60.0	12.9	54.2
2009-10	-1.8	60.2	12.4	32.8
2010-11	-2.6	59.3	10.5	51.5
2011-12	-4.2	61.3	10.4	57.3
Average	**-0.87**	**67.0**	**11.5**	**29.9**

n.a = not available

Source: Pakistan Economic Survey (various issues)
SBP, Annual Reports (various issues)
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 percentage 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	4.9	7.6	2.9	10.0	9.8
2008-09	4.6	5.7	5.7	10.0	9.1
2009-10	4.8	5.7	5.0	10.1	8.9
2010-11	4.4	5.6	4.3	10.3	8.6
2011-12	4.6	5.6	3.3	11.0	9.1
Average	**4.4**	**10.9**	**3.9**	**11.4**	**9.2**

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

[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[a] (% Change of broad money)	Net Domestic Assets[b] (% Change of broad money)	Private Credit Growth (%)	Interest Rate on Six Month Treasury Bill (%)	Broad Money Growth (%)	Interest Rate Spread[c] (%)
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	11.5	15.3	8.4
2008-09	-3.2	12.8	0.7	12.0	9.6	9.8
2009-10	-6.9	0.8	3.9	12.3	12.5	9.3
2010-11	23.5	-2.4	4.0	13.7	15.9	9.0
2011-12	-40.2	5.3	-34.1	11.9	14.1	8.3
Average	**4.9**	**8.9**	**9.5**	**9.0**	**14.8**	**8.5**

Source: State Bank of Pakistan, Annual Report (various issues)
IMF Article 4 Consultation's Press Releases
[a]Growth rate of net foreign assets/broad money ratio
[b]Growth rate of net domestic assets/broad money ratio
[c]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	0.23	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	0.23	8.0
2007-08	16.5	0.722	0.19	31.2
2008-09	-6.4	0.709	0.16	-10.3
2009-10	2.9	0.717	0.199	-1.7
2010-11	28.9	n.a	n.a	14.9
2011-12	-2.8	n.a	n.a	11.9
Average	**10.2**	**0.763**	**0.214**	**14.2**

n.a = not available

Source: Pakistan Economic Survey (Various issues)
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	-11.5	38.9
2008-09	2.8	41.9
2009-10	0.0	42.3
2010-11	2.8	42.7
2011-12	-5.9	45.8
Average	**-5.4**	**36.6**

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	-1.12
2008-09	-5.7	212.9	9118	2.8	25.5	-1.0
2009-10	-2.3	218.9	12958	2.9	6.8	1.0
2010-11	0.1	191.2	14784	3.6	2.0	6.5
2011-12	-2.0	208.5	10803	2.9	4.4	3.0
Average	**-1.7**	**222.1**	**9103**	**3.4**	**4.8**	**0.5**

Source: SBP, Annual Report (various issues)
IMF Article IV Consultation's Press Releases

Table A-13
Trend in Income Inequality Growth in Real Per Capita Income by Quintile

(*Annual Growth Rate, percent*)

	QUINTILE					
	Total	1st	2nd	3rd	4th	5th
			2001-02 to 2005-06			
Pakistan	**8.4**	**4.9**	**6.3**	**7.5**	**8.1**	**10.4**
Urban	5.3	0.7	0.7	3.7	2.8	6.1
Rural	9.5	5.8	8.0	9.0	11.2	14.9
			2005-06 to 2007-08			
Pakistan	**0.4**	**-0.9**	**0.7**	**-0.9**	**-0.2**	**1.0**
Urban	2.4	5.7	6.5	1.2	4.7	2.0
Rural	-0.7	-2.1	-1.1	-1.7	-3.0	0.1
			2001-02 to 2007-08			
Pakistan	**5.6**	**2.9**	**4.4**	**4.6**	**5.3**	**7.2**
Urban	4.3	2.3	2.6	2.9	3.4	4.8
Rural	6.0	3.1	4.9	5.3	6.3	9.7
			2007-08 to 2010-11			
Pakistan	**0.4**	**0.3**	**-0.5**	**0.0**	**1.6**	**0.3**
Urban	0.7	-1.1	1.7	0.7	3.2	-0.1
Rural	-0.1	0.6	-1.3	-0.3	0.6	0.6
			2001-02 to 2010-11			
Pakistan	**3.9**	**2.0**	**2.7**	**3.1**	**4.0**	**4.9**
Urban	3.1	1.2	2.3	2.2	3.3	3.1
Rural	4.0	2.2	2.8	3.4	4.3	6.6

Source: Household Integrated Expenditure Survey, PBS (various issues)

Table A-14
Trend in Regional Inequality
Coverage of Education and Health Services

	1998-99	2001-02	2006-07	2007-08	2008-09	2010-11
Gross Primary Enrolment Rate						
Punjab	75	76	100	97	97	98
Sindh	64	63	79	80	84	84
K-PK	70	77	82	83	87	89
Balochistan	64	62	72	75	75	74
Max/Min Ratio	**1.172**	**1.242**	**1.389**	**1.293**	**1.293**	**1.324**
Net Primary Enrolment Rate						
Punjab	44	45	62	61	62	61
Sindh	41	40	50	51	54	53
K-PK	39	41	49	49	52	51
Balochistan	36	32	41	41	44	47
Max/Min Ratio	**1.222**	**1.406**	**1.512**	**1.488**	**1.409**	**1.298**
Gross Middle Enrolment Rate						
Punjab	43	45	55	59	57	58
Sindh	38	34	43	46	49	48
K-PK	37	38	53	52	54	57
Balochistan	29	33	34	35	36	35
Max/Min Ratio	**1.483**	**1.364**	**1.618**	**1.686**	**1.583**	**1.657**
Net Middle Enrolment Rate						
Punjab	19	18	20	19	22	23
Sindh	17	14	17	18	18	19
Khyber-Pakhtunkhwa	11	12	16	14	17	17
Balochistan	9	8	9	12	11	13
Max/Min Ratio	**2.111**	**2.250**	**2.222**	**1.583**	**2.000**	**1.769**
Gross Matric Enrolment Rate						
Punjab	37	44	51	54	57	61
Sindh	51	42	45	44	50	55
K-PK	36	41	45	48	51	54
Balochistan	41	29	33	34	34	38
Max/Min Ratio	**1.244**	**1.517**	**1.545**	**1.588**	**1.676**	**1.605**
Net Matric Enrolment Rate						
Punjab	12	12	11	13	13	14
Sindh	10	13	10	11	11	11
K-PK	6	10	6	6	8	7
Balochistan	3	6	5	5	5	6
Max/Min Ratio	**4.000**	**2.000**	**2.200**	**2.600**	**2.600**	**2.333**
Literacy Rate (10 +)						
Punjab	46	47	58	59	59	60
Sindh	51	46	55	56	59	59
K-PK	37	38	47	49	50	50
Balochistan	36	36	42	46	45	41
Max/Min Ratio	**1.417**	**1.306**	**1.381**	**1.283**	**1.311**	**1.463**
Full Immunisation						
Punjab	55	57	83	76	85	86
Sindh	38	45	65	67	69	75
K-PK	54	57	76	74	73	77
Balochistan	34	24	54	57	43	53
Max/Min Ratio	**1.618**	**2.375**	**1.537**	**1.333**	**1.977**	**1.623**

Source: Pakistan Social and Living Standard Measurement Survey, PBS (various issues)

Table A-15
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS: EARLIEST YEAR[a] Year	Number of Countires	Ranking[c]	LATEST YEAR[b] Year	Number of Countries	Ranking[c]
1 Transparency International (TI)	Corruption Perception Index (CPI)	1995	41	39	2012	176	139
2 Freedom House (Freedom in the World)	Political Rights Score	2002	151	131	2012	193	123
	Civil Liberties Score	2002	151	135	2012	193	162
	Status	2002	Not Free	-	2011	Partly Free	-
3 Freedom House (Countries at the Crossroads)	Civil Liberties	2004	30	28	2011	35	28
	Rule of Law	2004	30	27	2011	35	21
	Anticorruption and Transparency	2004	30	22	2011	35	24
	Accountability and Public Voice	2004	30	27	2011	35	12
4 Freedom House (Countries at the Crossroads)	Voice & Accountability	1996	191	123	2008	197	138
5 Freedom House (Press Freedom Survey)	Status	2002	Not Free	-	2009	Not Free	-
	Legal Environment	2002	187	172	2009	195	174
	Political Environment	2002	187	177	2009	195	178
	Economic Environment	2002	187	176	2009	195	172
	Total Score	2002	187	172	2009	195	175
6 World Bank Institute (Governance Matters)	Voice & Accountability	1996	194	139	2012	214	158
	Political Stability and Absence of Violence	1996	180	162	2012	213	212
	Government Effectiveness	1996	182	120	2012	212	165
	Regulatory Quality	1996	183	130	2012	212	149
	Rule of Law	1996	171	105	2012	214	170
	Control of Corruption	1996	154	127	2012	214	179
7 World Bank - World Development Indicators [Country Policy and Institutional Assessment (CPIA)	CPIA Building Human Resources Rating	2005	76	46	2011	78	51
	CPIA Business Regulatory Environment Rating	2005	76	15	2011	78	52
	CPIA Debt Policy Rating	2005	76	12	2011	78	42
	CPIA Economic Management Cluster Average	2005	76	15	2011	78	66
	CPIA Efficiency of Revenue Mobilisation Rating	2005	76	40	2011	78	58
	CPIA Equity of Public Resource Use Rating	2005	76	38	2011	78	39
	CPIA Financial Sector Rating	2005	76	1	2011	78	10
	CPIA Fiscal Policy Rating	2005	76	41	2011	78	71
	CPIA Gender Equality Rating	2005	76	75	2011	78	74
	CPIA Macroeconomic Management Rating	2005	76	17	2011	78	76
	CPIA Policies for Social Inclusion/Equity Cluster Average	2005	76	54	2011	78	52
	CPIA Policy and Institutions For Environmental Sustainability Rating	2005	76	22	2011	78	71
	CPIA Property Rights and Rule-Based Governance Rating	2005	76	41	2011	78	62
	CPIA Public Sector Management and Institutions Cluster Average	2005	76	39	2011	78	46
	CPIA Quality of Budgetary and Financial Management Rating	2005	76	34	2011	78	33
	CPIA Quality of Public Administration Rating	2005	76	19	2011	78	16
	CPIA Social Protection Rating	2005	76	55	2011	78	55
	CPIA Structural Policies Cluster Average	2005	76	2	2011	78	42
	CPIA Trade Rating	2005	76	37	2011	78	60
	CPIA Transparency, Accountability, and Corruption In The Public Sector Rating	2005	76	63	2011	78	62

Table A-15 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

		INDICATORS					
		EARLIEST YEAR[a]			LATEST YEAR[b]		
Source	Type	Year	Number of Countires	Ranking[c]	Year	Number of Countires	Ranking[c]
8 UNDP Human Development Report	Gender Empowerment Measure	1996	104	101	2007	109	99
9 Overseas Development Institute (World Governance Assessment)	Civil Society	1996	16	15	2000	16	16
	Political Society	1996	16	16	2000	16	16
	Government	1996	16	15	2000	16	16
	Bureaucracy	1996	16	14	2000	16	12
	Economic Society	1996	16	15	2000	16	13
	Judiciary	1996	16	16	2000	16	16
	Total	1996	16	15	2000	16	15
10 Human Rights Commitment (Danish Centre for Human Rights)	CPR Violations	2000	72	30	na		
	Formal Commitment	2000	72	15	na		
	Social Commitment	2000	72	41	na		
	Gender Commitment	2000	72	42	na		
11 Data on Governance Indicators (IADB/DIFID)	Freedom of the Press	1993	92	80	2008	211	180
	Political Rights	1993	92	85	2008	211	162
	Political Stability and Absence of Violence	1993	92	72	2008	211	195
	Voice and Accountability	1993	92	60	2008	211	185
12 Center for Global Development	Commitment to Development Index	n.a	n.a	n.a	n.a	n.a	n.a
13 Democracy Index Economist Intelligence Unit (EIU)	Overall Score	2006	167	113	2012	167	108
	Electoral Process and Pluralism	2006			2012	167	104
	Functioning of Government	2006			2012	167	83
	Political Participation	2006			2012	167	148
	Political Culture	2006			2012	167	142
	Civil Liberties	2006			2012	167	106
14 Polity IV Country Reports (University of Maryland - Center for International Development and Conflict Management)	Polity	1972	154	112	2007	163	145
	Democracy	1972	154	121	2007	163	129
	Autocracy	1972	154	110	2007	163	134
	Durable	1972	154	135	2007	163	148
	Tentative	1972	Not	-	2007	Yes	-
15 Business Environment Risk Intelligence (BERI)	Political Stability and Absence of Violence	1996	101	47	2008	101	92
	Government Effectiveness	1996	101	84	2008	119	87
	Rule of Law	1996	119	87	2008	119	52
	Control of Corruption	1996	119	59	2008	119	57
16 Gallup International (Gallup World Poll)	Voice & Accountability	2006	122	80	2008	143	102
	Government Effectiveness	2006	122	61	2008	143	53
	Rule of Law	2006	122	62	2008	143	94
	Control of Corruption	2006	122	75	2008	143	62
17 Index of Economic Freedom (Heritage Foundation and Wall Street Journal)	Business Freedom	1995	101	88	2013	183	69
	Trade Freedom	1995	101	87	2013	180	144
	Fiscal Freedom	1995	101	63	2013	179	74
	Government Size	1995	101	35	2013	180	17
	Monetary Freedom	1995	101	48	2013	181	151
	Investment Freedom	1995	101	33	2013	182	137
	Financial Freedom	1995	101	21	2013	180	122
	Property Rights	1995	101	32	2013	180	123
	Freedom from Corruption	1995	101	90	2013	184	140
	Labor Freedom	1995	155	88	2013	182	143
	Overall Index	1995	101	52	2013	177	121

Table A-15 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS: EARLIEST YEAR[a]: Year	Number of Countires	Ranking[c]	LATEST YEAR[b]: Year	Number of Countires	Ranking[c]
18 Voter Turnout: Global Report	Vote to Registration Ratio, Parliamentary Elections	1945-2004	169	164			
19 Inter-Parliamentary Union (Women in National Parliaments -Statistical Archive)	Lower or single House Upper House or Senate (Women's weight)	1997	102	95	2008	136	46
	Lower or single House Upper House or Senate (Women's weight)	1997	102	95	2008	136	46
20 The Opacity Index (Price Waterhouse Coopers)	Corruption	2004	48	42			
	Efficacy of the Legal System	2004	48	36			
	Deleterious Economic Policy	2004	48	44			
	Inadequate Accounting and Governance Practices	2004	48	29			
	Detrimental Regulatory Structures	2004	48	19			
	The Opacity Index	2004	48	28			
21 Reporters without Borders (Press Freedom Barometer)	Press Freedom Index	2002	139	119	2013	179	159
22 University of California Santa Barbara (Stohl)	Political Terror Scale Amnesty International	1977	101	89	1977	152	
	US State Department	2008	111	96	2008	179	
23 Governance-III (USAID)	Voice & Accountability	1996	192	151	2005	208	182
	Political Stability and Absence of Violence	1996	186	165	2005	213	201
	Government Effectiveness	1996	180	108	2005	210	139
	Regulatory Quality	1996	182	138	2005	203	147
	Rule of Law	1996	167	104	2005	208	158
	Control of Corruption	1996	151	127	2005	204	140
24 Bertelsmann Transformation Index (Bertelsmann Stiftung)	Voice & Accountability	2002	116	85	2008	125	93
	Government Effectiveness	2002	116	53	2008	125	81
	Regulatory Quality	2002	116	61	2008	125	78
	Rule of Law	2002	116	80	2008	125	97
	Control of Corruption	2002	119	63	2008	125	86
25 Cingranelli-Richards (CIRI) Human Rights Database (CIRI Human Rights Data Project)	Voice & Accountability	1996	159	136	2008	192	156
	Political Stability and Absence of Violence	1996	174	152	2008	192	186
	Rule of Law	1996	159	109	2008	192	176
26 International Fund for Agricultural Development (IFAD Rural Sector Performance Assessments)	Voice & Accountability	2004	124	21	2008	90	59
	Government Effectiveness	2004	124	27	2008	90	68
	Regulatory Quality	2004	124	71	2008	90	28
	Rule of Law	2004	124	106	2008	90	62
	Control of Corruption	2004	124	45	2008	90	59
27 Institutional Profiles (Institutional Profiles Database)	Voice & Accountability	2006	85	63	2008	85	63
	Political Stability and Absence of Violence	2006	85	81	2008	85	81
	Government Effectiveness	2006	85	75	2008	85	75
	Regulatory Quality	2006	85	59	2008	85	59
	Rule of Law	2006	85	69	2008	85	69
	Control of Corruption	2006	85	49	2008	85	49
28 International Budget Project Open Budget Index	Voice & Accountability	2005	59	19	2012	100	29
29 Global Insight Business Conditions and Risk Indicators	Voice & Accountability	1998	181	127	2008	203	170
	Political Stability and Absence of Violence	1998	181	142	2008	203	194

Table A-15 (Contd.)
Trend in Pakistan's Ranking in Different Governance Indicators

Source	Type	INDICATORS					
		EARLIEST YEAR[a]			LATEST YEAR[b]		
		Year	Number of Countires	Ranking[c]	Year	Number of Countries	Ranking[c]
	Government Effectiveness	1998	181	157	2008	203	176
	Regulatory Quality	1998	181	159	2008	203	199
	Rule of Law	1998	181	133	2008	203	185
	Control of Corruption	1998	181	150	2008	203	179
30 Country Security Risk Ratings (IJET Country Security Risk Ratings)	Political Stability and Absence of Violence	2004	167	149	2011	190	183
31 Cerberus Corporate Intelligence Gray Area Dynamics [Merchant International Group (MIG)]	Political Stability and Absence of Violence	2002	118	118	2008	164	162
	Government Effectiveness	2002	118	118	2008	164	145
	Regulatory Quality	2002	118	107	2008	164	57
	Rule of Law	2002	118	113	2008	164	87
	Control of Corruption	2002	118	118	2008	164	148
32 Country Policy and Institutional Assessments (Asian Development Bank)	Government Effectiveness	2005	25	6	2011	212	165
	Regulatory Quality	2005	25	6	2011	212	149
	Rule of Law	2005	25	16	2011	212	170
	Control of Corruption	2005	25	19	2011	212	179
33 Brown University's Center for Public Policy	Government Effectiveness	2002	194	127	2008	196	109
34 Trafficking in People Report (United States Department of State)	Rule of Law	2000	82	74	2008	153	76
35 World Economic Forum	Global Competitiveness Scale	2008	131	92	2013	144	124

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

Source: IPP estimates from the various international sources of governance indicators.

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Notes:

CHAPTER 1

1. *State Bank of Pakistan Annual Report*, 2011-12, Karachi, 2012, p. 1.
2. *Ibid*, p. 8.
3. See the *International Monetary Fund, Pakistan: 2011 Article IV Consultation and Proposal for Post-Program Monitoring*, IMF Country Report No. 12/35, February 2012.
4. See Transparency International, *Corruption Perceptions Index*, 2012.
5. Richard Leiby, '*U.N. says U.S drone strikes in Pakistan violate sovereignty*', The Washington Post, March 16, 2013, p. A7.
6. Institute of Public Policy, *State of the Economy, Pulling Back from the Abyss*, Lahore, 2010, p. 75.
7. Gunnar, Myrdal. *Asian Drama: An Inquiry into the Poverty of Nations*, Volumes 1, 2 and 3, The Twentieth Century Fund, New York, 1968.
8. Samuel P. Huntington, *Political Order in Changing Societies New Haven*, Conn., Yale University Press, 1968.
9. *The Economist*, 'Election time in Pakistan: Hollow Milestone', March 23, 2013, pp. 48-49.

CHAPTER 2

1. See Saqib Shirani, *Informal Economy*, Dawn Newspaper February 22, 2013.
2. Dawn Newspaper October 4, 2012.
3. The Sixth NFC in January 1997 made the larger share in divisible pool provided to the provinces contingent on their taxing of agricultural incomes. The provinces committed themselves to taxing agricultural incomes at the rate 2 percent per annum. This was to be done by using a production price index for estimating incomes from agriculture. However, the index to be used was not linked to the rate of inflation. Consequently the tax rate related to agriculture income has declined to less than one percent of combined provincial product in 2011-12. Restoring – preferably increasing – the incidence of tax on agricultural incomes should be taken up by the federal government in the Council of Common Interests.
4. Reference Dawn Report above.
5. Transactions with the IMF are denominated in SDRs (Special Drawing Rights) and its rate with the US dollar fluctuates daily because of changes in the value of dollar in relation to other major currencies that provide the basket for the SDR. At present, the value of an SDR unit is equal to US $1.5.
6. Institute of Public Policy, *State of the Economy: Pulling from the Abyss*, 2010, Chapter 4 Box 4.1
7. State Bank of Pakistan, Annual Report 2011-12 Volume 1.

CHAPTER 3

1. In view of the rapidly changing economic situation, especially with regard to the level of foreign exchange reserves, latest monthly data up to 15 April 2013 is analysed in this chapter.

CHAPTER 4

1. This gap is based on little or no growth in demand in 2011.
2. Including restart times.
3. With exchange rate of $1 = Rs 98.

CHAPTER 6

1. Government of Pakistan, *Towards a New Growth Strategy*, Islamabad, The Planning Commission, January 2011.
2. The Nation, '*New Army Doctrine declares guerrilla activities, bombings as biggest threat*', 3 January, 2013, p. 1.
3. For details see Chapter 8 of 2010 Annual Report of IPP.
4. Charles Leadbeater, 'Time to look again at Pakistani society', *Financial Times*, November 7, 2012.
5. The data are from Asia Society, *Asia's Next Challenge: Setting the Region's Water Future*, New York, 2009.
6. Michael Kugelman and Robert M. Hathaway, *Running on Empty: Pakistan's Water Crisis*, Woodrow Wilson Center for Scholars, Washington Dc, 2009.
7. Adrien Couton, "Tackling the water crisis in Pakistan: What entrepreneurial approach can do", in Michael Kugelman and Robert M. Hathaway (editors), *Running on Empty: Pakistan's Water Crisis*, Woodrow Wilson Center for Scholars, Washington Dc, 2009.

CHAPTER 7

1. Confidence intervals at 95 percent level are available from the author on request.