IPP's Annual Report
2008

State of The Economy: Challenges and Opportunities

Institute of Public Policy
Beaconhouse National University

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

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

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

The IPP Executive Council consists of eminent personalities devoted to improvement of public policy in Pakistan. The members are:

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■ Mr. Ziad Alahdad	Member
■ Mrs. Nasreen Kasuri	Ex-officio Member, Chairperson, BNUF
■ Mr. Sartaj Aziz	Ex-officio Member

Mr. Khalid Mahmood, former Ambassador of Pakistan is Director of the Institute, while Dr. Aisha Ghaus-Pasha is Director of Research.

PREFACE

This is the first Annual Report of BNU's Institute of Public Policy on the State of the Economy and is being released at a very critical time in Pakistan's history. The new coalition government which has just taken over after the landmark general elections held on 18 February 2008, is faced with a number of difficult challenges, amid high post-elections expectations from the public and the need to provide relief to the poor.

This Report presents an independent and objective analysis of the State of the Economy alongwith specific recommendations for correcting the serious imbalances, especially on the fiscal and external accounts, and for containing the rate of inflation, particularly in food prices. It also focuses on: (i) promoting export oriented, sustainable and inclusive economic growth; (ii) according high priority to agriculture and other labor-intensive sectors; (iii) undertaking the unfinished task of decentralizing functions and transferring more resources to the provinces and from the provinces to the districts; and (iv) addressing the problem of regional and rural-urban disparities in the country.

I hope the Report will be useful not only for the new federal and provincial governments but also for the members of Parliament, the academic community, the media and the public.

I would like to thank Mr. Shahid Javed Burki, Dr. Hafiz A. Pasha, Dr. Pervez Hassan, Dr. Akmal Hussain and the IPP Research team led by Dr. Aisha Ghaus Pasha for preparing and publishing this Report within the terms of reference given by the Executive Council of the IPP as a timely input into the process of policy making in Pakistan.

Sartaj Aziz

Sartaj Aziz
Vice Chancellor
Beaconhouse National University

FOREWORD

This is the first report on the state of Pakistan's economy and society by the Institute of Public Policy, which has been under preparation for over a year. The report has gone through a process of evolution. In the October 2006 meeting of IPP Executive Council it was decided to focus the first annual report on the issue of sustainability and inclusiveness of growth experienced during the last few years. The rise in income inequality and emerging physical constraints to growth had raised serious concerns about the nature of development strategy being followed.

The next meeting of the Executive Council in Summer 2007 was held against the backdrop of institutional tensions between the executive and the judiciary and a strong perception that over centralization of power was the root cause of governance problems. Accordingly, the emphasis in the design of the report shifted towards decentralization and devolution of power, especially since IPP was engaged in two related projects supported by the Government of Punjab.

As the report progressed, major developments took place. Adverse trends in the global economy started becoming visible, including the unprecedented upsurge in oil and food prices. The induction of the new government following the elections led to the revelation that the Pakistani economy was under considerable stress and that macroeconomic imbalances had reached virtually unsustainable levels. Consequently, in the final phase of writing the report, the focus had to shift to the process of short-run adjustment in order to avert a crisis.

The report as it comes out reflects all three sets of issues: sustainability and inclusiveness of growth; institutional development; decentralization; short-run macroeconomic adjustment to bring down inflation; and the 'twin' budget and current account deficits.

The report is in nine chapters. Chapter 1 contains an executive summary highlighting the principal recommendations. Chapter 2 focuses on the state of the economy and identifies the radical adjustments required to contain the macroeconomic imbalances. Chapter 3 focuses on the issue of accelerating growth especially by identifying the opportunities that could emerge from long term developments in the global economy. Chapter 4 identifies the structural causes of poverty and the types of institutional changes required to build in equity in the process of growth alongwith a programme of short-term relief to the poor.

The thrust in Chapter 5 is on the role of fiscal policy in stabilization, growth and redistribution. A series of proposals are presented both on the revenue and expenditure side to achieve these objectives. Chapter 6 takes up the issue of a greater role for provincial governments in economic development and presents the contours of a regional growth strategy for two provinces, Punjab and the NWFP. Chapter 7 follows up with a discussion on trends in fiscal federalism in Pakistan since the last NFC Award and demonstrates how greater fiscal equalization among the provinces can be reached. Chapter 8 analyses developments since 2001 following the implementation of the devolution plan and highlights how the local governments can be made more efficient, responsive and participatory in nature. Finally, Chapter 9 looks at the performance and prospects for Pakistan's exports and presents a strategy for export diversification.

The report has been produced by a team that has experience of working in many fields and in many countries. Sartaj Aziz, of course, has served Pakistan the longest, having held many ministerial positions over the last three decades. He also held several senior positions in international development organizations. Pervez Hasan has also been a senior official in Pakistan and, at the World Bank, served as the Chief Economist of East Asia before moving to Central Asia. Hafiz Pasha, after a distinguished career as an academic in Pakistan, joined the government and served as a minister at different times, looking after a variety of economic portfolios. He then joined the UNDP and was in charge of that organization's Asia-Pacific Bureau. Currently he is Dean of Social Sciences and Professor of Economics at BNU. Akmal Hussain is a Distinguished Professor of Economics at BNU and has written extensively on rural development, human development and the burning issues of poverty and inequality. Aisha Ghaus-Pasha is a noted public finance economist and has advised the United Nations and other agencies extensively on governance issues. I began my career in Pakistan before going to the World Bank where I served in senior positions looking after China, Latin America and the Caribbean.

It is our hope that we have put our combined experience, expertise and knowledge to good use in producing this report. We hope that it will be read with some interest by the public and by the policymakers.

Shahid Javed Burki
Chairman
Institute of Public Policy

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CONTENTS

TABLES:

BOXES:

CHARTS:

LIST OF ACRONYMS

- ANP Awami National Party
- AKRSP Aga Khan Rural Support Programme
- BNU Beaconhouse National University
- BOP Bank of Punjab
- BIMSTEC Bangladesh, India, Myenmar,Srilinka, Thailand Economic corporation
- CCB Citizen Community Board
- CSP Communicating Sequential Processes
- CCI Central Information Commission
- CPI Corruption Perception Survey
- CBOS Community Based Organization
- DA District Administration
- DCO District Coordination Officer
- DFPI Direct Foreign Private Investment
- DFI Direct Foreign Investment
- FRDL Fiscal Responsibility and Debt Liability
- FATA Federally Administer Tribal Area
- FBS Federal Bureau Statistics
- GDP Gross Domestic Product
- GNP Gross National Product
- GST Goods and Services Tex
- HST Hybird Synergy Drive
- ICT Information and Communication Technology
- ISC Industrial Support Center
- ICORS Incremental Capital-Output Ratios
- IMF International Monetary Fund
- IPP Institute of Public Policy
- KSE Karachi Stock Exchange
- LFO Legal Frame Work Order
- LDO Light Diesel Oil
- LGO Local Government Ordinance
- LUMS Lahore University of Management Sciences
- LSM Large Scale Manufacturing
- MNA Member of National Assembly
- MNC'S Multi National Corporation
- MPA Member of Provincial Assembly
- MAF Multi Fiber Arrangements
- MRTB Market Related Treasury Bills
- MMA Muttahida Majlis-e-Amal
- MDG'S Millennium Development Goals
- MTSU Multidonor Transparency Support Unit
- MQM Muttahida Qaumi Movement
- MAF Ministry of Agriculture and Forestry
- NWFP North West Frontier Force
- NHDR National Human Development Report

- NEC National Economic Council
- NGO Non Government Organization
- NFC National Finance Commission
- NRSP National Resources System Program
- PTCL Pakistan Telecommunication Limited
- PIHS Pakistan Integrate Household Survey
- PPP Pakistan Peoples Party
- PFC Provincial Finance Commission
- PRSP Poverty Reduction Strategy Papers
- POL Petroleum Oil and Lubricant
- PIB's Pakistan Investment Bonds
- PSDP Public Sector Development Program
- PPC Provincial Vocational Councils
- PLSMS Pakistan Living Standard Measurement Survey
- PRSP Punjab Rural Support Program
- RTA Regional Trading Arrangements
- R&D Research & Development
- SMEDA Small and Medium Enterprise Development Authority
- SME'S Small and Medium Enterprise
- SAARC South Asian Association for Regional Association
- SAFTA South Asian Free Trade Area
- SPS Sanitary and Phyto-Sanitary
- SAP South Asian Program
- SPDC Social Policy and Development Center
- SSI Services of Small Scale Industries
- SSE Small Scale Enterprise
- SEA School Education Authority
- TFP Total Factor Productivity
- TMA Tehsil Municipal Administration
- UNDP United Nations Development Program
- UNIDO United Nations Industrial Development Organization
- USAID United States Agency for International Development
- UDF University Development Foundation
- VTI Vocational Training Institute
- WTO World Trade Organization
- WAPDA Water and Power Development Authority
- ZMC Zila Mushaverait Committee
- ZTE China's Telephonic company

Chapter - 1

Executive Summary: A Vision for the Future

Chapter - 1
Executive Summary:
A Vision for the Future

INTRODUCTION

Pakistan's economy is once again at a critical juncture. After a period of strong economic expansion, relative macroeconomic stability, and increased foreign investor confidence, over the years 2003-2006, the country is facing very serious economic strains and social challenge across a broad front.

Macroeconomic balances have deteriorated very sharply over the last few years. Inflation has touched record levels this year on the back of three previous years of high single-digit inflation. This is despite the fact that the sharp increases in international oil prices during the last year have not been fully passed on to the final consumers and wheat is being subsidized. The burden of high prices, especially of basic food items, has become intolerable for poor households. The roots of inflation since 2004 may have been monetary in character but now it has acquired a structural nature, given the high dependence on imported energy.

Poverty is consequently on the rise again. There was some decline in the poverty incidence, over 1999-2005. However, the unprecedented rise in food prices since 2004, along with the more recent shortages of wheat flour and a slowing economy have wiped out any gains that were made in recent years in reducing poverty. Also, there is evidence that labor absorption has been limited despite rapid growth.

Structural problems constraining long term growth have come dramatically to the fore front with major power shortages and large scale load shedding. On top of this, the erosion of competitiveness of our dominant exports, textiles and clothing, and a sharp slow down in export growth since 2006-07 have led to a large increase in the trade imbalance and limited the prospects for growth in labor- intensive manufacturing.

Given this backdrop, the first objective of this report is to take stock of the economy focusing on;

- the immediate financial problems arising out of large and virtually unsustainable twin fiscal and balance of payments deficits,
- a high and rising rate of inflation, especially in food and energy prices,
- a slowing down of the economy, especially manufacturing, and the need to remove the principal constraints on long term growth like the power deficit and water scarcity,
- widespread poverty incidence and growing income disparities among income groups and across regions, and
- the governance and institutional problems that not only hamper productivity and growth but also discriminate against the access of the poor to resources, public services and government decision making.

In attempting to assess the present position, the report analyzes the short term causes of the economic unraveling as well as the underlying longer term issues that continue to impede our economic and social progress. This is critical because not only are we quite a distance away from matching the record of the Asian tigers but also are seriously falling behind India.

The second and the main objective of the report is to outline a comprehensive and integrated economic and governance strategy that will facilitate the tackling of the above mentioned challenges that require the urgent attention of the new economic and political leadership all at once.

The report recognizes that efforts to restore macroeconomic stability from the present position of almost uncontrollable fiscal and balance of payments deficits could dampen short-term growth and investment and make the addressing of poverty and distribution issues harder during the period of adjustment. The pain of a sharp adjustment is unavoidable through public policy measures and well designed interventions, to largely protect the poor who account for not much more than 10-11 per cent of total private consumption. It is important to realize that in the absence of a strong adjustment the country runs the risk of a deep financial crisis, with catastrophic consequences on the lives of the people.

In the longer run, the goals of financial stability, rapid growth and fairer income distribution can be made, through appropriate public policies and resilient national institutions, not only consistent with each other but also mutually reinforcing and inter-dependent.

In looking at future prospects of growth and seeking better distribution outcomes the report highlights both the gains made in the last few years as well as the many unmet challenges and unexplored opportunities, especially in the context of developments in the global economy. In looking at the choice of policy instruments to advance the economic and social agenda, the reports stresses specially the need to move simultaneously on a number of fronts because of the interlocking and mutually reinforcing effect of many policy and institutional changes. For example, improvements in governance could partly alleviate the pain of economic adjustment.

We start first by a brief description of the state of the economy which will be followed in the subsequent section by a description of the strategy to place the economy on a sustainable path.

STATE OF THE ECONOMY

Macroeconomic Imbalances

The macroeconomic situation has unraveled very quickly. The fiscal deficit (excluding grants) has grown eightfold over the last four years and could be as large as Rs. 750 billion or 7.5 per cent of GDP. The Finance Minister has, in fact, projected the fiscal deficit at 9.5 per cent of the GDP on the basis of current trends. We expect that a deficit reduction of 2 per cent of the GDP will be made by the government in coming weeks, especially through some rationalization of the PSDP.

The current account of balance of payments which had a surplus of almost 2 per cent of the GDP as late as 2003-04 could reach the record level of $ 12 billion or 7.5 per cent of GDP in the current year. It has already approached 5.5 percent of the GDP in the first eight months. Our projection is based on the fact that in the last quarter of the year there is seasonally a tendency for the trade deficit to moderate. But even at the lower level, the current account deficit is unsustainable. The large deficit is cutting into the foreign exchange reserves at a most worrying rate. In the last four months the decline in reserves financed nearly 40 per cent of the current account deficit. By April 12, the foreign exchange reserves had dropped to $ 13 billion and were $ 3.5 billion below the level in end October 2007.

Our present predicament is the result of a combination of factors, large exogenous shocks, wrong or absence of policy responses, and a neglect of emerging structural problems in three key sectors- energy, agriculture, and exports.

The negative shocks-devastating earthquake in 2005, the inexorable rise in international oil and in food prices, especially of grains and edible oil-- have amounted to a huge tax on the economy and have effectively reduced the real growth of income in Pakistan on average by about 1.5 per cent per annum during the last four years. Just this year, the further increase in oil prices could cost Pakistan over 2 per cent of GDP.

The policy response to these developments has been poor or misguided. These developments required major adjustment in consumption and possibly investment plans. But the need for scaling back aggregate demand, especially by reining in the expansionary monetary policy, was ignored partly because privatization revenues and sovereign borrowing in world markets were easily available to finance growing deficits and partly because delivering high growth was considered, mistakenly it turns out, a political imperative for winning elections.

Domestic absorption of resources, in fact, increased very sharply over 2004-07. Real consumption and investment together increased by 35 per cent over the three years in contrast to the growth in national income, adjusted for terms of trade loss, of little more than 25 per cent. The imbalance was directly reflected in the deterioration of the balance of payments. Consequently, the propensity to import jumped three times during the last five years as the economy sucked in more resources from abroad.

There is no doubt that the most urgent need is to avoid a balance of payments crisis that would shake the confidence of foreign investors and citizens alike and could trigger capital flight as well as limit Pakistan's access to the international capital markets.

Inflation

The rapid accumulation of foreign assets resulting from the quantum jump of home remittances and the emergence of a current account surplus after 9/11 facilitated the resort to an expansionary monetary policy from 2002-03 onwards. This policy remained 'too easy for too long' and led to a precipitous fall in interest rates which promoted a mushroom growth of consumer financing. By 2004-05 there was evidence that the economy was beginning to overheat with the inflation rate jumping up to over 9 per cent, even in the absence of international inflation and rising commodity prices. Expansionary policies did succeed in reviving growth but they have put the economy on a high inflation path. After nearly four years of high single- digit inflation, inflationary expectations have become built into behavior of economic agents, especially with regard to consumption and savings. Even stronger policy action is now required to counter these expectations.

Superimposed on the history of inflation is the recent upsurge of oil and food prices. This has imparted a spiraling tendency to prices, even though full domestic adjustments to higher international prices have not yet been made. On a year to year basis the inflation in food prices is currently running at 20 per cent.

Fiscal policy is now beginning to reinforce monetary policy in adding to inflationary pressures. On surface, the actual deficits of 4.3 per cent of GDP (including earthquake related spending) in 2005-06 and 2006-07 may not appear excessive. But the way they were financed triggered further strong monetary expansion. The government has had difficulty since 2005-06 in meeting the growing domestic borrowing amount from the market on longer term Pakistan Investment Bonds (PIBs) without offering higher interest rates. It thus resorted to the low cost alternative of borrowing huge amounts from the central bank. This moderated the cost of government borrowing (thus helping to keep interest payments on domestic debt in the budget low) but it also contributed to higher rates of monetary expansion by creating excess liquidity in the banking system.

Despite the measures taken to tighten monetary policy in 2006-07, broader money (M2) grew by over 19 per cent during the year, even somewhat higher than the average annual rate in the previous three years. During 2007-08, the money supply growth is running at around 7 per cent, but this is mainly due to decline in foreign assets. Government borrowing from SBP during July-March was at the record level of almost 4.5 per cent of the GDP.

The State Bank of Pakistan has correctly tightened monetary policy in recent weeks. The scope for maneuver by the central bank can and should be expanded by largely eliminating the sizable government borrowing from it. Recourse by government to market borrowing through PIBs, will help to truly identify the cost of public debt service, improve the interest rate structure thus encouraging savings, and last, but not the least, reduce the supply of reserve money.

The major instrument of economic adjustment, however, must be the fiscal policy. Fortunately, fiscal adjustment can take place in an environment much more favorable than in the 1990s when elected governments had little fiscal space because of the extraordinary burden of interest payments on public debt. Real public non- interest spending which had shown no increase in the decade of the 1990s because of the growing burden of interest payments, has expanded, adjusted for inflation, by over 60 per cent during the period, 2004-07, and would show a further increase this year because of large subsidies on oil.

The details of a desirable fiscal adjustment path are discussed below. A strong fiscal adjustment and a tight monetary policy will send strong signals to the markets that Pakistan seriously intends to tackle the disequilibrium in its foreign transactions and avoid any disruptive change in the value of its currency or a flight of capital.

Growth: Emerging and Structural Constraints

Since independence Pakistan's average annual growth rate has been a little over 5 per cent per cent per annum, much below the 8-9 per cent growth enjoyed by East Asian countries. Even in periods of high growth, average growth never exceeded 7 per cent per annum. There cannot be much dispute that some fundamental demographic, governance and growth problems have kept Pakistan from joining the rank of Asian Tigers. These problems have had long roots and had their origins in: a high population growth rate; low rate of savings and consequently inadequate investment not only in human capital but also in infrastructure, industry and agriculture; a weak industrial and export structure, dominated by cotton based exports; an ambivalent attitude towards the private sector and the absence of liberal economic framework till the early 1990s; a level of defense spending that the country could ill afford; inability of the government to collect enough revenues; a major neglect of human development; an inability to develop viable democratic political institutions and effective governance structures; over centralized decision making, weakening public institutions and rule of law, public corruption, and lack of accountability.

Though progress towards removing these constraints has remained mixed as discussed in Chapter 2, there are several positive signs including the demographic transition, liberalization, privatization and reforms of the financial system, increased confidence in the economy which helped to energize the private sector and increased foreign investment flows and financial reforms which generally augur well for economic efficiency. More depth in the capital market has enabled it to handle the recent bad economic news well.

Still there are major problems that relate to the private sector development and public sector priorities. There is a crisis in the power sector. Insufficient investment in generation and distribution and inefficiencies not only increase the costs for the private sector by requiring alternative generating capacity but also result in large losses for public entities which are a significant drain on public resources. The tilt of policy is too much towards the traditional private sector, for example, textiles. The medium and small industries, though are faring better than before, are not getting the support they deserve. Also, large foreign investment flows appear to be taking place in areas that do not contribute directly to export development. Since export growth remains critical for Pakistan's development, a lop- sided pattern of foreign investment could prove costly in the long run.

Poverty

The poor in Pakistan continue to face markets, institutions and local power structures which discriminate against their access to resources, public services and governance decisions. Due to unequal access over capital, land and labor markets, inequality and poverty are built into the structure of the growth process itself.

On the basis of new estimates by IPP, evidence has been provided for the first time on the incidence of poverty in the period, 2005 to 2008, with forward projections for the next four years. The evidence shows that after a decline in poverty during the period, 2000-01 to 2005-06, the poverty levels have increased to neutralize the earlier gains, as food inflation accelerated and GDP growth declined. For the Musharraf period as a whole (1999-2008), the percentage of population below the poverty line increased from 30 percent in 1998-99 to almost one-thirds currently, with an additional 16 million people being pushed into poverty during this period. The central policy lesson of the economic performance of the Musharraf regime is that poverty levels increased in spite of high GDP growth in later years because of the fact that growth was heavily tilted in favor of the rich and high food inflation was not controlled. The analysis highlights the importance of controlling food inflation and at the same time bringing about the institutional changes necessary for pro-poor growth.

On the basis of the analysis of the institutional structures underlying markets and governance, a set of policy proposals for institutional change have been made in chapter 6 to enable rapid poverty reduction with sustained growth.

PLACING THE ECONOMY ON A SUSTAINABLE PATH

Overall, we believe that if Pakistan has to get on to a sustainable development path, things have to be done differently. The main message of the report is that growth, equity, and financial soundness must be pursued simultaneously. The strategy shifts being recommended have several prongs as follows:

- Making a radical macroeconomic adjustment by gradual elimination of energy and wheat subsidies, a sharp cutback and a restructuring of public spending that has grown sharply during the last five years, a determined effort to mobilize tax revenue from segments of society whose incidence of taxation has come down sharply and those who escape the tax net and improving incentives for savings and discouraging luxury consumption.
- Substantially expanding the safety net for the poor by allocating at least Rs. 50 billion to minimize the impact of phasing out of wheat subsidy and likely further rise in food prices.
- Making expansion and diversification of exports a central plank of growth revival strategy with special focus on agriculture and promising labor- intensive manufactured exports, based on geographical comparative advantage.
- Strengthening devolution by decentralizing governance and expenditure from the center to provinces and from provinces to local governments.
- Expanding education at all levels, by improving the quality of public education and increasing outlays for research and development especially agricultural research in recognition of the fact that high growth in Pakistan will require pushing through productivity improvements and efficiency gains at a faster pace because low domestic savings remain a major constraint on investment.

We believe that the economic and political costs of adjustment in terms of consumption restraint and popular support will be real but should not be exaggerated. The growth of GDP could decline to 5 per cent per annum for a year or so but combined with a necessary reduction in the current account balance of payments of at least 2.5 per cent of GDP, and a significant cut in government current expenditure would make possible moderate increases in real consumption of 0.5 -1.0 per cent per head for most income groups. Considering that average private consumption per head grew by well over 20 percent over 2003-07 the transition should be manageable, provided the burden of adjustment is equitably distributed.

It needs to be emphasized that if the macroeconomic adjustments are combined simultaneously with measures that improve the fairness of policies, increase participation and empower the people following the return to democracy, a temporary slow down in consumption growth might be acceptable to the people. Greater control over a somewhat smaller pie would be welcomed by lower tiers of government because the pain of expenditure cuts would be balanced by gains in efficiency and reorientation of priorities towards the poor.

Policy changes necessary to achieve the above paradigm shift for more sustainable and inclusive growth are elaborated below.

Balance of Payments Adjustment

The current account deficit is so large and the need for curtailing it as well as curbing speculative pressures on the exchange rate is so urgent, that fiscal and monetary policies would have to be strongly supported by trade, exchange rate and foreign exchange reserve policies and confidence building measures such as adopting a strong export orientation and clearly articulated external finance strategy.

As mentioned above, the current account balance of payments deficit in the 2007-08 is likely to be around 7.5 per cent of GDP. We believe that this should be reduced to 5 per cent of GDP in 2008-09 and 4 per cent in 2009-10. In our view, Pakistan can safely run current account balance of payments deficits of this latter magnitude provided export growth recovers to at least 10 per cent per annum, private transfers remain strong and supply of concessionary assistance remains ample. Equally important, limiting the deficit to 4 per cent of GDP would bring the saving-investment gap (a measure of self reliance) to 15-20 per cent range from a record 33 per cent imbalance likely to be recorded this year.

The biggest contribution to reducing the saving-investment gap would be the early elimination of negative savings on general government revenue account which have reemerged and become very sizable (3 per cent of GDP) during 2007-08. Strengthening incentives for small savers by improving returns on bank deposits which are sharply negative and improving returns on government saving schemes should also help to curb consumption.

Some curbs on imports of consumer goods especially luxury goods should also be considered though imposition of moderately higher tariffs. Similarly in reviewing defense expenditures, postponement of foreign exchange intensive expenditures on weapon systems should be seriously considered. One proposal which merits serious examination is the levy of a temporary regulatory import duty on all imports, excluding essential imports like food (pulses, wheat, edible oil), medicines, fertilizer and POL products, with a higher rate on luxury goods.

The biggest challenge for short-term balance of payments management is to maintain, indeed restore foreign exchange reserves to a level of around $ 15 billion over the next few months while financing the substantial uncovered gap in financing. More adequate reserves are necessary to ward off the speculators in the liberal global framework in which Pakistan is operating. We, therefore, strongly support the Finance Minister's plans to shore up reserves by $ 2.5 billion, presumably, at least partially, with support from friendly countries.

With recent downward moves in the value of the rupee, Pakistan's exchange rate does not need any significant once-and-for-all realignment. However, it is important to lay down the policy that the real effective exchange rate will not be allowed to appreciate in the near future. In others words, the much higher rate of inflation in Pakistan than in its competitors will be allowed to be reflected in the change in the nominal rate against a basket of currencies. Otherwise, the competitiveness of our exports would suffer and import growth will be artificially stimulated. The approximately 6 per cent appreciation of the rupee between 2004-05 and 2006-07 may be one factor explaining the slow down in exports and continued rapid growth of imports.

Pakistan cannot hope, however, to solve its fundamental growth and balance of payments problems without making export development a center piece of its development strategy. Rapid export development helps to create jobs, raise wages and meet the rising obligations of debt servicing and investment income payments

The major elements in an export focused strategy should be:

- Strong national commitment.
- Recognition that while textiles and clothing will remain a vital and expanding export sector, it cannot be the future engine of growth. Limits of government support for textiles have been reached and the industry must learn to be competitive through investments in physical capital and skills.

- Diversification deserves the highest priority, manufactured goods other than textile and clothing and agricultural exports should lead the way and get necessary government attention and support.
- Role of state can be crucial in the early stages of export diversification through aggressive targeting of markets and products, improving access and speedily removing obstacles.
- Foreign direct investment should be specially encouraged in export fields.

Pakistan also needs an external finance strategy and a framework for balance of payment's management to complement the Fiscal Responsibility Law that puts limits on public debt, fiscal deficits and contingency liabilities. To avoid future balance of payments difficulties, the adoption of a few specific guidelines to implement a viable external finance strategy is recommended. The first guideline should establish the ceiling of 20% of total investment to be financed from foreign savings. A second guideline should place limits on total external debt and foreign investment obligations in relation to total foreign exchange earnings at the present level of 100-110 per cent. Another guideline should define the balance between equity and debt financing of say 2:1 to meet a given balance of payments gap.

Fiscal Adjustment

The objectives of fiscal policy must be to, first, stabilize the economy by reducing the size of the fiscal deficit and financing it to the extent possible by non-inflationary sources. The resulting restraint on aggregate demand can also exercise a favorable impact on the external balance of payments. Second, fiscal policy must play a strong redistributive role and help in reducing the income equality that has emerged between the rich and the poor and among regions of the country in recent years. Third, the aim of fiscal policy should also be towards sustaining the rate of economic growth to the extent possible by generating resources for development and guiding the allocation of these resources towards agriculture and labor-intensive manufacturing with export potential away, in particular, from capital-intensive non-tradable services.

The task of fiscal adjustment will require strong actions on the revenue and expenditure fronts if the deficit is to be brought down to the sustainable level of about 4 percent of the GDP, in terms of avoiding a building up of the public debt-to-GDP ratio and elimination of any deficit on the revenue account, such that borrowings are used only to finance development projects. We believe that the fiscal deficit reduction from 7.5 percent of the GDP to 4 percent has to be completed within two years, if inflationary pressures are to be contained and there is to be less pressure on the external current account deficit. In 2008-09, the target financial deficit must be brought down to 5.5 percent of the GDP and in 2009-10 to 4 percent of the GDP, with development expenditure sustained at the minimum level of 4 percent of the GDP each year. This would imply a revenue deficit of about 1.5 percent of the GDP in 2008-09 which will be eliminated in 2009-10, and the economy can get back to a fiscally sustainable path consistent with the Fiscal Responsibility and Debt Liability (FRDL) act.

Financing the Deficit

Beyond the concern with size of the fiscal deficit is the issue of how the deficit is financed, especially from the viewpoint of inflationary impact. During the next two years, in the period of fiscal adjustment, the government will have to operate strictly within the 'safe' limits of deficit financing. Earlier studies reveal that the scope for 'seignorage' in the Pakistan economy is about 1 to 1.5 percent of the GDP, if a low single-digit rate of inflation is targeted. Other non-inflationary sources of financing will have to be resorted to. Up to 1 percent of the GDP can be mobilized from commercial banks through the market flotation of PIBs of varying maturities. At this level, there should not be a significant 'crowding out' of credit to the private sector.

Beyond this, the biggest increase in borrowing will have to come from non-bank sources, that is, the national savings schemes. In the face of large reductions in the rate of return on certificates, the net inflow has plummeted to only about 0.5 percent of the GDP in recent years. This will have to be raised substantially to between 1 to 1.5 percent of GDP by linking the return to that of PIBs, with the expectation that the return will rise by two to three percentage points. In addition, an effort must be made to develop a secondary market for PIBs. The offering of positive real rates of return on savings instruments should help in raising the rate of domestic savings and reducing the dependence on foreign savings. The residual deficit will have to be met by continued resort to concessionary external assistance at the, more or less, unchanged level of about 2 percent of the GDP.

We turn next to the strategy for elimination of the revenue deficit in the next two years, while keeping the PSDP at about 4 percent of the GDP in order to avoid jeopardizing the process of growth in the economy. A balanced and politically acceptable strategy will require, more or less, the same effort at containment of current expenditure and mobilization of resources. If the focus is only the expenditure side then this will severely limit the possibility of providing social protection to the poor, especially through an expanded program of food subsidies. On the other hand, if the deficit reduction strategy relies solely on additional taxation then this could have adverse effects on investment and growth.

Containment of Expenditure

As highlighted above, non-interest current expenditure has, in fact, risen rapidly since 1999-2000 by almost 2 percent of the GDP. The fiscal space which became available earlier has been largely taken up by rapidly increasing outlays on general administration, growing subsidies (especially to the power utilities), rising defense expenditure and buoyant expenditure on services (particularly by the provincial governments). Symbols of extravagance by government are the bloated size of federal and provincial cabinets, hiring of large number of consultants and retired officials on lucrative salaries and perks, removal of recruitment bans, import of large fleets of luxury vehicles, expensive foreign missions of dignitaries, etc.

There is, therefore, significant scope for containment of current expenditure without adversely affecting perceptibly the delivery of services. The Prime Minister has already announced a reduction of 40 percent in the costs of running his secretariat. This yardstick of reduction in non-salary expenditure over the next two years should apply throughout the federal and provincial governments and in all semi-autonomous organizations and attached departments. This could yield up to 1 percent of the GDP or about RS. 100 billion by the end of 2009-10.

The large oil subsidy will have to be gradually reduced by the end of 2008 to yield a saving of about Rs 100 billion. This is essential if demand for POL products is to be contained in order to keep the oil import bill at a sustainable level. Of course, the impact on the poor can be limited by increasing less the price of products like kerosene oil, high speed diesel oil and light diesel oil and targeting for the maximum increase in motor spirit, consumed mostly by upper income groups. We believe that if the oil price remains at about $ 110 per barrel then further adjustment in domestic prices is inevitable if the fiscal and current account deficits are to be contained. This will also release resources for supporting food consumption, in particular, of the poor through appropriate social safety nets.

Resource Mobilisation Strategy

The big disappointment in the area of public finances is that four previous years of continuously high growth has not led to a rise in the tax-to-GDP ratio in the economy, which has remained stagnant at between 10 to 11 percent of the GDP. This is despite the buoyancy in major tax bases, like value added in large-scale manufacturing and imports. The explanation for the failure of the tax-to-GDP ratio to rise lies in the decline in effective tax rates. Import tariffs have been brought down to a maximum of 25 percent. Concomitantly, this has also affected revenues from the sales tax on imports. Excise duties have been replaced by sales tax in a number of sectors and the specific rates have not been fully indexed to inflation.

The big decline in tax rates is in direct taxes. The maximum personal income tax rate has been reduced from 30 percent to 20 percent for salaried tax payers and from 35 percent to 25 percent for the self-employed. Simultaneously, the corporate tax rate has been brought down from 45 percent to 35 percent for private companies and to 35 percent from 50 percent in the banking sector, at a time of sharply rising profitability.

Major tax concessions and exemptions have also been granted since 1999, starting with the abolition of the wealth tax in 2000. The most dramatic example is the continued exemption of capital gains from taxation especially at a time when massive unearned incomes were accruing to the relatively well-off, due to the exceptional buoyancy of the stock market and property values. The government's own estimate is that the implied revenue foregone was as much as Rs 112 billion in 2006-07, almost 1.5 percent of the GDP. The cost of other exemptions or concessions add up to another Rs 200 billion or so. This includes the cost of exemptions from import duty, income tax holiday and accelerated depreciation allowance, lack of coverage of sales tax on wholesale and retail trade, effective exemption of a large number of services from GST, effective zero rating of domestic sales of export-oriented sectors like textiles, and so on. If all these concessions and exemptions are accounted for then the aggregate loss of revenue is a whopping Rs 300 billion or so. This is equivalent to over 3 percent of the GDP and about one-thirds of the revenue actually collected.

The provincial governments have also demonstrated little fiscal effort. Currently, provincial tax revenues aggregate to only 0.5 percent of the GDP. The agricultural income tax which was introduced in the late 90's has been languishing as a source of revenue despite rising incomes of large farmers. Consequently, land taxes represent less than 1 percent of agricultural incomes in the economy. The urban immovable property tax also remains underdeveloped, currently exploiting only one-fourths of its revenue potential. Despite the boom in real estate values, stamp duty revenues have remained stagnant during the last three years and a capital gains tax on property has not yet been introduced.

Altogether, there has been an unprecedented capture of the state by the elite in the form of large tax breaks during the last eight years. There is no doubt that considerable slack exists in the tax system not only for significantly incresing the tax-to-GDP ratio but also for simultaneously achieving a measure of redistribution through the tax system in order to arrest the rising inequality between the rich and the poor in the country.

We have identified a series of taxation proposals for implementation in the next two years, during the period of fiscal adjustment, by either the federal or provincial governments, with a potential yield of up to 2 percent of the GDP by 2009-10. These include:

- An 'Excess' Profits Tax:
- Higher Tax on Private Companies
- Introduction of Capital Gains Tax
- More Progressive Personal Income Tax
- Higher Taxation on Non-essential Imports, especially Luxury Goods
- A Broad-based Services Tax
- Development of Provincial Taxes

Details of these proposals are presented in chapter 5.

Overall, the above proposals are oriented towards mobilization of revenues from direct taxes or from indirect taxes on goods and services consumed by upper income groups. Implementation of these proposals will make the tax system more progressive while improving public perceptions about a fairer distribution of the tax burden.

Promoting Inclusive Growth

We turn our attention to some structural weaknesses in the growth process and indicate how they could be overcome. Our subject here will be growth and how it could be produced and sustained over time, while ensuring that the benefits are spread more widely.

Sectoral Strategy

Sectors like banking, telecommunications and automobiles, that were in the lead during the last five years will not keep the economy on a high growth track for very long. They will also not do enough for the poor. The number of jobs created by these sectors and the types of employment they generated did little to reduce the incidence of poverty as demonstrated earlier. In addition the pattern of growth widened inter-personal, inter-provincial and intra-provincial income disparities. Increases in such disparities usually lay the ground for social and political instability, a development Pakistan does not need at such a difficult period in its history.

A move towards the basic commodity-producing sectors of the economy - agriculture and manufacturing - is needed. This change in sectoral focus will require actions from all three tiers of government - federal, provincial, and the local - as well as from the private sector. The new Finance Minister has already given the indication that it is the intention of his government to place emphasis on the development of the real economy; that the sectors of agriculture and manufacturing will receive high government priority. This raises the question: how will this be done? We attempt below an answer to this question.

Agriculture

Pakistan has one of the best endowed agricultural sectors in the world. It has one of the world's largest contiguous irrigation areas; it has rich soil created by deposits made by rivers over thousands of years; it has hard working farmers who have shown their ability to absorb new technologies when presented with the opportunities to do so; and, now, it has rapidly growing internal and external markets for the products produced by high value added agriculture. While the agricultural system is entirely operated by the private sector, these operators are responsive to the incentives provided by the public sector. The public sector, therefore, has an important role to play. In this context three aspects of public policy are particularly important.

One of the more important ones is the price signals embedded in public policy. These have a profound impact on cropping patterns. The most important price signal the government provides is the wheat procurement price. Wheat is the country's most important crop. The anticipated income the farmers draw from cultivating wheat significantly effects what else they grow. In determining the procurement price of wheat - the subject should continue to be handled by the Federal Government - the government must keep in view the level and expected trends in international prices. We believe that the recent rise in world wheat prices represents a secular trend caused by the increase in demand for food grains in rapidly growing populous countries such as China and India and the increasing return given for bio-fuel production by such large consumers of energy as the United States. The rise in the price of wheat has affected the prices of other food grains - commodity prices normally move in tandem -and has changed the sectoral terms of trade in the favor of agriculture. The benefit of these should be passed on, to the extent possible, to agricultural producers. For that to happen there should not be a large difference between the government's procurement price and the price in international markets. In the context of the need to make a fiscal adjustment, increase in the price of wheat will have to be mitigated by directly helping the poor through vehicles such as the Bait-ul-Maal and Food for Work programmes, discussed below.

The next important area for government's role in promoting agriculture is in improving the technological base of the sector. Here Pakistan has lagged seriously behind. Very little research and development work gets carried out by the private sector. This is not surprising given the absence of large commercial operators from the sector. The little research that gets done is by the public sector but that is too widely scattered among too many government departments and agencies to be effective and does not reach the farmers. The result is that Pakistan has developed gaps between average yields and yields obtained by the "best farmers"; between the best farmers and those obtained by research institutions; and between research institutions and those obtained by farmers in the large agricultural systems in other parts of the world. The Government role is important in closing the technology gaps. This can be done in two ways: by focusing on the development of research in agricultural universities (an approach followed by the United States) and by setting up crop or product specific research institutions (as is being done by China). While we endorse this dual approach we also believe that incentives should be provided to the private sector to enter the field of research and development.

The third role for the state in promoting agriculture development is to provide the infrastructure the sector requires. Pakistan has a rich inheritance of elaborate irrigation infrastructures. Impressive improvements to this network have been made as a part of the agreement with India on the distribution of the waters of the Indus River systems. But these were replacement works; they did not result in bringing much additional land under cultivation. However, not enough attention was paid to maintaining this system and for improving it to preserve water. In recent years, the Punjab and Sindh governments, encouraged by the World Bank, have begun to devote sizeable resources to maintenance.

Punjab, in particular, has gone further by developing a fairly elaborate system of information available on the internet to monitor the flow of water. This information is available to both users of water as well as those who manage the system. As the provinces strengthen their capacity to get engaged in economic development, it is important that maintenance work on the system of irrigation and improving its efficiency receive a high government priority. The resources being committed to it by the public sector should be protected during the period of adjustment discussed above.

Within the sector of agriculture, livestock has acquired a more prominent place and modernization of livestock markets need to be promoted. The sector contributes almost half to agriculture's gross output which translates into a contribution of over 10 per cent to GDP. It engages 35 million people in the rural economy and provides almost 40 percent of total income of the farming community. The sector is dominated by small operators; those owning less than two animals account for slightly more than two - fifths of the total population of cattle and buffaloes. As in the case with the crop sector, yields are low. The government estimates the yield gap - outputs of the current livestock population compared with the output obtained in more developed systems - at between 60 to 80 percent. The reason for low productivity have been identified as inadequate and poor quality feed and fodder; limited animal health coverage; widespread breeding of genetically inferior livestock; poor marketing infrastructure; shortage of trained manpower; inadequate incentives for small producers; and lack of extension services.

Improving yields in the livestock sector would make a significant contribution to increasing value added in agriculture. It would also have a profound impact on reducing the incidence of poverty in the countryside. A strategy aimed at achieving this objective should provide better education and training to the people engaged in livestock and better health coverage for animals. The quality of food and fodder needs to be improved. Flow of credit to livestock owners also needs to increase. At this time 90 percent of bank lending to agriculture goes to the crop sector with the livestock sector receiving 10 per cent. The proportion needs to be raised to reflect more closely the contribution to value added.

Manufacturing

The other plank of the strategy for developing the real sectors of the economy is to encourage the growth, modernization and exports from small and medium sized enterprises. Numbering some 3.2 million, these enterprises follow a long tradition of entrepreneurship and craftsmanship in the country, particularly in the provinces of Punjab and NWFP. The sector contributes almost 30 per cent to the output of manufacturing, over 5 per cent to GDP and 20 per cent to non-farm rural employment. We believe that an industrial policy aimed at the development of this sector should have three components.

The first is the, identification of winners - both sub-sectors and enterprises within these sub-sectors - that will receive government's attention. Not only should the choice of the winners be subject to the endowments of the economy but also reflect the opportunities available in the rapidly evolving global systems of production and trade. The second is the facilitation and development of the chosen sectors. The third is to help the chosen sectors with financial support. While the second component of the strategy is in the mandate of the Small and Medium Enterprises Development, the SMEDA, a federal corporation established in 1998 to promote the development of the industries long neglected by the government - the first and the third components have not engaged the state. This needs to be remedied.

By underscoring the need for making additional financing available to the SME sector, we don't mean the provision of subsidized credit. We don't even imply directing the banking system to finance these enterprises. What is envisaged is the introduction of relatively new instruments of finance into the sector. These include private equity and venture capital funds that share risks with the entrepreneurs that own the enterprises in which they invest while expecting high returns for themselves if their investments bear fruit. We believe that by bringing these instruments of finance to the SME sector it will help to release not only the capital locked up for generations in small enterprises. It will also deepen the country's under-developed capital markets.

The priority areas identified for attention by public policy will only produce desired results if the quality of the human resource available to the economy is improved. Concentrating on developing the large human resource would mean a focus on at least four areas of public policy. These are improvements in primary and secondary education, getting literacy to reach women, providing modern skills to a large proportion of the country's youth, and creating synergies between research and development of the various sectors of the economy. After years of experience with using human resource development as an important contributor to growth, practitioners of development have realized that they need to work towards not only universal primary education but getting children to stay in school for at least eight to ten years. It is only then that children are prepared to enter institutions of higher learning or to make a contribution to the economy by entering the workforce. Emphasis in the past has mostly been on primary education. That was the case in the World Bank sponsored Social Action Program that was implemented in Pakistan in the early 1990s. While the program increased the rate of enrollment in primary schools, it had a negligible impact on improving the country's human resource. The SAP's failure to achieve promised results was because of institutional failure as discussed in Chapter 8. Development thinking has now reached the conclusion that it needs much more than five years of schooling to change behavior and to prepare people for the modern sectors of the economy. The priority now has to shift more towards secondary education.

The provinces will have to play a key role in promoting agricultural development and SMEs. For this they will need more authority, a subject which we will come back to in Chapter 6. With greater economic authority, the provincial governments will be in the position to lend strategic coherence to their development programmes. Their focus should be oriented towards building analytical and planning capacity, establishing a stronger relationship with the private sector and focusing on opportunities that could emerge from favorable international developments.

Over and above the sectoral strategies, the government will also have to use other policy instruments to encourage and promote growth. One such instrument is fiscal policy. It is vital that in the process of fiscal adjustment the level of development expenditure does not fall sharply as happened in the earlier years of this decade. Not only will the size of PSDP have to be sustained at a minimum of 4 percent of GDP till 2009-10 but there will also have to more strategic and rational allocation of development funds to projects. Clearly, public investments in the water and agricultural sectors and in power generation will have to receive higher priority along with larger allocations for development of the more backward areas of the country. There will be a need for moratorium on new projects except in the priority sectors.

In addition, fiscal policy will have to be used selectively to incentivise the agricultural and manufacturing sectors as follows:

(a) The general sales tax introduced on fertilizer and pesticides needs to be withdrawn in order to improve the ratio of output to input prices and thereby stimulate agricultural production.

(b) Power load shedding has adversely impacted on production significantly, especially in the industrial sector. As such, a tax credit (chargeable against all tax liabilities) should be made available to manufacturing enterprises on the capital cost of captive power generation or energy-saving equipment. A similar tax credit can be offered on investments in renewable energy.

(c) In order to stimulate non-traditional exports, the presumptive income tax on such exports should be withdrawn and the research and development allowance be made available to all exports.

It is expected that the above measures will not cost the exchequer more than ¼ percent of the GDP or Rs. 25 billion but could play a significant role in raising production and export from the commodity - producing sectors and reduce the energy deficit in the economy.

Reducing Regional Disparities

Fiscal federalism plays a key role in addressing the issue of regional disparities. There is the need to ensure that the pattern of inter-governmental fiscal relations evolves in such a way that the greater need for support to the more backward provinces is recognized. The National Finance Commission (NFC) is expected to make an award every five years to resolve the problems, first, of vertical imbalance in resources between the federal government and the four provincial governments combined and, second, the horizontal imbalance among the provincial governments.

But the NFC has failed over the last six years since 2002 to arrive at a consensus on a new award to replace the 1997 award. Consequently, the President of Pakistan has promulgated an interim arrangement for transfers with effect from 2006-07. The changes with respect to the 1997 award are, firstly, the share of provinces in the divisible pool of revenues has been increased from 37.5 percent to 41.5 percent in 2006-07, rising to 46.25 percent by 2010-11; secondly, in 1997 NFC award grants-in-aid were only given to NFWP and Balochistan, which has now been extended to all four provinces on the basis of pre-determined shares. Overall, it is expected that revenue transfers from the divisible pool and grants-in-aid will constitute 50 percent of the revenues in the divisible pool by 2010-11. The sharing of revenues in the divisible pool on the basis of population and the coverage of straight transfers remains unchanged.

The basic issue is whether over the last seven years fiscal transfers have been adequate and if the goal of fiscal equalization has been achieved whereby the two smaller and less developed provinces, NWFP and Balochistan, have received higher transfers on a per capita basis. Incidentally, in the Pakistani context, straight transfers have also been performing historically an equalization function. NWFP has access to hydroelectricity profits and Balochistan to revenues from natural gas, which raise per capita transfers significantly.

A look at the four provincial budgets in chapter 7 reveals that transfers have probably been adequate to support an increase in their combined share of public expenditure. But a more in-depth analysis reveals that provincial expenditures have risen because of greater resort to borrowings, which are now financing as much as two-thirds of development expenditure. Also, the share of total transfers to provincial governments in federal revenues (tax plus non-tax) has remained virtually static at 35 percent over the last seven years.

What has been happening to fiscal equalization? The overall growth in per capita transfers of all types to the provinces from 2000-01 to 2006-07 has been 144 percent for Sindh, 106 percent for NWFP, 103 percent for Punjab and 75 percent for Balochistan. It appears that the process of fiscal equalization has largely broken down with the highest growth in transfers to the most developed province, Sindh, and the lowest growth in transfers to the least developed province, Balochistan. Today, the level of transfers per capita to Sindh is higher than to NWFP while Balochistan is unable to meet even its current expenditure obligations.

Overall, a review of the process of inter-governmental relations over the last seven years reveals the emergence of serious imbalances. Chapter 7 also discusses the reasons for the failure in fiscal equalization during this period. This has been one factor contributing to faster growth of the economies of Sindh and Punjab as compared to Balochistan and NWFP during the current decade. Clearly, there are strong reasons for dissatisfaction of the smaller provinces with the workings of the federation during the tenure of the last government.

Now that elected coalition governments are in place in Islamabad and in at least three provincial capitals with the common element of one party, PPP, there is need for urgent reconvening of the NFC to arrive at an early consensus award which ensures the following:

(i) Further expansion in transfers from the divisible pool to cover the emerging sizeable deficits of the provinces with the understanding that they will henceforth face a 'harder' budget constraint, with only limited access to borrowings. Provision will also have to be made for higher transfers to cover the costs of taking on Concurrent List functions by the provinces.

(ii) Adoption of multiple criteria for determination of transfers from the divisible pool, including, in particular, backwardness, to ensure more fiscal equalization. The collection criteria could also be given some, albeit small, weight. Punjab should now have less objection to this as research at IPP shows that the share in collection from the province of apportionable taxes (all taxes, excluding taxes on imports) has approached its population share.

(iii) Higher grants-in-aid be restricted largely to NWFP and Balochistan.

(iv) Review of the formula for determination of hydro-electricity profits to NWFP, a long standing demand of the province.

There is no doubt that the transition from an ad-hoc award by the President to a consensus based NFC award will be a major step forward in strengthening the federation and be a key indicator of success of the newly elected governments.

Poverty Reduction

While the implementation of the inclusive growth strategy of the type described above will strengthen the process of poverty reduction in the medium run, there is need to ensure that the aggregate demand management of the economy and the withdrawal of subsidies does not lead to sharp rise in poverty. Strong social safety nets will have to be put in place to ensure that there is adjustment with a human face. In particular, food security of the poor will have to be protected to avoid a big fall in nutrition levels. This can best be achieved by a combination of cash transfers and employment guarantees. Hitherto the subsidized sale of food items through the utility stores has been fraught with problems of limited coverage, especially in the rural areas, and ineffective targeting.

The cash transfer scheme will primarily benefit the disabled, the elderly, female- headed households, widows, etc. The employment guarantee scheme can provide an opportunity to earn to able-bodied workers, especially in the off-peak season.

The Prime Minister has announced in his 100 day package the intention of his government to launch an employment guarantee scheme in the more backward districts of the country. The Pakistan Bait-ul-Maal already runs a cash supplement scheme for food support, which can be upscaled to cover a larger proportion of poor households.

India is the first country to have introduced, in 2006, a national rural employment guarantee scheme, based on the experience gained in one state, Maharastra. The scheme is being run in over 40 per cent of the districts with the help of Panchayati Raj institutions. It is estimated that at full coverage the scheme could cost up to 2 per cent of the GDP in India. The scheme should initially be piloted in Pakistan in a few of the most backward districts. It would be appropriate to also give this scheme the characteristics of a food for work program, so that the poor workers are automatically protected against inflation.

The cash transfer scheme could be based on identification of the poor beneficiaries by the lowest tier of local governments, the Union Councils, and community based organisations. Efforts must be made to reduce the transaction costs and leakages in the scheme especially through development of appropriate thrid party monitoring arrangements. Initially, the Bait-ul-Maal can be given funds to at least double the coverage of the scheme to about three million households, with cash support per household of about Rs. 1000 per month. It is expected that the total cost of running the two programs for protecting the poor will be in the vicinity of Rs. 50 billion. Implementation of these programs must proceed on a priority basis.

Decentralizing Governance

One of the more important elements of the strategy enunciated in this report is giving greater operational space to the provinces and to the institutions of local government. The declaration by the Prime Minister in his maiden speech before the newly elected parliament that his administration will, within one year, transfer all the subjects listed in the constitution's concurrent list is an encouraging start. For this to be effectively and efficiently done would require a great deal of work at the two upper tiers of government within the current governance structure. This effort should lead to reduction in consolidated current expenditure by eliminating the duplication in the coverage by the government at the federal and provincial levels. In building their own capacity to handle the transferred subjects, the provincial government should place emphasis on the quality rather than the quantity of the staff they employ.

While decentralization of a significant amount of economic responsibility from the federal government to the provinces would be an important part of the strategy for promoting inclusive growth, it is equally important to continue with the process of devolution to the institutions of local government. A new system set up in 2001 is in place. It should be continued. Pakistan has not been able to develop a viable system of local government because of the continuous experimentation it has been engaged in since its birth. Five different systems have been tried in the past. The need now is to further evolve the system in place rather than create from scratch something new. That said, a number of reforms will be needed. We have noted the recent statement by the Prime Minister that his government will reform the local government system after evaluating how it has performed since its establishment in 2001. The areas where the structure needs to evolve include the direct election of the nazims to make them more accountable to the people. Governance related services such as law and order should be decentralized, perhaps initially on a pilot basis, with responsibility resting with the nazims. District services cadres should be established. Beside these, Chapter 8 of the report includes a number of other proposals to strengthen local governments and make them more efficient, equitable, participatory and responsive to the people.

In conclusion, our report has focused on dealing with the current difficulties faced by the economy by undertaking an extensive program of fiscal and balance of payments adjustment. However, we have suggested that this program should be developed in a way that it does not hurt the poor, does not exacerbate various kinds of income inequalities, and does not compromise growth prospects over the medium term. We believe that, not withstanding the difficulties faced at this time, the economy has the potential for getting back to a high growth path, but one which is more sustainable and inclusive. For this to be realized the state will need to be strongly engaged, but in ways different from the approach adopted earlier.

Chapter - 2

State of the Economy: Need for Radical Adjustments

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State of the Economy: Need for Radical Adjustments

INTRODUCTION

After a period of strong economic expansion, relative macroeconomic stability, and increased foreign investor confidence, over the years 2003-2007, Pakistan economy is once again facing serious strains and challenges, as highlighted in tables of the Statistical Annex on key indicators. Macroeconomic balances have deteriorated; stabilization measures necessary will, in the short run, not only slow down economic activity but also further increase price pressures. The current rates of domestic inflation, a year over year consumer inflation rate of nearly 12 per cent and a food inflation rate of 20 per cent in March 2008, are already at record levels, despite the fact that the sharp increases in international prices of oil during the last year have not been fully passed on to the final consumers and wheat is being subsidized.

The strong reemergence of inflationary pressures has further fueled the debate about the impact of high growth of past several years on poverty reduction and ignited dissatisfaction with the narrow base of prosperity. The previous government's claim that sustainability of growth of 7-8 per cent per annum had been achieved appears increasingly questionable. Equally, the optimistic view that the economic model followed during the Musharraf Government and the existing governance structures would ensure equitable growth or at least shared prosperity is being refuted by most economists.

Indeed there is the view, that adjusted for the positive impact of large aid and private investment flows following 9/11 and the successful stabilization during 2000-2002, and negative effects of political instability in the 1990s and nuclear sanctions the underlying growth rate in recent years was not much higher than the underlying growth rate of 5-5.5 per cent during 1993-99 [Burki (2008)].

The extent to which economic frustration fed the political disenchantment with Musharraf regime that has led to a massive victory for the opposition in the elections can be debated. But there is no doubt that there is a clamor for revisiting economic policies and the overall economic framework in light of sharp rise in inflationary pressures, disaffection with the distribution of growth benefits and rising concerns with widespread poverty.

The newly elected governments both at the center and provinces face a host of difficult economic and political choices. But the polarization of views, on the one hand as expressed by the Interim Finance Minister just a few months ago that the economy is in good shape and a recent commentator saying that the economy is in deep crisis is not likely to help the new economic and political leadership. The gap between rhetoric and reality must be narrowed and bridged if a national consensus on needed economic adjustments and strategic shifts is to be developed and implemented [Hasan (2007)].

There are three major tasks that require the urgent attention of the new economic and political leadership. They are as follows:

- Restoring and maintaining macroeconomic stability
- Aggressively addressing the distribution and poverty issues

- Solving the structural problems hampering rapid long-term growth

These objectives can, in the short run, be somewhat in conflict. Efforts to restore or maintain macroeconomic stability can dampen growth and long- term investment and make the addressing of poverty and distribution issues harder. But in the longer run they are mutually reinforcing. In our view, restoring and maintaining macro-economic stability must be a foremost objective though the economic adjustment should be made as poor friendly as possible. International experience strongly suggests that without low inflation, confidence in the currency, and strong government finances, the objectives of sustained high growth and poverty reduction are difficult to achieve. Inflation hurts the poor the most. High rates of inflation also distort investment patterns and discourage monetary savings thus undermining long- term growth.

RESTORING MACROECONOMIC STABILITY

It is ironic that handover of power to elected representatives comes at a time when some of the early economic successes of the Musharraf years –reduced fiscal deficits, strong government finances, a comfortable balance of payments position, high level of foreign exchange reserves have– are in danger of unraveling.

In some ways, the financial problems Pakistan is now facing are different than the ones the country faced at the end of 1990s. For instance, the public and external debt burdens are now smaller, foreign investment interest is strong, the foreign exchange reserves, though declining, are at a higher level and the confidence in the currency remains relatively strong. On the other hand, the level of fiscal and current account balance of payments deficits have already reached dangerous levels and indeed are well above the level of the 1990s. Also, the rates of domestic inflation have the danger of exceeding the persistently high levels of 1970s, early 1980s and first half of the 1990s. In addition, the physical constraints to future growth are stronger as reflected in the power shortage and water scarcity.

The new Finance Minister in a recent Press Conference has substantially revised the macroeconomic estimates for 2007-08 and projected the final deficit at 9.5 percent of the GDP and the inflation rate for the year at 10 percent. The most urgent need is to avoid a balance of payments crisis that would shake the confidence of foreign investors and citizens alike and could trigger capital flight as well as limit Pakistan's access to international capital markets. The need for a radical adjustment is thus urgent and this adjustment would have to be deeper and faster than could have been imagined just a few months ago.

Fiscal Expansion

The fiscal deficit (excluding grants) which reached a low of about 2 percent of the GDP in 2003-04 had risen to above 4 per cent of GDP by 2006-07. But it is likely that that the estimated deficit last year would be revised upwards. It is also not clear that reported figures fully include the build up of arrears to oil companies and the losses of public enterprises, notably WAPDA. The deficit in the current year is now expected to be 7.5 per cent of GDP following cutbacks in development spending and modest energy price increases announced recently. A shortfall in revenues reflecting slackening of economic activity, much higher oil subsidy bill, and sharply higher interest payments on the growing domestic debt are the immediate reasons for the ballooning of the fiscal deficit. There is now no doubt that the fiscal outcome this year will substantially exceed the limits laid down in the Fiscal Responsibility and Debt Limitation Act (FRDL).

The fiscal expansion in recent years has also triggered high rates of monetary growth because of the pattern of financing. Unfortunately, a large part of the domestic financing for fiscal deficit during the last three years, about two-thirds, was through borrowing from the central bank. This moderated the cost of government borrowing (thus helping to keep interest payments on domestic debt in the budget low) but it also contributed to higher rates of monetary expansion by creating excess liquidity in the banking system. Despite the measures taken to tighten monetary policy in 2006-07, broader money (M2) grew by over 19 per cent during the year, even somewhat higher than the average annual rate in the previous three years.[1] During 2007-08, the money supply growth is running at around 7 per cent but this is mainly due to decline in foreign assets. The Minister of Finance's projections put money growth for the year at 19 per cent.

Balance of Payments Gap

The most alarming aspect of the present macroeconomic imbalances is the steady deterioration in current account balance of payments deficit over the past four years. In 2002-03, the current account actually recorded a large surplus of over $3 billion, admittedly due to combination of exceptional circumstances: an economy that had not yet revived fully after the strong stabilization program of 2000-02 and did not fully reflect the impact of large official transfers and worker remittances. By 2006-07 the current account had gone into deficit of $ 7 billion, a swing of $10 billion or nearly 10 per cent of GDP. The deficit figures for the first 7 months of 2007-08 suggest that the current account deficit has deteriorated further in the current year, 2007-08, and is likely to approach a totally unsustainable level of $ 12 billion or 7.5 per cent of GDP.

The sharp balance of payments deterioration has worsened the savings - investment gap greatly. While there appears to have been downward pressures on real consumption of the low and middle groups in the last year or so, for the economy as a whole, consumption levels have been artificially sustained by the large current account deficit in the balance of payments. Also the reemergence of large negative general government savings has also depressed the saving rate. Reliance on foreign savings to finance investment this year would be almost 33 percent, a record level. This does suggest that at the margin it is consumption more than investment that is being supported by large foreign inflows.

Factors Behind Worsening Macroeconomic Balances

How did we get here from the heady days in 2003-04 when inflation was still relatively low, foreign exchange reserves were at their peak in relation to import payments, and the current account was actually in surplus?

The basic explanation for our present predicament is three fold:

- Severe negative exogenous shocks:
- Wrong government policy responses to them, most likely, as a result of preoccupation with pushing short-term growth to even higher levels in preparation of elections.
- And persistent structural weaknesses in the economy which continue to hamper investment, productivity growth and competitiveness and have shown up starkly in poor performance of exports since 2005.

External Shocks

Negative shocks, either natural or external, have taken three forms. First, the devastating earthquake in October 2005 caused untold death and destruction and required large spending on relief as well as reconstruction expenditures alone estimated at $ 5 billion. Unfortunately the government made a totally unrealistic assumption that all of the reconstruction costs would be met from additional concessionary assistance. Supplies of soft multilateral assistance are severely limited and its allocation among countries is, in large measure, pre-determined. In actual fact Pakistan will probably end up by spending at least $3 billion on earthquake reconstruction from its own resources.

The international oil prices started rising in 2003 but still averaged only $ 30 per barrel in 2003-04. They have risen inexorably and steadily and in recent weeks have breached the $ 117 level. The higher oil prices will increase our oil import bill to an estimated $10 billion in FY 2007-2008 an increase of $ 7 billion over the last four years and almost $3 billion this year, as shown in

Table 2.1. The failure of government to pass on the full increase in oil costs was either on the mistaken assumption that the rise in oil prices would not be lasting or that difficult political decisions could be left for after the elections.

Most recently, the rise in world food prices, shown in Table 2.2, especially of grains and edible oil oils, have further adversely affected Pakistan's terms of trade and increased both the import bill and wheat subsidy outlays. Here again, wheat policy was not well managed, wheat exports earlier in the year were not justified, there was excessive optimism about the size of the 2007 wheat crop. The response to rising international prices was not speedy enough and there was such a delay in announcement of the higher procurement price that its purpose as an incentive for higher production was largely lost. More fundamentally, not enough attention was given over time to the slowing trend growth rate in agriculture, especially food crops.

TABLE 2.1
OIL IMPORT BILL OF PAKISTAN

	POL Imports ($ in Billion)	Average Crude Oil Price ($ per Barrel)
2002-03	3.1	26.9
2003-04	3.1	30.3
2004-05	4.5	41.5
2005-06	6.7	58.5
2006-07	7.3	65.0
2007-08	10.0	94.0

Source: Foreign Trade Statistics, Ministry of Petroleum, IPP's estimates for 2007-08.

TABLE 2.2
INTERNATIONAL PRICE OF COMMODITIES

	Average		January - February
	2006	2007	2008
Wheat, Canada,$/mt	216.8	300.4	623.1
Wheat US,$/ mt	159.0	238.6	389.2
Fertilizer DAP $/mt	260.3	432.5	767.9
Fertilizer Urea $/mt	229.9	309.4	634.3
Palm Oil $/mt	478	780	1121
Soybean Oil $/mt	599	881	1351

Source: World Bank Commodity Price Data

Neglecting Response to External Shocks

All told, negative external shocks reduced the real growth of income in Pakistan on average by about 1.5 per cent per annum during the last four years thereby affecting the real annual growth rate in national income by more than 20 per cent to 6 percent and growth in per capita GDP by nearly one -fifth from 5.0 per cent per annum to 4.0 per cent per annum.

These shocks required adjustment in consumption and possibly investment plans. But the need for scaling back aggregate demand was ignored partly because privatization revenues and sovereign borrowing on world markets were easily available to finance growing deficits and partly because delivering high growth was considered, mistakenly it turns out, a political imperative.

Domestic absorption of resources increased very sharply over 2004-07. Real consumption and investment together increased by 35 per cent over the three years in contrast to the growth in national income, adjusted for terms of trade loss, of little more than 25 per cent. The imbalance was reflected, as discussed above, in the sharp deterioration in the current account of the balance of payments.

In retrospect, the fiscal and monetary policies remained excessively expansionary even though domestic inflationary pressures had already developed by 2004-05, while international and commodity inflation were largely absent. The general price level, as measured by the consumer price index, increased by over 9 per cent in 2004-05.

The tight fiscal policies of 2000-04 and substantial unused capacity in the wake of a major stabilization effort made possible a very accommodative monetary policy and a sharp decline in interest rates. While this policy did result in reviving economic growth strongly, it has remained 'too easy for too long'. Among other effects, it encouraged the mushroom growth of consumer financing.

On surface, the actual deficits of 4.3 per cent of GDP (including earthquake related spending) in 2005-06 and 2006-07 may not appear excessive. But the way they were financed triggered further strong monetary expansion. The government has had difficulty since 2005-06 in meeting the growing domestic borrowing requirement from the market on longer term PIBs without offering higher interest rates. It thus resorted to the low cost alternative of borrowing huge amounts from the central bank. This moderated the cost of government borrowing (thus helping to keep interest payments on domestic debt in the budget low) but it also contributed to higher rates of monetary expansion by creating excess liquidity in the banking system.

It should be added, however, that economic imbalances would not have deepened so much and so suddenly if exports had not stumbled badly after the end of 2005. After a strong cumulative growth of 60 per cent over FYs 2003-06, export growth has slowed down seriously. Export growth in 2006-07 was only about 3 per cent. Though some recovery in exports appears to be underway during the current year, government's target aiming at a sustained growth in exports of 15 per cent per annum over 2006-2015 appears unrealistic.

This is mainly because textile and clothing exports, which still account for 60 per cent of total exports and more than 80 per cent of manufactured exports, are, after a relatively good performance in the first year after the phase out of MFA from January 2005, experiencing serious competitive problems.

On the other hand, very strong growth in worker remittances from $3.9 billion in 2003-04 to $5.5 billion in 2006-07 has been a very positive factor in the balance of payments position. Total private transfers, which since 2004-05 include funds coming through the authorized foreign exchange companies, totaled well over $ 10 billion annually in 2006-07, paradoxically a sign of both strength and vulnerability.

Ignoring Macroeconomic Imbalances Poses Major Risks

Sadly for the new government, very strong adjustment can no longer be avoided because if the present level of current account balance of payments deficit were to persist. This would soon lead to major financing problems and/or deep in roads into foreign exchange reserves that have already declined sharply since 2004 as a proportion of foreign exchange payments. In absolute terms also, foreign exchange reserves have fallen by $3.2 billon over October- April and now are at $ 13 billion, equivalent to less than 3 ½ months imports of goods and services. The huge deficit is shrinking the foreign exchange reserves at a most worrying rate. In the last four months, the decline in reserves financed nearly 40 per cent of the current account deficit. If current trends continue, the reserve cover could fall to below two months by the end of 2008, as shown in Table 2.3.

TABLE 2.3
LEVEL OF FOREIGN EXCHANGE RESERVES
($ Million)

End of	Level	Change
October 2007	16486	-
November 2007	15808	-678
December 2007	15589	-219
January 2008	14658	-931
February 2008	14031	-627
March 2008	13233	-798
12 April 2008	13044	-189

Source: SBP

Any further decline in foreign exchange reserves would negatively affect the confidence in the rupee and could trigger serious capital flight thus endangering both investment and growth. On the domestic front, the longer- term control of inflation also requires immediate action though in the short - term necessary price adjustment would raise key energy prices further.

The economic and political costs of adjustment in terms of consumption restraint and popular support are real but should not be exaggerated. The growth of GDP could decline to 5 per cent per annum for a year or so. With a necessary reduction in the current account balance of payments of at least 2.5 per cent of GDP in the next year, the growth in resources for consumption and investment would be quite modest. But on the other hand, a significant cut in government current expenditure i.e. government consumption, is both necessary and feasible. This would make possible moderate increases in investment as well as real private consumption of 0.5 -1.0 percent per head for most income groups. Considering that average private consumption per head grew by well over 20 percent over 2003-07 the transition should be manageable, especially if the burden of adjustment is equitably distributed.

It should be possible to protect the poor by increasing substantially the direct transfer payments to them that are at present only 0.1 to 0.2 to per cent of GDP to 0.5 per cent of GDP or at least Rs.50 billion and attempt should be made to improve targeting. This would minimize the impact of phasing out of wheat subsidy and likely further rise in food prices. (See Chapter 5.)

The key goals of macro-economic policies should be to reduce the fiscal and the current account balance of payments deficits, by at least 2.0 per cent and 2.5 per cent respectively during 2008-09 and to reduce the size of both these deficits down to at 4 percent of GDP by 2009-10. The goal should also be to bring down the inflation rate to 5-6 per cent range in two years. The fiscal deficit reduction is mandated by limits set by Fiscal Responsibility and Debt Limitation Law, limits that were probably breached last year and certainly this year.

Needed Policy Responses

The State Bank of Pakistan has correctly tightened monetary policy in recent weeks. The scope for maneuver by the central bank can and should be expanded by largely eliminating the sizable government borrowing from it. Recourse by government to market borrowing through Public investment Bonds (PIBs), will help to truly identify the cost of public debt service, improve the interest rate structure thus encouraging savings, and, last but not least, reduce the supply of reserve money.

The major area of economic adjustment, however, must be the fiscal policy. Fortunately, fiscal adjustment can take place in an environment much more favorable than in the 1990s when elected governments had little fiscal space because of the extraordinary burden of interest payments on outstanding public debt. Real public non- interest spending which had shown no increase in the decade of the 1990s because of the growing burden of interest payments, has expanded, adjusted for inflation, by over 60 per cent during the three FYs 2004-7 and would show a further increase this year because of large subsidies on oil.

The large expansion of public spending of the last few years was in large part badly needed after the fiscal drought of the 1990s and has contributed to improvement in growth and in social indicators. Public Sector Development Program (PSDP) has grown from the low of Rs.88 or 1.6 per cent of GDP in 2003-04 to an estimated Rs.394 billion or 4.5 per cent of GDP in 2006-07. According to the IMF, the program was projected to grow by another 42 per cent but even with recent cuts the development spending will be probably be at about 4.5 per cent of GDP in 2007-08.

Non-development spending has also risen sharply, not all related to necessary pay hikes and increases in social spending. The growth of current expenditure has been particularly rapid over the last two years, showing a record expansion both in federal and provincial expenditures as shown in Chapter 5. As a consequence, current expenditure exceeded total revenue by more than five percent, a gap that was only partly met by grants. The revenue deficit is expected to increase very sharply during the current year possibly reaching a level of 3 per cent of GDP. The specter of large borrowing for current expenditure thus hangs once again over government finances.

Thus the phase out of oil subsidies as well as a consolidation and cutback of other public expenditures has become an urgent necessity. The focus should be on minimizing the reduction in development spending. Instead all revenue expenditure, including defense, should come under close scrutiny.

Cutting overall public expenditures say by 1 to 1.5 per cent of GDP and combining it with a vigorous effort to tax the well to do and wealthy 10 per cent of the population, that receive well over 25 per cent of the national income, would help reduce fiscal deficit initially by 2 per cent of GDP in 2008-09. Raising more revenue from those that can afford to pay and are taxed lightly at present would also be a crucial test of whether the newly elected government can change the elitist image associated with past governments, a perception and reality that has hampered progress of real democracy in the country. Simultaneously, it is necessary to expand social safety nets for the poor.

Some effects of reduced public spending on growth and welfare would be unavoidable. But they can be greatly mitigated by structural reforms that strengthen the longer term goals of moving government closer to the people, and paying much greater attention to the incidence of fiscal tax and expenditure policy changes.

Finally, in consolidating expenditures, priority should be given to development expenditures that can yield relatively quick results and are not especially foreign exchange intensive. The latter should apply equally to big- ticket weapons spending by the military.

A strong fiscal adjustment and a tight monetary policy will send strong signals to the markets that Pakistan seriously intends to tackle the disequilibrium in its foreign exchange transactions and avoid any disruptive change in the value of its currency.

But the current account balance of payments deficit is so large and the need for curtailing it as well as curbing speculative pressures on the exchange rate is so urgent, that fiscal and monetary policies would have to be strongly supported by trade, exchange rate, foreign exchange reserve policies and confidence building measures such as adopting a strong export orientation and clearly articulated external finance strategy. The case for imposing a regulatory import duty on all imports, excluding essential imports of food, pharmaceuticals, fertilizer and POL products, should be examined, with a higher rate on luxury goods.

As mentioned above, the current account balance of payments deficit in the 2007-08 is likely to be around 7.5 per cent of GDP. We believe that this should be reduced to 5 per cent of GDP in 2008-09 and 4 per cent in 2009-10. In our view, Pakistan can safely run current account balance of payments deficits of this latter magnitude provided export growth recovers to 10 per cent per annum, private transfers remain strong and supply of concessionary assistance remains ample. Equally important, limiting the deficit to 4 per cent of GDP would bring the saving-investment gap (a measure of self reliance) to 15-20 per cent range from a record 33 per cent imbalance likely to be recorded this year.

The biggest contribution to reducing the saving investment gap would the early elimination of negative savings on general government revenue account which have reemerged and become very sizable (3 per cent of GDP) during 2007-08. Strengthening incentives for small savers by improving returns on bank deposits which are sharply negative and improving returns on government saving schemes should also help to curb consumption.

The biggest challenge for short-term balance of payments management is to maintain, indeed restore, foreign exchange reserves to a level of around $ 15 billion over the next few months while financing the substantial uncovered gap. More adequate reserves are absolutely necessary to ward off the speculators in the liberal global framework in which Pakistan is operating. We, therefore, strongly support the Finance Minister's plans to shore up reserves by $ 2.5 billion, partly through support from friendly countries.

The foreign exchange reserves have fallen from the peak of 7 months of imports of goods and services in mid 2003 to 3.5 months' equivalent at present. An increase in the reserves gradually to 4 -6 months' import equivalent over the next three-five years appears to be highly desirable.

This would be a challenging task in the short run because of competing financing needs and the rather large deficit that needs to be financed.

With recent downward moves in the value of the rupee, Pakistan's exchange rate does not need any once-and-for-all significant realignment. However, it is important to lay down the policy that the real effective exchange rate will not be allowed to appreciate in the near future. In other words, the much higher rate of inflation in Pakistan than in its competitors would be allowed to be reflected in the change in the nominal rate against a basket of currencies. Otherwise, the competitiveness of our exports would suffer and import growth will be artificially stimulated.

Pakistan cannot hope, however, to solve its fundamental growth and balance of payments problems without making export development a center piece of its development strategy. Rapid export development helps to create jobs, raise wages and meet the rising obligations of debt servicing and investment income payments. Export development is critical to future high and equitable growth. Chapter 9 of the report focuses on the strategy for export growth.

But there remains, nevertheless, an urgent need to develop a framework for balance of payments management to avoid foreign exchange difficulties The framework of fiscal and public debt management exists but needs to be adhered to. However, there is no framework for balance of payments management and no external finance strategy to implement desired goals.

Need for Long Term External finance Strategy

There are two reasons why Pakistan needs an external finance strategy and a framework for balance of payment management to complement the Fiscal Responsibility Law that puts limits on public debt, fiscal deficits and contingent liabilities.

First, Pakistan has a history of excessive reliance on external flows. This has discouraged long term domestic saving efforts, encouraged excessive consumption and abrupt disruptions in these flows frequently in the past have had deleterious effects on the domestic economy. Pakistan has a very low rate of domestic savings. In 2006-07 this rate was 13.5 per cent of GDP: large private transfers of over $ 10 billion offset only in part by a net investment income payments of $ 3.5 billion explain why the national saving rate of 18 per cent of GDP is higher though it still compares unfavorably with other major developing countries. In 2007-08 the domestic saving rate fell by 2 per cent of GDP to 11-12 per cent range. (It should be noted that the IPP estimate of domestic savings rate is lower than the reported government figure of 16.1 per cent of GDP for 2006-07. This is because the national accounts understate net factor income from abroad and are not consistent with the balance of payments figures on private transfers.) Successive governments have argued for greater self-reliance but rarely practiced it.

Second, even though there has been a welcome shift in financing current account BOP deficits from debt to equity, the notion that the large balance of payments deficits do not matter if they are financed principally by foreign investment flows is flawed. Foreign investment flows do have costs though they are not rigidly fixed as in the case of external debt obligations. The investment income payments from Pakistan on account of portfolio and direct investment have almost doubled in the last two years to $3.4 billion in 2006-07 and were more than three times the interest payments on external debt of $1.1 billion. Furthermore, in an open system, private flows especially of portfolio investment can be extremely volatile. Finally, in Pakistan's case the biggest argument for limiting balance of payments deficits is that they have been used to sustain consumption more than investment.

These are not arguments for discouraging foreign investment, especially direct foreign investment, which is badly needed to expand overall investment levels and to upgrade technological capabilities and exports but merely to put these flows in the perspective of sustainable current account balance of payments and a gradual move to greater self-reliance.

Concept of a Sustainable Balance of Payments deficits

There are of course no magic formulae to avoid balance of payments difficulties. However, the concept of sustainable deficits is a useful one. The tendency of policy makers in Pakistan has been to focus excessively on the size of the deficit as a percentage of GDP.

In actual fact the level of sustainable deficit can vary significantly depending on 1) the prospective growth rate of foreign exchange earnings, 2) mix of equity and debt flows, 3) cost and maturity of external borrowing, and 4) extent of savings and investment gap or in other words what the deficit is financing.

It is common sense that the long- term sustainable level of the balance of payments deficit could be quite high provided:

- Growth in foreign exchange earnings from exports of goods and services, worker remittances and other private transfers is expected to be high,
- External borrowing is largely concessionary and/or market terms borrowing does not increase real debt burden over time, and
- Large external flows finance investment rather than consumption.

On the other hand if external flows are financing a growing savings-investment gap, the prospects for expansion of foreign exchange earnings are not good, and if the borrowing terms for external debt are onerous, there would be little sustainability even at low levels of deficit. In our view, if Pakistan's export growth recovers to 10 percent per year, private transfers continue to grow at the relatively high rate of the recent past, the savings investment gap is reduced to 15-20 per cent and the supply of concessionary assistance remains ample, Pakistan could run current account BOP deficits of upto 4 percent of GDP.

To avoid future balance of payments difficulties, the adoption of a few specific guidelines to implement a viable external finance strategy is recommended as follows:

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

ii. Limits on total external debt and foreign investment obligations in relation to total foreign exchange earnings at the present level of 100-110 per cent.

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

Finally, more thought needs to be given to managing the process of private inflows. There has been a quantum change in the climate for private and foreign investment in recent years. The basic strategy to undertake further large scale privatization and encourage other foreign equity flows through private direct and portfolio investment is sound. But it is essential that a significant part of this investment contributes to foreign exchange earning capacity, upgrading of skills and diversification of output and export structures.

SUSTAINING GROWTH

Macroeconomic stability is not an objective in itself. It should create and support the conditions for sustained high growth and facilitate the process of poverty reduction.

What are the long-term prospects of growth of Pakistan economy, looking beyond the period of stabilization needed for the next two years? What will it take to move the growth rate to a sustained level of at least 7-8 per cent per annum consistent with a better distribution of benefits of growth than in the past and a rapid progress towards poverty reduction?

The specific issues that can make growth more equitable and poor friendly are discussed in the next section. But the incontrovertible fact remains that high growth which leads to a rapid expansion of employment opportunities that in turn lead to a tightening of the labor market and a significant and steady increase in real wages remains necessary for reduction of poverty.

It is necessary to look, in the historical context, at the broad structural problems that have constrained or continue to hamper rapid growth in Pakistan (a la East Asia or more recently India), before discussing policy reforms that are needed to markedly improve growth prospects.

Taking the last half -century as a whole Pakistan's average annual growth rate has been close to 5 per cent per cent per annum, much below the 8-9 per cent growth enjoyed by East Asian countries including China for a long period: in the last decade India has also been able to expand its growth rate to 8-9 per cent per annum. In Pakistan, even in periods of high growth, 1960s, 1980s, and 2002-2007, average growth never exceeded 7 per cent per annum and moreover the periods of high growth have been frequently followed by periods of sputtering growth due to a variety of reasons including political changes, shifts in economic direction and neglect of underlying macroeconomic realities.

There cannot be much dispute that some fundamental demographic, governance and growth problems have kept Pakistan from joining the rank of the Asian Tigers. These problems have had long roots and had their origins in:

- An inability to develop viable democratic political institutions and effective governance structures,
- Personalized rule, over centralized decision making, weakening public institutions and rule of law, public corruption, and lack of accountability,
- A high population growth rate which averaged over 3 per cent per annum for nearly four decades,
- A level of defense spending that the country could ill afford,
- Inability of the government to collect enough revenues,
- A major neglect of human development outlays and quality of public education in face of rapid growth of population and rising needs for skills,
- A weak industrial and export structure, dominated by cotton based exports resulting from both from insufficient progress in education and trade policies that discouraged backward linkages, exports based on imported inputs and diversification,
- At best, an ambivalent attitude towards the private sector and a liberal economic framework till the early 1990s, and
- Low rate of savings and consequently inadequate investment not only in human capital but also in infrastructure, industry, agriculture.

Whether the recent political developments would lead to a plural society in which rule of law and the will of the people at all levels of government is respected, personal politics become less important and accountability for all sections of society is enforced, is too early to tell. But institutional development in the broad sense would go a long way to create enabling conditions for sustained rapid growth.

As for other structural factors that influence development, progress towards removing constraints on rapid growth has remained mixed despite reform efforts. But at least there are two positive signs as follows:

- The demographic transition has begun. Pakistan's population growth has come down from over 3 per cent to 1.8 per cent per annum. The rate is likely to decline further and can be accelerated through greater efforts to reduce fertility rates in rural areas. Lower population growth will relieve pressures on social development and with a substantial lag on the employment situation. If the rate of population growth averages 1.5 per cent per annum, a per capita growth of nearly 6 per cent per annum would be possible with a GDP growth of 7.5 per cent per annum.

- The liberalization, privatization and reforms of the financial system – processes that were started in 1990, and deepened and extended since 2000 – are providing a strong base for healthy private sector development, large foreign private investment flows and strong private investment.

Private Sector Development and Privatization

The strengthening of the country's financial position and increased confidence in the currency, has helped to energize the private sector by the induction of large foreign investment flows, facilitated by accelerated privatizations and improvement of the investment climate through continuing reform of the financial sector and further liberalization of the trade policies.

The growth in private investment has been particularly strong during the last three years and machinery imports data suggests that the momentum is, by and large, continuing this year. Real private investment has grown by 67 per cent over 2004-07 and private investment now accounts for nearly 75 per cent of gross fixed capital formation, compared to 50 per cent in the 1990s. As a proportion of GDP private investment rose to a record 16.2 per cent of GDP in 2006-07.

Direct foreign private investment has been the leading edge of the sharp rise in private investment during the last two years. Contrary to general impressions, privatization sales to foreigners have been a relatively small and declining part of total direct foreign investment (DFI), (see Table 2.4). But, on the other hand, foreign investment through mergers and acquisitions mainly in the service industries has been substantial. The obverse of this is that foreign investment in real economy and export oriented activities has been small.

TABLE 2.4
FOREIGN PRIVATE INVESTMENT FLOWS AND TOTAL PRIVATE INVESTMENT

($ in Billion)

	DFPI	Privatization Sales	DFPI (Exc. Privatization)	Private Investment
2001-02	0.5	0.1	0.4	7.5
2002-03	0.8	0.2	0.6	8.3
2003-04	1.0	0.2	0.8	7.8
2004-05	1.5	0.4	1.2	8.8
2005-06	3.5	1.5	2.0	10.0
2006-07	5.1	0.3	4.9	12.1
2002-07	12.4	2.6	9.8	54. 5

Note it is assumed that there are no lags in foreign private investment reported in balance of payments and in the national accounts.
Source: BOP data and National Accounts in SBP Annual Reports.

An analysis of the likely impact of the burgeoning private investment led by large private foreign direct investment on output, employment and exports would be useful. The phenomenon is important enough to try to understand its dynamics and impact on the economy. The new government needs to have this issue studied without in any way implying any change in present policies towards foreign investment.

The privatization sales to the foreigners have been concentrated in banking, telecommunications and thermal power while other direct foreign investment flows have been much more broad based, in oil and gas, power, telecommunications, manufacturing as well as services. Though precise figures are not available, the impression is that much of investment flows have not been directed at activities that strengthen exports and/or foreign exchange earnings. This is also a policy area that needs further examination.

The opening up of the financial and telecommunications sectors partly with the help of foreign sectors is transforming and modernizing the economy in a fundamental fashion. The growth in cellular phones in Pakistan has been nothing short of phenomenal and the competition in the telecommunications sectors has pushed down prices very sharply, essentially reducing the cost of information and doing business.

The largely publicly owned banking system was misused by vested interests both to earn economic rents and thwart genuine entrepreneurial activity. In a very short time, the control of the banking system has moved into private hands. Regulatory capacity of the central bank has been greatly enhanced though its autonomy needs to be further increased [Hussain (2005)].

Financial reforms have improved resource allocation by making lending follow sound economic and financial criteria. It has also improved governance by closing avenues for corrupt practices and political influence paddling. There is also evidence of financial deepening as the ratio of monetary assets to GDP has risen from 40 to 44 percent over the last five years after having been stagnant for a long period. The increased financial intermediation also generally augurs well for economic efficiency.

There is also evidence that investment climate for the private sector is improving and the cost of doing business is going down. According to the World Bank, Pakistan was one of the top reformers in terms of doing business in 2004. It ranked 76th in 2008 out of 178 countries (China was 83rd and India was 120th) in the overall ease of doing business. According to World Economic Forum Global Competitiveness Reports, Pakistan's ranking improved from 75th out of 102 in 2003 to 66th out of 116 in 2005. However, Malaysia, Thailand, India, China, and Turkey were substantially ahead of Pakistan in rankings [World Bank (2006, 2008)].

Still there are three major problems that relate to the private sector.

First, there is a crisis in the power sector. Insufficient investment in generation as well as distribution, the inefficiencies, frequent breakdowns in supplies as well as load shedding not only increase the costs for the private sector by requiring alternative generating capacity but also result in large losses for public entities which are a significant drain on public resources. It is not clear that large-scale privatization of WAPDA's energy corporations is a quick and fully feasible answer at least in the short run.

Second, though much progress has been made the private sector still looks too much to the government for solving its competitiveness problems by seeking tax, credit and other concessions. A Rs.100 billion package demanded by the textile industry and largely provided by the government to cope with competitive pressures in the post MFA era is a case in point. Rent seeking behavior has not entirely disappeared and genuine entrepreneurship is still hampered though medium and small industries are faring better than before.

Third, as mentioned above, large foreign investment flows appear to be taking place in areas that do not contribute directly to export development. Since export growth remains critical for Pakistan's development a lop- sided pattern of foreign investment could prove costly in the long run.

Looking ahead, the new government should reaffirm its commitment to free markets but develop a new compact with the private sector in which rent seeking would be greatly discouraged and accountability in respect of taxes and economic regulation will be strictly enforced, with the State Bank of Pakistan, the Securities and Exchange Commission, the Competition Authority, and, last but not least, the Federal Board of Revenue enjoying freedom from pressures for patronage.

The expansion in private investment, accompanied by a rise in public investment, have raised the overall investment rate significantly since 2003-04 from a low of 16.6 per cent of GDP in 2003-04 to a record 23.0 per cent of GDP in current prices in 2006-07. This normally should augur well for future growth. However, it seems that the rise in investment rate, as measured in GDP in current prices, is not fully matched by the increase measured in terms of 1999-2000 prices.

As Table 2.5 below shows, the rate of gross fixed capital formation, measured in 1999-2000 prices increased only from 15.6 to 17.9 per cent of GDP over 2003-07, much less than an increase (from 15.3 per cent to 21.4 per cent of GDP) over the same period when measured in current prices. The explanation of this divergence lies in a much sharper rise in the price of investment goods than the GDP deflator. The investment deflator grew by over 14 per cent per annum over the last four years while GDP deflator grew by about 8 per cent per annum.

The prices of investment goods and the factors that are causing them to rise need to be analyzed and carefully monitored. The objective should to maintain an annual real growth in investment of 10 per cent for the next several years. Only then will Pakistan be able to lift its overall investment rate to say 25-27 per cent of GDP which, in our opinion is a pre-requisite for raising and sustaining the long- term growth rate to 7-8 per cent per annum.

TABLE 2.5
GROSS FIXED CAPITAL FORMATION (AT CONSTANT PRICES OF 1999-2000 AND AT CURRENT PRICES)

Year	GFCF as Percentage of GDP at 1999-2000 Prices	GFCF as Percentage of GDP at Current Prices
1999-2000	15.9	15.9
2000-01	16.3	15.9
2001-02	15.7	15.6
2002-03	15.6	15.3
2003-04	13.6	15.0
2004-05	14.4	17.5
2005-06	15.8	20.4
2006-07	17.9	21.4

Source: Economic Survey of Pakistan 2006-07
IPP estimates.

Domestic Saving and Tax Effort

Since the current account balance of payments deficit is already above the sustainable level, the financing for higher investment levels must come mainly from a rise in national savings. Hopefully, the strong growth in remittances and private transfers will continue raising their contribution further as a percent of GDP to national savings. Sill, the rate of domestic savings will have to rise substantially from its low level to meet the challenges of financing a rising investment program.

Pakistan's inability to raise domestic saving levels over long periods is related to a complex interplay of social and political forces as well as policy and institutional failures. Historically, six factors have adversely affected domestic savings performance: political conditions and social attitudes; high rate of population growth and high number of dependents as percentage of working age population; relative ease of external resource options; failure of fiscal policies to generate public savings given the pressures of large defence spending; absence of a clear framework for private sector development; and poor development of the financial sector [Hasan (1998)].

Political leadership in Pakistan has rarely emphasized the importance of sacrifice and savings for long-term development and social attitudes have compounded the problem. At a more fundamental level, the low rate of domestic savings denotes low confidence in the future. Increased savings imply postponed consumption and unless confidence in the future is strong, future consumption is heavily discounted. If political stability is ensured and the leadership sets an example of discouraging conspicuous consumption, change in social attitudes may be possible.

It has also been noted that the dependency ratio (the proportion of dependent children to working age population) is often associated with lower household savings and Pakistan was no exception. Because of high population growth, dependency ratio in Pakistan was 0.9 in 1995, compared to 0.7 in India, 0.5 in China, and 0.6 in Indonesia. The slowing down of population growth is improving this situation and should increase the scope for household savings.

The greater role for the private sector and financial sector reforms have in principle also improved conditions for domestic savings. Unfortunately, with the rise in inflation, the deposit rates remain substantially negative and the spread between bank deposits and loan rates remains huge. This is an area requiring urgent attention. Governor State Bank of Pakistan's jawboning efforts with the bankers has not so far been very successful.

With the small savers, safety of assets such as government paper is very important which explains the popularity of government savings schemes. From this point of view, the revamping of the Directorate of Savings as a full- fledged corporation is a helpful step. It should provide keen competition to the banks by providing positive real interest rates without entailing a subsidy.

It should also be possible, for instance, to develop a secondary market for PIBs and package PIBs in smaller amounts for sale to households. The possibilities of enhancing institutional savings though pensions and retirement schemes for workers in the private sector also need to be explored.

Despite government initiatives, Pakistan lags far behind other countries in the development of micro-credit, an important instrument for saving and investment for poor households. This needs to be rectified as an overall policy of stimulating savings. Finally, preferential access should be provided for small savers to the capital markets especially the buoyant stock exchange.

Fiscal Imperatives

Notwithstanding some hopeful developments, Pakistan's savings problems remain intractably linked to its fiscal position. The high defense spending and low rate of tax revenue, led in the past to borrowing for current expenditures and mounting burden of public debt, with rising interest payments becoming the main driver of fiscal deficits. After an austere stabilization program, reduced fiscal deficits, and substantial external debt relief, the debt burden in relation to GDP was brought down by nearly 40 per cent over 2000-06 and interest payments on public debt were cut by nearly half to 3.1 per cent of GDP over the same period.

But, as mentioned above, fiscal imbalances have again grown and again are at unsustainable level, interest payments on public debt jumped by 55 per cent to 4.2 per cent of GDP in 2006-07[2] and general government saving probably turned negative. Meanwhile, there has been little improvement in the tax to GDP ratio that remains at about 11 per cent of GDP. It must be quickly noted, however, that one reason why the tax to GDP ratio has not risen despite improvements in tax administration is that the desired reform of the structure of taxation involving substantially lower level of import taxation has had costs in terms of revenue estimated at 1 to 1.2 percent of GDP, although the big jump in import level in recent years has compensated for these revenue losses. Meanwhile, the demand for subsidies and other pro-poor expenditures have grown and would need serious consideration. Also, despite a substantial growth in development spending, there are huge requirements of long-term investment in infrastructure especially water and power.

How can the dilemmas posed by fiscal policy be resolved is discussed in greater detail in Chapter 5. But it is clear that without higher level of resource mobilization at all levels of government, reduced defense spending over time say by limiting the growth in defense outlays to one thirds to one half of the rate of growth of GDP, and a decentralized fiscal framework which strengthens incentives both for resource mobilization and more effective resource use, public sector would not be able to support the objectives of higher and more equitable growth. While wasteful public spending must have grown with the substantial opening up of fiscal space over 2001-2006, it is important to stress that total public expenditures in Pakistan (excluding interest and defence) at 11-12 per cent of GDP are much lower than almost all developing countries [Hasan (2007)]. The comparable figure for India is around 20 per cent.

Real Economy, Key Sectors and Factor Productivity

Steady progress towards higher rates of savings and investment over the next five years would facilitate the move to a higher growth path. But as the growth accounting methodology suggests, the sources of output growth are not only the accumulation of factors of production i.e. capital and labor, but also the growth of total factor productivity. Factor productivity growth results from more efficient use of resources, technological progress and technological diffusion, learning by doing, and improved management of production activities [World Bank (2006)]. Public policy through a favorable macroeconomic policy environment and structural reforms facilitating change can contribute to rate of factor productivity growth.

According to World Bank estimates, growth in total factor productivity (TFP) in Pakistan has varied widely over the last forty five years (1960-2005) but on average has shown an annual increase of 1.2 per cent compared to 1.3 per cent in India and 1.7 per cent in East Asia and Pacific. The acceleration of growth rates in India and maintenance of very high growth rates in China would suggest that TFP growth in these countries is now higher than in the past.

Two factors may explain the disappointing growth in productivity. First, after important gains made in agricultural crop productivity following the green revolution and the breakthrough in cotton in the 1980s, crop productivity growth was actually negative over 1990-2003 at least in Punjab for which data are available [World Bank (2006)]. Severe drought in several years and long- term deterioration in the quality of water and soils are part of the explanation but reduced effectiveness of agricultural research and extension services also played a role [World Bank (2005)].

Second, the industrial and export sectors of Pakistan have not diversified and not increased productivity by taking advantage of the tremendous opportunities opened up by the explosive growth in international trade, new products and new technologies. Pakistan has remained excessively locked in the textile and clothing industries and has missed out in the new areas like electronics, information technology, and services. It has not thus been able to move to higher value added new products or move up the value chain in traditional products. Another indicator that Pakistan does not have a very modern manufacturing sector is the low rate of employment in the large- scale sector, which at 0.7 million, according to the Census of Manufacturing Industries of 2001, has not grown significantly and constitutes only 16 per cent of total manufacturing sector employment and 2 per cent of total employment.

But because it has fallen so far behind in world exports and apparently in levels of productivity in agriculture, industry and services, there are major possibilities for playing catch up provided strategic directions can be set right and policy actions and investments support the new priorities. The two areas which hold special promise for accelerated growth in TFP as well as total output are agriculture and exports. Pakistan desperately needs renewed focus on exports where Pakistan has lost ground to almost all major developing countries over the last few decades (See Chapter 9).

Agriculture

The agriculture sector also deserves more attention than it has received. Sustained agricultural growth of nearly 4 per cent per annum over four decades, 1960-2000, has been historically an important factor in keeping Pakistan economy on an even keel even in periods of economic turbulence. This high growth rate which was matched by few large developing countries was made possible first and foremost by expansion of area due to enormous increases in availability of irrigation water supply (nearly trebling over 1960-2000) as a result of storage at Mangla and Tarbela and a sharp expansion in private tube-wells. The increased certainty in the supply of water also provided a great stimulus to increased use of modern inputs, fertilizers and pesticides and facilitated the quick spread of the green revolution.

However, agricultural growth has slowed down during the 2000-2007 period to 2.5 per cent per annum as shown in Table 2.6 and this slowdown cannot be attributed solely to the severe drought conditions in 2001-03. By 2006-7, the surface water supplies and rainfall had recovered to normal levels [SBP, Annual Report (2006-07)]. The slowdown in agricultural growth is notwithstanding the continued strong growth in the livestock sector that now accounts for half of the value added in agriculture.

TABLE 2.6
GROWTH RATE OF AGRICULTURE SECTOR
(%)

	1990s	1999-2000 to 2006-07
Major Crops	3.5	2.5
Minor Crops	4.1	0.3
Livestock	5.3	3.9
Fishing	7.3	2.2
Forestry	6.4	-9.6
Total Agriculture	4.4	2.5

Source: PES

There has been a slow down of growth in major crops production and minor crops are not growing at all. As a consequence, wheat self-sufficiency remains in doubt forty years after the green revolution, edible oil imports continue to grow rapidly, and imports of pulses have become sizable. Meanwhile, there has been little progress in diversification towards higher value crops and potential of agricultural exports remains largely untapped.

It is highly doubtful whether Pakistan can meet its high GDP growth target and make a dent in its poverty and employment situation without accelerating the growth rate of agriculture back to the historical growth of around 4 per cent per annum. But this revival in agricultural growth rate will, face some very serious obstacles. First, while a substantial expansion in major and minor crops is needed, the issue of water scarcity is very real. Even assuming normal weather conditions, Pakistan cannot expect much increase, in the medium term, in irrigation water supplies. There is a critical need for expanding storage and increasing hydroelectric power through large storage dams. But realistically even if political consensus on a multi-purpose dam emerges quickly, its planning, finance and construction could take a decade. Meanwhile, the storage capacity of Mangla and Tarbela Dams would continue to decline gradually. Even more to the point, the net addition to surface irrigation water supply from a large reservoir would be only 8 million acre feet (MAF) compared to the present average system availability of over 100 MAF. It would not be a magic bullet for agriculture even though this would help to expand electric power generating capacity and bring down its cost.

Efficiency of water use would be central to the future of crop agriculture. This requires investments in lining of canals and watercourses, on- farm development, use of drip irrigation, much higher water charges, and movement away from crops like sugarcane which require large quantities of water and do not necessarily have a high rate of economic return. The last two are sensitive politically but combined with investments in irrigation infrastructure and a move to metering of water use can be made palatable. Fortunately, a good beginning has been made in last few years in expanding investments below the canal command level. These must continue to be pursued strongly.

It has been suggested that a shift in area cultivated devoted to water-intensive crops like sugar cane and rice to less water-intensive crops like oilseeds (sunflower and canola), maize, and vegetables irrigated with drip irrigation techniques, could result in large water savings. The transition to new cropping patterns would require projects and programs involving agricultural extension, market development and credit. Coping with the burden of some processing facilities (e.g. sugar mills) that may become unprofitable would also pose a challenge [World Bank (2007)].

Achieving substantial growth in agricultural incomes will also require greater investments in agricultural research over a broad front: cereals, cotton, and higher value crops such as oilseeds, vegetables and fruits, as well as livestock. In the past investments in agricultural crop technology (especially for cereals) have had very high payoffs in South Asia and now with the worldwide rise in the price of food grains they have become once again urgent.

Programs to increase livestock production should have a regional focus; production of dairy cattle and milk in Punjab and Sindh, and sheep and goats in NWFP and Baluchistan. Because livestock ownership is more evenly spread across rural households than is access to land, productivity gains in livestock are generally more pro-poor than gains in productivity of major crops. Such productivity gains for small-holders are feasible through use of improved feeds, better veterinary services, and more efficient marketing channels to help ensure remunerative prices of milk for farmers.

Finally, faster growth in exports of non-traditional agricultural products (fruits and vegetables, meat, fish) will require improved capacity to meet Sanitary and Phyto-Sanitary (SPS) standards imposed by importing countries. Pakistan lacks a coherent strategy for quality and SPS management in relation to its trade. Organizationally, there is a need to remedy the fragmented, isolated, and non-coordinated capacity of SPS management institutions and regulations by better defining roles and responsibilities of the various agencies involved in SPS management, strengthen technical capacity for risk assessment, and re-institutionalize early warning and surveillance systems for pest, diseases and contaminants.

An immediate issue for the policy makers is the determination of a wheat policy and domestic wheat price in light of sharp and sudden rise in the global prices of food grains. The level of food grain prices has major consequences for the non-farm poor who spend a considerable part of their income on staple grains. The real drop in the price of food grains worldwide over the last several decades, spurred by the discovery of dwarf varieties of wheat and rice in the 1960s and the spread of green revolution, was a significant factor in reduction of poverty levels every where. But now the fundamentals of supply and demand have changed partly because of the race to produce bio-fuels.

We believe the rise in world food prices especially wheat is an opportunity for Pakistan because it does have comparative advantage in cereals and there are hardly any places in the world where wheat is grown on large scale on land under irrigation. The long term wheat policy should have three objectives, (1) to generate at least modest export surpluses in good years after meeting domestic needs (including Afghanistan and inevitable smuggling to border areas), (2) to keep domestic prices below the international price by a margin that would permit exports and absorb transport and trading costs, and (3) to bring down the costs of wheat by intensive research and extension efforts in cooperation with the private sector but not by subsidies on inputs such as fertilizer.

At present international prices, a domestic support price of Rs. 625 per 40 Kilos for wheat would appear to be low. Both producer and consumer prices would have to rise if, as is likely, the world prices stay high. The hardship for the poor should be mitigated mainly by transfer payments. Improved incentives and technical support for the farmers would have a strong supply response and within a relatively short time the artificially created scarcities should disappear.

DISTRIBUTION OF THE BENEFITS OF GROWTH

The dissatisfaction with the pattern of development and distribution of benefits of growth has been a perennial issue in Pakistan's history. However, the current disquiet about poverty and equity is somewhat reminiscent of 1969 when wide spread popular discontent forced Ayub Khan to resign after what was touted by some of his colleagues as a decade of development. 1960s were indeed the first period of high growth in Pakistan: the average growth rate was nearly 7 per cent per annum and the rapid spread of the green revolution resulted in a record agricultural growth of 5 per cent per annum. But a lot of people felt left out. Real industrial wages rose very little over 1960-68.The green revolution which was led by the middle farmers initially passed by the small farmers who were not well placed to obtain high varieties of seeds, fertilizers and sink tube-wells. Also, per capita agricultural production declined in the rain-fed areas leading to sharp disparities in regional development.

Evidence available later does not support the view that that poverty incidence increased in the 1960s or that income distribution became skewed. But there was a clear loss of momentum of development after the 1965 War with India. Defense spending increased, foreign aid declined, tax burden grew and outlays on social development were cut back. Above all, the perception that the economic power in the modern sector was increasingly concentrated in a few hands ignited public anger [Hasan (1998)].

Now, once again, the equity issues are in the forefront. The impact of recent high economic growth on distinct but interrelated aspects of welfare, employment and wages, income distribution, poverty, and access of general population to public services such as education, health, and safe water is being vigorously debated. The rise in oil and food prices and a sharp rise in the rate of inflation are triggering discontent as external shocks have imposed a heavy tax on Pakistan. At the same time, the perception of deepening income and wealth inequalities seems to be supported by the extraordinary booms in the real estate and stock market that have mainly benefited the relatively well to do.

Poverty Incidence

What does the evidence suggest? Widespread poverty remains the most critical welfare issue. There has been a great deal of research and writing on poverty levels, trends and determinants by academics, government officials and international institutions.[3] There is general agreement that starting from high levels, the incidence of poverty declined significantly over 1960-90 but increased again somewhat in the 1990s.

TABLE 2.7
PAKISTAN POVERTY ESTIMATES: 1998-99, 2001-02 AND 2004-05

		1998-99	2001-02	2004-05 (WB)
Poverty Headcount Rate	National	30.0	34.4	29.2
	Urban	21.0	22.8	19.1
	Rural	33.8	39.1	34.0
Poverty Gap	National	6.3	7.0	6.1
	Urban	4.3	4.6	3.9
	Rural	7.1	8.0	7.2
Squared Poverty Gap	National	2.0	2.1	2.0
	Urban	1.3	1.4	1.2
	Rural	2.2	2.4	2.3

Source: World Bank Staff estimation based on PIHS 1998-99, 2000-01 and PSLM 2004-05. (See Vishwanath and Yoshida, 2006, internal memo.)

Recent discussions of poverty have focused on the results of the two household surveys, PIHS 2000-01 and PSLM 2004-05. According to official numbers, these surveys indicate a decline in the incidence of national poverty from 34 per cent in 2001 to 24 per cent in 2005 and a decline in the incidence of rural and urban poverty from 39 percent and 24 percent to 28 per cent and 15 per cent respectively over the four years. The results are arrived at by adjusting the nominal household expenditures by the consumer price index. The government claims that this dramatic empirical reduction in poverty incidence reflects the success of its economic and social policies. The World Bank estimates using a different set of price deflators (prices implicit in the surveys themselves) arrive at a smaller reduction in the incidence of overall poverty, 5 percentage points instead of 10 to 29 percent (See Table 2.7). The reported reduction in poverty incidence of 5-10 percentage points over 2001-05, after some worsening of poverty in the 1990s, is neither surprising nor terribly reassuring. Why is the recent reported reduction in poverty incidence not surprising?

First, and perhaps foremost, the overall average annual growth rate of the economy over the four years, 2001-05, was nearly 6 per cent compared to only 3.3 per cent annually during the preceding four years Second, the exceptional growth rate of agriculture of 7.6 per cent during 2004-05 helped create incomes in the rural areas where poverty is particularly widespread. Good wheat harvest and wheat import liberalization also helped during that year to reverse at least partly the rise in real wheat prices witnessed in the previous years. Third, there was a 50 per cent increase in public spending (other than interest and defence) over 2001-05, which not only increased incomes but improved social indicators moderately.

The recent reduction in reported poverty must also be placed in perspective. As noted above, this reduction comes after a decade in which the long-term trend towards poverty reduction was halted or reversed. Furthermore, the recent reduction in poverty is from the base of 2001, a very poor agricultural year showing a negative agricultural growth of 2.2 per cent. If allowance is made for cyclical factors, that made 2000-01 a bad crop year and 2004-05 an exceptionally good crop year, a good part of the reported reduction in rural poverty from 39 percent to 28 per cent over 2001-05 might evaporate.

Thus even on the basis of official poverty numbers, the challenges of poverty alleviation remain as huge as ever. Even though GDP growth remained strong during 2005-07, it shows signs of slowing down this year. More importantly, the sharp rise in inflation and especially food inflation during the last year and the fact that 2006-07 was a more normal agriculture year (the provisional estimate of 5 per cent agricultural growth is likely to be revised downwards) strongly suggests that poverty incidence has increased in the last three years. Thus, even if one ignores the reservations expressed by the World Bank about the official deflators, poverty incidence would appear currently to be close to the 1998-99 level of 30 per cent, as disscussed in Chapter 4.

This means that nearly 50 million persons are poor, a very sharp rise in the absolute numbers over our history: it is assumed that at partition the number of poor did not much exceed 18 million or 60 per cent of the population of around 30 million. The dramatic rise in the total number of poor over the last half century remains at the core of Pakistan's social and political problems. It is hardly surprising that tensions within society have grown over time and have erupted with increasing frequency in ethnic and sectarian violence. The law and order situation has deteriorated, and more recently terrorist threats from extremists have multiplied. In a real sense, the governance problems facing Pakistan have had their roots in both demographics and the pattern of economic development.

It has been cogently argued that in Pakistan unstable GDP growth and endemic poverty are rooted in an elite based power structure that excludes the majority of the people from high quality education, health facilities, access to land and the high end of the labor market [Hussain (2008)]. The poor in particular face a structure of state power, markets, and institutions which discriminate against their access to resources, public services, and government decision making. Thus it is the governance model that is the key. But as mentioned above, a pattern of development that leads to rising number of absolute poor also makes governance difficult. Indeed a vicious cycle of poor governance, leading to widespread poverty that in turn hampers both growth and governance can be a real danger.

To the extent that the elite power structure is a major factor in persistent poverty, only gradual political change in which a rising and educated middle class throws up genuinely new and enlightened leadership would bring about fundamental changes in the structure of incomes, asset ownership and access to public services. Recent political changes as well the great efforts of the lawyers' movement to restore judiciary and the strong support it received from the civil society are hopeful signs.

The challenge for the new leadership is to set a clear agenda of change needed to ensure better distribution outcomes than in the past and to build a national consensus around it. This would be a daunting task under most circumstances because of the vested interests. It is going to prove particularly difficult in a situation where macroeconomic realities dictate the need for sacrifice by the elite and belt- tightening even by the middle classes.

Making Growth More Inclusive

How can the model of growth be made fairer without going back on the very substantial liberalization of the economy and much greater reliance on market forces witnessed since the early 1990s and without turning back on globalization?

At the strategic level, the pattern of growth and development should aim at a shift towards:

- More labor- intensive areas of production notably manufactured goods exports other than textiles, and high value agricultural crops both to expand agricultural exports and reduce imports of edible oils, and service exports including the rapidly growing area of information technology,
- Far higher levels of investment in human development especially education, skills development, and making demographic transition more rapid, and

- Greater attention to research and development, technological change, and growth in productivity to strengthen international competitiveness

The shift in the pattern of growth through greater export orientation, greater diversification and modernization of output structures, and new way of doing things will raise not only the overall growth rate but also will create more employment opportunities and higher returns to both capital and labor.

Critical Importance of Education and Skill Development

In a real sense, the issue of adequate investment in human capital is at the very heart of strategic shifts needed to accelerate export -oriented growth. The lags in social development and very low ratings for Pakistan on most indicators of human development in international comparisons including South Asia are well known and need not be outlined in detail here.

Pakistan is paying a high price for its neglect of educational development and mismanagement and manipulation of its public education systems. The failure at the basic education level has been the most catastrophic. Just one statistic (the gross primary enrollment ratio at 47 per cent in 1987 was only moderately higher than the ratio of 40 per cent in 1970) explains why there are more than 50 million illiterate Pakistanis to-day [SPDC (2001)].

There was improvement in primary enrollment ratios in the 1990s as an effort was made to protect basic education despite major resource shortages and there was further improvement since 2000 especially in girls' education. But in 2005-06, according to PSLM Survey, the gross primary enrollment ratio was still only 87 per cent. More relevant, the net enrollment ratio, which adjusts for overage students in primary classes, was still only 52 per cent. This means that nearly half the primary school age children are not in school. The gap is much larger in less developed regions and sizable gender differences remain.

The previous government must be given credit for turning its attention to higher education and skills gap and developing cogent plans. But the enrollment ratios at the higher education level at 3-4 percent are abysmally low. Also, the expansion in higher education must not come at the expense of lower levels of education.

Total public education spending has grown more than 10 percent per annum, in real terms, over 2001-07. However, it is still only 2.4 percent of GDP, very low by international standards. Furthermore, the quality and governance issues in public education remain huge.

The steep hill that Pakistan will have to climb to upgrade its labor force is also underscored by international comparisons of average years of schooling and skill levels of labor force. In 2000 the average years of schooling in Pakistan was 3.9 compared to 5.1 in India, 6.3 in China, and 8.2 in the Philippines. The skills index scores as reported by UNIDO for 1998 were 4.1 for Pakistan, 8.1 for India, 14.7 for China, and 21.6 for the Philippines [Hasan (1998)].

Pakistan's progress towards catching up with at least other South Asian countries in educational attainments and skill levels should be an important test of success for any future government.

Public Policy Instruments for a More Equitable Society

Strategic shifts in priorities and directions must be accompanied by well- designed policy interventions that are implemented seriously. Several public policy instruments will need to be used more effectively than in the past to help progress towards a more equitable society.

- Improved governance, especially access of underprivileged to reasonable quality public services,
- Fairer tax and expenditure policies including greater use of direct income transfers to the poor rather than indirect subsidies and higher taxation on the well to do and the rich,

- More equitable access to credit and land for both the rural and urban poor and middle classes, and
- Last, but not the least, tougher and more effective public regulation which reduces anti-competitive behavior, curbs economic manipulation and guards against economic rent seeking.

Poor governance hurts the poor the most. But they cannot be helped unless they have a greater voice. The creation of political structure at the local government level with Nazim as the elected head of the district government is an important start. But the initiative is not adequately supported and provincial governments' backing to it remains generally ambivalent.

The decentralization process needs to be pushed much harder by devolving, in the spirit of the federation, the essentially provincial functions from the center and funding the local governments more liberally. This will not only streamline administrative processes, but also encourage healthy economic competition among provinces (a la states in India and the US), and give local governments a real chance. Fortunately, all the major parties seem agreed on this. But pragmatic implementation plans need to be developed relatively quickly.

In public service delivery, more targeted interventions especially to raise levels of girls' education have been introduced in recent years. Such programs need to be expanded. Federal government should continue to give a lead in developing national policies, and provincial governments must be in charge of design of interventions and monitoring of progress and implementation, but implementation must be devolved to local level. Similarly, as mentioned above, there is a case for expanding direct transfers to the poor including payments from Zakat and Baitul Mal.

However, the government cannot deliver adequate and better quality public services without resources. Presence of waste, inefficiency and corruption in the public sector should not obscure the woeful inadequacy of the financial capacity of the government especially taking into account the high expenditure on defense.

Raising tax revenue is a both a moral and practical imperative. But additional revenue must be raised through equitable means. By any standard, the burden of taxation on the rich and the well to do is light in Pakistan, there is no tax on income earned abroad by residents, no capital gains tax, and no estate taxation even for the very rich. Individual income tax which in most countries serves as a tool for some redistribution of incomes mobilizes less than 1 per cent of GDP.

Meanwhile, the studies of the incidence of tax and expenditures should be taken up and the share of pro-poor spending in public expenditures should be expanded, giving special attention to rural areas (See discussion below). Unless fiscal policies can be made more effective and equitable, the free market model would come under increasing attacks.

The allocation of both rural and urban land is heavily tilted in favor of the already well to do. The agricultural land that opens up as a result of new irrigation should be reserved almost exclusively for the rural poor. Similarly, any implicit subsidies for urban land for housing should be given only to the bottom 40 per cent of urban income receivers. Despite progress in recent years, micro-credit level remain low in Pakistan. Policy changes in these areas can be a very potent tool for helping the poor and the urban middle classes.

While implementing public policy changes suggested above, more attention needs to be given to the two aspects of income distribution and equity which are particularly problematic, high incidence of rural poverty and growing regional differentials. These sub-dimensions of the equity problem have neither received sufficient analytical attention nor given adequate recognition in the design of poverty strategy.

Rural poverty is pervasive; the current incidence of rural poverty is probably close to 35 per cent and 80 per cent of the poor live in rural areas. They are also most deprived in terms of access to justice, education, health, safe water and electricity. Even though 60 per cent of the rural poor are non-farm households (including agricultural labourers), there are few good employment opportunities in rural areas and rural based industry is not very significant.

According to a recent survey, rural non-farm enterprises annual sales revenues ranged from a median value of Rs 102,000 for village enterprises to Rs 180,000 for small town enterprises. The median value-added per worker was Rs 18,000 for village enterprises and around Rs 27,000 for small town enterprises. The median value of enterprise fixed assets was around Rs 120,000 for village enterprises and Rs. 150,000 for small town enterprises. This highlights the low level of productivity in the rural non-farm sector.

The depth and breadth of rural poverty reinforces the need for high agricultural growth rate, more land for the rural poor, more investment in rural infrastructure, more rural based industry which is reportedly constrained above all by availability and cost of finance. The demand for stimulating change would have to come principally from sub-national governments and the change would have to be delivered both with better funding and better governance.

Rural poverty reduction strategy should also place more emphasis on population issues. Fertility rate, average number of children born to women of child bearing age, is much higher in the rural areas of Pakistan (4.8) than in urban areas (3.3). Both for rural and urban areas a two -prong population control strategy makes sense, reducing the desired family size especially through higher levels of female education and making contraception easily available to those who desire family planning services. But the present efforts to increase the level of female education must be combined with the better availability of contraceptive services in rural areas because the prevalence rates there are very low at present.

Regional disparities in income and availability of basic services are growing. Among the provinces, Punjab clearly seems to be in the lead certainly in the growth rate of output and household incomes, as shown in Table A-15 of the Statistical Annexure. These trends could be accentuated with greater devolution to provinces. The answer should not, however, be to hold back de-centralization which will be a key to greater competition, more accountability, and thus more efficiency but to increase subventions to the underdeveloped regions and explore regional comparative advantages. From this point of view, focus on provincial disparities may not be enough. It will need to be supplemented by direct attention to the most deprived districts, both urban and rural [World Bank (2006)].

In conclusion, it is unfortunate that the newly elected government has to cope with a host of economic and social issues all at once with seriously deteriorated macroeconomic imbalances, the impact of rising inflation on large number of poor and middle income households which is probably raising poverty incidence once again, deep seated structural problems of poor governance, low rates of savings, inadequate levels of tax revenue, low levels of education and skills and weak international competitiveness. The present structures of exports, production and income distribution cannot deliver sustained high rates of growth of output and employment that would make possible a steady reduction in incidence of poverty. The agenda for reform remains urgent and extensive.

Chapter - 3

Acceleration of Sustainable Growth

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The belief that the economy was climbing to new heights was embedded in two "vision" documents, one issued from Islamabad and the other from Lahore[1]. Both argued that the structural changes introduced by the policies of the governments that took office in 2002, following the elections held in October of that year, had made it possible for Pakistan to join the ranks of the rapidly growing economies of the developing world. While the economy grew at an impressive rate - at a rate of 7 per cent a year in 2002-07 which meant that income per head of the population grew by 5 per cent a year - these were not sustainable rates. They were a combination of a number of fortuitous circumstances as well as the release of the "pent up growth" locked into the economy by the pursuit of generally restrictive economic policies for a couple of decades.

The crises that the economy was suddenly confronted with in the closing days of 2007 and the first quarter of 2008 lend credence to the view that Pakistan had not climbed onto a high growth trajectory. The subject is discussed in greater detail in the previous chapter. What are the options available to the new administrations as they settle down in Islamabad and the four provincial capitals? Is it possible for Pakistan to set its sights high and aim at sustainable rates of growth of around 8 per cent a year over the next couple of decades? If this is possible, what should be the choice of public policy?

This chapter has three sections. In the first we take a brief detour of where economic theory stands today with respect to growth, in particular in terms of identifying the factors that can help the countries that have fallen behind to catch up with those that have moved ahead. The second section examines the opportunities created by the changes in the global economic system for a country such as Pakistan. This section will briefly discuss some of the structural transformations that have taken place in the global economy and identify the opportunities they present to Pakistan. The third section briefly identifies the choices available to Pakistan at this time in its history in order to climb on to a growth trajectory that would make it one of the high growth economies in the developing world.

ACCELERATING THE PACE OF GROWTH AND CATCHING UP

While the jumps and falls in economic rates of growth are still to be fully explained, the theory of growth economics has advanced by leaps and bounds. The developments are supported by a vast body of theoretical work. Economists now understand better why economies grow. The subject was first investigated by Adam Smith, the father of economics, who focused on how division of labor brings about increases in productivity. Productivity increase causes wages and incomes to rise. Smith also recognized the importance of international trade which expands the markets for producers who are able to increase their output by allowing division of labor to produce specialization in the process of production[2] [O'Rourke (2007)]. To Smith's insights about the advantages produced by divisions of labour and specialization David Ricardo added those of "comparative advantage" thus embedding international trade firmly in the economics of growth.

When the move to a higher growth path occurs it may happen because of the accumulation and concentration of power in the hands of a leader with an exceptional vision and with an equally exceptional ability to implement (his or her) ideas. This is what happened to South Korea, Singapore and Malaysia. Or, the country may have in abundance of a natural resource which is in high demand and the prices for which continue to increase. That is happening to many of the oil producing and exporting countries in the Middle East. Or, it may happen that a resource once considered to be redundant, as was the case with the computer programmers of India, suddenly becomes relevant. Overnight India's computer engineers found a market for their skills. This took place when what came to be called the "Y2K crisis" made old computer languages and their users suddenly valuable. These are all examples of accidents: the arrival of an exceptional leader, the discovery of a new resource in high demand, the sudden relevance of something that had once lost its utility.

If none of these factors is present and if these accidents don't happen, could the move from one trajectory of growth to another be produced by the formulation of public policy based on intelligent design? The answer to the question is most obviously "yes" but there is a considerable amount of debate among academics and development practitioners about the content of such a strategy. The question of coming up with appropriate designs for accelerating the pace of development has been addressed for several decades. In many developing countries, including Pakistan, governments spent precious human resources to write multi-year development plans. In Pakistan's case one particular plan - the Second Five Year Plan implemented from 1960 to 1965 - did produce positive results.[3] The pace of economic growth picked up appreciably. But the economy did not move to a new growth trajectory. The rate of growth of the 1960s could not be sustained in the 1970s. The change of pace produced by the Second Five Year Plan was not robust enough to survive the political shocks delivered in the late 1960s. These resulted not only in the demise of the regime of Field Marshal Ayub Khan but also of the economic model it had pursued.

In fact over the last sixty years Pakistan's economy has been on a roller coaster ride.[4] The ups and downs were the consequence of mostly one factor contributing to growth: the availability of foreign capital. The country performed well whenever large capital flows were available to augment domestic savings. Pakistan's domestic savings rate has remained low, much lower than most countries at its stage of development. Public policy never fully addressed the problem posed by low domestic savings and the country's continued dependence on external savings. Even today-in 2008-ebbs and flows in foreign capital can have a profound impact on growth.

The question of moving in a sustainable way from one growth path to another remains a tantalizing one. One conclusion we can draw from the experience of Pakistan is that sustainable progress requires not only reducing the dependence on external flows. It also requires the incorporation of a number of other economic variables into the change equation. It must also include historical, social, and cultural variables as well as the external environment in which the economy is operating. It is the purpose of this study to present an approach-a strategy and associated public policy choices-that could be applied to Pakistan for it to catch up with other rapidly growing economies of Asia.

While this report is about economic policymaking it is important to note at the very outset that economic progress is contingent upon relative peace and tranquillity. Even by the standard of Pakistan's torrid history, 2007 was an exceptionally troubled year. It saw confrontation between the various parts of the civil society and the government. It witnessed a political assassination in the year's closing days that shook not only the country but the entire world. It saw the arrival of suicide bombing as a weapon used by those who were set to disturb not only public peace but shake the very foundations of the state of Pakistan. As noted in the opening paragraphs of this chapter, if these developments go unaddressed, they will obviously have a serious consequence for the development of the country.[5]

GLOBALIZATION: THE CHALLENGES IT PRESENTS AND THE OPPORTUNITIES IT CREATES

By now the term globalization is well understood. It means a world reduced in terms of the distances that once separated its many parts. The reduction in distance was, of course, not in the physical sense but in the sense of flow of information and reduced transportation costs that brought together distant places. One important consequence of this is the rapid evolution towards a global economy in which its components are tied together by the sharing of new technologies, development of new production processes, new trade links, greater and faster flow of finance, and greater movement of people - five areas that require the attention of the state in those countries that still aspire to draw benefit from the changes that have occurred or are occurring in the structure of the global economic system.

It is recognized that the countries that took advantage of the process of globalization while adopting the needed measures to deal with its challenges, have benefited a great deal. These include not only the miracle economies of East Asia but also Asia's largest and most populous countries, China and India. Unfortunately, Pakistan is one of the countries that benefited very little from the emergence of a global economic system. It has remained on the sidelines for several reasons two of which are important: one, political uncertainty that has bedeviled the country for many decades and two, the absence of analytical capacity to inform the making of public policy.

The elections of February 18, 2008 have set the country on a political trajectory that may produce stability over the medium and long term. In many ways these elections produced unexpected results especially when they were held after an exceptionally turbulent year even by the standards of Pakistan's torrid political history. This raises the obvious question: could Pakistan, now set on a political course that may bring some stability, catch up with the countries that have moved forward? Could it, in terms of the rate of growth of its economy, reduction in the incidence of poverty, as well as better integration in the global economic system repeat what has been achieved by so many other Asian economies? Could Pakistan, in other words, catch up with the more progressive economies of Asia?

We believe that there is still time for the country to benefit but for that to happen the state will have to play an important role. This role will revolve around the adoption of the right set of public policies in the five areas mentioned above where much has happened to the global economy over the last two to three decades. In what follows we deal briefly with the changes that have occurred in these areas and also identify the opportunities they have created for Pakistan which are still available. However, before analyzing these areas it would be useful to underscore one important point.

The policy stance that Pakistan needs to adopt will be very different from those taken by the East Asian miracle economies and also by China and India. The reason for this is that the structure of the global economy has changed significantly and the opportunities that were available to these countries when they began to integrate their systems with the global economy are no longer present. This means that the policymakers in Pakistan will need to carefully study the structure of the global economy in order to identify the niches in which Pakistan could take advantage of the opportunities that are still there in the world economic system.

Rapid growth in information and communication technologies

One of the arguments advanced in this report is that whatever their level of development and no matter how far they have been left behind in this area, countries should consider building their economic futures on a more knowledge and innovation-based development process. As a recent World Bank report puts it, "knowledge is special because it is difficult to obtain, whether through creation or purchase. Unlike information, knowledge involves combination of facts that interact in intangible ways. Because it is difficult to obtain, it constitutes an entry barrier to growth - and this entry barrier, in turn helps generate the rent earned from knowledge" [World Bank (2007)]. Empirical work done at a number of development institutions supports the growth models developed by economists such as Paul M. Romer and Robert E. Lucas that assign a large role to knowledge in producing development. Another World Bank study conducted an econometric analysis comparing the gross domestic product growth profiles of slow growing Ghana and the rapidly growing Republic of Korea over the 45 year period between 1960 and 2005. It concluded that close to two-thirds of the difference between the two were attributable, not to the accumulation of physical capital and labor - the determinants of growth in the classical growth models - but to other factors in which knowledge was a critical component [World Bank (1999)].

It is now recognized that the spread of Information and Communication Technology (ICT) technologies has contributed significantly to the increase in worker productivity and has added to the rate of growth in gross domestic products of the countries which are at the forefront of what is often called the information revolution. The governments can facilitate the acquisition of knowledge by encouraging the spread and deep penetration of both the "hardware" and "software" associated with it. While government's policies in the sector have encouraged the development of mobile telephony - Pakistan has some 76 million mobile phones, indicating a penetration ratio of close to 50 per cent of the population - it has seriously lagged behind in developing high speed broadband services. As a recent government report puts it: "It is no secret that with broadband access, worker productivity increases, job skills are enhanced and direct opportunities are created alongside growth in wages and subsequent higher efficiency of the economy…The economic benefits of broadband can also be attributed to indirect factors including e-commerce, reduction in commuting needs, increased demand for and consumption of entertainment. Internet telephony increases savings in health care, and benefits associated with sophisticated telemedicine and distance learning services."[6]

In spite of the government's recognition of the benefits from the spread of this technology, Pakistan is doing poorly in this sector. There are only 5 million "personal computers" (PCs) which means a penetration ratio of only 3 per cent; there are only 3.5 million internet connections and these are mostly "dial up" with only 100,000 broadband connections. Pakistan ranks 143rd in the world in terms of the provision of this service. Even in the country's large cities, broadband penetration is very low - 0.48 per cent in Lahore and 0.32 per cent in Karachi. World wide, broad band has reached one billion people. Developing countries, while lagging behind the rich world, are attempting to catch up. Pakistan also needs to make a serious effort in this respect.

A new industrial production system

One important consequence of the information and communication revolution that began to take hold in the late 'eighties was to create a new system of industrial production centered around the operations of tens of thousands of multinational corporations, the MNCs. Mostly located in the developed parts of the world - in the United States, the European Union and Japan - these corporations have relocated their production facilities in the countries that can help to reduce the cost of production. This outsourcing of work has had one important consequence: trade in parts and components has become the fastest growing element in international trade. Most final products ranging from aeroplanes, automobiles, computers and small electronic devices are assembled from the components produced in several different places, often located thousands of miles apart.

These changes in the production system are having a profound impact on the structure of global industry. To take one more example: the entry of ZTE, the Chinese telecoms equipment maker into the big league - it is now among the ten largest producers of mobile phones in the world, replacing Motorola of the United States. According to one report, "ZTE's success contrasts sharply with the fall from grace of Motorola, the US telecoms company that is considering selling its loss-making handset business. Motorola saw its market share fall to 11.9 per cent in the last three months of 2007 form 21.5 per cent in the same period in 2006…ZTE has struck deals with mobile operators including Vodaphone, the world's largest operator in revenue, to provide cheap handsets for emerging markets" [Parker (2008)]. This is one area where the state could help Pakistani producers to create an opportunity for themselves. Global handset sales are rising fast all over the world but the increase is higher in countries such as Pakistan. While global sales rose 16 per cent in 2007 to 1.2 billion devices, the market in the populous developing countries is increasing at the rate 30 to 40 per cent a year. Pakistan share in annual world sales is more than 2 per cent which should make it possible for the country to enter into production alliances with manufacturers such as ZTE of China.

Given these changes in the international production system, policymakers in Pakistan would do well to identify the niches that exist for a country such as Pakistan. Two additional areas that deserve both study and government attention are small scale engineering and automobile and tractor vending industries. Pakistan has considerable potential in both since it has some of the skills, at least in their rudimentary forms, that could be used for the development of these sectors. But these need to be improved and this, once again, is a role the state could and must play.

International trade

Largely on account of the moves made by industrial countries in the period since the Second World War, international trade has become a larger proportion of global product. These moves were aimed at progressively reducing tariffs on manufactured items traded by rich nations. Trade has also grown because of the remarkable developments in information and communication technologies that, in turn, changed the nature of the industrial production system. Whereas trade represented 28 per cent of world GDP in 1970, its share increased to 47 per cent in 2000. The growth in international trade and its *apparent* impact on economic growth has led many - perhaps most - economics to argue for lowering of trade barriers not just for trade among developed countries but also among developing countries and between developed and developing parts of the world. Economic openness - *or apertura* as the Latin Americans called it - became an important component of the advice most given by development experts to developing countries. Rather than develop behind high tariff walls and use other ways to insulate their economies, the developing countries should opt for openness.[7]

The experience of India which, after choosing relative openness over a tightly controlled economic system saw a quantum jump in its rate of GDP growth, is cited as evidence of the advantage in following this approach. However, there are those who believe that this advice should be taken with a large dose of salt by the developing world. "Free trade economists have to explain how free trade can be an explanation for the economic success of today's rich countries, when it simply had not been practiced before they became rich," writes Ha-Joon Chang (2007) a South Korean economist who teaches in Britain's Cambridge University. Although advocates of free trade extol the British as the pioneers of open markets, Chang argues that that is misreading of history. London reduced its tariffs in the mid-19th century only after its industries had firmly established their lead over potential rivals. Britain was not alone in following the protectionist approach to development. The United States maintained high tariffs throughout the period of its industrialization. However, if this reading of economic history is correct today's developing countries don't have the same policy choices. The World Trade Organization, created in 1995 following the completion of the Uruguay round of multilateral trade negotiations, came into existence with the full support of the developing world. It would not allow the world's trading nations to follow the kind of protectionist routes pursued earlier by some of the countries that are now developed.

This debate on the benefits of openness notwithstanding, Pakistan could have taken advantage of the expanding global trading system had it adopted the right kind of trade and development policies. Several developing countries benefited from this surge in international trade but Pakistan was not one of them. It did not benefit largely because it continued to focus its attention on conventional exports whereas the world trade was moving into a number of new and potentially more rewarding areas. Textiles and cotton products remained the dominant items of export for Pakistan. The share of non-traditional items remained close to insignificant.

Also in terms of the direction of trade, Pakistan continued to defy what was expected from the application of the "gravity model". According to this the share of trading partners in a country's total trade was determined by two factors: their mass and their distance. Applying this model to Pakistan would suggest that India and China would be the country's largest trading partners and not the United States. The United States while with a very large economy was more than 7,000 miles from Pakistan; it should not account for more than a quarter of Pakistan's exports. That the US was such an important destination for Pakistani exports was because of the emphasis placed by the government as well as the private sector on textiles. There was an expectation that after the end of the multi-fibre arrangement, the MFA, in 2005 which had restricted textile exports from countries such as Pakistan by prescribing quotas for their products, Pakistan would gain market share in the international market. It was in this expectation that a number of large industrial houses invested heavily in the modernization of their plants. But Pakistan did not increase its share; it was not able to compete with countries such as Bangladesh that continued to enjoy not only quota-free but also tariff-free entry into the markets of rich countries. This was the case because being "least developed countries", as defined by the United Nations, Bangladesh along with a number of African nations were allowed to export their textile products without any duty whereas Pakistani exports were subjected to import duties ranging from 15 to 18 per cent in the North American and European markets.

Pakistan also did not take full advantage of a new trend in international trade: regional trading arrangements, or RTAs, became an important component of the way nations traded with one another. It was the success of the European Union that led to an interest in this type of arrangement; by now more than 300 arrangements have been concluded among different countries. In some cases, one country may have membership in a number of different regional treaties. While Pakistan has also entered into a number of RTAs with the countries around its borders, the one that matters the most is the South Asian Free Trade Area, the SAFTA. However, for political reasons both India and Pakistan - South Asia's largest economies - have not given enough attention to this arrangement for it to have a real affect on the pattern of their trade[8]. India chose to focus on other arrangements which did not include Pakistan. One of these is BIMSTEC which includes all countries that are the members of SAFTA but Pakistan. It also includes Myanmar and Thailand. The attention given by India to this arrangement is a part of its long-standing policy of isolating Pakistan. While from New Delhi's narrow perspective such an approach may make some sense, there is little reason why Pakistan should also have neglected SAFTA. It did this believing - wrongly, of course - that it could use its membership in SAFTA as a lever to obtain concessions from India on such bilateral issues as Kashmir. The result is that while formally inaugurated on January 1, 2006 and while having become fully operational six months later on July 1, SAFTA has had little impact on the content and direction of Pakistan's trade.

In a US AID study, we estimated the impact on India-Pakistan trade if the SAFTA was allowed to change the trade regimes operated by the member states. "With the economy more open and with trade with India allowed free of the positive test of permitted exports and imports, India-Pakistan trade is likely to increase tenfold, from the current $2 billion (including informal trade) to $20 billion. In other words, of the 58 billion increase in trade projected for this period, $18 billion - or almost 31 per cent of the increase - could come from the increase in exports to imports from India."[9] In fact, our estimate was at the lower end of the one made by the World Bank (2003) using the gravity model according to which India-Pakistan trade has the potential of increasing more than 40-fold in the same period.

RTAs go beyond lowering of tariffs and facilitating trade; they also encourage member countries to cooperate on trade matters. This has not happened in the case of SAFTA. For instance, at the fifth ministerial meeting held at Cancun in 2005, the seven members of the organization failed to work together. India and Pakistan joined other large developing countries in a group that goes by the name of G-20; Bangladesh, Bhutan and Nepal joined the group of "least developed countries" while Sri Lanka decided to work with the group of developing countries that cooperated with the United States [(Kalegman (2007)].

With this as the background this report recommends a significant change in trade policy. It suggests that the state should pick some winners that have the potential to do well in international markets and provide incentives to the enterprises engaged in their production. These incentives should go beyond what states normally do - improve physical infrastructure, provide market information, invest in research and development, improve the quality of the available human resource - and also include the provision of financial subsidies through the banking system. Since such subsidies may not be totally compatible with the WTO requirements they can be fashioned in a way that would not make Pakistan non-compliant.

Developments in Global Finance

Over the last decade and a half significant changes have occurred in the structure of international financial markets. This has happened and is happening for a variety of reasons. Three of these are important from the perspective of a capital-short country such as Pakistan. One, developments in information and technology have reduced the reaction time of people operating in the financial markets. There is now a 24-hour news cycle in operation; nothing of importance happens in any part of the world without it being noted in the financial markets. This applies to both good news which identifies the opportunities that exist for investment and also bad news that makes the markets nervous. One consequence is the arrival of extreme volatility in capital flows. The best example of this is the 1997 Asian financial crisis when billions of dollars were withdrawn from several "miracle economies" of Asia because of the concerns that suddenly appeared for their long-term financial and economic viability. More recently, the assassination of Benazir Bhutto on December 27, 2007, resulted in the outflow of hundreds of millions of portfolio investment in the firms listed in Karachi stock exchange which caused the KSE 100 index to plunge.

The second important development that has influenced the structure of global finance is the appearance of new centres of savings. Continued trade deficits run by the United States, the world's largest economy, has produced surpluses in the export-oriented economies of Asia. These surpluses accumulated by the exporting countries are reserves invested largely in the US treasury which made it possible for the Americans to continue to run large trade deficits. More recently, however, some of the capital surplus countries have created a new investment vehicle, the sovereign funds. The Chinese have placed $300 billion in such a fund, a modest amount given the size of their reserves, now estimated at $1.5 trillion. But the size of the fund is likely to increase as the country gains experience in managing the fund. Oil exporting countries of the Middle East have also opted for the use of this vehicle for managing their surpluses which have grown significantly because of the sharp increase in the price of oil. In all sovereign wealth funds control more than $2 trillion, a figure that could approach $12 trillion by 2015 according to some estimates [Thomas (2008)].

For developing countries, private flows have become a much more important source of finance than official development assistance. This is also the case for Pakistan. During the 2002-07 period, when the Pakistan's economy expended at the rate of 7 percent a year with income per head of the population increasing at a respectable rate of 5 percent per annum, considerable support for growth was provided by private foreign capital. This came in largely in three different forms: private direct investment, much of it associated with privatization of the assets owned and managed by the government as well as mergers and acquisitions in the the private sector; portfolio investments which made the Karachi stock market one of the more buoyant capital markets in the developing world; and investment and remittances sent by the members of the large Pakistani diasporas in the Middle East, Britain and North America. Given political instability that has plagued Pakistan for the last several months and led to the rise of Islamic extremism in the country and brought suicide bombings to the country, would foreign capital follows continue and be available in the quantity required to sustain a high level of growth? Even if the political situation improves and Pakistan is able to develop a structure that would help to stabilize politics and even if the rise of Islamic extremism can be curbed, it is still important for Pakistan to change the model of development it has followed since it achieved independence. It has to follow a strategy that factors in some of the prescriptions that have gained salience in modern economics.

Demographic asymmetry

The last important change in the structure of the global economy we will discuss in this report has been produced by what we have described elsewhere as "demographic asymmetry" - the significant difference in the rates of fertility in rich countries on the one hand and populous developing countries on the other. These differences are most tellingly reflected in the age composition in the populations in these two parts of the world. To take one example: Pakistan's total population is slightly more than one-half the population of the United States. However, Pakistan has the same number of people below the age of 20 as the United States whereas the US has four times the number of people above the age of 65 compared to Pakistan. The rapid aging of the populations in developed countries are producing a number of stresses in their economies which can be taken care of only by the import of young workers from the developing world as well as outsourcing of work from developed and developing countries. Both are happening. This has created an opportunity for countries such as Pakistan.

AN AGENDA FOR CHANGE

The main purpose of this report is to present an agenda for change; to suggest how Pakistan could restructure its economy and take advantage of the changes that have taken place in the global economic system. While much of what we recommend is aimed at the public sector - at the administrations at the federal as well as at the provincial levels - our suggestions are also worth the consideration of the private players in the economy. Our agenda covers ten points some of which are drawn from the analysis in this chapter while the remaining will be developed in the chapters that follow.

1. An appreciation of changes in the structure of the global economy and politics:

We believe that the government should inform itself more than it has done in the past about the structure of the global economy. While the changes that have occurred in the world economic system means that some of the opportunities that helped a number of Asian economies to develop in the last several decades, there are still many opportunities available to a "catch-up" economy such as Pakistan. To understand what they are, the government should study the evolving system of international production, the changing pattern of trade, the evolving system of global finance, and the demographic changes that are taking place in developed countries. In all of them there are opportunities for Pakistan.

Policymakers should also understand the changes that are taking place in the distribution of wealth and economic power in the globe. Some analysts have suggested that the world is moving away from the unipolar system that emerged after the collapse of the Soviet Union in 1991 and the emergence of the United States as the sole superpower. They believe that the world is moving rapidly towards a three-power system centered on the United States, the European Union and China. According to Parag Khanna, an American scholar of Indian origin, a new system is evolving in which at least three global economic powers will compete with one another for influence and also for resources. "At best America's unipoloar moment lasted through the 1990s but that was also a decade adrift" he writes in a recently published book. "The post-cold-war 'peace dividend' never converted into a global liberal order under American leadership. So now, rather than bestriding the globe, we are competing - and losing - in geopolitical marketplace alongside the world's other superpower: the European Union and China. This is geopolitics in the 21st century: the new Big Three. Not Russia, an increasingly depopulated expanse run by Gazprom.gov; not an incoherent Islam embroiled in internal wars, and not India, lagging decades behind China in both development and strategic appetite. The Big Three make the rules - their own rules - without any one of them dominating. And the others are left to choose their suitors in the post-American world."[10]

How will this new world dominated by three economic players look like and what kind of adjustments should Pakistan make to this development? Some clues to formulating an answer to this question have begun to emerge by the way the Americans, the Chinese and the Europeans have begun to conduct business, both in politics and economics. Two of these three centers of power have their own peripheries which they would want to influence and have begun to do so. The Europeans will continue to work with their immediate neighbors which include the Soviet Union, the Middle East and North Africa. The Chinese will continue to take interest in East Asia, the Central Asian "stans", the Middle East and the resource rich countries of Africa and Latin America. It is only the United States that will continue to project its economic and military power across the globe.

Let us get back to the second part of the question posed above: What does this rearrangement of global economic-political system imply for Pakistan? For most of the country's history, Pakistan has worked closely with the United States. The reason for this is that for the first half century after its birth, the country remained preoccupied with what it perceived to be the Indian challenge. To the policymakers in Islamabad, Washington seemed to offer a way for balancing the growing power of India. It was not often realized that if the United States favored Pakistan it did so for its own reasons and not to help Pakistan deal with its anxieties. Whenever there was confrontation with India, the United States stepped back and did not offer the support Pakistan had hoped for.

First under Zulfikar Ali Bhutto in the 'seventies and later under Pervez Musharraf, Pakistan's foreign policy stance has shifted. In the 'seventies, Pakistan was successful in developing a close relationship with China and under Musharraf it has been successful in removing the India-centric approach to the making of foreign policy. Nonetheless, the focus remains on the United States. Washington's war against terrorism after 9/11 and the fact that the northwestern Pakistan is one of the two places - the other being Iraq - that have become the theatres of this struggle has kept Islamabad's attention focused on Washington.

The close strategic alliance with the United States, especially during the rule by the military, also affected the government's economic policies. Pakistan became highly dependent on capital flows from the United States to the extent that it disregarded one of the basic premises of development economics: that sustainable growth is only possible if it is based on mostly internal resources. The dependence on the US produced a roller-coaster ride for the country: the economy performed well when Pakistan was in favor with the United States; it did poorly when the flow of American resources became constrained. But that was not the only dependence Pakistan created for itself. It also tied its export sector closely to the United States. Contrary to what the "gravity model of trade" suggests the US rather than China and India became the largest trading partner for the country. If the conclusion reached by Khanna in his closely argued book is correct and if the new world order will have three large players dominating the global system in all its manifestations, then it is necessary for Pakistan to reorient its economic policies.

There are many indictors that the Americans are losing the dominant role they once had in the global economic system. One of them is the establishment of sovereign funds as vehicles for investment by the countries that have surplus capital. As discussed above, some of these funds, including the largest, the Abu Dhabi Investment Authority, are located in areas geographically close to Pakistan. While the movement of finance is constrained by distance, proximity does bring familiarity on the part of the fund managers. It is not surprising that the sovereign funds in Abu Dhabi and Dubai are supporting a number of very large investments in Pakistan in telecommunications and real estate development.

Policymakers in Pakistan should explicitly factor in Pakistan's somewhat unique geographic location into strategic thinking. It is the only reasonably large economy - the other two, Nepal and Bhutan, are too small to be of much significance for the development of the Asian region - that shares borders with the two billion plus countries in the world in terms of their population. They also happen to be among the most rapidly growing economies in the world. And if Khanna is correct one of them - China - is the third pole of the tri-polar world that is evolving.

The task for studying the structure of the global economy and the redistribution of global political power should be assigned to the Planning Commission, the Foreign Office, and the Ministry of Commerce and should draw upon the experience available in other ministries/departments. The main purpose of this exercise would be to identify the niches that are potentially available to the Pakistani economy. Based on this analysis the government should rewrite and reissue the 2030 Vision statement.

2. Picking the winners:

After studying the changes in the global economic system and developing an understanding of the way it is evolving, state functionaries should pick the winners they would be prepared to support. "Picking the winners" strategy was followed successfully by the miracle economies of East Asia in the quarter century between the early 'seventies and the late 'nineties. This approach lost its popularity when an influential group of economists developed what came to be called *The Washington Consensus.* The argument behind this consensus was that the state can go terribly wrong in picking the winners; this is the job of the market. The states should let the markets find out what are the sectors and activities that could succeed in the global economy. *The Washington Consensus* is now being reevaluated and there is an emerging consensus that the state can play a role in choosing some areas for concentration. However, for this to be done, policymakers should carefully identify what some analysts have called "product space" and determine "the density of the forest" for a particular economy [Hansmann, and Klinger (2006)].

Translated into simpler language what this implies is that countries can move from one set of products in which they have been engaged in towards another set which has higher productivity and higher value added by mapping the space the economy occupies. Such maps will reveal that the "trees" (activities) of the economy are generally clustered together; the forests (clusters) are dense in more developed countries than in those that are less developed. Such mapping for Pakistan will reveal that the forest is dense around activities involving cotton products but moving to higher value activities will not be very productive for the economy since there is not much space available in the international economy for their absorption. The trick for the state is to identify other forests which may be less dense but for which there are both external and internal demand and for which migration of workers and capital is possible from one type of tree (activity) to another within the same forest (cluster). It would be more advantageous for the economy to place emphasis on agro-processing, sports goods, leather products, surgical goods, hospital equipment, small-scale engineering in which some skills are available and for which there is growing external demand. Economists such as Ricardo Hausmann and Bailey Klinger have developed models which would help identify more clearly which "trees" in the Pakistani economic forest should the state concentrate its attention on. Chapter 9 of the report focuses on the promise of Pakistan's exports and how the potential can be exploited by appropriate policies.

Once these winners have been identified, what are the avenues available to the state through which support could be provided? There are at least three ways in which help can be identified. Fiscal incentives can be given. These are now well identified in economic literature which takes note of the restrictions that have been placed by the WTO on the type of help that can be provided. Even more important is the need to promote research and development in the chosen areas. Empirical work done at the World Bank suggests that the expenditures on R&D doubled over a periods of ten years in all those countries that have gone through the Rostowian stage of take-off. R&D expenditure remains low in Pakistan. Empirical work also suggests that the countries that have succeeded in promoting economic development have done so by encouraging research by the private sector. About 10 per cent of the R&D effort is done by the universities, another 20 per cent by government institutions and the remaining 70 per cent by private sector corporations. In other words, Pakistan will not only have to increase the proportion of GDP it spends on R&D, it will also need to motivate the private sector to commit a sizeable amount of resources to this activity. Finally, the state will need to improve infrastructure needed by the chosen industries activities before they can make a contribution to the economy.

3. The role of the state:

The state in Pakistan - not just at the federal level but also at the sub-national levels - will have to play a more active role than was once considered prudent by development economists. Under the set of policies advocated in the context of what came to be called *The Washington Consensus*, the state's role was reduced to that of a bystander while that of the private sector was given considerable prominence. This was a swing in the pendulum after the state, for almost four decades, played a much more prominent role. Two developments in the 'eighties encouraged the view that the state had to pull back a great deal from the position it had begun to occupy. The first was a severe economic crisis in India in the mid-eighties that led to the abandonment of the "license raj" and allowance of much greater space to the private sector. As Gurucharan Das (2002), one of the many chroniclers of the consequences of the opening of the Indian economy, wrote "Indians have learned from painful experience that the state does not work on behalf of the people. More often than not, it works on behalf of itself." The second event was the collapse of the Soviet Union in 1991. The early Soviet experience with rapid industrialization under the control of the state had inspired many leaders of the developing world to opt for putting the public sector on the commanding heights of the economy.

Development economists are now prepared to grant a larger role to the state in moving the economies forward than was the case when *The Washington Consensus* was all the rage. What does this mean in the context of Pakistan? This report has identified a number of areas where the state in Pakistan could concentrate its efforts to accelerate the rate of economic change and increase the rate of GDP growth. For these areas to show results, the state will need to improve both physical infrastructure as well as the quality of the workforce available in the chosen sectors. It will need to provide information to the private operators about the markets that can be exploited by them. But it may need also to provide financial incentives to the entrepreneurs operating in the chosen sectors, as highlighted in Chapter 6 of the report.

4. Focusing on the development of information and communication technologies:

As has happened on a number of other occasions and in a number of other areas, Pakistan is missing out the opportunities offered by changes in the global economy and developments of new technologies in the area of information and communication. The country is performing poorly in developing better access to broadband which should be provided not through fixed lines but by the use of wireless technology. For that to happen the state will have to be more proactive than it has been in the past. This will involve at least three specific steps. One, the use of subsidies, to be provided over a limited period, in order to attract private operators in the areas that are fairly capital intensive. This should be done in a transparent manner in order not to create rents for the operators and those involved in the decisions to provide financial assistance. Two, to create opportunities for the private sector by making the government move more rapidly towards the adoption of various "e-technologies" in its own operations. Three, to facilitate the development of skills in the area. Pakistan continues to face serious skill shortages in this sector.

This objective could be achieved by the use of these steps by announcing a plan to improve the penetration of broadband over a specified period, say, five years. The cost to the government for implementing the plan should be worked out and made public. The implementation of the plan should be reviewed at least once a year and a report presented to the national assembly for debate.

5. Increased emphasis on the sector of agriculture and changing the structure of the economy:

While economic growth and economic modernization brings about a significant change in the structure of the economy with the manufacturing sector first overtaking agriculture as the predominant sector and later giving way to modern services, this change may have gone further in the case of Pakistan than warranted by its endowments and its geo-economic position. If the policy agenda proposed in this report is adopted, it may not only initially arrest the decline in the share of agriculture in the gross domestic product but increase it. By emphasizing the move towards value-added agriculture not just in Punjab but in all provinces of the country, there is a good possibility that the structure of the economy would change and incrementally increase the role of agriculture. The large jump in international food prices provides Pakistan a real opportunity to exploit its strong agricultural base to generate larger exportable surpluses. As discussed in Chapter 6 the province of Punjab can once again become the 'food granary'.

6. Decentralization and devolution of the authority of the state:

There are several issues of governance that have relevance for economic management. It is necessary for a country as large and diverse as Pakistan to bring government closer to the people. This change in the way the country is governed will not need tinkering with the constitution but a change in the way the ruling elite looks at the issue of governance. This calls for considerable devolution of authority from the federal to the provincial government and from the provinces to the newly established local governments. This report focuses in particular in Chapters 7 and 8 on the question of decentralization and devolution of economic authority from the federal government to the governments in the provinces and from the provinces to the newly established local government institutions. Pakistan is too large a country to be governed from Islamabad and some of its provinces are too large either in terms of population (as is the case with Punjab) or in terms of the area (as is the case with Balochistan) to be governed from the provincial capitals. Decentralization and devolution will not require a significant change in the country's basic law, the Constitution of 1973, or many changes in the Local Government Ordinance of 2001. What is required is political will to transfer some of the authority currently exercised by Islamabad and the provincial capitals.

7. Placing trade at the center of the strategy for development:

The government should place trade at the center of its development strategy. The aim should be to develop a line of products that have growing markets available in both developed and developing countries. With this mind, Islamabad should devote considerable energy to developing trade with India and China. We believe that this will help Pakistan in many different ways: it will restructure the economy in line with the country's comparative advantage, increase employment as well as reduce the incidence of poverty, and set the stage for higher level of sustainable increase in GDP.

8. Focus on inter-provincial and intra-provincial income disparities:

Pakistan has not explicitly adopted an economic strategy aimed at addressing the growing problem of acute income and wealth disparities among its four provinces and in the regions within the provinces. This is unfortunate since there are serious social and political consequences for allowing some regions and provinces to lag behind those that have made impressive gains in the past. The reason why the country is currently faced with serious discontent in the provinces of Balochistan and the Northwest Frontier is partly the result of this neglect as highlighted in Chapter 7 of the report. The strategy of growth proposed in this report would help to focus attention on the more backward areas of the country. By giving a great deal of attention to the production of some high value added crops - fruits and flowers in the areas of Balochistan and the Northwest Frontier Province where horticulture has been practiced for centuries, oilseeds in the rain-fed areas of the Potohar plateau in northern Punjab - would provide the poor people of these areas with sources for income. By encouraging the development of the livestock sector in the desert areas of Sindh (Tharparkar) and southern Punjab (Cholistan) where considerable potential exists and where some work in this direction has already begun, the policymakers will help to bring economic relief and opportunity to these long-neglected areas. By developing the needed physical infrastructure to allow the surpluses from the areas to enter the export market, the government would pave the way for bringing the backward people of these communities into the modern world.

But agriculture and animal husbandry are not the only areas of economic activity that would help the development of the areas of the country that have been left behind. Opportunities exist for encouraging the development of small scale industry to exploit the resources that are available and the skills that are already present.

Some of the backward areas have natural resources in abundance - copper in Balochistan and coal in the Tharparkar desert of Sindh - that could be exploited. However, for that to be done in way that would bring economic growth and development to these backward places, the government should devise a policy for adequately compensating them for the advantage the exploitation of these resources would bring to the rest of the country. This was not done when the Sui gas fields were developed over the last four to five decades. This has been a source of serious contention on the part of some people of Balochistan. A formula for sharing the income drawn from these resources should be worked out and embedded in the National Finance Commission awards, as discussed in Chapter 7 of the report.

9. Dealing with urbanization:

In spite of the large increase in the size of the urban population and a rate of urbanization that has been more rapid than for most countries at Pakistan's stage of development, the country has not developed a consistent and viable approach towards dealing with the problems and making use of the opportunities produced by urban growth. As suggested in the discussion on urbanization in the previous section, policymakers need to distinguish among the different dynamics that operates in different parts of the urban sector and adopt public policies specific to each one of them. This means that the country does not need one urban policy but four: one for the large cities, one for the peri-urban areas that surround the large cities, a third for the middle sized cities and the fourth for small towns. That notwithstanding there will be one thing common in these approaches: in all of them there has to be greater space given to the institutions of local government. Chapter 6 of the report discusses, for example, the need for a more balanced hierarchy of cities in the large province of Punjab.

10. Interesting the Pakistani Diasporas in the development of the homeland:

Pakistan should make a concerted effort to draw upon the resources available with its diasporas in the Middle East, Britain and North America for investment in the homeland. The aim of this effort should be to draw this resource into the sectors that would help the country in increasing the level of employment and reducing the incidence of poverty in particular by investing in education. The diaspora is already making a major contribution by remitting over 5 billion dollars. The focus should be on how to use the financial and human resources of the diaspora, in line particularly with the experience of China and India.

CONCLUSION

This report has focused on, one, the need to study the structure of the global economy in order to identify the opportunities that are available to a country such as Pakistan. Pakistan has fallen behind other rapidly developing countries of Asia in not being able to place its economy on a trajectory of growth that would ensure a significant increase, year after year, in its economy, while making the rewards of growth available to all segments and all regions of the country. This can be done by finding a place for the country in the global economy. The report has also identified a number of areas that need the attention of the state in order to obtain high levels of sustainable growth in GDP. The areas identified need to be embedded in a development framework that spells out the role of the government and the private sector. We believe that by adopting this two-step approach the country could achieve a rate of growth of 7 to 8 per cent a year over the medium term. If that were to happen with the aid of the policies identified in this report, a new structure of the economy would evolve and the country would be better integrated into the global economic system. Also, the incidence of poverty would decline at a more rapid rate and the disparities in income per capita in different parts of the country would be reduced.

Chapter - 4

Institutional Imperatives of Poverty Reduction

Chapter - 4
Institutional Imperatives of Poverty Reduction[1]

INTRODUCTION

The high food inflation in the last three years has pushed 11 million people into a state of hunger and poverty. Given the present trend, if no policy action is taken, an additional 22 million people will be impoverished over the next four years. According to the World Food Programme Survey for the Vulnerability Analysis and Mapping Unit as many as 77 million people up to March 2008 are deemed "food insecure"[1], where the food insecure population is defined as those consuming less than 2350 calories per person per day. The statistical evidence clearly shows Pakistan is in the grip of a poverty crisis, which has already driven some people to suicide.

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

This paper provides evidence to show that the poor have unequal access over capital, land and labour markets. It is argued therefore that inequality and poverty are built into the structure of the growth process itself. It is now widely recognized that inequality adversely affects both the sustainability of growth as well as its capacity for poverty reduction World Bank (2006). The power structure, and the inequality it engenders, excludes a large proportion of the population (poor, women, the sick and the illiterate). Therefore there is a constriction of the human potential through which entrepreneurship, investment, innovation and productivity growth can occur to sustain GDP growth.

Until 2003, most studies on poverty in Pakistan had examined the problem simply in terms of measuring the number of people below certain poverty lines. However if poverty is to be overcome, it is important to understand the processes of poverty creation and to identify points of intervention in the process through which the poor can be enabled to overcome poverty on a sustainable basis. In this context some of the questions that arise are: How do distorted markets for inputs and outputs of goods and services result in the loss of the actual or potential income of the poor? How do local structures of power with respect to landlords, local administrative officials, and institutions for the provision of health, credit and dispute resolution, deprive the poor of their income, assets and the fruits of their labour? These questions will be examined in the first section of the chapter. Equally important for an understanding of the nature of poverty and the growth process is the question of how the institutional structures of governance and the incentive systems embodied in government policy constrain growth and poverty reduction.

The argument in this chapter is that poverty is rooted in the institutional structure of society and state in Pakistan. Therefore overcoming poverty will involve inducing changes in both the polity and the economy as part of an integrated process of institutional change. As North (2005) has argued, the polity is the fundamental basis of economic performance. This is because it is in the realm of the polity that the "rules of the game" and the associated incentive systems for the economy, are stipulated. In this chapter however while acknowledging the primary role of the polity, we will focus on institutional changes in the economy as the basis of sustainable growth with equity (North, Wallis and Weingast (2006).[2]

It is in moving towards a stable democratic constitutional order that Pakistan can create the institutional conditions for sustained and equitable growth: opportunities in the polity and economy for all citizens, merit based selection, competition, efficiency and innovation. Thus the path to democracy within a stable constitutional order is also the path to sustainable and equitable economic growth.

In first and second sections of this chapter the structural factors that constrain growth and induce endemic poverty have been identified. These structural factors are located in the institutional framework that conditions both markets and governance. In the third section we briefly indicate some of the policies for institutional change in the medium term that can be undertaken to overcome the structural constraints to equitable growth. In the following section an analysis of poverty trends during the Musharraf regime 1999-2008 is presented alongwith with new estimates of the impact of food inflation on poverty during the last three years. Finally the last section focuses on short term policy actions for addressing the poverty crisis.

MARKETS, INSTITUTIONS AND POVERTY

In this section the four features of the power structure that make markets asymmetric to function adversely against the poor, are examined.

Power, Tenancy and Tied Labour

In landlord dominated areas, where landlords control the local state apparatus as well as the credit market the poor tenants are locked into a nexus of power and debt bondage with the landlord. Consequently the tenants are obliged to work part time on the landlord's farm as labourers either at less than market wage or no wage at all. The NHDR survey data shows that 51 percent of the tenants get locked into debt dependence on the landlord, and out of these, 57 percent are obliged to work as labourers on the landlord's farm without wages, while 14 percent work for a wage below the market rate (Hussain et.al., 2003). Thus the structure of power and dependence creates distortions in the labour and capital markets, which systematically deprive the poor of their actual and potential income. The consequent inefficiency in the allocation of labour and capital resources constrains agricultural growth, increases inequality and engenders persistent poverty. (See Table 4.1).

TABLE 4.1
LOAN DEPENDENCE ON THE LANDLORD AND LABOUR EXPLOITATION OF THE POOR PEASANTRY

	Extremely Poor	Poor	Non-Poor	Total
Loan from landlord (%)	50.8	29.4	11.7	34.4
Work for landlord against wages (%)	14.0	24.3	5.1	16.9
Daily wages (Rupees)	28.0	43.6	60.0	40.0
Work for landlord without wages (%)	57.4	38.5	25.4	43.5

Source: NHDR/PIDE survey 2001.

Power and the Double Squeeze on the Peasantry

In landlord dominated areas the landlord's power impacts the disposal of the produce by poor farm households which have direct consequences for their food consumption. As Table 4.2 shows, under asymmetric tennurial arrangements, the extremely poor farmers are obliged to pay a larger proportion of their farm produce to the landlord as rent, compared to other categories of

TABLE 4.2
DISPOSAL OF CROP HARVEST BY INCOME CLASS

	Total Production Value (Rs)	Paid in kind to Labour (Value)/Total Production Value	Paid as Rent (Value)/Total Production Value	Paid to landlord under share cropping agreement (Value)/Total Production Value	Given to Relatives (Value)/Total Total Production Value	Crop Sold (Value)/Total Production Value	Crop Kept for Own Use/Total Production Value
Extremely Poor	13864	1.45	1.10	28.21	0.09	29.57	39.59
Poor	22538	2.76	1.40	13.39	1.06	33.27	48.12
Non-Poor	37626	4.70	0.83	8.41	1.61	30.02	54.43

Source: NHDR/PIDE Survey 2001.

the peasantry. For example, the extremely poor have to pay 28.2percent of their production value to the landlord, compared to 13.4 percent by the poor households and only 8.4percent by the non-poor households. Consequently, the extremely poor households are forced to keep only about 39.6 percent of their crop output for household consumption, compared to 48 percent by poor households and 54 percent by non-poor households.

The evidence suggests that due to the relatively smaller crop share retained by the poor tenant households, they face a food deficit near the end of the year. As they run out of their household stock of food grain, they are obliged to purchase grain in the market at year end when market prices are relatively high. Such households are then faced with the necessity of borrowing for food consumption. This is also suggested by the NHDR evidence, which shows that the extremely poor households borrow for food consumption.

Poor farm households are thus placed under a double squeeze: first, by the power of the landlord, who obliges them to give up a relatively larger proportion of their crop output as a crop share to the landlord. A second squeeze is placed by the seasonal variation in the market price of grain, which obliges the extremely poor households to purchase a relatively larger proportion of their food consumption requirements from the market near the end of the production cycle, when prices are high.

Adverse Changes in Tenancy Arrangements and Poverty

Since majority of the rural poor are tenants any deterioration in tenancy arrangements is bound to accentuate poverty. Due to weakening relative power position of poor tenants, tenancy arrangements have changed adversely against them. They now have to bear a higher proportion of input costs compared to the landlord on the tenant operated farms. For example as the Table 4.3 shows the contribution of tenants to input costs (for each of the major crops) such as tractor rental, hired labour, seeds and fertilizers has increased during the period 1990-91 to 2000-01.

TABLE 4.3
CONTRIBUTION OF TENANTS TO INPUT COSTS

(%)

	1990-91				2000-2001			
	Tractor	Labour	Seeds	Fertilizer	Tractor	Labour	Seeds	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
Non-poor	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: NHDR/PIDE Survey 2001.

GOVERNANCE, INSTITUTIONS AND GROWTH

In this sub-section we will show how the institutional structure of governance constrains the provision of adequate health, education and security, which are major factors in perpetuating poverty. We will also show how the incentive system implied in rent seeking based governance constrains sustained and equitable growth.

Poverty and Illness

The NHDR showed that due to inadequate diet and lack of access over safe drinking water and sanitation facilities, 65 percent of the extremely poor and 55 percent of the poor in the sample survey were suffering from ill health. The data also shows that the poor respondents reporting sickness at the time of the interview had on average suffered from their sickness for 95 days of the year. (See Table 4.4).

TABLE 4.4
PERCENTAGE OF POOR WHO ARE SICK, NUMBER OF DAYS OF SICKNESS, TREATMENT EXPENSES AND DISTANCE TRAVELLED FOR MEDICAL CONSULTATION [HEAD OF HOUSEHOLD ONLY]

	Sick at the Time of Survey (%)	Number of Days in Current Sickness (Mean)	Treatment Expenses (Rs.)	Percent of Patients Travelling over Kms.
Extremely Poor	65.1	94.0	1885	49.4
Poor	55.6	27.4	497	29.5

Source: NHDR/PIDE Survey 2001.

The study showed that the prevalence of disease amongst those who are slightly above the poverty line is a major factor in pushing them into poverty. Those who are already poor get pushed into deeper poverty as a result of loss of income due to absence from work, and high medical costs resulting from illness. Thus the unequal access over public health facilities and the relatively high prevalence of disease amongst the poor becomes a structural factor that further accentuates both poverty and inequality.

Education, Poverty and Growth

Although the literacy rate has increased 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[3]. The gross primary school enrolment rate has gone up but net enrolment has grown at a much slower pace over the last two decades. 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.

The survey evidence in the Pakistan National Human Development Report shows that one of the key factors that can pull a poor household out of poverty is whether or not the family has a second earner. The data indicates that the magnitude of the second earner's income depends on the level of education.

Poverty, Justice and Citizens' Security

The poor live in localities both rural and urban, which are inadequately policed and in case of theft or violence against their person the cost of seeking redress through the judicial system is in most cases unaffordable and where undertaken, the expenses in terms of time and money, lock the poor into permanent debt. This is another factor that engenders endemic poverty, reinforces inequality and thereby constrains economic growth. [See Table 4.5].

TABLE 4.5
FREQUENCY OF DISPUTES, RESOLUTION AND COST OF RESOLUTION BY ECONOMIC STATUS (CASES REPORTING DISPUTES ONLY)

	Distribution of Reported Disputes (%)	Amount spent on Mediation (Mean)	Reported Disputes Resolved (%)
Extremely Poor	17.1	Rs. 18,333	38.5
Poor	48.7	Rs. 12,074	59.5
Non Poor	34.2	Rs. 18,264	80.8
Total/Average	100	Rs. 15,123	63.2

Source: NHDR/PIDE Poor Communities Survey 2001.

Low Domestic Savings Rate, Taxation and Growth

Given the rent seeking based governance model in Pakistan the business elite enjoys various forms of financial support from the government (subsidies, cheap credit, import protection, tax exemptions). Therefore, it is not surprising that entrepreneurs (many of whom are also landlords) following the tradition of the landed elite engage in conspicuous consumption and tend to have a low propensity to save. An estimate of the revenue cost of concessions to the rich is given in Chapter 5.

The high debt servicing requirements resulting from a tendency of the rent seeking elite to consume rather than save, and at the same time avoid direct taxes, has obliged successive governments to charge high and increasing rates of indirect taxes. Thus the rent seeking based governance model and its incentive systems have induced a pattern of elite consumption and government tax policy that further reinforces income inequality in the growth process.

Institutions, Export Structure and Growth

Pakistan's slow export growth and the consequent perennial pressures on the balance of payments constitute a structural constraint to sustaining high GDP growth. Slow export growth is rooted in the rent seeking nature of the industrial elite and its failure to diversify into non-traditional high value added exports, as highlighted in Chapter 9.

Official Corruption and Poverty

Poverty and inequality increased during the 1990s due to the decline in foreign aid flows and the resultant slowdown in GDP growth, coupled with a decline in employment elasticities, labour productivity, and real wages in both the agriculture and the industrial sectors. In the subsequent period, 1998-99 to 2004-05, while GDP growth accelerated sharply there was no significant poverty reduction. (See Table 4.7). This proposition is also established in the recent work of Anwar(2006) and Gazdar.et.al(2008). At the same time unemployment as well as inflation rates, particularly food inflation, increased sharply. The economic burden on the poor has intensified further due to inadequacies in governance.

Widespread corruption in government contributes to constraining growth and increasing poverty in three ways: (a) the rising magnitude of corruption over time and at different levels of decision making in the government is a major factor in the uncertain policy environment and a constraint to estimating accurate project feasibilities. This would be expected to constrict investment, GDP growth and employment; (b) the transfer of resources from entrepreneurs to politicians and government officials results in a misallocation of national resources and a lower level of productive investment and hence GDP growth, than would be the case in the absence of such corruption. (c) the financial cost of individual projects increases, thereby simultaneously inducing slower GDP growth for given levels of investment and also reducing the employment elasticities with respect to investment. (d) To the extent that the poor are obliged to pay bribes for public services while in many cases the affluent with political influence may not have to pay bribes, means that the distribution of real income between the rich and the poor is worsened by the mode of provisioning of public services.

Institutional Factors in Slow and Unstable Crop Sector Growth

In agriculture the average annual growth rate of major crops has declined from 3.3 percent during the eighties to 2.4 percent in the nineties. At the same time, the frequency of negative growth years in some of the major crops has increased. This has accentuated the process of poverty creation: In a year of negative growth (i.e. bad harvest) the small farmers operating at the margin, have to borrow for consumption requirements and go 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 the increased frequency of negative growth years becomes a structural factor in poverty creation. Underlying this phenomenon are five major institutional constraints:

(a) 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, the requirement of water at the farm level has increased due to increased deposits of salts on the top soil and the consequent need for leaching[4]. The consequent large water deficit means that the farmers even in the irrigated areas are dependent on rain fall. Given the vicissitudes of weather particularly due to global warming, (which has caused wide variation in the timing, location and quantum of rain fall) rain does not always fall in the right quantity at the right time for the water deficit farmers. Consequently, there is greater instability in crop sector output than before.

(b) What makes improved efficiency of irrigation even more important is that the extensive margin of irrigated acreage has been reached, so the 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 for improving irrigation efficiency has become a crucial policy challenge for sustainable agriculture growth.

(c) It is well known that high yielding varieties of seeds gradually lose their potency through re-use, changing micro structure of soils, and changing ecology of micro organisms in the top soil. In wheat for example the average age of seeds in Pakistan is 11 years compared to 7 years for all developing countries. Therefore, breeding of more vigorous seed varieties adapted to local environmental conditions, and their diffusion amongst farmers through an effective research and extension programme is necessary.

(d) A new dimension to the imperative of improving research capability in the crop sector is indicated by the possibility of declining yields per acre related with global warming. Given the sensitivity of wheat seed to temperature increase, even a 2-degree centigrade increase in average summer temperatures could mean an absolute yield decline of between 10 to 16 percent during the 21st century. [Quareshi and Iglesias (1992)] With a 1.8 percent population growth, even a decline of 5 percent in yield per acre associated with global warming, could mean serious food deficits and high food inflation rates for Pakistan, with relatively greater adverse consequences for the poor. It is, therefore, necessary to develop heat resistant varieties of food grains.

(e) One of the most important constraints to sustainable growth in the crop sector is the degradation of soils, resulting from improper agricultural practices such as: (i) lack of crop rotation and the resultant loss of humus in the top soil; (ii) stripping of top soil and resultant loss of fertility associated with over grazing; (iii) water erosion along hill sides and river banks due to 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 and Mirza (1993)]

Institutional Constraints to Growth in the Large Scale Manufacturing Sector

The growth rate of the manufacturing sector was 8.2 percent in the 1980's, and fell to 4.8 percent in the 1990s. In the subsequent four years (2001-2005) the growth of this sector accelerated sharply, but has begun to decline again in the last two years. The factors underlying the tendency for large scale manufacturing to decline are as follows:

(a) A fundamental structural constraint to industrial growth as indeed the underlying factor in slow export growth, is the failure to diversify exports. The large scale manufacturing output, particularly exports are concentrated in the traditional low value added end of textiles, as highlighted in Chapter 9.

(b) A changed pattern of global demand for industrial products with a shift towards higher value added and knowledge intensive products. Pakistan's industrial structure was not positioned to respond quickly to these changed market conditions.

(c) An erosion of the domestic framework within which investment and growth is sustained. This includes: (i) a continued threat to the life and property of citizens due to the persistent poor law and order situation; (ii) high electricity tariffs and loadshedding; (iii) lack of trained professionals especially in the high skill sector; (iv) an inadequate technological base through which industry can respond in a flexible way to changing patterns of demand; (v) an adverse policy environment within which tariff and export incentives were distorted against those entrepreneurs who were seeking to improve quality and productivity for export growth; (vi) dumping of smuggled, poor quality and extremely low priced imported goods which are in many cases counterfeit copies of branded Pakistani manufactured goods.

POLICIES FOR ADDRESSING THE STRUCTURAL CONSTRAINTS TO GROWTH AND POVERTY REDUCTION

In the preceding section we have identified some of the structural factors underlying endemic poverty and unstable growth. In this section we will indicate briefly the policies that can be undertaken to overcome the structural constraints to sustained and equitable growth.

Empowering the Poor for Market Access

The evidence shows that asymmetric markets and local power structures constitute structural factors in persistent poverty. They siphon off as much as one third of the actual incomes of the poor, deprive them of their potential savings and keep their productivity and incomes at a low level. A pro-poor policy must address these structural factors if poverty is to be overcome on a sustainable basis. Better access for the poor over the markets for labour, land, agricultural inputs and outputs, means changing the balance of power in favour of the poor at the local level. This requires facilitating the emergence of autonomous organisations of the poor, particularly poor women at the village, Union Council, Tehsil and District levels. It also means enabling the poor to access credit, training, and technical support for increased employment, productivity, and incomes.

Land for the Landless

One of the most important factors in endemic poverty in the rural areas (where the majority of Pakistan's poor reside), is the fact that millions of households do not have access over land or their ownership of this productive asset is less than the critical level required for subsistence. The data show that the poor peasants where they own land have on average two acres while the bigger farmers are able to rent additional land. The poor ones either rent out their small holdings for a pittance or are obliged to sell their land altogether. As many as 76.5 percent of the extremely poor farmers and 38.9 percent of the poor farmers sold their land over the last 10 years. The evidence shows that the poor had to sell their land for urgent consumption needs related with health expenditures, crop failures and marriages. Thus lack of access over this vital productive asset is an important structural factor in endemic poverty.

In order to alleviate the problem of landlessness it is proposed that the government launch a programme of allotting state owned land to the landless as part of its overall strategy of growth with poverty reduction. However, it is important to recognize that providing ownership of land to the landless is a necessary but not a sufficient condition for alleviating their poverty. Enabling the landless to make the transferred land cultivable, to actually settle on the new land and to achieve a sustainable increase in their income, productivity and savings are equally important factors in making the scheme successful.

Mainstreaming the Poor through Equity Stakes

An institutional change that could bring the poor into the mainstream of the market economy could be to establish professionally managed public limited companies in which the poor have a substantial equity stake. 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. Kurien who set up the Amul (originally a cooperative) which is entirely owned by the poor and is now one of the largest manufacturers of milk products in the corporate sector in South Asia.

In Pakistan, there may be considerable potential for developing horticulture, livestock and milk production by the rural poor and providing these products to large private sector corporations for the manufacture and export of milk and meat products. These private sector corporations which would be buying their inputs from the poor could also be owned substantially by the poor. The equity stake to the poor could be initially achieved through the provision of loans which could be paid back from the dividends of the corporations. Similar public limited companies owned by the poor and run by high quality professionals could also be established in key main stream sectors of the economy such as energy, telecommunications and electronics.

Health Policy for the Poor

The preceding section shows that illness is a major factor that pushes people into poverty therefore improved nutrition and health conditions are important for poverty reduction. Improving the nutrition, preventive hygiene, provision of safe drinking water, improving the service delivery of basic health units, and improved diagnostic and treatment capabilities of Tehsil and District Hospitals are urgent imperatives to deal with the crisis of health and poverty.

Education for Development

Education is a major factor that pulls people out of poverty. It is also perhaps the single most important factor that can induce sustained and equitable growth. Education can achieve this objective by providing equality of opportunity for productive employment to all the people and not just the elite. The strategic aims of an education policy would be: (a) Improve the coverage and quality of schools, particularly for girls. (b) Skilling the labour force by establishing a network of industry specific vocational training institutes in every province. (c) Capacity building of selected universities to enable them to conduct research and teaching at world class standards.

Combating Corruption

The institutional structure that makes corruption endemic, also increases transaction costs and thereby constrains specialization, productivity and growth. Therefore, a policy of combating corruption through the establishment of institutions in state and civil society, would be important drivers of change for development. In this context five new institutions could help control corruption:

- An independent judiciary with adequate resources and judicial officers to provide access to justice at every tier of governance and in every region: national, provincial and district levels.
- An independent and constitutionally mandated structure of ombudsman's offices at the district, tehsil and union council levels to listen to and rectify public complaints about the equitable provision of public services. At the same time the ombudsman's offices at each tier would hear and rectify citizens' complaints about corruption and misuse of office by government functionaries.
- Citizens' Protection Committees at the mohallah and village levels where complaints about the provision of public services and against corrupt officials can be registered and systematically taken up.
- An independent media equipped with adequate investigative reporting capabilities to independently report corruption cases and monitor the performance of government departments with respect to the provision of public services, following the promulgation of a Right to Information Act.
- An independent Federal Bureau Statistics (FBS) that directly reports to the Parliament through a Parliamentary Committee on Policy Impact Assessment. The FBS would be tasked to conduct periodic surveys on the incidence of poverty, gender specific employment, inflation, productivity and real wages. The FBS would also be tasked to provide survey based data on the quality and coverage of services such as health, sanitation, hygienic drinking water, education and vocational training.

Institutional Policies for Stabilizing Crop Sector Growth

- *Institutional change for improved irrigation efficiency.* The poor maintenance and operation of the canal irrigation system, that is a major constraint to the rate of crop sector growth, is associated with both a decline in the efficiency of the irrigation department as well as inadequate funding. Given the lack of motivation, management capability and funding, a restructuring of the role, functioning and organization of the irrigation department may be necessary. Therefore the required policy initiative is to develop more cost effective and decentralized institutional structure, involving local communities in the operation and maintenance of canals and water courses. In this context autonomous community organizations of water users along individual distributaries need to be formed and then take responsibility for both revenue collection and maintenance.
- *Policies for improved seeds, agriculture research and diffusion:* The breeding of more vigorous seed varieties adapted to local environmental conditions and their diffusion amongst farmers is required through an effective research and extension program.

The existing institutional framework for agriculture research suffers from a proliferation of research institutes, which are inadequately funded, often lack professional expertise, proper equipment and the research environment necessary to produce significant results. There is considerable overlapping of research responsibilities across institutes. Consequently, research has by and large failed to produce operationally usable results much less increase input efficiency. This issue has also been discussed earlier in Chapter 3.

Institutional Change for Sustaining Growth in the Manufacturing Sector

- To induce sustained growth in the manufacturing sector the present institutional structure characterized by rent seeking would need to give way to an open access economy where all direct and indirect subsidies are phased out and the manufacturing sector subjected to a competitive environment in which there can be growth in efficiency, innovation and productivity.
- The emergence of a democratic government and the rule of law under which the security of life and property of citizens can be ensured and contracts can be enforced.
- Increased capacity for electricity generation and improved quality of distribution to provide a stable electricity supply at a price lower than the present exorbitant one.
- Enforcement by the government of international law and WTO regulations to prevent the import of counterfeits of branded domestic manufactured goods.

Institutional Framework for Pro Poor Growth

Pro poor growth can be defined as a process which directs a disproportionate share of the increase in national income in favour of the poor. Beyond this, it means restructuring the growth process in favour of the poor by empowering them to participate in the economic, social and political decisions that affect the material conditions of their life.

Designing a policy for pro poor growth involves addressing the structural features of Pakistan's growth process which constrain its capacity at the macro level for poverty reduction. Therefore at the macro level a pro poor growth policy should aim to achieve increased employment elasticities increasing the weight in GDP of micro enterprises and small scale enterprises, particularly for milk and livestock production for the rural poor. The pro poor growth strategy would also feature institutions for taking to scale a localized process of capital accumulation through Participatory Development.

POVERTY TRENDS DURING THE PERIOD 1999-2008

Poverty trends in this section will be analyzed with respect to two sub periods: First 1998-99 to 2004-05 and second, 2005-06 to 2007-08. Projections made for the next four years are also indicated.

The Question of Poverty Reduction in the Period 1998-99 to 2004-05

The Musharraf government had claimed that it reduced the percentage of population below the poverty line from 34 percent in the year 2000-01 to 24 percent in the year 2004-05, i.e. a reduction of 10 percentage points. This means that almost one third of Pakistan's poverty problem had been eliminated within a period of four years. If true this would be one of the most remarkable economic achievements in the history of the developing countries. India achieved a 10 percentage point reduction in poverty in a decade with an average annual growth rate of 8 percent.

An analysis of the sources of growth during the period 2000-01 to 2004-05 shows that the composition of growth during the period was pro-rich rather than pro-poor. It was fueled mainly by the services sector, (particularly banking and communications) which contributed 60 percent of GDP growth during the period and the manufacturing sector, primarily manufacture of automobiles, luxury consumer electronics, cement and textiles, which contributed 30.4 percent of GDP growth during this period. It is clear that GDP growth during the period was overwhelmingly pro-rich since none of the sectors which mainly constituted the growth was either

TABLE 4.6
UNEMPLOYMENT TRENDS, 1999-2004

Mid Year (End June)	Labour Force Participation (%)	Unemployment Rate (%)
1999	29.4	6.1
2000	29.0	6.0
2001	29.0	6.0
2002	29.6	7.8
2003	29.6	7.8
2004	30.4	8.3

Source: Labour Force Surveys, various issues.

producing goods for the poor or directly providing employment to them. In fact the labour force survey data of the government shows that unemployment rates rose sharply from 6.1 percent in 1999 to 8.3 percent in 2004. (See Table 4.6). Therefore the nature and composition of GDP growth during this period could not be expected to have substantially reduced poverty.

Let us now scrutinize the poverty estimates of the government. With respect to the estimation procedure it is important to understand that the magnitude of change in the incidence of poverty depends on two factors: (a) The base year used for comparison at two points in time. (b) The inflation rate used as a deflator to estimate changes in the consumption over time at constant prices. Now, regarding the first factor the government's estimate of poverty reduction uses the year 2000-01 as the base year which is a year of bad harvest, and compares it to the year 2004-05 which is a good harvest year. Clearly comparing a drought year with a good harvest year will, ceteris paribus, exaggerate the magnitude of poverty reduction as highlighted already in Chapter 2. It is therefore more appropriate to compare the year 1998-99 with the year 2004-05.

TABLE 4.7
INCIDENCE OF POVERTY, 1999 TO 2012

Year	Head Count Ratio World Bank Estimates (%)	Impact of Food Inflation on Poverty: Head Count Ratio (%)	Impact of Food Inflation on Poverty: Number of Poor Million
1998-99	30.00	30.00	40.35
2001-02	34.40	34.40	50.21
2004-05	29.20	29.20	45.48
2005-06		28.68	45.74
2006-07		29.47	48.12
2007-08		33.81	56.55
2008-09		36.11	61.84
2009-10		38.41	67.35
2010-11		40.71	73.10
2011-12		43.01	79.08

Estimates: by IPP

Note: The estimation procedure for the levels of poverty in various years assumes no change in the distribution of income in the period 2005 to 2008. To the extent that income distribution in this period has become more unequal, the poverty levels would be higher than those given in the table.

With respect to the second factor, the government's poverty estimate uses an inappropriate inflation rate based on the consumer price index, which only covers 16 urban centers. It does not take account of prices in the rural areas where the majority of the poor reside. Indeed inflation rate data based on both urban and rural areas was available from the Pakistan Living Standard Measurement (PLSM) survey. The PLSM data of course shows a much higher inflation rate. The government instead chose the CPI index for inflation which would yield an artificially low inflation rate and thereby a much higher magnitude of poverty reduction. Anwar (2006) in an earlier study has attempted to correct the biases in the official poverty estimates by using the year 1998-99 as the base year and the inflation rate drawn from the PLSM data. His estimate shows that during the period 1998-99 to 2004-05 poverty declined by only 1.8 percentage points, from 31.1 percent in 1998-99 to 29.3 percent in 2004-05. The estimate of Gazdar et.al. (2008), which excludes the Sindh sub-sample on grounds of serious inconsistencies, yields a poverty reduction estimate of only 0.6 percentage points with poverty declining from 31.3 percent in 1998-99 to 30.7 percent in 2004-05. The World Bank poverty estimates which also use the PLSM data for the inflation rate yield a poverty reduction of 0.8 percentage points over the period 1998-99 and 2004-05. (See Table 4.7).

One can conclude therefore that, there has been no significant poverty reduction during the period 1998-99 to 2004-05. This conclusion is consistent with the sources of growth analysis based on national income data.

The Impact of Food Inflation on Poverty: 2005-06 to 2007-08 and Beyond

In Table 4.7, estimates of the incidence of poverty are also provided for the period 2005-08. Projections are also provided in this table for the period 2008-12 to illustrate the poverty scenario for the future in case no policy action is taken now. These estimates use Sajjad and Mansoor (1999) figures, for the elasticity of poverty with respect to food inflation, adjusted for growth in per capita income.

The table shows that in the year 2005-06 poverty continues to decline slightly as high GDP growth is maintained and food inflation kept under control. However after this poverty begins to increase gradually as food inflation increases. The upward trend in poverty accelerates subsequently as GDP growth slows down and food inflation rises sharply. By the year 2007-08 the poverty level reaches 33.8 percent which is about the same level as the high point of 2001-02. The absolute number of poor could increase from 40.35 million in 1998-99 to 56.55 million in the year 2007-08. Thus about 16 million more people were pushed into poverty during the Musharraf regime. On the basis of evidence presented in Table 4.7 it can be concluded that the poverty reduction achieved during the period 2001-02 to 2004-05 was neutralized by the high food inflation rate and the slow down of GDP in the later years.

The evidence presented above clearly indicates that the objective of poverty reduction cannot be achieved by GDP growth alone. The evidence in Table 4.7 highlights the importance of controlling food inflation and at the same time bringing about the institutional changes necessary for pro-poor growth as emphasized earlier. If no policy action is taken now, and the institutional factors in endemic poverty persist while food inflation continues unchecked, then the incidence of poverty can be expected to rise sharply and reach the daunting level of about 43 percent by 2011-12. In such a case the number of people unable to afford adequate food (persons below the poverty line) could reach 79 million over the next four years.

Food Inflation and Unemployment: Targeted Relief for the Poor

The new democratic government in its programme for the first 100 days has shown a laudable intent to provide employment to the poor and housing for the homeless. An equally important task in the economic sphere confronting the democratic government is to provide relief to the poor who are in a state of acute distress. The relief package could consist of targeted relief for the poor from food inflation and a short term programme for employment generation. In this sub-section we will briefly indicate a Relief Programme for the poor that can be immediately undertaken.

A three pronged Relief Programme for the poor is proposed: (1) Food security programmes consisting of targeted food subsidy for the poor on the one hand and urban *lunggars* on the other. (2) Food for work. (3) Asset building for the poor. The idea is to combine immediate relief with a subsequent stream of regular income, through employment and asset building. This programme ought to be conducted on the basis of a partnership between the government, members of Parliament working actively for the poor in their constituencies, councilors in local governments, development NGOs, women's NGOs and Chambers of Commerce. Each of the three elements of the "Relief for the Poor Programme" and the institutional mechanisms for implementation and monitoring are summarized below:

Food Security for the Poor. This would consist of a two-year programme of government sponsored targeted food subsidy for the extremely poor and a private sector based network of *lunggars* (free cooked food outlets) in the urban areas. Consider the targeted food subsidy programme. There may be at least 3 million households (about 20 million persons) in the category of *extremely* poor, defined as those who borrow for food consumption or seriously underconsume. Funding for *atta*, lentils and cooking oil consumption could be provided to the extremely poor households with the total support for all three items amounting to Rs.1000/- per household per month. The subsidy could be provided either through food stamps or cash grants depending on which mechanism will have lesser leakages. This means an annual food subsidy expenditure of Rs. 36 billion by the government for 3 million households. This programme could be financed from a new fund that could be called the National Relief Fund (NRF) for the poor, to be chaired by the Prime Minister. This fund could be created through an Act of Parliament stipulating that 10 percent of the privatization proceeds be transferred to this fund: In the period 1999 to 2007 privatization proceeds amounted to Rs. 363 billion. This means that a relief fund of Rs. 36 billion could be created immediately. If the privatization proceeds are not immediately available the fund could be financed through multilateral donor support, contributions from private sector commercial and industrial organizations, individual donations and by diverting resources from other programs.

Implementing such a programme would require members of Parliament in the National and Provincial Assemblies and union councilors to work closely with the Bait-ul-Mal to quickly prepare a provisional list of extremely poor households in every constituency in the country. Development NGOs such as the PPAF, Kashaf, Baanh Beli and specialized women's NGOs such as Shirkat Gah and Aurat Foundation could help finalize the list of extremely poor households that would be eligible for food support and monitor the implementation of the program. To ensure gender equality, the distribution mechanism should include representatives from women's organizations, women members of Parliament and women councilors at the local government level. Moreover, wherever possible the food stamps or cash grants should be handed over to women members of recipient households.

The purpose of private sector *lunggars* is to strengthen food relief in the urban areas by providing *Dal* and *Roti* in the evening to the extremely poor in the locality. In pursuit of this objective, city based Chambers of Commerce and various associations of traders could be encouraged to establish *lunggars* in each locality, and also at the sites of sufi saints. A network of *lunggars* named after national martyrs of democracy such as Mr. Zulfiqar Ali Bhutto and Mohtrama Benazir Bhutto could also be established through foundations named after them. *Lunggar* networks could also be established in the name of national heroes. These *lunggars* could be financed through donations from members of the Chambers of Commerce, traders' associations, philanthropic organizations and individual citizens. They could be administered by city based coalitions of Chambers of Commerce, NGOs, councilors of local government and philanthropic organizations such as the Edhi Foundation.

To enable a scientific specification of poor households and systematic impact assessment of the food support programme and the *lunggar* networks, a time series database on the nutrition status of the extremely poor households, needs to be established. Regular surveys could be conducted on the same set of households on a six monthly basis by a reconstituted Federal Bureau of Statistics (FBS) whose independence is ensured by an Act of Parliament. An independent validation of the FBS data on a sample basis could be undertaken by a committee of independent experts.

Food for Work: Wage Employment through Improved Irrigation. Pakistan's farmers are facing an acute shortage of irrigation water. This is due to the failure to build adequate storage capacity on the one hand and deteriorating irrigation efficiencies on the other. The reduced water availability is occurring at a time when deterioration of the top soil has increased the requirement of water per acre. To overcome this water deficit it is proposed that a national campaign be launched for building small dams, desilting and lining of canals wherever possible and building *pucca khalas*. (This proposal in outline has already been announced by the Prime Minister in his speech before the National Assembly on 29th March 2008). This construction activity would not only bring more water to the farm gate but would also be a major mechanism for generating employment and sustainable incomes for the poorest sections of rural society.

Asset Building and Income Streams for the Poor. To enable the rural poor to quickly build an asset base and generate increased incomes for themselves a national credit programme for the rural poor is proposed whereby poor tenant farmers and agricultural worker households could be provided with loans for one additional milch animal per household. This programme of asset building for the rural poor would combine loans with establishing a marketing infrastructure for milk collection and cash payment at the door step. This would give an almost immediate asset and associated steady income stream to the poor peasants.

Those who get employment in the irrigation infrastructure programme or successfully use their loans for milch animals would become eligible for an additional loan equal to their annual income from employment or milk sales. This additional loan would range from Rs.40,000 to Rs.70,000 per household. The loan recipient would be provided with training and support for identifying micro enterprise projects which she/he could undertake at the household level to enhance and diversify their income base. The training and support for micro enterprise development could be provided by development NGOs such as the Pakistan Poverty Alleviation Fund (PPAF).

This programme for Relief to the poor proposed is designed to provide immediate economic relief to the poorest while at the same time enabling them to start building their assets, increasing incomes and thereby laying the foundations of economic democracy. The outlay for the relief of the poor by the government for programs mentioned above should be fixed at about Rs 50 billion or 0.5 per cent of the GDP.

CONCLUSION

The central lesson from the economic performance of the Musharraf regime is that inspite of high GDP growth rates over the period poverty, inflation and unemployment increased. This was primarily because of the structure of the growth process which was oriented towards the rich rather than the poor, and the failure to control high food inflation rates.

This paper has focused on analyzing the institutional basis of endemic poverty and unstable growth at the level of the economy. However it is important to understand, that the polity is the fundamental determinant of economic performance. It is in the realm of the polity that the rules are articulated and the associated incentive systems specified that condition economic behaviour and determine the transition to development. Pakistan's path to democracy within a stable constitutional order is also the path to sustainable and equitable growth. This is because it is precisely a stable democratic constitutional order in Pakistan that can create the institutional conditions for sustained and equitable growth: Opportunities in the polity and economy for all citizens, merit based selection, competition, efficiency and innovation.

Chapter - 5

Fiscal Policy in Pakistan: Role in Stabilization, Growth and Redistribution

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Fiscal policy has taken the backseat to monetary policy in stimulating the process of growth in the economy since 2002-03. The policy stance has been on maintaining a moderate level of the fiscal deficit while gradually raising the level of development expenditure in order to sustain a high growth rate in the medium run. Three shocks, however, have complicated the task of fiscal management more recently. The first is the large 'oil price' shock which, in the absence of upward adjustment in retail POL prices, has led a big increase in the subsidy bill. The second is a large upward jump of over Rs 100 billion (over 1 percent of the GDP) in the head of debt servicing due to the maturity primarily of defence savings certificates purchased at high interest rates by savers a decade ago.[1] The third shock is the fall in tax revenues due to a slowing down of the economy resulting from power load shedding and violent disturbances. These shocks are exerting a strong upward pressure on the fiscal deficit, if immediate adjustments are not made. Therefore, fiscal policy has emerged as an area of prime concern for the incoming government, especially in light of the prevailing high rate of inflation in the economy.

Alongwith the need now for stronger fiscal policy to achieve macroeconomic stabilization, there is also a general recognition that fiscal policy has failed to perform a significant redistribution function during the period of high growth witnessed over the last four years. Consequently, the gap between the rich and the poor has widened appreciably[2] and the issue of equity both on the taxation and expenditure sides of the budget has become important.

The objective of this chapter is to identify the scope for using fiscal policy more actively as an instrument for stabilization and redistribution in the economy, while sustaining the growth process. This chapter has eight sections highlighting fiscal trends, mechanisms for financing the fiscal deficit, strategy for achieving significant deficit reduction, key elements of tax policy designed not only to mobilize more resources but also to distribute the tax burden more equitably among different sections of the population, changes in expenditure priorities required to achieve a measure of redistribution of the benefits and the role of fiscal policy in growth. The last section summarises the principal findings and recommendations.

FISCAL TRENDS IN PAKISTAN

The fiscal trends since 1999-2000[3] of federal and provincial governments combined of Pakistan are highlighted in Table 5.1. Two distinct sub-periods can be identified, one from 1999-2000 to 2003-04, when there was a strong process of fiscal adjustment and the deficit declined from almost 5½ percent to below 2½ percent of the GDP. This was achieved primarily by the reduction of three percentage points of the GDP in interest payments. A roughly one percentage point increase in the revenue-to-GDP ratio enabled a corresponding increase in development expenditure. The second period starts from 2004-05, with the fiscal deficit showing a tendency to rise once again, reaching 4½ percent of the GDP by 2006-07. This is due primarily to the rise in non-interest current expenditure and an almost 2½ percentage point of GDP increase in

TABLE 5.1
TRENDS IN PUBLIC FINANCES
(Federal and Provincial Governments Combined)

(% of GDP)

	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
TOTAL REVENUES	**13.4**	**13.1**	**14.0**	**14.8**	**14.3**	**13.8**	**14.2**	**14.9**
Tax Revenues	**10.6**	**10.5**	**10.8**	**11.4**	**10.8**	**10.1**	**10.6**	**11.0**
Federal Tax Revenues	10.1	10.0	10.3	11.0	10.3	9.6	10.1	10.4
Provincial Tax Revenues	0.5	0.5	0.5	0.4	0.5	0.5	0.5	0.6
Non-Tax Revenues	**2.8**	**2.6**	**3.3**	**3.4**	**3.7**	**3.7**	**3.7**	**3.9**
Federal Non-Tax Revenues	2.3	2.1	2.8	2.9	3.3	3.3	3.1	3.4
Provincial Non-Tax Revenues	0.5	0.5	0.5	0.5	0.4	0.4	0.6	0.5
CURRENT EXPENDITURE	**16.4**	**15.3**	**15.7**	**16.2**	**13.5**	**13.3**	**14.8**	**15.8**
Federal Current Expenditure	**12.5**	**11.4**	**11.8**	**12.3**	**10.3**	**10.2**	**10.4**	**n.a**
Defence	3.9	3.1	3.4	3.3	3.3	3.3	3.2	2.9
Interest	6.4	5.6	5.5	4.3	3.6	3.2	3.2	4.2
Subsidies	0.4	0.5	0.6	1.0	1.1	0.9	1.1	n.a
General Administration	1.2	1.7	1.3	1.2	1.3	1.3	1.4	n.a
Other	0.5	0.5	1.1	2.4	10	1.6	1.6	n.a
Provincial Current Expenditure	**3.9**	**4.0**	**3.9**	**3.9**	**3.2**	**3.1**	**3.2**	**n.a**
Interest	0.4	0.3	0.6	0.5	0.4	0.1	0.3	n.a
Subsidies	0.2	0.2	0.1	0.1	0.1	0.1	0.2	n.a
General Administration	1.2	0.7	0.8	0.8	0.8	0.8	0.7	n.a
Services	2.1	2.7	2.4	2.5	1.9	2.1	2.0	n.a
DEVELOPMENT EXPENDITURE	**2.2**	**1.7**	**2.8**	**2.2**	**3.1**	**3.9**	**4.8**	**4.9**
Descrepancy/Unidentified Expenditure	**0.2**	**0.4**	**-0.3**	**0.1**	**-**	**-**	**-1.1**	**-1.4**
FISCAL DEFICIT	**-5.4**	**-4.3**	**-4.2**	**-3.7**	**-2.3**	**-3.4**	**-4.3**	**-4.4**
Revenue Deficit	-3.0	-2.6	-1.4	-1.5	0.8	0.5	0.5	0.5
Primary Deficit	1.5	1.6	2.0	1.1	1.7	0.0	-1.3	-0.2

Source: Pakistan Economic Survey, Government of Pakistan

BOX 5.1
THE MYSTERY OF UNIDENTIFIED EXPENDITURE

The growing inability of the Ministry of Finance in Islamabad and the Finance Departments in the provincial capitals to manage and correctly monitor expenditures is highlighted by the emergence of an item called 'unidentified expenditure' or 'statistical descrepancy'. This is the difference between 'booked expenditure' and the level of expenditure implied by the budget deficit derived on a bottom-of-line basis as the aggregation of borrowings (external and domestic) and privatization proceeds.

In five out of the seven years, 2000-01 to 2006-07, the level of 'booked expenditure' appears to be higher than estimated expenditure, as shown in the table below. The discrepancy appears to be increasing over time, reaching 7 percent in 2006-07 of total 'booked expenditure'. How is it possible for 'booked expenditure' not to be incurred? This raises the suspicion that the accounts have been manipulated to show a smaller budget deficit. For example, if 'booked expenditure' is used to derive the deficit in 2006-07 then the budget deficit rises from 4.4 percent to 5.8 percent of the GDP.

Level of Unidentified Expenditure
(Rs in Billion)

	Reported in Fiscal Operations	Reported in PES	% of Total Expenditure
2000-01	14.8	14.7	2.0
2001-02	-11.7	-5.4	-0.7
2002-03	3.2	9.8	1.1
2003-04	-	-35.8	-3.8
2004-05	-	-78.5	-7.0
2005-06	-86.3	-86.3	-5.8
2006-07	-124.5	-124.5	-6.9

Source: Ministry of Finance, Government of Pakistan

development expenditure, with only a modest increase in the revenue-to-GDP ratio of ½ percent. A worrying phenomenon is the growing inability to monitor the level of expenditure (See Box 5.1).

The significant development in 2006-07 was the reversal in the declining trend in interest payments to the GDP. These payments rose unexpectedly by almost 1 percent of the GDP. The primary reason for this appears to be a sudden hump in maturity of defence savings certificates. This process is expected to continue till 2009-10 and put additional pressure on the budget.

The Finance Minister has indicated on the 9th of April 2008 that the current fiscal situation is indeed very serious. As opposed to the fiscal deficit target of 4 percent of the GDP for 2007-08, the actual outcome could be as high as 9½ percent of the GDP, if no corrective actions are taken in the next few weeks. The massive spillage of 5½ percent of GDP is attributable to higher debt servicing and defence expenditure, larger subsidy to WAPDA and claims of oil marketing companies, financial support to exports and a large revenue shortfall. In effect, the impact of the shocks has been larger than anticipated and the previous government largely failed in responding to the shocks.

Why has the process of fiscal adjustment not been sustained after 2003-04? The primary reason is the failure of the tax-to-GDP ratio of the economy to rise significantly even in a period of rapid growth during the last four years.[4] The stagnation in this ratio at the low level of 11 percent of the GDP has meant that the efforts made to raise the level of development expenditure have translated into a corresponding rise in the fiscal deficit, in the absence of any containment of current expenditure. This failure in resource mobilization places severe limits on future levels of development spending. A diagnosis of the stagnant tax-to-GDP ratio is given in section IV of the paper.

Table 5.1 also gives the trends in revenue and primary deficits in public finances. The former is an indicator of the level of public savings in the economy while the latter indicates the ability of revenues to cover on-going expenditure obligations (excluding interest payments linked to past borrowing). The strong process of fiscal adjustment in earlier years led to an improvement from revenue deficit to surplus after 2002-03. This has remained at about ½ percent of the GDP during the least three years but is now threatened by the sharp rise in current expenditure in 2007-08 due to factors described above.

A contrasting trend is observed with respect to the primary deficit. The primary budget was actually in surplus upto 2003-04 and has since gone into deficit. The principal reason for this is the rising level of development expenditure. The emergence of larger primary deficits will imply greater difficulty in reducing the debt-to-GDP ratio in the economy.

An important issue is the extent to which the trends in public finances are consistent with the targets embodied in the *Fiscal Responsibility and Debt Limitation Act (FRDL)* promulgated by the National Assembly in 2005. The key targets in this Act are as follows:

(i) Reduce the revenue deficit of the federal government to zero not later than 13th of June 2008 and thereafter maintain a revenue surplus. According to the Fiscal Policy Statement of the Debt office, the budget carried a revenue deficit of 0.6 percent of GDP during the last four years, 2002-03 to 2005-06, and at 0.9 percent of GDP in 2006-07. However, as mentioned earlier, the primary deficits become surpluses if current expenditure is reduced by the amount of 'unidentified expenditure shortfall'.

(ii) Ensure that by 30th June 2013, the total public debt does not exceed 60 percent of GDP and thereafter remains below this level. According to the Debt office this target has already been met in 2005-06. At the end of 2006-07, it stood at 55.2 percent.[5]

(iii) Ensure that in every financial year from 2003-04 to 2012-13, the public debt is reduced by no less than 2½ percent of the GDP, provided that social and poverty alleviation related expenditures are not reduced below 4.5 percent of the GDP and the budgetary allocation to education and health is doubled in terms of percentage of GDP in the next ten years. The overall poverty alleviation expenditures were 5.7 percent of the GDP in 2006-07, but it is not clear if the target for education and health will be met.

(iv) Not issue new guarantees for any amount exceeding 2 percent of GDP. In 2006-07, government issued guarantees of 0.8 percent of GDP.

The severe deterioration in the fiscal position in 2007-08 is likely to imply a large revenue deficit while the debt-to-GDP ratio could stop falling, especially since the exchange rate depreciation (of almost 4 percent already) could lead to a rise in the external debt to GDP ratio. Clearly, the newly elected government will have to face the ignonimony of informing the Parliament that the Fiscal Responsibility Act has been violated. Of course, the blame can be assigned to the previous government. But there is no doubt that the new government will face serious challenges in ensuring that the limits imposed by the Act are not exceeded in the next few years.

We are of the view that the fiscal deficit is alarmingly high and will lead to large violation of the targets embodied in the Fiscal Responsibility and Debt Limitation (FRDL) Act in 2007-08. There is the likelihood that the PSDP will be reduced by about one percent of the GDP in the current financial year. As such, the year is likely to close with an underlying fiscal deficit of about 7.5 percent of the GDP, still also to twice the target for 2007-08, with a revenue deficit of about 3 percent of the GDP and development expenditure at 4½ percent of the GDP of the federal and provincial governments combined.

TABLE 5.2
DEFICIT PROJECTIONS FOR 2008-09 AND 2009-10

(% of GDP)

	2007-08 (likely outcome)	2008-09 (projected)	2009-10 (projected)
Fiscal Deficit	**7½**	**5½**	**4**
Revenue Deficit	3	1½	0
Development Expenditure	4½	4	4

* A lower fiscal deficit of say 4 to 4 ½ percent of GDP in 2009-10 and 2010-11 will imply a fall in the public debt-to-GDP ratios.

Source: IPP estimates.

Therefore, the task of fiscal adjustment will require strong actions on the revenue and expenditure fronts if the deficit is to be brought down to the sustainable level of about 4 percent of the GDP, in terms of avoiding a building up of the public debt-to-GDP ratio and elimination of any deficit on the revenue account, such that borrowings are used only to finance development projects. We believe that the fiscal deficit reduction from 7.5 percent of the GDP to 4 percent has to be completed within two years, if inflationary pressures are to be contained and there is to be less pressure on the external current account deficit. Otherwise, the country will move, sooner or later, inexorably to a deep financial crisis. In 2008-09, the target financial deficit must be brought down to 5.5 percent of the GDP and in 2009-10 to 4 percent of the GDP, with development expenditure sustained at the minimum level of 4 percent of the GDP each year. This would imply a revenue deficit of about 1.5 percent of the GDP in 2008-09 which will be eliminated in 2009-10, and the economy can get back to a fiscally sustainable path consistent with the FRDL act.

FISCAL POLICY FOR STABILIZATION

The impact of fiscal policy on macroeconomic stabilization hinges crucially on the size of the fiscal deficit and the nature of mechanisms used to finance the deficit. If there is heavy reliance on printing money (through borrowings from the SBP in the form of Ways and Means advances or purchase by the Central Bank of market related treasury bills (MRTBs), usually of six months duration) then this could exacerbate the already high inflationary pressures. If there is excessive borrowing from external resources then this could lead to a build up of external debt and, in the absence of an adequate foreign exchange reserves cover, expose the economy to a crisis in the balance of payments.

If substantially higher borrowings are resorted to from the commercial banking system (either by auctioning of market treasury bills of 3, 6 and 12 months maturities or by sale of Pakistan

Investment Bonds of 3, 5, 10, 15, 20 and 30 years maturities) then there is a danger that this will push up interest rates and 'crowd out' the private sector. Finally, if substantial financing is done through non-bank borrowing from public savings schemes then this also diverts resources away from the private sector. Overall, it is necessary to adopt a policy of financing the budget deficit by a balanced mix of sources. In the current Pakistani context, it is particularly important to minimize the inflationary implications of budget financing.

Table 5.3 gives the contribution of different sources to financing the fiscal deficit since 1999-2000. Significant variation is observed year-to-year in the importance of different sources. During the last three years, external resources have contributed about 2 percent of the GDP. This explains the relatively modest increase in external public debt from $ 29.5 billion in 2003-04 to $ 35 billion in 2006-07, implying a decline in the external debt to GDP ratio from 32 percent to 25 percent, aided by a relatively low nominal rate of depreciation in the exchange rate. The other major source is domestic bank borrowing (both from SBP and commercial banks), at about 1 percent of the GDP. Privatisation proceeds have made a significant contribution only in 2005-06.

TABLE 5.3
FINANCING OF BUDGET DEFICIT

(% of GDP)

	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08 (Budgeted)
BUDGET DEFICIT	**5.4**	**4.3**	**4.3**	**3.7**	**2.4**	**3.3**	**4.3**	**4.3**	**4.0**
Financed by:									
External	*1.8*	*2.9*	*1.9*	*2.3*	*-0.1*	*1.9*	*2.0*	*2.3*	*1.9*
Domestic:	*3.6*	*1.4*	*2.4*	*1.4*	*2.3*	*1.4*	*2.3*	*2.0*	
Non-Bank	2.5	2.2	1.9	2.5	1.1	0.1	0.1	0.6	0.8
Bank	1.0	-0.8	0.3	-1.1	1.1	0.9	0.9	1.2	0.5
Privatisation Proceeds	-	-	0.2	0.1	0.2	0.4	1.3	0.2	0.8

Source: Pakistan Economic Survey, Government of Pakistan.

With regard to the future financing strategy, there is need, first, to determine the target fiscal deficit (as done in the previous section) and, second, to find to the extent possible non-inflationary sources of financing. This takes us to the issue of the 'safe' level of deficit financing (printing of money) or the scope for *'seignorage'* in Pakistan. This source of financing is also sometimes referred to as the 'inflation tax'.

The amount of revenue that can be obtained from seignorage is determined by a number of factors.[6] These include the demand for base or high powered money in the economy, the real rate of growth of the economy, and the elasticity of demand for real balances with respect to inflation and income. As highlighted by Easterly and Fisher [1990] if the income elasticity of demand for base money is unity, then with a currency to GNP ratio of about 9½ percent currently in Pakistan, for every one percentage point that GNP increases, the government can obtain 0.095 percentage points of GNP through printing of money that just meets the increased demand for real balances. With an annual growth rate of 6 percent, the government should be able to obtain about 0.5 percent of the GDP for financing the budget deficit through non-inflationary printing of money. During the last three years the level of deficit financing has been high in 2004-05 at almost 2½ percent of the GDP and almost 2 percent in 2005-06. Currently, government borrowing in the first nine months of 2007-08 has attained a peak of Rs 448 billion or almost 4½ percent of the GDP. This is an extremely high rate of printing of money and will, no doubt, contribute to intensifying inflationary pressures in the economy.

Pasha and Ghaus [1996] demonstrate that the in Pakistan the long run elasticity of currency demand with respect to real income is estimated at close to unity, while with respect to inflation the elasticity is negative but low. As such, there is somewhat greater scope for seignorage in Pakistan. If a low rate of inflation is targeted, then the 'safe' limit of deficit financing is about 1 to 1½ percent of the GDP.

The other issue of interest is the extent to which savings schemes should be tapped for providing funds to the government. This includes certificates (defence savings, special savings, regular income and Behbood) and accounts (savings, special savings and pensioners' benefit). Details of each scheme are given in Table 5.4. These schemes witnessed large inflows in the late 90s when interest rates offered were high (at over 18 percent, for example, at the peak on defence savings certificates). In 1999-2000, the total level of non-bank borrowing was as high as 2½ percent of the GDP, equivalent to almost half the deficit for the year. Since then, the inflow into the savings schemes has declined sharply, because of the steep fall in interest rates offered and as the returns on other investments, like the stock market, have become much more attractive.

The merit of the savings schemes is that they are anti-inflationary in character and can also contribute to raising the level of household savings in the economy. They are useful in providing

TABLE 5.4
NATIONAL SAVINGS SCHEMES

Scheme	Maturity Period (Years)	Eligibility[a]	Maximum Limit	Markup/Profit[b] (%)	Tax Status
Defence Savings Certificate	10	All	None	7-10.15[c]	10% withholding tax[d] on profit
Special Savings Certificate (Registered)	3	All	None	9 - 10.50[e]	"
Regular Income Certificate	5	All	None[f]	9.54	"
Bahbood Savings Certificate	10	Widows and senior citizens	3 million	11.64	Exempt
Saving Account	None	All	None	6.50	10% withholding tax[d] on profit
Special Savings Account	3	All	None	9 - 10.50[e]	"
Pensioner's Benefit Account	10	Pensioners of government departments	3 million	11.64	Exempt

NOTES:
[a] in the case of individual
[b] per annum
[c] depending upon period of holding
[d] exemption upto investment of Rs 150,000
[e] 9% for first five six monthly payments; 10.50% for last payment
[f] minimum investment of Rs 50,000

Source: Central Directorate of National Savings, Government of Pakistan.

a flow of income to special groups like widows and pensioners who need support. Currently, returns are low, almost zero in real terms, after deduction of withholding taxes. There is, therefore, a strong case for increasing the reliance on these schemes for financing a larger part of the deficit. It is recommended that the returns on the schemes be linked to the return on Pakistan Investment Bonds, with the expectation of an increase of two to three percentage points per annum. Based on the interest-elasticity estimates of Pasha and Ghaus [1996] this could increase the inflow into the various savings instruments to about 1 to 1½ percent of the GDP. The greater competition that this would induce with the banking system could also lead to a corresponding increase in the rates of return on time deposits of commercial banks and exert an overall stimulatory effect on savings.

With regard to borrowings from the commercial banks, there is the danger of 'crowding-out' of the private sector. But credit demand from the private sector has shown moderate growth of at about 12 percent in the first eight months of 2007-08. Therefore, borrowing of about ½ to 1 percent of GDP annually over the next two years from the banking system should not lead to significant displacement of the private sector.

Altogether, the suggested financing pattern of the deficit in 2008-09 is given in Table 5.5. Such a financing strategy would contribute to the stabilization role of fiscal policy, and help in reducing inflationary pressures in the economy.

TABLE 5.5
FINANCING OF BUDGET DEFICIT

	2008-09	2009-10
External Resources	**2**	**1½**
Domestic Resources	**3½**	**2½**
Bank Borrowing	2	1½
(SBP)	(1)	(1)
(Commercial Banks)	(1)	(½)
Non-Bank Borrowing	1 ½	1
TOTAL	**5½**	**4**

Source: IPP estimates.

There is another important aspect of the stabilization role of fiscal policy which needs to be emphasized. This is the relationship between the size of the fiscal deficit and the current account deficit in the balance of payments. The latter is beginning to approach near crisis proportions (projected at almost 9 percent of the GDP in 2007-08). It has been argued that part of pressure on the current account deficit is due to the rising fiscal deficit. The Keynesian accounting identity highlights this relationship as:

$$\textbf{Current Account Deficit} = \textbf{(Private Investment - Private Savings)} + \underbrace{\textbf{(Public Investment - Public Savings)}}_{\textbf{Fiscal Deficit}}$$

The fiscal deficit here is more macro in character and relates to the overall deficit of the consolidated public sector, including public enterprises. From 2001-02 to 2003-04 there was significant net saving by the private sector, over and above its own investment, which not only financed the gap between investment and saving of the pubic sector, but helped in generating a current account surplus, as shown in Table 5.6. However, primarily due to the sharp fall in interest rates, the surplus generated by the private sector has disappeared since 2004-05. Simultaneously, the public sector deficit has increased sharply. Both factors explain the big increase in the current account deficit, which approached 5 percent of the GDP in 2006-07 and runs the risk of reaching 9 percent of the GDP in the current fiscal year.

TABLE 5.6
INVESTMENT AND SAVINGS AND CURRENT ACCOUNT DEFICIT

(% of GDP)

	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
IG - SG	5.7	4.3	2.4	2.2	-0.8	0.9	2.5	3.1
IP - SP	-5.5	-4.9	-5.5	-8.0	-2.1	-0.9	0.6	0.3
ΔT	1.4	1.3	1.3	1.9	1.6	1.6	1.5	1.5
CAD	-1.6	-0.7	1.8	3.9	1.3	-1.6	-4.5	-4.9

IG = public investment, SG = public saving, IP = private investment, SP = private saving
ΔT = change in stock, CAD = Current Account Deficit

Source: State Bank of Pakistan, Annual Reports.

Clearly, action is required on both fronts if the balance of payments position is to be stabilized in 2008-09 and if a potential foreign exchange crisis is to be averted. The gap, in particular, between private sector saving and investment will have to be eliminated and this may require upward adjustments in interest rates of the type described above. Simultaneously, the fiscal deficit will also have to be brought down, by a minimum of 2 percent of the GDP (see previous section).

STRATEGY FOR DEFICIT REDUCTION

As determined in Section II, stabilization through fiscal policy and adherence to the limits imposed by the Fiscal Responsibility Act will require a reduction in the fiscal deficit of about 3.5 percent of GDP in 2008-09 and 2009-10 from the likely level of about 7.5 percent of the GDP in the current fiscal year. Also, the correction will have to come largely through elimination of the revenue deficit.

The strategy for deficit reduction will, therefore, have two components-current expenditure containment and resource mobilization. A balanced and politically acceptable strategy will probably require effort on both fronts. If the focus is only on the expenditure side, then this will imply that severe economy has to be exercised and a postponement of the implementation of the various social and economic programs announced in the election manifestos of the ruling parties (PPP, PML(N) and ANP) for providing relief to the people at a time of high inflation, especially in food prices. On the other hand, if the deficit reduction strategy relies solely on heavy additional taxation then this runs the risk of jeopardizing the growth process in the economy and possibly scaring away potential investors while adversely affecting the popularity of the newly elected government.

We discuss below some of the key elements of the strategy for bringing down the deficit in 2008-09.

Expenditure Containment

Non-interest current expenditure has grown rapidly since 1999-2000, as shown in Table 5.1. The fiscal space made available by the fall in interest payments as a percentage of GDP has been largely taken up by rapidly increasing outlays on general administration (with frequent salary hikes), growing subsidies (especially to the power utilities), rising defence expenditure and buoyant expenditure on services (particularly by the provincial governments).

Symbols of extravagance by government are the bloated size of federal and provincial cabinets, hiring of large number of senior officials and consultants on lucrative salaries and perks, setting up of new ministries, departments and organizations, removal of recruitment bans, import of a large fleet of luxury vehicles, expensive foreign missions of dignitaries, etc. As highlighted by SPDC [2007] the higher outlays on services have not translated into a corresponding improvement in social indicators and there are serious concerns about the efficiency of expenditures, especially by the newly established district governments which are largely funded by provincial resources. The overall consequence of this display of 'affluence' by different levels of government is that non-interest current expenditure has increased by over 2 percent of the GDP between 1999-2000 and 2006-07. It is expected to rise further in 2007-08 due to the substantially higher outlay on oil and food subsidies.

There is, therefore, significant scope for containment of current expenditure without adversely affecting perceptibly the delivery of services. The new government needs to ensure, to start with, that despite being a coalition, the size of federal and provincial cabinets is kept small. This will be the first indication of the commitment to containment of expenditure.

Beyond this, the first issue of policy to be tackled is the extent to which domestic POL prices should be adjusted in line with the phenomenal increase in international prices (passing $ 110 per barrel). Already, at the fag end of its tenure after the elections, the caretaker government has increased POL prices twice within the time span of two weeks. As a consequence, the prices of HSD, LDO, Kerosene oil and motor spirit have gone up cumulatively by 14, 18½, 17½, and 17 percent respectively. The new government has also announced an increase. It is not clear what the full-year impact of these price increases will be on the oil subsidy bill in 2008-09, if the international price remains at the currently very high level. According to the Ministry of Finance [2008] there still continues to be a large subsidy on oil prices.

The new government will need to transmit, more or less, the full impact of rising oil prices in order to contain the demand for POL products and keep the oil import bill at a sustainable level. Of course, the impact on the poor can be limited by increasing less the price of products like kerosene oil, high speed diesel oil and light diesel oil and targeting for the maximum increase in motor spirit, consumed mostly by upper income groups. We believe that if the oil price remains at about $ 110 per barrel then further adjustment in domestic prices is inevitable if the fiscal and current account deficits are to be contained. This will also release resources for supporting food consumption, in particular, of the poor through appropriate social safety nets.

Turning to other sources of economy in expenditure, it is imperative that an across-the-board cut of, say, 40 percent be imposed both on the civilian and military budgets in non-salary expenditure, coupled with a general ban on recruitment. This could yield upto 1 percent of the GDP by 2009-10. Already, a cut of 40 percent has been announced in the budget of the Prime Minister's Secretariat.

Resource Mobilisation

The big disappointment in the area of public finances is that four previous years of continuously high growth has not led to a rise in the tax-to-GDP ratio in the economy, which has remained stagnant at 10 to 11 percent of the GDP. Is this because the tax base of different taxes has somehow been concentrated in the slower growing parts of the economy or that the opening of fiscal space in the economy (especially due to the decline in the debt servicing burden) has led to a slackening of fiscal effort both in terms of tax policy and tax administration?

In order to answer this question, we have derived the buoyancy of revenues with respect to growth of the tax bases for different taxes and the buoyancy of the respective tax bases with respect to the GDP. The general conclusion from Table 5.7 is that tax base to GDP buoyancies are all in excess of unity, implying that the tax bases of all taxes have grown faster than the GDP between 1999-2000 and 2006-07. As opposed to this, with the notable exception of direct taxes, the tax to tax base buoyancies are below unity, implying that the effective tax rates have fallen in the economy. Even in the case of direct taxes the effective tax rate was falling upto 2005-06. It was only the

TABLE 5.7
BUOYANCY OF TAXES
1999-2000 to 2006-07

Tax	Tax Base	Tax to Tax Base	Tax Base to GDP	Tax to GDP
Direct Taxes	Value added in large-scale manufacturing + banking + public administration and electricity and gas	1.11	1.21	1.34
Import Duties	Value of Imports	0.58	1.58	0.92
Sales Tax on Imports	Value of Imports + Import Duties	0.80	1.47	1.18
Sales Tax on Domestic Value Added	Value added in large-scale manufacturing + electricity and gas + transport and communications	0.98	1.22	1.21
Excise Duties	Value added in large-scale manufacturing	0.17	1.57	0.28

Source: IPP estimates.

exceptional growth of revenue in 2006-07 that raised the tax to tax base buoyancy to above unity for the period. The first indication for 2007-08 is that the growth rate of income tax revenue will fall sharply.

A major factor contributing to the decline in effective tax rates is the fall in statutory tax rates in the economy. As part of the process of trade liberalization, import tariffs have generally been scaled down, from a maximum of 35 percent to 25 percent. While the share of dutiable imports has remained, more or less, unchanged, the effective tax rate on imports has fallen from 17 percent in 2000-01 to 13 percent in 2005-06. Concomitantly, this has also affected revenues from the sales tax on imports. Excise duties have been withdrawn from a number of sectors and replaced by the sales tax, alongwith the fact that the tax rates are specific in character and have not been fully indexed to inflation in the economy.

The big decline in tax rates is in the income tax. Not only has the exemption limit of personal income tax been raised but the maximum tax rate has also been reduced from 30 percent to 20 percent for salaried tax payers and from 35 to 25 percent for the self-employed. Simultaneously, the corporate tax rate has been brought down to 35 percent for private companies from 45 percent and to 35 percent from 50 percent for the banking sector, at a time of sharply rising profitability.

Combined with a tax policy of reducing rates, presumably from the viewpoint of stimulating the process of investment and growth, major concessions and exemptions have also been granted which have restricted the exploitation of the potential tax base in the economy. The most dramatic example of this is the continued exemption of capital gains from income taxation especially at a time when massive unearned incomes were accruing in the economy to the relatively well-off, due to the exceptional buoyancy of the stock market and property values. The Pakistan Economic Survey [2006-07] has admitted that the exemption alone of capital gains on stocks from income taxation cost the economy annually about Rs 112 billion, almost 1½ percent of the GDP. Other tax expenditures (the revenue cost of exemptions or concessions) aggregate to Rs 72 billion. These include import duty exemptions on import of sugar, machinery and other items; income tax holiday to independent power producers and sales tax exemption on items like pharmaceuticals and tractors.

But the list of tax expenditures given by the Pakistan Economic Survey is not exhaustive. It does not include the revenue cost of accelerated depreciation allowances, lack of coverage of sales tax on wholesale and retail trade, effective exemption of a large number of services from GST, effective zero-rating of domestic sales of export-oriented sectors, etc. If all these concessions and erosions of the tax base are accounted for then the aggregate tax expenditure in the federal tax system could reach a whopping Rs 300 billion or so. This is equivalent to almost 3½ percent of the economy and about one third of revenues actually collected.

The Federal Board of Revenue has made some moves for improving the quality of tax administration like facilitating the process of self-assessment, simplification of processes, establishment of large tax payer units, computerization, etc. But, perhaps due to lack of political will, there has been limited effort to extend the tax net to hard-to-tax sectors like domestic trade, small-scale manufacturing and services, especially those provided in the informal sector, private companies and incomes of the self-employed. The share of withholding/presumptive taxes has remained high at almost 57 percent of direct tax revenue. The share of voluntary payments is still low at 39 percent.

Overall, a lax tax policy coupled with a reluctance to make tax administration more effective has implied that the tax-to-GDP ratio has remained stagnant in the economy during a period of rapid economic growth. Given the emerging resource constraints it is important now to remove the slack in the tax system especially by taxing the incomes or consumption of sectors and households with greater ability-to-pay. This takes us to the role of fiscal policy in redistribution.

TAX POLICY FOR REDISTRIBUTION

The incidence of taxes in Pakistan is unevenly distributed among sectors[7] of the economy and among households at different income levels. This has led to serious concerns about the equity of the tax system and the need for tax policy to focus more on achieving a fairer distribution of the tax burden. Numerous studies highlight this concern. Kemal [2004] quantifies the incidence of the overall tax system of Pakistan. He finds that from being progressive in 1987-88, the incidence had become regressive by 1999-2000. He states that the decline in corporate income tax rates and tariff rationalization have benefited the well off, while with the broadening of the sales tax base, the tax burden on the poor has increased.

Rafaqat [2005] assesses the welfare impact of GST reform from 1990 to 2001, during the period when the tax emerged as the largest source of revenue. The conclusion is that the incidence has worsened and the tax has become more regressive, due to taxation of items like sugar, vegetable ghee and fuels. Richer households remain better off because most of the services remain out of the GST tax net.

What are the developments since 1999-2000 which may have contributed to even greater regressivity of the tax system? These include the following:

(i) Abolition of the wealth tax in 2000 and continued reduction in personal and corporate income tax rates, as highlighted above, especially on private companies and on the banking sector, at a time of sharply rising corporate profitability.

(ii) Further reduction in import tariffs, especially on luxury consumer goods, like automobiles, and withdrawal of excise duties on domestically produced consumer durables.

(iii) Reduction of revenues from the petroleum development surcharge and its virtual elimination in 2007-08. The surcharge has historically taxed motor spirit at a differentially higher rate, with the burden falling more on the upper income groups.

(iv) The extension of GST to fertilizer and pesticides which has impacted relatively more on small farmers.

We have identified a series of taxation proposals for implementation in the next two years, during the period of fiscal adjustment, by either the federal or provincial governments with a potential yield of upto 2 percent of the GDP by 2009-10. A menu of these proposals is summarized below.

An 'Excess' Profits Tax: Rates of corporate profitability remain high in Pakistan in the presence of demand-pull inflation. The average return on equity of non-financial public limited companies has gone up from 12 percent in 2000 to 29 percent in 2006. Therefore, the ability of the corporate sector to add to government tax revenue has fortunately increased at a time when there is need for more revenues for macroeconomic stabilization. As such, it is recommended that an 'excess' profits tax provision be introduced for the next two years, during the period of fiscal adjustment, whereby profits upto a return on equity of 20 percent pay tax at the normal rate of 35 percent, while profits above this level could be taxed at a higher rate of, say, 45 percent.

Higher Tax on Private Companies: In order to encourage corporatisation, the tax rate differential between private and public limited companies should be restored with profits of the former being taxed at 40 percent.

Introduction of Capital Gains Tax: as a first step, a capital gains tax on property can be introduced by the provincial governments in the next budget. In order to minimize assessment problems, the tax could initially be presumptive in nature. The tax rate on the capital value at the time of sale should be linked to the period which has elapsed since the acquisition of the property. For example, beyond an exempt value, the tax rate on a property sold after 20 years should be 5 percent which could fall to 2 percent in the case of relatively new properties. Tax payers would have the option of paying the tax at 10 percent on actual capital gains. Alongwith stamp duties, the imposition of a capital gains tax should discourage speculative investment in real estate and divert resources to more productive sectors of the economy. This should also help in making housing more affordable in the country.

Beyond this, depending on the buoyancy of the stock market and prevailing macroeconomic conditions, a capital gains tax on shares may be introduced at the appropriate time to avoid any outflow of portfolio investment which could exacerbate the balance of payments problem. Perhaps, this tax be considered for the budget of 2009-10 when the economy has begun to stabilize following the commencement of the process of fiscal adjustment. At that time, the capital value tax on shares can be withdrawn.

More Progressive Personal Income Tax: This decline in marginal tax rates in 2006 has reduced the element of progressivity in personal income tax, with tax breaks in excess of 30 percent to large tax payers. Action needs to be taken at both ends of the income scale. At the lower end, the exemption limit may be enhanced to allow for high inflation and the rise in tax rates be made more progressive beyond the monthly income of Rs 50,000 such that the maximum tax rate in the case of salaried tax payers rises to 22½ percent and for others to 27½ percent.

Higher Taxation on Non-Essential and Luxury Goods: The rationalization of import tariffs and the withdrawal of excise duties have reduced the effective taxation on luxury goods. One of the consequences has been phenomenal growth in import of such goods. In particular, the increased consumption of electronic goods has led to fast growth in power consumption. As such, it is suggested that an additional regulatory import duty of 10 percent be introduced on luxury goods in the forthcoming budget. In addition, a similar duty of 5 percent be imposed on all other imports excluding essential imports of food, fertilizer, medicines and POL products.

A Broad-based Services Tax: The various service sectors of the economy have been growing fast and have accounted for more than half the incremental GDP. Many of these services cater primarily to the demand of upper income groups and to corporate entities. But their revenue contribution is very limited and they will increasingly have to be brought into the tax net.

Introduction of a broad-based sales tax could follow the lines of development of the service tax in India. The number of taxed services is 80 and the number of tax assessees has approached one million in India. The yield has crossed one percent of the GDP, with a tax rate of 12 percent.

The services tax could be extended in Pakistan within the provision of the Sales Tax Act, 1990, and the revenues fully reverted to the provinces. In order to effectively widen the tax net, the tax rate may initially be kept low at 5 percent and the tax may be also be paid by withholding tax agents in the economy, who receive the supply of taxable services.

Development of Provincial Taxes: The presumptive income tax rates of agricultural income tax need to be enhanced in order to yield significant revenue. As an interim measure, pending a comprehensive process of reassessment of annual rental values, the urban immoveable property tax could be doubled especially for properties above 500 square yards (or one canal).

Overall, the above proposals are oriented towards mobilization of revenues from direct taxes or from indirect taxes on goods and services consumed by upper income groups. Implementation of these proposals will make the tax system more progressive while improving public perceptions about a fairer distribution of the tax burden.

EXPENDITURE POLICY FOR REDISTRIBUTION

We turn now to the role of public expenditure in achieving a measure of redistribution in the economy by benefiting relatively more the poorer segments of the population. Traditionally, expenditure policy has been considered as a more powerful instrument than tax policy in reducing the gap in living standards among the people especially by improving access to basic services like education, health, drinking water, sanitation, etc.

As part of its poverty reduction strategy, Government of Pakistan has been maintaining, since the early years of the decade, an account of poverty related expenditure, both current and development, by all levels of government--federal, provincial and local. This enables an identification of the evolution of expenditure priorities in recent years.

PRSP expenditures have been defined broadly to include, first, expenditure on economic infrastructure like roads, highways, bridges, irrigation, land reclamation, rural development and village electrification. These are essentially growth-promoting expenditure with possibly large 'trickle-down' benefits to lower sections of the population. The second category consists of expenditure on social services like water supply and sanitation, education (all levels), health (both curative and preventive) and population planning. With the possible exception of higher education, all such expenditures are likely to benefit poor people. The third category relates to outlays on social safety nets like food subsidies, food support program, social security and welfare and low cost housing. These are targeted at particular groups of the population who are either disadvantaged or handicapped. The fourth group of 'other expenditure' includes governance related expenditure on law and order, justice etc.

Table 5.8 highlights the levels of PRSP expenditure in recent years. These have risen collectively from less than 4½ percent of the GDP to over 5½ percent by 2005-06.

It is significant that since 2003-04, poverty related expenditures have been able to meet the minimum level (4½ percent of GDP) of such expenditure in the Fiscal Responsibility Act. Public expenditure that is classified as non-poverty related includes debt servicing, defence, subsidies (excluding food subsidies), general administration and development expenditure on sectors like power generation. The share of poverty-related expenditure in total public expenditure (excluding debt servicing) increased from 30 percent in 2002-03 to 35 percent in 2004-05. However, there was a fall in the share to less than 34 percent in 2005-06. A striking conclusion in the Pakistani context is the low share of public expenditure which can even broadly be considered as poverty related.

TABLE 5.8
PRSP EXPENDITURE
(As % of GDP)*

(%)

	2002-03	2003-04	2004-05	2005-06
Economic Infrastructure	1.0	1.1	1.5	1.7
Social Services	2.2	2.4	2.5	2.8
Social Safety Nets	0.3	0.3	0.2	0.1
Others	0.8	0.8	0.8	1.0
Total	**4.3**	**4.5**	**4.9**	**5.6**
% of Non-Interest Expenditure	**30.4**	**34.6**	**35.0**	**33.9**
(S H A R E S) (%)				
Economic Infrastructure	23.6	24.3	30.0	30.3
Social Services	51.5	52.6	50.4	49.2
Social Safety Nets	7.0	6.1	3.3	2.2
Others	17.7	16.9	16.3	18.3
Total	**100.0**	**100.0**	**100.0**	**100.0**

*Fiscal responsibility Act requires 4.5% of GDP as PRSP expenditure

Source: PRSP Secretariat, Ministry of Finance.

Table 5.8 also gives the share of the different categories of poverty–related expenditure. Significant changes are observed in these shares during the four year period. The buoyant component has been expenditure on economic infrastructure, which testifies to the previous government's view that faster growth is the prime element of the strategy for eliminating poverty.

The other relatively fast growing category is governance related, especially law and order and justice. Such expenditure is more likely to be of greater value to the upper income groups who have more wealth and assets to protect.

Expenditure on social services, which is the major component in poverty-related expenditure, has increased from 2.2 to 2.8 percent of the GDP. At this rate, it can be expected to double (as % of the GDP) in about 11 years. This is, more or less, in line with the target of doubling education and health expenditure as a percentage of GDP in ten years. However, it needs to be emphasized that not all social services expenditure is likely to be benefiting the poor. In particular, expenditure on tertiary education is probably of greater value to the urban middle class. This has, infact, been the fastest growing level of education. Between 2002-03 and 2005-06, expenditure on tertiary education increased cumulatively in nominal terms by 240 percent as compared to 58 percent in the case of primary education and 66 percent for secondary education. Given the existing low rates of primary and secondary enrolments in Pakistan, the push towards higher education by the previous government appears to be a somewhat premature decision to achieve a knowledge economy without a solid base of basic education.

Another strong impression from the trends in poverty-related expenditure is how low the expenditure is on social safety nets. From 0.3 percent of the GDP in 2002-03 it has fallen to a low of only 0.1 percent of the GDP in 2005-06, representing a share of only about 2 percent of poverty-related expenditure. This is one of the reasons why rapid growth may not have been accompanied by fast reduction in poverty. Particular groups who are outside the mainstream of the process of growth need targeted social safety nets to survive close to the poverty line. Currently, food prices are escalating very rapidly and there is no doubt that an expanded program of food subsides and support is required to maintain the nutrition levels of the poor. It is not unreasonable to expect that in the prevailing conditions the expenditure on social safety nets should aggregate to minimum of 0.5 percent of the GDP.

Overall, it is recommended that the priorities for public expenditure policy to achieve redistribution should be based on the following targets:

a) The overall level of poverty-related expenditure should be pitched at a minimum of 5½ percent of the GDP, rising to 6½ percent of GDP by 2010-11.
b) The share of social services should be at least 55 percent in 2008-09 rising to 65 percent by 2010-11, in order to ensure that the FR&DL target of doubling public expenditure on education and health (as % of GDP) is met in ten years.
c) Within education expenditure, the share of primary and secondary education should be at least two-thirds.
d) Expenditure on social safety nets should be a minimum of ½ percent of GDP, rising to 1 percent of GDP by 2010-11.

FISCAL POLICY FOR GROWTH

It is vital that in the process of fiscal adjustment the level of development expenditure does not fall sharply as happened in the earlier years of this decade. Not only will the size of PSDP have to be sustained at a minimum of 4 percent of GDP till 2009-10 but there will also have to be more strategic and rational allocation of development funds to projects. Clearly, public investments in the water and agricultural sectors and in power generation will have to receive higher priority alongwith larger allocations for development of the more backward areas of the country. There will be a need for moratorium on new projects except in the priority sectors.

In addition, fiscal policy will have to be used selectively to incentivise the agricultural and manufacturing sectors, as emphasized by the Finance Minister, as follows:

(a) The general sales tax introduced on fertilizer and pesticides needs to be withdrawn in order to improve the ratio of output to input prices and thereby stimulate agricultural production.

(b) Power load shedding has adversely impacted on production significantly, especially in the industrial sector. As such, a 20 percent tax credit (chargeable against all tax liabilities) should be made available to manufacturing enterprises on the capital cost of captive power generation or energy-saving equipment. A similar tax credit can be offered on investments in renewable energy.

(c) In order to stimulate non-traditional exports, the 1 percent presumptive income tax on exports should be withdrawn and the research and development allowance at 3 percent be made available to all such exports.

It is expected that the above measures will not cost the exchequer more than ¼ percent of GDP but could play a significant role in raising production and export from the commodity - producing sectors and reduce the energy deficit in the economy.

CONCLUSIONS AND RECOMMENDATIONS

The primary focus of this chapter has been on the role of fiscal policy in *stabilization*, to tackle the problem of high and rising rate of inflation (especially in food prices), and in *redistribution*, given the growing inequality between the rich and poor in Pakistan. The principal findings and recommendations are as follows:

(i) Fiscal trends are likely to worsen substantially in 2007-08 due to the large increase in subsidies (especially on oil) and a shortfall in revenues (due to a slow down in growth) and the budget deficit may almost double to 7.5 percent of GDP in relation to the target, leading to a violation of most of the targets embodied in the Fiscal Responsibility and Debt Limitation Act.

(ii) The budget deficit in 2008-09 will have to brought down to 5.5 percent of the GDP in 2008-09 and to 4 percent of the GDP in 2009-10 in order to contain aggregate demand and bring down inflationary pressures and the external current account deficit.

(iii) Access to borrowing from SBP will have to be limited to a maximum of 1½ percent of GDP in order to minimize inflationary pressures on the economy in 2008-09. Non-bank borrowing will need to be resorted to more than in previous years. This will require an increase in interest rates on national savings schemes of two to three percentage points in order to stimulate savings, through linkage with the return on PIBs.

(iv) The deficit reduction of 2 percent of the GDP in 2008-09 will need to be achieved by a reduction in non-interest current expenditure of 1 percent of the GDP, with a fall in the oil subsidy bill and 40 percent cut in non-salary expenditure (both civilian and defence). The remaining 1 percent of GDP will have to be mobilized by raising the tax-to-GDP ratio. A similar effort will be required in 2009-10.

(v) The stagnation in the tax-to-GDP ratio, despite rapid economic growth, during the last four years, is attributable to a fall in effective tax rates arising, first from the fall in statutory rates, especially in income tax and import duties, second, due to rising tax expenditures which approached a whopping amount of Rs 300 billion in 2006-07 and, third, the failure of federal and provincial tax administrations to extend the tax to relatively hard-to-tax sectors.

(vi) From the viewpoint of mobilizing resources and distributing the tax burden more fairly a menu of taxation proposals includes a an 'Excess' Profits Tax, higher tax rate on private companies, introduction of capital gains tax on properties, more progressive personal income tax, higher taxation of non-essential imports and luxury goods, a broad-based services tax and development of provincial taxes. The capital gains tax on shares may be considered for introduction in 2009-10.

(vii) Changes in expenditure policy to achieve a measure of redistribution will require preservation of poverty-related expenditure at minimum of 5½ percent of the GDP, alongwith the enhancement of the share in such expenditure of social services and social safety nets and higher priority to primary and secondary education.

It needs to be emphasized that fiscal policy must continue to play a role in sustaining growth in the economy while focusing on stabilization and redistribution. This will require continued commitment to fairly high levels of development expenditure, projected at 4 percent of the GDP in 2008-09 and 2009-10.

Chapter - 6

Pakistan's Challenges and Provincial Imperatives

Chapter - 6
Pakistan's Challenges and Provincial Imperatives

It is our belief that the evolution of the Pakistani economy has reached the point where the next big push will need to come from the provinces that are part of the federation. This is the intention of the new government as revealed by the Prime Minister in his maiden address to the newly elected National Assembly. While Islamabad must continue to facilitate and regulate, the provinces will need to get more fully involved in using the resources available to them for accelerating the rate of economic growth and addressing the problems of poverty and uneven distribution of income. They will need to establish the goals they should aim to achieve, determine how they will be reached and define how the public sector will need to work with private enterprise to move forward. If the provinces must move into the drivers' seat, they will have to be much more explicit in giving shape to public policy in reaching the defined goals.

Public policy itself must be shaped by discourse between those who govern and the citizenry. This dialogue must be conducted within a well defined institutional framework so that a tradition can be established for continuous consultation and feedback into the decision making process. An institutional mechanism now exists that can be used to have on-going discourse between those who govern and those who are governed. Thanks to the promulgation of the Local Government Ordinance in 2001, a mechanism is in place that could become part of this institutional process. This subject is discussed at greater length in Chapter 8 of the report.

Given Pakistan's history - if we begin history with the launch of the movement to create an independent state for the Muslims of British India - the country should have created a political structure that allowed considerable autonomy to the provinces. That did not happen. Of the three constitutions that have been used with varying degrees to govern political life in the country, those promulgated in 1956 and 1973 were supposedly federal in their design. The second, authored by President Ayub Khan in 1962, was federal only in name. It prescribed for all intents and purposes, a unitary form of government with concentration of power in the hands of the president. By design, the 1973 Constitution gave more power to the provinces and created institutions such as the Council of Common Interests, the CCI, to which the provinces had recourse in case the federal government violated the basic principles governing the division of powers between different tiers of administration. It also entitled the provinces to receive compensation for the exploitation of their natural resources for national development.

These provisions notwithstanding, the system of governance that was in operation during the 1999-2007 period concentrated most powers in the hands of the president who, in effect, was not only the head of the State but was also the country's chief executive. The CCI remained inactive, the National Finance Commission was convened but not at regular intervals as mandated by the Constitution. The last time the Commission offered an award was in February 1997.

In order to realize the full development potential of its people and its endowments, Pakistan must allow more space within which the governments at different levels can function without the center's often stifling control over the provinces. This implies the allowance of not only greater provincial autonomy but also the grant of a greater role for the various institutions that make up the system of local government. For this to happen, the systems already in place don't need to be changed.

There is growing economic literature that focuses on the very positive role sub-national governments can play in bringing the process of development closer to the people. There is a consensus among the practitioners of development that bringing government closer to the people promotes economic development. It also provides a valve through which economic and political tensions can be released.[1]

What happens to Pakistan's four provinces will affect the country's economic and political future in several different ways. Not only will the provinces deeply influence the country's economic progress. They will also profoundly impact its social and political development and its relations with the outside world. There are many examples of the way the provinces will affect the direction and pace of the country's economic progress. Some of this will happen for non-economic reasons. To take one obvious example: dealing with the rise of Islamic fundamentalism, a subject to which we turn later in this chapter.

Having argued for a greater role for the provinces in promoting not only provincial development but also economic growth in the country, we will develop this theme by using two to rather different examples - the Punjab and the North West Frontier Province (NWFP) - as the case studies for a growth strategy that builds on decentralization and devolution. These two provinces are not only different in size - the Punjab with an estimated population of 95 million in 2008 is the country's largest while the NWFP with 23 million is the third largest in size - they have different economic endowments, different economic potential and also face very different economic and social problems. The choice of these two provinces as provincial case studies for this report was motivated by several different reasons. The main one is that the problems they face and must overcome are very different in their nature and scope and can not be by dealt with by Islamabad acting on its own. Also, the opportunities they have for promoting development and for improving the well being of their citizens are also very different and, again, can be better exploited by the administrations acting from the provincial capital rather than from Islamabad.

With this as the background we go on to present the two case studies, one using the Punjab and the other the NWFP. Two different approaches are followed, limiting the discussion to dealing with the most urgent issues that must get addressed in these two provinces. For Punjab, the chapter will focus on identifying the public policies that need to be adopted in order to quicken the rate of provincial GDP growth and make its rewards available to the poorer segments of the population. For the NWFP, the chapter develops an approach to deal with the restive tribal belt in the province. Bringing peace and development to this part of the province will not only help the entire province but also assist the country in achieving high and sustainable rates of GDP increase.

TRANSFORMING PUNJAB'S ECONOMY

A soon to be published report prepared by the Institute of Public Policy [Burki, (2008)] takes a comprehensive look at the provincial economy. It begins with a brief description of the evolution of the province's economy before Punjab became part of Pakistan in 1947 and then, also briefly, traces its performance in the period between 1947 and 1990. In 1990 the province acquired an administration that was not only committed to its rapid development but also had a good working relationship with the federal government. With a brief interruption in 1993-97 when there was once again lack of full understanding between the administrations governing from Islamabad and Lahore, the two capitals have followed the same approach to development. The elections of February 2008 have once again created an opportunity for the province to work closely with Islamabad.

What lies in the province's future as a new political order takes shape? What should be the direction of public policy in order to quicken its pace of economic growth and do it in way that its benefits reach all segments of the province's large policy? What needs to be done in order to close the income and wealth gaps that are developing among the different parts of the province? Should the policy makers in the province adopt an approach that would help with economic growth in other parts and provinces of the country? We will provide some answers to these questions in this part of the chapter.

Punjab's Rich Inheritance

History is important not only to understand the past but also to prepare for the future. In focusing on some aspects of Punjab's history - recent history, not history of the distant past - we will highlight only those aspects that have relevance for the present and are pertinent for discussing the future. Several of these are important. Since they will have significant impact on the future development of the province, it is our suggestion that in designing public policy those responsible for taking decisions should remain fully cognizant of these legacies.

Punjab's three legacies - an elaborate system of local government, long tradition of entrepreneurship and craftsmanship and a well developed irrigation and communication networks - should have helped Punjab to grow rapidly. This did not happen. For several decades and largely for political reasons the province received less than full attention from the central government.

The State of Punjab's Economy

It is a safe assumption to make that Punjab accounts for 60 per cent of Pakistan's gross domestic product, slightly more than its share in the country's population. The provincial economy has grown at a rate slightly higher than the average for the Pakistani economy. According to the World Bank (2005), "between 1991/92 and 2002/03, the provincial GDP of the Punjab increased in real terms at about 4.5 per cent a year, faster than the 4.1 per cent annual growth recorded in the rest of the country." This means that the growth rate was almost 10 per cent higher than the national average. The gap is even wider if we compare Punjab's growth rate not with all of Pakistan, of which the province is a significant part, but with the rest of the country. The rest of Pakistan, with Punjab excluded, grew at a rate of only 3.7 per cent a year. Punjab's growth was 22 per cent higher than the rest of Pakistan.

TABLE 6.1
PUNJAB'S ECONOMY: BASIC FACTS, 2007

	Pakistan	Punjab	Punjab's Share
Population[1] (million)	162.4[2]	93.13	57.4
Urban (million)		30.84	
GDP (mp) (Rs billion)	9,024[3]	5427	60.14
GDP $ billion	148	89	60.14
GDP per capita	925	957	n.a
GDP growth, 1991-92 to 2005-06	4.5	5.0	n.a

n.a = not available

[1]Extrapolating form World Bank's estimate for 2004 (152.1 million) at a rate of growth of 2.2 per cent a year. See World Bank, Punjab Economic Report, March 2005.

[2]Extrapolating from 1998 estimate of 73.6 million at a growth rate of 2.4% from 1998 to 2004 and 2.2% from 2004-07. See Annex 1.

[3]Extrapolated at 18% growth of the estimated 2004-05 product in the Economic Survey, 2005-06.

As shown in Table 6.2, the structure of Punjab's economy is not much different from that of all of Pakistan. Again, this is not surprising since Punjab is the largest component of the country's economy. Even then, there are some differences worth noting. Punjab is much more agricultural than the whole of Pakistan, largely because of the concentration of large scale industry and several other modern service sectors in Karachi, the country's largest city. Karachi's influence also shows up in Punjab's lower share of transport storage and communication group of sectors. The same is true for the sectors of trade, finance and insurance. However, this structure is changing as a result of the differences in the rates of growth of the various sectors of the economy. It is likely to change considerably if the rate of economic growth picks up.

TABLE 6.2
STRUCTURES OF PAKISTAN AND PUNJAB ECONOMIES, 2002-03

(% of GDP)

	Pakistan[1]	Punjab[2]
Agriculture	23.6	27.0
Manufacturing	15.0	16.1
Large Scale	(10.7)	(9.6)
Small Scale	(5.4)	(6.5)
Mining and Quarrying	1.9	0.2
Construction	2.3	3.6
Electricity and Gas Distribution	2.7	2.6
Transport, Storages and Communications	13.6	9.6
Wholesale and Retail Trade	17.5	15.9
Finance and Insurance	3.2	2.2
Ownership of Dwellings	3.0	5.9
Public Administration and Defense	6.4	6.2
Other Services	10.8	11.0

1 See Burki et. al (2008)
2 See footnote 1 in the text
Sources: Table 6.1 above.

As shown in Table 6.3, "Services" was the most rapidly growing part of the provincial economy. This is not necessarily a positive development if the growth in this sector is mostly the result of a large number of migrants from the rural areas taking up low income jobs in the low productivity parts of the economy. While this has certainly happened in Punjab's case, there is also some evidence of the growth of some of the modern components of the service sector such as banking, information technology, education, health services and communications.

TABLE 6.3
SECTORAL GROWTH RATES: PUNJAB AND PAKISTAN 1990-91 TO 2005-06

(% of GDP)

	Punjab	Pakistan
Agriculture	3.9	3.9
Industry	5.3	5.0
Services	5.6	5.1
GDP	5.3	4.8

Sources: World Bank
Burki et. al. (2008)
SBP, Annual Report.

The World Bank estimates that in 2001 the incidence of poverty in Punjab was about 5 percentage points lower than for all of Pakistan, slightly more than 34 per cent of the total population compared to more than 37 per cent for all of Pakistan. In other words, Punjab had 32 million of its 93 million people living in poverty compared to over 50 million for all of Pakistan. This means that 64 per cent of the country's pool of poverty is located in Punjab.

One additional point about the character of the poor in the province relates to their spatial distribution. The ranking of living standard, poverty and social indicators generally follows a North-South pattern in the province. Income and non-income indicators are better in the northern part of the Punjab, followed by the province's central part. The province's southern part is the poorest. (See Table 6.4 below.) This is somewhat a surprising finding since most of the industry and modern sectors of the economy are located in the province's central parts.

There are, of course, many reasons for the persistence of poverty in such large numbers in many parts of the developing countries. Among the many cited reasons these are particularly important: demography, low level of investment in human resource development and lack of job opportunities in various parts of the economy. All three play their roles in keeping more than 20 million people poor in the Punjab. The rates of population growth have been high which leads to closely spaced children in large families. Parents don't have the time to tend to all the children in the household; selection for attention is based on sex, girls get less attention than boys and therefore have a higher incidence of morbidity and mortality compared to their male siblings. They are also poorly educated. This produces, for the next generation, poorly literate women in poor health who continue to produce a large family and the cycle repeats itself.

TABLE 6.4
POVERTY HEADCOUNT RATE: REGIONS OF PUNJAB: 1998/99 - 2001/02
(Per cent of population)

	1998-99			2001-02		
	Urban	Rural	Overall	Urban	Rural	Overall
Northern Punjab	18.3	29.6	26.2	20.1	33.8	29.8
Central Punjab	25.2	32.1	29.9	24.6	35.3	31.8
Southern Punjab	36.1	40.6	39.7	38.7	40.8	40.4
All-Punjab	26.9	34.7	32.4	27.4	37.0	34.1

Source: 1998/99; FBS (2002), 2001/02: The World Bank staff estimates based on the 2001 2001/02 PIHS.
See Table 4.3 for the study from which this table is derived.

The World Bank report on the economy of the Punjab suggested that a 6 to 7 per cent rate of growth in the province's gross domestic product was required in order to keep up with the need to create jobs for a rapidly growing population. According to the Bank, one percentage point increase in the provincial GDP resulted in an increase of 0.5 per cent in the number of people employed. The recommended rate of growth therefore would create an additional one million jobs a year, the number required to keep the rate of unemployment at no more than 5 per cent of the workforce. [World Bank (2005)]

The Future: Three Scenarios

In this section we will use three simple assumptions to present three different scenarios for Punjab's economic growth in the period 2007 to 2020. According to these projections, the provincial GDP would increase at various multiples of the projected increase in population. The least ambitious picture sees the province's GDP increasing at a rate twice that of the population growth. Punjab's population increase is expected to decline to below 2 per cent per annum over the next decade. Therefore, according to this scenario, GDP increases at a rate of only 4 per cent. This is about the same as the structural rate of growth for the province. At this rate, the provincial gross domestic product would increase by 66 per cent in the 13-year period between 2007 and 2020. A rate of increase of 4 per cent of GDP will probably result in keeping the proportion of the poor unchanged at about one-thirds of the total population. However, the number of poor will increase to 34 million and poverty will continue to be a major feature of life in the province. The increase of 4 per cent in provincial product could become possible with some improvements in the quality of human resource through education and training, and some improvements in technology used by the workforce. The only contribution public policy needs to make to achieve this level of growth rate is to ensure there are no serious disruptions to overall security in the province, that there is a reasonable amount of continuity in public policy, that the quality of education improves somewhat, that some provision is made for improving health care, and that some effort is made to remove the bottlenecks that have appeared in the availability of physical infrastructure, especially power.

The second scenario sees an increase in the provincial GDP equal to three times the rate of growth of population. In other words, provincial output will increase at a rate of 6 per cent a year, with GDP more than doubling in this period. This is very close to the scenario envisaged by the the World Bank [see World Bank (2005)]. According to the Bank's analysis, this rate of increase could be achieved only if a significant change is made in the structure of the economy, particularly in the non-farm sectors. Also, to maintain this level of increase in GDP - "maintain," since this is the rate at which the provincial output has been increasing over the last several years - considerable amount of effort will have to be made in creating a pro growth environment. The Bank has a long list of recommendations aimed at realizing this growth rate. These focus in particular on improving the productivity of small and medium enterprises and improving the efficiency of the sector of agriculture.

The final scenario presented in this chapter, on which we will focus the rest of the discussion, is the most ambitious one. That notwithstanding, we believe that it could be achieved with supporting public policies not only in the sectors identified by the World Bank and were part of the previous administration's Vision 2020 statement. We will discuss in the following section the areas of attention for public policy in case the aim is to achieve this scenario.

Under this scenario, the provincial GDP will increase by 8 per cent a year and income per head of the population will grow by 6 per cent per annum. The size of the provincial GDP will grow by more than one and a half times, increasing from the current $89 billion to $242 billion. GDP per capita - a better measure of development - will more than double, from less than $1,000 in 2007 to more than $2,000 in 2020. There will be dramatic effect on the level of poverty, with the proportion of the poor declining to just above 12 per cent of the total population to only 14 million. There will also be a significant change in the distribution of population. By 2020, one half of the 120 million people will live in urban areas. Lahore - counting its suburbs and satellite cities - will have a population of 15 million. Lahore's own output could reach $50 billion with the city's per capita income climbing to $3,300, more than 50 per cent higher than the projected provincial average. (See Table 6.5 for some comparisons in the three scenarios.)

TABLE 6.5
THREE POSSIBLE SCENARIOS

	2007	2020-I[1]	2020-II[2]	2020-III[3]
Population (million)	93	120	120	120
Rural	62	68	65	60
Urban	31	52	55	60
Provincial GDP ($ billion)	89	148	190	242
Provincial GDP per capita ($)	957	1235	1585	2016
Number of poor (m)	32	41	20	14
% of poor in population	34	34	17	12

[1] GDP increases at a rate twice the rate of increase of the population at 4% per year. The incidence of poverty remains the same at 34%.

[2] GDP increases at a rate three times the rate of growth of the population or at 6% per year. The incidence of poverty declines by 5% a year, which means the current pool of poverty shrinks by one half to only 12 million people.

[3] GDP increases at a rate four times the rate of growth of the population at 8% a year.

Scenario III, therefore, envisages a dramatic change in the structure of the provincial economy. Several modern sectors, now at a stage of infancy, will mature and become economic leaders. This transformation is not beyond the realm of possibility. Sustained changes of this magnitude have occurred in other "growth areas" in Asia's populous countries. Two examples of this type of successful economic and social transformation can be found in the eastern provinces of China and the southwestern and southeastern states of India. For Punjab to realize this change, both public and private sectors will have to play a variety of roles, sometimes independent of each other and sometimes working together. These roles are the subject of the section that follows.

As shown in Table 6.6, literacy rate was low in Punjab, particularly for women and particularly in the rural areas. Dropout rate was high, surprisingly higher for boys than for girls in both urban and rural areas. There is a great deal of ground to be covered if the province aims to meet the target of universal primary education by 2015. Pakistan has committed itself to the target under Millennium Development Goals [UNDP (2002)].

TABLE 6.6
EDUCATION INDICATORS FOR PUNJAB

	1998-99	2001-02	2006-07	ACGR 1998-99 to 2001-02	ACGR 2001-02 to 2006-07
Primary					
Gross Enrolment Rate	75	76	100	0.44	5.64
Net Enrolment Rate	44	45	62	0.75	6.62
Middle					
Gross Enrolment Rate	43	45	55	1.53	4.10
Net Enrolment Rate	19	18	20	-1.79	2.13
Matric					
Gross Enrolment Rate	37	44	51	5.95	3.00
Net Enrolment Rate	9	11	11	6.92	0.00
Literacy Rate (10 +)	**46**	**47**	**58**	**0.72**	**4.30**
Male	57	57	67	0.00	3.29
Female	34	36	48	1.92	5.92

Concentrating on developing the large human resource would mean focusing on at least four areas of public policy. These are improvements in primary and secondary education, getting literacy to reach women, providing modern skills to a large proportion of the province's youth, and creating synergies between research and development of the various sectors of the economy. After years of experience with using human resource development as an important contributor to growth, practitioners of development have realized that they need to work towards not only having universal primary education but getting children to stay in school for at least eight to ten years. It is only then that children are prepared to enter institutions of higher learning or to make a contribution to the economy by entering the workforce. For many years practitioners of development focused only on primary education. That was the case in the World Bank sponsored Social Action Program that was implemented in Pakistan in the early 1990s. While the program increased the rate of enrollment in primary schools, it had a negligible impact on improving the country's human resource, including that of the Punjab. Development thinking has now reached the conclusion that it needs much more than five years of schooling to change behavior and to prepare people for the modern sectors of the economy.

The Devolution Plan, implemented in 2001, which led to a transfer of primary and secondary education to local governments, has resulted in a visible quickening in the rate of increase in enrolments and literacy. Prior to this reform, the literacy rate had remained virtually static for three years, since then it has been increasing by over 2 percentage points per annum. As discussed in Chapter 8 this is the first indication that decentralization is beginning to work and have an impact on key social indicators.

Insofar as increasing literacy among women, there is now abundant empirical evidence to indicate that there is a positive correlation between women's education and economic modernization. It has also been repeatedly observed that educating women has positive demographic consequences by lowering fertility rate and thus reducing the rate of increase of population.

But the efforts of public policymakers must not stop at primary and secondary education and education of women. They must also focus both their attention as well as public resources on improving the development of skills for a wide segment of the population. Here it would be useful to enter into various degrees of collaboration with the private sector, something that has already begun to happen.

One of the most neglected areas concerning human resource development has been the promotion of science and technology and its use in the productive sectors of the economy. It is unfortunate that the laudable efforts directed towards these goals by the government preceding that of Ayub Khan and by the military administration were not followed up by later administrations. The institutions then set up such as the Council for Scientific and Industrial Research and Agricultural Research Council were allowed to languish. In this area as well serious public-private partnership could begin to fill the gap that now exists between the need for new technologies and scientific know how in the productive sectors and their availability.

Agriculture

Within agriculture, the government needs to formulate strategies that would aim to improve productivity as well as create the incentives for a larger share of high value added crops. In spite of the rich endowment the province has in agriculture - in particular the availability of water for irrigation - yields of most crops are lower than international comparators. This not only suggests lack of appropriate technologies and inefficiency in using available technologies, but also indicates the enormous potential, which can be exploited without many additional resources. The rapidly rising prices of agricultural commodities in international markets, if largely transmitted to farmers, can provide strong incentives for enhancement of yields. Punjab can once again become the 'food granary' and generate larger exportable surpluses. The provincial government needs to focus particularly on agricultural research and extension. Budgets of the agricultural universities of the province also need to be substantially enhanced.

The provincial government needs to adopt a comprehensive strategy to improve the output and productivity of the province's well endowed agriculture sector. There are several elements in this strategy as indicated in the policy matrix in Box 6.1.

As in the case of human resource development, it is important to shift the focus of policy making to the provinces. This means strengthening the capacity of both Planning and Development and Finance Departments and the departments responsible for agriculture, irrigation, livestock, local government and marketing to develop the capacity to do policy analysis in this most vital component of the provincial economy. Included in the strategy should be pricing and subsidy policies, policies concerning marketing, improvement and expansion in the irrigation network, research and its application in this field, and creating price and other incentives for moving cropping pattern towards higher value added crops. It needs to improve physical infrastructure such as roads and railways which can carry surplus produce from the farmers to the major markets of consumption. And, once again, there has to be considerable emphasis on the development of new product techniques as well as new processing technologies in order to modernize the sector. Concentrating on agriculture as one of the determinants of growth will have a significant impact on the structure of the province's economy.

Small and medium sized industries

Punjab's non-farm economy is dominated by small enterprises. This is the case in manufacturing as well as in the modern parts of the service sector. While in the early stages of structural transformation, micro and small enterprises dominate the industrial sector, their predominance in Punjab is also the result of public policy. The industrial and transport licensing schemes operated by the government during the era of President Ayub Khan, encouraged the spread rather than the concentration of industrial and transport enterprises.

Some industrial concentration was also discouraged by the nationalization program followed by the government of Zulfikar Ali Bhutto when most large scale industrial and financial enterprises were taken over by the state. Since development of scale is important for economic growth - in particular for greater integration in the global economy - public policy should encourage a move in that direction. However, in the case of Punjab, the industrial sector is dominated by small enterpsrises.

BOX 6.1
POLICY MATRIX FOR ACCELERATING PUNJAB'S GROWTH
(2007-2020)

Area of Reform	Level of Government Responsibility	Required Public Policy
1. Human Resource Development	Local	1. Universal primary education 2. Universal secondary education 3. Girls education 4. Research and development 5. Curriculum reform at all levels 6. Accreditation of private institutions 7. Teacher training
	Provincial	1. Text book improvement 2. Public-private sector partnership 3. Opening private institutions to low-income students
2. Agriculture	Local	1. Infrastructure improvement - roads and markets. 2. Information about prices
	Provincial	1. Provision of price information about inputs and outputs 2. Marketing of surpluses 3. Research and extension 4. Establishment and strengthening of land grant agricultural colleges and universities 5. Land titling and land records 6. Pricing policy
	Federal	1. Addition to water storage capacity
3. Small and medium scale industries	Local	1. Land policy for locating industries
	Provincial	1. Rationalization for regulation to reduce visits by inspectors concerned with labor, health and environmental laws 2. Improvements in physical infrastructure 3. Information about marketing in places outside the provinces
	Federal	1. Provision of credit 2. Rationalization of tax structure 3. Rationalization of tariff structure
4. Trade	Federal	1. Improving the scope of the South Asia Free Trade Area 2. Growth of transit rights to the countries in the neighborhood

An overwhelming share (86 per cent) of private sector employees work in units with less than 10 employees. According to the Small and Medium Enterprise Development Authority (SMEDA), about 80,000 SMEs and 3.2 million micro-enterprises were operating in 2003. The SMEs share a number of characteristics that include financing through retained earnings; operation within clusters; poor integration and linkages with large enterprises; reasonably qualified workers; and relatively little focus on international trade. Given these characteristics and the potential of the SMEs, public policy should aim to remove some of the obstacles faced by the sector and create an environment that would promote the development of scale. The areas to be touched upon by public policy should include improving access to finance and technology and skilled labor; removing policy uncertainty; ensuring a steady supply of electricity; reducing the number of regulations and the number of official entities exercising oversight; and providing information about markets both outside the country as well as in other provinces.

This part of the manufacturing sector has considerable potential given the way global industry is being restructured. Most large scale firms now depend on outsourcing for parts and components, confining their own activities to the assembly of the final product and marketing.

This restructuring of industrial enterprises has led to the creation of suppliers all over the globe. For the moment, the countries in East Asia are benefiting the most from this development. The Indian industries are also developing the capacity to work as suppliers in these chains. Pakistan could also join in but both the private sector as well as the government will have to carefully study the opportunities that exist. In this context, the scope for outsourcing of production from China should be examined.

Location and trade

Up until now, formal trade has played a relatively small part in developing the provincial economy. The structure of trade as well as the structure of the economy will change quite dramatically if the country's economy is opened to India. Punjab sits on top of the rapidly growing economy of India. It could also serve as an area of transit for India's exports and imports. Wider trade and other exchanges with India could become important contributors to Punjab's growth and modernization.

A USAID study estimated that if the potential of regional trade is realized, Pakistan's total trade in real dollars (2004/05 dollars) could increase from the present $33.5 billion to $90 billion over the ten year period between 2004/05 and 2014/15. "With the economy more open and with trade with India allowed free of the positive test of permitted exports and imports, India-Pakistan trade is likely to increase tenfold, from the current $2 billion (including informal trade) to $20 billion. In other words, of the $58 billion increase in total trade projected, $18 billion - or almost 31 per cent of the increase - could come from increased exports to imports from India" [See Burki and Akbar (2005)].

TABLE 6.7
PROJECTED VALUE OF PAKISTAN'S FORMAL AND INFORMAL TRADE IN 2005/15
($ billion)

	2002-05				2002-05			
Type	Exports	Imports	Total	% of GDP	Exports	Imports	Total	% of GDP
Formal	14	18.0	32.0		43.0	47.0	90.0	
Informal	0.5	1.0	1.5		--	--		
Total	14.5	19.0	33.5	30	43.0	47.0	90.0	42.0

Source: Burki and Akbar (2005).

Intra-Provincial Disparities

As the province develops, focus will have to be on reduction of intra-regional disparities. Special emphasis will have to be placed in particular on the faster development of the South of Punjab. The Provincial Finance Commission will have to ensure that there is greater fiscal equalization in its awards through larger development allocations to the more backward districts of Punjab. As discussed in Chapter 7, this is currently not the case. In addition, with a population of almost 100 million by 2010 the province needs to have a more balanced hierarchy of cities. Currently, there is too much emphasis on the development of the metropolitan city of Lahore. The attention will have to shift towards the emergence of more vibrant medium-sized cities in different parts of the province. Also, towns at the urban -rural interface can begin to play a stronger role in off-farm employment generation by strengthening the backward and forward linkages with agriculture.

Resource Mobilisation

The province also has the potential of mobilizing resources for its development. As demonstrated in Chapter 7, the relatively rapid growth of the province over the last 15 years has led to an increasing contribution to the collection of federal taxes, which form part of the divisible pool. Today, the population share and the share in collection is, more or less, the same. Therefore, there is no significant transfer of fiscal resources from other provinces (especially Sindh) to Punjab. This implies that future growth of the province will be largely self-financed.

Also, Punjab has shown the fastest growth in own revenues among the provinces over the last seven years. Chapter 7 highlights in detail the potential for further development of provincial revenue sources.

What are the policy implications of the foregoing discussion? In particular how could Punjab climb on to a trajectory which would produce a sustainable growth rate of 8 per cent a year in its GDP and about 6 per cent increase in income per capita of the population? There are four resources available to the province on which policymakers could concentrate their attention. The most important of these is the human resource, the second is the province's strong agricultural sector, the third is its geographic location, and the fourth is the recently created but still to be fully developed capacity to handle development at administrative levels closer to the people.

THE NORTHWEST FRONTIER PROVINCE AND THE TRIBAL BELT

The second case study presented in this chapter is on the Northwest Frontier Province, the NWFP, the third largest in the country but politically by far the most restive at this time and relatively depressed economically.

Key Characteristics of the Economy of NWFP

Between 1990-01 and 2004-05, the provincial GDP of NWFP is estimated to have grown at 4 percent, somewhat below the national average. The levels of poverty in NWFP is also substantially higher (by almost 12 percentage points) than at the national level. Rural poverty is much higher than urban poverty, and the open unemployment rate is twice that for the country.

The sectoral composition of NWFP's economy at the start of the decade shows the relative importance of forestry, construction and ownership of dwellings, electricity and gas, wholesale and retail trade and public administration and defence, which have a higher share in the economy of the province than in the country as a whole. Also, the dependence of NWFP on home remittances is the greatest among the four provinces. These flows, both from the rest of the country and abroad, account for almost 20 percent of household expenditure in NWFP. Labor migration has played a strong role in integrating the province into the mainstream of the national economy.

While the case study on the Punjab was focused accelerating its economic growth to possibly reach 8 per cent a year over the next few years, that on the NWFP deals with an entirely different provincial problem: bringing political and social stability to the province that has not known it for decades and by introducing a degree of economic dynamism to the province. The same way that Punjab's growth would have an enormous consequence for the rest of the country, the failure of the NWFP to deal with the rise of militancy will also have a profound impact on the country. In discussing the case of the NWFP, there is the need to focus attention on the tribal belt on the border with Afghanistan. In dealing with this area, we believe that a solution can only be found if the two countries - Pakistan and Afghanistan - jointly address the problem posed to them by the economic, social and political backwardness of their Pathan populations. If that were to happen, trade between the two countries could grow further creating a dynamism that would bring development to both sides of the border.

Uneasy relations between Afghanistan and Pakistan that persisted over a period of nearly six decades have had a number of undesirable consequences including the rise of Islamic extremism in both countries. New dynamics now prevail in the area that may lead to the settling of some of the issues that have kept the two countries apart. Both are operating in a world that has come to realize the importance of securing rapid economic growth, poverty alleviation, improved income distribution and better integration into the global economy as a way of handling the menace of Islamic extremism. This chapter will present the case that the most effective way of achieving these objectives is to bring about an integration of the economies of Afghanistan and Pakistan with trade as the main driver.

For the last six decades transit trade was the basis of economic relations between Afghanistan and Pakistan. Under international law, Pakistan had to grant transit rights to landlocked Afghanistan with tariff-free access to the goods imported by Kabul. This was done and Afghanistan was allowed to trade with the world outside through Pakistan. While the Pakistan-Afghanistan corridor was actively used by Kabul to bring in imports and also to export some of its products, bilateral trade did not develop to any significant extent between the two countries.

Transit trade had three significant consequences for Pakistan and two for Afghanistan. Sharp tariff differences between the two trade regimes - relatively low tariffs in Afghanistan compared to those in Pakistan - created an opportunity for arbitrage which was exploited by the private sector on both sides. The second important impact of the border trade was the development of road transport. Once again Pushtun operators, ever alert to the use of new business opportunities, took advantage of the growing transit trade and became major truck operators on both sides of the border. The Pushtun dominated trucking industry in Pakistan had several consequences for the country's transport sector. It was responsible for the reduced role played by the railways in the development of the Pakistani economy. Third, the informal character of the transit trade also created the infrastructure that supported the development of the drug trade as Afghanistan became a major poppy producing country in the world. The United Nations has estimated that in 2007, Afghanistan was the source of 90 per cent of heroin supplies to the world's illegal drug markets. The amount of land devoted to poppy cultivation reached 323,570 acres, a two-thirds increase over 2003.

On the Afghan side, the large *private* returns from transit trade, fuelled initially by the tariff differentials and later by trade in contraband items - in particular illegal drugs - inhibited private investment in industry and agriculture. The development of a large underground economy based on this trade deprived a resource-poor government of the tax revenues it needed.

The second important consequence of transit trade for Afghanistan was more positive. It helped to develop networks linking Afghan communities with traders and transporters in Pakistan's major cities, in particular Karachi and Rawalpindi. These linkages could support integration of the economies of the two countries.

Agricultural products dominated the trade between the two countries in the period before 1979. Afghanistan exported mostly high value products such as fresh and dry fruits and animal skins (in particular karakul skins). However, the set back suffered by Afghanistan's agriculture since then has resulted in constraints on producing exportable surpluses.

As Afghanistan entered the phase of relative peace, its trade structure changed. Pakistan is now the country's main trading partner; in 2003 it was the destination of 69 per cent of the country's exports ($99 million) while it provided 9 per cent of total imports ($181 million). In other words, Pakistan had a trade surplus of $82 million with the countries. Much of the trade was focused on agricultural commodities.

Imports from Afghanistan into Pakistan have also experienced a sudden surge since 2001. Imports more than doubled during the past three years from just over US $ 22 million to US $ 44 million 2003-04, growing at an average annual rate of more than 44 percent. However, the share of Afghanistan in Pakistan's total imports remains negligible (under 0.3 percent of total Pak imports).

The prospects for stimulating trade between Pakistan and Afghanistan and beyond have improved very recently with GDP growth rates, currently over 7 percent in Pakistan and with the trade-reform measures being implemented by Pakistan, one of the two Afghanistan's most important trading partners. The most important foundation for reviving commerce between the two countries is establishment of security and trade enabling environment in Afghanistan itself. This will accelerate the rate of conversion from subsistence to commercial agriculture and encourage new investment in the private sector. Once this happens the neighboring countries in general and bordering cities in particular will greatly benefit. Therefore there is a great potential for the NWFP economy due to the advantage of geographical proximity with Afghanistan. NWFP can and should try and get the most out of the opportunities that are being unleashed by the massive development activities in Afghanistan and the return of normalcy in the country.

New opportunities exist for re-building and enhancing Afghanistan's transportation and energy infrastructures. These opportunities will help recreate previously established trade links between several countries in the region and also open up new trade routes. The promotion of regional trade will boost private investment and growth in the short-to-medium term and help to realize the long-term vision for Afghanistan as a country moving toward rapid economic growth based on sustainable development of its agriculture and other natural resources. NWFP can cash in all these opportunities including trade in services.

CONCLUSION

The main theme of this chapter is that the next big economic push in the country will come by bringing the various provinces into the decision-making process. We used two case studies - one dealing with the Punjab and the other with the North West Frontier Province - to underscore one important conclusion: that the economic policies that would get adopted if the provinces were given greater authority to formulate and implement them will have a different content from the one being currently pursued. A strategy to accelerate the rate of economic growth of the Punjab will build on some of the province's endowments that have not been factored into the past growth strategies. We believe that a growth strategy that developed the province's potential in value-added agriculture, further developed the small scale engineering sector, developed the large human resource and made it available for the information and communication sectors, modernized domestic commerce and developed domestic tourism will significantly add to long-term growth - taking it to 8 per cent, possibly 10 per cent per annum. This climb in the rate of growth would also be helped by developing the external trade sector. This sector would also benefit from increased supplies from the growth areas identified above. For the Punjab to benefit from the opportunities available in international trade, it will be important to quickly normalize trade relations with India. Once India was the largest trading partner for Punjab; this is no longer the case for mostly political reasons. If political tensions continue to ease between the two countries there is no reason why India should not reemerge as the Punjab's most important trading partner.

The strategy proposed in this report for the Punjab has the added advantage that it will create more jobs for the province's youth and in the process help to alleviate poverty and improve the distribution of income. This strategy will also help with narrowing the regional gap that has developed quickly in the recent past since the process of development that brought rapid growth to the province in the last several years was focused on the province's large cities. The investments that helped to bring dynamism in the provincial economy included the construction sector which was focused on building modern apartment buildings, offices and shopping centers in the province's major urban areas. These investments created few jobs for the lower income groups. They also created contingent balance of payments liabilities for the central government. By focusing on the development of the areas of production in which the province has a comparative advantage, it would be possible to take economic activity to the more backward areas.

The economic strategy that would yield positive results in the North West Frontier Province will have an entirely different focus than the one that is appropriate for Punjab. The approach recommended in this report puts a great deal of emphasis on three elements: developing the lines of product that have markets in the neighboring Afghanistan, improving transit trade on which Afghanistan depends for most of its exports and imports, and giving transit rights to India for trade with Afghanistan. In this strategy trade and transport are more central than even in the Punjab. The area's Pakhtun population has been associated with these two sectors for decades, even for centuries. The constraints they face in further developing their skills in these areas are mostly political. However, poor education and poor development of the needed skills have also played their part in not realizing the full potential of these two sectors.

We have also recommended the development of the industries and processing activities for which there is tradition, experience and knowledge in these areas. This is particularly the case in the tribal areas that have become the focus of so much international interest on account of the involvement of some of its residents in acts of terrorism. Weaning away these people from violence would be helped by their involvement in the area's economic life. A development program directed at the tribal areas and a program for bringing the tribal belt into the country's political mainstream are the sorts of approaches that are more likely to work than the use of great military force.

The main thrust of the argument presented in this report is that the provinces need to be given much greater role in economic decision-making than has been the case in the past. Since we have made international trade such a focal point of our proposed strategy, the provinces should also have a role in designing trade policy. Under the Constitution of 1973, international commerce is a federal subject. This will need to be changed.

With the elections of February 2008, Pakistan has entered into a new phase of political development. Two of its features are important in the context of what the report is proposing. The first is the importance the new leadership is attaching to the role of the assemblies in the making of public policy. This will make it possible for peoples' representatives to debate and direct economic policies Second, political parties with strong followings in the provinces will wield power in the provincial capitals - PML(N) in the Punjab, PPP and MQM in Sindh, and the ANP in the NWFP. These parties and the governments they will head are likely to demand greater provincial role in economic policymaking than was the case in the past.

While provincial assertiveness would take Pakistan in the right direction, it will need to be tempered with the requirement that the more prosperous provinces allow a greater flow of federal resources to those that are more backward. The National Finance Commission is the obvious vehicle for achieving this objective. In this way Punjab will be able to share some of its prosperity with the less developed parts of the country.

Chapter - 7

Decentralization from Federal to Provincial Governments

Chapter - 7
Decentralization from Federal to Provincial Governments

There is a growing clamour for empowering the provinces within the federation of Pakistan. As described elsewhere in the report, the election manifestos of most political parties for the 2008 elections have made a strong commitment to decentralization of more functions to the provinces, as originally provided for in the 1973 Constitution. The basic question is whether the disillusionment with the working of the federation is due to growing centralization of resources and decisions in Islamabad, during the tenure of the quasi-military government, and/or is the consequence of a growing imbalance in the nature of inter-governmental fiscal relations whereby the two larger and more developed provinces, Punjab and Sindh, have been able to pre-empt an increasing share of the national pool of resources and affairs of the two smaller and less developed provinces, NWFP and Balochistan, have been relatively neglected.

The latter issue becomes more important in view of the failure over the last six years to arrive at a consensus on a new NFC award which could focus explicitly on the issue of fiscal equalization among the provinces like the two previous awards in 1991 and 1997. It is possible that any ad-hoc arrangements put in place meanwhile may have contributed to greater inter-provincial tensions.

The objective of this chapter is to study the process of fiscal decentralization from the federal to the provincial governments during the current decade, especially from the viewpoint of fiscal equalization. The sections below review the status of institutional arrangements for managing the federation, the extent of fiscal decentralization, the ad-hoc award on fiscal transfers by the President of Pakistan in 2006, the fiscal status of each province and the relationship between the evolving pattern of fiscal transfers and trends in regional inequality. The last section presents key conclusions.

INSTITUTIONAL FRAMEWORK

According to the 1973 Constitution of Pakistan, federal functions are embodied in the Federal Legislative List, while the Concurrent List contains functions which are to be performed by either the federal or provincial governments. The former list also prescribes the fiscal powers of the federation. Article 160 states that a National Finance Commission (NFC) will be constituted every five years to decide on the level and formula of fiscal transfers from the federal to the provincial governments. In addition, Article 153 provides for a Council of Common Interests (CCI) which will formulate and regulate policies in relation to matters in Part II of the Federal Legislative List and electricity. Also, there is the National Economic Council (NEC) with the responsibility of framing plans in respect of financial, commercial, social and economic policies.

A review of the existing institutional arrangements for managing the federation indicates the following:

(i) Most of the Concurrent List functions like population planning, labor related functions, electricity, regulation of print media, curriculum development and setting of standards, tourism, etc., continue to performed largely by the federal government. In a landmark speech on 29 March 2008 after obtaining the vote of confidence in the National Assembly the newly elected Prime Minister has announced the transfer of all Concurrent List functions to the provincial governments within one year.

(ii) The last NFC Award came in 1997. Due to a failure in reaching consensus there has been no award since then, although another award was due in 2002. Instead, the President has promulgated, on an interim basis, the Distribution of Revenues and Grant-in-Aid (Amendment) Order 2006, effective from July 1 2006. The resulting changes in inter-governmental fiscal relations are described below.

(iii) The Council of Common Interests has not been convened for a long time. The last meeting of the Council was in 1992. Important decisions like the construction of large dams have remained pending.

(iv) Pakistan has abandoned the practice of Five Year Plans. The last plan was the 8th plan which came to an end in 1998. Since then sectoral and individual project allocations have been made within the ambit of Annual Plans, approved by the National Economic Council every year.

Therefore, it is clear that the institutional framework and the mechanisms for governance of the federation have not been working too well and need to be strengthened. In particular, the NFC has to be reconvened to give a proper award, which has remained pending since 2002, and the CCI has to play a more active role in inter-provincial co-ordination.

EXTENT OF FISCAL DECENTRALIZATION

Various measures of decentralization have been formulated in the literature, like the World Bank fiscal decentralization indicators [2005], to quantify the relative importance of national and sub-national governments. Perhaps the most popular indicator is the share of public expenditure by sub-national (state/provincial and local) governments. In the case of Pakistan local governments do not add significantly to total sub-national expenditure, because bulk of their expenditure is financed by transfers from provincial governments. These transfers are reported as part of provincial expenditure.

According to Table 7.1, the share of public expenditure by provincial governments in Pakistan was about 23 percent at the beginning of the current decade. This share has been increasing rapidly and has approached 32 percent by 2006-07. Therefore, during the last seven years, there

TABLE 7.1
MEASURES OF FISCAL DECENTRALIZATION

(%)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Share of Provincial Governments in:							
Tax Revenues	4.3	3.9	3.9	4.6	5.3	4.6	3.9
Non-Tax Revenues*	17.8	13.9	15.3	12.0	9.3	17.4	13.2
Revenues	7.0	6.3	6.6	6.3	6.4	7.8	6.3
Current Expenditure**	22.3	24.6	24.5	28.1	27.0	29.7	29.2
Development Expenditure	31.7	16.2	36.8	32.2	36.6	38.4	43.0
Total Expenditure	23.3	23.2	26.0	28.8	29.0	31.8	32.4
Budget Deficit	Surplus	0.5	11.9	20.8	15.4	14.2	31.6
Share of Transfers to Provincial Governments in Federal Revenues	**35.1**	**31.8**	**32.5**	**31.1**	**34.4**	**36.9**	**35.3**

* excluding interest income to federal government from provinces
** excluding interest paid by provincial governments and grants to provinces by federal government
Source: Fiscal Operations, MOF, GOP

is a visible trend towards decentralization in Pakistan. Is this due to larger transfers by the federal government or due to a more vigorous effort at resource mobilization by the provinces?

Table 7.1 also gives the evolution of the share of revenues generated by provincial governments. Contrary to expectations, in view of the rising share in expenditure, the contribution to revenues by provincial governments has actually declined somewhat from about 7 to 6 percent. This implies that the degree of vertical imbalance between expenditure and revenues is not only very large in Pakistan but is also increasing over time, necessitating larger transfers. Currently, about 35 percent of federal revenues have to be transferred to provincial governments. This share declined from 2000-01 to 2003-04 and has since risen rapidly, with a peak of 37 percent in 2005-06.

A factor which has not been adequately realized yet is the emergence of much larger deficits in provincial budgets and the greater resort to borrowings to finance the rapidly increasing expenditure, especially on development, during the last few years. From a positive balance of about Rs 10 billion of the four provincial governments combined in 2000-01, these governments carried a combined deficit of almost Rs 120 billion in 2006-07. This represents almost 32 percent of the consolidated budget deficit for the year. Financing sources for provincial governments include foreign and federal loans and cash credit accommodation with the banking system.

Development expenditure of the provincial governments has increased cumulatively by eight times since 2000-01 while federal level development spending has been raised to about five times the level prevailing at the beginning of the decade. Consequently, the share of provincial governments in development expenditure has increased substantially from 32 percent in 2000-01 to 43 percent in 2006-07. However, since almost two-thirds of the development expenditure has been financed by borrowing, the sustainability of the high development spending by provincial governments is seriously in doubt. In future, provincial governments must face a 'harder' budget constraint, including a clear policy on borrowing limits, if the overall budget deficit is not to acquire a runaway character as has happened elsewhere in countries with a federal structure like Brazil and India.

Overall, Pakistan appears to have reached an intermediate level of fiscal decentralization in terms of expenditure. At 32 percent of public expenditure accounted for by sub-national governments, Pakistan is lower than India at 45 percent, China at 54 percent and Argentina at 42 percent and higher than Indonesia at 10 percent, Malaysia at 19 percent and Mexico at 29 percent. However, Pakistan is at a low level of decentralization with respect to allocation of fiscal powers, with one of the lowest shares of revenue generated by sub-national governments.

NFC AWARDS

As highlighted above, in the absence of a consensus, the President has promulgated an interim arrangement for transfers with effect from 2006-07. The sharing arrangement comprises three components: revenue assignment from the divisible pool, grants-in-aid (subventions) and a district support grant in lieu of abolition of octroi and zila tax. The formula specifies the vertical distribution (between the federation and the provinces) and horizontal sharing (among the provinces).

A comparison of the ad-hoc award with the original 1997 NFC award reveals the following:

(i) The original distribution of revenues in the divisible pool was 37.5 percent to the provinces and 62.5 percent to be retained by the federal government. This has been raised to 41.5 percent for the provincial governments in 2006-07; 42.5 percent in 2007-08; 43.75 percent in 2008-09; 45 percent in 2009-10 and 46.25 percent in 2010-11.

(ii) In the 1997 NFC, grants in aid were only proposed for the two provinces-NFWP and Balochistan. These will now be made to all the provinces in the following proportions: Punjab, 11 percent; Sindh, 21 percent; NWFP, 35 percent and Balochistan, 33 percent.

(iii) As far as the distribution from the divisible pool is concerned, there is no change in the revenue-sharing formula which is linked solely to the 1998 population share as follows: Punjab, 57.36 percent; Sindh, 23.71 percent; NWFP, 13.82 percent; Balochistan, 5.11 percent.

(iv) The district support grant, equivalent to one sixth of revenues from GST, will be shared 50 percent on the basis of collection of octroi/zila tax at the time of abolition and 50 percent on population. This benefits the three provinces-Punjab, Balochistan and NWFP-to the detriment of Sindh.

(v) Straight transfers, which represent reversion of revenues to the provinces on the basis of collection will continue to include the excise duty, royalty and development surcharge on gas and the royalty on crude oil, alongwith the newly developed sales tax on services.

Overall, it is expected that revenue transfers from the divisible pool and grants in aid will constitute 50 percent of the revenues in the divisible pool by 2010-11.

There is no doubt that the interim award represents a significant enhancement in the level of transfers to the four provinces combined in relation to the original NFC provisions. But, the revenue sharing formula, which has been major bone of contention of provinces, has been left unchanged with a single criterion only of population. It has been argued that this criterion favours Punjab, in particular, and while Sindh would like a reflection of collection, NWFP emphasizes backwardness and Balochistan, land area, as additional criteria to be included in the revenue sharing formula.

The fundamental issue is whether the transfers promote a degree of fiscal equalization or not. This occurs when on an overall basis the transfers on a per capita basis are higher for the more backward provinces of the country, that is, NWFP and Balochistan. Of course, since this role is not being performed by divisible pool transfers, grants in aid have primarily to contribute to fiscal equalization. This was primarily the reason why grants were instituted only for NWFP and Balochistan in the 1997 NFC Award. But grants are now being extended to all four provinces. Incidentally, in the Pakistani context, straight transfers have also been performing historically an equalization function. NWFP has access to hydroelectricity profits and Balochistan to revenues from natural gas. This has effectively raised transfers significantly to the two underdeveloped provinces. The largest province, Punjab, gets little in the way of straight transfers.

TABLE 7.2
PER CAPITA TRANSFERS* TO THE PROVINCES

(Rs)

	Punjab	Sindh	NWFP	Balochistan
2000-01	1059	1485	1406	2885
2006-07	2133	3625	2897	5061
Growth (%)	103.3	144.1	106.0	75.4

*inclusive of divisible pool transfers, grants-in-aid and straight transfers (including profits from hydroelectricity).

Source: Derived by IPP

Table 7.2 gives the summary of overall per capita transfers to the provinces in 2000-01 and 2006-07 respectively. In 2000-01, overall transfers were the highest on a per capita basis to Balochistan. But, even after the inclusion of profits from hydro-electricity, NWFP received lower per capita transfers than Sindh, which is considered the most developed province of Pakistan in terms of per capita GDP.* in 2000-01, the ratio of per capita transfers between the least developed province (Balochistan) and the most developed province (Sindh) was 1.94:1. However, intervening developments during the last six years, have altered the picture significantly. The ratio has fallen to 1.40:1 by 2006-07 while the gap between Sindh and NWFP has diverged even further.

Therefore, the degree of fiscal equalization achieved by transfers has decreased during the current decade, for the following reasons:

(i) Grants in aid have shown relatively modest growth in relation to divisible pool and straight transfers

(ii) Sindh has been the prime beneficiary of the growth in straight transfers, especially on oil and gas. By now, straight transfers account for 35 percent of the total transfers to Sindh, the highest proportion among the provinces.

(iii) Transfers to NWFP in the form of profits from hydroelectricity have largely remained static

(iv) The generosity of the federal government in announcing grants-in-aid also for the more developed provinces, Sindh and Punjab, has narrowed the gap in per capita transfers with respect to the backward provinces.

Achieving more fiscal equalization will require the following: a) higher grants-in-aid to NWFP and Balochistan; b) explicit recognition of backwardness in any future NFC horizontal revenue-sharing formula; c) review of the formula for determination of hydro-electricity profits to NWFP, a longstanding demand of the province.

The issue of the impact of the evolution of inter-governmental fiscal relations on the implied resource transfer from one part of the federation to another part is examined in Table 7.3. The basic question is whether the share of a province in divisible pool transfers and grants in aid is more or less than the share of revenues from taxes in the divisible pool collected from the province. The results are striking and perhaps contrary to expectations. By 2005-06, the net implied resource transfer to Punjab had been virtually eliminated. Punjab is estimated to have contributed to apportionable taxes almost 56 percent of revenues as compared to its population share of about 57 percent, with a share in collection of 48 percent in income tax, 49 percent in excise duty and as much as 71 percent in domestic sales tax.

TABLE 7.3
PROVINCEWISE CONTRIBUTION TO COLLECTION OF APPORTIONABLE TAXES*

Province	Year	Population Share (%)	% Contribution: Income Tax	Excise Duty	Sales Tax (Domestic)	Total
Punjab	2001-02	57.4	48.3	49.7	63.2	52.7 (4.7)
	2005-06	57.4	48.3	49.4	71.4	55.5 (1.9)
Sindh	2001-02	23.7	48.3	28.8	28.7	39.3 (-15.6)
	2005-06	23.7	47.1	38.3	26.0	39.4 (-15.7)
NWFP	2001-02	13.8	2.6	15.6	5.8	5.9 (7.9)
	2005-06	13.8	3.7	10.6	1.0	4.1 (9.7)
Balochistan	2001-02	5.1	0.0	5.6	2.3	2.1 (3.0)
	2005-06	5.1	0.9	1.9	1.5	1.0 (4.1)

*excluding taxes collected on import, that is, import duties and import sales tax. Figures in brackets are share in revenue minus population share
Source: Federal Board of Revenue

The emerging pattern is one of net transfers from Sindh to NWFP and Balochistan only and not to Punjab. This is more consistent with the pattern of transfers observed in other federations whereby the most developed region tends to subsidise the most backward regions. This also implies that the traditional resistance of Punjab to any reflection of collections in the distribution criteria is no longer necessarily to the advantage of the province. The prospects for a more balanced revenue sharing formula have improved with some weightage being attached to the share in collection to the advantage of the developed provinces and some weightage to criteria like backwardness and land area to the benefit of the more underdeveloped provinces.

TABLE 7.4
KEY PUBLIC FINANCE MAGNITUDES BY PROVINCE

(Rs per capita)

	2000-01				
	Punjab	Sindh	NWFP	Balochistan	Combined
Revenue Transfer	1009	1351	946	2186	1141
Provincial Own Revenue	218	310	429	276	269
Federal Grants	50	134	194	699	123
Total Revenue	1277	1775	1569	3161	1533
Current Expenditure	1109	1731	1401	2569	1372
Development Expenditure	147	90	221	468	160
Total Expenditure	1256	1821	1622	3037	1532
Balance*	53	-52	232	333	67
	2006-07				
	Punjab	Sindh	NWFP	Balochistan	Combined
Revenue Transfer	2090	3471	2090	3842	2507
Provincial Own Revenue	509	506	616*	359	515
Federal Grants	43	154	443	1219	185
Total Revenue	2642	4131	3149	5420	3207
Current Expenditure	2248	3350	2234	4726	2633
Development Expenditure	1196	928	1073	1751	1144
Total Expenditure	3444	4278	3307	6477	3777
Balance*	-879	-398	-405	-1841	-749
	Cumulative Growth, 2000-01 to 2006-07				(%)
	Punjab	Sindh	NWFP	Balochistan	Combined
Revenue Transfer	107	157	121	76	120
Provincial Own Revenue	133	63	44	30	91
Federal Grants	-14	15	128	74	50
Total Revenue	107	133	101	71	109
Current Expenditure	103	94	59	84	92
Development Expenditure	714	931	386	274	615
Provincial Transfers + Grants	101	144	122	75	113

*Balance is derived after including federal loans in revenue

Source: Ministry of Finance, Government of Pakistan

We turn now to an examination of the fiscal status of the individual provinces.

FISCAL STATUS OF PROVINCES

Table 7.4 presents the key public finance magnitudes for each provincial government in 2000-01 and 2006-07, as well as the cumulative growth of each magnitude over the period. The basic issue is whether the transfers plus own revenues are large enough the meet the fiscal needs of the current expenditure on provision of services from the existing network and provide a surplus for financing development expenditure to expand service coverage. Therefore, the general expectation is that the provincial governments will not carry large deficits and will have, more or less, balanced budgets. This was the case in 2000-01 which appears to have been generally violated in later years. In fact, by 2006-07, transfers to Balochistan were not even enough to finance the current expenditure in the province.

The inter-provincial comparison in 2000-01 reveals that while Punjab had the lowest per capita revenue it also had the lowest per capita current expenditure. This testifies to the existence of significant economies of scale in the provision of sub-national services and in general administration. Balochistan had the highest per capita expenditure with the lowest coverage of services, highlighting the high unit costs of service delivery in the province due particularly to the very low population density.

Reduction in regional inequality in access to basic services like education, water supply and sanitation, health, roads etc., requires that per capita development expenditure is highest in the backward provinces so that a process of 'catching up' can take place. This was the case in 2000-01, with the highest per capita development expenditure in Balochistan followed by NWFP. But due to the phenomenal jump in development expenditure of 714 percent in Punjab and 831 percent in Sindh the differences in expenditure levels has narrowed considerably. In fact, per capita development expenditure in Punjab in 2006-07 was higher than NWFP. Such expenditure in Balochistan was almost three times the national average in 2000-01. The ratio was reduced to 1.5:1 by 2006-07.

Table 7.4 demonstrates that the fastest growth in revenue transfers has taken place to Sindh between 2000-01 and 2006-07. This is due especially to the buoyancy in straight transfers. Provincial own revenues have expanded most rapidly in the case of Punjab. This is the first indication that the regional economy has performed relatively well and the provincial tax administration has also perhaps demonstrated a higher level of fiscal effort. Current and development expenditure have also grown faster in the two more developed provinces reflecting the more rapid increase in total revenues. This is partly a consequence of the relative buoyancy of receipts but is also the consequence of resort to deficit financing, especially in the case of Punjab.

The key conclusion is that the process of fiscal equalization has largely broken down during the tenure of the previous government. The two politically powerful provinces, Punjab and Sindh, with governments that were part of the ruling coalition have not only been able to get a favourable dispensation from the ad-hoc 2006 Award but also take advantage of their greater taxable capacity. NWFP, which was governed by the opposition (MMA), and Balochistan have had difficulties in keeping pace with the dynamism of the two larger provinces. Consequently, there is probably a greater sense of deprivation now on the part of the people in these provinces as regional inequality may have widened during the period. A reconvened NFC will have to address more intensively the problem of fiscal equalization and also devote more time to specifying clearly the borrowing limits of the provinces.

In addition, the NFC will have to examine the issue of transfer of the general sales tax to the provinces. The transfer will be rendered difficult, first, by problems of apportionment of the sales tax collected at the import stage among the provinces as most of these revenues accrue at Karachi, second, the general sales tax is in the nature of a value added tax. Provincialisation of the tax will create the problem of input tax being collected in one province and the output tax in another. A complex system of refunds will, therefore, have to be established among the provinces. The sales tax in India has been a state subject, but as the country moves to a VAT the tax is being centralized. The other option is for the entire revenue from the tax to be reverted to the provinces after collection by FBR on the basis of the revenue-sharing formula specified by the NFC.

We examine next the available evidence on trends in regional inequality, especially in light of the growing fiscal imbalances demonstrated above.

TRENDS IN REGIONAL INEQUALITY

A critical element in influencing the state of the federation is whether all parts of the country benefit, more or less, equally from the process of development, especially from the rapid growth of the last four years. This depends upon the regional inclusiveness of growth which is influenced by its sectoral character. For example, if the major part of the growth is in spatially dispersed sectors like agriculture, small-scale manufacturing and trade, then most regions of the country are likely to benefit. But if growth is concentrated in sectors like large-scale manufacturing, banking and telecommunications, as is the case after 2002-03, then much of the growth is likely to occur in the developed areas of the country and regional imbalances are likely to widen.

As shown in Table 7.5, there was a degree of convergence among the provinces during the 90s. The most developed region, Sindh, grew relatively slowly due particularly to the stagnation of the manufacturing sector during the decade. Punjab and NWFP showed a better performance, mostly perhaps because of the buoyancy of the agricultural sector. But Balochistan continued to lag behind with the lowest growth rate.

TABLE 7.5
GROWTH RATES OF PROVINCIAL GDPs

(%)

	Ratio of Per Capita GDP to National Average 1999-2000	1979-80 to 1989-90	1989-90 to 1999-2000	1999-2000 to 2055-06
Punjab	0.954	5.9	4.8	6.0
Sindh	1.274	6.5	3.8	
NWFP	0.826	5.7	4.6	5.0
Balochistan	0.725	6.3	3.4	
Pakistan	**1.000**	**6.1**	**4.4**	**5.5**

Source: Kaiser Bengali [2004]
World Bank [2005]

The growth pattern has altered dramatically during the last few years of rapid growth. According to World Bank [2005] estimates, the economy of Punjab has shown exceptional dynamism and demonstrated a growth rate which is almost 1½ percentage points higher than the rest of Pakistan. Sindh is also likely to have performed well due to its larger share in fast growing sectors.

Both NWFP and Balochistan are likely to have experienced growth rates which may be as much as 3 percentage points below the national growth rate. This trend of rapidly rising regional imbalances does not auger well for the future of the federation. A growing perception on the part of the smaller provinces of being marginalized from the process of growth will impose severe strains on inter-provincial relations and on arriving at a consensus on development strategy. To the extent that the divergence in growth rates has been contributed to by the above-mentioned disequalising changes in fiscal transfers, these will have to be corrected by larger grants and a greater premium to backwardness. In fact, this is probably the time to announce a special Balochistan and FATA Development Program of about Rs 5 billion each with funding annually from federal sources. Down the road, a new NFC award must focus more strongly on fiscal equalization.

CONCLUSIONS

The current decade has witnessed greater fiscal decentralization to the provinces, facilitated by larger transfers and borrowing by provincial governments. However, in the process, the biggest beneficiaries have been the two large and relatively developed provinces and the goal of fiscal equalization has effectively been abandoned. This is likely to have contributed to the greater regional inequality observed during the period. It is imperative that the NFC be reconvened to finalise a new award which is more sensitive to the needs of the smaller provinces.

Chapter - 8

Decentralization of Governance: Provincial to Local Governments

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All political parties have specifically expressed the course of action they plan to take to improve governance, particularly devolution in their manifestos. Implicit in the manifestos is perhaps a realization of over centralization in the past which needs to be rectified through decentralization of functions. There is near consensus among the parties that provinces should be strengthened through a transfer of concurrent list functions from the centre to the provinces. In fact, the stand of the smaller regional parties on the issue of fiscal federalism appears to be stronger. ANP and MQM talk about full provincial autonomy with the centre principally retaining the control only of defense, foreign affairs and currency. On the revenue side, MQM proposes the reassignment of general sales tax and excise tax to provinces along with provincial engagement in the privatization process and a share in privatization proceeds. PPP is in favour of expansion in the distribution criteria for National Finance Commission award beyond population to contribution to revenues, geographic size, backwardness and level of development. It also proposes the progressive reversion of sales tax to provinces.

Political parties have also indicated their position with regard to devolution to local governments. There is a whole range of views on devolution in the manifestos. At one extreme is MQM (with a pro-devolution agenda), calling for further strengthening of local governments through an integrated system, with specialized agencies being brought under the control of district administrations. At the other extreme is PML (N), which appears to oppose devolution of power to local governments implemented by the previous government but does recognize the need to look at the entire governance structure, including the devolution/decentralization process to suggest amendments in law and practices that recognize the ground realities in each province.

Next on the pro-devolution side is PML (Q), which emphasizes devolution as one of the "5-Ds" on which their manifesto is based. Dominating the local government system, at least in Punjab, the party suggests that devolution should become more comprehensive and not be limited to sub-national governments only. The process should be extended to include devolution within federal ministries/departments, downsizing of the Prime Minister's Secretariat and transfer of the right to control and regulate natural resources to the provincial governments.

PPP lies in the middle of the spectrum. It proposes revamping of the local government introduced by the military government, in line with the party's devolution plan and following reelection of local governments. Unlike the present system, the proposed list of local services identified as local by PPP is restricted to education, health, water supply and sanitation.

It is clear that the present ruling coalition (PPP, PML (N), and ANP) will revisit the devolution process in Pakistan. They will do so because presently the local governments' especially in Punjab, are under the control of PML (Q) - the out-going political party. The view is that the local government elections were generally regarded as not being free and fair, an allegation which perhaps has some credence. International observers, local civil society institutions, including the media, did highlight malpractices in the last elections held in 2005. There is also effectively "state capture" by local elites, over 90 percent of nazims of district administrations in Punjab, for example, belong to influential political families/baradaries. Given the current political dispensation, these nazims are potentially political competitors of MNAs/MPAs. On top of this, there is the perception that the devolution plan is over-designed, whereby too much has been devolved from the provincial to the local governments and lop-sided as federal-provincial decentralization has been totally ignored. Only when provincial governments are given more functions will there be a willingness to delegate some functions to local governments. This subject is covered in Chapter 5 that discusses the role decentralization can play in accelerating the rate of economic growth in the provinces.

The objective of this chapter is to analyse the design, implementation and impact of the Devolution Plan since 2001, one of the most fundamental reforms by the previous government. The chapter has seven sections which identify the pros and cons of decentralization to local governments, describe the key features of the devolution plan, analyse the institutional challenges, fiscal transfers to local governments and assess the impact of devolution on the coverage and cost effectiveness in the delivery of basic services. Finally, based on the experience gained over the last six years, the reforms required to strengthen the devolution process are indicated in the last section.

PROS AND CONS OF DECENTRALIZATION TO LOCAL GOVERNMENTS

There is a growing view that decentralization is more conducive to good governance for achieving economic growth and as a means of faster social development and poverty reduction. Participation and empowerment of people, transparency, accountability, human rights and equity, the rule of law and containment of corruption are all important attributes of good governance. Decentralization increases popular participation in decision-making because it brings government closer to the people- making it more accessible and knowledgeable about local conditions and more responsive to people's demands. Central governments' located at some distance and preoccupied mostly with national and regional issues fall short of adequately reflecting local preferences and efficiently providing services essentially local in nature. In short, because of greater degree of accountability, responsiveness and participation, effective decentralization can make a big difference by making the provision of local (social and economic) services more efficient, equitable, sustainable and cost-effective. Through community participation in decision making, planning, implementation and monitoring and backed by appropriate institutions and resources, devolution can go a long way in improving the quality of life, particularly of the poorer and marginalized segments of population.

There has, in fact, been a progressive and sweeping wave of decentralization globally during the last two decades. A cursory review of this process reveals that decentralization reforms have been introduced in countries ruled by all varieties of regimes, ranging from military dictatorships, authoritarian presidencies and monarchies to single party or dominant party systems and multi-party competitive democracies. Different forms of decentralization appear across most regime types. For example, elected, democratic local governments have been introduced by military regimes, as in Bangladesh in the 80s and in Pakistan more recently. As opposed to this, technocratic, administrative deconcentration has taken place in otherwise democratic set ups, like in Indonesia during the late 90s.

The motivations for decentralization are diverse and manifold. A movement towards democratic decentralization has been driven by the need to deepen the process of democracy by giving citizens a greater say in matters which impact more on their daily lives. This has been referred to as bringing government to the 'doorsteps' of the people or promoting 'grass roots' democracy.

The 73rd Amendment to the Indian Constitution in 1993 leading to the establishment of the Panchayati Raj (village assembly) system can be interpreted as one such move. These village councils are expected to become the implementation agencies for government programs and include reserved seats for women and the scheduled castes in order to facilitate participation by hitherto marginalized groups. A comparison of local functional allocation in Pakistan and India is presented in Box 8.1

As opposed to this, military or single party governments have opted for elected local governments as a surrogate for broad-based democracy at the national level. This is seen as part of managing the long-term process of transition to a full-fledged democratic system. Elections for representation in local governments are expected to contribute to nurturing democratic values and creating future leadership without losing control over the process. This appears to be the motivation behind the local elections at the commune level recently in China and the devolution Plan in Pakistan.

These "political economy" objectives have been very significant historically in Pakistan. The importance of local governments in the overall governmental structure has had a relationship with the presence or absence of democracy in the country. During Martial Law regimes, local government institutions, being the only forum of public representation, have flourished. A brief history of local governments is presented in Box 8.2. Basic Democracies Order of 1959, Local Government Ordinance of 1979 and Devolution Plan of 2001, all introduced by military governments, significantly raised the profile and political clout of local governments. However, with the revival of national and provincial assemblies, local institutions have tended to lose significance. Elected MPAs and MNAs have taken over development responsibilities, including that of local services. This role was reinforced by the Junejo Five Point Programme in the late 80s which continued in subsequent elected governments under different names like the Peoples' Works Programme (Benazir Bhutto government), The Tameer-e-Watan Programme (Nawaz Sharif government) and more recently the Khushal Pakistan Programme.

BOX 8.1
LOCAL FUNCTIONAL ALLOCATION IN PAKISTAN AND INDIA*

Functions only in Pakistan

- Civil defense
- Information Technology
- Revenue
- Literacy
- Law and order

Functions only in India

- Land reforms, consolidation
- Poverty alleviation programmes
- Libraries
- Welfare of the weaker sections
- Women and child development
- Non-conventional energy
- Rural electrification, distribution of electricity
- Safe guarding the interest of weaker sections
- Urban poverty

Functions Common to both Pakistan and India

- Agriculture, including extension
- Fisheries
- Forests
- Soil conservation
- Education (all levels)
- Livestock
- Drinking water, on farm water management
- District coordination
- Community development and social welfare
- Cultural activities
- Registration of births and deaths
- Health and sanitation
- Family welfare
- Slaughter houses
- Fire services
- Cottage, small and medium sized enterprises
- Urban planning and town planning
- Regulations of land use and construction of buildings
- Markets, fairs
- Environment
- Water supply to domestic, industrial and commercial use
- Solid waste management
- Works and services
- Burial, cremations and its grounds
- Public amenities, including street lighting
- Parking lots, bus stops and pubic convenience
- Planning and development
- Energy

*as part of the Panchayati Raj

BOX 8.2
BRIEF HISTORY OF LOCAL GOVERNMENTS IN PAKISTAN

Despite a long history of local self-government in pre-partition India, local government institutions were not very developed at the time of partition in areas which now constitute Pakistan. Local councils, panchayats, were largely confined to the province of Punjab. The first real focus on local governance came with the launch of Pakistan's Village Agricultural and Industrial development Programme, commonly known as V-AID, in 1954. The programme's objective was to foster effective citizen's participation in rural self-help projects. Administratively, the programme was under the federal Ministry of Health and a central V-AID committee, consisting of related federal secretaries with a similar set-up at the provincial level. Despite its impressive achievements, V-AID was dissolved in 1961, largely because the new Martial Law government of the time came up with the idea of launching Basic Democracies, which had political objectives in addition to community development. Since the national and provincial assemblies were dissolved, it was realized that minimal involvement of the people in the running of the government was necessary to prevent a general perception of disenfranchisement. A key aspect of the Basic Democracies system was that the elected Basic Democracies members acted as the "electoral college" for election of the President and the assemblies. Overall, it may be said that some achievements did take place under the Basic Democracies and level of service provision improved somewhat, especially in the rural areas. The pronounced objective of mass participation in community development was, however, not realized. Bureaucratic control on operations and the political involvement of basic democrats became obstacles in the way of economic development.

The elected government of Pakistan's People Party abolished the Basic Democracies and introduced the People's local government Ordinance of 1972. No elections were, however, held under this Ordinance but the Integrated Rural Development Programme (IRDP) was launched in the early to mid 70s. IRDP could not be replicated successfully at the national level. The institution of local councils was revived in 1979 by the Martial Law regime. During the period, 1979 to 1985, when the political vacuum existed in the country, local elected representatives were called upon to play an increasingly important role. However, following the return of the civilian government in 1985, the elected MPAs and MNAs took over development responsibilities, including that of local services. The martial law government of Pervaiz Musharraf introduced the Devolution Plan in 2001. The plan significantly enhances the profile of local governments by substantially enhancing their role and responsibilities and their political clout.

Altogether, the basic conclusion which emerges is that the process of evolution of local governments after the creation of Pakistan has not been a progressive one. The policies have lacked continuity and every time when the institution was revived it was essentially a new experiment without real linkage with past practice and experience. As far as the importance of this institution in overall government structure is concerned, this has varied. The point to note is that its importance, has had a relationship with the presence of democracy in the country. During Martial Law regimes, local government institutions, being the only forum of public representation, have flourished. However, with the revival of national and provincial assemblies, local institutions have tended to lose significance.

A basic issue in the Pakistani context is whether social services like education or health should be delivered by provincial or local governments. Historically, provincial governments have been principally responsible for the provision of these services. However, Pakistan's performance in social development has lagged behind. At the turn of the millennium, only 43 percent of Pakistanis were literate, 108 children out of every 1000 were not able to live beyond five years and 70 percent of Pakistani households did not have access to clean, potable drinking water or proper sanitation facilities. As such provincial governments through the line departments have failed in providing adequate levels of social services.

The Social Action Program (SAP) was launched 1991 by the provincial governments to redress the substantial deprivation, particularly in rural areas. SAP was programmed to raise financing of social services to 1.8 percent of GDP and reform institutional delivery mechanisms. It had three over-achieving objectives: (1) improvement in service delivery through decentralization and community participation; (2) policy reforms to improve access and quality of social services; (3) increased and sustained fiscal commitment and the protection of funding from austerity cuts.

Research undertaken on SAP [SPDC, (1997), World Bank (1996)] demonstrates that though SAP was able to ensure increased financial outlays on social sectors, even during periods of austerity cuts, it had limited success in expanding coverage. For example, real expenditure on education expanded by 4 percent during the 90s while enrolments increased by 3 percent. The reasons for the failure were multiple and included: the lack of cost effectiveness; centralization and lack of devolution; duplication and dichotomy; lack of accountability; misuse of discretionary powers; overstaffing; selection by patronage; excessive transfers and absenteeism; lack of community participation; lack of approved policy; lack of cross-sectoral synergy; failure to involve the private sector; lack of monitoring and evaluation. Consequently SAP was abandoned by 2001 to be replaced by the Devolution Plan.

International experience, however, shows that for decentralization to local governments to be successful, there are certain pre- conditions, which may not exist in a country at a given period of time. According to the UNDP Human Development Report (2003), the pre-requisites include the following:

- Effective state capacity
- Empowered, committed and competent local authorities, and
- Engaged, informed, organized citizens and civil societies.

Decentralization requires coordination between levels of government and more regulation -not less- to ensure basic transparency, accountability and representation. Also, the state has to raise adequate fiscal resources to support decentralization. For these to be achieved, effective state capacity is necessary. Furthermore, to ensure that decentralization effort is not hijacked by the local elites, and there is broad based participation, both a strong state and a mobilized civil society is required.

Decentralization is influenced by a country's size, population, its political and institutional inheritance and diversity. These attributes have an overbearing affect on the design and modalities of decentralization, which are crucial for its success. Appropriateness of functions to be decentralized, adequacy of fiscal resources to be transferred to the sub-national governments, efficacy of administrative and legal setups and sufficiency of technical/skilled personnel at all levels of government are important ingredients for successful decentralization.

Politicians have more often than not used the slogan of decentralization as rhetoric to strengthen their own power rather than improve governance. In practice, the lack of willingness of the center to relinquish or share power has been a major impediment to effective decentralization. In fact, the inability to make the transition to a people-centered governance, with its commensurate implications for participation and empowerment is perhaps a bigger bottleneck in the process of decentralization than legislative changes, which in their right are also crucial.

Finally, lack of public awareness and an absence of a culture of participation and a weak voice of particularly the poor and marginalized sections of population has inhibited the development of: first, a two way accountability system whereby local governments are not only supervised by an effective state government from the above but also a strong civil society from below; second, a local government system which is responsive to the needs of all sections of populations, particularly the poor and the marginalized. Decision making process is dominated by local elites and government functionaries with little, if any, participation by the masses.

THE DEVOLUTION PLAN

The devolution plan of 2001, through a process of administrative, political and fiscal decentralization brings about a fundamental change in the structure of local governance in

Pakistan. Until the introduction of the LFO 2002 and LGO 2001, the Constitution of Pakistan (1973) recognized only two tiers of government - the federation and the provinces. Local governments now constitute a separate tier of government. Implementation of the Devolution Plan is a major step towards legally empowering local governments.

Structurally, the devolution plan is unique in a number of ways compared to the local government system tried in Pakistan before (see Box 8.3). First, it abolishes rural/urban distinctions in the territorial jurisdiction of local authorities. For example, the Tehsil Municipal Administrations (TMAs) now serve not only their traditional jurisdictions-the urban areas, but rural areas also.

BOX 8.3
COMPARISON BETWEEN THE BASIC DEMOCRACIES SYSTEM, LGO 1979 AND THE DEVOLUTION PLAN, 2001

Dimensions	BDO, 1959	LGO, 1979	Devolution Plan, 2001
A. HIERARCHY OF LOCAL GOVERNMENT			
1. Tiers of Rural Councils	*Four Tiers* ● Union Councils/Town Committees ● Tehsil Council ● District Council ● Divisional Council	*Three Tiers* ● Union Council ● Tehsil Councll	Four Tiers with No Rural/Urban distinction ● Village Committee ● Union Administration ● Tehsil/Town Municipal Administration ● District Council
2. Tiers of Urban Councils	*Four Tiers* ● Union Committees ● Municipal Committee ● District Council ● Divisional Council	*One Tier* ● Town Committee or Municipal Committee or Municipal Corporation or Metropolitan Corporation	
B. METHOD OF SELECTION OF MEMBERS			
1. Union Councils	Election	Election	Election
2. Tehsil Councils	Ex-officio: Chairman of UCs and Town Committees	Ex-officio: Chairman of UCs	Ex-officio: Naib Nazim of UAs
3. District Councils	Ex-officio: Chairman of Tehsil Councils; Municipal Committee; Nomination of official Members	Election: Nomination of official Members	Ex-officio: Nazims of UAs
4. Municipal Committee/	Ex-officio: Chairman of Union Committees; Nomination of official Members	Election	-
C. TERMS OF COUNCIL	Five Years	Four Years	Four Years
D. HEAD OF THE COUNCIL	UC - Elected TC - Assistant Commissioner of Tehsildar DC I - Deputy Commissioner DC II - Commissioner MC - Deputy Commissioner	UC - Elected TC - Elected MC - Elected	UA - Elected TMA - Elected DC - Elected
E. REPRESENTATION OF VULNERABLE GROUPS	-	Reserved seats for: ● Women ● Workers/Peasants ● Minorities	Reserved Seats for: ● Women ● Workers/Peasants ● Minorities
F. COORDINATION WITH NATION BUILDING DEPARTMENT	Strong	Loose	Loose
G. CONTROLLING AUTHORITY	Deputy-Commissioner or Commission	Chairman and House	Chairman and House
H. FREEDOM OF ACTION OF COUNCIL	Restricted	Less Restricted	Less Restricted
I. BUDGET APPROVAL	Deputy Commissioner	Elected House	Elected House

Second, the devolution plan not only separates the executive and judicial functions of the local bureaucracy it also abolishes the post of Deputy Commissioner and replaces it by the District Coordinating Officer (DCO) who, at least in theory, reports to the District Nazim. Third, the devolution process has led to the transfer of a large number of functions from provincial to local governments. This includes major social services like primary and secondary education, preventive and curative health, water supply, drainage and sewerage, and economic services like urban transport, farm-to-market roads and law and order. Consequently, provincial governments have been left with justice, higher education, agricultural development, irrigation, land reclamation, and highways. Fourth, the devolution plan enhances participation and community involvement. The 33 percent quota for women in the local councils, along with enhancement of reserved seats for minority and workers and peasants is a first step at empowering vulnerable groups. Fifth, resource transfers to local governments are based on the Provincial Finance Commission (PFC) Awards. Criteria-based, non-discretionary transfers auger well for local autonomy, transparency and continuity. However, the lack of enhancement in local fiscal powers is a major weakness in the process of fiscal decentralization. It has fundamental implications for the level of fiscal autonomy of local governments and on achieving higher levels of allocative efficiency in public expenditure through linking of taxation with benefits.

INSTITUTIONAL CHALLENGES

Devolution has come in an era of increased globalization and the resultant enhancement in the level of people's awareness and expectations, which have modified the requirements for government institutions, including local governments. Now the requirement is for the state institutions to be democratic, efficient in the use of public resources, effective in delivering public goods, and strong and capable of dealing with challenges. People want the state and its public administration to act as a social and economic promoter, capable of ensuring equitable distribution of and access to opportunities (political, economic, social and cultural), sustainable management of resources, fostering dynamic partnerships with civil society and the private sector, enhancing social responsibility and ensuring broad participation of citizens in decision - making and monitoring public service performance. In sum governments need to be efficient in the delivery of services and capable of promoting equity and empowerment.

Are local governments in Pakistan geared to cope with these changing demands of rapidly evolving socio-economic and political environment? What are some of the key emerging institutional, political and fiscal challenges?

In the six years since the implementation of the devolution Plan, local governments are faced with a number of challenges which affect their efficiency. These include:

- The design of the devolved structure
- Inter-governmental relations
- relationship between elected representatives and bureaucracy
- limited institutional capacity
- lack of transparency and accountability
- a reliable financial resource base

As mentioned earlier, the Devolution Plan 2001 overwhelmingly altered the local government system in Pakistan. The new system not only changed the structure of local government, eliminating rural/urban differences, but also transferred many more functions to the local governments. This unification of rural and urban governance and the "big-bang" approach to devolution of functions has stretched the capacity limits of the local governments.

Lack of coordination and clarity of roles and responsibilities has resulted in parallel jurisdictions between provincial and local governments. There is multiple reporting, whereby a local bureaucrat not only reports to the local elected representative but also to the provincial government, as the power of hiring, firing and transfer of local senior officials continues to be under the purview of the provincial government. It is clear that there exists a problem of 'mind set'. Provincial governments are yet to reconcile with the new situation of providing a dominating role to the elected representatives in running the affairs of the governments at district level. The political divide further aggravates the tension between the provincial and local administrations.

There are serious issues of coordination between the three tiers of local governments. TMAs are vertically independent in the new local governmental structure. The LGO does provide a mechanism of coordination between tiers through the Zila Mushavarati Committee (ZMC). However, in practice meetings are neither held regularly nor decisions implemented with any seriousness.

There are also significant capacity constraints. Local governments, particularly TMAs and UAs, are generally understaffed. However, at the district level the capacity constraint is not so much of the number of staff but rather the technical quality of the staff. Lack of proper accountability and transparency is another important challenge. Accountability is a key pillar of good governance that compels the government to focus on results, develop effective strategies, and monitor and report on performance. Though the LGO provides mechanism of monitoring and overseeing of public service functions by elected representatives through various committees like Village/ Neighborhood Councils, Monitoring Committees (District, Tehsil, Union), Complaint Cells, Musalihati Anjuman, etc. these generally have not been formed yet (except for Monitoring Committees) or are not performing according to their mandate as envisioned in the LGO.

Turning next to the other key question: Has devolution enhanced participation, broad-based political power and given a "voice" to the previously "voice-less"? The first mechanism of enlisting people's participation is through the election process. Two local government elections have been held to date under the devolution plan, one in 2001 and the other in 2005. Overall, local government elections demonstrate both positive and negative aspects. On the positive side, voter turnout has been relatively high, seats have been more keenly contested in 2005, especially for the position of Zila Nazim, and there has been a decline in the proportion of vacant or uncontested seats. On the negative side, the number of seats has been reduced significantly bringing down the degree of representation and there have been allegations of malpractices in the conduct of elections. This has perhaps been the major factor frustrating the process of empowerment of people as free and fair elections remain a basic pre-requisite for genuine empowerment.

As far as broad-basing of representation is concerned, there is clear evidence of state capture by local elites. SPDC (2006) demonstrates the overwhelming influence of family, zaat/ biradari/tribal ties and of political affiliation in the district Nazims election. The option of direct elections of District Nazims/Naib Nazims needs to be explored in order to reduce the possibilities of state capture.

On the positive note, the LGO reserved 33 percent of seats for women (in general and among peasants and workers) along with quotas for minorities, peasants and workers. Since Pakistan's independence, there has been some provision for reserved seats for women in the legislature, in addition to their constitutional right to contest elections. However, the operation of these provisions was never as effective as now. The initial skepticism about women not being willing to form a political cadre was largely put to rest with the nomination of a large number of women in the first local body election under devolution in 2001, though well grounded critiques have emerged about their state of preparedness for taking on the challenge. Despite the handicaps of limited capacity and a patriarchal governance structure, women's political commitment and personal emancipation and confidence appear to be on the rise.

Overall, the devolution process has not yet led to significant empowerment of the people. However, a number of significant processes have been put in motion including greater representation for the marginalized groups, especially women, and enhanced development role at the local level to community based organizations. But the true tests of success will be free and fair elections in future and a broad-basing of political representation so that the degree of state capture by local elites is reduced. To realize the dream of a truly equitable and empowered system, deep-rooted structural issues have to be resolved, which will require dedicated, sincere and sustained efforts by all-government, politicians and civil society.

FISCAL DECENTRALIZATION

On the fiscal side, there has been a significant rise in provincial transfers to the local governments. These have increased from Rs. 113.6 billion in 2002-03 to Rs. 209.9 billion by 2006-07, registering a double-digit growth rate (See Chart 8.1). This is largely due to the expansion in the provincial allocable pool of resources resulting from the rapid increase in federal transfers to provincial governments, which in turn increased substantially due to the buoyancy in federal tax revenues in response to the higher rate of GDP growth and an upsurge in the rate of inflation. Therefore, as earlier studies conclude (SPDC (2006)) the process of decentralization has been facilitated more by improvement in macroeconomic environment, than perhaps by a conscious effort on the part of the provincial governments to give greater priority to local governments. Transfers to local governments have actually declined from over 39 percent in 2002-03 of provincial allocable resources to 37.7 percent in 2006-07, as shown in Chart 8.2. By and large, it appears that devolution took place at the right time when the economy was able to create more fiscal space to enable expanded financing of local services.

CHART 8.1
TRANSFERS TO LOCAL GOVERNMENTS
(Rs. Billion)

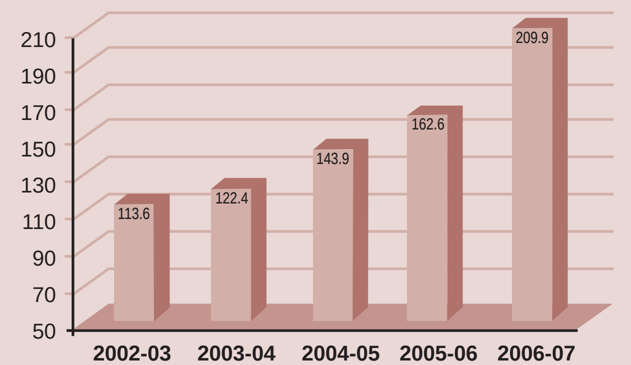
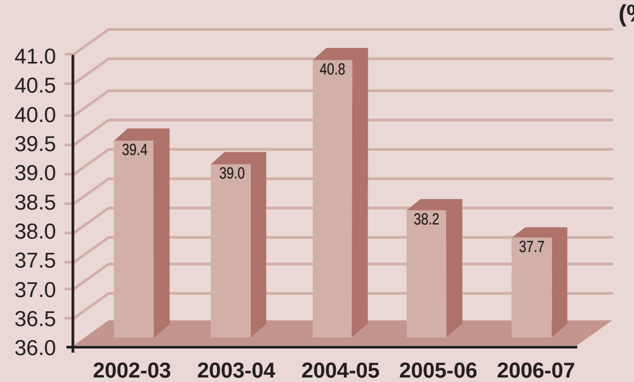


CHART 8.2
SHARE OF TRANSFERS TO LOCAL GOVERNMENTS IN PROVINCIAL RESOURCES
(%)



Has the devolution plan improved equity? The equity dimension of fiscal decentralization is influenced primarily by the formula given by the PFCs for the horizontal distribution of transfers among local governments. If the PFC award is such that the backward districts receive relatively large transfers per capita then it can be concluded that fiscal equalization is taking place. Broadly speaking, the formula for horizontal distribution can be distinguished between current and development transfers (see Box 8.4).

BOX 8.4
PFCs FORMULAE FOR CURRENT AND DEVELOPMENT TRANSFERS TO LOCAL GOVERNMENTS

PUNJAB

Current Transfers: According to the latest 2006 PFC Award, current transfers are classified into two types of grants: a general purpose grant and an equalization grant, with shares of 89 percent and 11 percent, respectively. The general purpose grant is distributed according to population while the equalization grant is shared on the basis of the fiscal gap between baseline expenditure and the general purpose grant.

Development transfers: Two third of the funds are distributed on the basis of population and one third on the extent of underdevelopment.

SINDH

Current Transfers: The 2007 PFC Award has specified multiple criteria for distribution of current transfers with varying weights such as: population (40 percent), service infrastructure (35 percent), development needs (10 percent), area (5 percent) and performance (10 percent). Transitional grants are only given to districts with relatively high levels of expenditure.

Development Transfers: 50 percent of the funds are given on the basis of population, 30 percent due to backwardness, 10 percent for backlog of on-going schemes and 10 percent are given through equal share.

NWFP

Current Transfers: Salary transfers are made as per needs of respective districts. Non-salary transfers are formula-driven, according to which 90 percent are distributed on the basis of population (50 percent), backwardness (25 percent) and lag in infrastructure (25 percent). The remaining 10 percent are set aside for equalization grants.

Development Transfers: 90 percent of development funds are distributed on the basis of population (50 percent), 25 percent for backwardness and lag in infrastructure gets 25 percent.

10 percent are on the discretion of the Governor and Chief Minister of the province.

BALOCHISTAN

Current transfers: to district governments are allocated on the basis of shares in total expenditure during 2001-02, the first year of devolution.

Development Transfers: 50 percent of the fund is distributed among districts on the basis of population and 50 percent on the basis of area.

An examination of the pattern of transfers to local governments reveals that their basis for distribution among districts differs widely among the provinces. Interestingly, Punjab relies primarily on population, while Sindh has introduced tax collection as one of the criteria and the NWFP focuses more on backwardness. An analysis of correlation between total transfers and the level of backwardness of the districts demonstrates that current transfers in Punjab are not "fiscally equalizing" Likewise, there is no evidence of fiscal equalization in Sindh [SPDC (2006)]. Also, there does not appear to be any significant link between the increase in a district's share in transfers over the period 2001-02 to 2006-07 in Punjab and its development ranking (see Table 8.2). Also, development transfers have grown somewhat less rapidly in Punjab than current transfers.

TABLE 8.1
TREND IN CURRENT AND DEVELOPMENT ALLOCATIONS TO DISTRICT GOVERNMENTS, PUNJAB

(Rs in Million)

	Current	Development
2001-02	37593	11192
2002-03	46613	10551
2003-04	48782	14353
2004-05	54785	17361
2005-06	66758	19195
Annual Growth Rate (%)	15.4	14.4

Source: Finance Department, Government of Punjab.

TABLE 8.2
TOTAL TRANSFERS TO DISTRICT GOVERNMENTS IN PUNJAB

(Rs in Million)

Districts	2001-02	2006-07	Change in Districts Share in Transfer 2001-02 to 2006-07	Development Ranking of District*
Rawalpindi	2126.7	4395.4	-0.22	4
Attock	1225.4	2528.5	-0.13	10
Jhelum	972.5	1732.5	-0.36	9
Chakwal	1184.8	2771.2	0.18	8
Sargodha	2036.7	4132.6	-0.28	18
Mianwali	828.1	1904.0	0.10	19
Bhakkar	1050.7	2036.1	-0.24	21
Khushab	963.0	1576.9	-0.49	22
Gujranwala	1647.3	4173.1	0.55	2
Hafizabad	1007.2	1485.4	-0.67	16
Gujrat	1495.5	3422.0	0.16	5
Sialkot	1736.5	3466.0	-0.30	3
Narowal	1189.0	2020.4	-0.53	13
M.B.Din	996.6	1947.9	-0.21	12
Lahore	2573.6	7239.1	1.54	1
Sheikhupura	1841.6	2720.1	-1.21	7
Kasur	1312.3	3078.2	0.21	14
Okara	1406.8	3092.9	0.03	23
Multan	1752.4	3934.8	0.11	15
Lodhran	847.7	1754.2	-0.09	34
Vehari	1233.7	3034.3	0.33	26
Sahiwal	1394.8	2652.7	-0.36	17
Pakpattan	828.3	1855.3	0.05	29
Khanewal	1355.2	3142.2	0.18	24
Faisalabad	2737.9	6700.3	0.70	6
T.T.Singh	1318.7	2386.3	-0.46	11
Jhang	1967.5	3925.7	-0.34	25
D.G.Khan	1361.4	2696.9	-0.25	30
Rajanpur	897.1	1623.8	-0.31	32
Muzafargarh	1314.4	3425.9	0.53	33
Layyah	1026.8	2164.3	-0.07	31
Bahawalpur	1713.5	3232.7	-0.47	27
Bahawal Nagar	1757.3	3458.7	-0.34	20
R.Y.Khan	1684.7	4563.8	0.84	28
Nankana Sahib	0.0	1915.3	1.80	-
TOTAL	**48785.8**	**106189.6**		

*Based on PERI (2001)
Source: Finance Department, Government of Punjab.

IMPACT OF DEVOLUTION

Has the Devolution Plan made a difference in the quality of life of people-which is the ultimate objective of improvements in the governance system? Six years have lapsed since the promulgation of the devolution Plan. Given the long term nature of the process it is probably too early to judge the success or failure of the devolution plan. However, the period is long enough for some of the effects to start becoming visible.

Our analysis demonstrates a mixed pattern of accomplishment in the post-devolution period. While, as highlighted above, expenditures on social services have increased substantially in the last few years, social outcomes have registered a varying degree of improvement. Real expenditure on education, for example, increased by 7.6 percent per annum during 2001-02 to 2005-06, enrolments have increased at a faster rate, at over 9 per cent. (See Table 8.3) Compared to this, in the pre-devolution period, 1992-2001-02, growth in real expenditure (4.1 percent) was higher than growth in enrolments (3.4 per cent). Clearly, the post devolution improvement in education has been more rapid than in the 90s under the Social Action Program. The private sector has, of course, played a major role in this. Likewise, there has been faster improvement in the coverage of water supply and sanitation. However, progress in the health sector after devolution has been limited and there are growing concerns about cost effectiveness of delivery by local governments in this sector.

AGENDA OF REFORMS

The analysis in previous sections has highlighted the changes that appear to manifest themselves in the six years following the implementation of the devolution plan. Clearly, some processes have been put in motion that can yield desired outcomes of improved efficiency in service provision, empowerment of the people and enhanced equity. However, for the objectives to be fully accomplished, the institutional, political and fiscal challenges emerging in the last few years need to be addressed. Stated below are future reforms required to address some of the major issues.

TABLE 8.3
GROWTH IN REAL EXPENDITURES AND OUTCOMES IN THE PRE AND POST DEVOLUTION PERIOD

(%)

	Primary and Secondary Education	Water Supply and Sanitation
1992-93 to 2001-02 - Pre-Devolution		
Growth Rate of Real Expenditure	4.1	n.a
Growth Rate of Coverage	3.4	0.7
2001-02 to 2005-06 - Post-Devolution		
Growth Rate of Real Expenditure	7.6	9.3
Growth Rate of Coverage	15.2	10.0

Design of the devolved structure of local governments

- District governments should be the apex development body for the district. All development activities (including funding, planning) should be routed through them. The introduction of district plans will facilitate 'bottom-up' and spatial planning in Pakistan.
- In the present scheme of things, there is hardly a linkage between the district government and TMAs. This is not only administratively undesirable but also creates anomalies in the development of infrastructure. It is, therefore recommended that TMAs should be integrated more effectively with district governments.
- Musalihati Committees are a good forum for conflict resolution. But these should be made more effective and their powers enhanced to ensure implementation of their recommendations.
- The local governments may be limited to major municipal (social and economic) services. Governance related services, like law and order and regulatory functions may be decentralized only when the local government structures are firmly established and the District Nazims are made more accountable to the people through direct elections. Meanwhile, on a pilot project basis in two districts of Pakistan, the police may be brought directly under the control of the Nazim.

Inter-Governmental Relations

- A short list of officials eligible for a particular position should be made available by the provincial government to the Nazim. Once the selection is made, the local official should enjoy a fixed tenure.
- Local Government Commissions have an important role under the Local Government Ordinance 2001. These have become all the more important after certain amendments in the LGO. For instance, the Chief Minister has been empowered to suspend a district Nazim. But if he does so, the matter is to be referred to the Commission. Similarly, if any resolution of decision of the district council or tehsil council is suspended by the Chief Minister, that too is to be referred to the commission. It is, therefore, recommended that the Commission should be made more autonomous and broad based. It may, perhaps, be headed by a retire judge of the High Court and should also include two to three persons on the recommendations of leader of opposition in the provincial assembly.

Local Institutional Capacity

- In order to make the district governments functionally independent, it is necessary to establish district cadres for different service groups.
- Elected representatives and bureaucracy at provincial and local levels may be trained for proper orientation to the new administrative structures.
- It is necessary to address capacity constraints particularly at the TMA level, by enhancing staff and strengthening technical capacity, and not reverting the functions to provincial line departments as has been the case with water supply in towns of Punjab.

- Priority must be given to strengthening local capacity through technical training such as use of modern tools for drafting, project management, planning, audit, as well as efficient maintenance of infrastructures
- UAs should have the option of securing additional development funding for small specific development projects in their jurisdiction. A proportion (say 40 percent) of funds earmarked currently for CCBs, could, perhaps, be used for this purpose. These funds are currently under-utilized..
- Special training programs may be offered for female elected representatives focusing on, among other things, communication skills. The appropriateness of the design of such training programmes is important. This is an area where donor support can be easily mobilized.

Transparency and Accountability

- The monitoring and supervisory committees provided for in the LGO, should be made effective and their functioning improved through training and necessary resource allocation.
- Enhancement of capacity for auditing in view of the greater authority and resources of local governments.
- Promotion of more active external monitoring of local governments by media and civil society institutions.

Political issues

- The amendment in LGO prior to the 2005 local government elections reducing the strength of union council from 21 members to 13 members, undermines the objective of enhanced representation and, therefore, needs to be revisited.
- Direct elections of Nazims and Naib Nazims to DAs and TMAs may be considered. The present system of indirect elections provides an opening for potential maneuvering and undermines the objective of grassroots democracy.
- It has been observed that there are planning and execution problems due to the political divide at the local levels. The desirability of holding joint elections at the district and tehsil levels may be examined. This may imply elections of panels of candidates at the district and tehsil levels.
- A significant amount of non-lapsable funds earmarked for CCBs have accumulated in many districts. The requirements and process of CCB project approval need to be streamlined and simplified.

Fiscal Issues

Own resource mobilization

- There is a strong case for enhancing fiscal powers to local governments. These are currently rather limited. Collection of municipal taxes like the urban property tax should be transferred initially to City District governments. Besides, the district governments may explore the possibility of levying service related taxes, as provided in the LGO. Also, local rates may be enhanced in the rural areas in lieu of the agricultural income tax.
- There is also a need to provide incentives to local governments for enhancing local fiscal effort. A separate criteria capturing local fiscal effort can be built into the formula for revenue transfers to local governments.
- Some of the more creditworthy jurisdictions may be authorized to tap the capital markets for raising resources for commercially viable projects. This approach could be tested on a pilot basis in a few districts that have already demonstrated the ability to raise and earmark resources for development. Sialkot in Punjab is an example of self-taxation for the purpose of

improving infrastructure in the district. This was the way the city was able to build an international airport.

Fiscal Equalization through transfers

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

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

At present with a newly elected government in power we are again in some state of uncertainty. Will this government resort to the same course of action as its predecessor elected governments? Or it will it demonstrate more vision and wisdom and let the process of decentralization of governance flourish in an effort to genuinely bring government closer to the doorstep of the people. Fortunately the present ruling coalition is committed to the process of decentralization (as per their manifestos). It is important to emphasize that for deepening of the local government structures their operation has to continue in an uninterrupted manner and their role has to be explicitly provided for in the national constitution. Also, it is necessary that the elections to local governments should be held periodically.

We feel that the reforms recommended in this chapter will strengthen the process of decentralization from the provincial to local governments. Coupled with decentralization of functions from the federal to provincial levels, discussed separately in this report, Pakistan has an opportunity today for taking strides towards the deepening of democracy and genuine empowerment of the people.

Chapter - 9

Promise and Potential of Pakistan's Exports: Developing A New Paradigm

Chapter - 9
Promise and Potential of Pakistan's Exports: Developing A New Paradigm

INTRODUCTION

The great success stories of development during the last half century, Korea, Taiwan, Hong Kong, Singapore, Thailand, and Malaysia including the relative newcomer China have one thing in common. They have all successfully exploited the possibilities offered by almost explosive growth in international trade. Putting it another way, there are few cases of rapid economic advance in modern history that have not relied on exports as an engine of growth.

In contrast, Pakistan, though it has enjoyed periods of spurts in export growth, has missed major opportunities to expand its exports especially manufactured goods exports. Indeed one can go as far as to say that failure to develop manufactured exports aggressively was one of the main reasons that Pakistan did not match the economic performance of the Asian tigers during the last half century. High rate of expansion of labor intensive manufactures would have also helped creating jobs and raising real wage rates at a faster pace, and thus could have also contributed to poverty alleviation.

Rapid International Trade Growth

Stimulated by liberalization of trade, reduction of tariffs, and technological changes reducing transport costs and improving information flows, the world trade has grown at a much faster pace than world output since the 1960s. The leading edge of this expansion has been the growth in world manufactured goods exports which have increased steadily from less than $ 200 billion in 1970 to $8.2 trillion in 2006, showing an average real growth of 11 per cent. While the nature of international trade in manufactures has changed quite significantly from finished goods to intermediate products or components, there has been no clear trend of slowing down in the pace of this growth. During 2000-06 world manufactured exports still expanded at average annual rate of 11 per cent.

Furthermore because of the shifting comparative advantage especially in labor- intensive manufactured goods, the share of developed countries (USA, Japan and EU15) in world manufactured exports has been declining. It came down from 75.8 per cent in 1980 to 63.8 percent in 2000 and it is estimated to have dropped further to around 55 per cent in 2006. These dramatic shifts in shares have been accompanied by major changes in composition of exports from developed countries away from textiles, clothing and other labor intensive goods. For instance, EU, US and Japan accounted for over two-thirds of world's textile and clothing exports even as late as 1980. By 2000 this share had dropped to a little over 35 per cent and has declined further to an estimated 30 per cent in 2006.[1]

Table 9.1 shows that for the sixteen major developing countries/entities, manufactured exports have risen nearly 30 times in the last quarter century, from $ 94 billion in 1980 to $ 2.7 trillion, while for the world as a whole they grew by less than eight fold from $ 1.1 trillion to $ 8.3 trillion over the period. The average annual growth rate of developing countries' manufactured exports has been around 14 per cent.

TABLE 9.1
MAJOR DEVELOPING COUNTRIES' EXPORTS AND TREND IN THEIR MARKET SHARE OF WORLD MANUFACTURED EXPORTS

Country	2006 Total Exports in US $ Billion	1980 Manufactured Exports in US $ Billion	2006 Manufactured Exports in US $ Billion	Manufactured Exports Market Share 1980	Manufactured Exports Market Share 1995	Manufactured Exports Market Share 2006
China	969.0	8.7	895.4	0.80	3.36	10.80
Hong Kong	322.7	18.0	304.7	1.60	4.32	3.69
Korea	325.7	15.7	290.1	1.43	3.08	3.50
Singapore	271.8	8.3	214.1	0.76	2.66	2.59
Taiwan	223.6	17.4	191.6	1.59	2.78	2.32
Mexico	250.3	4.4	189.2	0.40	1.61	2.29
Malaysia	160.6	2.4	117.9	0.22	1.48	1.42
Thailand	130.6	1.6	98.4	0.15	1.11	1.19
India	120.2	5.0	83.8	0.46	0.62	1.01
Brazil	134.5	7.5	68.4	0.69	0.66	0.83
Turkey	85.1	0.8	69.4	0.07	0.43	0.84
Indonesia	104.0	0.5	44.4	0.05	0.62	0.54
Philippines	47.0	2.1	40.6	0.19	0.37	0.49
Vietnam	39.6	--	17.8	----	NA	0.24
Pakistan	16.9	1.3	13.8	0.12	0.18	0.18
Bangladesh	12.1	0.5	9.3	0.05	0.07	0.10
Total for above Countries	3,216.0	94.1	2646.9	7.82	23.35	32.03
World Exports	12,062.0	1,092.4	8256.8	100.0	100.0	100.0

Source: WTO Statistical Tables. Note: Figures for Singapore, Bangladesh and Vietnam relate to 2005.

Almost all the market share lost by developed countries has been captured by Asian countries whose exports are increasingly dominated by manufactured goods exports. As is well known, export expansion by China during the last couple of decades has been spectacular. China's market share in world manufactured goods exports grew rather astoundingly from 0.8 per cent of the total in 1980 to 10.8 percent in 2006. But many other countries did well. The high performers of the 1960s and 1970s in East Asia (Korea, Singapore, Hong Kong Taiwan, Malaysia, Thailand) further expanded their dominant export positions especially during 1980-95. In the more recent decade gains in export shares by Mexico, Turkey, India and Vietnam have been particularly impressive though they did not nearly match China's performance that has been in a category by itself.

Pakistan's Export Performance

Against the background of this buoyant expansion in world trade in manufactured goods, Pakistan's export performance has been disappointing. In 1980 Pakistan was still substantially ahead of Turkey, Thailand and Indonesia, though it had already fallen behind Malaysia, Philippines and Mexico in the 1970s in the level of its manufactured exports. But now Pakistan's manufactured exports are less than one thirds of Indonesia's level, less than 20 percent of Turkey's and only 14 per cent of Thailand's.

Consequently, Pakistan's share in world manufactured exports at 0.17 per cent is lower than it was in 1970[2]: Pakistan's total share in world trade which now stands at 0.15 per cent has also not changed much over the last several decades. Pakistan has lost relative ground over time to all the major developing countries listed in the above Table with the exception of Brazil. This has happened notwithstanding 80 percent increase in manufactured exports during 2000-2006. The rise during the last several years merely compensated for the near stagnation in value of manufactured exports and loss of market share during the previous five years.

The trend since the end of 2005 has been even more disturbing. Pakistan's manufactured exports grew by less than 6 per cent during 2006 while world exports of manufactures grew by 13 per cent. Why Pakistan fell behind historically is discussed below in some detail. But our current export problems have much to do with both the structure of our exports and their competiveness.

World trade in textiles, our dominant category of exports, is growing at a much slower rate than the rest of the manufactures. Equally serious, Pakistan has recently lost market share in both garments and textiles as it has found itself unprepared to meet the new environment after the phase out of MFA and rather relentless competition from both China and India. In the process the profitability of the textile and clothing sector has declined sharply notwithstanding financial support provided by the government.

Why has Pakistan fallen so far behind in the export field? There are several reasons that are rooted in past policies and attitudes towards exports. First, export growth has never been a central pillar of development strategy a 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 of domestic raw materials. Export development based on imported inputs was strongly discriminated against by generally high duties on imports. Finally, the spurts of export growth that materialized in 1960s and 1980s were to a substantially extent artificially supported by indirect subsidies to the textile sector that 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 have been removed or reduced. The export taxation of cotton was phased out at the end of 1980s. Import tariffs have been gradually reduced and imports greatly liberalized.

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

As Table 9.2 shows, among large developing countries Pakistan has the least diversified pattern of manufactured exports with the exception of Bangladesh. More than 80 per cent of Pakistan's manufactured exports consist of textiles and clothing compared with less than 12 per cent for developing countries as a group and 6.5 per cent for world as a whole. While Pakistan is a major exporter of textiles and clothing, accounting for 2.1 per cent of world exports, its exports of manufactured exports other than textiles and clothing are very small. At $2.7 billion in 2006 they were only 0.033 per cent of world manufactured goods exports totaling nearly $8 trillion. India's manufactured exports (excluding textiles and clothing) are nearly twenty five times that of Pakistan while countries like Philippines, Indonesia, Turkey – by no means stellar performers in the export field – have other manufactured goods export levels around 15 times that of Pakistan's. Even a newcomer like Vietnam enjoys a 5-fold advantage over Pakistan in this regard.

Rationale for Export Push

In our view, if Pakistan hopes to sustain a high GDP growth rate of say 7-8 per cent per annum and at the same time avoid future balance of payments difficulties, it would need to nearly double its long term real export growth rate to 11 percent per annum, implying annual growth of around

TABLE 9.2
TEXTILES, CLOTHING AND OTHER MANUFACTURED EXPORTS FROM MAJOR DEVELOPING COUNTRIES
2006

(In Billions of $)

	Textiles Exports	Clothing Exports	Other Manufactured Goods Exports	Total Manufactured Exports
China	48.7	95.4	751.3	895.4
Hong Kong	13.9	28.4	262.4	304.7
Korea	10.1	2.2	277.8	290.1
Singapore	0.9	2.0	211.2	214.1
Taiwan	9.7	1.4	180.5	191.6
Mexico	2.2	6.3	180.7	189.2
Malaysia	1.4	2.8	113.7	117.9
Thailand	2.9	4.3	91.2	98.4
India	9.3	10.2	64.3	83.8
Brazil	1.4	0.3	66.7	68.4
Turkey	7.6	11.9	49.9	69.4
Indonesia	3.6	5.7	35.1	44.4
Philippines	0.2	2.6	37.8	40.6
Vietnam	----	4.8	13.0	17.8
Pakistan	7.5	3.6	2.7	13.8
Bangladesh	0.2	6.4	0.7	7.3
Total for above Countries	119.6	188.3	2338.0	2646.9
World Exports	218.6	311.4	7726.8	8,256.8

Source: WTO Statistical Tables. Note: figures for Bangladesh and Vietnam are for 2005. 2006 data for Turkey is provisional.

13 per cent in nominal US dollars. This would involve, unlike the past, substantially increasing the share of merchandise exports in its GDP (at present only 13 per cent - roughly the same level as in 1980 to 25 per cent over the next two decades) as well as significantly expanding Pakistan's share in world manufactured exports from 0.17 per cent at present to 0.35 per cent over the next twenty years.

But this is not as easy as it may seem. Pakistan's export push will unfortunately come at a time when more than a dozen large developing countries have established strong international competitive positions. Pakistan having missed several rounds of opportunities in international trade, now faces stiff competition not only from China, which continues inexorably to expand its market share, but also from relative newcomers like, India, Turkey, Mexico and Vietnam.

Competition from China appears particularly ominous for Pakistan. On an incremental basis, China captured 20 per cent of the growth in world exports of manufactures in 2006. In textiles and clothing Chinese share in 2006 growth was an almost unbelievable 55 per cent and its share in world textile and clothing exports rose to 27 per cent.

Those who might not be in favor of a highly export -oriented strategy can raise other questions. Is it a good time to enter the foray when the global economy appears to be slowing down? Is international trade still the dynamic force it has been in the last several decades? Can Pakistan, an almost total newcomer in most areas outside textiles and clothing, overcome the difficulties of making inroads in new markets and new products.

First, the international context. As mentioned above, there are no signs that the long-term world trade growth is slowing down. The trend towards liberalization and globalization are likely to continue because of sheer force of shifting comparative advantage. The fact that labor force growth in much of the developed world outside US is becoming negligible would continue to move the advantage to low labor cost countries in labor intensive goods and services.

Thus at the global level the opportunities for strong export expansion are likely to continue and the growth in world trade would continue to outstrip growth in output in the foreseeable future. Labor intensive manufactured exports and services remain a especially promising area. While China and now India and Vietnam are making international competition more difficult, some of more established East Asian countries/entities, Singapore, Hong Kong, Taiwan, Malaysia, Thailand and Korea, are finding it harder to increase their market share because of rising labor costs (See Table 9.1) and are shifting to more skill and technology intensive products. For instance, in textiles and clothing, exports from Korea, Hong Kong, Taiwan and even Malaysia are growing little and they are losing market share.

In the longer run, say over 10 to 15 years China may face a similar situation if its record speed of economic growth continues. China 's labor surplus will not last forever though right now this prospect may be difficult to visualize. Also, China 's large current account balance of payments surpluses, a reflection of global imbalances, cannot continue indefinitely. The pressures of domestic consumption along with policy shifts such as exchange rate appreciation will, on the one hand, slow down export growth from China and on the other hand increase imports into China. The opportunities for poor and populous Asian countries like India, Pakistan, Bangladesh, Indonesia and Vietnam in world trade would remain substantial.

It must also be stressed that Pakistan's very low share in manufactured exports other than textiles and clothing should be viewed as a source of major opportunities. Similarly the rise in world grain prices can give new lease of life to Pakistan's agriculture. Finally, even in textiles and clothing which are the most problematic areas at present, the low level of productivity and low levels of valued added provides a great scope for improving competitiveness and raising export earnings.

The overriding argument for a genuinely export oriented strategy is that Pakistan does not have a choice if it wants to pursue a high growth strategy. The domestic market is simply not large enough to sustain desired high levels of growth. Even a continental economy like China has had to look for overseas markets to sustain its very rapid growth.

The task of a major and truly historic turnaround in exports is huge. Clear national resolve and a multi-pronged approach remain important pre-requisites for success. Even then, there would be no quick paths to rapid export development and one needs to take a long view.

Export Development Strategy

However, a comprehensive development strategy focused on export growth as well as export diversification, improvements in productivity, education and skills, much better coordination within the government on export issues and much better interface between the government and the private sector will greatly enhance the prospects of attaining the suggested goals. Essentially, the export strategy cannot be and should not be separated from an overall vision of development that stresses rapid growth as well as job creation through a modernization process in which returns to both labor and capital increase and some of the productivity gains are passed on to the consumer through lower real prices. Some of the elements of such a multi-pronged approach are discussed below.

This should not be confused with target setting. Rather it should involve a full understanding of the constraints and bottlenecks hampering exports, a consensus within the society on realistic plans to deal with institutional, financial and policy issues, monitoring progress and results closely, and finally problem solving in a collaborative effort between the government and the private sector.

Overambitious targets can actually detract from problem solving solutions because they are often not taken seriously. Last year Pakistan government set an export target of $40-45 billion for 2013, implying a growth rate of 15 percent per annum over 2006-2013. These export goals are not realistic given the current weakness in exports. For one thing, the export target pins its hopes excessively-once again- on an expansion in textile and clothing exports to $22-25 billion from $11 billion at present- or more than 50 per cent of the growth in overall exports.

Pakistan's textile and clothing industries will remain vital for the country's economic future for decades and there is thus a need for developing a strategy looking beyond some of the current industry problems. A doubling of textile and clothing exports over 2006-13 as per government targets is, however, not on the cards and indeed should not be attempted because it will focus unduly on the short- term results rather than longer- term strength and could lead to clamor for financial assistance from the government.

But over the next ten years Pakistan can significantly improve its world market share in both textiles and clothing, markets which are expected, on a conservative basis, to grow on average by 5 and 7 per cent annually. Doubling of textile exports and trebling of clothing exports from Pakistan over the next ten years should be within reach.

However, as stressed above a strategy and national commitment are more important than plain targets. What should be strategy for this critical sector?

First, there needs to be a better understanding of the both facts and issues impacting the textiles and clothing exports in Pakistan. A few stylized facts are worth noting:

- The international trade in textiles and clothing totaled $ 530.8 billion in 2006, of which textile exports amounted to $218.6 billion and clothing exports were $311.4 billion.
- Clothing exports have risen substantially faster than textiles exports since 1980 and the trend continues. Over 2000-2006, textiles exports grew at an average annual rate of 5.5 per cent while clothing exports expanded at an annual rate of 8 per cent.
- China accounts by far the largest share of world textile (22.3 per cent) and clothing (30.6 per cent) exports, that is still growing rapidly.
- Exports from several major exporters of textiles, European Union, Hong Kong, Korea, and Taiwan (who still account for nearly half of world exports) are either stagnant or growing slowly and their declining shares are being captured not only by China but also by India.
- Pakistan remains the sixth largest world textile exporter. Its share in world exports expanded from 2.9 per cent in 2000 to 3.5 per cent in 2005 but declined slightly to 3.4 per cent in 2006
- Pakistan's clothing exports at $ 3.9 billion in 2006 were only 1.2 per cent of world exports, a share only slightly higher than in 2000 (1.1 per cent).
- The unit values of Pakistan's textile and clothing exports are among the lowest in the world and have been under further pressure because of intense international competition.

Several inferences can be drawn from the above facts. World textiles exports are not likely to grow fast, perhaps only at 5-6 per cent per annum. Though China would probably increase its share further for at least a few more years, substantial opportunities would still be available for countries like India and Pakistan, low wage cost countries and large producers of cotton. This is because some dominant textile exporters like EU, Taiwan, Korea and Hong Kong would face the pressure of rising costs and labor shortages just as Japan and Singapore who have had out to phase out their textile exports in the past. Eventually even China would face serious expansion limits in textiles.

Since Pakistan's market share in clothing is quite small and world clothing exports would grow faster than textiles, perhaps around 8 per cent per annum, more policy attention needs to be given to the clothing sector which also has much greater potential for creating jobs.

The strong government support given to the textile and clothing sector amounting to nearly Rs. 100 billion was necessary to avoid short term disruption in employment and foreign exchange earnings. This has included concessionary export finance, zero rating from general sales tax of all sales, refinancing of capital loans, research and development allowance, etc. Considering the extremely difficult fiscal situation, further financial support for textiles would not be feasible. In any case the focus only on boosting the short- term profitability of the sector may be misplaced. Since the unit values of textile exports are already the lowest, further financial support might just mean further loss of terms of trade. Subsidy in support of export activities where international prices are falling is not a good option.

Pakistan's textile industry problems are mainly structural relating to low skills, poor quality, low scale, poor delivery records, and not much movement up the value added chain. These structural problems cannot be solved without major new investment in both plant and equipment and human skills, which is not happening on the scale needed. To rectify the situation, greater induction of direct foreign investment must be sought actively by industry and government.

The garment industry also suffers from the same problems, low productivity, lack of scale, concentration on the low quality end of the product, and long lead times in delivery. A recent study on value chain analysis of cotton jean exports from Pakistan, as a proxy for the garments sector, suggests that Pakistan labor is cheaper but less productive. "The lack of shop-floor management and limited training are the key constraints to raising productivity." The low quality is reflected in very low unit value of exports that is one half of Turkey and 30 per cent lower than of India. But there are substantial differences between productivity, value added and profit margins between SMEs and large-scale producers. Exporters which are large garment producers employing thousands of workers and are "integrated down to the spinning or weaving stage are likely to employ up-to-date technologies and business processes and have become better at meeting the mass customization needs of foreign buyers" [World Bank (2006)].

Pakistan's exports especially of garments also suffer because of higher shipment time and costs. In clothing markets, time to delivery has become important because of changing fashion requirements. "Efficient port structure, reliable and competitive modes of transport, as well as efficient customs procedures figure as important public goods" [World Bank (2006)]. It has been estimated that Pakistan's relative time and shipping costs for US market are not only very much higher than USA's neighbors Canada and Mexico but also much above those for China and Hong Kong. Pakistan government realizes this and has initiated actions to reduce both transport and port costs and improve trade facilitation generally.

A strong textile and clothing industry also requires a large production base of good quality cotton. Lint quality remains a hindrance to upgrading fabrics and increasing value added for all types of producers. Better upstream processes of ginning, cleaning and drying of cotton, quality seed, pest control management would all help to improve the competitiveness and increase value added in textile exports. But right now incentives for investments in more modern machinery for ginning and drying and cleaning equipment are weak because there is an absence of cotton standards that will ensure higher prices for better quality.

To sum up increased scale of operations, greater investments and improvements across the value chain can increase the competitiveness and growth of textile and clothing industries. Foreign investment from countries like Korea, Taiwan and Hong Kong who are facing limits in their own textile industries could be a source of capital, know how and market access. China's help in investment, technology, and marketing should also be sought.

Although the level of Pakistan's manufactured exports, excluding textiles and clothing, a small at $ 2.7 billion in 2006-07, there are some promising new exports which have shown fast growth in recent years. This includes items like footwear, chemicals and pharmaceuticals, engineering goods and cement, as shown in Table 9.3. Also export, albeit very small, has started of products like cutlery, onyx, gems and jewellery, furniture, etc. These products could provide the basis for acceleration of non-traditional exports along with older exports like carpets, sports goods, surgical goods, and leather (tanned). It is essential that in-depth microstudies are undertaken of these sectors in order to identify the constraints to export growth and types of government intervention and support that is required.

TABLE 9.3
EXPORT OF OTHER MANUFACTURES
(EXCLUDING TEXTILE AND CLOTHING) BY PAKISTAN
($ Million)

	1999-2000	2003-04	2006-07	Growth Rate (%)
Carpets, Rugs, and Mats	264	231	260	-0.2
Sports Goods	279	325	412	5.7
Leather Tanned	175	252	469	15.1
Footwear	-	-	110	-
Surgical Goods	120	89	236	10.1
Chemicals and Pharmaceuticals	100	263	474	24.9
Engineering Goods	7	100	325	73.0
Cement	-	-	103	-
All Other	322	835	413	3.6
Total Other Manufacturing	1267	2095	2802	12.0

Source: FBS
SBP, Annual Report

Excessive government attention to and pre-occupation with textiles and clothing exports must be avoided. The vision for rapid export development must give a central place to the very speedy growth of manufactured goods other than textiles and clothing for which our presence in world markets is trifling. As mentioned above, for the longer run, the virtual absence of Pakistan in world markets for manufactures other than textiles and clothing (a 0.33 percent share) actually represents an unparalleled opportunity.

The potential of agricultural, horticultural, dairy and fisheries exports also remains largely unexploited. The rise in world price of grains has improved the prospects of wheat as well as rice exports.

Role of the State

A major transformation of the economy towards exports orientation on the scale that is being suggested here would involve a major role of the state not only in providing the overall vision but also in supporting, guiding and facilitating the progress especially in areas outside textiles and clothing.

Macroeconomic stability, low inflation, and a realistic exchange rate must be taken as given for a favorable investment climate. With recent downward moves in the rupee, Pakistan's exchange rate does not need any significant once-and-for-all realignment. However, it is important to lay down the policy that the real effective exchange rate will not be allowed to appreciate. In addition, Chapter 5 recommends a series of fiscal incentives to encourage non-traditional exports.

As mentioned elsewhere, the power system with its frequent load shedding and uncertainty of supply remains a major problem area for the industry though the evidence on whether the power tariffs in Pakistan are higher than in major competing countries is not clear cut. Overcoming the energy crisis would in any case be fairly high on the new government's priorities. Pakistan's national expenditures on education remain low and improving literacy and skills levels, important objectives in themselves, would greatly contribute to productivity increases and export competitiveness.

Providing duty free access to imported raw materials and intermediate products to exporters has been a classic instrument for export promotion in East Asian countries. The duty free zones were a great success in Korea and Taiwan while Hong Kong and Singapore had virtually no import duties. Starting in 1980, China, drawing on the example of Hong Kong, turned large parts of its Eastern coast into essentially free trade zones.

In Pakistan the one free trade zone that was initially planned in late 1970s has never really worked very effectively. Instead reliance has been on duty drawback and sales tax rebate schemes. Though substantial improvements have been made in these schemes over time, the level of distrust between government and the private sector remains high. Revenue officials complain about large-scale fraud by businessman and the businessmen perpetually complain about delays in receiving refunds. Recent improvements to further improve the schemes for the major export sectors are commendable but as has been suggested targeting new export activities and SMEs is even more important [World Bank (2006)].

The implementation of a recent agreement with China to start a free trade zone near Lahore needs to be pursued aggressively. The offer by US to give special export status to exports from special zones in tribal areas should be taken seriously. Jordan 's manufactured exports have gained a great deal from special access to the US in textiles. US has not done much so far for special access of Pakistan textiles and clothing imports. Concessions that can be obtained would be particularly valuable in the next a couple of years when voluntary restraint on textiles exports agreed by China lapses.

Since the task of rapid export development is so huge, the general export policies outlined above will not suffice. More targeted interventions are required to promote products with clearly high potential, new areas in which Pakistan appears to have a comparative advantage, to benefit from rapidly growing markets like China and Middle East, to seriously explore increasing trade with India and other neighboring countries, and last, but not least, using the considerable foreign investment to promote exports.

As indicated in Chapter 2, direct foreign private investment flows (excluding privatization) increased twelve fold to $ 4.9 billion over 2002-07. The impact of this dynamic process on job and growth needs to be better understood. However, bulk of this investment has been concentrated in telecommunications, oil and gas exploration, and financial sectors. Investment in manufacturing sector especially in export oriented industry has been small. This is a seriously lop sided situation. As mentioned above, Pakistan needs large new investment even in its premier textiles and clothing exports to overcome some of its current problems. More thought needs to be given to managing the process of large foreign investment flows to assist in upgrading technologies and expanding and diversifying exports.

Picking out winners in the export growth and development processes remains a somewhat controversial issue among economists. Pakistan has not done well by its continued heavy reliance on textiles and clothing and certainly in retrospect government support provided to the industry was excessive. The textile industry was protected too long through export tax on cotton and favored access to long -term credit. Now in the post -quota world it finds itself stuck in relatively low value added activities. But because the long-run fundamentals of textile and clothing business remain strong, this mature industry should be able to expand and prosper without further direct or indirect subsidies from the government. Indeed handouts are likely to impede and delay the process of structural change and productivity improvements.

The conversion of the Export Promotion Bureau into an autonomous Trade Development Authority is a step in the right direction. But the Authority will need to substantially upgrade its professional capabilities to earn the respect and confidence of the private sector.

Export promotion efforts must not only target commodity groups but also markets, indeed in many cases commodity groups in special markets like fruits and vegetables in neighboring countries. Pakistan should also focus on the fast-growing markets in China and the countries of the Middle East. In these countries, Pakistan must strive to use its good political relations effectively in pursuit of export goals. At the same time, trade relations with India should be opened up as quickly as possible.

Pakistan's trade with China is very imbalanced at present. No reliable figures on bilateral trade between China and Pakistan are available but there is a large trade balance in favor of China. Influx of cheap Chinese imports are dampening domestic manufacturing output while exports to China remain small. It is reasonable for Pakistan to seek a more balanced relationship considering China's huge balance of payments surplus and Pakistan's large deficit. Pakistan should seek a greater access to Chinese markets in agricultural products and at the same time seek Chinese help to develop Pakistan's manufactured exports, including clothing and textiles.

The instrumentalities for implementing plans and policies would also have to involve much better policy coordination within the government and much better inter- face with the private sector. At present the responsibilities for export promotion are quite dispersed among many actors, including the ministry of commerce, the trade development authority, the ministry of industries, the textiles ministry, etc and the provincial governments. A cabinet-level committee supported by sector groups in which private sector also has effective participation would help by closely monitoring exports and speedily resolving policy and implementation issues.

CONCLUSION

The major elements in an export development strategy should be:

- Strong national commitment.
- Recognizing that while textiles and clothing will remain a vital and expanding export sector, they cannot be the engine of growth. Limits of government support for textiles have been reached and the industry must learn to be competitive through investments in physical capital and skills.
- Diversification deserves the highest priority, manufactured goods other than textile and clothing, agricultural and information technology exports should lead the way and get necessary government attention and support.
- Role of state can be crucial in the early stages of this diversification through aggressive targeting of markets and products improving access and speedily removing obstacles.
- Foreign direct investment should be specially encouraged in export fields.
- The instrumentalities for implementing plans and policies would also have to involve much better policy coordination within the government and much better inter- face with the private sector.

Annexure Key Indicators

Annexure
Key Indicators

TABLE A-1
LEVEL AND PATTERN OF GROWTH

	GDP Growth Rate (%)	Incremental Capital Output Ratio	Volatility of Growth[a] (%)	Extent of Balanced Growth[b]	Relative Growth Rate of Labor Intensive Sectors[c]
2000-01	2.0	9.05	-2.2	6.01	0.78
2001-02	3.1	5.59	-0.2	4.04	1.01
2002-03	4.7	3.72	1.2	3.71	1.68
2003-04	7.5	2.10	3.9	10.98	0.16
2004-05	9.0	1.86	4.8	6.86	0.72
2005-06	6.6	2.72	1.3	8.46	0.72
2006-07	7.0	2.89	0.8	5.30	0.99
Average	**5.7**	**3.99**	**1.4**	**6.48**	**0.86**

Source: Pakistan Economic Survey, various issues.

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

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

[c] Labor-intensive sectors include agriculture, small scale manufacturing, construction, wholesale and retail trade, public administration and defence and social services.

TABLE A-2
LEVEL AND PATTERN OF INVESTMENT

	Gross Domestic Capital Formation (% of GDP)	National Savings as % of Investment (%)	Private Investment as % of Total Investment (%)	Share of Private Investment in Labor Intensive Sectors (%)
1999-2000	13.3	88.0	65.0	40.3
2000-01	17.2	90.7	64.0	37.5
2001-02	16.8	123.2	72.7	33.7
2002-03	16.8	128.6	73.8	31.6
2003-04	16.6	110.8	72.4	34.4
2004-05	19.1	92.7	74.3	36.0
2005-06	21.7	81.6	75.9	30.5
2006-07	23.0	78.3	75.2	28.1
Average	**18.1**	**99.2**	**71.7**	**34.0**

Source: Pakistan Economic Survey, various issues.

TABLE A-3
AGRICULTURAL GROWTH AND PROFITABILITY

	Growth Rate (%)	Share of Growth in Crop Sector (%)	Volatility in Agriculture Growth (%)[a]	Growth Rate of Inputs (%)	Change in Ratio of Output Prices to Fertilizer Prices (%)	Change in Agriculture Terms of Trade with Manufacturing (%)
1999-2000	n.a.	n.a.	1.3	5.8	6.6	n.a.
2000-01	-2.2	n.c.	-6.9	3.6	-3.1	4.6
2001-02	0.1	n.c.	-1.9	1.2	-5.4	0.0
2002-03	4.1	60.8	2.1	-1.3	-0.7	-0.8
2003-04	2.4	44.6	0.4	3.9	0.4	0.2
2004-05	6.5	95.7	4.4	10.2	-4.5	-2.1
2005-06	1.6	n.c.	-0.6	3.5	-4.9	-8.0
2006-07	5.0	54.7	2.1	4.4	13.2	6.4
Average	**2.9**	**n.c.**	**0.1**	**3.5**	**-1.0**	**0.0**

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

Source: Pakistan Economic Survey, various issues.

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

TABLE A-4
LEVEL AND PATTERN OF MANUFACTURING GROWTH

	Growth Rate (%)	Growth Rate of Export Oriented Industries (%)	Growth Rate of Import Substituting Industries (%)	Share of Growth in Large-Scale Manufacturing (%)	Growth Rate of Manufactured Exports (%)
2000-01	9.3	27.6	4.6	76.3	6.2
2001-02	4.5	9.7	3.1	52.0	1.5
2002-03	6.9	4.3	7.6	68.2	22.2
2003-04	14.0	8.0	15.5	84.6	11.6
2004-05	15.5	26.5	12.7	87.0	15.6
2005-06	10.0	5.9	11.1	75.2	14.4
2006-07	8.4	2.8	9.9	73.3	3.4
Average	**9.8**	**12.1**	**9.2**	**73.8**	**10.7**

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

TABLE A-5
GROWTH IN EMPLOYMENT BY SECTOR

	Employment (000)		Employment Growth Rate (%)	Value Added Growth Rate (%)	Employment Elasticity
	2001-02	2005-06			
Agriculture	20474	19075	-1.7	3.7	-0.48
Manufacturing and Mining	4982	5421	2.1	11.4	0.18
Electricity and Gas	299	296	-0.3	3.9	-0.07
Construction	2757	3579	6.7	4.4	1.53
Wholesale and Retail Trade	5090	6635	6.8	8.7	0.78
Transport and Communication	2216	2452	2.6	4.5	0.57
Finance and Insurance	247	491	18.7	17.9	1.05
Public Administration and Community Services	7151	8405	4.1	6.1	0.67
Total	**43286**	**46365**	**1.7**	**6.9**	**0.25**

Source: Household Integrated Survey, Federal Bureau of Statistics.

TABLE A-6
INFLATIONARY TRENDS

	Rate of Inflation (Consumer Prices) (%)	Rate of Inflation (Food Prices) (%)	Core Rate of Inflation (Non-Food Non-energy) (%)	Rate of Inflation in Import Prices (%)	Rate of Monetary Expansion less GDP Growth (%)
1999-2000	3.6	n.a	n.a	16.0	5.5
2000-01	4.4	3.6	n.a	15.2	7.2
2001-02	2.5	2.5	n.a	0.0	12.3
2002-03	3.1	2.8	n.a	3.7	13.3
2003-04	4.6	6.0	3.9	14.8	12.1
2004-05	9.3	12.5	8.8	10.4	10.3
2005-06	7.9	6.9	7.0	17.3	8.3
2006-07	7.8	10.3	6.9	4.6	12.3
Average	**5.4**	**5.8**	**6.6**	**10.3**	**10.2**

Source: Pakistan Economic Survey, various issues
State Bank of Pakistan, Annual Report
IMF Article 4 Consultation's Press Releases

TABLE A-7
FISCAL POLICY

(%of GDP)

	Revenues[a]	Expenditure[b]	Non-Interest Current Expenditure[c]	Budget Balance[d]	Revenue Deficit/Surplus[e]
1999-2000	14.1	18.7	9.5	-4.6	-3.0
2000-01	13.3	17.6	9.4	-4.3	-2.2
2001-02	14.2	19.7	9.6	-5.5	-1.7
2002-03	14.7	18.5	11.4	-3.8	-1.4
2003-04	14.1	16.4	9.5	-2.3	0.8
2004-05	13.9	17.2	9.9	-3.3	0.5
2005-06	14.2	18.5	10.2	-4.3	0.6
2006-07	14.9	19.2	11.5	-4.3	-0.9
Average	**14.2**	**18.2**	**10.1**	**-4.1**	**-0.9**

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

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

TABLE A-8
FISCAL POLICY

	Primary Balance[a] (% of GDP)	Total Government Debt (% of GDP)	Effective Interest Rate on Domestic Debt (%)	% of Deficit Financed by Bank Borrowing (%)
1999-2000	n.a	83.7	14.1	19.3
2000-01	1.3	88.8	11.3	-18.4
2001-02	0.1	81.4	12.4	7.4
2002-03	0.4	74.5	10.2	-30.5
2003-04	1.2	67.8	9.4	47.4
2004-05	0.0	62.9	8.5	27.7
2005-06	-1.2	57.3	10.2	21.8
2006-07	-0.1	54.6	13.8	36.5
Average	**0.2**	**71.4**	**11.2**	**15.9**

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

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

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

	Income Tax (%)	Customs Duty (%)	Excise Duty (%)	Sales Tax (%)	Total FBR Taxes (%)
1999-2000	4.3	19.1	6.4	11.6	9.1
2000-01	4.2	17.8	4.7	13.1	9.3
2001-02	4.5	12.0	4.3	14.1	9.1
2002-03	4.4	14.8	3.6	14.8	9.4
2003-04	4.0	14.3	3.1	12.7	9.2
2004-05	3.8	11.2	2.9	10.0	9.1
2005-06	3.9	12.1	2.4	10.3	9.4
2006-07	5.0	10.5	2.7	9.9	9.7
Average	**4.3**	**13.9**	**3.8**	**12.1**	**9.3**

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

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

TABLE A-10
MONETARY POLICY

	Net Foreign Assets (% Change of broad money)	Net Domestic Assets (% Change of broad money)	Private Credit Growth (%)	Interest Rate on Six Month Treasury Bill (%)	Broad Money Growth (%)	Interest Rate Spread[a] (%)
1999-2000	2.0	7.4	1.4	8.8	9.4	8.0
2000-01	5.1	3.9	4.0	10.4	9.0	8.3
2001-02	13.4	2.0	4.8	8.2	15.4	9.6
2002-03	17.5	0.5	18.9	4.1	18.0	7.8
2003-04	2.1	17.5	29.8	1.7	19.6	6.3
2004-05	2.2	17.1	33.2	4.7	19.3	7.4
2005-06	2.5	12.4	33.2	8.2	14.9	8.7
2006-07	8.1	11.3	17.2	8.8	19.3	9.0
Average	**6.6**	**9.0**	**16.6**	**54.9**	**15.6**	**8.1**

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

[a]Difference between the interest rate on advances and deposits.

TABLE A-11
LEVEL AND PATTERN OF TRADE

	Merchandise Export Growth (US $; %)	Extent of Product Diversification of Exports[a]	Extent of Market Diversification of Exports[a]	Merchandise Import Growth (US $; %)
1999-2000	11.2	0.801	0.230	13.1
2000-01	12.5	0.798	0.221	14.3
2001-02	2.3	0.786	0.221	-7.5
2002-03	20.1	0.791	0.223	20.1
2003-04	13.5	0.782	0.232	21.2
2004-05	16.2	0.778	0.218	38.3
2005-06	14.3	0.769	0.229	31.7
2006-07	3.2	0.737	0.230	8.0
Average	**11.7**	**0.780**	**0.226**	**17.4**

Source: Pakistan Economic Survey, various issues
International Monetary Fund, Database
UNCTAD

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

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

	Change in Terms of Trade (%)	Share of Essential Imports[a] (%)
1999-2000	-15.3	39.3
2000-01	-7.1	39.3
2001-02	-0.1	36.7
2002-03	-9.6	35.0
2003-04	-4.1	28.8
2004-05	-6.4	25.0
2005-06	-11.7	30.7
2006-07	-3.6	29.1
Average	**-7.2**	**33.0**

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

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

TABLE A-12
BALANCE OF PAYMENTS

	Current Account Balance (% of GDP)	External Debt as a % of Exports of Goods and Services	Gross Reserves (US $ Million)	Gross Reserves (In months of next years imports of goods and services)	Change in Value of Pakistani Rupee per US $ (%)	Change in Real Effective Exchange Rate (%)
1999-2000	-1.6	322.1	908	0.9	3.0	-0.6
2000-01	-2.7	309.4	1679	1.7	12.8	-2.5
2001-02	3.9	282.0	4337	3.7	5.1	-2.6
2002-03	4.9	229.0	9529	6.5	-4.7	-0.1
2003-04	1.8	209.5	10564	5.0	-1.5	-1.8
2004-05	-1.4	183.7	9805	3.5	3.1	0.3
2005-06	-3.9	167.2	10760	3.7	0.8	5.3
2006-07	-4.9	169.2	14287	4.5	1.3	0.5
Average	**-0.5**	**234.0**	**7734**	**3.7**	**2.5**	**-0.2**

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

TABLE A-13
TREND IN INCOME INEQUALITY
Growth in Real Household Income by Quintile
(Annual Growth Rate, %)
2001-02 to 2005-06

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

Source: Household Integrated Expenditure Survey, Federal Bureau of Statistics

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

	Number of Employed (000)		Annual Growth Rate (%)
	2001-02	2005-06	
Punjab	25224	27292	2.0
Sindh	10819	11043	0.5
NWFP	5208	5881	3.1
Balochistan	1931	1988	0.7
Pakistan	**43286**	**46365**	**1.7**

Source: Household Integrated Survey

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

	(Annual Growth Rate, %) 2001-02 to 2005-06		
	Urban	Rural	Total
Punjab	5.9	10.5	9.0
Sindh	1.8	8.9	6.1
NWFP	9.0	9.0	9.0
Balochistan	-3.1	-3.0	-2.5
Pakistan	**4.4**	**9.2**	**7.8**

Source: Household Integrated Survey

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

	1998-99	2001-02	2006-07
Gross Primary Enrolment Rate			
Punjab	75	76	100
Sindh	64	63	79
NWFP	70	77	82
Balochistan	64	62	72
Max/Min Ratio	**1.172**	**1.242**	**1.389**
Net Primary Enrolment Rate			
Punjab	44	45	62
Sindh	41	40	50
NWFP	39	41	49
Balochistan	36	32	41
Max/Min Ratio	**1.222**	**1.406**	**1.512**
Gross Middle Enrolment Rate			
Punjab	43	45	55
Sindh	38	34	43
NWFP	37	38	53
Balochistan	29	33	34
Max/Min Ratio	**1.483**	**1.364**	**1.618**
Net Middle Enrolment Rate			
Punjab	19	18	20
Sindh	17	14	17
NWFP	11	12	16
Balochistan	9	8	9
Max/Min Ratio	**2.111**	**2.250**	**2.222**

Source: Pakistan Living Standard Measurement Survey, FBS

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

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

Source: Pakistan Living Standard Measurement Survey, FBS

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Notes

CHAPTER - 2

1. See State Bank of Pakistan, Annual Report 2006-07 Chapter 5 Table5.2.
2. This is partly due to the encashment of the very high rate interest Ten year Defence Saving Certificates issued in mid 1990s which were held to maturity because of progressively high interest rates in the final years.
3. Rashid Amjad, Pakistan's Poverty Puzzle: Whom should we believe? What should we do? , Parvez Hasan, Mixed Messages In Poverty Numbers , Dawn, April 3, 2006, Ministry of Finance, Economic Surveys , 2005-06 and 2006-07, World Bank Reports, Pakistan Poverty Assessment: Vulnerability , Social Gaps and Rural Dynamics (2002) Pakistan Promoting Rural Growth and Poverty Reduction 2007, Dr. Sadia M. Malik, Poverty of Opportunity, Dawn, March 3, 2008.

CHAPTER - 3

1. Government of Pakistan, Planning Commission, *Vision 2030*, Islamabad, 2007 and Government of Punjab, *Vision 2020*, Planning and Development Department, Lahore, 2005.
2. Adam Smith's book *An Inquiry into the Nature and Causes of the Wealth of Nations* is seldom read in its original from. It is long and the language is often difficult. That notwithstanding, Smith remains by far the most quoted economist in economic literature. For a more readable and accessible account of Smith's contribution see P.J. O'Rourke, *On the Wealth of Nations*. New York, Atlantic Monthly Press, 2007.
3. Mahbubul Haq was the principal architect of the Second Five Year Plan. For a description of the model that underpinned the plan see his book, *The Strategy of Economic Planning: A Case Study of Pakistan*, Karachi: Oxford University Press, 1966.
4. Some of the problems Pakistan currently faces and the opportunities that exist for it were analyzed by me in my most recent book. See Shahid Javed Burki, *Changing Perceptions, Altered Reality: Pakistan's Economy under Musharraf, 1999-2006*, Karachi: Oxford University Press, 2007.
5. The likely impact of the damage done to the economy by the troubles that followed this assassination of Benazir Bhutto was analyzed by me in a newspaper article appeared soon after that that tragic event. See Shahid Javed Burki, "Economic cost of the Crisis," *Dawn*, January, 22, 2008.
6. Government of Pakistan, Ministry of Information and Technology, *Broadband penetration in Pakistan: Current scenario and future prospects*, Islamabad, 2007
7. Jagdish Bhagwati, an Indian-American economist now at Columbia University, is the most articulate exponent of this point of view. See his book,
8. The potential of the SAFTA for its various members was examined by a team of economists headed by this author for a study sponsored by the US AID. See US AID, *South Asian Free Trade Area: Opportunities and Challenges*, Washington DC, October 2005.
9. *Ibid.*, p. 194.
10. Prag Khanna, "Waving goodye to hegemony" *The New York Times Magazine*, Jnauray 27, 2008, pp.34-67. The article is based Khanna's forthcoming book, *The Second World: Empires and Influence in the New Global Order*, New York, Random House, 2008.

CHAPTER - 4

1. A more detailed research paper by Akmal Hussain on which this chapter is based is being published separately as an IPP Research Report.
2. North, Wallis and Weingast have posited the concept of a social order which is composed of the economic and the political systems. They classify countries into two broad categories: the under-developed countries are placed in the category of the "limited access social order" while the developed countries belong to the "open access social order". Limited access social orders are characterized by rent creation, privileged access over economic and political power for the elite and exclusion of a large proportion of citizens from equal access over markets, resources and political decision making. Consequently, North, et.al argue that limited access social orders "preclude thriving markets and long term economic development". By contrast open access social orders provide equality of opportunity to access economic and political power on the basis of systematic competition, innovation, merit and mobility. Consequently, they argue that open access social orders are characterized by "thriving markets and long term economic development" See, Douglass C. North, John Joseph Wallis, Barry R. Weingast, A Conceptual Framework for Interpreting Recorded Human History, National Bureau of Economic Research, Working Paper Series, Cambridge (Mimeo), December 2006.

3. Estimates based on Pakistan Economic Survey, 2006-07.
4. About 33 million tons of salts are annually brought into the Indus Basin Irrigation System, out of which 24 million tons are being retained. See: Interim Poverty Reduction Strategy Paper, Government of Pakistan, November 2001, Page 23.

CHAPTER - 5

1. Investment in DSCs which was about Rs 20 billion annually in the mid-90s jumped to over Rs 40 billion in the late 90s. The DSCs have a maturity period of 10 years. Therefore, redemption of the large investments made in the late 90s has come due at the end of this decade. Interest rates were pitched then at high levels of over 18 percent per annum. This implies that the value at redemption is over five times the investment. Therefore, the additional outflow currently is about Rs 100 billion. The fact that this was unanticipated by the Ministry of Finance highlights the pitfalls of continuing with cash accounting and not switching over to accrual accounting.
2. According to the Household Integrated Economic Surveys of the FBS, household incomes of the top quintile of the population have gone up twice as fast in real terms as that of the lowest quintile of population between 2001-02 and 2005-06.
3. The year 1999-2000 has been chosen as the first year of analysis because, first, this corresponds to the first year of the military takeover and, second, for statistical reasons, because the GDP was revised in 1999-2000 and ratios prior to this year are, therefore, not comparable.
4. The Indian economy has experienced rapid growth of over 8½ percent per annum during the last four years. During this period the tax-to-GDP ratio of the Union and State Government of India has increased from 16½ percent to over 18½ percent of the GDP.
5. If the rise in the principal value of defence saving certificate due to accumulation of interest is allowed for, then the size of public debt goes up by about Rs 400 billion and the public debt-to-GDP ratio approaches 60 percent.
6. The effective cost of borrowings from the Central Bank to the government is zero as interest payments revert back as profits of SBP.
7. The sector wise contribution to tax revenues in 2004-05 is estimated by the Debt Office [2008] as follows: agriculture, 1 percent, industry, 70 percent and services, 29 percent. The corresponding shares in value added are as follows: agriculture, 22 percent, industry, 24 percent and services, 54 percent. Within indirect taxes the major revenue spinners in 2006-07 were POL products (21 percent), automobiles (8 percent), telecommunications (7 percent), cigarettes (6 percent), machinery (5 percent), edible oils (5 percent) and iron and steel (4 percent).

CHAPTER - 6

1. The World Bank's World Development Report issued in 1999 provides a good summary of the thinking on the importance of devolution for promoting not only economic development but doing it in a way that also takes care of poverty alleviation and income distribution. See The World Bank, World Development Report.

CHAPTER - 9

1. The EU figures for 2006 include EU 25 while earlier EU figures refer to EU 15. Therefore an adjustment has been made for the change in the size of EU.
2. The share at 0.12 per cent in 1980 was lower than in 1970 because of poor performance of exports in the 1990s. So there was some improvement in share over 1980-2006 to revert to the 1970 level.