

**RASHID AMJAD**  
**SHAHID JAVED BURKI**

(Editors)

# PAKISTAN

MOVING THE ECONOMY FORWARD



**Lahore School of Economics**





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## Preface

When we, the two editors of this volume, joined a group of South Asian economic experts at a meeting held in Kathmandu, Nepal, in the summer of 2011, there was much discussion on the economic gains to be made if the South Asian countries could work together. We discussed how the differences in the endowments and advantages of these countries could be aggregated and used for the benefit of the entire citizenry. "Connectivity" was another subject of great interest.

In meetings such as these, there is as much talk around the table as off it. The Kathmandu meeting was no exception. Several of us spent a few evenings together reflecting on how the possibility for achieving the regional goal could be realized in South Asia. In our discussion, we were struck by one thing: there was a great deal of hope expressed by the representatives from Bangladesh, India, and Sri Lanka about their countries and how they could contribute to regional integration and South Asian development. Even the Bhutanese and Nepalese at the meeting thought that their most significant difficulties were behind them. It was only the Pakistani group that displayed some diffidence. It was at some point in this discussion that we began to ask whether Pakistan had been dealt such a poor hand that it could not sit at the table with hope and play the game the other South Asian nations were eager to join. It was then that the idea of assembling a book of essays on Pakistan's future was born.

We felt there was no reason for Pakistan should stay apart from the region, unable to take advantage of its size and the opportunities these offered. In fact, the country's location offered some unique advantages that could be exploited by intelligent public policymaking. But that would need good and detailed knowledge about the nature of the economy. We thought a book was needed on Pakistan and the country's future by a group of scholars who had deep understanding of the various aspects of the country's economy. We were well aware that there were a number of analysts who were beaver away in various institutions around the

country—and also outside it—developing an appreciation of the ways the various parts of the economy worked. We thought it would not only be useful but also necessary for the crafting of public policy to bring together these scholars within the covers of one edited volume. We agreed to contribute essays of our own to such a book and to edit it as well.

In asking for contributions to the edited volume, we agreed that the following three criteria would be kept in view. One, the discussion should be about the future. We could talk about the past but only if it informed our thinking about the future. Two, the book had to deal with a variety of topics but not go into disciplines that were too distant from economics. In other words, the proposed volume would be a book by economists on economics for economic policymakers. By focusing on many subjects within economics, there would necessarily be an emphasis on the micro rather than only on the macro. “Small” in the economies under stress needs even more attention than the big picture. Three, we would ask the invited authors to present their recipes for the future, which should be made available to a new set of policymakers who would be ushered into policymaking positions after the elections of May 11, 2013.

As the title of the book suggests, this is a forward-looking book. It is also a collection that discards the notion that Pakistan for some inexplicable reason is condemned to being the “sick man” of South Asia. Between the two of us, we have enough experience from around the globe to know that there are no permanent trends in the lives of individuals nor in those of nations. Countries have their ups and downs; Pakistan is currently passing through a “down”. There is enough inherent strength in the country and its people, and enough richness in its endowments, to pull the country out of its current slump.

The book’s appearance is timely since we believe that, no matter which way the election goes (this preface was written a day before the country went to the polls), it will bring about a change in the making of economic policies and also in the direction in which the country will go. As a politician said not too long ago, a crisis is too precious a thing to waste. Pakistan is in crisis. This is recognized by all its citizens. It is also understood by all politicians and all political parties. Reading the manifestoes of the mainstream political parties shows a remarkable amount of consensus on what ails the country, and also that there is no reason why the difficulties that have produced the current situation cannot be overcome.

What is needed at this difficult moment in Pakistan’s history is a development paradigm that simultaneously seeks to “go over” the number of obstacles that have slowed the pace of the economy’s advance.

To carry the metaphor forward, these are not “speed-bumps” that we need to cross by slowing down; these are real walls that we have run into time and again in our move forward. We need to pull them down, not skirt around them, as we have tended to do too often in the past. Bringing the wall down is something economists call structural changes. We have shied away from these, taking the easy route ahead. This approach will not do and that is the main theme of this collection of essays. Reading them together, as they should be read, there are enough ideas present in these essays to help the country move forward and stay on a course that will finally produce high rates of sustainable growth. We wish the new policymakers well in their new endeavors.

In putting this volume together, we must thank and acknowledge a number of people and institutions who have made this book possible. First and foremost are the authors of the different chapters who set aside their precious time to contribute to the volume, and have done so purely as a labor of love and because of their commitment to improving the lives of the people of Pakistan. We must also thank the Pakistan Institute of Development Economics (PIDE), which, with support from the Higher Education Commission, arranged the first meeting of the authors to discuss the outline of the book and its individual chapters.

In preparing the manuscript, Ms Maheen Pracha did an excellent job in editing the different chapters and her work drew praise from all the authors. Ms Anam Yusuf provided splendid support in the preparation of the volume. Mr Nasir worked tirelessly and literally around the clock to ensure the timely publication of the volume. To all of them our heartfelt thanks.

Shahid Javed Burki and Rashid Amjad  
Lahore, Pakistan  
10 May 2013



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# 1

## Overview

### **Rashid Amjad and Shahid Javed Burki**

The central question that the contributors to this volume seek to answer is how to reverse the current prolonged period of low growth and high inflation—stagflation—that the country has experienced over the past five years, and to suggest and implement measures that would decisively move the economy onto a higher, more sustainable growth path.

Eight key messages emerge from the studies presented in this volume:

The first is the urgent need to revive investment, which has fallen dismally to 12.5 percent of GDP in 2011/12 from its peak of 22.5 percent in 2006/07, by improving the investment climate and removing binding constraints—especially in energy—on new domestic and foreign investment. Pakistan needs to increase its investment-to-GDP ratio to over 30 percent over the next decade if it is to generate sufficient employment to productively employ its fast-growing labor force and compete effectively with other rapidly growing developing countries. However, in the medium term, investment may continue to be constrained by resource availability and so, in the near future, a large part of the revival of growth will have to come from exploiting unused capacity and productivity gains.

The second is that Pakistan's economic problems are basically structural and not just cyclical in nature. Deep economic reforms are needed to remove structural imbalances to increase efficiency and competitiveness, and to spur entrepreneurship and innovation in the economy. Undertaking these reforms will require political will and a carefully sequenced pace of critical reforms so as to ease the burden of adjustment.

The third is to overcome the binding constraints to Pakistan's growth in order to revive the economy and ensure sustainable growth. These

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include overcoming the crippling energy shortage, increasing revenues to regain macroeconomic stability and reduce the current unsustainable fiscal deficit, and ensuring the availability of water to meet the needs of the agricultural economy.

The fourth message is to make exports a major driver of economic growth. This will mean reversing Pakistan's past poor performance in integrating with global markets—reflected in the country's stagnant share in global exports. It will need bold steps to create and take advantage of regional trade opportunities, including trade with India. Critical to the success of this strategy will be to improve the quality of Pakistan's human resource, which could provide the cutting edge in a highly competitive global economy.

The fifth is that the economy has been badly mismanaged, not just in recent years, but also over a long period of time. This has considerably hampered its economic performance and reflects poor economic decision-making, uncoordinated responses, lack of implementation, rampant corruption, and poor governance.

The sixth is that the country must aim not only for sustained and higher growth, but also inclusive growth such that the poor and vulnerable both participate in as well as share the gains of economic growth, and that development spreads to the country's less developed economic regions.

The seventh is that, after the passage of the National Finance Commission (NFC) Award and the 18th Constitutional Amendment, a much greater responsibility falls on the federating units. The provinces will now have to play a major role in economic management and improving the welfare of the people. This will require their greater participation in overall macroeconomic management as well as close coordination between the federal and provincial governments in formulating and implementing development plans.

The eighth message concerns the roles of the state and the private sector. Having alternated between the ascendancy of the state and private enterprise for decades, the country needs to settle into a mutually supportive relationship between these two components of the economy. The private sector should play the leading role in all economic activity but within a well-functioning regulatory environment developed by the government. The government's primary role should be to provide social and physical infrastructure, support for cutting-edge research, and affordable social protection and safety nets for the poor.

Pakistan has enormous potential for high and inclusive growth if its resources are well and effectively managed. The policy recommendations emanating from this volume can play an important role in realizing this potential.

### **Lessons from the Past**

Pakistan's economic performance over the past 65 years has both confounded its critics—when the country has performed much better than expected, especially in the early years—and disappointed those who had high expectations, given its initial start and economic potential. Hasan (Chapter 2) traces Pakistan's economic history since independence as the economy went through recurring cycles of high and low economic growth. He identifies factors responsible for these episodes under different regimes and seeks to answer the key question of "why sustained growth has been elusive."

Hasan also makes the important observation that tensions with India, which led to three wars between the neighbors (1948, 1965, and 1971), have played an important role in determining policy choices. One example is Pakistan's decision not to devalue its currency in 1949, which led to the cessation of trade between the two countries and the start of import-substitution industrialization that fed on the Korean boom as the price of raw materials increased dramatically. Moreover, the dispute over the division of Indus river waters remained unsettled for the first decade and a half. These tensions have meant that Pakistan had to set aside far more resources for defense than it could economically afford.

The broad lesson that he draws from Pakistan's experience is that, while its average growth of around 5.2 percent between 1960 and 2010 can be considered respectable, it certainly does not match its potential, especially when compared with the fast-growing East Asian economies and more recently those of China and India. Pakistan's past economic performance should not be a source of comfort because output and employment have slowed down severely over the last four years and the prospect of strong economic revival has become uncertain.

Hasan identifies the following factors that have constrained Pakistan's growth over the years:

- High spending on defense to counter the real or perceived threat from India.
- High population growth.

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- The considerable neglect of human resource development, in particular, education.
- A low savings rate and the inability to translate large foreign aid inflows into high, sustainable levels of investment and growth.
- A steady decline in governance, which has resulted in a serious institutional decline, a decline in public services, and a slow reduction in poverty incidence.
- Major missed economic opportunities.

Amjad (Chapter 3) traces the more recent growth cycle through which the economy has passed, covering the period of the Musharraf government and subsequent coalition rule from 1999/2000 to 2012/13. He argues that, despite the revival of economic growth and upturn during the Musharraf period, Pakistan's fundamental economic structure did not change; it could not, therefore, stand up to the external global economic shocks that started in 2007/08 with unprecedented increases in oil and food grain prices, followed by the global financial meltdown and ensuing recession.

He also describes the extremely poor performance of all the key economic indicators when averaged out over the period. With little growth in productivity—especially total factor productivity—there was little structural change in the economy or movement toward higher-productivity sectors.

The strength of Amjad's chapter is that it covers in some detail issues related to economic management, including lessons from the International Monetary Fund (IMF) programs that both governments entered into soon after taking office, though for very different reasons. He also assesses the current institutional arrangements for economic decision-making and how these can be improved, including the role of the Finance Ministry in budget making and the Planning Commission in development planning and monitoring economic reforms.

Burki's chapter (Chapter 4) is important in that it takes a broader socioeconomic-political view of where the economy is today and the challenges it faces, and then recommends policies to revive the economy as well a medium-term strategy, which, as he states, "builds on the positives in Pakistan's current economic situation." Burki's basic hypothesis is that Pakistan may well be on its way to developing a new way of managing its affairs and he traces this to the political development that began after March 2007 with the lawyers' movement and the restoration of the Chief Justice of Pakistan.

Besides the economic factors responsible for the longest downturn in Pakistan's economic history, he identifies other important factors that have resulted in a deep economic malaise, harming the economy in ways that are not easily quantified. The most significant of these is the impact on economic stability and development, which also results in very high direct costs to the economy. Among the factors responsible is the rise of extremism, which has taken many forms including sectarianism and communal violence.

### **Overcoming Major Constraints**

To move the economy forward, it is vital to overcome the major constraints to economic growth and to search for practical solutions, especially in the short term, to revive the economy. This section analyzes three of these major constraints: energy, revenues, and water.

An important conclusion that emerges from the chapters dealing with these issues is that poor economic management in the form of ad hoc and inconsistent policy responses has contributed greatly to the current situation. This poor economic management results from lack of technical expertise, a tendency to follow donor-driven advice without examining alternative options, rampant corruption, inter-provincial rivalries, and strong vested interests.

#### *The Energy Crisis*

Given the overwhelming impact of energy shortages, both direct and indirect, on the economy and people's lives, several chapters in the book (including those by Hasan, Amjad, and Burki) draw attention to the problem and suggest solutions.

Malik (Chapter 5) presents a comprehensive review of how the problem arose, what factors accentuated it, and why there are no simple solutions to solving it. She then presents in some detail areas of policy action that could help ease the crisis and gradually overcome it.

The energy crisis is not manifest merely in terms of its direct impact on output and the fact that it has shaved off 1.5 to 2 percentage points of GDP growth over the last five years. It is also responsible for digging a large hole in government finances and causing the fiscal deficit resulting from untargeted subsidies on energy consumption to balloon; it has also resulted in the emergence of an unending circular debt of huge proportions (almost 3 percent of GDP).

The root causes of the problem can be traced to Pakistan's decision during the 1990s to opt for an energy mix that involved independent power

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producers (IPPs) who set up oil- and gas-fired energy plants to overcome the country's energy shortages. As the price of oil increased from around USD 15–20 a barrel to USD 100–140, these plants could only supply electricity at high prices, which had to be subsidized for fear of public reaction spilling over into street violence. Prices were not adjusted during 2004–07 till the subsidy became unsustainable; when, eventually, they were adjusted in 2008 and over the years, they were never done so in sufficient measure to overcome the cost and prices charged to consumers. The result has been a widening gap between supply and demand and between costs and prices. The prices also reflect almost 30 percent worth of losses from theft and technical factors, of which theft comprises almost 60 percent.

What, then, are some of the more short-term solutions (12 to 18 months) to the problem? Malik (Chapter 5) and Burki (Chapter 3) suggest the following measures:

- Increase output through the best use of existing capacity, which would mean diverting oil and gas from inefficient public sector thermal plants to private sector plants (IPPs), which have excess capacity and can generate electricity at a lower cost.
- Eliminate the recurring circular debt by (i) cutting down on line losses resulting from theft and then (ii) gradually increasing prices to cover costs once consumers are assured of a regular supply and that they are not paying for the inefficiency of the system, including corruption and theft.
- Shift some of the major IPP thermal power plants from oil and gas onto imported coal. This would reduce costs and also allow these large plants to work at full capacity.
- Shift the ownership of all thermal plants operating in the public sector to an entity that can sell part of its share to the private sector. This entity could also issue bonds backed by its assets in order to liquidate the accumulated circular debt.
- Encourage the provinces to invest in the development of the energy sector (which, under the 18th Amendment, they are empowered to do), with the assurance that their power supply from the national grid will not be reduced.
- Transfer the distribution companies operating in different provinces to the provinces so that they can take effective steps—backed by law enforcing agencies—to stop theft and reduce line losses.
- Develop a market for trading power in which provinces can sell and buy electricity from each other.

Medium- to long-term solutions include the following:

- Correctly price power consumption to attract private investors.
- Change the country's currently expensive energy mix by utilizing its enormous coal supplies, especially the unexplored 185 billion tonnes of coal reserves in Thar. The shift to coal should be accompanied by measures to reduce its environmental impact.
- Build run-of-the-river hydropower projects.
- Move to alternative environment-friendly energy generating systems, including wind power, biogas, and solar energy.
- Build more major dams: start by raising resources for the construction of the Bhasha-Daimer dam and plan to build two major dams over the next decade and a half.
- Actively pursue the completion of the Iran–Pakistan gas pipeline and establish links with energy networks from Central Asia through Afghanistan.

*Macro-Stability: Raising Revenues and Reducing the Fiscal Deficit*

If crippling energy shortages is the first of the major constraints to economic revival and sustained growth, then the second is the rising unsustainable fiscal deficit as government expenditures outstrip revenues. Without a determined effort to raise the currently very low revenue levels in terms of current expenditures, macroeconomic stability will remain elusive. Of course, raising taxes must be accompanied by cutting down sharply on wasteful expenditures; the government must demonstrate that these resources are being efficiently used and reflected in improved public services, including the security and law and order situation.

This critical issue is analyzed in a number of chapters, but Pasha and Pasha (Chapter 7) present a detailed account of the existing system of tax collection in Pakistan, and the path that tax reforms must take if tax revenues are to increase from the current dismal level of less than 10 percent of GDP to around 15 percent over the next few years. Most manifestos issued by the mainstream political parties have endorsed this or similar goals.

The package of tax reforms that Pasha and Pasha identify has a focus on direct taxes, which would result in an increase in tax yields but also make the tax system more progressive. The measures suggested to achieve this include levying an effective agricultural income tax; reintroducing the wealth tax; instituting a minimum tax on turnover;

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targeting tax exemptions; rationalizing tax rates; developing the property tax; and providing incentives for taxpayers to file returns.

In the domain of indirect taxes, the authors propose introducing a broad-based integrated VAT and bringing into the tax net major services currently not covered by the sales tax. They also propose rationalizing the statutory tariff rates into essentially three slabs of 5 percent, 15 percent and 25 percent, and simultaneously withdrawing most of the statutory rules and orders (SROs), except those pertaining to trade agreements.

Finally, the authors are of the view—shared by many—that radical changes are needed in the Federal Board of Revenue to make it more efficient and effective.

### *The Critical Role of Tax Reforms in Making Devolution Work*

In Chapter 8, Ahmad examines whether the major reforms undertaken through the 7th NFC Award and the 18th Constitutional Amendment will work effectively and ensure higher living standards for all people in all four provinces. In this context, he also examines in detail the downward slide in Pakistan's tax-to-GDP ratio and argues that, unless effective measures are taken to raise revenues, any structural shifts involving significant decentralization to the provincial governments are "of little more consequence than shifting deck chairs on the Titanic."

Examining the recent history of tax reforms in Pakistan, he points out that the government's approach to the IMF in 2008 was predicated on tax reforms. He argues that the failure of tax reforms has seriously jeopardized both the NFC award and the 18th Amendment. Indeed, as he starkly puts it, "without the tax reforms, the NFC award is just a mirage in the desert."

Ahmad points out that the greatest shortcoming of the decentralization process in developing countries—and this must also apply to Pakistan—is the lack of attention given to adequate own-source revenues at the subnational level. He details China's successful reforms undertaken during 1993/94 from which Pakistan could learn. An important recommendation he makes is that provinces and districts should be provided flexibility in generating their own-source revenues.

### *Water: Maintaining and Harnessing the Indus Basin Irrigation System*

Pakistan, it is rightly said, is the gift of the Indus and, as Chaudhry states in Chapter 9, "Pakistan's Indus Basin irrigation system is the strong heart of the country's economy." The chapter provides an historical overview paying tribute to the British irrigation engineers who created the original

system (1847–1947) and the Pakistani irrigation engineers and institutions (particularly the Water and Power Development Authority and provincial irrigation departments) who have added new dams and barrages, built new link and branch canals, and maintained the world’s most complex and extensive irrigation system.

A critical concern is whether adequate policy measures have been taken and investments made to increase surface water storage in line with rising demand and to rehabilitate the Indus irrigation system. Chaudhry provides details of the important projects that have been built in the last decade, largely financed by the Government of Pakistan, including (i) the Mangla dam raising project, which added 2.9 MAF to its existing capacity of 6 MAF; (ii) the Greater Thal Canal project in Punjab, which created a new culturable command area (CCA) of 1.5 million acres; (iii) the Kachi Canal project for Balochistan, covering Dera Bugti, Naseerbad, and Thal Magsi, and creating a CCA of 0.71 million acres; and (iv) the Rainee Canal project area in Sindh, covering Ghotki, Khairpur, and Sukkur, and creating a new CCA of 0.41 million acres. In addition, an irrigation system rehabilitation project started in Sindh is now nearing completion.

The author highlights the fact that, with the exception of a few barrage irrigation projects, the World Bank has provided no funds for such projects and its focus since 1997 has been solely on institutional development and in the long term to encourage the privatization of the irrigation system. (This is very similar to the World Bank’s early decision since 1987 not to lend for energy development and focus on the privatization of the energy sector instead.)

Excluding climate change requirements, Chaudhry estimates that Pakistan optimally requires about 22 MAF of storage on the Indus—its present storage capacity is about 8 MAF at Tarbela and an additional 6 MAF if the construction of Basha-Daimler goes as planned at an estimated cost of USD 8 billion. He therefore recommends building additional storage capacity in the form of two dams on the Indus to deal with the present situation. While the Asian Development Bank has indicated support for Basha-Daimler, the World Bank has recently shown interest in funding a hydroelectric project at Dasu downstream of Basha-Daimler and upstream of Tarbela. Chaudhry also draws attention to the increasing pressure on the Indus Water Agreement signed in 1960 as the Indian Punjab runs out of groundwater and India continues to build barrages on the rivers that were allocated to Pakistan under this agreement.

The six major conclusions of this chapter are that Pakistan should focus on (i) creating additional surface storage; (ii) preserving surface water, particularly by lining canals; (iii) controlling groundwater and

salinity by discouraging excessive tubewell use; (iv) encouraging general efficiency of irrigation water use through better pricing policies and improved land management techniques; (v) enhancing yields through improved farm practices; and (vi) fully meeting the environmental concerns of the Indus delta, river system, and wetlands.

### **Increasing Exports: A New Driver of Economic Growth**

A major thrust of this volume is that, unless Pakistan is able to increase its currently stagnant share of exports in GDP (around 10 percent) and its share of exports in world trade (around 0.15 percent), it will be very difficult for the country to generate either sustainable or higher economic growth. Pakistan's poor performance in integrating with and taking advantage of the fast pace of globalization prior to the financial crisis is brought out in a number of chapters (Hasan, Chapter 2; Amjad, Chapter 3) but Ahmed, Hamid, and Mahmud (Chapter 6) focus on measures to increase overall exports.

Pakistan's exports have been dominated by the textiles and garments sector since the 1960s, but in the last decade, their combined share has fallen from about 75 percent of total exports in 2000/01 to 55 percent in 2010. On the other hand, the SME sector's exports have increased steadily, with the bulk of SME units operating in industrial clusters around Karachi, Lahore, and the Sialkot–Gujrat–Gujranwala triangle in central Punjab. The cement sector has also performed better.

Hamid et al. identify textiles, garments, and SME exports as the key potential export drivers in the manufacturing sector in the medium term. They argue that cement exports have been mainly to Afghanistan and these may taper off with the withdrawal of US forces in 2014 and downturn in coalition civilian aid, though it is possible they may increase if India reduces its nontariff barriers (NTBs) against Pakistan's cement exports. For textiles, they hope that the possibility of Pakistan being given GSP-plus status by the European Union from 2014 will offset weakening demand in the latter.

In the case of garments, the authors point to opportunities that are coming up as China (with current exports of USD 130 billion in 2010) moves from low-end manufactures to higher value-added products. In the case of SME exports, they identify sports goods, surgical instruments, fans, and automobile parts as the ideal export drivers in the medium to long term.

In the agriculture sector, they identify cotton as a potential driver based on a 50 to 80 percent increase in cotton production in the last five

to seven years as a result of using BT cottonseed; this, in turn, could increase cotton exports by over USD 3 billion per annum and, if converted into textile products, a multiple of this amount. They also identify high-value nontraditional agricultural exports that include fruits and vegetables, and *halal* meat and meat preparations as having considerable potential. Finally the authors point to the large potential that lies in emulating India by expanding knowledge-based exports, including information and communication technology, as well as entertainment and health services. In fact, in some IT areas, Pakistan is doing better than India: some of its firms are in “product development”—an area in which India is relatively weak.

As a strong proponent of increasing the export-orientation of the Pakistan economy, Hasan (Chapter 2) argues that the pessimism some observers have expressed about future globalization is not justified, and that even despite the slowdown in international trade, “Pakistan can hope to gain a market share provided it follows policies that strengthen competitiveness, diversify the product mix, and move up the value chain.” Some specific policies he suggests, complementing those mentioned earlier, include:

- Instituting an exchange rate that would fully reflect the differential between movements in Pakistani prices and the international price level. Here, it is important to note that the large and increasing share of remittances does in fact raise the real effective exchange rate relative to what it would be based on the current account balance; to some extent, this does make it more difficult for Pakistani exporters to compete in global markets.
- Promoting foreign investment through joint public and private sector initiatives in textiles, clothing, and other promising export sectors from countries such as the Republic of Korea, Hong Kong, Malaysia, and Taiwan.
- An in-depth review of the free trade agreement signed with China and the establishment of a free trade zone with the country; the latter is likely to increase exports.
- Encouraging the development of export supply chains and linking these efforts to the National Trade Corridor Improvement Project.
- In the context of the Strategic Trade Policy Framework (2009–12), reducing the anti-export bias in the current incentive structure by withdrawing protection from inefficient industries, and minimizing taxation at the investment stage.

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- Coordinating more closely between the commerce ministry and related ministries, including industry and textiles, as well as the Planning Commission and the provincial governments. This degree of interface is sadly missing and sorely needed.

### *Encouraging Regional Trade: A New Vent for Growth*

In a fascinating historical discourse, Nabi (Chapter 15) traces the major drivers of economic growth: the development of canal irrigation in the later part of the 19th and early 20th centuries, the Korean War boom in the early 1950s, the start of import-substituting industrialization, the green revolution in the 1960s leading to enormous increases in the productivity of major crops (wheat and rice), overseas migration and remittance inflows in the 1980s, and finally, post-9/11, increased external assistance received as a frontline state in the war against terror.

He argues that Pakistan now needs a new driver for economic growth if it is to break out of its current prolonged economic downturn; he finds this in the country's geographical location, which has historically served as a center of trade, commerce and finance, and education in the region. Nabi argues that Pakistan's investment in communications infrastructure over the last 65 years and the development of a north-south trade corridor makes possible the creation of an integrated "Indus Basin market" that could open the way for east-west trade through the regions as well as spokes with Central Asia and China.

### *Trade with Regional Neighbors*

Hamid and Hayat (Chapter 14) carry this analysis further by pointing out that, over the last decade, there has been a fundamental change in Pakistan's trading partners, which were earlier dominated by the West. For 2011, they show that 25.1 percent of Pakistan's exports and 35.3 percent of its imports were from neighboring countries (the UAE, China, Afghanistan, India, and Iran) and, consequently, that this group of neighbors is now more important to Pakistan's trade than North America and Europe. They discuss in detail the prospects of increasing trade with these five countries.

In the case of China, Hamid and Hayat trace the fast-growing trade between the two countries with China's share in Pakistan's total imports (which they suggest are grossly underestimated) increasing from around 5 percent in 2000 to over 15 percent in 2011. They highlight the considerable potential for increasing exports to China as it moves into higher value-added products as well as attracting investment from China toward labor-intensive employment generating industries in Pakistan.

Pakistan could also seize the opportunity to accelerate development in China's western provinces.

As far as increasing trade with Afghanistan is concerned, a positive development has been the rise in nontraditional exports (vegetables and fruits, petroleum products, cement, metal manufactures, machinery, and transport equipment), which have considerable long-term export potential. Similarly, the Central Asian Republics, including Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, with a combined population of 61 million, offer substantial opportunities for Pakistan's exports.

#### *India–Pakistan Trade*

Over the last few years, there has been considerable progress in removing barriers to trade between India and Pakistan. While India had granted most-favored-nation (MFN) status to Pakistan in 1996, the latter moved in 2011 from a positive to a much smaller negative list for imports from India and has in principle agreed to granting India MFN status in early 2013.

In a carefully crafted and well-analyzed paper, Pasha and Imran (Chapter 13) examine the prospects of India–Pakistan trade, including the level of import tariffs in the two countries and their potential impact on the volume of trade as well as NTBs. Pasha and Imran establish that the low trade complementarity between Pakistani exports and India arises primarily because Pakistan does not have a diversified export base and its two major product groups—agricultural items and textiles—also account for a significant portion of India's total exports. They do point out, however, that if free trade were to take place between the two countries, further specialization could develop with Pakistani exporters finding “niche” markets in India. A number of Pakistani manufacturers in favor of granting MFN status to India also hold this view.

Having examined the existing tariff and subsidy regimes for agricultural products and tariffs on textiles and clothing, Pasha and Imran reach the important conclusion that, as a result of these measures, India has effectively restricted imports, which will deny access to Pakistani exporters in these two vital sectors. They strongly advocate, therefore, that Pakistan seek the withdrawal of specific duties on textiles and clothing and opt for the application of only ad-valorem duties. The study also shows that, compared to India, Pakistan operates fewer and less vigorous NTBs. These issues need serious consideration in both countries.

Overall, based on existing export patterns, Pasha and Imran project that, in the medium term, imports from India could rise to almost USD 7 billion to USD 8 billion, while Pakistan's exports would rise to around

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USD 1 billion. This quantum jump in bilateral trade could result in the fear of “serious injury” to industries in Pakistan that have enjoyed high protection levels in the past. It will be necessary, therefore, to build up the capacity of the Ministry of Commerce and National Tariffs Commission to investigate such complaints and take necessary safeguards as allowed under the World Trade Organization and South Asia Free Trade Area agreement.

Other studies present much larger estimates of the increase in trade resulting from the lifting of trade restrictions between the two countries, and some believe that the quality and novelty of Pakistani products will considerably enhance their demand in Indian markets. International experience of trade between neighbors (EU, NAFTA, ASEAN) also shows that opening up trade results in major changes to the existing pattern of exports as dynamic forces are unleashed.

The other key conclusion that Pasha and Imran draw is the need for Indian exporters to move into Pakistani markets gradually even after MFN status is granted to them. This is so that a large, stark trade imbalance does not arise in their favor, which would otherwise lead to agitation by the affected parties, seriously slowing down the whole process.

### *Remittances and the Pakistan Diaspora*

Under the overall rubric of increasing foreign exchange earnings Amjad, Arif, and Irfan (Chapter 12) analyze the remittances market in Pakistan and attempt to explain the almost tenfold increase in official remittances between 1999/2000 to 2011/12 from around USD 1.5 billion to over USD 13 billion. The share of remittances in GDP has risen to 5.5 percent and, in terms of foreign exchange earnings, they are equal to half of Pakistan’s total exports of goods and services. The main reasons for this increase in remittances is traced to: (i) a shift from unofficial (and unrecorded) channels (*hawala*) to official channels; (ii) an increase in the number of Pakistanis living and working abroad; and (iii) a rise in migrants’ skill levels. As to the unofficial flow of remittances, though they suggest their share has decreased over the years, the authors’ rough estimates suggest that these amounts could still be as high as USD 5 billion. Other estimates are even higher.

By analyzing in detail the functioning of the remittances market, Amjad et al. make the important observation that remittances entering Pakistan have a far great multiplier impact on the economy than remittances through unofficial channels, which normally result in movements of currency within Pakistan and within the destination

country. They also make the key point that these remittances represent real demand for Pakistani rupees, which are backed by the foreign currency of those who demand Pakistani rupees. They play down the general notion that these official remittance flows represent the “whitening” of black money from Pakistan.

Based on the results of a household survey, their chapter also investigates why migrants prefer to send remittances through unofficial or hawala channels, and suggests incentives and measures (such as the Pakistan Remittance Initiative) for them to be sent through official channels.

### **Improving Governance, Transparency, and Accountability**

An important premise of this volume is that, if Pakistan’s economy is to move forward, then the current decline—indeed rot—that has set in its public services and institutions needs to be reversed rapidly. This is extremely unfortunate though, sadly, a trend not restricted to Pakistan. As Hasan (Chapter 2) recounts, Pakistan was able to establish its economic viability and later displayed economic resilience through an outstanding and upright civil service.

Husain (Chapter 10) states that, “Most observers and analysts within and outside Pakistan firmly believe that the quality of economic governance and decision making and the capacity of the country’s key institutions have gradually deteriorated over time. Pakistan’s main problem in maintaining macroeconomic stability, sustaining economic growth, and delivering public services to the poor is weak governance and the gradual but perceptible decline in institutional capacity” (p. 285).

Husain argues that a major reason for poor economic management is that governments have operated with short-term horizons—so as to claim credit for their ostensible performance during their tenure of office—rather than according to what the long-term national interest may dictate. He identifies a number of important developments that warrant wide-reaching reforms. These include inadequate checks and balances in the existing institutional arrangements, which have been further changed by the 18<sup>th</sup> Constitutional Amendment.

The author also argues that the state’s failure to perform its functions is most glaring in terms of the government’s ability to serve its citizens. Acts of terrorism, violence, and extremism have become so frequent over the last several years that *the writ of the state does not appear to exist any longer* (p. 294, emphasis added).

Husain presents a proposed governance reform agenda for restructuring and revitalizing government institutions. The measures

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suggested include the need to reduce the discretionary authority exercised by government functionaries at all levels; this needs to be minimized and made more transparent, including through the introduction of e-governance, e.g., in land records and land titling. He also suggests that the role of the Council of Common Interests in formulating national policies after the 18th Amendment be defined more clearly and strengthened. He recommends creating incentives that would encourage competing civil servants to upgrade their skills, and instituting promotions based on past performance and potential for shouldering greater responsibilities. Finally, he emphasizes giving high priority to reforms in areas that affect people's daily lives, such as education, health, the police, and land administration.

This is an important agenda for undertaking reforms and an implementation system should be set up to track these reforms.

### *Institutional Reforms: Empowering the Poor and Middle Classes*

While Hussain presents an agenda for reforms that would considerably improve the functioning of government, Akmal Hussain (Chapter 18) suggests a more radical approach that aims to replace the current "rent-based institutional structure and associated patron-client-based governance model" with new institutions through which equitable growth and poverty reduction are built into the structure of the economic growth process to make it sustainable.

Hussain critiques the neoliberal view that markets necessarily deliver efficient outcomes and are self-regulating. He does not subscribe to the neoliberal idea that incentives for innovation and growth will necessarily lead to the emergence of new entrepreneurs, which will then lead the economy into sustained growth. His basic argument is that the economic elite that now constitutes Pakistan has historically functioned within a patron-client system that has not changed radically in recent times. The institutional structure systematically generates rents for the coalition of elites that has emerged. His implicit argument, therefore, is that this rent-earning elite keeps out new entrants, and that an emphasis solely on economic reforms and the hope for well-functioning markets will fail to deliver in the presence of these entrenched vested interests.

Hussain presents a set of institutional initiatives that could help remove the structural constraints to sustained, equitable growth, and start a process of pro-poor growth. These include (i) distributing state land to the landless, (ii) removing structural constraints to SME growth and its export potential, and (iii) giving the poor a share in the

ownership of large corporations (e.g., in marketing agriculture products) run by professional management.

**Reviving Private Investment: Overcoming the Barriers Faced by the Pakistani firm**

The strength of this volume is that it combines macro- and sectoral issues with the micro-dynamics of the Pakistan economy. Manes (Chapter 16) analyzes the critical role that the Pakistani firm must play in moving the economy forward. His analysis draws on empirical evidence gathered from a survey of firms conducted by the World Bank through its enterprise surveys in 2002 and 2007, as well as a perceptions survey of firms in 2013.

Manes draws two important conclusions when comparing responses from the 2002 and 2007 surveys on the major obstacles that firms face. First, firms perceived a major improvement in those areas of reform where the government had devoted resources and policy attention in the first half of 2000 (finance, tax administration, anticompetitive practices, labor regulations, and customs and trade regulations). Second, in 2007, the electricity supply (with 80 percent identifying this as their most constraining factor in 2007 compared to 39 percent in 2002), corruption (57 percent compared to 40 percent), macro-instability (57 compared to 34 percent), political instability (47 compared to 40 percent) and crime, theft, and disorder (32 compared to 21 percent) had all deteriorated substantially.

Manes also argues that productivity gains for firms accrue from innovation, structural change, and “creative destruction.” Pakistan’s economy is perceived as having shown little structural change and has remained a low technology exporter. While most firms operating in Pakistan use very low levels of technology, the evidence based on the 2002 and 2007 surveys suggests that aggregate productivity in manufacturing has increased. From this he concludes that “the period was characterized by a policy-induced creative destruction, productivity increases, and competitiveness improvement.”

His major conclusions relate to improving the business environment in Pakistan and the importance of surveys (such as “Doing Business”) in identifying its deficiencies, progress in implementing reform, and organizing the private sector for collective activities. An important contribution of this study is that it analyzes the incentives and disincentives for firms to move from the informal to the formal economy; it argues that firms will only seek formality if the benefits outweigh the losses from such a shift.

*Foreign Firms Operating in Pakistan: Foreign Direct Investment*

The study by Hamdani (Chapter 11) analyzes foreign companies that operate in Pakistan and “assesses the potential for a more ambitious industrial strategy: private sector-led, fueled by FDI, and supported by policies and institutions that encourage technological deepening” (pp. 313–314).

Hamdani points out that the dynamic private sector that took shape after independence and in the earlier years of the 1950s and 1960s attracted foreign participation. FDI was initially permitted in manufacturing, with larger investments used to form joint stock companies with local equity participation. He lists a galaxy of multinational companies that invested in Pakistan soon after independence and in the 1950s and 1960s, including Lever Brothers, the Lakson Group (in collaboration with Colgate-Palmolive), Glaxo Laboratories (today, Glaxo-Smith-Kline), Abbot Laboratories, Pfizer, KSB, Hercules Chemicals (fertilizer), Exide, and Honda motorcycles.

When private investment fell in the 1970s with the spate of nationalization carried out by the Pakistan People’s Party government, so did foreign investment. However, it picked up in the 1980s, growing at an annual average rate of 22 percent. FDI growth fell to only 8 percent in the 1990s, despite policy reforms and generous incentives. On the other hand, India emerged as a major destination for foreign investors during this period. Pakistan’s FDI inflows only picked up in 2003 and reached a peak of around USD 5 billion in 2007, after which they fell drastically. During the upturn, FDI shifted from manufacturing to services. In 2008, three industries—finance, telecommunications, and power—amounted to nearly half the FDI stock.

Hamdani points to the general failure of foreign manufacturing affiliates in Pakistan to develop an export-oriented approach in part due to the protected markets in which they operate. This is in contrast to the experience of other countries where, over time, they have graduated to becoming major players in global markets.

The author spells out policy measures needed to revive private investment, given that FDI and private investment have moved in tandem over the years. He argues that the government’s role in industry should be less of a player—with public enterprises being autonomous and self-sufficient or privatized—and more that of a referee to ensure that markets run efficiently and that laws are well administered.

A change in policy direction, together with efforts to overcome the current energy crisis, build technological capability through investment in

research and development, and promote links between education and training could prepare the ground for attracting and benefiting from FDI. He believes that, were the right policy environment created, there is every reason to expect FDI of USD 10 billion annually or twice the highest level attained in the past.

### **Ensuring Inclusive Growth: Reducing Poverty**

The merit of the study by Chaudhry, Chaudhry, Haseeb, and Afzal (Chapter 17) is that it moves beyond the income measurement of poverty (as defined by a poverty line) toward a more comprehensive analysis of what makes people “poor” and what the best way is to target poverty in Pakistan. They argue that the official poverty line based on income misses out a large share of those who should be counted among the multidimensional poor.

Their study focuses on three dimensions of poverty: income, education, and health, using the PSLM data for 2004, 2008, and 2010. In terms of the income-based poverty line (USD 1.08 per day in 2004 and USD 1.25 per day in 2008 and 2010), their results show that the number below the poverty line declined from approximately 20 percent to 16 percent between 2004 and 2010, and then increased marginally to 16.5 percent by 2010, which was not statistically significant. Urban poverty declined from 11.5 percent in 2004 to 9.2 percent in 2008 and remained approximately the same till 2010. The percentage of the rural poor fell significantly from 25 to 19 percent between 2004 and 2008, and though rural poverty increased from 19 to 20 percent, it was not statistically significant.

In terms of the second indicator of poverty—education—the study focuses on the percentage of people without primary education: their results show that there was a significant decrease in the number of people above the age of 20 without primary education between 2004 and 2008 from approximately 59 percent to 55.5 percent. Again, there was no significant decrease in the number between 2008 and 2010. The fall in the number of those below the age of 20 with primary education between 2004 and 2008 is seen both for men (44.6 percent to 40.6 percent) as well as for women (73.9 percent to 70.5 percent). However, between 2008 and 2010, there is no significant change.

The health dimension of poverty is measured by the source of clean drinking water. The study’s results show the number of those without access to drinking water; in contrast to the other two indicators, it increased from 11 to 15 percent between 2004 and 2008, and this higher level was also observed in 2010.

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By using a multidimensional measure of poverty, the chapter brings out starkly the percentage of the overall population that is poor in terms of at least one criterion (income, education, or health). They estimate this at 73 percent of the overall population in 2004, which then fell to about 70 percent in 2008 and remained constant till 2010.

The chapter also examines the association between those below the poverty line, the circumstances in which they were born, and the factors determined by their own efforts. On the whole, the authors' results imply that parents' income and education are significant in determining whether their children, on becoming adults, will live above or below the poverty line. Their study also shows that factors such as education have a significant impact on determining a person's income.

### **Provincial Economic Development: Challenges and the Way Forward**

This volume makes an important contribution in its comprehensive analysis of the economic challenges that the provinces face in the wake of the 7th NFC award and the 18th Constitutional Amendment; it outlines the main elements of a development strategy for the provinces, given their own peculiar economic circumstances and challenges. Ikram (Chapter 19) draws on his recent detailed work at the provincial level and the data generated during this work to put together a comprehensive analysis of the importance of a province-level approach.

Ikram stresses that a key requirement to ensure better economic planning and monitor progress at the provincial level is that the Pakistan Bureau of Statistics (PBS) issue officially sanctioned figures of GDP and other macroeconomic variables for the provinces. The data used in his chapter draws on his and other earlier studies, and should be taken as broad indicators of trends and orders of magnitude and not as firm estimates.

In his comparative analysis, Ikram examines the trends in provincial GDP growth over the 11-year period 2000/01 to 2010/11. He comments on the disparities in areas such as education levels, immunization coverage, piped water supply, security, geological assets, human resources, the availability of power, and ease of doing business.

He finds that Balochistan's GDP growth has been far lower than that of the other three provinces (50 percent compared to 72 percent, taking the other three provinces together). It also shows considerable fluctuations, pointing to widening disparities as well as uncertainty and an increased perception of risk for new investment.

Ikram finds that Punjab stands well ahead of the others in education, immunization, and ease of doing business, but falls surprisingly behind in access to piped water. He emphasizes that the poor security situation and lack of energy emerge clearly as common factors impeding development in the case of all four provinces. These differences are accentuated when we compare Balochistan and the other provinces in terms of education, immunization, and access to piped water.

As future paths to development, Ikram's approach is that the provinces should exploit their natural resources and competitive advantage to the maximum. Balochistan's strategy needs to tap its geological resources, which remain largely unexplored, as well as its 750-km-long-coastline, which provides a potential base for the development of fisheries and tourism. The strategic location of its coastline also provides considerable potential in Gwader port as well as the development of new ports.

Khyber-Pakhtunkhwa (KP), Ikram suggests, would benefit from exploiting its comparative advantage in producing hydel electricity and setting up industries based on an intensive use of these inputs. Given its distance from seaports, it should energetically pursue the possibility of exporting to neighboring Central Asia and Afghanistan.

In the context of the current situation, the author also examines the critical problem facing the Federally Administered Tribal Areas (FATA). He identifies the creation of productive and remunerative jobs as being critical to improving the situation, and believes that the task of generating 250,000 jobs is manageable, based on a strategy that could effectively tap remittances to support the growth of SMEs (as happened in Punjab in the 1980s) together with direct public works programs.

In the case of Punjab, raising agricultural productivity through efficient water usage and shifting cropping patterns toward high-value added items would be a prudent course to follow, besides promoting SME growth, improving governance, and reducing intra-provincial disparities.

Sindh needs to reorient its strategy of relying principally on Karachi as a growth center and, while maintaining the dynamism of Karachi, develop additional growth poles that relieve pressure on its infrastructure and take advantage of Sindh's other assets that are located near urban centers. A strategy for developing its rural areas, Ikram suggests, will need to be based on improving the productivity of water by adopting more effective water management practices, encouraging the movement toward high value-added crops, developing high value-added nonfarm

activities, integrating agriculture with the storage and transport sectors, strengthening the marketing system, and closely integrating rural and urban markets.

### **Main Conclusions**

The studies in this volume will, the editors hope, assist the government that comes into power after the elections both at the federal and provincial levels, to meet public expectations, especially after its great disappointment with the performance of the previous coalition administration. Experience from other economies in stress suggests that there can be fairly rapid recovery if the quality of governance is improved and if the right set of policies is adopted. A program aimed at reviving growth should distinguish between the economy's immediate needs and those appropriate for the medium and long term.

The analysis and policy recommendations emerging from the studies on which there is broad consensus suggest that policymakers need to focus on the following areas over the next 12 to 18 months:

1. Restoring macroeconomic stability and reviving private investment.
2. Increasing the supply of electricity by tackling the problem of "circular debt" that has kept IPPs from utilizing their installed capacity.
3. Restructuring public sector enterprises to make them profitable. Privatizing loss-making enterprises with the active participation of both management and workers is one option to consider.
4. Opening up further trade with India and granting it MFN status at the earliest.
5. Improving economic management, radically improving the quality of governance, and firmly stamping out rampant corruption.

The strong revival of growth on the lines suggested above, together with a strengthened 'income support program' would help reduce poverty and contribute to a fairer share of growth benefits than in the past. Much greater emphasis on job creation through the expansion of labor-intensive exports, small industry, and agriculture could dramatically transform the employment situation, especially for women and the young, educated unemployed. On the other hand, strictly controlling economic rents and corruption practices that benefit the few will improve government revenues and enable access to good-quality social services for the poor and middle classes.

Indeed, the first two elements listed above are closely linked. Restoring macroeconomic stability will mean reducing the fiscal deficit and that will require removing or drastically reducing untargeted subsidies, the bulk of which originate in the energy sector. The real challenge for the new government will be to reduce power sector losses and improve efficiency. This would provide a cushion to increases in energy prices to cover costs and, by reducing the recurring circular debt, allow energy supplies to be increased and power outages reduced.

Regaining macro-stability will also require increasing revenues, and the new government should consider introducing a VAT as soon as possible as well as bringing agriculture into the tax net and imposing GST on services in sectors that are currently not covered. The provinces should also take responsibility in areas that fall under their tax jurisdiction. As for raising private investment, first and foremost, there is a need to restore business confidence. Improving the security situation, reducing the energy gap, and improving the quality of governance together with immediate measures to stamp out corruption can go a long way in attracting new domestic and foreign investors.

Measures in the medium and long term, as suggested by the studies in this volume, coalesce around a medium-term strategy that could gradually move the economy onto a higher growth trajectory of around 8 percent. The strategy should:

1. Implement economic reforms to remove the major constraints to economic growth; this would also help unleash the major drivers of economic growth including moving toward a much higher level of investment and exports.
2. Effectively tap emerging forces that could propel the economy forward, namely the population of young, educated women and large Pakistani diaspora.
3. Invest in people by significantly increasing the resources committed for education and health.
4. Afford a much greater role to provinces in overall economic management and the formulation of development plans; and ensure better integration between the policies and plans of the provinces and those of the federal government.
5. Carry out comprehensive reforms to strengthen institutions and reduce corruption for better economic management.
6. Make a determined effort to reduce the high growth rate of population.

## *Overview*

## **Failed Economic Promise: Lessons from Pakistan's Development Experience**

**Parvez Hasan\***

### **1. Introduction**

Pakistan has had a checkered economic and political history. The country's periods of rapid growth in the 1960s, the first half of the 1980s, and 2002–07, have been followed by periods of sharp economic slowdowns. Sustained economic growth has been elusive; there has been no real deepening of the structure of the economy, and social and distribution issues have become increasingly troublesome. Yet Pakistan has somehow managed to attain an annual average gross domestic product (GDP) growth rate of 5.2 percent and a per capita income growth rate of 2.5 percent over the last half-century (1960–2010) that has more than trebled the average living standard over the period.

The distribution of gains from growth has, undoubtedly, not been equitable. However, the country's economic record, though of course not able to match that of East Asia—especially China, and more recently India—seems to compare favorably with the average for developing countries. This is no mean achievement considering the great deal of political instability and long periods of military rule that entailed relatively good governance but a high cost in terms of defense spending, continued tension with India, and weakening institutional authority.

However, Pakistan's past economic performance is also somewhat misleading because the growth of output, investment, and employment have very seriously slowed down during the last four years and the

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prospect of strong economic revival has become uncertain (Institute of Public Policy, 2012, chap. 2). GDP growth averaged less than 3 percent per annum over 2008–12. Gross fixed capital formation dropped more than 30 percent in real terms over 2008–12 and the ratio of fixed investment to GDP at around 11 percent in the financial year (FY) 2012 was at its lowest level in half a century. Public finances have deteriorated very significantly and external finances are being kept afloat largely as a result of substantial workers' remittances, both through official channels and money market companies. Consequently, gross national product (GNP) growth has averaged 3.6 percent per annum or is 0.7 percent higher per annum than GDP growth over the last four years (2008–12).

In looking for lessons from Pakistan's development experience, we cannot and must not overlook the factors that have made fairly respectable growth rates possible for long periods despite considerable odds. But the more important questions relate to the many missed opportunities that have come Pakistan's way and the many policy missteps that kept it from attaining its fairly widely heralded economic promise in the 1960s. Most urgently, a look at the country's development experience is essential to learn lessons on how to break out of the economic stagnation that now threatens not only people's economic wellbeing but also the country's political future.

## **2. Salient Aspects of Economic History**

Before drawing lessons from Pakistan's development experience, it is necessary to provide a thumbnail sketch of the major economic periods it has undergone.

When the idea of Pakistan was put forward in the 1940s, doubts were continually expressed about its economic and financial viability. Despite the turmoil caused by Partition, the early development of tension with India, and frequent changes in what were weak governments without a strong public mandate, the 1950s marked a period of rapid industrialization. The decade laid down the basis of future growth by sharply increasing investment, both in physical and human capital, and creating strong economic institutions, notably the State Bank of Pakistan, the Water and Power Development Authority (WAPDA), Pakistan Industrial Development Corporation (PIDC), and Pakistan Industrial Credit and Investment Corporation (PICIC). By 1959/60, fixed investment in West Pakistan (now Pakistan) had risen to 11.5 percent of GDP from 4.1 percent in 1949/50, with public investment accounting for nearly two thirds of capital formation (Hasan, 1998). It may seem surprising but education was not neglected in the 1950s. Gross primary enrolment grew

by 10 percent per annum though girls' enrolment accounted for only 22 percent of the increment.<sup>1</sup>

The financing of investment, however, relied excessively on external flows—a pattern that was to become endemic. While private investment, especially in the rapidly growing textiles sector was financed mostly by reinvested burgeoning profits under strong protection, the more-than-six-fold increase in real public investment in the 1950s relied on foreign assistance and money creation.

Apart from foreign assistance, there were three main drivers of growth in the early years: (i) a competent, committed, and honest bureaucracy with strong economic leaders such as Ghulam Mohammad, Chaudhry Mohammad Ali, Ghulam Faruque, and Zahid Hussain; (ii) a large number of migrants consisting of well educated professionals who played a vital role in strengthening the civil services and the financial sector; and (iii) private sector entrepreneurs led mainly by members of the Bohra, Memon, and Khoja communities that had migrated from India but settled in Karachi, making it Pakistan's premier industrial city.

The annual economic growth rate that had been a little over 3 percent in the 1950s shot up to nearly 7 percent in the 1960s, and in the heyday of the Ayub era in the mid-1960s, Pakistan's development efforts were hailed as a rare success story (Papanek, 1996). The transformation in economic performance compared to the previous decade was the result of both a massive increase in foreign aid and investment, economic liberalization, technological breakthroughs in agriculture, and exceptionally well-coordinated economic policies and speedy decision-making supported by strong planning processes. A less well-known fact is that real defense spending from Pakistan's own resources grew little during 1960–65, the size of the army was kept strictly under control, and all the incremental expenditure on weapons and equipment was financed through substantial US military assistance.

Public investment and aid flows were especially stimulated by large expenditures under the Indus Basin Water Treaty signed with India in 1960. The treaty was a consequence of the initiative taken by the World Bank. Including the expenditure on Indus Basin replacement works of about USD 1.2 billion, water and power investment totaled USD 2.5 billion (about 3.6 percent of GDP) during the 1960s and accounted for more than 50 percent of total public spending. Fixed investment reached an all-time peak of 20.8 percent of GDP in 1964/65, with more than 50

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<sup>1</sup> Note, however, that only 5–6 percent of primary school-going-age girls were in school in 1948, and even girls' enrolment increased much faster than the rate of growth of population, though less than 8 percent of primary school-going-age girls were in school by 1960.

percent financed through external assistance. The massive long-term investment in infrastructure was critical in sustaining agricultural growth through the mid-1990s.

The 1965 war with India had the disastrous consequences of a decline in aid flows, upsetting the balance between defense and development, and setting in motion currents that led to the separation of East Pakistan in December 1971. The near-doubling of defense spending between the first and the second half of the 1970s was also a major setback for education—additional primary school enrolment during 1965–70 was one third less than in 1960–65. Based on an imperfect knowledge of the level and rate of growth of population, the Third Plan had set an ambitious 70 percent enrolment target for 1969/70—the actual result was only 40 percent enrolment.

Had it not been for the country's exceptional agricultural growth rate of 5 percent made possible by speedy private tube-well development and the highly successful exploitation of the green revolution in wheat and rice production, economic activity would have slowed down very seriously in the second half of the 1960s. Even so, the fixed investment-to-GDP ratio fell to 14.3 percent by 1969/70. More importantly, the exchange rate and trade policies that were initially supported by the large influx of aid flows had progressively distorting effects on the economy.

The large supplies of long-term credit available for industry through PICIC and the Industrial Development Bank of Pakistan at a grossly overvalued exchange rate led to wasteful and unviable investments. The multiple exchange rate regime that had been put into place under the export bonus scheme in 1959 created an effective subsidy to manufactured exports of over 100 percent for textiles, while substantially taxing agricultural exports. This stalled industrial deepening and inhibited the development of a really competitive diversified manufactured export base while low value-added cotton yarn exports were aggressively promoted.

Z. A. Bhutto's five-and-a-half-year rule encompassed a wide range of economic policy initiatives and state interventions. While Bhutto did not have a grand design for the economy and only a vague belief in socialism, he felt he had the popular mandate to curb the power of the industrialists and bureaucrats and improve the lot of the poor. He therefore vastly expanded the state's role in economic activity by nationalizing education, banking, insurance, and a number of heavy industries. While he did not nationalize light industry, the Punjab government under the Pakistan Peoples Party invested in several sugar and textile mills. Including the large and not very economical steel mill and other investments in cement,

fertilizers, and heavy industries, public sector industrial investment grew tenfold in real terms while the large-scale private industrial sector essentially shriveled because of perceived hostility to the “twenty-two families”.

It is not an exaggeration that Bhutto’s economic policies virtually halted the growth of the modern industrial sector and reinforced the anti-export bias of the country’s industrial strategy. To this day, labor-related and other regulations adopted have continued to provide strong disincentives to the growth of large-scale industry.

Other Bhutto policies that had a negative impact on long-term growth were the large increase in defense establishment (even after the country was reduced by half); the nationalization of educational institutions; a cavalier attitude toward public spending (that his nemesis, Zia-ul-Haq eagerly replicated); and the serious erosion of the capacity and authority of public institutions, especially those responsible for planning. A great deal of the responsibility for the failures in basic education, which remain an important constraint to growth, can be traced back to the decision to nationalize educational institutions in 1972. As a direct consequence of this decision, the government’s management capacity was extended, competition for resources within the education sector deepened the urban bias of education, and the development of basic education and literacy slowed down.

In terms of Bhutto’s short-term policies, three points stand out. On the positive side, following his populist instincts, his decision to greatly relax passport controls did much to help migrant workers and initiate a stream of remittances that, for a while, became a flood in the first half of the 1980s. The same populist instinct led Bhutto to postpone energy price adjustments that became necessary after the first oil shock at the end of 1973. Consumers were protected through grants and loans from friendly Arab countries, and it was only after the second oil shock in 1979/80 that the painful adjustment of energy prices was undertaken in Zia-ul-Haq’s time. Meanwhile, a well-functioning public entity such as WAPDA had become a loss-making enterprise. Finally, the loss of fiscal and monetary discipline in the Bhutto years had the consequence of triggering strong inflationary pressure—consumer prices doubled between 1972 and 1976—that wiped out a good part of the gains accruing to labor through increases in nominal wages.

GDP growth in the Bhutto period, though a respectable 4.9 percent per annum, suffered as a result of several natural disasters, including floods and drought. The substantial additional availability of irrigation water from Tarbela dam was delayed by two years due to technical

problems, which proved to be a lucky break for Bhutto's successor, General Zia-ul-Haq.

Compared to other Pakistani rulers, Zia-ul-Haq took relatively little interest in the economy, partly because it performed quite well through most of his period as a result of a number of exogenous factors. Agricultural growth recovered to nearly 4 percent per annum during 1977–88 from a dismal 2 percent during 1972–77. A good deal of this was not related to price policies but rather to the huge addition to water supplies from Tarbela and private tube-wells, and to the breakthrough in cotton productivity in the mid-1980s. The fivefold jump in workers' remittances between 1976/77 and 1982/83 to a peak of nearly USD 3 billion or 10 percent of GDP was another strong boost to economic activity. At the same time, external assistance for the Afghan Mujahedin, estimated to be USD 5–7 billion in the first half of the 1980s and channeled through Pakistan also helped the economy.

Lulled by high economic growth and a comfortable foreign exchange position, Zia-ul-Haq's regime, with Ghulam Ishaq Khan as finance minister, made economic decisions and policy choices that were to have serious long-term consequences. First, the defense budget, which had already expanded significantly under Bhutto, increased by more than two-and-a-half times in real terms or at an average rate of 9 percent per annum. The result was a sharp rise in public expenditure and sizable fiscal deficits since there was only a marginal improvement in the tax-to-GDP ratio. At the same time, development outlays were squeezed, rising only 3 percent per annum over 1977–88 in real terms: by 1987/88, defense spending had overtaken development spending.

The shift in priorities and the way in which budget deficits were financed had two results. They led to a slowing down in investment and a sharp rise in public debt. The rise in national savings as a result of the large inflow of remittances made it possible to finance the large deficits, mainly through nonbank borrowing, especially as government savings schemes offered highly favorable tax-free interest rates. This kept inflation low but the large pre-emption of savings by the public sector crowded out the private sector and dampened private investment.

Combined with stalled public development expenditures, this resulted in an essentially stagnant investment-to-GDP ratio that had negative consequences for long-run growth. Although economic policies became more market-friendly, Zia-ul-Haq did not do much to reverse the nationalization of the Bhutto period. Ghulam Ishaq Khan had an instinctive distrust of the private sector, and the bureaucracy had quickly come to appreciate the power and privilege that an extended public sector afforded.

Finally, two important structural problems—the high population growth rate and the serious lag in education—were neglected. Additionally, the two policy problems inherited from the 1960s and 1970s—the inelasticity of the tax system and the strong anti-export bias of trade policy—actually worsened because of increasing reliance on foreign trade taxation.

The succession of weak political governments that followed found it difficult to deal with the worsening macroeconomic balances and buildup of debt. There were, however, major efforts, starting with the first Nawaz Sharif government in the early 1990s, to liberalize the economy, expand the role of the private sector, and redress the imbalances in the social services. Investment controls on both domestic and foreign investors were greatly relaxed; the foreign exchange regime was substantially liberalized; high tariffs began to be dismantled; the economy's heavy reliance on foreign trade taxation was reduced; private sector involvement in infrastructure, especially energy, was encouraged; and the prices of agricultural outputs and inputs were aligned more closely with international prices. At the same time, interest rates were considerably liberalized and credit subsidies reduced. A start was made to privatize public sector assets, not only in industry but also in banking, telecommunications, and energy.

Privatization efforts and the shift toward the private sector were influenced largely by pragmatic considerations. The losses of public sector enterprises hastened the decision to divest industrial assets. The policy decision to involve the private sector in energy and infrastructure development reflected the realization going back to 1987 that public sector funds had become a major constraint to development.

However, for a number of reasons, the reforms did not succeed in avoiding an economic slowdown and an external debt crisis by the end of the 1990s. The biggest factor was the failure to reduce macroeconomic imbalances: sizeable deficits financed by credit creation led to a large spurt in inflation and a loss of competitiveness as exchange rate adjustment lagged. The attraction of large foreign currency deposits with a large implicit interest rate subsidy sustained consumption and imports at a high level, but sowed the seeds of a future foreign exchange crisis.

The effectiveness of public sector resource use also deteriorated; the well-intentioned Social Action Program to expand and improve primary education, basic healthcare, family planning, and rural water supply and sanitation did not deliver because of leakages, such as the phenomenon of “ghost schools” and “phantom teachers”. Finally, growing abuses in the largely public sector-controlled financial system led to the siphoning off

of valuable resources. The result was that per capita GDP growth slowed down to 1 percent per annum in the 1990s compared to the average of over 3 percent per annum during 1960–90 and the rate of investment declined significantly.

Overall, the Musharraf era delivered high growth for a number of years (2002–07), partly as a result of good management and partly as a result of good luck (see Hasan, 2011). For a few shining years, a new economic dawn even appeared possible, but the return of old-style politics after the 2002 elections and the increasing compromises made by Musharraf in order to stay in power led to policy mistakes. When adverse exogenous shocks struck—the 2005 earthquake and the sharp rise in international oil prices during 2005–08—the government in its hubris ignored the need for adjustments, hoping to ride the tide on the mistaken assumption of wide public approval. As a result, the need to deepen structural reforms was put on the backburner, and thus, in terms of fundamentals, Pakistan's economy in 2008 found itself in not much better shape than it was at the end of the 1990s. However, credit must be given to Musharraf for giving greater voice to women, local bodies, and the media, initiatives that in the long run benefitted governance considerably.

### **3. Lessons from Experience**

#### ***3.1. Positive Policy Actions***

This brief economic history narrative throws up several points. Political leaders, both civil and military, have had a major impact on the course of economic and social development. On the positive side, the emphasis on infrastructure development in the early years; the rapid development of the textiles industry in the mid-1950s, initially under heavy protection; the sharp acceleration of growth in the Ayub era through an unmatched rise in investment—especially in the water and power sectors—through large foreign aid inflows and effective planning and policy coordination; Nawaz Sharif's major initiatives for economic liberalization in the early 1990s; and Musharraf's strong push for both stabilization and growth in the first half of his rule were important elements in whatever economic success Pakistan has achieved. The 1950s and the 1960s were also periods of institution building, including the establishment of public enterprises that worked.

#### ***3.2. Early Policy Mistakes***

Notwithstanding the positive side, there is a long list of policy mistakes made and opportunities missed over several decades, which is vital to understanding why Pakistan has been unable to achieve a sustainable high rate of growth. The decision in September 1949 not to follow the

devaluation of the pound sterling and Indian rupee, in the final analysis on the ground that it would make Pakistan look good in relation to India, was costly because it led to a trade deadlock with India and eventually a sharp reduction in trade with the big neighbor—though it yielded some benefits in import substitution, such as in fruit production.

Next, a huge foreign exchange windfall—worth several billion dollars in today's prices—from the Korean War boom that increased the prices of jute and cotton, was frittered away in 18 months in the totally unsustainable liberalization of imports under an overvalued exchange rate regime. The fact that imported cloth became cheaper than in India for a while was a source of great pride for citizens as well as populist politicians. Meanwhile, the emerging elite, both civil and military, indulged in large imports of luxury automobiles with low import duties at an overvalued exchange rate.

These early policy mistakes clearly point to the two fundamental drivers of policy that have continued to shape economic development in Pakistan for most of its history: tension and competition with India, and the real or perceived need to maintain a high level of defense spending.

Because relations with India deteriorated early after independence, especially on the issue of Kashmir, a strong defense capability was a top priority, even under successive civilian governments in the early years. It is to Ayub Khan's credit that he gave very high priority in the early years of his rule to economic development by containing military spending, partly because military assistance obviated the need to spend money on arms and equipment. However, hubris and the miscalculation that resulted in the 1965 war with India led to a sharp increase in military spending as US military assistance disappeared. After a military defeat and the separation of East Pakistan, real defense expenditures were increased under Bhutto and rose sharply under Zia-ul-Haq. With the debt hangover, real defense expenditures did not increase in the 1990s but neither did other public spending.

High spending on defense has been a constraining factor on social and economic development almost throughout Pakistan's history. The problem has been compounded by the fact that, after the mid-1980s, government revenue expenditures in most years have not covered current expenditures, including defense, necessitating government borrowing to finance nondevelopment expenditures. Another way of putting it would be that governments have desired strong defense but not been able to raise the commensurate tax revenues.

Several other factors and policies that have also affected economic outcomes adversely are: (i) high population growth; (ii) the neglect of education; (iii) the persistent failure to exploit tremendous opportunities offered by rapidly growing international trade in manufactured goods; (iv) a low savings rate and the inability to translate large foreign aid inflows into a high, sustainable level of investment and growth; and (v) an almost steady decline in governance over the decades, which is now reflected in serious institutional decline, the weakening of public services, and slow reduction in poverty incidence.

### ***3.3. High Rate of Population Growth***

Pakistan's population is six times what it was at independence in 1947, having increased from 30 million to 180 million in 60 years. Its high average population growth rate of 2.8 percent per annum has seriously affected the level and sustainability of growth in per capita income. At the same time, high population growth has contributed to an abysmal record in social and human development and to persistently high levels of poverty despite an agricultural sector that has performed reasonably well for long periods.

Of course, low level of tax revenues, high levels of spending on defense, and poor governance of the large public education sector are also responsible for the low level of human development in Pakistan. But if the annual population growth rate had been only half a percent lower over Pakistan's history, its population would be more than 25 percent smaller than it is today. The political, economic, and social landscape might then have been vastly different, and the divisions in society not as deep as they are now.

The population control policies of the 1960s and 1970s did not succeed because of the excessive focus on provision of contraceptives. During Zia-ul-Haq's rule, the policy on limiting family size was, at best, ambivalent. This was in sharp contrast to the effective policy success in Bangladesh, which focused on reducing desired family size through women's education, employment, and social mobilization.

### ***3.4. Neglect of Education***

The makings of a disaster in education have been a slow process. Progress in education was reasonable during 1950–65. High targets for universal education were set from the beginning, but then there were three major setbacks. First, as noted earlier, after the 1965 war with India, the sharp increase in defense spending, reduction in foreign aid inflows, and the

urgent need to increase food grain production dealt a blow to the allocations for the social sectors.

Second, Bhutto's nationalization of educational institutions in 1972 had continually weakened the effectiveness of public sector education expenditures and educational institutions. Third, the allocations for education remained low during the Zia period despite the *iqra* tax. More attention has been given to the social sectors, including education, during the last two decades, but the results have been mixed because of poor governance and the reemergence of serious financial constraints.

Less than 60 percent of Pakistan's adults are literate. The situation is worse for women with less than 40 percent of adult females literate. Despite rapid progress in increasing primary enrolment across regions and gender, only three out of five children aged 5–9 years are enrolled in primary school, and only two thirds of those who enroll actually complete Grade 5. Currently, public educational expenditures are only 2 percent of GDP. In almost all these respects, Pakistan compares unfavorably with India and Bangladesh.

### ***3.5. Missed Export Opportunities***

An important feature of Pakistan's history is that it has continued to fall behind other developing countries in export development and has not exploited the tremendous opportunities for exports offered by international developments. Stimulated by growth in world income, the liberalization of trade, reduction of tariffs, and technological changes reducing transport costs and improving information flows, world trade has grown at a much faster pace than world output since the 1960s.

The leading edge of this expansion was the growth in world exports of manufactured goods, which increased steadily from less than USD 200 billion in 1970 to a peak of USD 11.5 trillion in 2011, showing an average annual growth of 10 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. There was a fairly sharp decline in 2009 due to the deep international recession, but growth recovered quickly in 2010, and had exceeded the earlier peak by 2011.

The biggest economic story of recent times is the rise of China in large 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. 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 is now probably lower than it was in 1970 (Hasan, 2011).

In 1980, Pakistan was still substantially ahead of Turkey and Indonesia in the level of its manufactured exports and had about a quarter of Indian exports, though it had already fallen behind Malaysia, the Philippines, and Mexico in the 1970s. Thirty years later, Pakistan's manufactured exports are less than 30 percent of Indonesia's, and only 18 percent of Turkey's. India's exports are now eight to nine times larger, while Vietnam, a newcomer to the field, has manufactured exports three times those of Pakistan (Institute of Public Policy, 2012, chap. 2).

Table 2.1, which provides a country comparison on the basis of the total export of goods and services, presents clear evidence of how far Pakistan has fallen in orienting its economy toward exports, which have been virtually the engine of global growth. China and most other East Asian countries are in a class by themselves, but even traditionally inward-looking economies such as India, Turkey, and Bangladesh have increased their export orientation remarkably in the last 30 years. In 1980, India had an export-to-GDP ratio (6 percent) half that of Pakistan (12 percent); now its ratio at 23 percent far exceeds that of Pakistan. Even Bangladesh has moved ahead in this respect.

**Table 2.1: Export of goods and services as a percentage of GDP**

Country	1960	1970	1980	2000	2008	2009	2010
Bangladesh	NA	NA	5	14	20	19	18
China	NA	3	11	23	35	27	30
India	4	4	6	13	24	20	23
Indonesia	15	13	34	41	30	24	25
Pakistan	NA	8	12	13	13	13	14
Thailand	16	15	24	67	76	68	71
Turkey	2	4	5	20	24	23	21
Vietnam	NA	NA	36	55	78	68	78
			(1990)				
Lower middle-income countries	11	11	17	26	30	26	28

*Source:* World Bank.

Why has Pakistan fallen so far behind in the export field? (See Institute of Public Policy, 2008, chap. 9). There are several reasons for this that are rooted in past policies and attitudes toward exports. First, export growth was never a central pillar of development strategy à la Korea, Malaysia, and China. Second, exports were not as profitable as sales in the domestic markets, which were heavily protected for a long period. The anti-export bias in policy was reinforced by an industrial strategy that favored manufacturing based on processing domestic raw materials. Export development based on imported inputs was strongly discriminated against by generally high import duties. Finally, the spurts of export growth that materialized in the 1960s and 1980s were, to a large extent, supported artificially by indirect subsidies to the textiles sector, which kept the domestic price of cotton well below the international price and thus encouraged relatively low value-added textile exports, notably cotton yarn.

Over time, many of the distortions in trade policy acting against exports were removed or reduced. The export taxation of cotton was phased out at the end of the 1980s. Import tariffs were gradually reduced and imports greatly liberalized in the 1990s.

Why then, has the liberalization of trade in Pakistan, which went further than countries like India, not resulted in major gains in exports? One explanation is that Pakistan's real exchange rate was periodically overvalued, for example, after the mid-1990s and again after 2004/05. Moreover, some of the consequences of past policies, including the neglect of human capital development, insufficient investment in infrastructure, and excessive attention to textiles remain with us, and are reflected not only in the relatively low level of our manufactured exports but also in the structure of these exports.

Among large developing countries, Pakistan has the least diversified pattern of manufactured exports with the exception of Bangladesh. Nearly 75 percent of Pakistan's manufactured exports consist of textiles and clothing compared with less than 12 percent for developing countries as a group and 6.5 percent for the world as a whole. While Pakistan is a major exporter of textiles and clothing—accounting for nearly 2 percent of world exports—its exports of manufactured exports other than textiles and clothing are small. At USD 4.5 billion in 2011, they were only 0.04 percent of world exports of manufactured goods. In comparison, Vietnam, a relatively new exporter, had other manufactured goods exports ten times that of Pakistan in 2011.

### **3.6. Savings, Investment, and Foreign Aid**

Pakistan has received enormous amounts of foreign aid over the last half-century or so. Both in per capita terms in constant dollars and as a percentage of gross national income (GNI), net official development assistance (ODA) peaked in the 1960s but declined as repayments on all fronts except grant aid naturally continued to climb. Even so, net ODA in the last decade was 1.7 percent of GDP—close to 10 percent of gross fixed investment.

As Table 2.2 shows, the availability of foreign aid in relation to national income in Pakistan compared to that in India was fourfold in the 1980s; during the last decade, the difference has grown more than eightfold. The more important point is that aid flows are no longer significant for India for sustaining its fairly high rate of investment and growth, whereas Pakistan's growth and investment are in the doldrums and the country is far from reviving sustained high growth on its own.

**Table 2.2: Net official assistance to Pakistan and India**

ODA	Pakistan			India		
	1960s	1980s	2000s	1960s	1980s	2000s
Per capita net ODA in current USD	7.7	10.2	11.1	2.0	2.4	1.3
Net ODA as % of GNI	7.1	3.1	1.7	NA	0.8	0.2

*Source:* World Bank.

It would be difficult to argue that foreign aid in Pakistan was used particularly ineffectively compared to most other developing countries. Indeed, the large early aid inflows financed an extraordinary level of investment in the water and power sectors in the 1960s and 1970s, partly for Indus Basin works under the water treaty with India that was facilitated by the World Bank. These large investments helped sustain the high agricultural growth of 4 percent per annum over 1960–2000.

The more serious problem was that large external flows—foreign aid in the 1960s and 1970s, workers' remittances in the 1980s, resident foreign currency deposits in the 1990s, and direct private investment in 2003–08—reduced incentives for export development on one hand, and on the other, allowed policymakers to avoid difficult choices between consumption and savings. Judging from the long-term trends in gross

capital formation (Table 2.3), and the foreign savings available to finance the current account balance of payments deficits, it would appear that gross national savings, which averaged 14–15 percent of GDP in the 1980s and the first half of the 1990s, have shown no clear upward trend. After a brief growth spurt to over 20 percent of GDP during 2002–4, gross national savings have dropped almost steadily since and touched a low level of 13 percent of GDP in FY2012 (see Institute of Public Policy, 2012; Hasan, 1998).

**Table 2.3: Gross fixed capital formation as a percentage of GDP**

Country	1960	1970	1980	2000	2008	2009	2010
Bangladesh	NA	NA	14	23	24	24	24
China	NA	24	29	34	41	46	45
India	13	14	18	23	32	32	30
Indonesia	NA	NA	22	20	28	31	32
Pakistan	11	14	18	16	20	17	14
Thailand	14	24	28	22	27	24	25
Vietnam	NA	NA	NA	28	35	35	36
Lower middle-income countries	NA	14	20	21	27	26	26

*Source:* World Bank.

Apart from the relative ease with which external resources were available, other factors also help explain Pakistan’s dismal savings performance. The political leadership has rarely emphasized the importance of sacrifice and savings for long-term development. Indeed, the governing elite have often set high standards of conspicuous consumption. At a more basic level, the low measured savings rate reflects low confidence in the future. Indeed, real savings are understated because of considerable capital flight. The high savings rate during 2002–04 partly reflected returning capital because political stability seemed to be assured and the investment climate had improved considerably.

In addition, for long periods, the high population growth rate meant that Pakistan had a dependency ratio (the ratio of dependent children to the working-age population) of 0.9, compared to 0.7 in India and 0.5 in China (Hasan, 1998, p. 36). Finally, for most years since the mid-1980s, general government savings have been significantly negative—in many years, as high as 3 percent of GDP—as stagnant or slowly growing tax revenues have not been able to cover government current expenditures in most years.

The low 'available' savings are reflected in the persistently low level of gross fixed capital formation. As mentioned earlier, after a recovery during 2005–08 from the low level reached in 2000, fixed investment as a percentage of GDP has, again, fallen to a very low level.

### ***3.7. Deteriorating Governance, Institutional Decline, and Weakened Public Services***

Looking at Pakistan's history over the last half-century, governance failures stand out even more than growth disappointments. Indeed, poor governance has been even more of a problem than poor policy choices. Had governance not deteriorated so much and the strength of public institutions not eroded over time, the resources mobilized through taxation would have been more adequate and the quality of public services—especially law and order and education—would not have declined so precipitously. Poor governance hurts the poor and low-income groups especially as they depend more heavily on public services.

Over time, growth and governance problems became increasingly intertwined. Because growth benefits were not widely shared, the quality of public services, especially education, deteriorated; the pace of poverty reduction slowed down; and the tensions in society began to erupt with increasing frequency in ethnic, sectarian, and random violence. Now, the extremely uncertain security situation has become a major constraint to investment and growth, second only to power shortages. 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. Only belatedly is there a realization that the Pakistani Taliban pose an existential threat to the country as a modern, moderate, and progressive state (Amir, 2012).

Unfortunately, the religious extremists draw some tacit support from sections of society that rightly perceive widespread corruption, growing income inequalities, and lack of any meaningful accountability of the political leadership as the very antithesis of Islam. These quiet sympathizers do not see, however, the dangers of an extremist, theocratic, authoritarian rule.

The greatest sources of public dissatisfaction are high-level corruption and a governance style that does not give regard to merit and integrity in key appointments. The 2011 Transparency International corruptions perception index puts Pakistan's score at 2.5—on a scale of 0 (worst) to 10 (best)—and 137<sup>th</sup> out of 182 countries. Pakistan's score is well below India's (3.1), lower than Bangladesh's (2.7), and very close to that of Nigeria (2.4).

Why did governance, which was relatively good till the end of the 1960s, decline so sharply over time? In the early years, the sanctity of public expenditure was observed and there was not the cavalier attitude toward the use of public funds. High-level corruption was relatively rare. It seemed that the politicians who grew up under the British Raj and were either lawyers or feudal landlords did not focus on accumulating fortunes. Relatively new public entities such as WAPDA and PIDC had strong leadership and were fairly effective because they had more operational freedom, including the ability to adjust prices. Later governments were either populist or weak and unsure, and tended to postpone difficult decisions for the sake of short-term gain.

Arguably, extra-judicial interventions, first by Ghulam Mohammad as Governor General in 1951 and later by military regimes, and disregard for the Constitution—facilitated by either a pliant or weak higher judiciary—were the root cause of the problem. It needs to be noted, however, that in some respects Pakistan's military regimes were less arbitrary than some democratically elected leaders, starting with Z. A. Bhutto. The democratic governments of Benazir Bhutto and Nawaz Sharif that followed the end of Zia-ul-Haq's rule in 1988 did not play by democratic norms and often proceeded to persecute opposition leaders. For instance, the well-conceived establishment of a high-level public accountability bureau was undermined by its use as a political tool. Meanwhile, the core competency and authority of the bureaucracy—central to effective administration and the delivery of public services—declined steadily because of falling real compensation and frequent political interventions in violation of rules and regulations.

The early Musharraf years saw a significant improvement in economic management with greater reliance on technocrats and greater stress on merit in recruitment and promotion. Ultimately, however, political compromises after the 2002 elections limited progress on some fundamental issues such as improving tax administration and reforming the civil services.

The last five years represent somewhat of a paradox. On one hand, governance has declined further, corruption has risen, and effective decision-making has suffered because merit has not been the key criterion for senior appointments. Militancy and terrorism have increased and the authorities have dragged their feet on holding high-ranking public servants accountable for abuse of power. On the other hand, the higher judiciary, especially the very independent-minded Supreme Court, has become highly proactive in governance issues and the free media,

especially the electronic media, has come to play an important role in highlighting public policy issues and exposing wrongdoings.

Furthermore, there are basic constitutional changes that augur well for the future of democracy in a meaningful federal setting. The 18<sup>th</sup> Amendment to the Constitution, passed in April 2010, restored in letter and spirit parliamentary democracy and the relationship between the federation and the provinces as envisaged in the 1973 Constitution. This amendment does more than repeal the 17<sup>th</sup> Amendment introduced by Zia-ul-Haq, which gave enormous authority to the President. It transfers major economic powers to the provinces by abolishing the concurrent list in the 1973 Constitution.

The amendment also lays down procedures for nominating judges for the higher judiciary, makes the office of chief election commissioner autonomous of both the executive and the Parliament, and prescribes a procedure for appointing the head of the Accountability Bureau. Through the subsequent 19<sup>th</sup> and 20<sup>th</sup> amendments, procedures for appointments to the high courts and Supreme Court are clarified and arrangements for caretaker governments to oversee elections laid out with the final authority on the caretaker Prime Minister being given to the chief election commissioner in case the outgoing Prime Minister and leader of the opposition are unable to agree on a nominee.

The substantial devolution of power to the provinces is underpinned by the 2009 National Finance Commission (NFC) award, which substantially increased the share of the provinces, and within the provincial allocation, the share of the two poorer provinces, Balochistan and Khyber Pakhtunkhwa. However, it has been rightly pointed out that, ideally, the transfer of additional resources to the provinces under the award should have followed the transfer of increased executive responsibilities to avoid wrangling over additional resource transfers and a significantly weakened federal revenue position.

The impact of significant new structural changes will depend on, among other things, how effectively the provinces improve the efficiency of expenditure and mobilize additional taxation to meet their greatly enhanced responsibilities in the social sectors. One key question is whether the provinces will take steps in turn to devolve greater authority to the local level as broadly envisaged by the Musharraf government (see the discussion below). The results of the next election will also be important in indicating whether the hold of traditional parties remains strong or whether new leadership can emerge.

### **3.8. Translating Lessons into Future Actions**

The above discussion clearly suggests that, first and foremost, good governance in the broadest sense and realistic national agendas focused on equitable economic development are critical to “moving Pakistan’s economy forward”. What Pakistan needs is an enlightened leadership that can take a long-term view, inspire national confidence and cohesion, and that does not concern itself unduly with perpetuating its own rule. Although this cannot be ordained, a democratic set-up with decentralized authority, guarantees of open and fair elections at all levels, and strong deterrents against abuse of power and law-breaking applied to all citizens is a prerequisite.

Specifically, governance will not improve significantly unless three conditions are met: (i) a firewall is established between the executive authority and accountability mechanisms—it would be fair to say that Pakistan has one of the worst records in punishing wrongdoers, whether politicians, bureaucrats, businesspersons, or military leaders; (ii) a deliberate effort is made to reform the civil service and restore the independence of public institutions through autonomy, proper selection of top management and professional staff, and adequate pay; and (iii) effective steps are taken to decentralize authority to the local government level.

Hopefully, both politicians and the military will have learnt their lesson, given their less-than-glorious record, and collaborate rather than confront each other in efforts to move Pakistan toward a better future. They need to remember that no leader after Jinnah in Pakistan’s 65-year history has become a national icon—something of a shame and of course a considerable cost to the country.

Among the specific steps mentioned above to strengthen governance, decentralizing governance to the local level deserves special mention. In an important study on decentralization, Cheema, Khwaja, and Qadir (cited in Institute of Public Policy, 2010) make two important points. First, historically, military governments seeking political legitimacy have undertaken decentralization to local governments while centralizing political power in their own hands. Second, the bureaucracy has also sought to exercise control through local governments.

Under Musharraf, however, a genuine, albeit highly ambitious, devolution plan was introduced in 2000 (see Institute of Public Policy, 2010, chap. 8, for details). The lynchpin of the plan was to create the elected office of district *nazim* (mayor) invested with substantial authority and responsibility for economic and social development functions. It is not clear, however, whether the local government system devised by 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; under pressure from the Muttahida Qaumi Movement, it has now proposed a hybrid system of local government in which only major urban centers will have decentralized 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 in all districts, accountable only to the federal or provincial ombudsman, depending on the nature of crimes being investigated. On the positive side, healthy competition among districts might improve performance as nazims attempt to burnish their reputations and showcase their administrative skills.

Without devolution, much needed improvements in public service delivery, especially education, will not take place. While public expenditure on education at 2 percent of GDP is woefully inadequate, political promises to treble or quadruple this level are unrealistic because of the financial constraint the country faces. The fact is that 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 are too many stories about ghost schools and phantom teachers that require structural solutions such as the 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. Shahbaz Sharif's initiative and idea for Danish schools is an excellent one, but why should Danish schools be restricted to the public sector that is so short of funds? Civil society in the districts could be encouraged through promotion, land grants, and selective subsidies to establish such schools countrywide on a scale and at a speed that is not likely to be possible otherwise.

#### **4. The Need for a National Economic Strategy**

Along with an agreed governance agenda, the major political parties need to seek a broad consensus on key elements of a long-term economic strategy, for instance, on the lines of the Charter of Democracy, which led to many constitutional changes aimed at strengthening democracy. The Framework of Growth formulated by the Planning Commission last year

already stresses a number of important points, the need for urban development, public transport, and strengthening of internal markets. It is, thus, an important start, but there remains a need for a comprehensive national strategy for an accelerated economic and social advance that recognizes squarely the faults and shortcomings of the past and attempts to develop a national consensus on at least six broad areas:

- Better political and economic relations with India, especially the opening of trade, travel, and investment.
- A better balance between defense and development.
- Recognition of the major role that the private sector has to play in economic development—not a private sector that actively seeks economic rents and government patronage, but one that is open to fair competition from both inside and outside.
- A strong revival of investment in both human and physical capital.
- Strong export orientation with emphasis on technological changes, productivity improvements, and diversification.
- Greater attention to population control.

Many of these subjects are discussed in other chapters in this book, and so this chapter is confined to only a few points where policies need either more thrust or better definition.

#### **4.1. Population**

As discussed earlier, population pressures have hampered growth in incomes and employment. Population control issues deserve more attention than they are receiving. Fortunately, the population transition has begun: the growth rate of population has come down to 1.8 percent per annum. However, the 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, the focus should be on the high fertility rate of 4.5 in rural areas through the continued acceleration of women's education, employment opportunities for women, and availability of family planning services. In general, and especially in rural areas, continued policy efforts to encourage a reduction in birth rates will help increase savings, reduce poverty, and make it easier to improve social indicators.

#### **4.2. Exports**

Another area in which Pakistan's policymakers need to make a resolute commitment and a big push—beyond the crippling energy crisis—is increasing the economy's export orientation. As discussed earlier and as Table 2.1 illustrates, Pakistan did not make much use of the opportunities offered by the almost explosive growth in global trade, especially in manufactured goods, and fell far behind other major developing countries. However, it is not too late to change course and focus.

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

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 move onto a higher growth path. Rapidly rising exports can be an important instrument for improving productivity and keeping capital requirements for growth low.

Specific policy actions that should be taken to promote exports include:

- An exchange rate that fully reflects the differential between movements in Pakistani prices and the international price level.
- Strong incentives for new investments and skill upgrading in textiles that increase the scale of and update technology, and encourage mills with low productivity and profitability to exit the industry.
- A determined push aimed at small and medium industries to expand and diversify exports in areas outside textiles.
- Joint public and private sector efforts to promote foreign investment in textiles, clothing, and other promising export sectors from countries such as the Republic of Korea, Hong Kong, Malaysia, and Taiwan, which are losing ground in labor-intensive industries due to high and rising wage costs. The focus of these efforts should be to upgrade skills and technology and utilize 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 could provide some leverage.
- A special and speedy implementation review of the free trade agreement and establishment of a free 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.
- Strengthening monitoring mechanisms, including quarterly meetings of the high-level Export Board.
- Implementing the recommendations of the Strategic Trade Policy Framework 2009–12 to reduce anti-export bias by withdrawing protection from inefficient industries, minimizing taxation at the investment stage, and eliminating or zero-rating customs duty on important inputs to textiles and clothing exports.
- Closer coordination of commerce ministry policies and activities not only with the textile ministry but all other production-related ministries, which appears to be sorely needed.

#### **4.3. Investment**

The control of fiscal deficits, which have averaged over 7 percent of GDP annually in recent years, should be a top priority; this will require improvements in tax revenues, sharp cutbacks in wasteful administrative expenditures, restraints in military purchases, and a solution for loss-making enterprises. This may appear to be a very tall order, but the fact is that there have significant slippages in these areas and resolute government action has been lacking. There has not been much attempt to introduce austerity in spending—public or private. Real private consumption in 2011/12 was 27 percent higher than in 2007/08, suggesting that there is certainly room for belt-tightening, especially because of substantial income inequalities. Strong governance and committed political leadership can help bring public finance problems under control.

In the somewhat longer run, resources need not be a major constraint to reviving growth and investment. Provided the security situation and

governance improve, and economic relations with India expand, investors' confidence—both domestic and foreign—in Pakistan will revive. Capital flight will slow down and, in time, be reversed. There is a large amount of Pakistani capital sitting on the other side hesitant to invest because of noneconomic factors.

Similarly, foreign private investment both from the Middle East and more successful exporting countries in East Asia, including China, who are feeling the pressure of rising real wages, is a strong potential source of financing development, improving technology, upgrading labor skills, and finding export markets. It is worth recalling that, under improved investment climate conditions, foreign private investment totaled more than USD 12 billion or 2–2.5 percent of GDP in the three years FY2005–08, though it was unfortunately not focused on exports and the main productive sectors.

#### **4.4. *Human Capital***

Strengthening the country's substantial but neglected human capital resources is as important as reviving physical capital formation. This is not, however, just a matter of increasing public resources for education, which are admittedly at a very low level. As the growing buoyancy in the private education sector suggests, families are willing to save and invest in their children's education, provided there is a reasonable confidence in the quality of education being imparted. The public sector has failed this test. Deep structural reforms are needed that aim to increase the effectiveness of spending, the quality of the curricula, and much greater accountability of teachers. Increasing the transfer of authority to local bodies, public-private partnerships, and even school vouchers that can be used in private schools are some critical steps that should be seriously considered and implemented.

#### **4.5. *The Mechanics of Change***

None of these changes can occur or be successfully implemented until there is strong political commitment. Even robust political will, however, needs to be backed up by empowered and informed institutions, and workable instruments of change that improve governance.

During the last few years, legislators in the national assembly and the Supreme Court have, by and large, shown enlightened leadership. The independent media is vigorous in its critiques, though perhaps not always well informed. Some independent policy institutes are doing a heroic job. Nevertheless, there appears to be an intellectual vacuum,

which hurts informed public debate and limits the impact of what would be 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 carried out by international financial institutions, notably the World Bank and International Monetary Fund. Many of the country's domestic policy institutes remain dependent on foreign funding.

The state's major organs require more intellectual support and analysis. For instance, the Council of Common Interests has become critical to resolving disputes among and between the provinces and center, but there has not been much thought to giving it an independent secretariat. Similarly the important National Finance Commission could, as is the case in India, benefit from the assistance of a professional group. Finally, the Parliament should consider establishing an independent budget office that could inform and educate politicians and clarify policy choices.

The governments both at the federal and provincial levels need to deepen their involvement with private sector bodies, but especially with independent institutions such as the important Pakistan Business Council.

Among 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 planning processes. The Debt Policy Coordination Office that was established more than a decade ago needs to be invigorated with strong leadership. Its performance so far, either as a source of reliable debt statistics or regular analysis of Pakistan's debt situation, has been greatly disappointing.

In terms of instrumentalities, an independent, well-paid, and honest civil service remains crucial for improving governance. One focus should be on the remuneration and quality of the top tiers, i.e., grades 19 to 22. A quote from the World Bank (2003) Public Expenditure Report on Pakistan deserves attention:

There is a *prima facie* strong case for significantly adjusting upwards the compensation for higher managerial and professional grades, say grades 19 to 22. The numbers involved are small. For instance, Federal employees in the grades 19 to 22 are only about 3,200, less than 1 percent of total Federal employment. The share is somewhat higher in the provinces.

But overall these grades account for less than 3 percent of the government wage bill. So financial costs of, say, a 100 percent real pay increase – would be only 0.1 percent of GDP. A substantial part of this increase could be financed from natural attrition of lower grade staff focused on areas where employment is excessive and services are no longer needed. Restraints on recruitment coupled with attrition might be easier politically than retrenchment as a method for creating fiscal space, but it is recognized that the de-compression in compensation that is being recommended here is nevertheless politically challenging. It is however urgently needed if high-level managerial and professional skills are to be attracted to the public sector.

## **5. Conclusion**

Looking forward, nothing seems quite as important as restoring the public's confidence in the government and the country. While a number of important constitutional steps have been taken in the last two years to strengthen the basis of a democratic set-up based on a working federation, it remains to be seen whether the elections will result in a strong leadership committed to better governance and sounder economic management.

The country's main political leaders need to come together to attempt to define and agree on the major parameters of better governance and a long-term economic vision. The goal should be to develop a broad consensus on the main items of a governance agenda and the key elements of a long-term economic strategy. Just as the Charter of Democracy triggered many helpful constitutional changes aimed at strengthening democracy, a charter of governance and growth, implemented seriously, could improve governance and invigorate growth. Above all, it could strengthen national unity and increase public confidence.

In light of the country's past economic record analyzed in this chapter, it would appear that a good starting point for debate and discussion is a three-point governance agenda that aims to improve governance by (i) clearly separating the executive authority and accountability mechanisms; (ii) reforming the civil service, restoring the independence of public institutions, and ensuring that they are staffed by competent top management and professional staff who are adequately

remunerated; and (iii) decentralizing authority to the local government level.

The chapter has also proposed a parallel six-point economic strategy that draws on Pakistan's experience and especially its shortcomings in the past. It should aim to (i) develop better political and economic relations with India by opening up trade, travel, and investment; (ii) achieve a healthier balance between defense and development; (iii) nurture the private sector as a key player in economic development, but a private sector that allows fair competition from both inside and outside rather than one that seeks economic rents and government patronage; (iv) revive investment in both human and physical capital; (v) orient the economy strongly toward exports with an emphasis on technological changes, productivity improvements, and diversification; and (vi) pay greater attention to managing the country's population.

This is a very challenging agenda. However, there are some good signs. The military leadership has renewed its efforts to combat militancy though a military solution alone will not be enough. Relations with India are improving and prospects for increased trade, investment, and tourism between the two countries appear to be good. None of these changes can occur or be successfully implemented until there is strong political commitment and collaboration. As the chapter has discussed, even robust political will must be supported by empowered and informed institutions and workable instruments of change that will improve governance.

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## **Economic Management under Musharraf and Coalition Rule: Key Lessons for Sustainable Growth**

**Rashid Amjad\***

### **1. Introduction**

Over the last 65 years, the Pakistan economy has displayed considerable resilience as it has moved through recurring economic cycles of high economic growth followed by prolonged spells of low growth. Its average economic growth of around 5 percent during this period would be considered respectable by most developing countries' standards, even though this performance is now clearly overshadowed by the stellar growth rates achieved since the 1980s, first by the East Asian economies, followed by China, and then till recently by India.

Is there a limit to the strain that even a reputedly resilient economy can bear? After being mired in deep stagflation for the last five years (2009–13),<sup>1</sup> there is a growing despondency that the Rubicon may well have been crossed. Breaking out of the current recession will need firm and resolute policy action and a commitment to deep economic reforms. The time to resort to easier options such as external financial support as a means to procrastinate on essential economic reforms has now passed. Neither is external assistance going to be so easily forthcoming after the country's dismal record of renegeing on promised reforms, nor for that matter will it be sufficient. The problem is now much more deep-rooted and structural. It is no longer business as usual to rekindle sustained growth.

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<sup>1</sup> In terms of financial years (July–June, e.g., 2009 refers to 2008/09).

*Economic Management under Musharraf and Coalition Rule: Key Lessons for Sustainable Growth*

Indeed, to many, the immediate priority must be to stabilize the economy and avert a possible meltdown triggered by a looming debt default. The economy needs a strong dose of financial austerity to restore macroeconomic balance before one can give serious attention to the task of reviving growth and moving to a high and sustainable growth trajectory.

This chapter addresses the fundamental economic challenges that confront the economy. In addressing these issues, it does not restrict the analysis to the last five years of democratic rule (2009–13) but covers the entire economic cycle that started in 1999. This has merit in that it allows us to identify the critical economic factors that helped the country break out of the recession of the 1990s, and to assess the revival and acceleration of growth in 2003–07, followed by the outset of the current stagflation. It also has the advantage of not merely blaming one or the other government in power for the problems we now face, but more dispassionately evaluating the relative performance and weaknesses of both in economic management, including the lack of will to undertake fundamental structural reforms.

As we shall see, much of the problem that arose as growth first increased and then plummeted stemmed from (i) the Musharraf government not doing enough to take advantage of the spurt in economic growth, and (ii) the succeeding democratic coalition's failure in taking the concerted action necessary to revive growth and restore macroeconomic stability. Indeed, by the end of its term, the coalition government could rightly be accused of gross negligence and wanton economic mismanagement.

Section 2 analyzes the movement of key economic variables over the economic cycle to establish the key constraints that prevented the economy from achieving a sustainable growth trajectory after the initial burst of economic growth. These include the low level of savings and investment, the incapacity to raise sufficient revenues, falling international competitiveness, infrastructure constraints—especially energy—and continuing poor human development indicators (HDIs).

Drawing on this analysis in Section 3, we explore the Pakistan economy's underlying dynamics during this period that appear not to have been fully captured by the broader macroeconomic indicators. This dynamism is reflected in a certain buoyancy and resilience in the economy even during the last five years and could also help explain why certain sectors of the economy have performed well while others remained stagnant or showed lackluster growth. Identifying these factors and the dynamism they create in the economy could also help explain why the labor market and poverty impacts of the current stagflation have

been far smaller than what earlier studies had predicted or even why poverty may have declined in this period as some studies appear to show. We also suggest that the size of the economy may be much larger than the official statistics show and this could help explain the rise of the middle class during this period.

A fundamental premise of this chapter is that Pakistan's poor economic performance is as much due to poor economic management as to structural or other constraints. Indeed, poor economic management is an important reason why these constraints continue to persist. Section 4 therefore assesses how well or poorly the economy was managed over this period in terms of what economic policymakers did right and what they did wrong—most importantly, what they did not do and should have done. In assessing their performance, we also critically evaluate the International Monetary Fund (IMF) agreements entered into and to what extent the conditionalities agreed on were met.

In the last two sections, we suggest policy measures and reforms needed in the short term to regain macroeconomic stability and revive growth, and in the medium and long term to move the economy onto a higher, sustainable, and inclusive growth path.

## **2. The Pakistan Economy: Bust-Boom-Bust Cycle (1999–2013)**

Till recently, identifying the economic cycles through which the country has moved over the years and the factors responsible for them appeared to be reasonably well established. Economists have tended to divide the overall period into cycles of low economic growth, i.e., the 1950s, 1970s, 1990s, and 2009–13, which were also associated with civilian rule, in contrast to periods of relatively high growth, i.e., the 1960s, 1980s, and 1999–2008, which coincided with military rule.<sup>2</sup> These cycles have also been characterized by significant changes in foreign resource inflows as well as with important geopolitical developments such as the Soviet invasion of Afghanistan in 1979 and 9/11 in 2001. Given this association, many economists have, therefore, explained, the spurts in economic growth as having been caused by injections of large foreign resource inflows, and downturns by slowdowns or sharp declines in these inflows.

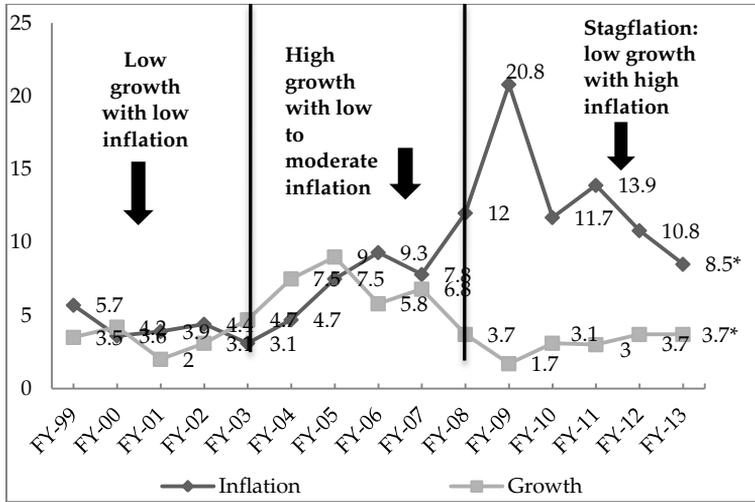
This dominant view has been questioned by McCartney (2011), who uses rigorous statistical measures to analyze Pakistan's growth performance and identifies three episodes of growth—1951/52 to 1958/59, 1960/61 to 1969/70, and 2003/4 to 2008/09—and two episodes of stagnation—1970/71 to 1991/92 and 1992/93 to 2002/03. Moreover, he

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<sup>2</sup> This division is followed by Ahmed and Amjad (1984) to cover the period till the early 1980s.

finds no credible evidence for attributing Pakistan’s episodes of growth to foreign aid inflows and circumstances emanating from the global economy. McCartney’s basic hypothesis is that acceleration of economic growth takes place when the state successfully creates conditions in which high profits are generated for investors and channels credit toward them. In addition, he finds no systematic relationship between economic growth and external finance or economic liberalization.

**Figure 3.1: Pakistan’s macroeconomic performance, 1999–2013**



Note: \* = projected average figures.

Source: Pakistan Economic Survey for 2011/12 for FY1999–FY2012; State Bank of Pakistan, Annual Report (2012) for FY2013.

Given the lack of consensus on a general theory explaining Pakistan’s growth performance, the recent economic cycle provides good ground to search for some credible answers. Let us first present some stylized facts that are relevant to the economy’s performance over the 1999–2013 economic cycle.

First and foremost, over almost the entire period starting post-9/11 in 2001, Pakistan has been a frontline state in the war against terrorism. This has taken a considerable economic toll both in terms of direct costs as well as in undermining business confidence, and the severity of the latter has increased over the years. This situation has, at the same time, allowed Pakistan to become a recipient of higher levels of donor funding, both military and development aid.

Second, both governments of this period started under the shadow of a looming debt default though the circumstances responsible for this were quite different. The Musharraf coup took place only a year after the Pakistan nuclear test in May 1998, which had led to the imposition of international economic sanctions including suspended aid inflows and a sharp slowdown in the economy that brought it to the brink of default. The newly elected democratic government that took over in March 2008 inherited a precariously balanced economy with untenably high fiscal and current account deficits, falling foreign exchange reserves, and a strong imminent threat of debt default and bankruptcy.

Third, at the start of their terms, both governments entered into agreements with the IMF to bail them out of their economic predicament. The Musharraf government entered into a one-year stand-by arrangement (SBA) of USD 596 million in June 2000. On successful completion, it followed this with a three-year poverty reduction growth facility (PRGF) arrangement amounting to USD 1.3 billion in December 2001. The elected coalition government that took over in March 2008 entered into a 23-month SBA with the IMF in October 2008 of USD 7.6 billion, which was augmented in August 2009 to USD 11.3 billion and extended through December 2010. It was then extended by another nine months till September 2011. What is important to note is that, during the 13-year economic cycle, the economy was under the aegis of an IMF program over half the time. While these loans helped tide over the immediate economic crisis and restore confidence, they also had important implications for economic management—including the flexibility that could be exercised in policymaking—over these years.

Fourth, throughout this period, the economy was run under an almost open or fully liberalized foreign exchange regime. This meant that residents could open foreign exchange accounts and send out foreign exchange with hardly any restrictions. It is important to note here that many other developing countries—including those like Pakistan who received large amounts of remittances—had liberalized their foreign exchange regimes but not to the extent that Pakistan had done in this period. This meant that the Pakistan economy was much more globally integrated in terms of international capital movements, both legal and illegal, and therefore also vulnerable to global economic fluctuations and meltdowns.

Fifth, the period 1999–2013 saw an almost tenfold increase in remittance flows into the economy, from around USD 1.5 billion in 1998/99 to an expected USD 14 billion in 2012/13. These flows provided critical support to both governments in the face of a precarious current

account trade situation in most years. These increases were the result of a significant rise in the number of overseas Pakistanis with higher skills as well as due to a shift in remittance flows from illegal to legal channels following 9/11 and increased vigilance over such flows (see Chapter 11 and Amjad, Arif, & Irfan, 2012). With a Pakistani diaspora now estimated to be around 6 to 8 million (some say even higher), this also points to the strong links between the global and Pakistan economy.

Finally, this period witnessed a series of unfortunate natural disasters: the drought in the earlier years of the Musharraf government, the tragic earthquake in the winter of 2005 in northern Pakistan and Azad Kashmir, and the floods of epic proportions in the autumn of 2010. Their economic and human cost, especially of the last two disasters, was extremely high and, though in the case of the first, substantial international humanitarian assistance was forthcoming, in the case of the latter it was far less, given the magnitude of the disaster.

## **2.1. Economic Growth and Structural Change**

To judge how well the economy was managed over the economic cycle, we examine the behavior of the key variables that are normally associated with economic growth and structural change in a developing economy as it moves up the development ladder toward higher and sustained growth. These include the ability to maintain high levels of savings and investment, the capacity to raise sufficient revenues to meet development and nondevelopment expenditures, increasing international competitiveness, investment in human capital, infrastructure constraints, and trends in poverty.

### **2.1.1. Savings and Investment**

The levels of savings and investment are critical to the economy. Total investment is financed in part by domestic savings, and the gap that remains by foreign savings. The latter includes both foreign loans and grants as well as remittances and net private transfers from abroad.<sup>3</sup> National savings are defined as domestic savings plus net transfers from

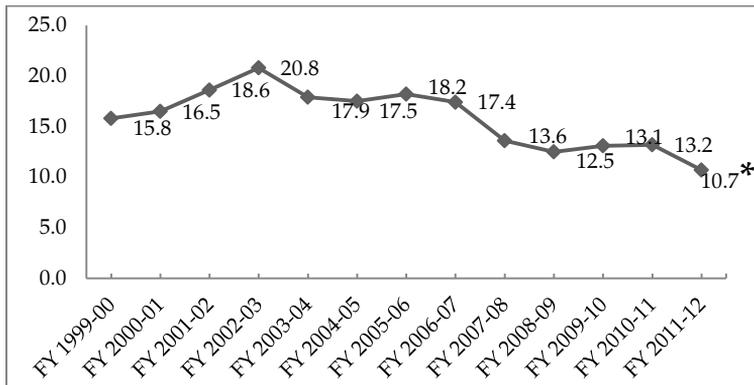
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<sup>3</sup> Foreign savings is taken as equivalent to the current account deficit. As such, it reflects not just the trade deficit, i.e., the excess of imports over exports but also net private transfers, including remittances and private inflows, which correspondingly reduce the trade deficit. The important point to grasp here is that, to the extent that remittances and private transfers allow the country to finance more of its imports, the dependence on foreign loans and grants to cover the trade deficit is correspondingly reduced. As remittances increased manifold over the period, the corresponding dependence on foreign borrowings declined and national savings increased concomitantly.

abroad, i.e., remittances and net private transfers, and are taken as a more accurate indicator of the domestic resources and foreign exchange available for investment, compared to domestic savings alone.

The initial spurt in national savings caused by remittances from abroad—which almost doubled in this period—eased the foreign exchange constraint and contributed to the revival economic growth. However, after climbing to a peak of 20.8 percent in 2002/03, they fell to 13.6 percent with the advent of the democratic government and further to around 10 percent at the end of the period (Figure 3.2). This decline in national savings at a time when foreign remittances were increasing manifold points to the fact, which we will explore further in the next section, that consumption levels were increasing and that the rise in remittances was feeding primarily into increased consumption that was largely met by imports, given the low growth of domestic output.

Figure 3.2: National savings-to-GDP ratio, 1999–2012



Note: \* = provisional.

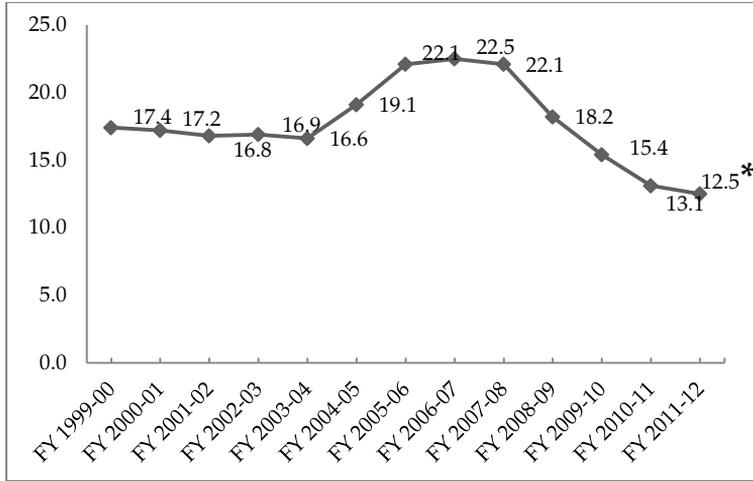
Source: Pakistan Economic Survey for 2011/12 for FY1999–FY2012.

Pakistan’s national savings rate, relative to the average of fast-growing developing countries, is much lower and pales in comparison to India’s average of well over 30 percent during the latter’s recent high economic growth.

Figure 3.3 shows that investment levels increased steadily during the Musharraf regime to a peak of 22.5 percent in 2006/07, but plunged during the democratic period when they fell to about 12 percent. This fall reflects both a sharp decline in private investment due to a loss of business confidence but also low levels of public investment due to lack of funding. It should also be noted that Pakistan’s peak investment rate of

22.5 percent in 2007/08 was also far lower than the average achieved by the fast-growing developing countries, as well as by India (over 30 percent) during the last ten years, with China being well over 40 percent.

**Figure 3.3: Total investment-to-GDP ratio, 1999–2012**



Note: \* = provisional. Figures for “total investment” are taken after accounting for stocks.

Source: Pakistan Economic Survey for 2011/12.

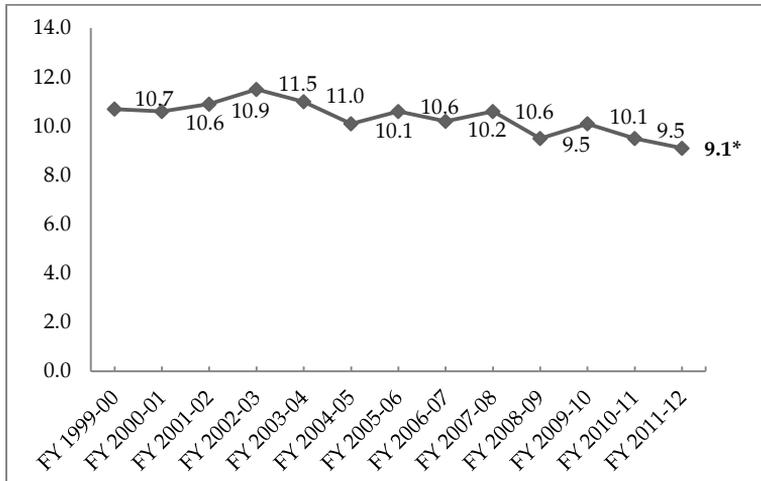
### 2.1.2. Tax-to-GDP Ratio

As Figure 3.4 shows, there is hardly any significant change in the critical tax-to-GDP ratio over the economic cycle as it averaged around 10 to 11 percent during the Musharraf period and between 9 and 10 percent under the democratic government. The total revenue-to-GDP ratio also stagnated at between 13 and 14 percent. The message here is quite clear. Over this period, both governments were unable to put in place the badly needed tax reform measures to increase the tax-to-GDP ratio from an average of around 10 percent over the cycle to the required 15–17 percent, which is around the average of developing countries.

The failure to increase the tax-to-GDP ratio had severe consequences for the economy, especially when growth plunged and the fiscal deficit reached dangerous levels during the period of democratic government. Indeed, it is important to note how the fiscal deficit initially fell under the Musharraf government due to stabilization and other measures adopted under the IMF program, but that as soon as the government exited the

IMF program, the fiscal deficit began to increase. Additionally, when the Musharraf government failed to pass on the unprecedented rise in global oil and food prices in 2007/08, the fiscal deficit rose to an untenable level of near 8 percent.

Figure 3.4: Total tax-to-GDP ratio, 1999–2012



Note: \* = figure from the Annual Report of the State Bank of Pakistan.  
Source: Pakistan Economic Survey for 2011/12.

Again, under an IMF program that the democratic government entered into, which introduced stabilization measures including cuts in government expenditure—mainly the federal Public Sector Development Program (PSDP)—the deficit fell in 2008/09 but rose once again as a result of the failure to raise revenues and curtail expenditures. In 2012/13, it is expected to be between 6.9 and 7.3 percent.<sup>4</sup> This deficit was financed by borrowings from the State Bank of Pakistan and later through commercial banks. The resulting increases in money supply fueled inflation, which remained in double digits for most of the government’s term in office. Inflation fell in 2011/12 but is expected to increase again during 2012/13.

The fiscal deficit is most strongly reflected in the rising national debt, both domestic and foreign. This increased from approximately PRs 3,000 billion in 1999/2000 to PRs 6,000 billion in 2007/08, and then rose steeply to just over PRs 12,000 billion in 2011/12. Foreign debt rose from

<sup>4</sup> Finance adviser to the Prime Minister, as cited in the *Daily Times* (24 April 2013).

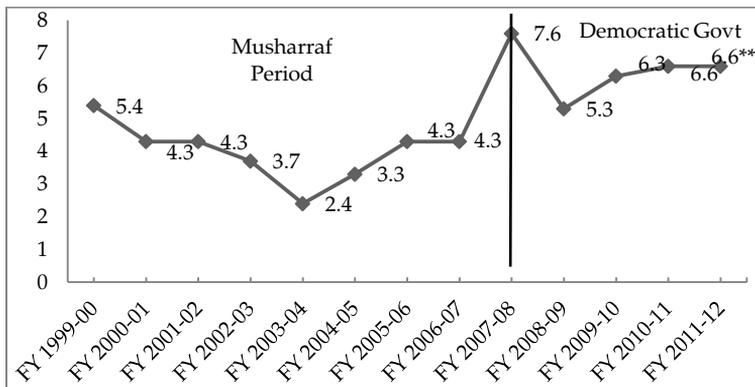
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approximately USD 28.8 billion in 1999/2000 to USD 60.3 billion as of March 2012 (Pakistan, Ministry of Finance, 2012). More important than the absolute amount of domestic and foreign debt is the burden it can put on the government in servicing and paying back the debt. Therefore, while as a percentage of GDP, total debt declined from 78.9 percent to 58.2 percent by the end of the period, interest payments on domestic debt accounted for a hefty 33.4 percent of current government expenditures. These payments were a major factor in curtailing development expenditure during the period of democratic government.

Again while external debt servicing is currently well within what is considered a safe limit (20 percent of export earnings), the bunching of repayments on foreign debt—especially on borrowings from the IMF as in the case of the 2008 SBA—has put considerable pressure on foreign exchange reserves in 2012/13. This will also be the case in the subsequent year.

It is important to mention here that, in the two years post-9/11, the Musharraf government benefitted from debt relief given by donors, mostly in terms of extending the period of repayment rather than writing off the foreign debt. This resulted in overall debt relief estimated at around USD 13 billion or around 40 percent of the total external debt outstanding in 2000/01 (Siddiqui & Siddiqui, 2001). This provided the space for the government to sharply increase its development expenditures after 2003 and was a factor in reviving the economy.

**Figure 3.5: Fiscal deficit as a percentage of GDP, 1999–2012**



Note: \*\* = figure from the State Bank of Pakistan, excluding one-off debt payment of PRs 391 billion from PSE’s debt settlement.

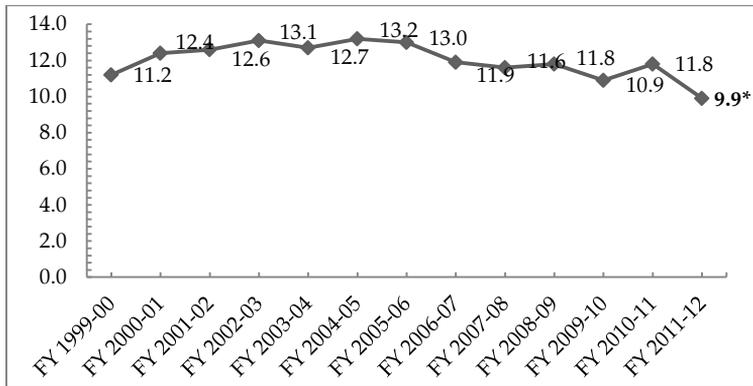
Source: Pakistan Economic Survey for 2011/12.

2.1.3. Competitiveness: Exports-to-GDP Ratio

Pakistan's Achilles' heel is its failure to increase its international competitiveness and resulting exports in a highly competitive global economy. How have exports as a percentage of GDP fared over the economic cycle? As Figure 3.6 below shows, there has been no significant change over the period, and exports as a percentage of GDP remain around 11 to 13 percent.

Even more worrying is the fact that Pakistan's share in world trade stagnated throughout this period (see Chapters 2 and 13) while those of India and China increased significantly—a strong sign of the falling competitiveness of Pakistan's exports in highly competitive global markets. Pakistan failed, therefore, to take advantage of the opportunity to gain out of the rising share of developing countries as global trade increased till 2008 and the share of industrialized countries fell. Exports never served as a major engine of growth as they had done earlier for many of the fast-growing economies of East Asia, followed by China and India.

Figure 3.6: Exports-to-GDP ratio, 1999–2012



Note: \* = author's calculation based on July–March figures.

Source: Pakistan Economic Survey for 2011/12.

The result is that the trade deficit has risen over the period and it is only because of the tenfold increase in remittances from USD 1.5 billion to over USD 14 billion over the period that the current account deficit remains in check, though there has been increasing pressure during the last two years of the cycle.

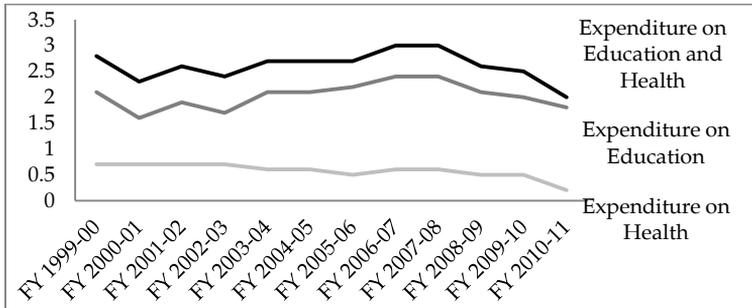
2.1.4. *Investment in Human Capital: HDIs*

The share of resources going into education (between 2 and 2.5 percent of GDP) and health (less than 1 percent of GDP) remained abysmally low throughout this period (Figure 3.7). These amounts are far smaller than those needed (a minimum of 4 percent in education), as well as much lower than those of other countries at the same level of development as Pakistan.

A significant and positive change that did take place during this period, starting in the Musharraf regime, was the very large increase in the amount and share of higher education (i.e., those enrolled in universities offering four-year undergraduate and postgraduate degrees) and in the total education budget. This has led to an increase in university-level enrolment from around 276,000 in 2001/02 (at the start of the period) to nearly 1.4 million by 2011/12, with almost 40 percent of the total being women.<sup>5</sup>

Not surprisingly, Pakistan has been unable to meet many of the Millennium Development Goals (MDGs) to which it had committed. This reflects not just the lack of resources diverted to human development but also a major failure in the delivery of social services and the poor quality of education and health services delivered in the public sector. The share of the private sector in education and health has increased significantly during these years but here too, with certain exceptions, quality issues persist even though it is better than most public institutions and more cost-effective.

**Figure 3.7: Expenditure on education and health as a percentage of GNP**



Source: Pakistan Economic Survey for 2011/12.

<sup>5</sup> The figures for 2001/02 are from the Higher Education Commission’s medium-term development framework for 2011–15 (Pakistan, Higher Education Commission, 2010); those for 2011/12 are from the Pakistan economic survey for 2011/12. They do not include those in college education (two-year graduate degrees), which was around 1 million in 2011/12, with 30 percent of those enrolled being women.

*2.1.5. Lack of Infrastructure: The Energy Crisis*

During this period, a key infrastructure constraint that emerged besides water scarcity (see Chapter 9) was the increasing gap between the rising demand and supply of energy. This gap arose due to a number of factors, which are discussed in some detail in Chapter 5 and also touched on later in this chapter. Prominent among these were the failure in the Musharraf period to anticipate demand as consumption levels rose in energy-intensive products (e.g., air-conditioners, motor vehicles). This occurred initially due to the availability of cheap credit resulting from a loose monetary policy and then because sufficient steps were not taken to attract private investors to set up or upgrade existing rundown public sector plants to meet this increased demand.

The democratic coalition opted to set up rental power plants to augment the energy supply in the short run; this proved to be a bad decision because the binding constraint on energy supply was not the availability of power generating capacity but the lack of adequate fuel (i.e., imported oil and domestic gas supplies) to run the existing power plants. The shortage of fuel arose due to the difference in the subsidized selling price and cost of production, which led to a large circular debt as the government was unable to meet the full cost of the subsidy. With power plants not being paid their full costs, and even the amounts received not being paid on time, they were unable to use fully the existing generating capacity.

The basic problem can be traced back to the setting up of oil- and gas-fired energy plants through independent power producers (IPPs) in the 1990s when the proposal to build a new dam (Kalabagh) had reached a political stalemate, although the dam would have made it possible to generate electricity much more cheaply.

Indeed, the shortage of energy and supplying it at subsidized prices was responsible for many of the economic ills that the coalition government suffered during its five years. The energy subsidy cut into a large portion of government revenues, reducing development expenditures, and raising the fiscal deficit besides adding to the circular debt. It was a major factor in the abandonment of the 2008-negotiated SBA in autumn 2011 as the IMF insisted on removing subsidies on energy.

Although the coalition government initially raised energy prices and then continued to make adjustments (see Chapter 5), it could never marshal the political strength to remove the subsidy completely. There was vociferous opposition to increasing energy prices, especially in later years, both from opposition parties as well as the coalition partners. The threat of widespread street protests and even occasional riots was

strongly feared, though most riots were against the long hours of power outages than higher prices.

Admittedly, the solution to the problem was not easy and as Chapter 5 shows, raising prices was, at best, a partial solution. However, by not taking bold steps to resolve the energy crisis, the coalition government got the worse of both worlds—mounting energy shortages and untenable fiscal deficits, which ended up pleasing nobody.

#### 2.1.6. *Growth in Total Factor Productivity*

How well an economy combines the use of its capital and labor resources is captured by growth in total factor productivity. This is the additional growth in national or sectoral output after accounting for the increase in the inputs of labor and capital. Data is only available for 2001–08 and, as Table 3.1 shows, there is some improvement in this period compared to the 1990s, a period of low economic growth. Factor productivity growth must have fallen further in the period of the democratic government when growth rates plummeted again.

It is also interesting to compare the growth of total factor productivity with that of India and find that, even during Pakistan's period of relatively high growth (2001–08), its total factor productivity was only one third that of India.

**Table 3.1: Sources of annual growth in total factor productivity in Pakistan and India by sector and reallocation effect**

	1990–2000		2001–08	
	Pakistan	India	Pakistan	India
Reallocation	0.2	0.3	0.3	0.5
Services	0.2	1.2	0.4	2.2
Industry	0.4	0.3	0.4	0.6
Agriculture	0.1	0.4	0.1	0.3
Total	0.8	2.2	1.2	3.6

Source: World Bank (2012).

#### 2.1.7. *Sectoral Composition of GDP*

The lack of productivity growth due to reallocation of labor in Pakistan is reflected in the fact that there is little change in the overall sectoral composition of GDP. The share of manufacturing returned to nearer 20 percent after declining in the 1990s, reflecting its high growth in the

Musharraf period, but it did not result in any significant increase in its share of the labor force, suggesting low labor absorption and use of capital-intensive technology mainly in the large-scale manufacturing sector.

**Table 3.2: Sectoral composition of GDP and labor force (percent)**

Sector	GDP			Labor force (10 years and above)		
	1990/91	1999/2000	2011/12	1990/91	1999/2000	2010/11
Agriculture	25.7	25.9	21.1	47.5	48.4	45.1
Industry	25.8	23.3	25.4	19.8	18.0	21.2
Manufacturing	17.5	14.7	18.6	12.2	11.5	13.7
Services	48.6	50.7	53.5	32.8	33.6	33.7

*Note:* Figures for sectoral composition of GDP in FY2011/12 are provisional.

*Source:* Pakistan Economic Survey and Labor Force Survey (various issues).

#### 2.1.8. *Poverty Trends*

If there is one possible positive trend over this period, it is that extreme poverty declined. From around one third of the population living in 2000/01 below the poverty line of 2,250 calories (which works out to PRs 55 per day per person at current 2011/12 prices or around PRs 10,000 for a household of six), the data based on household surveys conducted by the Federal Bureau of Statistics shows that poverty had declined to around 12 percent by 2010/11 (see Amjad, 2012). This decline was in both urban and rural areas.

There is some controversy over these results, not just concerning the decline in the Musharraf period, but especially in the more recent period of democratic rule, given the high levels of food inflation and low economic growth. However, other studies suggest that, even if poverty levels did not decline between 2004 and 2010, they certainly did not increase significantly (see Chapter 17 and Arif & Farooq, 2012, which is based on three rounds of panel household data in 2001, 2004, and 2010).

It must, however, be kept in mind that changes in poverty are very sensitive to the poverty line used as well as to short-term economic fluctuations in the economy, especially in rural areas due to years of good or poor harvests. With a slightly higher poverty line, the numbers in poverty increase significantly. What is important to analyze, therefore, is not just the numbers below or above the poverty line in a given time period but the poverty dynamics as households move in and out of poverty. The recent PIDE study (Arif & Farooq, 2012), based on three rounds of the panel survey in 2001, 2004, and 2010, shows that half the

rural population in Punjab and Sindh remained poor for at least one period in the last ten years, with the figure for rural Sindh alone showing it to be as high as two thirds.

## **2.2. Binding Constraints to Economic Growth**

The foregoing analysis clearly shows that, over the last ten years, despite the opportunities that arose, there was hardly any significant shift in the basic structure and working of the economy that would have propelled it to move onto a sustainable high-growth trajectory. All the key ingredients needed to achieve this were either missing or had fizzled out after a brief spurt. Low savings, low investment, low revenues, lack of adequate infrastructure—especially the rising energy gap—and poor HDIs all point to the need for strong policy action to break out of the current stagflation.

### *2.2.1. Sustainable Growth Rate*

An important study conducted for the final report of the Panel of Economists (Pakistan, Planning Commission, 2010) shows that 5 percent is a sustainable level of growth for the economy. This is given the resources it can generate to finance investment through savings, as well as avoiding an unsustainable current account deficit. This calculation is based on a long-term 20-year average (till 2006/07) of the savings rate (15.5 percent), the average current account deficit of the last ten years, again till 2006/07 (just over 3 percent), and an incremental capital-output ratio (ICOR) of 4.0.<sup>6</sup>

Based on past trends, the current feasible economic growth rate has two implications. First, if the economy grows faster than 5 percent, it will either hit a savings constraint or a balance of payments constraint. Although it could improve efficiency by lowering the ICOR and generating higher growth, this cannot serve as a long-term solution.

The other implication of growing at around 5 percent is that this rate would be insufficient to absorb the increase in the labor force, which is growing at around 3 percent. Again, based on historical estimates of employment elasticity, the economy needs to grow at 6–7 percent to absorb the increase in the labor force, and indeed faster if the current levels of unemployment and underemployment are to be reduced and respectable growth in productivity achieved.

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<sup>6</sup> This study was conducted by Naved Hamid and Azam Chaudhry of the Lahore School of Economics as members of the Panel of Economists.

That the economy grew, on average, at even less than 5 percent over the last five years shows that it was further constrained by supply-side shocks. This includes the rising energy gap, which shaved off 1.5–2 percent of the growth rate that would otherwise have been around 5 percent (Amjad, Din, & Qayyum, 2011).

What, then, are the binding constraints to economic growth that need to be overcome? In the short term, the energy gap must be resolved and the economy's existing productive capacity utilized better. In the medium term, the challenge is to restore business confidence and attract new investment by creating an environment conducive to business through much needed economic reforms. The overarching binding constraint that needs to be overcome, however, is the low savings rate and low export levels. For the latter, the development of a well-educated and well-trained labor force is essential because in the new global economy, knowledge rather than physical capital will serve as the main engine of economic growth.

Before leaving this section, it may be useful to draw some lessons and add to the current debate on Pakistan's recurring economic cycles, based on this chapter's analysis of the last cycle. McCartney (2011) is correct in pointing out that the growth upsurge takes place when there is business confidence and the state creates conditions to boost profitability, which leads to new investment. In the Musharraf period, these conditions were created initially through restoring macroeconomic balance and then through a cheap supply of credit and later by a fast-growing domestic market after the initial export surge fizzled out. At the same time, one cannot discount in this growth surge the increased availability of foreign exchange that resulted post-9/11 from the increase in aid inflows, debt rescheduling, and increase in remittances.

McCartney is also correct in arguing that economic liberalization is not a sufficient condition for economic growth. The constraints to growth that emerged during the democratic coalition period resulted from a combination of factors, namely the security situation, energy shortages, and poor economic management. Undertaking important economic reforms, which would have included further economic liberalization, would have made an important difference to the business and investment environment, but this was in itself not sufficient to overcome the binding constraint to growth in this period.

### **3. Economic Dynamics**

It would be a gross mistake to judge the Pakistan economy's performance during this period—especially the last five years—simply in terms of the behavior of key macro-variables, however important they may be. While

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these variables do reflect at a broad aggregate level the state of the economy, they do not fully reflect or capture important dynamic forces that were working themselves through the economy at the same time, and which may well explain the economy's resilience, and indeed buoyancy, in certain sectors even during these difficult times.

This dynamism emanates from two sources with both positive and negative consequences. The first is a large undocumented economy that traverses not just the informal sector but also the formal economy. Added to this is a large illegal economy fueled by corruption and other practices. The unsettled conditions in Afghanistan and the border belt also contribute to the growth of the informal as well as the illegal economy.

The second is the existence of a large Pakistani diaspora (see Chapter 11) that injects considerable purchasing power into the Pakistan economy, not just through remittances, recorded and unrecorded, but also other flows, legal and illegal. These flows are facilitated considerably by the existing foreign exchange regime, which allows both residents and nonresidents to transfer money abroad with few or no restrictions.

To these two, one must add the large favorable shift in the terms of trade for agriculture and the rural economy resulting from the coalition government's policies, which increased the prices of agricultural commodities. In particular, the procurement price of wheat rose from PRs 450 per 40 kg to PRs 950 per 40 kg during 2008/09, along with the rising world prices of rice and the domestic prices of other agricultural products, including vegetables, milk, and poultry. This shift in favor of the rural economy injected a large amount of purchasing power, which also resulted in a large increase in consumption and an increase in the demand for labor that was reflected in a rise in agricultural workers' real wages (see Amjad, 2012). As discussed later, it fuelled inflationary pressures in the economy.

There is an important reason for investigating these and other economic forces that are not sufficiently captured in the official macroeconomic estimates. Over the last five years, the economy has been afflicted by deep stagflation with low growth and high inflation. It faces a severe energy crisis that, according to recent studies, is shaving off as much as 2 percent of GDP (see United States Agency for International Development, 2013). At the same time, companies quoted on the stock market—especially in the food, cement, automobile, and motorcycle sector—are growing at a healthy pace, with sales in the food sector growing at about 20 to 25 percent per annum in the last five years. Corporate profits, according to one source, have grown on average at 15 percent each year in the last five years, which, even after

adjusting for inflation and exchange rate depreciation is creditable (see Bloomberg, 2012).<sup>7</sup>

Studies including those in this volume show that, if poverty has not fallen, then it did not significantly increase over the last five years. Almost all earlier studies had projected a very large increase in poverty given the very high rate of food inflation of almost 80 percent over the last five years and the expected rise in unemployment (see Amjad, 2012). Clearly, something else is happening. Is Pakistan a two-speed economy or one that you see and one that you do not see in the official figures?

### 3.1. Sources of Growth

To gauge the buoyancy in the economy, let us examine the major sources that were driving growth over the cycle in this period. As Table 3.3 shows, if we break down the sources of GDP growth over the period, despite considerable fluctuations mainly due to the movement of national savings, except for a few years when investment contributed significantly to economic growth during the Musharraf years, overall growth was mainly consumption-led. The contribution of exports was, again, limited to the initial few years of the economy.

**Table 3.3: Contribution to GDP growth (demand-side), 2000/01–2011/12**

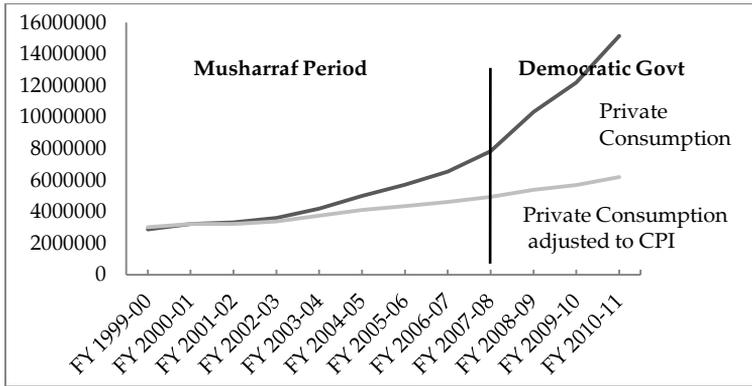
Flows	2000/ 01	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/ 08	2008/ 09	2009/ 10	2010/ 11	2011/ 12
Private consumption	-0.1	0.6	0.3	7.1	8.7	0.8	3.4	-1.9	8.3	-1.5	2.3	8.5
Public consumption	0.1	0.3	0.6	0.1	0.1	3.9	-1.1	3.8	-4.2	5.1	0.4	0.9
Total consumption	-0.1	0.8	0.9	7.2	9.4	4.7	2.3	1.9	4.1	3.6	2.7	9.4
Total investment	0.9	0.1	1.1	-0.9	2.0	2.9	2.3	0.7	-2.7	-1.4	-1.2	-1.4
Exports (goods and services)	1.7	1.9	4.5	-0.3	1.7	1.8	0.4	-1.0	-0.6	2.2	2.4	-2.1

Sources: Pakistan Economic Survey (various issues) for FY2003–12. Figures for FY2001/02 from Lorie and Iqbal (2005).

<sup>7</sup> According to a report in *Dawn* (“Corporate profits”, 2013) quoting the CEO of a securities company: “Whereas the overall GDP has grown by an average three percent in the last five years, corporate earnings have grown on average by an impressive 15 percent.”

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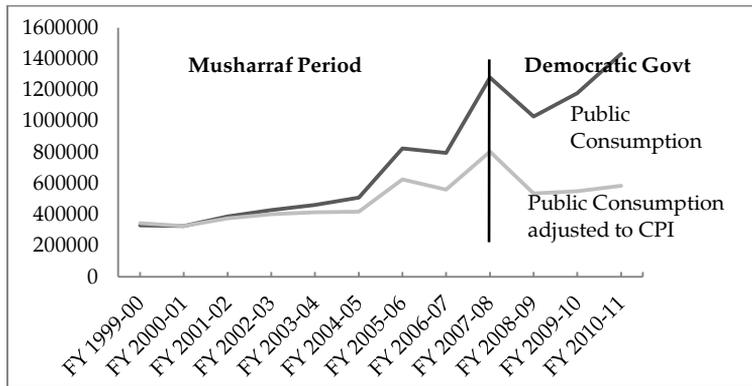
**Figure 3.8: Private consumption, FY1999–2011 (PRs million)**



Note: Base year = 2000/01.

Source: Pakistan Economic Survey (various issues).

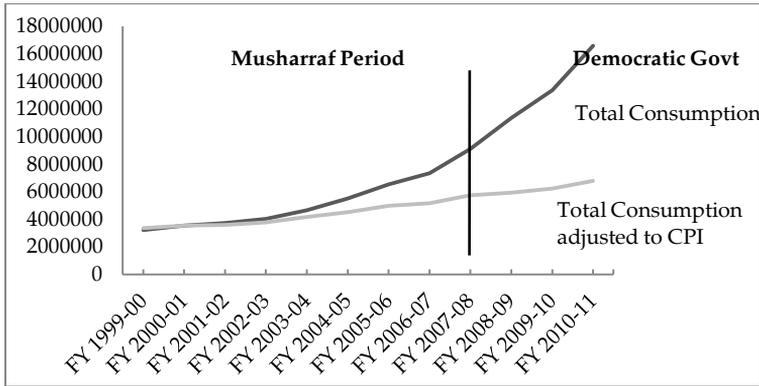
**Figure 3.9: Public consumption, FY1999–2011 (PRs million)**



Note: Base year = 2000/01.

Source: Pakistan Economic Survey (various issues).

Figure 3.10: Total consumption, FY1999–2011 (PRs million)



Note: Base year = 2000/01.

Source: Pakistan Economic Survey (various issues).

What factors drove this consumption-led growth during the economic cycle?

The first major factor was remittances, both formal and informal, with the former increasing from around 1.5 percent in 1999/2000 to nearer 5.5 of GDP. The second was the massive injection of purchasing power into the rural economy, as mentioned earlier. The third was that there was no marginal rise in taxes, reflected in the fact that the tax-to-GDP ratio barely increased in this period. Finally, was the generous increase in money wages for government and public sector employees, which more than doubled in the last five years, with a hefty 50 percent increase announced in the budget for 2010/11. Provincial governments also had to follow suit.

Nonetheless, there were other factors at play. The first was the inflow of remittances through informal channels. Though gradually reduced after 9/11 in 2001 due to much stricter international vigilance of such flows, these could even today be as high as USD 4–6 billion, i.e., around 2 to 3 percent of GDP (see Chapter 12). Then there were capital flows in the shape of private transfers, mainly from Pakistan to the Middle East (with Dubai as the hub). Informed sources suggest that these flows might have been as high as USD 8–10 billion in the shape of investments made in Dubai during the Musharraf period. A large part of this money also flowed back sharply after the global meltdown and the collapse of the Dubai real estate boom in early 2009.

There is also what is called the “whitening” of black money (tax evasion, bribes, etc.), which is partly not reflected in GDP, but even where it is (e.g., investment in public sector projects), once “whitened”, it flows mainly into current consumption. Then there are illegal funds generated in Afghanistan and the tribal border belt by the cross-border heroin trade (valued at approximately USD 5 billion a year) as well as money shaved off donors’ civilian aid to Afghanistan by politicians and others (total donor assistance to Afghanistan as civilian aid was as high as USD 8 billion in 2011/12). A part of this money flows into Pakistan and is used to buy houses, properties, and businesses within the country.

### **3.2. The “Real” Size of the Pakistan Economy**

The size of the Pakistan economy in terms of its gross national product (GNP) is estimated at the current exchange rate to be near USD 250 billion in 2011/12. In addition to this, however, there is a significant undocumented economy, parts of which we have identified. What, then, is the “real” size of the national economy?

Recent estimates made by PIDE researchers (Kemal & Qasim, 2012) suggest that the undocumented economy as measured by consumption estimates could be as high as 90 percent of the documented economy.<sup>8</sup> Taking into account other net foreign exchange flows they do not consider, GNP could be as high as USD 500 billion. The methodology used in the PIDE study still needs further refinement and has many shortcomings, but it does suggest that earlier estimates, which put the undocumented or hidden economy near 30 to 40 percent, could be widely off the mark. What needs to be kept in mind is that the undocumented economy is found not only in the informal economy but also the formal economy since registered firms also considerably underreport their production and profits to avoid taxes.

If Pakistan’s GDP is, say, double its current estimated size, this would have important implications, both positive and negative, for judging the performance of the economy. On the negative side, it would show in an even poorer light the revenues that are collected; if most of the

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<sup>8</sup> Kemal and Qasim (2012) calculate total consumption in the economy based on the household Pakistan Social and Living Standards Measurement Survey for 2007/08, and adjust for mis-invoicing in imports and exports based on a recent PIDE study. They calculate the “true” estimate of GDP (implicitly accepting official estimates of investment), and then compare it with GDP estimates reported at current prices in the national income accounts for that year. These estimates show that the undocumented economy (which they mistakenly term the informal economy) was 91 percent of the formal economy. On the assumption that the consumption estimates might include elements of investment, they calculate the size of the undocumented economy to be between 74 and 91 percent of the documented economy.

undocumented economy flows into consumption rather than savings or investment, this also reduces the extremely low savings and investment ratio by almost half. It would reflect even more poorly on public sector expenditures on education and health and other social sectors, but it would also mean that Pakistan was generating growth with very low levels of investment and, in this sense, using resources more efficiently.

At this stage, our conclusions on the undocumented economy and its underlying dynamics must, at best, be considered conjectural. The important lesson at this stage is that there is a real need to carry out much more research to understand and analyze the macroeconomic dynamics of the Pakistan economy than presently exists, especially to build into the analysis the factors identified in this section. The other is the urgent need to bring the undocumented economy into the legal framework of the documented economy as far as possible, and, at the same time, to ensure that it is better reflected in official estimates of the national income accounts.

### *3.2.1. A Two-Speed Economy*

Since we do not know the size of the undocumented economy at the beginning of the period 1999–2000, even if we had a mid-period estimate, it would be extremely difficult to work out if the economy was growing faster (or slower) than the official estimates suggest. We are, therefore, forced to accept the official growth estimates with the proviso that, in all probability, the actual absolute levels of consumption are much higher and could be almost double that of the official estimates.

This might also explain why, during the recent sharp slowdown in economic growth and period of high inflation, extreme poverty levels either came down or at least did not significantly increase. In a recent study, Amjad (2012) has argued that it is quite possible that the positive developments in factors that affect poverty (remittances, improved terms of trade for agriculture, rising rural real wages) negated or at least considerably dampened the impact of the negative factors (low per capita income growth, high inflation, declining real wages in manufacturing) that cause an increase in poverty.

This much greater size of the Pakistan economy that the chapter suggests and the growth dynamics that it attempts to identify might also explain the emergence of a significant middle class in Pakistan. Based on household surveys and using an “extended” definition of the middle class, Nayyab (2011) estimates that this could constitute 35 percent of all households. The rise of the middle class also explains the rise in consumption expenditure on food items, cosmetics, small cars, and motorcycles.

It is also important to note that, while consumption expenditures rose significantly, they did not result in increased investment. Indeed, investment levels fell by almost half in the period of democratic rule. The fall in private investment is clearly the result of prevailing insecurity as well as severe energy constraints. What this means is that rising consumption in the face of low growth in domestic output leads mainly to an increase in imports.

#### **4. Economic Management**

##### ***4.1. Decision Making under Different Governments***

How well was the economy managed over the economic cycle? Before we set up some criteria to judge economic management, it is important to differentiate between the relative ease and difficulty of economic decision-making under a military government and an elected coalition government working in a democratic polity. It is generally believed that making difficult economic decisions or undertaking economic reforms is easier in the former than the latter. This is primarily because a democratic government is far more sensitive to an adverse public reaction as well as much more vulnerable to the influence of vested interests from whose political support it draws its strength in the electorate. The latter issue becomes even more important when the democratic government is a coalition, as was the case in the period of democratic rule, with different parties representing different groups and vested interests also spread across different regions in the country.

In differentiating between the two periods, we also need to take into account that, under a military regime, the country despite its federal structure actually runs almost as a unitary one, with the provincial governments working very closely and in line with policies laid out by the federal government in Islamabad. In the Musharraf period, even though a civilian government had been installed at the federal and provincial levels in November 2002, the regime still functioned primarily under the umbrella of a military dictator, with his nominees (or those with his tacit approval) running the federal government as well as those in the provinces. In contrast, in the period of democratic rule, there was much greater provincial autonomy and in the largest province, Punjab, the government was run by the main opposition party in Parliament.

It also needs to be recognized that the adoption of the 7<sup>th</sup> National Finance Commission (NFC) award in 2009 and subsequent adoption of the 18<sup>th</sup>, 19<sup>th</sup>, and 20<sup>th</sup> Constitutional Amendments has considerably increased the power of the provincial governments. As a result, the provinces' share of resources in the divisible pool, especially the amount

they can allocate to development expenditures, has increased significantly. Additionally, with the abolition of the concurrent list, education, health, social services, labor, and other sectors are now dominantly under provincial control. Should there now, therefore, be greater emphasis on economic management at the provincial level, given this devolution of power?

Finally, the reality of a proactive and assertive higher judiciary taking cognizance of economic matters, which earlier it had rarely done, also needs to be taken into account when judging the executive's freedom in making economic decisions in areas that were earlier considered to be clearly the latter's domain. In what ways has this empowered judiciary affected economic decision-making by the government?

In terms of economic management, let us judge the performance of both governments in terms of the following criteria:

1. Since both governments entered into IMF agreements to obtain badly needed financial support at the start of their rule, a key question is whether it was necessary to enter into such agreements at all, how well the economic policymakers of the day negotiated the terms and conditions on which these loans were obtained, and finally whether they were able to deliver on the terms agreed.
2. What did each of the governments do right in terms of major economic policy decisions and economic reforms, and what were some of the key mistakes in terms of the cost to the economy to which we can trace the lack of any real improvements in economic performance, which could have galvanized it toward sustainable and higher growth?
3. What important lessons emerge from this overall analysis in terms of results achieved, missed opportunities, and glaring mistakes that can help guide politicians and economic policymakers in the immediate and long term?

#### ***4.2. Pakistan and the IMF over the Economic Cycle<sup>9</sup>***

Countries turn to the IMF for support almost as a lender of last resort when they face severe balance of payments problems and risk going into default on repayment of loans or simply becoming bankrupt. Pakistan has entered into as many as 11 agreements with the IMF over the last 20 years. Except for two that were successfully completed, all the agreements were scuttled well before completion mainly because of lack of progress

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<sup>9</sup> For a succinct summary of relations between Pakistan and the IMF, see Ahmed (2012).

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in implementing the agreed reform program. The two successfully completed were the one-year SBA signed in June 2000, followed by the three year PRGF availed starting in December 2001, both under the Musharraf government.

When a government enters into an agreement with the IMF, it is mutually agreed that it will take a number of measures to regain macroeconomic stability as well as economic reforms to overcome the structural imbalances and constraints that were responsible for bringing on the economic crisis and help propel the economy onto a sustainable growth path.

In the short term, drastic measures are adopted to restore macro-stability in order to avoid default as foreign currency reserves dwindle, and to restore confidence primarily through a severe compression in demand that is aimed at slowing down the economy, reducing imports, and stabilizing the foreign exchange situation. This demand compression is carried out through a combination of fiscal and monetary measures, with the former concentrated on reducing the fiscal deficit and the latter on reducing government borrowing from the central bank and raising the interest rate to dampen private sector demand. Strict monetary targets in terms of regulating the money supply are set out. It is for this reason that both the finance minister and governor of the central bank sign off on IMF agreements.

These short-term measures are complemented by a series of economic reforms aimed at improving performance to revive growth and move the economy into a position of sufficient economic strength to repay the IMF loan. These reforms encompass taxation measures to increase revenues; opening up the economy to greater internal and external competition to increase efficiency and competitiveness—by lowering tariffs, removing untargeted and unsustainable subsidies, improving the performance of public state enterprises (PSEs), and privatizing public utilities—financial sector reforms to improve the functioning of the banking sector and other financial intermediaries; and reforms to improve governance encompassing the functioning of the civil service, the judicial system, and local government.

As one can see, the economic reform program entered into with the IMF can be all encompassing. Even if there is broad ownership by the government of the need for such reforms, it does tie it down to carrying out these reforms within a strictly monitored timetable, reducing the flexibility of the pace and sequencing of the reform process.

In recent years, because of considerable criticism of the economic costs of entering into an IMF program, given the resulting very low

economic growth and rise in unemployment and poverty, the standard programs now include measures to protect the poor and vulnerable through appropriate safety nets. The PRGF perhaps best represents the new IMF facility, which caters to reforming the economy while at the same time emphasizing measures that would help reduce poverty and improve social welfare.

The grey areas in working out the details of an IMF program and its implementation could include the following:

First, the standard IMF model that calculates the needed compression in demand to restore macroeconomic stability and the resulting growth rate can, in many cases, be far off the target with growth plummeting far more than planned.

The second grey area is the sequencing and timing of economic reforms to be undertaken as part of the program. Facing a balance of payments crisis and possible default, the major aim of the government negotiating team is to obtain the first tranche of the loan as quickly as possible and so stabilize the situation and calm the markets. This can result in them promising far more than they can deliver. It is all too well to suggest that the government should take ownership of the agreed program (see Ahmed, 2012) but, in fact, its bargaining position may be weak and can be further weakened if its negotiating team is inexperienced or technically incompetent.

The third grey area is the country's capacity to pay back the loan in the stipulated time. As part of the program, an exercise is undertaken to gauge this ability, but this is difficult because the projections assume that, if the program conditionality is met, the economy will have regained its strength and be in a position to rebound. In many cases, this is placing far too great a faith in economic reforms to show dividends in a few years after the reforms are introduced. Structural reforms take time to embed themselves in the economy and raise its growth potential. The time for repayment of the IMF loan is, in most cases, far too short to allow this to happen. Not surprisingly, therefore, the country often finds itself unable to repay the loan and is forced to go back to the IMF to pay back the loans it had borrowed in the first place.

The truth is that, in most cases, the government gives very little consideration to repayment and focuses mainly on coming to an agreement and obtaining the loan. It is not, therefore, a coincidence that very rarely do governments publicize the repayment part of the loan obtained, and once the loan agreement is signed, restrict themselves to taking credit for having successfully completed an agreement with the IMF and obtained the loan.

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Let us now, albeit briefly, cover the sequence in which the three IMF programs were signed—two by the Musharraf regime and one by the democratic coalition government.

In the case of the Musharraf government, at first, given the strong feeling against the military coup, it was only able to reach a one-year SBA of USD 590 million with the IMF. The economic team used this year to establish its credibility with the IMF with its commitment to faithfully executing the agreed conditions. Over the course of the year, the Planning Commission prepared the Interim Poverty Reduction Strategy Paper (PRSP). This document was accepted by the IMF, which together with the government's resolve shown to implement economic reforms paved the way for the signing of the three-year PRGF for a loan of USD 1.1 billion in December 2001.

Some may disagree. Did not 9/11 a month before the signing of the PRGF strengthen the hand of the Musharraf economic team negotiating with the IMF? From a pariah regime, the Musharraf government was now a critical partner in the war against terror and Pakistan the frontline state in this conflict.

These ifs and buts remain but, by and large, the Musharraf economic team had also performed well in initiating reforms in key sectors of the economy (Husain, 2003) and formulating a poverty reduction strategy that paved the way for the PRGF to be signed. Over the next three years, the economy stabilized and on the surface there was a surge in economic growth; with increasing business confidence and improving government finances, there was also a steep increase in both private and public investment.

The IMF and the government were euphoric over the results achieved.<sup>10</sup> The government did not even ask for the last tranche of the payment due under the PRGF and informed the IMF that it was not extending the facility. There was talk of the "begging bowl" having been broken, the country's dependence on loans and aid now a story of the past, and the economy now being well set on a path of unbridled growth.

Now, outside the aegis of the IMF program, however, old habits reappeared. The fiscal deficit began to increase. Imports increased much faster than exports and the current account became vulnerable once again. The "strong" economy began to show signs of weakening. By the time the unprecedented increase in global oil and food prices struck in the course

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<sup>10</sup> See the speeches of the directors of the IMF that deal with Pakistan during this period ([www.imf.org/external/country/pak/](http://www.imf.org/external/country/pak/)). Indeed, the IMF's highly positive assessment of the Pakistan economy continued well into 2007 even when there were clear signs that major problems were emerging that threatened both growth and macro-stability.

of 2007, the economy had begun to flounder. The government starting in March 2007 faced strong street protests on the ouster of the chief justice of the Supreme Court. The Musharraf government shied from passing on the higher import prices of oil, energy, and food grains to consumers. The interim government followed suit as elections were around the corner. The budget deficit increased to alarming levels. The foreign reserves built up during the good years began to be rapidly depleted.

What needs to be recognized is that the economy was always vulnerable to external shocks, the macroeconomic turnaround had not been sustained, and the gains of the earlier years under the IMF program had been frittered away (see Amjad & Din, 2010). The government, and sadly the IMF too, had got caught up in their own rhetoric and started believing prematurely that they had brought about a structural shift in the economy (see Lorrie & Iqbal, 2005). But was it just “smoke and mirrors” and good public relations? The fact was that, while some real reforms had been undertaken, these were certainly not sufficient or sustained to ride out the economic shocks, and so the economy was poised to stumble.

The democratic coalition government that took over in March 2008 inherited an economy on the verge of financial collapse. The fiscal deficit, as the new government found, was well near 9 percent and the current account deficit at 8 percent. With continuing high oil prices, the foreign exchange resources were being fast depleted and the currency was coming under increasing pressure. There was no option but to resort to a strong dose of stabilization and restore macroeconomic balance and confidence, especially at the outset of the global financial meltdown. A panel of economists set up by the government also reached the same conclusion, albeit stabilization with a human face. But were there any other options besides the IMF?

In the first month, the Pakistan Muslim League (Nawaz) (PML-N) was part of the coalition and held the finance portfolio. Its view appears to have been that, while stabilization was necessary and would be undertaken, there was no immediate compulsion to go to the IMF.<sup>11</sup> It proposed raising domestic resources by utilizing the unspent government expenditures that government departments and autonomous organizations had accumulated over the years, and that were lying idle with commercial banks. The foreign exchange crisis, rising pressure on the currency, and a possible run against the rupee could be resolved through short-term borrowings from friendly countries, raising funds from the Pakistan diaspora by floating bonds, and keeping the exchange

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<sup>11</sup> Based on the author’s discussions with senior policymakers advising the then finance minister.

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companies in check through strong administrative measures. In addition, measures would be taken to attract foreign remittances.

However, once the PML-N left the coalition and the Pakistan Peoples Party (PPP) assumed the finance portfolio, the donors—represented by the major Western governments—appear to have put a major squeeze on them to go to the IMF. Although the PPP-led government did try to obtain some short-term financial support from Saudi Arabia and China, there seems to have been a trust deficit even with its friends, all of whom appear to feel that only the IMF could keep the government on track and enforce badly needed reforms. This was unfortunate because an injection of funds could have given the democratic coalition the time it needed to carefully work through its strategy to stabilize the economy and, if needed, go to the IMF.

It is important to evaluate the IMF's involvement in the management of the economy with the PPP-led coalition government, not just in terms of what was agreed on under the SBA signed in October 2008. The imprint of the IMF was clearly reflected in the budget announced in June 2008 by the new government. The macroeconomic framework—including growth estimates—was revised downward and annual development plan expenditures cut down, in part to satisfy the IMF. Indeed, it would appear that the government agreed to seek IMF assistance before the budget was announced, and that it incorporated a number of the measures agreed to in the June 2008 budget, even though the SBA was formally signed in October 2008.

To view the October 2008 SBA in isolation is, therefore, not the correct way of evaluating the IMF's involvement with the new government. By so doing, it has led to claims that the IMF has been soft on Pakistan, some say because of US pressure, and the agreement was generous in the amount pledged—an unprecedented USD 7.6 billion, as well as in the conditionalities agreed on. The reform package was not frontloaded and the fiscal deficit target had been slightly raised to accommodate the newly launched Benazir Income Support Program for direct income support to poorer households (see Sherani, 2012).

This in no way suggests that the measures adopted in the 2008 budget were not needed. Clearly, as said earlier, foreign exchange reserves were falling dramatically and the exchange rate was coming under pressure. The real issue is whether the extent of deflationary measures adopted in the 2008 budget—as well as those reflected in the subsequent SBA signed in October 2008—were of the right magnitude, and whether the burden of adjustment placed on the economy was one that it and the people could bear.

The other issue is whether the situation was so desperate that Pakistan needed to enter into a huge USD 7.6 billion SBA knowing well that repayments would be due after three years of the first disbursement. Again, those involved in negotiating the loan have argued that such a large amount was needed to calm the market and restore confidence in the Pakistan economy.

Others may disagree. Would it not have made sense to initially agree on a smaller program, firm up a medium-term strategy, and then be in a good bargaining position to enter into an agreement, perhaps even a PRGF (which offered much better terms of repayment) as the Musharraf government had done?

In the circumstances, the PPP faithfully carried out the strong stabilization measures agreed on to regain macroeconomic stability. But the price paid was high, given the “*malba*” or debris left behind by the previous government, which had fallen into economic paralysis in its last year. The results were far worse than anyone had predicted, including the IMF and the Panel of Economists (see Amjad, 2008). Growth plummeted to about 1.7 percent and inflation reached an unprecedented 25 percent—the highest in the country’s history. If this was a soft program, then heaven help Pakistan had it been cajoled into accepting a strong one.

Although these measures restored some stability to the macroeconomic situation, the resulting unpopularity seriously impaired the government’s resolve to carry out the program. To make matters worse, that autumn marked the beginning of the global financial meltdown. As they say, when troubles come, they come in battalions!

Despite what may be termed a promising start to the IMF program—in that a semblance of macro-stability emerged and growth picked up in 2009/10—even after an agreement to increase its size and extend its duration by another two years, the program’s days were numbered. The finance minister who formulated and announced the June 2008 budget was replaced soon after with a hard-nosed banker who had a reputation for getting things done. The SBA was signed under his tutelage in October 2008. He too did not last long (around 15 months), mainly due to his strong commitment to economic reforms and opposition to the policy of setting up rental power plants in a nontransparent manner. The finance minister’s departure in early 2010 marked an important turning point in the way the economy was managed. Though a new finance minister took over, economic decision-making shifted to the highest echelons of the ruling party. Pragmatic politics rather than economic factors became the main criteria in running the economy. Economic reforms were placed on hold, and even the few the new economic team had been able to introduce were soon reversed.

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We now turn to some important lessons emerge from the IMF programs adopted during this economic cycle that should be kept in mind for future negotiations:

- Both regimes failed to gauge the initial impact of their respective programs on economic growth. The economy slowed down to standstill levels, making an economic revival that more difficult. This sharp contraction was caused primarily by the compression in demand through a steep decline in the budget deficit to the level stipulated in the IMF program and mutually agreed to. It would appear that the IMF model used to make the projections may be well off the mark. More importantly, it is necessary to be very cautious when agreeing on the targeted fiscal deficit for the initial years, given its very strong impact on economic growth.
- To achieve this sharp decline in the fiscal deficit, the brunt of government expenditure cuts fell on the federal PSDP—the “low-hanging fruit” under both regimes—and this was a major cause of the more-than-expected decline in economic growth, given its deep linkages with the rest of the economy.<sup>12</sup>
- This sharp decline in public development expenditure results in high costs to the economy since the completion of many ongoing projects is lagged with high costs, leading to shortages in badly needed social and physical expenditure.
- The terms and conditions on which a loan from the IMF is obtained need to be worked out very carefully, especially the strategy for loan repayment. This is clearly one of the lessons from the 2008 SBA. There was much euphoria on the size of the loan obtained, but in hindsight with little attention to how it was to be paid back. When the time has come to pay back the loans in 2013, they have put extreme pressure on the country’s low and declining foreign exchange reserves.
- Pakistan’s experience also shows that, in most cases, it turns to the IMF when its economic situation is very desperate and, hence, its bargaining position very weak. It also means that, IMF or not, fairly strong stabilization measures are needed to restore the situation. This failure stems from poor economic management, a failure to make important decisions in time, and reluctance to take remedial measures when needed, e.g., adjusting the exchange rate to reflect the impact of domestic inflation. In undertaking an agreed economic reforms

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<sup>12</sup> The fiscal multiplier of a cut in the national PSDP equivalent to 1 percent of GDP leads to a 2 percent decline in GDP in the same year (Planning Commission, 2011a).

program with the IMF, the need for and importance of undertaking reforms is not as key as allowing oneself sufficient flexibility to pace these reforms and seeking alternative solutions if economic circumstances so dictate. An example of this was the need in 2006 to opt for public sector investment in the energy sector, when the energy gap was fast widening to dangerous proportions and the private sector was not forthcoming. The Musharraf economic team led by the finance minister, who was also Prime Minister, continued under the strong influence of the international financial institutions to hope that the private sector would fill this gap; this turned out to be a mirage.

- One must also keep in mind when negotiating an IMF-driven reform program that its fundamental premise is that a market-driven private sector is the cure for all economic ills. In some cases, this may be the right path to take. What one must, however, avoid is being pushed into an economic reform the consequences of which one has not sufficiently thought through. A good example of this was the decision to “unbundle” and privatize the Water and Power Development Authority (WAPDA), which the IMF and World Bank strongly supported. It should have been kept in mind that WAPDA over the last 30 years had built up its knowledge base and reputation as a world leader on water and energy issues. The cost of giving all this up without first seriously examining options to improve its performance was a serious mistake. This is a prime example of economic ideology trumping economic commonsense. The result has been that the country has ended up with the worse of both worlds—a decentralized, inefficient structure still working in the public sector.

The analysis of Pakistan’s experience with the IMF would not be complete without also saying a few words on the IMF’s own performance in this relationship. It is now clear that the IMF, too, whether under the strong influence of the US, appears to have been either too lenient or too harsh without much consistency, and that its technical skills in the design of at least the 2008 program left much to be desired. There is much that not only Pakistan, but the IMF too, can learn from experience.

#### ***4.3. Mismanagement of the Economy: Byzantine Decision-Making***

Pakistan’s economic managers are fairly well experienced; they are far from easy pushovers in hard negotiations with international agencies and are fairly adept in economic decision-making. However, from their experience over the 13-year economic cycle, it strongly appears that glaring mistakes were made and that, except for a short-lived economic growth spurt, the economy emerged as weak, if not weaker, than it was at the start.

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The discussion below points to some of the controversial decisions made during this period.

*4.3.1. Monetary Stimulus: Jump-starting the Economy, 2002–04*

At the end of 2002, the Musharraf government found itself in a classical economic quandary. The strong stabilization measures adopted under the IMF program had brought about macro-stability, but the economy was caught in a low-level equilibrium trap of stability with very low growth. The State Bank of Pakistan decided to jump-start the economy with a monetary stimulus by pumping in money at very low interest rates to encourage private investment. It also encouraged leasing and other arrangements to fund expenditures on consumer durables, including the purchase of motorcars. While these measures, together with other favorable developments, ignited economic growth, the resulting monetary overhang fuelled inflation as the stimulus was too strong and its duration too long (see Janjua, 2005). It also fuelled an energy-intensive consumer-led boom. The result was much-higher-than-expected inflation as well as a rising energy gap.

*4.3.2. Lack of Coordination Between Finance and Planning, 2006/07*

In the Islamabad Secretariat, the Planning Commission and Finance Ministry are adjacent to one another with the two blocks, 'P' and 'Q', joined by a corridor. Despite their physical proximity, the lack of coordination between the two—indeed, some would say, tension—is responsible for many of the economic ills the country faces.

The best example of this is their lack of timely action to at least contain the energy crisis, since solving it would need much more concerted long-term action. The Planning Commission had projected energy demand based on historical trends. Jump-starting the economy with a loose monetary policy and the Finance Ministry's implicit backing, together with fast-rising remittances, fuelled consumption and increased energy demand much faster than projected. When the Planning Commission realized its mistake, as mentioned earlier, it proposed setting up short-gestation hydel power plants in the public sector. This was shot down by the Finance Ministry, which argued strongly against any further public investment in energy. WAPDA, instead of taking a strong stand, also decided to kneel before the financial czars.

*4.3.3. Electioneering Economics, 2006/07*

At the outset of the financial year 2006/07, the economy was precariously balanced and vulnerable to external economic shocks. Inflation was

hitting double digits and the fiscal and current account deficits were rising at an alarming rate. This would have been an opportune time to slow down expenditures and allow the economy to cool down. However, it was also the Musharraf government's last year in power with general elections to follow in the second half of 2007. The Prime Minister-cum-finance minister did not pay any heed to economic advice that would show up any structural weaknesses in the economy and decided to gallop ahead with a targeted growth rate of more than 7 percent to show for his laurels. He cited the very high growth at which India and China were growing. The Planning Commission advised caution but was ignored.<sup>13</sup> Surprisingly, the State Bank also decided to support the government's stance to target a high growth rate.

When the unprecedented increase in global oil and food prices hit the economy in the second half of the financial year, the economy veered out of control. The current account deficit began to increase. The fiscal deficit also rose because the government, in the face of a strong lawyers' protest movement, lacked the political strength to pass on higher prices. This shock marked the end of the Musharraf boom. It also showed the difficulty of overcoming an external shock when the economy is precariously balanced. The Pakistan economy faltered well before the advent of the global financial meltdown.

#### *4.3.4. Unprecedented Increase in Wheat Prices, 2008/09*

During the wheat "fiasco" of 2007, the government first proclaimed a bumper harvest, allowed the export of wheat, then faced wheat shortages, and had to import wheat at a much higher price.<sup>14</sup> This brought into prominence the need to examine the whole issue of ensuring food security and setting an appropriate procurement price, especially given the sharp spike in world prices for oil and food grains, including wheat.

How should this price be determined? In May 2008, the Planning Commission set up a Food Security Task Force headed by a former finance and agriculture minister, which included a number of prominent specialists in the field. In its interim report (Planning Commission, 2008) in September 2008, it proposed fixing the procurement price of wheat at PRs 950/40 kg. Earlier on, when taking over in March 2008, the new government had increased the procurement price from PRs 425 to PRs 625/40 kg at the start of the wheat-harvesting season. Its justification was based on the premise that, due to adverse terms of trade and rising global prices, the wheat supply had not kept pace with demand and led to the

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<sup>13</sup> Based on discussions with senior officials of the Planning Commission at that time.

<sup>14</sup> Wheat was exported at USD 200/tonne and then subsequently imported at USD 300/tonne.

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import of wheat at a much higher price. Additionally, as a result of increasing oil prices, the prices of fertilizer and energy had increased, squeezing the further declining profits of farmers. To offset the resulting increase in food inflation estimated by the task force, a comprehensive safety net was proposed, which would rely primarily on the Benazir Income Support Program.

Unfortunately, the task force's recommendations were never examined seriously. Indeed, after hearing the views of the task force and of the Ministry of Agriculture (which recommended the even higher price of PRs 1,050/40 kg based on the import price), the Prime Minister decided to fix the price somewhere between the two levels recommended.

The decision was ultimately a political one as the PPP coalition government represented large farmers both in Punjab and Sindh. The cost to the economy was ultimately extremely high.<sup>15</sup> The unprecedented price increase injected a large dose of inflation into the economy that took years to work itself through. Moreover, as global wheat prices fell to nearer PRs 750/40 kg by the time the wheat crop was to be harvested, the federal and provincial governments of Punjab and Sindh had to procure large amounts of wheat which they did not have the space to store as well large borrowings from the State Bank that locked in money in the "food" circular debt.

It would have been much more prudent to fix a somewhat lower procurement price (say, around PRs 800/40 kg), but the macro-implications of setting the higher prices were never examined and the fact that global prices could fluctuate in large bands was also ignored.

*4.3.5. 7th NFC Award: "On a Wing and a Prayer" 2009*

The 7<sup>th</sup> NFC award is rightly seen as a major step forward in addressing the genuine grievances of the smaller provinces by distributing a larger share of federal revenues to them, and by moving from a single criterion, i.e., population as a basis for distribution, to multiple criteria that encompass size and other variables. Its politics was right and so was, some would say, its timing. But its economics has gone horribly wrong. The award was based on the important assumption that the tax-to-GDP ratio would gradually increase by 1 percent each year. Unfortunately, it has remained stagnant. This has put considerable pressure on federal resources, especially given the large unexpected increases in expenditure

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<sup>15</sup> The Punjab government's representative at this meeting opposed the very high procurement price being proposed for wheat since he was aware that the Punjab government would have to buy a large part of the marketable surplus.

on security and law and order. Additionally, no incentives were put in place for the provinces to generate resources and linking this performance to an increased share in the divisible pool of resources.

What has happened is that the provinces, now somewhat flush with funds, have simply not made the effort and taken the politically easier route of not imposing any new taxes (agricultural incomes) or increasing tax rates in line with economic realities (e.g., property tax in the Punjab). Nor has sufficient attention been given to building the capacity of provinces such as Balochistan and Sindh to effectively use these resources.

One of the reasons for some of the poor decisions made in this context is that the NFC body effectively failed to do its homework. Many countries set up research institutions to examine issues related to the distribution of resources among their federating units; these institutions also serve as research secretariats to the permanent NFC body. This could initially be done by setting up a similar unit at, for example, PIDE, to carry out these functions.

#### *4.3.6. Procrastination, Thy Name is R-GST 2010*

It has now been over a decade and a half that the government has come close to adopting a value-added tax (VAT) but at the last moment lost courage to do so. The best opportunity was during the Musharraf period when the economy was growing at a healthy pace but the government vacillated. The democratic government that followed came very close to imposing VAT since it was part of the IMF agreement, but in the end, got cold feet because one of its coalition partners strongly opposed it.

The real hurdle in the way of imposing VAT (“christened” the R-GST by the last finance minister) is not, as is normally argued, that the Federal Bureau of Revenue or private sector firms lack the capacity to implement it, or that much more preparatory work is needed, but that it would lead to the documentation of the economy and, therefore, bring into the tax net a large part of the economy that defaults on tax payment. Here, politics holds hostage an economic reform that is simply necessary to improve government revenues and allow the economy to function better.

#### *4.4. Strengthening Short-Term Economic Management*

For prudent economic management, the real challenge is to develop the political will and finesse to take important decisions, to ensure that they are properly formulated and implemented, and to monitor progress. Our analysis shows not only why important decisions are not made but, equally importantly, that decisions are made without their consequences

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having been considered and with a lack of coordination between important government agencies at the federal level as well as between the provincial and federal governments.

The real question, therefore, is how to build in institutional mechanisms that will ensure better management of the economy, especially in light of the 7<sup>th</sup> NFC award and the 18<sup>th</sup>, 19<sup>th</sup>, and 20<sup>th</sup> Constitutional Amendments as well as the fact that the newly elected government will, in all probability, be a coalition.

Let us start with the existing institutional framework for the short-term management of the economy, i.e., primarily the annual budget and the annual plan of the federal government and the corresponding provincial budgets and development plans. On paper, there is an elaborate process to ensure consistency and set realistic targets. In reality, this entire exercise is more procedural than practical, with no real attempt to test the authenticity of the targets set or projected, no clear mechanisms in place to gauge how they will be achieved, no serious attempt to monitor progress, and worse, hardly any serious attempts to ensure that the targets set are adhered to or modified after sensible debate and discussion.

The current practice, under a medium-term budgetary framework<sup>16</sup> started in 2009 is to prepare the budget through a budget strategy paper (BSP). The exercise starts four or five months before the presentation of the budget in end-May or early June. It consists of two parts: a macroeconomic framework and a budget exercise. The team responsible for developing the macroeconomic framework is led by the chief economist of the Planning Commission and includes senior representatives from the Ministry of Finance, the Economic Affairs Division, Federal Bureau of Revenue, State Bank of Pakistan, and Federal Bureau of Statistics. It is tasked with coming up with the targeted growth rate, fiscal deficit, trade and current account deficit, revenue and expenditure targets, including development expenditures, and targets for money supply.

The framework is based on a consistency model. In reality, when the economy is being run under an IMF program—as it was for most of the period under review—the growth rate is determined outside this framework by the IMF in discussions with the Finance Ministry. So are almost all the other key variables, including the targeted size of the fiscal deficit, revenue targets, and other key variables. Once these variables are fed into the consistency model, it generates the other variables.

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<sup>16</sup> For details, see the Ministry of Finance website (titled MTBF Secretariat), which has sections on the MTBF overview and budget preparation process ([www.finance.gov.pk/main.htmls](http://www.finance.gov.pk/main.htmls)).

The exercise has other shortcomings too, the most important of which is the lack of any meaningful inputs from the provincial governments. The fiscal revenue targets are the mirror image of the planned expenditure and perhaps the weakest part of the exercise.

The first task must be to empower the macroeconomic team, regardless of whether or not the economy is being run under an IMF program. Even if the final targets are to be negotiated with the IMF, the macroeconomic team must carry out its own exercise first and this should be the basis of negotiations with the IMF. As a minimum, the chief economist must be part of the Finance Ministry's team that negotiates the macroeconomic targets with the IMF.

Once the macroeconomic targets are finalized, they should then be discussed with leading economists<sup>17</sup> including the chair and members of the Prime Minister's economic advisory team before being discussed by the Annual Plan Coordination Committee and finally approved by the National Economic Council (NEC). Unfortunately the macroeconomic framework is never discussed seriously at either body's meetings with line ministries, and the provincial governments are interested only in proposed projects or resources for ongoing projects. The debates in Parliament on the budget also rarely touch on the macroeconomic framework.

The second part of the budget exercise, i.e., the preparation of the current and development budget of the line ministries and autonomous departments are supposed to be based on a results-based management exercise. Each ministry is to set out clear strategic objectives and outcomes together with outputs and activities to achieve the objectives. The total resources made available to each ministry must be justified according to the objectives outlined. Interestingly, there are no clear indicators of success and no real review of what has been achieved in the preceding year as part of this exercise and needs to be incorporated.

The BSP exercise is a two-way process under the concerned federal secretary with the resources available and objectives defined by the top management, and activities to achieve them worked out by line departments and bodies. The proposals are then presented to the Priority Committee, which is headed jointly by the secretaries of finance and planning. In reality, it is usually chaired by the additional finance (budget) secretary, leading in many cases to bad blood between the finance and planning ministries.

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<sup>17</sup> Two to three nonofficial leading macroeconomists are in fact stipulated to be part of the macroeconomic team but this is rarely done.

The BSP exercise by each ministry as well as by the Macroeconomic Working Group is carried out under an overall three-year rolling plan with expenditure ceilings provided by the Ministry of Finance. These ceilings are based on a financial programming framework that analyzes alternative macroeconomic scenarios to ensure overall consistency as well as a medium-term fiscal framework that draws on the former. These exercises are conducted by the Ministry of Finance and are somewhat arbitrary with targets being modified each year depending on performance in the preceding year and projections for the next year.

The important point to grasp is that there are systems in place that could lead to a fairly robust macroeconomic framework and realistic budgetary exercise. Unfortunately, little attention is given to each ministry's plans and ultimately it boils down to a firefight on projects and resources. What is worse is that, in most years, due to some emergency or other, budget cuts are made and the tedious long-drawn exercise undertaken becomes irrelevant before it has even started. Economic cuts are then made somewhat arbitrarily, for which some criteria are put in place, but again these are rarely followed.

Mention should also be made here of the PRSP and the MDGs. There has really been no attempt to incorporate the objectives and targets set under either in the BSP exercise. A unit of the Finance Ministry undertakes an ex-poste exercise every six months to gauge if allocations have been made in line with the PRSP. Since the monitoring exercise of the PRSP is based on allocations to about 18 heads of expenditures (including education, health, and social protection), the amount allocated under these heads and progress or lack of it is then reported. The minimum targeted expenditure under these 18 heads is around 5 percent of GDP, which shows how seriously we take the PRSP or MDG targets in the first place.

## **5. Breaking out of Stagflation**

Following an earlier study (Amjad, Din, & Qayyum, 2011), we propose a four-pronged strategy for breaking out of the current stagflation:

- Regaining macroeconomic stability and reigniting economic growth
- Stimulating the economy by reviving the role of the government in development while restoring fiscal balance
- Loosening monetary policy in order to spur the private sector
- Improving social safety nets

**5.1. Short-Term Measures to Revive Growth While Keeping Inflation Broadly in Check**

In suggesting measures to revive economic growth, we emphasize reviving the role of the government in development while taking stringent measures to cut down on non-development expenditures, especially untargeted subsidies so as to reduce the fiscal deficit. The underlying model is adapted from that used by Haque and Amjad (2012). In our proposed measures to reignite economic growth, the initial emphasis is on increasing public sector investment to draw in private investment, while Haque and Amjad's model relies primarily on stimulating private investment, which, we believe, in the current conditions may not be immediately forthcoming.

The underlying justification for this approach is the strong linkage between the PSDP and private sector investment as well as economic growth. This proposed increase should spark growth and draw in private investment. We also advocate further loosening the monetary policy stance by reducing the interest rate and making available more credit to the private sector. This could be made possible by cutting down on non-development expenditures, especially untargeted subsidies such as in the energy sector.

The rationale here is that inflation has tapered off and is currently at around 7 percent. Even if oil prices increase in the immediate future, their impact on inflation would be at most 1 to 1.5 percent, and even if this increase is fully shifted to consumers, the inflation rate would not enter double digits. We propose according higher priority to reviving growth if inflation can be kept to a manageable level.

For such an exercise to have any real chance of success, the government would need to:

- Immediately impose the R-GST, remove all zero-rated duties and taxes, gradually introduce an agricultural income tax, and make a major effort to increase the tax net
- Ease the energy constraint
- Remove all untargeted subsidies
- Set enforceable targets to cut down the losses of PSEs
- Target an increase in the PSDP in short-gestation employment-intensive projects

Some of these measures, especially removing untargeted subsidies, may raise inflation further and will, therefore, need to be gradually

phased out. In addition, safety nets for the poor and vulnerable may need to be augmented.

## **6. Ensuring Sustainable, Inclusive, and Higher Economic Growth**

The five basic tenets we suggest as pillars of a development strategy for Pakistan are:

- Macroeconomic stability with economic growth
- Increasing efficiency, productivity growth, and international competitiveness through economic reforms
- Restoring business confidence and creating a favorable business environment to encourage the revival of domestic and foreign investment by removing bureaucratic and other obstacles
- Investing in people by significantly increasing the resources for education and health
- Strengthening institutions and reducing corruption for better economic management

Macroeconomic stability is essential for instilling business confidence, and for attracting both domestic and private investment as well as building the confidence of global financial markets and international financial institutions. Pakistan's economic history over the last 65 years is also testimony to the fact that periods of economic growth are strongly related to periods of macroeconomic stability.

Together with macroeconomic stability, strong, well-functioning, democratic, and transparent institutions are equally essential. While stopping corruption will take time and require drastic measures, reducing it through appropriate measures must remain the government's top priority. The role of the superior judiciary in taking notice of corruption and lack of transparency in economic decisions involving large public resources is, therefore, commendable; so is the increasing presence of a free media in Pakistan.

It has to be recognized, however, that while macroeconomic stability and well-functioning institutions are good for economic growth, they cannot generate economic growth per se. Sustained economic growth can only result from structural change in the economy—this requires extensive economic reforms that will create opportunities for the private sector to invest as well as remove obstacles to economic entry. So, if Pakistan is to grow, hard decisions will need to be made and far-reaching economic reforms undertaken.

### **6.1. Economic Reforms to Increase Productivity and International Competitiveness**

Pakistan's growth trajectory may be cyclical but, as we have established in Section 2, its fundamental problems are structural. The overarching objective of economic reforms is to transform this existing inefficient structure into one that can generate sustained growth driven by a healthy growth in productivity and increased international competitiveness.

Economic reforms can be divided into those that allow the state to provide basic essential services by generating sufficient revenues, those that make the economy more competitive by opening it to increased domestic and international competition, and above all, those reforms that create an environment conducive to attracting private investment and new entrepreneurs who must serve as the main driver of economic growth.

The basic rationale for these reforms is that, due to interventions primarily by the government, certain sectors and individuals or companies within these sectors are earning unjustified "rents", which they would not if they were not afforded this protection, and which prevents possible competitors from entering these activities. Such protection leads to inefficiencies and costs to the economy and is also detrimental to the welfare of consumers who are then forced to pay higher prices for products.

Essentially, the structure of the economy that emerged in the first two to three decades following Pakistan's independence was built up—as indeed was the case for most developing countries—under a highly protected import substitution strategy to encourage industrialization, which resulted in a transfer of resources from the dominant agriculture sector in favor of industry. The "new orthodoxy" that emerged in the 1980s challenged this import substitution-led growth strategy, arguing that it resulted in an inefficient industrial structure and an inefficient economy. Instead, it made a case for dismantling protective barriers and drastically reducing the role of the state and state-owned enterprises in economic development.

Subsequently the new orthodoxy was represented by the so-called "Washington Consensus", which broadly became the overarching framework for economic development by international financial institutions, primarily the IMF, the World Bank, and regional banks including the Asian Development Bank. Its basic premises were private sector, market-driven growth, deregulation, and privatization.

In Pakistan, the private sector market-driven growth strategy has gained recognition since the 1990s, and subsequent political and military

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governments have broadly adhered to its fundamentals. The challenge, however, has been that the old structure created strong vested interests and protected an economic elite—dismantling it and putting in place the new, more competitive, and efficient structure has been a somewhat rough ride.

One of the areas of contention in moving to a more open and less protected economy is the old argument for building up an industrial base, and this remains the justification for continued protection of selected industries in engineering and certain other fields. This regime is complicated by an SRO system, enforced partly by the Engineering Development Board, which also somewhat arbitrarily provides protection to specific industries. In recent years, the protective regime appears to have expanded in scope.

This issue of an optimal level of protection and the phased drawing down of existing and arbitrary trade barriers must be one that the new government decides and for which it plans a clear-cut industrial policy. This exercise could also take into account the implications of removing the negative list and granting most-favored nation status to India.

The current economic paradigm emphasizes not sectors of growth but factors of growth by investing in people, since knowledge has replaced physical capital as the major driver of growth. In the early development literature, industry was seen as synonymous with economic development; this was the historical path that earlier industrialized economies had followed. It was argued that only manufacturing could generate sustained productivity growth through increasing returns to scale and new products through innovation and new technologies (Kaldor, 1966). There was also strong evidence that the terms of trade in global markets had historically favored industry against agricultural products.

Much of this has changed. Economies of scale are no longer found only in industry but also in other sectors, especially through the use of information technology and other technical advances including in agriculture and services. In recent years, the terms of trade have favored commodities and food grains rather than manufacturing. Even if a case could be made for fostering new industries and providing initial protection, there is very little justification for continued protection well over the stipulated period. At some stage, an infant industry must learn to stand on its own feet.

While the optimal level of protection to manufacturing and the speed and sequencing of tariff reforms remains controversial, this should in no way detract from important and much needed economic reforms. The underlying framework for these reforms must move in a number of

critical areas, remove unnecessary and distortional government interference, and improve the quality of economic governance. However, while accepting many of the premises of private sector market-led growth, it is necessary to take reforms dictated by our economic situation and overall vision of development than by blindly following an economic ideology derived from the Washington Consensus.

This is the path adopted by most successful developing countries, including the East Asian 'tigers', China, and India. The underlying goal must be economic reforms for structural change that recognize the important role that market forces, both domestic and global, play in driving reforms, and their limitations. Pakistan must learn from the global economic meltdown, which resulted from an unfettered reliance solely on market forces and the belief that they would be self-correcting.

## **6.2. "The Best is the Enemy of the Good"**

In drawing up an economic reform program, the government should learn from some of the democratic government's recent mistakes. If one moves on too broad a front (as, for example, was done under the Nine-Point Program) and expects to be successful in every area of proposed reforms in just a few years, one will end up with very little to show for it.

What we propose are three areas that need to be given the highest priority in the economic reform program, and which target:

- Revenue generation
- Energy sector reforms
- Documenting the economy

Together with these priority areas, reforms should focus on:

- Improving the performance of public sector enterprises
- Tariff reforms, abolishing the Engineering Development Board, and putting an end to the SRO regime
- Financial sector reforms
- Labor market reforms to encourage skills development and set up an efficient, well-functioning labor market in which flexibility is provided to employers to adjust their labor force as demand conditions change as well stability to the work force to encourage skills development at the workplace.

### **6.3. Implementing Economic Reforms**

The new government and its coalition partners must come up with a clear-cut agenda for economic reforms and a timetable for sequencing the implementation of the reform package. There will be tradeoffs and political costs. Reforms will be painful—they will entail removing subsidies and laying off redundant workers. Adequate safety nets and retraining programs will need to be put in place to protect the poor and vulnerable groups.

Within the government, which body should take the lead to ensure implementation and monitor progress? At present, this is the responsibility of the Finance Ministry and its Economic Reforms Unit, which is headed by a joint secretary. Such an institutional arrangement is clearly inadequate. The finance minister, however, much as he or she may be committed to reforms, simply does not have the time to follow up on the nitty-gritty that the reform process entails. Individual ministries whose task is ultimately to implement the reforms in many cases are the biggest hurdles because these reforms will reduce their discretionary powers. They are certainly not going to be the driver of the reform process.

There is little point in setting up a new ministry or division charged solely with the reform process. A good option would be to set up a subcommittee of the Economic Coordination Committee (ECC) headed by the deputy chairperson of the Planning Commission. The committee should then bring in representatives of the provincial governments and the private sector. The deputy chairperson should report on its progress at every other meeting of the ECC, which is headed by the finance minister. In turn, the finance minister should report to the Cabinet—presided over by the Prime Minister—every month on the progress made on the reform agenda.

The real remaining challenge will be to embed the key economic reforms in the working of the line ministries and departments. It may be useful to learn from India's experience where economic reforms were carried out effectively—economic advisers who were strongly committed to economic reforms were assigned to key ministries. In many cases, they were also experienced and well-trained economists.

Ultimately, the success of the economic reform program will rest on the finance minister, who should be a political heavyweight or have the full confidence and backing of the Prime Minister. This was the case of Manmohan Singh—a technocrat rather than politician—as finance minister, who had the strong backing of the then Prime Minister Narasimha Rao.

6.3.1. *Lack of a Consistent Medium-Term Development Framework, 2008–13*

During the period of the democratic government, the Cabinet approved three medium-term frameworks. The first was the Nine-Point Program adopted by the Cabinet; the second was the Outline of the Tenth Five-Year Plan (2010–15) titled “Investing in people” prepared by the Planning Commission and approved by the NEC in June 2009; and the third was the Framework for Economic Growth prepared by the Planning Commission and approved by the NEC in June 2011.

That the same government could pass three medium-term frameworks and plans during the course of its five-year term must be a record of some sort, reflecting the frequent changes in its top economic team. The fact is that there was little ownership by the government of these documents, which is reflected in the virtual absence of any serious debate or discussion on them in the Cabinet, the NEC, or in Parliament. The lack of continuity in the economic team also means that there was no real ownership of the strategy—a situation made worse by the fact that the economy was buffeted by so many uncertainties and crises that it was difficult to use the medium-term frameworks as a guide to policymaking.

The announcement of their manifestos by the major political parties before the election will hopefully be translated into a consistent medium-term strategy to be followed by the elected government during its tenure.

6.3.2. *The Role of the Higher Judiciary in Economic Decision-Making and Economic Management*

In the recent years of the growth cycle, and especially after the restoration of the higher judiciary in early 2009, there has been a significant increase in public interest litigation, which has questioned the rationale and transparency of economic decisions taken by the government.

Elaborating on its position on economic management issues in its judgments, the superior court has recognized the executive’s authority in economic management. However, it has argued that, if an economic decision is made in a manner contrary to the procedures and regulations in force, and is clearly against the ultimate welfare and good of the people, then the court has the right to question it and rule against it.<sup>18</sup>

This subject needs much more analysis and research, but a few general points can be made here. The first is the issue of price fixing. Here, the higher judiciary appears to have learnt, as has the executive over the years,

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<sup>18</sup> See the Supreme Court’s judgment in the rental power plant case (Supreme Court of Pakistan, 2012).

that fixing the prices of consumer goods is almost impossible to put into practice. This lesson clearly emerged from attempts to fix the price of sugar in the early years of the democratic government. In areas where prices can be fixed and enforced (e.g., electricity and CNG), the judiciary has questioned the rationale for imposing new or increasing existing levies and taxes, and increasing prices. Here, the government has been given ample opportunity to justify its reasons and the courts have taken note of these in their final decisions. Perhaps one issue here is relying only on government representatives to explain the rationale for increasing prices and not asking professional economists and experts.

On admitting litigation where contracts have been awarded without following rules and procedures in a clearly nontransparent manner and with clear mala fide intentions, the courts are fully justified in questioning these decisions. In so doing, they are exposing both corruption in the government in power and the complicity of the higher bureaucracy in these decisions, which they should have opposed. Giving in to political pressure and not doing their basic homework to examine the merits and demerits of alternative policy options—as appears to be the case in their decision to set up rental power plants, for instance—cannot be justified as recent judgments of the court clearly bring out.

It must, however, be said that by enlarging its jurisdiction to examine economic issues under the overall rubric of protecting citizens' welfare, the superior judiciary needs to carefully consider where and when it should intervene as almost all economic decision-making has an impact—direct or indirect—on people's welfare.

## **7. Conclusions**

Pakistan's economic plight is clearly of its own making. Over the years, it has simply refused to read the clear writing on the wall in terms of what needs to be done and postponed critical economic reforms, which were essential to make the economy more efficient and break out of the recurring stop-go growth cycles.

By concentrating on the previous economic growth cycle over the last 13 years, spanning both a period of military and democratic rule, this chapter has focused on key issues of economic management that are responsible for many of the economic ills we face today. Lack of political will and poor economic management emerge as clear villains of the piece.

That Pakistan has managed to keep its head above water and avoid economic collapse is primarily due to a number of favorable developments, mostly emanating from outside the domestic economy.

These can offer no permanent or long-term solutions and must not, in any case, be used as shields against economic reforms.

By pointing out clear instances of poor economic management, this chapter has also identified existing gaps in policymaking and shown how these can be overcome, including by setting in place more transparent and better functioning institutional arrangements. It also points to the gradual erosion of technical capacity in the government at all levels, but especially in relation to the expertise needed for prudent economic management and decision making.

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## 4

### A Country and an Economy in Transition

Shahid Javed Burki\*

#### 1. Introduction

The main thrust of this chapter is that Pakistan is finally in a position to move forward and set its economy not only on the path to recovery, but on a trajectory that will ensure high levels of sustainable growth. This could happen since some of structural problems that have dogged the political system since its creation seem to be nearing resolution. Since there is a close connection between political and economic developments, this advance in the former will have positive meaning for the latter. Pakistan may well be on its way to developing a new way of managing its affairs—meaning the way in which the political system is run, how the economy is managed, and how social interactions take place among different segments of the population. With the adoption of an appropriate set of public policies, it may also be possible to pull the economy out of the deep slump into which it has fallen and achieve a much higher rate of gross domestic product (GDP) growth.

This way of thinking about the future seems much too optimistic for a time that brings grim news every day—of an economy that is not able to

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move out of the slow growth groove in which it has been stuck since 2007; of national bankruptcy believed to be just around the corner; and of a country increasingly isolated in a world that is busy reorganizing itself. The GDP growth rate has been on a declining trend since the 1965 war with India. For the last six years, the average rate of growth has been just slightly more than 3 percent a year—only one percentage point above the estimated yearly increase in population.

An unsettled economy and one in which many people fail to respect the rule of law creates costs that are borne largely by the poorer segments of the population. This makes the situation unsustainable in the sense that the people affected by all this uncertainty—and that means the majority of the population—will begin to search for a new order that might possibly overcome the surrounding chaos. That people buffeted from many sides find themselves increasingly alienated and begin to search for some resolution in order to bring order to their lives is not a new finding. The search may at times also include resorting to violence, not against other people or segments of society but against the state.

This conclusion was reached some decades ago by several social scientists. Huntington (1968) has focused precisely on the kind of situation that Pakistan faces today.<sup>1</sup> His conclusion is that a large, alienated population will destabilize the system in which they live, hoping that change will better their lives. Hirschman's (2004) equally influential treatise on "exit, voice, and loyalty" deals with a similar situation, and analyzes the three options that people unhappy with their situation can choose from. Both, in other words, conclude that societies under immense stress must make a serious effort to transit to an order that equitably dispenses the fruits of economic advance; only then will it become durable. Is such a change taking place in Pakistan? Has the Pakistani citizenry concluded that it needs to play a role in determining how it wants to be governed?

At this time, Pakistan faces five immediate problems in the economic arena: (i) the longest downturn in its history, (ii) serious macroeconomic imbalances, (iii) a large but poorly trained human resource base that could be an asset if properly developed or a burden if ignored, (iv) the absence of consensus on how to move the economy onto a plane of higher and sustainable GDP growth, and (v) an appropriate role for the state and how it can work with the private sector to move the economy forward.

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<sup>1</sup> Samuel P. Huntington, with whom the author worked as a research associate in 1970/71, followed the trends in Pakistan in the late 1960s and the early 1970s to develop his thesis (see Huntington, 1968).

Policymakers must address these inter-related issues simultaneously. Growth needs to become the basis of a new development paradigm. At the same time, large macroeconomic imbalances must be eliminated. Progress on one front will improve the prospects on the other four. Restoring macroeconomic stability will improve the investment climate for both foreign and domestic investors. The increased confidence and recovery in growth will lay the basis both for expanded revenues and exports. However, a growth strategy must have public support without which it will be hard to implement. This will necessarily involve some sacrifices by the relatively well-to-do in society so that those who have been left behind can begin to benefit from the process of growth. This challenge, properly and immediately met, will put the country on a constructive path, first aimed at economic survival and then at reviving the highly stressed economy.

## **2. Economic and Social Challenges**

The chapter begins by focusing on the deteriorating external finance situation, followed by the government's persistent reliance on fiscal deficits to manage its affairs. It then assesses whether the country can be rescued by an external player or players from the brink of bankruptcy. This approach—what in finance is called “moral hazard”—has worked in the past but might not produce satisfactory results this time around. This brief discussion on the economic situation is rounded off by some speculation about the rate of economic growth in the future.

The pace at which the country has been using up its foreign exchange reserves over the last year and a half appears to signal the arrival of yet another balance of payments crisis. The reserves reached a peak of USD 18.294 billion in July 2011 but started hemorrhaging soon after. The situation was saved somewhat both by the current economic slowdown, which reduced the current balance of payments deficit, and by the release of some blocked funds by the US. In 2011/12, the deficit was USD 4.6 billion. In the first eight months of 2012/13, it stood at USD 700 million compared with USD 3.325 billion in the same eight-month period in 2011/12.

The depletion in the level of reserves has, however, continued. They stood at only USD 7.45 billion (i.e., those held by the State Bank of Pakistan) on 21 March 2013. Payments to the International Monetary Fund (IMF) in May and June 2013 will account for USD 785 million, further squeezing the State Bank's foreign exchange holdings. The expected fall in foreign exchange reserves is likely to further weaken the rupee, which has lost 58 percent of its value against the US dollar in the last five years. The rupee's depreciation would help exporters if they could produce products for which there was good demand in the global

marketplace. With supply constraints—mostly the result of severe power shortages—the expected fall in the value of the rupee may not significantly increase the volume of exports and thus export earnings. It will, however, put some additional pressure on domestic prices.

The type of external payments crisis toward which the country seemed to be inexorably heading in the spring of 2013 has become a regular feature of the Pakistani economy. On a number of occasions—in 1996, 1999, and 2008 for instance—Pakistan was able to re-emerge from a situation of near-default and bankruptcy with the help of bilateral donors and international financial and development institutions. In 1996, China came to the country's help with a deposit of USD 500 million paid into Pakistan's account at the Federal Reserve Bank in New York.<sup>2</sup> In 1999 and 2008, the IMF, backed on both occasions by the World Bank, helped Pakistan to avoid defaulting on external obligations.

This time, however, such help is not likely to be forthcoming. The motive for providing assistance in past crises was both economic and political. For instance, in 2008, the IMF wanted to help the country consolidate the new political order the civilian leadership was developing. It was understood in Washington by the IMF, the World Bank, and the US government that a financial crisis would hinder political progress. As discussed below, this had happened on numerous occasions in the past.

When approached informally in December 2012 by the outgoing Pakistan Peoples Party (PPP)-led government in Islamabad, the IMF made it clear that it was prepared to assist if there was clear political support from most segments of the political establishment for implementing what it called "prior actions". This was an understandable exercise of caution on the IMF's part since, on numerous occasions, Islamabad was unable to complete the program it had signed with the institution.

The constraint to the flow of foreign capital comes at a time of declining domestic resource generation, which has further reduced the already low rate of investment. Given the resource situation, it does not seem possible that Pakistan can lift the economy out of the continuing slump. The current economic downturn has already affected the country in several different ways, and the negative consequences are likely to become even more pronounced. With a relatively low GDP growth rate, there will likely be a palpable increase in the rate of unemployment, which will only add to the strain on Pakistan's political and social structures.

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<sup>2</sup> The author, as the de facto finance minister in the caretaker administration that oversaw the elections of 1997, negotiated this deal with Beijing.

The country has now come to rely heavily on “workers’ remittances”, which crossed USD 13 billion in 2011/12 and are likely to reach USD 15 billion in the current financial year. 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 to finance a significant part of the needed investment to greater reliance on tapping the incomes of its own citizens. Given that these citizens do not, however, live within the country’s borders, the country has come to depend on people of Pakistani origin who live and work outside the country. Nonetheless, the flow of remittances as shown by experience is volatile, and excessive dependence on it is not prudent. The country needs another transition: to raising resources for investment primarily from within its own borders. This will require the show of political will that was in short supply during the last five years.

Before leaving the subject of economics and taking up those that also affect citizens’ lives, it is important to address some of the other factors that have resulted in deep economic malaise. This means going beyond the signs of poor performance already noted—large and unsustainable current account and fiscal deficits, sharp reductions in the flow of external development assistance, and the continuing slow rate of GDP growth—to those that also harm the economy in difficult-to-quantify aspects of economic illness.

Three such manifestations are of considerable importance: (i) the absence of a well thought-out strategy for the revival of growth—one that is more practical than the framework for economic growth proposed by the Planning Commission (see Pakistan, Planning Commission, 2011a) (discussed in Section 3); (ii) in-your-face populism; and (iii) 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 aid the poor are license to collect rents to benefit oneself, and one’s family, friends, and political associates. By all accounts, the last five years of democratic rule saw Pakistan at its most corrupt while the quality of governance remained extremely poor. All this raises the obvious question: Will the establishment of a new political order succeed in addressing these problems? The answer to this is: only time will tell.

Economics is not the only area where the country has faced difficulties. During the tenure of the coalition government led by the PPP from 2008 to 2013, Pakistan had to deal with a variety of problems. The most significant of these from the perspective of economic stability and development—and also the most costly—was the rise of extremism, which has taken several forms. Groups operating from the “no-man’s

land” belts bordering Afghanistan continued to defy the state’s authority and challenge US and NATO operations in Afghanistan, using sanctuaries they have 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”.

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. Sunni-Shia conflict was not the only communal violence the country experienced. In March 2013, Sunni extremists resorted to large-scale arson aimed at a particularly poor Christian community living in the heart of Lahore, Punjab’s capital and after Karachi, Pakistan’s second largest city.

The rise of extremism was not the only development that set back the economy. Very serious floods, severe power shortages, acute natural gas shortages, weakening exports on account of the continuing slowdown in the main markets for the country’s merchandise, and a weak foreign exchange position combined to deal a serious blow to investor confidence.

These negative developments notwithstanding, there were some positive moves, most of them 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 ongoing political transformation. There was a great deal of this in the last six years, and it appears that, after much trial and error, the country may be on the way to developing a new and durable political order.

As the chapter discusses later, the political system has evolved since March 2007 in a way to open it up to the citizenry. This is why it is necessary to date the political transition of the last few years to an earlier date (rather than to February 2008 when General Pervez Musharraf agreed to hold general elections)—namely, the chain of events that caused the country’s fourth military government to unravel. The way in which the Musharraf government slowly collapsed provides some assurance that the country will not see another military interlude.

Constitutional changes initiated by the 18<sup>th</sup> Amendment prescribed the procedure for appointing the head of the National Accountability Bureau. Through the subsequent 19<sup>th</sup> and 20<sup>th</sup> amendments, detailed procedures for the appointment of high court and Supreme Court judges were laid down, and arrangements for putting in place a caretaker government to oversee elections prescribed.

These constitutional developments and changes were an indication that, at one level, the political establishment recognized that a serious constraint needed to be imposed on the way it managed the political process. On the other hand, the establishment itself, which held the reins of power, continued to exceed the limits allowed them by the rules of business. This was particularly the case with senior-level appointments. For instance, in two cases, the ever-vigilant Supreme Court took upon itself the responsibility for 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 Pakistan International Airlines, the executive director representing Pakistan on the board of the World Bank, and the chairperson of the Federal Board of Revenue.

Another area of transition is federal-provincial relations, which are still evolving after the adoption of the 18<sup>th</sup> Amendment. A number of federal responsibilities have now been devolved to the provinces. The 7<sup>th</sup> National Finance Commission Award, which preceded the adoption of the amendment, significantly increased the provinces' financial situation. The provinces, however, having become used to handholding by the federal government, have made little effort to improve their resource base on their own.

Nonetheless, these changes should move the country toward 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 three interlinked issues: stabilization, reviving growth, and improving governance.

### **3. Developing a Better Economic Future**

This brings us to the point where serious consideration needs to be given to developing a better economic future for Pakistan. The Pakistani economy is in a state of great flux. There is consensus among those studying the economic situation that, were the present rate of economic growth of 3 to 3.5 percent to persist into the future, it would cause a great deal of political and social harm. The economy must grow at about 7 percent annually to absorb the two million workers (i.e., a rate of growth of over 3.5 percent per annum) who currently enter the labor force every year. Past large increases in population have meant that this level of increase in the workforce will continue for several years. A high rate of

growth—a rate more than twice that achieved in the recent past—is, therefore, needed and must be sustained for many years into the future.

Additionally, economic expansion must occur in a way that ensures that its rewards become available to all segments of the population and to all parts of the country. Modern economists call this approach “inclusive development”. How is this doubling of the rate of growth and its equitable distribution to be achieved in a country such as Pakistan?

In what it termed the “Framework for Economic Growth”, the Pakistan government’s Planning Commission (2011) 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 approaches that had been adopted in the past. It argued that the previous emphasis on investment—particularly by the public sector—had created a number of growth-retarding distortions in the economy, and that “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” (Pakistan, Planning Commission, 2010a).

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 (Pakistan, Planning Commission, 2010a).

Having offered this criticism, the Planning Commission promised a strategy that would factor in Pakistan’s situation in 2010/11 and some developments in economic thought.

“Never has there been a more pressing need in Pakistan’s history to search for a new model” (Pakistan, Planning Commission, 2010a). The commission was of the view that, in the past, there was emphasis mostly on developing a public sector development program comprising 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 needed to move from “hard” to “soft” growth (Pakistan, Planning Commission, 2011b).

By “hard” growth, the commission meant large public sector investments in brick-and-mortar development—building roads, bridges,

dams and, of course, buildings. What was needed instead was a combination of efforts that would improve the quality of governance and reduce interference by the government in the working of the private sector, encouraging greater innovation within the economy and greater focus on activities that could produce higher rates of growth with low rates of development.

Implicit in this strategy was the recognition that it would take a long time to increase the rate of investment, in particular by the public sector. To have that happen would require fundamental changes in the tax system—something for which there was little or no political appetite. Pakistan's growing and unsustainable fiscal deficit had brought the economy close to the edge of disaster, but it had not resulted in action by the political establishment. It would also require significant changes in the way the part of the economy that was still under government control was managed. Collectively, public sector enterprises had become a big charge on the budget since most were poorly managed, even though they were still treated as institutions of "first resort" for providing employment to political associates and supporters. The status quo thus appealed to the political establishment but drained the economy.

The most important conclusion to be drawn from this approach would be that, given the harsh political realities, there not much space for adopting economic policies that would help to revive the economy. Was this why the Planning Commission chose to adopt a policy stance of least resistance? Did it believe that, since investment could not be increased to obtain a higher rate of GDP growth, economic revival should come from increasing economic efficiency? In the jargon of economics, policymakers opted to 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, what the commission did not sufficiently recognize was that the "soft" approach would take a long time to become embedded in the structure of the economy. Following it would not help the country climb out of the low-growth trap into which it had fallen. Recognizing, albeit implicitly, that the country's existing institutional structures and prevalent style of governance could not move the economy onto a higher growth plane, the Planning Commission's proposed growth strategy put its faith in the private sector. This was a throwback to the approach advocated in the late 1980s and early 1990s by a number of Washington-based think-tanks and development institutions—the policies they advocated came to be known as the "Washington consensus".

Pursuing the strategy proposed by the Planning Commission will not rescue Pakistan's economy from its current slump. The commission's prescriptions are valid for the long term and should become the basis for introducing the structural changes needed to make this approach a success. When Pakistan's situation is compared to the rest of the world, an entirely new approach becomes necessary to pull the economy out of the current slump in growth, develop a political consensus on the various elements included in the approach to be adopted so that it can be sustained over a long period of time, and spread more widely the fruits of growth once that growth materializes.

#### **4. A New Development Paradigm**

This section proposes a two-step approach to economic revival. The first should be taken immediately after the elections are over, the new federal government is in office in Islamabad, and new governments have been formed in the provinces. The second should be implemented after the needed analytical work has been done and the appropriate political ground has been prepared to cover the long term.

In the immediate, three aspects need to be focused on: (i) improving the quality of governance by developing a system of accountability; (ii) increasing the supply of electricity by tackling the problem of "circular debt" that has kept independent power producers (IPPs) from fully utilizing their installed capacity; and (iii) privatizing loss-making enterprises, in particular those that provide essential public services. The longer-term growth strategy should be built on the "positives" in Pakistan's current economic situation.

The suggested approach is "new" in that it differs from previous growth strategies, in which development planning, whenever it was undertaken with some seriousness, was concerned mostly with allocating public resources between different sectors and for projects within the various sectors. The new development paradigm offered here also differs, however, from the Planning Commission's framework for economic growth, which suggests that the government's efforts should focus on a number of areas that were neglected in the past.

Here, this chapter offers a "new development paradigm". Before describing the new approach to development, it provides a brief overview of Pakistan's current economic and social situation. There are several ways of doing this, one of which is to use the data recently published by the UK-based Wealth and Well-being Legatum Institute to highlight what the country is faced with at this time. This data is presented in terms of what the institute calls the "prosperity index", according to which eight indices

are used to rank the 192 countries it studies to determine their relative position in the world. As shown in Table 4.1, Pakistan's position is strongest when measured in terms of "entrepreneurship and opportunity"; not surprisingly, it is weakest in terms of "safety and security".

**Table 4.1: Pakistan's position on the Legatum prosperity index**

<b>Index</b>	<b>Position*</b>
Economy	115
Health	112
Entrepreneurship and opportunity	103
Governance	115
Education	121
Safety and security	139
Personal freedom	132
Social capital	137

\* Total number of countries = 192.

Source: Legatum prosperity index, 2012.

Another way of understanding Pakistan's relative position is to work out the ratios of various measures for the country with respect to world averages (see Table 4.2). Pakistan accounts for 2 percent of the world's population. This share will increase since the country's birth and fertility rates are 24 percent and 21 percent higher, respectively, than the global average. Life expectancy at 94 percent of the global average compares relatively well with the rest of the world. The country's GDP per capita is only 18 percent of the global average. What is surprising is the country's relatively sound situation with respect to the various satisfaction indices—the degree of overall satisfaction is close to the world average. For female participation in the national legislature, Pakistan scores 13 percent above the world average.

**Table 4.2: Pakistan's social and economic performance in the global context**

Measure	Pakistan	Global average	Ratio
Birth rate in 1,000	27.3	22.0	1.240
Fertility rate (births per woman)	3.4	2.8	1.210
GDP (per capita) (PPP)	2,687.6	14,774.7	0.181
Internet access at home	6.7	34.2	0.195
Job satisfaction as revealed by surveys	73.0	73.2	0.990
Life satisfaction as revealed by surveys	5.3	5.5	0.960
Life expectancy (years)	65.2	69.6	0.940
Population (million)	173.6	6,800.0	0.020
People's treatment by the state level of satisfaction	90.0	85.1	1.050
Female representation in parliament (percentage)	22.2	19.5	1.130

Source: See Table 4.1.

*The main conclusion to be drawn from this comparative analysis is that the country needs to do more to increase the economy's rate of growth, improve those indicators that contribute to lowering the fertility rate, and adopt measures to improve security and public safety.*

A number of elements distinguish this development approach report from that of the Planning Commission's framework and also from previous development efforts. First, it is important to launch a national discourse on the development approach suggested here in order to gain broad acceptance of its various constituents. As discussed earlier, political and economic developments interact with one another—undertaking one while ignoring the other produces tension that ultimately kills the effort being made. This has happened repeatedly in Pakistan's history. Even though the government that took office in 2008 and governed for five years achieved some success in constructing a new political order, it did not make a serious effort to set the economy on a growth trajectory.

Second, as already indicated, this chapter divides its proposed strategy into two parts: the immediate and the medium term. The immediate covers a period of one year, starting on 1 July 2013. The medium term is defined as

a period of three years, starting on 30 June 2014 and ending three years later on 30 June 2017. This way, it is possible to clearly separate what needs to be done immediately. The aim of the proposed measures is to revive the economy by increasing investor confidence, slowing down and eventually stopping capital flight, and creating a new understanding with the private sector on the respective roles of the state and private enterprise. The immediate effort also aims to fill in the many institutional holes that currently exist in the economic system.

Third, given the enormous changes introduced by the passage of the 18<sup>th</sup>, 19<sup>th</sup>, and 20<sup>th</sup> amendments to the Constitution in the system of governance, our strategy provides for active roles for the provinces in the development of the national economy. The provincial efforts should take cognizance of their different inheritances and also the differences that exist in their capacity to undertake serious economic work. At this time, the fact that three of the four provinces are seriously troubled by various insurgencies also needs to be factored into the development strategy. Punjab is the exception.

Fourth, the medium-term strategy should focus on what the chapter has described as the “positives”. This strategy identifies and then discusses six such economic attributes, beginning with two of Pakistan’s economic inheritances that were largely ignored in previous development efforts—agriculture and skills-based small and medium industries. The strategy gives considerable importance to international trade and, in that context, the potential in the growing trade between India and Pakistan. Another positive is Pakistan’s location, which could turn the country into an important corridor for international commerce.

The proposed strategy also treats Pakistan’s large, growing, and young population as a positive, focusing on the demographic window of opportunity that has opened up and will remain open for several decades. However, this population will become an asset and not a burden only if it is properly educated and trained. The large number of highly trained and skilled women graduating from various institutions in the country is another positive, especially so since thousands have now become successful entrepreneurs in several modern sectors of the economy.

Finally, Pakistan’s large diaspora scattered over three continents is another positive. It is already making a key contribution by sending large amounts of money to the country as remittances. This particular type of foreign capital flow has helped the country remain afloat when several other types of flows have become highly constrained. However, the diaspora could play a number of other roles provided the stage is set by the development of certain necessary financial institutions.

Fifth, by focusing on the positives that have been identified, economic growth could become more “inclusive”. Widening income and regional disparities have become a source of great concern in recent years, not only in Pakistan but in a number of other emerging markets as well. The disparity is most glaring in districts in southern Punjab that have been left behind (see Institute of Public Policy, 2012) for which the neglect of agriculture is partly to blame. Incorporating the positives will help to bring in some segments of society and some regions in the country as dynamic components of a growing economy.

Sixth, the strategy suggests a compact with the private sector, which will give it an important role in moving the economy forward faster. The idea is not to pull back the state and leave a great deal of space for private enterprise; instead, both sectors—the government and private entrepreneurship—need to work in tandem and perform their respective roles.

## **5. Focusing on the Immediate**

This chapter takes up the subject of governance in the belief that improving it will create confidence in the economy’s future. That alone would slow down the flight of capital from the country, making more resources available for investment in the domestic economy. The Pakistani state—meaning the numerous institutions that support the working of the government and guide the public’s interaction with it—has been weakened over time. This has been the result of many factors, most notably the political rollercoaster ride Pakistan has been on ever since it became an independent state almost 66 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 toward a genuinely representative system of government. There is now national consensus that Pakistan should be governed by a system that gives voice to its diverse population; this implies the establishment of a durable political order.

*In a real sense, improving governance must be the key element of a growth strategy.* If the quality of governance had not deteriorated as much as it did in the last several years, if the strength of public institutions had not been eroded over time, and had adequate resources 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 have become increasingly intertwined. Because growth benefits were not widely shared, the quality of public services, especially education, deteriorated and the pace of poverty

reduction fell. Consequently, there was a palpable increase in social tension, with a rising frequency in ethnic, sectarian, and random violence.

Without necessarily increasing the role of the state, governance can be improved significantly by erecting a firewall between the executive authority and its accountability mechanisms, and strengthening 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, businesspersons, or military leaders. Effective steps need to be taken to decentralize authority to the local government level, initially at least for the provision of social services. There is evidence from other countries that locating government closer to the public improves the sense of accountability of those responsible for providing public services. The country also needs to make serious efforts to reform the civil service and restore the independence of public institutions through autonomy, the proper selection of top management and professional staff, and adequate pay. It should encourage the development of civil society institutions at all levels of government.

Pakistan has tried several institutional mechanisms to ensure that public officials—both elected and those belonging to the various administrative services—are accountable for carrying out the duties entrusted to them. Each institution was ultimately politicized and lost the public's confidence. Three improvements in the existing system should help restore confidence. Following the recent 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.<sup>3</sup>

Pakistan needs to draw lessons from countries where the state's weaknesses were compensated for by the development of various institutions in the private space. Bangladesh is a notable example of a country that founded several nongovernment organizations (NGOs) to provide public services that normally fall within the state's ambit. 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.

A number of analysts have also noted that Pakistan is now one of the more "giving" societies in the world, financed by donations from citizens in the country as well as those by people living and working abroad (see, for example, Najam, 2006). These charitable organizations are doing impressive work in the education sector that could become the basis for a

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<sup>3</sup> Access to such information in India led to the discovery of a number of malpractices by various government agencies, including the sale of G2 mobile phone licenses and the grant of coal mining concessions to private operators.

new approach to increasing the extent of literacy and 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 particularly active in developing this part of finance. Mobile telephone banking is another important area of economic activity in this context.

The Pakistani state's relations with the private sector 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 an enduring confidence. The government could work with the private sector to add to the amount of resources that need to be committed to developing the economy and improving public welfare. Our specific suggestions<sup>4</sup> can be summarized as follows:

- Issue a policy statement prepared in consultation with the private sector clearly defining the respective roles of the state and the private sector.
- Develop policy frameworks for the private sector's involvement in education, health, and vocational training.
- Thoroughly examine 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 in place only because they have created rent-seeking for certain vested interests.
- Formulate a program for the privatization of some of the economic assets that remain under public sector control. These include Pakistan International Airlines, the National Shipping Corporation, National Logistics Cell, and Pakistan Steel Mills. Private use of the railway system, launched recently, could also be expanded. The funds generated by these sales should be put in a new fund to be called the Future Generations Fund.

Over the years, Pakistan's energy sector has been studied from several different angles, including by the World Bank and Asian Development Bank in some detail. Both institutions have provided technical advice as well as finance for developing the sector. More recently, the energy problem has received the attention of the United

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<sup>4</sup> These suggestions draw on the Planning Commission's task force report on private sector development (see Pakistan, Planning Commission, 2010b). The author headed the task force, which included representatives of the private sector and eminent economists. See also Pakistan, Planning Commission (2011a).

States Agency for International Development. The Americans have identified the sector as one of their priority areas under the Kerry-Lugar-Berman initiative, and concentrated their efforts on the supply-side of the equation, offering assistance for several electricity generation projects. The Planning Commission was mandated to come up with a solution to ease the electricity supply shortage, which continues to cause enormous public discomfort and badly hurt the economy. Building on these analyses, the discussion below offers some ideas that could alleviate the situation in the short term as well as setting the stage for the sector's long-term development.

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 adopted a consistent approach to developing a sector that is critical for the economy's health and growth. As a result, the sources used to augment the supply of electric power did not reflect the country's comparative advantage. Each time it 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 which needs a different solution. To begin with, there is the problem of "circular debt"—a consequence of the type of contracts that were negotiated with IPPs to solve the crisis the country faced in the 1990s. The private entrepreneurs who entered the 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 Water and Power Development Authority (WAPDA) and, by default, to the government. Since the government lacked the political will to levy appropriate tariffs on the end-users, timely payments were not made to the IPPs. The circular debt became "circular" when the IPPs failed to make payments to their plants' fuel suppliers.

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

The third problem relates to the sources used to generate power, which do not appropriately reflect Pakistan's endowments. The country should have relied far more on hydropower and coal-based thermal power. According to one estimate, Pakistan could generate 100,000 MW of power using coal from the rich Thar deposits; this level of generation could be sustained for 100 years. However, the largest source used 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, while that of nuclear power is 6 percent. Coal accounts for a minuscule amount—only 0.1 percent.

In order to solve both the short-term and long-term problems faced by the energy sector, the ownership of all thermal plants operating in the public sector could be shifted to an entity that can sell part of its share to the private sector. This entity would own 4,900 MW of installed capacity, and should also issue bonds backed by its assets in order to liquidate the accumulated circular debt. The private sector should be invited to participate in the development of renewable sources of energy, in particular wind and solar energy. A beginning has been made by a private group to set up a wind power-generating plant.

Under the 18<sup>th</sup> Amendment, the provinces have the authority to invest in the development of the energy sector. This could be encouraged by the assurance that the power supply to them from the national grid would not be reduced if they were to generate significant amounts of their own supply. A market for trading power should also be developed in which the provinces could buy and sell electricity to each other.

## **6. Determinants of Sustained Long-Term Growth**

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 2011/12. This occurred notwithstanding a buoyant livestock sector and sharply rising level of milk production. The availability of water (mostly surface irrigation), which trebled between 1960 and 1990, is no longer increasing. Nor has there been any major breakthrough in the primary crop yields, which remain low.

The reasons that both productivity and output have remained low are well known, but no systematic attempt has been made to incorporate them into public policy. The areas that need the state's immediate attention are (i) increasing efficiency in the use of water, (ii) improving the use of modern technologies and basing them on Pakistan's circumstances, (iii) changing the system of incentives in order to develop a cropping pattern

that conforms to the country's comparative advantage, (iv) modernizing agricultural marketing, and (v) increasing agricultural exports to food-deficit as well as high-income countries in the neighborhood.

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 Agriculture Organization, Pakistan ranked last in a list of 26 Asian countries in terms of water availability. The country is expected to become "water-scarce"—defined as an annual availability of below 1,000 cm—by 2035, though some experts project that this could happen as soon as 2020 (Asia Society, 2009).

Much of the decline is because of global warming. Few areas in the world are suffering as much from climate change as the Himalayas, which are estimated to be experiencing a thinning of the glacier cover by as much as a meter a year. A recent report by the International Food Policy Research Institute (2012) 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 both in 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 parched communities. Most of the water they bring by truck 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.

Even more than most countries at its stage of development, Pakistan uses most of its available water for agriculture. History has a lot to do with current patterns of water use. An estimated 90 percent of the available water is used on 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" (Kugelman & Hathaway, 2009).

The solutions to the water problem are as well known as the problem itself. The two important ones are worth recalling. The first is to properly price water to reflect its scarcity; the second, to better manage 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 “earmarking” is not favored by economists, it helps to create constituencies for raising additional incomes from taxation.

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

Drip irrigation has particularly attractive characteristics. It 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 (Couton, 2009).

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, which is one reason that 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 now involved in processing and marketing agricultural products—to join hands with the government in setting up institutions devoted to research and extension.

Small and medium industrial enterprises are another area with high potential that public policy has neglected. Whenever public policymakers have turned their attention to industrialization as a driver of growth, they have tended to focus on large-scale industries. That notwithstanding, Pakistan has a long-established tradition of producing consumer manufactures as well as parts and components for larger products. Some clusters have developed in several parts of the country that specialize in different products: sports and leather goods in Sialkot, electrical appliances in the Gujranwala–Gujarat corridor, armaments in the vicinity

of Peshawar, and ceramics in Hyderabad. Some of the newer developments are fashion houses in major cities such as Karachi and Lahore that design, produce, and market their products. The automobile vending industry has also developed to facilitate the production of cars and trucks. Government policy has encouraged this industry by requiring automobile manufacturers to comply with what was called the “deletion” policy—the policy to force manufacturers to progressively use domestically produced components in finished products.

There are a number of sectors in modern parts of the economy where women now make up a significant part of the workforce. These include traditional areas, such as teaching and medicine, in which educated women have been active for decades. However, more recently, as the number of highly skilled women has increased, they have begun to take positions in sectors such as banking, communications, law, and politics. They also now make up a significant proportion of the workforce in companies engaged in information technology (IT). Some IT experts estimate that tens of thousands of women are engaged in this sector in what they call “cottage businesses”: women with good computer skills work from their homes undertaking small contractual work for family members or friends who are living and working abroad. Some estimates suggest that more than USD 1 billion worth of work is carried out in these informal establishments. These are, by and large, one-person shops that receive payments through informal transactions. However, it is the entry of women in the entrepreneurial field where the real revolution is occurring.

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

A recent *Financial Times* article draws the world’s attention to the role the private sector is playing in delivering a variety of services to the poorer segments 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” (Leadbeater, 2012). The article also points out the important role of private charity in helping the poor, which was evident at the time two floods hit the country in 2010 and 2011.

The private sector has done extremely well in the sphere of education. Low-cost private sector schools, charging perhaps USD 2 a week, are booming in slums and villages. Many such schools work in the homes of families whose female members have received a 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, which is 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 work equally well. In other words, while the demand for education has outpaced the state's financial and organizational capacity to meet such basic needs as education, the private sector has shown it is capable of filling 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. To begin with, the provinces should be encouraged to privatize some of the educational facilities in the public sector that are, at best, providing indifferent education. Some of the state universities could be sold to the private sector on the condition that the new owners and operators follow the curricula developed by the state in collaboration with educationists from the private sector. In order for poor households to access private universities, the state could finance a subsidized student loan program through the banking sector. Several countries in Latin America—most notably Mexico, assisted by the World Bank—have successfully tried a similar approach. The same approach could be followed in the health sector with the provincial governments selling some district hospitals to private operators.

Helping women to become active participants in developing and modernizing the economy has to be an important part of the long-term growth strategy. Women's assigned roles serve as drags on the economy. They affect the rate of growth in output, keeping it lower than would be if women were to participate more actively in the labor force. Economists have not factored into their analyses the role that Pakistan's women can play in developing their country if their participation in the workforce was to increase and if their productivity was up-scaled through better education. If women figure in economic writings on Pakistan at all, it is usually to highlight how far behind they have been left 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, particularly in terms of their participation in the workforce. Most of the work they do in their homes or the time they spend looking after household livestock is either not reported or not fully counted. In writings on Pakistan, both the negative and positive consequences of the lack of progress in improving women's wellbeing have not been fully investigated.

Exports are another area of government neglect. Development strategies followed by various administrations in the country did not pay attention to the export sector's potential role as a driver of growth—something the “miracle economies” of East Asia did. This neglect has resulted in reducing the share of Pakistani manufactures in world trade (Institute of Public Policy, 2008). Additionally, by focusing on exporting textiles to the West, Pakistan has not benefited from the enormous increase in size of the East Asian economies.

The gravity model of trade suggests that Pakistan should trade more with the large countries in its immediate neighborhood—China and India. Islamabad has signed a free trade agreement with Beijing, which has led to a large increase in bilateral trade, but Pakistan now has a large negative balance with China. In order to correct this, public policy should aim to develop supply chains that will link up with China's large industrial sector. These chains, as already indicated, should take advantage of the entrepreneurship that exists in the small and medium engineering sector.

The same approach should be followed to develop trade with India. The recent thawing in relations between the two South Asian nations should add significantly to their growth, particularly in Pakistan's case. Burki (2011) estimates that, if India-Pakistan trade reverts to the share it had in total trade in the late 1940s and using the established elasticities, Pakistan's rate of GDP growth could increase by 2.4 percentage points over a decade and a half. The possibilities of expanding trade with India thus 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.

Chinese manufactured exports have risen nearly two-hundredfold 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 is probably lower now than it was in 1970.

The ratio of the total export of goods and services to GDP also underlines Pakistan's failure to orient its economy toward exports as the engine of global growth. There are several reasons why Pakistan has not succeeded in the export field. First, the country's governments did not factor in international commerce as part of their development strategies. Second, Pakistan has the least diversified manufactured exports among the major developing countries because policymakers have focused excessively on its principal manufactured exports—textiles and clothing—and propped up this sector artificially for a long period by setting the domestic price of cotton well below the international price. Third, 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. Finally, political tension with its large neighbor India, which should be the country's natural trading partner, has limited cross-border trade. Pakistan has also not availed fully the potential of its close relationship with China to promote exports: indeed, as mentioned above, it has a large trade deficit with its large neighbor.

Finally, a growth strategy should factor in the role the Pakistani expatriate community can play in the development of what was once their homeland. Migrations have been important in shaping Pakistan, in particular the country's economy. Millions of people have crossed the country's borders and settled in various parts of Pakistan, affecting their lives as well as those of the host population. Millions have also left the country and gone abroad, creating large communities of Pakistanis in three geographic areas.

There are large Pakistani diasporas in Europe, the Middle East, and North America; two others are in the process of being formed in Southeast Asia and Australia. While the exact number of Pakistanis living abroad is not known, there are perhaps some 8 million people of Pakistani origin who now live outside the country. This is equivalent to 4.2 percent of the Pakistani population, making it one of the larger diasporas in the world. There are 25 million Indians in the various diasporas they form across the globe. The number is large but the proportion, at just over 2 percent of India's population, is less than half that of Pakistan.

The outward movement of Pakistanis started with mostly unskilled workers going to Britain to work in the country's textile mills. Once Britain began to recover from the ravages of the Second World War, it did

not have enough labor of its own to bring back to life the textile mills that had been closed down so that their workers could join the armed forces. The next large diaspora to be formed was in the Middle East in response to the opportunities created there in the 1970s and 1980s. Then, following the increase in the price of oil, a construction boom started in the oil-exporting countries—Pakistan was one of the main contributors to their needed labor force. The third large diaspora was formed in the US when the country, faced with a severe shortage of certain skills, allowed immigrants to enter the stressed labor market. Doctors, in particular, were in great demand. The North American Pakistani diaspora is different from the other two in that it comprises people with high skill levels. The average per capita income of this group is some 10 to 15 percent higher than the American and Canadian averages.

These three diasporas probably have a combined annual income of USD 100 billion or about half Pakistan's GDP. They now remit about USD 15 billion or about 15 percent of their total income, most of which is by way of charitable contributions or help provided to family members needing financial support. Additional amounts should become available if the government in Pakistan could create an investor-friendly environment. Doubling this amount over a period of five to eight years should be possible as the diaspora's asset base continues to expand. Using investments such as venture capital funds and private equity funds could channel finance into areas in which the expatriate community has considerable expertise. This additional flow could add 1 to 1.5 percentage points to the rate of GDP growth over the medium to long term.

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*A Country and an Economy in Transition*

## Tackling the Energy Crisis

Afia Malik\*

### 1. Introduction<sup>1</sup>

This chapter aims to discuss the crisis of the power sector in Pakistan—its origin and challenges—and, most importantly, to suggest strategies and possible solutions for coping with it. A sufficient energy supply is indispensable for all economic activity and for ensuring sustainable economic growth and development. Regrettably, Pakistan's power sector is beset by a crisis with the demand–supply gap growing continuously to unmanageable proportions. The electric power deficit has crossed the 5,000 MW level many times during 2011 and 2012; in the second week of June 2012, this shortfall had surpassed 8,000 MW.

The main reason for this growing gap is not only the rising demand and high system losses, but also the declining generation capacity. Seasonal reductions in the availability of hydropower, reductions in indigenous gas resources, the country's heavy reliance on imported fuel oil for power generation, and forced power outages due to capacity degradation or scheduled outages for the maintenance of existing power plants are all responsible for the declining generation capacity. The unavailability of oil—given the economy's mounting circular debt as the government fails to adjust energy prices to reflect supply cost—has only accentuated the energy crisis.

Energy demand has increased significantly over the last ten years, but unfortunately, supply has failed to respond to this expansion in demand. As a result, economic growth has been severely affected. Not

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only has production been badly hit, consumers of all ages have lost patience, even resorting to violence and destruction of public property in many urban centers in the country. According to one estimate, power shortages have resulted in an annual loss of about 2 percent of gross domestic product (GDP) (Abbasi, 2011).

The poor economic management of the power sector in Pakistan has created serious problems for fiscal managers, given the limited available budgetary resources and the need to put aside a substantial portion of revenues in subsidies given to the power sector. As much as 7.6 percent of total revenues were used up in providing subsidies to the power sector in 2007/08. This share increased to almost 15 percent in 2010/11 because of an enormous slippage of 146 percent (i.e., an unpaid power tariff differential subsidy from previous years) adjusted for a one-off payment of PRs 120 billion. In 2011/12, this share jumped to almost 18 percent, again, due to a one-off payment of PRs 312.8 billion and PRs 78.2 against previous years' unpaid power sector subsidies and commodity operations, respectively.

Since assuming power in 2008, the government then in office pledged not just to reduce power outages but, in the earlier years of its term, to eliminate them. Recognizing the magnitude of the crisis and its effect on the people and economy, the government initiated significant reforms, including tariff increases, to manage the crippling impact of the power sector crisis. Unfortunately, these reforms were not only inadequate, but the wrong priorities were set and many of the reforms were abandoned for lack of focus, perseverance, and most importantly, political will. Poor governance practices, including rampant corruption, have prevented progress in this vital sector. As a result, after more than four years, the problems in the system have been aggravated rather than being resolved.

It is generally believed that the present crisis is a self-imposed problem ensuing from years of bad management, lack of proper vision, and poor policies. Failure to formulate a coherent energy policy has affected the country's economic performance. The stark truth is that Pakistan's policymakers have always focused on short-term goals, followed inconsistent and disorganized financial strategies, and repeatedly made the wrong choices.

This chapter will highlight the genesis of this problem and suggest means for overcoming the energy crisis overall—specifically, the power sector crisis—to help bring the economy back on track and return to a sustainable economic growth path. The chapter is organized as follows: after an overview of the electricity sector in Section 2, Section 3 discusses the beginnings of the power sector crisis in Pakistan. Section 4 analyzes the challenges faced by the energy sector. Section 5 discusses various

options to tackle these challenges and secure energy supplies in the short, medium, and long run. The final section lists the main conclusions.

## **2. The Electricity Sector: Demand and Supply Analysis**

Over the past decade, supply has failed to keep up with demand. For instance, from 2000/01 to 2011/12, consumption grew by almost 50 percent, while supply, i.e., generation, increased by only 40 percent. However, the percentage increase in the total installed power generation capacity in this period was only 25 percent.

In 2011/12, the total installed power generation capacity was estimated to be 23,538 MW. Out of this, 16,035 MW was thermal (68.1 percent), 6,716 MW was hydroelectric (28.5 percent), and 787 MW was nuclear (3.4 percent). Since 2007/08, under the Pakistan Peoples Party (PPP) regime, installed capacity has grown at a rate of almost 4 percent, which is relatively high compared to 2 percent under the previous government's tenure (2000/01 to 2006/07). The addition to installed capacity in the last four years (2007/08 to 2011/12) has occurred not only as a result of captive power plants (set up by business enterprises to meet their unmet demand, increasing their capacity from 239 MW to 324 MW), but also by independent power producers (IPPs) (increasing from 6,035 MW to 8,560 MW), which were commissioned under the previous regime. In addition, a second nuclear power plant with a capacity of 340 MW was added to the system at CHASNUPP.

On the generation side, however, the situation has been quite alarming in the last five years. The increase of 40 percent (as mentioned above) in actual generation from 2000/01 to 2011/12 can rightly be attributed to the growth in generation from 2000/01 to 2006/07 by almost 6 percent because of better utilization of the available capacity. However, in the last five years (2007/08 to 2011/12), the growth in generation has been only 0.33 percent. The main reasons for this depressing performance include the unavailability of fuel, weather-related water shortages, and the aging of thermal power plants in the public sector. For example, the shortage of gas, smaller water releases from the Indus River System Authority (IRSA), and the annual maintenance shutdown of thermal and nuclear power stations were the main reasons for the decrease in generation in 2008/09 (Pakistan, Planning Commission, 2009). Similarly, in 2010/11, total electricity generation declined by 5 percent compared to 2009/10, as generation from thermal sources—gas and furnace oil—

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declined by 18 percent and 11 percent, respectively, due to the lack of gas and furnace oil supplies<sup>2</sup> (State Bank of Pakistan, 2011).

**Table 5.1: Power sector performance: Some technical indicators**

Year	Total installed capacity (MW)	Total generation (GWh)	Consumption (GWh)	Peak power deficit/surplus	
				In PEPCO system (MW)	In KESC system (MW)
2000/01	17,689	70,132	48,584	465	-
2001/02	17,798	72,405	50,622	435	-
2002/03	19,257	75,682	52,655	-86	-
2003/04	19,522	80,731	57,491	236	-
2004/05	19,550	84,710	61,328	194	-
2005/06	19,561	92,892	67,607	-1,247	-
2006/07	19,692	97,814	72,040	-1,846	-66
2007/08	20,232	97,369	72,770	-4,396	-178
2008/09	20,556	94,647	69,659	-4,215	-59
2009/10	21,614	99,766	73,561	-5,716	-169
2010/11	23,327	100,582	73,806	-5,328	-328
2011/12	23,538	98,664	73,085	-6,325	-193

KESC = Karachi Electric Supply Corporation, PEPCO = Pakistan Electric Power Company.

Source: National Electric Power Regulatory Authority (*State of industry report for various years*) and National Transmission and Despatch Company (*Power system statistics for various years*).

### **3. The Roots of the Power Crisis in Pakistan**

The country started with a power generation capacity of 60 MW at the time of its independence in 1947. In the first ten years, by the end of the 1950s, this had increased to 100 MW. In the 1960s, after the establishment of the Water and Power Development Authority (WAPDA), power infrastructure development gained momentum and by the end of the decade, generation capacity was almost 1,234 MW. In the 1970s and 1980s, it rose sharply and reached a level of 9,651 MW in 1993/94.

<sup>2</sup> The supply deficit of natural gas to KESC and a number of IPPs affected generation during the winter of 2010/11, while financial problems hindered the import of furnace oil, thus disturbing power generation at the beginning of summer.

The overall performance of WAPDA and the Karachi Electric Supply Corporation (KESC), the two leading public sector utilities at the time, remained satisfactory till the mid-1980s. Heavy financial losses due to unwarranted political interference, the corrupt management of limited capital resources, overstaffing and bureaucratic delays in handling routine matters in these public utilities, inappropriate and costly investments, poor-quality services, high system losses, and the poor collection of bills from customers all negatively affected the industry's financial health (Malik, Mahmood, & Ahmed, 2009).

In addition, severe constraints to the availability of capital did not allow the increase in supply of electricity to keep pace with demand during that period (the mid-1980s to early 1990s), which grew consistently at 9–10 percent per annum. On the demand side, there was a weak link between electricity price and demand, which resulted in poor demand management. As a result, the early 1990s witnessed an excessive shortage of electricity, especially for industrial and commercial consumers.<sup>3</sup>

The sector's overall operational inefficiency created a need for restructuring. Thus, under pressure from international financial institutions (the International Monetary Fund, World Bank, and Asian Development Bank), the government started a reform process in the sector. The power policy of 1994 helped to overcome load shedding in the country. It also resulted in surplus power since the actual load growth was far smaller than projected and the projects were contracted beyond what was required.

However, the policy's major drawback was that it attracted only thermal power projects, resulting in a larger share of thermal power in the overall generation mix. The share of hydropower in the national electricity supply mix fell—its contribution to the total electricity generation mix decreased from 60 percent in 1962/63 to less than 29 percent in 2011/12.<sup>4</sup> Although the policy encouraged private sector participation, the generation mix has not been managed sensibly. IPPs entered the market, increasing the generation capacity but predominantly through furnace oil. This trend has continued over the past decade as additional incentives were provided to the power sector under the 2002 policy.

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<sup>3</sup> Load shedding of up to 30 percent of peak demand (National Electric Power Regulatory Authority, 2001).

<sup>4</sup> Even in 1990/91, the share of hydropower in the total generation mix was 45 percent. After IPPs were introduced into the system, the share of hydropower declined drastically since there was no substantial addition to its potential after the initiation of power sector reforms in the mid-1990s.

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Until 2002, this policy worked reasonably well because oil prices in the international market remained low, ranging between USD 10 and USD 25 per barrel. After the United States' invasion of Iraq in 2003, however, the international price of oil started rising and so did the cost of generation through thermal power plants (A. H. Khan, 2012). In 2011, almost 55 percent of the country's thermal plants were operating on furnace oil, while the remaining plants required natural gas to generate electricity. Consequently, the generation cost of electricity is now exposed to fluctuations in global oil prices since the dependence on imported furnace oil has increased over time (State Bank of Pakistan, 2011).

The second significant reason for the current crisis in the power sector has been the rising demand for power. After a moderate growth rate of around 4 percent per annum in the second half of the 1990s, growth in the demand for electricity during the first seven years of the 2000s was around 7 percent. Electricity demand grew by 3 to 4 percent annually up to 2003/04, increasing sharply in subsequent years and reaching 10 percent in 2007/08. The increase in demand, however, reflected the economy's expansion. Growth in demand requires substantial investment to maintain the continuity of supply, which in this case did not, unfortunately, happen. According to one estimate, every 1 percent of GDP growth in Pakistan requires an increase of 1.25 percent in electricity supply. Thus, GDP growth of 7 percent (as in 2002–07) would have required an increase of 8.8 percent (Merrill Lynch, 2007; cited in United States Agency for International Development, 2007). However, in that period the installed capacity grew at a rate of only 2 percent, despite 6 percent growth in electricity supply. The slow growth in installed capacity in this period led to the decline in the supply of electricity (generation) in subsequent years.

Unfortunately, the growth in demand during this decade was clearly not fully anticipated, and there was insufficient investment to accommodate the increased demand. Moreover, the presence of surplus power in the first half of the decade made the government complacent rather than inclined to take serious policy initiatives. Not only was the new capacity slow to grow, power plants were as slow in being upgraded—a task that could have been accomplished at one third of the cost of expansion. The power sector's share in public sector development programs fell to less than 3 percent of GDP during this decade, although it used to be higher (Pasha, 2010). Moreover, the public sector was not allowed to add any new capacity (thermal), meaning that there were no capacity additions in this decade.<sup>5</sup>

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<sup>5</sup> In 1987, a one-page notification barred WAPDA from initiating thermal generation.

Another important issue that had a negative impact on the electricity supply chain was the lack of timely and essential maintenance of existing plants, specifically in the public sector. This neglect on the part of the authorities significantly reduced the efficiency of existing plants. The capacity of state-owned thermal generation plants has since fallen regularly due to lack of proper maintenance.<sup>6</sup> There was no significant investment in the 2000s in the existing generation companies (GENCOs), affecting the operational performance of their power plants and their ability to supply power to the grid. As a result, of the old plants' total installed capacity (522 MW)—in GENCOs commissioned in the 1960s or early 1970s—the available capacity fell to 256 MW (National Electric Power Regulatory Authority [NEPRA], 2011).

Thus, the power sector in Pakistan has not only failed to add to the generation capacity, it has also been unable to use the existing power plants to their full potential. Table 5.2 shows that the fuel cost per unit is substantially high in the public sector (GENCOs). In 2000/01, the fuel cost was lowest for GENCOs, but in 2007/08 it was highest compared to the private sector, indicating the inefficiency of power plants used in public sector GENCOs.<sup>7</sup>

**Table 5.2: Fuel cost in public and private utilities (paisas/kWh)**

Year	GENCOs	KESC	IPPs
2000/01	177.33	221.75	184.10
2003/04	193.29	213.45	178.08
2004/05	214.87	248.38	187.13
2005/06	293.93	320.28	235.31
2006/07	366.31	350.10	288.88
2007/08	468.01	347.99	264.73

Source: Hydrocarbon Development Institute of Pakistan (*Pakistan energy yearbook* for various years).

Clearly, greater investment is required in response to a continuous increase in electricity demand, directly linked to economic growth. The starting point for this should be correctly priced power consumption. The basic consideration for investment decisions by the private sector in any country is the price of electricity that generates sufficient profits to supply

<sup>6</sup> The government allows IPPs to charge PRs 0.45 per unit as operation and maintenance charges, while GENCOs are allowed to charge only PRs 0.08 per unit (Ali, 2012a).

<sup>7</sup> GENCOs' present ability to produce power is almost 20 percent less than their installed capacity, mainly due to the aging factor and use of furnace oil (WAPDA, 2007).

power in a cost-effective manner. Unfortunately, appropriate tariff reforms were not introduced in Pakistan in this period (2000–07). The notified electricity tariffs were below cost-recovery level.

The previous military government did not allow electricity prices to rise in line with the steep increase in international oil prices<sup>8</sup> for political reasons. In fact, tariffs were frozen between 2003 and 2007 at a very low level. The cost of electricity generation rose (as discussed above, due to the rising price of oil in the international market) but, unfortunately, the notified tariffs were not sufficient to cover the higher cost. The high commercial and technical losses suffered by distribution companies (DISCOs) also added to the cost of service. It is interesting to note that system losses (including transmission and distribution [T&D] losses, and auxiliary consumption) were also very high in the same period that the country had surplus electricity.<sup>9</sup> This indicates the low level of managerial focus in utilities on operational efficiency when there was surplus production.

Since there was a huge gap between the cost of service and the government-notified uniform tariff across all DISCOs, the government had to provide a tariff differential subsidy to power companies to bridge the gap. However, it did not compensate the latter accordingly against the provision of increasingly subsidized electricity at the consumer end. This left the power companies unable to make payments to the oil companies; the oil companies, in turn, were left unable to import the oil needed for thermal power plants.

The problem of circular debt arose in 2006 as a consequence of below-cost tariffs. Had cost-effective electricity tariffs been introduced at the right time, they might have suppressed the growth in domestic demand to some extent and helped attract new investment. Additionally, cost-effective prices might have protected the power sector from the inter-corporate circular debt problem it now faces.

#### **4. Present Challenges**

At present, the power sector in Pakistan faces a number of very serious issues, which need to be resolved for the sector to progress. This section analyzes these issues in detail.

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<sup>8</sup> The price of imported furnace oil, which represents about a third of the fuel mix for power generation, increased by 76 percent from 2003/04 to 2007/08. Similarly, global gas prices also rose considerably in that period.

<sup>9</sup> More than 25 percent—the average for the whole country.

#### **4.1. Circular Debt**

The electricity sector has been seriously affected by inter-corporate debt. Besides creating budgetary problems, this has badly affected the power sector. As indicated earlier, the problem of circular debt emerged in 2006 but was aggravated in 2010 and power outages increased to an alarming level. The failure of the Pakistan Electric Power Company (PEPCO) and KESC to clear their dues to fuel suppliers and IPPs is a result of their (DISCOs') inefficiency in collecting revenues, T&D losses, and below-cost power tariffs (issues discussed in detail in the later subsections). As a consequence, most thermal power plants are forced to operate at a very low 'capacity factor', thus causing a massive increase in power load-shedding. The country has lost between 2,000 and 2,500 MW of potential thermal power generated by private power companies that have remained off-grid due to the nonavailability of fuel supply, coupled with the lack of funds brought about by swelling dues (Asian Development Bank [ADB], 2010; Bhutta, 2011). This debt issue has had serious consequences for downstream energy sector companies.

Since the problem arose, the amount of circular debt has continued to fluctuate between PRs 100 billion and over PRs 400 billion, owing to reductions in recovery and the failure to retrieve fines from power thieves. Till April 2011, the net circular debt was PRs 258.5 billion, compared to PRs 103.9 billion in April 2009, indicating an increase of almost 147 percent. Only 86.5 percent was recovered in the fiscal year 2010/11 compared to 104.3 percent in 2009/10. In May 2012, the overall circular debt amount stood at more than PRs 420 billion.

The government has attempted to address the issue of circular debt but on an ad hoc basis by pumping in money up to fivefold (PRs 1,122 billion in the last four years) to rescue the system from total collapse, but it has not been successful in clearing the total debt stock. So far, it has failed to work out a mechanism to permanently curtail the accumulation of debt, and it has not been strict with defaulters.<sup>10</sup> Instead, the continual injection of money has meant that the government borrows billions of rupees from commercial banks through various instruments to make partial payments against the debt to reduce it to a manageable limit. Generally, the default amount is larger than the government's capacity to pay at a given time, with the result that circular debt continues to build up.<sup>11</sup>

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<sup>10</sup> Extremely low collection compared to what DISCOs require has increased the amount of receivables by almost PRs 100 billion from PRs 285.846 billion in 2010/11 to PRs 385.619 billion in 2011/12.

<sup>11</sup> In 2011/12, despite fiscal constraints, the government paid PRs 391 billion for the unpaid tariff differential subsidy of previous years.

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Circular debt not only affects the available capacity, the creditworthiness of the country/sector in investors' eyes is also badly affected, as reflected in the higher security demanded for rental power plant (RPP) payments (ADB, 2010).<sup>12</sup> This deep-rooted problem demands that not only the government but also consumers and power (generation and distribution) companies take serious initiatives to resolve it completely.

### **4.2. Pricing Policy**

One of the main factors to have aggravated the circular debt problem is the inability of DISCOs to pass on the cost of electricity to consumers. Given that 68 percent of our electricity generation is thermal-based—where 99.8 percent relied on imported oil and gas<sup>13</sup>—the impact of almost frozen tariffs (from 2003/04 to 2006/07) was so large that the increase in tariffs in subsequent years could not make up for the cost price deficit. Even after 2007, government-notified tariffs remained below those determined by NEPRA (on the basis of cost) (Table 5.3)—i.e., too low to cover the average costs of the power companies. As a result, the companies started to incur losses that eventually reached unmanageable levels. In 2011/12, the gap between NEPRA-determined tariffs and government-notified tariffs crossed PRs 3 per unit (Table 5.3), which has added to the subsidy responsibilities of the government.

In addition to inefficient and below-cost recovery tariffs, the system of electricity subsidies<sup>14</sup> is a major source of inter-corporate circular debt, that is, not only the inability of the DISCOs to pass on the cost of electricity to customers, but also the inability of the government to pay the tariff differential subsidy (the difference between the applied tariff and the determined tariff) in a timely manner. In the absence of extremely heavy subsidies, PEPCO has delayed payments both to the IPPs and the oil

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<sup>12</sup> A 7 percent mobilization advance was envisaged for RPP sponsors with a supporting standby letter of credit (SBLC). However, given the financial crisis, it was difficult to open confirmed SBLCs due to high confirmation charges, which were between 6 and 8 percent, and additional expenditure for each year of currency. Thus, the Ministry of Finance allowed the mobilization advance to be raised to 14 percent with a guarantee from the Government of Pakistan in lieu of a confirmed SBLC (for details, see ADB, 2010).

<sup>13</sup> Domestic gas resources are being depleted and, therefore, reliance on imported oil is increasing.

<sup>14</sup> The government provided subsidies worth PRs 342 billion to the power sector against total federal development spending of PRs 280 billion in the outgoing fiscal year.

companies.<sup>15</sup> The lack of funds with which to purchase oil has meant that the IPPs are producing electricity far below capacity (low plant factor).<sup>16</sup>

**Table 5.3: Average electricity tariffs (PRs/kWh)**

<b>Tariff effective</b>	<b>NEPRA-determined</b>	<b>Government-notified</b>	<b>Gap</b>
24 February 2007	5.14	4.25	0.89
1 March 2008	5.60	4.78	0.82
5 September 2008	8.42	5.58	2.84
25 February 2009	8.42	5.63	2.79
1 October 2009	8.42	5.96	2.46
1 January 2010	10.09	6.67	3.39
2010/11	9.58	7.78	1.80
2011/12	11.89	8.72	3.17

*Source:* National Electric Power Regulatory Authority (2010, 2012) and Trimble, Yoshida, and Saqib (2011).

The current mechanism for determining tariffs operates on the basis of the minimum cost of generation.<sup>17</sup> Further, the presence of a tariff differential subsidy serves as a disincentive to DISCOs, which continue their inefficient practices. To avoid provoking a political reaction in the smaller provinces, the government has followed the uniform tariff principle despite the fact that some DISCOs incur line losses above 30 percent. If different DISCOs were charged different tariffs, profitable DISCOs would be in a position to buy more power for their consumers.

Determining the appropriate tariff appears to be a simple matter of demand and supply, which could be easily resolved. However, given the

<sup>15</sup> For instance, on 8 August 2011, the IPPs warned they would shut down power plants within ten days unless the government injected PRs 150 billion into the companies that had stock left for a maximum of three days.

<sup>16</sup> At present, the IPPs and GENCOs are averaging about a 50 percent plant factor, which means that they are not being used to their potential level. A higher plant factor in these power stations could provide 20 to 30 percent more energy, which would circumvent the present shortages to a certain extent. Improving the plant factor is far more economical than setting up new plants. The plant load factor in India has increased continuously and reached almost 78 percent.

<sup>17</sup> The government issues consumer-end tariffs where the minimum consumer-end tariff for a particular consumer category among eight DISCOs is adopted for application across the board to all DISCOs. NEPRA determines consumer-end tariffs for each DISCO on the basis of its consumer mix, losses, and operational cost. The tariff so determined is different for each DISCO because of its peculiar conditions.

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nature of this particular product,<sup>18</sup> it has become a complex issue. Appropriate policy decisions by the government in this area would help improve tariff imbalances and resolve the implicit subsidy issue for the benefit of most stakeholders including consumers (Trimble, Yoshida, & Saqib, 2011).

Further, the major drawback of tariff differential subsidies is that they are not appropriately targeted. Poor customers (small users) have benefited the least from this subsidy. This is because the majority of rural customers are lifeline customers (extremely small users) and experience load shedding for up to 20 hours, but the allocation of the tariff differential subsidy to them is only 0.42 percent of the total. More than 60 percent of the subsidy is allocated to consumers of more than 100 kWh (Friends of Democratic Pakistan [FODP], 2010).

The PPP government (2008–13) deserves some credit for taking the hard decision to regularly revise power tariffs in line with international oil prices on a quarterly basis to recover the cost of power despite political compulsions and severe criticism. Yet, and importantly, this increase is insufficient as the government is still paying subsidies to cover the cost. Moreover, to accommodate the changes in oil prices more frequently, the government has decided that monthly fuel adjustments should be passed on to the DISCOs. Meanwhile NEPRA is to determine consumer-end tariffs on a quarterly basis.

In the last two years (2010/11 and 2011/12), a significant increase in tariffs has taken place.<sup>19</sup> One change to the tariff structure includes the imposition of general sales tax (GST) on the consumption of more than 100 units of electricity. Another significant step has been the elimination of cross-subsidies to a certain extent from commercial and industrial consumers to agricultural and domestic consumers, as the domestic tariff is now greater than the industrial tariff. This is important because domestic customers consume more than 45 percent of electricity. Additionally, the tariff structure has generally become more progressive—at higher levels of consumption, it is more expensive. For domestic consumers, the price of electricity is now greater than the cost of supply in the two highest slabs. However, this does not significantly reduce the fiscal burden since only a low volume (4 percent) is consumed in the higher slabs (Trimble et al., 2011).

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<sup>18</sup> For instance, ownership and control of utilities, technology, and fuel used for power generation, government taxes on different fuels, and on electricity.

<sup>19</sup> From March 2010 to September 2011, a 125 percent increase in the power tariff, in addition to the transfer of fuel costs to consumers every month.

The International Monetary Fund has demanded an end to the subsidy to the power sector to make it financially viable. However, this is only a partial solution—it is argued that merely increasing the power tariff has not worked, is not working, and will not work in the future, unless the inefficiencies in the power system are removed. Relying solely on tariff increases will just lead to more inefficiencies, and to theft and corruption (A. H. Khan, 2011). The reason is that a large part of this subsidy is rooted in the corruption and incompetence of the management in the collection of bills, no real effort to control power theft, poor fuel choice, and complete apathy in facing the problems of a degraded generation and T&D system (Umar, 2011).

#### **4.3. T&D Losses**

Consumer-end tariffs are highly sensitive to losses in T&D systems. With every percentage increase in losses, the tariff increases exponentially as the cost of production goes up. The safe and reliable T&D of electricity remains a major problem in Pakistan. The situation of huge power losses from T&D networks and auxiliary consumption over the years has hardly improved. In fact, it deteriorated in the early half of the 2000s (Table 5.4).

**Table 5.4: T&D losses in DISCOs (%)**

<b>Company</b>	<b>2006/07</b>	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>
IESCO	12.17	10.29	10.51	9.81	9.75	9.52
LESCO	12.71	12.85	13.23	13.78	13.22	13.51
GEPCO	11.63	11.14	10.72	10.98	11.96	11.24
FESCO	11.19	11.20	10.59	10.48	11.25	10.91
MEPCO	19.28	18.49	18.37	18.94	18.29	17.94
PESCO	35.74	36.06	37.40	36.91	37.25	35.97
HESCO	36.90	35.86	34.75	34.79	28.58	27.73
QESCO	21.37	20.79	20.12	20.68	20.40	20.87
SEPCO*	-	-	-	-	39.76	39.51
KESC	34.20	34.10	35.86	34.89	32.14	29.71

*Note:* \* SEPCO data was included in HESCO prior to 2010/11.

IESCO = Islamabad Electric Supply Distribution Company, LESCO = Lahore Electric Supply Distribution Company, GEPCO = Gujranwala Electric Supply Distribution Company, FESCO = Faisalabad Electric Supply Distribution Company, MEPCO = Multan Electric Supply Distribution Company, PESCO = Peshawar Electric Supply Distribution Company, HESCO = Hyderabad Electric Supply Distribution Company, QESCO = Quetta Electric Supply Distribution Company, KESC = Karachi Electric Supply Corporation.

*Source:* National Electric Power Regulatory Authority (2010, 2011, 2012).

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In comparison to other Asian countries, these losses are extremely high. For instance, in the Republic of Korea, T&D losses are only 3.6 percent; in China, they are 8 percent; while in the OECD countries, T&D losses are just 7 percent.<sup>20</sup> Of the total T&D losses, distribution losses account for almost 68 percent while the remaining are transmission losses. Of the 68 percent of distribution losses, a significant portion occurs through electricity theft. During 1985/86 to 1994/95, the units of electricity supplied that were also billed grew at a rate of 9.8 percent, while during 1994/95 to 2006/07, the units billed grew at 5.4 percent. Over the period 2007/08 to 2009/10, the units billed increased at a rate of less than 2 percent, thus, indicating the inability to curtail power theft.

Except for IESCO, LESCO, GEPCO, and FESCO, the other DISCOs (MEPCO, PESCO, HESCO, QESCO, and KESC with a combined 30 percent consumption of the total) have extremely high losses, ranging from 18 to 37 percent. The major portion of these losses is due to theft. Over the years, there has been no progress in minimizing power theft or overcoming technical constraints. Companies with high system losses also suffer from low recoveries of the billed amount.<sup>21</sup> For instance, in 2011/12, PESCO's losses were almost 36 percent and its recovery 82 percent; HESCO had losses of 29 percent and its recovery ratio stood at 69 percent; SEPCO with losses of almost 40 percent recovered only 51 percent of the billed amount; QESCO recovered only 36 percent of the billed amount; and IESCO, LESCO, GEPCO, FESCO, and MEPCO recovered between 95 and 98 percent.<sup>22</sup> These inefficiencies in the DISCOs have not only affected their financial position but led to an additional unjustified cost to those consumers who pay their bills regularly or to the government in the form of a tariff differential subsidy.

The difference of roughly around PRs 2/kWh between the NEPRA-approved average tariff and the average tariff charged to consumers is because of system losses. According to the Ministry of Finance, successive cash injections by the government have impeded power companies' efforts to improve their governance and efficiency, and reduce their

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<sup>20</sup> Although in neighboring India, the situation is more or less similar to Pakistan as T&D losses are close to 27 percent.

<sup>21</sup> This means that DISCOs with high system losses are so inefficient that not only are they unable to curtail theft/leakages in electricity transportation from grids to end-consumers, they are also unable to collect what is documented in the bills. There is also the apprehension that DISCOs sometimes resort to excessive billing to give a better impression of their losses. NEPRA has thus advised them to introduce an automated meter reading system so that their losses are better accounted for (NEPRA, 2012).

<sup>22</sup> According to an unofficial estimate, the government failed to collect PRs 495 billion in electricity bills between July 2011 and May 2012, taking the recovery ratio to 47 percent—one of the lowest ever in the country's history.

losses. Whenever power companies face problems, the federal government extends financial help out of the national budget or by increasing tariffs, resulting in more inefficiencies and system losses. Given that a 1 percent system loss translates into PRs 6.5 billion, all DISCOs (excluding KESC) are losing roughly PRs 130 billion a year through system losses alone despite the increase in consumer tariffs. Therefore, genuine efforts must be made to reduce these losses. If losses are reduced by even 5 percent, over PRs 30 billion will be saved.

#### **4.4. Fuel Mix in the Power Sector: Shift from Low-Cost Generation to High-Cost Generation**

At present, of the total installed generating capacity, about a third is accounted for by hydropower and two thirds is thermal-based (nuclear power has a minor share). Over the last three decades, a sluggish approach toward building large dams together with the 1994 Power Policy (as discussed earlier) that attracted only thermal power plants has caused the share of hydropower in the national electricity supply mix to fall. This has increased the overall cost of generation in Pakistan.

Hydroelectric power stations are classified as the most efficient power plants because they can have an operational efficiency of up to 90 percent given the availability of water. This source of energy is environment-friendly and is the cheapest source of producing electricity (Table 5.5).

**Table 5.5: Average cost of units delivered to DISCOs, 2011/12**

<b>Source</b>	<b>GWh</b>	<b>Share (%)</b>	<b>Cost (PRs million)</b>	<b>Cost (PRs/kWh)</b>
Hydropower	28,643	31.93	4,660	0.16
Coal	66	0.07	206	3.12
High-speed diesel	1,474	1.64	27,848	18.89
Residual furnace oil	30,662	34.18	488,617	15.94
Gas	23,431	26.12	99,340	4.24
Nuclear	4,413	4.92	4,978	1.13
Imported	296	0.33	2,662	8.99
Mixed	730	0.81	9,331	12.78
Wind	6	0.01	51	9.12

*Source:* National Electric Power Regulatory Authority (*State of industry report for 2012*).

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Pakistan has the potential to produce more than 40,000 MW of hydropower, but unfortunately, the installed capacity is only 6,716 MW, that is, roughly 16 percent of the total potential. Moreover, the 6,716 MW is only available provided the hydro-generating units work to their full potential. It is unfortunate that, after the construction of the Mangla and Tarbela dams, political differences have prevented the construction of large dams. Ghazi Barotha is the only exception.

Among the fuels used in thermal power plants, oil is the most heavily used with a share of more than 50 percent in 2011/12 (Table 5.6). There was a shortage of more than 8,000 MW of electricity in June 2012. This figure keeps changing not only because of changes in peak demand (seasonal variations) but more so because of variations in supply, given the availability of furnace oil.

At present, almost a third of the country's total imports comprise oil. Of the total oil consumption of over 20 million tonnes, furnace oil consumption stands at about 10 million tonnes. Currently, the price of furnace oil has increased to PRs 75,000 per tonne<sup>23</sup> and the cost of electricity based on furnace oil plants has crossed PRs 15 per unit. Almost 5,000 MW of oil-based power projects are currently in the pipeline, which, combined with existing oil-based projects will place an unrealistic burden on the national economy. Oil-based plants at present require 36,000 tonnes per day. Between 3,000 and 4,000 tonnes per day are produced locally. While the port capacity for handling oil imports is less than 25,000 tonnes,<sup>24</sup> even this much oil could not be imported because of circular debt issues, resulting in higher electricity shortfalls (Kiani, 2011b).

**Table 5.6: Electricity generation (thermal) by fuel type (GWh)**

<b>Fuel</b>	<b>2000/01</b>	<b>2006/07</b>	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2011/12</b>
Coal	241	136	136	113	139	131	66
% of total	0.5	0.21	0.21	0.17	0.20	0.20	0.10
Oil	26,904	26,449	29,928	25,513	35,641	35,847	35,692
% of total	55	41.59	45.56	39.41	52.09	55.07	55.12
Gas	21,780	37,006	35,624	39,108	32,647	29,118	28,992
% of total	44.5	58.19	54.23	60.41	47.71	44.73	44.78
Total	48,925	63,591	65,688	64,734	68,427	65,074	64,750

*Note:* Oil includes furnace oil and diesel oil.

*Source:* Hydrocarbon Development Institute of Pakistan (*Pakistan energy yearbook* for various years) and National Electric Power Regulatory Authority (2011, 2012).

<sup>23</sup> Import price effective on 1 January 2013.

<sup>24</sup> Limited port capacity is a serious constraint to meeting domestic demand.

The shift from hydropower to thermal power implies that the country now depends on imports to meet its energy requirements,<sup>25</sup> thus placing considerable strain on the economy by raising the external account deficit and worsening the country's balance of payments (Trimble et al., 2011). Moreover, the increased dependence on imported fuels has greatly undermined the government's efforts to overcome its corporate debt.

The share of electricity generation based on natural gas is decreasing drastically given the country's depleted gas resources.<sup>26</sup> Gas tends to be reserved for domestic consumers and industry; its availability for power generation is minimal. Power generation based on natural gas costs PRs 4.24 per kWh (in 2011/12), which is much lower than the generation cost of using furnace oil (PRs 15.94 per kWh) or high-speed diesel (PRs 18.89/kWh) (Table 5.5). To generate electricity using gas would require that new gas reserves be discovered. Although newspapers and development forums often report that there are still many unexplored and unexploited gas reserves—far more than presently known—in the country, no serious efforts to explore new gas reserves have been made.<sup>27</sup>

Efforts to find alternatives, such as the import of liquefied natural gas (LNG) have remained slow. The idea of LNG imports was first envisioned in the National Energy Plan 2005, which focused on importing LNG for short- and medium-term needs and on transnational gas pipelines, such as the Pakistan-Iran and Turkmenistan-Afghanistan-Pakistan-India (TAPI) lines for long term needs. The Sui Southern Gas Company (SSGC) initiated the Mashal LNG Import Project, but regrettably, this was cancelled because of bureaucratic mismanagement (for details, see Ahmad, 2010). It is crucial that infrastructural, transportation, and pricing issues be resolved immediately to allow the import of LNG.

The Oil and Gas Regulatory Authority (OGRA), however, has rejected the LNG option in its recommendations to the Economic Coordination Committee on the grounds that it will cost four times as much. People are already opposed to the proposed 14 percent increase in the existing gas tariff, and the Supreme Court's interference in the price-fixing of compressed natural gas (CNG) has caused a further crisis in its

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<sup>25</sup> With limited oil production and low refining capacity, the import of crude oil and oil products accounted for 83 percent of oil supplies in 2009/10.

<sup>26</sup> Gas reserves are being fast depleted because of the extremely inefficient pipeline system subject to theft in the Third World (*The Express Tribune*, 9 December 2012).

<sup>27</sup> Not only do new discoveries of natural gas fail to keep pace with consumption, exploration activity is slow, given unfavorable gas producer prices.

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closure and nonsupply. The situation will become worse with the arrival of LNG, which will be as expensive as oil (Zaidi, 2012).

As far as the Pakistan-Iran gas pipeline is concerned, despite strong opposition from the West, the Presidents of the two countries officially inaugurated construction work on the delayed USD 7.5 billion gas pipeline from Iran to Pakistan on 11 March 2013.<sup>28</sup> The pipeline will facilitate the export of 21.5 million cubic meters of Iranian natural gas to Pakistan on a daily basis. Iran has already constructed more than 900 km of the pipeline on its soil. It is expected that the cooperation of state-owned companies—Tadbir of Iran and Inter State Gas Systems of Pakistan—will bring the project on-stream by January 2014. However, there are apprehensions (see, for example, Ahmad, 2010) that this gas will only be sufficient to cover the existing gas shortage rather than providing gas for new power generation projects that are in the pipeline. Therefore, other options also need to be pursued seriously, such as the TAPI gas pipeline project, for instance.

Given the shortage of gas, our dependence on furnace oil imports for electricity generation has made the electricity supply chain quite vulnerable. Any fluctuation in the international oil market directly affects the average cost of electricity generation. Similarly, any interruption in oil supplies may result in power supply interruptions. Therefore, it is essential that power generation sources be diversified to include more indigenous resources such as hydropower, coal, and renewable energy resources, including wind and solar power, which are known to be abundantly available in Pakistan.

Coal is the cheapest source of fuel used in thermal production (PRs 3.12 per kWh in 2011/12). At the same time, it is the source least used to generate electricity and its use is declining, given the lack of adequate maintenance (Table 5.6). Like water, the country has enormous coal reserves, with an estimated 185 billion tonnes in Thar. It is estimated that, by using only 2 percent of these reserves, Pakistan could generate around 20,000 MW of electricity for almost 40 years (Ghani, 2009)<sup>29</sup>. The contribution of coal to the total electricity supply in a number of developed

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<sup>28</sup> The agreement was signed in March 2010.

<sup>29</sup> A number of projects based on Thar coal resources have been identified in the power plan for 2010/11. All these are in the private sector except for one coal gasification project (100 MW) in the public sector. Work on this underground gasification pilot project, supervised by the renowned nuclear scientist Dr Samar Mubarakmand, is underway and it is expected that the first burn will be connected to power turbines and that generation of the planned 100 MW electricity will start by December 2013. The Sindh Engro Coal Mining Company in collaboration with the government of Sindh performed the groundbreaking ceremony in March 2013.

economies such as the UK, US, and Australia, is between 60 and 70 percent. India has increased its reliance on coal and at present, 54 percent of its total electricity production is from coal-based thermal power stations with only 1 percent of its total thermal capacity running on fuel oil.

#### **4.5. Limited Capacity Addition**

Growth in demand suggests that substantial investment will be needed to maintain continuity of supplies. Apart from generation, which is the most capital-intensive segment in the sector, the T&D segment needs investment to overcome the huge losses it has suffered in the last few years. Providing adequate supply requires mobilizing far more private investment. Besides correct pricing, the quality of the regulatory environment along with transparent and efficient public sector management is crucial for investor confidence.

A substantial increase in the share of private investment after 1994/95 can be attributed to the restructuring process started in the mid-1990s. IPPs started their operations in Pakistan in 1994, but their involvement became controversial in the initial stages (for details, see Malik et al., 2009). Although the dispute with IPPs were later resolved, it had an adverse impact on the future expansion of private participation. Furthermore, as Fraser (2004) has pointed out, until the expected efficiency improvements are achieved, fresh private capital in the power sector in general and for new generating capacity in particular, is not possible.<sup>30</sup>

Seven new IPPs were inducted into the system in 2010/11 under the 2002 Power Policy<sup>31</sup> with a capacity addition of 1,604 MW to the national grid system, but none of them has a capacity of more than 300 MW. All these projects were initiated under the previous military government (1999–2007). Another addition was also made to nuclear installed capacity—the Chashma nuclear power plant II, started in 2005, was completed by the Pakistan Atomic Energy Commission in collaboration with the China National Nuclear Company. However, the PPP government's (2008–13) efforts to meet the energy shortfall on an emergency basis by inviting RPPs have failed for the reasons given below.

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<sup>30</sup> Circular debt and fuel availability, the time and cost involved in tariff determination by the regulator and below-cost tariffs, the lack of exploitation of indigenous coal reserves, and the critical security situation are all factors that have hampered foreign private investment in Pakistan.

<sup>31</sup> This provided extra tax incentives as well as assurances to investors, such as protection from political force majeure, payment of compensation in case of termination due to government default, tariff adjustments for variations in currency exchange rates and fuel prices, ensuring the conversion of Pakistani rupees, and the remittance of foreign exchange for project-related payments, etc.

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The installed capacity of thermal plants under public sector GENCOs' control was reduced by almost 600 MW due to the exclusion of RPPs from the system during 2012.

One of the basic problems in Pakistan is that governments (not only the PPP but also its predecessors) have failed to implement long-term and low-cost projects that could have helped increase the country's energy supply. Undoubtedly, many projects were conceptualized and discussed, but bureaucratic wrangling or occasionally international pressure have led to projects being delayed, failing to materialize, and even being canceled at the final stage (Ali, 2012b). For instance, in 2008/09, a memorandum of understanding (MOU) for the construction of the Kohala hydropower project (1,100 MW) was signed with a Chinese company, but owing to the controversies surrounding the project,<sup>32</sup> it failed to take off even after three years.

Many planned hydropower projects (in the public sector as well as in the private sector) have been delayed. The main reason for the significant delay in most cases is the absence of any coherent and comprehensive energy policy—development planning in the hydropower sector by the federal government was essentially left to WAPDA for the public sector and to the Private Power and Infrastructure Board for the private sector after the 2002 Power Policy. Although both organizations work under the same ministry, there is no link between their respective priorities, resulting in a lack of complementary development plans.

Most of these hydropower projects are planned on the Indus River. Their implementation requires political will, without which they will continue to be delayed. The sharing of water resources has also been a major source of contention among the provinces.<sup>33</sup> The availability of sufficient financial resources is another major hurdle in the completion of

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<sup>32</sup> WAPDA accused decision makers of violating the Pakistan Power Regulatory Authority rules, neglecting to ensure transparency, and evading international competitive bidding. However, documentary evidence revealed that WAPDA had signed an MOU with China International Water and Electric Corporation (CWE) for the construction of the project in 2008. Now, WAPDA has raised several provocative issues that were not discussed earlier at any level. WAPDA wants to execute the whole project itself or alternatively become a partner with a 51 percent share in a joint venture with CWE while the latter has opted for a build, own, operate, and transfer (BOOT) option under which the project would be handed over to the Azad Jammu and Kashmir government after 30 years. The company will construct the project from its own funds as an IPP in accordance with the 2002 Power Policy (for details, see Mughal, 2011)

<sup>33</sup> The provincial (Khyber Pakhtunkhwa) government took the position that the Power Policy 2002 was beyond the powers of the Constitution and, hence, any letter of interest issued under the policy had no legal value. As a result, regulatory approval for two major private sector hydropower projects has been delayed until the legal issues are resolved (for details, see FODP, 2010)

both public and private sector hydropower projects. Commercial banks are involved in the IPP market, and the shortage of liquidity has restricted their capacity to finance large hydropower projects. International project financing has also fallen due to the recent global financial crisis. Political and economic instability has discouraged commercial lenders from entering large project finance agreements (FODP, 2010). The Diamer-Bhasha Dam (4,500 MW), inaugurated in October 2011, is expected to be completed in eight years, but the truth is that its completion depends on the availability of the required financial resources.

The government's most well-known and controversial step was to include RPPs in the power system as a quick-fix solution. Despite criticism from different quarters, it approved the induction of 14 rental projects (most of them oil-based) with a capacity of up to 2,250 MW<sup>34</sup> to ensure an end to the power deficit.<sup>35</sup> The objection raised to the rental power program concerned its financial viability given its below-par efficiency<sup>36</sup> and high tariff structure.<sup>37</sup>

In September 2009, the government through the Ministry of Finance asked ADB to carry out a third-party audit of the power sector, including RPPs. ADB also declared these plants to be expensive and ineffective.<sup>38</sup> In the end, the proposed 14-RPP program had no significant impact on reducing load shedding in 2009/10 and onward because none of the RPPs became functional before 31 December 2009 as initially declared by the government.<sup>39</sup>

The effectiveness of RPPs depends on the sufficient availability of fuel, something that has not happened in the last few years. Even the existing thermal power generation (both in the public and private sectors) has not been fully utilized due to the shortage of gas or unavailability of furnace oil because of the circular debt problem. In these circumstances, it seems absurd on the part of policymakers to opt for expensive RPPs,

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<sup>34</sup> Out of 2,250 MW, only 453 MW from RPPs came on-stream by 2010/11.

<sup>35</sup> The government approved the RPP program without evaluating its financial implications. After being approved, the program went to ADB for its evaluation.

<sup>36</sup> The project efficiency committed to by the RPP sponsors was only 32–35 percent but the government would be legally bound to make payments for 90 percent capacity utilization (Kiani, 2010).

<sup>37</sup> According to one independent estimate, 2,250 MW of rental power would have incurred a net deficit of PRs 135 billion for the country, given the furnace oil price of PRs 26,000/tonne, and offered a tariff to RPPs of US cent 13.5/kWh (claimed by the minister at the time) (for details, see Asif, 2011). One can imagine the real loss to the economy as the current price of furnace oil is PRs 64,000/tonne.

<sup>38</sup> In terms of reducing the electricity shortfall.

<sup>39</sup> ADB also pointed out to the government that the contracts with the RPPs lacked a sound clause in case of nonperformance (by the RPPs).

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which are 100 percent thermal-based. Instead of launching RPPs, the government could have supported the existing IPPs, which are not generating at full capacity. Second, the government should have expedited the process of initiating those IPPs and small hydropower projects that were in the pipeline and likely to commence generation in 2009/10 and later.

The electronic and print media also raised serious reservations about behind-the-scenes nepotism and corruption, for instance, in the RPP deals (Asif, 2011). In March 2012, the Supreme Court finally cancelled the RPP contracts<sup>40</sup> and ordered civil and criminal action in accordance with the law against all responsible persons.

### **4.6. Energy Conservation**

Efficiency in the use of energy can generate substantial gains in supply, thus reducing the supply–demand gap. Pakistan’s total energy savings potential is estimated to be 11.16 MTOE. Savings from energy efficiency could reach 18 percent of the total energy consumed, corresponding to a 51 percent reduction in net oil imports. Pakistan is highly energy-intensive as a consequence of large energy losses, wastage throughout the supply chain, and insufficient investment in replacing obsolete infrastructure (FODP, 2010). The 23 percent in T&D losses is not a small amount; it has a significant impact on the cost of electricity and contributes to power shortages. Therefore, it is essential that, apart from setting up new power generation plants, the conservation of energy be given serious attention.

## **5. Tackling the Energy Crisis**

### **5.1. Short- and Medium-Term Measures**

First, and most importantly, the available capacity needs to be used more effectively to conserve energy. This demand-side strategy has proved to be quite successful in the short term in many countries. There is a savings margin of over 20 percent in electricity consumption across all sectors, but unfortunately, proper management, such as steps to improve energy efficiency, and loss reduction programs with the least incremental cost are not prioritized as new supply-side initiatives. The energy saved by the proposed compact fluorescent lamp program would have reduced electricity demand by over 1,280 MW countrywide and by 1,133 MW in

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<sup>40</sup> The Supreme Court took serious notice of all the observations (as mentioned above) against RPPs and why government functionaries had opted for this expensive and inefficient option when other cheaper and more effective choices were available.

the PEPCO system. Similar programs have been successfully implemented in other countries (ADB, 2010)

Generally speaking, the legislative framework for energy conservation in Pakistan is weak. Even the small effort of avoiding unnecessary consumption can reduce energy use by more than 10 percent. For instance, controlling cooling or heating by 1°C can reduce the heating or cooling load by around 7 percent. Switching off lights and other appliances when not in use is not difficult. Similarly, unnecessarily lit shops could easily reduce their consumption; incorporating motion sensors could reduce the idle running time of production lines and machines in industrial applications. A further saving of 10 to 15 percent could be achieved by introducing the second and third levels of energy conservation practices (for details, see Asif, 2011). When Brazil experienced an energy crisis in 2001/2, its first step was to implement strict demand-reduction programs<sup>41</sup> and achieve the goal of reducing consumption by 20 percent.

Second, there are thermal power plants in both the public and private sectors with substantial capacity that are producing far below capacity because of their inability to purchase fuel to run the plants. In order to fully utilize the available capacity, it is essential that the fiscal management of the energy sector be improved as a priority.<sup>42</sup> This requires engaging professionals on the basis of their experience and qualifications rather than political affiliation (discussed in detail in the subsequent suggestions). Moreover, maintaining existing plants, specifically in the public sector, is less expensive and less time-consuming than setting up RPPs and will improve the former's efficiency and capacity quite significantly. The government must identify inefficient power plants and then invest in them to improve their efficiency. The number of plants in GENCOs could be upgraded/renovated to produce around 3,000–4,000 MW of electricity more quickly and cheaply (Asif, 2011).

Third, the politics of pricing is such that it is difficult to ask people to pay more for a product that is undersupplied. Therefore, instead of further increasing the price, line and theft losses—which are as high as 37 percent in certain areas—should be brought down to a level comparable to other countries. This will automatically bring down the cost of producing electricity. This is neither very difficult nor expensive and only requires determination on the government's part to ensure improvement

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<sup>41</sup> The government established a quota system based on historical and target consumption levels, and a corresponding bonus and penalty scheme whereby consumers were rewarded or penalized according to whether they remained within or exceeded their quota.

<sup>42</sup> The government has injected five times the money but the problem of circular debt persists.

## *Tackling the Energy Crisis*

in the operational performance of the DISCOs. The government should update the system gradually and make every effort to reduce the system's losses. Power theft can easily be controlled if there is the will to do so (in the short term), while technical losses can also be improved gradually through appropriate investment (in the medium term). When the inefficiencies in the system are removed and the due amount recovered from defaulters, the problem of circular debt will be resolved automatically in the medium if not short term.

The government must restructure the whole system of bill collection (perhaps through incentives in the form of easy installments or through tough decisions, such as disconnections, depending on the situation) to recover outstanding bills from all defaulters—whether in the public sector or from private consumers, provincial or federal governments, or the military<sup>43</sup>—as quickly as possible to effectively resolve financial issues. Roughly 1,500–2,000 MW of additional capacity can be made available by reducing T&D losses, which, ideally, should be in the range of 6–7 percent.

The implementation of the above three recommendations depends on strengthening the governance and regulation of the energy sector. Therefore, our fourth suggestion is that the process of restructuring be re-examined in the light of ground realities. A new wave of power sector reforms is badly needed in the medium term, but what must be understood is that successful power sector reforms depend on a wider group of reforms—not only power sector reforms but also judicial reforms that will empower regulators<sup>44</sup> to make reliable and justifiable decisions, and financial reforms that will allow power generators to pay the real cost of capital and that are subject to hard budget constraints (Victor & Heller, 2007).

The strategic plan for restructuring the country's power sector, which was developed in 1992 and formally implemented in 1994/95, has not been successful. Although more than 15 years have passed, it has failed to achieve its objectives of improving operational or financial efficiency. The status of the power sector in terms of technical, economic, and financial efficiency has deteriorated. Institutional weaknesses and governance issues, which used to be the main hurdle in the sector's development, persist.

Though unbundled to a certain level, the power system as an outcome of first-generation reforms has once again become centralized under PEPCO, which continues to hold sway in financial management,

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<sup>43</sup> It is a misconception that the public sector is the main defaulter in payments due to DISCOs; payments due from the private sector are almost equal to those of the public sector.

<sup>44</sup> However, the judiciary should avoid unnecessarily interfering in pricing decisions if they are made on justifiable grounds.

power purchase and sales, and the appointment of senior management over the operating companies (GENCOs and DISCOs). These companies lack the technical and managerial skills to operate independently, and their structure on the basis of corporate governance principles has not been established in the true sense (FODP, 2010).

Apart from their inferior operational performance, DISCOs are not aware of their role and need for good governance as corporate entities. Despite being corporate entities, their attitude is still that of a public sector organization. Not only are they overstaffed, their power purchase contracts are not in place, and defaults and delays are considered routine. They remain unable to recover dues from the public sector and provincial government departments due to a bureaucratic style of governance, causing high losses in the distribution system. This may be because they are staffed by the same workforce and professionals as the previous public entity or have inherited its behavior and are unwilling to change.

As DISCOs, they were expected to introduce efficiency into the system and quality to the service, but they have failed to do so and now seek support from the government. The single-buyer model<sup>45</sup> accompanied by the delay in payment of subsidies by the government and the lack of discipline in these DISCOs have forced them to default; significant arrears in payments to the GENCOs have resulted in the upsurge of the circular debt problem. The resolution of circular debt depends on the self-sustainability of the DISCOs, for which public sector presence may need to be gradually phased out.

Low production and lack of any effort to reduce theft from line losses are both due to institutional weakness. Therefore, the thrust of any policy change or reform process should be on institutional issues to tackle efficiency, affordability, cost minimization, losses, and theft. Unless all DISCOs are made accountable for all their decisions and finances, it will not be possible to make the power sector efficient because inefficient DISCOs—such as Quetta, Hyderabad, and Peshawar—are indirectly subsidized by profit-making DISCOs—such as Lahore, Islamabad, and Faisalabad.<sup>46</sup> Therefore, a complete corporate structure for all DISCOs with a professional and honest management, and tariffs for each DISCO based on its efficiency, is crucial if the sector is to progress.

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<sup>45</sup> Under the single-buyer model, no direct contractual links exist between GENCOs and DISCOs. Generators sell electricity at regulated prices, which is supplied to DISCOs at pooled average power purchase prices.

<sup>46</sup> The government has delayed the announcement of separate tariffs for all corporate DISCOs despite separate determinations made by NEPRA—a tough decision to implement politically. It has found it difficult to defend higher tariffs in Balochistan, Sindh, and Khyber Pakhtunkhwa, where DISCOs are making losses.

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Fifth, following on from the previous suggestion, there is a need to overcome the institutional and organizational weaknesses of the energy sector as a whole, which no government has so far done. Generally speaking, vested interests in these governments have stalled the due level of competence and commitment that are prerequisites for its progress. They have not only lacked the capacity to foresee emerging challenges but also failed to respond efficiently. Energy offices are considered the most lucrative and desirable slots in any cabinet<sup>47</sup> (Asif, 2011).

As a result of these problems, tariffs, investment, and the appointment of senior management and staff have largely been politicized. Lack of expertise in financial and commercial skills is a serious impediment to accountability, quick decision-making, and commercial orientation. It is generally believed that policymakers have caused enormous damage to this sector either by approving and sanctioning public investment in inappropriate projects or by endangering essential projects for their personal interests, which include corruption, political motives, or other agendas. The sector has always remained in the limelight because of financial corruption, whether in IPP programs, the privatization of KESC, the curtailment of the 1,000 MW thermal power project that was supposed to have started in 2005 (see Asif, 2011), or the initiation of RPPs. The unnecessary involvement of politicians, therefore, needs to be curtailed.

Sixth, an effective institutional framework is needed to ensure sustained and efficient output growth and to avoid unnecessary delays in decision-making. Cumbersome bureaucratic procedures and administrative inefficiency cause enormous delays in decision-making in Pakistan and also discourage the private sector. Having multiple agencies involved in the energy sector in general and in the power sector in particular is a certain recipe for delays as well as lack of coordination because it becomes necessary to acquire the overall commitment or approval for any required changes. For example, delays in the transfer of responsibilities from the government to the private sector or to the power regulator means ministers and civil servants giving up responsibilities they have exercised for many years.<sup>48</sup>

International experience has shown that there is often resistance from interest groups benefiting from market distortions or enjoying special privileges in the form of bribes or other prerequisites. For the success of

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<sup>47</sup> Whether it is the post of minister, the chief executive of a power company, or chairperson of NEPRA—all are appointed under political influence and not on the basis of professional expertise and merit.

<sup>48</sup> For example, the delay in determining separate tariffs for all DISCOs.

reforms, a committed government must engage with all stakeholders to gain public support and provide some form of compensation to those who are unhappy with the change in the state of affairs. For effective decision-making, integrated energy planning and policy formulation can be a viable option since it would allow the restructuring of policy institutions in order to check the unnecessary fragmentation that has occurred over the years (Allahdad, 2012). A single energy ministry responsible for all energy offices is a possible solution. It would then be responsible for the development and implementation of integrated policies, plans, and strategies for the energy sector based on good governance and operational efficiency (FODP, 2010).

The current state of affairs (under the PPP government from 2008–2013) as cited in different documents is not very different from that of previous regimes. Hardly any deal or project is undertaken in a fair and transparent manner and free of controversy. For instance, the compact fluorescent lamps project worth PRs 6.7 billion reportedly suffered from serious irregularities; the RPP and IPP programs also became controversial; and the Kohala (1,100 MW) hydropower project was shelved amid accusations that decision makers had violated the Pakistan Power Regulatory Authority rules, ignored the need for transparency, and evaded international competitive bidding (Mughal, 2011). The appointment of inappropriate and incompetent personnel to the highest possible energy offices has not improved matters (Asif, 2011).

Delays in decision-making and implementation are also common. For example, the privately managed Central Power Purchasing Agency was supposed to be replaced by PEPCO as planned in the power sector reforms package approved by the Cabinet Committee on Restructuring (set up in December 2009); so far, this has not been done.<sup>49</sup>

Seventh, there is a need for a strong regulatory environment. NEPRA's weak administrative governance takes the form of a lack of autonomy, resulting in its overall institutional inability to carry out the desired functions effectively. In addition, NEPRA lacks the professional expertise<sup>50</sup> to supervise and control the power sector and establish a rational and equitable pricing regime (Malik, 2007).

NEPRA is often blamed for most of the problems in the power sector, including load shedding, system losses, and high tariffs. It has been unsuccessful in developing and pursuing a regulatory framework to

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<sup>49</sup> The Ministry of Water and Power along with NEPRA have been blamed for the delay (for details, see A. F. Khan, 2011a).

<sup>50</sup> The chairperson and members of NEPRA are appointed not on the basis of their competence and merit, but under political influence.

guarantee reliable, efficient, and affordable electricity to consumers. NEPRA is mandated to attract investment in the power sector but, except for thermal power plants, no significant addition has been made to projects generating electricity from renewable sources (see Kiani, 2011a). Its role has so far been limited to determining tariffs and issuing licenses, that too, under the influence of the government. Moreover, its weak capacity to formulate market rules has delayed the implementation process and formation of the independent Central Power Purchasing Agency.

The lack of uniform regulation in the energy sector as a whole creates distortions between the gas and electricity sectors. Inconsistent regulation between NEPRA and OGRA sends confused signals to investors and creates disharmony in pricing strategies between gas and electricity (FODP, 2010). This issue can be resolved either with the formation of a single regulatory authority or through regular coordination between NEPRA and OGRA.

The most serious challenge, that of circular debt, can be resolved very easily if the appropriate steps (as mentioned above) are taken. All these measures, including the improved corporate and operational governance of power sector companies, the elimination of inefficiencies in the system, and cost-effective pricing (not dependent on government subsidies) are important for the sustainability of the sector and can easily be achieved in the short to medium term.

## *5.2. Long-Term Measures*

In the last ten years or so, any additions made to installed capacity have been mostly thermal, and these too have relied on an expensive fuel option. From an economic point of view, it is very important that the full cost of generation be passed on to the consumer. At the same time, however, it is equally important to keep the cost of generation low. The dependence on imported oil and gas should be minimized, given the fluctuating prices of the former and the latter's depleted resources. This is not possible in the short term. Therefore, in the long term, the focus should only be on indigenous resources such as coal, hydropower, and other renewables.

All the hydropower projects under construction should be completed in time to enhance cheap electricity generation capacity. The emphasis should be on exploiting more hydropower resources, not only in public sector but also in the private sector. The government needs to concentrate on those issues—for instance, the availability of credit and a comprehensive hydropower policy—that have discouraged the private sector from becoming involved in hydropower projects. There are many

countries in the world where hydropower has a predominant share in the electricity supply mix. For example, Norway produces 99 percent of its electricity from hydropower while Brazil produces 92 percent, Iceland 83 percent, Austria 67 percent, and Canada 70 percent (Asif, 2011). Similarly, coal gasification projects should be seriously pursued. These could effectively contribute to meeting Pakistan's ever-increasing demand for electricity in a cost-effective way.

The mistake of relying on an expensive fuel option to add to installed capacity—an outcome of the 1994 Power Policy—needs to be corrected. The country has ended up with a subsidy of roughly PRs 3 per unit. The key to good governance is the realization that every citizen is entitled to equitable dividends out of any system. This will only be possible when all efforts are made to minimize the cost of generation.

That Pakistan relies on expensive fuels for thermal generation reflects not only the lack of incentive to minimize costs, but also a lack of vision on the part of our decision makers who have failed to explore cheaper options. As a result, no power project has been set up in the last ten years or so. In our planning strategies for the last eight or nine years—not only under the present government but also previous governments—the utilization of indigenous resources has always been at the forefront, but unfortunately these plans have not been implemented. Until we stop relying on oil- and gas-based thermal power generation and focus on cheaper sources of producing electricity, the financial problems of the power sector will not be resolved.

## **6. Conclusion**

Improving the process of decision-making and its timely implementation, and holding all stakeholders accountable for their actions is an important ingredient in working toward a fair and sustainable electricity sector. The issues of the power sector can only be addressed if the management of the energy sector becomes more professional and competitive. The challenge for policymakers is to build the sector's organizational and institutional capacities and make them compatible with its actual environment.

The power sector in Pakistan is affected by a number of institutional and organizational weaknesses, with inefficient generation and distribution systems, dependence on expensive fuels, nonoptimal tariffs, financial mismanagement, and high levels of corruption and incompetence. Poor governance and the misdirection of adopted policies are responsible for the energy sector's current crisis.

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The energy sector has been the victim of bad decisions and policies, and a serious inability to make and implement appropriate decisions in time, coupled with the public sector's lack of incentive to be efficient. These issues can only be addressed if the management of the energy sector becomes more professional, competitive, honest, and free of political influence and pressure.

Furthermore, the resolution of circular debt requires that an efficient administrative system be put in place—one capable of ensuring that the problem of circular debt will not recur once resolved. All power companies should be made accountable for all their decisions and finances in order to improve the system in the medium term. A sound business environment—free of administrative and institutional hurdles, and of issues such as circular debt—is necessary to encourage private investors in the power sector. As suggested by FODP (2010), there is a need to eliminate untargeted energy subsidies. In addition, electricity pricing on a full-cost recovery basis is necessary to restore the financial sustainability of the energy sector, but at the same time, costs need to be minimized. Further, efforts must be made to liberalize the energy sector and encourage private sector investment in the development and production of indigenous resources (i.e., gas, coal, hydropower, and other renewable resources).

It is high time that we learnt from experience. Power sector utilities need to be reorganized and managed along commercial lines to tackle issues of efficiency, availability, and affordability. In short, the focus should be on improving government capabilities to effectively manage the state of affairs.

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## 6

### Exports: Lessons from the Past and the Way Forward

Hamna Ahmed\*, Naved Hamid\*\*, and Mahreen Mahmud\*\*\*

#### 1. Introduction

The idea that trade is important for economic growth dates back to the nineteenth century when classical economists such as Adam Smith, David Ricardo and John Stuart Mill advocated the favorable effects of international trade on output. Since then, a rich body of theoretical and empirical literature has evolved with regard to the role of trade in growth and development. Initially, post-Second World War, development economists viewed trade as a negative factor in developing countries' industrialization objectives, and from the 1950s through the early 1970s most newly independent countries adopted an import-substitution industrialization (ISI) strategy. By the mid-1970s, however, there was growing disenchantment among development economists concerning ISI and in favor of the export-led growth strategy that several East Asian countries had successfully adopted. Subsequently, this was formalized in what is referred to as the Washington consensus: generally described as an outward-oriented development (OOD) strategy, it has since been adopted by most developing countries.

According to proponents of the OOD strategy, outward orientation can promote economic growth through three main channels. The first is trade, which enables firms (at the micro-level) and countries (at the macro-level) to gain through specialization and economies of scale. This is because increased competition results in the least efficient producers being driven out of the market, while the most efficient producers expand their market

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share, thus raising aggregate productivity through the reallocation of resources (Tyler, 1981; Melitz, 2003). The second is exports, which serve as the primary source of foreign exchange needed to purchase imported inputs such as raw material and machinery and, more broadly, to help ease the balance of payments constraint (Faridi, 2012). The third channel involves trade as an important source of knowledge and technology transfer, with the potential to encourage innovative activity—such as research and development, and the introduction of new products and processes—by increasing the returns on innovation as exporters have access to a larger market than nonexporters.

Pakistan was one of the most successful countries in implementing the ISI strategy during the 1960s. Although it has slowly moved away from ISI since the late 1970s, there has never been any domestic ownership of the OOD strategy. Thus, while the anti-export bias may have weakened over time, it remains substantial. India, which had followed the ISI strategy for a long time, began to change in the 1980s, while Bangladesh, after continuing for a few years with policies inherited from Pakistan, also started to move toward an OOD strategy in the 1980s. This is evident in that global integration, measured by the trade-to-GDP ratio, increased by 25–40 percent in Bangladesh and India between 1980 and 2000. In contrast, there was no change in Pakistan’s trade-to-GDP ratio even though its average tariff rates declined significantly over this period (Dollar, Hallward-Driemeier, & Mengistae, 2006).

Pakistan’s share of world exports has remained more or less stagnant over the past three decades, pointing to the country’s inability to expand exports faster than world trade (see Table 6.1). On the other hand, its South Asian neighbors and the East Asian countries have shown a tremendous increase in export shares. Malaysia and Thailand entered their rapid export growth phase in the 1980s and 1990s, while Bangladesh and India started theirs in the 1990s, which continues to date. India has managed to increase its export share almost fourfold and Bangladesh by more than three times since 1980. As a result, Pakistan’s exports, which were more than a third of India’s and almost four times that of Bangladesh in 1980, are now less than one tenth of India’s and about the same as Bangladesh. The latter has achieved this tremendous export growth on the back of its garments sector, and today Bangladesh exports garments worth over USD 14 billion, which is almost four times the value of Pakistan’s garment exports.

**Table 6.1: Country-wise share of world exports (1980–2011)**

Country	1980	1990	2000	2010	2011
Bangladesh	0.04	0.05	0.09	0.14*	N/A
India	0.43	0.57	0.70	1.55	1.78
Pakistan	0.15	0.18	0.15	0.15	0.15
Malaysia	0.74	0.94	1.61	1.40	1.34
Thailand	0.37	0.74	1.13	1.37	1.35

Note: \* Bangladesh's data is for 2007.

Source: Authors' calculations based on data from UN comtrade.

Pakistan has experienced several periods of high GDP growth, but given that its income elasticity for imports is almost twice as high as that for exports, growth accelerations have been invariably followed by balance of payments crises and periods of stagnation. Thus, solving the problem of poor export performance is key to breaking the stop-go cycle in which Pakistan has been stuck for more than 30 years. This is particularly important today when the country is passing through a prolonged period of economic stagnation—after a spurt of growth in the mid-2000s that was brought to an end by a balance of payments crisis—and it seems to be headed toward another balance of payments-cum-debt crisis.

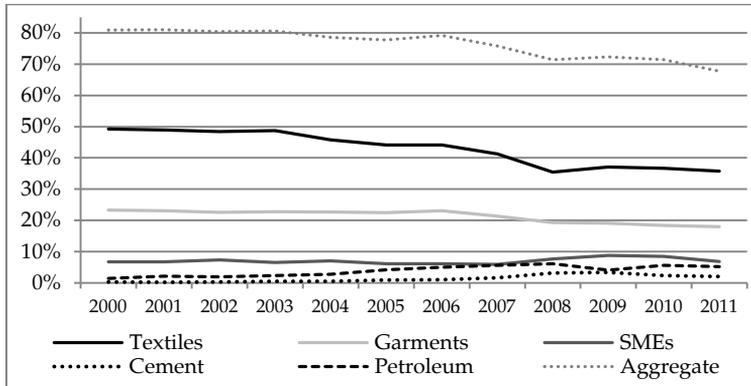
The aim of this chapter is to use Pakistan's experience to identify potential drivers that could boost its export performance in the medium term. We define an export driver as a product (or a product group) that has the potential to expand output (i.e., domestic production conditions are favorable) and in which Pakistan has a demonstrated competitiveness. Sections 2 and 3 analyze Pakistan's manufacturing and agricultural exports, respectively, with the aim of identifying potential drivers that could substantially boost the country's exports in the medium term. Section 4 provides a brief discussion of the foreign exchange earnings potential of the export of information technology (IT) and entertainment services. Section 5 identifies elements that cut across sectors and can boost overall export performance. Section 6 concludes the chapter.

## **2. Manufacturing**

If we analyze Pakistan's important manufacturing exports, we find that the combined share of the top five exports has declined from over 80 percent of total exports to 71 percent over the past decade (Figure 6.1). This drop has occurred primarily because of a fall in the share of textile exports by over 10 percentage points. The only other product group to lose export share during this period was garments. The country's

manufacturing exports have been dominated by the textile and garments sectors since the 1960s, but in the past decade, their combined share has fallen from about 73 percent of total exports at the start of the 2000 to 55 percent in 2010. Other exports in the top five—small and medium enterprise (SME) manufactures,<sup>1</sup> cement, and petroleum—all registered a steady increase in their share during this period.

**Figure 6.1: Manufacturing export performance (share in total exports)**



Source: Authors' calculations based on data from UN comtrade (SITC Rev. 3).

In order to have a significant impact on aggregate export performance in the medium term, we need to identify drivers from among the existing major exports. Therefore, we focus on the top five exports in 2010. Out of these, petroleum exports are primarily a result of mismatch between refinery output mix and domestic demand, and Pakistan does not seem to have a comparative advantage in this industry. Cement exports have grown rapidly in the last decade largely because of excess capacity in the country and a massive increase in demand in Afghanistan associated with the aid financed-postwar rebuilding process. It is likely, however, that this demand will taper off after the withdrawal of US forces in 2014. Cement is also an energy-intensive industry and there are major concerns about its environmental impact. Therefore, only textiles, garments, and SMEs in the manufacturing sector have the

<sup>1</sup> We include in SME exports miscellaneous manufactured articles (primarily sports goods), scientific equipment (primarily surgical instruments), general industrial machinery and parts, road vehicles and parts, telecommunications and sound recording equipment, power-generating machinery and equipment (primarily motors and fans), and specialized machinery for particular industries (primarily machine tools). Most of the export production of these products takes place in small and medium units in industrial clusters around Karachi, Lahore, and the Sialkot–Gujrat–Gujranwala triangle in central Punjab.

potential to become export drivers in the medium term. Each of these is discussed in turn with some recommendations for realizing this potential.

### **2.1. *Driver 1: Textiles***

In 2012, exports of cotton fiber, yarn fabric, household textiles (towels and bed linen), and garments constituted 5, 13, 40, and 28 percent of textile exports, respectively. Although the share of textiles in total exports has fallen substantially in recent years, given its share in the medium term, export growth cannot be accelerated without higher growth in textiles. The decline in the share of textiles is partly a natural process that occurs in all countries as they develop, but its precipitous decline in Pakistan over the last decade is attributable to (i) the imposition of regulatory (antidumping) duty by the European Union (EU) for several years on bed linen imports from Pakistan; (ii) the weakening of demand in the EU, in particular, since the global financial crisis; and (iii) the worsening energy crisis in the country since 2007. However, if Pakistan succeeds in getting GSP-plus status in the EU in 2014, textile exports could expand substantially. If, at the same time, the country were to increase cotton production significantly—of which there is a good possibility (see Section 3.2)—this would boost the export growth of textiles even further.

As cotton moves up the textile chain, its value increases from USD 1 for the fiber to USD 2 for yarn, to USD 4–6 for “towels, bed linen and fabric”, to USD 12 for garments (knitwear and woven items). There is considerable scope for accelerating textile (and garments) exports by moving up the value chain. Although the fastest-growing portion of textile exports in recent years has been yarn, it accounts for very little value-added, particularly the low- and medium-count yarn that Pakistan exports. Hence, an export strategy that aims to push textile exports up the value chain should provide incentives for higher-value textiles, and could be initiated by imposing a small export tax on low-count yarn. This might encourage the spinning industry to produce higher-count yarn and reduce the cost of yarn (which is almost 50 percent of the cost) for domestic towel and woven (denim) garment producers. This would, on one hand, encourage the production of higher value-added yarn and fabric and, on the other, boost the competitiveness and exports of two of Pakistan’s main higher value-added products.

### **2.2. *Driver 2: Garments***

The fallout from 9/11, in terms of travel restrictions by the US on Pakistan and heightened security concerns, coincided with the transition phase of the end of the Multi-Fiber Arrangement (MFA) and quota regime in 2005.

Major international brands and retail chains, particularly from the US, in planning for the period post-2005 aimed to reduce their reliance on Pakistan as a major source country for garments. As result, the phasing out of the MFA benefited Bangladesh at Pakistan's expense. In 2000, the latter's garment exports were about USD 2 billion compared to USD 5 billion for Bangladesh; by 2010, they were less USD 4 billion and over USD 14 billion, respectively. Thus, Pakistan lost out on the opportunity offered by the expansion in international trade in garments following the end of the MFA.

However, another opportunity is emerging: China, with exports worth USD 130 billion in 2010, is presently transitioning from the export of low-end manufactures to higher value-added products, and its current world market share of 37 percent of garment exports will decline in the foreseeable future. Pakistan could be one of the countries to pick up a part of this share.<sup>2</sup> Moreover, with rising wages in China, firms there are looking to relocate production; just as East Asia benefited from the relocation of industry from Japan, and Bangladesh from Korea, Pakistan could benefit from the relocation of industry from China, especially given its special political relationship with that country.

The strategy for seizing this opportunity has to address those factors that are currently a drag on Pakistan's garment industry. These include the country's critical energy shortages, and the security and law and order situation that prevents foreign buyers or their technical staff from visiting Pakistan.<sup>3</sup> In addition, it is important to make trade policy and customs procedures friendly to those who use imported materials, such as fabrics, dyes, and clothing accessories, to produce their exports. As pointed out earlier, it is also imperative that the incentive structure be one that encourages value addition and generates employment. There are considerable differences in the degree of labor intensity between different stages of the value chain. According to one estimate,<sup>4</sup> converting 50,000 kg of fiber into yarn and yarn into fabric requires 400 person-days at each stage, while converting fabric into garments requires 1,600 person-days. This highlights the importance of the garments industry not only for exports but also for employment generation.

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<sup>2</sup> Pakistan's current share is about 3 percent and thus a small gain in its world market share would translate into a large increase in its garment exports.

<sup>3</sup> The Punjab government was establishing a "garment city" on the Sunder industrial estate near Lahore on the basis of an understanding with Chinese firms who were interested in relocating to Pakistan when the kidnapping and murder of several Chinese engineers working on construction projects in other parts of country made the firms change their mind.

<sup>4</sup> Data provided by Shaukat Ellahi Shaikh, the managing director of Nagina Cotton Mills Ltd., during an interview on the subject.

### **2.3. Driver 3: Traditional and Emerging SME Exports**

SME products are diverse, and include sports goods, surgical instruments, fans and other electrical products, automobile parts, and vehicles (rickshaws and motorcycles). Their collective total share has been increasing and was about 8.5 percent in 2010. Pakistan has a long history of exporting some of these products—sports goods and surgical instruments, in particular—while others, such as fans and automobile parts, are just beginning to be noticed. However, all have a huge and expanding international market and the potential for increasing Pakistani exports in them is considerable. In addition, SMEs—including those that produce these goods—are generally highly labor-intensive and their growth would generate substantial employment. These four SME product groups are, therefore, ideal export drivers in the medium to long run. An effective strategy to develop the export of these products would entail promoting industrial clusters, improving SMEs' access to finance, and providing a supporting environment for innovation, particularly for improvements in production processes, design, and quality standards.

#### *2.3.1. Promoting Industrial Clusters*

Industrial clusters are defined as a collection of related companies located in the same region, which leads to the development of a pool of skilled labor related to that industry, spillovers, and the availability of needed raw material and intermediate goods (Krugman, 1991). According to Porter (1990), underlying the phenomenon of clustering are mechanisms that facilitate the interchange and flow of information between firms while rivalry is still maintained. There is empirical evidence to suggest that firms in clusters benefit from the above externalities and are likely to grow faster than firms located outside (see for example Naudé & Rossouw, 2010; Aitken, Hanson, & Harrison, 1997; Fujita, Krugman, & Venables, 2001). Industrial clusters also help small firms enter export markets.

Firms that wish to start exporting face significant costs associated with the search for suitable markets and international contacts. This involves accumulating detailed knowledge on consumer preferences to tailor products to local tastes, developing distribution channels, and at times expanding or upgrading existing plant and equipment. These costs are referred to as "sunk costs", and a firm will only choose to incur them if the perceived benefits of exporting outweigh these costs. In situations where sunk costs are too high, especially due to difficulties in accessing knowledge, they will act as a deterrent. Clustering can help reduce such costs for an individual firm because of the spillovers that exist within clusters and the possibility of pooling resources when incurring some of the sunk costs.

The geographic concentration of exporters may also promote the development of specialized transportation infrastructure, such as storage facilities, dry ports, and long-distance trucking operations, or it may improve access to information about goods that are in demand and market players in the importing countries (Aitken et al., 1997). Location advantages in terms of backward links, such as the existence of raw material and intermediate goods suppliers, and the availability of labor with specialized skills, can also reduce the cost of exporting. Thus, the existence of spillovers within a cluster will increase member firms' propensity to export. The city of Sialkot (where there are probably more individual manufacturing exporters than in any other city in the country, including Karachi and Lahore) is a testament to the effectiveness of such forces.

A number of large SME clusters have developed in Pakistan.<sup>5</sup> An important element of a policy to promote industrial clusters should be to give priority to export clusters in the provision of infrastructure, particularly power and gas, the development of common facilities, particularly for testing and certification, and skills training centers and programs (for details, see Ahmed, Mahmud, Hamid, & Rahim, 2010).

### *2.3.2. Improving Access to Finance*

There is a positive link between financial development and international trade (see, for example, Beck, 2002; Svaleryd & Vlachos, 2005; Do & Levchenko, 2007). This is because entering foreign markets is costly since it entails additional costs as discussed above. Thus, credit-constrained firms will find it more difficult to export than firms that have access to finance, and only those firms will become exporters that are able to overcome their liquidity constraints. For a sample of manufacturing firms in Italy, Minetti and Zhu (2011) find that the "probability of exporting is 39 percent lower for credit-rationed firms than for nonrationed firms and that rationing reduces foreign sales by more than 38 percent."

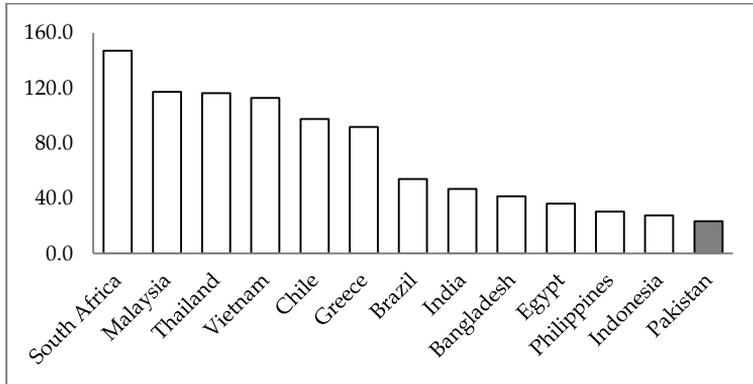
Pakistan's financial markets are underdeveloped relative to those of other developing countries (Figures 6.2 and 6.3) because "the terms of loans are much shorter, average loan sizes are larger, and bank requirements for collaterals against loans are higher" in the former (World Bank, 2009). As a result, financial access is restricted primarily to large firms, and SMEs are mostly excluded. Ahmed and Hamid (2011) find that, other things being equal, SMEs are 12.2 percent and 7.4 percent less likely to have access to external finance than large firms. The situation

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<sup>5</sup> "Such as the textile cluster around Faisalabad, the engineering, pharmaceutical, and textile clusters around Karachi, and the textiles, light engineering and sports goods cluster in the Sialkot, Gujrat, and Gujranwala triangle" (Ahmed et al., 2010).

tends to worsen as credit markets tighten, as is evident from the fact that SMEs' share in total bank lending is estimated to have declined between 2004 and 2007 (World Bank, 2009). Since credit availability has tightened even further since then, it is likely that SMEs today are almost entirely excluded from bank credit.<sup>6</sup>

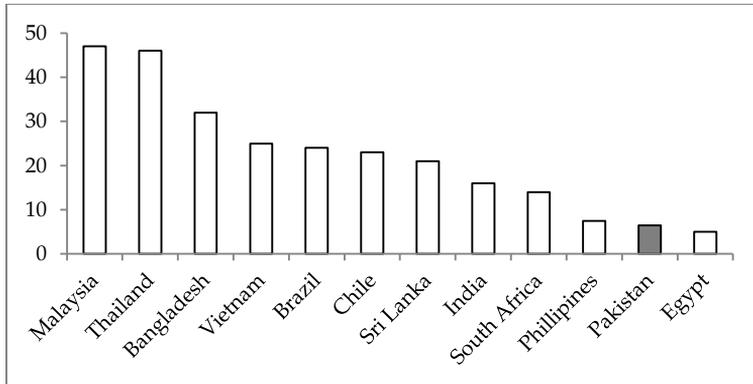
**Figure 6.2: Financial depth\***



Note: \* domestic credit to private sector (as a percentage of GDP).

Source: World Development Indicators, 2011.

**Figure 6.3: Bank credit as a share of working capital (%)**



Source: Various rounds of the World Bank's Investment Climate Assessment Surveys.

<sup>6</sup> In connection with a study on the garments industry, one of the authors recently interviewed a number of firms and found that not a single SME was using bank credit (International Growth Centre, 2013).

Financial access for firms is a function of (i) the degree of financial deepening in the country, and (ii) the lender's risk evaluation of the borrower. While there is substantial financial penetration in large cities such as Lahore and Karachi, access to finance has not spread uniformly across the country. Ahmed and Hamid (2011) find that firms located in smaller cities such as Sheikhpura, Sukkur, and Hyderabad, have a lower probability of financial access relative to firms located in metropolitan cities such as Karachi and Lahore or those in export clusters (such as Sialkot). Consequently, emerging export industries, that must incur additional costs when entering export markets and are not located either in large cities or export clusters, are likely to be the most affected by financial constraints.

The data also shows that there is a link between financial access and exports in Pakistan's manufacturing sector. According to the second round of the Investment Climate Assessment Survey (World Bank, 2007), financial access is three times greater in the study's sample of exporters compared to nonexporters.<sup>7</sup> Thus, innovative policies are needed to increase financial access for SMEs by introducing appropriate financial products and encouraging banks to move from collateral- to returns-based lending.

### *2.3.3. Providing a Supporting Environment for Innovation*

There is consensus in the literature that a firm's trade status is linked to innovative activity (defined as the introduction of a new product or process or both). However, the direction of causality between the two has not been established. Ahmed and Mahmud (2011) find that, while export status did not determine innovative activity for a sample of manufacturing firms in Pakistan, there was a significant increase in the number of firms that started exporting post-innovative activity. Their study also shows that a firm's presence in a cluster is an important factor explaining its innovative activity, and that financial access is a significant determinant of innovation for SMEs.

The East Asian economies have exhibited tremendous export-led growth on the back of a successful transition from low- to high-end technological production. What matters for growth is not just the scale of production, but also the ability of countries to innovate. The important question is how to promote innovation. According to INSEAD's global

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<sup>7</sup> Splitting the sample of firms by those with and without financial access shows that the probability of exporting is lower for firms without financial access than for those with financial access; 50 percent of the firms with financial access are exporters compared to only 18 percent of credit-rationed firms.

innovation index for 2011, Pakistan ranked 123<sup>rd</sup> out of 125 countries on the innovation input subindex,<sup>8</sup> which captures the environment for innovation. However, on the innovation output subindex,<sup>9</sup> which measures actual achievement in innovation, the country ranked 67<sup>th</sup>. As a result, it ranked fourth on the innovation efficiency index.<sup>10</sup> These numbers show well both Pakistan's tragedy and resilience, i.e., its environment is among the worst in the world but its people are among the most innovative. Thus, to promote innovation, Pakistan needs to improve the input environment. For this purpose, the most cost-effective strategy would be to invest in the development of human capital and industrial research infrastructure, promote industrial clusters, and improve financial access for SMEs.

#### *2.3.4. Facilitating Regional Trade*

Pakistan's regional trade has expanded rapidly in the last decade, and overland trade with Afghanistan has been its fastest-growing component (Hamid & Hayat, 2012). Trade with Afghanistan has boosted SME exports, particularly in the light engineering industry. For example, Afghanistan accounted for 33 percent and 17 percent of Pakistan's global exports of metal manufactures and machinery and transport equipment, respectively, in 2010/11 (Hamid & Hayat, 2012). Similarly, in 2010/11, Bangladesh accounted for 52, 45, 45 and 16 percent of Pakistan's global exports of textile and leather machinery, heating and cooling equipment, motorcycles and bicycles, and pump compressors and fans, respectively (United Nations Statistics Division, 2010). As Hamid and Hayat (2012) argue, these exports could play an important role in the future overall export of such products because "it is always difficult to develop new export products, but once export capacity, production experience, and domestic supply chains are developed for a particular product, it is much easier to export that product to other markets."

Trade with India, particularly overland trade, would boost SME exports in two ways. First, the opening up of the large Indian market, where conditions and tastes are similar, would provide much greater export opportunities than in Afghanistan or Bangladesh. Second, India's engineering exports have expanded rapidly and the industry is becoming increasingly integrated with global supply chains, from which Pakistani industry is, unfortunately, isolated. Overland trade with India would help

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<sup>8</sup> The index comprises five pillars: institutions, human capital and research, infrastructure, market sophistication, and business sophistication.

<sup>9</sup> The index comprises two pillars: scientific outputs and creative outputs.

<sup>10</sup> This is calculated as the ratio of the two subindexes, and examines how economies leverage their enabling environments to stimulate results in innovation.

link Pakistan's light engineering industry to the Indian supply chain and through that to global supply chains.

As an example, in 2009/10, car sales in India accounted for 1.9 million vehicles, and 489,000 motor vehicles and 1.3 million motorcycles and auto-rickshaws were exported, yielding total automobile industry exports of USD 4.3 billion (Banerji, 2012). According to Banerji, the automobile components industry had a compound annual growth rate of 16 percent for the period 2004 to 2010. By 2020, "passenger car sales in India are set to touch nine million, with [the] auto-component industry set to grow to USD 113 billion" and "exports of auto parts are expected to touch USD 40–45 billion" (more than a third of output in revenue terms). India's major global automobile manufacturers—such as General Motors and Ford—source original equipment manufacturer (OEM) parts from the country, while companies such as Suzuki, Hyundai, Ford, and Volkswagen operate in the local market. The Indian automobile market, including exports, therefore offers huge growth potential for automobile component manufacturers in Pakistan. The same is true for surgical instruments, white goods, and industries in Pakistan's light engineering sector.

In terms of policy measures, Hamid and Hayat (2012) argue that, "given the growth prospects of most of the neighboring governments, one can expect that the potential for Pakistan's exports will continue to expand. It is up to Pakistan to adopt appropriate policies to take advantage of this potential. This will require a change in the mindset of the policymakers—an 'economy-first' approach is needed." With regard to Pakistan-India trade, the Pakistan Business Council's (2011) panel on regional trade concludes that

SMEs in garments, footwear, food processing, auto parts, metal products, and IT have considerable potential to benefit from liberalized bilateral trade if they can identify market niches in India by acquiring specialized local knowledge, participating in trade fairs and cutting business deals. This requires both easy travel as well as access to commercial bank branches to facilitate quick cross border transactions.

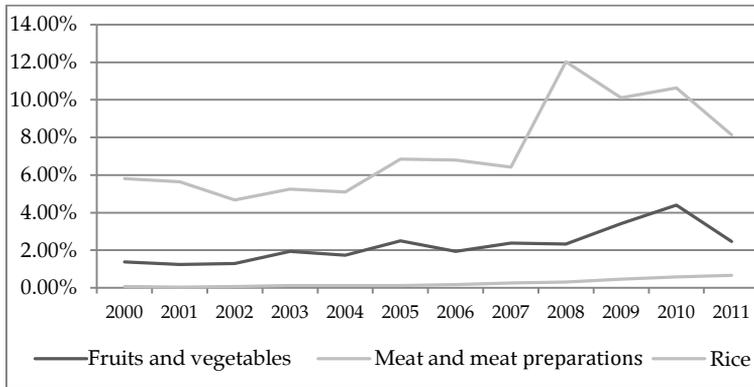
This requires the government to move quickly toward implementing the agreement to relax visa regimes and allow Indian banks to start operations in Pakistan.

### **3. Agriculture**

The agriculture sector provides employment to half the country's labor force and account for a significant share of exports. Rice exports are

increasing and are second only to the textile sector in terms of value. High-value nontraditional agricultural exports such as meat, fruit, and vegetables have also grown: their combined share rose to almost 5 percent of total exports in 2010, though it fell in 2011 (Figure 6.4). Rice and high-value products are, therefore, potential export drivers for Pakistan’s agriculture sector in the medium term. Cotton is also a possible export driver, given its large unexploited potential in terms of increases in yield through BT cottonseed. All three drivers are discussed in turn below.

**Figure 6.4: Agricultural export performance  
(commodity share in total exports)**



Source: Authors’ calculations based on data from UN comtrade (SITC Rev. 3).

### 3.1. Driver 1: Rice

Pakistan is the world’s fourth largest rice exporter with exports increasing from USD 0.5 billion in 2000 to over USD 2 billion in 2011—rice accounted for 8.1 percent of Pakistan’s total exports in 2011 (United Nations Statistics Division, 2010). The increase in the value of rice exports in the last decade was the result of a twofold increase both in export price and the quantity exported. The world demand and price outlook for rice in the medium term is strong and Pakistan should benefit from this. However, the country’s rice yields are well below those of the rest of the world and, as the extensive margin is more or less exhausted, it is necessary to focus on improving yields to realize the crop’s full potential as a driver of export growth in the future.

Additionally, Pakistan receives far lower prices for Basmati rice than India. To obtain premium prices, the country needs to facilitate investment in DNA testing and certification facilities, which should be done through

public–private partnerships to attract international expertise and investment. There is also potential for tapping niche, high-value markets for Japonica rice, which has been grown successfully in Swat. The potential for expanding rice exports is, therefore, considerable, but realizing it will require a set of policies aimed at enhancing export value and rice yields, i.e., areas in which Pakistan holds a good track record.

### **3.2. *Driver 2: (BT) Cotton***

Pakistan enjoyed a record cotton crop in 2012, largely due to the use of BT cottonseed, which is based on smuggled seed varieties developed by Monsanto in India. Farmers in Pakistan started using BT cottonseed in 2002 and, currently, the bulk of the area under cotton is sown with BT seed. However, since this seed is based on varieties developed for conditions in India and are marketed without any formal approval and regulation of minimum quality standards, their yield is far below the potential. In 2010, an initiative in Punjab aimed to reach an agreement with Monsanto under which BT cottonseed suited to conditions in Pakistan could be developed. However, since Pakistan has no law protecting the intellectual property rights (IPR) of seed breeders and the government was not willing to compensate Monsanto for the reproduction and sale of the seed varieties it would develop, the MOU was never signed.

Unfortunately, Pakistan continues to waste its enormous potential for increasing cotton production. A major cotton exporter for 50 years after independence, it has been unable to significantly improve its yield per hectare since 2000 and has now become a net importer of cotton. In contrast, India, which was initially a net importer of cotton, doubled its production between 2000 and 2005 following the introduction of BT cottonseed. It achieved this by doubling the yield per hectare while the area under cultivation remained almost unchanged. Today, India is a net exporter of cotton.

Were Pakistan to use BT cottonseed tailored to local conditions and that met minimum quality standards, it could increase its cotton production by 50–80 percent in five to seven years. This, in turn, could increase cotton exports by over USD 3 billion per annum, and if converted into textile products, could increase exports by a multiple of that.

### **3.3. *Driver 3: High-Value Nontraditional Agricultural Exports***

Pakistan’s fruit and vegetable exports have grown slowly, with their export share increasing to 4.4 percent in 2010. The Competitiveness Support Fund (2007) cites issues with the production, harvesting, and

transportation of produce, observing that growth could otherwise have been much faster. While the quality and variety of fruit and vegetables is good, exports suffer due to wastage, a short shelf-life, and lack of certification. In other product types, Pakistan exported a negligible amount of meat and meat preparations in 1998. Since then, the sector has shown significant growth, attaining a 0.6 percent share in total exports by 2010. Over 50 percent of these go to the United Arab Emirates and Saudi Arabia alone, and the top five destinations are all in the Middle East.

These emerging product groups have considerable potential; improving trade relations with India, particularly freeing up overland trade, should accelerate the growth of export fruit and vegetables, while developing the necessary infrastructure and certification facilities could result in the rapid growth of meat exports by tapping into the huge market for *halal* meat in the Middle East and Southeast Asia (i.e., Malaysia and Indonesia).

### **3.4. Strategy for Promoting Agricultural Exports**

We have argued that there is considerable potential for accelerating the growth of agricultural exports and that this would require sustaining the growth momentum in rice, revitalizing cotton production, and developing a marketing infrastructure to export higher value-added products such as fruit, vegetables, and meat. However, the government plays a critical role in developing a high-quality seed market, establishing grading and quality standards and the associated testing and certification facilities, and facilitating investment in the necessary marketing infrastructure.

**High-quality seed.** Pakistan appears to be stuck in a low-level equilibrium in the production of its major crops, i.e., wheat, rice, cotton, and sugarcane. An important factor in this is the failure to develop a market for high-quality seed, a key reason for which is the lack of legislation protecting IPR (a bill for the Plant Breeder's Rights Act, for example, has been lying in the National Assembly since 2010). As a result, research in the development of new seeds is confined to the public sector, which has become increasingly ineffective. The example of Monsanto's refusal to develop BT cottonseed in Pakistan for this reason was discussed earlier.

The success in the production of maize in Punjab is another example of missed opportunities in other crops. Hybrid maize seed, which cannot be reproduced in farmers' fields and is, therefore, less dependent on an IPR regime, was developed and marketed in Punjab by an international seed company. Since 2000, the area under maize production has increased by almost 15 percent while the yield per hectare has more than doubled—from 1,741 to 3,944 kg/hectare (Pakistan, Ministry of Finance, 2012).

Maize is the only crop in which yields are higher than in Indian Punjab. The private sector faces significant costs in developing new seeds and the infrastructure to market them, and without IPR protection there will be gross underinvestment in this sector. In fact, the benefits accruing to Pakistan from the use of high-quality seed are so large that the government should consider subsidizing the development of a modern seed industry through grant incentives or public-private partnerships.

**Product markets.** Market failure in domestic agriculture markets is an important factor slowing down the growth of high-value crops. This market failure is reflected in the large wedge between farm-gate prices and the retail prices of fruit and vegetables. One of the reasons for this is that agricultural marketing in Punjab (and other provinces) is governed by an almost-century-old agriculture markets act<sup>11</sup> that perpetuates the role of the traditional “*arthis*” who for generations have been members of the district and local market committees that monopolize the trade of agricultural produce in their areas. This has resulted in multiple layers of intermediaries between the farmer and the consumer, which are responsible for the large price wedge as well as for the very high wastage rate in perishable products. It makes it difficult for a modern marketing system, which usually consists of only two intermediaries—the wholesaler and the distributor—to develop. It also greatly dilutes the impact of changes in market prices on production decisions and incentive to invest in improving production methods. Thus, Pakistan must reform its agricultural markets regulatory framework for the high-value agriculture sector to develop.

The presence of international supermarket chains (such as Metro and Hyperstar) in the country has a role to play in developing the domestic supply chain, introducing quality standards, and providing international market access. Supermarkets are better connected and more aware of international best practices, and also have the incentive to make or facilitate investment in upgrading market infrastructure. (See Hamid, 2008, for a more detailed discussion on the likely impact of international supermarket chains on marketing and the export of high-value agricultural commodities.)

**Standards, testing, and certification.** Pakistan lacks the market infrastructure for meeting quality and phytosanitary standards, which has impeded the growth of high-value agricultural exports, especially to developed countries. Creating this infrastructure requires actions both on

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<sup>11</sup> The Punjab Agricultural Produce Markets Act 1939 is the basis of the laws and regulations that govern the operation of agriculture markets in Punjab. While this act has been amended several times, its basic structure remains more or less unchanged.

the demand and supply side. As discussed above, reforms in agriculture marketing regulations and the growth of international and local supermarket chains will promote demand for these facilities. On the supply side, the government needs to step in to facilitate investment in testing and certification facilities by international players through partnerships or franchise arrangements with domestic firms involved in the agriculture sector.

#### **4. IT and Entertainment Services<sup>12</sup>**

The export of IT services has played a key role in the Indian economy's high growth performance over the last two decades. The development of the IT sector not only helped the country ease its balance-of-payments constraint but boosted investment and growth in other sectors of the economy. In recent years, the expansion of knowledge-based exports in the fields of entertainment and health tourism have made a growing contribution to India's foreign exchange earnings and employment generation. With the right policies in place, these sectors are capable of contributing similarly to economic growth in Pakistan.

Pakistan's earnings from the export of computer and IT services in 2010/11 were USD 215 million with another USD 18 million generated by call centers (State Bank of Pakistan, 2012). This can be compared to India's software exports of approximately USD 61 billion in 2010/11 (Reserve Bank of India, n.d.). However, Pakistan's official figures are based on payments received for IT-enabled services through the banking system.

India has adopted the World Trade Organization's methodology for calculating exports of IT services, which not only takes into account payments for services shipped abroad, but also the incomes of Indian companies and IT professionals that are based abroad. Using this methodology, the Pakistan Software Export Board (2013) estimates that the country's global IT sales revenues are around USD 1.6 billion. This implies that the ratio between Pakistan and India's global IT exports is about 1:38 rather than 1:250, as implied by the official statistics. Given that the ratio for IT professionals between the two countries is 1:25—there are an estimated 110,000 IT professionals in Pakistan compared with 2.8 million in India (Pakistan Software Export Board, 2013; Reserve Bank of India, n.d.)—the figure of USD 1.6 billion for Pakistan's global exports seems more reasonable, although it is still well below potential.

Pakistan is considered one of the leaders in the second-tier countries in the global information and communications technology industry (Pakistan

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<sup>12</sup> This section draws on Hamid (2008).

Software Export Board, 2013). It has more or less similar endowments, in terms of human resources, culture, and language skills, as India and could also, therefore, become a major outsourcing center for IT services.

A key reason for why Pakistan has not been able to realize the foreign exchange earnings potential of the IT industry is that businesses in developed countries are reluctant to outsource to Pakistan due to the perceived country risk arising from its poor law and order situation, negative international image, and the US State Department's travel advisory. According to a pioneer of the industry and one of its largest software exporters, Pakistan could very easily earn over a billion dollars from the export of IT-enabled services (by the State Bank of Pakistan's definition) if there were no US travel advisory for the country.<sup>13</sup>

Another potential growth area is the emerging infotainment industry, particularly in the fields of mobile applications, gaming, and animation. According to one commentator,

Pakistan's mobile, gaming, and animation scene is increasingly a hotbed of a new generation of exciting entrepreneurs who are in the process making an impression on the rest of the world. These entrepreneurs include Babar Ahmed, whose Mindstorm Studios created Cricket Revolution™—the first PC game produced by a Pakistani gaming outfit to sell in retail stores internationally—and recently launched the official game of the ICC World Cup 2011; Brothers Rizwan and Irfan Virk, who [together with their MIT colleague Mitch Liu] set up Gameview Studios which created the successful Tap franchise that was acquired in 2010 by the Japanese social gaming giant DeNA; and Hasan Rizvi, whose Pepper.PK developed two top-ranking paid BlackBerry applications at BlackBerry's AppWorld store (Pakistan Software Export Board, 2013).

According to another commentator,

[While] the Philippines and Korea are highly preferred countries in animation sector ... India and Pakistan are growing massively in Asia... Although India is more forward in animation industry [it is] also more expensive than Pakistan ... Animation industry in Pakistan may seem [to] be a new expected hotspot of discussion and exploration ... Pakistan has full potential of fetching precious forex [foreign exchange] of USD 1 billion every year through promotion of Animation Industry [*sic*] (Azeem, 2012).

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<sup>13</sup> Interview with Aezaz Hussain, chairperson of Systems Limited, on 6 May 2013.

Exports by the traditional entertainment industry were less than USD 3 million in 2010/11 (State Bank of Pakistan, 2012). However, the potential for expanding export earnings from this industry has also grown rapidly in recent years. Pakistan has undergone a media revolution in the last 10 years: there are now 85 private satellite television channels (Pakistan Electronic Media Regulatory Authority, 2010) including 25 news channels, 23 entertainment channels, 14 regional channels, 7 music channels, 3 religious affairs channels, 3 food channels, and dozens of other assorted channels (Tirmizi, 2013).

This gives some idea of the scope and diversity of content being created in Pakistan. While their quality is uneven, a number of television series, such as Coke Studio (a music program now in its fifth season), HUM TV's *Humsafar*, and ARY's *Meri zaat zarra-e-benishan*, have had a large international audience. There is a large market for such entertainment content not only among the Pakistani (and South Asian) diaspora but also in India. At the moment, many Pakistani channels are aired on cable television in Europe and North America, and almost all the entertainment programs being produced are available on YouTube. The issue is how to convert this large international viewership into earnings for the industry and the country.

## **5. Cross-Cutting Boosters**

### **5.1. Leveraging the Diaspora**

The Pakistani diaspora offers great potential for expanding exports from Pakistan to their countries of residence. Recent estimates show that the Pakistani diaspora across the world may include as many as 10 million people (Pakistan, Planning Commission, 2011). In 2012, the country received total remittances worth USD 14 billion (International Monetary Fund, 2012). Members of the diaspora can play a role in increasing trade between their country of origin and country of residence in three ways (Figure 6.5):

1. Pakistanis residing abroad create demand for Pakistani goods and services.<sup>14</sup> In the UK, for example, there is rising demand for Pakistani food items (fruits, particularly citrus and mangoes, packed foods, and spices, such as Shan food masala) as well as for high-end consumer goods such as furniture, clothing (local brands such as Bareeze and Junaid Jamshed). This increase in demand is

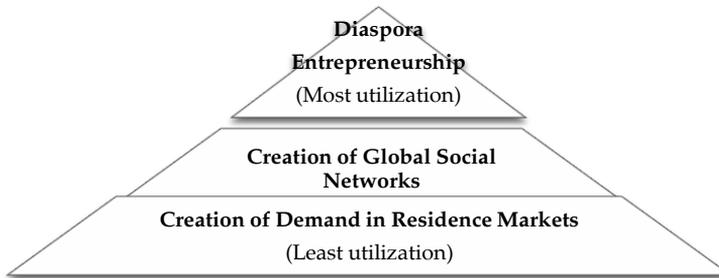
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<sup>14</sup> For example, a substantial market for Pakistani mangoes has developed in the UK through the Pakistani diaspora settled there. Initially, the mangoes were only available in small grocery shops in areas of Pakistani concentration, but with their availability came growing popularity, and now they are available even in mainstream supermarkets.

driven by the presence of a Pakistani diaspora in the UK (direct effect) and, to an extent, through the influence of Pakistani culture and cuisine on local culinary habits and tastes (indirect effect).

2. Members of the diaspora enjoy wider access to and greater knowledge of both their country of residence and their country of origin. These connections can be useful in creating opportunities for trade, outsourcing, and partnerships. Moreover, exporters can use the diaspora's context-specific knowledge to tap into new markets or identify high-growth products in existing markets. Thus, they serve as important agents of facilitation for increasing market presence in their residence countries as well as identifying profitable niches in those markets.
3. In the context of a country's export industry, diaspora-led investments in the country of origin can have a twofold impact.<sup>15</sup> By increasing the numbers of players in the market, such investments may bring with them foreign knowledge and facilitate the flow of technology and information. This may, in turn, fuel innovative activity among domestic producers.

**Figure 6.5: Benefits of engaging the Pakistani diaspora (in ascending order)**



The diaspora have had a huge impact on a country's development in a number of cases, with trade in the case of China and IT outsourcing by India as the best examples. Encouraging the Pakistani diaspora to play such a role may need a more proactive strategy that will target top executives of companies abroad as well as business owners in resident countries for purposes of mobilizing direct investment into Pakistan or facilitating the export of Pakistani products to the diaspora's countries of residence. Diaspora business forums, which help identify and address problems encountered by diaspora businesses in investing in Pakistan

<sup>15</sup>A more general impact of diaspora entrepreneurship is the creation of jobs in the overall economy.

and which support exhibitions and events in their countries to showcase Pakistani products, could be an effective instrument for such a strategy.

## **5.2. Improving the Business Environment for Trade**

A country's investment climate is an important determinant of international integration. For a sample of eight developing countries (including Pakistan),<sup>16</sup> Dollar et al. (2006) find that the proportion of exporters is higher in countries where the number of bottlenecks is low versus countries where it is high.<sup>17</sup> The study also estimates that, if Karachi had the same investment climate as Shanghai, the number of exporting firms in the former would more than double. It takes firms in Karachi four times as long to clear customs (15.8 days) compared to firms in Guangzhou (3.9 days) and Shanghai (4.4 days) (Dollar et al.).

According to the World Economic Forum (2012), Pakistan ranks 109<sup>th</sup> on quality of infrastructure—well below India (86) and Sri Lanka (48) (see Figure 6.6).<sup>18</sup> In addition, in Pakistan there is a strong anti-trade bias as firms bear a much higher burden of customs procedures and trade barriers than firms in other countries. Thus, to be more competitive, Pakistan must improve its infrastructure and regulatory framework for trade.

In terms of infrastructure, the most important is the energy sector, which has emerged as a severe bottleneck and a threat to the economy's competitiveness. Pakistan's rank on the quality of electrical supply is 126—better than Bangladesh (135) but worse than India (112).<sup>19</sup> According to the World Bank (2009), the greatest financial losses faced by Pakistani firms are due to power outages. Moreover, these losses due to power outages are far greater for Pakistani firms than for firms in comparator countries such as Thailand, India, and Turkey. While it is important to solve the energy problem, eliminating power shortages may take some time. For the time being, therefore, SME export clusters should be given priority in the allocation of power and natural gas.

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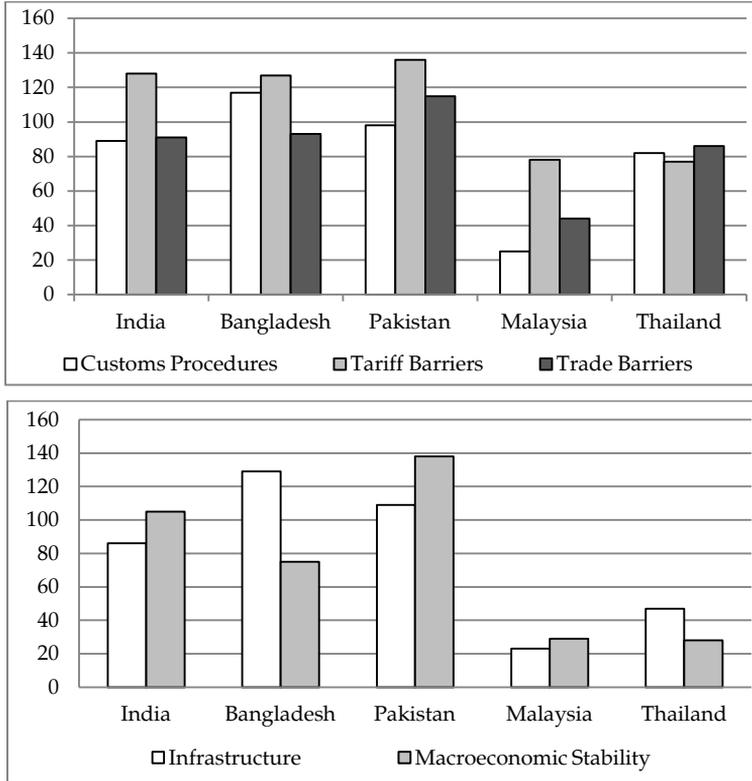
<sup>16</sup> The other countries studied include India, Bangladesh, China, Nicaragua, Brazil, Peru, and Honduras.

<sup>17</sup> Four specific bottlenecks are considered: (i) the number of days it takes to clear customs, (ii) losses due to power outages, (iii) the inefficiency of the government in providing public utilities, and (iv) limited access to financial services. Pakistan emerges as one of the least investment-friendly countries.

<sup>18</sup> These are country rankings based on individual pillars of the global competitiveness index and have been taken from the Global Competitiveness Report for 2011/12. Countries have been ranked from 1 to 133; the higher the rank, the lower a country's performance and vice versa.

<sup>19</sup> The data used in this report refers to 2010/11 and the current position is very likely much worse than two years ago.

**Figure 6.6: Ranking by various dimensions of the business environment: A cross-country comparison**



Source: World Economic Forum (2012).

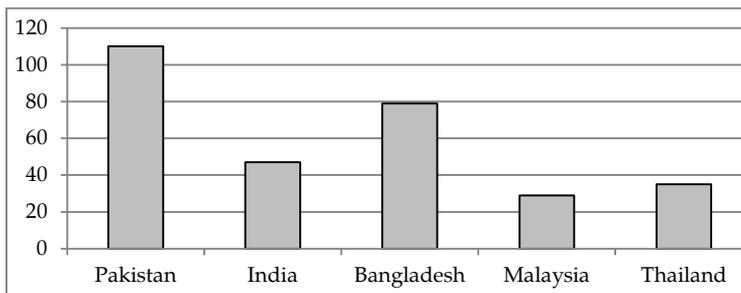
As regards the trade business environment, of which the logistics performance index (LPI) is a good overall indicator, Pakistan ranks 110<sup>th</sup> out of a total of 150 countries (Figure 6.7).<sup>20</sup> Disaggregating the country's performance along individual dimensions gives an even more dismal picture: Pakistan ranks the lowest on all the dimensions cited above relative to comparator countries in South and East Asia (Table 6.2). The gaps in performance between Pakistan and comparator countries such as India are very large in areas such as customs, logistics competence, and

<sup>20</sup> This index ranks countries on the basis of the quality and efficiency of various dimensions of trade logistics prevalent in a country. These include customs, international shipments, logistics competence, tracking and tracing, and timeliness. A high rank on the overall index as well as on individual dimensions denotes low performance on the index and vice versa.

timeliness. Customs procedures and trade deregulation have been the focus of numerous World Bank reports and structural adjustment loans that seem to have had hardly any impact.

It is hard, therefore, to make any recommendations in this regard except that, without progress in the area of customs procedures, particularly for the import of materials by export industries, diversifying exports or moving up the value chain will be difficult. Significant improvements in logistics competence can only take place if the logistics industry is developed on modern lines. This, in turn, requires measures such as ending the special treatment of the National Logistics Corporation and fixing the tax system, which favors haulage and trucking operations outside the formal corporate structure and restricts tariff concessions to industrial importers and duty refunds to direct exporters.

**Figure 6.7: Country rankings on the LPI, 2012**



Source: World Bank (2012a).

**Table 6.2: Dimensions of the LPI: Pakistan and comparator countries**

LPI dimension	Pakistan	India	Bangladesh	Malaysia	Thailand
Customs	134	52	90	36	39
International shipments	66	46	61	13	30
Logistics competence	120	40	96	31	39
Tracking and tracing	93	52	92	41	37
Timeliness	110	56	70	37	48

Source: World Bank (2012a).

## 6. Conclusion

Pakistan’s export performance paints a dismal picture—the country has failed to improve its world share and appears to be stuck in producing

and exporting products at the low end of value addition. It is necessary for the country to increase not only its export volumes but also to move up the value chain in terms of products exported. To this end, this chapter has identified potential export drivers and proposed a strategy for focusing on a limited number of product groups to deliver a sharp acceleration in export growth. In the medium term, these drivers are garments and other value-added textiles; SME manufactures; and rice, cotton, and high-value agricultural products such as fruit, vegetables, and meat. To leverage this growth, we have proposed engaging with the Pakistani diaspora to develop export markets, attract investment, and expand human capital, along with prioritizing the export sector for infrastructure allocation and improving the country's trade regulatory and administrative environment.

In the past, the case for export growth focused largely on its implications for the balance of payments. While this is obviously important, large-scale employment generation is equally important for sustainable rapid growth. Fortunately, the export drivers identified above are all labor-intensive and, therefore expanding their production will also yield a large employment bonus. This could help actualize the demographic dividend that the ongoing demographic transition has made possible, and initiate a virtuous circle of export growth leading to employment generation, poverty reduction, rising savings and investment rates, and still higher economic growth.

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*Exports: Lessons from the Past and the Way Forward*

## The Future Path of Tax Reforms in Pakistan

Hafiz A. Pasha\* and Aisha Ghaus-Pasha\*\*

### 1. Introduction

Pakistan's taxation system has come under intense scrutiny in recent years. The country's low and declining revenue yield has been attributed to wide-ranging concessions and exemptions, large-scale tax evasion, and a slack and corrupt tax administration. This has led to the perception of a virtual breakdown of tax compliance in the country.

Improving the tax effort has now become the lynchpin of any future economic reform process. Experience shows that this will require political determination in order to overcome the resistance from powerful vested interests. In addition, tax collecting agencies such as the Federal Board of Revenue (FBR), will need to undergo fundamental improvements to successfully implement the required changes in tax policy.

The objective of this chapter is to describe Pakistan's taxation system both at the federal and provincial levels, followed by an in-depth diagnosis of the factors contributing to the exceptionally low tax-to-GDP ratio. We also assess the level of tax rates, the magnitude of tax expenditures (revenue losses due to concessions and exemptions in the tax code), and the extent of tax evasion.

Based on this diagnosis, we identify the key elements of a reform package in the areas of tax policy and administration. This set of reforms will promote transparency of the tax system, improve the progressivity of the tax burden, and remove distortions in the allocation of resources in the economy. Importantly, the various measures proposed will help in significantly raising the tax-to GDP ratio.

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## 2. The Taxation System

### 2.1. Allocation of Fiscal Powers

The major taxes that can be levied at the federal level are given in Part I of the Federal Legislative List (FLL) in the Constitution of Pakistan. As shown in Table 7.1, this includes customs duties (including export duties), excise duties, taxes on income and corporations, sales tax, capital value tax, taxes on natural resources, capacity taxes, and terminal taxes on goods and passengers carried by different modes of transport. With the exception of capacity taxes, all these taxes are currently levied.

**Table 7.1: Fiscal powers of the federal government as per the Constitution <sup>a</sup>**

Item no. (FLL-1)	Included	Excluded <sup>b</sup>
43	Customs duties, including export duties	-
44 <sup>c</sup>	Excise duties, including duties on salt	Duties on alcoholic liquors, opium, and other narcotics
47	Taxes on income	Agricultural income
48	Taxes on corporations	-
49	Taxes on the sale and purchase of goods imported, exported, produced, manufactured, or consumed	Sales tax on services
50	Taxes on the capital value of assets	Taxes on property
51	Taxes on mineral oil, natural gas, and minerals used to generate nuclear energy	-
52	Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation	-
53	Terminal taxes on goods and passengers carried by rail, sea, or air; taxes on their fares and freights	-

*Note:* a = following the 18<sup>th</sup> Amendment, b = fall in the domain of fiscal powers of provincial governments, c = items no. 45 and 46 have been excluded (no. 45 included duties with respect to succession to property, no. 46 included estate duty with respect to property).

*Source:* Constitution of Pakistan (as updated up to the 20<sup>th</sup> Amendment).

The provincial governments have been given fiscal powers based on the exclusion of some parts of the federal tax bases. Agricultural income tax and property-related taxes have been declared provincial subjects. Following the 18<sup>th</sup> Amendment, the sales tax on services has been brought exclusively within the provincial domain. Further, all residual taxation powers are vested with subnational governments. This justifies the provincial governments' imposition of taxes such as stamp duty, motor vehicle tax, and entertainment tax. Additionally, Article 163 of the Constitution enables these governments to levy a tax on persons engaged in professions, trades, and callings.

## **2.2. Federal Taxes**

The salient features of each federal tax are described below.

**Income tax.** This is levied under the provisions of the Income Tax Ordinance 2001. The legislation indicates the types of income liable to taxation, tax rates, types of tax exemptions, credits, deductions, and allowances.

Revenues from income tax accrue in the form of voluntary payments (along with the filing of returns), collection on demand (following assessment), and deductions at source (in the form of withholding and presumptive taxes). A universal self-assessment scheme is in operation with returns being subject to a stratified random audit. Currently, deductions at source are the major source of revenue with a share of 57 percent, followed by voluntary payments, which contribute 32 percent to revenues.

There are two types of withholding/presumptive taxes. The first includes taxes collected at the point of accrual of different types of income, such as salaries, export proceeds, dividends, and interest income. The second, presumptive taxes, are collected on income proxies such as electricity and telephone bills, the sale of automobiles, and air travel. The major deductions at source are on income from services and payments for contracts, imports, and salaries with shares of 25, 20, and 14 percent, respectively.

**Sales tax.** This is levied under the Sales Tax Act 1990 and covers only goods. It has the features of a value-added tax (VAT) with provisions for the tax invoicing of inputs and zero-rating of exports. The act describes the registration process, filing of returns, offences, and penalties. It contains seven schedules, of which the sixth schedule gives the list of exemptions.

**Customs duties.** The Customs Act 1969 enables the collection of customs duties. Duties on imports are specified in the First Schedule at the 8-digit level of the Harmonized System. Pakistan's duty structure is

cascaded by the level of value added, with the lowest tariffs on primary raw materials and the highest on finished goods. There are some tariff peaks on luxury items such as automobiles and there is a list of banned items such as liquor.

Exemptions and concessions are granted under different statutory rules and orders (SROs); some of the major SROs include the following:

No.	Description
565(I)/2006	Exemption from customs duty on the import of raw materials, subcomponents, components, subassembly, and assembly for the manufacture of specified goods (mostly automobiles)
575(1)2006	Exemption from customs duty on machinery and equipment
567(1)/2006	Exemption from customs duty on the import of specified goods (nonsurvey-based)

In addition, there are SROs covering free trade and regional trade agreements.

**Excise duties.** Federal excise duty is levied under the Federal Excise Act 2005. Some goods, such as cigarettes, are subject to supervised clearance under this act. The First Schedule lists excisable goods and the rates of duty, which are either specific or ad valorem. Following the broad-basing of the sales tax, the coverage of excise duties has been substantially curtailed.

### **2.3. Provincial Taxes**

The key features of the major provincial taxes are described below.

**Sales tax on services.** This was introduced simultaneously by the four provinces with the enactment of the Sales Tax Ordinance 2000. The tax has been integrated with the federal GST (VAT), as though it were leviable under Sections 3, 3A, or 3AA of the Federal Sales Tax Act 2000; all the provisions related to payment, registration, audit, enforcement, and penalties are the same. Initially, its coverage was extended at the standard rate of 16 percent to hotels, clubs, and caterers; advertisements on television and radio; courier services; telecommunication services; stockbrokers; and miscellaneous services provided at ports. The responsibility for collecting this tax was assigned to the FBR's Inland Revenue Service, and revenues distributed among the provinces on the basis of population shares.

In 2011, the Sindh government introduced its own variant of the tax. It proposed creating its own capacity to collect the tax by establishing the Sindh Revenue Board. The tax no longer retains the features of a VAT and has effectively been transformed into a single-stage sales tax. Recently, the government of Punjab established the Punjab Revenue Authority.

**Stamp duty.** This was promulgated over a century ago, not as a fiscal statute but as a mechanism for authenticating a large number of instruments through the use of adhesive stamps. These stamps are classified as either judicial or nonjudicial. For example, the stamp duty on the value of a property sold is 2 percent.

**Land revenue.** This was originally promulgated under the Land Revenue Act 1887, and is essentially a land tax payable by owners of agricultural land. It is collected through the elaborate tax machinery of the provincial boards of revenue, which also maintain and update land records. Prior to 1947, land revenue was one of the main sources of revenue for the provincial governments.

**Motor vehicles tax.** This is levied under the Motor Vehicles Taxation Act 1958. Different lump-sum tax rates are specified for different types of vehicles, to be paid either once or annually. Persons with motor vehicles are obliged to make a declaration, pay the tax, and receive a license. The tax is collected by the provincial excise and taxation departments, and is intended to cover the costs of road operation and maintenance within the provinces. As such, the tax rises exponentially for larger vehicles. Motor vehicles tax rates vary among the provinces.

**Urban immovable property tax.** Introduced in 1958, the government levies this tax in urban areas that have been declared "rating areas". The tax is charged on the assessed rental value (ARV) of buildings and lands in a rating area at the rate of 20 percent. It is collected by the provincial excise and taxation departments on the basis of a formula for assessing the rental value contained in the valuation tables. Revenues from this tax are shared with local governments to the extent of 85 percent, after deducting 5 percent as the cost of collection. Properties that are owner-occupied and have an ARV of less than PRs 1,080 or are located on an area smaller than 5 *marlas* (125 square yards) are exempt.

The five taxes above account for more than 90 percent of the provincial governments' tax revenues. The overall composition of tax revenues is given in Table 7.2. Federal taxes account for the bulk of revenues, with a share approaching 95 percent in 2011/12. The largest federal tax is the sales tax, which generates 39 percent of total tax

*The Future Path of Tax Reforms in Pakistan*

revenues, followed by income tax at 35 percent. Customs duties and excise duties contribute 10 percent and 6 percent, respectively.

The share of provincial taxes is very small at only 5 percent, which is low in relation to countries like India where the share of state taxes is over 35 percent. The sales tax on services has emerged as the largest provincial tax, followed by stamp duties.

**Table 7.2: Share of revenues from different taxes (PRs billion)**

<b>Tax</b>	<b>2007/08</b>	<b>Share (%)</b>	<b>2011/12</b>	<b>Share (%)</b>
Federal	1,045.4	96.30	1,969.6	94.86
Direct taxes	387.9	35.72	731.9	35.26
Indirect taxes	622.5	57.33	1,153.7	55.58
Excise duty	86.5	7.97	126.2	6.08
Sales tax	385.5	35.50	809.3	38.98
Customs duty	150.5	13.86	218.2	10.52
Surcharge/levy	35.2	3.24	83.4	4.02
Petroleum levy	14.5	1.33	60.4	2.91
Gas development surcharge	20.7	1.91	23.0	1.11
Provincial	40.2	3.70	106.7	5.14
Stamp duty	11.3	1.04	16.5	0.79
Motor vehicle tax	7.8	0.72	11.1	0.53
Property tax	4.1	0.38	7.8	0.38
Others <sup>a</sup>	17.0	1.57	71.3	3.43
<b>Total</b>	<b>1,085.8</b>	<b>100.0</b>	<b>2,075.7</b>	<b>100.0</b>

*Note:* a = including land revenue, agricultural income tax, electricity duty, etc., and from 2011/12 onward, sales tax on services.

*Source:* Fiscal operation, Pakistan, Ministry of Finance.

### **3. Tax Administration**

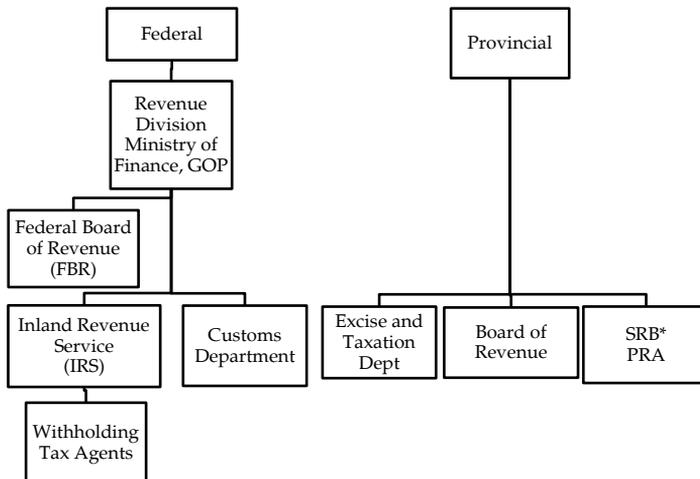
The FBR is the federal government's tax collecting agency. It comprises three types of members—line, functional, and support—under the chairperson. Line members are department heads who are directly responsible for tax collection, i.e., Customs, Inland Revenue (South), and Inland Revenue (North). The latter two departments are responsible for collecting income tax, sales tax, and federal excise duty.

Five functional members are responsible for inland revenue policy, taxpayer audits, legal issues, facilitation, and taxpayer education and enforcement, respectively. The support functions fall under members for administration, human resource management, strategic planning and statistics, and accounting and training. Withholding tax agents include employers, government departments/ministries, banks, telecommunication companies, electricity and gas distribution companies, airlines, and provincial taxation departments.

The provincial tax administrations comprise multiple agencies (Figure 7.1). The excise and taxation departments are responsible for collecting taxes from urban jurisdictions, such as property tax and motor vehicles tax. The provincial boards of revenue operate largely in rural areas and collect land revenue, agricultural income tax, and stamp duties. Following the 18<sup>th</sup> Amendment, the government of Sindh has established the Sindh Revenue Board primarily to levy and collect the sales tax on services. The government of Punjab has followed suit with the Punjab Revenue Authority.

At the federal level, the FBR's costs of collection are estimated to be 0.6 percent of the revenues that accrue to it, with 0.5 percent in the case of the Inland Revenue Service and 2 percent for the Customs Department. The provincial costs of collection are equivalent to 3 percent of own-revenues, which is low by international standards.

**Figure 7.1: Structure of tax administration in Pakistan**



*Note:* SRB = Sindh Revenue Board, PRA = Punjab Revenue Authority.

#### 4. Tax-to-GDP Ratio

The overall tax-to-GDP ratio, inclusive of federal and provincial taxes, surcharges, and levies, was 10 percent in 2011/12 (Table 7.3). During the last decade, the tax-to-GDP ratio has shown a declining tendency, falling from a peak of 11.5 percent in 2002/03. During this period, FBR revenues declined by about 0.5 percent of GDP. The major part of the overall fall was due to surcharges/levy on gas and petroleum, oil, and lubricant (POL) products, respectively.

A positive development has been the rise in the direct taxes-to-GDP ratio from 3.0 to 3.6 percent, which has contributed to a more balanced and progressive tax system. Indirect taxes have fallen significantly from 6.9 to 6.1 percent of GDP, between 2000/01 and 2011/12.

**Table 7.3: Tax-to-GDP ratio of Pakistan, 2000/01–2011/12**  
(percentage of GDP)

Year	Direct taxes	Indirect taxes	Surcharge /levy	Total taxes	FBR's revenue	Share of direct taxes
2000/01	2.99	6.89	0.73	10.61	9.42	28.18
2001/02	3.20	6.41	1.23	10.83	9.11	29.54
2002/03	3.17	6.94	1.41	11.53	9.57	27.49
2003/04	2.92	6.84	1.09	10.84	9.25	26.94
2004/05	2.72	7.01	0.41	10.14	9.05	26.82
2005/06	2.82	7.06	0.67	10.54	9.36	26.75
2006/07	3.85	6.41	0.74	11.00	9.76	35.00
2007/08	3.79	6.47	0.34	10.60	9.83	35.75
2008/09	3.46	6.00	0.99	10.44	9.08	33.14
2009/10	3.66	5.83	0.90	10.39	9.05	35.23
2010/11	3.31	5.64	0.63	9.58	8.60	34.55
2011/12	3.58	6.06	0.40	10.04	9.12	35.65

Source: Pakistan, Ministry of Finance.

Table 7.3 also shows the structure of tax revenues. Pakistan appears to rely heavily on indirect taxes, especially on taxes on goods and services. This also suggests that the major focus of tax reforms in the country will have to be on further enhancing the share of direct taxes.

Table 7.4 shows that Pakistan has the lowest tax-to-GDP ratio among 13 selected developing countries. The centrally collected tax-to-GDP ratio

of India and Pakistan is more or less, the same, but the contribution of subnational taxes is substantially larger in India. The average tax-to-GDP ratio of the 13 countries is 14 percent compared to less than 10 percent for Pakistan. This is the first (crude) estimate of the “tax gap” in Pakistan.

**Table 7.4: Comparison of tax-to-GDP ratio and taxation structure in selected countries**

Country	Year	Tax-to-GDP ratio (%) <sup>a</sup>	Percentage share of taxes on		
			Profits, income	Goods and services	International trade
Bangladesh	2011	10.0	26.7	36.9	36.6
Brazil	2010	15.3	43.4	52.9	3.7
China	2009	10.5	28.2	67.5	4.2
India	2010	9.7	56.5	28.1	15.4
Indonesia	2010	10.9	53.7	43.4	2.9
Malaysia	2010	13.8	77.7	19.5	2.8
Pakistan	2011	9.3	34.6	52.7	12.7
Philippines	2011	12.3	47.6	30.3	22.1
South Africa	2010	26.0	56.5	39.5	4.0
Sri Lanka	2011	12.4	21.8	56.4	21.8
Thailand	2011	17.6	46.4	48.2	5.4
Turkey	2010	20.6	31.4	67.0	1.6
Egypt	2010	14.1	48.5	42.3	9.2
<b>Average</b>	<b>2009–11</b>	<b>14.0</b>	<b>43.6</b>	<b>45.0</b>	<b>11.4</b>
<b>(13 countries)</b>					

*Note:* a = federal/central taxes only.

*Source:* World development indicators, World Bank.

Next, we examine the factors that have contributed to Pakistan’s low tax-to-GDP ratio by isolating the “base” and “rate” effects on the change in the tax-to-GDP ratio. The “base” effect arises when the relevant tax base rises faster/slower than GDP, while the “rate effect” comes into play when the effective tax rate on the tax base rises/falls. The methodology used to identify the two effects is given in the Appendix.

The analysis spans the period 2007/08 to 2010/11 (see Table 7.5). The main reason for the significant fall in the FBR’s tax-to-GDP ratio (by over 1.2 percent of GDP) is the large negative base effect. The two primary tax bases in the economy, large-scale manufacturing and imports, grew little during these years. The former has largely remained static while imports showed a growth rate of only 1 percent in dollar terms.

**Table 7.5: Base and rate effects on the change in tax<sup>a</sup>-to-GDP ratio, 2007/08 to 2010/11 (%)**

Tax	Base effect	Rate effect	Change in tax-to-GDP ratio
Direct taxes	-0.03	-0.50	-0.48
General sales tax	-0.56	0.30	-0.26
Customs duties	-0.28	-0.15	-0.43
Excise duties	-0.12	0.06	-0.06
<b>Total</b>	<b>-0.99</b>	<b>-0.24</b>	<b>-1.23</b>

Note: a = only federal taxes.  
Source: Authors' calculations.

The Social Policy and Development Centre (2008), however, concludes the opposite where the base and rate effects are concerned. Between 1999/2000 and 2006/07, the tax-to-GDP ratio rose by 0.7 percent with a large positive base effect of 3.0 percent of GDP; this was largely neutralized by a sizeable negative rate effect of 2.3 percent of GDP. The large-scale manufacturing sector grew by over 11 percent and imports expanded rapidly at the rate of 15.7 percent per annum. In fact, the economy should have witnessed major "fiscal drag"<sup>1</sup> during this period of fast growth, but the revenue gains were largely frittered away by the policy to reduce tax rates.

## 5. Tax Rates

Tax rates were brought down sharply by the military government. The maximum income tax rate on individuals and associations of persons (AOPs) was scaled down from 35 to 25 percent in the Finance Bill of 2006/07. Tax rates were reduced substantially for small companies (from 45 to 25 percent) and for banking companies (from 50 to 35 percent), in a staggered manner.

The maximum import tariff was brought down from 45 to 25 percent by 2002/03, along with a cascading down of the overall tariff structure as part of the process of trade liberalization. This simultaneously affected revenues from sales tax at the import stage and from the presumptive income tax on imports. The rate of excise duty on cigarettes was also reduced. Overall, it appears that the Musharraf government essentially followed a supply-side strategy of bringing down tax rates in order to boost the economy. The tax bases did expand but not enough to enable a major jump in revenues.

<sup>1</sup> "Fiscal drag" occurs when fast economic growth leads to an increase in the tax-to-GDP ratio.

The subsequent democratically elected government had to reverse this policy somewhat in the face of a declining tax-to-GDP ratio. A minimum income tax was introduced, while the maximum tariff on imports was raised once again to 35 percent and brought down to 30 percent in the Finance Bill of 2012/13. The standard sales tax rate was raised from 15 to 17 percent, and only recently reduced to 16 percent. An across-the-board special excise duty of 2 percent was introduced on imports and domestic manufacturing, but withdrawn in 2012/13 in the lead-up to the elections.

Following these changes in the tax policy, how do Pakistan's tax rates now fare in international comparisons? Table 7.6 shows that the corporate tax rate on large companies is relatively high at 35 percent as opposed to the average of 27 percent in the 13 selected countries. However, the maximum individual income tax rate appears to be relatively low at 25 percent, while the standard sales tax rate is on the higher side. These conclusions suggest the future direction of changes in tax rates.

**Table 7.6: Comparison of tax rates<sup>a</sup> in selected countries (%)**

<b>Country</b>	<b>Corporate tax rate (large companies)</b>	<b>Individual income tax (maximum rate)</b>	<b>VAT/GST rate</b>
Bangladesh	45	25	15
Brazil	34	27.5	17–25
China	25	45	17
India	13	33	5.5–14.5
Indonesia	25	30	10
Malaysia	25	26	-
Pakistan	35	25	16
Philippines	30	32	7–12
South Africa	28	40	14
Sri Lanka	35	35	12
Thailand	20	37	7
Turkey	20	35	18
Egypt	20	20	10–25
<b>Average</b>	<b>27</b>	<b>32</b>	<b>12–16</b>

*Note:* a = federal/central taxes only.

*Source:* [http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_tax\\_rates](http://en.wikipedia.org/wiki/List_of_countries_by_tax_rates)

## **6. Tax Exemptions and Concessions**

Along with the reduction in statutory tax rates, the Musharraf government granted wide-ranging exemptions and concessions that contributed further to the reduction in the “effective” tax rates. These included the following measures:

- Abolition of the wealth tax
- Exemption granted on capital gains from shares
- Zero-rating of the domestic sales of major export sectors, such as textiles
- Exemption from sales tax granted to agricultural inputs, such as fertilizer and pesticides
- Exemption from sales tax granted to plant and machinery
- Promulgation of a large number of SROs for exemption from or concession in import duties.

Presumably, these measures were taken to gain the support of powerful interest groups.

According to Bari (2012), the one exemption that was granted to capital gains from shares led to a huge cumulative revenue loss of over PRs 1,000 billion between 2003/04 and 2006/07, at a time when the stock market was booming and the share price index had jumped up by 280 percent. This massive tax break led to the emergence of a new class of big capitalists in the country, who had invested heavily in the stock exchange.

This brings us to a very basic question: How far has Pakistan’s tax-to-GDP ratio been eroded by exemptions and concessions? This requires estimating tax expenditures, defined by Atshuler and Dietz (2008) as “revenue losses attributed to tax laws which provide for a special exclusion, exemption, deduction, tax credit, preferential rate of tax or a deferral of tax liability.” The word “special” refers to tax breaks that are not commonly observed in tax systems internationally.

The *Pakistan economic survey* for 2011/12 gives an official estimate of PRs 186 billion as the value of tax expenditures incurred under federal taxes, which is equivalent to 0.9 percent of GDP (Pakistan, Ministry of Finance, 2012). The largest share is that of customs duties (49 percent) followed by income tax (38 percent). This compares with an estimate of 5.1 percent of GDP as India’s total tax expenditure, with the largest share (54 percent) accounted for by customs duties. The corresponding estimates by Mortaza and Begum (2006) for Bangladesh are 2.5 percent of GDP, with 90 percent accounted for by indirect taxes. As such, tax expenditures appear to be lower in Pakistan.

In the following subsections, we provide, for the first time, a comprehensive estimation of tax expenditures in Pakistan, inclusive of both federal and provincial taxes. Presented in Table 7.7, these estimates are almost three times the official estimates, at PRs 550 billion in 2010/11, which is equivalent to 3 percent of GDP. A detailed description of the tax expenditures is given below.

**Table 7.7: Major tax expenditures in Pakistan**

<b>Tax/head</b>	<b>Tax expenditure (PRs billion)</b>	<b>Percentage share</b>
Federal	466	83
Direct taxes	164	30
Exemptions	46	
Deductions/allowances	88	
Concessionary tax rates	30	
General sales tax on goods	91	16
Exemptions	70	
Zero rating	21	
General sales tax on services	64	12
Exemptions	64	
Custom duties	136	25
Exemptions	44	
SROs	80	
FTAs	12	
Excise duty	11	-
Exemption of luxury goods	11	
Provincial	95	17
Agricultural income tax	50	
Urban immoveable property tax	30	
Capital gains tax	15	
Total	561	100
As percentage of revenues	34	
As percentage of GDP	3	

*Source:* Authors' calculations.

### **6.1. Federal Taxes**

The main federal taxes levied are described below.

- Income tax. The major tax expenditures in 2010/11 included an accelerated depreciation allowance at 50 percent<sup>2</sup> in the first year

<sup>2</sup> The normal depreciation rate is 8–10 percent.

(PRs 55 billion),<sup>3</sup> a capital gains exemption on shares (PRs 22 billion), a 30-year tax holiday<sup>4</sup> for independent power producers (PRs 12 billion), tax deductions on loan provisioning by commercial banks (PRs 9 billion), an exemption on profit from Behbood savings certificates (PRs 9 billion), tax deductions on charitable contributions (PRs 2 billion), a concessionary presumptive income tax on the export of goods (PRs 16 billion), the exemption of export income from services (PRs 1 billion), and others<sup>5</sup> (PRs 28 billion).

- Sales tax on goods. This includes exemptions on goods (PRs 64 billion) including agricultural inputs, machinery, processed foods, pharmaceuticals, etc.; and the zero-rating of domestic sales of export-oriented sectors such as textiles and leather (PRs 21 billion) (Social Policy and Development Centre, 2010).
- Sales tax on services. This includes exemptions on services (PRs 70 billion) (Ghaus-Pasha, 2011), including those listed in the First Schedule but not in the Second Schedule of the Sales Tax on Services Act.
- Customs duty. This includes zero duties on POL products, fertilizer, and cotton (PRs 44 billion); exemptions in SROs, especially SRO 567(I)/2006, 565(1)/2006, and 575(1)/2006 (PRs 80 billion); and preferential rates of duty in trade agreements, especially with China (PRs 12 billion).
- Excise duty. This refers to exemptions on luxury goods such as air-conditioners, freezers, large automobiles, televisions, perfumes, and cosmetics (PRs 11 billion).

## **6.2. Provincial Taxes**

The main provincial taxes levied include:

- Agricultural income tax. Low presumptive rates of taxation (Institute of Public Policy [IPP], 2010) (PRs 50 billion).
- Urban immovable property tax. Low presumptive rates of gross annual rental values, preferential treatment of owner-occupied properties, and lack of extension of rating areas (PRs 30 billion).
- Capital gains tax. Exemption on properties (PRs 15 billion).

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<sup>3</sup> The magnitude of tax expenditures is given in parentheses.

<sup>4</sup> The normal tax holiday period is five years.

<sup>5</sup> Including tax deductibility of payments to Workers' Welfare Fund and Workers' Participation Fund, tax credit for provident funds, exemption on income from trusts, concessionary rates of sales tax, and lower income tax rates for suppliers and teachers.

### 6.3. Analysis of Tax Expenditures

Some important conclusions emerge from this analysis of tax expenditures:

1. Tax exemptions and concessions in direct taxes (income, capital gains, and property taxes) account for a tax expenditure of almost PRs 260 billion, equivalent to 46 percent of the total. There is, therefore, empirical evidence to support the perception that tax breaks in Pakistan disproportionately benefit the rich and powerful, including the feudal class, the textile lobby, trading community, property owners, and investors in shares.
2. The structure of customs duties has been perverted by the large number of SROs and exemptions granted to industries such as automobiles, fertilizers, and textiles. The duty structure needs to be rationalized by adhering to the principle of standard statutory rates to enable proper cascading by the level of value added.
3. In the case of the sales tax, the strategy must consist primarily of broadening the tax base, especially by bringing those services into the tax net that have grown rapidly and are consumed chiefly by the upper-income groups.

### 7. Incidence of Taxes

It is useful to derive explicitly the implications of features of the tax system in terms of who bears the burden of taxes in Pakistan. Wahid and Wallace (2010) have derived these for the year 2007/08 as part of a study commissioned by the FBR. The pattern of incidence is given in Table 7.8, according to which the burden appears to be mildly progressive, despite the numerous tax expenditures on the richer segments of society.

**Table 7.8: Incidence of taxes in Pakistan, 2007/08**

Decile	Taxes paid as percentage of income		
	Direct taxes	Indirect taxes	Total taxes
1	2.01	6.42	8.43
2	2.20	6.17	8.37
3	2.18	6.08	8.26
4	2.30	6.20	8.50
5	2.35	6.59	8.94
6	2.38	6.73	9.11
7	2.50	6.26	8.76
8	2.91	6.82	9.73
9	3.35	6.28	9.63
10	6.38	6.74	13.12

Source: Wahid and Wallace (2010).

However, there is reason to believe that the tax burden has become less progressive since 2007/08. First, the incidence of indirect taxes on the lower income deciles has increased because of the change in the contribution of different commodities to revenues. In particular, the share of revenues collected from POL products has risen from 19 percent in 2007/08 to over 32 percent by 2011/12. The bulk of revenues accrue from HSD oil, which is used primarily for public transportation.

Second, the incidence of withholding taxes, especially on imports, contracts, electricity, and telephones, is likely to be more regressive than allowed for in the methodology used by Wahid and Wallace (2010). In fact, Kemal (2008) demonstrates that the overall incidence of taxes was regressive in 1999/2000. More recently, Qadir (2011) has calculated the burden of indirect taxes by quintile in 2008/09. The results indicate that the incidence is substantially more regressive than indicated by the FBR study.

## **8. Tax Evasion**

Tax evasion is commonly perceived as being rampant in Pakistan. The two statistics frequently cited to highlight this are, first, that only one in 100 persons in the country pays income tax, and second, that more than 60 percent of parliamentarians do not file their tax returns. However, it needs to be recognized that Pakistan has an elaborate withholding tax regime that has played a major role in curbing evasion. It is estimated that, as a result of these deductions, the actual number of taxpayers is substantially larger than perceived. This is because:

- payments are made on over 100 million mobile/line phones on bills/prepaid cards,
- almost 17.7 million bank accounts contribute to income tax via the fixed tax (at 10 percent) on interest income, and
- over 306,800 industrial units and over 2.9 million commercial enterprises pay income tax in the form of withholding tax on electricity bills.

The income tax net is thus wider than perceived due to the presence of a large number of deductions at source. The problem is that the payments are usually small and the element of progressivity has not been built into the withholding/presumptive tax regime.

Additionally, there is too much emphasis on personal income tax evasion. It is likely that more revenues could be generated by focusing on corporate tax evasion. The numbers are striking: out of the 52,800 or so companies registered with the Securities Exchange Commission of Pakistan, less than a third file returns, and out of those who do, only a

fifth actually declare taxable profits. The State Bank of Pakistan (2008) estimates the additional revenues that could be generated if tax evasion was curbed to be 2.5 percent of GDP while Junaid (2011) calculates the share to be 3 percent of GDP.

## **9. Tax Reforms**

Based on the above analysis, we now identify the package of reforms required in tax policy and administration to achieve a major jump in the tax-to-GDP ratio. The primary focus is on direct taxes, not only in order to increase the yield but also to make the tax system more progressive.

### **9.1. Tax Policy**

The major steps required are explained below.

#### *9.1.1. Direct Taxes*

**Effective agricultural income taxation.** As per the Agricultural Income Tax Act enacted by the provincial governments in 1947, the present structure comprises either a fixed presumptive tax (with an exemption limit) per acre or a progressive rate structure on actual agricultural income (with scope for substantial deductions). The presumptive tax rates vary from only PRs 150 to PRs 250 per acre, which is less than 1 percent of the net income per acre. These rates need to be raised substantially. Simultaneously, the penalty for failing to file a return should be raised from the present maximum amount of PRs 1,000 to 100 percent of the assessed tax, following the detection of nonfiling.

**Development of personal income tax.** This is considered a prerequisite for signaling greater equity in the tax system, and could help raise taxpayer compliance generally.

**Taxation of assets.** As indicated earlier, a wealth tax was levied on individuals up to 2000. It was an indicator of equity in the tax system and wealth returns also provided collateral evidence of income. This tax should be reintroduced; alternatively, a minimum assets tax could be levied at 1 percent of global net assets, as the minimum income tax payable.

**Minimum tax on turnover.** As mentioned above, a very small percentage of companies actually pay corporate income tax. Although a minimum tax on turnover was introduced in the Finance Bill of 2009/10, it was withdrawn in the Finance Bill of 2012/13. There is a strong case for reintroducing this tax with the usual carry-forward provisions in order to curb corporate tax evasion.

**Withdrawal of tax expenditures.** As is the case in India, transparency and the proper accounting of tax expenditures should be introduced as part of the information provided when the budget is presented to Parliament. This will enable public debate on which exemptions and concessions are justified.

**Direct taxes.** Initially, the following tax expenditures need to be effectively targeted:

- capital gains (short- and long-term) on shares and property
- tax holidays beyond five years
- reduction in the first-year depreciation allowance
- tax deduction on loan provisioning by banks (to be allowed only for priority sectors such as small and medium enterprises, agriculture, and exports).

**Rationalization of tax rates.** The divergence in tax rates between individuals, and small and large companies needs to be eliminated. The corporate tax rate on large companies (especially those that are publicly quoted) could be brought down gradually to 30 percent. Simultaneously, the maximum tax rate on individuals and AOPs/small companies could be raised to 30 percent. This would encourage the process of corporatization in the economy and imply a more progressive personal income tax structure.

**Moving from schedular to comprehensive income taxation.** Currently, most forms of unearned income are taxed at source as separate blocks of income at a fixed and final rate of 10 percent. As highlighted earlier, this has reduced progressivity. These fixed taxes should be converted into withholding taxes in the case of income from bank deposits, savings schemes, dividends, and interest on securities and prize bonds, etc. This will also enable persons whose total income is below the exemption limit to claim refunds.

Fixed taxes are also levied on income proxies. In the case of contractors, suppliers, service providers, and importers, we propose a scheme whereby the current fixed rate is raised for taxpayers who want to make this their final payment, and a lower rate for those who prefer to make a withholding tax payment and include the income derived in their returns. This could promote the process of documentation in the economy.

**Development of property tax.** This will involve extending rating areas, levying a higher tax on commercial properties, and reassessing gross annual rental values.

**Incentives for filing returns.** Numerous incentives could be offered to taxpayers (AOPs and small companies) who have regularly filed their returns over a period of two years with no under-declaration or short payment. These incentives could include the following:

- some preference in contracts for suppliers to government departments;
- a guaranteed refund within the stipulated time;
- access to a bank loan up to a certain limit;
- provision for the carry-forward of losses;
- partial or full exemption from withholding taxes, contributing thereby to an improved cash flow position;
- preferential treatment in obtaining access to public services such as passport issuance and electricity or gas supply; and
- tax credit.

These incentives could induce a significantly higher number of tax returns.

#### *9.1.2. Indirect Taxes*

Proposals to reform indirect taxes include the following:

**Introduction of a broad-based integrated VAT.** The passage of the VAT bill of 2010 should be reconsidered. Recent developments such as the establishment of separate tax machinery to collect the sales tax on services by the provincial governments of Sindh and Punjab have made the task of integration more difficult, and have complicated the process of input-tax invoicing services in manufacturing and manufactured goods in services. A system for recording tax invoices issued across provincial boundaries and of credits/refunds between governments needs to be introduced.

Broad basing has considerable scope, especially in the area of services. For example, the services tax in India is levied on 125 services and generates 1 percent of the country's GDP. In Pakistan, major services that are not covered by the sales tax on services include credit cards, security, consultancy, accountancy, legal, airport, and air travel agent services. Such services are consumed mostly by corporate entities or upper-income groups. The standard rate could be brought down to 12.5 percent once again, following the broad basing.

**Rationalization of customs duties.** The statutory tariff rates (by nature of the good in terms of value added) must be adhered to with essentially three slabs of 5 percent, 15 percent, and 25 percent,

respectively. Simultaneously, most SROs, except those pertaining to trade agreements, should be withdrawn.

Additionally, in order to eliminate the problem of under-invoicing, a system of minimum import prices could be introduced for some commodities, with the provision that these prices be periodically revised. This system was in operation in Pakistan in the 1990s and does not violate World Trade Organization rules, if used selectively.

## **9.2. Tax Administration**

**FBR.** Radical changes are required to make the FBR more effective in implementing reforms in tax policy and collecting more revenues. The following measures need to be undertaken on a priority basis:

- Converting the FBR into an autonomous revenue authority
- Strengthening the Revenue Division of the federal Ministry of Finance to formulate tax policy
- Requiring tax officials to file asset declarations periodically
- Strengthening the tax ombudsman and vesting him/her with judicial powers
- Strengthening the FBR internally in the areas of audit and intelligence
- Developing a data warehouse linked particularly to withholding tax payments
- Streamlining the process of payment of refunds
- Augmenting the quality of human resources
- Publishing an annual tax directory of payments by taxpayers.

**Provincial tax administration.** The following proposals need to be considered:

- Reducing the multiplicity of taxes by abolishing taxes such as the cotton fee, entertainment tax, and tax on property transfers that generate low yields
- Avoiding overlapping taxes, for example, on property by “piggy-backing” on federal taxes
- Merging the Excise and Taxation Department with the Revenue Board/Authority, following the process of screening officials

- Making intensive efforts to streamline business processes and to introduce information and communications technology, especially to enable taxpayers to e-file their returns or make payments
- Appointing a provincial tax ombudsman, also vested with judicial powers
- Augmenting the quality of human resources
- Publishing a tax directory of payments of agricultural income tax and urban immovable property tax.

Clearly, this agenda of reforms is an ambitious one, but it has become necessary in the presence of a low and falling tax-to-GDP ratio and the incipient breakdown of Pakistan’s tax culture. However, it will require strong political will and the capacity building of the implementing institutions. If the proposed reforms are put in place within the next two years, they could yield a conservative estimate of almost PRs 500 billion—equivalent to an additional amount over 2 percent of GDP (see Table 7.9).

**Table 7.9: Revenue yield from tax reforms (with a tax base of 2012/13\*)**

<b>Direct taxes</b>	<b>Revenue yield*</b> (PRs billion)
Effective agricultural income taxation	60
Taxation of assets	50
Minimum tax on turnover of companies	22
Withdrawal of tax expenditures	130
<b>Total</b>	<b>262</b>
<hr/>	
<b>Indirect taxes</b>	
Introduction of a broad-based integrated VAT	140
Withdrawal of SROs in customs duties	96
<b>Total</b>	<b>236</b>
<b>Overall total</b>	<b>498</b>
<b>Percentage of GDP</b>	<b>500</b>

*Note:* \* = 20 percent above the estimates given in Table 7.7.

*Source:* Authors’ estimates.

## **10. Conclusion**

Pakistan’s low and declining tax-to-GDP ratio has been attributed to the major tax bases’ lack of buoyancy, low personal income tax rates, wide-

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ranging exemptions/concessions, and widespread tax evasion, leading to large revenue losses. There are also serious perceptions of inequity and corruption in the tax system, which have gravely affected tax compliance such that the tax culture in the country stands in danger of breaking down.

This chapter has, accordingly, proposed a structural and radical reforms agenda both in the areas of tax policy and administration. These reforms will go a long way in making the tax structure more progressive, reducing tax evasion, and raising the revenue yield in the next two years by over 2 percent of GDP.

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## Appendix

The methodology for decomposing the change in the FBR's tax-to-GDP ratio into "base" and "rate" effects respectively is described below.

We designate the following:

T = actual tax revenue

t = effective tax rate

b = tax base

Y = GDP

That is,  $T = tB$

The tax bases for different taxes are as follows:

Tax	Tax base
Direct taxes	Nonagricultural GDP
Sales tax	Imports + large-scale manufacturing + banking and insurance + telecommunications
Customs duties	Imports
Excise duties	Large-scale manufacturing

Subscripts 0 and 1 designate the base and terminal years, respectively.

The change in the tax-to-GDP ratio is given by

$$\begin{aligned} \frac{T_1}{Y_1} - \frac{T_0}{Y_0} &= \frac{t_1 B_1}{Y_1} - \frac{t_0 B_0}{Y_0} \\ &= \frac{t_1 B_1}{Y_1} - \frac{t_1 B_0}{Y_0} + \frac{t_1 B_0}{Y_0} - \frac{t_0 B_0}{Y_0} \end{aligned}$$

That is,

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = t_1 \left[ \underbrace{\frac{B_1}{Y_1} - \frac{B_0}{Y_0}}_{\text{base effect}} \right] + \frac{B_0}{Y_0} \left[ \underbrace{t_1 - t_0}_{\text{rate effect}} \right] \quad (1)$$

Equation (1) gives the expressions for the base and rate effects, respectively.

*The Future Path of Tax Reforms in Pakistan*

## Can the New Intergovernmental Structure Work in Pakistan? Learning From China

Ehtisham Ahmad\*

### 1. Introduction

The 18<sup>th</sup> Amendment to the 1973 Constitution of Pakistan disentangles overlapping spending responsibilities between the federation and provinces in a wide range of functions, devolving them to the latter. The legislation was also a reaction to relatively poor service delivery and living standards that had fallen continuously behind those in other countries in South Asia, and, indeed, are now lower than sub-Saharan Africa in most respects.

The Musharraf government had used this argument for its own decentralization effort—delegating power to the districts and bypassing the political centers of power in the provinces. The 18<sup>th</sup> Amendment reasserts the provinces' power and the associated political centers of power. It is designed to weaken the center, and correspondingly make it less attractive for the military to assume power by moving against an elected Prime Minister, as it has done periodically in Pakistan's history.

But will this major reform work effectively and ensure higher living standards for all people in all the provinces? To what extent is the need for a national identity important in ensuring that the decentralization does not cause the federation to unravel or the overall delivery of public services to deteriorate and lead to greater exclusion of the poor? These are important issues and could well determine the fate of the 18<sup>th</sup> Amendment as well as social stability in Pakistan.

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Section 2 outlines developments in theory linking governance and the decentralization process. The links between the two are critical.<sup>1</sup> The main question is whether decentralized service provision can better provide for the poorer sections of society by utilizing information that may be available at the local level in tailoring services to local preferences and making access easier. How are these responsibilities financed? Does the process impede closer economic integration between the federating provinces? This chapter argues that positive approaches to intergovernmental reforms, as exemplified by the People's Republic of China, are perhaps more important for countries such as Pakistan that face significant structural challenges.

Section 3 focuses on the 7<sup>th</sup> National Finance Commission (NFC) Award and key elements of the 18<sup>th</sup> Amendment. Their components are examined in relation to the main criteria for good governance, utilizing positive approaches to institutional and multilevel governance reforms. The section argues that the failure of tax reforms poses serious difficulties both for the NFC and the stability of assignments arising from the 18<sup>th</sup> Amendment. These accentuate the danger of Pakistan becoming a "failed state", highlighted by commentators prior to the NFC award or the 18<sup>th</sup> Amendment (see Haque, 2009).

In order to prevent dire consequences arising from the NFC award and the 18<sup>th</sup> Amendment in the presence of failed tax reforms and opaque governance, Section 4 outlines an agenda for urgent action that revisits archaic and inefficient revenue assignments dating back to the Government of India Act 1935. The chapter concludes with some proposals that might be considered in the context of the next NFC award, and possibilities for another constitutional amendment on the revenue side to parallel that on the spending side. Joint action on tax policy and assignments, as well as the complete overhaul of the country's tax administration framework are needed.

## **2. Normative or Positive approaches to Federalism and Decentralization?<sup>2</sup>**

This section sets the stage by reviewing the normative and positive approaches to decentralization, and examining theory and evidence, including the example of China. It also draws some lessons regarding preconditions for good governance in a decentralized framework, and links these to the Pakistan context.

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<sup>1</sup> See Burki and Perry (2000). See also Shah (2010), who also draws attention to the very important lessons that can be drawn from the Chinese experience.

<sup>2</sup> This section draws on Ahmad (2010a) and Ahmad and Brosio (2006).

### **2.1. *Developments in Theory***

The post-Second World War normative literature on fiscal decentralization has been much influenced by the experience of the US, and the work *inter alia* of Musgrave (1959) and Olson (1969). These were based on the assumption that governments are benevolent. This reflected the views of Montesquieu, and of Hamilton and Madison in the Federalist Papers, that a government should be small and its functions separated, with the center responsible for issues that affect all lower levels of government, such as defense and monetary policy. The assumption has been, particularly on the part of some bilateral and multilateral agencies, that decentralization leads to more efficient service delivery, higher growth, and poverty reduction.

Experiences outside the US, particularly in the European Union (EU) and especially in developing countries, have led critics to question the normative approach, spawning a surge in the “political economy” literature (see surveys in Ahmad & Brosio, 2006; Oates, 2008; Lockwood, 2009). This reflects an earlier debate associated with De Tocqueville and John Stuart Mill, which focused on the actual workings of government and an evaluation of the pros and cons of “decentralized” operations. The main difference is that the assumption of “benevolent” government is dropped, and that incentives facing politicians and bureaucrats become important as does the role of institutions and information flows.

Bardhan and Mookherjee (2000) write about the possibility of “capture” by vested interests (see also Ahmad & Brosio, 2011). Besley and Case (1995) introduce the concept of “yardstick competition” in which voters evaluate the performance of their local government in relation to the results achieved in neighboring jurisdictions. Given increasing mobility and information flows, the yardstick competition idea has recently been extended to relate to countries, as citizens in one country examine what results are achieved in other countries with which they are familiar (Salmon, 2010; Besley & Case, 1995).

The building blocks of both the normative and positive traditions are similar—spending and taxation assignments, design of transfers, debt management, and information flows and instruments for implementation. However, the sequencing and mix of these instruments can vary, as discussed below.

### **2.2. *Decentralization Trends***

The impetus to decentralize has differed in many cases. In Latin America, the shift from one-party or military rule has led to a resurgence of interest in decentralization as a means of consolidating political gains, whereas

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China—a large, one-party, unitary state—has actually been quite decentralized. The cross-country push to decentralize, supported by international agencies, is in line with the normative approach to decentralization on the grounds that it would lead to better service delivery and poverty reduction. However, the evidence on this is at best mixed (see Ahmad, Brosio, & Tanzi, 2008, for a discussion on the evidence in OECD countries). Table 8.1 gives some trends from Ahmad and Brosio (2009).

**Table 8.1: Main traits of recent intergovernmental reforms in selected countries**

Country	Main characteristics of intergovernmental relations	Comments
Australia	Federal system	Center administers VAT on behalf of states; reforms introduced in early 2000s.
Belgium	Federalization based on linguistic divisions	Transformed from unitary to federal state
Bolivia	Three-layered unitary system	Municipalities' powers considerably increased. Election of governors of departments, some demanding substantial but asymmetrical powers—associated with natural resources.
Brazil	Federal system based on three layers of government	National reform and coordination of VAT is an urgent priority, although proposals for reform since the late 1990s have not been acted on.
Canada	Federal system	Asymmetric federation (special treatment for Quebec)
China	Highly decentralized system within a unitary constitution; operates like a quasi-federation	Taxing power recentralized (1994)
Colombia	Three-layered unitary system	Extensive devolution of resources to provinces (departments); movement toward a quasi-federation.
Denmark	Unitary system with strong municipal governments	Recentralization of higher education and health since 2006

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<b>Country</b>	<b>Main characteristics of intergovernmental relations</b>	<b>Comments</b>
France	Regional system	Regulatory, fiscal, and political decentralization initiated
Germany	Federal system with extended concurrent responsibilities	Reforms to the federal structure initiated in a wide-ranging set of issues, but little change effected as a result of two commissions.
Indonesia	Unitary state	Extensive decentralization of spending powers to district-level administrations after the fall of the Suharto administration, accompanied by a new revenue-sharing arrangement.
Italy	Unitary, with asymmetric arrangements	Fiscal, regulatory, and political decentralization initiated with a new constitution
Mexico	Federal system with high political and low fiscal decentralization	Fiscal and regulatory decentralization since late 1980s, with basic education (1992) and healthcare (1996) devolved to states, although revenues have been effectively centralized since early 1980s.
Pakistan	Federal constitution with interludes of military rule	Deconcentration to districts in the early 2000s by Musharraf. Overlapping responsibilities on the spending side unwound with the 18 <sup>th</sup> Amendment—most spending powers fully assigned to provinces. Relatively little subnational reliance on own-source revenues.
Peru	Unitary state—moving toward a quasi-federation?	Election of governors of regions—sharing of natural resource revenues. Overlapping responsibilities with relatively limited spending or revenue devolution.
Poland	Unitary	Political and fiscal decentralization with emphasis on the local level

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<b>Country</b>	<b>Main characteristics of intergovernmental relations</b>	<b>Comments</b>
South Africa	Post-Apartheid constitution introduced a quasi-federal system	Devolution of extensive responsibilities for education and health to provinces
Spain	Regional, quasi-federal system	Transition toward a federal system. Fiscal equalization with own-source revenues at subnational level. Asymmetric assignments for some regions.
Switzerland	Federal system	Equalization transfers from federation to cantons
UK	Regional	Introduction of regional government in Scotland and Wales

*Source:* Ahmad and Brosio (2009).

As in Pakistan, many Latin American countries have experienced some movement toward decentralization over the last two decades, often as a reaction to periods of one-party or military rule. This has been more marked on the spending side than on the revenue side. With respect to the latter, the trend has taken the opposite direction: countries have established more or less centralized systems for implementing value-added tax (VAT)—sometimes with the help of international agencies and particularly the International Monetary Fund (IMF)—often replacing myriad subnational taxes at the state and local levels.

Despite the rhetoric, the approach on the spending side—particularly in the Latin American countries—has entailed mixed and overlapping responsibilities that have not been adequately addressed. This partly reflects the centralized tendencies of the past together with a paternalistic approach, including by donors who do not trust subnational governments to make the right choices for their citizens in their area of competence (including education and social policy in general), or who feel that the lower levels lack the capability to manage their affairs effectively.

The evidence on the effects of decentralization regarding improvements in service delivery in the OECD countries is mixed (see Ahmad et al., 2008). The evidence for developing countries is not much more conclusive (see Ahmad & Brosio, 2009). The links between decentralization and preference matching and with growth are often examined together. The studies confirm that any relationship, if it can be established, is at best weak and tenuous.

Perhaps the greatest lacuna in the decentralization processes of developing countries is their lack of attention to adequate own-source revenues at the subnational level. This may be due to the normative approaches that suggest focusing first on the spending side, especially at the intermediate tier of government/states/provinces/departments.

### **2.3. *Political Economy in Action: China***

In the 1990s Chinese context of murky spending responsibilities—where state-owned enterprises (SOEs) at different levels of government carried out a lot of social spending—in a legal unitary state with no central tax collection other than customs, the center had very limited ability to levy taxes. Economic reforms in the 1980s had moved from a system of 100 percent profits taxation targeting largely SOEs (collected by local governments on behalf of the center) to a more moderate level of taxation. However, this caused the tax-to-GDP ratio to fall from more than 22 percent to about 12 percent by 1993; more alarmingly, the central government’s share of collection fell from just under 60 percent in the early 1980s to under 30 percent by 1993. This severely constrained the center from pursuing macroeconomic and redistributive policy goals.

The debate at the time was whether the normative model of federal reforms should be followed, i.e., to clarify spending responsibilities and then adjust tax assignments accordingly—the “big bang” model also being used in Russia. Alternative approaches supported the Chinese administration’s view that it would be preferable to bolster central finances by establishing a state administration of taxation (for the first time in Chinese history) responsible for collecting modern taxes, particularly VAT (see Ahmad, Gao, & Tanzi, 1995). This view was accepted by the leadership, which was keen to avoid the difficulties that were apparent by then in Russia, following the collapse of the Soviet Union—another example of international yardstick competition.

The new tax-sharing system with a central administration operated from 1994, and spending assignments were to be addressed over time as the SOEs were gradually reformed.<sup>3</sup> The VAT reforms in particular were spectacularly successful, raising the central government’s share immediately and helping to bring the tax-to-GDP ratio up toward 20 percent of GDP (see Figure 8.1). The interests of the local governments in the tax reforms were protected by a “stop-loss” provision that ensured that all local governments would get the amounts they had

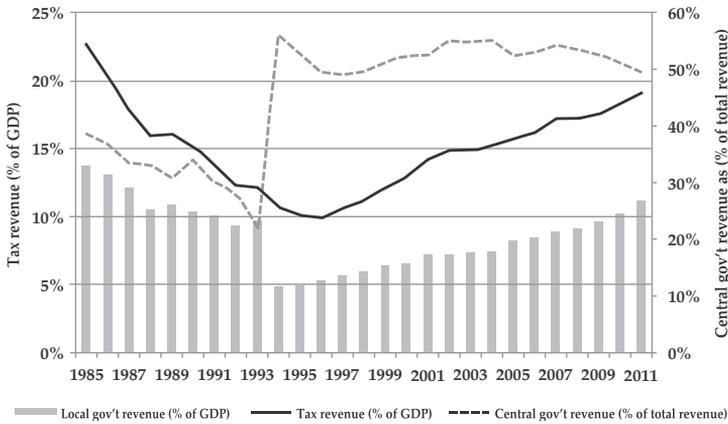
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<sup>3</sup> See also Ahmad, Li, and Richardson (2002); Ahmad, Lee, and Kennedy (1993); Ahmad et al., (1995); Ahmad, Craig, and Mihaljek (1994); Ahmad, Craig, and Searle (1994); Ahmad (1997); Lou (1997); and Ahmad, Brixi, Fortuna, Lockwood, and Singh (2003).

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received in 1993 and the new system would be phased in. All local governments shared incrementally as the new taxes were implemented (rich regions benefitted concomitantly). Political economy concerns were protected by an equalization system together with a Chinese innovation—“revenue returns”.

**Figure 8.1: China: Total tax revenue, local government revenue, and central government share of total revenue, 1985–2011**



Source: Ahmad, Rydge, and Stern (2013).

A new equalization transfer system was established similar to the most advanced in the world (Ahmad et al., 1994; Ahmad, 1997, 2013) but its operations were phased in over time. In the short run, a “revenue returned” system was constituted that “returned” resources to the regions generating them (over and above) the revenue-sharing arrangement. While this was criticized as increasing inequality, in reality it was an essential component of “protecting” overall growth and investment. With the freeing up of the labor market (there were now 150 million migrants working in the coastal areas), it was essential to ensure full employment and reduce poverty (Lou, 1997). This is again an example of a pragmatic “positive” action to meet the specific circumstances of a country in rapid transition, for which the normative models are of limited utility.

Reforms of the budget, treasury, and reporting systems were also set in motion in the late 1990s in a sequence of measures to prepare for the operations of a modern economy. A second phase of the reforms is now needed to clarify spending responsibilities at the lower levels of government, and also to examine own-source revenues and debt in a way that optimizes land and local resource use.

The Chinese reforms of 1993/94 are an excellent example of the positive approach to intergovernmental issues in action, and the importance of a new tax administration as well as a nondistortive tax, such as VAT. There was no concern that VAT would either affect the poor or hurt investment or growth. In fact, the form of VAT that was in operation for the first 15 years after implementation was the “investment” type that does not provide credits or refunds for capital purchases. This did not, however, seem to affect either investment or growth, which were spectacularly high during this period. The move to a more normal consumption-type VAT was initiated only recently as the need for efficiency became more pressing and the scope for raising revenues efficiently to around 25 percent of GDP became more difficult.

### **3. Preconditions for Good Governance**

#### **3.1. Overall Strategy for Sustainability**

Normative approaches to fiscal federalism emphasize the sequencing in which “finance follows function.” There is considerable validity in this proposition, especially when marginal changes are envisaged. This “recommendation” is designed to avoid an unsustainable expansion in overall spending and with a view to maintaining macroeconomic stability. It is also an argument that countries should begin decentralization reforms by starting with a devolution process on the spending side first, followed by the reassignment of revenues.

The problems occur when finance does not follow function or when it encourages access to irresponsible financing mechanisms, such as borrowing without controls or accountability, or running up arrears. In such cases, a macroeconomic crisis is likely because local governments have every incentive to borrow and pass the buck to others. It is usually the central government that has to pick up the pieces, as in Latin America in the 1990s. In other countries, such as Nigeria, the absence of adequate local own-source revenues has meant that there was no incentive for local governments to pay teachers under the devolution stipulated by the new constitution, and the functions had to be moved up to a higher level.

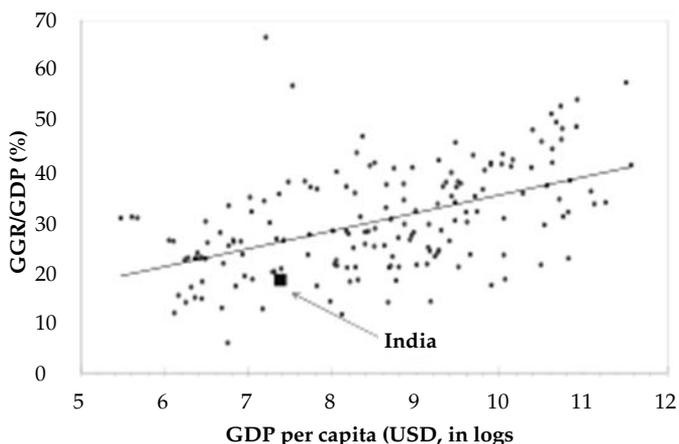
Additionally, under certain political economy circumstances, as in China in the early 1990s, it may make sense to start with the revenue side first to ensure that there are adequate overall revenues to match the spending needs of general government, i.e., of the central and subcentral governments and associated public sector undertakings. The 1994 reforms that facilitated substantially decentralized spending over the following two decades were predicated on an effort to consolidate central revenues, including though VAT, accompanied by automatic redistribution

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mechanisms such as revenue sharing, equalization, and revenue returns, all of which served different purposes. Thus, a careful redesign of the transfer system is critical if a major structural reform on the revenue side is to be attempted in a multilevel or federal country.

It is generally accepted that, in order to meet the Millennium Development Goals (MDGs), a tax-to-GDP ratio of around 18 percent is necessary for all levels of government or general government (Ahmad, 2013). India and China have worked very hard to increase their tax-to-GDP ratios to around 20 percent of GDP, but given their substantive investment needs in education and physical infrastructure, and for a more environmentally friendly growth strategy, a tax-to-GDP ratio in the range of 25 percent is more likely required (see estimate for India in Figure 8.2; IMF, 2013).

**Figure 8.2: General government revenue and GDP per capita, 2012**



Note: The figure excludes oil exporters and microstates.

Source: International Monetary Fund (2013).

Pakistan's tax-to-GDP ratio was 14.5 percent in the early 1980s, and had declined to 10 percent by 2008 at the onset of the macroeconomic crisis that led to a mega-loan from the IMF. This was predicated on fixing the tax system, especially the moth-eaten general sales tax (GST) replete with exemptions and "holes" for 65-year-old infant industries (to use a turn of phrase popularized by a prominent Pakistani economist, Dr Nadeem Ul Haque) and for friends and relatives of those in power. The tax reforms failed, leading to the suspension of the IMF program in 2011.

As the tax-to-GDP ratio slid below 9 percent in 2009, Haque (2009) correctly pointed to the dangers of Pakistan becoming a failed state. This level of tax effort barely finances debt servicing and defense, and leaves precious little for public services or investment at any level of government. Under these circumstances, a major structural shift involving a significant decentralization of spending to the provincial governments—unbundling the parallel responsibilities of government—is of little more consequence than shifting deck chairs on the Titanic.

### **3.2. Spending Assignments**

A useful typology of spending responsibilities showing how different countries approach these issues is given in Figure 8.3. It addresses the subsidiarity principle, which states that assignments should be devolved to the lowest level capable of effectively providing them. This is a general principle of the EU's legal framework, constraining the supranational level from legislation to areas where action at the national, regional, or local levels is insufficient (see "Consolidated Version of the Treaty", 2002).

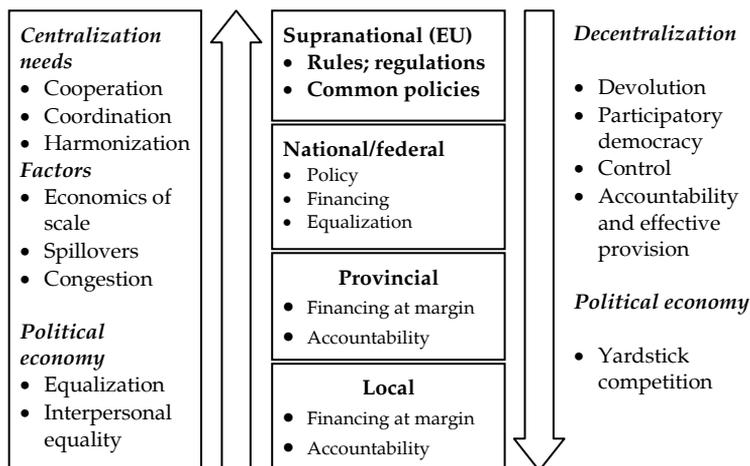
The concept has both legal and political ramifications. The focus is on scale as well as effects, including externalities, on other jurisdictions; this has given rise to actionable cases where there is a legal connotation, as in the EU.<sup>4</sup> In political terms, the concept of subsidiarity is often taken beyond the multilevel government connotation to include the boundaries between the private sector and the role of the state (at any level). The assumption, especially by conservative commentators in the US, is that the private sector should be encouraged to provide public services as far as possible because this is expected to be more efficient than public provision.

Figure 8.3 shows the differing trends regarding the centralization/decentralization debate in different countries or regions. Arguments for the decentralization of functions are based largely on accountability and effective provision, given the subsidiarity principles. However, it is not enough to legislate the assignments—the lower levels have to have the capability as well as the incentive to provide services. Both are linked closely to the financing issue as well as incentives for effective provision. Thus, the argument that local governments lack "capacity" is not strictly binding if they have the financial resources to hire skilled workers.

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<sup>4</sup> An interesting example is the European Court of Justice's rejection of a case brought by the German government against the EU Directive on Deposit Guarantee Schemes (Case C-233/94).

Figure 8.3: Modified subsidiarity principles



Source: Adapted from Dafflon (2006).

An important hypothesis governing accountability comes through the electoral process when voters are able to assess the performance of their “elected” rulers in relation to standards in neighboring jurisdictions (see Salmon 1987, 2006; Besley & Case, 1995).<sup>5</sup> Again, the incentives are critical and voters are more likely to be responsive if, at the margin, local governments rely on own-source revenues over which they control rates or bases.<sup>6</sup>

Offsetting the decentralization trends are concerns that limit subsidiarity—mainly externalities such as spillovers (including those with environmental considerations), congestion, and economies of scale. Moreover, decentralization, especially of resource bases, can exacerbate inequalities across regions and limit the extent of interpersonal redistribution that might be feasible. In all cases, the federal, central, or supranational agencies have a role to play in coordinating and harmonizing essential policies.

The US and certain other federations maintain a unified economic space facilitated by a “commerce clause.” In the EU, the common external tariff and harmonization of country-level VATs (see the EU Sixth Directive) ensure a common economic space to minimize harmful

<sup>5</sup> A recent extension by Salmon posits that cross-country comparisons may be even more important for voters.

<sup>6</sup> See Ambrosiano and Bordignon (2006) for a discussion on the general issues, and Gadenne (2012) for an interesting assessment based on the case of Rio de Janeiro.

competition. Thus, a combination of legal and regulatory frameworks is essential to ensure equal treatment and opportunity. Again, for this to work efficiently, full information is needed on who spends what and on the buildup of assets and liabilities; as the recent EU experience illustrates, inadequate attention to the standardized flow of information could jeopardize a common economic space.

### ***3.3. Full Information on Transactions, Including the Uses and Flow of Funds***

A key element in accountable governance is timely information on the sources and uses of funds at all levels of government. This is critical for establishing benchmarks against which the performance of governments—federal, provincial, and district—should be evaluated. Typically, it involves using the IMF's (2001) government financial statistics (GFS) manual standards for economic classification (wages, social contributions, interest, operations and maintenance, etc.), and the UN's Classification of Functions of Government (COFOG) for education, health, and other functions. This should provide an indication of what revenues were generated, what was budgeted, and what was spent. In principle, this information for Pakistan should have been generated by the Project to Improve Financial Reporting and Auditing (PIFRA) project, which has been implemented over ten years at a cost exceeding USD 100 million (under a World Bank loan).

Most governments provide economic and functional data for each level of administration to the IMF's GFS yearbook. Pakistan's GFS page for the most recent yearbook only covers information on the budgetary central government. Given that most spending is at the subnational level or is carried out by agencies associated with the central government, the data in the GFS yearbook is less than useless for policy purposes. With declining outcomes in education and healthcare—where Pakistan is now falling behind sub-Saharan Africa—and donors' focus on the social sectors, the absence of readily available information<sup>7</sup> in these critical areas is a serious problem. This ensures that the electorates of the districts and provinces, indeed of the country as a whole, are comparatively uninformed about relative spending by the public sector in areas of key policy importance.

In addition to the financial information on public spending that forms the basis for evaluating governments at election time, it is important to have information on the outcomes of spending by the public sector. Again, this is

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<sup>7</sup> For example, on the websites of the Ministry of Finance, the Federal Bureau of Statistics, or the State Bank of Pakistan.

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a critical element in the operation of “yardstick competition” and in the operation of the electoral process to discipline governments.

The cash-basis of the budget process in Pakistan also poses problems: it permits “game-play” by the respective governments in terms of pushing liabilities into the future and bringing forward credits, e.g., the securitization of revenues or asset sales that inflate short-term revenues. A typical mechanism for hiding liabilities is to shift them on to SOEs. Astonishingly, in the early 1990s the IMF agreed to ignore the liabilities being generated in the SOEs (see Ahmad & Mohammed, 2013). This would not be appropriate under the IMF’s (2001) GFS manual framework and may have contributed to the buildup of circular debt in the country.

Public-private-partnerships (PPPs) are an increasingly convenient vehicle for “kicking the can of responsibility” down the road. This is true of developing and developed countries alike and contributed significantly to the fiscal problem in the EU. It has led to tighter accounting rules, especially the recognition of “public” liabilities in PPPs. Consequently, the accounting rules regarding PPPs were also tightened, leading to a need for provisioning to prevent mechanisms to circumvent liabilities.

For full accountability, it is not sufficient to be able to track and report on budgeted amounts, eventually also focusing on the results of the spending. Equally important is tracking government cash. Typically, countries maintain treasury single accounts (TSAs) into which all public funds flow and from which all spending is authorized. Although in certain cases, commercial bank accounts may be needed to facilitate payments or receive revenues, these should not contain balances. These zero-balance accounts are linked with the TSA for overnight deposit of revenues or the reimbursement of authorized payments.

At the time the government was considering an IMF program in spring 2008, Finance Minister Dar asked for the government balance sheet to be drawn up. This indicated government balances of around USD 10 billion in commercial bank accounts at low or zero interest. Although the IMF’s 2008 program had a provision for the establishment of a TSA, this has not happened—both military and political governments are disinclined to be subject to the discipline and transparency of a TSA. As for the banks, they are quite happy to lend the same money back to the government as the deficit increases and is financed by bank borrowing.

With this opaque system, it is hard to impose accountability at any level of government. There is no information on what should be spent, is actually spent, or what is happening to public funds. Yardstick competition is impossible with a poor governance structure. As important

as the tax reform has been in China, the establishment of a GFS 2001-compliant budget framework, and of TSAs at the central and provincial levels, has been equally important in instituting an effective system of decentralized investment and governance.

#### **3.4. *Own-Source Revenues, Transfers, and Access to Credit***

A critical part of the story of accountable governance at the subnational level concerns “own-source” revenues. This relates to the ability of a lower-level government to raise revenues by varying the rate of a reasonable tax base. Thus, in North America, state and local governments are able to set the rates of state or local income taxes using the federal tax base. This ensures that additional revenues can be generated in case of need. There need not be a state or local tax administration, and the federal tax administration could be used to do the “heavy lifting” in relation to IT, cross-referencing information, and audits. It can be thought of as a “piggy back” or co-occupancy of a tax base, in case there are parallel administrations.

Note that shared revenues are not strictly own-source revenues and are closer to transfers, since subnational governments can do little to influence the rate or base and are merely recipients of the revenues. Additionally, taxes administered by the central tax administration can be considered own-source if the local government is able to vary the rate. Analogously, if it is difficult to vary the rate of a subnational tax base (such as the GST on services), that tax base is not an effective “own-source” revenue.

Without an effective own-source revenue handle, it is not possible to hold a subnational government responsible for its debt or buildup of liabilities (Ambrosiano & Bordignon, 2006). This would weaken hard budget constraints, if any, and reduce local accountability. One of the biggest macroeconomic problems in Latin America during the 1990s was countries’ uncontrolled subnational borrowing, often from their own banks. Following the Brazilian lead in the late 1990s, many countries have constituted fiscal responsibility legislation at the subnational level. This too can, however, be oversold—such legislation is only as good as the systems to monitor and report on the buildup of liabilities. Moreover, hard budget constraints are critical and require, in turn, effective own-source revenues.

Even if a country has an assigned own-source revenue handle, lower levels of government may have little incentive to use it if they have access to badly designed transfers or credit for which the liability can be shifted to others. Thus, if central transfers are a function of actual deficits at lower

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levels (called “fiscal dentistry” in India; see Rao, 1998), they will have no incentive to use own-source revenues or spend efficiently.

It is thus clear from theory and practice that good governance at the subnational level is a complex set of policy measures where interaction matters in terms of generating appropriate incentives for accountability. It is likely that isolated reforms, such as for spending assignments in isolation, may not work as anticipated and might even make matters worse.

#### **4. Challenges for Pakistan: Stalled Reform Agenda**

Although Pakistan has always been a federal country, extensive periods of military rule have led to perceptions of dominance by the center, despite attempts to “decentralize”. In the 1960s, Field Marshal Ayub Khan’s administration experimented with a system of “basic democracies”—setting up an electoral college at the local level that also formed the basis of development activities in their regions. This effort at political “deconcentration” was abolished under the 1973 Constitution, which restored the rights and functions of the provinces—the main subnational unit of governance under the Government of India Act 1935 (the basis for both India and Pakistan’s constitutions after independence).

General Musharraf’s administration also promoted a form of so-called “decentralization” in the post-9/11 period. While it was ostensibly a mechanism to move services closer to the people and elected local officials, there was little attempt to adjust spending assignments or financing arrangements. Although the process was clearly an attempt to bypass the established political parties and power centers in the provinces, bilateral donors and multilateral banks rushed to support the process along with the Federal Board of Revenue (FBR)’s institutional reforms and government financial information systems at all levels of government. Each of these reforms had failed or was in significant difficulty by the time Musharraf left office in 2008 (see Ahmad & Mohammed, 2013).

The impetus for the 18<sup>th</sup> Amendment was primarily a reaction against a decade of military rule. It also came at a period of economic distress, after food and oil price shocks had severely affected the stability of an economy that had relied on capital inflows to generate growth and neglected domestic resource mobilization. The government’s approach to the IMF in 2008 was predicated on tax reforms—principally fixing the holes in the GST. At the same time, the NFC met to work on the 2010–14 award, keeping in view the provinces’ deplorable levels of spending on the social sectors, principally education and healthcare. The Finance Division’s Poverty Reduction Strategy Paper (PRSP) envisaged significant progress

toward meeting the MDGs, for which additional resources were to have been allocated to the provinces. This section argues that all three sets of reforms were closely intertwined, and that the failure of the tax reforms has seriously jeopardized both the NFC award and the 18<sup>th</sup> Amendment.

#### **4.1. Tax Reforms**

The reform of the tax administration has been recognized as a priority since the early 1980s and the report of the Tax Reforms Commission headed by Qamar-ul Islam, which had called the then Central Board of Revenue a hotbed of corruption and rent seeking. A GST was introduced in 1990 under an IMF-supported program (but brought in through the back door, when the entire sales tax act was replaced as part of the finance bill). It was administered very arbitrarily, with the tax administration treating it like a production excise (Ahmad, 2010b), setting reference prices and continuing to give exemptions and preferences through a system of administrative orders (SROs) that provided ample opportunity for the rent-seeking and corrupt practices to continue. The ability to give preferences and exemptions and reward specific groups, while threatening to punish others without reference to Parliament, provided convenient handles to politicians of successive weak administrations to make friends and influence people.

At the end of the 1990s, a committee led by former World Bank official Shahid Husain recommended the creation of an integrated revenue administration, using the modern principles of self-assessment, an arm's-length functional administration with minimal contact with taxpayers, and consequently limited opportunities for rent seeking. This was supported by a large World Bank loan to create the new FBR on the Argentine Revenue Authority model.

By the spring of 2008, the World Bank had classified the project as "unsatisfactory". A functional organization structure had not been created and an IT system was prepared in-house that largely automated the old procedures. Additionally, key productive structures had been removed from the GST net with domestic zero-rating, largely to offset delays in refunds and ease pressure on these sectors from an overvalued exchange rate in a manner that would not attract the World Trade Organization's attention. In order to appear "investor-friendly", the audit system had been effectively abandoned in 2004/05. It is no wonder that the GST failed to raise revenues, as had been expected under the strategy to replace tariffs by the GST (the plan had been to replicate the Singapore strategy that had very effectively used this method). An attempt to revive the project under the IMF's 2008 program also failed, as discussed below.

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By 2009, the GST's efficiency in Pakistan had fallen to around 0.26 (as measured by the C-efficiency ratio; see Ahmad, 2010b, for more details), and collection had declined to 3.1 percent of GDP from 3.9 percent in the 1990s (see Table 8.2). If Pakistan were to achieve the C-efficiency of Sri Lanka (from around 2004 at the height of the civil war), it would more than double the collection or reach around 7 percent of GDP with a 15 percent rate. It is worth noting that the taxation of goods and services in China generates around 9 percent of GDP (Ahmad, Rydge, & Stern, 2013).

**Table 8.2: GST productivity—declining and low in comparison with competitors**

Country		Standard rate	Revenue/GDP	Productivity
Pakistan	(1990s)	15		0.39
Pakistan	(2005)	15	3.4	0.30
Pakistan	(2009)	16	3.1	0.26
Sri Lanka		15	6.7	0.47
Philippines		12	4.3	0.45
Turkey		18	7.1	0.48
Lebanon		10	5.1	0.50
Jordan		16	10.1	0.62
Korea		10	6.7	0.67
Singapore		5	1.8	0.63
New Zealand		12.5	8.9	0.93

*Source:* International Monetary Fund, various country papers.

#### **4.2. The Stabilization Program**

The economic crisis of 2007/08 led to a significant rise in the budget deficit and overall debts—leading to a hemorrhaging of record high reserves. A government stabilization plan in September 2008 was based on raising the tax-to-GDP ratio by five percentage points, and its key element was the reform of the VAT that formed the basis of the submission to the IMF. The argument was that the government needed roughly two years to revive and implement the Shahid Husain plan to restructure the FBR, and that the IMF monies would be a “bridging loan” while this reform took effect.<sup>8</sup>

<sup>8</sup> The former head of the Argentine Revenue Authority was hired by the World Bank to prepare a plan to enable a reformed VAT to be implemented in a reformed FBR by summer 2010—the key date under the IMF program (Silvani, Biber, Crandall, Grant, Reos, & Seymour, 2008). By 2011, this effort had been abandoned. The original USD

The revised VAT law was meant to remove distortions in the GST—especially the domestic zero-rating and exemptions that were largely designed to benefit special interest groups and, *pari passu*, consumers of luxury textiles and oriental carpets. The other main objective had been to create the basis for an arm’s-length tax administration based on self-assessment and effective audit, minimizing the problems of direct contact between the tax administration and taxpayers and also the difficulties with the issue of refunds, which had created considerable rent seeking. A critical additional objective was to remove the tax administration’s ability to confer benefits on the chosen few through the notorious SRO system; the new law required any such change to be submitted to Parliament and that the FBR would be stripped of this power.

The “streamlined” VAT law would also have replaced multiple rates (from 17 to 26 percent) and the cascading associated with reference prices by a single rate and considerable simplicity, including the elimination of SROs, but it was badly sold to the public and to Parliament. This was partly due to opposition from the vested interest groups that had benefitted from the holes in the GST, and partly due to the tax administration’s reluctance to relinquish its “rent-seeking powers” and the loss of the SRO handles. Although the Senate passed a corrupted version of the VAT bill (retaining some draconian powers for the FBR), there was enough opposition to the bill in the lower house to stall it on the absurd grounds that it would “crush the poor”, without empirical or analytical support. In reality, the poor would have been largely unaffected by the GST, but will surely be crushed by the resort to deficit financing and borrowing from the banking system.

In order to “rescue the IMF program”, the government proposed a Plan B in March 2011 to remove the main “exemptions” under the GST, but without the full overhaul of the law. This was to remove by administrative order the SROs that had led to the exemptions. This option faced no legal difficulty. It would not have raised much additional revenue and may even have led to less revenue in the short run, but it would clearly indicate that the authorities intended to tackle vested interests seriously. The reform lasted less than a fortnight as the vested interests coalesced, and the proposals were replaced with a far worse situation with the SRO283, issued on 1 April 2011.

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135 million loan was not fully drawn. The World Bank now plans to revive the project with a USD 300 million loan. The problems lay in the incentive structures facing officials and politicians and not the financing constraints.

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SRO283 provided all sorts of exemptions and lower rates on all manner of final and intermediate goods—184 items in all—and recreated the “cascading” that is the antithesis of a GST. Finally, item 185 stipulated that any other exemptions that might be needed in the future would be included without having to issue an additional SRO—this is SRO making *ad absurdum*. More problematic is that the FBR has effectively abandoned the logic of the arm’s-length administration that was the basis of the Shahid Husain proposal. Indeed, the use of third-party information from the National Database and Registration Authority (NADRA) is being accessed and selectively used. Without adequate safeguards, there will be enhanced scope for reinvigorated rent-seeking in an administration reliant on the SRO culture. It is extremely dangerous to leave tax making powers in the hands of an unaccountable tax administration, and it negates the basis of a parliamentary system.

The SRO powers also reduce the trust of the federating provinces in the FBR since they effectively reduce the overall revenues that should accrue to the provinces through the divisible pool. This is also the subject matter of the NFC, which is addressed next.

#### **4.3. *The 7th NFC Award***

The provinces have long been responsible for the bulk of spending on health and education. Given long-standing budgetary constraints, however, this spending has fallen far short of what is considered necessary to meet minimum standards, let alone the MDGs—indeed, outcomes in both sectors have fallen behind all other South Asian countries. Total spending on health and education in 2007/08 was 5.4 percent of GDP, which the PRSP aimed to increase to 6.8 percent of GDP by 2011 (Pakistan, Finance Division, 2010, p. 331). The main vehicle for this was an increase in the provinces’ share of the divisible pool, given that they did not have adequate own-revenue sources.

The calculation made by the finance minister at the time was that, with the proposed tax reforms, an increasing total pie would leave sufficient resources in the hands of the center even as the provincial share was increased from under 47 percent in 2008/09 to 56 percent in 2010/11 and 57.5 percent thereafter. The logic was understandable, even as Pasha, Pasha, and Imran (2010) warned that the projections might be optimistic.

As it happens, the collapse of the 2008 tax reform proposals, taken by the government to the Friends of Democratic Pakistan and then to the IMF, proved to be calamitous for the NFC award. First, it opened up a gap almost immediately between the provinces’ expected and actual revenue-sharing transfers—from 1.3 percent of GDP in 2010/11 to 2.9

percent by 2013 (Table 8.3). This gap is in relation to the spending assignments that were in place in 2009, and does not factor in the 18<sup>th</sup> Amendment (which is discussed in the next section).

**Table 8.3: NFC projections 2010–14 (percentage of GDP)**

Item	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Divisible pool (actuals)	3.8	4.8				
Total provincial resources	4.56	6.2				
Federal tax collections projected by NFC	10	11	12	13	14	15
NFC provincial shares expected		6.16	6.90	7.48	8.05	8.63
Tax collections (actual) 2010/11		8.7	8.5	8.5	9.0	10.1
Revised NFC divisible pool		4.87	4.89	4.89	5.18	5.81
Provincial funding gap		-1.29	-2.01	-2.59	-2.88	-2.82
Education and health (PRSP II)		6.79				

*Source:* Government of Pakistan (2010); and author’s own calculations.

The second difficulty was that the failure of the tax reforms left far too little in the hands of the federal government. Thus, for 2010/11, the share of the divisible pool in the hands of the federation was around 4 percent of GDP. Debt servicing alone was 5.6 percent of GDP in the same year (IMF, 2011).

It had been clear that the reforms promised under the 2008 IMF program involved an integrated GST, building on the Musharraf government’s arrangement to ensure a common administration but removing the exemptions and zero-ratings that had been introduced by the previous regime. At the time the NFC award was being finalized, a Ministry of Finance team had worked on drafting a revised GST/VAT law that was to be presented to Parliament by end-December 2009. Yet the NFC award finalized in December 2009 reiterated that the GST on services was a provincial subject and that collection could also be provincial. Although there was an attempt to paper over the gaping cracks and ensure that the FBR would continue to administer those services that entered

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inter-industry transactions, affecting cross-provincial ones—especially banking and insurance, telecommunications, and trade-related services—the proposals did not stick and the whole structure collapsed.

The failure of the tax reforms implies that there is no conceivable way of reaching the 15 percent of GDP target for the overall tax-to-GDP ratio by 2014/15; the budget strategy paper issued in 2012 brought the target down to 10.1 percent of GDP. This is catastrophic for the federal government since the increasing cost of borrowing alone will far exceed the federation's share of the post-7<sup>th</sup> NFC divisible pool. This can only hasten the collapse of the federal government forecast by Haque (2009).

Unfortunately, the situation in the provinces is no better. As mentioned above, a shrinking resource pie relative to expectations puts the pre-18<sup>th</sup> Amendment goals out of reach, e.g., as enunciated in the PRSP-II (see Pakistan, Finance Division, 2010). The 18<sup>th</sup> Amendment merely adds to the unfunded mandates, which can only lead to further erosion in public services and gaps vis-à-vis the MDGs.

#### **4.4. *The 18th Amendment***

The devolution process that has begun with the 18<sup>th</sup> Amendment presents a great opportunity to change the way that public policy is formulated in Pakistan, and hopefully to make it more responsive to the needs and desires of the population. However, if the tax reforms do not succeed, given the vociferous opposition by the vested interests that have benefitted from exemptions and zero rating,<sup>9</sup> the entire devolution process will run into trouble, as has the current NFC award. This seriously risks the implosion of the existing intergovernmental fiscal system.

Shah (2012) provides a very comprehensive assessment of the benefits and challenges arising from the 18<sup>th</sup> Amendment. The chapter focuses here on the issue of unfunded mandates, which could lead to an implosion of public institutions and services, as well as the very real dangers posed by increasing barriers to interprovincial trade. Both are extremely damaging to the concept of an integrated federation, and each is considered in turn.

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<sup>9</sup> This has been couched in “populist” terms as affecting the interests of the poor—in fact, a properly functioning tax system would reduce the government's borrowing requirements and the current inflationary pressures. It is also unlikely that relative prices would change adversely for the poor with the removal of these extraordinary benefits for the pampered sectors and a downward revision and consolidation of the GST's rate restructure.

#### **4.5. *Unfunded Mandates***

The unfunded mandates have been exacerbated by the new responsibilities added to the pre-18<sup>th</sup> Amendment spending assignments in relation to the assigned own-revenue bases and shared revenues and transfers. As discussed above, the provinces and local governments lacked the necessary resources, prior to the 18<sup>th</sup> Amendment, to effectively provide for their responsibilities at that time. Without the tax reforms, the NFC award is just a mirage in the desert.

#### **4.6. *Subsidiarity and Spending Assignments***

The 18<sup>th</sup> Amendment eliminated the Constitution's concurrent lists, giving provinces sole powers in a number of areas, including health and education. The speed at which the spending functions were devolved meant that inadequate attention was given to the role of "subsidiarity", the role of regulations, and the coordination of functions with associated externalities, such as primary healthcare, university education, climate change and environment, and natural disasters.

Almost immediately, the provinces discovered that they could not finance the very heavy expenditures that had been incurred by the Higher Education Commission, and made a reference to the Council of Common Interests to return the function to the federation. Unfortunately, financing for the function was no longer available, and the federation attempted to move the function under a line ministry rather than an independent commission, as had been the case prior to the 18<sup>th</sup> Amendment. Some commentators suspect that this might have been linked to the Higher Education Commission's refusal to certify the questionable educational credentials or degrees of a large number of lawmakers (of all major parties).

In other areas too, such as preventive healthcare and pharmaceutical standards, once a function with widespread externalities is dismantled and handed over to subnational governments, it is likely that there will be conflicting or confusing standards that could increase the likelihood of epidemics. If the provinces cannot handle the function, it is exceedingly difficult to reestablish the previous institutional arrangements at the national level, not to mention that the federation now has to borrow to meet its current expenditures and is caught in a debt trap.

The 18<sup>th</sup> Amendment unwound the steps taken by the Musharraf government to constitute a third tier of government, passing virtually all powers to the provinces and leaving it to provincial assemblies to decide whether or not to devolve further. This reaction to a desirable reform by the military government (made, albeit, for the wrong reasons) is

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understandable, but not well thought out. The functions and operations of the third level of government should be clearly delineated, as well as the role of the federation in keeping with the subsidiarity principles outlined above.

In addition, more work is needed to improve effective service delivery at the district or local levels, and to counter the possible inadequacy of local incentives in providing for the most vulnerable, e.g., the aged without extended family support, single women, and minorities. It is likely that the local or provincial government has less interest in providing services or protection to minorities, such as the Hazaras in Balochistan, who are nonetheless full citizens of the country and entitled to the same privileges and safety as any inhabitant of Islamabad or the exclusive neighborhoods of Karachi or Lahore. This could lead to significant miscarriages of justice and equity in the future; indeed, it is happening with alarming frequency—reminiscent of North, Wallis, and Weingast’s (2009) warning of failure in the context of limited access states.

The expectations raised by the 1973 Constitution bear no relation to what can be financed. It guarantees:

- “Compulsory and free” education till secondary level [#37(b)]
- “Access to technical and higher education for all on merit” [#37c]
- The “basic necessities of life, such as food, clothing, housing, education and medical relief for all such citizens, as are permanently or temporarily unable to earn their livelihood on account of infirmity, sickness or unemployment” [#38d].

The social benefits for the unemployed or incapacitated are very Bismarckian. The guarantees are very clear, with no additional targeting or score cards that are open to “capture” or “clientelism.” These are constitutional basic rights and actionable in court, but in order to finance these rights, a revenue-to-GDP ratio commensurate with the more advanced developing countries, such as Chile or Brazil, is needed—i.e., 25 percent or more. This is also the goal that China is pursuing. However, it appears almost completely out of reach under the present configuration of policy and administration in Pakistan.

#### ***4.7. Barriers to Trade and Integration***

On the spending side, as pointed out by Shah (2012), the absence of a national standard setting capability might be a severe constraint to establishing a common integrated market. On the revenue side, the sales tax on services, if applied at one of the few ports by the respective

province without providing credit to purchasers in other provinces, could become an effective import duty on cross-provincial trade. This is a potential conflict with the commerce clause in the Constitution.

#### **4.8. Revenue Reassignments**

A fundamental problem lies in the absence of effective own-source revenues at the provincial or local levels. As seen in the Latin American and East Asian cases, this is the Achilles' heel of the devolution process in many countries, leading to a loss of accountability and responsibility for local service delivery. A share in the divisible pool or the unstable assignment of the GST on services does not count as effective own-source revenues.

In keeping with the Government of India Act 1935, Pakistan's current constitution maintains the concept of split revenue bases, both for sales as well as incomes. This has opened up vast avenues for tax avoidance and evasion—such as the abuse of the agricultural income exemption. Moreover, with the rent seeking in the FBR, there is little confidence in its ability to keep the provinces' interests in mind in performing its functions.

The 18<sup>th</sup> Amendment reiterates the right of the provinces to administer the GST on services, if they so desire—the revenues belong to them in any case. This makes it very difficult for a provincial government to vary the rate structures without making their GST almost impossible to implement for fear of it degenerating into an instrument for “provincial tax wars” or impediments to trade. There is also a danger with credit invoices issued by one province to be honored by others or the federation—this would be akin to the “invoice sightseeing” that has become a serious problem in Brazil, and would magnify the “flying” invoices that are already a serious problem with zero-rating in Pakistan's case (and that is with a single administration).

The split base of the GST relating to goods and services is unique to the Subcontinent, and has its origins in the Government of India Act 1935 that assigned the sales tax on goods to the states/provinces. After independence, the goods part was taken over by the federal government in Pakistan, and the more difficult element on services was left to the jurisdiction of the provinces, reiterated in the 1973 Constitution. As there was no GST or VAT at that time, the complexity of this assignment was not realized. Thus, Pakistan finds itself in a unique position as being the only country in the world trying to implement a GST on services at the subnational level, without the administrative machinery to do so. Even if it had the administrative machinery, this would be a herculean task.

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A cooperative solution would have been to permit the FBR to function on behalf of the federation and the provinces (as had been initiated by the Musharraf administration) to collect an integrated GST for the federation and all the provinces, close loopholes, and deliver a larger pie to the provinces directly as well as through the common divisible pool. After all, this was the basis of the NFC award. However, one province rejected this arrangement, given the severe trust deficit associated with the FBR. A complex alternative mechanism was proposed to work around this difficulty, with the current FBR effectively operating the crediting and refund mechanisms associated with the GST—the only agency capable of doing so. But, as discussed above, vested interests opposed fixing the loopholes in the GST and there is very little confidence in the current FBR's ability to operate on an arm's-length basis.

By now it is clear that the current system underpinning the 18<sup>th</sup> Amendment is not sustainable. A more stable solution is needed that provides the provinces with significant tax handles that also generate greater accountability for subnational spending. Marginal changes to tax rates will not do. Also, as the post-NFC discussion on the GST illustrates, agreements are not easy to reach and are unstable. Ideally, a new arrangement should be sought and another constitutional arrangement on the revenue side introduced to preserve the thrust of the 18<sup>th</sup> Amendment and positive elements on the spending side. Both policy options and new administrative arrangements need to be examined—this is a significant research agenda that should also involve the next NFC award.

It is not possible to initiate sensible reforms in the tax policy agenda without an arm's-length tax administration that has the trust of the federating units. Similarly, such an administration cannot be conceived without overhauling the tax policy framework and the associated assignments to different levels of government. This is as complex a task as the 18<sup>th</sup> Amendment, but should be more carefully designed before being rushed through Parliament. However, there is nothing like an economic crisis to concentrate minds and create the political will to carry out serious reforms, so if there is the opportunity, it should be taken. Some of the lines of reform can be gleaned from the successes in China and the difficulties faced in other federations such as Brazil and India, who are also stuck with inefficient split bases and find it hard to overcome the vested interests that coalesce around the benefits conferred.

#### **4.9. Policy Options**

A fundamental principle guiding the tax policy agenda should be that the major tax bases should be consolidated, and that both the provinces and

districts should be assigned tax handles that allow flexibility to set rates at the margin. This flexibility is the crux of own-source revenues and the foundation for accountability in both revenue generation and spending.

At the national level, the major tax bases could be consolidated along the following lines:

- *Income taxes.* All sources of income are income and should be treated equally to avoid distortions, tax shelters, and handles for rent seeking and corruption. This implies that the following:
  - o *Personal income tax.* All sources of income should be included in the tax base, including agriculture, property, and foreign source income. The provinces and districts should be allowed to “piggyback” on the full base; this will give them more revenues than at present and does not require separate administrations, just the setting of rates.
  - o *Corporate income tax (CIT).* The holes and preferences should be closed, and the rate reduced to 25 percent, as in China and many other countries. A gross assets tax should be constituted in the short run to plug the gaps, and this should be creditable against CIT liability. The CIT could continue to go into the divisible pool.
- *GST.* This should be treated as an integrated tax and administered as an arm’s-length agency. It should have a single rate and no exemptions other than on unprocessed food. The sharing arrangements could include the following:
  - o *Fully entering the divisible pool.* This would allow 57.5 percent of the hopefully better-performing GST to go to the provinces, thereby fulfilling the objectives of the 7th NFC award.
  - o *Australian model.* In Australia, the VAT is centrally collected but 100 percent is returned to the states through an equalization system run by the Commonwealth Grants Commission on which the states are equally represented. This option closes both horizontal and vertical gaps and is compatible with maintaining incentives for subnational efficiency. If this model is chosen, the divisible pool could be scrapped since the personal income tax piggyback (and similar arrangements for the CIT as in the US) would provide for own-source revenues.
  - o *Sharing arrangements.* This is the Chinese model, which gives rich provinces an opportunity to share in the country’s growing revenue generation. However, it needs to be

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accompanied by an equalization framework in order to provide incentives for the poorer provinces that do not generate revenues, given the lower volume of transactions.

- *Carbon tax.* This should replace the petroleum levy, as originally designed, and should also be shared with the provinces (see Ahmad & Stern, 2009).
- *Excises.* Some excises could be established at the national level and feed into the divisible pool. Others could be purely provincial, provided they do not affect interprovincial commerce.
- *Property taxes.* These should be assigned to the districts/municipal governments as far as rate setting is concerned, although the provinces could be responsible for the cadaster, land register, and valuation.
- *User charges and tolls.* These should be largely local, although the old octroi should not be resurrected.

The above options provide provinces with both additional revenues as well as own-source tax handles, without the need for separate administrations. In the Pakistan context, however, it would be necessary to establish an arm's-length tax administration that was acceptable to the provinces.

#### **4.10. Administration**

The trust deficit vis-à-vis the FBR/Central Board of Revenue has only grown since the warnings of the Qamar-ul Islam Commission in the 1980s. The failed attempt to implement the Shahid Husain report under the World Bank's USD 135 million Tax Administration Reforms Project (TARP) highlights the incentive problems inherent in the current structure. The World Bank's proposal to throw more money at the problem through the USD 300 million TARP II is likely to meet the same fate since neither the authorities or the donors recognize the incentive incompatibility of the existing arrangement, and the political economy difficulties in making the current model work.

TARP and the rescue of TARP in 2009 could not reform the existing FBR to make it operate on an arm's-length basis. With its ability to use NADRA data, the FBR has become truly intrusive and quite dangerous given that rent-seeking opportunities have been magnified out of all proportion. An FBR that can issue SROs at will, overriding tax laws without reference to Parliament and in the absence of any consultation with the provinces whose revenue shares are compromised, is a

nonstarter for the sort of tax administration that needs to underpin a new intergovernmental framework in Pakistan.

It may be necessary to start on the tax administration afresh, with a completely new staff (as was the case in Peru in the early 1990s). The entity may need to be detached from the Ministry of Finance, with its own responsible and accountable minister (as in China), and placed under a board with representation from the provinces. As the Peruvian example shows, a new administration can be constructed quite quickly as long as the roles and modus operandi are clear from the outset.

Given the implosion of public services and growing failures to keep minorities and other citizens secure, the intergovernmental and governance framework needs to be subject to urgent review and action. There is much to learn from China. Significant additional work is needed to recalibrate spending responsibilities and, particularly, to completely redesign the tax assignments and administration for the 18<sup>th</sup> Amendment to work effectively without unraveling the federation.

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## **Pakistan's Indus Basin Water Strategy: Past, Present, and Future**

**Shahid Amjad Chaudhry\***

### **1. Introduction**

Pakistan's Indus Basin Irrigation System (IBIS) is the strong heart of the country's economy. Its creation is a tribute to the British irrigation engineers who created the original system (1847–1947) that Pakistan inherited in 1947, and to the Pakistani irrigation engineers and institutions (particularly the Water and Power Development Authority [WAPDA] and the provincial irrigation departments) who have spent the last 60 years adding new dams and barrages, building new link and branch canals, and modernizing and maintaining the world's most complex and extensive irrigation system. From the 1950s onward, the IBIS has also been the product of the generosity and intellectual input of a host of international experts and international institutions, particularly the World Bank. This chapter starts with a review of what has been accomplished in order to put the IBIS into perspective and illustrate the magnitude of the effort put into building the present system. The chapter's aim is to sketch the task ahead and develop a coherent national strategy for the preservation of the IBIS for the future.

### **2. The Indus Basin: The First Decade 1947–57**

The Revelle Report commissioned by President Kennedy following a request from President Ayub Khan in 1961 provides a fascinating look at Pakistan in this period. It paints a West Pakistan of 43 million people, malnourished and desperately poor with an average income of less than

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20 cents/day, and an average life span of less than 45 years, with a 10 percent rate of literacy—"industrious, frugal, progressive ... their watchword: 'our sons will have it better'" (US Department of the Interior, Panel on Waterlogging and Salinity in West Pakistan, 1964, p. 35).

Pakistan at this time was overwhelmingly rural. There was a magnificent canal irrigation system based on the River Indus and its five tributaries (the Jhelum, Chenab, Ravi, Sutlej, and Beas), but it was plagued by its seasonal nature and lack of surface storage (nearly half the flows went to sea unused in the summer, with less than 2 feet/acre left for the irrigated land). Thirty percent of the cultivated land of 35 million acres was affected by waterlogging and salinity. Most of all, the report said: "In West Pakistan we have the wasteful paradox of a great and modern irrigation system pouring its waters onto lands cultivated as they were in the days of Abraham, Isaac and Jacob" (US Department of the Interior, Panel on Waterlogging and Salinity in West Pakistan, 1964, p. 65).

The report also presented estimates of irrigation requirements in West Pakistan for various crops: wheat 16"/acre, cotton 28-37"/acre, sugarcane 64-80"/acre, and rice 35"/acre (US Department of the Interior, Panel on Waterlogging and Salinity in West Pakistan, 1964, p. 213). The irrigation system during the 1950s (largely inherited pre-1947) consisted of 10 barrages (Thal, Jinnah, Taunsa, Guddu, Sukkur, Kotri, Trimmu, Dipalpur, Suleimanke, Islam, and Panjnad) and 35,000 miles of canals. Indus Basin inflow was 167 million acre feet (MAF) (average 1921-46 and 1952-57) of which 32.7 MAF (average 1921-46) was from the Ravi (6.4 MAF), and Sutlej/Beas (26.3 MAF) (p. 69). India had started depriving Pakistan of water from the three eastern rivers, i.e., the Ravi, Sutlej, and Beas from March 1948. This led Pakistan to negotiate and sign the Indus Water Accord (IWA) in 1960, with India giving Pakistan the rights to the Indus, Jhelum, and Chenab, and India the rights to the Ravi, Sutlej, and Beas in perpetuity (Kazi, 1999, pp. 164-169).

### **3. Indus Basin Replacement Works (1960-80) and Salinity Control (1960-2000)**

#### **3.1. Indus Basin Works (1960-80)**

Subsequent to the Indus Waters Treaty negotiated with India with the help of the World Bank, a massive irrigation river link canal water scheme comprising two large storages, several barrages, and a number of major link canals was undertaken by the newly created WAPDA (under a World Bank umbrella) to transfer 20 MAF of water from the Indus and Jhelum to the Ravi and Sutlej irrigation commands within Pakistan to substitute for the 30 MAF given to India (the Beas merges with the Sutlej

in India) (Liefstinck, Sadove, & Creyke, 1968, annex map). Two major dams were constructed—one at Mangla (6 MAF) on the Jhelum, and the second at Tarbela (9 MAF) on the Indus—to provide water to the new link canals in the lean winter (*kharif*) season.

Thus, by 1980 Pakistan had two major dams (Mangla and Tarbela), one medium barrage-cum-dam at Chashma (0.8 MAF), 19 barrages, 12 link canals, 43 canal commands covering 90,000 *chaks* through about 40,000 miles of branch canals, main canals, and distributaries; and watercourses, field channels, and field ditches running approximately another 1 million miles (Ahmed, 1999, pp. 73–76). The total replacement cost of the infrastructure is currently estimated at more than USD 60 billion (World Bank, 2005, p. 58), and of these, the two major dams (Tarbela and Mangla), a syphon-cum-barrage (Mailsi), five barrages (Chashma, Rasul, Qadirabad, Marala, and Sidnai), and eight major link canals were built under the Indus Basin Replacement Works (Ahmed, 1999, pp. 73–76). A large number of existing canals and their associated irrigation infrastructure were also remodeled to accommodate the increased requirements of the replacement system.

The World Bank's assistance was invaluable, both on the technical and financial side, as was its role as guarantor of the Indus Basin Water Treaty and its assumption of responsibility for the completion of the replacement works. The role of WAPDA in designing and executing the program was as important. This combination, together with Pakistani and international funding, enabled the entire Indus Basin Replacement Works to be completed by the early 1970s.

### **3.2. Salinity Control (1960–2000)**

While covering the entire agriculture sector, the Revelle Report (1964) also focused on salinity control, this having been President Ayub Khan's original request to President Kennedy during the former's visit to the US in 1961. At the time of independence (1947), Pakistan's Indus Basin was already affected by waterlogging and salinity because the massive irrigation canal system had been established on a flat plain with no natural drainage. By the end of the 1950s, almost 30 percent of the entire Indus Basin command was badly affected while another 30 percent had high water tables and indicated the adverse effect of salinity.

The Revelle Report was bold in its recommendations. It recommended covering 70–80 percent of the Indus Basin irrigated land or 25 to 30 million acres of the total cultivated area of 35 million acres by dividing it into 25 to 30 project areas of roughly 40 miles square (1,600 square miles) or approximately 1 million acres, with each new project

starting every year after a two-year preparatory period and extending over two decades (Liefertinck et al., 1968, pp. 130–131). The projects were to focus on the provision of large public sector tubewells to lower the water table and, as an additional benefit, to provide more irrigation water. As a result of the White House study, the World Bank in collaboration with the Government of Pakistan and at the urging of the US government financed a large number of salinity control projects over the course of 40 years (from the 1960s to the end of the 1990s), costing more than USD 1 billion.

This effort started with the Salinity Control and Reclamation Programs (SCARPs) of the 1960s, which focused on vertical drainage through large capacity public sector tubewells and vertical drains. These projects were executed by WAPDA over three decades and covered all major salinity-affected areas, proving a great success. However, by the 1970s, it was evident that the private sector had started using Pakistan-made small private tubewells essentially for groundwater extraction but with the same ground table-lowering effect; as a result, the SCARPs had become largely superfluous (World Bank, 2005, pp. 94–99). However, by this time, 16,700 large capacity public tubewells had been installed: a substantial number still exist today and provide 7.81 MAF of water to the system (Pakistan Bureau of Statistics, 2009a, p. 64).

The Government of Pakistan and the World Bank then shifted their strategy and focused on overall drainage management throughout the Indus Basin including through tile drainage. An innovative salinity drainage project, the Left Bank Outfall Drain (LBOD), was also executed in this period in Sindh to transfer saline water directly to the sea on the left bank of the Indus River. A small Right Bank Outfall Drain Project (RBOD I) was also undertaken to channel saline water from upper Sindh and Balochistan to the Indus River near Manchar Lake in Sindh, but due to general opposition in Sindh to adding saline water to the Indus River, ended up terminating at Manchar Lake with severely adverse consequences for the lake.

This problem is now being resolved through RBOD II (discussed later). Today, as a result of these World Bank-financed projects and more than 0.8 million private tubewells providing more than half of Pakistan's total water requirements (Qureshi, McCornick, Qadir, & Aslam, 2008, p. 2) (or about 50 MAF), Pakistan's salinity problem is confined to about 5 million acres of irrigated areas of which 30 percent lies in the Punjab and the balance in Sindh. In addition, another 2.44 million acres is waterlogged (p. 3). This is a vast improvement from the 1950s when salinity had rendered 10–12 million acres of land unusable and was, to some extent, estimated to affect a total of about 25–30 million acres by the Revelle Report (1964).

#### **4. IBIS Investments in 2000–10**

##### **4.1. Irrigation Investments 2000–10**

The last decade has seen the initiation and completion of a number of important projects relating to the Indus Basin, financed in large part by the Government of Pakistan itself. These include: (i) the Mangla Dam Raising Project 2003–10 (raising the Mangla Dam 30 feet and thereby adding an additional 2.9 MAF to its existing capacity of 6 MAF at an original cost of PRs 63 billion); (ii) the Greater Thal Canal Project in Punjab 2002–10 (creating a new culturable command area [CCA] of 1.5 million acres at a cost of PRs 30 billion); (iii) the Kachhi Canal Project for Balochistan, covering Dera Bugti, Naseerabad, and Jhal Magsi 2002–12 (creating a new CCA of 0.71 million acres at a cost of PRs 31 billion); and (iv) the Raine Canal Project for Sindh, covering Ghotki, Khairpur, and Sukkur 2002–12 (creating a new CCA of 0.41 million acres at a cost of PRs 19 billion) (WAPDA, 2004). In addition, a major effort was made for the first time in Pakistan to rehabilitate the Indus water irrigation system by starting the Irrigation System Rehabilitation Project in Sindh in 2002 at a cost of PRs 12 billion (Pakistan, Planning Commission, 2002, p. 306). This project is nearly complete.

All these projects were financed almost entirely by the Government of Pakistan and executed exclusively by WAPDA, except for the Sindh Irrigation Rehabilitation Project, which is being executed by the Sindh government and marks for the first time a separation between Government of Pakistan and World Bank projects. As far as the water sector has been concerned in this period, the World Bank has focused almost entirely on institutional development (World Bank, 2005, pp. 113–115). Except for a barrage rehabilitation project, World Bank irrigation-related projects were only for “institutional development” and represented a continuation of its boycott of irrigation infrastructure investment in Pakistan from 1997 onward and its policy decision to focus on institutional issues and, in the longer term, seek the privatization of Pakistan’s irrigation sector.

This was similar to its earlier decision not to lend for energy development since 1987 and focus on the privatization of the energy sector. In 1987, the World Bank also stopped the government through legal covenants from building thermal power plants in the public sector, which is largely responsible for the energy crisis facing Pakistan today. However, there are reports that the World Bank may finance new public sector hydroelectric projects and continue the rehabilitation of barrages.

#### **4.2. Salinity Control Investment 2000–10**

On the salinity drainage control front, a large second RBOD project in Sindh was undertaken to channel away saline water from Sindh and Balochistan that was previously being disposed of into Manchar Lake (discussed earlier). This project (RBOD II) aims at extending RBOD I from near Manchar to the Arabian Sea, together with additional saline water collected along its length. It is intended both to revive Manchar Lake and also to remove saline water along the entire right bank of the Indus in Sindh. With a capacity of 4,000 cusecs, the project was started in 2002 at a total cost of PRs 10 billion and is nearing completion (Pakistan, Planning Commission, 2002, p. 306). This project was financed entirely by the Government of Pakistan and is being executed by the Sindh government.

#### **5. The Recent Situation of the IBIS (2008–10)**

Today, the IBIS is relatively stable as a result of investments in the Indus Basin replacement works, additional storages built at Mangla and Tarbela, and the large-scale reduction and, in many areas, elimination of waterlogging and salinity earlier through SCARPs and subsequently through private sector tubewells. Private sector tubewells and SCARP tubewells add an additional 50 MAF to the system (mostly in the Punjab) and lower the water table, thereby reducing salinity in substantial part in Punjab and to some extent in Sindh. Saline water is also removed by the LBOD and RBOD in Sindh. Table 9.1 below summarizes the current situation with regard to surface water use and availability. The situation with regard to waterlogging and salinity and surface water use is discussed later.

**Table 9.1: IBIS canal withdrawals**

Area	Average 1952–57 <sup>a</sup>		Drought year 2001/02 <sup>b</sup>		5-year avg. 2001/02– 2004/5 <sup>b</sup>				Interprovincial accord (1990), Indus Basin <sup>c</sup>	
	MAF	%	MAF	%	MAF	%	MAF	%	MAF	%
Khyber Pakhtunkhwa	2.8	4	4.6	6	4.6	5	5.1	5	8.78	7
Punjab	40.4	55	40.4	51	46.6	52	55.4	53	55.94	48
Sindh and Balochistan	30.4	41	34.6	43	38.8	43	44.0	42	52.63	45
Of which Balochistan									3.87	3
<b>Total</b>	<b>73.6</b>		<b>79.6</b>		<b>90.0</b>		<b>104.5</b>		<b>117.35</b>	
Downstream Kotri	68.6		1.9		5.1		15.8		To be determined	

Sources: a = US Department of the Interior Panel on Waterlogging and Salinity in West Pakistan (1964, p. 69); b = Pakistan Bureau of Statistics (2009b, p. 67); c = Indus Water Accord 1990/91 in World Bank (2005, p. 20). The accord protects Punjab on the basis of historical use (1977–82) in case of shortages below 117.35 (MAF).

In addition to the need for water storage to provide a regular supply of water downstream Kotri in order to preserve the Indus delta, the seasonality of the Indus system rivers' flows (with more than 80 percent of the water flowing in the kharif season (largely June–August) also requires the storage of summer flows so that an adequate winter crop is cultivable. As Table 9.2 below indicates, in good river flow years, virtually the entire existing storage capacity at Mangla and Tarbela (13.5 MAF in 1998/99, about 12 MAF in 2007/08) can be used, while in drought years, about 40–50 percent of the storage capacity can be used to carry water into the next crop.

**Table 9.2: Seasonality in the Indus River system**

Flows	1998/99		2001/02		2007/08	
	MAF	%	MAF	%	MAF	%
Actual flows, western rivers <sup>a</sup>						
Kharif	124.97	84	79.88	82	105.89	84
Rabi	24.56	16	17.29	18	20.19	16
<b>Subtotal</b>	<b>149.53</b>		<b>97.17</b>		<b>126.08</b>	
Actual flows, eastern rivers	12.26		1.38		1.25	
Canal withdrawals						
Kharif	72.79	66	58.11	73	74.45	71
Rabi	37.91	34	21.50	27	30.08	29
<b>Subtotal</b>	<b>110.70</b>		<b>79.61</b>		<b>104.53</b>	
Downstream Kotri	35.15		1.93		15.80	

Note: a = actual flows at rim stations (Indus at Tarbela, Jhelum at Mangla, Chenab at Marala, for western rivers only).

Source: Pakistan Bureau of Statistics (2009b, pp. 66–67).

### **5.1. Current Situation of Salinity**

The waterlogging and salinity problems of the Indus System irrigation areas stem from its geography. The Indus Plain is essentially flat, rising gradually at a rate of about 1 foot per mile from the sea in the south to the Kalar Kahar Range in the north near Islamabad. Lahore, at a height of 700 feet, is 700 miles from Karachi. The generally level ground allows canal irrigation but it also means that salts will leach into the soil from the Indus rivers' water that contain salts brought down from the mountains where the rivers originate. In addition, both southern Punjab and Sindh were originally deserts and the present alluvial surfaces of these lands were created by river floods which themselves contained salts (US Department of the Interior, Panel on Waterlogging and Salinity in West Pakistan, 1964, p. 56). Thus, both the irrigation waters and the soils themselves contains salts, and when the water table rises to about 10 feet underground, the capillary action of the soil forces the salt-impregnated underground water to the root zone of the crops, damaging plant growth and even killing the plant.

As mentioned earlier, at the time of the Revelle Report (1964), while only about 30 percent of the Indus Basin was affected by waterlogging and salinity, another 30 percent had water at least 10 feet near the surface. The Revelle Report had anticipated that the salinity problem would ultimately affect almost 70–80 percent of the Indus Basin, hence the report's ambitious basin-wide proposed projects. Revelle's SCARPs and their subsequent

successors—private tubewells—have largely reversed the problem, and today, while there is still a salinity problem because of the nature of the irrigation system and now subsequently through secondary tubewell water-induced salinity, it appears to be more containable.

Presently, it is estimated that about 5.4 million acres (of the total of 48.7 million acres under cultivation in the Indus Basin) or about 11 percent is affected by primary or secondary salinization (Qureshi et al., 2008, p. 3). A third of the affected area is in Punjab and the remaining in Sindh. In Punjab, salinity is due to both canal water and tubewell irrigation, but the major problem now is secondary or tubewell-related salinity. In Sindh, the problem is overwhelmingly canal water-related salinity since the water aquifer is largely saline and tubewell use is relatively limited.

Table 9.3 below summarizes the situation with regard to Indus Basin salt balances. A noteworthy feature is that, in aggregate, the Indus Basin's salt balances retained in the root zone appear to be in balance and may be marginally decreasing (World Bank, 2005, p. 48). In addition in Sindh, the LBOD has been remarkably successful and, together with the new RBOD, may actually allow successful management of salt levels in the area.

**Table 9.3: Indus Basin salt balances**

	Estimates of salt <sup>a</sup> (mg/L)			Estimates of salt <sup>b</sup> (million tonnes)
	Indus Basin (1) + (2)	Punjab (1)	Sindh (2)	Indus Basin
	1. Total annual addition, net*	52.2	38.3	13.9
Net Indus River system	24.0	13.6	10.4	19
From tubewells	28.2	24.7	3.5	49
2. Total annual disposal, net*	52.2	38.3	13.9	68
Retained in soil (root zone)	50.0	36.1	13.9	57 (-3)
Evaporation ponds	2.2	2.2		
LBOD directly to sea				4.0
3. Indus water to sea	9.0			10.0
4. Total salt/annum	61.2			78.0

Note: \* = excluding 9 mg/L annual salt flow washed out to sea (Qureshi et al., 2008) or 10 million tonnes of annual salt flow washed out to sea (World Bank, 2005).

Sources: a = Qureshi et al. (2008, p. 4), b = World Bank (2005, p. 48).

## **5.2. Current Situation of Groundwater**

The increasing use of groundwater extracted through small private tubewells has changed the nature of the IBIS. Encouraged initially by the example of the massive number of SCARP-imported tubewells which, as the Revelle Report (1964) had anticipated, added dozens of MAF to the irrigation system, Pakistan's private farmers used local electricians to fabricate small tubewells running on both electrical and diesel power. This in large part freed farmers from the water shortage experienced in the *rabi* (summer) season and enabled them to balance the system at times of canal closure. In addition, it enabled them to plant more water-intensive crops such as rice in the kharif season by using tubewells to augment the already plentiful supply of irrigation water during this period (a time when water tables are already high because of monsoon rains). Finally, and most important, it enabled Pakistani farmers to counter the approximately 3–5-year drought cycle of the Indus River system (discussed later in this chapter).

There were costs to underground water both in terms of additional salinity (discussed earlier) and the decline in water table levels. However, the overuse of groundwater was mitigated at least to some extent because (unlike in India) electricity and diesel for tubewells was not subsidized. Qureshi, McCornick, Sarwar, and Sharma (2009) point out that the average cost of tubewell water is about 30 times that of canal water or roughly USD 5.5/hectare/year for canal water compared to USD 167/hectare/year for tubewells. However, as Table 9.4 below shows, groundwater extracted through tubewells amounted to about 50 MAF in 2007/08 of which about 40 MAF was from private tubewells, 7.8 MAF from SCARPs, and 1.73 MAF from public tubewells. As a result, aquifers are being slowly depleted in Pakistan's Indus Basin (although not as dramatically as in Indian Punjab; this is discussed later).

Currently, 80 percent of Punjab's aquifer recharge is from the irrigation system (World Bank, 2005, p. 15). The balance is largely from monsoon rainfall and return flow from groundwater. It is estimated that the groundwater level has dropped to inaccessible depths in 5 percent of Punjab (a sign of groundwater depletion) and this is expected to decline to 15 percent in the next decade (Qureshi et al., 2009, p. 7). This implies that, at current rates, Pakistani Punjab's aquifers will be completely depleted in 50–100 years. Groundwater prospects are discussed in detail later.

**Table 4: Pakistan’s overall water availability, 2007/08 (MAF)**

	Surface water		Groundwater			(1+2+3+4) Total water availability
	At canal head	(1) At farm gate	(2) Private tubewells	(3) SCARP tubewells	(4) Public tubewells	
2007/08						
Kharif	70.78	61.12	19.70	3.90	0.86	85.58
Rabi	27.94	31.40	20.68	3.91	0.87	56.86
Total	98.72	92.52	40.38	7.81	1.73	142.44

Source: Pakistan Statistical Year Book 2009, p. 64.

## 6. An IBIS Strategy for the Coming Decades: The Supply Side

Any analysis of a future IBIS strategy must necessarily begin with the supply side since absolute initial constraints—the flows of the Indus system’s three western rivers—limit the total availability of surface water in Pakistan. Secondary constraints relate to the absolute size of groundwater aquifers where more than 80 percent of the recharge is by the same western rivers. Within these constraints there is annual flexibility in the surface water system determined by storage capacity in dams and multiyear flexibility in the groundwater system with the aquifers acting as huge underground dams. However, before discussing these supply-side constraints and mitigation measures, it is important to examine the IWA with India and its future prospects.

### 6.1. Prospects of the IWA 1960

As discussed earlier, the total flow of the entire Indus waters system (the Indus plus its tributaries) is about 180 MAF, which was divided by the IWA by giving the Indus, Jhelum, and Chenab (150 MAF) to Pakistan and the Ravi, Sutlej, and Beas (30 MAF) to India. However, the IWA gave certain rights to India over the western rivers including limited agricultural use (70,000 acres from the Indus, 400,000 acres from the Jhelum, and 225,000 acres from the Chenab—a total of 695,000 acres). The IWA also gave India the right to construct runoff river hydroelectric plants with limited pondage and dead storage (“The Indus Waters Treaty”, 1960, annexes C and D). As legally written and if properly enforced, Pakistan would lose only a maximum of 3 to 4 MAF from its western rivers, which would be in conformity with the IWA.

However, in practice, major problems are beginning to emerge as a result of the construction of new hydro-projects by India. The first of these, Baglihar, completed in 2009 was questioned by Pakistan in that it had live-

gated storage. This was challenged by Pakistan before the World Bank (the guarantor of the IWA); the World Bank with the agreement of both India and Pakistan appointed a "neutral expert" as laid down in the IWA. Unfortunately the neutral expert "reinterpreted" the treaty to allow limited live storage to allow the flushing out of silt, and this permission allowed India to cause immense damage to Pakistan by completing and filling the Baglihar Dam on the Chenab during the rabi season in 2009/10 when Pakistan received almost no water from the Chenab (Briscoe, 2010, p. 6).

John Briscoe, the World Bank's irrigation advisor at the time and the person responsible for selecting the neutral expert, stated recently that, "if Baglihar was the only dam being constructed on the Chenab and Jhelum, this would be a limited problem. But following Baglihar is a veritable caravan of Indian Projects—Kishanganga, Sawalkat, Pukuldul, Bursar, Dal Huste, Gyspa ... The cumulative live storage will be large, giving India an unquestionable capacity to have major impact on timing of flows into Pakistan" (Briscoe, 2010).

This situation is further complicated by the fact that the Indian Punjab's much-vaunted "agricultural miracle" is running out of groundwater. A recent authoritative academic study on the province's groundwater points out that Indian Punjab's agriculture is overwhelmingly dependant on groundwater that is being rapidly depleted. The study states:

The total surface availability at different head works is about 1.80 hectare meter (Mha-m) per annum (Government of Punjab 2005). Out of this 0.35 Mha-m per annum is lost during conveyance and only 1.45 Mha-m is available at the outlet that irrigates about 1.0 Mha land. The total sustainable availability of groundwater is 1.68 Mha-m annum. The current crop production pattern dominated by paddy wheat crop rotation requires 4.37 Mha-m of irrigation water per annum, against the total supply of 3.13 Mha-m per annum from both surface and annual recharge of groundwater resources, leading to a net deficit of 1.24 Mha-m (Government of Punjab 2005). Consequently the deficit is being met by over exploitation of the groundwater resources. This has played havoc with the groundwater resources of the state (Jeevendas, Singh, & Kumar, 2008, p. 195).

In a concept note on water security in Indian Punjab, the Columbia Water Center (2010) states: "In 1985 less than 5 percent of tubewells were sustainable. By 2005 that number had increased to over 60 percent. If these trends of aquifer depletion continue, it is estimated that Punjab's groundwater will be entirely exhausted in 15–20 years."

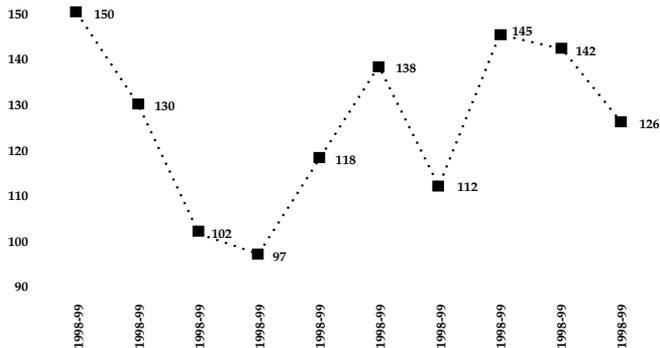
India is developing the capacity to violate the IWA and needs Pakistan's waters as shown above. It is, therefore, imperative that the Office of the Commissioner Indus Water Accord within the Pakistan government's Ministry of Water and Power be strengthened and a dialogue with India undertaken to ensure that the latter does not violate the IWA in letter or spirit. In the meantime, Pakistan should anticipate at a minimum that India will use to the full its allowable water use on the western rivers according to the IWA.

This will mean a minimum withdrawal of about 5 MAF of water in both flood, normal, and drought years. Thus, if 1998 is considered a flood year with 111 MAF of canal withdrawals, 2007/08 is considered a normal year with 105 MAF withdrawals, and 2001/02 is considered a drought year with 80 MAF of withdrawals, this use of water by India under the IWA would mean a reduction in the Indus system's canal water availability of western rivers' waters to 105 MAF annually in flood years, about 100 MAF in normal years, and about 75 MAF in drought years.

### **6.2. Indus River Seasonality, Drought and Climate Change: The Requirement for New Storage Dams on the Indus**

As shown earlier in this chapter, the Indus River system exhibits seasonality through the year with 80 percent of its flows occurring in the kharif season when the glaciers melt in the summer in Kashmir (in the Western Himalayas). This necessitates having live storage capabilities. A further complicating factor that also requires live storage for mitigation is that the Indus River also seems to have a "3- to 5-year flood and drought cycle" as Figure 9.1 below indicates.

**Figure 9.1: Western rivers: Inflow at rim stations (MAF)**



Source: Pakistan Statistical Year Book 2009, pp. 66.

In addition to the “flood-followed-by-drought cycle” illustrated above, Pakistan faces the prospects of climate change. Current forecasts (despite their uncertain nature) show the Western Himalayan glaciers melting in the next 50 years, which will mean initially massive river flows followed by meltdown and consequent 30 to 40 percent decreases in river flows. This climate change will be accompanied by increased rainfall, which will accentuate the flooding problems of the rivers in the first 50 years and subsequently mitigate low river flows in the next 50 years (World Bank, 2005, p. 25). This is a daunting prospect and needs to be managed.

Overall, the implications of the latter three IBIS supply-side situations (the kharif-rabi imbalance, the multiyear imbalance, and the climate change imbalance) all require the construction of additional storage on the Indus River. Excluding climate change, requirements for normal Indus River imbalances can be determined on the basis of “yield curves.” Lieftinck et al. (1968) have calculated a yield curve for storage capacity on the Indus shown in Table 9.5 below. This seems to indicate that Pakistan optimally requires about 22 MAF of storage on the Indus while the present storage capacity is about 8 MAF at Tarbela and an additional 6 MAF if Basha is constructed as planned. Thus, an additional storage facility or two after Basha will be required on the Indus to deal with the present situation. The climate change requirement for storage on the Indus will have to be determined after further analysis.

The Asian Development Bank has indicated that it will support the construction of Basha on which preconstruction activities (roads, colonies, etc.) have been started by WAPDA, and which will cost about USD 8 billion over the period 2010–16. The World Bank is still shying away from investing further in Pakistan’s water resource development as indicated earlier, but has recently shown interest in a hydro-electric project at Dasu (downstream Basha, upstream Tarbela). The storage capacity at Dasu has not yet been established and it is not yet clear whether this is an optimal second large new storage dam site.

However, if a second storage on the Indus is constructed with a further capacity of 6 MAF, this (together with Basha) should add another 12 MAF of usable canal head availability to the Indus River system in flood and normal years, and about 6 MAF of additional capacity to the system in drought years. Again, applying the same numbers for Indus River system availability and use by India according to the IWA, Pakistan after constructing this additional storage of 12 MAF will have available usable canal head availability of about 117 MAF per annum in flood years, 112 MAF in normal years, and about 87 MAF in drought years.

**Table 9.5: Storage yield curves for the Indus River**

Storage MAF	10	15	20	25	30.0
Additional yield in MAF/year	10	15	20	22	22.5

*Source:* Author's estimates based on yield curve for the Indus given in Liefinck et al. (1968).

Yield curves for the Jhelum River are not available. However, with its average flows of 15–23 MAF/annum (compared to the Indus's average flows of 70–100 MAF/annum), it currently has about 9 MAF of storage capacity as a result of the recent raising of the Mangla dam by an additional 30 feet, which increased its storage capacity by 2.9 MAF to the 6 MAF of storage capacity already existing. This capacity now appears adequate for managing current Jhelum River inter-year and multiyear imbalances. However, additional capacity may have to be added to meet the requirements of climate change. Similarly, while yield curves are not available for the Chenab River and there are no mountainous natural storage sites on the plains where the Chenab enters Pakistan, climate change requirements may require in-line and off-line storage in the future (on/off the rivers and canals).

### **6.3. Groundwater Supply-Side Prospects**

As discussed earlier, Pakistan's groundwater aquifers are diminishing—although not at the furious pace of those of Indian Punjab. It is imperative that Pakistan's groundwater aquifers be stabilized (i.e., tubewell withdrawals be equivalent to aquifer recharging by irrigation water leaching, rainfall, etc.) Table 9.6 below presents some estimates (dated almost 10 years), which show that IBIS aquifers were generally in balance during normal years, with about 9 MAF/annum of depletion in drought years with this depletion being confined entirely to Punjab.

This situation must inevitably have worsened in the last decade. Qureshi et al. (2009) estimate that groundwater was inaccessible through small tubewells (operable at less than 20 m water depth) in 5 percent of Punjab in 2000 and that this figure was expected to increase to 15 percent in the next decade. Given this situation, it is clear that Pakistan, and particularly Punjab, cannot count on any further increase in groundwater extraction. Regulatory controls have been legislated but it has not proved possible to enforce them. Energy pricing policies with no real subsidy on agricultural tubewells, and the fact that 85 percent of tubewells run on market-price diesel, has naturally dampened tubewell demand as compared to Indian Punjab where electricity for tubewells is free.

Pakistan will need to watch its aquifers carefully and take corrective measures if tubewell extraction soars above current levels. On the supply side, however, it needs to be recognized that additions to water supply for irrigation from groundwater in the IBIS is not practicable and even minor subsidies, if any, on agriculture tubewell electricity should be withdrawn as soon as possible.

**Table 9.6: IBIS aquifer balances 2001/02 (MAF)**

	<b>Punjab normal</b>	<b>Punjab drought</b>	<b>Sindh normal</b>	<b>KP normal</b>	<b>IBIS normal</b>	<b>IBIS drought</b>
Aquifer balance	0	-8.6	0	-0.4	-0.4	-9.0
Tubewell abstractions	-30.8	-33.6	-3.5	-1.8	-36.1	-38.9
Base flow to rivers/subsurfaces	-2.5	-0.4	-1.2	-1.4	-5.1	-3.0
Evapo-transpiration losses	-1.6	-0.8	-13.8	-0.2	-15.6	-14.8
Recharge from Irrigation System	20.6	15.5	15.4	1.9	37.9	32.8
Recharge from Rivers	3.2	0.8	0.3	0.1	3.6	1.2
Return flow from groundwater	4.6	5.1	0.8	0.1	5.5	6.0
Recharge from rainfall	6.5	4.8	2.0	0.9	9.4	7.7

Source: Qureshi and Hirashima (2007).

#### **6.4. Increasing Water Supply by Reducing Irrigation Water Transmission Losses**

IBIS surface water transmission losses are substantial—25 percent or a normal 25 MAF in the canal system alone (Ahmed, 1999, p. 79). There is another substantial loss in watercourse transmissions and further losses in field application. However, as Table 9.6 above indicates, the IBIS depends in normal years on about 38 MAF of groundwater recharge from the irrigation system. The only savings that are possible are in saline water areas. In Punjab, poor water quality is found in 23 percent of the area and this number rises to 78 percent for Sindh (Qureshi et al., 2009). The lining of canals in saline groundwater areas in Sindh and the saline areas of Punjab is likely to make about 5 MAF of additional irrigation water available in Sindh and another 5 MAF in Punjab.

WAPDA's chairperson has stated that WAPDA is studying the possibility of lining the Rohri, Dadu, and rice canals in Sindh, and that if this is undertaken, it would allow an additional 492,000 acres of land to be

brought under irrigation in Sindh (Durrani, 2010, p. 15). Another area of savings lies in the lining and rehabilitation of water channels. The Planning Commission estimates that 90,000 watercourses (out of a total of 135,000 countrywide) could be improved by lining and rehabilitation, thereby saving about 6 MAF (Pakistan, Planning Commission, 2001, pp. 283–288). Total cumulative Indus water system farm-gate availability, after adding these water transmission loss savings and savings from additional surface storage and abstracting from Indian IWA uses is, therefore, likely to be almost 133 MAF in flood years, 128 MAF in normal years, and 103 MAF in drought years.

## **7. IBIS Demand Management Prospects**

### ***7.1. Future Requirements of Agriculture Crops***

Pakistan is already a great agricultural country producing about 24 million tonnes of wheat, 7 million tonnes of rice, 3.6 million tonnes of maize, 50 million tonnes of sugarcane, 12 million tonnes of vegetables, and 7 million tonnes of fruit in 2008/09, in addition to an assortment of other crops (Pakistan Bureau of Statistics, 2009a, p. xi). The country's cultivated area extended over 52 million acres in 2008/09 (of which 90 percent is part of the IBIS) and crop production was fairly mechanized with all plowing done by tractors and a sizeable percentage of wheat and rice crops mechanically harvested. Pakistan itself produced about 65,000 tractors per annum (Pakistan Bureau of Statistics, 2009b, p. 2, 64). However, yields are low by international standards and particularly in comparison with Indian Punjab. Thus, recent wheat yields are estimated by the World Bank to be 7 tons/ha or 130 mds/acre in Imperial Valley, USA, 3.8 tons/ha or 62 mds/acre in Bhakra, India, and 1.8 tons/ha or 31 mds/acre in Punjab, Pakistan.

The conclusion drawn by the World Bank is that “attention will have to shift from productivity per unit of land to productivity per unit of water” (2005, p. 30). This is an interesting distinction but not very useful in practice since yield per acre may be significantly different because of the use of high-yielding varieties of seed, higher use of fertilizers, etc., while still using the same quantities of water. Data from a recent study that examines irrigation water use in Haryana (India) and Punjab (Pakistan) has estimated water use for wheat in Haryana at 2,200 m<sup>3</sup>/hectare and in Punjab at 2,500 m<sup>3</sup>/hectare, while for paddy, the estimated water use is 18,900 m<sup>3</sup>/hectare for Haryana and 16,000 m<sup>3</sup>/hectare for Punjab (Table 9.7) (Erenstein, 2009, p. 1803). Specifically, Pakistan's Punjab uses water 12 percent less efficiently than India for wheat production and is 18 percent more efficient in water use for rice

production using the traditional definition of water use per acre. However, both Indian Haryana's and Indian Punjab's wheat and rice productivity is higher than that of Pakistani Punjab.

**Table 9.7: Comparison of Haryana, India, and Punjab, Pakistan (per hectare)**

Productivity	Haryana	Punjab
	India	Pakistan
Wheat		
Total nutrients ([kg N+P2O5+K2O]) ha-1	246.0	174.0
Estimated irrigation water use ('000 m3 ha-1)	2.2	2.5
Grain yield (ton ha-1)	4.2	3.2
Rice		
Total nutrients ([kg N+P2O5+K2O]) ha-1	209.0	139.0
Estimated irrigation water use ('000 m3 ha-1)	18.9	16.0
Paddy yield (ton ha-1)	4.6	3.6

Source: Erenstein (2009, p. 1803).

The particularly striking difference in average crop productivity between Indian Punjab and Pakistani Punjab is sometimes argued in part to be due to the availability of free electricity for tubewells, which, it is estimated, saves the Indian Punjab farmer about USD 162/hectare/year for solely tubewell-irrigated land compared to solely canal-irrigated land (Qureshi et al., 2009), or about PRs 7,000/acre/year for each combined crop-cycle of wheat plus rice. This saving, it is argued, is used by Indian Punjab's farmers to purchase additional fertilizer, pesticides, mechanical land-leveling, mechanical planting, and mechanical harvesting, which helps double their yield compared to that in Pakistani Punjab. This may well be the case. In addition, the Indian Punjab farmer may also have access to cheaper fertilizer, more advanced seeds, and a guaranteed and efficient procurement system.

It is important to learn from Indian Punjab's experience in increasing yields. This includes using better land and crop management practices. It has also been estimated that the single most important factor in the efficient use of water in Pakistani Punjab may be land-leveling—resulting in savings of as much as 20–30 percent compared to unlevelled land (Ahmad, Turrall, Masih, Giordano, & Masood, 2007). Finally, Pakistan should seriously consider shifting away from water-intensive crops such as rice to alternative efficient water-use crops such as vegetable oils (sunflowers, soy bean), maize, and more cotton.

A future IBIS strategy for meeting addition crop/food requirements over the next decades will therefore require the following: (i) doubling or tripling yields by improving land practices and greater use of hybrid seeds, fertilizers and pesticides; (ii) using water, both surface and groundwater, resources more efficiently, preferably by reducing average surface water requirements for crops through land leveling, and reducing, if possible, groundwater use. A shift in kharif away from rice to more efficient crops is also required. Total water use in terms of canal withdrawals for crop production should be “frozen” at present “normal year” uses, i.e., about 105 MAF and groundwater withdrawals in IBIS should also be “frozen” at present levels of about 50 MAF.

### **7.2. Environmental Use of IBIS Waters**

A source of contention since the IWA has been the fact that, in drought years, there is almost no water downstream of Kotri, causing immense damage to the Indus delta. In order to get agreement on the 1990 Inter-Provincial Accord, this issue was deliberately left unaddressed to be determined later by “expert studies.” Subsequently, studies were commissioned which came up with the following findings:

- Downstream Kotri requirements and recommended associated environmental flows from the Indus were estimated at 3.60 MAF in dry or average years with 25 MAF additional every five years in times of flood, or alternatively, 8.60 MAF as an average for all years to be provided from the overall share (Montgomery Watson Harza, 2005, p. 56).
- The recommended environmental flow allocation for the Indus, Chenab, Ravi, Sutlej, and Jhelum to maintain a minimum water depth of 0.5 to 1 m were 8.25 MAF to be provided from the overall share.
- The recommended environmental flows allocation for Punjab’s lakes, water bodies, and riverine areas were 6.22 MAF to be provided from Punjab’s share.
- The recommended environmental flows allocation for Sindh’s lakes, water bodies, and riverine areas were 2.53 MAF to be provided from Sindh’s share (Pakistan, Federal Flood Commission, 2005, pp. 1–8).

Table 9.8 below summarizes the expert consultants’ recommendations.

**Table 9.8: IBIS environmental flow requirements**

Source	Dry year			Average year			Every 5 years (flood year)		
	Total	Rabi	Kharif	Total	Rabi	Kharif	Total	Rabi	Kharif
Downstream Kotri <sup>a</sup> (alt. 1)				8.60	1.80	6.80			
(alt. 2)	(3.60+)	(1.80)	(1.80+)	(3.60+)	(1.80)	(1.8+)	(25.0)	(0.0)	(25.0)
Indus, Jhelum, Chenab, Ravi, Sutlej <sup>b</sup>				8.25	2.25	6.00			
Punjab inland water bodies <sup>b</sup>				6.22	1.82	4.40			
Sindh inland water bodies <sup>b</sup>				2.53	0.43	2.10			
Total average year requirement <sup>b</sup>				25.60	6.30	19.30			

Source: a = Montgomery Watson Harza (2005, p. 57), b = Pakistan, Federal Flood Commission (2005, p. 1).

The recommendations for the use of net additional water from IBIS storage augmentation (12 MAF), lining of canals (10 MAF), and improvement of watercourses (6 MAF), or a total of 28 MAF for the next few decades flow, almost naturally from the above. In flood years: (i) the equivalent of additional water to be made available from the new storage at Basha on the Indus plus a large portion of the flood should be used to meet downstream Kotri requirements; (ii) part of the additional flood water plus equivalent additional water to the second storage dam on the Indus (Dasu) should be used to meet the environmental requirements of the Indus, Jhelum, Chenab, Ravi, and Sutlej; (iii) the equivalent of the additional waters to be saved from the lining of canals and watercourses in Punjab and Sindh together with part of the flood waters should be used for reviving the wetlands of Punjab and Sindh.

In normal years, half the additional water from additional storage and lining of canals in saltwater areas and watercourse rehabilitation should be used for irrigation flows, and the other half for environmental flows (particularly downstream Kotri). In drought years, three quarters of this additional water should be used to augment irrigation water supplies and the remaining amount for environmental flows (again, with special attention to downstream Kotri).

It is not clear whether Pakistan is politically and economically ready to make such an environmental commitment to its IBIS waters. Yet this

will have to be done, whether by this or subsequent generations, for Pakistan needs to make its rivers, wetlands, and delta alive again so that Pakistan can revert to being the land of the “Five Rivers” with inland navigation (ultimately) from the Indus delta to the banks of all the five rivers as was historically the case.

### *7.3. Efficiency in the use of IBIS and Groundwater*

If additional water to be made available from the IBIS is recommended for use in substantial part to meet drought and environmental requirements, then the question arises as to how Pakistan will expand its irrigated areas, particularly in northern Punjab (Thal), southern Punjab (Bahawalpur/Cholistan), Sindh (eastern and western banks), and Balochistan. The sensible answer would be to put a restriction on adding any new command areas to the IBIS. Such a restriction is likely to be unenforceable. Therefore, the many important technologies currently available to preserve water, including precision land-leveling, zero tillage, bed and furrow planting, and drip irrigation together with the adoption of high-yielding varieties of genetically modified crops (particularly in maize and cotton) will be useful both in saving water and expanding irrigated areas.

The only note of caution that needs to be made is that the current drive by international institutions (particularly the World Bank) to reform the institutional arrangements surrounding the IBIS system is well intentioned but should be handled with sense. The newly created provincial irrigation department authorities proposed by the World Bank is a good idea especially if it enables these replacements of provincial irrigation departments to retain irrigation revenues (currently these go directly to the provincial government accounts) to be used to rehabilitate the provincial irrigation systems.

The creation of farmers’ organizations (which now cover 20 percent of the irrigation areas in the IBIS) also proposed by the World Bank to monitor water supplies from the distributaries (the sequence is rivers to branch canals to main canals to distributaries) to the *khalas* (watercourses) which each command about 500 acres is also a welcome initiative and has led to improved supplies to tail-enders and some controls over water theft. Farmers also need to pay more for their canal waters to control waste in water use and also to maintain and augment the IBIS. They should also not be charged if they do not use their assigned water entitlements. However, the current elaborate system of irrigation entitlements throughout the IBIS (i.e., 20 minutes/acre/week for field crops, double for fruit orchards) through a defined capacity and regulated outlet that is uniformly administered should not be touched at any cost since this is the bedrock of the system.

No attempt should be made to charge the “full opportunity cost of water” or privatize the system, as is the current long-term thrust of the World Bank’s recommendations. However, cost recovery for adequate maintenance of the irrigation system by the provincial governments is essential and “*abiana*” or water rates need to be increased to cover these requirements. Large-scale capital investments in the irrigation system will have to be financed by the federal government although it is tempting to think of some cost recovery from investments in the federal government (WAPDA)-owned and operated storages.

## **8. Conclusions on a Future IBIS Strategy**

The analysis presented above indicates that Pakistan has come a long way in its development of the IBIS. The first two decades, 1950–70, were occupied by the urgent need to “re-plumb” the entire system by connecting the western river to the eastern rivers to meet the consequences of Pakistan’s requirements under the IWA. The next two decades (1970–90) with an overlap between 1965 and 1970 were used primarily to stem the menace of waterlogging and salinity. The decade 1990–2000 was the “lost decade”—it focused on institutional issues, which are important but which were used as a means to stop major investments by the public sector in the IBIS. The last decade (2000–10) is the first where Pakistan has been able to build and modernize the IBIS and several decades of further enhancement of the system are expected to follow.

As the system is modernized, however, it is imperative that Pakistan focus on: (i) creating additional surface storage to offset both intra-year variations in the Indus River system and its three- to five-year flood and drought cycle; (ii) surface water preservation particularly by lining canals in saline areas and watercourse improvement; (iii) groundwater conservation and salinity control by discouraging excessive tubewell use; (iv) encouraging general efficiency of irrigation water use through improved land management techniques including land-leveling and also by changing the kharif cropping pattern away from water-intensive rice to sunflower, soya, maize, and more cotton; (v) yield enhancement through improved farming practices, adopting hybrid seeds, and increased fertilizer and pesticide use; and (vi) fully meeting the environmental concerns of the Indus delta, river systems, and wetlands.

This, together with a clear vision that the IBIS will be publically owned and operated but with sensible institutional reform (including the increased price of canal waters) which would increase water use efficiency without destabilizing the entire system of existing irrigation entitlements, is the recommended strategy for the future.

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## Economic Governance and Institutional Reforms

Ishrat Husain\*

### 1. Theoretical and Empirical Insights

The link between good governance and economic and social development has been well established in the last few decades. There is a wide consensus that good governance must lead to broad-based, inclusive economic growth and social development. It must enable the state, civil society, and the private sector to enhance the wellbeing of a large segment of the population. Economic policies, however sound or benign, cannot disperse their gains widely unless the institutions intermediating these policies are strong, efficient, and effective.

There is no precise definition of governance but a number of attempts have been made to define it. According to the World Bank (1992), governance refers to the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services. Institutions establish formal and informal rules that determine whether the public sector acts in its own interests or on behalf of all citizens. Corruption is one outcome of poor governance involving the abuse of public office for private gain. The World Bank's (2012a) Governance and Anticorruption Strategy of 2012 surmises that governance is about what the state can do and how it does it—what the state can do is determined by its capacity, legitimacy, and authority:

Capacity is the availability of the state to procure and deliver goods and services, design and implement policies, build infrastructure, collect revenue dispense justice and maintain a conducive environment for the private sector. Legitimacy is

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\* The author is former governor of the State Bank of Pakistan, prior to which he held a number of senior positions in the World Bank, including that of chief economist for the Bank's East Asia and Pacific Region.

simply whether citizens feel the government has the right to govern and whether they trust the government. Authority is the ability of the state to govern its territory effectively, reach all citizens regardless of their location, gender or ethnicity, maintain law and order and protect citizens from predation and violence. It is the ability of the laws and rules of the state to trump all other laws and rules (World Bank, 2012a).

The Asian Development Bank (1997) considers the essence of governance to be sound development management. The key dimensions of governance in this context are public sector management, accountability, the legal framework for development, and information and transparency. The Overseas Development Institute (2006) identifies historical context, previous regime, sociocultural context, economic system, and international environment as the main determinants of governance and development. The six core principles identified by Hyden, Court, and Mease (2004) that relate to good governance are (i) participation, (ii) fairness, (iii) decency, (iv) accountability, (v) transparency, and (vi) efficiency.

Governance assumed importance in the 1980s when developing countries began to feel the adverse effects of the state's extension to functions beyond its capacity. The earlier concept of "modernization" that was propagated in the 1950s and 1960s was synonymous with state-led development. It was argued that, where market institutions and local entrepreneurs were weak, only state-owned enterprises were capable of investing in and expanding the economy. The import substitution-industrialization strategy provided the intellectual underpinning to this argument, and state intervention in the choice of industries, choice of production technologies, level of employment, and determination of inputs, output, and prices became widely accepted policy instruments. Protection against imports insulated the state-owned enterprises from the competitive pressures of the market and generated substantial revenues for the governments of poor countries through high tariffs. This "inward-looking" strategy was pursued vigorously by many countries in Asia, Latin America, and Africa during the 1950s, 1960s, and 1970s.

Empirical academic research evaluating the experience of these countries during this period presented persuasive evidence that this "statist" model, based on an import substitution-industrialization strategy, had done developing countries more harm than good. "Government failure" rather than "market failure" was found to be a more pervasive phenomenon in the developing world. It was argued that public bureaucracies were driven by their own narrow and parochial

interests rather than by the larger goals of development. The “soft state” syndrome articulated by Myrdal (1968) for Asia and the “weak state” phenomenon applicable to sub-Saharan Africa debunked the myth of a neutral, competent, and legitimate state capable of enforcing policy or managing the enterprise to maximize the collective good of society.

By the end of the 1970s, a serious debt crisis in Latin America, dictatorial regimes’ mismanagement of the African economies, and economic stagnation in India—a pioneer in practicing the “statist” model—had forced economists to rethink the larger role of the state. In the meanwhile, the success stories of newly industrializing countries such as the Republic of Korea, Taiwan, Singapore, and Hong Kong demonstrated that opening up the economy to the rest of the world and an “outward” export-oriented strategy could bring about rapid, sustained, and shared growth for the majority of people.

Although the state played a proactive role in these countries and intervened selectively, it avoided the mistakes made by proponents of the “statist” model, which entailed the government’s widespread involvement through political leaders and the bureaucracy in its pursuit to control the “commanding heights” of the economy. The “heavy and overextended state” model was gradually replaced by an approach where the state acted more as a strategist, guide, facilitator, provider of infrastructure, and promoter of human development, facilitating market competition among the private sector rather than occupying directly the economic space of production, exchange, and distribution of goods and services. The domestic private sector was allowed to compete with industrial export markets while protection was avoided. Wade (1990) characterizes the experience of the East Asian economies under the rubric of “governed market” rather than either a free market or command economy.

The governance structure in East Asia that led to these impressive outcomes was characterized by a public bureaucracy that was, by and large, meritocratic, performance-oriented, and free from political interference. Evans (1995) uses the term “embedded autonomy” to describe these states. While keeping strong contact with social groups crucial to development, these bureaucracies had sufficient authority to maintain a distance from social pressures. Public-private consultations, networks, and partnerships formed the bedrock of their mode of functioning. Rodrik (1997) shows convincingly that the bureaucratic quality explains much of the difference between the most and least successful East Asian economies.

It also became obvious that high rates of economic growth can take place without benefiting large segments of the population. Growth

spurts that do not yield any enduring benefits for a country's population are to be shunned for their inimical effects on social cohesion and the political unity of the subgroups of a country's population. Therefore, the two characteristics of a successful and desirable development model, i.e., inclusive growth and sustained growth, will spread the benefits of high economic growth among a vast majority of the population over an extended period of time. Governance is the glue that binds these two characteristics with economic growth to produce sustained and inclusive development. If we accept this definition of development, then we must consider how such an outcome can be achieved. This question can be addressed by exploring the ways in which governance and institutions interact.

How do governance and institutions interact? Governance refers to the manner in which power is exercised in the management of a country's economic and social resources. Good governance requires checks and balances in a country's institutional infrastructure, such that politicians and bureaucrats have the flexibility to pursue the common good, while restraining arbitrary action and corruption. According to Acemoglu and Johnson (2003), good institutions ensure two desirable outcomes: (i) that there is relatively equal access to economic opportunity (a level playing field), and (ii) those who provide labor or capital are appropriately rewarded and their property rights protected.

The risk is that the state's monopoly on coercion, coupled with access to information not available to the public, creates opportunities for public officials to promote their own interests or those of friends or allies, at the expense of the common interest. The possibilities for rent seeking and corruption are considerable. This tension between the potential that institutions offer as instruments of good governance and the incentives for state functionaries leading and working in these institutions to hijack them for their narrow self-interest is the major challenge that developing countries face.

A variety of institutional mechanisms can provide the checks and balances necessary that will lead to good governance and reduce corruption. To be enduring and credible, these mechanisms need to be anchored in core state institutions. Power can be divided horizontally among the judiciary, legislative, and executive, and vertically among the central, provincial, and local authorities. This balancing act between the different power structures ultimately determines the governance outcomes for a particular country. If there is collusion among these countervailing forces, the result is disastrous.

## **2. Pakistan's Experience**

Against this background of theoretical and empirical evidence, we now review Pakistan's experience with respect to governance. Recapitulating a brief history of governance in Pakistan provides the context in which reforms will be rooted. Next, the rationale for these reforms is spelled out. Finally, we ask what can be done to improve governance and strengthen institutions in Pakistan to promote the welfare of the majority.

### ***2.1. History of Governance in Pakistan***

Pakistan inherited a well-functioning judiciary, civil service, and military structure but relatively weak legislative oversight at the time of independence. Over time, the domination of the civil service and military over the affairs of the state disrupted the evolution of the democratic political process and further weakened the state's legislative organ. The judicial arm, with a few exceptions, plodded along, sanctifying the dominant role of the military and civil service.

The institutions inherited from the British rule more or less suited the needs of the rulers at the time. Following independence, these requirements expanded in scope and content while the expectations of the public and their elected representatives grew. These inherited institutions failed to adapt to meet the new challenges of development and social change, and to respond to the heightened expectations and aspirations of a free people. The "business-as-usual" mode of functioning, and the approach and attitudes of incumbents holding top and middle positions in the bureaucracy and operating these institutions did not endear them either to political leaders or to the public.

Several commissions and committees were formed over the first 25 years after independence to reform the administrative structure and civil services. Some changes were introduced during Ayub Khan's regime in the 1960s to improve the efficiency of the secretariats, but the tendency toward centralized control and personalized decision-making worsened in this period. The reluctance to grant provincial autonomy to East Pakistan—the country's most populous province—so remote physically from the hub of decision making, i.e., Islamabad, led to serious political backlash and the eventual breakup of the country into two independent nations.

Pakistan continued to suffer from what has been termed "confused federalism", in which weak local and provincial bodies are unable to match the ability of the central government to mobilize resources and provide services. Whether it is health or education, highways or agriculture, the federal government has much larger programs under

implementation than the provincial or local governments. Although the money is spent in the provinces or districts, their inability to identify, design, approve, and implement these projects caused resentment among the provincial governments.

In 1973, a populist government headed by Z. A. Bhutto took the first step in breaking the steel frame of the civil services by taking away the constitutional guarantee of job security. He also demolished the exclusive and privileged role of the Civil Service of Pakistan within the overall structure of the public service.

The next 25 years witnessed a significant decline in the quality of new civil service recruits as the implicit tradeoff between job security and low compensation ceased to operate, and the expanding private sector, including multinational corporations, offered more attractive career opportunities. The erosion of real wages in the public sector over time also led to low morale, demotivation, and inefficiency, and encouraged civil servants at all levels to resort to corrupt practices. The abuse of discretionary powers, bureaucratic obstruction, and delaying tactics adopted by government functionaries were all part of the maneuvering to extract rents to supplement their pay.

In real terms, the compensation paid to higher civil servants had declined by 2004 to only one half of the 1994 package. The lower wages meant that the civil service no longer attracted the most talented young men and women. Some civil service incumbents, in their instinct for self-preservation, fell prey to the machinations of the political regimes in power and many started to identify with one political party or the other.

They also benefited from the culture of patronage practiced by politicians. During the 1990s, the replacement of one political party by the other in the corridors of power was followed by changes in the top bureaucracy. This growing tendency toward informal political affiliation in order to tenaciously hold on to key jobs was also responsible for the end of an impartial, neutral, and competent civil service responsive to the needs of the common person. Loyalty to ministers, chief ministers, and the Prime Minister took ascendancy over accountability to the public. Frequent takeovers by military regimes and the consequential screening of hundreds of civil servants made the civil service subservient to the military rulers, eroded the authority of traditional institutions of governance, and led to loss of initiative among the higher bureaucracy.

The 2001 devolution plan dealt another major blow to the Civil Service of Pakistan when the posts of commissioner, deputy commissioner, and assistant commissioner were abolished, and the reins of the district

administration were transferred to elected *nazims* (mayors). For ordinary citizens, the government was tangibly embodied in these civil servants, whom they approached on a daily basis. The substitution of civil servants by elected heads of the administration upset the checks and balances implicit in the previous administrative setup, and concentrated too much discretionary power in the hands of indirectly elected individuals.

The police assumed greater clout as a coercive force. Opportunities for collusion between *nazims* and the police multiplied and, in many instances, alienated the common citizen and diluted the impartiality of the administration at a grassroots level. The sanctity of private property rights was threatened in several cases where *nazims* had ordered unauthorized changes to be made to rural land records in collusion with revenue department functionaries to benefit themselves and their cronies. The district administration, which was the pivot for most citizens, therefore, lost its impartiality and neutrality.

Most observers and analysts within and outside Pakistan firmly believe that the quality of economic governance and decision making and the capacity of the country's key institutions have gradually deteriorated over time.<sup>1</sup> Pakistan's main problem in maintaining macroeconomic stability, sustaining economic growth, and delivering public services to the poor is weak governance and the gradual but perceptible decline in institutional capacity. The elitist nature of the state and society, and both the conflict and collusion among the country's various power structures can explain this phenomenon (see Husain, 1999).

Acemoglu and Robinson's (2011) recent study on extractive institutions as compared to inclusive ones corroborates this observation. The military governments that took power at various times were forced to make serious compromises to establish their legitimacy. The elected leadership, when their turn came to assume power, lacked not only the vision to help the divergent forces in society coalesce, but also promoted individual self-interest rather than collective public interest. Along with the decline in civil servants' competence, this led to the gradual erosion of public institutions' capabilities. The state's authority to govern its territory effectively was, therefore, badly impaired.

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<sup>1</sup> Transparency International, which carries out perception surveys on corruption across a large cross-section of countries, has consistently ranked Pakistan among the most corrupt countries. Although the actual ranking has varied, the direction remains unchanged. World Bank governance indicators, the Economist Intelligence Unit index, the failed state index, international country risk guide, Heritage Foundation, and Economic Forum index all corroborate the decline in various indicators of governance and institutional strength.

Improved economic governance was not pursued faithfully in Pakistan; its implementation would have spanned several decades while the elected and military governments that took power have had short time horizons. The elected governments, in their quest to win the next election, and the military governments, in their attempt to gain legitimacy became involved in ad-hoc and, at times, populist measures without addressing the root cause, i.e., building institutional capacity to deliver improved living standards for the majority of the population and setting up a viable governance structure. Decision making according to the whims and caprices of individuals in power therefore displaced informed and well thought-out institutionalized processes.

Chronic political instability and the frequent changes in political regimes have also had disastrous consequences for economic governance in Pakistan. During the 1990s, there were too many changes marked by too much chaos. Invariably, incoming governments abruptly abandoned, discontinued, or slowed down the implementation of policies, projects, and programs inherited from the previous regime. Given that institutions take a long time to nurture, the implementation of projects is spread over many years, and the impact of policies is considerably lagged, this premature abandonment caused more harm than good. Starting all over again and before the benefits had begun to accrue, the government was either overthrown or had to step down before completing its tenure. The incoming government would begin the cycle afresh.

In 2001, the Musharraf government introduced a local government system with the objective of decentralizing authority, delegating power, and deconcentrating decision-making. Although the system had some weakness (as outlined earlier) that could have been rectified, the new government that took office in 2008 completely abandoned the system, creating a vacuum. The resumption of powers by the provincial governments has once again made ordinary citizens' lives miserable since they cannot access services at the grassroots level or have their problems resolved. The situation is quite the opposite in India, as aptly summed up by Shourie (2010):

In India, there is a consensus in practice so that whenever a group is in office, wherever it is in office, it attempts to do the same sorts of things. But when it is in opposition, where it is in opposition, it strains to block the same measures. We have the Communists in West Bengal garnering credit for implementing reforms in the State that they are blocking at the Centre.

What has been the effect of this unending cycle of politically motivated, poor economic governance on the majority of the population?

A sense of deprivation and the denial of basic economic rights create cynicism, negativism, and frustration. The credibility of governments in power—any government—is completely eroded. Distrust of ‘the government’ becomes so widespread and its credibility so low that unsubstantiated rumors, mudslinging, and suspicion about their motives assume a momentum of their own.

In the last six to seven years, the media, taking advantage of this widespread lack of government credibility, has assumed the role of the opposition party and accentuated the negativism. Markets, on the other hand, function on sentiment. If market participants have confidence in the government and its institutions, the overall result is stability in the markets, but if there is lack of credibility, an air of uncertainty, and a crisis of confidence, markets are apt to become nervous and volatile. However sound a government’s policies may be, in circumstances of low credibility and mistrust, private investment is hampered and the economy suffers. Credibility is a fragile thing, and once lost takes a long time to re-establish.

A society with a positive attitude gives enterprises far greater freedom to compete than a society that perceives businesses as unethical or in cahoots with the government for their personal gains. Patronage and cronyism in the form of licenses, tariff concessions, and tax exemptions for a select few, the sale of public assets to rulers’ favorites, and appointments to key public offices not on merit but on the basis of loyalty, affiliation, and friendship sharpen the negative sentiment. This is why, for instance, the program to privatize public enterprises—economically desirable and badly needed—has almost been abandoned ever since the perception, right or wrong, gained currency that Pakistan Steel Mills was being sold for too low a price to cronies of the government.

Alesina’s survey of the literature (1997) suggests that, when we compare the values of political-institutional variables for the ten slowest and the ten fastest growing economies in the study’s sample, the slowest countries tend to be more ethnically fractionalized and more politically unstable. They also tend to have much poorer indicators for the rule of law and institutional quality, a much higher black market premium, and greater income inequality. Alesina, Özler, Roubini, and Swagel (1996) find that political instability, government fragility (the frequency of government changes and coup d’états), and sociopolitical instability (political assassinations, riots, and revolutions) have a negative effect on growth. Pakistan fits this model quite well, given that episodes of frequent changes in government and socioeconomic instability have been associated with low growth and macroeconomic turbulence.

## **2.2. Rationale for Reforms**

It must be conceded at the outset that the time horizon for the consummation and impact of the proposed reforms is long-term, i.e., the next 10 to 20 years, and not immediate- or short-term. The rationale for this plan should, therefore, be viewed in the context of a long-term vision for Pakistan, the external environment in which it operates as a country, lessons learnt from other successful developing countries, diagnostic studies including public opinion polls on government performance in Pakistan, and the public's growing expectations overall.

### *2.2.1. Long-Term Vision and External Environment*

The New Economic Growth Framework prepared by the Planning Commission (2011) envisages Pakistan as a developed, industrialized, just, and prosperous nation by the end of the next 20–25 years. This vision is to be achieved through rapid and sustainable development in a resource-constrained economy by deploying knowledge inputs. The framework proposes that the transition for achieving this objective be managed by intelligently and efficiently exploiting globalization through competitiveness, and that Pakistan should, therefore, opt to become an active participant in the globalized economy for goods, labor, capital, technology, and services.

This option has serious consequences for the future of governance in the country. The imperative of integrating Pakistan in the larger global economy places certain essential demands on the country, one of which is that state structures and the instruments of government are redesigned to use knowledge and technology inputs to create opportunities for increased productivity and competitiveness within the constraints imposed by dwindling resources. Among the world's 180 nations who are Pakistan's competitors for market share in an expanding global economy, only those will survive that remain agile and can adapt to changing demand patterns, supply value chains, and technological upgrades. The main actors in a country that, together, impinge on its competitiveness and productivity are the state, market, and civil society. Their respective roles and interrelationships have to be, therefore, redefined and recalibrated.

Structural economic reforms to improve Pakistan's prospects for competing in the globalized economy require stable, functioning, competent, and responsive institutions for implementation. Unfortunately, at present, the country is caught in a difficult logjam. While economic reforms create displacements in the transition period, strong working institutions provide the resources and armory to withstand these shocks, thus minimizing the costs of adjustment and

maximizing the benefits to the poor and marginalized. The urgency of building strong institutions to implement these structural reforms is, therefore, quite obvious.

Following this logical sequence, the state's various organs—the executive, judiciary, and legislature—need to be assessed and evaluated to determine whether they are capable of meeting this new challenge or if they need to be revamped to develop new response capacities.

### *2.2.2. Lessons from Other Developing Countries*

The role and limitations of governments in various types of developing countries have been analyzed at great length. The majority view is that governments should do what they are capable of doing better than in the past. A strong and effective government is needed rather than weak and expansive government. An all-encompassing government is too cumbersome and centralized with overlapping and competing interests, making it inefficient and unresponsive to the emerging needs of the public. Civil servants are poorly trained, sub-optimally utilized, unmotivated, and indifferent. Development economists have argued that effective government in developing countries was not only necessary due to abundant market failures, but also possibly even sufficient to achieve economic development.

A number of developing countries have successfully reformed their governments and tackled market failures as well as achieved rapid economic development. How have they managed to transform expansive governments into effective, well-focused, well-functioning, and result-oriented ones? Interpreting the success of East Asian countries, such as the newly industrializing countries, Asian countries, and China is a matter for serious debate. Neoclassical economists attribute their success to market-friendly, private sector-led growth and openness to trade, with their governments providing macroeconomic stability, security of person and property, and infrastructure services, while promoting research and development, and investing in education, health, science, and technical training. Others such as Wade (1990) and Amsden (1989) argue that an interventionist state that steered a proactive industrial policy and picked its winners was largely responsible for these countries' success.

By now, there is some consensus that, if labels and ideologies are set aside, the evidence suggests that relatively successful countries have tended to promote competition and avoid monopolies or oligopolies; ensured a level playing field and the entry of newcomers in the market; made privatized firms face competition; exercised regulatory vigilance (but eliminated inefficient and outdated regulations); opened up the

economy to international trade; provided the way for judicial independence; provided dispute resolution mechanisms and enforced contracts; promoted transparency; and observed the rule of law. In short, their governments have provided an enabling environment for private businesses in which to carry out the production, distribution, and trade of goods and services without indulging directly in these activities.

The other piece of empirical evidence that is beginning to gain wide acceptance is that decentralization and greater devolution of power, authority, and resources to lower tiers of government also makes a difference through better allocation and the more efficient utilization of resources. Devolution also helps in moving toward a relatively more egalitarian outcome in the provision of basic public goods services.

Another effective way to promote human development and deliver social services to poor segments of the population is through the wider participation of the private sector, communities, and civil society organizations. Participation, besides being considered a means to further human capabilities *a la Sen*, is also a way of choosing the right kind of projects and ensuring that development funds are used more judiciously. Many countries successfully use private-public partnerships and public-nongovernment organization (NGO) or civil society organization partnerships to provide infrastructure, education, health, and other social services. These partnerships not only supplement limited public resources and counter governance issues through monitoring, evaluation, and corrective actions, they also enable local communities to participate in decision making through their organizations. The reduced efficiency of public sector expenditure can also be corrected through such partnerships.

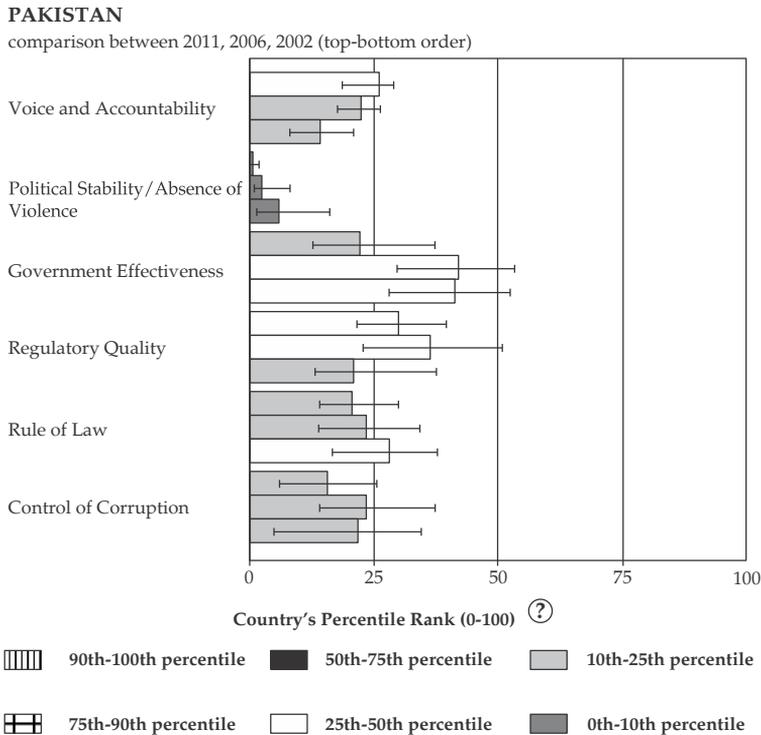
### *2.2.3. Changes in the Pakistani Scene*

In addition to historical reasons, the changes that have taken place in Pakistan over the last several years and that are also likely to affect the functioning of the government in the future, clearly point to the need for reform. There are at least seven new developments that warrant serious consideration.

First, it is becoming increasingly apparent that the benefits of economic growth have not been distributed equitably among lower-income groups, backward districts, rural areas, and women. Although the government has used the channels of devolution and targeted poverty interventions to spread these benefits, the results have been less than satisfactory. Almost all studies point out that governance institutions, *i.e.*, the governmental machinery at the federal, provincial, and local level, have become largely dysfunctional due to protracted neglect.

Almost all comparative country rankings, whether originating from the World Bank’s governance indicators, the World Economic Forum’s Global Competitiveness Report, or other think-tanks and institutions have consistently rated Pakistan fairly low in terms of public sector management, institutions, and governance. The World Bank has been compiling governance indicators for its member countries for the last 15 years. These include (i) voice and accountability, (ii) political stability, (iii) government effectiveness, (iv) regulatory burden, (v) rule of law, and (vi) corruption. The World Bank’s (2012b) governance indicators for Pakistan are reproduced in Figure 10.1.

**Figure 10.1: Pakistan’s ranking in governance indicators**



Source: Kaufmann, Kraay, and Mastruzzi (2010).

Along with its low human development indicators, this weak institutional dimension makes the task of poverty reduction, income distribution, and delivery of public services considerably difficult. The impact of good economic policies on the lower strata of Pakistan’s society,

particularly those who are illiterate and not well connected, is thus muted. The widespread hue and cry about the absence of the trickle-down effect of good economic policies is a manifestation of the country's dysfunctional public sector governance. Government institutions have to be strengthened to meet this challenge.

Second, the government's responsibilities in the field of owning, managing, and operating public enterprises and corporations have undergone a significant change both in thinking as well as action over the last 16 years. A large number of government-owned corporations, businesses, industrial units, banks and financial institutions, and service providers have either been privatized or ought to be privatized. This will reduce the burden on the administrative apparatus at all levels of the government. Shedding these activities also has serious implications for the oversight function of ministries/departments in the post-privatization period.

Third, the devolution of administrative, operational, and financial powers to the provincial governments has introduced a completely new element to the governance structure that will require suitable modifications in other tiers of the government. The federal government has already transferred all the functions in the Constitution's concurrent list to the provincial governments. The actual and projected increase in financial resources to the provinces under the National Finance Commission awards has significantly expanded the fiscal space available to them for directly carrying out essential public services. However, the devolution remains incomplete because the next logical step of reallocating administrative resources and strengthening the local government's capacity has not yet been taken; moreover, it has met fierce resistance from provincial ministers and legislators. The unfortunate past association of local government systems with military regimes has given rise to much apprehension, especially in the multi-ethnic provinces of Sindh and Balochistan.

Fourth, the unbundling of the policy, regulatory, and operational responsibilities under these functions remains incomplete, uneven, and mixed across the ministries and needs to be firmly rooted. Addressing the lack of competence and adequate knowledge of regulatory functions will require the development of expertise in this field as well as in policy formulation, implementation, and evaluation. The experience with the regulatory agencies has not been very encouraging and has led to unproductive confrontation between the ministries and regulators. The thrust has been on grabbing power rather than finding solutions to the problems faced by the industry or consumers.

Fifth, some limited success has been achieved by fostering private-public partnerships in infrastructure, education, and health, but these partnerships can only be nurtured if the government departments and ministries concerned have adequate skills to design concession agreements, build-operate-transfer (BOT) or contractual arrangements, monitoring and evaluation tools, and legal recourse to enforce the obligations and stipulations agreed to by their private sector partners. Similarly, NGOs and community organizations such as the Rural Support Program have been actively engaged in public service delivery in the education, health, and water supply, etc. The government departments and ministries concerned need to be reconfigured to develop their capacity to design and operate such partnerships.

Sixth, there is a great deal of uncertainty and anxiety among members of the civil services concerning their career prospects. Specialists serving in ex-cadre jobs such as scientists, engineers, medical doctors, and accountants, are demoralized because they have limited opportunities for career progression. They also feel that they are not treated at par with cadre service officers in matters of promotion and advancement.

Seventh, the switchover from manual to automated processes and the government's commitment to move toward e-government will require an assessment of the skill mix and training requirements of existing and future civil servants throughout the hierarchy. E-government will itself flatten the hierarchical texture and expose redundancies in the system. At the same time, it will involve the need for basic computer literacy at all levels and grades, digital archiving, storage, and document retrieval. Consequently, only a few clerical and subordinate staff positions can be utilized in the government's future organization.

#### *2.2.4. Expectations-Delivery Gap*

South Asia's recent political history clearly points to the failure of successive governments to meet the expectations of the majority of their population. This trend has become even more acute in the last decade or so with the advent and spread of the electronic media. Although all the countries in the region have performed well and attained respectable rates of economic growth, every incumbent government has been voted out of power at the time of election. The benefits of growth may have filtered down but their speed and distribution have not satisfied the electorate.

The information and communication technology (ICT) revolution that has touched even remote areas in these countries has tended to exaggerate the disparities and led to higher expectations from the government. On one hand, the capacity of government institutions responsible for the delivery of

public goods and services has been rapidly eroded while the large variety of goods and services available and advertised by the electronic media has whetted the appetite of the poor. These low-income groups believe that the means through which they can acquire these goods and services for themselves and their children is via public sector employment, education and training, and government transfers.

In practice, the allocation of public goods, services, employment, and subsidies is rationed by access to government functionaries or the payment of bribes. Since these groups have neither the access nor the money to pay bribes, they suffer from a relative sense of deprivation while observing the influential and well-to-do segments of the population preempt and enjoy the benefits of government jobs, contracts, permits, and land, etc. Large untaxed incomes also accrue to the same privileged groups and individuals. The resentment of this poor and unconnected population is conveyed through the only instrument they possess, i.e., their vote at the time of an election. This gap between expectations and delivery is also one of Pakistan's biggest challenges.

Popular perceptions expressed in public opinion polls, media commentaries, academic forums, and the observations of politicians and civil society actors all convey, with a few honorable exceptions, a negative image of civil servants in Pakistan and a high level of dissatisfaction with the functioning of ministries and other government bodies at different tiers of the government. These perceptions are in contrast to civil servants' views, who see themselves as poorly paid, highly demoralized, and under immense stress. They feel they have been unfairly treated by their political masters and are unappreciated by the public. Empirical studies and casual observations show that the root cause of this disillusionment can be traced to the structural, procedural, and motivational deficiencies in the overall system of governance. Any attempts to treat the symptoms in an isolated manner without coming to grips with the root causes will be counterproductive. A proposed reform package should be comprehensive with a clear blueprint but the introduction of each set of reforms could be phased and sequenced.

Nowhere is this gap more glaring than in the government's failure to protect the lives and property of its citizens. Acts of terrorism, violence, and extremism have become so commonplace over the last several years that the writ of the state does not appear to exist any longer. State functionaries are either reluctant or incapable of taking serious action against perpetrators and arrests and apprehensions are rare. Known perpetrators are seldom convicted by the courts because eye-witnesses are liable to retract their statements for fear of retribution by those

accused. Investigators and judges avoid getting involved in such cases. Under these circumstances, the cost of crime is virtually zero while the gains are enormous and almost guaranteed.

In light of this changing landscape, the role and functions of the government need to be redefined. The government has to: (i) provide external and internal security for its people, (ii) collect taxes, (iii) manage public finances, (iv) conduct foreign affairs, (v) maintain a stable macroeconomic environment including a sound financial system, (vi) make available basic infrastructure facilities, (vii) develop an education and training system capable of supplying skilled human resources, (viii) encourage and undertake research and development, and (ix) ensure an enabling regulatory framework for private sector and community participation in development. The plan for future restructuring should, therefore, be guided by these functions.

### **2.3. Proposed Reform Agenda**

The governance reform agenda for the future should, therefore, be designed to restructure and revitalize government institutions to deliver the core functions of the state, i.e., the provision of basic services—education, health, water and sanitation, and security—to common citizens effectively and efficiently, and to promote inclusive markets through which all citizens have an equal opportunity to participate in the economy. The restructuring should lower transaction costs and provide access without friction by curtailing the arbitrary exercise of discretionary powers; reducing over-taxation; minimizing corruption, cronyism, and collusion; and ensuring public order and security of life and property. The proposed reforms should take place along the lines discussed below.

#### **2.3.1. Fostering the Private Sector**

To achieve sustained economic growth, a competitive private sector has to be nurtured and relied on. A major area of reforms in Pakistan should, therefore, be the creation of space for the growth of new entrants in the private sector by removing state-created constraints to their entry and operation. Despite the pursuit of liberalization, deregulation, de-licensing, and disinvestment policies over the last 20 years, the overbearing burden of government interventions in the business lifecycle looms large. New businesses still face dire problems in acquiring, titling, pricing, transferring, and possessing land; obtaining no-objection certificates from various agencies; acquiring water and gas connections, sewerage facilities, a reliable electricity supply, and access roads; and securing finances for greenfield projects or new enterprises using emerging technologies. The

considerable powers of petty inspectors from various departments/agencies can either make or break a business.

The growing trend toward the “informalization” of the economy, particularly by small and medium enterprises, is testimony to the still-dominant nature of the government. Over 96 percent of the establishments reported in the economic census for 2005 fall in this category. The attitude of middle and lower government functionaries in the provinces and districts toward private business remains ambivalent—they may be inclined to harass a business to extract pecuniary and nonpecuniary benefits for themselves or simply remain distrustful, hostile, or hesitant toward private entrepreneurs. The involvement of multiple agencies, the need for too many clearances, and avoidable delays at every level raise transaction costs for new entrants. Unless the government facilitates firm entry and exit, competitive forces will remain at bay and the collusive and monopolistic practices of large businesses will continue to hurt consumers and common citizens.

### *2.3.2. Federal and Provincial Restructuring*

Federal-provincial interaction in formulating national policy matters has no formal anchor after the 18<sup>th</sup> Amendment. The National Council of Ministers, consisting of federal and provincial ministers working under the aegis of the Council for Common Interests should formulate national policies for the transferred subjects. The federal government should remain responsible for international relations and interprovincial coordination in these subjects.

In view of the fresh challenges that face the country, we propose that the following new ministries be set up within the revised structure by merging some existing ministries and replacing others: ministries for energy, technology development, regulatory affairs, human resource development, social protection, infrastructure development, and special and underdeveloped areas. The existing autonomous bodies and attached departments, corporations, companies, councils, institutes, and subordinate offices at the federal government level should either be retained, regrouped, merged, privatized, wound up, liquidated, or where appropriate, transferred to the provinces.

### *2.3.3. Civil Service Reforms*

A lingering legacy that has contributed to the sub-optimal utilization of civil servants and demoralized the majority among them has to do with the existence of superior and nonsuperior services. The concept of the superior services should be discarded so that all services at the national,

federal, and provincial levels are considered equal. Their terms and conditions in matters of recruitment, promotion, career progression, and compensation should be similar. Specialists and professionals working in ex-cadre positions should be brought at par with the cadre services in terms of promotion and career advancement.

To provide equality of opportunity to all deserving civil servants, a National Executive Service (NES) and Provincial Executive Services (PES) should be constituted to staff all federal and provincial secretarial positions. Under this reform, any Grade 19 (or equivalent) officer serving the government at the federal or provincial level or autonomous body level and other eligible professionals will be allowed to sit the competitive examination held by the federal or provincial Public Service Commission. Those who qualify will be selected for the NES. To redress the grievances of the smaller provinces concerning their lack of representation at higher decision-making levels, provincial and regional quotas will be introduced for entry to the NES. The NES will comprise two streams—general and economic—thus promoting some limited specialization among civil servants.

Given that most government interaction with ordinary citizens takes place at the district level and that the present stock of functionaries are ill-trained, poorly paid, unhelpful, and discourteous individuals with arbitrary powers, a new setup is required at the district level. A District Service should be constituted for each district government. All employees serving in Grades 1–16 will become part of the District Service and serve in districts of their choice throughout their careers. Direct recruitment to Grades 11 and above will be made on merit through the provincial Public Service Commission. The District Service will consist of two cadres—generalist and technical. This will minimize political pressure for transfers and postings since two thirds of the 2 million employees working in the provinces will remain under their respective district governments.

Training in technical and soft skills will be made mandatory for all members of the District Services. The district governments will need to be strengthened by establishing administrative linkages between union councils, town committees/tehsil councils, and district governments. The office of executive magistrate will need to be revived. In case the system of district nazims is revived, which ought to be, law and order, disaster management, and land record management should be removed from the nazims' purview and transferred to the deputy commissioners. The office of deputy commissioner should be transformed into that of a district chief operating officer with an enlarged scope of duties. The devolution of

development activities, projects, programs, and departments was working satisfactorily and should have remained with the district governments.

All-Pakistan services should consist of the proposed NES, a Pakistan Administrative Service (presently the District Management Group), and the Police Service of Pakistan. The federal services should comprise the Pakistan Foreign Service, Pakistan Audit and Accounts Service, and Pakistan Taxation Service. Direct recruitment to other existing services through the Central Superior Services examination should be discontinued in a phased manner. The proposed provincial services will include the PES, Provincial Management Service, Provincial Technical Services, and Provincial Judicial Service. All direct recruitment to positions at Grade 17 and above will be merit-based with due representation for regional and women's quotas. Recruitment in all cases will be made only by the federal and provincial Public Service Commissions through an open, transparent, competitive examination and interview process.

One of the main weaknesses of the present system is that civil servants who enter the service at a young age are not compelled to upgrade their skills or knowledge. Career advancement is divorced from skill and knowledge acquisition and application. Promotion and placement policies should be aimed at rewarding those who perform well and demonstrate potential for shouldering higher responsibilities. The promotion policy should lay down criteria for each level including the weight given to the performance evaluation report (PER), training and skills acquisition, rotation of assignments, diversity of experience, and complexity of jobs, etc. Training for all civil servants at all levels—cadre or ex-cadre—should be mandatory and linked explicitly to promotion to the next grade. For this purpose, the existing training institutions should be made autonomous and provided the requisite human and professional training for engineers, scientists, accountants, health experts, educators, and economists, etc., while new institutions could be established to fill any gaps.

A fair and equitable compensation system cannot work well unless it is accompanied by an objective performance appraisal system. The current system of annual confidential reports has outlived its utility and should be replaced by an open PER system in which goals and targets are agreed on at the beginning of the year, key performance indicators to measure achievements are established, and an open discussion is held between the appraisee and supervisor to identify further development needs.

A mid-year review should be held to assess progress and provide feedback, and an annual evaluation held jointly through a discussion between the appraisee and his/her supervisor. The appraisee can then sign the report or appeal to the supervisor next in line against his/her immediate supervisor's findings if need be. This way, the PER will be used mostly as a tool for the development of the individual to meet the needs of the organization. The system should focus on poor or underperformers in particular to facilitate them in achieving better performance outcomes.

About 100 key public sector institutions in the country such as Pakistan International Airlines, the Water and Power Development Authority, Pakistan State Oil, the Oil and Gas Development Company, and Pakistan Railways, etc., have a critical impact on economic and social outcomes. There have been serious questions about the appointment of these organizations' chief executives. Even when competent individuals have been appointed, their detractors or other aspirants have carried out malicious media campaigns and virtually paralyzed the chief executive from making effective decisions.

To overcome this tendency, the governance structure has to be made more transparent and merit-based so that the right candidate is chosen as chief executive of an organization through a well laid-out process. A special selection board should screen and interview all candidates, and prepare a shortlist for consideration by the Prime Minister. This process will minimize arbitrary use of discretionary powers in appointments, attract capable candidates for these key jobs, and discourage the trend of making frivolous charges against the selected candidates.

Corruption among the majority of civil servants cannot be curbed by moral persuasion but instead by providing them with adequate compensation packages. The present compensation structure under which officers are grossly underpaid in relation to their comparators and do not earn a decent living wage has given rise to poor morale and a sense of professional apathy. None of the reforms proposed above will succeed unless the compensation package offered to the officer cadre is substantially upgraded.

To keep the government's wage bill within the limits of the fiscal deficit, we propose imposing a freeze on fresh recruitment to lower grades, except for teachers, health workers, and police officers. Although this is likely to prove a politically difficult decision, it should also be remembered that high fiscal deficits result in high rates of inflation that undermine popular support for the political party in power. After all, government employment accounts for less than 6 percent of total

employment in the country, and makeshift employment in the public sector will not satisfy voters.

#### *2.3.4. Information and Communication Technology*

The world is moving swiftly toward ICT, which benefits the lives of common citizens. E-government tools and developments in digital technology offer promising prospects for improving government efficiency, reducing transaction costs, making ordinary citizens' lives more convenient, introducing transparency and reducing discretionary powers and corruption, and tracking performance and output. Despite the potentially powerful impact of e-government, it has met with fierce resistance and contrived delays in adoption. A modest beginning has been made in an ad hoc manner but the process still lacks a concerted effort steered by the top leadership in the federal and provincial governments.

Without serious attention from the country's leadership, the pace will remain uneven, the impact will be marginal, and the opportunities foregone will be tremendous. Training current government employees in e-filing, messaging, document sharing and retrieval, reporting, and archiving will smooth the transition from a paper-based environment. The transparency achieved through e-government will also help curb corruption and the exercise of arbitrary discretionary powers by government functionaries.

#### *2.3.5. Government Rules and Regulations*

Another public grievance is the uneven and discriminatory application of government rules, regulations, and instructions. The limited number of lower functionaries familiar with these rules—of which most other people are unaware—tend to exploit their power by hoarding this knowledge for their own benefit. Multiple rules exist on the same subject where no systematic exercise has been undertaken to remove them. All such instances of multiple rules, regulations, instructions, and circulars in manuals should be removed, updated, and compiled in the form of a concise and accurate manual. The establishment and finance manuals deserve priority attention. After being updated and revised, these manuals should then be uploaded to the Government of Pakistan's websites so that they are accessible to the public.

One reason for the inefficient disposal of government business is the concentration of powers in the hands of the finance and law ministries, the Establishment Division, and Planning Commission. The Ministry of Finance had agreed to replace the outdated concept of a financial advisory organization with a chief financial and accounts officer in each

ministry directly answerable to the principal accounting officer, who is the secretary of the division. The full powers for reappropriation within the approved budget should be delegated to the secretary of the division, who can further delegate some financial powers to the head of executive departments or other officers in the ministry.

Ministries/divisions should bear full responsibility and accountability for their actions, achievements, and failures, and thus exercise their power to deploy financial and human resources in the most effective manner possible. The line ministries should be fully empowered to spend their budgetary allocations subject to the rules of the Public Procurement Regulatory Authority, with internal controls and audits duly carried out and the support ministries ensuring that the rules and procedures are complied with.

#### *2.3.6. Education, Health, the Police, and Land Administration*

In addition to these medium- and long-term reforms in governance structure, processes, and policies, four areas that affect people's daily lives the most—education, health, the police, and land administration—should also be reformed as discussed below.

Governance reforms in education are badly needed to uplift the state of literacy in Pakistan. These reforms should begin with a clear division of responsibilities between the federal, provincial, and district governments in service delivery. The federal government should focus on higher education financing, regulations and standards, and curricula, while the provincial governments are responsible for college, technical, and vocational education. The district governments should have exclusive power to manage and operate primary and secondary education up to matriculation level. Examination reforms should be carried out to bring the standards of various boards up to par. The management and teaching cadres should be separated and career paths for the two cadres should not discriminate against teachers.

A district education board should be established in each district to bring about better coordination and ensure uniform standards for public, private, and not-for-profit schools. Each board should consist of eminent, reputable persons with the district education officer as its secretary. The board will be assisted by a school management committee empowered to oversee the school's functioning. Head teachers will have more administrative authority in running schools and disciplining teachers, while arranging periodic school inspections.

The management and teaching cadres should be separated, and career paths for the two cadres should not discriminate against teachers. Endowments funds at the provincial government level should be augmented every year out of the budget to fund talented students to pursue their education at the country's best institutions. Student vouchers or stipends should be available for meritorious children from poor families to attend private schools of their choice. Private-public partnerships in the form of "adopt-a-school" programs should be encouraged and given incentives. Female teachers should be employed in primary schools as far as possible to promote girls' enrollment.

Most of the problems in healthcare delivery arise not from financial constraints but due to poor management practices. The health management cadre should, therefore, be separated from teaching and service providers in each province and the federal government. Only those with the necessary aptitude should be recruited as health managers and trained at the national and provincial health academies. District, teaching, and other specialized hospitals should have their own independent board of directors and be given autonomy in administrative, financial, legal, and human resource matters. Health human resources and development, particularly in the nursing and paramedical professions, require urgent attention to improve their quality and volume. The health regulatory framework should be made more effective and also set up at the provincial level.

There is near-consensus that law and order and security problems have worsened in recent years due to the inefficiency, corruption, and politicization of the police force. The original Police Order 2002 was compromised by amendments that weakened the functioning and accountability of the police. Legislative amendments and revised disciplinary rules are needed to allow police officers to perform their duties in accordance with the Police Order and to remove their discretionary powers. The reversal to the earlier Police Act after 2008 has only aggravated the situation by highly politicizing the police. The police force should not fall under the purview of the Civil Servants Act (except those belonging to the Police Service of Pakistan) since it impedes internal accountability.

Disciplinary rules should be framed under the Police Order. Provincial police offices should be organized along functional lines and their powers delegated according to the Police Order. Police stations should be merged, upgraded, and headed by directly recruited Grade 17 officers with full responsibility for watch and ward, investigation, and operations. The police force's training, allowances, mobility, logistics support, board and lodging, medical facilities, and welfare fall short of

their requirements and create demoralization; these should be reviewed and strengthened. The traffic police in all large cities should be reorganized to operate on the lines of the motorway police.

Land records as maintained by *patwaris* are the largest source of disputes and litigation in the country. Attempts to create a digital database of land records have remained halfhearted except in Punjab where some progress has been made. Land revenue assessment and collection, adjudication, and dispute resolution should remain the responsibility of the district governments but the maintenance and update of land records should be removed from their purview and placed directly under the Board of Revenue. *Patwaris* should be replaced by revenue assistants at BS 11 and above and recruited through the provincial Public Service Commissions. The Colonization of Government Lands Act 1912 should be revised to ensure better and more transparent allocation and utilization of state land.

### *2.3.7. Accountability of Government Bodies*

Another area that needs to be addressed is the absence of effective accountability for results. There is both too much and too little accountability of those involved in public affairs in Pakistan. On one hand, the plethora of laws and institutions such as anti-corruption bureaus, the National Accountability Bureau (NAB), auditor general's reports, public accounts committees of the legislature, parliamentary oversight, judicial activism, and the ombudsman system have created an atmosphere of fear and inertia, and hindered decision-making among civil servants. On the other hand, instances of rampant corruption, malpractices, nepotism and favoritism, and waste and inefficiency are common folklore in the country's administrative culture.

An over-emphasis on ritualistic compliance with procedures, rules, and form has taken the place of substantive concern with results and outcomes for welfare and justice. The NAB should be an independent body reporting directly to the Prime Minister, and chaired by a candidate selected jointly by the Prime Minister and leader of the opposition on the basis of competence, integrity, and independence. The investigation and prosecution of white-collar financial crimes and corruption should be entrusted to the NAB. Accountability courts should be staffed by honest judges who are free from influences and pressure. The provincial anti-corruption establishments should also be reorganized on the lines of NAB.

Introducing transparency by simplifying, codifying, and upgrading rules and regulations and disseminating them widely through e-governance tools such as a dynamic website, information kiosks, and

online access to government functionaries would help enforce internal accountability standards. At the same time, this would make it easier for citizens to carry out hassle-free transactions. Strong pressure from organized civil society advocacy groups in specific sectors or action by the media, political parties, the private sector, and think-tanks can also compel government departments and ministries to become more accountable for the results they produce.

The governance agenda outlined above should not be considered a technocratic exercise; it is essentially a political one that takes into account the existing power relationships in which the polity is rooted. Balancing the diverse interests of the various stakeholders concerned will involve many politically tough choices, which cannot be made by technocrats.

The sustainability of these reforms requires broad consultation, consensus building, and communication to articulate a long-term vision. People must see beyond the immediate horizon and buy into future changes. Concerns, criticism, and skepticism should be addressed. The scope, phasing, timing, implementation strategies, and mitigation measures involving those who will lose as a result of the reforms should be widely discussed and debated. If things do not proceed the way they were conceptualized, corrective action should be taken in the light of the feedback received. Citizens' charters, surveys and report cards, panels, and focus groups should be used as instruments to collect regular feedback on the impact of reforms on different segments of society.

If implemented earnestly, these recommendations will generate a much-needed sense of confidence among ordinary citizens in the country, relieve undue pressure on politicians to chase officers from various departments, and yield dividends to the political parties in power in the federal and provincial governments.

### **3. Conclusion**

Our survey of Pakistan's governance structure and institutional infrastructure amply confirms the validity of the theoretical literature and empirical evidence on governance in developing countries. The elitist capture of the state, excessive centralization of power both by elected and military rulers, chronic political instability, politicization of the civil services and, until recently, collusion between the power structures—the politicians, the army, and the judiciary—have reinforced the tendency toward institutional decay and huge governance deficits. Conflict between these power structures is not rooted in a benign balancing act for the collective good of society, but in the assertion of authority by different actors advancing their own parochial interests. Unlike other societies, the

cost that Pakistan is paying for poor governance and institutional decay is relatively high and poses an existential threat to the country.

This agenda for reforms draws on Pakistan's experience, lessons drawn from other successful examples of developing countries, the changing nature of Pakistan's sociopolitical landscape, best practices, and characteristics peculiar to the country's situation. It forms a logical sequence to the 18<sup>th</sup> Amendment to the Constitution and the recent National Finance Commission award. It is now essential to realize that the value chain can be completed only by taking this reform agenda to culmination over the next five years.

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## *Appendix*

### **Summary of Recommendations**

#### *Civil Services*

1. Ensure open, transparent, merit-based recruitment to all levels and grades of public services with regional representation as laid down in the Constitution.
2. Institute performance-based promotions and career progression for all public sector employees with compulsory training at post-induction, mid-career, and senior management levels.
3. Ensure equal opportunities for career advancement for all employees without preference or reservations for any particular class.
4. Replace the concept of the superior services with equality among all cadres and noncadres of public servants.
5. Grant a living wage and compensation package, including decent retirement benefits, to all civil servants.
6. Observe strictly the security of tenure of office for a specified period of time.
7. Establish a separate cadre of regular civil services at the federal, provincial, and district levels coexisting with contractual appointments.
8. Create an all-Pakistan National Executive Service (NES) for senior management positions drawn through a competitive process from among federal, provincial, and district-level civil servants and external professionals.
9. Introduce three specialized cadres under the NES for economic management, social sector management, and general management.

#### *Structure of Federal, Provincial, and District Governments*

1. Devolve powers, responsibilities, and resources from the federal to the provincial governments, and from the provincial to the local governments.
2. Establish intergovernmental structures with adequate authority and powers to formulate and monitor policy.
3. Clearly separate the policymaking, regulatory, and operational responsibilities of different ministries/provincial departments.

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4. Empower each ministry/provincial department to make decisions and be held accountable for their results, while ensuring they are adequately resourced to do so.
5. Streamline, rationalize, and transform the attached departments/autonomous bodies/subordinate offices/field offices, etc., into fully functional arms of the ministries in order to carry out operational and executive functions.
6. Reduce the number of layers in the hierarchy of each ministry/provincial department.
7. Designate the cabinet secretary as the main coordinator among the federal secretaries on the lines of the provincial chief secretaries.
8. Revive and strengthen secretaries' committees at the federal/provincial level as the main vehicles for inter-ministerial coordination and dispute resolution among various ministries.
9. District-level officers interacting with the public in day-to-day affairs should have adequate powers, authority, status, and privileges to be able to resolve citizens' problems and redress their grievances.
10. The police, revenue, education, water supply, and health departments are highly relevant to ordinary citizens' daily lives. Accordingly, the internal governance structure of these departments, public grievance redressal systems, and checks and balances on officials' discretionary powers need to be introduced.

### *Business Process Reengineering*

1. All laws, rules, regulations, circulars, and guidelines issued by any government ministry/department/agency should be available to the public in updated form, free of cost, and in a user-friendly format both in electronic and print forms at public places.
2. Service standards with timelines for each type of service rendered at the district, *thana*, and union level should be developed, disseminated, and posted at public places in each department.
3. The rules of business at the federal, provincial, and district government levels should be revised and simplified to empower secretaries/heads of department/deputy commissioners to make decisions without need for multiple references, clearances, and the back-and-forth movement of files. Decisions made should be post-audited to ensure accountability rather than requiring prior clearance.

4. The delegation of financial, administrative, procurement, and human resource management powers should be revisited, and adequate powers commensurate with the authority should be delegated at each tier of the hierarchy.
5. Estacode, the financial rules, accounting and audit rules, fundamental rules, and all other rules in force should be reviewed systematically and revised to bring them in line with modern management practices.
6. E-government should be introduced gradually and in phases. Technological solutions and hardware and software applications are easy to institute but the most difficult aspect is training users and incorporating a change in their culture, attitude, and practices. E-government should be driven by business needs rather than crafted as an elegant technical solution.

#### **Institutions of Economic Governance in Pakistan**

##### *Federal Government*

1. Finance Division
2. Planning Commission
3. Economic Affairs Division
4. Pakistan Bureau of Statistics
5. Commerce Division
6. Privatization Commission
7. State Bank of Pakistan
8. Securities and Exchange Commission of Pakistan (SECP)
9. Federal Board of Revenue (FBR)
10. Auditor General of Pakistan
11. Board of Investment
12. Trade Development Authority of Pakistan (TDAP)
13. Competition Commission of Pakistan (CCP)
14. Pakistan Telecommunication Authority (PTA)
15. Oil and Gas Regulatory Authority (OGRA)
16. National Electric Power Regulatory Authority (NEPRA)

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17. Indus River System Authority (IRSA)
18. Engineering Development Board (EDB)
19. Private Power Infrastructure Board (PPIB)
20. Alternate Energy Development Board (AEDB)
21. Pakistan Standards and Quality Control Authority (PSQCA)

*Provincial Governments*

1. Finance Department
2. Planning and Development Department
3. Board of Revenue
4. Excise and Taxation Departments
5. Revenue Boards

## Benefiting from Foreign Direct Investment

Khalil Hamdani\*

### 1. Introduction

It is commonly held that foreign direct investment (FDI) has played an insignificant role in Pakistan's economic development.<sup>1</sup> Certainly, the aggregate data supports this view: FDI inflows have accounted for less than 1 percent of gross domestic product (GDP) in most of Pakistan's 60-plus years, and less than 4 percent in the peak year of 2007 when the country ranked among the 10 largest recipients of FDI in Asia.<sup>2</sup> At the same time, FDI has been more important in Pakistan than in India: annual inflows have been larger in most years from 1947 to 1993, and even now, while our larger neighbor receives four times more inflows, the share of FDI in capital formation is three times as large in Pakistan. Such comparison, while superficial, suggests the relevance of FDI.

This chapter considers the role that FDI can play in moving the economy forward by improving its technological base and placing production on a more dynamic growth path, as other countries have done with great success. It begins with a brief history to remind readers that Pakistan's economy has always been open to foreign investment, even in the heyday of nationalization. Next, it looks at the particular type of investment and technological profile that has evolved: weighty, but largely insular, statist, and low on competitiveness. Finally, the chapter assesses the potential for a more ambitious industrial trajectory: private

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\* The author was director of the Investment Division at the United Nations. He is grateful to Faizullah Khilji and Rashid Amjad for comments on an earlier draft of this chapter.

<sup>1</sup> See, for example, A. H. Khan (1997). Even advocates of market-led growth, such as Papanek (1991), have neglected the role of FDI.

<sup>2</sup> The top ten Asian recipients of FDI were China, Hong Kong, Singapore, India, Thailand, Malaysia, Taiwan, Indonesia, Vietnam, and Pakistan (see United Nations Conference on Trade and Development [UNCTAD], 2008, p. 48).

sector-led, fueled by FDI, and supported by policies and institutions that encourage technological deepening.

## **2. Foreign Direct Investment**

Foreign companies have operated in Pakistan since even before independence. Standard Chartered Bank claims a heritage of over 140 years, to operations set up in Karachi in 1863. Shell Petroleum dates its operations back to 1903, and Imperial Tobacco to 1905. Siemens opened an office in Lahore in 1922; Grindlays Bank opened branches in Lahore in 1924 and in Peshawar in 1926; Imperial Chemical Industries (ICI) set up a soda ash manufacturing facility in Khewra in 1944; and there were still others.

Pakistan's formative years were a particularly dynamic period. Economic growth was driven by private investment. The government's policy of import substitution provided a profitable environment for Muslim migrant families from pre-Partition India with capital to invest and set up their businesses anew.<sup>3</sup> Many were motivated by patriotic zeal. A vibrant domestic private sector, in turn, attracted foreign participation.

FDI was initially permitted in manufacturing, and large investments had to be in the form of joint stock companies with local equity participation.<sup>4</sup> One of the first foreign investments in the new country was a vegetable oil factory built by Lever Brothers in Rahimyar Khan in 1948; today, Unilever is the largest consumer goods manufacturer. The Lakson Group collaborated with several multinationals, such as Colgate-Palmolive, which established operations in 1954. In pharmaceuticals, Glaxo Laboratories was incorporated in 1948 and is today, as GlaxoSmithKline, the largest in the industry; other early entrants were Abbott Laboratories in 1948, Pfizer in 1961, and Searle in 1965.

The domestic Batala Engineering Company (BECO) attracted KSB (a German multinational manufacturer of machines, pumps, and valves) to locate its first subsidiary in the Asia-Pacific market in Pakistan in 1953; today, the KSB Pakistan foundry at Hasan Abdal produces submersible pumps, automotive components, and supplies castings for cars and tractors.

The motor vehicle industry began modestly in 1949, with distributorships of Vauxhall cars by General Motors & Sales, a domestic company, and of Ford trucks by Ali Automobiles. Exide commenced the production of batteries in 1953. Allwin Engineering was manufacturing

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<sup>3</sup> The import substitution experience has been widely debated; for a thoughtful review, see Noman (1991).

<sup>4</sup> These restrictions were relaxed in 1976 and removed in 1997.

precision automobile parts by 1961, and Bedford trucks were being assembled by Ghandara Motors in 1962. The Atlas Group set up a Honda motorcycle plant in 1962 among other investments with Japanese partnership.

In the services sector, the banking, insurance, and air transport industries quickly gained prominence. In 1951, Habib Bank became Pakistan's first multinational corporation with operations in other countries. American Life Insurance Company (ALICO) entered Pakistan in 1952. The precursor to Pakistan International Airlines (PIA) was Ispahani's privately owned company, Orient Airways, which, in a leasing arrangement with the British Overseas Airways Corporation established a flight service between Karachi and Dhaka in 1954.

Although annual FDI inflows were less than 6 percent of total private industrial investment, FDI was crucial for the success of import substitution and infant industry policies in the post-independence period. There were a number of joint ventures or licensing, franchising, and distribution arrangements between startup Pakistani firms and foreign companies. Some were launched with World Bank lending, such as the 1968 joint venture between the Dawood Group and Hercules Chemicals to manufacture fertilizer. An indicator of the welcoming attitude toward foreign investment was the bilateral investment treaty signed between Pakistan and Germany in 1959—the very first in the world.<sup>5</sup>

FDI inflows increased at an average annual rate of 10 percent between 1965 and 1969 (see Figure 11.1), contributing to investment and facilitating technology transfer. During these years, manufacturing value-added (MVA) grew at 9 percent, and total factor productivity (TFP) is estimated to have increased at 4.3 percent (Kemal, Din, & Qadir, 2002). The relatively good performance in the country's formative years reflects the infancy of manufacturing and the low initial level of the technological base, but also a dynamic period of technology acquisition, application, and learning through equity and nonequity ties between domestic and foreign companies.<sup>6</sup>

This golden era of Pakistan industry lasted 25 years. A feature of the 1947–1972 expansion was the rapid rise of family businesses into

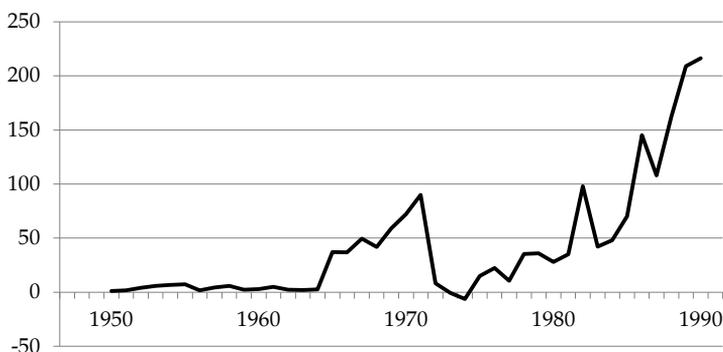
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<sup>5</sup> There are, today, more than 2,800 such treaties among 181 countries (see UNCTAD, 2012, p. 84).

<sup>6</sup> The International Monetary Fund (2002) attributes the strong economic growth performance in the 1960s to factor accumulation rather than TFP; physical capital stock (which embodied technology) expanded at an annual average rate of 13.1 percent in 1961–71.

industrial conglomerates,<sup>7</sup> favored with privileged access to financial credit and foreign exchange for the import of industrial inputs (Amjad, 1982).<sup>8</sup> These conglomerates were not very different from those of other countries—the robber-barons of the US, the zaibatsu and keiretsu of Japan, and the chaebols of Korea—and perhaps they might have propelled Pakistan alongside Korea into a newly industrialized country, but this was not to be.

**Figure 11.1: FDI inflows in the early years (USD million)**



Source: State Bank of Pakistan.

Pakistan's resort to nationalization in the 1970s was not uncommon at the time.<sup>9</sup> The duration was brief (1972–77) but the impact was widespread and long lasting. A great many different units were seized.<sup>10</sup> The focus was mainly on domestic companies, although some FDI was affected. ALICO, with an investment of more than USD 36 million, was nationalized in 1972. Esso's petroleum operations were purchased in 1976

<sup>7</sup> Mahbub ul Haq, chief economist of the Planning Commission, noted in April 1968 that Pakistan's industry was owned largely by just 22 families. Equally, it could also have been noted that agriculture was concentrated among relatively few landowning families. Ownership of large farms (of more than 15 hectares of land) is concentrated among 1 percent of all households (see Anwar, Qureshi, & Ali, 2004).

<sup>8</sup> Subsidized credit and inputs were also provided in agriculture (see M. H. Khan, 1983, table 6).

<sup>9</sup> Industry was also nationalized in India (banking, coal, and petroleum) and Sri Lanka (mining, petroleum, and plantations) during this period.

<sup>10</sup> The largest 31 manufacturing firms (in cement, engineering, electrical goods, iron and steel, metals, motor vehicles, petrochemicals, and utilities) and 13 insurance companies were nationalized in 1972. Others included the emerald mines in Swat in 1972; the vegetable ghee industry in 1973; banking, shipping, cotton ginning, and some 2,000 units in rice-husking and flour-milling in 1974; and some 3,000 private colleges and schools in 1972 (see Junejo, 1996, chap. 16, pp. 79–80).

and its gas operations in Mari, one of the largest in the country, were acquired in 1983. Some foreign companies, e.g., Shell, reduced shareholdings to below 50 percent in locally registered affiliates. Although nationalization was reversed as early as 1977 in the agro-processing industry, it was slow to unwind in other industries. Banking was not denationalized until 1991. ALICO was denationalized in 1994, and a further decade passed before Habib Bank was denationalized in February 2004.<sup>11</sup> To this day, a number of enterprises remain slated for denationalization, for reasons not unique to Pakistan.<sup>12</sup>

The main effect of nationalization on foreign investment was the lapse of nonequity arrangements and the shelving of investment proposals, such as the proposed collaboration between BECO and Toyota to manufacture textile machinery in Pakistan—a venture that would have kept Pakistan at the forefront of a fiercely competitive global industry.

When private investment subsided, so did foreign investment: FDI inflows fell to zero in 1973, became negative in 1974, and did not recover for a full decade, until 1982 (see Figure 11.1). The Foreign Private Investment (Promotion and Protection) Act of 1976 was enacted to (i) protect foreign investments from nationalization and expropriation, (ii) guarantee capital repatriation and the remittance of profits and dividends, and (iii) encourage investment in capital goods industries. These assurances, however, had little effect on FDI inflows.

Public enterprise and public investment dominated Pakistan's industry for the next three decades (1972–2002). Although aggregate investment never quite attained its earlier levels, this period was not without expansion and growth. An unanticipated windfall after 1976 was the substantial inflow of overseas workers' remittances, which sustained consumption and invigorated private investment.<sup>13</sup> In the food industry, Nestlé acquired a 40 percent share in Milkpak in 1988. In transport, Indus Motor was formed as a 1990 joint venture between the House of Habib and Toyota, and in 1992 Atlas Honda expanded production from motorcycles and batteries to cars, among yet other examples.

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<sup>11</sup> The original owners reopened operations in Pakistan in 1989 through branches of their bank in Switzerland. The irony of the Habib family operating as a multinational in their own country was commemorated with a five-rupee postage stamp issued by the Pakistan Post Office in March 2001 displaying the logo and headquarters of the Swiss multinational, Habib Bank AG Zurich.

<sup>12</sup> The experience of India is similar (see Srinivasan, 2002).

<sup>13</sup> Remittance inflows began in 1976 and averaged USD 1.8 billion per year during 1976–2002; in the 1980s, remittances amounted to 11 percent of private consumption and 8 percent of GDP (see Siddiqui & Kemal, 2006).

### *Benefiting from Foreign Direct Investment*

In the public sector, too, there were a variety of technology-intensive joint ventures between Pakistan's parastatals (public enterprises) and foreign companies. An example is the 1978 nitrogen (urea) fertilizer project between the quasi-public Fauji Foundation and Haldor Topsoe A/S of Denmark; it further expanded manufacture in 1993, with Jordan Phosphate Mines to include phosphate fertilizer. The fertilizer industry also attracted parastatal investment from China, Saudi Arabia, and the United Arab Emirates (UAE).

Pakistani-Arab joint ventures tapped into the capital of the oil-rich states. A particularly successful joint venture with the Emirate of Abu Dhabi established the Pak-Arab Refinery Ltd. in 1974, which is now active in refining, transportation, storage, and marketing, and has technology partnerships with French, Dutch, Austrian, and American multinationals. A parastatal collaboration with China established the Heavy Mechanical Complex Ltd. in 1979, with fabrication and machining facilities for the design, engineering, and manufacture of industrial plants and machinery.<sup>14</sup> In transport, the state-owned Pakistan Automobile Corporation formed joint ventures with Japanese companies to establish Pak Suzuki Motor Company in 1983, and Hinopak Motors (also with Arab involvement) in 1985.

FDI inflows, attracted both to the private and public sectors, increased at an average annual rate of 22 percent in the 1980s (see Figure 11.1), while MVA grew at 8.1 percent, and TFP is estimated to have increased at 5.4 percent (Kemal et al., 2002). It was an altogether remarkable recovery after the 1970s, though the worst decade was yet to come.

The Achilles' heel of public enterprise was the inability to generate sufficient earnings for reinvestment. A few publicly owned or managed enterprises flourished into conglomerates—the Fauji Group<sup>15</sup> and Askari Group<sup>16</sup>, for instance—but the totality of public enterprises and nationalized banks required government support of some USD 1.7 billion annually.<sup>17</sup> This proved unsustainable, and given the constraints on the public budget, investment (and technology acquisition) in public

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<sup>14</sup> The facility is also a key component of Pakistan's military-industrial complex.

<sup>15</sup> The Fauji Foundation, a military welfare trust, owns or controls 19 commercial and industrial enterprises in such industries as oil and gas, power, fertilizer, cement, cereals, sugar, and financial services. The enterprises are limited companies listed on stock exchanges, and the general public may also buy and sell shares; however, their chief executive is always a government nominee.

<sup>16</sup> The Askari Group, an army welfare trust, runs 17 business enterprises in agriculture, aviation, banking, cement, insurance, petroleum, and real estate, among others.

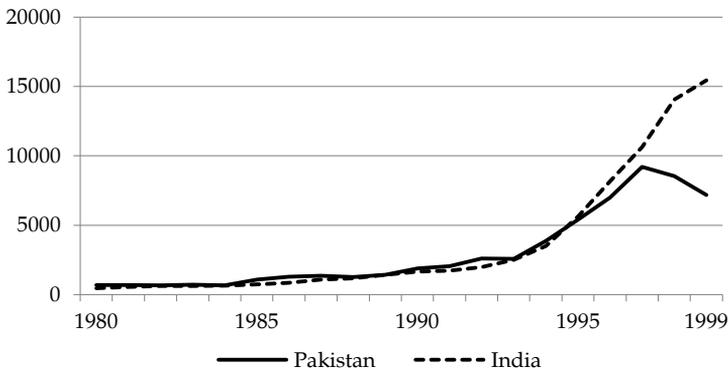
<sup>17</sup> "Almost PRs 100 billion a year were spent out of the budget annually on plugging the losses of these corporations, banks and other enterprises," says Husain (2005).

enterprises slowed significantly in the 1990s. The growth of public investment decelerated from 4.6 percent in the 1980s to 0.5 percent in the 1990s (Hyder & Ahmed, 2004, table 1).

The investment slowdown in the 1990s had a serious impact on growth and productivity. In contrast to the previous decade, growth in MVA slipped from 8.1 percent to 4 percent, and TPF grew by only 1.6 percent (Kemal et al., 2002). FDI inflows grew at an average annual rate of only 8 percent in the 1990s in spite of policy reforms and generous incentives. During this decade, India, which had generally trailed behind Pakistan in FDI inflows, took the lead and went on to become a major investment destination (see Figure 11.2).

Pakistan's policy liberalization was gradual but comprehensive. In trade policy, the Export Processing Zones Authority was established in 1980, import quotas were largely removed in the 1980s and tariffs were significantly lowered in the 1990s. In foreign exchange policy, currency convertibility was guaranteed in 1994. In FDI policy, the Board of Investment was established in 1990 and restrictions on entry, equity ownership, and royalty payments were eliminated. By 1997, Pakistan had a fully open and progressive foreign investment policy regime—the most liberal in the Subcontinent.

**Figure 11.2: FDI stock in Pakistan and India (USD million)**



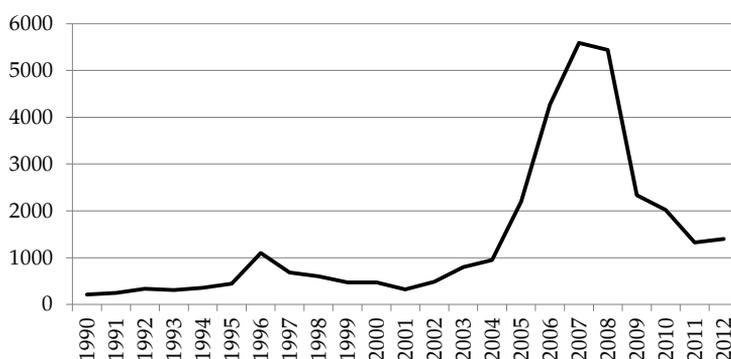
Source: UNCTAD FDI/TNC database.

A major pickup came in 1995/96 when FDI inflows doubled in a year and exceeded USD 1 billion for the first time (see Figure 11.3). The centerpiece was the build-operate-transfer infrastructure project on the

Hub River, HUBCO.<sup>18</sup> However, the bulk of new investments were made by some two dozen independent power producers (IPPs) lured by an overly generous incentive scheme that allowed them to acquire fuel to generate power on favorable terms (low taxes, duty-free import of plant and equipment, financing of capital costs, and foreign exchange risk-insurance on external loans) and also guaranteed the purchase of the power produced at a pre-set, dollar-indexed tariff structure for 15–30 years (for details, see Khan & Kim, 1999).

The incentive scheme quickly proved unsustainable for the public sector: Pakistan State Oil (PSO) had difficulty supplying the fuel to the power producers and the Water and Power Development Authority and other utilities had difficulty purchasing the power generated. This meant significant foreign exchange outflows in excess of USD 1 billion per year well into the next decade. Trouble maintaining the set payment schedule disrupted production and built up so-called “circular debt” between the state utilities, IPPs, and PSO.<sup>19</sup> The larger legacy is continuing power shortages, which have adversely affected all industry.

**Figure 11.3: FDI inflows in recent years (USD million)**



Source: UNCTAD FDI/TNC database.

It took another ten years before annual FDI inflows topped USD 1 billion again, in 2005—this time driven mainly by privatization in banking and telecommunications. Banking attracted FDI from the Arab

<sup>18</sup> HUBCO, a limited-liability company privately financed with 13,000 shareholders, was developed during 1985–95 with technical support from the World Bank, loans from 43 offshore banks, guarantees from France, Italy, Japan, the UK, and the US, and equity participation by Saudi Arabia and the UK.

<sup>19</sup> The amount of circular debt reached PRs 382.5 billion or USD 4 billion in July 2012 (see State Bank of Pakistan, 2013, chap. 1, Box 1.1).

states (Bahrain, Kuwait, Oman and UAE) and other countries (Malaysia, the Netherlands, UK, US, and Switzerland). These investments infused the industry with fresh capital and managerial know-how—modernizing the now denationalized United Bank, Muslim Commercial Bank, and Habib Bank—and provided competition in the shape of new entrants such as Faysal Bank, Bank Alfalah, and Meezan Bank (Islamic banking).<sup>20</sup>

In telecommunications, Motorola (US) started the first cellular mobile service with Mobilink in 1994, which was subsequently acquired by Orascom (Egypt) in 2001. Telenor (Norway) also acquired a mobile license (GSM) in 2004 and has since made investments in excess of USD 2 billion. The privatization of the Pakistan Telecommunication Company Limited (PTCL) in 1991 bore fruit in 2006, with an investment by Etisalat (UAE) to acquire a 26 percent equity share valued at USD 2.6 billion.<sup>21</sup> China Mobile established its first overseas subsidiary, Zong, in 2008 with investment commitments of USD 1.7 billion. There was also FDI from Oman (to acquire WorldCall), Japan, Singapore, and Qatar. While these investments have generated dividend payments and profit remittances overseas, the significant improvement in the availability, quality, and cost of communication services is also visible throughout the country.

As a consequence of the power and privatization policies, the composition of FDI has shifted from manufacturing to services. Manufacturing was predominant in the early years—receiving 75 percent of the FDI inflows in 1980—but from 1995 onward, the services sector has attracted significant FDI. By 2008, the share of manufacturing in the stock of FDI had fallen to 31 percent, while the share of services had risen to 58 percent (see Table 11.1). Three industries—utilities, financial services, and telecommunications—therefore, account for nearly half the entire FDI stock.

The extractive industries (mining and quarrying) have received a small but steady amount of FDI over the years and account for 10 percent of the FDI stock. At present, they are foreign investors' main attraction: their share in FDI inflows rose from 13 percent in 2008 to 34 percent in 2010. The government is aggressively awarding concessions for oil and gas exploration. A dozen foreign companies have invested in the country, including BP and Premier Oil (UK), ENI (Italy), BHP Billiton (Australia), OMV (Austria), Petronas (Malaysia), and Petrobras (Brazil), which specifically plans to explore offshore. There were also investments from Canada, China, Hungary, Switzerland, and the UAE.

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<sup>20</sup> For a study on the improved performance of privatized banks, see Khan and Kamal (2006).

<sup>21</sup> Some USD 800 million is pending in the resolution of legal and property issues.

*Benefiting from Foreign Direct Investment*

**Table 11.1: FDI by economic sector and industry, 2002, 2008**  
(USD million or percentage share)

<b>Industry/sector</b>	<b>FDI</b>	<b>Flows</b>	<b>FDI stock</b>
	<b>2002</b>	<b>2008</b>	<b>2008</b>
<i>All sectors/industries</i>	823	5,437	16,472.9
<i>Extractive (%)</i>	35.2	13.2	10.4
Mining	4.7	39.2	13.0
Oil and gas exploration	285.2	675.9	1,706.5
<i>Manufacturing (%)</i>	18.0	9.8	30.5
Food	-5.1	69.3	847.5
Chemicals	87.6	102.3	711.8
Petroleum refining	4.5	79.2	481.2
Pharmaceuticals	5.6	41.9	711.3
Transport equipment	0.6	103.6	823.3
Other manufacturing	54.7	140.2	1,449.9
<i>Services (%)</i>	45.1	75	58.0
Power	25.0	112.7	1,563.0
Trade	45.3	170.5	1,284.6
Communications	24.2	1,678.2	2,593.3
Finance	192.9	1,877.6	3,831.1
Other services	83.8	237.1	277.2
<i>Unspecified (%)</i>	1.7	2.0	1.1

*Source:* State Bank of Pakistan.

Pakistan has attracted FDI from a variety of sources (see Table 11.2), traditionally from the UK and US, followed by Switzerland, Japan, the Netherlands, and Germany. Newer sources are from Asia, Latin America, and the Middle East, with the UAE being the single largest investor during 2006–08. A third of the inward FDI stock in 2008 originated from developing countries, and was diversified in a range of industries, including telecommunications, financial services, cement, textiles, construction, real estate, logistics, airlines, and oil and gas. FDI from developed countries is relatively more concentrated in manufacturing, while that from developing countries is relatively more so in services.

**Table 11.2: FDI by geographic origin, 2002 and 2008**  
(USD million or percentage share)

Country	FDI	Flows	FDI stock
	2002	2008	2008
<i>All countries</i>	823	5,437	16,472.9
<i>Developed economies (%)</i>	68.5	43.5	65.4
Australia	1.9	75.5	212.0
France	-5.7	5.4	172.7
Germany	9.0	73.4	436.5
Japan	13.3	108.5	812.9
The Netherlands	-6.4	140.7	787.3
Switzerland	3.7	169.0	1,707.8
United Kingdom	194.6	458.8	4,241.7
United States	348.7	887.9	1,638.5
Others	4.5	445.1	770.3
<i>Developing economies (%)</i>	24.3	48.1	32.8
Bahrain	29.9	32.0	183.3
China	1.0	6.2	694.8
Hong Kong	5.6	368.2	254.6
Kuwait	2.0	20.0	258.9
Malaysia	1.3	862.3	353.0
Mauritius	0.0	312.7	608.1
Oman	9.0	115.8	196.3
Saudi Arabia	21.5	40.8	148.9
Singapore	3.6	228.3	201.2
United Arab Emirates	114.1	432.5	1,663.9
Others	11.6	195	839.1
<i>Unspecified (%)</i>	7.2	8.4	1.8

Source: State Bank of Pakistan.

Pakistan also has FDI in other countries: the stock of outward FDI in 2008 was some USD 2 billion. Two thirds (67 percent) is located in developing countries, mostly in trade and financial services (96 percent), and the largest destinations are the UAE (20 percent), the UK (7 percent), and Bangladesh (6 percent). Pakistani investments in the latter have risen in recent years and Bangladesh is now the second most popular destination, accounting for 12 percent of Pakistan's outward FDI in 2011.

## *Benefiting from Foreign Direct Investment*

Overall, FDI inflows averaged USD 4 billion annually during 2005–09—a level commensurate with the size of Pakistan’s population (175 million) and its economy. During this period, FDI comprised 15 percent of gross fixed capital formation compared with an average for developing countries of 12 percent. Pakistan ranked briefly among the top ten FDI recipients in Asia.

FDI flows to Pakistan have since receded by more than half to well below USD 2 billion per year. While current levels are still respectable in the present context of the global downturn and domestic instability, Pakistan can, and should, do better.

### **3. FDI and Technology**

It is common to value FDI for its contribution to capital inflows but its importance lies more in its accompanying benefits. In addition to the financial capital that supplements savings and adds to investment, jobs, and economic growth, FDI brings technology, skills, technical know-how, and access to inter-industry trade and foreign markets. These other benefits are particularly important in Pakistan’s case; unlike many developing countries, it has had recourse to alternative forms of resource inflows, such as official capital flows (development assistance) and income transfers by migrants (remittances), which have also been substantially greater than FDI inflows.<sup>22</sup>

As already discussed, Pakistan has been reasonably successful in attracting FDI. For many years, it attracted as much or more FDI than its larger neighbor. In more recent years, Pakistan’s stock of inward FDI increased at an average annual rate of 12.5 percent between 1990 and 2009, rising from USD 1.9 billion and reaching USD 18 billion. This marks a reasonably good performance, comparable to that of a number of developing countries that have opened up in an expansive period of worldwide FDI growth.<sup>23</sup>

Pakistan has attracted resource-seeking and, mainly, market-seeking FDI in a wide range of industries, initially in marketing as well as manufacturing and more recently in services. These investments were often undertaken with local partners; at first, some were marketing arrangements and others involved simple manufacturing. Over time, however, marketing expanded to production, and manufacturing expanded into new product lines and more complex assembly operations.

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<sup>22</sup> The only year in which FDI and remittances were close to par was 1996: FDI was USD 1,102 million and remittances were USD 1,284 million. In all other years, remittances have been several times larger.

<sup>23</sup> For additional background, see Hamdani (2011).

In this way, FDI has facilitated the transfer of technology necessary for industrial development.

There are many examples of sequential investment and technological upgrading. In pharmaceuticals, Abbot Pakistan was established in 1948 as a marketing affiliate, and now operates a couple of manufacturing plants. In automobiles, as already noted, the Atlas Honda joint venture began with the assembly of motorcycles (in 1963), diversified to the manufacture of batteries (in 1966) and, with the acquisition of Allwin Engineering (in 1981), became a manufacturer of motorcycle parts and components for other local manufacturers (OEM) and the replacement market.

In addition to this vertical integration, the Atlas Group expanded horizontally into the manufacture of motor vehicles (in 1992), into power generation (taking advantage of the 1997 incentive scheme in a joint venture with the German company, MAN Diesel), and into financial services (with the acquisition of Muslim Insurance in 1980). Such expansion creates value-added and jobs, and deepens the technological base of industry.

The link between FDI and technology is visible in the manufacturing sector's growth trends. Several studies on TFP in Pakistan typically observe a cyclical pattern in growth rates.<sup>24</sup> Kemal et al. (2002), for example, show that MVA grew at 6.4 percent during 1965–2000 but varied between periods, while the physical capital stock in manufacturing grew at a steady rate at around 2 percent, implying higher (or lower) output growth with about the same input of capital at higher (or lower) levels of productivity.<sup>25</sup> Therefore, TFP in manufacturing followed the pattern of MVA, which also paralleled the trend in FDI inflows (see Figure 11.4). The broad pattern, as previously discussed, is one of:

- A dynamic 1960s, with high rates of manufacturing expansion, FDI inflow, technology acquisition, and productivity growth (all from an admittedly low base).
- A regressive 1970s, disrupted by nationalization: negative growth in FDI and slower manufacturing activity.
- A revived 1980s, with resurgent economic activity, significant FDI, and technological learning in the public and private sectors.

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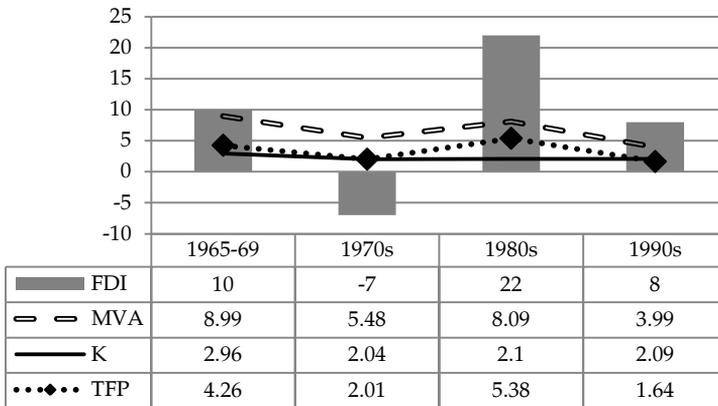
<sup>24</sup> In addition to Kemal et al. (2002), see H. A. Pasha, Pasha, and Hyder (2002); International Monetary Fund (2002); Sabir and Ahmed (2003); Mahmood and Siddiqui (2000); and S. U. Khan (2006), among others.

<sup>25</sup> Kemal et al. (2002) also control for other factor inputs, namely labor which grew at 0.9 percent during 1965–2000.

- A weak 1990s, with declining public sector investment, FDI mainly in services (power), and a relatively sluggish manufacturing sector.

Overall, the trends suggest that FDI contributed to technology transfer and growth in TFP. S. U. Khan (2006) shows TFP, during 1960–2003, to be inversely related to the budget deficit and positively related to government consumption, private credit, domestic investment, and FDI.

**Figure 11.4: Growth of manufacturing sector (percent)**



Source: Growth rates of manufacturing value added (MVA), capital (K), and total factor productivity (TFP) as presented in Kemal et al. (2002). FDI growth rates are for aggregate inflows and based on data from the State Bank of Pakistan.

The link between FDI and technology is also visible in its industrial concentration. About a third of the entire FDI stock in Pakistan in 2008 was concentrated in manufacturing (30.5 percent; see Table 11.1), which, when disaggregated by technology category according to the standard industrial classification,<sup>26</sup> shows the following:

- 44 percent of the FDI in manufacturing involved resource-based manufacturing (food, beverages, tobacco, sugar, paper, rubber, cement, and petroleum refining).
- 4 percent was in low-technology manufacturing (textiles, leather, ceramics, and metal products).

<sup>26</sup> United Nations Industrial Development Organization [UNIDO] (2009, Annex II). The technology classification is rough: some segments in each category may involve more (or less) sophisticated skills and complex production. The same classification underpins Table 11.3.

- 52 percent was in medium- and high-technology industries (chemicals, basic metals, pharmaceuticals, cosmetics, fertilizers, machinery, electrical goods, electronics, and transport equipment).

In the first and last of the categories above, for resource-based and medium- and high-technology industries, managerial efficiency and technology absorption contributed to TFP gains for most years during 1998–2007 (Raheman, Afza, Qayyum, & Bodla, 2008). Overall, FDI appears to have deepened the technology base of manufacturing production.

FDI has also deepened the technology base in key services industries. In telecommunications, the economy leapfrogged from sparse, dysfunctional landlines to mobile telephony almost overnight, with 120 million subscriptions by 2012 and a million new connections a month. In finance, new technologies and managerial practice have modernized banking, reducing costs and nonperforming loans, improving customer service, and extending lending to small enterprises and other inadequately reached segments (Husain, 2005). In port management, transport costs and delays have lessened. In trade, there has been a diffusion of new methods of inventory control, supply chain management, packaging and product development, and advertisement targeting a growing urban middle class. Domestic firms have participated in the growth and spread of these services.

However, FDI has been mainly market seeking and so, its benefits of technology transfer have not flowed directly into the export industries. Ahmad et al. (2003) examine the causal relationships between FDI, MVA, and exports over 1972–2001 and observe that causality runs from FDI to MVA but not from FDI to exports.<sup>27</sup> Weiss and Lall (2004) also observe that, during 1990–2001, technological upgrading in manufacturing was slow but occurred in domestic production rather than in exports. Raheman et al. (2008) find that low technology absorption contributed to a decline in TFP in the textiles sector (a major exporter) during 1998–2007.

A general failure of the foreign manufacturing affiliates operating in Pakistan in all industries has been their reluctance to develop an export-oriented approach, even within the global network of their parent companies. This, in part, is attributable to the protected markets within which they have operated—the downside of the earlier trade and industrial policies that worked so well to attract FDI.<sup>28</sup> However, the

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<sup>27</sup> For other studies showing how FDI has had a positive impact on growth, see Shabbir and Mahmood (1992); Atique, Ahmad, and Azhar (2004); Mohey-ud-din (2007); and Rahman and Salahuddin (2010).

<sup>28</sup> For a discussion on trade policy, see Hasan (2008).

experience of other countries is that, over time (as much as a decade), market-seeking affiliates can and do graduate to become world players.

This has begun to happen in Pakistan. Pak Suzuki Motor Company, established in 1983, began exporting pickup vehicles in 1997 to Bangladesh, Nepal, and Afghanistan, and now exports sheet metal parts to Europe. Hinopak Motors began exporting school buses to the UAE in 2010. ICI Pakistan exports to regional markets in the Middle East and Central Asia. Pak Elektron Limited, established in 1956 to manufacture transformers (in collaboration with the German AEG in 1956), added to its product line air-conditioners (with General Corporation of Japan in 1981), refrigerators and freezers (with Iar Siltal and Ariston of Italy in 1986), and now exports its appliances.

The cement industry, set up with FDI, is a major exporter within the Subcontinent and to East Africa and the Middle East. Similarly, the pharmaceutical industry, which includes two dozen multinationals, has begun to export with overseas sales of USD 100 million in 2007. The food industry (beverages, tobacco, etc.) also exports. The national Pakistan Aeronautical Complex (PAC), established in the early 1970s, has had various technical collaborations with China, France, Sweden, the Netherlands, and the US, and now exports aircraft to the Middle East and overhauls those of other countries. Recently, as part of an offset deal for the purchase of aircraft by PIA, Boeing transferred technology to enable PAC to manufacture spare parts in Pakistan for its global supply chain.<sup>29</sup> Weiss and Lall (2004) show that total exports increased at an annual rate of 7.9 percent during 1985–2002, while exports of medium- and high-technology products increased at 8.3 percent, of which automotive exports increased at 14 percent and electronic exports at 16 percent.

The relationship between FDI and technology begins with the acquisition of technology (through capital goods and licensing) and the transfer of skills and know-how to the local workforce (through the use of technology in production). Technology transfer through FDI enhances labor productivity. Based on a 1981 sample of 25 of Pakistan's large-scale manufacturing industries, Mahmood and Hussain (1991) observe that foreign affiliates have higher labor productivity than domestic firms (of equal capital size and producing similar products). Din, Ghani, and Mahmood (2009) also note that foreign affiliates demonstrate better export performance than local firms.<sup>30</sup>

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<sup>29</sup> The USD 1.8 billion purchase order was made in 2002, the aircraft were delivered over 2004–08, and the manufacturing facility for spare parts was operational by 2006.

<sup>30</sup> Rehman and Wizarat (2010) find that there is significant potential for learning-by-doing in Pakistan's large-scale manufacturing sector.

FDI also diffuses technology through the economy—to competitors, consumers (e.g., mobile phones), and suppliers. An example of the latter is Nestlé Milkpak's provision of technical assistance to farmers to increase animal feed stock, improve milking techniques, prevent livestock disease, and develop the cattle breed. Such improvements benefit all dairy producers and, as a result, milk production per animal (cattle/buffalo) in Pakistan is the highest in the Subcontinent.

Other benefits include the expansion of the intermediate capital goods industry: the stainless steel milk transport tanks that used to be imported are now manufactured in Pakistan through a joint venture between a Dutch company and a local manufacturer. Burki and Khan (2007) provide evidence that dairy farmers receive higher prices for their milk supplies and earn higher income; concomitantly, girls' school enrolment is higher in milk-producing districts. The nutritional benefits for consumers are better-quality milk and other food products, as well as bottled water.

An example of industrial maturity is Engro, which started as a USD 43 million fertilizer investment by Esso in 1965/66—at the time, the largest FDI in Pakistan—and grew in technical and managerial competence to the point that, in 1991, it was bought by its own local employees (and financial partners), when the parent company divested out of fertilizer globally. The new owners also acquired fertilizer plants in the UK and US and relocated them to Pakistan. Over the years, Engro's farmer education programs have improved farming practices and raised crop yields. Engro has also expanded into food, energy, chemical storage, and other industries, and in the process transformed from a turnkey plant into a holding company.

While there are other success stories, two caveats are in order. First, when technology transfer occurs outside a parent–affiliate FDI relationship as a joint venture or technical collaboration between domestic enterprises and foreign companies, greater effort is needed to develop technological capabilities. Without such effort—to move from simply using turnkey technology to learning how that technology works—the domestic enterprise remains reliant on further acquisitions for technological upgrading. In such cases, additional investments are necessary to keep up with technological progress, and a slowing down of investment means falling back technologically and consequent uncompetitiveness.<sup>31</sup> This appears to have been the fate of many of Pakistan's public enterprises when public investment decelerated in the 1990s.

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<sup>31</sup> There is an extensive literature on technological learning: see, for instance, Lall (1997); UNCTAD (1996); Lall and Urata (2003); and UNIDO (2005).

The second caveat is that the share of FDI in the country's total investment has been small—2 percent in 1980 and 6 percent in 2000—and so its potential contribution to improving the economy's technological base has also been small.<sup>32</sup> Therefore, broader economy-wide efforts are needed to build learning capabilities, particularly through human resource development. Pakistan has lagged in this respect.

All the various studies on TFP cited earlier attribute low growth performance to low rates of human capital formation. This is evident in the low levels of our human development indicators (education, health, income) and our low overall ranking relative to other countries.<sup>33</sup> It is also reflected in our low levels of research and development (R&D) expenditures and personnel (Rahman et al., 2005, table 3.5) and in low intensity of technical skill creation (measured in terms of student enrolments in science, mathematics, computing, and engineering at the tertiary school level).<sup>34</sup> Moreover, technical education has few linkages with industry, and there are not many institutions to diffuse technical knowledge (Rahman et al., 2005). It is, therefore, not surprising that the benefits from FDI inflows and technology transfers have not permeated the economy.<sup>35</sup>

One consequence is that Pakistan has a smaller manufacturing base with far less technological content than the average developing country (see Table 11.3). The manufacturing sector grew at 6.8 percent during 2000–10, which was average for developing countries (6.9 percent). However, the share of MVA in GDP was just 19 percent in 2009 and only 25 percent involved medium- or high-technology production. In comparison, the share of MVA in GDP for developing countries as a whole was 22 percent, 43 percent of which consisted of medium- or high-technology manufactures. Also, while Pakistan exports relatively more manufactures than the average developing country, its manufactured exports involve relatively less medium or high technology—only 11 percent as opposed to 56 percent for all developing countries.<sup>36</sup>

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<sup>32</sup> Even in 1995/96, when FDI surged in the power industry, its share in total investment was only 14 percent.

<sup>33</sup> In a ranking of 186 countries, Pakistan is at 146 on the human development index, with a score below the average for South Asia (see United Nations Development Programme, 2013).

<sup>34</sup> In 1995, Pakistan ranked below India, Bangladesh, Nepal, and Sri Lanka (see Lall & Urata, 2003, Table 2.7).

<sup>35</sup> The food and transport equipment industries have had some positive spillovers, as previously mentioned, but there are few backward linkages in the chemical and pharmaceutical industries.

<sup>36</sup> The findings of Weiss and Lall (2004) are similar.

**Table 11.3: Technological content of manufactures (percent)**

Year	Pakistan		Developing countries	
	1990	2000	2009	2009
Manufacturing value added to GDP	15.5	13.8	18.8	21.8
Of which medium- or high-technology	31.9	29.7	24.6	43.0
Manufactured exports in total exports	88.8	87.0	83.3	79.2
Of which medium- or high-technology	8.1	11.0	11.3	55.8

Source: UNIDO (2005, 2009, 2011).

Such comparison suggests that Pakistan is reasonably well industrialized relative to other developing countries, but that its technological base is weak, particularly for engaging in world trade. A ranking of Pakistan's industrial-technological profile places it as a distant follower to the high performers of East Asia (UNIDO, 2005, table 10.1). Pakistan is also a laggard in trade performance: the share of trade in GDP has stagnated over the past two decades at around 32 percent while neighboring countries have raised their trade shares multiple times (Bangladesh raised its trade share from 18 percent in 1990 to 54 percent in 2011, while India raised its share from 13 percent to 40 percent). Pakistan should be trading twice as much as it does currently, given its economic size.<sup>37</sup> The technological sophistication of its exports, and the intensity of factor use should also be improving faster and in pace with other countries (Waglé, 2011).

Pakistan can, and should, do better.

#### 4. Policies and Prospects

Pakistan has a planned economy but the extent of government involvement has varied over the years. The private sector played a leading role in the first 25 years after independence; during the next 25 years, the public sector was dominant. Throughout this period, FDI has been both welcome (often with generous government support) and forthcoming: both foreign and private investors helped build the country's industrial base in the 1960s; foreign investors and public enterprises deepened it in the 1980s. FDI was indifferent to the ownership of the host enterprise, whether public or private; the choice between market and planned economy is, therefore, a false one.

<sup>37</sup> Waglé (2011) finds that Pakistan's trade-to-GDP ratio is half its "predicted" ratio of 62 percent when trade shares are estimated in a linear cross-country regression using 2010/11 data for 159 countries and controlling for income, market size, and distance from world markets.

## *Benefiting from Foreign Direct Investment*

However, Pakistan's experience also shows that FDI inflows have risen and subsided with domestic investment (usually through joint ventures and technological collaboration); and that the country's public enterprises have generally not been able to sustain high levels of investment. Looking to the future, it is clear that the economy has reached a size, complexity, and degree of openness where it must be driven largely by the private sector with public institutions providing a supportive role.

The government's role in industry has evolved over the years: at various times, it has been a player, a coach, and a referee. Looking to the future, the government needs to be less of a player—Pakistan's public enterprises need to be autonomous and self-sufficient or privatized—and more of a referee to ensure that markets run efficiently, laws are well administered, and policies are implemented. Moreover, the government needs to be a different type of coach—providing protection and subsidies to domestic enterprises is inferior to providing support to improve efficiency and help build up their technological infrastructure; providing incentives to foreign companies is inferior to providing a stable economic environment and world-class infrastructure. In these several ways, a range of policies and priorities need to be rethought. Some change is in process;<sup>38</sup> more is needed.<sup>39</sup>

It is particularly desirable that the government divest its assets in the financial sector. Pakistan's early experience and that of other countries underscores the importance of fostering a dynamic relationship between finance and industry, rooted in the private sector with public institutions ensuring appropriate regulatory compliance and fiduciary oversight. More generally, a revival of privatization—revamped and made more transparent<sup>40</sup>—would significantly improve FDI prospects, as it did in 2005–07.

While support to industry is desirable, industrial policy should focus on developing technological capabilities and export competitiveness. The era of import protection and export subsidies has run its course, but there is much else that the government can do to improve conditions for

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<sup>38</sup> In the budget speech for the fiscal year 2010/11, the government committed to restructuring public enterprises to make them financially solvent. The eight major public sector enterprises (railways, airlines, highways, trading, storage, utilities, power, and steel) incurred an annual loss of USD 2.8 billion in 2009/10.

<sup>39</sup> The Planning Commission recently issued a constructive framework for growth (see Pakistan, Planning Commission, 2011a, 2011b).

<sup>40</sup> During 1991–2008, 167 enterprises were privatized but the process was set back in 2006 when the Supreme Court, citing irregularities, annulled the divestment of Pakistan Steel Mills.

production and investment. Various studies have suggested that manufacturing efficiency is low.<sup>41</sup>

A major constraint to efficiency is the high cost and poor quality of infrastructure, particularly in the power sector. According to one survey of small and medium enterprises, production-time losses due to electricity outages average 33 hours per week (State Bank of Pakistan, 2008); larger enterprises have standby power generators but still suffer disruptions and incur added costs. Transport and communications infrastructure are important for export efficiency. The functioning of institutions—administrative, financial, and judicial—affects transaction costs and industrial efficiency. Kemal (2007) notes that Pakistan ranks low, relative to other countries, on most indicators of market efficiency. There has been some improvement in recent years, notably in the ease of doing business, but further efforts are needed, particularly to alleviate the unsatisfactory power situation.

The government could also do more to build technological capabilities. Weiss and Lall (2004) note that Pakistan's performance in skill creation has worsened since the mid-1980s and is below that of other South Asian countries. They observe that per capita R&D expenditure is low, enterprise-financed R&D is insignificant, and that Pakistan lags behind its neighbors in R&D capacity (e.g., in the per capita number of scientists, technicians, scientific and technical journals, and royalty and technical fees). In order to begin to rectify these shortfalls, the government should accord higher budgetary priority to the social sectors (basic education and health) and invest more in higher education.

Human resource policy and training programs should promote linkages between industry and technical education, which includes some 57 technical colleges and over 700 vocational technical institutions. Public R&D should support industrial clusters in partnership with industry associations and market leaders. The key point is for government to facilitate technological interaction and cooperation between industry, the public sector, and learning institutions nationally and internationally. Rahman et al. (2005) have proposed an ambitious agenda for technology development that deserves serious consideration by policymakers.<sup>42</sup>

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<sup>41</sup> See, for example, Mahmood and Siddiqui (2000); Burki and Khan (2005); Mahmood, Ghani, and Din (2006); Din, Ghani, and Mahmood (2007); Kemal (2007); Raheman et al. (2008); and others.

<sup>42</sup> The Rahman et al. (2005) report was commissioned by the Higher Education Commission, COMSTECH, and the Pakistan Institute of Development Economics, in consultation with experts and the private sector.

An overall context of a private sector-led economy supported by policies and institutions that encourage technological upgrading, provides a fertile basis for attracting and benefiting from FDI. Given Pakistan's economic size, its natural resource endowments and the experience of other comparator countries, there is every reason to expect annual FDI inflows of at least USD 10 billion, or twice the highest levels attained in the past. The official target is more modest—to attract USD 5.5 billion in FDI inflows per year.<sup>43</sup> Nevertheless, even that goal appears ambitious in the current circumstances of a protracted global downturn and domestic instability: FDI inflows have declined by 70 percent since 2008. Arresting this decline and putting it on an upward trajectory will not be easy.

In the immediate future, Pakistan can expect to continue to receive FDI in extractive industries (which tend to be impervious to the investment climate), and also from the more resilient economies of developing Asia. Market-seeking investment is also likely, particularly in urban areas.<sup>44</sup> However, these inflows are offset by an overall fall in reinvested earnings. Thus, the immediate prospects of reversing the current decline of inward FDI hinge on the government's efforts to retain investors' confidence. These include potential as well as existing investors, a number of who have been operating in Pakistan for many years. They also include domestic investors, whose actions shape the perceptions of new investors.

FDI strategy, therefore, should be shaped around the country's ample natural resource endowment and its considerable market potential, with threefold efforts to (i) retain investors' confidence; (ii) target new investors; and (iii) work with existing investors, both foreign and domestic.

#### ***4.1. Retaining Investor Confidence***

Pakistan has a fully open and progressive foreign investment policy regime as good as that of any developing country, and an incentive structure more generous than most. It also compares well on the ease of doing business, although in recent years (2009–11), the country has slipped nine positions in the global ranking, and within the Subcontinent

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<sup>43</sup> The Investment Policy 2013, prepared by the Board of Investment, was approved by the federal Cabinet on 13 March 2013. It aims to increase annual FDI inflows by 40 percent in 2013 to USD 2 billion, and then onward and upward to USD 2.5 billion in 2014, USD 2.7 billion in 2015, USD 3.25 billion in 2016, and USD 4 billion in 2017.

<sup>44</sup> A feature of the current global crisis is the increased market-seeking activity of multinationals in emerging economies (so as to sustain revenue growth through worldwide sales). Examples in Pakistan include the expansion of Coca-Cola (through its affiliate in Turkey), Yamaha motorcycle assembly, Metro Cash & Carry (Germany), and similar greenfield investments from Saudi Arabia and the UAE in retail and wholesale trade, hotels, and shopping complexes.

has dropped from first to third place.<sup>45</sup> A major foreign investor concern is political risk, and Pakistan is ranked among the five riskiest investment destinations (World Bank Group, 2009).

However, risk can be mitigated by investor confidence. A 2009 business perception survey by the Pakistan Overseas Investors' Chamber of Commerce and Industry shows that more than three quarters of its 124 respondents were willing to invest in 2010/11. Similarly, a 2010 survey by the American Business Council of Pakistan showed that 71 percent of its participating firms had investment plans in the next 12 months, and that 41 percent of them planned to invest USD 250,000 or more. Nevertheless, in both surveys, investors raised similar concerns: law and order, political uncertainty, energy deficiency, the high cost of operations, and infrastructure bottlenecks. In the American survey, 79 percent were pessimistic about short-term prospects but, more importantly, 86 percent were optimistic about long-term prospects.

American investors have reason to be positive: earnings on their equity in Pakistan amounted to 33 percent in 2009. This return is better than in other countries that have received more investment (see Table 11.4). However, incomes appear to fluctuate from one year to the next in Pakistan: earnings on equity were only 7 percent in 2008. A more stable and predictable business environment would align expectations closer to the higher end of actual rates of return and attract large investment inflows as in other comparator countries.

**Table 11.4: Income on US direct investment, 2009**

<b>Host country</b>	<b>Income/FDI (%)</b>
China	13.6
India	12.3
Indonesia	21.6
Malaysia	20.7
Pakistan	33.1
Thailand	19.0

*Source:* US Department of Commerce, Bureau of Economic Analysis, Survey of Current Business Online, US Direct Investment Abroad Tables (September 2011), table 14.

<sup>45</sup> Pakistan scores low on starting a business, acquiring electricity, and paying taxes (see World Bank Group, 2011).

It is important, therefore, to solicit the industry perspective in any discussion of measures to move the economy from the short to the long term. Some business groups, such as the Pakistan Business Council, have position papers on fostering economic growth. The channels for public-private dialogue should be utilized fully to engage business involvement and support for future policies, thereby sustaining investor confidence.

#### **4.2. Targeting New Investors**

Pakistan has been successful in diversifying its sources of FDI and attracting investment from developing countries. The most recent data suggests that their share has increased further,<sup>46</sup> indicative perhaps of continuing growth in Asia and also of the greater affinity that Asian investors may have with the country's investment environment. Efforts to target FDI toward the textiles industry have attracted FDI from the UAE, and the government is also seeking investors from China and other countries with the Special Economic Zones Act 2012. The Haier Group of China has made an initial investment of USD 35 million (in a joint venture with the Ruba General Trading Company) to manufacture household appliances, including for export, in a 63-acre zone in Lahore that will enclose a plant and workers' colony.

Such proactive FDI promotion efforts are desirable, though it should be noted that Pakistan already has some 82 industrial zones and the majority perform below capacity (Asian Development Bank, 2001). Additionally, incentive schemes should be time-bound and not too generous. A revival of privatization would ignite huge investor interest.

#### **4.3. Working with Existing Investors**

FDI involves long-term commitment to a host location, ideally to expand output, upgrade production, and increase market presence, which frequently justifies reinvesting short-term profits for longer-term gains. When opportunities sour or become uncertain, a greater portion of profits and dividends are repatriated to the parent company, and sometimes investors—"voting with their feet"—disinvest and relocate.

Sizeable investments, such as those in telecommunications in 2004–08, generate commensurate profits that can be retained and reinvested or repatriated. The good news is that companies are making profits;<sup>47</sup> the

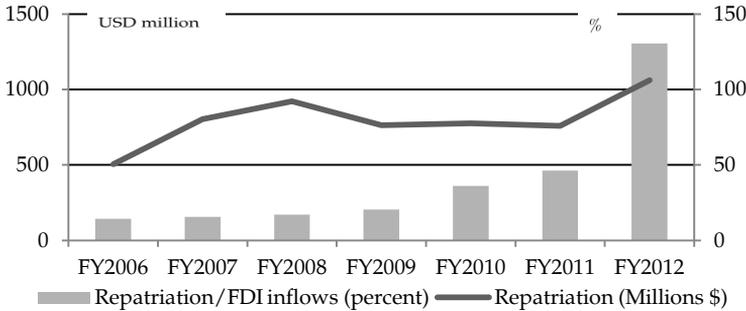
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<sup>46</sup> The share of developing countries in the stock of FDI increased from 33 percent in 2008 to 46 percent in 2009, while that of developed countries declined from 65 percent to 53 percent. The changes also reflect reinvestment.

<sup>47</sup> As noted by Rashid Amjad in Chapter 3 of this volume, companies appear to be doing well with increasing retail sales of consumer goods and food products, and corporate

bad news is that these profits are being repatriated rather than reinvested. Repatriations out of Pakistan have increased in recent years (see Figure 11.5); in 2011/12 (FY2012), foreign investors repatriated USD 1.1 billion in profits and dividends. In some industries, such as textiles, firms are in the process of relocating to Bangladesh (attracted by the prospect of access to continuous, uninterrupted power supply and other promised benefits). In such circumstances, it is important for the government to work with existing investors (foreign and domestic) to encourage and facilitate greater reinvestments.

**Figure 11.5: Repatriation of profits and dividends**



Source: State Bank of Pakistan. Data given for fiscal years (e.g., FY2012 = July 2011–June 2012).

The experience of other countries should be emulated, particularly policies and programs to support the creation of local supply chains and linkages with domestic firms; R&D projects with universities, science institutes, and technology centers; and the development of export markets. There are many examples, including in Pakistan, of public-private partnerships for building infrastructure and industrial clusters, giving effect to corporate social responsibility—for training workers and disseminating technical advice to farmers—as well as support services and finance for small and medium enterprises.

Pakistan’s private sector has responded generously in helping earthquake and flood victims, and would likely join “win-win” partnerships to accelerate economic growth and deepen industrialization.

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profits growing some 15 percent annually in recent years. For earlier years, Lorie and Iqbal (2005) note that the increase in the after-tax profits of the 700 companies listed on the Karachi Stock Exchange in 2001–03 amounted to more than 1 percent of GDP.

Their current healthy profits provide the basis, and the prospect of future profits the incentive, to do so. The country's public institutions should intensify its efforts to work with the private sector to enlarge opportunities and overcome business bottlenecks in the current difficult environment.

## **5. Conclusion**

FDI can contribute significantly to moving Pakistan's economy forward. The country's FDI strategy and policies correctly emphasize the importance of a modern investment framework and regulatory regime, and a conducive, business-friendly environment. There is also a case for special economic zones and time-bound fiscal incentives. However, these efforts must be pursued within a resolute attack on the basic malaise gripping the economy—the energy crisis, the security situation, and the immobilized privatization program. Hopefully, one outcome of the 2013 election will be a renewed willingness on the part of the country's key institutions to work in unison.

At the same time, there is a longer-term challenge. Although capital inflows can alleviate the external resource constraint and bolster the balance of payments, the real benefits of FDI are longer-term, involving second-order economic impacts that improve the technological base, diversify the export structure, and place production on a more dynamic growth path. These positive spillovers gestate slowly but can be nurtured by a supportive public policy.

Successful examples abound in other countries. Yet, Pakistan has been slow to devise such 'second-generation' FDI promotion policies that capture the synergy between investment and trade, and production and technology. Malaysia and other Asian 'tigers' have been able to deploy such policies to attract FDI and extract from it substantial technological and other economic benefits. Pakistan's failure to do so has handicapped its industrial development.

Pakistan must, therefore, arrest the dramatic decline in FDI inflows of recent years, but also seek to benefit from future inflows with greater drive and ingenuity. Other countries are doing so with success and there is every reason to think that it can do the same in a relatively short span within the current decade.

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*Benefiting from Foreign Direct Investment*

## An Analysis of the Remittances Market in Pakistan

Rashid Amjad\*, M. Irfan\*\*, and G. M. Arif\*\*\*

### 1. Introduction

Remittances to developing countries sent through official channels were estimated at USD 406 billion in 2012 (World Bank, 2012). This represents a growth of 6.5 percent over 2011, and is projected to rise by 8 percent in 2013 and 10 percent in 2014. Current remittance flows are over three times the amount of official development assistance (World Bank, 2012). In Pakistan, remittances through official channels have grown from just around USD 1.5 billion in 1997/98 to slightly over USD 13 billion in 2011/12 (State Bank of Pakistan, n.d.; see also Table 12.1). In the first six months (July–December 2012), they were slightly over USD 7 billion—an increase of 12 percent over the corresponding period in the previous year (July–December 2011).

An earlier study (Amjad, Arif, & Irfan, 2012) analyzes the possible reasons for this manifold increase and in its preliminary findings suggests that the increase is primarily due to (i) a shift from unofficial (and unrecorded) channels (*hawala*) to official channels; (ii) an increase in the number of migrants abroad; and (iii) a rise in migrants' skill levels, resulting in higher wages and incomes abroad. The study also makes the important observation that the inflow of remittances is not just from Pakistani workers abroad but from the larger Pakistani diaspora, many of

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whom may have acquired nationality of their country of residence.<sup>1</sup> The study also infers that official remittance flows also reflect shifts in the diaspora's savings and assets to their home country.

Amjad et al. (2012) also attempt a rough estimate of the volume of remittances coming through both official and unofficial channels. This is based on estimates of the size of the Pakistani diaspora, as reported by different sources, as well as the average volume of remittances sent, based on recent survey data. The range of these estimates suggests that total remittances could be as high as 180 percent of official recorded remittances. Using an alternative methodology based on a range of estimates of the size to unofficial remittances and household survey data on amounts received through unofficial channels (Pakistan Social and Living Standards Measurement Survey for 2007/08), Amjad et al. (2012) guestimate that total remittances could be even higher than the 180 percent suggested by the "high-scenario" estimate of total remittances.

The importance of remittances to the Pakistan economy needs to be put into perspective. At around 55 percent of the total export of goods and services (around USD 26 billion in 2011/12) and corresponding imports (USD 40 billion), official remittance flows provide critically needed support to the country's precarious current account balance. These flows also inject additional aggregate demand into the economy (at around 5.5 percent of GDP), which not only spurs economic growth but, based on earlier evidence, favorably impacts employment and poverty (see Amjad, 2012). In addition, Amjad (2010) argues that remittances that come through official channels have a much greater multiplier income impact on the economy than those through hawala or unofficial channels because the latter in most cases represent transactions within the sending and receiving countries with little 'real' additional income and foreign exchange accruing to the labor sending country.<sup>2</sup>

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<sup>1</sup> The US State Department defines diasporas as migrant groups that share the following features: (i) dispersion, whether voluntary or involuntary, across sociocultural boundaries and at least one political border; (ii) a collective memory and myth about their homeland; (iii) a commitment to keeping the homeland alive through symbolic and direct action; (iv) the presence of the issue of return, although not necessarily a commitment to do so; and (v) a consciousness and associated identity expressed through diaspora community media, the creation of diaspora associations or organizations, and online participation (International Monetary Fund, 2011).

<sup>2</sup> Afram (2012, p. 43) provide a useful description of how this informal hawala or hundi market works: "A typical hawala transaction consists of a remitter, a recipient, and two intermediaries, that is, hawaladars. When transferring the funds to the home country, the migrant-remitter makes payment to an intermediary hawaladar in the remitting country. The hawaladar then contacts their partner service provider in the recipient country who then arranges for the payment in local currency to the beneficiary. The beneficiary is required to present a pre-agreed

For these important reasons, there is a pressing need to put in place policies that would facilitate the maximum possible amount out of total remittances to flow through official channels. Identifying the key factors and policies that could help realize this objective is the study's main purpose. The analytical framework adopted builds on the one developed in the earlier study (Amjad et al., 2012) and also draws on a more recent study that analyzes the remittance market in India (Afram, 2012).

## **2. The Remittance Market in Pakistan<sup>3</sup>**

The remittance market for sending foreign exchange into Pakistan using remittance transfers both by overseas workers and the rest of the Pakistani diaspora, as well as by other agents for both legal and illegal transfers, can be broken down into the following:

1. Remitters from overseas who demand Pakistani rupees in exchange for a foreign currency to be paid in Pakistan through official or unofficial channels.
2. The remittance market within Pakistan that transfers both officially recorded remittances through banking and other recognized channels under an overall regulatory framework supervised by the State Bank of Pakistan (SBP), as well as unofficial remittances through domestic networks linked with foreign networks abroad.
3. Receivers of remittances—mainly households and families—that are sent through official or unofficial channels, who use these remittances for their own needs or to upkeep or purchase new assets for the remitter.

Any attempt to divert the flow of remittances from unofficial to official channels requires an analysis of each of the above three segments of the remittance market to determine why remitters prefer one channel to the other. Clearly, given information and data constraints, it is only possible to analyze the proximate causes of these choices. We attempt this as follows:

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identification document or code. When this transaction is conducted, the agent in the remitting country is indebted to the agent in the recipient country. Their transactions are settled through similar transactions going in the opposite direction, cash payments, or bank account transfers. In some cases, their positions also can be transferred to other intermediaries.”

<sup>3</sup> We use a broader framework to define the remittance market in Pakistan than that used by Afram (2012) in that he defines it as representing the formal financial institution and regulatory framework for the transfer of remittances while we examine the entire remittances process and cover both the official and unofficial or unrecorded flow of remittances.

- We identify and analyze the factors responsible for the very large increase in official remittances from 1997/98 to 2011/12 by enlarging the scope of Amjad et al. (2012) and examining in more detail inflows from individual countries and regions.
- We examine recent household survey data to identify the extent to which remittance transfers are made through official rather than unofficial sources, identify the characteristics of households that prefer one channel to the other and their reasons for this, and use these findings to understand better the working of the informal hawala/hundi remittance market.

Based on the analysis above, we suggest practical measures that could lead to a more efficient and better functioning remittance market in Pakistan that also encourages the flow of remittances through official rather than unofficial channels.

### **3. Explaining the Increase in Flow of Official Remittances: 1997/98 to 2011/12**

Kock and Sun (2011) analyze the factors responsible for the rapid increase in official remittances to Pakistan over the period 1997–2008. Their methodology departs from most previous studies that have used aggregate data, in that they model remittance behavior at a more micro-level and focus on per capita remittances instead of aggregated remittances or the growth of remittances. Their argument is that remittances need to be explained essentially by individual behavior since the amount remitted is “determined by the economic fortunes of the remitter and the recipient, among other variables” (p. 13).

Kock and Sun’s (2011) model uses average remittances per worker and four sets of explanatory variable: (i) job skill index, (ii) investment return, (iii) a proxy for recipients’ economic conditions in Pakistan, and (iv) a proxy for the real value of remittances. The regression estimation is based on a panel of 15 countries with bilateral remittance flows to Pakistan, using data from 1997 to 2008. Their results show that, besides the rapid increase in the out-migration of workers, immigrants’ skill level, investment return in the host country and in Pakistan, exchange rates (real and nominal), and Pakistan’s economic conditions all play a strong role in explaining remittances. Somewhat surprisingly, they find that changes in domestic economic fortunes (represented by the output of major agricultural crops as a proxy) were pro-cyclical although they do not detail the reasons for this.

A major weakness of Kock and Sun's (2011) study is that their model does not take into account increases or decreases in official remittance flows caused by shocks or interventions that lead overseas workers and the broader Pakistani diaspora to shift their mode of sending remittances from one channel to another. These shocks or interventions can result in (i) a temporary increase or decrease in official flows, and (ii) a shift in the trend level of remittance flows. These shifts in the level or growth of remittances cannot, therefore, be explained solely by the factors that Kock and Sun (2011) identify.

We identify six major shocks or interventions that could explain both significant fluctuations and an upward shift in the official remittances flow during 1997/98 to 2011/12. These are:

1. The freezing of foreign exchange accounts following the nuclear test carried out by Pakistan in May 1998, which was a major blow to the confidence of nonresident Pakistanis.
2. The 9/11 attacks on the US caused anxiety among the Pakistani diaspora leading them to transfer part of their savings/assets to Pakistan especially from the US, as a fallback in case living in the US or other Western countries became unbearable or unsafe.
3. Following 9/11, the US authorities' and other financial institutions and countries increased surveillance of the Pakistani diaspora's incomes and transfer of money abroad, especially through nonofficial channels.
4. Anti-money laundering measures adopted by Pakistan in 2002 post-9/11, which included the registration of money exchange companies for a considerable fee (between PRs 100 million and PRs 200 million), forcing smaller companies to merge with larger companies to be able to pay the registration fee.
5. The collapse of the real estate boom in Dubai in 2009, in which both Pakistanis living there and in Pakistan had heavily invested, which led to a large number of Pakistani professionals and workers returning to their home country.
6. The Pakistan Remittances Initiative (PRI) launched jointly by the Ministry of Finance, the SBP, and the Ministry of Overseas Pakistanis in early 2009 to encourage remittances through formal channels, including incentives for Pakistani banks to increase such flows.

### **3.1. *The Impact of Shocks and Interventions on the Flow of Official Remittances***

Let us now examine the evidence based on Table 12.1.

Following the nuclear test in May 1998 and subsequent freezing of foreign currency accounts in Pakistan, we see an immediate decline in total official remittances from almost USD 1.5 billion in 1997/98 to USD 1.06 billion in 1999/2000, which continues till 2001/02. The decline occurs across all countries, and we can assume that a large part of it was then remitted through unofficial channels.

Following 9/11 in September 2001, total official remittance flows double from USD 1.09 billion in 2000/01 to USD 2.4 billion in 2001/02, especially in the case of flows from the US—from USD 134.8 million to USD 779 million. This amount from the US rises further to USD 1.2 billion in 2002/03, after which it remains around the same till 2005/06. The jump in official remittances from Dubai and Abu Dhabi follows broadly a similar pattern.

This increase in remittances in the case of the US appears strongly to represent a shift in the transfer of remittances from unofficial to official channels as well as the transfer of savings and assets by the Pakistani diaspora in the US back to Pakistan. As confidence among the Pakistani diaspora in the US is gradually restored, these official remittance flows begin to even out.

There is an initial fall in official remittances from Dubai following the crash of the building boom and financial crisis in 2008/09—from USD 970 million in 2008/09 to USD 851 million in 2009/10. This is, however, followed by a sharp increase the next year to USD 1.2 billion and a further increase to USD 1.4 billion in 2011/12. In the case of Abu Dhabi, there is no initial fall but a sharp continuous increase from 2009/10.

After the initial decline, the subsequent increase in remittances from Dubai reflected to some extent returning migrants' accumulated savings. The large increase, especially in subsequent years, however, was most probably due to panic selling of real estate by Pakistanis living in Pakistan who had invested in Dubai and were now bringing back into Pakistan what was left of their investments.

To what extent has the PRI increased flows since its launch in early 2009? A careful look at flows from individual countries shows that the increase in official remittances was most marked in the UK's case, where it increased from USD 605 million in 2008/09 to USD 1.5 billion in 2011/12. Following this initiative, there is also a significant increase in

Saudi Arabia and the United Arab Emirates (UAE), where aggressive marketing by Pakistani banks taking advantage of the PRI's financial incentives helped to divert remittances toward official channels.

More specifically the PRI initiated the following steps to increase the flow of remittances through official channels ("Pakistan remittances", 2013):

- Preparing and implementing a national strategy on remittances.
- Playing a catalytical role in mobilizing and energizing the financial sector in Pakistan resulting in its playing a major role in attracting remittances through formal channels. The initiatives taken by the PRI included bringing in new players (commercial banks, microfinance banks, exchange companies, the Pakistan Post) and increasing competition between them to provide more efficient services and introducing new innovative products and services to facilitate transfers at lower costs and in minimal time.
- Creating separate efficient remittance payment highways with a manifold increase in developing formal links with financial institutions abroad (from less than 20 to over 400) and adding as many as 10,000 physical locations in Pakistan for receiving remittances through banks, exchange companies and post offices since the establishment of the PRI.
- Establishing formal links with the increased number of financial institutions abroad allowed these institutions to offer Pakistanis the initiatives being offered by the State Bank of Pakistan to encourage transfers through formal channels mainly the reimbursement of the cost of transfers (6 Saudi riyals on a transfer of 100 Saudi riyals), which was not possible earlier.
- Reducing the remittance delivery time with remittances being received instantly or at least very quickly in contrast to a lag of many days earlier. The beneficiaries can also claim compensation (65 paisa per PRs 1,000 daily) for the delayed period from the concerned bank.
- Serving as a focal point for overseas Pakistanis through round-the-clock call centers with toll-free lines.

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**Table 12.1: Official remittances from countries of origin**

Country/region	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002
TOTAL	1,489.55	1,060.19	983.73	1,086.57	2,389.05
Saudi Arabia	474.76	318.49	309.85	304.43	376.34
UAE	207.70	125.09	147.75	190.04	469.41
Dubai	(101.01)	(70.57)	(87.04)	(129.69)	(331.47)
Abu Dhabi	(75.53)	(38.07)	(47.30)	(48.11)	(103.72)
Other GCC countries	160.85	197.28	224.32	198.75	224.29
US	166.29	81.95	79.96	134.81	778.98
UK	98.83	73.59	73.27	81.39	151.93
Other EU countries	35.87	26.48	24.06	21.50	28.80
Other countries	66.38	34.03	35.28	67.71	256.24
Encashment FEBCs	251.87	184.64	70.24	64.98	48.26
	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007
TOTAL	4,236.85	3,871.58	4,168.79	4,600.12	5,493.65
Saudi Arabia	580.76	565.29	627.19	750.44	1,023.56
UAE	837.87	597.48	712.61	716.30	866.49
Dubai	(581.09)	(447.49)	(532.93)	(540.24)	(635.60)
Abu Dhabi	(212.37)	(114.92)	(152.51)	(147.89)	(200.40)
Other GCC countries	474.02	451.54	512.14	596.46	757.33
US	1,237.52	1,225.09	1,294.08	1,242.49	1,459.64
UK	273.83	333.94	371.86	438.65	430.04
Other EU countries	53.53	74.51	101.51	119.62	149.00
Other countries	658.05	497.14	417.25	573.31	642.11
Encashment FEBCs	46.12	45.42	16.25	12.09	2.68
	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
TOTAL	6,451.24	7,810.95	8,905.90	11,200.97	13,186.58
Saudi Arabia	1,251.32	1,559.56	1,917.66	2,670.07	3,687.00
UAE	1,090.30	1,688.59	2,038.52	2,597.74	2,848.86
Dubai	(761.24)	(970.42)	(851.54)	(1,201.15)	(1,411.26)
Abu Dhabi	(298.80)	(669.40)	(1,130.33)	(1,328.82)	(1,367.62)
Other GCC countries	983.39	1,202.65	1,237.86	1,306.18	1,495.00
US	1,762.03	1,735.87	1,771.19	2,068.67	2,334.47
UK	458.87	605.59	876.38	1,199.67	1,521.10
Other EU countries	176.64	247.66	252.21	354.76	364.79
Other countries	530.39	609.00	577.37	653.26	562.14
Encashment FEBCs	2.40	0.48	1.02	0.07	13,186.58

*Note:* EU = European Union, FEBC = foreign exchange bearer certificates, FY = financial year, GCC = Gulf Cooperation Council.

*Source:* State Bank of Pakistan (n.d.).

### **3.2. The Impact of an Increase in Pakistani Emigrants and Rise in Skill Levels on Official Remittance Flows**

While the preceding analysis helps establish that the flows in remittances post-9/11 have clearly been impacted by shifts in remittances from unofficial to official channels, we need to separate this impact from the rise in remittances resulting from an increase in the number of Pakistanis working abroad and, as Kock and Sun (2011) argue, an increase in their skill levels.

Kock and Sun (2011) use official data on Pakistanis workers leaving for abroad for employment by their country of destination and then aggregate these figures to estimate the total numbers working abroad. They use the same data to classify these workers by their level of skill. It should be pointed out that these flows do not take into account the number of returning migrants from these countries and, therefore, do not reflect net migration to these countries. To overcome this problem, we use estimates of the stock of Pakistanis abroad, as given by official sources, but it is important to keep in mind that these estimates also include students from Pakistan as well as family members who may not be working.

Table 12.2 provides estimates of the Pakistani diaspora abroad, which gives us an approximate idea of the recent increase in stock. These estimates are for all countries as well as for Saudi Arabia, the UAE, the US, and the UK, which together account for almost three fourths of all Pakistanis abroad and for the same share of total remittances.

If we examine the data in Tables 12.2 and 12.3, it is clear that, for the years post-2004, there has been a significant increase in the numbers of Pakistani diaspora; when these figures are adjusted for the number among them working, the number of workers abroad also rises. These figures are in line with the very significant increase in flow of overseas migrants between 2007 and 2012 (see Table A12.1 in the appendix). Remittances per head have also increased sharply since 2004 (Table 12.3).

**Table 12.2: Stock of overseas Pakistanis/Pakistani diaspora (millions)**

Country	2004a	2010b	2012c
All countries	4.0	6.3	6.7
Saudi Arabia	1.1	1.5	1.7
UAE	0.5	1.0	1.2
US	0.6	0.9	0.9
UK	0.8	1.2	1.2

*Sources:* (a) Pakistan, Planning Commission (2005). (b) Data supplied by the Ministry of Foreign Affairs, Islamabad, at the authors' request. (c) Khan (2012, February 15).

**Table 12.3: Official remittances per Pakistani diaspora/per working Pakistani (USD)**

Country	2004	2010	2012
All countries	1,049	1,777	1,968
Adjusted	(1,614)	(2,733)	(3,027)
Saudi Arabia	570	1,780	2,168
Adjusted	(713)	(2,225)	(2,710)
UAE	1,425	2,038	2,374
Adjusted	(1,781)	(2,547)	(2,967)
US	1,425	2,038	2,374
Adjusted	(2,850)	(4,076)	(4,748)
UK	465	1,188	1,267
Adjusted	(930)	(2,376)	(2,534)

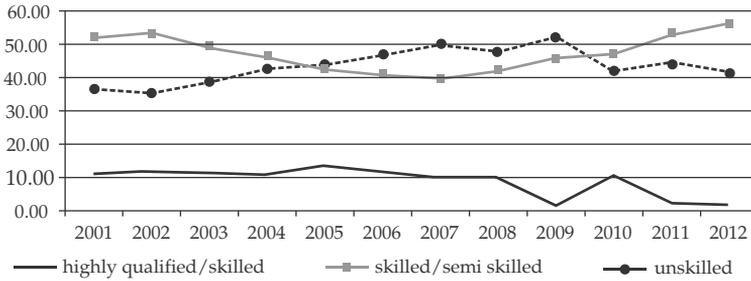
*Note:* Adjusted for number working out of total stock: 0.65 for all countries, 0.8 for Saudi Arabia and the UAE, and 0.5 for the US and UK.

*Source:* Tables 12.1 and 12.2.

Kock and Sun (2011) point out that there has been an increase in the number of skilled as compared to unskilled workers going abroad. As Figure 12.1 shows, the share of skilled/semi-skilled increased from around 40 percent in 2007 to just over 55 percent in 2011/12. However, the official figures do not show an increase in the number of highly qualified and highly skilled emigrants (Figure 12.1). Indeed, there is a sharp fall in 2009, which, after a recovery in 2010, falls again in 2011/12 and rises in 2012. Contrary to this, the press has frequently reported that a large number of professionals (doctors, engineers, scientists, bankers, IT experts, chartered accountants, teachers, etc.) have been going abroad in recent years to work in the US and EU, but also in Saudi Arabia, the UAE, Qatar, Bahrain, Kuwait, the UK, Canada, Australia, Malaysia, South Africa, and Japan.

Countries in the EU include Germany, France, Spain, Italy, Ireland, and Norway (“Changing profile of overseas Pakistanis”, 2011). Clearly, the official figures fail to capture these outflows, perhaps because such categories of workers might not have officially registered themselves as going abroad to work.

**Figure 12.1: Percentage distribution of overseas Pakistanis by occupation, 2001–12**



*Note:* The highly qualified and highly skilled are grouped together, and the skilled and semi skilled are grouped together.

*Source:* Bureau of Emigration and Overseas Employment, Pakistan.

The figures in Table 12.4 are, however, revealing as they clearly show that the increase in remittances between 2004 and 2012 cannot be explained solely by the increase in number of workers abroad or by an increase in their skill level because the differences between their growths are just too wide to support such a contention. For example, for all countries of the 230 percent increase in remittances, only 70 percent can be explained by the increase in number of workers. Even if we take into account a significant increase in the share of professionals and higher skills by 2012 and the corresponding increase in their share of remittances—even to the extent of it doubling—this would still leave a large unexplained gap.

**Table 12.4: Percentage increase in number of workers/remittances, 2004–12**

Country	Increase in number of workers	Increase in amount of remittances
All countries	70	230
Saudi Arabia	55	487
UAE	140	300
US	50	80
UK	50	308

*Source:* Tables 12.1 and 12.2 (the latter adjusted for labor force participation rate: 0.65 for all countries, 0.8 for Saudi Arabia and the UAE, and 0.5 for the US and UK.

As Table 12.4 also shows, this difference is especially pronounced for Saudi Arabia and the UK and to a slightly lesser extent for the UAE. For the US, this shift caused by 9/11 may have worked itself through by 2004

but probably brings out the continuing transfer of assets and savings to Pakistan. These findings reinforce our earlier finding that the increase in remittances is not just for the reasons pointed by Kock and Sun (2011); rather, it also represents a significant shift from informal to formal channels for sending remittances.

**3.3. *Factors Responsible for the Higher Number of Professionals and Better-Skilled Workers Going Abroad: Reaping the Demographic Dividend?***

Pakistan is currently passing through a demographic transition (Nayab, 2006), which has resulted in a “youth bulge” and an increase in the working-age population as a share of the total population. To reap the “demographic dividend” of this change, the economy needs to create productive and remunerative employment for young workforce entrants.

Unfortunately, after a short-lived growth spurt during 2002/03 to 2005/06, the economy has been mired in stagflation, growing at around 3 percent while it would require a growth rate of between 7 to 8 percent to productively employ new entrants into the labor market. Inflation has remained in double digits and only started to come down during the second half of 2012. It must also be kept in mind that Pakistan has increased substantially its investment in higher education over the last ten years, increasing enrollment almost fourfold to about 1.2 million in 2011/12 (Pakistan, Ministry of Finance, 2012).

With the economy slowing down, there is increasing evidence that young professionals and skilled workers are leaving for employment abroad. Three factors have spurred this demand: (i) increased demand for labor in Saudi Arabia, Abu Dhabi, and the Gulf Cooperation Council (GCC) countries, which were not affected by the financial collapse in Dubai; (ii) new job opportunities in Europe (especially in Italy, Spain, and Norway), possibly due to its fast-aging population; (iii) job opportunities in the US and UK which, despite the economic slowdown, remain attractive job markets for professionals and higher-skilled workers, for whom demand has continued to grow at the expense of unskilled workers; and (iv) the emergence of Australia as an attractive job market for Pakistani professionals.

Is Pakistan, therefore, reaping the demographic dividend through the migration of professionals and higher-skilled workers? Amjad (in press) draws attention to this possibility, but it is clearly an area that needs further investigation.

### **3.4. *Illegal Transfers and Remittances***

Official remittance flows are also associated in the public perception with the transfer of illegally gotten gains, which are transferred back to Pakistan through remittances and thus legalized since the latter's sources are not questioned. These flows include:

- The so-called 'whitening' of 'black' money<sup>4</sup> generated in Pakistan, which is then converted into US dollars or other foreign currency through domestic moneychangers, sent abroad, and then sent back as remittances through existing or fictitious Pakistanis living abroad.
- The receipt of kickbacks and commissions on deals with international companies in contracts awarded to them in Pakistan, which are then transferred back in part or whole as remittances.
- The under-invoicing of imports of machinery and goods and services to avoid full payment of import duties, after which the nonpaid amount of the cost of the import is sent back through a domestic moneychanger in foreign currency leading to an outflow of resources from Pakistan.
- Illegal earnings through the drug trade (or other related activities) that are transferred back to Pakistan in the form of official remittances and thus legalized.

Amjad et al. (2012) rightly argue that, as far as the 'whitening' of 'black' money is concerned, such transactions would not result in a net addition to the total size of official remittance flows. This is because converting domestic currency into a foreign currency would need buyers of the local currency. These transactions, if made through remittances, would require a Pakistani working abroad or a member of the larger Pakistani diaspora to 'demand' these rupees and then send them back as remittances. Since he or she would only do so if already planning to transfer money to Pakistan, when such a remittance is sent it does not add to the total amount of remittances flowing into Pakistan.

On the other hand, the transfer of part of or all illegal foreign exchange earnings—from kickbacks, the drug trade, and other sources—as remittances does lead to an increase in official remittances. However, the transfer of such illegal earnings, including non-taxed earnings by Pakistanis abroad, might not occur through the official remittance channel for fear of being detected; hence, those making such transfers prefer the use of the unofficial hawala route.

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<sup>4</sup> This covers all kinds of bribes and undeclared income for avoiding taxes.

Has the amount of illegal transfers increased in recent years? One example is the real estate collapse in Dubai in 2009, in which many Pakistanis had invested both their legal and illegal earnings. It would appear that a part of these assets, or what was left of them after the crash, was transferred back to Pakistan as official remittances. This would explain the increase in 2009 and 2010 of official remittances into Pakistan at the time when the number of migrants working in Dubai was falling. Clearly, however, a significant part of this amount may also have come through illegal channels.

Similarly, anecdotal evidence suggests that some of the illegally gotten wealth in Afghanistan by the Afghan political elite is transferred into Pakistan through the channel of official remittances, mainly to buy businesses, real estate, and property in Pakistan. It is difficult, however, to gauge the amount of these flows, which again appears to be mainly channeled through Dubai.

How large, then, are these illegal flows being remitted through official channels and how much through illegal channels? While it is extremely difficult, if not impossible, to quantify them, one needs to be somewhat cautious in inferring that illegal flows account for a significant part of the rapid growth in official remittances in the past decade. For one, official remittance flows have increased not only in Pakistan but also Bangladesh, the Philippines, and India (see Figure A12.1 in the appendix). Indeed, it would be a strange coincidence that the worldwide growth in official remittances has been due substantially to increases in the transfer of illegally earned funds abroad. Again, we therefore caution against a generally held view that official remittance increases are in any way significantly related to an increase in illegal flows, though clearly a part of these flows represents such activities.

An important conclusion that we would like to draw from our analysis in this part of the study is that the remittance market is complex and highly segmented by region and by countries. Therefore, policy measures and direct initiatives and interventions should, in large measure, target countries and regions if the flow of official remittances is to be encouraged and increased.

#### **4. Households Receiving Remittances: Why do They Prefer Official or Unofficial Channels of Transfer?**

What factors underlie the demand for unofficial or hundi transactions and how can these be influenced? Understanding the practices, procedures, and regulatory structures of the international value transfer system with particular focus on third-party settlement is, therefore, immensely important. Similarly, understanding the behavior of overseas migrants

and their families toward the use of banking or nonbanking channels to transfer money home is important to attract more money through official channels. So, an important question is whether migrants, who send remittances home through hundi, are socioeconomically different from those who use the banking channel to transfer money.

Investigating the behavior of migrants and their families in using unofficial or official channels to transfer money requires a dataset that has some basic information about migrants using one channel or the other for these transfers. For this purpose, we use micro-data from two household surveys carried out in 2009 and 2010. The first, the Household Survey of Overseas Migrants and Remittances (HSOMR) carried out in 2009, comprises a small sample of 548 households—randomly selected from nine districts of the country—each of which had a member employed in Saudi Arabia at the time of the survey. The second is the Pakistan Institute of Development Economics' (PIDE) panel survey conducted in 2010 in 16 districts—the Pakistan Panel Household Survey (PPHS), with a sample size of more than 4,000 households. Both surveys collected information on overseas migrants' personal characteristics, their earnings while abroad, remittances transferred home, channels used to transfer money, and their reasons for using these channels, particularly for not using the banking channel.

To supplement the PIDE household survey-based information, some in-depth interviews were also carried out in the district of Gujrat among families that had a member working abroad at the time. The aim of these interviews was to identify the factors that underlie the use of hundi to transfer money. Thus, the study uses both qualitative and quantitative information to understand whether users of hundi are different from users of the banking channel.

Based on the literature on overseas migrants' remittance-sending behavior, we attempt to examine the relationship between the methods used to transfer money and four characteristics of migrants and their families: (i) migrants' place of origin or their families' place of residence in Pakistan (urban or rural), (ii) migrants' education level, (iii) their skill level, and (iv) the duration of their stay abroad.

The basic hypotheses tested are whether:

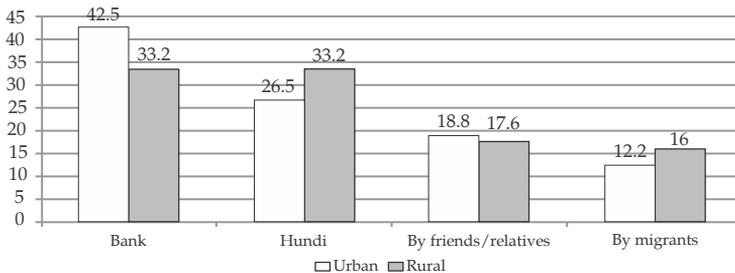
- urban migrants use the banking channel to transfer money more than their rural counterparts;
- migrants' education level has a positive association with the use of the banking channel;

- because of its strong correlation with education, skilled and professional workers use the formal channel to transfer remittances more than unskilled workers; and
- the longer the duration of their stay abroad, workers are likely to be positively associated with the use of the formal or banking channel for money transfer because of increased awareness about the benefits of using it.

We apply bivariate and multivariate techniques to analyze the datasets mentioned above. Take first the case of overseas migrants’ rural-urban origin. The majority of Pakistani migrants came from a rural background and their families live in these areas, thus money is transferred there on a large scale. Using data from the Household Income Expenditure Survey, Irfan (2011) finds that “the distribution of remittances underwent a shift wherein the share of rural areas in total remittances increased from 49 percent in 1996–97 to 72.4 percent in 2007–08.” So, the question is whether the practice of rural migrants in terms of using channels to transfer money from abroad is different from that of their urban counterparts. Banking facilities in Pakistan are better in urban centers than in rural communities, and urban migrants are also likely to be more educated than rural migrants, making it more possible that urban-origin workers will remit money home through the banking channel.

Figure 12.2 does indicate that urban families have received more money from abroad through banking sources (43 percent) than rural families (33 percent). This difference may be statistically significant,<sup>5</sup> but more importantly, the use of the banking channel in urban areas to transfer money is very low (43 percent), let alone in rural areas.

**Figure 12.2: Methods used to transfer money from abroad by rural and urban origin of migrants (percent)**



Source: Arif (2009).

<sup>5</sup> In fact, it is significant and we examine this later in this section.

In the PPHS 2010, migrant families were asked why they did not use the banking channel. Table 12.5 shows the responses of urban and rural migrant families, and helps us better understand migrants' remittance-sending behavior. In the survey's questionnaire, some of the possible reasons suggested for not using the banking channel included the high transaction cost involved, the nonavailability of a bank, the long distance to the nearest bank, the long waiting times involved, and uncooperative behavior of bank staff.

However, as Table 12.5 shows, neither rural nor urban respondents cited the nonavailability of a bank or/and the distance to the nearest bank as reasons for not using the banking channel. In fact, approximately two thirds of the rural families surveyed could not give reasons for not using the banking channel. However, about a quarter of the rural sample said that it took a long time to withdraw money from the nearest bank. The situation of urban households is not much different: the high transaction cost involved is given as the main reason (Table 12.5). Nonetheless, according to the survey data, there is no major difference in transaction costs between banking and hundi channels (see Table A12.2 in the appendix). The reported distance to nearby banks in Table A12.2 also cannot be considered for long, given the availability of better transport sources.

Based on the qualitative work carried out in Gujrat and the survey data used (PPHS 2010 and HSOMR 2009), we find that migrants and their families appear hesitant to use the banking channel. Migrants account for this hesitation, saying that "the banking procedure is difficult for us. We get money through hundi at our doorstep." There seems to be a strong perception barrier to using the banking channel.

The in-depth interviews also reveal that migrants abroad with households, particularly in the Middle East, live in groups and usually have an informal group leader who manages the transfer of money through informal sources. Further, this type of common living arrangement creates a network among the migrants, which enables them to send money home through a mutual friend visiting Pakistan. Thus, opening new bank branches in high-migration rural or urban areas, as is generally believed, may not be the only solution to channeling more remittances through banks.

**Table 12.5: Percentage distribution of households who received remittances through hundi and reasons for not using a bank**

Reasons	Overall	Urban	Rural
High transaction cost	9.78	40.00	3.90
Long time required	20.65	-	24.68
Security	1.09	-	1.30
Family finds it difficult	7.61	13.33	6.49
No bank available	-	-	-
Bank too far away	-	-	-
Bank staff does not cooperate	3.26	13.33	1.30
Others	57.61	33.33	62.34
Total	100.00	100.00	100.00
N	92.00	15.00	77.00

Source: Pakistan Panel Household Survey (2010).

Table 12.6 presents data on migrants' education levels and the methods used to transfer money during the year preceding the PPHS 2010. The table also categorizes the use of formal or informal sources of money transfer by migrants' skill levels, i.e., as skilled workers and unskilled workers. The skilled category includes professionals and clerical workers. There is no linear relationship between migrants' level of educational attainment and their use of the banking channel to transfer money, although migrants with a college or higher level of education are more likely than other categories to use this source. Despite this difference, it is important to note that about a third of migrants with a college or higher level of education did not report using the banking channel. There is no marked difference between skilled and unskilled workers in their use of hundi, although it is modestly higher in the latter's case.

**Table 12.6: Migrants' level of educational attainment and the methods used for money transfer**

Education/occupation	Bank	Hundi	Others
Up to 5	45.28	47.17	7.55
6-10	28.57	63.27	8.16
10 or above	68.75	25.00	6.25
Skilled workers	34.72	58.33	6.94
Unskilled workers	42.27	50.52	7.22

Source: Pakistan Panel Household Survey (2010).

The relationship between the methods used to transfer money and migrant workers' duration of stay abroad is also not as expected. Table 12.7 indicates a negative association between migrants' period of stay abroad and their use of the banking channel. Longer stays abroad appear to enable workers to find informal ways of sending money home. It is not easy to explain why, but there could be several reasons. For example, long-stay migrants' preference for informal channels may be associated with their legal status abroad. Illegal workers are more likely to use the nonbanking channel than legal workers. It can also be argued, however, that illegal workers are likely to be new migrants rather long-stay workers. Nonetheless, studies carried out in the 1980s tend to characterize illegal workers as 'over-stayers'—those who stayed abroad without following the legal procedure.

**Table 12.7: Migrants' duration of stay abroad and methods used to transfer money (percent)**

<b>Duration of stay abroad</b>	<b>Bank</b>	<b>Hundi</b>	<b>Others</b>
Up to 3 years	63.38	22.54	14.08
4–6 years	12.90	83.87	3.23
7–10 years	22.22	77.78	0.00
11 years or more	30.23	65.12	4.65

*Source:* Pakistan Panel Household Survey (2010).

#### **4.1. Estimating Effects of Socio-Economic Factors on Means of Money Transfer**

To determine the independent effect of the socioeconomic factors given above on methods used to transfer money, we also carry out a multivariate analysis, applying a logistic regression to the PPHS 2010 micro-data. The unit of analysis is a household with a member working abroad. If the household received money during the last year through a banking source, it is assigned a value of 1 and 0 otherwise. The dependent variables include migrants' age, household size, duration of stay abroad, migrants' education level, skill level, land ownership, and region (rural or urban).

The results of this analysis are presented in Table 12.8, and our findings are not very different from what has already been discussed. Rather, they give a better message. For example, while a college or higher level of education does not emerge as statistically significant, migrants with a middle or matriculate level of education are even less likely than those with a lower level of education to use the banking channel to transfer money. Skill level does not show a significant correlation with the use of formal sources, while the duration of stay abroad has a negative

association with the use of the banking channel. Two demographic variables, household size and migrants' age, have a significant association with the use of formal sources of money transfer. The larger a household, the less likely it is to receive remittances through the banking channel. Age also has a negative association with its use, but the positive and significant association of the age term with the use of formal sources indicates a curvilinear relationship.

**Table 12.8: Effects of demographic and socioeconomic factors on methods used to transfer money transfer from abroad (logistic regression model)**

Correlates	Coefficient	Standard error
Age of migrant (years)	-0.214*	0.100
Age-squared of migrant	0.002*	0.001
Years spent abroad (of migrant)	-0.059**	0.031
Education level of migrant (up to primary as ref.)		
6–10	-0.894*	0.449
Intermediate or above	0.120	0.770
Skilled worker (yes = 1)	-0.408	0.447
Household size (number of members)	-0.114**	0.059
Region (urban = 1)	1.603*	0.552
Land (acres)	0.310*	0.109
Constant	7.304*	2.931
LR chi2	47.76	
Log likelihood	-73.806	
Pseudo-R2	0.2445	
N	147	

Note: \* denotes significance at 5 percent, \*\* denotes significance at 10 percent.

Source: Authors' estimates based on Pakistan Panel Household Survey (2010) micro-data.

Finally, what are the policy implications? These are outlined in the last part of this chapter but a major finding of this analysis is that migrants who use hundi to send home remittances are not systematically different in socioeconomic terms from those who use the banking channel for this purpose. It is thus difficult to identify the migrants with certain characteristics who might be identified as a target group for using the banking channel.

In interpreting these results, however, two important caveats should be kept in mind, The analysis presented in this section is based on a relatively small household survey and that a deeper investigation requires a relatively larger survey which the study recommends.

The second is that the survey was conducted just a year after the launch of the PRI and that the extent to which the increased services offered in subsequent years (i.e., post-2010) by the PRI had on emigrants' behavior needs further investigation. Our view is that it should have led to an increase in the perception and practice of overseas Pakistanis in sending their remittances through official channels.

##### **5. Conclusions and Policy recommendations: Setting up an Efficient, Transparent, and Well-Functioning Remittances Market in Pakistan**

The Pakistan economy and a significant proportion of its population depend on the flows of remittances from overseas workers and the broader Pakistani diaspora. At over USD 14 billion in official remittances expected in 2012/13—which is just over half the projected total export value of goods and services and corresponding imports of around USD 40 billion—they provide critical support to a precarious current account situation. Remittances to households also have a favorable impact on poverty reduction and job creation. Also accounting for around 5.5 percent of GDP, remittances inject much needed additional aggregate demand into an economy that has been mired in stagflation over the last five years.

Given the important role that remittances play, a major objective of policymaking is to ensure that remittances flow through official channels since this would maximize the development benefits to the economy. The main purpose of this study was to identify factors that would facilitate the transfer of remittances through official channels. To do so, we have analyzed the remittances market and its major players both outside and within Pakistan to identify factors that drive remittances to be sent through official or unofficial channels.

An important contribution of this study is its analysis of remittances within an overall framework of a remittances market that encompasses both formal and informal players. This helps us better understand its functioning dynamics and identify factors that might explain the growth of remittances as well as forces that influence its flows through official and unofficial channels.

We build on the earlier study by Amjad et al. (2012) and critically examine the results of Kock and Sun (2011) who attempt to explain the growth of remittances during the period 1997–2008. Our study covers the period between 1997/98 and 2011/12.

The main conclusions of the study are as follows:

In explaining the manifold increase in official remittances since 2001/02, it is just as important to examine the economic shocks and

policy interventions that may have impacted these flows as it is to look at the increase in number of overseas workers leaving Pakistan in this period, their skill composition, and economic conditions within and outside Pakistan.

The major shocks and policy interventions that we have identified are:

- The freezing of foreign exchange accounts in the aftermath of Pakistan's nuclear test in May 1998.
- The 9/11 attacks on the US, which created a sense of insecurity among the Pakistani diaspora and caused US authorities and banking and other financial institutions to scrutinize the flow of remittances far more closely.
- The collapse of the real estate boom in 2009 in Dubai and the accompanying financial crisis, which led to a number of Pakistani professionals and workers leaving Dubai, while Pakistanis who had invested in Dubai pulled out their investments or what was left of them back into Pakistan.
- The PRI, launched jointly by the Ministry of Finance, State Bank of Pakistan, and the Ministry of Overseas Pakistanis, and the initiatives taken and incentives offered to Pakistani banks to increase the official flow of remittances, which has clearly contributed to its growth since 2009.

An important finding of this study is that the remittances market is complex and geographically segmented; identifying the major factors that resulted in increases in official remittances requires examining each segment of this market to draw appropriate conclusions and policy measures and initiatives, rather than studying them at the aggregate level. The segments identified are:

- The remittances market originating from (i) Saudi Arabia, (ii) Abu Dhabi, and (iii) Dubai.
- The remittances market originating from the US.
- The remittances market originating from the UK.

Since these three segments and subsegments account for over 70 percent of official remittances, analyzing each in depth provides important insights into their functioning and contribution to the large increase in official remittances. These main findings are:

- The remittances market originating from Dubai is the most complex as it serves as a major global hub of the hundi network and is closely integrated with remittance inflows from the US and the UK. The

official flows of remittances from Dubai mask investments by Pakistanis living in Pakistan as well as illegal earnings channeled back into Pakistan. The real net extent of these two flows is difficult to gauge but in examining movements and increases in flows, they appear to be significant.

- The remittances market in Saudi Arabia and Abu Dhabi, once the post-9/11 impact on the flow of official remittances works through, reflects both an increase in the number of migrant workers from Pakistan as development activities financed by rising oil prices were expanded, as well as aggressive marketing by Pakistani banks with PRI support.
- The US remittances market is where, besides Pakistani overseas professional workers, a significant part of the Pakistani diaspora resides, and its movements reflects both income transfers as well as the transfer of savings and assets to Pakistan. Since different factors influence the two flows, these need to be analyzed separately.
- The PRI's initiatives launched since early 2009 appears to have yielded sound results especially in tapping remittances flowing earlier through unofficial channels from the UK and Saudi Arabia as well as in identifying new countries as sources of remittances. In the case of the UK market, this was done by diverting flows from UK financial institutions to Pakistani banks since the former appeared to transfer funds that were not reflected in official flows.

A striking and important finding of the study, based on recent household surveys for 2009 and 2010, is that households receive almost 40 percent of their remittances through unofficial channels. Even more striking is the finding that, whether migrants are better educated or the receiving households live in rural or urban areas, makes no great difference to which channel they use. In interpreting these results, however, two caveats must be kept in mind: first, that the results are based on a relatively small household survey; and second, that it is very possible that these results may change as the PRI became more effective post-2010.

Based on its analysis of the factors that have led to an increase in remittances—as well as diversion from unofficial to official channels—including as a result of very recent PRI incentives, the study concludes the following:

- At less than USD 1 billion, the official flow of remittances in 1999–2000, following the freezing of foreign currency accounts in Pakistan after the nuclear tests, can be taken as its lowest point in terms of the share of flows through official channels. Based on estimates by

earlier studies, these could be taken to constitute around 20 percent of total flows.

- Post 9/11, given the heightened scrutiny and continuing economic boom in the West as well as increased economic activity in the Middle East, official remittances increased sharply. The combined effect of these factors was that, by 2005/06, the share of flows through official channels could have gone up to 60 percent of total remittances.
- The continuing increase in remittances after 2005/06, despite the global financial meltdown and real estate collapse in Dubai in 2009, can be explained by (i) the increased activity in Saudi Arabia and Abu Dhabi; (ii) the significant increase in outflow of Pakistan professionals to the US, UK, and Europe; and (iii) the PRI. These factors, we believe, could have increased further official remittances to around 70 percent or at least maintained them at around 60 percent of the total.
- Our tentative conclusion is, therefore, to scale down our estimates of the flow of remittances through unofficial channels to nearer 30–35 percent compared to the much higher estimate (up to 80 percent) in Amjad et al. (2012). It must be emphasized again that these estimates are inferred from global, regional, and national developments and interaction with “knowledgeable sources” rather than hard evidence and should be treated accordingly.

Finally, the study suggests two further areas of research. The first concerns the role of foreign exchange companies in the remittances market in Pakistan. The second entails undertaking a more comprehensive survey of families receiving remittances in Pakistan. Both these studies would not only assist in identifying measures needed to increase remittances through formal channels but as in better documentation of the Pakistan economy.

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Appendix

**Table A12.1: Outflow of overseas Pakistanis by occupational category (numbers)**

Year	Highly qualified	Highly skilled	Skilled	Semi-skilled	Unskilled	Total
2001	3,155	10,846	64,098	2,768	47,062	127,929
2002	2,618	14,778	74,968	3,236	51,822	147,422
2003	2,719	22,152	101,713	4,601	82,854	214,039
2004	3,291	15,557	77,033	3,840	74,103	173,824
2005	3,737	15,467	57,793	2,675	62,463	142,135
2006	5,708	16,332	71,898	3,375	85,878	183,191
2007	8,178	20,975	110,938	3,243	143,699	287,033
2008	9,713	33,173	177,791	4,209	205,428	430,314
2009	4,954	3,260	182,657	2,465	210,192	403,528
2010	7,081	31,650	165,726	5,181	153,266	362,904
2011	6,974	3,018	171,672	73,247	201,982	456,893
2012	6,861	3,035	191,354	74,071	195,011	470,332

Source: Bureau of Emigration and Overseas Employment, Pakistan.

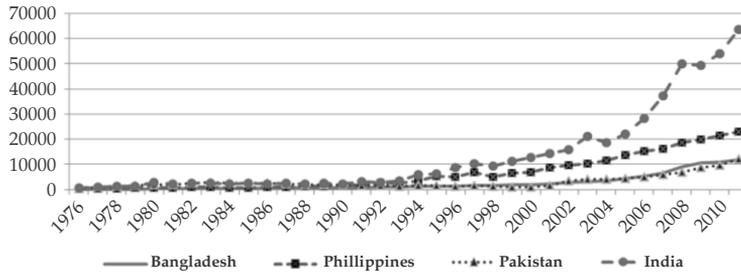
**Table A12.2: Percentage distribution of overseas Pakistanis by occupational category, 2001–12**

Year	Highly qualified/skilled	Skilled and semi-skilled	Unskilled
2001	10.94	52.27	36.79
2002	11.80	53.05	35.15
2003	11.62	49.67	38.71
2004	10.84	46.53	42.63
2005	13.51	42.54	43.95
2006	12.03	41.09	46.88
2007	10.16	39.78	50.06
2008	9.97	42.29	47.74
2009	2.04	45.88	52.09
2010	10.67	47.09	42.23
2011	2.19	53.61	44.21
2012	2.10	56.43	41.46

Note: The highly qualified and highly skilled were grouped together, and the skilled and semi-skilled were grouped together.

Source: Bureau of Emigration and Overseas Employment, Pakistan.

**Figure A12.1: Trends in remittances in four selected countries (USD million)**



Source: Remittances data, Development Prospects Group, World Bank (2011).

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**Table A12.3: Cost, distance, and time spent on dealing with banks and hundi system**

	Total sample	Province					Region	
		Punjab	Sindh	KPK	Balochistan	AJK	Urban	Rural
<i>Bank</i>								
Time involved in each transaction (days)	4.44	4.16	5.68	2.80	2.00	8.38	4.64	4.19
Average cost of each transaction (PRs)	696.85	1,049.02	533.18	30.61	325.3	183.33	690.38	704.72
Distance to bank from home (km)	5.22	5.47	2.91	8.54	3.06	7.82	3.20	7.71
Average time spent drawing money from bank (hours)	4.20	3.19	3.07	10.98	2.05	2.00	5.79	2.30
Friendly behavior of bank staff (yes = 1)	92.80	99.50	90.10	100.00	60.00	62.50	93.80	91.60
<i>Hundi</i>								
Time involved in collecting money (days)	1.76	2.56	1.15	1.34	1.67	1.29	1.91	1.69
Average cost of each transaction (PRs)	702.48	1,927.85	396.5	10.89	767.33	17.00	582.17	769.32

Source: Household Survey of Overseas Migrants and Remittances (2009).

## The Prospects for Indo-Pakistan Trade

Hafiz A. Pasha\* and Muhammad Imran\*\*

### 1. Introduction

Trade between India and Pakistan has been fundamentally influenced by factors that are not purely economic. At the time of Partition in 1947, both economies were heavily interdependent, with the share of the Indian market in Pakistan's exports at close to one fourth, and over half of Pakistan's imports coming from India. Thereafter, bilateral trade has had a chequered history. Trade virtually ceased after the wars of 1965 and 1971.

Some positive steps have been made since 1995, when India announced its decision to grant most favored nation (MFN) status to Pakistan, and the latter established a positive list with respect to imports from India. The signing of the South Asian Free Trade Agreement (SAFTA) in 2004 was a major step forward in the eventual establishment of a customs union in the region. Recently, Pakistan announced its potentially landmark decision to grant MFN status to India by the end of 2012. In the interim period, a restricted positive list has transitioned to a negative list, which opens up a large percentage of tariff lines for imports from India. Further, the two countries have agreed to simplify customs procedures and facilitate the process of goods certification. India has also announced that it welcomes investment by resident Pakistanis and companies.

Clearly, the environment for bilateral trade has greatly improved. This augurs well for future growth in trade between the two countries, who are making an effort to move away from the old view of "peace first,

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trade later” to “trade now, peace later.” It is hoped that the expansion of trade will create stronger constituencies for peace in both countries.

The objective of this chapter is to explore the possibilities of Indo-Pakistan trade in the new environment. Section 1 describes the current level and pattern of bilateral trade. Section 2 identifies some basic issues in the context of trade development between the two countries. Section 3 quantifies the degree of trade complementarity between the Indian and Pakistani economies. Section 4 describes the levels of import tariffs in the two countries and their potential impact on the volume of trade. Section 5 assesses the existing nontariff barriers (NTBs), especially with regard to each other, and identifies the particular restrictions that need to be removed for trade to flourish. Section 6 evaluates the prospects for Indo-Pakistan trade, following the India’s granting of MFN status and Pakistan’s reciprocal gestures in the form of relaxing certain NTBs.

## **2. Trade Between India and Pakistan**

Both India and Pakistan have become substantially more open economies over the last four decades. The combined share of global imports and exports in India’s GDP was less than 7 percent in 1970, but had risen to almost 32 percent by 2010. In Pakistan’s case, the corresponding share has increased from 12 percent to 34 percent. Both countries have clearly realized the gains from global trade and how this can contribute to faster economic growth.

This increase in their degree of global openness is not, however, reflected in the trade between the two countries. As shown in Table 13.1, Pakistan’s exports to India are of a small magnitude—only 1 percent (as compared to over one fourth at the time of Partition) of global exports and an insignificant portion of Indian imports. India’s exports to Pakistan constitute only about 1 percent of its total exports, and about 5 percent of the latter’s global imports (as compared to over half at the time of Partition). Clearly, any potential gains from trade have been sacrificed due to strained political relations.

**Table 13.1: Trade between Pakistan and India, 2000/01–2010/11**

<b>Pakistani exports to India</b>			
<b>Year</b>	<b>Exports (USD million)</b>	<b>As percentage of exports</b>	<b>As percentage of Indian imports</b>
2000/01	56	0.8	0.1
2006/07	344	2.6	0.1
2009/10	268	1.9	0.1
2010/11	264	1.0	0.1

<b>Indian exports to Pakistan</b>			
<b>Year</b>	<b>Exports (USD million)</b>	<b>As percentage of exports</b>	<b>As percentage of Pakistani imports</b>
2000/01	238	0.4	2.7
2006/07	1,236	1.1	5.1
2009/10	1,226	0.9	4.2
2010/11	1,734	0.9	4.9

*Source:* State Bank of Pakistan.

Indian exports to Pakistan have been restricted by the latter's positive list. Only 27 percent of the tariff lines are open for imports from India (Table 13.2). The restriction is particularly severe in the case of product groups such as prepared foods, footwear and personal articles, textiles, ceramic and glass products, and vehicles and transport equipment. An estimated 77 percent of India's major exports (above USD 500 million) have been excluded from access to the Pakistani market. However, despite limited access, Indian exports have shown significant growth during the last decade, rising from USD 238 million in 2000/01 to USD 1,734 million in 2010/11. At the same time, while Pakistan enjoys MFN status with respect to India, its exports are not only very small, they have also shown a declining trend since 2006/07.

**Table 13.2: Positive list of items for import from India**

Section of HC	Description	Total tariff lines	Lines in positive list	Percentage of tariff lines
I	Live animals, animal products	248	33	13.3
II	Vegetables and products	311	157	50.5
III	Animal, vegetable fats/oils	53	2	3.8
IV	Prepared foodstuffs	228	11	4.8
V	Mineral products	195	74	37.9
VI	Chemicals or allied industries	1,149	574	50.0
VII	Plastics and articles	300	93	31.0
VIII	Hides and skins, leather goods	92	45	48.9
IX	Wood and articles	106	52	49.1
X	Paper and paper board	182	37	20.3
XI	Textiles and articles	929	104	11.2
XII	Footwear and personal articles	59	2	3.4
XIII	Ceramic and glass products	189	28	14.8
XIV	Jewelry, etc.	55	5	9.1
XV	Metals and articles	744	156	21.0
XVI	Machinery	1,193	353	29.6
XVII	Vehicles and transport equipment	245	15	6.1
XVIII	Optical and precision instruments	269	103	38.3
XIX	Arms and ammunition	52	-	-
XX	Miscellaneous	186	5	2.7
XXI	Works of art	72	1	1.4
	<b>Total</b>	<b>6,857</b>	<b>1,870</b>	<b>27.3</b>

HC = Harmonized code.

*Note:* The percentage of tariff lines may not necessarily correspond to the percentage of imports.

*Source:* Pakistan, Ministry of Commerce (2012).

Tables 13.3 and 13.4 show the two countries' trade composition. As Table 13.3 indicates, two relatively large Indian exports to Pakistan were cotton (USD 372 million) and sugar (USD 69 million) in 2010/11—the year in which Pakistan was hit by devastating floods that badly affected standing crops. This is a classic example of how shortages can be met by a neighboring country, albeit at commercial terms. Other significant

imports from India include soya bean oil cake, vegetables, chemicals, artificial staple fiber, and tea. It is interesting that the share of agricultural exports to Pakistan is almost 30 percent. This is in contrast to the pattern of trade at the time of Partition when India exported mostly manufactured consumer goods and imported agricultural items, such as cotton and wheat.

**Table 13.3: Pakistan's major imports from India, 2010/11 and 2011/12**

HS code	Item description	July–May (USD million)	
		2010/11	2011/12
	(> USD 50 million)		
0702	Tomatoes, fresh or chilled	41	68
0713	Leguminous vegetables	40	52
1701	Sugar	69	0
2304	Soya bean oilcake	122	202
2902	Cyclic hydrocarbons	166	191
5201	Cotton	372	75
	(> USD 20 million – ≤ 50 million)		
0902	Tea	26	36
1209	Seeds for fruits	20	17
2933	Heterocyclic compounds	25	29
3204	Synthetic organic coloring matter	23	26
3817	Mixed alkyl benzenes	17	24
3901	Polymers of ethylene	3	20
3902	Polymers of propylene	23	35
5504	Artificial staple fiber	11	35
7202	Ferro alloys	25	18
7311	Containers for compressed gas	24	11
Subtotal		982	839
<b>Total</b>		<b>1,367</b>	<b>1,144</b>
Percentage of subtotal		72	73

Source: State Bank of Pakistan.

Pakistan's major exports to India are dates, cement, textiles, and certain chemicals. The export volumes are relatively small, as shown in Table 13.4. As opposed to its substantial imports of cotton from India in 2010/11, Pakistan exported cotton (USD 60 million) to India in 2011/12. There is also evidence of some intra-industry trade in sectors such as chemicals. A further promising sign is the emergence of some new

exports to India, such as leather, woven cotton fabrics, and medical and surgical instruments, which are among Pakistan's major global exports.

**Table 13.4: Pakistan's major exports to India, 2010/11 and 2011/12**

HS code	Item description	July–May (USD million)	
		2010/11	2011/12
	(> USD 10 million)		
0804	Dates	44	48
1006	Rice	13	1
2520	Gypsum	1	11
2523	Cement	39	33
2707	Oils from coal tar	14	0
2710	Oils from petrol	15	11
2917	Polycarboxylic acid	12	16
5201	Cotton	0	60
5205	Cotton yarn	9	11
5209	Woven cotton fabrics	8	10
	(> USD 5 million – ≤ 10 million)		
2903	Halogenated derivatives	8	7
4107	Leather	8	7
5103	Waste from wool	7	4
6305	Sacks/bags of textile material	5	5
9018	Medical and surgical instruments	5	5
Subtotal		203	230
<b>Total</b>		<b>268</b>	<b>311</b>
Percentage of subtotal		76	74

Source: State Bank of Pakistan.

Given its relatively large, growing volume of imports from India, and small, declining volume of exports to India, Pakistan has a relatively large trade deficit with respect to India, estimated at over USD 900 million in 2011/12. This has fueled arguments on the part of opponents of trade liberalization that further opening up will lead to a flood of Indian imports<sup>1</sup> to the detriment of Pakistani industry. It must, however, be recognized that, to the extent that imports from India represent “trade diversion” at lower prices—especially with lower transport costs—from

<sup>1</sup> The same concern was voiced when the Free Trade Agreement (FTA) was signed. However, although Chinese exports have reached USD 4.5 billion, many Pakistani industries have withstood the FTA well.

other sources, then while the trade balance with respect to India may deteriorate, the global balance of trade could improve.

### **3. Key Issues**

The current level, pattern, and balance of trade between India and Pakistan raise a number of key issues. First, why have Pakistani exports performed poorly in India, despite the former's MFN status? There are a number of possible reasons for the low and declining volume of exports to India.

1. The trade complementarity between Pakistani exports and Indian imports may be low. In other words, Pakistan is not producing and exporting many of the goods that India imports globally. Therefore, there is low scope for diversion of Indian imports to Pakistan.
2. The regime of import tariffs and para-tariffs in India could be providing more effective protection to sectors in which Pakistan might potentially have a relative comparative advantage, for example, in some agricultural items and textiles.
3. India has a restrictive trade regime relative to other developing countries in terms of the range and intensity of NTBs. Additionally, it might be applying some of these barriers more rigorously to Pakistan, effectively raising costs for Pakistani exporters and precluding their access to the large Indian market.

As opposed to this, despite the limited positive list, Indian exports to Pakistan have done fairly well and shown rapid growth. This could be for the reasons below.

1. Given the two countries' relative level of development, especially in terms of the extent of diversification of the industrial base, there is a high level of trade complementarity between Indian exports and Pakistani imports. Consequently, following Pakistan's granting of MFN status to India, imports could rise substantially, especially due to diversion from more expensive sources.
2. Pakistan has a relatively more liberal trade regime. Generally, it has managed its protection policy for different economic activities primarily through import tariffs (and SROs); the presence of NTBs is limited. This has encouraged market penetration by Indian exporters.

Beyond the granting of MFN status to India, the final phase of trade liberalization in South Asia under SAFTA is expected to reach completion by 31 December 2012. At this stage, items in all tariff lines (except those on each member country's sensitive list) will see import tariffs being

reduced to 5 percent or less.<sup>2</sup> The question is the extent to which this will further improve access for Indian exports to Pakistan. Is there even the possibility of some “trade creation” whereby Indian products begin to displace Pakistani products, and not just Pakistan’s imports from other countries? Simultaneously, will lower Indian import tariffs provide greater opportunities to Pakistan exports?

It needs to be emphasized that, in the short to medium term, the prospects of raising Pakistani exports, both globally and specifically, to India, are limited by severe supply-side constraints. These include record levels of power load-shedding, and gas and water shortages, which have restricted the extent of capacity utilization. Simultaneously, private investment in Pakistan is at an all-time low.

The subsequent sections attempt to answer the questions raised above. First, we quantify the extent of trade complementarity between the two countries. This is followed by a comparison of their tariff regimes and incidence of NTBs. Based on these analyses, we assess the prospects for Indo-Pakistan post-31 December 2012, following the granting of MFN status to India and completion of the trade liberalization process under SAFTA.

#### **4. The Extent of Trade Complementarity**

We develop the following index of trade complementarity between two countries:

$$TCI = \frac{\sum_i x_{ij} m_{ik}}{\sum_i x_{ij} x_{ij}} \quad 0 \leq TCI \leq 1$$

where TCI = trade complementarity index between countries  $j$  and  $k$ ,  $m_{ik}$  = the share of the  $i$ th commodity in the total imports of country  $k$ , and  $x_{ij}$  = the share of the  $i$ th commodity in the total exports of country  $j$ . The higher the magnitude of TCI, the greater will be the trade complementarity between the two countries.

The TCI has been estimated at the 4-digit HC level of India and Pakistan. The resulting magnitudes are as follows:

1. TCI between Indian exports and Pakistani imports = 0.420
2. TCI between Pakistani exports and Indian imports = 0.082

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<sup>2</sup> Pakistan has already notified vide SRO 558(1)/2004 the schedule of reduction of customs duties under SAFTA on different items by 31 December 2012.

Therefore, there is clear evidence that India is in a position to potentially export more items to Pakistan than the reverse. This is a major factor explaining the substantially larger volume of exports from India to Pakistan, even in the presence of the positive list. Table 13.5 lists significant Indian exports (above USD 250 million) that are also significant imports for Pakistan (above USD 100 million) for 2010/11. It shows that ten major Indian exports on Pakistan's positive list had a potential export value of USD 3.7 billion in the latter country. Actual exports in 2010/11 were worth USD 1.1 billion, implying that India's share in these exports was almost 30 percent. This share could increase further after the tariff reductions by Pakistan under SAFTA.

Following its transition to full MFN status and reduction in tariffs under SAFTA, a further market of over USD 11 billion potentially opens up for India in Pakistan, consisting primarily of the trade diversion of previously banned imports. If the market share in the old positive list rises to, say, 50 percent while that for new items reaches 30 percent in the medium term, Indian exports could rise to over USD 5 billion.

**Table 13.5: Simultaneously significant Indian exports and Pakistani imports, 2010/11 (at 4-digit HC level)**

N o.	Code	Description	Volume of global		Pakistan's imports from India
			Indian exports	Pakistani imports	
Included in positive list*			(USD million)		
1	0902	<i>Tea</i>	708	311	24
2	1701	<i>Sugar</i>	1,196	691	335
3	2304	Soya bean oil cake	2,057	142	51
4	2902	Cyclic hydrocarbons	1,594	467	185
5	2933	<i>Heterocyclic compounds</i>	600	113	11
6	3204	<i>Synthetic coloring matter</i>	1,249	162	7
7	3808	<i>Insecticides, etc.</i>	1,140	195	25
8	3902	Polymers of polypropylene	771	435	17
9	4011	<i>New rubber tyres</i>	1,029	144	42
10	5201	Cotton, not carded or combed	2,866	1,031	406
<b>Total</b>			<b>13,210</b>	<b>3,691</b>	<b>1,103</b>
Not included in positive list					
11	2711	Petroleum products	41,076	8,261	
12	3004	<i>Medicaments n.e.s.</i>	5,637	194	
13	5402	Synthetic filament yarn	774	392	
14	7208	<i>Flat rolled products of steel</i>	862	267	
15	7210	"	1,384	283	
16	8471	<i>Automatic data processing machines</i>	285	103	
17	8502	<i>Electrical generating sets</i>	342	289	
18	8517	<i>Electric apparatus for telephony</i>	3,329	518	
19	8703	<i>Motor vehicles for transporting persons</i>	4,211	477	
20	8704	<i>Motor vehicles for transporting goods</i>	619	142	
21	8708	<i>Parts and accessories for motor vehicles</i>	2,189	120	
22	8711	<i>Motorcycles</i>	856	100	
23	9018	Medical, surgical, and dental instruments	414	125	
<b>Total</b>			<b>61,978</b>	<b>11,271</b>	

\* Note that not all items at the 8-digit level are part of the positive list.

Items in italics are on Pakistan's sensitive list.

Sources: India, Ministry of Commerce and Industry (2012) (figures in last column); State Bank of Pakistan.

There are two other possibilities. The first is the diversion of informal trade—currently routed through the UAE, Singapore, and Iran or smuggled across the border—to formal channels after most items become importable from India. The volume of informal trade was estimated by the

Sustainable Development Policy Institute (2007) at USD 500 million, and has by now probably increased to USD 1 billion. The second prospect is that of some “trade creation” with India, especially in products where tariffs are high (currently at 20 to 30 percent), which do not feature on the sensitive list, and which consequently experience a significant reduction in the tariff rate. Estimating the magnitude of trade creation requires detailed micro-studies of different sectors, which is the subject of further research.

Within the limited trade complementarity of Pakistani exports and Indian imports, we identify trade prospects following the relaxation of some NTBs (discussed in a subsequent section) and reduction in tariffs by India under SAFTA. Table 13.6 gives a list of potentially larger exports to India.

**Table 13.6: Simultaneously significant\* Pakistani exports and Indian imports\*, 2010/11 (at 4-digit HC level)**

No.	Code	Description	Volume of global		Potential diversion to India**
			Pakistani exports $X_i$	Indian imports $M_i$	
(USD million)					
1	0804	<i>Dates, figs, etc.</i>	100	180	100
2	1001	Wheat	310	133	133
3	2523	Cement	496	77	77
4	3004	<i>Medicaments n.e.s.</i>	56	764	56
5	3907	Polyesters, primary	265	1,024	265
6	4102	Leather	79	60	60
7	5007	<i>Woven fabrics of silk</i>	50	129	50
8	5201	<i>Cotton, not carded or combed</i>	519	56	56
9	5208	Woven cotton fabrics	519	159	159
10	5209	Woven cotton fabrics	936	60	60
11	5407	<i>Woven fabrics of synthetic yarn</i>	59	107	59
12	6006	Other knitted fabrics	67	112	67
13	6403	<i>Footwear</i>	72	56	56
14	7113	Articles of jewelry	158	338	158
15	9018	Surgical instruments	295	1,028	295
16	9506	Sports articles	342	118	118
<b>Total</b>			<b>4,323</b>	<b>4,401</b>	<b>1,769</b>

\* At least USD 50 million each.

\*\* Corresponding to  $\text{Min}[X_i, M_i]$  for the  $i$ th product.

Items in italics are on India’s sensitive list.

Source: India, Ministry of Commerce and Industry (2012); State Bank of Pakistan.

Major Pakistani exports that could be further diverted to the Indian market (in view of lower transport costs) include dates, cotton, primary polyester, woven cotton and silk fabrics, jewelry, and sports articles. The quantum of total trade diversion is estimated at USD 1.8 billion (Table 13.6). If about 50 percent diversion takes place, exports could reach USD 900 million, as compared to USD 350 million currently. The prospect of such diversion—and possibly some trade creation—would improve if India were to relax some of its NTBs and if present impediments to trade were removed. Moreover, the competitive position of Pakistani exports to India would be enhanced if the SAFTA tariff reductions were implemented.

## **5. Tariff Policies**

The low trade complementarity between Pakistani exports and India exists primarily because Pakistan does not have a diversified exports base and its two product groups—agricultural items and textiles—account for 60 percent of its total exports. These are also major exports of India with a share of 17 percent. Of course, if free trade were to take place, a degree of specialization could develop, depending on relative comparative advantage. Pakistan could then find “niche” markets in India for a range of products from the two sectors.

The possibility of intra-industry trade has been largely precluded by the tariff policies pursued by India and support provided in the form of relatively large subsidies, especially to agriculture. Table 13.7 compares the level and pattern of import tariffs in the two countries, demonstrating that customs duties on agricultural products are significantly higher in India. For example, in cereals, and fruits and vegetables, India’s average tariff on imports is 30–32 percent as compared to 18–19 percent in Pakistan. As opposed to this, Pakistan generally offers its domestic industry more protection.

Duty rates on textiles and clothing also appear to be lower in India than in Pakistan. This is the case for ad valorem duties, but India operates a dual tariff structure in these product groups with an ad valorem or specific duty, whichever is higher. Generally, the specific duties appear to be far higher and, in some cases, exceed 100 percent, especially on value-added textiles (see Table 13.8). These rates are even higher than India’s tariff bindings with the World Trade Organization (WTO) in some cases. Pakistan, however, operates a normal ad valorem duty structure in clothing and textiles.

**Table 13.7: MFN-applied tariffs by product group in India and Pakistan\***

<b>Product group</b>	<b>India</b>	<b>Pakistan</b>
Animal products	33.1	14.6
Dairy products	33.7	30.0
Fruit, vegetables, plants	30.4	18.2
Coffee, tea	56.3	12.8
Cereals and preparations	32.2	18.8
Oilseeds, fats, and oils	18.3	8.8
Sugars and confectionery	34.4	17.2
Beverages and tobacco	70.8	52.5
Cotton	12.0	7.0
Other agricultural products	21.7	6.7
Fish and fish products	29.8	10.6
Minerals and metals	7.5	12.4
Petroleum	3.8	10.7
Chemicals	7.9	9.6
Wood, paper, etc.	9.1	15.5
Textiles	14.7	16.7
Clothing	13.4	24.8
Leather, footwear, etc.	10.2	14.9
Nonelectrical machinery	7.3	9.3
Electrical machinery	7.2	14.7
Transport equipment	20.7	24.7
Manufactures, n.e.s.	8.9	13.1

\* For latest year for which information is available.

Source: World Trade Organization, country tariff profiles.

**Table 13.8: Distribution of effective ad valorem tariffs on textiles in India**

<b>Range (%)</b>	<b>Rate (%)</b>	<b>Percentage</b>
0 to 10	35	15.7
Above 10 to 25	83	37.2
Above 25 to 50	61	27.4
Above 50 to 100	31	13.9
Above 100	13	5.8
	<b>223</b>	<b>100.0</b>

Source: Authors' estimates.

India also operates an elaborate subsidy regime in agriculture. Subsidies on agricultural inputs such as fertilizer, power, water, tractors,

and seeds, etc., exceed 5 percent of GDP (Institute of Public Policy, 2012). The corresponding magnitude for Pakistan is 1 percent of GDP. It must, of course, be recognized that the agricultural subsidies are WTO-compliant, but their high level in India has served to make domestic production artificially competitive in relation to imports.

Overall, India's tariff and subsidy regimes for agricultural products and tariffs on textiles and clothing have effectively restricted imports. For Pakistan, the consequence has been limited access of its traditional exports to the Indian market. It is worth noting that these two product groups also feature prominently in SAFTA's sensitive list. As such, the process of trade liberalization is unlikely to provide a significant new opening to Pakistani exporters.

As a special concession, India has recently offered Bangladesh duty-free access to a range of textile products, including readymade garments. This is presumably justified on the grounds that Bangladesh is a least-developed country member and merits special treatment. However, in the negotiations prior to granting India MFN status, Pakistan should seek the withdrawal of the specific duties on textiles and clothing and application only of the ad valorem duties.

## **6. Nontariff Barriers**

The perception in Pakistan is that India operates a generally restrictive trade regime in the form of a wide range of NTBs, some of which are applied more strictly on Pakistani consignments. The following sections list the two countries' NTBs.

### **6.1. NTBs in India**

According to the WTO (2011), India operates the following key NTBs.

- Sanitary and phytosanitary (SPS) measures are harmonized with international standards and cover mostly food items.
- The import licensing and permit regimes are complex, varying according to product or user.
- There are a large number of notifications specifying mainly sampling and testing procedures as well as labeling and packaging requirements for food products, pharmaceuticals, textiles, etc.
- Quarantine is imposed on animals and plants.
- Some goods can only be imported through specified ports and/or by particular agencies.

- Pre-shipment inspection is mandatory for some goods such as metal scrap, textiles, etc.
- India actively uses antidumping duties and countervailing measures.

## **6.2. NTBs in Pakistan**

Compared to those listed above, Pakistan operates fewer, less rigorous NTBs, listed below.

- Pakistan's main trade policy instrument is the tariff regime (including SROs) rather than NTBs.
- Pakistan's SPS legislation is outdated and not effectively applied.
- Imports of products such as pharmaceuticals, agricultural products, and engineering goods require clearance by the relevant ministry/agency.
- Import restrictions are applied for health, safety, security, religious, and environmental reasons.
- State trading agencies (such as the TCP) play a dominant role in the import of agricultural inputs and products.
- Pakistan seldom resorts to antidumping and countervailing measures.

The World Bank (2012) has developed an overall trade restrictiveness index (OTRI), which calculates the equivalent uniform tariff of a country's tariff schedule and NTBs that would maintain the overall import level. NTBs covered by the index include price control measures, quantity restrictions, monopolistic practices, SPS and technical regulations, and agricultural support.

Table 13.9 presents the OTRI for a sample of Asian countries. India has the highest OTRI, not only among countries in South Asia but also in relation to the sample of countries in the rest of Asia. The impact of NTBs on the magnitude of the OTRI also appears to be relatively high in India's case. A comparison with Pakistan reveals clearly that NTBs play a far less dominant role than in India. This point needs to be stressed in ongoing negotiations with India.

**Table 13.9: OTRI in a sample of Asian countries**

<b>Country</b>	<b>OTRI</b>	<b>Percentage increase in OTRI due to NTBs</b>
<i>South Asia</i>		
Bangladesh	23.8	0.8
India	46.7	24.5
Nepal	16.1	0.0
Pakistan	22.2	5.1
Sri Lanka	9.9	0.0
<i>East Asia</i>		
China	21.2	9.9
Malaysia	39.7	30.0
Philippines	34.5	30.5
Thailand	22.8	8.1
<i>Rest of Asia</i>		
Turkey	15.1	2.7

*Source:* World Bank (2012).

Specific impediments to trade between India and Pakistan include the following.

1. Severe visa restrictions by both countries make it difficult for businesspersons from one country to develop contacts/markets in the other.
2. Restrictions on the choice of routes that can be used to transport goods constrain trade. For example, Pakistan limits the use of the Atari–Wagah border overland route to 137 goods from India.
3. There is limited capacity for transport on overland routes, especially the availability of wagons from Pakistan Railway. In addition, there are no testing or quarantine facilities at the check-post at Atari–Wagah. There is no e-filing system in operation at the border customs, leading to significant delays, frequently for security reasons.
4. In some cases, the testing and certification required under SPS measures and technical barriers to trade take considerable time in India.
5. Banking channels remain underdeveloped in the absence of bank branches in one country of banks in the other. This has created problems in honoring letters of credit. Payments through the Asian Clearing Union are also subject to long delays.

These impediments appear to have had a major impact on the volume of trade between the two countries. Fortunately, some steps have recently been taken to improve the situation. The countries have reached a bilateral agreement to expedite customs clearance on accepting each other's certification of goods. There are ongoing discussions on a visa protocol to facilitate longer, more frequent by businesspersons. Overall, it is clear that NTBs are generally more restrictive in India, especially on agricultural items. There are also a number of specific impediments to bilateral trade, which, if removed, could significantly enhance the volume of trade.

## **7. Prospects for Indo-Pakistan Trade**

The chapter has demonstrated that granting MFN status to India, rationalizing tariffs on Pakistani products by India, and mutual efforts to remove specific impediments to trade could substantially enhance the volume of trade between the two countries. A number of other studies have already reached this conclusion, including those by Batra (2004), Nabi and Nasim (2001), the State Bank of Pakistan (2006), Sayeed (2005), Kemal, Abbas, and Qadir (2002), Hussain (2011), and Taneja (2007). Such studies have adopted different approaches to demonstrate that the potential volume of trade could be a multiple of its present level.

Following the granting of MFN status, there is considerable scope for the diversion of imports by Pakistan to India, especially in product groups such as chemicals, pharmaceuticals, iron and steel, electrical appliances, plant and machinery, motor vehicles, and transport equipment. The gains to Pakistan would be in the form of lower prices (especially due to India's proximity and the resulting lower transport costs). The State Bank of Pakistan (2006) estimates that the diversion of trade to India could confer savings in the import bill of over USD 1 billion.

There is also the likelihood of some "trade creation" following the implementation of SAFTA, especially in items that are currently not imported but could witness the entry of Indian products as the result of a sizeable fall in the rate of customs duty from 20–30 percent to 5 percent. In addition, informal imports through various channels from India could shift to official imports. Overall, in the medium term, it is estimated that imports from India could rise to almost USD 7 billion to 8 billion, especially if there is significant trade creation. This would more-than-quadruple the present level of imports. If this happens, India could become one of Pakistan's largest trading partners in Asia, along with China and the Middle East countries.

On the export side for Pakistan, the prospects appear somewhat more limited. The outcome depends on the extent to which India eases both general and Pakistan-specific barriers to trade, and rationalizes

tariffs, especially on textiles. The reduction of duties under SAFTA may not be of great benefit because its sensitive list protects agriculture and textiles. Indian duties on manufactured goods, except textiles and clothing, are relatively low and, consequently, the extent of tariff reduction under SAFTA will not be so pronounced. Overall, Pakistan would do well if it were able to increase its exports to India to USD 1 billion from the present level of about USD 350 million in the next few years. This would nearly treble its exports to India.

It needs to be emphasized that there are threats to realizing this quantum jump in bilateral trade. First, industries in Pakistan that have traditionally enjoyed high levels of effective protection will lobby for the negative list, including their products, to be retained beyond 31 December 2012 on the grounds that they fear "serious injury" due to the opening of trade following full trade normalization with India. While Pakistan adheres to its commitment to grant MFN status, it may be necessary to enhance the institutional capacity of the Ministry of Commerce and National Tariff Commission to investigate complaints of serious injury and take appropriate safeguard measures, if necessary, permissible under the WTO and SAFTA.

Second, there are likely to be elements in India who are opposed to granting any concessions to Pakistan in negotiations on the future bilateral trading regime. This may include not only right-wing political forces, but also, potentially, certain industries such as textiles and clothing.

Third, the prospects of an increase in Pakistan's trade deficit with respect to India will fuel arguments on the part of right-wing elements and industrial lobbies in the country that the process of liberalization has been to India's advantage and that Pakistan has lost the major leverage it had with regard to resolution of the longstanding Kashmir problem. It will be necessary to convey the message that, while the trade deficit with respect to India may worsen, the global balance of trade will simultaneously improve due to cheaper imports from India. A powerful way of establishing this point may be to demonstrate the large consumer welfare gains that could accrue in a range of products, including certain basic food items, medicines, personal care items, electrical goods, and transport equipment (especially for public transport).

Finally, the recent improvement in the trading environment between the two countries can only be sustained if both pursue a policy of reciprocity and mutual cooperation, and if political relations are not strained and security concerns not heightened. It is possible that the expansion of trade between the two countries will facilitate the process of composite dialogue and confer a large peace dividend in the not-so-distant future.

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*The Prospects for Indo-Pakistan Trade*

## The Opportunities and Pitfalls of Pakistan's Trade with China and Other Neighbors

Naved Hamid\* and Sarah Hayat\*\*

### 1. Introduction

There is increasing recognition in Pakistan that regional trade could be an important driver of growth for the country. However, much of this debate has focused on India–Pakistan trade.<sup>1</sup> While, undoubtedly, trade with India could give a tremendous boost to Pakistan's economy, there are other neighbors with whom trade could be equally important. We propose to look at this neglected aspect of regional trade and show that promoting trade with the rest of Pakistan's neighbors could have a significant positive impact on the country's growth over the next decade or more. Trade with India and trade with the other neighbors are two sides of the same coin—promoting trade with both would have tremendous synergies. The overall impact on Pakistan's economy could well be to raise the trend growth rate for the next decade or so by 2 to 3 percentage points above the historical trend growth rate of 5.5 percent per annum.

Section 2 provides a review of the trends in growth in trade, particularly exports in the last decade. In the next three sections, we discuss trends in exports at the aggregate and commodity level, as well as

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<sup>1</sup> An important exception was a report prepared at the request of Jahangir Khan Tareen, federal minister for industries, production, and special initiatives, for the Government of Pakistan in 2005 by a team of economists led by Ijaz Nabi (see Nabi, Kardar, Bari, Cheema, Siddiqui, & Kemal, 2005).

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the pitfalls, opportunities, and appropriate policies to promote exports with respect to Pakistan's three largest trading partners of its neighboring countries, i.e., China, the United Arab Emirates (UAE), and Afghanistan. Section 6 briefly reviews the potential for trade with Central Asia, overland through Afghanistan. Section 7 concludes the chapter.

## 2. Regional Trade

There is an impression that Pakistan trades (excluding imported crude oil and petroleum products) primarily with the West. This was the case for a long time, but it has changed in the last decade. In 2011, about 25.1 percent of Pakistan's exports and 35.3 percent of imports were from neighboring countries (UAE, China, Afghanistan, India, and Iran); as a group, these neighbors are now more important for Pakistan's trade than North America and about as important as Europe (Table 14.1). The fact that trade between Pakistan and its neighbors has increased so rapidly, despite the lack of progress in formal regional economic agreements such as the South Asia Free Trade Area (SAFTA) and Economic Cooperation Organization (ECO), is indicative of the potential and dynamics of trading with neighboring countries.

**Table 14.1: Pakistan's trade in 2011**

Country	Exports		Imports	
	USD billion	% Share	USD billion	% Share
Neighbors*	6.4	25.1	15.4	35.3
North America	4.0	15.8	2.4	5.5
Europe	6.4	25.3	4.7	10.8
East Asia (excl. China)	1.4	5.4	7.0	16.1
Pakistan's total	25.3		43.6	

*Note:* \* China, UAE, Afghanistan, India, and Iran.

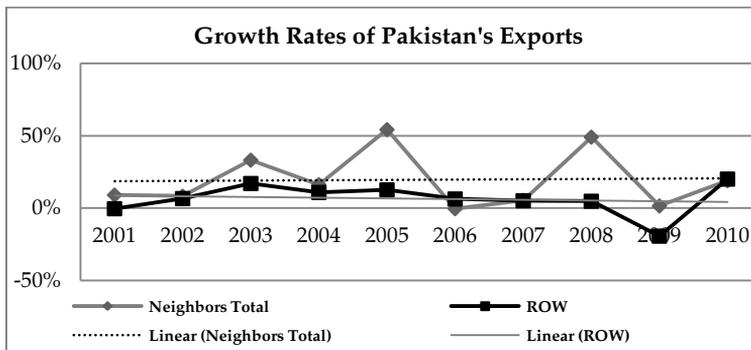
Source: United Nations Statistics Division, UN comtrade.

This chapter focuses primarily on exports. This is not to imply that imports are not important, but simply that, historically, poor export performance has been Pakistan's Achilles' heel and the main reason for the country's stop-go growth experience since the 1970s. Therefore, it is critical for Pakistan to improve its export performance, and to do that it must diversify its exports both in terms of products and markets. We show that this had already started happening in the last decade due to growing trade with its neighbors. We also argue that these neighbors could provide the dynamic and potentially large export markets that

might help resolve Pakistan's historic export dilemma and serve as one of the drivers of its growth for the next decade or more.

In the last decade, although aggregate exports to neighboring countries fluctuated greatly, they grew at an average of more than 19 percent per annum compared to only 6 percent to the rest of the world (Figure 14.1). As a result, its neighbors' share in Pakistan's total exports increased from less than one tenth to about one fourth in 2010, when three of the world's five top export markets for Pakistan were neighboring countries.

**Figure 14.1: Trends in Pakistan's exports to its neighbors and ROW\***



Note: ROW = exports to world – exports to neighbors.

Source: United Nations Statistics Division, UN comtrade.

In the last decade, exports to all neighboring countries grew more rapidly than to the rest of the world, but exports to Afghanistan grew fastest (Table 14.2). As a result, Afghanistan's share of Pakistan's exports increased eight-fold, making it the second most important export market in the world for Pakistan in 2011 (after the US). The next most rapid growth in exports was to Iran, but this was from a very small base and, consequently, total exports to Iran were still relatively small in 2011. China's export share increased by about 2.5 times during this period and that of the UAE almost doubled, making them the third and fourth most important export markets in the world, respectively, for Pakistan in 2011. Although exports to India increased more slowly than to the other neighbors, they grew faster than exports to the rest of the world.

**Table 14.2: Neighbors' export shares, 2000–11**

Country	2000		2011	
	USD million	% Share*	USD million	% Share*
UAE**	304.5	3.3	1,558.3	6.3
Afghanistan	124.0	1.3	2,660.3	10.5
China	244.6	2.7	1,678.9	6.6
India	65.0	0.7	272.8	1.0
Iran	16.6	0.2	153.3	0.6
Neighbors' total share	754.8	8.2	6,353.5	25.1
Pakistan's total exports	9,201.1		21,413.1	

Notes: \* As a percentage of Pakistan's total exports. \*\* Data for UAE is based on import values reported by UAE.

Source: United Nations Statistics Division, UN comtrade.

In brief, regional trade expanded rapidly during the last decade with imports and exports from Pakistan's neighbors increasing, on average, by 17 and 19 percent per annum, respectively. However, while the growth in exports to all the neighboring countries was high—ranging from 29 percent per annum for Afghanistan to 15 percent per annum for India—the products exported and the factors responsible for this growth were quite different for each country. Therefore, it is necessary to look in more detail at each individual country's experience to form an idea of the nature of expansion in regional trade in the last decade, as well as the potential opportunities and pitfalls. The next three sections examine in greater detail the trends in export growth in the last decade for China, the UAE, and Afghanistan, both at the aggregate and product levels.

### **3. People's Republic of China**

China has been the world's fastest-growing major economy for many years; it is now the world's second largest economy, after the US, the largest exporter, and the second largest importer of goods. Its overall trade was more than USD 3.6 trillion in 2011, with exports and imports of USD 1.9 trillion and 1.7 trillion, respectively (International Monetary Fund, 2011). China's outward foreign direct investment (FDI) has also shown a marked increase in recent years, and was USD 65 billion in 2011 (United Nations Conference on Trade and Development, 2012).

Overland trade ties between Pakistan and China were established in 1979, following the completion of the all-weather Karakoram Highway.

However, a very small proportion of Pakistan’s trade with China is through this route, and the overland link is seen primarily as enhancing the country’s defense. In fact, Pakistan has always looked at China largely from a security perspective—as a counter to political pressure from the US, support in a confrontation with India, and as a source of military hardware. China, as an emerging global economic power, offers immense opportunities to Pakistan, particularly as a neighbor and an old ally.

Pakistan’s economic interdependence with China has grown rapidly in the last decade—in 2010, the latter was Pakistan’s second largest source of imports and its fourth largest market for exports. Pakistan’s exports to China grew rapidly throughout the decade, with growth accelerating sharply following the signing of a free trade agreement (FTA) in 2006. The average annual export growth increased from 19 percent between 2003 and 2006 to 28 percent from 2007 to 2011. As a result, China’s share in Pakistan’s exports almost doubled in just three years (Table 14.3).

**Table 14.3: Pakistan’s exports to China (USD million)**

	2000		2003		2005		2007		2011	
	Value	% Share	Value	% Share						
Exports	244.6	2.7	259.6	2.2	435.7	2.7	613.8	3.4	1,678.9	6.6

*Source:* United Nations Statistics Division, UN comtrade.

Even though aggregate exports to China have increased rapidly, one needs to look at the structure of exports to fully understand the dynamics of this change. A review of the structure of exports reveals two things. First, the export structure in 2011 is not encouraging, with raw materials and primary manufactures such as cotton fiber, chromium ores, and cotton yarn accounting for 63 percent of total exports (Table 14.4). Second, this structure has not changed much in the last decade—the same six commodities account for over 80 percent of exports in 2000 and 2011. However, over the 11 years, the shares of chromium ores and cotton yarn have increased at the expense of cotton fabrics, a change that most would see as a move backward.

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**Table 14.4: Structure of Pakistan's exports to China, 2000–2011**

No.	Commodity	2000		2011	
		USD million	% Share*	USD million	% Share*
1	Cotton yarn, excl. thread	100.0	40.9	869.9	51.8
2	Chromium ores and concentrates	4.5	1.8	97.4	5.8
3	Cotton fabrics, woven	56.5	23.1	179.1	10.7
4	Textile fibers: cotton	10.7	4.4	87.1	5.2
5	Fish, crustaceans, mollusks	15.3	6.3	49.1	2.9
6	Leather	15.9	6.5	47.5	2.8
7	Machinery and transport equip.	0.8	0.3	8.1	0.5
8	Plastics in primary form	2.5	1.0	46.7	2.8
	Subtotal	206.2	84.3	1,384.9	82.5
	<b>Total exports to China</b>	<b>244.6</b>		<b>1,678.9</b>	

Note: \* = as a percentage of Pakistan's total exports to China.

Source: United Nations Statistics Division, *UN comtrade*.

Pakistan needs to shift from exporting primary commodities and simple manufactures to higher-value-added products, if export growth is to be sustained and exports are to contribute to expanding employment and GDP in the country. The FTA with China should give Pakistan an edge over other countries in a number of potentially high-growth products as it provides market access at zero duty for cotton fabrics, bed-linen and other home textiles, leather articles, sports goods, and fruits and vegetables among other goods (Pakistan, Ministry of Textile Industry, 2008). However, in almost all these products, Pakistani exporters have failed to make headway because of nontariff barriers. For example, Pakistan is a major exporter of towels and bed-linen to the US and Europe, but exports of these products to China are negligible.<sup>2</sup> Pakistan needs to focus on having these nontariff barriers removed in areas that are its export strengths, such as cotton fabrics, bed-linen, towels, and sports goods.

<sup>2</sup> According to a former chairperson of the Towel Manufacturers' Association of Pakistan, "The landed cost of Pakistani towels in China is 15 to 20 percent less than the price of equivalent towels made in China and with zero duty under the FTA we should be able to export substantial quantities to China. But no large store or distributor in China will buy imported towels unless the Chinese Government gives them the go-ahead. Since, thus far, the Chinese Government has not given its okay; Pakistan is unable to export any towels to China" (personal interview with Tahir Jahangir, 22 July 2012).

Besides exports, investment from China could provide a major boost to Pakistan's export industry. According to Eichengreen, Rhee, and Tong (2007), the structure of China's exports has been changing over the years—from "clothing, footwear, other light manufactures and fuels that dominated its trade in the 1980s and early 1990s, toward office machinery, telecommunications, furniture, and industrial supplies in the late 1990s and automated data processing equipment and consumer electronics in recent years" (p. 202). In other words, China has been moving up the value chain, but because of its huge labor force, it has continued to export labor-intensive products as well. However, after almost 30 years of rapid growth, most of the surplus labor has now been absorbed and wages are rising rapidly, particularly in the coastal belt. As a result, exporters in China are losing competitiveness in the more labor-intensive industries and beginning to look at the possibility of relocating these industries elsewhere.

In Asia, this has happened many times before, i.e., as wages rose in one country, its export industry tended to move to manufacturing more sophisticated products at home and relocated the labor-intensive product processes to neighboring countries. This started with industry relocating from Japan to Korea, Taiwan, Singapore, and Hong Kong in the 1960s and 1970s, then to Thailand, Malaysia, and Indonesia in the 1980s and to China and Vietnam in the 1990s and 2000s. This process has often been referred to as "the flying geese model of Asian economic development," with Japan in the forefront (Kojima, 2000; Kumagai, 2008).

Owing to China's huge labor force, it has taken much longer for this process to start, but it is beginning to happen, with industry being relocated to Vietnam, Laos, and Cambodia. According to the *World Investment Report 2011*, "A new round of industrial restructuring and upgrading is taking place in China, and some low-end, export-oriented manufacturing activities have been shifting from coastal China to low income countries in South-East Asia and also Africa" (United Nations Conference on Trade and Development, 2011, p. 50). However, the Southeast Asian countries do not have enough population to absorb a significant portion of the labor-intensive industry relocating from China once the process starts in earnest. South Asia, because of its large population, should be the main recipient of this industry and Pakistan should aim to be the leader in this regard.

This is a window of opportunity for Pakistan, which has a large textile sector as well as strong clusters in sports goods, surgical instruments, and light engineering. It therefore needs to develop a strategy to attract Chinese investment in these areas. Thus far, Pakistan's approach has been the traditional one, i.e., trying to attract investment

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from China in import-substituting industry by providing incentives, including special industrial zones, and corporate income tax and import duty concessions for the manufacture of consumer durables, such as televisions, refrigerators, air conditioners, washing machines, etc. This strategy has failed in the past and it is unlikely to do much better this time since it will only attract investment for assembly plants producing for the domestic market.

Pakistan's strategy should aim to attract Chinese investment into export industries, particularly those labor-intensive industries that are likely to be relocating out of China in the next 10 years and that are also Pakistan's strengths, such as garments, textiles, leather and footwear, surgical goods, cutlery, and sports goods. The strategy needs to be developed in partnership with larger exporters and the representatives of export associations in these industries. Once such a strategy is developed, the government should leverage its long-standing relationship with the Chinese government to garner the latter's support in implementing the key elements of the strategy.

In addition, Pakistan should seize the opportunity provided by China's drive to accelerate development in its western provinces. The Karakoram Highway provides the shortest overland route to the sea for these provinces, and China has indicated an interest in upgrading the highway to handle heavy traffic. If Pakistan were to prioritize this project and control the movement of Islamic militants crossing over into China, the resulting transit trade through Pakistan could provide a tremendous boost to economic activity. It would attract Chinese investment into the northern regions of Pakistan and create opportunities for the export of Pakistani products to western China.

Any discussion on Pakistan's economic relations with China would be incomplete without at least a brief look at the import side. Pakistan's imports from China have grown dramatically from about USD 0.6 billion in 2000 to USD 6.5 billion in 2011. China's share in Pakistan's total imports has increased from less than 5 percent to over 15 percent during this period. This is not surprising since China's exports to the rest of the world have also grown rapidly, but because of Pakistan's security dependence on China, the government tends to turn a blind eye to violations on imports from the latter. This has provided an opportunity for collusion between unscrupulous Pakistani importers and Chinese exporters to misclassify imports from China and understate their value to evade import duties and taxes. As a result, the actual increase in imports has been even greater than that indicated by official figures.

Although there is no way to estimate the full extent of tax evasion, one can get a rough idea of the undervaluation by comparing the value of “imports from China” reported by Pakistan and “exports to Pakistan” reported by China in the UN comtrade dataset. Exports reported by China exceeded imports reported by Pakistan by 30 percent in 2011 (Table 14.5). The underreporting is probably even greater since exports are reported on a free-on-board (f.o.b.) basis and imports on a cost-insurance-and-freight (c.i.f.) basis, and the cost of “insurance and freight” is generally between 10 and 20 percent of the import value (see World Bank, n.d.). Even with a conservative 10 percent adjustment for insurance and freight, the underreporting comes to 43 percent. Thus, actual imports from China in 2011 were in the range of USD 8.5 billion to 9.5 billion.

The problem is not only the loss in government revenue, but also the impact of this “unfair” competition on domestic industry. The rapid growth in imports from China has decimated a number of industries in Pakistan; generally, these have been industries that were dominated by small to medium firms producing for the local market. This was not because the imported products were of better quality—based on anecdotal evidence and personal experience, they are in many cases of very poor quality and often imitations of established local brands—but because they were extremely cheap due to the evasion of taxes and import duties. Small local producers were unable to compete with these products because the effective tariff (including sales tax) on the final product imported from China is, in many cases, substantially lower than the effective tariff on the raw materials used by small manufacturers in Pakistan. Small producers have to buy raw materials from commercial importers, who have to pay the statutory rates of duties and a 16 percent sales tax on the duty-paid value of imports because they are not eligible for the concessions that large manufacturers enjoy under Pakistan’s notorious Statutory Regulatory Order regime (Pursell, Khan, & Gulzar, 2011).

**Table 14.5: Pakistan–China trade: Value understatement (USD million)**

Reporting country	2000	2003	2005	2007	2011
Imports reported by Pakistan	550.1	957.3	2,349.4	4,164.2	6,470.6
Exports reported by China	670.3	1,855.0	3,427.7	5,831.4	8,439.7

*Source:* United Nations Statistics Division, UN comtrade.

However, the impact of Chinese imports has not been all negative. There has been a huge consumer gain in industries where Pakistan did not have any local manufacturing, such as mobile phones. Pakistan would have never achieved the tele-density that it has, if only “full” duty-paid and sales

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tax-paid phones were available in the market. In the motorcycle industry, which was highly protected and had an oligopolistic structure, Chinese imports have led to huge producer and consumer gains. The opening up of the motorcycle industry by removing entry restrictions on the assembly of motorcycles and allowing the import of parts and components from China in 2006 resulted in a dramatic growth spurt in the industry. The domestic production of motorcycles rose from less than 600,000 in 2004/05 to over 1.6 million in 2010/11 (Association of Pakistan Motorcycle Assemblers, 2010). One of the reasons for the large increase in size of the domestic market for motorcycles was probably the decline in their price in real terms (by about 40 percent) between 2006 and 2012.<sup>3</sup>

Thus, a sensibly designed and implemented trade policy—for example, one that eliminates the distinction between commercial and industrial importers of raw materials and components—would not only mitigate the negative impact of imports on the local industry, but also dramatically improve its prospects. Clearly, the automobile industry in Pakistan is a prime candidate for “motorcycle industry-type” opening up to imports from China and India.

#### **4. United Arab Emirates**

The UAE is Pakistan's closest neighbor by sea (after Oman)—the distance from Karachi to Dubai is almost the same as from Karachi to Islamabad. Estimated to have 8.5 percent of the world's oil reserves and the fifth largest gas reserves, the UAE's economy and exports are obviously dominated by the oil and gas sector. However, around one third of its total merchandise exports are re-exports (World Trade Organization [WTO], 2012), which means that it is also an important trading hub and packaging and distribution center. In 2010, the UAE's total nonoil exports (including re-exports) were USD 126.4 billion, of which India had the highest share (33.7 percent), while Pakistan, with a 2.5 percent share, ranked among the top ten. As for the UAE's imports, the top two countries for nonoil commodity imports are India and China with 17.1 and 10.3 percent, respectively (WTO, 2012), while Pakistan's share is about 1 percent (United Nations Statistics Division, n.d.).

The UAE is an important economic partner for Pakistan, and there are many dimensions to the relationship. For example, there are over half

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<sup>3</sup> The price of a Honda 70 cc motorcycle, the most popular make and size in Pakistan, increased from PKR 54,000 in 2006 (“Motorcycles sales stagnating,” 2007, April 4) to PKR 67,000 in 2012 (Qeemat Prices in Pakistan, 2011), i.e., by less than 25 percent, while the overall price level more than doubled (the consumer price index increased from 132 in 2005/06 to 269 in 2011/12).

a million Pakistanis resident in the UAE, who officially remitted USD 2.6 billion to Pakistan in 2010/11. Most large international banks have regional offices in the UAE with many Pakistani professionals on their staff, including in senior management positions. Most Pakistanis traveling overseas pass through the UAE—there are more than 100 flights a week from Pakistan to the UAE, more than to any other country in the world or between any two destinations in Pakistan. During the civil disturbances in Karachi in the 1990s, many Pakistani business families set up operations in UAE and it became a major destination for Pakistani investors, particularly for real estate. Dubai is an offshore base for many Pakistani businesses that maintain a presence there to meet with foreign buyers, suppliers, investors, and bankers, who for reasons of security or inconvenience are reluctant to travel to Pakistan. Until recently, a substantial part of the India–Pakistan trade was routed through the UAE to circumvent the trade restrictions imposed by the two countries. Finally, the UAE is Pakistan’s fourth largest export market, with a share of 6.3 percent of total exports in 2011.

Having so many linkages also has its pitfalls, since it makes the UAE a convenient base for avoiding or exploiting the Pakistan government’s economic regulations. The UAE is the most commonly used channel for capital flight or for taking advantage of arbitrage possibilities created by government policies. For example, when Pakistan has provided product-specific export incentives in the past—such as tax rebates, duty drawbacks, and subsidized credit—Pakistani businesses have mislabeled or overvalued exports to the UAE in order to make windfall gains at the state’s expense. This is evident from the large gap between “exports to UAE” as reported by Pakistan and “imports from Pakistan” as reported by the UAE in the UN comtrade dataset. Between 2003 and 2007, for instance, the former were two to three times the value of the latter (United Nations Statistics Division, n.d.).

It is also the likely explanation for the large year-to-year fluctuations in the value of exports of individual products (in the Pakistan data), since the duty drawbacks on individual items were regularly adjusted (often in response to stories in the press of the misuse of these incentives by exporters). For example, in 2003, “fabrics from man-made fibers” and “household linen” accounted for 12.8 and 16.2 percent, respectively, of Pakistan’s total exports to the UAE (as reported by Pakistan), but these fell to only 2.9 and 6.7 percent in 2005, in which year clothing exports accounted for 16.3 percent of the total. Clothing exports came down to 6.4

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percent in 2007.<sup>4</sup> As the government phased out various export incentives after 2007 because of fiscal difficulties, the gap between the numbers reported by Pakistan and the UAE also started to decline and had virtually disappeared by 2009.<sup>5</sup>

This creates a problem in analyzing trends in exports to the UAE. To circumvent this, at least at the aggregate level, we use the value of “imports from Pakistan” for Pakistan’s exports to the UAE as reported by the UAE instead of “exports to UAE” as reported by Pakistan. We see that exports so measured increased by almost six times between 2000 and 2010, and growth accelerated after 2005 (Table 14.6).<sup>6</sup> Thus, in the last decade, exports to the UAE grew at an annual average rate of 18 percent, which resulted in the its share of Pakistan’s exports increasing from 3.3 percent in 2000 to 8.3 percent in 2010.

**Table 14.6: Pakistan’s export trend to UAE (USD million)**

Reporting country	2000	2003	2005	2007	2009	2010
Exports reported by Pakistan*	516.9	1,010.2	1,012.9	1,503.6	1,340.6	1,497.4
Imports reported by UAE*	304.5	419.3	520.4	778.7	1,569.7	1,782.9

*Note:* \* = excluding petroleum exports.

*Source:* United Nations Statistics Division, UN comtrade.

This rapid export growth has taken place without any focused effort by the government. However, if Pakistan were to implement a strategy of leveraging the existing advantages—proximity, outstanding connectivity, its extensive banking presence in the UAE, a large Pakistani diaspora as well as those from other South Asian countries with similar cultures and taste, and excellent political relations—to promote exports, it could significantly increase exports further, not only to the UAE but to the entire region. The UAE is potentially a huge market for Pakistani consumer products, such as packaged foods, clothing, furniture, and furnishings, and for entertainment content such as music and television serials. It could also become a showcase for Pakistani products for export to the rest of the world.

<sup>4</sup> Calculated by the authors using data from the UN comtrade dataset (United Nations Statistics Division, n.d.).

<sup>5</sup> Keeping in mind the point made earlier that exports are reported on an f.o.b. basis and imports on a c.i.f. basis, it seems that exports are still being overstated by about 10–20 percent.

<sup>6</sup> Interestingly, “exports to UAE” as reported by Pakistan, show an opposite trend, i.e., phenomenal growth between 2005 and 2007 and then a collapse.

Some of this may already be happening, but a focused approach by the government to promote the UAE as Pakistan's offshore hub could make a qualitative difference. This may involve establishing a trade and investment liaison office in Dubai, which has high-level representation of all the relevant government ministries and agencies—including the Ministry of Finance, Board of Investment, and Trade Development Authority of Pakistan—and setting up a Pakistan expo-center. The latter should be run as a public-private partnership between the government and major exporters/export associations. It should have, in addition to exhibition halls, common facilities such as office space and business services for exporters' use to reduce their cost of interacting with international buyers (earlier suggested in Ahmad, Mahmud, Hamid, & Rahim, 2010, pp. 43–44). In brief, the strategy's goal should be to make it possible for the UAE to play a role similar for Pakistan as Hong Kong did for China in the 1990s.<sup>7</sup>

## **5. Afghanistan**

Historically, Afghanistan has been a major trading partner of Pakistan, though in the past most of this trade was undocumented. Following the Soviet invasion of Afghanistan in 1979, and the subsequent period of civil war, formal trade between Pakistan and Afghanistan ceased but informal trade between the two countries probably remained substantial. However, since the end of the Taliban regime in 2001 and resumption of normal trade relations, documented trade between the two countries has expanded rapidly. Between 2002 and 2011, there was an eleven-fold increase in Pakistan's exports to Afghanistan, and by 2011 Afghanistan was Pakistan's second largest export market, accounting for 10.5 percent of the latter's total exports.

Afghanistan is not only an important export market for Pakistan, it has also been instrumental in the development of a number of nontraditional exports that have long-term export potential. For example, in 2011, Afghanistan accounted for 33 to 59 percent of Pakistan's total exports of vegetables and fruit, petroleum products, cement, and metal manufactures and 17 percent of its exports of machinery and transport equipment (Table 14.7). These are the documented exports—since informal trade between the two countries was also substantial, Pakistan's exports of nontraditional products to Afghanistan were probably larger and even more diverse. The development of such exports to Afghanistan is important. It is always difficult for a country to develop new export

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<sup>7</sup> This point was first made by Ashwani Saith in his comments on this paper at the Lahore School's Conference on Management of the Pakistan Economy (May 2012).

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products, but once the export capacity, production experience, and domestic supply chains are developed for a particular product, it becomes much easier to export that product to other markets. Therefore, the export of these products to Afghanistan is likely to promote their future export to other countries.

**Table 14.7: Structure of Pakistan's exports to Afghanistan, 2011**

No.	Commodity	Value (USD million)	% Share
1	Rice	165.0	8.0
2	Vegetables and fruit	297.7	47.5
3	Petroleum and petroleum products	773.5	59.1
4	Lime, cement, and construction materials	246.9	51.7
5	Metal manufactures	72.2	32.7
6	Machinery and transport equipment	74.9	16.8
	Subtotal	1,630.2	
	<b>Total exports to Afghanistan</b>	<b>2,660.3</b>	

Note: \* = as a percentage of Pakistan's total exports of the commodity to the world.  
Source: United Nations Statistics Division, UN comtrade.

While it is evident that Afghanistan contributed significantly to Pakistan's export growth in the last decade—accounting for almost 16 percent of the entire increase in exports during this period—it could potentially have an even greater impact in the next decade or so. No doubt, there is some uncertainty about future political developments in Afghanistan, but Pakistan is in a position to create a win-win outcome for both countries. However, this will require Pakistan to switch from looking at Afghanistan through the security lens to an economic one. If Pakistan's decision makers are able to change this mindset, it would greatly improve the prospects of peace. It would also make it possible to invest in appropriate infrastructure, such as roads and truck-ports at the border, which could have a substantial additional impact on trade with Afghanistan.

An increase in Afghanistan–Pakistan trade will promote prosperity in the border regions and beyond, which should help break the cycle of militancy and violence in the region. This, in turn, would make it easier for Pakistani banks and businesses to establish a physical presence in Afghanistan and expand exports of Pakistani products, such as food,

textiles and clothing, tractors and transport equipment (motorcycles, rickshaws, etc.), electrical machinery (fans, washing machines, electric motors, etc.), and simple industrial and agricultural machinery (lathes, diesel motors and pumps, grain threshers, etc.). Pakistan should focus on establishing its economic presence in Afghanistan rather than worrying about other countries capturing its markets. Cultural and ethnic linkages are continually demonstrated to be far more powerful drivers of trade than political affiliations; it is therefore likely that products and businesses from Pakistan, particularly from Khyber Pakhtunkhwa, would have an edge over those from most other countries.

As Nabi (2012) explains, the areas that now constitute Pakistan were historically important transit hubs for trade routes between Central Asia and Persia on one side and China and India on the other. Peshawar was a great trading city at the time, and it has the potential of once again emerging as a key transit hub for trade in the region. Afghanistan, neighbored by Iran to the west and by Turkmenistan, Uzbekistan, and Tajikistan to the north, is Pakistan's bridge to Central Asia. It is a member of SAARC and ECO and, given its increasing emphasis on regional trade, is undertaking what is termed the "New Silk Road" trade project—a major element of which is the development of infrastructure in the country to facilitate overland trade. The Afghanistan–Tajikistan Bridge, which was completed in 2007, is an important component of the road network for trade between Afghanistan and Central Asia. Similarly, the Afghanistan–Pakistan Transit Trade Agreement, signed in 2010, aims to promote not only the smooth flow of goods between the two countries, but also to provide access to the sea for Afghanistan and ultimately for the rest of Central Asia. Therefore, peace in Afghanistan would not only boost Pakistan's trade with Afghanistan, it would also facilitate exports to Central Asia and the import of gas and power from the latter, which could go a long way toward easing Pakistan's critical energy constraint.

## **6. Central Asian Republics**

The Central Asian republics (CARs), i.e., Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, with a combined population of 61 million and GDP of USD 219 billion, are becoming an increasingly important economic region (Table 14.8). After a prolonged period of low (or negative) growth, the region has grown at an impressive rate in the last decade. Some of their main advantages have been their abundant natural resources (oil, gas, gold, etc.) and a "reasonable infrastructure and human capital as legacies of Soviet rule" (Dowling & Wignaraja, 2006, p. 10).

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**Table 14.8: Central Asia in 2011**

Country	Population <sup>a</sup> Million	GDP <sup>b</sup> USD billion	Imports <sup>b</sup> USD billion	Average growth rate 2000–11	
				GDP <sup>c</sup>	Imports <sup>c</sup>
				%	%
Kazakhstan	16	188	40	9	20
Kyrgyzstan	5	6	8	4	26
Tajikistan	7	7	4	8	21
Turkmenistan	5	28	7	14	16
Uzbekistan	29	45	10	7	16
<b>Total</b>	<b>62</b>	<b>274</b>	<b>69</b>		

Sources: a = World Bank (2012), *World dataBank*; b = United Nations Statistics Division, *UN comtrade*; c = authors' calculations using a and b.

Trade has grown rapidly with the development of the market economy and increasing incomes. In 2011, the CARs' imports were USD 69 billion, having expanded at an average rate of almost 20 percent per annum during 2000–11. Individually, all the countries exhibited an increased demand for imports, with import growth ranging from 16 to 26 percent per annum; in Kazakhstan, the largest of the CAR economies, imports increased by more than six-fold in 11 years. The importance of imports from their neighboring countries has also increased in the last decade, the share going up from 47 to 60 percent. In 2000, Russia accounted for the largest share of imports, but imports from China have grown dramatically, and in 2011 it was almost the same as Russia, accounting for more than USD 18.6 billion imports (Table 14.9). The value of imports from Turkey rose nine-fold during period, and imports from Iran also increased rapidly. However, imports from Pakistan declined—in 2011, they were almost 40 percent of that in 2000. The key factor in the decline was the disruption of Pakistan's overland trade with Central Asia because of the war in Afghanistan.

**Table 14.9: The CARs' imports from their neighbors**

Country	2000	2011
	USD million	USD million
China	767.3	18,585.2
Russia	2,810.6	19,151.5
Turkey	342.4	3,148.8
Iran	249.9	845.0
Pakistan	26.7	11.2
Afghanistan	-	10.3
Subtotal	4,196.9	41,752.0
<b>Total imports from the world</b>	<b>8,800.0</b>	<b>69,000.0</b>

*Note:* Export values from partners to CARs reported.

*Source:* United Nations Statistics Division, UN comtrade.

To assess the potential market for Pakistan, it is useful to look at what the CARs are importing from their neighbors. Imports from Russia were primarily petroleum, iron, steel, and different types of heavy machinery and mechanical apparatus. However, more relevant for Pakistan were the imports from China and Turkey. Table 14.10 summarizes the CARs' major imports from these two countries, and also presents Pakistan's world exports of these commodity groups. We can see that Pakistan actually exports significant quantities of four of the ten main items that the CARs were importing from China and Turkey in 2011. Two items of particular interest are "clothing and accessories" and "textile yarn, fabric, etc."—the CARs' two largest imports from China and also Pakistan's biggest exports to the rest of the world. Nonmetallic mineral manufactures, i.e., cement, and miscellaneous manufactured goods are also potential export items for Pakistan.

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**Table 14.10: Main exports from China and Turkey to the CARs and Pakistan's exports of these to the world, 2011 (USD million)**

No.	Commodity	China	Turkey	Pakistan's exports to world
1	Clothing and accessories	4,783.2	127.9	4,549.6
2	Textile yarn, fabric, etc.	2,673.4	209.3	9,082.1
3	Footwear	1,805.3	27.4	112.3
4	Nonmetallic mineral manufactures	581.6	91.8	518.2
5	Road vehicles	775.4	64.6	57.1
6	Special industrial machinery	835.1	113.3	92.7
7	Metal manufactures	734.4	366.0	220.4
8	Misc. manuf. goods	572.8	232.9	963.4
9	Electric machine apparatus, parts, etc.	654.2	404.6	53.6
10	Plastic, nonprimary form	173.0	159.7	36.9
	Subtotal	13,588.4	1,797.5	15,686.3
	<b>Total exports to CARs</b>	<b>18,585.2</b>	<b>3,148.8</b>	<b>25,343.8</b>

*Note:* Blank cells indicate values of less than USD 0.1 million.

*Source:* United Nations Statistics Division, UN comtrade.

Given the positive growth trajectory of the CARs and the fact that the distance from Peshawar to Tashkent (1,281 km) is even smaller than that from Peshawar to Karachi (1,382 km), Central Asia appears to offer huge economic opportunities for Pakistan, both as a market for the latter's exports and as a low-cost supplier of energy. However, without peace in Afghanistan, which is necessary for the transport of goods overland and for building gas pipelines and power lines between Central Asia and Pakistan, this potential cannot be realized.

## 7. Conclusion

Pakistan's trade with its neighbors has grown rapidly over the last 11 years; together, they constitute the largest market for Pakistani exports. These exports are not only important in terms of absolute value, they have also promoted the development of new export products such as fruit and vegetables, cement, and metal manufactures to Afghanistan; and jewelry to the UAE. Given the growth prospects of most of the neighboring governments, we can expect the potential for Pakistan's exports to continue to expand. It is up to Pakistan to adopt appropriate policies to take advantage of this potential.

This will require a change in policymakers' perspectives, who need to adopt an "economy first" approach. Such a change, together with a strategy to focus in each country on a few areas that are likely to provide the greatest immediate benefits, could significantly accelerate exports. This may, in turn, be a driver of sustained growth for the next decade or more. Policies with respect to China include gaining market access for Pakistan's exports and attracting Chinese investment to the export industries. The UAE should be developed as an offshore center for facilitating exports and investment inflows. Trade with Afghanistan and Central Asia will require a change in mindset to give priority to economic issues, measures to end the conflict in Afghanistan, and building the necessary infrastructure for overland trade and energy imports.

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## A Growth Vent Anchored in History and Geography

Ijaz Nabi\*

### 1. Introduction

In explaining economic growth, economists invariably turn to analytical frameworks such as the Harrod-Domar growth model and its many extensions (e.g., Solow, 1956). The main drivers of growth in such models are capital, labor, and more recently, knowledge (Romer, 1990). These models are useful in that they allow us to separate out growth arising from an increase in capital and labor, from productivity-led growth associated with the quality of overall economic management. This separation is useful because it brings into focus the efficient use of available resources rather than an insatiable quest for ever-more investment.

Another approach is to look at episodes of rapid and sustained economic growth and identify the “big ideas” (vents for growth) that have made them happen. These ideas stimulate, borrowing from Keynes, the “animal spirits” and result in both higher investment as well as higher productivity growth. The discussion presented in this chapter takes this approach, arguing that Pakistan has enjoyed several episodes of rapid economic growth since 1947 that are associated with changes in technology, institutions, and legal systems that support the rolling out of a

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big idea (growth vent). Those growth vents have run their course. Pakistan now has to seek a growth vent that results in geographically balanced growth and can thus be sustained politically for a prolonged period.

This requires tapping into lucrative markets outside the borders in the neighborhood in a manner that creates several growth nodes, namely Karachi, the Arabian Sea coastline of Sindh and Balochistan, Lahore, and Peshawar. This chapter reviews Pakistan's recent growth vents and their impact on the economy in terms of creating a vibrant Indus Basin market. It then argues that the new growth vent Pakistan seeks requires recreating historical trade routes. This will be good for regional equity in Pakistan and will also give new energy to the Indus Basin market.

The discussion owes a debt to Sibte Hassan's *Pakistan main tehzeeb ka irtiqa* [The evolution of culture in Pakistan] (1974) and to Aitzaz Ahsan's *The Indus saga and the making of Pakistan* (1996) for stimulating the ideas extended in the chapter's economic framework, which emphasizes Pakistan's role as a regional hub of economic activity and thus as a bridge between Iran, Central Asia, China, and India.

## **2. Pakistan's Major Growth Episodes**

There have been five major growth episodes in the region that constitutes Pakistan in the last 100 years. These are described below.

### **Canal Irrigation**

Starting in the 1860s, the Indian Subcontinent saw a remarkable expansion of the irrigation system. For 60 years, the average annual increase in the area under canal irrigation was a phenomenal 50,000 acres (Stone, 1984, p. 340). Punjab, Sindh, and parts of Khyber Pakhtunkhwa benefited substantially from this phase of canal expansion in British India.

Canals were preferred over previous modes of irrigation, not only because of the lower unit costs but also because they extended the range of cropping options for farmers, who could then water crops at their own discretion. These benefits resulted in both intensive and extensive land cultivation, thereby increasing production and, hence, the rate of return to agriculture. Several complementary developments—a legal framework governing land-related transactions, a network of roads and railways, and public services such as education, health, and policing—kick-started economic growth in the regions constituting the Indus Basin market and brought about a substantial increase in income and living standards for nearly 100 years.

### **The Korean War and Import-Substituting Industrialization**

The second major growth vent is associated with the Korean War. Pakistan's economic managers made a strategic decision in 1949 not to devalue the rupee with respect to the US dollar when Britain devalued the pound and India (the rupee was linked to the British pound) followed suit. Pakistan's rationale was that capital goods had to be imported in order to industrialize and that, therefore, the rupee had to be strong.

The world events that followed supported Pakistan's decision. The Korean War, which broke out soon after the Second World War, led to stockpiling because of the fear of shortages of critical raw material. The jute and cotton produced by Pakistan benefited from the resulting price increase (in four months, the price of 289F Punjab cotton rose by 80.3 percent from PRs 81/maund to PRs 146/maund). This strengthened the rupee and resulted in the accumulation of reserves. India, a major importer of Pakistani cotton and jute, had countered Pakistan's decision not to devalue the rupee by banning imports from Pakistan. This gave Pakistan the opportunity to diversify exports to nontraditional markets and look to foreign trade as a source of sustained economic growth. The fiscal account also became favorable as government revenue increased on account of the export duties imposed, contributing an additional 2 percent of gross national product (GNP) (Hasan, 1998, p. 113).

By not devaluing the rupee, the government kept the cost of imported capital goods low. This was accompanied by import controls, especially on consumer goods, that slanted the incentive regime in favor of industrial production (Zaidi, 2005, p. 93) and launched a period of import-substituting industrialization in the 1950s. The policy that Pakistan followed has been summarized as "produc(ing) anything that can be reasonably produced domestically... once production has started domestically, ban imports of competing goods so as to save foreign exchange" (Lewis, 1969, p. 70).

Import-substituting industrialization proved to be very successful, particularly in the heavily protected consumption goods industries. Textiles also expanded spectacularly. However, heavy protection exacted a price—the lack of competition resulted in less efficient production (Hasan, 1998, p. 116). The strategy also led to a high concentration of wealth, both regional and interpersonal. At the time, 22 families allegedly controlled 80 percent of the country's assets. Manufacturing was concentrated primarily in Lahore, Karachi, and Faisalabad, which together accounted for 60 percent of the total value-added in 1959/60. This disparity persisted for a decade and contributed to the dissatisfaction that eventually resulted in East Pakistan separating from the federation.

### **The Green Revolution**

Ayub Khan's government began to focus on agriculture in the 1960s, which had stagnated as policy, energy, and incentives (especially via the exchange rate) were directed to implementing import-substituting industrialization. During the first half of the 1960s, there was massive investment in irrigation: link canals were dug, the Mangla dam was constructed, and the number of tube-wells increased from a few hundred in 1960 to 75,000 by 1968 and a massive 156,000 by 1975 (Zaidi, 2005, p. 30). The well-timed availability of water was necessary to introduce a technology package of high-yield varieties of seed, fertilizers, and pesticides, initially focusing on two crops: Mexi-Pak (adapting research from Mexico to Pakistan) and IRRI rice (research based in the Philippines). Between 1960 and 1970, the Mexi-Pak and IRRI output increased by 91 and 141 percent, respectively (Zaidi, 2005, p. 29). Between 1965 and 1970, the average wheat yield rose by around 50 percent per hectare (Hamid & Tims, 1990, p. 14). The agricultural growth rate started rising in the early 1960s within the range of 3–6 percent, but after 1966, when all the agricultural inputs had been improved, growth rates jumped to 10 percent per annum.

### **Overseas Migration and Remittances**

The 1970s and 1980s were characterized by a large outflow of labor, both skilled and unskilled, from Pakistan to the Middle East. This was facilitated by a liberal labor export policy. The number of migrant workers increased from 79,000 per annum in the 1970s to 107,000 in the 1980s, and remittances jumped from USD 565 million to USD 2.3 billion per annum, respectively. The high volume of remittance income was geographically spread, benefitting even less well-off regions. At the household level, remittances improved the living standards of recipient families, propelling them to middle-class status.

The foreign exchange that workers sent home also had macroeconomic benefits, allowing a high volume of imports at a relatively stable exchange rate. However, there was a downside. Remittances fuelled consumption-led growth for nearly three decades, contributing to the loss of international competitiveness in manufacturing. This was both because of the high equilibrium exchange rate as well as the broader consumption-favoring policy environment (energy pricing, credit allocation, tax regime, public investment in transport, etc.; see Nabi, 2010). This manifestation of the “Dutch disease” in Pakistan contributed to the anemic growth of manufacturing and the paucity of high-productivity, high-wage jobs.

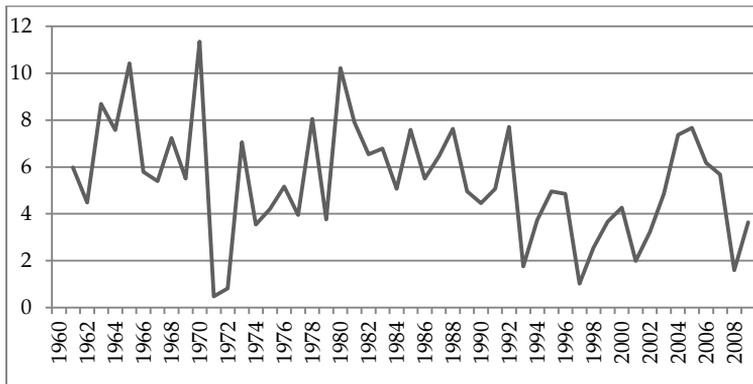
### The “War Against Terror”

A major growth spurt occurred under Musharraf in 2002–07. For its role in the war against terror, Pakistan was rewarded in terms of concessionary capital from international financial institutions. A substantial portion of the country’s external debt was written off and rescheduled, and foreign direct investment increased. Remittances, which had fallen sharply in the preceding years, shot up again as confidence in the rupee was restored. This resulted in a substantial improvement in Pakistan’s balance of payment, which recorded a surplus of USD 2.7 billion in the early 2000s (Mullick, 2004). GDP growth, which had been at 3.1 percent in 2001/02, began to rise, reaching 6.8 percent by 2006/07. From a deficit of 0.3 percent of GDP in 2000, the current account balance improved to a surplus of 4.9 percent of GDP by 2003.

However, the end years of this growth phase (2006–08) coincided with rising inflation and energy shortfalls. The share of investment and manufacturing in GDP and employment did not show any increase, growth in imports far exceeded that of exports, and the tax-to-GDP ratio stagnated. Growth and its salutary effects were, therefore, short lived.

Figure 15.1 shows an oscillating growth pattern—the boom-and-bust cycles of Pakistan’s growth. There appear to be ten-year cycles. The 1960s and 1980s (with growth in most years above 6 percent) were decades of robust growth, while the 1970s and 1990s (with an average growth rate of around 4 percent) saw modest growth. The 2000s experienced high growth in 2001–07, followed by a slump starting in 2008.

Figure 15.1: Annual GDP growth (%)



Source: World Bank, World development indicators, 2010.

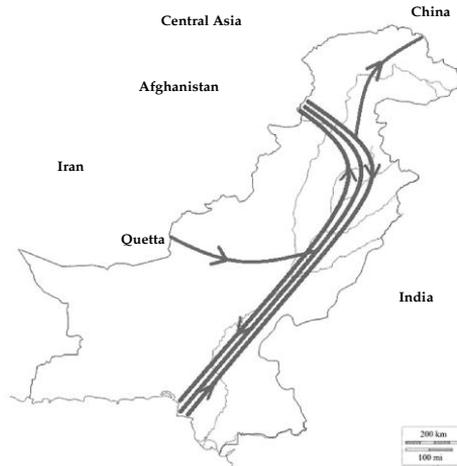
Assessing these growth vents in terms of their effect on regionally balanced growth, the canal colonies would rank first, followed by the Green Revolution. Protection and industrialization would be a distant third, both because they could not be sustained and because they resulted in unbalanced growth. Migration to the Gulf is fourth, simply because the primary stimulus comes from outside and Pakistan has not yet found a way of climbing up the skills ladder; the growth vent is thus vulnerable. The externally financed, geopolitically driven growth spurts under Zia and Musharraf fail the sustainability criteria; the latter was, geographically, decidedly unbalanced, and also increased inequality across income groups.

Another way to look at the growth of the last six decades is in terms of the creation, perhaps for the first time in history, of an integrated Indus Basin market. A strong and interdependent market for products, labor, and financial flows has been created between the Indian border to the east and the Indus River to the west (Figure 15.2). Pakistan's economic managers wisely invested in a communications infrastructure spanning railways, ports, roads, a postal system, and telephones, which has been key to the development of the Indus Basin market. Spokes in the southwest extend the market to Quetta in Balochistan and in the northeast to the regions of the Karakorams and the Hindu Kush. The market enjoys perhaps the best connectivity of any subregion in South Asia. The National Trade Corridor (NTC) links Peshawar, through Lahore to Karachi and Port Qasim, and "handles the major part of Pakistan's external and internal trade" (World Bank, 2006, p. 8). The World Bank also points out that

the bulk of Pakistan's international trade, about 40 million tons per annum... is transported by road along this main corridor. Almost all of this trade (95 percent) is handled by the two seaports of Karachi and Port Qasim, located about 50 km from each other. Pakistan's trade is characterized by a concentration of movements within the country (mainly along the NTC), a small number of export destinations and import origins (2006, p. 17).

This connectivity has, therefore, facilitated Pakistan's growth spurts and the sharing of welfare from that growth across a wide region.

**Figure 15.2: Pakistan's Indus Basin market along the north-south trade corridor**



### 3. Searching for a New Growth Vent

While the growth episodes helped create a vibrant Indus Basin market and resulted in robust growth for several decades, the north-south focus also turned Pakistan into a lopsided economy. Despite a relatively small coastline compared to the country's land borders with three major economies (Iran, China, and India) and one important region (Central Asia), Pakistan's economic connectivity with an increasingly globalizing world is via one port city, Karachi, that constitutes a mega-growth node. Although this strategy worked well for 60 years, given the congestion of Karachi's ports and the city's complex and volatile politics, it may now have run its course.

This chapter argues that a new growth vent, one that will yield a prolonged period of growth as the canal colonies did 100 years ago, requires tapping into external lucrative markets in a manner that will create multiple entre-ports for growth (such as Lahore, Peshawar, and other ports on the Sindh/Balochistan coastline). Such a growth vent will enable the country to achieve a sustained growth path that is not as susceptible to the political vicissitudes of one mega-growth node.

### **3.1. A Historical Perspective**

Pakistan's border regions have shared systems of economic transactions and cultural ties with neighboring regions that lie outside its current political borders. The area that is now Pakistan was home to one of the world's earliest civilizations. For centuries, this region held a central position in relation to the rest of the world, a place where different societies mingled, culturally and economically. Cities such as Lahore, Multan, and Peshawar, and those in upper Sindh lay on trade routes connecting lands to their west—Iran, Central Asia, and China—and those to the east—India. They became centers of trade, commerce, and culture and brought prosperity to the regions they commanded (see Figures 15.3 and 15.4).

Lahore in Punjab was the center of trade, commerce, finance, and education for a region that included Indian Punjab, Haryana, the Jammu and Kashmir valleys, and Himachal Pradesh to its east, and linked these regions with Persia and Central Asia to its west. However, Lahore was cut off from the lands to its west with the coming of the British and from those to the east soon after 1947 as a result of India–Pakistan feuds.

The ancient walled city of Peshawar has cast a large shadow on South Asian culture. A number of famous Indian actors (the Kapurs, Dilip Kumar, and Shahrukh Khan) hail from Peshawar as do several world squash champions. The city's prominence stems from its history—its merchants constituted a prosperous hub of economic transactions between South Asia and the Central Asian territories. The influence of trade on the surrounding Pashtun areas could also have been substantial had imperial rivalry between Russia and Britain not cut off Peshawar from its northern markets and had 1947 not severed access to the Indian market. Subsequently, the pool of economic transactions for Peshawar shrank dramatically. It is also noteworthy that the modern "Silk Route" through Hazara and Gilgit–Baltistan on the Chinese border is an attempt to recreate the ancient trade links that were severed during colonial times.

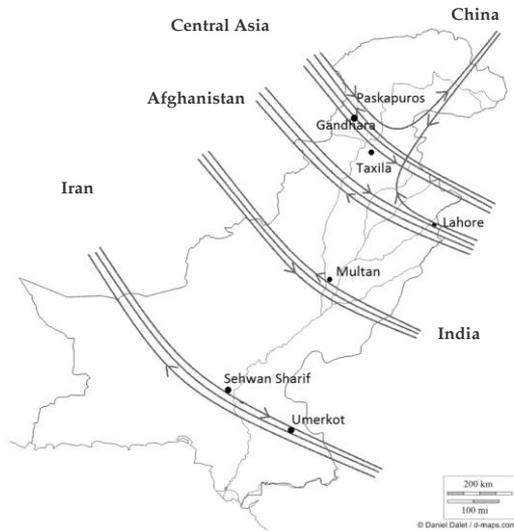
Sindh has been hugely significant in shaping Pakistan's religious/cultural psyche, which is historically embedded in the venerated Sufi tradition of Islam. The Sufi saints chose to settle in Sindh along the Indus because there were receptive host communities that benefited from the trade routes between markets in territories that now lie in India and Iran through Balochistan.

**Figure 15.3: The cultural influences that have shaped Pakistan**

Back to the Future



**Figure 15.4: ... and the East–West trade routes they spawned**



Historically, these cultural centers have defined themselves as parts of much larger regions that lie outside the borders of the modern nation-state of Pakistan. Indeed, they were better connected with trade and cultural centers outside modern Pakistan than those that lie within it. This has posed a challenge for the country's nation builders. Hemmed in by colonial borders on one hand and hopelessly bad relations with India on the other, Pakistan's policymakers have attempted to reshape the country's economic geography. Departing from historical patterns that emerged over centuries, they created the north-south corridor defined by new borders, which, as discussed earlier, facilitated the major growth vents of the last six decades.

### **3.2. *The Changing World Around Pakistan's Land Borders***

As recently as the 1980s, it did not matter that the old east-west trade routes lay abandoned. China was in a long slumber and performing far below its capabilities as a potential economic giant. Western China, in particular, was mired in low growth and, for Pakistan, that was the more relevant region. Central Asia's mineral wealth was being exploited in Russian interests. India, with its low "Hindu" growth rate, was shackled to a heavy-handed and stifling regulatory framework born of Fabian aspirations and a decaying colonial bureaucratic heritage. In the last 30 years, however, all this has changed.

Under Deng Xiao Peng, China arose from its slumber in the early 1980s and has since become an economic powerhouse with growth rates of 10 percent per annum for over two decades. It is undergoing major restructuring to deepen growth beyond the Pacific coast to western China, which will bring it to Pakistan's northern land border. The rising Chinese middle class constitutes a huge consumer market for Pakistani products. China's high savings could be a deep pool of investment for Pakistan. An economy of over a billion people with the potential to grow at 10 percent for several more decades beckons from across Pakistan's northern border.

India followed China a decade later, with the reforms of Prime Minister Narasimha Rao. Its cumbersome regulatory framework was dismantled and its spectacular growth in the information technology sector gave India a "techie" shine that has attracted world attention. The country is on an impressive growth trajectory of 7-8 percent growth per annum and is now recognized as a major emerging economic power. In short, another economy of over a billion people, high savings, and rising living standards lies beyond Pakistan's long eastern land border.

Across the northwestern border, beyond troubled Afghanistan and our own volatile tribal belt, are the newly independent Central Asian

republics—Turkmenistan, Uzbekistan, Kazakhstan, Kyrgyzstan, and Tajikistan. Rich in natural resources that are no longer being siphoned off by the Soviet behemoth, the Central Asian republics are engaging with the world to exchange their mineral wealth for goods and services that satisfy the growing consumption and rising living standards of their citizens.

Finally, beyond Pakistan's western border lies Iran, rich in oil and natural gas that it would be free to sell to needy South Asia in exchange for skilled labor and consumption goods once its strategic interests are allied with its citizens' welfare.

#### **4. What is Needed?**

The east-west economic routes—which go beyond trade in goods and include energy flows, the movement of workers, and investment flows—and the growth vent associated with them will not be realized till there is peace in Afghanistan, Pakistan's tribal belt straddling the Afghan border is stabilized, and Balochistan effectively re-engages with the federation. Furthermore, without normalizing trade with India, the Indus Basin will remain a T-junction rather than a crossroads of economic transactions, which will circumscribe the welfare gains from the new growth vent.

##### **4.1. *Stabilizing the Durand Line***

To contribute to peace in Afghanistan, the concept of strategic depth needs to be revisited and cast in terms of deepening economic transactions. Residents on both sides of the Durand Line well understand the welfare gains to be garnered via economic synergies between Peshawar and Jalalabad on one hand and Kandahar and Quetta on the other. Pakistan's light engineering sector can service the rich agricultural lands in Afghanistan and, in turn, become a market for Afghanistan's cash crops, demand for which could extend to all of South Asia. Pakistan's financial sector and flourishing private school networks could provide key services and assist Afghanistan in building its own systems. The extension of roads beyond the Durand Line and trade-facilitating infrastructure on the border would be a precursor to trade in Afghanistan's substantial mineral wealth.

Throughout history, Pakistan's land-poor tribal belt has looked to out-migration for sustenance. Canal irrigation in the Peshawar valley and the plains of Mardan was a major growth vent in the past. Many tribespeople settled on the lands and brought about lasting productivity, improvement, and prosperity. During Pakistan's import-substituting industrialization phase, Karachi became a magnet for jobs and entrepreneurial activity, attracting a large number of tribespeople. As a

result, it is today the largest Pathan-populated city where people with strong connections with the tribal belt dominate the transport sector and its networks throughout the Indus Basin market.

As trend economic growth declined in Pakistan and job creation slowed down, people from the tribal belt found opportunities abroad, especially in Saudi Arabia and the oil-rich Gulf states. With the decline in economic dependence on Pakistan, the tribal belt's relationship with the federation weakened, contributing to the ongoing militancy. The relationship of mutual dependence between the federation and tribal belt needs to be restored. This will require higher economic growth in Pakistan, ensuring that the tribal belt benefits from regional trade via the transport networks, and upgrading skills in the area to allow its citizens to secure higher-wage employment in the Middle East.

#### ***4.2. The Centrality of Balochistan***

Balochistan is central to Pakistan's prospect of becoming a regional hub for trade in goods and energy. The province's strategic location makes it pivotal both for the east-west and north-south trade routes. The historical trade route linking markets in Indian Gujrat, upper Sindh, and Iran traverses Balochistan, as does the trade route to Kandahar in Afghanistan and beyond to Central Asia. Thus, establishing peace in Balochistan and upgrading its infrastructure and transport networks along the east-west routes must become a priority both for the province's development as well as for Pakistan's own overall economic growth.

Balochistan also offers exciting prospects with considerable economic benefits in terms of a second north-south trade corridor. These arise from the province's 800-kilometer-long Makran coastline on the Arabian Sea and Indian Ocean. According to some estimates,

90 percent of inter-continental trade and two thirds of all petroleum supplies travel by sea. Globalization relies ultimately on shipping containers, and the India Ocean accounts for one half of all the world's container traffic. Moreover, the Indian Ocean rim land from the Middle East to the Pacific accounts for 70 percent of the traffic of petroleum products for the entire world. Indian Ocean tanker routes between the Persian Gulf and South and East Asia are becoming clogged, as hundreds of millions of Indians and Chinese join the global middle class, necessitating vast consumption of oil (Kaplan, 2011).

Kaplan goes on to write: “If there are great place names of the past—Carthage, Thebes, Troy, Samarkand, Angkor Wat—and of the present Dubai, Singapore, Tehran, Beijing, Washington—then Gwadar might qualify as a great place name of the future.”

Raman (2009) muses:

So imagine now a bustling deepwater port with refueling and docking facilities at the extreme southwestern tip of Pakistan, more a part of the Middle East than of the Indian Subcontinent, equipped with highway and oil and natural gas pipelines that extend northeast all the way through Pakistan—cutting through some of the highest mountains in the world, the Karakorams—into China itself, from where more roads and pipelines connect the flow of consumer goods and hydrocarbons to China’s middle class fleshpots farther east.

Wirsing (2008) points out that “the pipelines would also be used to develop China’s restive, Muslim far west; indeed, Gwadar looked poised to cement Pakistani and Chinese strategic interests.” Kaplan (2011) expands on this, saying:

Meanwhile, another branch of this road and pipeline network would go from Gwadar north through a future stabilized Afghanistan, and onto Iran and Central Asia. In fact, Gwadar’s pipeline network would lead into a network extending from the Pacific Ocean westward to the Caspian Sea. In this way, Gwadar becomes a pulsing hub of a new silk route, both land and maritime: a mega-project and gateway to landlocked, hydrocarbon-rich Central Asia—an exotic twenty-first century place name.

Thus, both Islamabad and Quetta have much to gain from a joint strategy of economic growth based on regional trade. This requires strengthening the relationship of mutual dependence and trust. To that end, the 18<sup>th</sup> Amendment to the Constitution and the supporting 7<sup>th</sup> National Finance Commission (NFC) Award in 2010 was an important first step. The constitutional amendment virtually eliminates the concurrent list and transfers most of the responsibility for economic development to the provinces. To back this up financially, the NFC award has reduced the federal share of the pool of resources and substantially increased Balochistan’s share. This follows from greater weight given to underdevelopment and thin population density (which increases the cost of service delivery) in the distribution formula.

In turn, Balochistan needs to develop its capacity to utilize the additional resources more effectively. The NFC award presents opportunities to that end. National investment priorities to promote regional trade could be dovetailed with complementary Balochistan investments via the provincial annual development plan to implement a comprehensive strategy for upgrading infrastructure that supports a larger volume of regional trade.

The federation also needs to revisit the sensitive issue of natural resource pricing, given the perception that it is skimming off large rents. Natural gas is a case in point. Subsidizing natural gas for urban residential consumers, most of them in Punjab and Karachi, by keeping well-head prices far below international prices fuels resentment in Balochistan.

The land grab in Gwadar has not helped in building trust between the Baloch and the federation. As Gwadar's prospects brightened with the construction of the port, the rich and well-connected from Karachi, Lahore, and other parts of Pakistan are alleged to have bribed low-ranking local officials to allot them land at rock-bottom prices, which they then sold off to developers at much higher prices, thus skimming off huge speculative rents. The Baloch regard this as theft and cite it as an example of the unfair treatment meted out to them by the federation. Solutions such as a turnover tax on each land transaction that is deposited in a fund for the exclusive use of the Baloch in Gwadar would help allay such perceptions.

These examples show that Pakistan must explicitly incorporate regional equity into its national development strategy. The fact that Balochistan has less than 5 percent of the country's total population of 180 million but most of its mineral wealth and coastline should be enough incentive to pursue such strategies.

#### **4.3. *Engaging with India***

A number of studies (Khan, 2009; Nabi, 2012; Nabi & Nasim, 2001; Naqvi & Nabi, 2008) have estimated the salutary impact of India–Pakistan trade liberalization on Pakistan's economy, both in terms of overall trade volumes as well as on the vast majority of stakeholders. Pakistan's role as a hub of regional trade is incomplete unless the east–west (and north–south) trade routes extend to India.

Current trade flows indicate the greater vibrancy of Indus Basin economic transactions, following the re-establishment of the east–west trade corridors. Liberalizing the country's economic relationship with India takes on greater urgency if Pakistan is to enjoy the current entry-point comparative advantage in the cost of doing business, and especially the

advantage in infrastructure efficiency. This advantage will be eroded as India reduces business costs and improves its infrastructure. Had Pakistan liberalized 20 years ago, it would have enjoyed the entry-point advantage of a far better overall investment climate that has eroded over time.

India's recent (1 August 2012) liberalization of its investment regime—lifting the ban on foreign direct investment from Pakistan into India—and Pakistan's earlier announcement that it would move from positive list-based to negative list-based bilateral trade (granting India most favored nation [MFN] status) are welcome developments. However, for trade to resume on a meaningful scale, several remaining stumbling blocks need to be addressed.

The granting of MFN status to India was accompanied by the announcement of a long and unwieldy negative list of 1,200 items. Pakistan has stated that the list will be phased out in a year, and it must adhere to this timetable. In addition, a bilateral commission should be set up to address the issues that are closely tied to India and Pakistan having a normal economic relationship with sustained benefits. The commission should focus on the following areas.

1. Goods- and services-related nontariff barriers (NTBs): The objective would be to use the WTO framework to address Indian (and Pakistani) NTBs and then bring these into the strategic regional trade policy framework outlined above. The institutional capacity (National Tariff Commission) to address NTBs and antidumping complaints should be developed with a view to promoting rather than hindering trade.
2. Land routes: The maximum benefits of a more liberal trade regime with India will come from land routes that minimize response time to market forces. This will require opening up as many overland routes as possible, building on the old road and railway networks all along the border from the Kashmir region to the Arabian Sea.
3. Travel: Travel (visas, air/road/railway transport) must be facilitated to promote competitive trade in goods and services that will benefit small and medium-sized firms. This will make it possible to tap into the large pool of Indian skilled workers, gain access to Indian farm and other technology, and encourage cross-border tourism.

To create a sustained momentum for liberalizing trade and investment flows, it would be useful to set up a regional trade forum comprising the private sector, academia, and the media, to monitor the working of the bilateral commission described above. The forum should

(i) identify barriers to trade embedded in the trade policy, payment system, and communications (including travel); (ii) help identify the losers from the trade liberalization process and suggest ways of compensating them; and (iii) help formulate a broader regional trade and investment promotion strategy.

#### ***4.4. India's Role in Promoting Bilateral and Regional Trade<sup>1</sup>***

All paths to economic development and prosperity do not have to be routed through sweatshops catering to affluent Western consumers. A large and vibrant Asian regional market would constitute a significant and, given demographic shifts, growing part of global demand for products. India's long-term strategic interest is to help create that Asian market. That, in turn, requires strengthening Pakistan as an effective regional hub that would connect the Asia-wide market.

Successfully managing the new liberalized India–Pakistan trade regime to scale it up to a full-fledged economic relationship will be vital. In the short term, this may well mean exercising voluntary restraint on exports that might hurt small and medium-sized Pakistani manufacturers. It will also require focusing on the export of machinery and technology to Pakistani firms that currently import these at a high cost from more expensive developed country sources. Joint ventures and other investment strategies will need to be developed to set up production units for the Asia-wide market. The visa regime will need to be liberalized and travel facilitated so that small entrepreneurs develop cross-border business linkages and the gains from liberalization can be more widely shared.

#### ***4.5. Strengthening International Competitiveness***

Sustained welfare improvements for the citizens of a regional hub arise when it transitions from being a transportation hub for goods and energy into a manufacturing hub that creates high-productivity, high-wage jobs in multiple regional growth nodes. Such a transition requires strengthening Pakistan's international competitiveness as a manufacturing base. Key to this is a skilled workforce, modern infrastructure (ports, roads, and energy), substantially improved governance to improve service delivery, and a development framework that promotes investment and manufacturing over consumption. Several recent studies detail ongoing/proposed reforms in each of these areas.<sup>2</sup>

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<sup>1</sup> This discussion is based on Nabi (2012a).

<sup>2</sup> See Pakistan, Planning Commission (2011) and Nabi (2010), who assess education and skills, governance reform, the NTC, fiscal reform, and industrialization in this context.

These need to be distilled to draw up an agenda of reform for the medium term aimed at strengthening Pakistan's international competitiveness. This will help make the transition from a transportation hub to a manufacturing hub that can sustain high growth and create employment opportunities that improve living standards across Pakistan.

Reopening the historic east-west trade routes and connecting the energy-rich economies of Central Asia with the fast-developing economies of India and China will bring rich rewards to Pakistan as a regional trading hub. Modernizing the north-south corridor will deepen and enlarge the land mass and population base (stretching to Central Asia and western China and India) that seeks access to the Indian Ocean via multiple ports along Pakistan's Makran coast on the strategic Arabian sea. Initially, Pakistan will benefit as the transport hub facilitating this access. Strengthened international competitiveness, furthermore, has the promise of converting Pakistan from a transport hub to a manufacturing hub, thus increasing economic transactions manifold. This will bring a new vibrancy to the Indus Basin market (Figure 15.5) spurring high and regionally balanced economic growth, raising productivity and high-wage employment, and thus bringing about a sustained improvement in citizens' welfare.

**Figure 15.5: Enhanced vibrancy of the north-south (Indus Basin) trade flows after reopening the historical east-west trade routes**



## 5. Concluding Remarks

Pakistan's recent growth performance is worrisome because it is far below the trend growth rate and, given its population growth, threatens the objective of sustained welfare improvement for the country's citizens. Furthermore, this poor growth performance is in stark contrast to rising prosperity within the region. China, India, the Central Asian republics, and Iran are all doing well. A review of the major growth vents of the last 60 years shows the important role of policy in promoting economic growth. Policy, furthermore, helped create a strong and well-integrated Indus Basin market, perhaps for the first time in history, through investment in communications and a regulatory framework that allowed the market to promote a network of integrating transactions throughout the Indus Basin. The fact that countries outside the region were caught up in internal turmoil and poor economic governance also helped strengthen this market because Karachi became the principal trading hub for all regions of the country.

The present regional outlook is different. While Pakistan's growth vents have run their course, China and India, both billion-people-plus economies, are the world's new growth engines; the Central Asian republics are ready to exploit their mineral wealth for the welfare of their own citizens, and so will Iran as it begins to engage with the world.

These fast-improving regional prospects underscore the importance of Pakistan's centrality as a connector of regional markets. We have shown that this is a familiar role. Historically, three regions in Pakistan—the Peshawar valley and Hazara in the north, Lahore and Multan in the center, and upper Sindh in the south—were on the east–west trade routes that connected markets in the east (now India) with markets in the west (now the Central Asian republics and Iran). As regional trading hubs, they enjoyed cultural richness and economic prosperity and were hugely influential in shaping the South Asian identity.

The chapter argues, furthermore, that reopening the historical east–west trade routes to trade in goods and energy will give a renewed strength to the Indus Basin market by increasing the flow of economic transactions. It will also help restore the economic and cultural vibrancy of the subregions and promote more equitable growth. The new growth vent, one that will propel sustained high growth for several decades, thus entails Pakistan reoccupying its centrality a hub for regional trade. This, in turn, requires stabilizing the Durand Line and re-engaging with Balochistan in a mutually advantageous economic relationship.

Becoming a regional hub also entails normalizing economic relations with India. The transactions dynamics of a T-junction, i.e., regional trade without India, are different from those of a hub, i.e., regional trade with India included. A good beginning has been made with the resolution of India's MFN status and the liberalization of the bilateral investment regime. This should be followed up by paring down the negative list, addressing NTBs, allowing multiple trade points along the border, and most importantly, facilitating travel for business and tourism. A liberal visa regime will make small businesses stakeholders in regional trade, which is essential to keep the process on track, given the political pitfalls in India-Pakistan relations.

Finally, to realize the full benefits of a regional trading hub requires strengthening international competitiveness to become a manufacturing hub. This will create regionally balanced high productivity and high-wage employment, and result in welfare improvements for the country's citizens well into the future.

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*A Growth Vent Anchored in History and Geography*

## The Role of the Firm

Eric Manes\*

### 1. Introduction

This chapter on the Pakistani firm describes the microeconomic factors underpinning economic growth and wealth creation, focusing on enterprise-level analysis. Notwithstanding the key role of the firm highlighted in the chapter, data at the firm level is difficult to obtain and even more problematic to analyze. While the statistical issues associated with enterprise-level analysis in Pakistan are beyond the scope of this chapter, it is important to note up front the various limitations of the firm-level data available and the caveats stemming from firm-level analysis.

The Census of Establishments for 2005–07 (Pakistan Bureau of Statistics, 2007), gives a relatively clear picture of the family of Pakistani firms: many small, locally focused firms exhibiting varying degrees of formality and market participation, coexisting with relatively few, large formal firms (often multi-product conglomerates that account for the bulk of production, exports, and higher-wage employment). Only 5 percent of a total of almost 3 million establishments surveyed employed more than five persons at that time. In manufacturing, the figure is similar at 91 percent of the half-million firms surveyed, with only 1,100 of these establishments reporting employment of over 50 workers.<sup>1</sup>

Pakistan's enterprise sector is seen through the duality described above: a set of firms that operate either fully outside the formal market,

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<sup>1</sup> In the census, out of a total of 580,000 manufacturing establishments, 43 percent were associated with the textile and leather industry, 20 percent were food- and beverages-related firms, and 11 percent were engaged in machinery, equipment, and basic metals where higher value-added and intra-industry linkages are evident.

institutions, and government, or that employ a subset of informal practices and participate in government revenue collection efforts only if necessary. Finally, there remain those firms that are responsible for the country’s economic activity; these firms are few but in Pakistani terms can be quite large.

Two other comprehensive surveys sponsored by the World Bank have attempted to characterize Pakistan’s enterprise sector, and draw generalizations about the Pakistani firm in 2002 and again in 2007. Another survey of firm-level perceptions of the principal obstacles they faced was carried out in 2013. For the purposes of this chapter, the World Bank’s enterprise surveys in 2002 and 2007 are the primary sources of information, along with the International Finance Corporation’s Doing Business (DB) database. Although five years have passed since the last survey, its conclusions are representative of the structural relationships prior to the financial crises and political instability that characterize this period.

## 2. The Role of the Firm in Moving the Economy Forward

Since Solow’s seminal work on growth decomposition, the concept of productivity—the idea of producing more with less—has been the key link between the performance of firms, economic growth, and a country’s potential for providing improved welfare to its population. As productivity drivers are organized at the firm level, the firm represents a critical “private sector institution” responsible for driving innovation, employment, and growth in the economy that Pakistan requires if it is to move forward in the 21<sup>st</sup> century.

This critical role played by the firm in the development process is seen through the decomposition of the microeconomic identity that underpins the growth of income per capita at the macroeconomic level—a key indicator of economic welfare and one of Pakistan’s specific development goals for the near term. Specifically, the identity in Figure 16.1 shows that income per capita is a function of nonindependent social, demographic, and economic forces.

**Figure 16.1: Microeconomic underpinnings of income growth**

$$\begin{array}{l}
 \text{GDP per capita} \equiv \text{Labor productivity} \times \text{Labor force participation} \times \text{Age composition of population} \\
 \\
 \frac{\text{GDP}}{\text{Total population}} \equiv \frac{\text{GDP}}{\text{Labor force}} \times \frac{\text{Labor force}}{\text{Population aged 15–64}} \times \frac{\text{Population aged 15–64}}{\text{Population}}
 \end{array}$$

In the identity, income per capita is a function of (i) labor productivity, (ii) labor force participation, and (iii) the share of labor force share in the total population. Further decomposing the “economic term”—labor productivity—into changes in capital deepening (the capital–labor ratio) and gains in total factor productivity (TFP) demonstrates the critical role of TFP in one of the key development objectives: growth in GDP per capita.<sup>2</sup>

As more people reach working age and a greater number of those begin to participate actively in the labor force, GDP per capita will increase as long as capital deepening persists through investment<sup>3</sup> and/or a concomitant rise in TFP. Thus, in the short run, with population dynamics and labor force participation (given certain parameters),<sup>4</sup> policymakers’ central focus in growth-starved countries around the world is the role of the firm in achieving the virtuous circles of higher TFP leading to more investment, capital deepening, higher labor productivity, better wages, and growing income per capita.

For Pakistan, which faces both an increase in working-age population (the so-called “demographic bulge”) along with higher labor force participation (in large part, female), labor productivity has grown slower than in the rest of South Asia and particularly East Asia (Figure 16.2). Moreover, despite a relative high during the 2000s—particularly in the boom years prior to 2009—the lower capital intensity of growth was due to a rapid increase in labor participation, particularly among female workers.

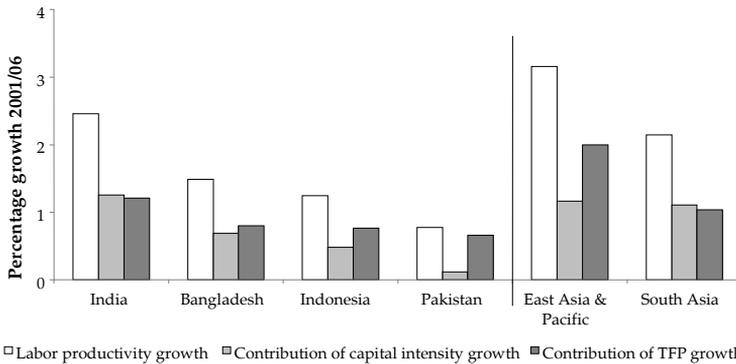
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<sup>2</sup> The economic literature attributes differences in output per worker between rich and poor countries to TFP. See Caselli (2005), Hall and Jones (1999), and Klenow and Rodríguez-Clare (1997).

<sup>3</sup> As the labor force increase, labor productivity decreases due to the declining marginal productivity of labor, requiring more capital investment to maintain the same level of labor productivity.

<sup>4</sup> In the medium term, labor force participation can be related to economic factors as people enter or leave based on the probability of finding work.

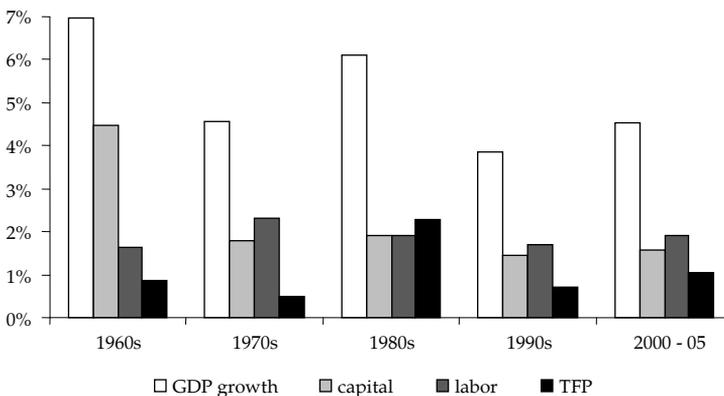
**Figure 16.2: Labor productivity growth decomposition in selected economies, 2001–06**

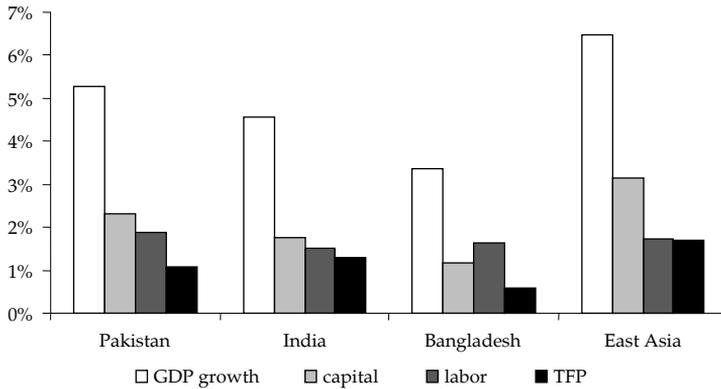


Source: World Bank (2006).

Importantly, however, while not in the same range of productivity as the East Asian countries, growth in TFP in Pakistan was comparable to other South Asian countries, though slightly lower than the average, owing to India’s high TFP growth over the period (Figure 16.3). Indeed, like most countries, “factor accumulation”—increased labor participation and investment—has been the primary source of growth in Pakistan over the past five decades, although the country’s growth spurts coincided with periods of higher productivity, particularly in the 1980s and 2000s. The most recent example of TFP-led growth was 2002–06 when it accounted for a quarter of the period’s growth rates (Figure 16.3).

**Figure 16.3: Growth accounting, 1960–2005 (by year and country)**





Source: World Bank (2006).

Currently, there are real binding limits to factor-driven growth in Pakistan, given its high labor participation rates and poor investment climate. Thus, sustained growth in Pakistan, as elsewhere, relies on initiating a virtuous cycle of rising firm-level growth of TFP accompanied by investment deployment directed to productive firms. Yet, as shown consistently throughout the world, unless the process is launched through the efficiency signal generated by firm-level productivity growth, investment is often misdirected to loss-making activities. Indeed, in Pakistan, the period of high growth coincided with macro-stability, microeconomic reforms, and political certainty.

### 3. Firm-Level Productivity and the Business Environment

Moving the economy forward, therefore, requires catalytic forces to jump-start firm-level productivity growth in the hope of launching a virtuous circle of efficiency improvement, productive investment, and organic growth by private sector firms in competitive markets. An analysis of the sources of these microeconomic foundations focuses on the collective set of amorphous institutions: (i) factor markets, involving capital, labor, and land; (ii) product markets, involving frictions in markets for domestic and international goods; and (iii) the government-business interface, involving public infrastructure, market regulation, and the provision of various public services. In recent years, considerable attention has been given to the role of (iv) innovation, competition, and industrial organization (entry and exit) in firm-level productivity.

These forces are captured in a summary concept called the business environment or investment climate, which can be growth-enhancing or, indeed, growth-retarding. An accommodating business environment

encourages efficient operation and strengthens innovation and productivity. A poor business environment amplifies or even creates obstacles to conducting business activities. TFP is central to both outcomes and is influenced by a series of factors—often considered the elements of the business environment—each with policy playing a central role in determining whether the element facilitates or hinders productivity. Recent research attributes 17 percent of the difference in aggregate productivity across firms in Pakistan to differences in the investment climate they face (see World Bank, 2009).

In gauging a complex and dynamic business environment subject to many exogenous and endogenous forces, it is practically impossible for one static indicator to capture the nature of business for a country, particularly one as dynamic, complex, and geographically diverse as Pakistan. Still, in order to set the scene for the discussion, it is instructive to understand what the incumbent Pakistani firm views as constraints to the business environment, and how they are ranked over the period 2000–13. During this period, three surveys of Pakistani enterprises were undertaken using a similar survey instrument and covering what Pakistani firms perceived as being the most significant constraints to the business environment. However, analyzing the various elements of the business environment needs numerous perspectives because the forces are, in themselves, not only difficult to observe, but also dynamic.

#### **4. The Business Environment: The View of the Firm**

Scaling up from a low level of equilibrium requires collective action. In most cases, due to the well-known “free rider” problem that prevents it from emerging on a private basis, collective action is effectively provided by the public sector—nationally, regionally, or locally, depending on the issue and the country. Such critical areas requiring collective action, which would allow economy-wide efficiencies through network effects (courts, regulation, functioning markets), may be undervalued in the face of individual inability to cope with the deficiencies of the investment climate.

This is particularly so when the public sector’s failure to provide public goods—such as those requiring collective action—causes the economy to adjust to second- or third-best solutions.<sup>5</sup> By understanding the problems the private sector faces, the authorities send critical signals to the business community that things will improve rather than deteriorate. Such activity is a key part of an overall push to spur reform,

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<sup>5</sup> For example, firms in Sialkot have substituted private collective action for public services in the form of collective infrastructure, including an airport and a dry dock.

particularly when it is not obvious where public actions are needed first and where public-private partnerships can play a role.

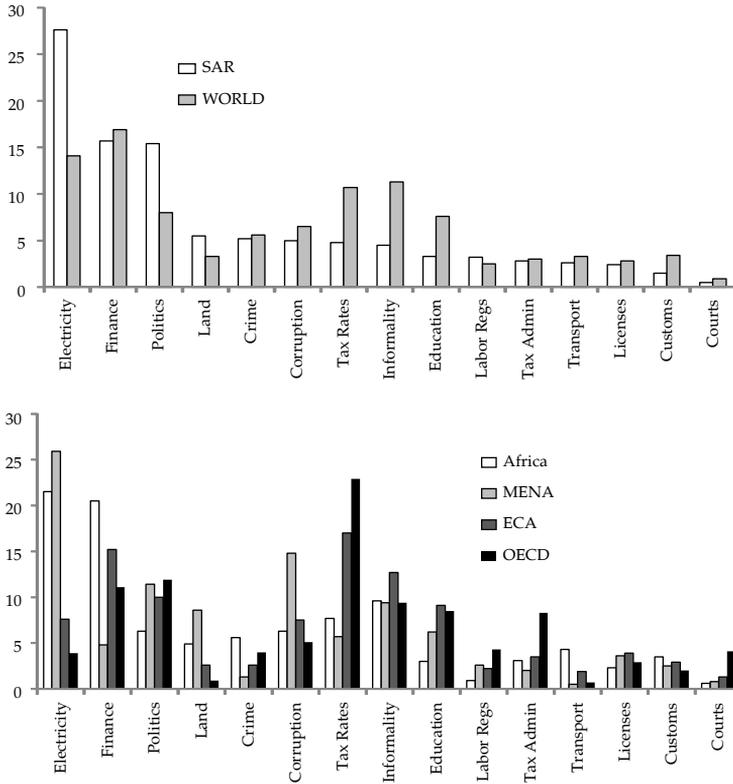
#### ***4.1. Firms' Perceptions of Obstacles Around the Globe***

The World Bank's enterprise surveys have polled firms around the world in a methodologically consistent way to enable the best possible comparisons of opaque and diverse areas. The surveys are conducted by the World Bank and its partners across all geographic regions and cover small, medium, and large companies. They are administered to a representative sample of firms in the nonagricultural, formal private economy. The sample is consistently defined in all countries and includes the entire manufacturing sector, the services sector, and the transport and construction sectors. Public utilities, government services, healthcare, and financial services are not part of the sample. The enterprise surveys collect a wide array of qualitative and quantitative information through vis-à-vis interviews with firm managers and owners regarding the business environment in their countries and the productivity of their firms.

As it turns out, global and regional firm-level perceptions differ from one another but center around a few areas (see Figure 16.4). In South Asia, Africa, the Middle East and North Africa, concerns about power dominate incumbent firms' perceptions of the investment climate. In Eastern Europe and the OECD countries, other issues matter more. Abstracting from the acute issue of power in less developed countries, key global issues from the private sector's perspective involve finance, education, informality, and tax rates. Political stability is also a concern almost everywhere, while in the more advanced countries, formal governance institutions responsible for tax administration and the courts are also a concern (though not as much in less mature markets). Issues such as corruption, land, labor, and transport are notable perhaps for the lack of concern they elicit around the world.

## The Role of the Firm

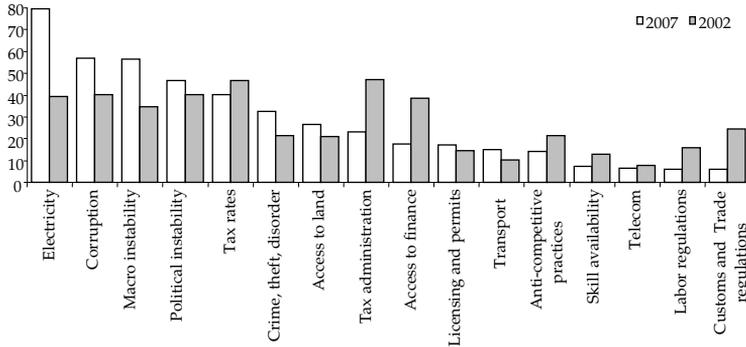
**Figure 16.4: Firms' perceptions of obstacles around the world**



Source: World Bank, enterprise surveys (various years).

In Pakistan, incumbent managers and entrepreneurs were interviewed three times during 2002–13 on hindrances in the investment climate (see Figure 16.5). The responses were instructive, reflecting the economic issues of the day. Moreover, taking the collective pulse of the business community on a regular basis allowed policymakers to see how views had shifted during the decade, providing insights into the dynamic forces on the ground.

**Figure 16.5: Major obstacles cited by Pakistani firms**  
(percentage of respondent firms)



Source: World Bank (2009).

#### **4.2. In Pakistan: Solid and Shifting Perceptions**

The surveys’ results for the period 2002–07 show that firms responded to first-level reforms to remove red tape and lower the cost of doing business during the first part of the 2000s in areas where the government had devoted resources and policy attention. The major improvements they perceived were in finance, tax administration, anti-competitive practices, labor regulations, and customs and trade regulations (Table 16.1). Issues that were perceived to be the top constraints in 2002 became less important, however, in the face of rising concerns about governance-related issues, such as political instability, macro-management, corruption, and law and order, which had worsened considerably.

#### **4.3. Energy: The South Asia Constant**

Electricity, which represented an important area of deterioration in governance, dominated the business community’s concerns in 2007—more than 80 percent of firms identified it as a problem, i.e., double the proportion just five years earlier. Clearly, compared to firms worldwide, Pakistan’s energy problem is one of the most serious operating issues and the most obvious case of public sector failure to provide an appropriate business environment.

**Table 16.1: Major obstacles cited by firm (%)**

<b>Obstacle</b>	<b>2007</b>	<b>2002</b>
Deterioration		
Electricity	80	39
Corruption	57	40
Macro-instability	57	34
Political instability	47	40
Crime, theft, disorder	32	21
Improvements		
Tax administration	23	47
Access to finance	18	38
Anti-competitive practices	14	21
Labor regulations	6	16
Customs regulations	6	24

Source: World Bank (2009).

The enterprise surveys show that Pakistan's problem—though severe even in 2007—was not out of line with other South Asian countries (Table 16.2). Firms around the world averaged seven outages per month; firms in South Asia experienced an outage at least once a day and lost more than double the amount of sales. Although the problem in other parts of South Asia was as severe in terms of outages, the number of firms identifying electricity as a constraint is much lower outside of Pakistan, and not far below the mean for the entire world.

**Table 16.2: Electricity: The Achilles' heel of the investment climate**

	<b>South</b>		
	<b>All</b>	<b>Asia</b>	<b>Pakistan</b>
No. of electrical outages per month	7.3	33.9	31.7
Losses due to electrical outages (percent of sales)	3.0	8.6	8.2
For those with outage losses due to electrical outages (percent of sales)	5.0	10.1	9.2
Firms owning or sharing a generator (%)	32.1	36.4	26.3
Share of electricity from a generator (%)	6.8	12.3	5.5
For those with generators, share of electricity from a generator (%)	20.8	27.2	29.3
Days to obtain an electrical connection	34.1	44.8	106.3
Firms identifying electricity as a constraint (%)	40.6	54.4	74.5

Source: World Bank enterprise surveys (various years).

#### **4.4. Idiosyncratic Issues in Pakistan**

However, there are two large differences between Pakistan and its South Asian counterparts. The first is the time required to acquire a connection from the electrical company. More telling, however, is Pakistan’s clear inability to cope with the severe deficiencies of the investment climate—in this case, the provision of electricity—as compared with its regional counterparts. Far fewer Pakistani firms rely on electricity from their own generators; those who do—getting almost a third of their electricity from this source—are only able to make up a small percentage of the energy deficit (less than the world average). As is the case for other public services, it is possible for firms to cope with the deficiencies of the investment climate where electricity is concerned but at a cost that many in Pakistan cannot afford.

In 2010, firms were asked to identify “the most important obstacle” rather than a list of major obstacles”; the results showed that the energy crisis—already a desperate concern—had actually worsened in 2010, surpassing all other concerns as the most important problem. In 2007, three quarters of the firms surveyed had cited electricity as a major problem, but less than half had considered it the top problem (Table 16.3). This had changed by 2010 when two thirds of Pakistani firms considered it the most critical problem compared to less than a third in South Asia as a whole.

**Table 16.3: Share of firms ranking obstacles as a major problem (share of total)**

	Global	South Asia	Pakistan	
			2007	2010
Electricity	16	29	44	65
Political instability	9	14	4	20
Crime, theft, and disorder	6	6	8	3
Access to finance	15	13	6	2
Access to land	3	4	6	2
Corruption	7	6	19	2
Informal practices	11	6	1	2
Licensing and permits	3	2	1	1
Customs and trade	3	2	1	1
Inadequate education	6	2	2	1
Tax rates	11	4	5	1
Courts	1	0	0	0
Labor regulations	2	2	1	0
Tax administration	3	3	1	0
Transport	3	3	1	0

Source: World Bank Group, Enterprise Note 27, J. S. Yang, (2011).

Apart from the overwhelming predominance of the energy sector in the investment climate during 2007–10, major political concerns appeared to overshadow economic issues in the private sector's view. Even concerns about corruption seemed to dissipate in the face of political events. It is important to note, however, that this does not mean that concerns about political corruption had fallen but that small-time business corruption of the traditional variety was being replaced by political instability concerns. So it is not a surprise to see the concern about corruption fall along with that of tax rates and other concerns while electricity and political stability take the lead role as concerns regarding the business environment.

### **5. The Role of the Business Environment: Empirical Evidence**

Gauging the role of the business environment based largely on the views of the incumbent business community can, however, bias the overall perception in several important ways. First, productivity gains are seen myopically and, therefore, cost reductions are valued over other types of improvements, such as those involving competitive pressures from increased formality and the process of creative destruction that may follow. Second, the issues cited reflect firm-level experience of coping with a fragmented, opaque investment climate; this may underplay institutional issues involving rules—courts, contracts, regulators—that incumbents have overcome but at a potential loss to innovation and a “low-level equilibrium.”

An econometric analysis seeking to empirically test the top constraints to productivity growth reveals that, in Pakistan's case, the results are consistent with firms' perceptions of the constraints described earlier. Using data from the same firms surveyed in 2002 and 2007, a clear set of specific variables—many of them necessary proxies for standard investment climate issues—have important statistical significance in explaining firm-level changes in productivity between 2002 and 2007.

As shown in Table 16.4, the data on Pakistani firms not only indicates a positive correlation between productivity and employment and facets of the country's investment climate, it also confirms the various hypotheses derived from firm-level perceptions. In particular, the key variables that stand out as being associated with firm-level productivity include: (i) power outages and the quality of power supply, (ii) the time, cost, and hassles involved in complying with regulations, and (iii) crime and security in a negative sense. Those variables associated with higher-productivity firms are (iv) access to finance, (v) training and skills up and down the line, (vi) innovation, and (vii) corporate governance. The proxy

for female worker is negative due to women being represented in lower-productivity activities.

**Table 16.4: Key investment climate variables, 2002–07**

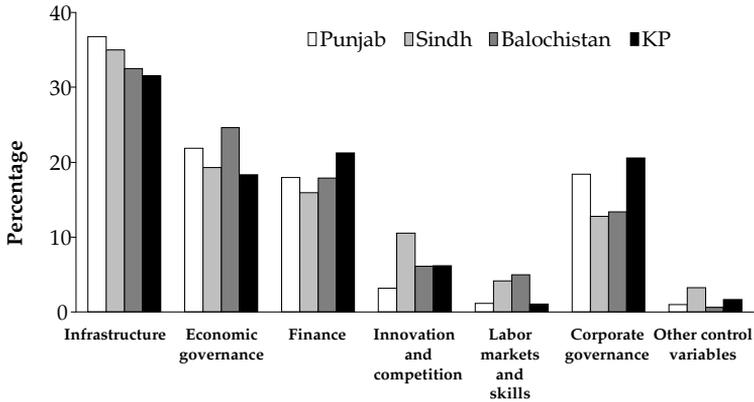
Infrastructure	Number of power outages	-
	Low quality supplies	-
Economic governance	Security expenses	+
	Crime losses	-
	Manager's time spent on red tape	-
	Number of inspections	-
	Informal payments for contracts	+
Finance	Illegal payments in protection	-
	Credit line	+
	Loans (with and without collateral)	+
	Trade association	+
Labor markets and skills	Management training	+
	Female workers	-
	University education for staff	+
Innovation		+
Corporate governance		+

*Source:* World Bank (2009).

Statistical attempts to quantify the contribution of different variables to firm-level outcomes demonstrate that, in 2007 at least, the investment climate issues facing Pakistan firms did not differ significantly across provinces (Figure 16.6). Not only were the issues similar—infrastructure, economic governance, finance, and corporate governance—they mattered to about the same degree across Pakistan. Governance and infrastructure were cited as concerns in all the provinces, led by Punjab, while the larger more globalized firms in Karachi brought into consideration issues of innovation and competition.

On the other hand, in Khyber Pakhtunkhwa, where economic governance and infrastructure contributed less to the investment climate, finance and corporate governance emerged as stronger contenders. To some extent, the different contribution of the various dimensions of the investment climate reflects the type of firm dominant in each province. Smaller informal firms are associated with less economic governance, less need for infrastructure and formal finance, and usually exhibit little, if any, formal corporate governance. These firms are lower-scale, more penalized by the investment climate, and exhibit lower productivity than larger, more formal firms.

Figure 16.6: Investment climate’s contribution to productivity



Source: World Bank (2009).

## 6. The Transmission of Efficiency from the Business Environment to the Firm

The empirical analysis confirms the perceptions and opinions of Pakistani firms while providing insight into how various aspects of the investment climate contribute to productivity and efficiency. Certainly, such information is important to policymakers wanting to improve the investment climate in order to strengthen the economy’s competitiveness and growth. However, for policy to be deployed strategically—while remaining aware of all the consequences—it is necessary to understand the various dynamic processes that take place at the micro-, sector and economy-wide level that have the potential to affect “aggregate” productivity.

For Pakistan, policies geared toward improving the economy’s productivity can entail three distinct but highly related processes: (i) lowering the “cost of doing business” to enable the same output at a lower cost; (ii) increasing the productivity of the enterprise sector through policies that make formality and scale attractive to encourage firm-level growth; and (iii) increasing firm entry and exit to enable competition, innovation, and a shift in resources from lower-productivity firms to more competitive firms through the process of “creative destruction.” In all three dimensions of productivity-induced growth, the business environment has a critical role to play in enhancing or obstructing private sector efficiency. Each of these areas forms the basis of the analysis below and the set of policy recommendations provided at the end of the chapter.

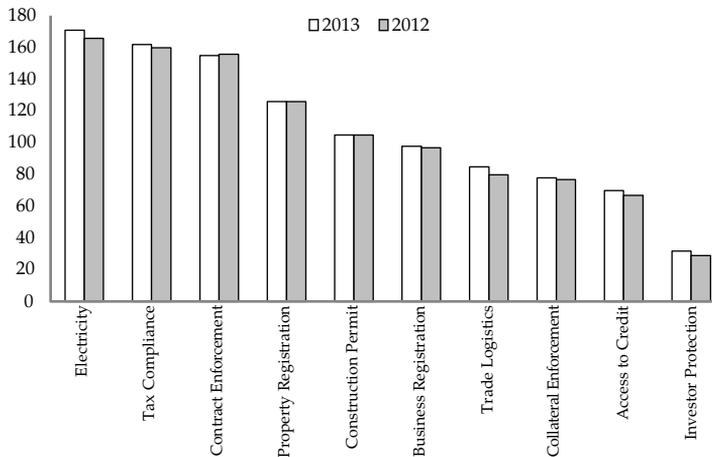
### 6.1. Lowering the Cost of Doing Business

Analyzing the cost of doing business in Pakistan involves examining three separate dimensions: (i) the cost of complying with official regulators; (ii) the unofficial cost of doing business as represented by the need to (and expectation of) to provide gifts to acquire public services; and (iii) given the amount of regulation and discretion, the difference between de jure and de facto regulation and its important impact on the general fitness of this activity. Given that, the firms that are most able and likely to avoid such informal costs, and those least able to afford them, as firms that can most easily cross the line into the state of informality.

#### 6.1.1. Official Costs of Doing Business

The cost of doing business affects all firms, but different costs affect different firms in various, often unpredictable, ways. Formal costs relate to the rules and regulations affecting the fees, time, and effort incurred. These “official” costs have been measured using indices and comparisons captured by the World Bank Group’s DB project, which collects annual data on the state of regulations for 181 countries. The project measures regulations in eight areas and has recently expanded this to ten (see Figure 16.7); the number of countries measured has also grown.

**Figure 16.7: Pakistan’s DB ranking: From 94 in 2004 to 104 to 107 in 2012/13**



Source: World Bank Doing Business database, 2013.

Pakistan has generally appeared relatively open and favorable on scales that measure the official regulation of firms. For much of the early

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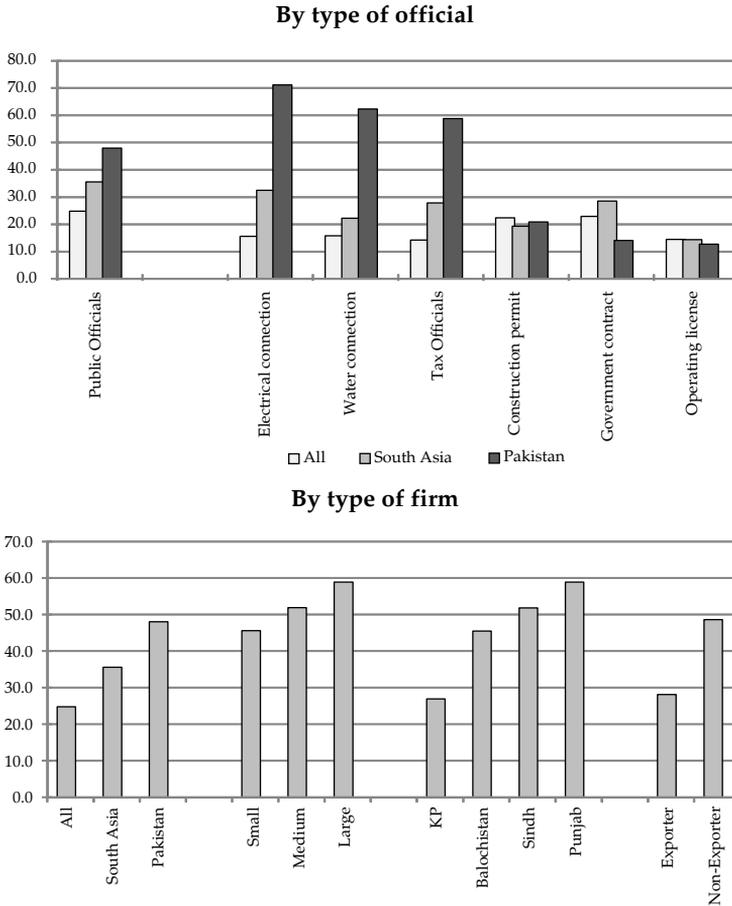
2000s, its composite index ranked highest in South Asia after the Maldives, hovering around halfway among the 180 countries measured. However, in recent years, what seemed on paper to be a relatively liberal and efficient regime has deteriorated in relative terms, based on the DB methodology, which ranks countries according to the composite DB index. Pakistan's ranking has since fallen steadily, dropping 13–15 places in the world rankings since 2004. The fall is sometimes associated with the introduction of an unfavorable business regulation or the elimination of a favorable one, but is more often linked to limited reforms at the micro-level while other countries have attempted to improve their own rankings.

Unfortunately, there is little consolation that the fall in ranking stems from inertia rather than policies harmful to the DB indicators. In the face of other reforming competitors, a country can fall behind simply by failing to reform. In the end, falling behind in relative terms is not costless, irrespective of how it has occurred. An analysis of firms' responses to regulatory issues—particularly official regulations of the kind measured in the DB project—reveals that firm performance is affected by variability, expectations, and perceptions of immanent policy implementation as much as the state of official regulation. In other words, the level of the indicator does not matter as much as firms' intuitive expectations of future policy implementation. Thus, in Pakistan, where regulatory streamlining is relatively recent, the inertia of the *de jure* policy regime over the past few years has been viewed by businesses as anything but benign neglect, particularly given the active reform being pursued by many of the country's competitors.

### *6.1.2. Informal Costs of Doing Business*

Related to reforms—or the lack thereof under the *de jure* policy regime—is the fact that the *de jure* or official cost of doing business can be quite different from a firm's actual costs (in terms of time, money, and hassle). The enterprise survey reveals that firms in Pakistan face far higher costs than just the official costs: almost half the firms surveyed reported that they were expected to provide public officials with gifts. This is a much higher share compared to South Asia as a whole and twice the share of respondents for all the countries surveyed (Figure 16.8).

Figure 16.8: Share of firms expected to provide gifts to officials



Source: World Bank enterprise surveys and World Bank (2009).

The situation's underlying texture provides some additional insight. The informal costs of doing business are highest with regard to the most significant and elusive government services globally, but particularly in South Asia. The survey's specific results in this area are revealing, and put into context the very high number of days reportedly required to secure electricity and water connections. Importantly, these areas also score globally as the most problematic from a de jure perspective.

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On the other hand, the high level of interface between tax officials and firms seems to have decreased significantly with the rising expectation of receiving gifts. Since required permits and official licensing were less prevalent in daily life due to the regulatory reforms of the early 2000s, there was no pretense of providing gifts in exchange for access, and so gifts in these two arenas do seem as significant today as they were some years ago. Similarly, gifts to secure government contracts are not as needed as the daily interface requirements, as government–business contractual relationships are fewer and more complex.

### *6.1.3. De Jure vs. De Facto Application of Regulations*

The World Bank and others have made a number of important attempts to carry out surveys, analyze laws, and engage in advanced statistical analysis in order to reveal the impact of the business environment on growth. Two dimensions of the business environment are important to consider, both of which are dynamic and complex. The first involves the de jure environment: the set of official rules and regulations on paper that can be referred to, analyzed, and changed.

The key distinctions between de jure and de facto regulation, as measured by the DB project and enterprise surveys, are listed below.

- Firms in the same country report, de facto, wildly different times and costs associated with completing the same transaction; de jure compliance involves a single estimate.
- Cross-nationally, there is very little association between the enterprise survey distributions and DB numbers. The patterns are much more complex as the de jure environment appears to affect only some firms, distinguishing between “favored” and disfavored” firms.
- In every country, the “favored” firms report little delay in any of the three indicators while the firms that find regulations to be an obstacle vary across countries in terms of the extent of delay.
- There is little association between DB improvements and reports in the enterprise surveys; improvements in DB are just as likely to be accompanied by deteriorations in the enterprise surveys.
- There are many substantial reductions in the DB reported time but almost no instances where this was associated with a fall in the ES reported time for compliance.

On one hand, the World Bank’s DB project attempts to benchmark each country’s de jure environment by continually monitoring,

measuring, and ranking the composite scores of the country's official regulations as they translate into time, cost, and procedures involved. On the other hand, firm-level surveys not only gauge perceptions but also attempt to collect and benchmark qualitative and quantitative indicators, measuring the implementation aspects of regulations—the de facto business environment.

## **6.2. *Bringing a Greater Degree of Formality into the Economy***

The addition of unofficial costs to official costs amplifies the cost of doing business; more importantly, though, it adds an added level of uncertainty between the de jure and de facto application of laws and regulations. This friction leads to such high, opaque, and unpredictable costs of doing business that a large part of the economy chooses to sacrifice firm growth and profitability by operating on some level of informality. Three dimensions of informality exist around the world and, indeed, are strong elements of Pakistan's economy: (i) firms that are unreported because they maintain a small number of employees (10–20), (ii) the avoidance of taxes and fees by firms that remain illegally unregistered; and (iii) informal practices by formal firms, usually in factor markets and property rights.

Almost two thirds of the firms surveyed in 2007 considered the application of regulations to be inconsistent and unpredictable. By remaining informal and consequently small, firms avoid the constraints imposed on them by over-regulation. For instance, senior management in large firms spent, on average, 13 percent of their time dealing with regulations—almost three times what smaller firms spent (5 percent). Large firms met or were inspected by tax officials almost seven times a year compared to three times for small firms. Labor market regulations are also important. Only 6 percent of small firms noted that labor market regulations affected their decision to hire and fire permanent workers compared to over four times that share for large firms (World Bank 2002, 2007).

The impact of over-regulation and weak institutions in Pakistan contributes to high compliance costs as well as to the informal costs of doing business, as described in the previous sections.<sup>6</sup> The result is a high level of cost avoidance through various means under the heading of informal markets. Consequently, the informal sector has been estimated to be as large as 35–40 percent of the official economy (World Bank, 2012b). Given that large firms cater to a different market from small firms, they are relatively unaffected directly by regulatory avoidance, although

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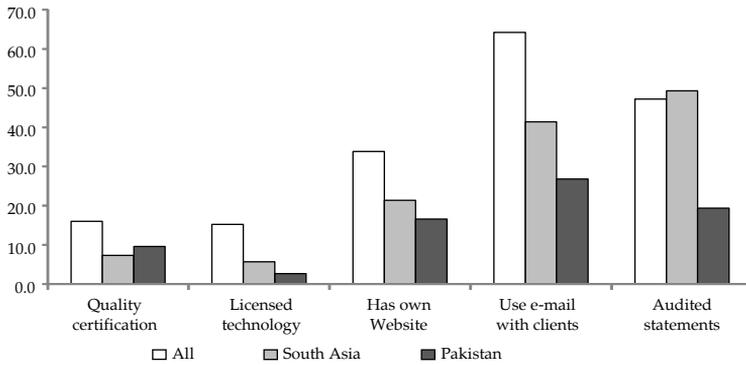
<sup>6</sup> Approximately 75 percent of firms state that it is common to have to make an informal payment or gift to get things done.

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some firms, particularly in areas of design and other intellectual property, report the unauthorized copying of designs.

A key indicator of formality that clearly reveals Pakistan's duality is the degree to which firms—whether those producing technology-intensive products for export or more traditional products for local consumption—have an incentive to adapt existing productivity-enhancing technology that is available to any firm at a low cost (Figure 16.9). The degree of adaptation of basic technology reflects the firm's degree of formality, market orientation, and indeed, incentive to compete with others who are also adapting.

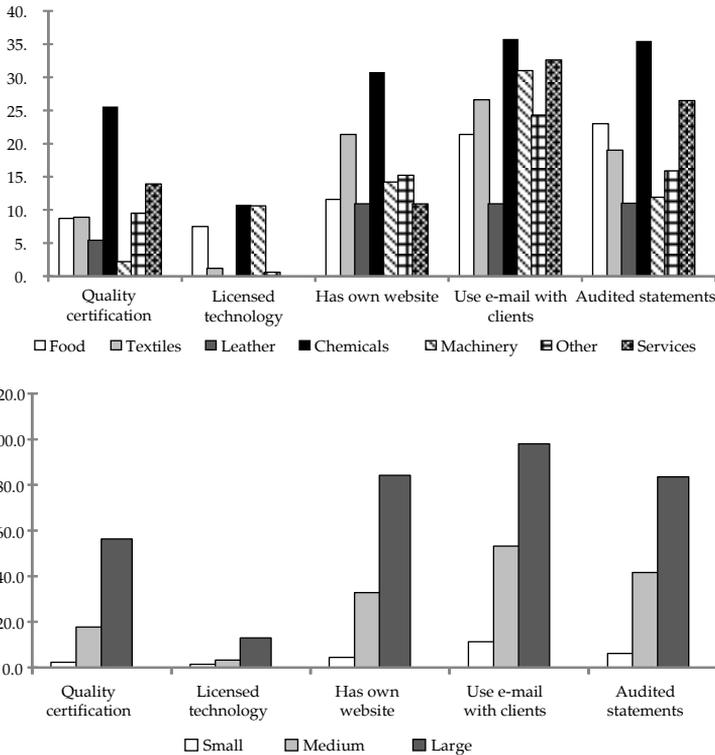
**Figure 16.9: Firms' use of technology, 2007**



Source: World Bank enterprise surveys (various years).

Firms in Pakistan comply with quality certification to a relatively high degree, particularly the country's international chemical industry and stronger elements of the food and textile industry. However, when looking at the use of the Internet in business as well as the degree to which financial statements are formally audited, a much more informal picture of the Pakistan firm emerges compared to firms in South Asia and around the world (see Figure 16.10).

**Figure 16.10: Indicators of technology and formality: Groups within Pakistan**



Source: World Bank (2007).

Breaking down the country's market structure by industry, geographic location, size, and trade orientation, further clarifies the picture of the Pakistani firm. As noted, the rising chemical industry in Pakistan, though limited to a small number of large firms, is clearly the most formalized and technologically oriented as would be expected for such high-technology firms. The textile industry, particularly the large sector located in Sindh, is equally formalized and technologically adapted (Figure 16.10). However, most of the enterprise sector is not, which also emerges clearly.

### 6.2.1. Nature of Firm-Level Governance

Academics, journalists, and casual observers have written widely on the governance aspects of the Pakistan economy and the resulting degree of

## The Role of the Firm

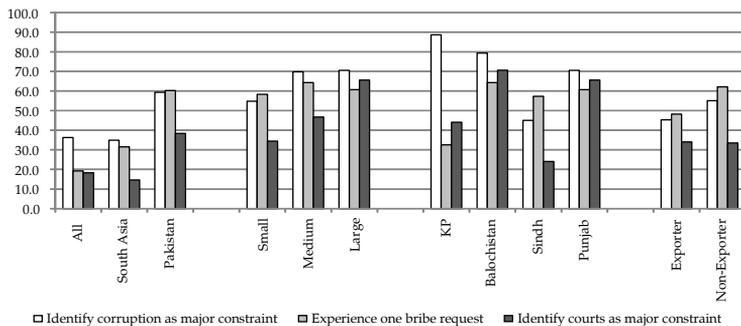
“social capital” in use in the form of informal, localized firm and market arrangements. In some analyses, this type of enterprise sector is the result of a “low-trust society” that forgoes arms’-length market arrangements even within the country for more informal arrangements due to the lack of property right protection and adherence to legal rules in conducting business.

Pakistan typically rates quite low on many governance indicators, represented by the 2012 composite indicator, covering such areas as the rule of law, quality of regulation, and political stability. Only Afghanistan scores worse than Pakistan in South Asia, which itself ranks the lowest among all regions. Without strong market governance by trusted institutions, predictability and transparency in the business environment are likely to suffer, keeping a large share of the economy outside the formal sector and creating a drag on the economy’s productivity.

### 6.2.2. Impact of Firm-Level Governance

The perception that governance is an issue faced at the firm level emerges clearly when we compare Pakistan with the rest of South Asia and the world in terms of views on corruption, bribes, and the role of the courts in the investment climate. Clearly, in 2007, firms in Pakistan showed more concern about governance at the firm level and likely continue to do so today. Importantly, while their perception and experience of corruption does not differ much across different sizes of firms, the concern with courts rises as the size of the firm grows, indicating the need of the more formal economy to have a more formal governance system. Across the provinces, corruption and the courts emerge as key concerns, apart from in KP where the concern seemed to outstrip the experience (see Figure 16.11).

**Figure 16.11: Strength of market governance (share of firms that... )**



Source: World Bank enterprise surveys (various years).

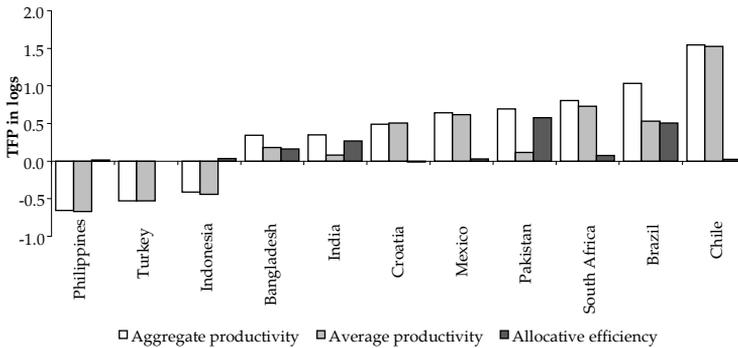
The impact of a strong degree of informality in the enterprise sector is that productivity is limited by the distribution of enterprises across the formal/informal spectrum, given that informality in any form is typically less efficient than a formal, market-based structure. In other words, the aggregate productivity of the enterprise sector is based on the productivity of the average firm, as well as the range and weighting around the average. For high-average firms with a low level of dispersion, the aggregate will generally be high. However, a wider dispersion will allocate resources to low- as well as higher-productivity firms and the country aggregate will depend on how much weight each firm is assigned.

### *6.2.3. Impact on Productivity*

Figure 16.12 shows estimates of TFP broken down by aggregate and average productivity for eleven countries where data was available. The statistical relationship between the investment climate variables and productivity is positive, but is due mostly to the allocative term rather than average firm productivity. Pakistan's mean productivity—that is, the part of productivity affected by the investment climate—is comparable with that of Mexico and South Africa, lower than that of Chile and Brazil, and higher than that of other countries in the region (Indonesia, Turkey, and the Philippines). This underscores the investment climate's positive impact.

However, in Pakistan, the investment climate's contribution to aggregate productivity is made prominent by the fact that it has a negligible and marginal impact on average productivity. This market characteristic is observed strongly in Brazil and Pakistan and to a lesser extent in India and Bangladesh. On the other hand, countries like Chile, Mexico, and South Africa derive their high levels of aggregate productivity growth from business conditions that raise the average productivity of the representative firm. The residual term—called "allocative efficiency"—represents the variance of the productivity across firms (size of term) and whether the weighting is associated with higher- or lower-productivity firms (the sign of the term). Countries like Brazil, India, Bangladesh, and at the highest level, Pakistan, have a high variance in productivity across different enterprises. The variance is positive in these cases because larger firms with higher weights have higher productivity.

Figure 16.12: Productivity (mean) breakdown across countries



Source: World Bank (2009).

From the perspective of overall efficiency and competitiveness, the high variance of firm-level productivity embodied in the allocative efficiency term may reflect market frictions that enable low-productivity/low-market share firms to exist without exiting. A large allocation term not only supports the hypothesis of duality in the economy where formal and (relatively) high-productivity firms coexist with smaller, informal, low-productivity firms. A positive allocation term indicates that top-ranking firms are using most of the resources in terms of average productivity. However, the coexistence of a high efficiency term and a low average productivity term shows that low-productivity firms dominate in terms of numbers but not market share. Traditionally, aggregate productivity in a dual economy is depressed because too many resources are allocated to low-productivity production in the informal sector.

#### 6.2.4. Role of Friction in the Economy and Firms' Ability to Cope

Friction may arise from a variety of factors, including the adjustment costs of entry and exit, difficulties in contract enforcement, lack of property rights enforcement, poor retail systems, competition issues, market structure, and technological factors. These sources of friction are part of the investment climate for doing business and affect the efficiency of the average firm in a given country, but they can also help explain the existence and role of a large allocative efficiency term. When trying to explain a pattern statistically, the most important findings confirm the hypothesis described above:

- Variables that relate to firms' degree of formality and the ability of formal firms to cope with business problems are highly significant in terms of explaining productivity patterns.
- In infrastructure, these factors include ownership of a generator, transport, and security, and the number of days of inventory. Location in an industrial estate is also significant, representing productivity gains from agglomeration economies.
- There is also a strong association between productivity and variables representing the formal nature of firms. Economic governance variables include (i) handling disputes through courts, (ii) reporting sales to the tax authorities, (iii) dispersed ownership concentration, and (iv) access to checking/savings accounts and working capital through private banks.
- Innovation and skill variables are also significantly associated with productivity differences, including process innovation, new equipment, foreign direct investment, and training.

In terms of infrastructure and economic governance, the evidence shows that firms with a larger market share seem to cope better with the negative elements of the business climate. In particular, the highly negative association with average productivity is muted since the effect is concentrated on firms with a small market share. For instance, ownership of a generator is slightly related to improved productivity but the impact is amplified for aggregate productivity because ownership of generators is concentrated among firms with a large market share. Similarly, the positive association with a firm that has a large amount of inventory, uses the courts, and pays for security is also amplified at the aggregate level through the allocative effect.

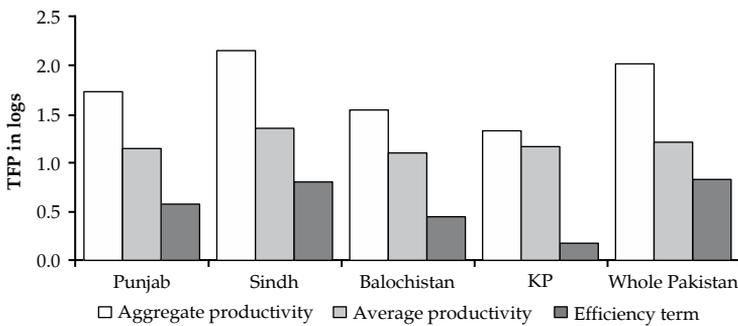
In the case of variables reflecting the degree of formality, the allocative efficiency effect is small, implying that the positive association with formality applies to all firms. Two variables are significant in this regard. First, under economic governance, reporting sales to the tax authorities contributes substantially to both aggregate and average productivity. Second, a firm's access to its own bank account is correlated with increased productivity at the average firm level. There is a small allocative efficiency term here, implying that having a bank account is positively associated with having a large market share. On the other hand, there is a strong negative association with concentrated ownership; unlike the other two variables, however, it is associated with a smaller market share, muting the aggregate impact.

The results strongly indicate that productivity-enhancing variables, i.e., finance, innovation, and labor skills, are associated with firms that have a larger market share. In the case of finance, the negative impact of prepayment for purchases and working capital financed by internal funds is concentrated on firms with a small market share. The positive correlation between productivity and working capital financed through private banks is associated with firms that have a larger market share. For innovation and labor skills, the positive association with productivity—especially for new processes and equipment—is concentrated on firms with a larger market share. The effect is stronger for the training variable because a small degree of association with average productivity is amplified at the aggregate level.

6.2.5. Differences Across Provinces

Differences in the relationship between investment climate variables and productivity are relatively robust across provinces and firm size, but with some small differences that are worth noting (Figure 16.13). Specifically, infrastructure accounts for the highest share of productivity differences in all the provinces with a somewhat lower impact in Balochistan. Conversely, economic governance contributes more to productivity in Balochistan than in the other provinces. In KP, unlike the other provinces, economic governance, finance, and corporate governance contribute relatively equally to productivity, with finance and corporate governance accounting for a larger share than in the other provinces. Innovation contributes to productivity the most in Sindh and the least in Punjab.

Figure 16.13: Productivity (mean) breakdown across provinces



Source: World Bank (2009).

**6.3. The Impact of the Investment Climate on Various Types of Firms:  
Results from the O&P Decomposition 2002–07**

The range of specific investment climate variables that are significantly associated with productivity differences, highlight the wide range of ways in which the investment climate affects economic growth. Some variables—infrastructure, economic governance, and finance—remain robust and significant over time. For example, the negative impact of power outages, crime losses, payments to receive government contracts, and the positive impact of access to formal finance are consistently significant. On the other hand, issues relating to government–business interface—for example, the number of inspections or the time taken to comply with regulations—fall in significance.

The effect of individual investment climate variables is associated with aggregate productivity through average productivity and the allocation of resources. Specifically, 14 percent of the effect that investment climate variables have on aggregate productivity is due to average productivity; the remaining 86 percent is due to the allocation effect. The key significant variables and their share in total average and aggregate productivity are as follows:

- Number of power outages (infrastructure). The share in average productivity is -13.3 percent and the share in allocative efficiency is 6.7 percent. Hence, the negative effect on productivity is biased toward low-market-share firms.
- Days of inventory of main intermediate material (infrastructure). The share in average productivity is 14 percent, while the allocation effect (9 percent) amplifies the average, indicating the positive effect concentrated in high-market-share firms.
- Sales reported for tax purposes (economic governance). This variable accounts for 12.8 percent of aggregate productivity and 12.3 percent of the average productivity effect.
- Working capital financed by internal funds (finance). Out of a total share of -6.6 percent in aggregate productivity, -8.3 percent is accounted for by average productivity, indicating that the effect is muted and concentrated among firms with a low share of sales.
- Working capital financed by private banks (finance). This variable is positively associated, accounting for 11.3 percent of productivity. The allocation effect accounts for almost the entire effect (9.6 percent) indicating that the positive effect is concentrated among firms with a high market share.

- Dummy for process innovation (innovation and competition). Its share in aggregate productivity is 15.7 percent but, like finance, this arises through allocative efficiency (13.1 percent) since the average effect accounts for one sixth of the overall contribution.
- Dummy for training (labor markets and skills). Of its total share of 12.4 percent in aggregate productivity, 11 percent is due to allocation and 1.4 percent due to the average.
- Largest shareholders (corporate governance). The aggregate effect is -8.1 percent, decreasing from -16.2 percent (average) by a positive allocative efficiency of 8.1 percent.

#### **6.4. *Encouraging Innovation, Structural Change, and the Process of “Creative Destruction”***

Perhaps the most traditional and possibly most important dimension of productivity growth comes from the process of “creative destruction” where competitive pressure forces firms to constantly discover and implement new technologies to produce new products or old products in new ways. In this way, all firms are not equal in terms of productivity growth. Schumpeter considered it the “essential fact about capitalism”; the body of work since then has analyzed firm-level data and confirmed the importance of both direct and indirect productivity effects of firm entry and exit over time (Bartelsman, Haltiwanger, & Scarpetta, 2004).

Firms differ not only in their managerial ability, location, organization, and know-how, but also in their ability to advance in a contestable market by adapting to new knowledge where other firms have not. Recent evidence supports the hypothesis showing that new and relatively more productive establishments displace older and relatively less productive ones. However, the empirical evidence also gives insights into how the process of creative destruction works, and shows that there are reinforcing indirect effects. First, the invention or application of superior technology by a new entrant may encourage incumbent firms to improve their own technology (Bartelsman et al., 2004). Second, the creation or deepening of the contestability of markets through creative destruction also serves to raise productivity through competitive pressure.

There are also impediments to the positive outcomes of creative destruction. Even in markets without friction, the advantages that firms have with which to advance while others fall behind may first show up in the form of profitability and only later, as productivity. New firms are not necessarily more productive as learning needs to take place and the empirical evidence supports this. If learning does not take place, then new

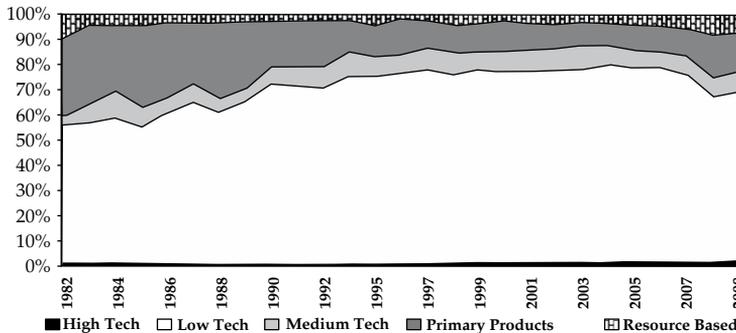
entrants exit quickly and only productive ones survive. Empirically, the high level of deaths in the early years of firm life supports this argument.

6.4.1. *Absence of Dynamic Structural Change*

This discussion is important in Pakistan’s context as the earlier sections explaining the wide variance in productivity demonstrate that large gains can accompany creative destruction. However, equally importantly for countries such as Pakistan, there are impediments to the process of creative destruction. As described earlier, the lack of strong institutional governance allows laws and regulations to be implemented in ways that favor firms in an unpredictable and opaque manner. Creative destruction thus occurs for reasons other than efficiency or not operating at all.

High-technology exports constituted less than 2 percent in 2008—a share that remains broadly unchanged over the last 25 years (Figure 16.14). This is extremely low for a country that has good educational and research institutions, and a large population. For example, Vietnam’s share of high-technology exports rose from 0.7 percent to 3.8 percent of the total in the same period, whereas India’s increased from 2.8 percent to 6.2 percent. Moreover, while the majority of Pakistan’s exports (around 54 percent) were classified as low-technology products even in 1985 (Lall, 2000), this share has increased further over time, reaching close to 80 percent in 2006.

**Figure 16.14: Technological content of Pakistan’s exports**



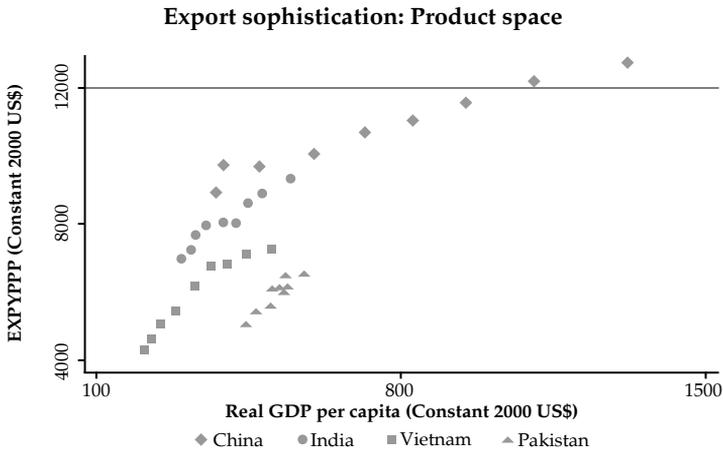
Source: World Bank (2012a).

Generally the consensus is that Pakistan’s economy has shown limited, if any, transformation over the past 20 years. One common aggregate export basket demonstrates that the country remains a low-technology exporter with very little movement in its share of exports,

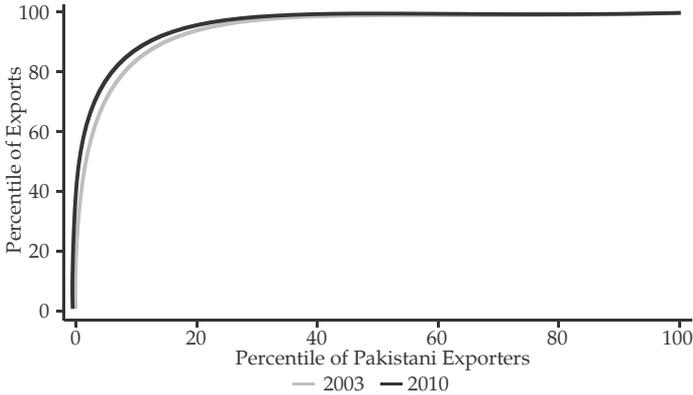
which could be an outcome of creative destruction. This low level of technology content is also reflected in the very low level of technology exhibited by firms operating in Pakistan.

Two other dimensions of Pakistan’s export dynamics support the low level of structural change in the economy over time. First, compared to other countries, and relating changes in export sophistication to changes in income per capita, Pakistan demonstrates far less structural change than countries thought to be going through such dynamics, e.g., China, India, and Vietnam. Second, when examining Pakistani exports, we see that not only is there a high degree of concentration of exports in only a few firms, this has not changed much over time. In 2002, 1 percent of firms accounted for 40 percent of exports and 5 percent accounted for 71 percent. In 2010, exporters became more concentrated among the top 1 percent, and the top five accounted for 76 percent—a trend opposite to that of other dynamic economies in the world, which are geared toward more participation in international trade, not less (see Figure 16.15).

Figure 16.15: Export sophistication and concentration, 2003–10



**Export concentration: Firm space**

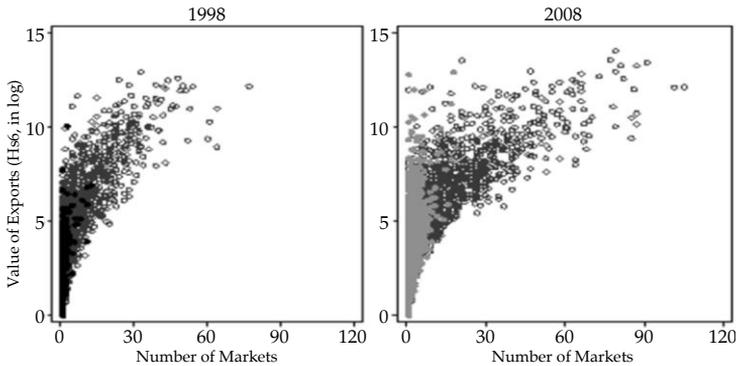


Source: World Bank (2012a).

*6.4.2. Some Low Degree of Discovery and Diversification*

The dynamic dimensions of Pakistan’s economy showed some promising signs during the early part of the 2000s. By 2007, there was evidence of structural change but growth in the technological content of exports remained miniscule. Unlike the limited data on firm entry and exit (births and deaths) in the domestic market, there is more firm data available for products bought and sold on international markets. Therefore, granular levels of entry and exit can be examined for export products and exporting firms as a proxy for creative destruction at the economy-wide level (Figure 16.16).

**Figure 16.16: Export product discovery and death**



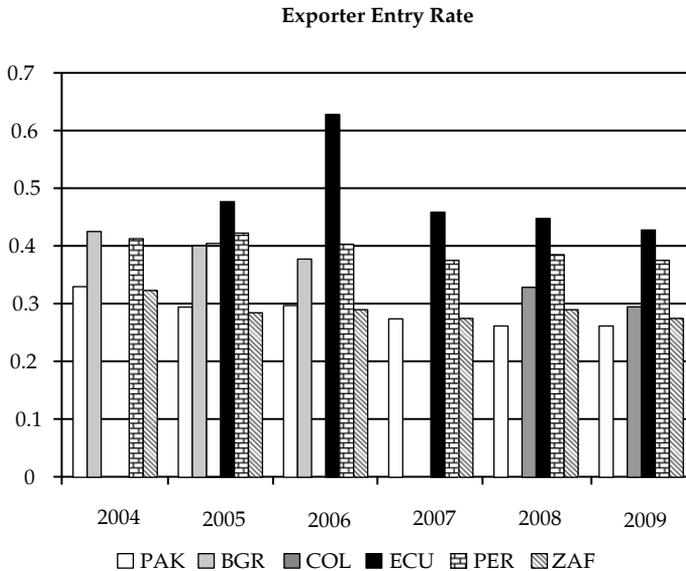
Source: World Bank (2012a).

## The Role of the Firm

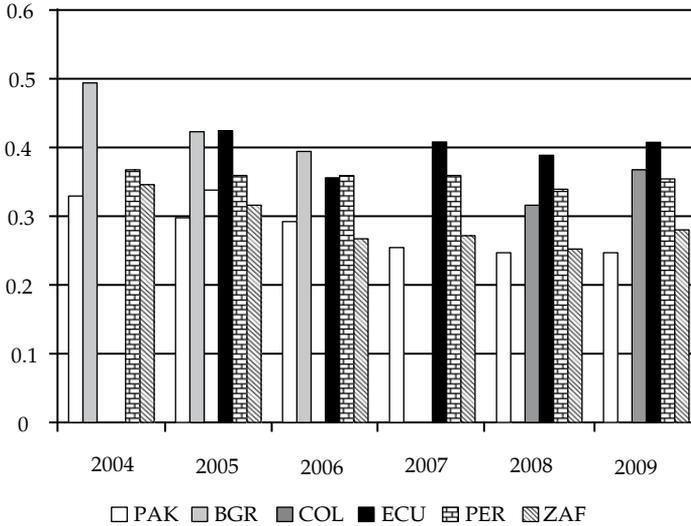
First, when looking at the product level, there is strong evidence of product discovery by exporters at low levels. Each point represents a product in a particular market. When mapping new products in new markets in 2008 and old products in 1998 (which no longer existed in 2008), it is clear that births well exceed deaths at the product level. The results are consistent with a low but positive degree of creative destruction.

Second, important patterns emerge when examining firm-level data on trade. Export entry and exit is lower in Pakistan than in its peer countries but new entrants have consistently offset the losses of exiting firms. This result, consistent with the finding at the product level, confirms some positive degree of churning at the firm level. Pakistani firms are quite dynamic along this margin, as seen by the significant entries and exits over the years from 2002 to 2010. According to the trade data, each year, anywhere between 16 and 37 percent of firms exit as another 19 to 37 percent enter (Figure 16.17).

Figure 16.17: Export entry and exit rates



Exporter Exit Rate

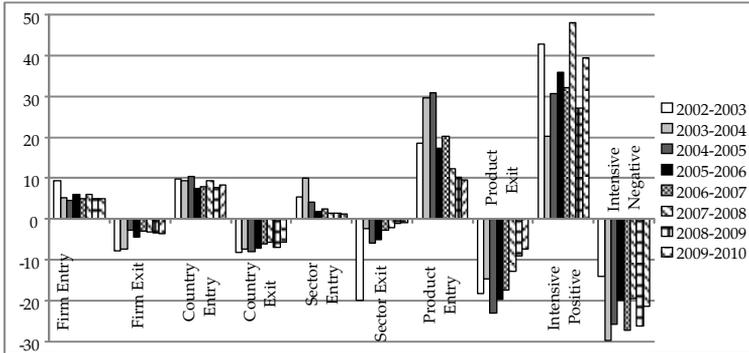


Source: World Bank (2012a).

Third, at first sight, there seems to be significant destruction and creation of exporters in the data; entry and exit rates are in fact lower than in other lower middle-income countries. Moreover, the net effect on the number of exporters seems to be marginal. This suggests that the number of exporters is not expanding any significantly over time. Firm export growth due to the entry of new firms into the export market during 2002–10 was, on average, 1–2 percent higher than the loss in growth due to firms that stopped exporting.

Finally, dynamism fell significantly after 2004. This emerges clearly if we decompose export growth by intensity and firm, country, sector, and product-extensive margins (Figure 16.18). Fewer firms have entered and exited the export market since 2004 and incumbent exporters have become more conservative in terms of export markets, sectors, and product experimentation. In short, over the second half of the last decade, entries and exits by new firms as well as existing firms in new countries, sectors, and products, all fell consistently.

**Figure 16.18: The dynamics of exports: Firms, markets, sectors, and products, 2002–10**



Source: World Bank (2012a).

The declining entry and exit at the firm, sector, and product level provides a strong indication of the decrease in the dynamism of exports in Pakistan over this period. This fall in some of the dynamic aspects of exports in the early part of the decade may have been a rational response to the deteriorating business environment, which, in turn, can be traced to (i) macroeconomic, political, policy or other form of instability experienced by the Pakistani firm, and (ii) a policy framework that offered declining incentives to enter, compete, and innovate.

#### 6.4.3. Evidence of Reform-Based Productivity

An analysis of the World Bank’s enterprise surveys of 2002 and 2007 to identify limited evidence of creative destruction confirms that aggregate productivity in Pakistan’s manufacturing sector increased over this period.<sup>7</sup> The observed increase in productivity was due mainly to the allocation becoming more biased toward larger-market-share firms and only marginally due to a rise in the term measuring average productivity. This indicates that there was indeed a process of reallocation, but of market shares toward higher-productivity firms, i.e., the larger, more traditional firms (as indicated by their export concentration). The lower-

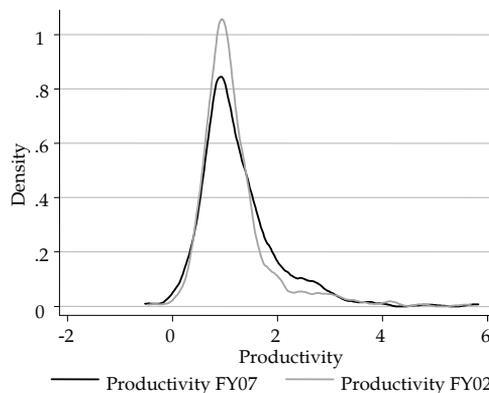
<sup>7</sup> Caution should be used when interpreting productivity purely as efficiency. There is a debate in the field on whether productivity is better viewed as firm-level revenue generation power; this consists of using factors more efficiently (i.e., technical efficiency) resulting from firm-specific investments in technology, competition, labor, and skills on one hand, coupled with firm-specific market power that allows a firm’s own prices to be raised in relation to the sector deflators being used. In this analysis, such a distinction is not possible, so the term “productivity” is used to cover both instances.

productivity firms lost market share but not while they remained in the market and increased the “average firm” productivity term.

The increase in aggregate productivity is observed for both the datasets and is confirmed by extracting a nonrepresentative panel sample of 400 firms that were surveyed twice. The increase was due to a rise in firm-level productivity as well as economy-wide productivity gains resulting from market shares going to firms with higher levels of productivity. The change in the productivity distribution over 2002–07 indicates a slightly smaller concentration of low-productivity firms in 2007 than in 2002.

This observation is shown as kernel density graphs for the two sample periods where the average productivity distribution of firms moving to higher-productivity areas supports a dynamic analysis of rising firm-level productivity (Figure 16.19). The results clearly show the high concentration of low-productivity firms, which characterizes Pakistan’s enterprise sector. This underscores the results described above, which imply low average productivity and a wide range of productivity differences among coexisting firms. This migration of firms toward the more productive areas of the frequency distribution is consistent with the hypothesis that the period was characterized by policymaking that induced creative destruction, productivity increase, and improved competitiveness.

**Figure 16.19: Kernel density for productivity, FY2002 and FY2007**



Source: World Bank (2009).

## **7. The Role of Public Policy**

The investment climate plays a critical and determining role in supporting two driving forces of Pakistan's development strategy: (i) an increase in competitiveness and firm-level efficiency, and (ii) the creation of high-quality jobs to provide employment to a large proportion of the working-age population. In both cases, the investment climate plays a critical role through complex transmission mechanisms.

As described in detail, the business environment has a direct and indirect effect on both these objectives through various transmission channels—each of which contain policy options to help foster the effectiveness of the transmission. As the chapter has described, the investment climate affects firms' employment and efficiency either negatively or positively by: (i) affecting the cost of doing business, both official and unofficial; (ii) creating incentive for participation or not in the formal economy; and (iii) proactively fostering the process of entry and exit so that creative destruction leads to inclusive growth. All three transmission mechanisms are highly susceptible to the policy frameworks established by governments, regulatory authorities, and judiciaries at various levels of jurisdiction.

Pakistan's policy and institutional landscape has been shifting since independence, and continues to do so. The most recent seismic shift was the 18th Amendment to the Constitution, which seeks to complete the process of establishing a federation of provinces. Therefore, as the predominant center of executive power shifts from the military to the federal and on to the provincial level, while the judiciary becomes more active and regulators continue to play an independent role, the business environment remains an irrelevant set of rules, a work in progress, a noisy annoyance, or a rent-seeking opportunity depending on the individual businessperson's perspective.

### ***7.1. Options in a Public–Private Dialog Framework***

Given the continuously shifting sands of Pakistan's business environment, it is critical that the public sector remains in close contact with the views of the business sector. Naturally, information gathered regularly can be informative in adjusting and calibrating the focus and priority of critical aspects of the public sector's effort. More important, however, is an ongoing public–private dialogue. This can be done in various ways, for example (i) through dissemination and discussion around surveys such as those analyzed here; (ii) through public–private task forces established for a short period of time, such as that established

by the Planning Commission in 2010; or (iii) through the more permanent participation of the private sector on various committees and councils.

In any of its incarnations, the results of maintaining close contact with the Pakistani business community will serve not only to collect input on the most important deficiencies of the business environment, but also to monitor the progress on implementing reforms, and even helping to organize the private sector for collective activities. Such engagement is not only informative but also empowering for the private sector, which will ultimately be making the investment and employment decisions. Indeed, public sector dialog with the business community represents a key aspect of the former's effort to provide the catalytic force needed to spur a productivity-virtuous circle.

### *7.2. Addressing the Cost of Doing Business*

Reviewing the regulations facing the firm in a structured and comparative way is a necessary first step to gauge where the country, region, or locality stands in terms of a regulatory framework for business. In its de jure form, the regulatory framework is often measured by benchmarking indicators, such as those created by the World Bank's DB project.

The importance of a DB-type review is threefold: (i) it can be deployed at various levels of jurisdiction and cover the various institutions establishing the rules of the game; (ii) it compares like indicators against those of other countries to help judge the severity of the problem; and (iii) it takes the first step in documenting the time-and-costs requirement based on legal and regulatory rules. The second step is usually a regulatory review of some sort that tries to (i) establish the rationale for a regulation, (ii) eliminate those that are redundant, and (iii) improve those where necessary by looking at front-line implementation issues.

More elusive is the effort to address the unofficial costs of doing business. The evidence shows, however, that some reforms are clearly without controversy in terms of reducing the unofficial costs of doing business. The first and most obvious measure is to minimize steps, procedures, and agencies, while ensuring that the bodies in charge of governance are empowered and accountable. Independence, checks and balances, and third-party verification are all ways that authorities around the world use to minimize the probability of prohibitively large costs imposed through unofficial means. Finally, involving and mobilizing the public, civil society, and other interested bodies through public awareness campaigns, can help change the narrative around the role of bribes and gifts for public officials, which is often part of the enabling environment.

### ***7.3. Improving the Incentive for Formality***

The issue of informality in transitional countries is difficult to understand and is opaque in its causes and effects. Additionally, it is not clear whether it yields a net loss to society or has a role in the way economies operate. Certainly, to the degree that regulations impose such high costs that firms find it profitable to remain informal to avoid them, it may be obvious that the official costs are too high. It may be the case that many of the basic business costs, such as for taxes, labor, and safety, are just too high. To the extent that the informal costs are unpredictable, opaque, and applied inconsistently, firms will avoid engagement.

On the other side of the equation, where the attraction of a formal structure—finance, contracts, land, etc.—is not enough to cause firms to register, pay taxes, and play by the rules, then it would be beneficial for society if these “pulls” for informal firms be made available even through a pilot, micro-, or social capital approach. The saying is appropriate that, if the system is not working for the average firm, then the average firm will find it difficult to work for the system. In other words, without the benefits of being formal, available, accessible, and applicable, firms will have no reason to participate in the formal economy.

### ***7.4. Encouraging and Enabling the Process of Entry and Exit***

A key dimension of fostering “good” creative destruction is that the governance of the system should be strong, transparent, and accountable. It is only through such legitimacy bestowed on the system that the process of creative destruction can be viewed by society as stable, beneficial, and worth the costs of structural adjustment. However, it is also the primary and perhaps the only way that an economy can upgrade its production over time so that growth is driven by private sector innovation, investment, and indeed, failure, in a risk-taking environment.

Specifically, the role of institutional governance is critical to an organic and productive process of entry and exit. Entry has to be governed by rules and procedures, and most importantly, have access to land, labor, markets, and services. The legal framework must be such that risk-based finance can be deployed based on clear and solid estimations of risk and uncertainty. At the same time, exit should be quick, decentralized to a creditor-based approach that allows for restructuring as well as liquidation, and is done in such a way that it fosters rather than hinders entrepreneurship. This means that entrepreneurs with ideas that did not work should not be penalized so much that they are unwilling to try again with another idea.

Finally, the principal driver behind the innovation and productivity growth that emerges from a holistic process of creative destruction is the competition generated with a level playing field in contestable markets. As competition is not a natural element of an economic landscape, the policy framework behind the business environment often needs to attend to both explicit as well as implicit competition dimensions. On the implicit side, the framework would include, for example, open markets for all firms who meet the basic criteria, a high propensity to import, and a welcoming attitude toward foreign direct investment. As a second step, an explicit framework would include a competition law and an enforcement agency ready and willing to take concerted efforts to address private competition breaches as well as discuss and lobby against public sector ones.

## **8. Conclusions**

This chapter has provided evidence from firm-level surveys that, in the grand scheme of poverty reduction and the growth of shared prosperity, the firm plays perhaps the most critical institutional role in a country's development goals. Total factor productivity, which determines the business sector's competitiveness and wellbeing, occurs at the firm level where the inputs of labor and finance are added to land and premises in order to make the output and sale such that the value of outputs is greater than the value of inputs.

In Pakistan—where the firm means so many things depending on one's experience, perspective, and interest—in its simple form, the country appears similar to many others with a dual economy: a large set of very small firms usually operating at some level of informality and coexisting with a small set of seemingly large firms, which, due to their export-oriented nature, large following, and traditional position in society would find it difficult to officially acknowledge the idea of operating informally. In Pakistan's case, however, the distribution of firms is skewed very much toward the smaller end.

At the same time, it is clear that large firms in Pakistan are not faring as poorly as expected, given their ability to cope with the investment climate's deficiencies unlike the large number of small informal firms that end up facing highly local markets. Overall, this configuration of productivity growth is beneficial to overall aggregate productivity, but to the extent that nonproductive or less productive smaller firms fail to exit, it will constrain existing opportunities for raising taxes and increasing productivity through new firms.

### *The Role of the Firm*

The way to the heart of Pakistan's development is, therefore, through the firm. The central focus of policymaking should be to foster the three transmission mechanisms of productivity enhancement at the firm level. In addition, by reaching out to the private sector from time to time, a productive public-private dialog should be initiated, which may create the spark to kick-start a virtuous circle of growth in Pakistan.

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## **Beyond the Poverty Line: A Multidimensional Analysis of Poverty in Pakistan**

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### **1. Introduction**

The issue of poverty is both simple and complex: at one level, the implicit or explicit objective of most economic policymakers in developing countries is to reduce the levels of poverty in a country; at another level, the tools that should be used are constantly open to debate. The debate in almost all developing countries concerns the correct policy mix between those that target economic growth, which have the potential to reduce poverty as overall income levels rise, and those policies that target poverty directly, such as social safety nets or income transfers.

There is little question that long-term growth reduces poverty, but in a country such as Pakistan, where growth is sporadic at best, the question that arises is what can be done to reduce poverty for those who will not benefit from growth for years or even decades. If we add to this the fact that development has been devolved to the provinces in Pakistan after the 18th Constitutional Amendment, the future of poverty alleviation initiatives is quite simple: Either we explicitly acknowledge that the state is only concerned with economic growth and wait for growth to reduce poverty—while pursuing intermittent and idiosyncratic poverty interventions that assist the poor but do little to move them out of

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poverty—or we clearly focus the limited resources of the state on explicitly targeted poverty interventions.

The purpose of this chapter is not to evaluate poverty reduction initiatives in Pakistan or to predict what will happen to poverty in the country over the next decade. Rather, we want to see what has been happening to poverty over the last decade by looking at poverty in unique ways: First, we look at what has been happening to poverty if we expand the definition of poverty to include not just income but also other basic necessities such as health and education. After this, we decompose poverty into two distinct categories in Pakistan: poverty as a result of the circumstances into which one is born (such as where one was born or the education of one's parents) as opposed to poverty as a result of one's own efforts (such as the level of education one obtains). The principle objective of our analysis is move the debate in Pakistan beyond the "poverty line" as defined in income terms and toward a more comprehensive discussion of what really makes people "poor" and the best ways of targeting poverty in Pakistan. We believe that, in an environment characterized by constrained resources and intermittent poverty reduction interventions, the only way one can make an active difference to the level of poverty is to clearly identify which areas to focus on.

The chapter is structured as follows: Section 2 discusses some of the literature on poverty in Pakistan as well as the more recent literature on poverty measurement. In Section 3, we look at a wider view of poverty, which includes health and education, and then at poverty trends from this wider perspective. In Section 4, we decompose poverty in that which can be explained by circumstances and that which can be explained by effort. We then see what happens to poverty if we were to equalize the circumstances in which people were born. Finally, we present some conclusions from our analysis.

## **2. Measuring Poverty and the Literature on Poverty in Pakistan**

### ***2.1. Trends in Poverty and Inequality in Pakistan***

On average, poverty has decreased in Pakistan over the last decade or so, after having risen in the 1990s. The proportion of people living below the international poverty line, i.e., on less than USD 1.25 a day, went from 58.5 percent in 1990 to 36 percent in 2001/02, finally falling to 22.6 percent in 2004/05 (World Bank, 2008, 2009). According to the national poverty line, poverty rose steadily from 17.32 percent in 1987/88 to 25 percent in 1993/94, dipping to 21.6 percent in 1996/97 before rising sharply to 30.6 percent in 1998/99, and finally peaking at 34.5 percent in 2000/01. After that, significant declines occurred, culminating in a poverty headcount of

22.3 percent in 2005/06—almost identical to the poverty rate seen in 1990/91. Households are vulnerable to shocks, such as the food price crisis in the latter part of the last decade, economic slowdowns, political turmoil, and other disruptions that can reverse gains in poverty alleviation, moving vulnerable households back into poverty.

Khan (2011) and Anwar (2009) reach similar conclusions about the overall fall in poverty when looking at other dimensions of wellbeing besides income per capita. Khan (2011) finds that multidimensional poverty fell by five percentage points between 1998 and 2008 to 38 percent. However, it was not a steady decline as steep increases in poverty occurred both in 2001/02 and 2005/06. At the end of the period studied, poverty continued to be higher in rural than urban areas, but the gap had narrowed. Naveed and Islam (2011) also consider multidimensional poverty in Pakistan, noting that the most common deprivations faced by households (in order of importance) are due to child mortality, lack of land ownership, and children not enrolled in school.

Anwar (2009) uses household data over the 2000–05 period to look at trends in consumption and other measures of wellbeing across income deciles, finding that inequality falls in terms of “opportunities” as measured by literacy, school enrollment rates (at all levels), child immunization, pre- and postnatal care utilization, access to electricity, and access to modern water and sanitation. However, he notes that income inequality likely increased over the period since the richest two deciles increased their share of consumption.

There are also seasonal aspects to the relationship between income and household wellbeing, particularly in rural areas. The vulnerability of low-wealth households can be more acute during certain times of the year, particularly in rural areas. Behrman, Foster, and Rosenzweig (1997) point out, in their analysis on rural households’ joint or linked production-consumption decisions in Pakistan, that food consumption is sensitive to wage income for low-wealth families (<1.5 acres) in the planting (lean) season, mainly due to the high prices of food and credit. However, in a plentiful harvest season, households’ consumption decisions are mostly invariant to income shocks. The authors measure a small positive productivity effect (in terms of additional output at harvest) of additional calorie consumption at the planting stage.

Shocks such as those to food prices can lead to large increases in poverty, though these are usually transient. Ivanic, Martin, and Zaman (2012) find that the spike in food prices in late 2010 that caused wheat prices to double and led to 65–75 percent increases in sugar, maize, and soybean and palm oils, led to a net increase in poverty of 44 million people around

the world. Further, they estimate that the poverty headcount in Pakistan increased by two full percentage points (the second largest increase in the sample) due primarily to the fact that the steep rise in global wheat prices was largely passed on in the form of higher local prices.

The World Bank (2011) also studies the effect of increasing food prices (particularly wheat) between 2006 and 2010, finding that households would have needed 27 percent more income between 2006 and June 2008 to maintain household utility levels in the presence of the price increases (increasing further over the course of the year), and that caloric availability fell by around 8 percent at the height of the food price crisis in 2008. The study finds that households sold assets to absorb the shock of higher food prices, and that those that owned land were somewhat protected.

Chaudhry and Chaudhry (2008) calculate the elasticity of the poverty gap (depth of poverty) with respect to food prices as 2.1 percent and 0.44 percent with respect to energy. Kurosaki (2006) also focuses on the effects of risk and shocks on poverty when decomposing poverty into chronic and transient components. He finds in Khyber Pakhtunkhwa (KP) that during 1996–99, more than half the population was always poor, 13 percent were usually poor, and 16 percent were occasionally poor. Earlier research by Alderman (1996) on the IFPRI panel from the late 1980s of rural households in Pakistan demonstrates that, even though households engage in precautionary saving, they experience a reduction in per capita consumption and sell assets when faced with multiple shocks.

## **2.2. *Measurement of Poverty***

The simplest and historically most commonly used indices to measure poverty include the poverty headcount, the poverty gap, and the squared poverty gap. These indices are known as the Foster-Greer-Thorbecke (FGT) measures of poverty. However, in recent years, newer measures of poverty have been developed to capture dimensions of poverty that are not contained in the FGT indices, such as poverty across time or different dimensions of poverty. These include measures that capture the detrimental impact of income fluctuations (see Kurosaki, 2006) or measures that capture multiple dimensions of wellbeing (such as Alkire & Foster, 2011) in the spirit of Sen's capabilities approach. Alkire and Foster (2011) first calculate deprivation on individual dimensions, such as consumption, health, education, or empowerment, after which the number of dimensions for which a person is deprived can be summed.

As we have seen, there is increasing recognition among development economists that poverty is more than simply the shortfall

of income or consumption below a certain threshold, but rather the deprivation of households along multiple dimensions. In fact, the relationship between consumption levels and deprivation can be weak, as noted by Naveed and Islam (2010) in their analysis of selected districts in Punjab and KP.<sup>1</sup> According to their analysis, the official poverty line has missed a large share of those who would be considered among the multidimensional poor. Measuring poverty by the official poverty line, only around 18 percent would be considered poor in these two provinces, but the share of households deprived in either five or six dimensions is 36 or 25 percent, respectively.

Similarly, McLeod (2006) finds for a larger group of countries including Pakistan that calculations of poverty through household expenditure surveys do not correlate highly with capabilities; rather, national accounts estimates of consumption growth are better predictors of improvements in wellbeing.

Kurosaki (2006) notes that one of the unattractive features of the FGT squared poverty gap measure is that it does not capture that income fluctuations have more serious welfare implications the greater the depth of poverty. Further, he finds that decompositions of poverty into chronic and transient components using the FGT squared poverty gap is not robust to changes in the poverty line, while the Clark-Watts measure which incorporates constant relative risk aversion, performs significantly better.

### **3. Incorporating Education and Health into Poverty Measures**

In this section, we analyze unidimensional and multidimensional measures of poverty using household-level data on income, health, and education in Pakistan. The reason for this is that poverty is a multidimensional concept in that certain segments of the population may be simultaneously deprived in numerous dimensions but their poverty can be underestimated if one looks only at their income. Similarly, certain segments of the population may be better off when assessed across various dimensions of deprivation as compared to a simple analysis of their income.

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<sup>1</sup> The dimensions of deprivation (and cutoff) considered were education (less than primary completed, child not enrolled), health and nutrition (an underweight woman in household, one death under age 5), housing (mud house), electrification, safe drinking water, (no covered sources), sanitation (lack of proper toilet), assets (none), livelihood (household head unemployed or in elementary occupation), child status (not enrolled in school), cooking fuel (dirty fuel used: wood, dung, or coal), land ownership (< 2 acres agricultural or some nonagricultural land), and consumption (less than the official poverty line).

For the purposes of this analysis, we focus on three dimensions of poverty: income, education, and health. As is the standard practice (see Labar & Bresson, 2011), when looking at educational deprivation, we have restricted our sample to individuals above the age of 20. In order to measure each type of deprivation, we use the following data for 2004, 2008, and 2010 from the Pakistan Social and Living Standards Measurement Survey: for income deprivation we use household per capita income, obtained by dividing the total household income by  $n^a$ , where  $n$  is the number of household members and  $a$  is an equivalence factor. For education, we use the number of years of education obtained by the household member. For health, we use a combination of indicators, including household sources of water and household sanitary conditions.

The income-based poverty line we use is USD 1.08 per day in 2004 and USD 1.25 per day in 2008 and 2010. For education-based poverty, we take a person to be below the poverty line if they have not completed primary education; for health-based poverty, we take a person to be below the poverty line if they do not have a clean source of drinking water.

First, we look at unidimensional comparisons of poverty over time. Here, we look at the poverty trend using each of these indicators across gender, provinces, and rural/urban divides. We then apply unidimensional stochastic dominance tests to gauge what has been happening to poverty, using these indicators separately.

Following this, we look at multidimensional poverty using all the indicators. Following Alkire and Foster, we use both the intersection and union approaches to poverty identification. The intersection approach implies that a person is considered poor if they are deprived in all dimensions of poverty, namely income, health, and education. In the union approach, a person is considered poor if they are deprived in at least one dimension of poverty. As for the unidimensional analysis, we initially look at the trend in multidimensional poverty across gender, provinces, and between rural and urban areas.

### ***3.1. Analysis of Unidimensional Poverty in Pakistan over Time***

The unidimensional poverty analysis checks to see if poverty has fallen when one looks at the three indicators of deprivation, income, health, and education, separately over time. We start with a look at the statistics on poverty levels, using each of these three indicators over time, and then carry out a stochastic dominance analysis to see if poverty has fallen significantly over the last decade in Pakistan.

Looking at poverty from the perspective of income, Table 17.1 shows the overall percentage of people below the poverty line for the years 2004, 2008, and 2010. What the numbers show is that there is a significant decline in the number of people below the poverty line between 2004 and 2008 from approximately 20 to 16 percent. From 2008 to 2010, the percentage of people below the poverty line rises to approximately 16.5 percent but this number is not statistically different from the corresponding number from the 2008 data, which implies that the percentage is approximately the same between 2008 and 2010.

**Table 17.1: Percentage of population below the income-based poverty line for the entire population**

	2004	2008	2010
Below poverty line	20.8	16.2	17.5
Above poverty line	79.2	83.8	82.5
Total	100.0	100.0	100.0

*Source:* Authors' calculations.

Table 17.2 shows what has happened in the rural and urban areas in terms of income-measured poverty: Between 2004 and 2008, there is a significant decrease in the percentage of the urban population living below the poverty line, from approximately 11.5 to 9.2 percent. After this fall, the level of urban poverty stays approximately the same from 2008 to 2010. A greater fall occurs in rural poverty from 2004 to 2008, with the percentage of the rural population living below the poverty line falling from approximately 25 to 19 percent. The level of rural poverty rises between 2008 to 2010 from approximately 19 to 20 percent, but this increase is again not statistically significant.

**Table 17.2: Percentage of population below the income-based poverty line for the entire population: Rural vs. urban breakdown**

	2004		2008		2010	
	Urban	Rural	Urban	Rural	Urban	Rural
Below poverty line	11.84	25.8	9.48	19.82	10.09	21.44
Above poverty line	88.16	74.12	90.52	80.18	89.91	78.56
Total	100.00	100.00	100.00	100.00	100.00	100.00

*Source:* Authors' calculations.

Finally Table 17.3 shows the breakdown of income-based poverty across the provinces. Again, there is a significant decrease in the

percentage of people living below the poverty line in all four provinces between 2004 and 2008, with the greatest decrease occurring in KP where the percentage of people living below the poverty line falls from 34 to 22 percent. In Punjab, Sindh, and Balochistan, this trend of falling poverty continues between 2008 and 2010, but what is striking is that the percentage of people living below the poverty line rises significantly in KP between 2008 and 2010 from 22 to 26 percent.

**Table 17.3: Percentage of population below the income-based poverty line for the entire population: Provincial breakdown**

	2004			
	Punjab	Sindh	KP	Balochistan
Below poverty line	20.00	16.02	34.66	12.22
Above poverty line	79.99	83.97	65.33	79.19
Total	100.00	100.00	100.00	100.00
	2008			
	Punjab	Sindh	KP	Balochistan
Below poverty line	16.46	14.27	22.42	11.79
Above poverty line	83.53	85.72	77.57	88.20
Total	100.00	100.00	100.00	100.00
	2010			
	Punjab	Sindh	KP	Balochistan
Below poverty line	18.8	12.9	28.7	14.1
Above poverty line	83.2	87.1	71.2	85.9
Total	100.00	100.00	100.00	100.00

*Source:* Authors' calculations.

Moving on to the second indicator of poverty, education, we focus on the percentage of people without primary education. Because individuals below a certain age may either still be in the process of obtaining education or still have the opportunity to complete their primary education, we have concentrated on individuals above the age of 20. The overall breakdown of people above the age of 20 who have not completed their primary education is shown in Table 17.4. As the numbers illustrate, there was a significant decrease in the number of people above the age of 20 without primary education between 2004 and 2008, from approximately 59 to 55.5 percent, but there is no statistically significant decrease in this number between 2008 and 2010.

**Table 17.4: Breakdown of population above the age of 20 who have not completed their primary education (%)**

<b>Only for ages 20 and above</b>	<b>2004</b>	<b>2008</b>	<b>2010</b>
Education below primary	59.1	55.4	54.9
Education above primary	40.9	44.6	45.1
Total	100.0	100.0	100.0

*Source:* Authors' calculations.

Similarly, Table 17.5 shows that there is a significant fall in the number of men and women above the age of 20 without primary education from 2008 to 2010, with the percentage of men without primary education falling by almost four percentage points from 44.6 to 40.6 percent and the percentage of women without primary education falling from 73.9 to 70.5 percent. Again, there are no significant changes in these numbers between 2008 and 2010.

**Table 17.5: Breakdown by gender of population above the age of 20 who have not completed their primary education**

<b>Only for ages 20 and above</b>	<b>2004</b>		<b>2008</b>		<b>2010</b>	
	<b>Male</b>	<b>Female</b>	<b>Male</b>	<b>Female</b>	<b>Male</b>	<b>Female</b>
Education below primary	44.67	73.88	40.62	70.52	40.45	69.28
Education above primary	55.33	26.12	59.38	29.48	59.55	30.72
Total	100.00	100.00	100.00	100.00	100.00	100.00

*Source:* Authors' calculations.

Tables 17.6 and 17.7 show the breakdown of people above the age of 20 without primary education in rural and urban areas and across provinces between the years 2004 and 2010. The three important points to note are: First, the significant decreases in the percentage of people without primary education between 2004 and 2008 (with a fall from 40.4 to 37.3 percent in the percentage of adults without primary education in urban areas and a corresponding fall from 70.4 to 66 percent in the percentage of adults without primary education in rural areas); second, the disparity in the percentage of adults without education when comparing rural and urban areas and the provinces of KP and Balochistan versus the provinces of Punjab and Sindh (with the former having a significantly higher percentage of adults without primary education than the latter); third, the lack of any significant change in all these percentages between 2008 and 2010.

**Table 17.6: Rural/urban breakdown of population above the age of 20 who have not completed their primary education**

Only for ages 20 and above	2004			2008			2010		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Education below primary	40.44	70.42	59.10	37.35	65.98	55.37	36.60	65.79	54.88
Education above primary	59.56	29.58	40.90	62.65	34.02	44.63	63.40	34.21	45.12
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Authors' calculations.

**Table 17.7: Province-wise breakdown of population above the age of 20 who have not completed their primary education**

Only for ages 20 and above	2004			
	Punjab	Sindh	KP	Balochistan
Education below primary	53.39	56.40	66.77	73.40
Education above primary	46.61	43.60	33.23	26.60
Total	100.00	100.00	100.00	100.00
	2008			
	Punjab	Sindh	KP	Balochistan
Education below primary	48.70	52.32	62.53	70.59
Education above primary	51.30	47.68	37.47	29.41
Total	100.00	100.00	100.00	100.00
	2010			
	Punjab	Sindh	KP	Balochistan
Education below primary	47.95	52.26	61.61	72.66
Education above primary	52.05	47.74	38.39	27.34
Total	100.00	100.00	100.00	100.00

Source: Authors' calculations.

The final dimension of poverty that we focus on is health, as measured by the source of drinking water available to individuals. As discussed above, we have characterized the sources of drinking water into categories above and below the poverty line. The overall picture for the years 2004 to 2010 is given in Table 17.8. Here we see an interesting reversal in the trend observed for the other indicators of poverty: From 2004 to 2008, the percentage of people below the poverty line as measured by their source of drinking water increased from approximately 11 to 15 percent, and this higher level was also observed in 2010.

**Table 17.8: Breakdown of population by access to drinking water (%)**

	2004	2008	2010
Source of drinking water below poverty cut-off	10.9	15.1	14.6
Source of drinking water above poverty cut-off	89.1	84.9	85.4
Total	100.0	100.0	100.0

Source: Authors' calculations.

Tables 17.9 and 17.10 show where this increase in poverty has occurred: Table 17.9 shows the breakdown between rural and urban poverty in terms of sources of drinking water and the numbers show a significant increase in the poverty rate (or, in other words, a significant deterioration in the sources of drinking water) in rural areas with an increase from 16 to 22 percent of the rural population falling below the poverty line in terms of sources of drinking water, while the percentage of people with poor sources of drinking water in the urban areas is significantly lower at around 1.5 percent.

**Table 17.9: Rural-urban breakdown of population by access to drinking water**

	2004			2008			2010		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Source of drinking water below poverty cut-off	1.52	16.23	10.91	1.48	22.30	15.07	1.27	21.85	14.63
Source of drinking water above poverty cut-off	98.48	83.77	89.09	98.52	77.70	84.93	98.73	78.15	85.37
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Authors' calculations.

Table 17.10 shows the provincial breakdown of people below the poverty line in terms of sources of drinking water; the numbers are striking because of the significantly lower levels of poverty in Punjab and Sindh compared to KP and Balochistan. Table 17.10 also shows where the greatest increase in poverty, as measured by the sources of drinking water, has occurred in Balochistan, with the number increasing significantly from 31 to 49 percent of the population being classified as poor in terms of their sources of drinking water. Finally, Tables 17.9 and 17.10 show that, like income-based and health-based poverty, there has been no significant change in poverty as measured by sources of drinking water between the years 2008 and 2010.

**Table 17.10: Province-wise breakdown of population by access to drinking water**

	2004			
	Punjab	Sindh	KP	Balochistan
Source of drinking water below poverty cut-off	1.14	6.41	24.06	31.89
Source of drinking water above poverty cut-off	98.86	93.59	75.94	68.11
Total	100.00	100.00	100.00	100.00
	2008			
	Punjab	Sindh	KP	Balochistan
Source of drinking water below poverty cut-off	1.41	7.95	24.07	49.21
Source of drinking water above poverty cut-off	98.59	92.05	75.93	50.79
Total	100.00	100.00	100.00	100.00
	2010			
	Punjab	Sindh	KP	Balochistan
Source of drinking water below poverty cut-off	1.83	7.83	21.77	49.92
Source of drinking water above poverty cut-off	98.17	92.17	78.23	50.08
Total	100.00	100.00	100.00	100.00

Source: Authors' calculations.

Thus, the numbers show that income-based poverty and education-based poverty declined between 2008 and 2010 while poverty measured by sources of drinking water increased between these years. Additionally, the numbers for all three poverty indicators show no significant changes between 2008 and 2010.

The obvious question that arises is whether these changes over time are significant for poverty when measured in terms of income as well as when measured in terms of education and health. Table A17.1 gives the results of unidimensional stochastic dominance tests for each of the poverty measures. The results are interesting in that they show that income-based and education-based poverty fell significantly between 2004 and 2008 while health-based poverty did not change significantly (even though the results imply that it actually rose, these results were not significant).

Moreover, even though the results seem to be implying an increase in all three poverty measures between 2008 and 2010, none of these are statistically significant, implying that there was no significant change in poverty between 2008 and 2010. A comparison of these different types of poverty measures between 2004 and 2010 yields the same results as those between 2004 and 2008: income- and education-based poverty decreased but the health-based poverty measure did not show a significant change over this period.

The rural/urban breakdowns of these unidimensional poverty measures given in Tables A17.2 and A17.3 are informative: Between 2004 and 2008, all three measures of poverty indicate that urban poverty fell significantly, whereas only income- and education-based poverty fell during in rural areas. What is interesting is that there was no significant change in income-based poverty in either rural or urban areas between 2008 and 2010, but there was a significant decline in education- and health-based poverty in urban areas between 2008 and 2010, which was not matched by any significant changes in education- and health-based rural poverty. Over the longer period 2004–08, urban poverty declined using all three measures of poverty while only income- and education-based poverty declined in the rural areas during this period.

The province-wise breakdowns of unidimensional poverty measures are given in Tables A17.4–A17.7. It is worth noting, first, that while income-based poverty fell in all the provinces between 2004 and 2008, education-based poverty fell in three of the four provinces (the outlier being Balochistan) and health-based poverty only fell in Punjab and KP. The second interesting observation is that, while there was no significant change in income-based poverty for all three provinces between 2008 and 2010, the only province that experienced a decline in education- and health-based poverty was Sindh. Finally, the statistics show that only KP did not experience a net decline in income-based poverty over the longer period 2004–10, while Balochistan was the only province that did not experience a net fall in education-based poverty during this period. Over the longer period, it seems that only Punjab experienced a significant decline in health-based poverty levels.

### ***3.2. Analysis of Multidimensional Poverty***

This section looks at multidimensional poverty, using a combination of income, health, and education indicators, and then performing tridimensional dominance tests (using these indicators) to see if multidimensional poverty has fallen over time in Pakistan.

Our approach uses the “intersection” of the various poverty measures to measure the poverty rate. By this we mean that we consider an individual to be above the poverty line if they fall below the poverty cutoff in at least one of the indicators while they are considered to be above the poverty line if all three of their indicators lie above the poverty cutoff. So an individual is considered to be above the poverty line if they are considered not poor in terms of income, health, and education; if any of these indicators lie below the poverty cutoff, they are considered poor.

Though we acknowledge that this is a far more stringent criterion for being above the poverty line than most commonly used measures, our rationale is that it allows us to build a more comprehensive picture of the state of poverty in Pakistan. So if 70 percent of the population lies below the poverty line according to this multidimensional measure, it does not imply that the figures we obtained for poverty above are incorrect; rather, it implies that, from the point of view of development, 70 percent of the population is still deprived in at least one dimension of poverty.<sup>2</sup>

Table 17.11 shows the percentage of the overall population that is poor in terms of at least one criterion. Here, we see that, according to our multidimensional view of poverty, almost 73 percent of the overall population is considered to be deprived in at least one of our key criteria (income, health, and education). This number falls to approximately 70 percent in 2008 after which it remains constant in 2010.

**Table 17.11: Percentage breakdown of overall population below the multidimensional poverty line (income, education, and health)**

	2004	2008	2010
Above cut-off in all three indicators	27.4	30.2	30.5
Below cut-off (poor) in at least one indicator	72.6	69.8	69.5
Total	100.0	100.0	100.0

Source: Authors' calculations.

Table 17.12 shows the rural/urban breakdown of multidimensional poverty, indicating the stark difference between multidimensional poverty in the urban and rural areas: Urban multidimensional poverty is almost 25 percent lower than rural multidimensional poverty (56 percent as opposed to 82 percent), and though there is a slight fall in both poverty levels between 2004 and 2008 (after which it stays relatively constant), the wide gap between urban and rural multidimensional poverty persists.

<sup>2</sup> We could also use the “union” approach in which an individual is considered poor if they lie below the poverty cutoff in all three dimensions of poverty. However, there are two problems with this approach: First, it might underestimate poverty; and second, the number of observations in our sample that meet this criterion is severely limited.

**Table 17.12: Rural/urban breakdown of overall population below the multidimensional poverty line (income, education, and health)**

	2004			2008			2010		
	Urban	Rural	Total	Urban	Rural	Total	Urban	Rural	Total
Above cut-off in all three indicators	43.99	18.01	27.39	47.48	20.99	30.18	48.48	20.78	30.49
Below cut-off (poor) in at least one indicator	56.01	81.99	72.61	52.52	79.01	69.82	51.52	79.22	69.51
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Authors' calculations.

Table 17.13 shows the provincial breakdown of multidimensional poverty. What is striking is the large gap between the level of multidimensional poverty in Punjab and Sindh versus that in KP and Balochistan. So while multidimensional poverty falls in Punjab, Sindh, and KP between 2004 and 2010 (with the most significant falls taking place in Punjab and Sindh), there is no significant decrease in multidimensional poverty in Balochistan over this period.

**Table 17.13: Province-wise breakdown of overall population below the multidimensional poverty line (income, education, and health)**

	2004			
	Punjab	Sindh	KP	Balochistan
Above cut-off in all three indicators	33.38	29.77	18.33	16.76
Below cut-off (poor) in at least one indicator	66.62	70.23	81.67	83.24
Total	100.00	100.00	100.00	100.00
	2008			
	Punjab	Sindh	KP	Balochistan
Above cut-off in all three indicators	37.78	33.15	22.91	15.22
Below cut-off (poor) in at least one indicator	62.22	66.85	77.09	84.78
Total	100.00	100.00	100.00	100.00
	2010			
	Punjab	Sindh	KPK	Balochistan
Above cut-off in all three indicators	46.46	42.31	28.30	17.60
Below cut-off (poor) in at least one indicator	53.54	57.69	71.70	82.40
Total	100.00	100.00	100.00	100.00

Source: Authors' calculations.

#### **4. Separating Circumstances from Effort in Income Determination**

A critical but often ignored question in the discussion on poverty is the impact of opportunities available to individuals on their poverty status. Obviously, there is a significant difference between the economic opportunities available at birth to individuals in Pakistan and the same amount of effort may be enough to take one individual out of poverty but insufficient in another's case. Roemer (1998), who formalized this idea, suggested decomposing economic outcomes such as income into circumstances and effort. By circumstances, we mean those exogenous factors that a person has no control over, such as gender, family background, or place of birth; by effort, we mean those factors that are affected by the choices made by individuals (or families), such as education or occupation.

In this way, economic outcomes such as income, and therefore poverty, are jointly determined by factors that are beyond the control of individuals and factors that a person can control through his/her choices. This is a powerful idea because not only can one say that a person's income lies below the poverty line, but one can also associate this income with observed circumstances beyond the control of individuals. In other words, we divide the determinants of income in Pakistan into factors determined by the circumstances into which an individual was born, and factors that are determined in his/her own life.

The small budgets and limited capacity that developing countries such as Pakistan have to work with limit their ability to equalize economic outcomes for individuals. For these reasons, in addition to notions of redistributive justice, a policy that aims to equalize opportunities is an attractive approach because it combines the idea of personal responsibility (that outcomes should vary with effort) with the recognition that many individuals are born into disadvantaged circumstances through no fault of their own.

Drawing on the concept of effort versus circumstances delineated by Roemer (1998), Bourguignon, Ferreira, and Menendez (2007) use data from Brazil on men's hourly earnings and determine that between 10 and 37 percent of the earning inequality for men aged 26 to 60 could be eliminated if they faced equal circumstances, which included race, place of birth, parents' education, and father's occupation. In their exercise, income is determined by three major factors: circumstances, effort, and unobserved individual characteristics (such as intrinsic ability and motivation). Circumstances are fully exogenous to income. However, they allow individual effort, including education, occupation, and migration, to be determined in part by circumstances. The motivation for

this, in the case of education for instance, is that the value that parents place on education may depend in part on the family's socioeconomic status, thus influencing the amount of education attained by their offspring, regardless of ability or intrinsic motivation.

This analysis is intuitively appealing, but it requires very specific data on circumstances such as place of birth and parents' education levels, as well as data on effort, such as education level and occupation. Though much of the latter information is available in household-level datasets in Pakistan, the former is not available in virtually any dataset. Thus, we take a unique approach to this problem: Using the PSLM data for 2010/11, we restrict our sample to working men aged 20 to 30 who are living with their fathers. This helps minimize the sample selection issue that would arise if men living with their fathers differed fundamentally from those who had left, in ways that were not exogenous to income.

For example, sample selection bias could occur if men who are more intrinsically motivated are more likely to move away from their parents and earn higher incomes. Since the majority of men in the 20–30-years-old age bracket will not yet have moved from their natal household, we feel that taking this subsample will minimize the sample selection bias. Given the different circumstance and effort variables that we consider, we lose additional observations due to missing data. We use the characteristics of the fathers in the households and separate the impact on income of the circumstances into which these men were born from that of their efforts.

#### **4.1. Persistence of Income and Educational Attainment over Generations**

However, before studying the joint effects of circumstance and effort variables, it is useful to take a step back and look at the persistence of key economic characteristics across generations. These are referred to as Galtonian regressions and take the form

$$\ln(Y_t) = \alpha + \beta \ln(Y_{t-1}) + \varepsilon_t \quad (1)$$

where  $Y_t$  refers to the attainment of the current generation, in this case income or education, and  $Y_{t-1}$  refers to the attainment of the previous generation. The coefficients  $\beta$  in each case indicate the persistence across generations and therefore  $(1 - \beta)$  allows us to measure intergenerational mobility. The greater the elasticity  $\beta$ , the greater is the persistence of inequality across generations; an elasticity of 1 would indicate that incomes are perfectly correlated between generations of the same family.

Table 17.14 reports the results of these Galtonian regressions of intergenerational persistence of income and educational attainment. For

each of the regressions, we run the Galtonian regression on two samples; in the first, we use the largest sample available for men aged 20 to 30, and in the second we use a smaller sample that is comparable with that used in the upcoming regressions to compute the effects of unequal opportunity on income.

**Table 17.14: Galtonian regressions of intergenerational persistence: Income and education**

	(1a)	(1b)	(2a)	(2b)	(3a)	(3b)
	Ln(yearly total income)	Ln(yearly total income)	Ln(1+education) (in years)	Ln(1+education) (in years)	Ln(1+education) (in years)	Ln(1+education) (in years)
Ln (father's annual total income)	0.40 (23.5)	0.36 (15.1)				
Ln (1 + father's education) (in years)			0.09 (10.4)	0.1 (3.6)		
Ln (1 + mother's education) (in years)					0.31 (34.2)	0.5 (16.7)
Sample	All men aged 20-30 living with their fathers	Same sample as in full regressions (below)	All men aged 20-30 living with their fathers	Comparable to sample used in full regressions (below)	All men aged 20-30 living with their fathers	Comparable to sample used in full regressions (below)
Number of observations	2844	1493	14741	1204	13753	1137

Source: Authors' calculations.

The results of Table 17.14 tell us that the income of men aged 20 to 30 has an elasticity of approximately 0.4 with respect to their fathers' income. That is, on average, a young man's income tends to be 4 percent higher if his father's income is 10 percent higher. When it comes to education, the attainment of men aged 20 to 30 is much more highly correlated with that of their mothers (elasticity 0.3–0.5) compared to their fathers (elasticity of 0.1). A young man's education tends to be more significantly affected by the level of education of his mother compared to that of his father.

On the whole, the results imply that parents' income and education are significant in determining if young men lie above or below the poverty line.

#### 4.2. The Effect of Effort and Circumstances on Income

In this analysis, following Bourguignon et al. (2007), we analyze separately the factors that affect a person's income level into those factors that a person faces at birth and has no control over, or "circumstances", and those that are determined during the life of a person, or "effort". We then analyze how the equalization of circumstances can reduce the inequality of outcomes. In determining these, two critical points emerge: First, we can assess which factors should be targeted in the effort to reduce poverty in Pakistan. Second, we can see that, in an environment of limited resources, what would be the impact on inequality of trying to simply reduce the unequal circumstances into which people are born instead of generally targeting the poor equally throughout Pakistan.

In our estimations, the circumstances that we consider are the average educational attainment of the man's parents ( $AEP$ ), the father's total annual income from all sources ( $FY$ ), occupation dummies for the father ( $FOD$ ), the household's wealth index ( $W$ ), and regional dummies for place of residence ( $RD$ ). The regression equation for the total effect of circumstances on income is:

$$\ln(w_i) = \alpha_0 + \alpha_1 AEP_i + \alpha_2 \ln(FY_i) + \alpha_3 FOD_i + \alpha_4 W_i + \alpha_5 RD_i + \varepsilon_i \quad (2)$$

where  $w$  is the yearly total income from all sources for men aged 20 to 30.

These results show that average parental educational attainment and household wealth has no real impact on earnings. However, the father's income and occupational status have impacts that are both large and statistically significant. More specifically, the children of sharecroppers have the lowest incomes while the children of farmers who own their land have slightly higher incomes. Interestingly, people with parents who are wage-paid employees tend to have higher incomes than the children of farmers while the highest incomes are those of children with parents who are self-employed or are employers. So, if one wanted to target poverty reduction funds, one should aim to focus on areas with significant populations of landless agricultural workers.

The results also show that the region of residence plays an important role. Men living in the urban areas of northern Punjab have the highest incomes, followed by those in Karachi. With the exception of KP, men in urban areas generally have higher incomes than their rural counterparts. Thus, in terms of targeting, central Punjab, southern Punjab, and northern Punjab are areas in which income levels tend to be the lowest after controlling for all other factors.

If, instead, we want to compute the direct effect of circumstances, in other words controlling for individual efforts, we start with the following expression:

$$\ln(w_i) = C_i\alpha + E_i\beta + u_i \quad (3)$$

The circumstance variables,  $C$ , are as above. The effort variables,  $E$ , chosen by the individual male aged 20 to 30 are education ( $ED$ ) and the decision to work in the agricultural sector ( $AG$ ). The regression specification we use to estimate the direct effect of circumstances  $C$ , controlling for efforts is:

$$\ln(w_i) = b_0 + b_1AEP_i + b_2 \ln(FY_i) + b_3FOD_i + b_4W_i + b_5RD_i + b_6ED_i + b_7ED_i^2 + b_8AG_i + u_i \quad (4)$$

The estimation results for equation 4 can be found in Table A17.9. The results show that the individual's own education has the expected positive and nonlinear relationship with earnings; an additional year of education increases annual total income by about 3.9 percent, emphasizing the important role of education in reducing poverty.

The father's income and occupational status have important effects on earnings. The elasticity of own income with respect to the father's income is 31 percent. Compared to men whose fathers are sharecroppers, those with fathers with higher occupational status also earn more, with the increase in wage rising with the occupational status. Men with fathers who are owner-cultivators, wage earners, or have their own business earn 20, 38, and 46 percent more than those whose fathers are sharecroppers. The region of residence is also important, with the highest incomes earned by those in northern urban Punjab and Karachi. Thus, the circumstances into which people in Pakistan are born have a significant impact on their future income levels.

Following Bourguignon et al (2007), we compare the actual earnings distribution with the theoretical distribution generated by equalizing circumstances and controlling for individual efforts using an inequality measure,  $I$ . In other words, we measure income inequality by equalizing the circumstances into which every person in the sample was born. Indices of inequality for the distribution of actual earnings, as well as the hypothetical earnings distributions computed with equalized circumstances and the residual inequality are summarized in Table 17.15.

In our results, equalizing all circumstances reduces the Theil index from 0.5 to 0.46—a fall of about 8.2 percent—when using the regressed sample of 1,493 observations. If we expand the sample to include observations for which effort variables are missing, the reduction in

inequality is 7 percent as measured by the Theil index. Thus, differing circumstances at birth lead to significant differences in income, and equating circumstances across Pakistan could have a significant impact on poverty reduction.

**Table 17.15: Decomposition of inequality measures due to unequal opportunities**

	Gini	Theil	Residual inequality after equalizing circumstances (share) GINI	Residual inequality after equalizing circumstances (share) THEIL	Number of observations
<i>Regressed sample, 1,493 obs.</i>					
Actual income distribution	0.479	0.501	Na	Na	1,493
Equalizing all circumstances	0.454	0.460	0.052	0.082	1,493
Equalizing family circumstances (only)	0.460	0.464	0.040	0.074	1,493
Equalizing all circumstances, conditional on effort	0.454	0.460	0.052	0.082	1,493
Equalizing family circumstances (only), conditional on effort	0.459	0.464	0.042	0.074	1,493
<i>Expanded sample, 2,148 obs.</i>					
Actual income distribution	0.469	0.471	Na	Na	2,148
Equalizing all circumstances	0.449	0.438	0.043	0.070	2,148
Equalizing family circumstances (only)	0.450	0.436	0.041	0.074	2,148

Source: Authors' calculations.

## **5. Conclusions**

This chapter's analysis is significantly different from typical analyses of poverty. We have looked at poverty as a multidimensional phenomenon and found that there are more significant differences between the rural and urban areas and between provinces if one expands the definition of poverty to include income levels, health indicators, and educational attainment.

Urban multidimensional poverty is almost 25 percent lower than rural multidimensional poverty and though there is a slight fall in both poverty levels between 2004 and 2008, the gap between urban and rural multidimensional poverty persists. Additionally, the provincial breakdown of multidimensional poverty shows a large gap between the level of multidimensional poverty in Punjab and Sindh versus that in KP and Balochistan. While multidimensional poverty falls in Punjab, Sindh, and KP between 2004 and 2010, there is no significant decrease in multidimensional poverty in Balochistan over this period.

We also adopt a new approach to looking at the factors that affect income levels in Pakistan. By dividing the factors that affect income into the circumstances into which people are born (and which they have no control over) and those that people can influence through their own efforts, we are able to gauge if targeting poverty reduction initiatives can have a significant impact on income levels.

We find that factors such as education have a significant impact on determining a person's income. Thus, an obvious way to reduce poverty would be to promote education in the least developed areas. A more interesting result is that the circumstances into which people are born have a significant impact on whether they will have low incomes or not; put another way, controlling for all the usual factors such as education, just being the child of a less educated father or sharecropper significantly reduces the levels of income a person will have and increases the chances that he/she will fall below the poverty line. We also find a significant decrease in income inequality if we equalize the circumstances under which people are born.

This final result is critical because normal policy reduction initiatives have a household-level focus: they are less concerned about targeting regions or communities and more concerned about targeting the lowest-income households. Our results imply that, in a situation where resources are constrained, there can be significant reductions in income inequality if one focuses on equalizing the circumstances under which people are born. This may mean that one should not have to target households with the lowest incomes, but rather target areas that have the most significant persistence of low incomes.

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**Table A17.1: Unidimensional stochastic dominance tests for entire population**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0)***	< (1)
2008-2010	< (1)	< (0.6)	< (1)
2004-2010	> (0)***	> (0)***	< (1)

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.2: Unidimensional stochastic dominance tests for urban population**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0)***	> (0)***
2008-2010	< (1)	> (0.02)***	> (0.01)***
2004-2010	> (0)***	> (0)***	> (0)***

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.3: Unidimensional stochastic dominance tests for rural population**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0)***	< (0.99)
2008-2010	< (1)	> (0.99)	> (0.16)
2004-2010	> (0)***	> (0)***	< (0.97)

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.4: Unidimensional stochastic dominance tests for Punjab**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0)***	> (0)***
2008-2010	< (0.99)	< (0.76)	> (0.17)
2004-2010	> (0)***	> (0)***	> (0)***

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.5: Unidimensional stochastic dominance tests for Sindh**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0.01)***	< (1)
2008-2010	< (1)	> (0)***	> (0)***
2004-2010	> (0)***	> (0)***	< (0.99)

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.6: Unidimensional stochastic dominance tests for KP**

Comparison years	Income	Education	Health
2004-2008	> (0)***	> (0)***	> (0.03)**
2008-2010	< (1)	> (0.84)	< (0.80)
2004-2010	> (0.11)	> (0)***	< (0.14)

Note: > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.7: Unidimensional stochastic dominance tests for Balochistan**

Comparison years	Income	Education	Health
2004-2008	> (0)***	< (1)	< (1)
2008-2010	< (1)	< (1)	< (1)
2004-2010	> (0)***	< (0.98)	< (1)

*Note:* > (<) indicates that the final distribution dominates (is dominated by) the initial distribution at the corresponding order of dominance. P-values are reported in parentheses and refer to the hypothesis of nondominance of the initial distribution with respect to the final one when < is reported and to the hypothesis of nondominance of the final distribution with respect to the initial one in the other cases. For simplicity, values less than  $10^{-3}$  or greater than  $1-10^{-3}$  are replaced by 0 and 1, respectively. \*\*\* indicates that the result is significant at the 1 percent level, \*\* indicates that the result is significant at the 5 percent level.

**Table A17.8: Regression of log total yearly income on only circumstance variables for men aged 20–30**

<b>Variable</b>	<b>Min</b>	<b>OLS</b>	<b>Max</b>	<b>t-stat</b>
Average education of parents	-0.014	-0.014	-0.014	-2.63
Ln (father's total annual income)	0.307	0.308	0.308	11.93
Father is employer or self-employed (dummy)	0.425	0.434	0.443	3.87
Father is wage-paid employee (dummy)	0.346	0.355	0.364	3.40
Father is owner-cultivator of land (dummy)	0.161	0.170	0.179	1.42
Wealth score of household	0.012	0.013	0.015	0.36
Punjab	0.049	0.069	0.091	0.41
Sindh	-0.274	-0.268	-0.261	-2.56
Northern Punjab	-0.300	-0.281	-0.261	-1.58
Central Punjab	-0.400	-0.380	-0.360	-2.55
Southern Punjab	-0.311	-0.292	-0.274	-1.79
Western Punjab	-0.091	-0.069	-0.048	-0.41
Karachi	0.162	0.165	0.169	1.58
Urban northern Punjab	0.463	0.470	0.476	2.65
Urban central Punjab	0.271	0.274	0.276	4.02
Urban western Punjab	-0.061	-0.055	-0.049	-0.35
Urban southern Punjab	-0.246	-0.240	-0.236	-1.92
Urban Sindh	0.198	0.202	0.206	2.26
Urban KP	-0.252	-0.245	-0.238	-1.54
Constant	7.803	7.817	7.828	24.13

*Note:* Number of obs. = 14,94, prob. > F = 0.0000. KP is the excluded province category and "sharecropper" is the excluded father's occupation

**Table A17.9: Regression of log total yearly income on effort and circumstance variables for men aged 20–30**

Variable	Min	OLS	Max	t-stat
Education (years)	0.037	0.039	0.041	2.55
Education squared	-0.003	-0.003	-0.003	-2.47
Average education of parents	-0.014	-0.014	-0.014	-2.53
Ln (father's total annual income)	0.307	0.308	0.308	11.95
Father is employer or self-employed (dummy)	0.444	0.455	0.465	4.05
Father is wage-paid employee (dummy)	0.370	0.379	0.389	3.62
Father is owner-cultivator of land (dummy)	0.194	0.204	0.214	1.7
Wealth score of household	0.013	0.015	0.016	0.4
Man aged 20–30 works in agriculture	0.127	0.129	0.131	2.2
Punjab	0.124	0.145	0.167	0.85
Sindh	-0.266	-0.258	-0.248	-2.45
Northern Punjab	-0.368	-0.351	-0.330	-1.95
Central Punjab	-0.460	-0.444	-0.424	-2.95
Southern Punjab	-0.382	-0.365	-0.345	-2.22
Western Punjab	-0.153	-0.135	-0.115	-0.79
Karachi	0.153	0.157	0.160	1.5
Urban northern Punjab	0.490	0.491	0.495	2.77
Urban central Punjab	0.273	0.274	0.276	4.03
Urban western Punjab	-0.059	-0.053	-0.047	-0.34
Urban southern Punjab	-0.211	-0.205	-0.201	-1.64
Urban Sindh	0.220	0.224	0.228	2.49
Urban KP	-0.259	-0.251	-0.242	-1.58
Constant	7.654	7.666	7.680	23.5

*Note:* Number of obs. = 1,494,  $F(22, 1471) = 14.63$ , prob. >  $F = 0.0000$ . KP is the excluded province, and “sharecropper” is the excluded father’s occupation.

## **Institutions, Economic Growth, and Participatory Development**

**Akmal Hussain\***

### **1. Introduction**

This chapter provides a new perspective, located in institutional economics, on the nature of the structural constraints to achieving sustained economic growth in Pakistan and overcoming poverty. It argues that the fundamental factor underlying the failure so far to embark on the process of sustained economic growth is the economy's rent-based institutional structure and associated patron–client-based governance model.

The institutional structure generates rents for a small coalition of elites by restricting competition and excluding the majority of people from the process of saving, investment, and high-wage employment. The consequent narrow base of economic growth is unequal; it is also incapable of being sustained because of lack of incentives for competitive efficiency and innovation on one hand and a low savings rate and export growth on the other. This chapter argues that sustainable economic growth can be achieved through an institutional change whereby the process of saving, investment, productivity increase, and income generation can be broad-based to include the poor and the middle classes.

Section 2 critically examines the neoliberal view that markets are self-regulating and necessarily produce efficient outcomes. Section 3 analyzes the institutional factors underlying the pattern of economic growth, endemic poverty, and slow growth in both export-based manufacturing and agriculture. Section 4 argues that elite-dominated power structures at the local level make markets as well as the provision of public services asymmetric with respect to the rich and the poor. Some of the main

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institutional factors underlying the asymmetry of markets and the provision of public services such as health, education, and justice are examined briefly. Section 5 presents an alternative approach: creating new institutions through which poverty reduction can be built into the structure of the economic growth process to make it both equitable and sustainable. Section 6 discusses one of the dimensions of this institutional initiative—participatory development—in the context of the nature of poverty and the processes through which the creative energies of the poor can be harnessed. In this new growth process, the poor and the middle classes become active subjects rather than merely passive recipients of an uncertain “trickle-down” effect.

## **2. A Conceptual Note: Are Markets Necessarily Efficient?**

Over the last four decades, the view that markets necessarily deliver efficient outcomes and are self-regulating gained ascendancy in the corridors of power in academia as well as the sphere of public policy. The lessons of the Great Depression of the 1930s were set aside and neoliberal economics became the framework for policy thinking. It prescribed nonintervention in markets on the grounds that market regulation was inefficient, except central bank control of the money supply. This led to policies deregulating markets and fostering privatization, reducing the public sector’s role and allowing the private sector free play.

Hussain (2006) has critiqued the neoliberal view that markets are self-regulating and should be allowed to function unfettered in the context of Pakistan. He argues that the view that “markets are self-organizing and self-regulating” implies “a physiology of markets where the dynamics of the market organism ... are independent of the specific history, institutional framework and the process of cultural change of any particular country.” Yet the process of self-regulation as the neoliberal view suggests is a messy and chaotic business, and “would necessarily occur in the concrete historical and cultural context of a particular country.”

How long the mess would last and what the magnitude of the chaos would be cannot be predicted by “market developers, but would be discovered by the people of that country.” On the basis of earlier research, Hussain (2006) suggests that

what are referred to in the literature as ‘market distortions’ are not marginal but may be central to the functioning of a significant part of the market space in Pakistan. The asymmetric nature of factor and product markets and the consequent allocative and distributional inefficiency may be organic to the nature of markets as they exist in the specific historical and social context of Pakistan.

Two years later, the world economy was struck by the greatest economic crisis since the 1930s. Under the influence of neoliberal economics, the US Glass-Steagall Act 1933, which forbade retail banks from engaging in risky investment activities such as selling securities, was repealed in 1999 (Skidelsky, 2010, p. 7). Such market deregulation was a key factor responsible for the world economic crisis in 2008. The neoliberal thesis that markets are self-regulating proved to be spectacular folly with tragic consequences for human societies across the capitalist world.

Neild's (2009) seminal study provides a powerful critique of economic orthodoxy, which he calls the general theory of market economics. He argues: "the problem is that competitive endeavor can run wild if it is not prudently constrained and policed by government. The orthodox theory of market economies has failed to provide adequate guidance as to why and how constraint should be applied" (p. 1).

Just as the Great Depression of the 1930s, as indeed the current world economic crisis have made clear, markets as they exist are subject to periodic failure not because of "market distortions" but because of the structural imperfections that are organic to their actual functioning. These include individual choice with imperfect information, the absence of an adequate self-correcting mechanism, and the unequal distribution of power where large economic organizations are interlinked. They can make highly risky individual decisions that can have a major impact on the economy as a whole. Investment decisions by individuals and organizations are based on the probability of individual rather than systemic risk, which can lead to greater risk in investment choices than any individual economic actor is able to estimate. Spence (2009) points out that, in a situation where individual risks are positively correlated and where the distribution of individual risk is changing, estimating systemic risk becomes inherently difficult.

In the case of Pakistan, the neoliberal idea is that incentives for innovation and risk taking will necessarily lead to the emergence of dynamic entrepreneurs, who will then lead the economy to sustained high GDP growth. As Hussain (2006) argues, this view ignores the possibility that entrepreneurs in Pakistan respond not simply to profit incentives and the presumed discipline of the market, but to a matrix of institutions that embody both formal and informal rules. "The latter are contained in norms and culture that change much more slowly than government policy. The economic elite in the areas that now constitute Pakistan has historically functioned within a patron-client model of governance since the late 18<sup>th</sup> century" (Hussain, 2006, p. 3). As Ali (2003) suggests, underlying the apparent discourse of modernity is the notion that neither the polity nor the economy has made a fundamental break from the past.

### **3. Institutional Structure and Unsustainable Economic Growth**

#### **3.1. Governance Model and Rents**

Central to the problem of unsustainable growth is a governance model where the institutional structure systematically generates rents for the ruling elites. North, Wallis, and Weingast define rents as unearned income that accrues to an economic asset when the benefit from its use exceeds its opportunity cost (2009, p. 19). In Pakistan, power has been historically constituted through rents by establishing patron–client relationships within a structure of dependency. In order to build political support, the ruling elites appropriate and use state resources for arbitrary transfer as rents to selected individuals and groups.

The rent-based model of governance originated under the British Raj in the 19<sup>th</sup> century, when the exigencies of establishing order required a convivial relationship with the new agrarian elite in the Punjab. This new elite had emerged following the peasant revolts in the late 18<sup>th</sup> century when the preceding Mughal elite was overthrown and replaced by the leaders of the revolt from among the upper strata of the peasantry (see Ali, 1988, 2003).

In the process of establishing colonial power, the British government consolidated the position of the new peasant lineages through revenue settlements that formalized the proprietorship of the new *zamindars* over land. Rent transfers in the form of resource gratification for the new agrarian elite was unprecedented in Indian history, and was accompanied by the British government's development of the canal irrigation system and the associated process of agriculture colonization in the late 19<sup>th</sup> century. These areas were appropriated by the government as Crown waste to be utilized or disposed of at administrative or political discretion. Landholdings of between 100 and 500 acres were granted to existing members of the landed elite who were loyal to the Raj. Some particularly favored individuals received much larger holdings (Hussain, 2008b).

Post-independence, the governance model and underlying institutional structure continue to systematically generate rents for the coalition of elites that had emerged. These included the landed elite of the pre-Partition period as well as the military, bureaucracy, and a state-supported nascent entrepreneurial elite. Particular forms of rents have characterized the policy and power framework of each government in the post-independence period. For example, in the first decade after independence, the principal form of rent was the grant of "evacuee" property by the government to selected migrants from India.

During the Ayub Khan period (1958–68), various forms of rent emerged through the regulatory economic policy framework. The modes of rent transfers that were made to a small industrial and commercial elite during this period included: direct and indirect subsidies, protectionist import controls, cheap imported machinery and raw materials through an overvalued exchange rate, and subsidized credit to favored entrepreneurs who were granted licenses to establish commercial and industrial enterprises.

During the Z. A. Bhutto period (1973–77), the main forms of rent consisted of lucrative appointments in the nationalized sector to favored individuals, government contracts, and bank loans. Rents were also transferred to loyalists through the new system of “lateral entry” where individuals could be granted direct entry at various levels into the elite Civil Service of Pakistan. Perhaps the largest source of rent transfers to a broad range of upper, middle, and working classes was conducted through the state-sponsored export of human resources to the Middle East (Hussain, 2008b, p. 40).

During the Zia-ul-Haq period (1977–88), a new form of rent generation emerged with the inflow of multibillion-dollar economic and military aid to Pakistan when it was positioned to play a frontline role in the US-sponsored Afghan jihad against Soviet troops in Afghanistan. The Pakistan government acted as a conduit for funds and weapons to support the war, during which a significant proportion of these funds and the sale of some of the weapons enriched individuals and groups favored by the government.

Under the Benazir Bhutto and Nawaz Sharif governments, the principal form of rent was the alleged siphoning of large funds from public sector banks, insurance companies, and investment institutions such as the National Investment Trust and the Investment Corporation of Pakistan. During the Musharraf government, the government allegedly manipulated stock markets to enrich insiders through the funds of banks and companies in the nationalized sector (Hussain, 2008, p. 39).

### ***3.2. Institutions and the Pattern of Economic Growth***

Despite over six decades of economic growth post-independence, mass poverty persists in Pakistan. This is because of an institutional structure characterized by rent generation for the elites; a highly unequal distribution of productive assets; and the exclusion of the majority of people from access to productive resources, capital markets, and high-wage employment. Consequently, the process of saving and investment is restricted to a small consumption-oriented elite coalition that has failed to

generate adequate savings and high rates of investment. At the same time, the constrained competition characteristic of such an institutional structure (North et al., 2009, p. 17) while generating rents for the elite creates disincentives for diversifying exports toward high value-added growth. Thus, two key constraints to sustaining high rates of GDP growth have emerged: (i) a low savings rate and (ii) slow export growth.

Table 18.1 provides evidence on gross fixed capital formation (GFCF) as a percentage of GDP in the private and public sectors under various political regimes during 1960–2010. The table shows that private sector gross investment as a percentage of GDP has remained low for the last five decades under all political regimes, military or civilian. In six out of the eight periods, private sector gross investment was below 10 percent and reached about 14 percent during the Musharraf regime. Total gross investment (private plus public) has also been low, varying between about 12 percent during Prime Minister Yousaf Raza Gillani’s regime to about 18 percent during the Musharraf regime.

**Table 18.1: GFCF as a percentage of GDP and GDP growth rates, 1960–2011**

Average during	GFCF as a percentage of GDP			Annual GDP growth rate (period average)
	Private	Public	Total	
1960–73	8.21	7.26	15.47	6.26
1973–78	4.79	10.71	15.50	4.99
1978–88	7.10	9.66	16.76	6.6
1988–93	9.22	8.73	17.95	4.92
1993–98	9.32	7.36	16.68	3.14
1998–2008	11.23	3.72	14.95	6.25*
2008–11	10.85	1.34	12.19	2.62

\* Refers to the period 2002–08.

Source: Pakistan economic survey (various issues).

At existing levels of income inequality, Pakistan requires a GDP growth rate of about 8 percent to have a substantial poverty reduction impact. To sustain a long-term GDP growth rate of 8 percent, investment as a percentage of GDP needs to be about 32 percent, given the incremental capital–output ratio (ICOR) of about 4. If Pakistan is to move onto a high-growth trajectory and reach the required investment target of 32 percent, while increasing the growth elasticity of poverty reduction, then a change in the institutional structure for broad-based

investment is necessary. This will require institutional changes through which the middle classes and the poor can be enabled to engage in the process of saving, investment, productivity increase, and innovation.

The New Institutional Economics literature shows that a defining feature of developed countries is their ability to sustain per capita GDP growth over long periods, while underdeveloped countries achieve brief spurts of per capita income growth but are unable to sustain it over longer periods (North et al., 2009, p. 6). The evidence shows that a fundamental factor underlying the characteristic failure of underdeveloped countries to sustain high GDP growth rates is their rent-based institutional structure, which inhibits broad-based competition, investment, productivity increase, and innovation.

The history of Pakistan's economic growth performance shows a structural inability to sustain growth. As Table 18.1 indicates, growth has occurred in brief spurts followed by sharply declining GDP growth. Relatively high GDP growth rates were achieved mainly during the military regimes when large concessionary capital inflows from the West were available to fuel growth. The average annual GDP growth during the military regimes of Ayub Khan and Yahya Khan (1960–73) was 6.26 percent, which declined to 4.99 percent in the subsequent period of Z. A. Bhutto's government (1973–78).

GDP growth accelerated again to 6.6 percent during the Zia-ul-Haq period (1978–88), followed by a sharp decline in the subsequent democratic interludes of Benazir Bhutto and Nawaz Sharif (1988–93 and 1993–98, respectively). Another spurt occurred during the Musharraf period (1998–2008) when GDP growth reached 6.25 percent, declining sharply to 2.62 percent under the subsequent government of Yousaf Raza Gillani (2008–11). It is clear that each of these spurts was followed by a decline in growth. At the end of each high-growth period, the structural constraints of a low domestic savings rate and slow export growth were manifested in fiscal and balance of payments pressures, which induced a subsequent slowdown in GDP growth.

### ***3.3. Low Savings Rate, Taxation, and Inequality***

Given the rent-based governance model in Pakistan, the business elite enjoys various forms of financial support from the government (subsidies, cheap credit, import protection, tax exemptions). It is not surprising, therefore, that entrepreneurs—many of whom are also landowners—following the tradition of the landed elite, engage in conspicuous consumption and tend to have a low propensity to save.

Historically, the domestic savings rate in Pakistan has been less than the investment rate, thereby creating a persistent savings gap that has induced growing national debt, particularly during high GDP growth periods. For example, average annual domestic savings as a percentage of GDP during 2001–2007 was 16.5 percent. By contrast, the investment rate required to sustain the target growth rate of 8 percent with an ICOR of 4 is 32 percent (Pakistan, Ministry of Finance, 2007, p. 11, table 1.6). The consequent debt-servicing problem has now become a constraint to growth just as it was in the Ayub period in the 1960s and in the Benazir and Nawaz periods in the 1990s. The low savings rate and consequent dependence on foreign inflows is a major factor in the stop-go pattern of GDP growth in Pakistan's history.

The high debt-servicing requirements resulting from the rent-seeking elite's tendency to consume rather than save, while also avoiding direct taxes, has obliged successive governments to levy high and increasing indirect tax rates. An earlier study on the increase in the incidence of the tax burden shows that the increase in the tax burden as a percentage of income was highest at 6.8 percent for the lowest income group (less than PRs 700 per month) and lowest for the highest income group (at -4.3 percent, over PRs 4,500 per month). The evidence shows that, over time, the tax burden on the poor has increased and declined for the rich (see Pakistan, Ministry of Finance, 1997, p. 6). Thus, the rent-based governance model and its incentive systems have induced a pattern of elite consumption and government tax policy that reinforces income inequality in the growth process.

Given the highly unequal distribution of productive assets in Pakistan, interpersonal inequality has risen in recent years. The Gini coefficient for income, which was 0.27 in 2000/01 (World Bank, 2005, p. 281), has increased over the last decade; the average for the period 2000–11 is 0.33 (United Nations Development Programme, 2011, p. 137). Even this level of inequality is understated because the top decile of the population tends to understate their income and expenditure to avoid taxes. Shahid Javed Burki has derived improved estimates of inequality in Pakistan on the basis of World Bank data. He suggests that the top 10 percent of the population holds 27 percent of the national income. The richest 18,000 people have an average income of USD 72,700 per capita, which is about 70 times the overall per capita income of USD 1,050 of the population as a whole.

As is now well known, the higher the initial income inequality, the lower the impact of GDP growth on poverty reduction will be. Pakistan's high and rising economic inequality has shaped the structure of the

growth process whereby mass poverty persists despite the relatively high trend rate of GDP growth (5.5 percent).

### **3.4. *Manufacturing, Export Structure, and Growth*<sup>1</sup>**

In 1947, Pakistan inherited not only various state institutions with their underlying structures of power, but also the rent-seeking and risk-averse behavioral proclivities of the economic elite.

Pakistan's failure to adequately diversify exports—and hence the slow export growth and consequent perennial pressures on the balance of payments—is a structural constraint to sustaining high GDP growth. Even after 60 years of industrial growth, the percentage of total investment channeled into textiles and related goods has not declined (it was 41 percent in 1964/65 and 44 percent in 1990/91). In terms of output, 80 percent of Pakistan's manufactured exports consist of textiles and clothing, compared to 12 percent for developing countries and 6.5 percent for the world as a whole (World Trade Organization, n.d.). The persistence of Pakistan's textile-based export structure is an important factor hampering overall export growth. This is because the composition of demand in the global market has changed: world trade in textiles is growing at a much slower rate than nontraditional manufactured exports.

Pakistan's textile industry, which has remained largely at the lower end of the value-added range, emerged in the 1960s as a result of large government subsidies. The institutional structure of policy created disincentives to innovation, productivity, and export diversification. By the 1990s, the structure of state support to industry had been substantially dismantled. However, even then, as late as 1990/91, as much as 7 percent of GDP was transferred by the government to industrialists in the form of subsidies (Kemal, 1999). The diversification of industry into higher value-added exports was constrained by government patronage on one hand and the lack of risk-taking dynamism among most industrialists on the other.

For the manufacturing sector as a whole, the major elements in the current institutional structure that constrain investment and growth are as follows.

- The continued threat to citizens' lives and property due to persistently poor law and order. The total number of terrorist attacks and other incidents of political violence in Pakistan increased from 254 in 2005 to 2,386 in 2008. The direct and indirect costs of the war on terror during 2005–08 have been estimated at PRs 2,083

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<sup>1</sup> This section draws on Hussain (2008a).

billion, with the average annual cost being 4.34 percent of GDP (Institute of Public Policy, 2009, p. 76, table 4.7).

- High electricity tariffs and frequent power outages. These incurred an estimated overall cost to the economy of PRs 1,228 billion in 2011/12, which was 6.3 percent of GDP in that year (Institute of Public Policy, 2013, p. 86).
- The adverse incentive/disincentive structure within the institutional framework and an inadequate technological base. These have constrained industry from responding flexibly as the global pattern of demand changes toward higher value-added and knowledge-intensive products.
- The adverse policy environment of the past. Tariff and export incentives have been distorted against those entrepreneurs seeking to improve quality and productivity for export growth (Pakistan, Planning Commission, 2010).
- A weak enforcement mechanism within the government with respect to trademark regulations and tariffs. This has led to the widespread dumping of smuggled, poor-quality, and extremely low-priced imported goods from China, which are in many cases counterfeits of branded Pakistani manufactured goods (Pakistan, Planning Commission, 2010).

### **3.5. *Institutional Factors in Slow and Unstable Crop Sector Growth*<sup>2</sup>**

In agriculture, the average annual growth rate of major crops declined from 3.34 percent during the 1980s to 2.38 percent in the 1990s. The frequency of negative growth years for some of the major crops has also increased, accentuating the process of poverty creation. In a year of negative growth (i.e., a bad harvest), small farmers operating at the margin have to borrow to meet their consumption requirements, and thus fall into debt. In the following season, in the absence of an investible surplus, they are unable to reconstitute the production cycle and, hence, slip into poverty. Thus, the instability of crop sector growth and increased frequency of negative growth years has become a structural factor in poverty creation.

Underlying this phenomenon are five major institutional constraints. The first is reduced water availability at the farm gate due to poor maintenance of the irrigation system and low irrigation efficiencies of about 37 percent. While the availability of irrigation water has been reduced, water requirements at the farm level have risen due to increased

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<sup>2</sup> This section draws on Hussain (1999).

salt deposits on the topsoil and the consequent need for leaching.<sup>3</sup> The resulting large water deficit means that farmers even in the irrigated areas are dependent on rainfall. Given the vicissitudes of weather—particularly due to global warming, which has caused wide variations in the timing, location, and quantum of rainfall—rain does not always fall in the right quantity at the right time for water-deficit farmers. Consequently, there is greater instability in crop sector output than before (Hussain, 1999).

What makes the improved efficiency of irrigation even more important is that the extensive margin of irrigated acreage has been reached, so that future agricultural growth will have to rely on improving the efficiency of water use and other inputs. Thus, the rehabilitation of Pakistan's irrigation system to improve irrigation efficiency has become a crucial policy challenge for sustainable agriculture growth.

It is well known that high-yielding seed varieties gradually lose their potency through reuse, the changing microstructure of soils, and the changing ecology of micro-organisms in the topsoil. The average age of wheat seed in Pakistan is 11 years compared to 7 years in all developing countries (Hussain, 1999). Therefore, breeding more vigorous seed varieties adapted to local environmental conditions and diffusing these among farmers through an effective research and extension program is necessary.<sup>4</sup>

The possibility of declining yields per acre related to global warming indicates a new dimension of the imperative of improving research capability in the crop sector. Given the sensitivity of wheat seed to temperature increase, even a two-degree-centigrade increase in average summer temperatures could mean an absolute yield decline of between 10 to 16 percent during the 21<sup>st</sup> century.<sup>5</sup> With a 2.8 percent population growth rate, a decline of 10 percent in yield per acre associated with global warming could mean serious food deficits and high food inflation rates for Pakistan, with greater adverse consequences for the poor. Indeed, the United Nations' Intergovernmental Panel for Climate Change

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<sup>3</sup> About 33 million tonnes of salts are annually brought into the Indus Basin irrigation system, out of which 24 million tonnes are retained (see Pakistan, Finance Division, & Pakistan, Planning Commission, 2001, p. 23).

<sup>4</sup> Yet there is no organized seed industry in Pakistan to meet farmers' needs for the supply of vigorous varieties of seed, even for the major crops. Compared to India, there was a sharp decline in total factor productivity growth in Pakistan after 1975, which can be attributed to the poorer level of research and extension in Pakistan (see Rosegrant & Evenson, 1993).

<sup>5</sup> If atmospheric carbon doubles, average summer temperatures in Pakistan are expected to increase by 1.5 to 4.5 °C (a base average of 2.5 °C) over the next 70 years. This could lead to a decline in wheat yields from 10 to 60 percent, depending on the type of wheat seed, planting time, and related atmospheric/weather conditions (see Qureshi & Iglesias, 1992).

(2007) predicts a 30 percent decline in the yield per acre of food crops in South Asia. It is, therefore, necessary to develop heat-resistant varieties of food grains through an institutional framework for collaboration between agriculture research centers across South Asia

One of the most important constraints to sustainable growth in the crop sector is soil degradation resulting from improper agricultural practices such as: (i) lack of crop rotation and the resultant loss of humus in the topsoil, (ii) the stripping of topsoil and resultant loss of fertility associated with overgrazing, and (iii) water erosion along hillsides and riverbanks due to the cutting down of trees and depletion of natural vegetation. According to one estimate, over 11 million hectares have been affected by water erosion and 5 million hectares by wind erosion (Mian & Mirza, 1993).

#### **4. Institutions, Markets, and Public Services**

This section examines four features of the power structure that makes markets asymmetric to function adversely against the poor.

##### **4.1. Power, Tenancy, and Tied Labor**

In areas where landowners control the local state apparatus as well as the credit market, poor tenants are locked into a nexus of power and debt bondage with their landowners. Consequently, the tenants are obliged to work part time on landowners' farms as laborers either at less than market wage or no wage at all. The Pakistan National Human Development Report (PNHDR)'s survey data shows that 51 percent of tenants get locked into debt dependence on their landowner; out of these, 57 percent are obliged to work as laborers on the landowner's farm without wages, while 14 percent work for a wage below the market rate (Hussain, Kemal, Ali, Hamid, & Mumtaz, 2003, p. 63, table 14). This structure of power and dependence creates distortions in the labor and capital markets, which systematically deprive the poor of their actual and potential income. The consequent inefficiency in the allocation of labor and capital resources constrains agricultural growth, increases inequality, and engenders persistent poverty (see Table 18.2).

**Table 18.2: Loan dependence on landowners and labor exploitation of the poor peasantry**

<b>Status</b>	<b>Extremely</b>			<b>Total</b>
	<b>poor</b>	<b>Poor</b>	<b>Nonpoor</b>	
Loan from landowner (%)	50.8	29.4	11.7	34.4
Work for landowner against wages (%)	14.0	24.3	5.1	16.9
Daily wages (PRs)	28.0	43.6	60.0	40.0
Work for landowner without wages (%)	57.4	38.5	25.4	43.5

*Source:* National Human Development Report 2003; Poor Communities Survey of Pakistan 2001 (Pakistan Institute of Development Economics).

#### **4.2. Power and the Double Squeeze on the Peasantry**

In landowner-dominated areas, a landowner's power affects the disposal of the produce by poor farm households, which has direct consequences for their food consumption. As Table 18.3 shows, under asymmetric tenure arrangements, extremely poor farmers are obliged to pay a larger proportion of their farm produce to the landowner as rent compared to other categories of the peasantry. For example, the extremely poor have to pay 28.21 percent of their production value to the landowner compared to 13.39 percent by poor households and only 8.41 percent by nonpoor households. Consequently, the extremely poor are forced to keep only 39.59 percent of their crop output for household consumption, compared to 48 percent by the poor and 54 percent by the nonpoor.

**Table 18.3: Disposal of crop harvest by income class**

Economic status	Total production value	Paid in kind to labor	Paid as rent	Paid to landowner under share cropping agreement	Given to relatives	Crop sold	Crop kept for own use/total production value*100
		(Value)/total production value*100					
Extremely poor	13,864	1.45	1.10	28.21	0.09	29.57	39.59
Poor	22,538	2.76	1.40	13.39	1.06	33.27	48.12
Nonpoor	37,626	4.70	0.83	8.41	1.61	30.02	54.43

*Source:* National Human Development Report 2003; Poor Communities Survey of Pakistan 2001 (Pakistan Institute of Development Economics).

The evidence suggests that poor tenant households face a food deficit near the end of the year due to the relatively small crop share they have been able to retain. As they run out of their household stock of food grain, they are obliged to purchase grain in the market at the year's end when market prices are relatively high.<sup>6</sup> Such households then need to borrow for food consumption. The PNHDR evidence supports this argument, and shows that extremely poor households borrow to meet their food consumption needs (Hussain et al., 2003, chap. 3, table 1).

Poor farm households are thus placed under a double squeeze. In the first instance, they are obliged to give up a relatively large proportion of their crop output as a crop share to the landowner. The second squeeze is a result of seasonal variations in the market price of grain, which forces extremely poor households to purchase a relatively large proportion of their food consumption requirements from the market near the end of the production cycle, when prices are high (Hussain, 2004, pp. 76–77).

### **4.3. Adverse Changes in Tenancy Arrangements and Poverty**

As the evidence suggests, since the majority of the rural poor are tenants, any deterioration in tenancy arrangements would be expected to accentuate their poverty. The weakening relative power position of poor tenants means that tenancy arrangements have changed adversely for them. They now have to bear a higher proportion of input costs than their landowners on tenant-operated farms. As Table 18.4 shows, tenants'

<sup>6</sup> An analysis of the mechanisms of poverty generation in the rural areas (with special reference to the Punjab) was first conducted on the basis of a 1978 field survey. See Hussain (1988, chap. 5, pp. 101–176).

contribution to input costs (for each of the major crops)—such as tractor rental (see Hussain et al., 2003, p. 64, table 16), hired labor, and seed and fertilizer—increased during 1990/91 to 2000/01.

**Table 18.4: Tenants' contribution to inputs (%)**

Economic status	1990/91				2000/01			
	Tractor	Labor	Seed	Fertilizer	Tractor	Labor	Seed	Fertilizer
Extremely poor	36.3	13.8	24.8	26.0	43.5	28.5	31.0	31.8
Poor	29.5	18.8	22.8	24.5	41.3	30.5	34.5	34.0
Nonpoor	39.8	25.8	28.8	27.3	44.5	32.8	38.8	34.5
Total	34.3	22.5	24.8	25.5	42.8	30.3	34.0	33.3

Source: National Human Development Report 2003; Poor Communities Survey of Pakistan 2001 (Pakistan Institute of Development Economics). For crop-wise figures, see Hussain et al. (2003, p. 64, table 16).

The above evidence suggests that the adverse changes in tenancy arrangements with respect to tenants' input contributions have become a significant structural factor in generating poverty. While the financial burden on poor tenants has thus increased, their lack of control over the timing of water application, combined with adulterated inputs, keeps the yield per acre low, thereby further squeezing their net incomes.

#### **4.4. Asymmetric Markets for Inputs and Outputs**

Hussain et al. (2003) argue that local elite power structures in rural areas distort markets in favor of the rich and against the poor. Poor peasants face input and output markets in which they have to pay a higher price for their inputs while receiving a lower price for their outputs than large farmers. The study shows that the latter lose as much as one third of their income due to asymmetric markets (pp. 65–68).

#### **4.5. Poverty and Illness**

Hussain et al. (2003) show that 65.1 percent of the extremely poor and 55.6 percent of the poor in the PNHDR's sample survey suffered from ill health due to inadequate diets and lack of access to safe drinking water and sanitation facilities. The data also shows that poor respondents

reporting sickness at the time of the interview had, on average, been unwell for 95 days of the year (see Table 18.5).<sup>7</sup>

The prevalence of disease among those who are slightly above the poverty line is a major factor pushing them into poverty. Those who are already poor are pushed deeper into poverty as a result of loss of income due to absence from work and high medical costs incurred by illness. Thus, unequal access to public health facilities and the relatively high prevalence of disease among the poor becomes a structural factor that accentuates both poverty and inequality (Hussain et al., 2003).

**Table 18.5: Profile of the poor who are sick (household head only)**

<b>Economic status</b>	<b>Sick at the time of survey (%)</b>	<b>Number of days of current sickness (mean)</b>	<b>Treatment expenses (PRs)</b>	<b>Patients traveling over 6 km for treatment (%)</b>
Extremely poor	65.1	94.9	1,885	49.4
Poor	55.6	27.4	497	29.5

*Source:* National Human Development Report 2003; Poor Communities Survey of Pakistan 2001 (Pakistan Institute of Development Economics).

#### **4.6. Education, Poverty, and Growth**

The relatively low levels of literacy, high-school enrolment rates, and poor quality of both school-level and higher education in Pakistan compared to other South Asian countries indicates the low priority given to education. This is understandable in a country where the allocation of public resources and the institutional framework for translating them into outcomes are determined by a ruling elite dominated by the military, bureaucracy, and landowners.

This power structure affords greater priority to expenditures on the military, bureaucracy, and transfer of public resources as rents to various strata of the elite and its dependents. Building an institutional framework for higher education based on high-quality research is also not a high priority. Education requires resources and institutional mechanisms for

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<sup>7</sup> They also relied predominantly on private allopathic medical practitioners due to lack of access to and the poor quality of most government hospitals. Private medical clinics, like government hospitals, have grossly inadequate diagnostic facilities and often poorly trained staff. The result is that when the poor fall ill, they suffer for a protracted period and are locked into a source of medical treatment that, despite being expensive, is frequently ineffective (see Hussain et al., 2003).

high-quality teaching, research, and the infrastructure facilities to pursue these activities. At the same time, it is necessary to have an environment of intellectual freedom to pose and pursue new questions and to engage in critical thinking. This is inimical to a rent-based power structure that relies on authoritarian rule, whether in military or civilian form.

Although the literacy rate has increased sharply from 46 percent in 1999 to 54 percent in 2006, the gender gap remains high (23 percentage points) and has not changed significantly over the period.<sup>8</sup> The gross primary school enrolment rate at about 70 percent has remained unchanged over the last two decades in spite of the multibillion-dollar Social Action Program of the 1990s. At the same time, almost 25 percent of the total population (over 40 million) consists of adult illiterates. Due to the relatively low school enrolment rates, the number of adult illiterates is expected to rise during the coming decade, thereby increasing poverty even if greater employment opportunities become available. In Pakistan, 91.6 percent of the labor force is unskilled (Majid, 1997, pp. 34–35), with low productivity and poor adaptability to technical change. This constitutes a significant structural constraint both to growth and poverty reduction.

The survey evidence in the PNHDR shows that one of the key factors that can pull a poor household out of poverty is the presence of a second earner. The data indicates that the magnitude of the second earner's income depends on his/her level of education (Hussain et al., 2003). The poor coverage and quality of school education and vocational training in Pakistan thus constitutes a significant structural constraint to growth as well as poverty reduction. The extremely poor quality of higher education in most Pakistani universities and control of some of them by obscurantist and coercive religious groups is as much a constraint to equitable growth as it is to building an enlightened, pluralistic, and democratic polity.

#### ***4.7. Poverty, Justice, and Citizens' Security***

The poor live in urban or rural localities that are inadequately policed. In case of theft or violence against their person, the cost of seeking redress through the judicial system is, in most cases, unaffordable; where undertaken, the expenses in terms of time and money lock the poor into permanent debt. This also engenders endemic poverty, reinforces inequality, and thereby constrains economic growth (see Table 18.6).

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<sup>8</sup> Estimates based on Pakistan, Ministry of Finance (2007, pp. 161–174).

**Table 18.6: Frequency of disputes and resolution, and cost of resolution by economic status (cases reporting disputes only)**

<b>Economic status</b>	<b>Distribution of reported disputes (%)</b>	<b>Amount spent on mediation (mean) (PRs)</b>	<b>Percent of reported disputes resolved</b>
Extremely poor	17.1	18,333	38.5
Poor	48.7	12,074	59.5
Nonpoor	34.2	18,264	80.8
Total/average	100.0	15,123	63.2

*Source:* National Human Development Report 2003; Poor Communities Survey of Pakistan 2001 (Pakistan Institute of Development Economics).

### **5. Building Poverty Reduction into the Structure of the Growth Process**

The preceding section has identified some of the structural factors underlying endemic poverty and unstable growth. This section presents a set of institutional initiatives that can be undertaken to initiate the process of pro-poor growth, helping to overcome the structural constraints to sustained and equitable growth. These include: (i) providing land to the landless as part of a new small farmer-based agriculture growth strategy, (ii) mainstreaming the poor by establishing large corporations owned by the poor but run by professionals, and (iii) overcoming the institutional constraints to the rapid growth of small-scale enterprises (SSEs). These three initiatives are only outlined in this section, since they have are discussed at length in Hussain (in press). A fourth initiative, participatory development, is elaborated in Section 6 of this chapter.

Pro-poor growth can be defined as a process that directs a disproportionate share of the increase in national income toward the poor. Going beyond this, restructuring the growth process in favor of the poor involves empowering them to participate in the economic, social, and political decisions that affect their material conditions.

Designing a policy for pro-poor growth involves addressing the structural features of Pakistan's growth process that constrain its capacity at the macro-level for poverty reduction (see Sections 3 and 4). Therefore, at the macro-level, a pro-poor growth policy should aim to achieve increased employment elasticities and lower ICORs by increasing the weight in GDP of microenterprises, and the output of small farms and small-scale manufacturing enterprises. The strategy would also feature institutions that could take to scale a localized process of capital accumulation through participatory development.

### **5.1. Land for the Landless**

One of the most important factors in endemic poverty in rural areas (where the majority of Pakistan's poor reside) is that millions of households do not own any land or that their ownership of this productive asset is less than the critical level required for subsistence. The data shows that poor peasants who do own land have, on average, 2 acres, while larger farmers are able to rent additional land. Poor farmers either rent out their small owned holdings for a pittance or are obliged to sell their land altogether (Hussain, 2008a). For example, according to the PNHDR's sample survey, as many as 76.5 percent of extremely poor farmers and 38.9 percent of poor farmers sold their land over the period 1990–2000 (Hussain et al., 2003). The evidence shows that the poor have to sell their land to meet urgent consumption needs related to health expenditure, crop failures, and weddings. Thus, lack of access to this vital productive asset is an important structural factor in endemic poverty.

Farms smaller than 25 acres constitute about 94 percent of the total number of farms and about 60 percent of the total farm area. This sector has untapped potential for increasing the yield per acre on cropland and increasing the output of milk and livestock products. As discussed elsewhere, a new small–medium farmer-based agriculture growth strategy could be initiated to transfer the existing 2.6 million acres of state-owned land to landless peasants (see Hussain 2008a, in press). This could be supported by the establishment of a small–medium farmer-owned corporation through a public–private partnership that would provide them with the following facilities: land development; access to high-quality seeds, fertilizers, and marketing services; extension services to improve the application efficiency of irrigation; and new technologies for high value-added crop farming such as tunnel farming.

### **5.2. Mainstreaming the Poor through Equity Stakes<sup>9</sup>**

One institutional change that could bring the poor into the mainstream market economy would involve establishing professionally managed public limited companies in which the poor have a substantial equity stake (for a more detailed discussion of the institutional framework of such an initiative, see Hussain, in press). This concept was first propounded by Professor Rehman Sobhan and successfully tried out in the diversification process of the Grameen Bank in Bangladesh. It was also tried out in India by Dr Verghese Kurien who set up Amul (originally a cooperative), which is owned entirely by the poor and is now

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<sup>9</sup> This section draws on Hussain (in press).

one of the largest manufacturers of milk products in South Asia's corporate sector.

In Pakistan's case, there may be considerable potential for developing livestock and milk production by the rural poor and supplying these products to large private sector corporations for the manufacture and export of milk and meat products. The private sector corporations that would buy their inputs from the poor could also be owned substantially by the poor. The equity stake to the poor could be achieved initially through the provision of loans to be paid back from the corporations' dividends. Similar public limited companies owned by the poor and run by competent professionals could also be established in key mainstream sectors of the economy such as energy, telecommunications, and electronics.

### **5.3. *Institutions for Stimulating Growth of SSEs***

SSEs in small towns and peri-urban localities of Pakistan have considerable growth potential because of their highly skilled technicians and innovative entrepreneurs. However, their growth is constrained by the following institutional factors: (i) lack of institutional linkages for subcontracted work with the large-scale manufacturing sector; (ii) lack of access to specialized fabrication facilities such as forging and heat treatment, which are necessary for the dimensional control of high value-added metal products; (iii) lack of expertise in establishing quality control procedures for the production of bulk orders; and (iv) lack of access to credit facilities and working capital with which to purchase high-quality raw materials.

These constraints could be overcome by facilitating the establishment of common facilities centers in the private sector. These could provide services such as linking SSEs with the large-scale manufacturing sector through marketing services; specialized fabrication facilities on a rental basis to SSEs; specialized training in production management and quality control; and access to credit for the purchase of high-quality raw materials and specialized equipment (see Hussain, 2009a, pp. 26–30; in press).

## **6. Sustaining Growth Through Participatory Development**

### **6.1. *The Nature of Poverty and Human Potential***

Like all human beings, the poor, too, have creative potential. Denied the minimum food and basic necessities, such as health and education; excluded from access to investible resources, training and high-wage employment; and living in atomized communities, the poor in Pakistan

are, however, unable to actualize their human potential.<sup>10</sup> The process of experiencing human potential as indeed of overcoming poverty involves a new relation with the community and oneself. It is when fragmented communities are reconstructed and organized to enable individuals to gain equitable access to markets, skill training, and credit that the poor can transform their condition. It is through creative thinking and action in harmony with the community for a better life that the poor experience their human potential.

The process of rediscovering community identity, acquiring new skills, upgrading their knowledge, and being able to take initiatives to improve their economic condition together with others, gives the poor new power over the social forces that shape their lives. This consciousness allows them to shift out of their self-perception of passive victims to active subjects able to initiate individual and collective interventions to overcome their poverty.

This consciousness of their potential to bring about change and the institutional capacity to actualize it constitutes empowerment: it gives the poor the ability to undertake a sustained increase in incomes by breaking out of the nexus of elite power that has locked them into a structure of dependence at the local level and systematically deprives them of a significant proportion of their incomes (see Section 3).

## **6.2. *Participatory Development: Individuals, Communities, and Markets***

Participatory development involves a dialectical relationship between the formation and progressive strengthening of group identity on one hand and the improvement of the individual household's material conditions on the other.<sup>11</sup> Community organizations (COs) change the balance of power at the local level in favor of the poor by giving them improved access to markets. As a CO emerges, it enables individual members to acquire skill training, achieve productivity increase, and obtain credit and access to product markets to systematically increase their household incomes, savings, and investment. Thus, a localized process of capital

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<sup>10</sup> Aristotle (1980, book 1, section 5) proposed that *human functioning* is the real object of value. The implication of this formulation for public action today in the context of poverty is that maximizing value in society requires enabling the maximum number of people to actualize their human potential.

<sup>11</sup> The discussion on participatory development in this section is based on the author's experience of organizing poor rural communities in nine districts of the Punjab in 1998, when, as the first chief executive officer of the Punjab Rural Support Program, he helped to initiate and establish the program on the basis of the methodology of participatory development. For a field report, see Hussain (2009b).

accumulation begins that is sustained by the leverage over markets and public sector services that COs enable.

This interaction between the individual, CO, and markets helps to strengthen group identity with each successful income generation project at the individual level. Strengthening the CO becomes, in turn, the basis of more complex and diversified projects. These can range from individual microenterprise projects to collective projects with spinoffs for individual welfare such as localized irrigation projects and the development of community schools and basic health services (Hussain, 1994).

### ***6.3. Process of Participatory Development: Dialogues, Communities, and Consciousness***

The process of participatory development begins usually with an external facilitator or development nongovernment organization (NGO) that initiates a series of dialogues with a particular community. The dialogues are meant to identify a set of feasible income generation projects that can be undertaken by individual households, possible sources of local resource generation, and the community's preferences with respect to collective projects for the provision of skill training, education, and health facilities. At the same time, these dialogues aim to rekindle the awareness that individual welfare can be more effectively pursued through the formation of a CO.

The size of any one CO is usually between 25 to 30 members, each from a different household, and the formal rules of this organization stipulate a weekly meeting of all the members, with a written record of the minutes. At these meetings, members identify projects, monitor implementation, help resolve teething troubles, and commit to supporting households that are facing problems of access to markets and public services in the pursuit of their individual income generation projects. External expertise is also brought to bear by the CO during these meetings, to facilitate household-level microenterprise projects or community-level social and physical infrastructure projects. Thus, the participation of members of a community is not through "representatives" who act on their behalf; rather, each member of the organization is actively involved in project identification, formulation, implementation, and evaluation.

The Punjab Rural Support Program (PRSP), established in 1998, is testament to the efficacy of participation through the institutional structure of a CO. Following dialogues with a peri-urban community near Gujranwala, the households agreed to form a CO with the proposed institutional structure if some of them could acquire their own weaving

machines (*khaddis*) for producing cotton mats (*durris*). These households were already producing *durris* on an outsourcing basis for an urban entrepreneur who provided the machines and thread but purchased the output at an extremely low price to maximize his intermediary profit. This arrangement yielded only PRs 3,000 per month to the producers.

Facilitated by the PRSP, the CO members provided the social collateral to obtain microfinance to purchase the machines and thread. The independent household production of *durris* more than doubled their income when they sold their product in the market. The CO ensured 100 percent payback on the loans that individual members had been granted.

Similarly, in a village near Multan, the PRSP's dialogues resulted in the formation of a women's CO for the production of bamboo sunshades. The CO was linked up with trainers who helped members to learn the craft. They were then facilitated through the CO in selling their product in the nearby market at a lucrative price. In both cases above, the weekly CO meetings helped to identify the project, assess its feasibility, facilitate implementation, and encourage members to save from their increased incomes as a basis for enlarging their project.

In each of the provinces of Pakistan, peasants may be poor, but they have inherited a rich cultural and philosophical tradition that is reflected in their forms of apprehending social life, their poetry, and folklore. Through their forms of love and social action, these peasants express their dreams and make their history.

The consciousness of the poor peasantry has been deeply influenced by Sufi saints. This emerges in their folklore and images of contemporary language use, for example in the Punjab. A central experiential reference point is love (*ishq*), as a mode of self-actualization. The peasants understand self-development as inseparable from nurturing the ability to love: It is a process of transcending the ego through a connection with the other. Says Shah Hussain, the 17<sup>th</sup> century Sufi poet:

*You are the woof and you the warp*

*You are in every pore*

*Says Shah Hussain Faqir*

*Naught am I, all is you.*

Accordingly, the more developed a person's consciousness, the more he or she locates himself in the collective being of the community, which Shah Hussain has expressed as follows:

*The Faqirs have their being*

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*in the coming together of the community*

*For their consciousness is in full bloom.*

In the peasantry, the consciousness of the Sufi tradition is woven into language use, and is manifest in the cadences of their speech as much as their silences.

Najam Hussain Syed, the great contemporary Sufi poet, refers to this subliminal consciousness of the peasantry as:

*Somewhere on the slopes of silence*

*Beat the drums of the unsaid*

and again as:

*Far on the banks of memory falls*

*Your shadow, Ranjha.*

In the process of participatory development through dialogue and action, there are moments when this counter-consciousness of love and relatedness of integrity and creative action, comes into play as a material force in the process of social and economic change. The challenge in the dialogues undertaken by the PRSP was to bring about this gestalt switch in consciousness, through word, gesture, and work procedures.

**6.4. Institutional Challenges in Taking Development NGOs to Scale**

If participatory development is to make a significant contribution to achieving inclusive growth in Pakistan, then COs need to be replicated at the necessary speed and scale and at a feasible resource cost to be able to have a national impact in the foreseeable future. Over the last few decades, development NGOs in Pakistan have used various versions of community participation, ranging in size from community-based organizations at the village or *mohallah* level to the union council level, such as the Pakistan Institute for Environment-Development Action Research (PIEDAR). Some NGOs have scaled up to the district or multidistrict level (the Kashf Foundation and Akhuwat). Others include large top-down government-initiated NGOs at the provincial level—such as the rural support programs in Punjab, Sindh, and Balochistan—and even the national level (the National Rural Support Program). Some development NGOs have grown rapidly, others slowly; some unleash communities' creative energies by enabling them to be autonomous, while others are more bureaucratic. Similarly, some development NGOs are cost-effective while others, particularly government-created top-down ones, have prohibitively high overheads.

In the case of some large top-down government-created NGOs, questions with regard to key issues of feasibility persist. High overheads create a continuing dependence on government and donor funds. The inaccurate targeting of the poor with respect to credit and organizational support poses a problem. Moreover, the pace at which poor populations are covered is so slow and the cost of social mobilization so high, that the prospect of covering a substantial proportion of the poor can become impossible within a realistic timeframe and given the government's resources.

The central challenges in achieving scale in participatory development are as follows. First, it is important to retain the autonomy of each CO and its institutional mechanisms for nurturing community consciousness and ensuring participation in project identification, implementation, and monitoring. Second, rapid multiplication should occur without falling prey to the formation of a centralized top-down bureaucracy that tends to stifle the CO's autonomy while being expensive. Third, COs need to become financially independent of donors and the government by keeping their overheads to a minimum and achieving economies of scale through reduced administrative (social mobilization) costs as the organization grows.

## **7. Conclusion**

This chapter has examined the roots of Pakistan's problem of achieving sustained growth in terms of the economy's institutional structure and the country's model of governance. The constraints to sustained growth that take the form of a low domestic savings rate and incapacity for adequate foreign exchange earnings are located in the institutional structure. A growth process that is narrowly based on a group of elites—generating rents for them by excluding the majority of people—creates inequality, persistent mass poverty, and disincentives for saving, efficiency, innovation, and international competitiveness.

The patron–client model of governance originated when, in the process of establishing the British Raj in the 19<sup>th</sup> century, the new agrarian elite that had emerged following the peasant revolts against Mughal rule in the 18<sup>th</sup> century, was consolidated. This was done through revenue settlements that formalized the proprietorship of the new zamindars and rent transfers granting land to loyal zamindars during the development of the canal irrigation system. The chapter has also discussed the various forms of rent generated by successive governments in Pakistan post-independence to show how the patron–client model of governance inherited from the Raj, persisted.

Additionally, the chapter has examined the institutional factors underlying slow growth in manufactured exports and unstable growth in agriculture. It has analyzed the structures of power, tenancy, and tied labor that systematically deprive the poor peasantry of a large proportion of their income. The evidence shows how illness, lack of education, and lack of access to justice play an important role in perpetuating poverty, inequality, and slow growth.

If growth is to be sustained and poverty reduced rapidly, then the process of investment and productivity needs to be broad-based to include the poor and the middle classes in both the agriculture and manufacturing sectors. This can be achieved through a new small farmer agriculture growth strategy to provide land to the landless together with ancillary services for land development, high-quality seed, improved irrigation efficiency, and access to new farming practices and technologies. At the same time, the growth of small and medium enterprises in the manufacturing sector can be accelerated by establishing common facilities centers in the main regional growth nodes.

Finally, the chapter has analyzed the nature of poverty and the possibility of overcoming it in terms of institutions that could actualize the human potential of the poor through participatory development. In this context, the chapter has discussed the main features of participatory development and the challenges of taking it to scale to show how the development of community consciousness can play a vital role in transforming the material conditions of the poor.

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## **Provincial Economic Development: Performance, Challenges, and the Way Forward**

**Khalid Ikram\***

### **1. Introduction**

Analyses of economic development in Pakistan have traditionally followed a “top-down” approach. They examine the behavior of macroeconomic indicators for the country as a whole, referring only in a general, even cursory, manner to the trajectories of each province, and even more summarily to the policy issues, constraints, and opportunities that confront the different provinces. The implicit attitude—that it is the federation as a whole rather than the federating units that matter—is so firmly embedded in the official mindset that, even after 65 years of Pakistan’s existence, the authorities do not produce official statistics of province-level gross domestic product (GDP), investment, savings, exports, imports, labor productivity, and other key economic indicators.

### **2. The Importance of a Province-Level Approach**

Why is a province-level approach important? The issue is not merely of academic interest. It is necessary to strengthen studies at the province level, because policies to address questions of employment, poverty, and

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\* The author is a former director at the World Bank. He was senior adviser to the World Bank and Asian Development Bank teams that prepared the province-level economic reports cited as World Bank, Asian Development Bank, Government of the Punjab, and DFID (2005); World Bank, Government of the North West Frontier Province, and UK Department for International Development [DFID] (2005); World Bank and Government of Sindh (2006b); and World Bank, Asian Development Bank, and Government of Balochistan (2008). He was also the principal author of the World Bank (2013) and DFID (2009, 2010) studies. This chapter draws on these reports and their background papers, on Ikram (2006, 2009), and on discussions with government officials, businesspersons, academics, and other representatives of civil society in the provinces.

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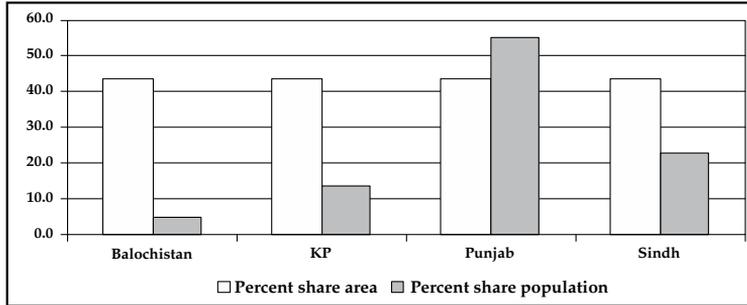
perceived deprivation, and to improve the delivery of key services are more effective if the perspective is as close to the ground as possible.

The validity of this approach is recognized by the burgeoning number of regional or state studies in India and in other parts of the world—such as China, Malaysia, Vietnam, Thailand, Indonesia, Brazil, Argentina, and Nigeria among developing countries, and of course the United States, Canada, Australia, Germany, Italy, and several others in the developed world—where individual provinces or states can exercise a significant degree of autonomy over many economic decisions. Stimulating the convergence of economic growth between the different provinces of Pakistan is vital, because the cohesion of the country depends on it. Is it really necessary to remind ourselves that the breakup of the original state of Pakistan in 1971 was triggered principally by economic disparities between East and West Pakistan, and which East Pakistan felt were not being addressed?

Disparities in the endowment of physical and human resources and divergences in the strength of institutions require different policies to realize the development potential of each jurisdiction—one size of policy will not fit all. Economic policy will be most effective if the usual countrywide macroeconomic analysis is supplemented by a detailed “bottom-up” approach, based on a comprehensive examination of the challenges and opportunities specific to each province.

The disjunction between the endowments of land and population is brought out in Figure 19.1. A comparison of Balochistan with the other provinces is especially striking. In 2011, Balochistan’s population density at 19 persons per square kilometer was only 5, 8, and 9 percent, respectively, of that of Punjab, Sindh, and Khyber Pakhtunkhwa (KP). The vast imbalance between area and population gives rise to special challenges—such as smaller markets; higher costs of production, distribution, and services; and difficulties of governance—as discussed in Section 5.3.

Figure 19.1: Share of provinces in area and population of Pakistan, 2011



Source: Pakistan Economic Survey, 2012.

The division of authority between the federal and provincial governments is laid down in the Constitution of Pakistan. Some areas—such as defense, foreign affairs, customs duties, and income tax—fall within the ambit of the central government, while others—for example, agriculture, irrigation, primary education, and health—are covered by the remit of the provincial authorities. In formulating a strategy for provincial development and recommending sectoral and other policies, one must bear in mind what the responsibilities and capabilities of the provinces now encompass.<sup>1</sup>

Thus, following the 7<sup>th</sup> National Finance Commission award in 2009, the overall squeeze on Pakistan's resources has been accompanied by a shift in revenue sharing in favor of the provinces. Consequently, the combined share of the provincial governments in the national Public Sector Development Program for 2010/11 rose from 26 percent of the total in 2000/01 to 60 percent. This indicates that the locus of development planning in the country is shifting to the provinces, and again underscores the importance of examining development constraints and strategies at the provincial level, and the necessity for making the provincial strategies congruent with those at the national level.

### 2.1. Data Sources and Caveats

With the passage of the 18<sup>th</sup> Amendment to the Constitution of Pakistan, a substantial amount of responsibility for economic development has been transferred to the provinces. However, the absence of much essential

<sup>1</sup> Central government policies impact on provinces in broadly similar ways; but not necessarily to the same degree. Thus, for example, when the federal government decided to support the mujahedin in Afghanistan, the effect on the Punjab was negligible compared with that on KP.

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information and data makes it almost impossible for provincial governments to design and implement economic policies that are firmly based on a foundation of knowledge. The dearth of reliable information on regional economic issues also makes it difficult for the federal government to ascertain the extent of, and the reasons for, divergences in economic growth between the provinces, and to formulate effective measures to accelerate the growth of lagging regions.

The data and other gaps have been partially filled by the efforts of private researchers and international institutions. The early attempts were designed primarily to address the question of income disparities between East and West Pakistan (see, for example, Haq, 1963; Khan & Bergan, 1966). These estimates, therefore, looked at West Pakistan as a whole and did not investigate regional subdivisions.

A pioneering effort at constructing individual GDPs for the four provinces of (West) Pakistan was made by Bengali (1997) and extended by Bengali and Sadaqat (2006). The analysis of provincial development issues—as opposed to calculations of provincial GDPs—has, in recent years, attracted the attention of a number of scholars and Pakistani think-tanks.<sup>2</sup> More comprehensive studies have been conducted by international institutions, especially by the World Bank, which, in partnership with the provincial governments, the Asian Development Bank (ADB), and the UK Department for International Development (DFID), has prepared reports on the economic development of each province.<sup>3</sup>

These joint studies are a valuable first step in analyzing critical issues and recommending policies, and also in generating time series of provincial GDPs using procedures consistent with those of the Pakistan Bureau of Statistics for the construction of the national accounts. At times, however, the nonavailability of survey data compels the unofficial estimates to resort to some assumed relationships between different variables, which can make the calculations less secure. The nonavailability of data has also meant that some key indicators, such as investment (public and private) and provincial savings could not be calculated. Finally, it has not been possible to obtain reliable estimates of the “shadow economy” (defined as legal activities concealed from the

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<sup>2</sup> See, for example, Hamid and Hussain (1992); Ghaus-Pasha, Pasha, and Ghaus (1996); Jamal and Khan (2003); Jamal and Aamir (2003); Ikram (2006, 2009); Social Policy and Development Center (2001, 2004); Institute of Public Policy (2012).

<sup>3</sup> See, for example, World Bank, Government of the North West Frontier Province, and DFID, (2005); World Bank, ADB, Government of the Punjab, and DFID (2005); World Bank (2006b); World Bank, ADB, and Government of Balochistan (2008); World Bank (2013); ADB (2005); United Nations Development Programme (2003); DFID (2009, 2010). Some of these reports are underpinned by a substantial array of background papers.

authorities) for each province. The exclusion of this would understate the actual production and GDP in the province. Thus, figures for provincial GDPs are better regarded as indicators of trends and orders of magnitude than as precise levels.

Most of the provincial GDP data used in this chapter have been prepared by the World Bank for its suite of provincial economic reports. This is not because the World Bank data are necessarily superior to those developed by other scholars and institutions, but they have certain clear advantages. First, the figures have been discussed with all the provinces in the context of the provincial economic reports (indeed, the Punjab's statistical department prepares its own, as yet unofficial, series on the lines of those prepared by the World Bank). Second, the figures have been used in other World Bank work—such as studies of poverty, income distribution, labor markets, rural development, etc.—making it possible to draw on those analyses. Third, they provide a consistent series of the provincial GDPs and their components for a two-decade span (1991–2011), based on 1999/2000 prices, as used by the Pakistan Bureau of Statistics for the all-Pakistan figures. The World Bank data have thus at least implicitly been accepted by the provinces, and are sufficiently long and detailed to permit a meaningful discussion of the underlying structural issues that each province confronts and how the provincial experience differs from that of the country as a whole.

The numbers generated by all the foregoing studies cannot, of course, substitute for an official set of figures prepared by the Pakistan Bureau of Statistics. Moreover, they are still incomplete in that there are no reliable estimates of provincial investment, savings, and other key variables. Thus, the present estimates can serve only as an interim measure. It is hoped that the Pakistan Bureau of Statistics will soon begin to issue officially sanctioned figures for GDP and other macroeconomic variables at the provincial level. Such data have long been published in India both by official and nonofficial sources (see, for example, India, Ministry of Commerce, 1949; National Council of Applied Economic Research, 1967).

### **3. Pakistan's Growth Requirements and the Growth Framework**

A detailed discussion of all the issues that have an impact on Pakistan's economic growth and development strategy is beyond the scope of this chapter; it therefore focuses on three central questions:

- Why it is urgent to expand Pakistan's economy at a rapid pace?

- What elements must be emphasized in the country's development strategy, given the constraints of a very tight resource position?
- What are the main issues that the provinces face, and how can they play their role in the rapid development of the country?

The last question is crucial, because the country's economy does not develop in some abstract space, but in the physical space of the provinces. It is, therefore, most important that the provinces' development strategies be harmonized with the country's overall development strategy.

### **3.1. *The Urgency of a High GDP Growth Rate***

Why is it urgent for Pakistan's economy to grow rapidly? The short answer is: to cope with the pressures of demography. Time is not on Pakistan's side. Every year Pakistan adds a New Zealand to its population; every two years, a Switzerland; every three years, a Greece; every four, a Netherlands; and every five, an Australia. Moreover, while it adds these populations, it does not add the capital assets or institutions of these countries.

The age-distribution of the population provides another imperative for acting quickly. Nearly 50 percent of Pakistan's population is below 20 years of age, and over 60 percent below 30 years. With growing unemployment, these youths become disconnected from the economy and disaffected with the polity, and are vulnerable to the blandishments of extremists. The demographic projections show this "youth bulge" continuing to dominate the population for perhaps another 30–35 years. Unless Pakistan can generate the required number of jobs through sustained, high GDP growth, its streets are likely to be crowded with thousands of young men and women desperately seeking jobs, justice, education, and medical care for themselves and their families—a serious threat to the country's stability and a mouth-watering prospect for an extremist recruiter.

#### **3.1.1. *The Required Rate of GDP Growth***

How fast must the economy grow? Pakistan's labor force is growing at an annual rate of around 3.5 percent. The World Bank's provincial economic studies cited above estimate the elasticity of employment with respect to GDP growth at between 0.45 and 0.6 for the different provinces—let us use 0.5 as an average. This means that a 1 percent increase in GDP growth leads to a 0.5 percent increase in the employment rate. Thus, if the economy is to generate a sufficient number of jobs to employ all the additions to the labor force, it must grow at least at 7 percent a year.

Indeed, if the backlog of the currently unemployed is to be reduced and/or the labor force expands more quickly, then the economy will need to grow even faster.

This will not be easy. Over the four decades 1970–2011, Pakistan’s economy is estimated to have grown at an average annual rate of about 5 percent. This could serve as a rough proxy for the economy’s potential growth rate at the existing level of investment, technology, and institutional performance. This rate is insufficient to produce the required number of jobs, and will have to be, on average, about one third higher over the next three decades than it has been over the last four. A business-as-before approach thus will not work.

### *3.1.2. The Growth Strategy*

What strategy could enable Pakistan’s economy to grow at the required rate? It is easier to start by explaining why Pakistan’s traditional strategy of relying heavily on public sector projects has to be modified. The modification is necessary for two reasons.

First, Pakistan simply does not have the financial resources to generate the required growth rate by piling public sector project on public sector project. In 2011, the “throw-forward” on public sector projects (the total cost of projects minus the amounts already spent on them) amounted to over PRs 2,000 billion, even if one were to exclude energy sector projects on the assumption that their financing could be arranged separately. At the current rate of allocations to the development program, it would take more than 11 years simply to complete the existing portfolio of projects (no new projects or schemes could be added), and even this assumes that there would be no increase in prices during these 11 years. (Pakistan Planning Commission, 2011a).

Given the average of price increases in the past, just completing the existing portfolio is likely to take 15 years or more (again assuming that no new projects are added). And, of course, if separate financing could not be arranged for the more than PRs 1,000 billion required for the crucial energy projects (of which the Diamer-Basha dam alone accounts for PRs 895 billion) implementing the total portfolio would take very much longer.

Second, Pakistan’s growth has relied excessively on adding factor inputs and too little on increasing productivity. Thus, between 1970 and 2005, only about 20 percent of GDP growth in Pakistan derived from productivity increases (World Bank, 2006a). More recently (1998–2008), the contribution of productivity was even smaller, accounting for only

about 11 percent of GDP growth (Favoro & Koehler-Geib, 2009). The likely impact of these trends in productivity on the country's competitiveness and its impact on prices and exports is all too clear.

Bearing in mind these constraints and other considerations, the Planning Commission formulated a framework for economic growth that was approved by the National Economic Council in May 2011 (see Pakistan, Planning Commission, 2011b). The growth strategy outlined in the report aims at creating a framework that would stimulate the private sector to increase investment, expand rapidly, and improve productivity.

In keeping with a policy of making the best use of straitened resources, the strategy lays primary emphasis on strengthening institutions (such as the judicial system, the civil service, the taxation system, and the education system), improving governance, reducing red tape and bureaucratic impediments, increasing competition, encouraging innovation and productivity, harnessing the growth potential of cities, and so on. The aggregate of these measures should significantly reduce the cost of doing business in Pakistan, thereby increasing enterprise profitability and encouraging a higher rate of investment, and at the same time making this investment more productive. Most of the (physical) public sector investment that is proposed in the strategy is aimed at breaking key bottlenecks, such as in the energy sector.

#### **4. Comparative Provincial Economic Performance**

Difficulties with provincial data have already been discussed and should be borne in mind when considering the analysis in this section. However, two complications deserve special mention.

First, in the case of Sindh, the presence of Karachi can seriously distort the results for the province. The city is the country's sole seaport and the major locus of manufacturing industry (and employment); the site of numerous educational and medical institutions; and home to the province's largest businesses, its legislators, administrators, and higher judicial system. All these factors combine to make most development outcomes much more favorable for the city than for the rest of the province. The "average" results for Sindh, especially concerning the impact on welfare, should therefore be interpreted with care.

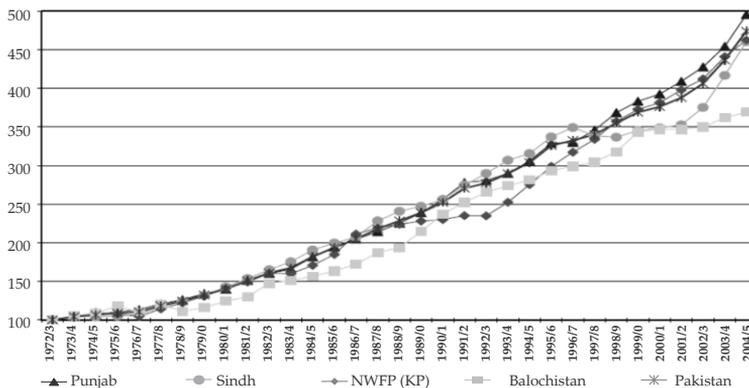
Second, in the case of Balochistan, the treatment of income from natural gas production creates a complication. The gas is produced in Balochistan, but an overwhelming amount is used in other provinces. Under the pricing formula that has been in effect, Balochistan does not receive compensation for the full value of its natural gas exports. The

practical effect is that GDP estimates, since they are based on value added within the province, can overstate the welfare benefits available to the residents of Balochistan.

#### 4.1. Provincial GDP Growth

The performance of the national and provincial GDPs is shown in Figure 19.2. During the three decades from 1973 to 2005, Pakistan’s GDP in constant prices increased at an annual average rate of about 5.0 percent. There were, of course, divergences between the growth rates of the provinces: Punjab’s GDP is estimated to have grown at about 5.2 percent annually, and that of Sindh and KP at 4.9 percent; Balochistan lagged behind with its GDP increasing at an annual rate of only about 4.2 percent.

**Figure 19.2: Provincial GDP growth rates, 1972/73–2004/05**  
(at constant 1972/73 prices; index numbers, 1972/73 = 100)



Source: World Bank Asian Development Bank, and Government of Balochistan (2008).

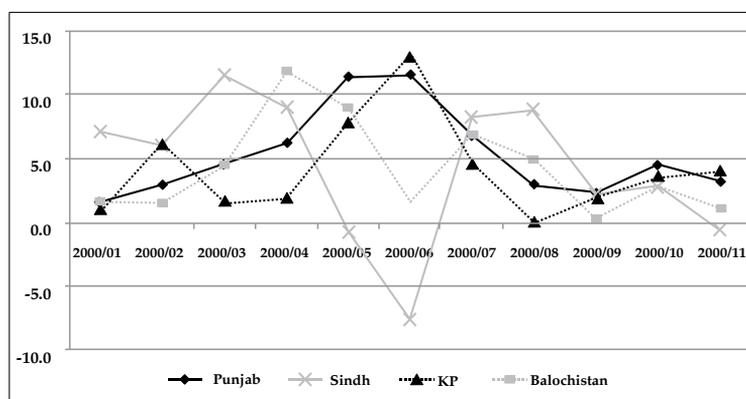
The difference of only one percentage point between the performance of the fastest- and the slowest-growing provinces might not appear to be too much. However, the power of compound interest is such that at the end of a 32-year period, an economy growing at 4.2 percent a year would be about three-and-a-half times its size at the beginning, while one that was growing at 5.2 percent a year would be more than five times its starting size. These differences translate into differences in the growth rates of per capita income (percent per annum): the Punjab, 2.7; Sindh and KP, 2.3; and Balochistan, 2.1. A person in Balochistan who started off in 1973 with an income of PRs 100 would have an income of PRs 194 in 2005; someone in the Punjab who started off with PRs 100 would see his/her income increase to nearly PRs 250—almost 30 percent

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higher than the individual in Balochistan. Standards of living between the provinces have thus diverged significantly.

The more recent performance, with the series rebased to 1999/2000 prices (in line with the rebasing of the national series by the Pakistan Bureau of Statistics) is shown in Figure 19.3 below.

**Figure 19.3: Provincial GDP growth rates, 2000–11**  
(percent at 1999/2000 prices)



Source: World Bank (2013).

Over the 11-year period, Balochistan's GDP increased by about 50 percent while that of Pakistan as a whole rose by 67 percent (and that of the other three provinces taken together increased by around 72 percent). However, Figure 19.3 shows that the growth rate of Balochistan's GDP fluctuated much more than that of the other provinces.

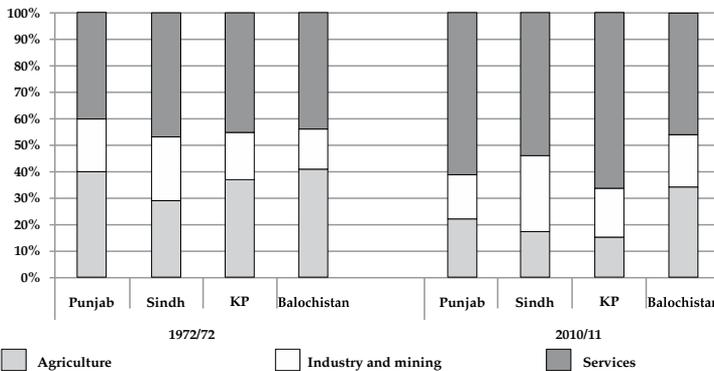
These fluctuations can be expected to have had two effects. First, for the period as a whole, the average per capita income remained below that of the other provinces. Second, the wide swings in the GDP growth rate would have created considerable uncertainty about returns on investment and heightened perceptions of risk which, as international experience shows, are likely to have deterred investors from making large-scale or long-term commitments. (The absence of data on provincial investment makes a more detailed analysis impossible.) This, in turn, would have further weakened the base for GDP growth in the province.

#### 4.2. Structural Changes

Between 1973 and 2011, the provinces' economic structures changed significantly. The main shift, as is normal in the process of development, was a relative decline in the share of agriculture and an increase in that of services. In the Punjab, the share of agriculture dropped from 40 percent of GDP to 20 percent. The share of services in that province increased substantially. Sindh witnessed a similar decline in the share of agriculture, but also saw an increase in the share of GDP contributed by manufacturing.

The smallest amount of structural change occurred in Balochistan. The contribution of agriculture in 2011 did drop from 40 percent in 1973, but the decline was only to 30 percent of the GDP. In view of the importance of crop agriculture and livestock in Balochistan's agricultural sector, it is evident that fluctuations in water availability would affect output in a major way. Indeed, the availability of water in Balochistan is extremely variable, because the province lies outside the main Indus River basin and also benefits the least from the monsoons. This has left it prone to frequent water shortages and, indeed, to severe droughts (the most recent from 1998 to 2005). The substantial share of Balochistan's GDP accounted for by agriculture, and that sector's vulnerability to the availability of water, explain the wider fluctuation in Balochistan's GDP compared with that of the other provinces. The structural changes in provincial GDPs between 1973 and 2011 are displayed in Figure 19.4.

**Figure 19.4: Structure of provincial GDPs, 1972/73 and 2010/11**  
(percent of provincial GDP)



Source: Bengali and Sadaqat (2006) and World Bank (2013).

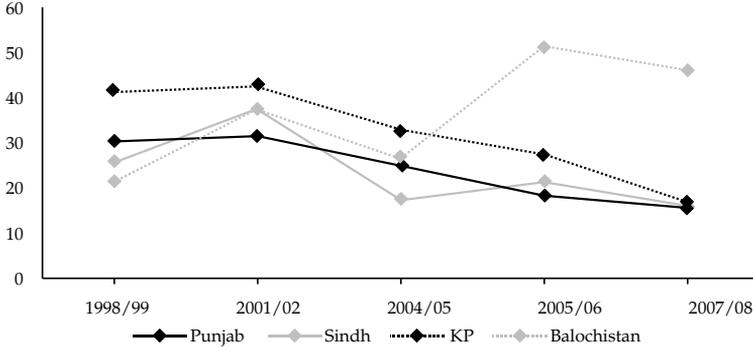
### **4.3. Poverty and Income Distribution**

The movements in GDP growth have had an impact on poverty reduction in the provinces. Figure 19.5 shows changes in the poverty headcount (the percentage of the population below the poverty line) in the different provinces between 1999 and 2008. The pace of poverty reduction was stable in the Punjab and KP, and resulted in a steady decline in the incidence of poverty, but poverty incidence in Sindh and Balochistan continued to fluctuate, quite substantially in the latter.

There appear to be two principal reasons for these different outcomes. First, the World Bank has found that the volatility in Sindh and Balochistan was highly correlated with the growth of agricultural GDP, and particularly with the value-added of the main crops. This was particularly important in the case of Balochistan because, as shown above, the share of agriculture in its GDP was significantly higher than in the other provinces. However, poverty rates in the Punjab and KP did not show a statistically significant linkage between variations in the value-added of the major crops and reductions in poverty.

Second, a major factor influencing the different outcomes was the relative contribution of workers' remittances. The ratio of foreign and domestic remittances to household expenditures is high in the Punjab and KP, but much less so in Balochistan and Sindh. Thus, data from the Pakistan Social and Living Standards Measurement (PSLM) survey for 2007/08 shows that the sum of foreign and domestic remittances amounted, on average, to more than 20 percent of household expenditure per-adult-equivalent in KP and about 12 percent in the Punjab. This compares with around 2.5 percent in Balochistan and less than 1 percent in Sindh (an expected result, since emigration from these two provinces is much higher than from the other two). Therefore, the sharp increase in workers' remittances from about \$1 billion in 1996/97 to around \$9 billion in 2008/09 flowed overwhelmingly to the Punjab and KP and benefited incomes in these provinces much more than in Balochistan and Sindh.

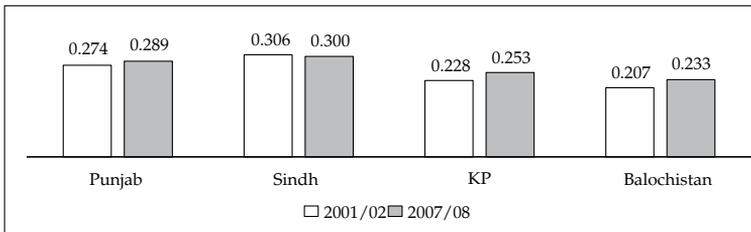
**Figure 19.5: Poverty headcount, 1998/99–2007/08**  
(percent of population)



Source: World Bank (2013).

What happened to income distribution? Between 2002 and 2008, income inequality increased in the Punjab, KP, and Balochistan, and remained more or less unchanged in Sindh. Even though inequality in Balochistan increased between these two dates, the income distribution in the province still remained less unequal than in the others. Further disaggregation of the data shows that in Balochistan, as in all the other provinces, inequality remained higher in urban than in rural areas. Indeed, the overall result for Balochistan was influenced chiefly by a steep fall in the inequality of rural incomes (possibly because of a recovery from the earlier drought years), which moderated the effects of an increase in the inequality in urban incomes. Figure 19.6 displays the Gini coefficients for all the provinces between these dates.<sup>4</sup>

**Figure 19.6: Gini coefficients, 2002 and 2008**



Source: World Bank (2013) based on Pakistan Integrated Household Survey 2001/02 and 2007/08.

<sup>4</sup> The larger the coefficient, the greater is the degree of inequality.

In view of the uncertainties connected with estimates of income data and poverty rates derived from household expenditure surveys, the following sections supplement them with an examination of other sources of physical and social indicators that bear on the quality of life.

#### **4.4. Social Indicators**

Provincial differences in social indicators are shown below in Table 19.1, and gender-disaggregated differences in education, literacy, and immunization in Figure 19.7.

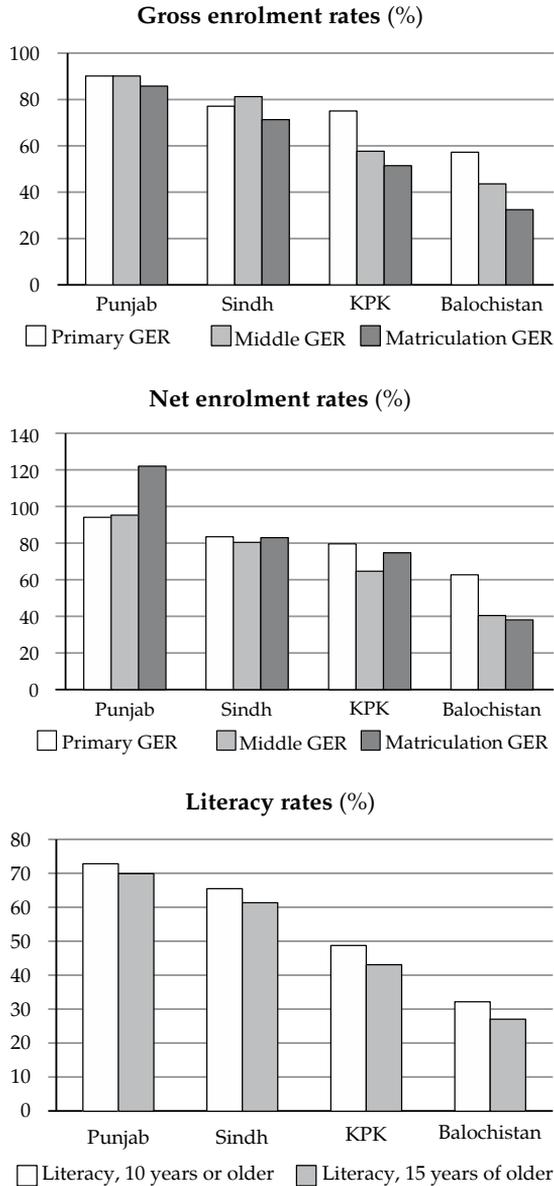
**Table 19.1: Provincial social indicators, 2011 (percent)**

<b>Indicators</b>	<b>Balochistan</b>	<b>KP</b>	<b>Punjab</b>	<b>Sindh</b>	<b>Pakistan</b>
Primary gross enrolment rate	74	89	98	84	92
Primary net enrolment rate	47	51	61	53	56
Middle gross enrolment rate	35	57	58	48	54
Middle net enrolment rate	13	17	23	19	20
Matriculation gross enrolment rate	38	54	61	55	57
Matriculation net enrolment rate	6	7	14	11	12
Literacy rate (10 years and older)	41	50	60	59	58
Adult literacy rate (15 years and older)	37	46	57	58	55
At least one immunization (12–23 months)	94	98	97	98	97
Full immunization (12–23 months)	53	77	86	75	81
Tetanus toxoid (percentage of married women aged 15–49 years)	31	61	77	60	69
Piped water	35	45	24	43	32
Toilet with flush	31	62	72	62	66

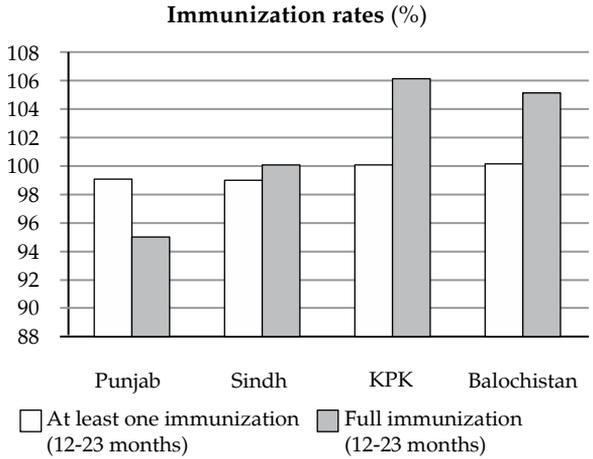
*Source:* Pakistan Social and Living Standards Measurement 2010/11.

Table 19.1 shows the wide differences that exist between Balochistan and the other provinces in education, immunization, and access to piped water. The Punjab also stands significantly ahead of KP and Sindh in terms of education and immunization indicators, although it lags well behind the other provinces, including Balochistan, in access to piped water.

Figure 19.7: Gender gaps in education, literacy, and immunization, 2010/11 (females as percentage of males)



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The gender gaps in education and literacy are highest in Balochistan. For immunization, the gaps are not very large and, interestingly, the lower figures here are for the Punjab.

**4.5. The Investment Climate and the Cost of Doing Business**

It was pointed out earlier that the development strategy for the country had to be formulated in the context of very tight public sector resources. This means that most of the investment and growth in the future will have to be generated in the private sector. This sector responds largely to considerations of profitability. If Pakistan is to successfully compete internationally, the private sector’s profitability must come from greater efficiency and decreases in costs, not from the maintenance of monopoly rents. It is therefore important for each province to ascertain which factors impact on the cost of doing business in its jurisdiction, how it compares with other provinces, and what the managers of enterprises view as the main impediments to investment and to the growth of the business.

It is possible to answer some of these questions by mining the World Bank’s databases. Table 19.2 ranks 13 major cities of Pakistan by the ease of doing business, using various criteria. The table shows a wide spread in the rankings, with cities in the Punjab generally ranking higher than those in the other provinces. Since most of the factors involved require little financial expenditure and mainly concern questions of policy and its implementation, it should be possible for cities (and provinces) at the lower end of the scale to significantly improve their performance.

**Table 19.2: Ease of doing business in Pakistan, 2010 (ranking of cities)**

	Ease of doing business	Starting a construction business	Dealing with permits	Registering property	Paying taxes	Trading across borders	Enforcing contracts
City, Province	Rank	Rank	Rank	Rank	Rank	Rank	Rank
Faisalabad, Punjab	1	2	6	1	3	4	2
Multan, Punjab	2	6	1	7	3	5	4
Lahore, Punjab	3	3	3	4	3	13	8
Islamabad, ICT	4	1	8	3	1	11	10
Sheikhupura, Punjab	5	9	8	5	3	7	6
Gujranwala, Punjab	6	13	2	6	3	10	4
Sukkur, Sindh	7	10	4	10	11	3	1
Peshawar, KP	8	3	6	9	10	8	8
Karachi, Sindh	9	3	10	11	11	1	3
Rawalpindi, Punjab	10	8	5	7	3	12	10
Sialkot, Punjab	11	12	11	1	3	5	10
Quetta, Balochistan	12	6	12	13	2	9	13
Hyderabad, Sindh	13	11	13	11	11	2	7

*Source:* World Bank (2010).

What do managers of business enterprises regard as the main impediments to expanding investment and production? These perceptions are important, because they shape the managers' view of the investment climate and, hence, of their decision to increase investment and expand their businesses and employment. The constraints to firms are discussed below.

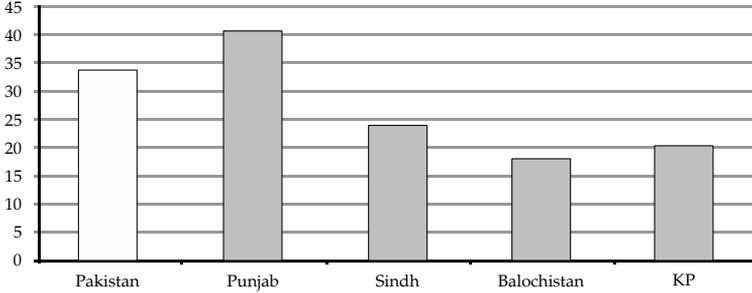
#### 4.5.1. *Power Supply*

Access to a reliable power supply was a serious deterrent for firms in all the provinces. The largest number of outages occurred in the Punjab, the second highest in Sindh (Figure 19.8). It is therefore not surprising that around 80 percent of the enterprises in these provinces in the World

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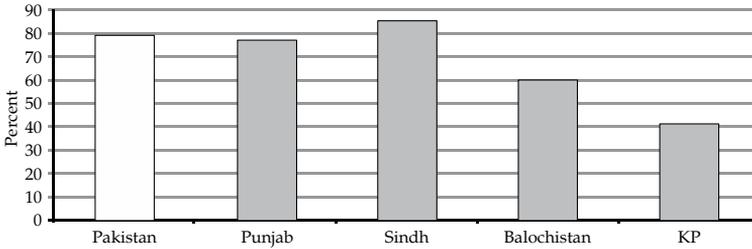
Bank's sample considered issues with electricity to be a major or very severe obstacle for operation and growth (Figure 19.9).

**Figure 19.8: Average number of electricity outages, 2007**



Source: World Bank (2007).

**Figure 19.9: Managers who consider electricity a major impediment, 2007 (percent)**



Source: World Bank (2007).

**4.5.2. Governance**

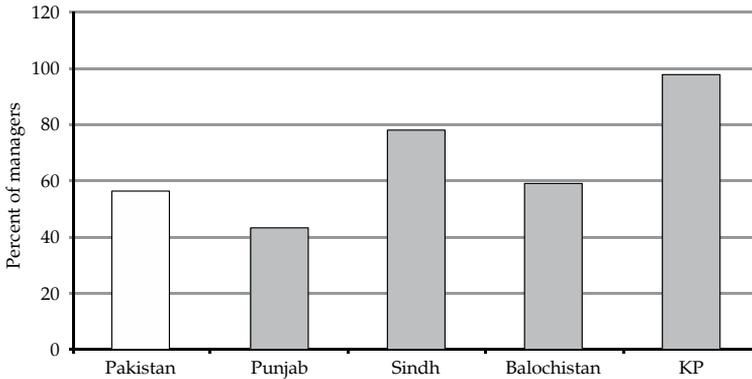
A great many of the factors that affect the investment climate relate to governance. The most important impediments include bureaucratic delays, corruption, intrusive inspections, the slow implementation of decisions, and inconsistent application of rules.

Managers of enterprises in the Punjab report having had to pay substantial bribes in order to get bureaucratic issues resolved. These payments are estimated to amount to more than 40 percent of the value of sales, and are significantly higher than those reported by managers in other provinces, even exceeding the national average. Nearly 20 percent of the establishments surveyed in the Punjab reported that they had been

requested for “gifts” during labor or tax inspections. This is a lower proportion than in the other provinces, but is nevertheless high.

Close to 100 percent of managers in Sindh and 80 percent of those in KP viewed corruption as a serious obstacle to the operation and growth of their enterprises (Figure 19.10). In view of the other responses to the survey, such as the amount of payments that had to be made to settle bureaucratic issues, it may be a little surprising that more Punjab managers did not share this view. It is possible that these payments have become more institutionalized in the Punjab and been factored into the cost of doing business.

**Figure 19.10: Managers who view corruption as a serious obstacle, 2007 (Percent)**

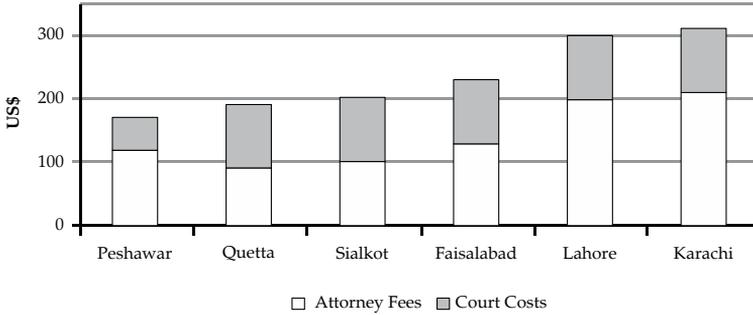


Source: World Bank (2007).

As a result of the delays caused by the procedures to obtain business licenses and permits and the costs incurred in bribes and similar payments, 17 percent of the managers surveyed by the World Bank regarded licensing procedures as a serious obstacle to the operation and growth of business enterprises.

A key consideration for the efficient functioning of any market-led economy is the time taken to register and enforce contracts and the costs of doing so. The World Bank (2010) notes that, as the Pakistani courts are all governed by the national code of civil procedure, they all require the same number of steps, irrespective of the location of the case. However, the survey also finds that enforcing contracts in Lahore and Faisalabad takes longer and costs more than in Peshawar, Quetta, or Sialkot (Figure 19.11).

Figure 19.11: Cost of enforcing a contract, 2007



Source: World Bank (2007).

The report finds that enforcing contracts in Lahore and Faisalabad takes about 20 percent longer than in Peshawar or Sialkot. The higher time required in Lahore and Sialkot is attributed to lengthy judicial and enforcement time (as opposed to filing time). The lengthier judgment time adds to lawyers’ fees and thus raises costs. In particular, even though the judgment time in Lahore and Faisalabad is only 8 percent higher than in Peshawar and 19 percent higher than in Sialkot, the time to enforce the judgment is 40 percent greater in Lahore and Faisalabad than in Peshawar. Even in Sialkot, the enforcement time is 17 percent higher than in Peshawar.

Clearly, the enforcement of contracts needs to be strengthened. This is particularly important to the functioning of a private sector economy, the basis of which is contestable markets based on secure property rights and enforceable contracts.

#### 4.6. Effects of Adopting “Best Practices”

An interesting question is how the country’s performance could be improved were it to adopt the best practices of all the provinces in key business activities (such as dealing with licenses, registering property, enforcing contracts, etc). Based on the World Bank’s (2010) Doing Business methodology, Pakistan—represented by Karachi’s indicators—ranks 74<sup>th</sup> in the world for ease of doing business. If it were represented by a hypothetical city that consolidated the scores for the highest-ranking Pakistani city, in 2010 the country would rank 52<sup>nd</sup> in the world. Again, this demonstrates the nexus between the practices of the provinces and their impact on the country as a whole, and the importance of improving the provinces’ scores.

## 5. Future Challenges

### 5.1. General Challenges

The future development of the provinces faces two broad types of challenges—those that will affect all provinces, and others that will be specific to the province concerned. Two challenges that are common to all the provinces will not be discussed here. The first is that of ensuring security. The federal and provincial responsibilities and powers for dealing with this issue are so complex and intertwined that a meaningful discussion would require far more space than this chapter allows. However, it should be understood that security is perhaps the most crucial issue that Pakistan's society faces, and that dealing with it is a *sine qua non* for sustained economic growth. The second is that of providing a reliable supply of power. In this area, too, the provincial authority and capability is so limited compared with the federal that one has to assume that the central government will discharge its responsibilities to resolve this problem.

A number of other factors are likely to shape the environment within which the development of all the provinces is likely to unfold over the next, say, 20–30 years. What are likely to be the chief factors?

#### 5.1.1. External Factors

The spread of globalization, meaning the continuing integration of the countries of the world, is likely to be a major factor shaping the world in which Pakistan's and the provinces' development will take place. Capital resources, both external and domestic, can be located in any province that offers the appropriate mix of security and financial return.

All the provinces, therefore, will be competing with each other to attract domestic and international capital. Moreover, in view of the relative paucity of labor and managerial skills, some provinces (particularly Balochistan and KP) can ill afford a brain drain. Talented people will move to places that offer not only good job opportunities, but also a high quality of life. If a province is not deemed more "livable" than other provinces in Pakistan, or indeed than other countries, it risks losing its ablest citizens. Thus, economic decisions made in any province will progressively have to take account of decisions and actions taken in other provinces and other countries.

#### 5.1.2. Internal Factors

Globalization will not be the only force impinging on the provinces' development in the next 20 years. The development strategy for each

province must also incorporate alterations to the domestic political and social profile. Two forces are likely to be especially important.

### ***Decentralization***

The first of these changes is likely to be a continuation of the movement toward increased decentralization, democratization, and people's participation in society. Legislative changes in Pakistan—such as the passage of the 18<sup>th</sup> Amendment to the Constitution—are also hastening moves in this direction

The increased decentralization and more vigorous civil participation will require changes in the manner in which economic and other policies are conducted. First, it means that there will have to be more transparency and accountability for government actions and less ability on the part of the government to impose its will unilaterally. This may initially cause some discomfort in certain areas of the government, but overall should make government actions more effective because they will be more responsive to people's perceived needs.

Second, the increased political pressure will almost certainly require the provision of full employment to become a central tenet of economic policymaking. This will call for a delicate balance. The budgetary resources of provincial governments do not permit the creation of large numbers of "make-work" jobs in the public sector, nor would this be an efficient use of scarce resources. Hence, most of these jobs will have to be created in the private sector. However, in dealing with the private sector, an important asymmetry exists. The authorities can prevent the private sector from doing certain things (by, for example, passing a law or denying the sector access to some key input), but they cannot make the private sector do something. They can only provide incentives that they hope the private sector will consider sufficient. Thus, a key challenge for the provincial governments in realizing their vision will be to create a business environment in which the private sector feels comfortable and secure, and in which it is willing to invest on the scale required to create the appropriate number of productive jobs.

Third, the experience of other regions and countries shows that wider political participation will increase the demand for improved social services, particularly health and education. Pakistan's provinces will not be exempt from such pressures. One cannot, for example, envisage a viable Balochistan 20 years hence in which the majority of the labor force is illiterate. Thus, the development agenda must incorporate substantial improvements in the coverage and quality of healthcare, in access to

higher-quality education, and in technical training to make it more relevant to the needs of the provinces' economies.

Fourth, participatory politics are likely to put more stress on equity in the distribution of incomes, both between persons and between different regions of the provinces. There will also be pressure to develop more comprehensive social safety nets so that the disadvantaged are, to a significant extent, protected from disaster. The development strategies must, therefore, explicitly incorporate policies to redress large-scale differences in the distribution of incomes between individuals, and explicit regional policies to stimulate the development of the more backward areas of the jurisdiction.

### ***Urbanization***

An important element that the development strategy must address is that of increasing urbanization; indeed, an important component of the growth framework described earlier is aimed at enabling cities to act as major engines of growth. A strategy of rapid development that depends largely on industrialization, the exploitation of minerals, the creation of a massive amount of infrastructure, and development of the backward areas of the provinces will almost inevitably accelerate the urbanization of each province.

Numerous studies show a strong correlation between urbanization and prosperity. On average, as the share of a country's urban population rises by 10 percent, the country's per capita output increases by 30 percent. Indeed, per capita incomes are almost four times higher in those countries where a majority of people live in cities than in those where the majority live in rural areas (Glaeser, 2011).

What challenges does this present?

In brief, rapid urbanization will present three major challenges:

- The cost of providing infrastructure to the rapidly expanding urban population.
- A political challenge, in that large concentrations of population make it easier to organize and enable groups to voice their demands more assertively.
- The imperative of using land more efficiently: most provinces lack an effective urbanization strategy, with the result that urban sprawl makes it difficult to provide services and steadily eats away valuable agricultural land.

## **5.2. Specific Challenges: Critical Issues and Development Strategies**

It is clearly impossible within the confines of a single chapter to provide a detailed analysis of all the development challenges that each province faces and a comprehensive account of how it should respond—this must be left to the provincial development plans. A more complete analysis has also been attempted in the World Bank/ADB/DFID reports cited earlier.

This chapter confines itself to highlighting the critical issues, describing the principal assets a province possesses that would enable it to deal with its development challenges, and outlining the most important policies that would be required to reap the fruits of these assets. Moreover, the chapter will not dilate on issues that are common to all the provinces—such as the general security situation in the country or the framework of macroeconomic policies; it focuses on the issues particular to each province. The purpose of this chapter is essentially to provide a framework for thinking about the critical issues and to suggest some ways in which they might be addressed.

## **5.3. Balochistan**

Balochistan occupies the largest land area of any province of Pakistan; it is a significant producer of natural gas; it possesses extensive deposits of copper, lead, gold and other minerals; it is home to vast tracts of rangelands that support large herds of ruminants; it accounts for 70 percent of the country's coastline; it possesses a very substantial potential for generating electricity from wind and solar sources; it is well-situated for trade with Iran, Afghanistan, and the Persian Gulf countries; but in spite of these natural resource and locational assets, it remains the poorest province in the country. Why? A successful development strategy for the province must ensure that Balochistan's past does not become its future.

The basic development predicament for Balochistan is that while it accounts for nearly 45 percent of the land area of Pakistan, it is home to only 5 percent of the population. This combination results in many of the province's inhabitants being thinly dispersed over wide areas—in 2011, Balochistan's population density at 19 persons per square kilometer was only 5, 8, and 9 percent, respectively, of that of the Punjab, Sindh, and KP. Such dispersion creates three principal difficulties. First, it means that the critical mass of skills required for specialization is present in only a few localities. Second, it results in smaller markets, thus losing economies of

scale. Third, it raises the cost of providing a unit of service, including governance, above that in the rest of Pakistan.<sup>5</sup>

A further challenge imposed by geography is the province's relatively small and highly variable water supply. Balochistan is an arid region because of its location and physiography. The province lies outside the monsoon belt of the Indo-Pakistan subcontinent—therefore it does not have a copious or a regular source of rainfall. About 556 m<sup>3</sup>/ha/year of water are available to Balochistan, compared with a national average of 2453 m<sup>3</sup>/ha/year, and an average of 3921 m<sup>3</sup>/ha/year for the other provinces. Spatial water availability in Balochistan is thus less than one-fourth the national average, and only about 14 percent of the average of the other three provinces.

Moreover, the province's topography ranges from a few feet to over 9000 feet above mean sea level—therefore the sparse and irregular rainfall that it does get, varies markedly between different parts of the province. The effects of physical geography have been made worse by human policies—uneconomic subsidies have encouraged the indiscriminate exploitation of groundwater, thus intensifying water scarcity and making water management even more difficult.

The combination of inefficient water use, waste of surface and groundwater, and inadequate investment in water infrastructure has resulted in less than 40 percent of the available water being utilized. It is not surprising that only about 2.1 million ha (approximately 6 percent of Balochistan's geographical area) are cultivated,<sup>6</sup> and that at recurrent intervals water shortages have been severe enough to tip the province into a prolonged drought. More recent experience indicates that the frequency of drought in the province has actually been higher than that projected using historical data. The most recent drought lasted seven years (between 1997 and 2004), and was the longest and most severe recorded in the history of Balochistan.

A major challenge to the development of Balochistan is the weak state of its human resource base—it has the lowest indicators of literacy, health, and labor force participation, and nearly 70 percent of the labor force is illiterate. The structure of Balochistan's society has also made the dissemination of benefits from economic development slower and perhaps less widespread than in the other provinces.

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<sup>5</sup> In 2010, Balochistan had 1.85 civil service posts per 100 of the population, compared with 1.06 in the Punjab, 1.21 in KP, and 1.29 in Sindh.

<sup>6</sup> About 47 percent of the cultivated area is irrigated, while the remaining 53 percent is under *sailaba* (runoff) and *khushkaba* (dryland) farming. The latter farming system contributes to the livelihood of a sizeable majority of the population.

What assets does the province possess that would help it overcome its liabilities? The assets include the vast land area (almost 45 percent of the area of Pakistan) that has been the major producer of Pakistan's natural gas for more than 50 years, and where many promising geological structures still remain unexplored, largely because of the security situation. The province also contains one of the largest deposits of copper in the world—a resource that has scarcely been touched—and barely developed deposits of gold, marble, granite, onyx, and other minerals. Balochistan's coastline of nearly 750 km—about 70 percent of the total coastline of Pakistan—provides a base for fisheries, port development, and tourism, and is a prime location for import-intensive industries.

Rangelands cover much of the province and support a large livestock sector which, if appropriately developed, could substantially increase the production of meat, leather, wool, and dairy produce. Preliminary assessments by USAID indicate that the province's topography and climate hold the prospect of generating large amounts of wind and solar power. Balochistan also occupies a strategic location that could help it act as a "hub" for trade between the Middle East and the Central Asian republics, as well as between Pakistan and Iran.

### *5.3.1. The Strategy<sup>7</sup>*

The task confronting Balochistan is to pursue a strategy that builds on its assets and overcomes its liabilities. Providing its citizens with a better quality of life will require sustained action in a number of areas that are discussed below.

**The first step is a strategy for increasing incomes.** In a modern economy, most incomes result from employment. The first priority for the Government of Balochistan is, therefore, to adopt policies that will accelerate provincial GDP growth and create sufficient jobs to absorb the additions to the labor force and progressively decrease the backlog of unemployment and underemployment. The growth rate required for this purpose was estimated at 7 percent a year.

How can this growth be attained? A viable strategy would comprise several elements. First, although Balochistan's public finances have improved with the passage of the 18<sup>th</sup> Amendment, its responsibilities have also expanded to cover, for example, agriculture, irrigation, health, and primary education. Thus, a substantial part of investment growth in the productive sectors will have to come from the private sector.

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<sup>7</sup> The following discussion draws in part on Ikram (2006, 2009).

Ultimately, GDP growth will depend largely on increasing the rate of investment in the province. If, in the long run, the private sector is to generate the majority of jobs, then the bulk of investment will have to be located in the private sector. This will require strengthening the investment climate in the province.

The next major element of the strategy should be to strengthen and develop efficiently the province's growth generators—those parts of the economy that are the primary creators of the region's economic wealth. A major sector of Balochistan's economy—contributing about 30 percent of GDP and employing nearly two-thirds of the labor force—is agriculture, including livestock and horticulture. The strategy in this area needs to be rethought.

The most critical constraint on Balochistan's agricultural development is water. In order to make the best use of its scarcest resource, the province will have to be very selective about the sources from which it elicits growth in the agricultural sector.

The most efficient path will be to concentrate on expanding sustainable high-value activities. In the context of a long-term strategy, this is likely to mean providing more support to ventures in livestock rearing and downplaying that to grain cultivation. It is also likely to require readjustments in the horticulture subsector, the present expansion of which derives largely from a generous subsidy to electricity for tube-wells (currently PRs 8 billion a year). This has resulted in the excessive use of water, because the private cost of using the resource has become much less than the social cost. Indeed, more water is extracted from the aquifer than is added to it, with the result that the water table is falling.

The increasing depth to which tube-wells have to be sunk—depths beyond 250 meters are now commonly reported—demonstrates the dwindling supply of groundwater. Moreover, the water table is dropping quite quickly: in some important districts (for example, Quetta, Mastung, and Mangochar), the level of groundwater has fallen by as much as 3 meters per year in the last eight years. The major part of groundwater has already been exploited. It is estimated that groundwater will contribute only about 2 percent of the total water available for future development.

The province must diversify the sources of its GDP. Agriculture by itself cannot accelerate the growth of the provincial GDP to the targeted 7.0 percent a year; Balochistan will have to turn increasingly to other sources, such as manufacturing and mineral development, while continuing to make agriculture as productive and efficient as possible.

Reducing poverty will also require moving labor from the slow-growing sectors to faster growing ones, such as industry.

At present, the agriculture sector employs the highest proportion of Balochistan's workforce—67 percent compared with the national average of 42 percent—while the industrial sector employs the lowest. Moreover, land ownership is highly skewed, with 10 percent of farmers owning 53 percent of the province's farm area. The majority of tenants work on small (5–12.5 ha) and not very productive holdings, with the result that their incomes remain below the poverty line. The desired changes to the structure of GDP mean that the industrial sector's share will have to increase.

The expansion of manufacturing in the province can rest on two foundations. One, it can be based on the natural resources—minerals such as natural gas, coal, marble, chromites, and copper, or the products of the agricultural sector (including those from the livestock and fisheries subsectors)—that are indigenous to the province. These would provide industries located in Balochistan with the advantages of lower transport costs and a steady and assured supply of inputs.

Two, Balochistan should take advantage of its long coastline—the province accounts for over 70 percent of Pakistan's coastline—and encourage the location of industries that use a significant amount of imported materials. Much of Pakistan's non-textile industry is based on imports, and to the extent that these facilities are situated away from Karachi, they are disadvantaged by having to pay additional transport costs. Moreover, Karachi itself is becoming a high-cost site. It will be in the interests of the country's industry and of the province to locate the expansion of import-intensive industries along the southern seaboard of Balochistan.

The province must develop its coastline in a comprehensive manner. Even though Balochistan occupies 750 km of Pakistan's 1,100 km coastline, its underdevelopment means that the province's economic activities are as disadvantaged as if the area were landlocked. A start toward rectifying this situation has been made by constructing a port at Gwadar. However, developing the potential of Gwadar will require a number of ancillary actions. These include providing freshwater to the population that will locate there, offering incentives such as low prices on industrial land, removing restrictions on foreign or local investment, and establishing fast one-window operations to start enterprises. Additionally, it will be necessary to enlarge the province's transport infrastructure and strengthen links with the other provinces so as to handle their domestic trade and traffic. In short, in order to develop Gwadar's potential, the Balochistan authorities must be very proactive in

attracting industries and the concomitant requirements of skilled labor, because the region has not traditionally hosted such activities. A major demand for transit and entrepôt trade from Afghanistan, the Central Asian republics, and China would be a bonus (see World Bank, 2004, 2006a). In the longer run, Balochistan's coastline has the potential to be used for different activities—to situate manufacturing industries, develop the fishing industry, and build additional ports.

Balochistan's fishing industry performs well below its potential because of low productivity along the entire value chain. Fishing boats are small and unable to reach many fishing grounds; harbors and auction halls do not meet international health and safety standards; and processing units lack proper preservation equipment and are largely innocent of the required packaging techniques. Modernizing the fishing industry will require investment in harbor facilities; the provision of echosounders to fishermen to locate fish; helping them finance on-board refrigerated fish-holds; and encouraging private investment to diversify activities in this sector, such as by moving into shrimp farming. The province will also have to strengthen institutions to ensure compliance with international standards of hygiene.

In Balochistan, as in the other provinces of Pakistan, most jobs are provided by small and medium enterprises (SMEs). Such enterprises work under four major disadvantages: (i) they lack access to finance, (ii) their technology is often outdated and inefficient, (iii) they cannot easily find skilled labor, and (iv) they are not aware of market opportunities outside their immediate locality. It will not be easy to solve these problems. Some of them, such as access to finance, are structural and result from "asymmetric information." SMEs know their financial position and its weaknesses much better than do banks, and the cost for the latter of obtaining accurate information can often outweigh the profit from the loan.

Moreover, the slow working of Pakistan's legal system means that recovering collateral in the event of a default by an SME is a drawn-out and expensive process. Thus, banks and other financial institutions prefer not to lend to very small borrowers. These difficulties only underscore the need for provincial authorities to make every effort to develop innovative solutions to these problems, drawing as required on the experience of other provinces and countries.

If private sector industry is to become the motor for Balochistan's economy in the longer term, then a number of important supporting measures will also have to be taken. One of the most important of these is to bring the supply of skills into line with demand. Nearly 70 percent of

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Balochistan's labor force is illiterate; it is virtually impossible to provide significant skills to workers laboring under this handicap.

Moreover, the skills imparted by the system of technical education and training often do not correspond to those required by private industry. The authorities must ensure that the education system at all levels delivers qualifications that meet employers' needs and that support a changing economy. It seems essential that, as in other countries, elements of the private sector be encouraged to work with the authorities in charge of Balochistan's technical education system. This is an ideal area for public-private partnership.

The provincial and federal authorities must make a concerted effort to develop more of Balochistan's mineral resources and to ensure that this development is integrated with the rest of the economy. So far, almost 90 percent of mineral production is attributable to natural gas alone, and production of this resource is now declining. Moreover, the natural gas sector in Balochistan developed as an enclave; it has virtually no links with other sectors of the province's economy and thus does not create spillover effects that benefit these parts.

The province must also begin to vigorously exploit other important minerals, such as copper, coal, and marble. This will require the government to concentrate on settling security issues and expanding the road network, while letting the private sector bring in more modern mining methods and technologies in order to speed up the development. Again, the aim must be to move up the value chain (see World Bank, 2003).

Balochistan is judged to have considerable potential for generating energy through nontraditional sources, such as the wind and sun. The US's National Renewable Energy Laboratory (2007) estimates Balochistan's wind resource potential to be more than 20,000 MW (to put this figure in context, Pakistan's total installed power generation capacity in 2011 was about 22,000 MW). The study has also assessed the national and provincial potential of solar energy. Its preliminary calculations estimate the total power generation potential of this source at as much as 1.2 million MW.

An underutilized asset of Balochistan is its location in the region. The province has the potential to act as a hub as Pakistan moves to reactivate its traditional trading routes to the west and northwest. The countries on these routes, such as Iran and the Central Asian Republics, are developing rapidly. They have the potential not only to provide a growing market for Pakistan's exports, but also to supply the country with oil and gas—two resources with which these countries are well endowed.

**Developing the province will call for a specialized water strategy.**

Balochistan is largely an arid region and drought is a frequent occurrence; the latest lasted from 1997 to 2004. About a quarter of the population was affected, and between 1996 and 2000, livestock holdings fell by almost a third.

Balochistan has three main sources of water: (i) the Indus basin irrigation system, which provides about 39 percent of the province's total water; (ii) floodwater (*sailaba*), which accounts for 57 percent; and (iii) groundwater, which supplies the remaining 4 percent. However, much of the groundwater has already been utilized, and the province will have to exploit the other two sources in order to meet the increasing demand.

An assessment of future water potential indicates that the sources are likely to be distributed as follows: (i) Indus water, 26 percent; (ii) floods and run-off, 72 percent; and (iii) groundwater, only 2 percent. Harnessing this future potential will, however, require a specialized strategy. As Ahmad (2006) points out, the chief strategic weakness of the province's water sector policy has been to treat water availability almost exclusively as a supply-side issue, to the neglect of demand-management considerations.

Such a long-term strategy must incorporate three pillars:

- Conservation. The province must conserve groundwater by recharging the aquifer through the construction of a number of storage/delay-action dams. It must also aim to reduce losses in irrigation and water use in agriculture through a combination of civil works and policy improvements (such as controlling the subsidy on tube-wells), and by taking steps to improve the system's performance. "More crop per drop" must be the guiding principle for water use in agriculture.
- Management. Following an integrated approach will yield maximum effectiveness in managing the province's water resources. This means that a hydrological basin must be taken as the basic unit for planning, and planning and policies tailored to the requirements of each basin (there are 14 such basins in the province).
- Augmentation. In the medium to long term, Balochistan should aim to build new canals to make use of the perennial and nonperennial flows of Indus Basin water. The province must make greater use of floodwater, and store and divert water for *salaiba* agriculture. It must also develop new water resources by recycling and reusing wastewater (such as sewage and agricultural effluents), and develop measures to desalinate brackish groundwater and seawater.

It has been argued that the frequency of water scarcity and drought conditions in Balochistan means that they ought to be regarded not as isolated or transient occurrences but as recurrent or structural phenomena. This implies that a long-term, pro-poor strategy should be developed to mitigate the impact of such events on the most vulnerable sections of society. Gazdar (2005) has put forward a proposal along these lines, arguing that future investment should target the poor in highly drought-affected areas by prioritizing projects that will maximize labor demand.

**The strategy must include the delivery of key services.** This chapter started by outlining various measures to increase per capita income. Clearly, however, income or wealth is not demanded for its own sake, but because it enables one to acquire the goods and nonmaterial services that help an individual lead a life that he or she has reason to value.<sup>8</sup> Economic development must be used as an enabler of improved quality of life. Therefore, in addition to the measures that have been outlined above, the province must pay attention to the delivery of key services.

The areas of service delivery on which the government must concentrate during the next two decades are health, education (especially of females), clean water and sanitation, transport, and the distribution and reliable supply of gas and electricity. The provision of some of these services will obviously have an economic impact as well, in that they could help produce a more efficient worker. However, while this is important, services such as health and educational facilities, and clean drinking water must be provided because they are essential to producing individuals who can function in a modern society.

#### **5.4. *Khyber Pakhtunkhwa***

Four factors shape the development challenge for KP:

1. *Distance from seaports.* KP is situated far from Pakistan's seaports. This raises the cost of imported inputs and also makes exports more expensive.
2. *A frontline state.* As a result of international politics, KP's recent history has been turbulent. An 11-year war against the Soviet occupation of Afghanistan, the succeeding civil hostilities, and the "war on terror" have all used KP as their base. This has created considerable uncertainty in the province regarding economic

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<sup>8</sup> Almost 2,400 years ago, Aristotle observed at the beginning of his *Nicomachean Ethics* that "wealth is evidently not the good that we are seeking, for it is merely useful and [sought] for the sake of something else."

conditions, and flooded the area with unregulated weaponry and more than 3 million refugees, about 1.5 million of whom are estimated to still be in the province.

3. *A limited modern private sector.* Modern private enterprise in KP is weaker than in the other provinces of Pakistan. The World Bank's (2007) study of the business community's perceptions indicates that Peshawar ranked lowest among the major cities of Pakistan for conducting business. The reasons cited included greater policy uncertainty in KP, a weak infrastructure, and institutional impediments that increased the cost of doing business in the province.
4. *Weak human resources.* KP's social outcomes, although improving, are significantly worse than those for Pakistan as a whole. The overall literacy rate for the population aged 10 years and older in 2010 was 50 percent in KP compared with 58 percent in Pakistan as a whole (the female rate was 31 percent compared with 42 percent); prenatal consultations were 32 percent compared with 41 percent; postnatal consultations, 7 percent versus 11 percent; births assisted by trained birth attendants, 15 percent compared with 20 percent; and 60 percent of households in KP had access to clean drinking water compared with 85 percent for Pakistan overall.

An effective development strategy must address these weaknesses to the extent possible, either by eliminating the deficiency or by mitigating its impact. Thus, while not much can be done to move KP closer to the sea, it should be possible to improve the efficiency of the transport and communications network so that the province's higher costs are minimized. It should also be possible to develop KP's potential for trade with countries such as Afghanistan and the Central Asian republics that are geographically closer.

#### *5.4.1. The Challenge of Poverty*

Along with Balochistan, KP has remained the poorest province of Pakistan. The difficulties imposed by geography and international politics have been compounded by natural disasters, such as the earthquake of October 2005. The first step toward improving the quality of life for KP's citizens is to tackle the problem of poverty.

What are the reasons for KP's poverty? The main reason is the slow growth of the province's GDP compared with the growth of population. Thus, between 1990/91 and 2010/11, KP's real GDP is estimated to have increased at an annual rate of about 4.5 percent; the population growth

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rate during this period averaged 2.8 percent a year, so per capita incomes increased by only about 1.5 percent annually.

However, three other factors have also contributed in substantial measure to the incidence of poverty in KP: (i) conditions in the labor market, (ii) the ownership of assets, and (iii) the educational attainment of the household head.

*Ownership of Assets*

Poverty in rural areas is closely associated with the lack of ownership of agricultural land. The incidence of poverty declined sharply for households owning between 1 and 4 ha of land, falling to almost zero for households with more than 4 ha. The close correlation between land ownership and poverty is evident in the finding that individuals with no land constituted about 58 percent of the rural population, but accounted for about 70 percent of the population in the poorest quintile.

*Education of Household Head*

Poverty in KP is characterized by poor outcomes for education and health. There is a strong association between the educational level of the household head and poverty incidence. The data indicate that in 2008, households whose head had never attended school constituted about 60 percent of the population, but accounted for nearly 70 percent of the lowest quintile. On the other hand, households whose head had been educated to the matriculation level or above constituted 16 percent of the population, but only about 10 percent of the poorest quintile.

*5.4.2. The Strategy*

A strategy to tackle poverty in KP can take heart from findings—for example, Heltberg and Narayan (2005)—that a large proportion of the province's population is clustered close to the poverty line, and that extreme poverty accounts for a relatively small share among the poor. Helberg and Narayan conclude that, since most of the poor are close to the poverty line, a large part of the measured poverty in the province is likely to be transitory. However, it also means that even small fluctuations in income can produce large changes in the measured poverty rate. Although a substantial part of KP's population is thus vulnerable to falling into poverty as a result of such shocks, it can also be lifted permanently above the poverty line if there is a sustained growth in GDP. It is important, therefore, to develop a strategy for sustained growth in employment and incomes.

The strategy must begin by estimating the GDP growth rate required to create the desired number of jobs. Following the analytical framework developed earlier, the long-term elasticity of employment with respect to real GDP growth can be used to estimate how fast the provincial GDP will have to grow in order to generate the required number of jobs. The World Bank, Government of the North-West Frontier Province, and DFID (2005) have estimated that this long-term elasticity is approximately 0.55 while the provincial labor force is growing at about 3.2 percent a year; this implies that GDP should grow at about 6 percent annually in order to provide employment to all new entrants to the labor force. However, the GDP growth will obviously have to be higher in order to cut into the backlog of unemployment. A rough estimate of the required GDP growth rate would then be in the neighborhood of 6.5 percent a year.

The World Bank, Government of the North-West Frontier Province, et al. (2005) also estimate the potential growth rate for KP's GDP. They conclude that, *given KP's existing institutional and technological base*, the potential rate of growth is around 4.5 percent a year, which is insufficient to attain the government's objectives. The priority for the authorities is thus to strengthen institutions and upgrade the technological base of the province.

What would be the drivers of the higher growth rate? Broadly speaking, the growth will have to be underpinned by more efficient use of resources in the existing drivers, such as agriculture, and a structural change in GDP toward sectors that have the potential for faster growth.

Agriculture will continue to play a central part in the strategy to accelerate growth and reduce poverty because of the sector's potential and because most of KP's poor live in rural areas. However, within the agriculture sector, structural change will be necessary for the province to deploy its scarcest resource—irrigated land—in uses that yield the highest returns. This means that thinking about agriculture must move away from emphasizing self-sufficiency in cereals toward a broader understanding of food security. Concretely, this means that farmers should be encouraged to move toward high-value activities, such as livestock and horticulture. The additional returns generated thereby can then be used to purchase cereals and other commodities in the production of which KP does not have a comparative advantage.

This does not, of course, mean that KP must give up the production of cereals; indeed, it cannot—these crops presently account for about three quarters of land use. It simply means that the authorities must increasingly recognize that the most efficient use of the province's limited fiscal resources for developing the agriculture sector and prosecuting the war on poverty would be to support the movement toward high-value products.

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According to the World Bank, Government of the North-West Frontier Province et al. (2005), farmers have indicated that converting from cereals to horticulture provides five times the income per hectare. Horticulture also requires up to five times the labor input of cereals; the move would, therefore, provide many more opportunities for landless laborers and underemployed farm households.

In addition to horticulture, a revised agricultural strategy would seek to expand the livestock sector (principally cattle, goats, and poultry). According to official statistics, the sector's contribution to provincial GDP is greater than that of crops. This is likely to grow quite rapidly as increasing urbanization in the province has expanded the demand for meat and dairy products.

KP is home to about 40 percent of Pakistan's forests (of which three quarters are in the northern mountains) and about 2.1 million ha of rangeland. Both these are sources of high-value products, but poor land-use rights and weak institutional arrangements have held back the optimal utilization of these assets, particularly in mountain areas.

In order to assist the move toward high-value products in the agriculture sector, the authorities will have to take a number of steps. The most important of these will be to:

- strengthen the infrastructure, particularly transport and cold-storage facilities, in order to reduce the post-harvest losses of high-value products;
- create a research system for best-practice research into commodities and activities (such as rearing sheep for high-quality wool in the high mountain areas and goats suitable for the southern districts of the province; improve fodder production; and enhance natural resource management, especially of forests and rangelands);
- improve the linkages between agricultural research, extension, and farmers; and
- increase the capacity of small farmers by developing farmer organizations.

As discussed earlier, KP's manufacturing sector labors under the handicap of distance from the seaports. The result, of course, is higher costs of imported inputs and for exports. A strategy to develop this sector must emphasize three factors.

First, it must develop manufactures based on materials that are indigenous to the province, such as gemstones, marble, granite, and construction materials; the latter could be especially useful for

reconstruction work in Afghanistan. While activities based on these materials offer considerable possibilities, they will not occur without intervention by the government. For example, an analysis by the World Bank of the value chain for marble shows that the government would have to (i) clarify ownership rights (not least in order to improve access to finance); (ii) facilitate the private sector in adopting better technology for extracting marble (at present much of the marble is extracted simply by blasting, which destroys a considerable part of the mineral and also results in nonstandard blocks, which reduces their price); and (iii) provide training for workers in finishing and polishing the stone.

Second, KP's comparative advantage in producing hydel electricity suggests that industries based on an intensive use of this input could prove competitive. This is discussed in a little more detail below.

Third, in view of KP's distance from Pakistan's seaports, the province should energetically explore the possibility of exporting to the Central Asian republics and Afghanistan (as the situation in the latter country stabilizes). Focusing on markets that are physically closer will reduce some of the disadvantage posed by its distance from the seaports. It also means that KP must engage more actively in obtaining market information from these destinations.

An activity related in some measure to manufacturing is construction. The authorities should pay particular attention to this industry both because it generates a considerable amount of employment, and because of its vertical and horizontal links with other industries, such as cement, glass, brick-making, wood- and metal-working, furniture, plumbing, electricity, and so on. Studies on this activity (e.g., in background papers for World Bank, Government of the North-West Frontier Province, and UK Department for International Development, 2005) show that the government must concentrate on policies to regulate the quality, safety, and protection of casual labor.

Another area that offers major possibilities is the generation of hydel power. KP's potential is a large multiple of the 4,000 MW that it currently generates.<sup>9</sup> Moreover, the electricity generated in the province is sold to the Water and Power Development Authority (WAPDA), which then sells it to consumers, including those in KP, at a higher price. One option suggested is for the province to set up electricity generating stations that, while covering their costs, could sell power to users within KP at a lower price than that provided by WAPDA to the national grid. A number of

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<sup>9</sup> The Sarhad Hydel Development Organization has identified hydel potential of more than 6,500 MW and completed feasibility studies of several hydel projects ranging from 8 MW to 125 MW.

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private sector representatives in KP have argued that this reduction in the cost of a major input could go a long way toward making the province's industries more competitive by offsetting the higher transport prices paid by KP's industry for the shipment of inputs from the seaports.

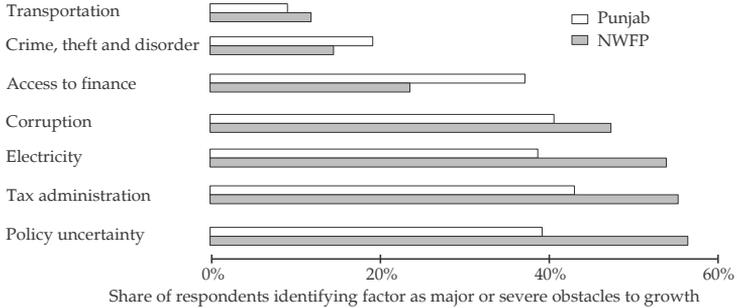
Of course, given the size of the province's potential in hydel generation, it would appear possible to pursue both options—selling large amounts of electricity to the national grid at WAPDA's price and smaller amounts at a lower price within the province—simultaneously. This would help the provincial budget as well as stimulate the province's industrial sector.

In the longer run, once the security situation stabilizes, another important source of growth could be tourism. KP is richly endowed with artifacts for cultural and historical tourism; these include ancient Buddhist monasteries, Ghandara sculptures, and a range of museums. The province is also replete with scenic sites, such as high mountain ranges, alpine valleys, and rivers and streams. The development of the tourism sector requires investment in roads and other infrastructure to make the region more accessible. Additionally, the security situation needs to be stabilized so that the private sector has an incentive to invest in hotels and tourists, and so that international tourists in particular, are encouraged to visit the region. Fortunately, the National Finance Commission Award of 2009 has vastly increased the financial resources available to KP, and thus puts the required investment within closer reach than was hitherto the case.

The bulk of jobs will have to be provided in the private sector. Therefore, improving the environment for this sector is an overarching issue in KP's strategy for development. One way of identifying areas in which the KP authorities should act is by comparing it with the other provinces, particularly those that are performing better.

The World Bank's (2007) study of the investment climate in Pakistan highlights a number of areas in which KP lags behind Punjab. These include the security situation, highly administrative barriers (particularly relating to tax administration), transport, and corruption. The findings are displayed in Figures 19.12 and 19.13, and underline the perception among investors that KP has some distance to go to become a major magnet for private investment.

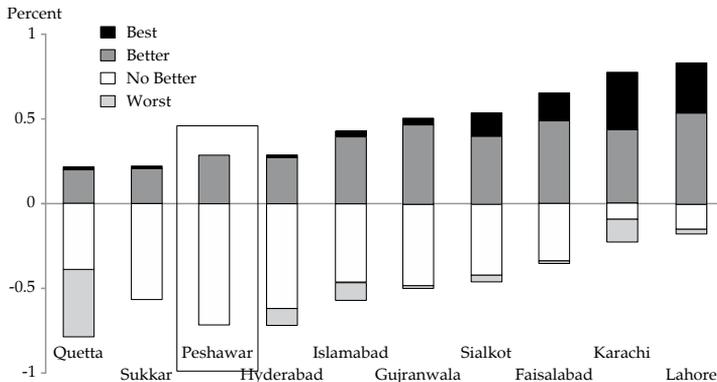
**Figure 19.12: Obstacles to growth in KP compared with the Punjab, 2004**



Source: World Bank, Government of the North West Frontier Province, and DFID (2005).

These findings are reinforced by the perception among investors that Peshawar is one of the least attractive cities in which to invest, as ranked by firms outside Peshawar (Figure 19.13). Additional investigations show that the business community views the state of governance in KP as being particularly inimical to private enterprise. This view is reinforced by several indicators, for example, the cost of enforcing a contract and the cost of creating a collateral agreement were both higher in Peshawar than in Karachi or in the main commercial cities of Punjab (Lahore, Faisalabad, and Sialkot).

**Figure 19.13: Perceptions of the investment climate, 2004 (rankings by firms outside the city)**



Source: World Bank, Government of the North West Frontier Province, and DFID (2005).

5.4.3. *The Problem of the Federally Administered Tribal Areas (FATA)*

The foregoing analysis dealt with areas under the provincial administration. However, in view of KP's close links—geographical, ethnic, and social—with FATA, a few words should be said about development issues in the latter. In thinking about development in FATA, two questions must be addressed:

- What should be the strategy for stimulating growth?
- How large is the development problem in FATA, and is it amenable to the strategy proposed?

**Employment and development strategies for FATA must rely on a combination of remittances and direct support.**

The basic question is: How can economic development be delivered and employment increased in FATA? Two approaches have been suggested.

The first, and one which agencies such as USAID appeared to be contemplating, would be to establish manufacturing and other enterprises in FATA (in what are termed the “reconstruction opportunity zones”). Although this route has been talked about for several years, nothing of substance has emerged. It is, therefore, impossible to judge how successful such a venture would be; if anything, the delay suggests that the difficulties have given even the proponents of this approach cause for introspection. On the face of it—given the fragile security situation, the undeveloped infrastructure, the paucity of trained workers, the distance from major population centers and transport hubs, and the difficulty of attracting managerial and other skills from outside the region—this strategy is unlikely to be very successful in the immediate future. It is probably best considered a supplement to the second strategy, described below.

The second strategy would essentially turn FATA into a “remittance economy” in the short run, and bank on the multiplier effects of a large volume of remittances to generate a range of economic activities within these territories in a somewhat longer timeframe. The strategy would rapidly develop economic activities in some of the cities in the settled areas—such as Peshawar, Mardan, Kohat, Nowshera, Charsadda—that already have the basic infrastructure and industrial base, and provide subsidies and tax breaks for enterprises there to employ workers from FATA.

A policy that combined boosting the employment of workers from FATA in the settled areas of KP with direct public works programs and substantial support for SMEs in FATA itself could produce successful

results. The secondary effect of a substantially increased flow of remittances to this region, plus the additional spending on public works, would be to trigger a significant increase in the demand for goods and services in FATA and in the growth of economic activities in the region to respond to this demand. This is likely to take the form initially of expanded retail trade—experience shows that stores selling food and grocery items, clothing, kitchen utensils, hardware, construction materials, and pharmaceuticals tend to start off first—together with construction, transport, and domestic services. This increase in economic activity should generate a substantial number of jobs within the FATA region itself.

The calculations presented in the next section suggest that a policy that combines remittances from FATA workers employed in the settled areas, together with measures to promote direct employment in FATA, could be viable.

**“Full employment” requires creating around 250,000 more jobs for FATA workers.**

A back-of-the-envelope calculation shows that the underlying development problem in FATA, namely, providing more employment, is not unmanageable. The region’s population in 2011 was 4.2 million (Pakistan, Ministry of Finance, 2011, statistical appendix, table 12.7), of which about half were women who, in the social mores of the region, were not available for work outside the home. Of the remaining 2.1 million, about 50 percent would be below 15 or over 60 years of age, assuming the same age distribution for FATA as for the rest of Pakistan. This leaves a potential labor force of about one million.

According to the Government of Pakhtunkhwa’s *Economic Growth Strategy* (Khyber Pakhtunkhwa, Planning and Development Department, 2011), the unemployment rate in KP was about 8.5 percent of the labor force. If one assumes an unemployment rate of 25 percent in FATA (three times that of KP), then 750,000 workers would be employed and jobs would have to be provided for about 250,000 additional workers.<sup>10</sup> Of course, not all the additional jobs would have to be created in FATA; workers from these territories could be employed in the settled areas of KP or indeed anywhere in Pakistan (as many of them already are).

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<sup>10</sup> In fact, in most countries, “full employment” is interpreted to accept unemployment of 5 percent because it has been found that, on average, about this proportion of the labor force remains unemployed at any given time for seasonal, frictional, and trade reasons. Thus, on these assumptions, 200,000 additional jobs would have to be created. However, let us ignore this for the moment.

The World Bank's economic report on KP calculated that the elasticity of employment with respect to GDP growth in the province was close to 0.6, i.e., an increase of 1 percent in the province's GDP would lead to an increase of 0.6 percent in its employment (World Bank, Government of the NWFP et al., 2005). If KP's employment elasticity was applicable to FATA, and remittances, additional government spending, and autonomous private sector expenditures created a GDP growth rate of, say, even 5 percent a year (the four-decade average of Pakistan's growth rate over 1970–2011), it would create 22,500 new jobs annually  $[(0.6 \times 5\%) = 3.0 \text{ percent of } 750,000]$  in FATA itself. (This is in addition to those created in the settled areas of KP and elsewhere resulting from the special incentives to employ workers from FATA.)

Of course, these estimates are offered only as ballpark figures and to provide a framework for thinking of possibilities. The actual outcome will depend on the employment elasticity calculated specifically for FATA, and accurate data on employment and the employment multiplier in that region. Indeed, the elasticity of employment with respect to GDP growth in FATA could quite likely be higher than that used here because many of the activities that would be triggered initially—retail trade, house construction, household services, and so on—are highly labor-intensive. Moreover, these "secondary effects" jobs could be supplemented substantially by direct action to finance public works in FATA itself, such as road building, brush clearing, and digging irrigation channels, which are also highly labor-intensive. FATA's employment problem would not appear to be unmanageable.

### **5.5. *The Punjab***

In 2011, the Punjab accounted for about 54 percent of Pakistan's population and about 56 percent of national GDP; the economic success of this province is, therefore, enormously important to the country. The Punjab's assets include an infrastructure and human resource base that are about the best in the country, a diversified agriculture sector, a large services sector (benefiting from the province's human resources), and a substantial industrial base. It is the only province that touches all the other provinces of Pakistan and also shares an extensive border with India.

However, on the other side of the ledger, the Punjab suffers the disadvantage of being a landlocked region, which makes imported inputs and exports relatively more expensive. Unlike the other provinces, it does not possess significant mineral resources; it is in danger of running short of water (which could have a profound impact on agriculture); and the structure of its industry has not modernized sufficiently. The absence of

mineral resources and the locational disadvantage of distance from the seaport suggest that the Punjab's economic growth must be rather more policy-driven than in some of the other provinces.

*5.5.1. Employment and the Required GDP Growth Rate*

The Punjab's labor force is estimated to grow at around 3.5 percent in the next decade. If the province aims to provide full employment (defined as incorporating 5 percent unemployment for frictional and structural reasons), then somewhat more than 10 million additional employment opportunities (including self-employment) will have to be created. The World Bank estimates the elasticity of employment with respect to GDP growth for the Punjab at 0.5. Thus, generating the required number of jobs suggests that the Punjab's GDP must grow at a sustained rate of about 7 percent a year.

*5.5.2. The Drivers of Growth*

On what can the Punjab base this higher growth? The potential drivers of the Punjab's growth are discussed below.

***Agriculture***

One must begin with the prospects for the provincial economy's largest sector, namely, agriculture. This sector contributes about 27 percent of the provincial GDP and employs around 40 percent of the total labor force; its fortunes therefore play a major role in the outcomes for the Punjab's economy. An adequate discussion of the issues in this sector merits more space than is available within the confines of this chapter; one must therefore satisfy oneself with highlighting the main issues.

*Shifting Cropping Patterns Towards High-Value Items*

The structure of the agricultural sector was not conducive to increasing employment in the last decade—according to the Labor Force Surveys, employment in the Punjab's agriculture between 1993/94 and 2010/11 increased at barely 1 percent per annum. On the other hand, through appropriate structural changes, it is possible to increase both the value added as well as employment in agriculture. For example, Ali and Abedullah (2002) report that the experience of several South and East Asian countries demonstrates that converting 1 ha of rice to vegetable cultivation for one season generates one year-round job. This suggests that diversifying the structure of agriculture in the direction of higher-value and more labor-intensive activities can lift the province's growth

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rate of agriculture and create more jobs. (Rice is not the only possibility; fruits and vegetables, for example, offer much the same opportunities.)

*Raising the Productivity of Water*

Raising the growth rate in agriculture requires a combination of physical investment and institutional improvements. Since the availability of water is an important constraint in the Punjab, growth in agriculture will require increased public investment in irrigation and water management. It is, therefore, a source of concern that the productivity of water used in agriculture has declined over the past three decades (see Ali & Byerlee, 2000).

*Modernizing Wholesale Agricultural Markets*

The production of high-value crops will be encouraged if the government facilitates the marketing of such products. In this context, significant reforms to wholesale markets will be necessary.

The World Bank, ADB, Government of the Punjab, and DFID (2005) comment that: "Market infrastructure tends to be biased towards major crops rather than livestock, fruits, vegetables, and other such high-value crops, the market information system is poorly developed, and the administrative structure to regulate output markets is highly bureaucratic and lacks effective private sector participation." The report goes on to recommend a number of concrete actions that the provincial authorities should take in order to modernize wholesale markets. These include (i) improving the market information system by revamping the district-level market information system; (ii) developing in collaboration with the private sector critical infrastructure such as refrigerator bogies, cold storage facilities at major airports, and laboratories for food safety testing; and (iii) establishing minimum grades and standards for all agricultural raw and processed products for domestic and export markets.

*Strengthening Institutions (Particularly Land and Water Markets)*

Other vital institutional improvements need to target the functioning of land and water markets, and to encourage research and innovation in agriculture. Perhaps the most important aspect of institutional strengthening that is required is the creation of an effective land records system. Such measures would clarify property rights and promote the smooth transfer of titles. Land taxes could be based on the size of holdings and calibrated to reflect the land's productivity potential (the existing "produce value" indices have not been revised for several decades). The combination of clearly defined property rights and this type

of taxation would discourage large landowners from holding on to underutilized land.

### *The Nonfarm Sector*

The authorities must, if anything, devote even more attention to the nonfarm sector. This includes manufacturing, construction, wholesale and retail trade, transport, and other services, and will be the main source of creating productive jobs. In 2010/11, the combined contribution of these subsectors accounted for well over two-thirds of the total provincial GDP. These areas fall largely under the private sector and are very important for providing employment—almost 90 percent of the Punjab's labor force is employed in the private sector. A strategy for developing the private sector (one such example is DFID, 2010) must, therefore, be a key component in any overall development strategy for the Punjab.

### *Focusing on the Problems of SMEs*

Within the Punjab's private sector, about 85 percent of jobs are in units that employ less than 10 employees. The authorities must provide supporting policies for the small and medium enterprises (SMEs), because it is on the performance of these enterprises that the wellbeing of the majority of the population depends. Moreover, these enterprises are important generators of employment—the elasticity of employment with respect to output in this sector is estimated to be 0.85 (i.e., a 10 percent increase in output would produce an 8.5 percent increase in employment).

The performance of these enterprises is constrained by access to finance and electricity, and the availability of skilled workers. Surveys by international agencies and other investigators (Ghaus-Pasha cited in DFID, 2009; Bari & Cheema, 2003) —show that only about 6–8 percent of fixed investment by SMEs is financed by development finance institutions and commercial banks. SMEs tend to rely on self-financing to begin operations and continue them with retained earnings. Large enterprises, on the other hand, draw on commercial banks both for working capital and fixed investment.

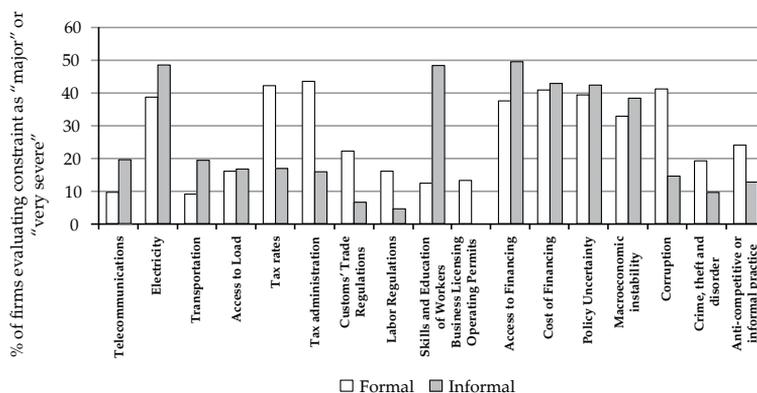
The problems of access to commercial bank financing arise from the banks' cumbersome procedures and their requirements for collateral. According to the Small and Medium Enterprises Development Authority (SMEDA), banks and other financial institutions often stipulate levels of collateral that exceed even those mandated by the State Bank of Pakistan. SMEDA reports that financial institutions frequently require SMEs to provide collateral worth 120–130 percent of the requested loan. It is possible that banks require such high levels because the unhurried

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working of the legal system makes recovering the collateral a slow, uncertain, and expensive process.<sup>11</sup> However, given the importance of such enterprises in providing jobs and generating incomes, it is essential that the provincial authorities examine ways of dealing with this problem, and can draw on the experience of other developing countries that have coped with such difficulties more successfully.

Figure 19.14 illustrates a comparison of the chief investment obstacles faced by formal and informal firms. The figure summarizes some of the findings of a survey conducted by the World Bank and SMEDA. The broad finding is that physical constraints (such as access to telecommunications, transport, and electricity) appear to be systematically greater obstacles for the informal sector, but areas (such as customs and trade regulations, tax administration, labor regulations) in which the sector can function “under the radar” pose smaller problems for it than they do for firms in the formal sector. Electricity-related problems were a major obstacle to investment both for formal and informal firms, but they affected nearly 50 percent of informal firms compared with 39 percent of formal enterprises.

**Figure 19.14: Investment obstacles in the Punjab: Formal vs. informal firms, 2009**



Source: World Bank

<sup>11</sup> The World Bank team working on the 2005 report was told by banks that the average period for taking custody of the collateral (in instances where they were able to do so) could be four to five years or more after default had been declared; all the time, the costs of pursuing the process of obtaining possession would keep mounting.

*Stepping up Training of Labor*

There is a saying in Arabic: "With every mouth, God sends a pair of hands; with every pair of hands, God sends a mouth." The problem in today's highly competitive and technologically-oriented world is that an untrained pair of hands is not quite a pair of hands. One is left with only the mouths.

Informal firms have reported difficulties in increasing their productivity because of their inability to attract skilled and educated workers. This is not surprising—skilled workers are in short supply in the Punjab, and can therefore choose to work largely in the formal sector where wages are higher and employment more stable. If the Punjab is to achieve its aim of accelerating GDP growth to a rate that can generate enough jobs for its labor force, it will have to invest more heavily in training this labor force. This is particularly important for the informal sector, which has few resources of its own to provide the training, but which must be supported because it provides the overwhelming share of employment and its low levels of productivity drag down the productivity and competitiveness of the entire provincial economy.

*Improving Governance, Especially in Property Rights, Contract Compliance, and Dispute Resolution*

Major development of the private sector requires a transparent and effective system of economic governance. Such a system would promote secure property rights and effective compliance with contractual obligations, create an environment of open and fair competition that would minimize costs, and establish an efficient mechanism for adjudicating and resolving commercial disputes.

The Punjab must do much more before such a system of governance can be said to be in place. For example, the World Bank cites a backlog in 2009 of over 100,000 cases in the high courts of the Punjab and Sindh (about half of which concerned commercial disputes), and estimate that, when these cases were taken up by the courts, it took an average of 46 steps and almost one third of the contract value to enforce a contract (see updated note to unfinished revision of World Bank, 2006b). A large number of such cases took more than five to seven years to be decided, while appeals and implementation of the judgment took a further year or two.

These drawn-out legal processes lead to higher court costs and lawyers' fees, and make access to justice an expensive proposition, particularly for small firms, which often view the legal system as invariably slow, frequently unfair, and generally costly. The slow and

costly judicial procedures can act as a severe disincentive to all business investment, but especially to foreign investment, which has very wide options about where it can go. The most important areas of governance fall within the remit of the provincial government, and it is essential that it act vigorously on them. (See DFID, 2010, for a more detailed list of recommendations for developing the private sector.)

### *5.5.3. Intra-Provincial Development Disparities*

An effective development strategy for the Punjab must recognize that the province is not a monolith, but contains important regional differences. Living standards differ significantly between regions. From the point of view of income, poverty, and social indicators, central Punjab is the most developed part of the province, followed by northern Punjab, with southern Punjab bringing up the rear (see, for example, World Bank, ADB et al., 2005; Cheema, Khalid, & Patnam, 2008; Institute of Public Policy, 2012). An interesting analysis by the Institute of Public Policy (2012) argues that, “overall, regional inequality has declined despite the fall in ranking of districts of South Punjab” (p. 128).

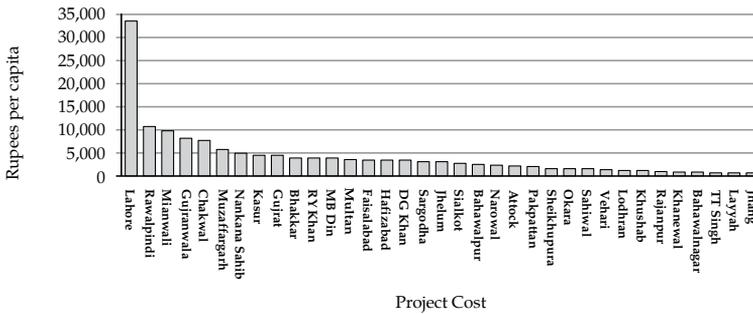
If this is indeed the case, it is an encouraging result. However, two points should be borne in mind. First, as the Institute of Public Policy study itself points out, the exclusion of the small-scale manufacturing sector biases the results against districts such as Lahore, Faisalabad, Sialkot, Gujranwala, Gujrat, and Wazirabad (all in central Punjab), which have large clusters of small enterprises. Again, the study emphasizes that the official statistics might not capture the private provision of social services, especially in the relatively large cities of the Punjab (most of them in central Punjab). This, again, is likely to imply greater regional inequality than estimated. Moreover, lumping the federal territory of Islamabad (for example, in electricity consumption) with northern Punjab can only have raised that region’s ranking with respect to the others.

Second, government actions do not appear to be assisting convergence. Mukhtar (2009) has argued that the Punjab’s public sector development program has been very “Lahore-centric.” Figure 19.15 expresses more vividly than any words could the disproportion in the allocations for Lahore compared with all the other urban centers in the province. Lahore has been provided with projects that cost about PRs 34,000 per capita, while the next largest recipient (Rawalpindi) was awarded projects that cost only PRs 10,000 per capita. At the extreme end of the scale, Sheikhpura, Okara, Sahiwal, Vehari, Lodhran, Khushab, Rajanpur, Khanewal, Bahawalnagar, Toba Tek Singh, Layyah, and

Jhangh—all significant urban centers—have been provided projects that cost only about PRs 1,000 per capita.

One must make the observation that the interests of equity and private sector development would both be better served if the government encouraged the private sector to enter to the maximum extent areas in which it has expressed the greatest interest—namely, Lahore. This would free up public resources that could be more generously deployed for infrastructure and service delivery in the smaller urban centers, for which the private sector shows less enthusiasm. It is to be hoped that the greater decentralization of powers will call for greater accountability and a quicker response from the authorities, facilitating such an outcome.

Figure 19.15: Cost of projects allocated to various cities



Source: Mukhtar (2009).

### 5.6. Sindh

At the time of Pakistan’s independence, Sindh’s per capita income was estimated to be perhaps 40 percent higher than that of the Punjab and 55 percent higher than the rest of the country. After Partition, with Karachi as the country’s only seaport, Sindh acted as a magnet for import-based and export industries; consequently, its economy grew rapidly. However, in the early 1970s, Sindh’s economic performance began to falter, and this trend has continued well into the 2000s. In 1991/92, Sindh’s estimated per capita income was one-third higher than the rest of the country; the difference fell to 16 percent by 2004/05.

Concomitantly, poverty increased faster in Sindh than in the rest of the country. From 1994/95 to 2004/05, while per capita incomes in Punjab and KP grew at 1.6 and 2.3 percent, respectively, that of Sindh grew by only 0.9 percent. During 2000–10, real per capita incomes in the rest of the

country increased at about 2.7 percent a year, compared with barely 1.0 percent in Sindh.

Sindh's earlier performance demonstrates its enormous potential. The central issue facing the province on the economic side is how to perform to this potential once again. Not surprisingly, the answer depends on accelerating the province's rate of GDP growth and improving the delivery of key services, such as education and health. However, the particular constraints and drivers of growth differ to some extent from those affecting other provinces.

#### *5.6.1. "Two Sindhs"*

Earlier, the chapter argued that provinces should not be regarded as monoliths and that attention should be paid to the regional diversity within each province. Sindh, in particular, exhibits a strong duality. About half the population lives in rural areas where more than 70 percent depend on agriculture, livestock, forestry, and fishing for their livelihoods. There are almost no organized manufacturing or services sectors in these areas.

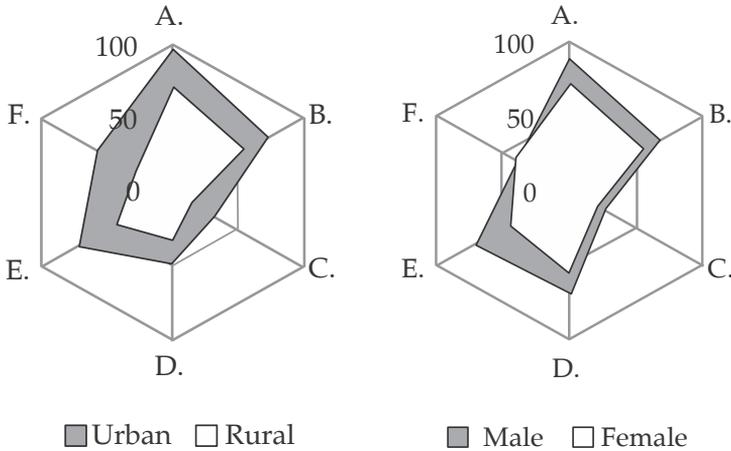
The other half of the population—about 18.3 million people—live in the urban areas; of this number, about 15 million live in Karachi. This segment of the population is heavily employed in the manufacturing and services sectors. The Labor Force Surveys show that about one-third and two-thirds of the urban labor force was employed in industry and the services sector, respectively, compared with only 9 and 21 percent of the rural labor force, respectively. The result of these structural differences is that mean per capita consumption in rural Sindh is only about half that in urban Sindh.

Indeed, the World Bank (2006b) argues that the urban-rural gap in Sindh is worse than the gender gap, even though the latter occupies much more of the attention of policymakers. The report goes on to say:

With 99 percent gross primary enrolment, a 72 percent literacy rate, and 87 percent of babies fully immunized, urban Sindh's social indicators equal or surpass the level of development in other developing countries with comparable per capita income. On the other hand, with 58 percent gross enrolment at the primary level, a 38 percent literacy rate, and 62 percent of babies fully immunized, the level of human development in rural Sindh is worse than that in some of the sub-Saharan African countries.

Figure 19.16 shows the social gap in 2009 between rural and urban residents compared with the gender gap. For each of the variables, the rural-urban gap is larger.

**Figure 19.16: Social gap between rural and urban Sindh, and between males and females, 2009**



Note: A= gross primary-level enrolment rate, B = net primary-level enrolment rate, C = matriculation-level enrolment rate, D = gross primary-level enrolment rate (private schools), E= literacy (population aged 10 years or older), F= fully immunized.

Source: Calculated from Pakistan Social and Living Standards Measurement 2008/09.

Moreover, the weight of Karachi is so overwhelming that it can seriously distort any analysis of the economic performance of Sindh as a whole. Therefore, while space and the available data do not permit a separate discussion of Karachi in this chapter, to the extent possible the problems of Karachi will be highlighted in the context of the development of urban Sindh.

A further comment is necessary. Karachi's rapid growth in the past has attracted waves of immigrants from other parts of Sindh and from the poorer provinces of Pakistan. This has put tremendous pressure on the city's physical and social infrastructure. The concern is that renewed growth would again lead to a massive influx of population from outside Karachi. This does not, of course, mean that Karachi's growth should not be accelerated. Rather, it means that (i) one must pay attention to a balanced development of all the provinces of Pakistan; and (ii) Sindh, in particular, should develop a comprehensive plan for its urban areas so

that other urban centers—such as Hyderabad, Sukkur, Larkana, Nawabshah, Rohri, Kotri—are also developed as alternative growth poles. Such a policy should help to reduce the “push” factor from at least the other parts of Sindh and ease the pressure on Karachi.

#### *5.6.2. A Strategy for Sindh*

The first point to consider is the likely expansion in Sindh’s labor force in the coming years. Four factors will shape the outcome. First, the size and age structure of the province’s population suggest that about 380,000 persons will enter the labor force annually over the next decade. Second, the rise in the literacy rate and increasing enrolment in primary and secondary schools are expected to add another 160,000 potential workers. Third, migration from other provinces could add as much as 50,000 persons a year to Sindh’s labor force. Fourth, social changes and increasing education are likely to increase the participation rate, especially of women, thereby adding more job seekers.

In short, while over the long term the province has created, on average, about 350,000 jobs annually (although job creation has touched about 500,000 in years in which the province’s economy expanded rapidly), it will be expected to generate 600,000-plus jobs a year in the coming decade. The World Bank (2006b) estimates that, if current economic trends continue, there could be an annual addition of nearly 100,000–250,000 to the pool of the unemployed every year. Such a situation could have very damaging social consequences.

On the basis of the past relationship between output growth and employment creation, it is likely that the GDP growth rate required to create 600,000 jobs a year will be closer to 7 percent a year in real terms than to six. Such a rate of growth will also be required to deal with the problem of poverty. The broad movement in Sindh’s poverty tracks that of Pakistan, but after 1994/95, poverty in Sindh increased more sharply than in Pakistan as a whole, and in 2001/02 it was estimated to be significantly higher. In that year, nearly 40 percent of Sindh’s population was estimated to be below the poverty line.<sup>12</sup>

Owing to the more rapid growth in the economies both of Pakistan and Sindh, the poverty headcount declined substantially to about 20 percent of the population in 2008. However, income distribution in Sindh remained more unequal than in the other provinces both in 2002 and 2008

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<sup>12</sup> There is some dispute over this figure because of questions pertaining to the small sample and high standard deviations in the measurement of income and consumption. The Social Policy and Development Centre (2004), using techniques more applicable to small-area estimations, puts poverty incidence at 31 percent in 2001/02.

(see Figures 19.5 and 19.6 above). In order to deal with poverty, Sindh will have to adopt an inclusive development strategy that can sustain the GDP growth rate at close to 7 percent a year and share the fruits of growth more equitably.

### *5.6.3. Developing Urban Sindh*

"Sindh needs to grow not in parts, but as a whole," commented the World Bank (2006b). It is not too much to say that the province has relied excessively on Karachi to act as its engine of growth. As a result, the potential of other urban centers has been stifled and no dynamic second-tier city has developed.

It appears that the strategy of relying almost exclusively on Karachi has gone as far as it can. In the future, Sindh will have to follow policies that maintain the dynamism of Karachi, but also develop additional growth poles that relieve some of the pressure on the city's infrastructure, and take advantage of Sindh's other assets that are located near these new urban centers. This will require the authorities to adopt a more comprehensive urban strategy that addresses issues specific to each major city.

While all cities in Sindh (including Karachi) face a number of common problems, such as an often unreliable and expensive electricity supply, there are a number of city-specific problems that discourage investment. A survey by the World Bank (in connection with the preparation of World Bank 2006b) showed that entrepreneurs in Karachi felt most discouraged by the high price of land and problems with electricity, while those in Hyderabad and Sukkur did not regard access to land as a critical problem, but were most concerned with the unavailability of skilled labor. Again, entrepreneurs in the interior of Sindh regarded the law and order problem as the biggest impediment to conducting and expanding their business.

The need to encourage private investment in the province means that the authorities must move vigorously to improve Sindh's investment climate, where the constraints have been changing quite rapidly. The World Bank (2006b) reports that, between 2001 and 2004, the nature of the problems described as being most hostile to the business environment changed significantly. In the earlier year, the most serious constraints related primarily to those for which the central government was responsible—tax administration, tax rates, the cost of and access to finance, and electricity. In 2004, the major problems came under the remit of the provincial government—corruption, utility hookups, law and order, and uncertainty regarding the application of regulatory policies. With the greater devolution of powers and responsibilities following the

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passage of the 18<sup>th</sup> Amendment and the increased financial resources made available to the province by the 7th National Finance Commission Award in 2009, the ball is even more squarely in the provincial government's court.

The major challenges to Sindh's investment climate can be grouped under four headings: (i) access to and workings of factor markets, especially land; (ii) governance issues, especially corruption, law and order, contract enforcement, and the performance of the judicial system; (iii) infrastructure, particularly electricity and water supply; and (iv) policy uncertainty.

The distortions characterizing land markets are well known. They include (i) unclear property rights; (ii) inflexible and apparently arbitrary zoning laws; (iii) the fragmentation of land ownership among public sector bodies (nine such bodies own more than 90 percent of Karachi's land, and there is very poor coordination between them); (iv) high taxes on property-related transactions; and (v) legislation that is tilted heavily in favor of tenants and against owners.

The efficient and inexpensive determination of a clear set of rights governing property is fundamental to any market economy. Enforcing contracts in Sindh, including Karachi, is both expensive and time-consuming. These are important weaknesses because the concept of a free, private sector-led market economy is based on the premise of enforceable rights and contracts that are rapidly and efficiently executed.<sup>13</sup> Sindh is also the most litigious province in Pakistan. For example, at the beginning of 2004, there were more than 2,647 pending cases per million of the population in the Sindh High Court, compared with 738, 429, and 377 in Punjab, KP, and Balochistan, respectively. The nearly 88,000 cases pending before 15 judges in the Sindh High Court accounted for 48 percent of all pending high court cases in the country. The situation is getting worse—Sindh is the only province where the number of new high court cases exceeds the number of cases disposed of.

#### 5.6.4. *Accelerating Growth in Rural Sindh*

The wide gap in living standards and social outcomes between urban and rural Sindh was pointed out earlier in the chapter. The biggest threat in rural Sindh to even the existing standard of living—and the biggest challenge to raising it—is the deteriorating water situation.

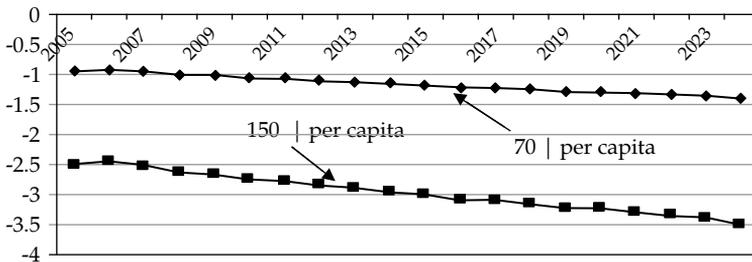
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<sup>13</sup> As Thomas Hobbes put it in *Leviathan* (1651): "He that performeth first has no assurance that the other will perform after, because the bonds of words are too weak to bridle men's ambitions, avarice, anger, and other passions without the fear of some coercive power."

Sindh is an arid region that receives sparse and irregular rainfall. To make matters worse, its groundwater is largely saline and the province is, therefore, exceptionally dependent on a supply of water from the Indus and its tributaries via the canal irrigation system. From 1996/97 to 2001/02, annual rainfall in Sindh was 35–80 percent lower than the long-term average. Since the drought had also affected much of the rest of Pakistan, the supply of canal water also decreased. In most years from 1992, canal withdrawals in Sindh were below their long-term average—withdrawals in 2000 were 28 percent below the average.

The situation is likely to deteriorate even further. Population growth is projected to turn the province’s water balance from a small surplus to a sustained deficit (see Figure 19.17). Rapid industrialization will intensify the problem. The World Bank (2006b) estimates that, if Sindh were to achieve the level of Indonesia’s industrialization, the water deficit would be twice the 2004 level. It is clear, therefore, that future growth in Sindh’s agricultural sector will have to emphasize water-efficient activities.

**Figure 19.17: Projected shortfall from present availability at different levels of requirements (percent of present availability)**



Source: World Bank (2006b).

A strategy for developing Sindh’s rural areas will have to incorporate at least five elements. First, it must improve the productivity of water. This will involve adopting more effective water management practices, relating water fees to actual consumption levels (this should help shift the cropping pattern in the direction of more water-efficient products), and setting *abiana*<sup>14</sup> rates at levels that cover operation and maintenance costs.

Second, the strategy must encourage a movement within the crop sector in the direction of high-value added crops. This move can be facilitated by eliminating some of the existing distortions relating to prices, subsidies, and regulations (in particular, the economics of sugarcane *versus* cotton must be revisited). The idea is that the cropping

<sup>14</sup> Income collected by government from irrigated (canal-fed) land.

pattern should, as far as possible, be determined by the market rather than by the government.

Third, developing the rural areas will also require a move away from the crop sector toward high-value nonfarm activities, such as livestock and fisheries. While the investment in such productive facilities is expected to come largely from the private sector, the government can help by improving the infrastructure and facilitating the transfer of techniques and technology.

Fourth, the authorities will also have to pay attention to those problems the agricultural sector faces that are not related to water. An important obstacle to the growth of the rural areas is that Sindh's agriculture is not properly integrated with the transport and storage sectors (nearly 20 percent of communities in rural Sindh lack basic motorable access and 60 percent of communities lack paved access), nor does it provide a broad base for the development of agro-industry.

Fifth, the marketing system must be strengthened, and the sector linked more closely with retail trade activities in Karachi and the rest of the province. Only when the rural and urban sectors are more closely integrated will there be a single, unified Sindh, the development of which will live up to the potential of the province and bring to all its citizens the benefits and wellbeing that they deserve.

## **6. Conclusions**

This chapter has covered too much ground to admit of some simple conclusions, but several points are worth stressing.

First, accelerating the GDP growth rate is imperative for Pakistan; the demographic dynamics do not allow an alternative. Failure to grow at the required rate will create a serious risk that the demographic transition, instead of offering a dividend, will construct a nightmare. In order to achieve the required rate of growth for the country, each province will have to capitalize on its assets to the maximum extent.

Second, each of the provinces will have to maintain a significantly higher GDP growth than in the past if they are to absorb all the additions to the labor force and reduce the backlog of the currently unemployed. However, they all possess the assets needed to arrive at a successful outcome. The discussion in this chapter has highlighted that it is largely a matter of adopting policies that will transform the potential of the province into actual results. Doing this is a question of political leadership and will, but a discussion of such matters lies outside the remit of this chapter.

Third, while this might seem paradoxical in view of the shortcomings of past policies and economic performance, the most important lesson that one should draw from Pakistan's experience is one of hope. At the time of independence, the areas that comprise Pakistan had a population of barely 35 million; today, the population of just the province of Sindh is 50 percent larger than that number. The *difference* between Pakistan's present population of nearly 180 million and that at the time of independence is equal to the total present-day population of Russia, or of the UK, France, Sweden, Norway, and Denmark put together.

Moreover, these 180 million persons—five times the number at the time of independence—have, on average, higher incomes, are better fed, housed, clothed, educated, and connected to the rest of the world, and have much greater opportunities to fulfill their capabilities than their counterparts in 1947. This fact alone would attest to the resilience of the economy and bear witness to the distance it has traversed over the last 65 years.

If one is critical of the economic performance of Pakistan and its provinces, the regret is for opportunities missed and for not performing to their potential, rather than for a disastrous outcome. The reproach is that the country and all the provinces could have done much better. If, say, Korea and Taiwan, perched on the edge of Asia, destitute of natural resources, and rent for long periods by war (and in the case of Korea, with its capital city occupied twice by enemy forces) could achieve so much so quickly, then it should not be impossible for Pakistan's provinces, with their abundance of natural resources, to achieve something comparable.

However, this will not happen by itself; as the discussion in this chapter has shown, such improvements will require a change in people's thinking. The Holy Qur'an repeatedly stresses this message: it says (viii, 53): "Allah never changes the favor He has bestowed on any people until they first change what is in themselves." This is reiterated (xiii, 11): "Allah changes not the condition of a people until they (first) change what is in themselves." It is in the spirit of this injunction that the present chapter has sought to identify some crucial areas in the economic field towards which changes in thinking could usefully be directed.

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