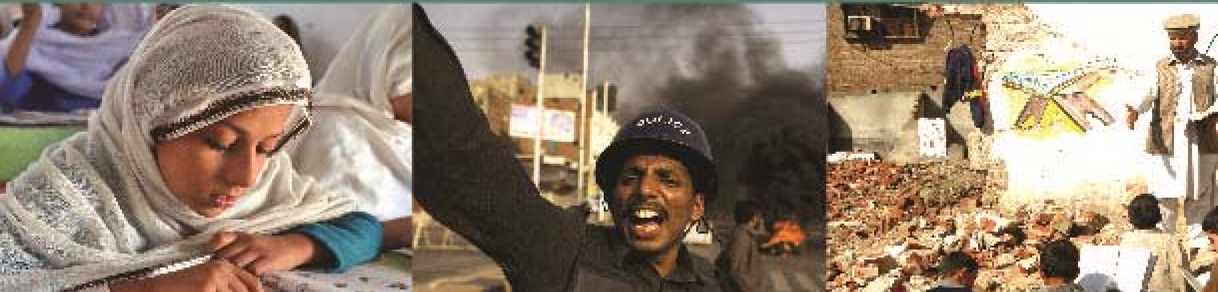
Seventh Annual Report 2014

THE STATE OF THE ECONOMY:

Challenges and Response



INSTITUTE OF PUBLIC POLICY
BEACONHOUSE NATIONAL UNIVERSITY, LAHORE

IPP's Seventh Annual Report
2014

The State of the Economy: Challenges and Response

Institute of Public Policy
Beaconhouse National University

Published by Institute of Public Policy
Beaconhouse National University

Cover Photograph: Saleem R. Khan

Printed by **Cross Media**
info@crossmedia9.com | www.crossmedia9.com
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Institute of Public Policy
Beaconhouse National University

Institutional backing is absolutely essential to policy makers of today, to guide their actions in promoting development and peace. These are times of change and challenge. There is a need for policy makers to base their policies on sound analytical work. Therefore, the Beaconhouse National University established the Institute of Public Policy (IPP) 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 Institute 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; seminars and workshops to bring together policy makers, experts and other members; funded research projects and dissemination of 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 the improvement of public policy in Pakistan. The members are:

▪ Mr. Shahid Javed Burki	Chairman
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▪ Mr. Tasneem Noorani	Member
▪ Mrs. Nasreen Kasuri	Ex-officio Member, Chairperson, BNUF
▪ Mr. Shahid Hafiz Kardar	Ex-officio Member, Vice Chancellor, BNU

Dr. Ummad Mazhar is the Senior Policy Advisor of the Institute.

PREFACE

This is the seventh annual report written and published by the Institute of Public Policy on the state of the Pakistani economy, and is subtitled “Challenges and Response.” The report is based on two main assumptions. The authors believe that, while 2013/14 was a very difficult year for Pakistan – perhaps the most difficult it has faced in its 67-year history – it came not only with challenges but also with opportunities. It is the job of Islamabad’s policymakers to recognize the first and to use the second to chart a different course for the country. The purpose should be to adopt a set of policies that will take Pakistan and its nearly 200 million citizens toward a better economic future.

We defined our work such that we could spell out in some detail the difficulties faced by the economy and the promises on which a better future could be built. This will require dedication and imagination on the part of the leadership that was put in place following the elections of May 2013. The need of the moment is to make public policy choices that will address the challenges identified in order to improve people’s wellbeing. This can be done, and the effort will be appreciated by a citizenry that has been hit by a perfect storm of poor governance, energy shortages, loss of investor confidence, and a very difficult external environment.

The report’s two authors have lived outside Pakistan for several decades. My colleague Parvez Hasan was closely involved in analyzing and advising the region of East Asia when it was fashioning the “miracle” that would take it through a period of extraordinary growth – that level of growth and the long period over which it lasted has had no precedence in history. He then worked on Central Asia at a time when, having freed itself from the control of the Soviet Union, it was embarking on an entirely different journey.

For a dozen years, I worked first on China and then on Latin America and the Caribbean. In both cases, I was in charge of the analytical work being carried out by the World Bank and its operations there. This was the time when China was abandoning its destructive experiment in collectivization and authoritarian control over the economy in favor of greater openness and trust in market forces. In the Latin American and Caribbean region, my period of stewardship coincided with a series of crises in a number of different countries. These countries not only overcame the crises, but also collectively turned the region into one of the more rapidly growing areas of the emerging world.

We came to the work this report required, equipped with this experience. Having participated in bringing about change in two dozen countries gives us hope that what they could achieve can only also be done in Pakistan. It is for the country's policymakers to make the right choices, and we hope that this report will help them undertake the transition from near-hopelessness to growth and shared prosperity. In undertaking this work, we were involved in several conversations with senior officials. We benefitted from these exchanges and believe that we have already made some contribution to the evolution of thinking among the policymaking community.

This work could not have been done without the financial assistance provided by the Asia Foundation through its Partnership with the Australian Department of Foreign Affairs and Trade. The Foundation has placed a great deal of faith in our ability to contribute to the development of the Pakistani economy. It is our hope that we have met its expectations.

Shahid Javed Burki

Shahid Javed Burki
Chairman
Institute of Public Policy
Lahore
25 April 2014

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

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ACRONYMS

ADB	Asian Development Bank
AEDB	Alternative Energy Development Board
APC	All-party Conference
BJP	Bharatiya Janata Party
BoP	Balance of Payments
CCP	Competition Commission of Pakistan
CCPP	Combined Cycle Power Plant
CIA	Central Intelligence Agency
CNG	Compressed Natural Gas
CPI	Consumer Price Index
DRAP	Drug Regulatory Authority of Pakistan
EBDO	Elective Bodies Disqualification Order
EU	European Union
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FDA	Food and Drug Administration
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GWh	Gigawatt Hour
GENCOs	Generation Companies
GIDC	Gas Infrastructure Development Cess
GNI	Gross National Income
GNP	Gross National Product
GSP	General System of Preferences
HDIP	Hydro Carbon Development Institute of Pakistan
HSD	High Speed Diesel
HUBCO	Hub Power Company
IBRD	International Bank for Reconstruction and Development
IFPRI	International Food Policy Research Institute
IMF	International Monetary Fund
IPP	Institute of Public Policy
IPPs	Independent Power Producers
ISAF	International Security Assistance Force
ISI	Inter-Services Intelligence
IT	Information Technology
KAPCO	Kot Addu Power Company
KP	Kyber Pakhtunkhawa
KWh	Kilowatt Hour
LNG	Liquefied Natural Gas

M&A	Mergers and Acquisitions
MDGs	Millennium Development Goals
MMBTU	Million Metric British Thermal Units
MMCFT	Million Cubic Feet
MNCs	Multinational Corporations
MW	Mega Watt
MWh	Megawatt Hour
NAB	National Accountability Bureau
NADRA	National Database and Registration Authority
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NPP	National Power Policy
NTDC	National Transmission and Distribution Company
NTPO	National Tax Policy Office
OGDC	Oil and Gas Development Company
OGRA	Oil and Gas Regulatory Authority
OPEC	Organization of the Petroleum Exporting Countries (OPEC)
PEPCO	Pakistan Electric Power Company
PIDE	Pakistan Institute of Development Economics
PML-N	Pakistan Muslim League (Nawaz)
PPP	Pakistan People’s Party
PSDP	Public Sector Development Program
PSLM	Pakistan Living Standards Measurement Survey
PTI	Pakistan Tehreek-e-Insaf
RFO	Residual Fuel Oil
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SECP	Securities and Exchange Commission of Pakistan
SROs	Statutory Regulatory Orders
TFP	Total Factor Productivity
TOE	Tonne of Oil Equivalent
TPS	Thermal Power Station
TTP	Tehrik-e-Taliban Pakistan
US	United States
USAID	United States Agency for International Development
WAPDA	Water and Power Development Authority
WDI	World Development Indicators

Executive Summary

Setting the Stage

Executive Summary
Setting the Stage

This report will be released when the Sharif government is just short of completing its first year in office. There is no doubt that, with the elections of May 2013, Pakistan crossed an important milestone in its tortuous political journey. In the last seven decades, the country has experimented with several different political models, which has meant that political institutions did not settle down long enough to allow policymakers to focus adequately on economic matters. The only exception was General Ayub Khan's 11-year rule. The economic model his government adopted then was widely praised by development economists, but its deep flaws became apparent once he had passed from the scene.

Pakistan's progress toward creating a democratic order has been a halting one. Short periods of quasi-democratic rule were interrupted by long spells of rule by the military. However, in 2008, more than 60 years after the country's birth, a durable democratic order appeared to be in sight. Pakistan's progress has not been linear, but what has motivated the change is people's realization that, despite its many faults, democracy is the preferred form of government.

The Institute of Public Policy's seventh annual report is based on an extensive program of policy analysis initiated in late 2013 with the generous assistance of the Asia Foundation. This support has made it possible for the Institute to carry out policy studies in areas on which the new government needs to focus. A key difference between this report and its predecessors is that, in preparing it, we have been in continual conversation with policymakers and high-level bureaucrats both in Islamabad and Lahore.

PAKISTAN'S ECONOMIC RECORD, 2008–13

The country's economic record during 2008–13 was dismal. The gross domestic product (GDP) growth rate – a little over 3 percent per annum – was the slowest of any five-year period in the last half-century and seriously compounded the country's unemployment situation. Inflation, whether measured by the GDP deflator or the consumer price index, had clearly accelerated, while the sharp rise in food inflation hit the urban poor, the middle classes, and rural nonfarm workers.

The deterioration in the macroeconomic situation was reflected in a large, unsustainable fiscal deficit – averaging well over 7 percent of GDP – and in the halving of gross foreign exchange reserves to $6 billion in five years despite substantial net use of resources provided by the International Monetary Fund (IMF).

An especially troubling aspect of the fiscal situation was that an increasing portion of the deficit reflected negative government savings (averaging at least 3 percent of GDP over 2008–13). Current expenditures far exceeded current revenues, given that the tax-to-GDP ratio had stagnated, while real public consumption – reflecting energy subsidies, administrative expenditures, security spending, and public enterprise losses – grew by 32 percent over this period. Perhaps the most worrying economic development from the point of view of future growth was the decline in the ratio of gross fixed capital formation to GDP from 17.9 percent in 2007/08 to 13.2 percent in 2012/13 – the steepest decline on record.

Even in the context of the last 25 years, Pakistan has had one of the slowest growth rates in per capita income among large developing countries, and has fallen seriously behind. Its lagging social indicators have improved only to a limited degree and it will not be able to achieve the Millennium Development Goals (MDGs) for education and health.

CHALLENGES AND OPPORTUNITIES

Despite the difficulties and obstacles ahead, 2013/14 could prove to be an important turning point in Pakistan's turbulent history. The new government has begun to tackle some of the numerous problems it has inherited. It has lost no time in eliminating the large circular debt that was responsible for aggravating the acute energy shortage and causing large-scale load-shedding. It has introduced an austerity budget and committed to fiscal adjustment. It surprised the IMF with an early request for assistance and was willing to accept a stabilization program that required not only a major reduction in the fiscal deficit and energy price adjustments, but also significant structural changes such as the large-scale privatization of state enterprises, phasing out of statutory regulatory orders (SROs), and widening the tax net.

By and large, the IMF program, subject to quarterly reviews, has remained on track. The government is relentlessly following plans to increase the country's power-generating capacity, with a special focus on coal and hydroelectric power. It has made a bold move to successfully enter the international bond market and raised a multiple of the original offering – though admittedly, the long-term cost to the economy will be high. International confidence in Pakistan seems to be increasing, notwithstanding serious security concerns.

More importantly, four moves are underway that could prove crucial for Pakistan to shape up as a fast growing, modern, and moderate country. One, a new political order is being established that will facilitate the launching of a well-thought out program for economic revival. Two, the country is defining its external relations by focusing on the economic benefits that could accrue to it rather than remain fixated on the perceived threat from India. Three, an effort is being made to stem the tide of extremism and to bring into the state's fold those groups that have defied the government's authority. Four, a serious effort is being made to encourage the private sector to play a greater role in reviving the economy and moving it onto a sustainable, high-growth trajectory.

However, some fundamental problems remain. Domestic resource mobilization for development is still very weak. The domestic savings rate and tax-to-GDP ratio are among the lowest by international comparison. External finances are vulnerable because of heavy dependence on workers' remittances and other external inflows. Export development and diversification have long been neglected with Pakistan having missed many opportunities offered by the almost explosive international growth in manufactured goods. As a result, it has a much lower exports-to-GDP ratio than either China or India (continental economies that were once believed to be too large to use exports as an engine of growth).

There has also been an almost steady decline in institutional capacity and governance, which, when combined with financial constraints, has adversely affected both the quality and quantity of public service delivery, especially in education. But for the most dynamic private sector involvement in education at all levels – from primary education in rural areas to higher education with growing female participation – the education system would be in an even more dire state than it is. To a certain extent, the same applies to the health sector.

At a more basic level, the economic model that Pakistan has followed for more than half a century has been flawed in several aspects. It has often focused too closely on short-term gains as against strategic long-term goals and imperatives such as sustained and inclusive growth, expanding exports, reducing energy import independence, remedying the lags in education and skills development, and improving governance. It has encouraged a culture of consumption rather than savings and investment. The large volume of resources available through foreign aid and investment, workers' remittances, and foreign currency deposits were used at the margin to support consumption, both public and private, rather than to enhance capital formation and develop human resources. The result was that the high growth rate of around 7 percent per annum over relatively brief periods during the 1960s, 1980s, and 2000s was followed not only by much slower growth but also by financial difficulties.

An economic turnaround and a move toward high, sustained, and more inclusive growth are possible – indeed likely – if past policy mistakes are avoided and if the new government resolutely deals with its multifaceted challenges while treading a new path. In this report, we discuss in some detail the key challenges that Pakistan faces. By and large, the new government has responded positively to a most difficult economic situation and appears to be focusing on the opportunities that exist for reviving growth, improving governance, strengthening the energy sector, curbing extremism, and making full and effective use of external relations to advance the growth agenda. Our key findings, analysis, and recommendations are summarized below.

THE IMF PROGRAM

Pakistan's external resource position in mid-2013 was precarious partly because of large scheduled pending payments due to the IMF. It had no real choice, therefore, except to go to the IMF early, even though the finance minister had already signaled the initiation of a strong fiscal adjustment in the budget for 2013/14. Friendly countries that could provide breathing space probably also encouraged the government to seek IMF assistance sooner rather than later. A good seal of housekeeping was also important for triggering other flows from the World Bank and other sources. More importantly, the government probably felt that tough decisions on electricity pricing could, politically, be handled better under the IMF program umbrella.

The precondition of satisfactory quarterly reviews for the release of tranches suggests that the IMF will keep Pakistan on a tight leash in light of its experience – rarely has an agreed program been completed satisfactorily. The large upfront release under the 2009 program also proved unproductive. The conditionality of the IMF program is fairly tough and broad-based, although its central focus is strong fiscal adjustment accompanied by a large build-up of international reserves. However, it is not correct, as the press has asserted, that the IMF program fails to address structural issues.

Critical structural measures in the energy sector have been given high priority. Substantial upfront increases in electricity tariffs were made even before the program with the IMF was finalized. During the program period, tariff differential subsidies will be phased out and tariffs will be brought to cost-recovery levels. Tariff adjustments will improve resource allocation and efficiency, and encourage conservation. Cost-cutting and efficiency measures will also be undertaken both in generation and distribution. Legal changes will be undertaken to tackle electricity theft by enhancing investigation, prosecution, and penalties.

As part of the gas price rationalization plan, a gas infrastructure development cess (GIDC) has been imposed, facilities to import gas are being developed, and incentives for higher domestic production of gas have been strengthened. Meanwhile, trade policy reforms envisage phasing out trade-related SROs over three years with the design of the plan to be completed by the end of May 2014. There are also plans to simplify the import tariff and move to a four-slab system and 0–25 rates.

A major stocktaking of all key loss-making public enterprises is being undertaken and the privatization of 26 percent of Pakistan International Airlines shares to a strategic investor has been initiated. The government has also called for an expression of interest for 10 percent of the outstanding in the Oil and Gas Development Corporation, the country's largest public enterprise in terms of total value. This will be followed by the implementation of medium-term action plans to privatize firms, restructure those with prospects of profitability that the government wishes to retain in the public sector, and close nonviable firms.

The IMF has judged the program's progress to be satisfactory after the first two quarterly reviews and has indicated that it expects the benchmarks set for the end of March 2014 will be met. It has recommended, however, that efforts to broaden the revenue base and improve tax administration be stepped up. It has also observed that the recently introduced investment incentive package to encourage more individuals to file their income tax returns runs counter to the efforts to strengthen tax administration, implying that similar future schemes should be avoided.

No doubt the fiscal adjustment the government will achieve during 2013/14 will be substantial. However, the pattern of adjustment has involved a less-than-robust revenue performance and a greater squeeze on development spending. It should also be noted that much of the growth in revenue has come from raising the sales tax and instituting the GIDC. As yet, it is not clear whether improvements in tax administration have yielded any significant increase in tax revenues, which remain, therefore, a major issue.

The IMF has not touched directly on the recent appreciation of the rupee but has noted the need for exchange rate flexibility. Our calculations suggest that a 4–5 percent real depreciation in the value of the rupee in 2013/14 over the average in 2012/13 was implicit in some IMF projections and may have been warranted.

Whether Pakistan should have had an effective real devaluation of 4–5 percent during 2013/14 compared to the previous year is debatable. However, there was little rationale for the present rate of Rs 98, which, if it persists for the rest of the year 2013/14, will mean that the rupee will have appreciated substantially in real terms – perhaps as much as 6–7 percent by June 2014 compared to June 2013 when the rate averaged nearly Rs 99. This will hurt competitiveness and export development.

REVIVING GROWTH

Undoubtedly, Pakistan's growth over the last several years has suffered a number of special setbacks: the worsening security situation, poor governance, and a crippling energy crisis. However, a number of deep structural problems that have persisted for decades are also to blame: the country's weak financial position rooted in very low tax revenues on the one hand and limited export growth on the other; grossly insufficient investment in human capital development, infrastructure, and economic activity at large; and steadily deteriorating governance.

Raising the growth rate gradually from the present underlying rate of around 4 percent per annum to a sustainable level of at least 6–6.5 percent will take four or five years. Reducing financial vulnerabilities and ensuring a better distribution of growth benefits represent both a tremendous challenge and a unique opportunity. Meeting the suggested targets would mark a huge achievement and a clear break from the past. However, merely increasing the annual growth rate will not be enough. The growth revival must also aim to substantially reduce the critical gaps in longer-term investments in water, power, and human development and lay the basis for a more equitable distribution of the benefits of growth. Failure to revive sustainable and more inclusive growth in the medium term will relegate Pakistan to the group of poorly performing economies in the coming decade.

The immediate constraints to reviving growth include (i) the lack of full confidence in the country's future, given the current security situation, (ii) the likely persistence of energy shortages, and (iii) concerns about the negative fallout of ISAF troops leaving Afghanistan. The present government is seeking a regional peace by focusing on better relations with key neighbors such as India and Afghanistan. It has also made strengthening the economy a central plank of its foreign policy and is giving high priority to resolving the energy sector's problems. There is reasonable hope that Pakistan's security situation will gradually be brought under control. The energy constraint to industry and agriculture is also expected to become increasingly less important. However, if the country is to move onto a sustainable and equitable path of high growth, it must resolutely tackle three fundamental and interrelated issues that are at the root of its failed economic promise:

- The inadequate mobilization of resources for development, highlighted by a very narrow tax base and low level of exports and reflecting a deep-seated bias in favor of consumption over investment and exports
- An uneasy relationship between the private and public sectors, where the public sector has often aspired to own and control what it regards as strategic national enterprises and where the private sector has relied too heavily and too often on government largesse to collect economic rents

- Weakening governance and a declining institutional capability to deliver effective public services, including law and order and justice; these are reflected in growing corruption, the increasing cost of doing business, and less effective public spending.

While foreign investment and, to an extent, foreign borrowing will be needed for decades to come, they should be used to supplement rather than supplant domestic effort. Large foreign investment, if used to support the production of home goods (as against exports), can actually worsen the country's foreign exchange position if it is not accompanied by an export expansion that strengthens the ability to service larger profit remittances. Foreign investment in independent power plants and telecommunications in the last two decades are good examples of how a country does not pay enough attention to future liabilities in terms of investment income payments.

While large external inflows are greatly needed, the viability of servicing additional external obligations needs carefully scrutiny. Income payments on private direct investment have risen steadily: at $2.7 billion in 2012/13, they were more than double the level of interest payments on external debt. Pakistan must avoid the tendency to underestimate the cost of foreign investment in terms of profit remittances. The main point is that foreign investment has benefits as well as costs, and without a strongly bolstered export-oriented strategy, Pakistan's balance of payments (BOP) difficulties will not be easily resolved.

A substantial part of growth in the near to medium term must come from raising the present low level of factor productivity, especially as more fixed investment will be concentrated in longer-gestation projects in energy and water. Fortunately, there is substantial scope for raising the contribution of total factor productivity to economic growth; this share has steadily declined and, by 2010, was only about a quarter of its level in 1980.

Three main drivers of growth – export expansion, better governance, and vigorous private sector development – can all work as major and interrelated sources of improved economic efficiency (see Box 1).

Promoting labor-intensive exports – both manufactured goods and agricultural products such as fruits and vegetables – could yield a large payoff in terms of a lower unit of investment needed per unit of output. Equally, increasing the export of services holds considerable promise.

Moving up the value chain in textiles and clothing – which are Pakistan's principal exports – and in other exports would also yield productivity gains. At the same time, diversification toward other

Box 1
Potential Drivers of Growth

Pakistan's economy is in dire need of a revival in growth. The strategy proposed in this report is based on four pillars: broadening the export base, making the environment more conducive to foreign direct investment (FDI), utilizing the potential of the youth population, and taking advantage of the opportunities offered by a vibrant regional economy. Unfortunately, Pakistan's poor global competitiveness ranking has worsened over time: from 83 in 2007 to 133 in 2013 (Global Competitiveness Survey). Given the rapidly changing global environment, the emergence of Asia as the new engine of growth, and the head-start availed by several of its neighbors, Pakistan must reformulate its economic and trade policies and shift its attitudes and ways of doing business.

On the one hand, Pakistan's future economic growth faces a potential slowdown as demand declines in its traditional export markets. On the other hand, the dynamic regional market that constitutes young consumers, as distinct from aging populations and contracting Western markets, furnishes the opportunity to overcome insufficient demand for its products and gradually move up the value chain into higher-value products and services. The European Union's grant of GSP-plus status to Pakistani exports should be considered a short-term option and should not detract from the more desirable objective of incentivizing the development of a diverse and vibrant export sector.

The only way for Pakistan to attain healthy rates of growth in the evolving international ecosystem is to become an integral part of global producer- or buyer-driven supply/value chains that have enabled the fragmentation of production. Today, the pattern of industrialization can be changed with this subdivision of production using modern technology and the opportunities for trade offered by lower transportation costs and improved physical infrastructure and communication, which facilitate the management of supply chains over long distances.

For Pakistan, with much of its industrial sector heavily protected from international competition and its exports disproportionately comprising only a few commodities, participating in regional and global production networks and benefitting from the dynamic complementarities linked with these intra-industry value chains (for example, in textiles, leather, and automotive products and services) provides the only realistic chance of achieving high and sustained growth.

Similar opportunities exist in the services sector for out-sourcing information and digital-based services. The new communications technology has enabled trade in services over time and space. Services can now be exported via e-commerce, stored electronically, and used long after they were produced. This makes them a potentially high value-added component, given Pakistan's comparative advantage in exporting labor-intensive services such as typing, data entry, programming, and call centers, etc.

Pakistan has a significant human and physical infrastructure as well as the price advantage of a large young labor force that is proficient in English and can work at relatively lower wages, with the stress being placed in the region on higher education. This would enable regional entrepreneurs to play the same role as Japanese businesses did in Southeast Asia by establishing enterprises across borders that benefited from lower wages. This would result in all gaining from the advantage of regional proximity.

A growth process set into motion by this strategy will have a multiplier effect, spreading and inducing change in the rest of the economy as other sectors adopt new technologies, processes, and management practices, which would build all-round managerial capacity and help transform the whole economy. Capital accumulation, higher incomes, and growth in employment opportunities will augment domestic demand. This, in turn, will reinforce a durable growth process as a rising middle class creates a demand for housing, hotels, restaurants, and retail for wide range of consumer goods and personal services. This will generate employment opportunities for even those already in the labor force but with modest education and skills. Simple policy modifications related to building and zoning regulations, the rationalization of property taxes and government levies on development and commercialization, and the disposal of prime commercial land tied up in unproductive state activities and functions will set into motion a virtuous circle.

manufactured goods for export (in which Pakistan's share in world trade is negligible) offers considerable potential. Phasing out SROs as planned will ensure that economic incentives do not protect low value-added sectors. This will not only raise government revenues but also improve social equality and encourage entrepreneurial behavior. Most SROs provide domestic protection, which increases the anti-export bias. On the other hand, underinvested areas such as agricultural processing, marketing, and storage could be provided investment incentives.

In addition, several sets of policies focusing on (i) improving the use of inputs in agriculture, notably water, fertilizer, and seed; and (ii) increasing the effectiveness of public spending would yield major gains in productivity. Greater efficiency in the use of scarce water resources should also be a high priority.

THE EFFECTIVENESS OF PUBLIC SPENDING

The effectiveness of public spending is a central issue. At present, there are several problems with the structure of spending. Some of these, such as the generous subsidies provided to the nonpoor and the large losses made by major public enterprises, are being addressed under the IMF program. There has also been an effort to contain administrative expenditure in the current budget.

However, there is a greatly overextended development program involving both low-priority projects and long gestation periods, which yield suboptimal economic impacts. Resources are thinly spread over a large and unwieldy number of projects, many of which have huge cost overruns and are many years behind their original completion date. Delays in the completion of priority projects and, in many cases, increases in their cost have obviously limited their potential economic return. Meanwhile, a large number of new and necessary projects are being approved.

Given the large overhang of projects, it is essential to thoroughly review all projects with a view to eliminating low-priority spending, setting new timetables for early completion, and adequately funding restructured programs. These reviews should be completed before the next budget is finalized. Moreover, the improvement in productivity must be underpinned, if not actually led, by the necessary advances in human development and by efforts to reverse the institutional decline and weakening governance.

HUMAN DEVELOPMENT

The challenges to the education sector are immense. It is a matter of great concern that any improvement in social indicators over most of the last decade appears to have slowed down in the last two or three years, presumably under financial pressure and slow economic growth. The crisis in education is centered on the public sector not only because of its declining share in enrollment but also given the persistent problem of declining quality. Even at the primary level, the increase in private school enrollment has outstripped the growth in government schools: the private sector's share grew from 35 percent to 39 percent over a short period of four years (2008–12).

Public spending on education needs to be increased, but equally importantly, the quality of education and the effectiveness of spending need to be enhanced by providing greater oversight, shifting the authority for lower levels of education to the local government level, and strengthening public-private partnerships. Additionally, skills development programs initiated through private-public sector collaboration need to be expanded substantially.

Finally, the neglected area of adult literacy needs urgent attention. There are no large programs for dealing with this growing problem; the latest figure for 2012 estimates the literacy rate among 15-year-olds and above at 58 percent. This means that, out of an estimated population of well over 100 million adults (above the age of 15), at least 50 million are illiterate. Given that the average life expectancy is at least 30 years, this mass of illiterate people will remain a drag on national productivity for a long time. To make matters worse, a large portion of youth – perhaps as many as 35 percent – entering adulthood in the near future will also be illiterate. So, while the adult literacy ratio continues to grow, albeit slowly, so does the total number of illiterates. This is an alarming prospect and will make social and economic progress difficult.

There is a need to address this issue by making a broad appeal to all groups in society, especially by involving civil society and local-level leaders if this mounting problem is to be tackled. It is worth noting that a large young labor force that is proficient in the English language and able to work at relatively low wages could be a great asset if provided with the proper education.

GOVERNANCE AND DEVELOPMENT

Development economists and experts agree that, for economic progress to become sustainable, countries must go beyond the efficient use of factors of production such as labor and capital. A few decades ago, they began to include technological progress and human development in their growth equations. Later still, they identified institutional development as an important contributor to economic development. Now, there is considerable focus on a contributing factor broadly defined as "governance." In fact, good governance and the quality of governance have come to be recognized as one of the most important reasons that economic growth in Pakistan has stalled in the last six or so years. All political parties marked governance as a priority area in their pre-election manifestoes of May 2013, promising to improve the quality of governance. However, none went much beyond this in indicating how they would handle the matter were they to gain power. The manifestoes had no serious policy content aimed at improving the quality of governance.

For the quality of governance to improve and for accountability to become an effective contributing instrument, it is clear that past approaches have to change. Previous attempts were very narrowly focused. Corruption and misbehavior in public office were always dealt with on an ex-post basis. Crimes allegedly committed in the past were looked at and those involved were investigated; if found guilty, they were to be appropriately punished.

A more effective approach would have been to deal with the issue as ex ante: taking steps to prevent actions – or lack of them – before poor governance occurs. This approach can be explained with an example that, in usual discourse, would not figure as poor governance. It is recognized not only in Pakistan but also in several other developing nations that teacher absenteeism is a major reason for the low quality of education offered by institutions in the public sector. Teachers draw salaries but do not go to their regular jobs, instead spending their time on activities that bring them additional income. They are able to do this because of poor oversight by the educational authorities. Poor governance and accountability, therefore, has to be looked at from a much wider angle than in the past.

THE ENERGY CRISIS

The most visible sign of energy shortages has been the inability of the power system to meet the growing demand for electricity, leading to major load-shedding. This, in turn, has caused not only widespread distress to millions of household consumers, but also loss of production in the commercial and industrial sectors.

Quite independent of the difficulties created by inadequate investment in power development is the serious problem that energy sector receipts do not cover total costs, resulting in circular debt. Despite the entire amount having been cleared and a sharp increase in energy prices, the circular debt had reportedly crept up to Rs 300 billion by the end of March 2014. This indicates it is not a problem in itself but merely a symptom of problems related to the nonpayment of bills, inefficiencies and systemic theft, and subsidies that are provided but not covered by the budget.

It is essential to recognize that Pakistan's continuing and deepening energy crisis has had a major adverse impact on the investment climate, the country's fiscal and BoP position, and consequently on economic growth. The roots of the crisis go well into the past and are, to an extent, attributable to policy decisions taken as early as the 1960s and 1970s. The principal reasons for the sector's mounting problems over time are as follows:

- The lack of a coherent gas policy has kept natural gas too cheap for too long. The large subsidy to the household sector has led to great wastage and discouraged gas exploration.
- New low-cost sources of hydroelectric power have been relatively neglected.
- Governments were reluctant to pass onto consumers the sharp increase in international oil prices during the 1970s and 2000s.
- Insufficient attention has been paid to the long-term consequences of high international oil prices.
- The government's approach to economic shocks has been short-term. No energy policy was developed in the long-term context of limiting or reversing the country's increasing dependence on imported energy.
- Holding back the necessary energy price adjustment greatly squeezed the profits of the relatively well-functioning Water and Power Development Authority (WAPDA) in the early 1970s. As a result, retained earnings, a key source of new investment, dropped dramatically.
- Policies toward the private sector were often ambiguous; even when privatization plans for parts of WAPDA were formulated in the 1990s, there was no real follow-through.
- Inefficiencies in the distribution and generation of electricity have increased over time and line losses, including as a result of theft, remain high.

It is no exaggeration to say that the present government has inherited a grim energy situation, with people revolting against the unprecedented load-shedding of twelve or more hours a day. In response, it has tried to take strong measures to provide some immediate improvement in power supply while reducing the burden of crippling energy subsidies on the budget. More importantly, it has moved quickly to develop the ambitious National Power Policy (NPP) in order to address the country's current and future energy needs. The NPP will also address the key challenges of the power sector to provide people with much-needed relief.

The NPP sets a direction for the long run, covering a range of issues. While this is an important start, the policy should be treated as a work in progress. Several areas need immediate attention.

- Given that natural gas is a scarce resource and the development of gas-based power generation is a low-cost alternative, issues of gas production, import, allocation, and prices cannot and should not be separated from issues of national power.
- The NPP must evolve into a more comprehensive policy and consider different scenarios

of domestic gas production and import as well as other sources of power generation. In order to prepare all gas consumers, the likely price of imported gas and domestic supply needs to be estimated and shared with the public. The government also needs to announce a clear decision that past anomalies in gas pricing will be removed and that future prices will fully reflect costs.

- The long-term demand for electricity, estimated at 5 percent per annum, is an underestimate and needs to be reviewed.
- Even rough cost estimates of the proposed power development program are not given. These figures need to be estimated for five-, ten-, and fifteen-year periods and related to the macroeconomic availability of resources both in the public sector and the economy as a whole.
- The future organizational structure of the power sector is not well defined. The policy pays no attention to decentralization to the private sector and to the provinces, and there appears to be too much authority centered on the federal government

In terms of specific policies, the present plans do not offer a clear or particularly hopeful picture of substantial increases in the share of hydroelectric or gas-based power generation over the next 10–15 years. On the hydroelectric side, unless a decision on a major dam such as Diamer-Bhasha is made in the next year or so, completion cannot be expected before 2025. On the gas side, major pricing decisions hold the key to more gas-powered generation. Large-scale power generation based on imported coal also raises issues of port and rail capacity. These need to be examined and the necessary additional investments undertaken.

Even if a single energy ministry cannot be created, there is an urgent need for a strong, capable, high-level, and empowered mechanism to review progress, monitor implementation, take course-correction decisions, and remove bottlenecks for the entire energy sector. Such a mechanism – a high-powered inter-ministerial committee with a small but independent secretariat, for instance – should also be charged with periodically checking that energy plans are consistent with the total resource envelope, the institutional capacities of WAPDA and distribution companies, and coordination with the private sector and provincial governments

EXTERNAL RELATIONS AND FOREIGN RESOURCES

Pakistan faces a serious resource dilemma to which there is no easy solution. There are two components of this dilemma: one, raising domestic resources to achieve high rates of growth that can be sustained over time; and two, ensuring that a steady flow of foreign funds will be available to meet the country’s external obligations. The analysis of foreign resources is built on the assumption that Pakistan will have to fashion its external relations in a way that eases its access to foreign funds. In doing so, however, Islamabad must learn to rely on external resources as a last resort, focusing on domestic resource generation to produce sustained growth in the long run. That said, FDI will remain an important contributor to growth and development, and Pakistan should seek as much of it as possible.

For almost its entire life as a sovereign state, Pakistan has relied heavily on foreign assistance to expand its economy. Aid arrived not as a gentle and steady flow but in large and short bursts. Whenever the capital flows were large, they produced economic booms, as was the case on three occasions – in 1964–66, 1984–87, and 2003–06. These spurts could not be sustained because they were not supported by domestic resource mobilization. Each of these boom periods lasted no more than three years. Meanwhile, the Pakistani political establishment's ability to obtain help during difficult periods postponed the needed structural changes at home.

Convinced that it was too large an entity located in too sensitive region of the world to be allowed to fail, Pakistan always assumed that help would arrive when it was needed. Effectively, it has always taken what the world of finance refers to as the "moral hazard" approach. There are three problems with this approach.

First, the dependence on external savings should be limited to the very short term. Ultimately, it is domestic resource generation that can sustain rates of growth at the desired levels. Second, in the rapidly shifting political global order, continued dependence on bilateral relations might call for making foreign policy choices that are not to the country's long-term advantage. Pakistan will have to move beyond such bilateral equations as Islamabad–Washington, Islamabad–London, Islamabad–Beijing, and Islamabad–Riyadh to obtain the external resources it needs. What is evolving is a multipolar world in which it may be difficult to include the old form of bilateralism. Third, Pakistan needs to focus quickly and resolutely on obtaining increased FDI flows. These do more for the economy than unconditional bilateral flows, which are often provided in pursuit of the giver's interests, not necessarily in those of the recipient.

Foreign investment can take several different forms, entering a particular country as portfolio investments, for instance, when foreign investors conclude that its stock market offers good short-term rewards compared to those available in rich countries. Over the last several months, Pakistan's capital market has performed relatively well, no doubt due in part to foreign money inflows. These are fickle flows, however, and can go out as quickly as they come in. For instance, when the US Federal Reserve announced that it was "tapering" down its bond purchases, this produced a sharp reversal of capital flow from emerging markets, putting pressure on the rate of exchange in countries such as Pakistan.

Two other types of FDI are more suited to the needs of emerging markets such as Pakistan. One takes the form of mergers and acquisitions (M&A). With the globalization of financial markets, M&A activity between developed and developing countries has increased. Established firms have acquired assets in emerging economies to expand their market share. Pakistan has had this type of investment in two services sectors – banking and telecommunications. Most firms that have taken advantage of the opportunities available in Pakistan are from the Middle East, perhaps being less intimidated by the country's poor security situation.

"Greenfield" investments are the other more stable form of foreign capital flows, and refer to the establishment of new enterprises. Foods and beverages are popular areas for foreign investment. However, since the income from this type of investment is in local currency and the profits are repatriated in foreign currency, this creates contingent liabilities for the government and increases pressure on external finances. Oil and gas are also areas of potential FDI involvement, and would have a positive impact on external finances.

While FDI is a more stable form of capital flows, it too can depart. This has happened in the case of American and European firms that had operated in Pakistan's banking sector for decades but opted to leave when the security situation worsened on account of growing extremism. Some foreign manufacturing firms have also sold their operations for the same reason. FDI can only play an important role in the country if the security situation improves.

EXTREMISM

Policymakers have correctly identified the rise of extremism as a serious challenge to the country's efforts to move forward politically, socially, and economically. A report produced by the Ministry of Interior assesses the extent of the economic damage that this phenomenon has inflicted. The report's implications are sobering. A number of other exercises have also been carried out, including by the Institute of Public Policy, to measure the economic cost of extremism. There is no doubt that the cost has been very high; it is even higher if we factor in the future into our calculations. The fear and uncertainty created by extremism and associated terrorism is also damaging because it discourages FDI, which, as indicated earlier in the summary, is critical for Pakistan's economic development.

However, in focusing on extremism, policymakers must recognize that it has taken several different forms in Pakistan apart from the terrorism associated with the Taliban in their attempt to forcibly change the country's political and legal structures. These other forms also need serious attention. Among them is the sectarian violence committed by various ethnic groups as they compete for political and economic space. These forms of extremism have combined to make

Karachi one of the most violent large cities in the world. Given Karachi's importance for Pakistan's economy, it is vital that the situation is quickly stabilized.

There is much national discussion on the viability of negotiations versus the use of force as the most appropriate way to bring extremism under control. Perhaps, ultimately, a combination of the two will be needed. However, in the longer term, the answer lies in the state's efforts to address a number of other areas, including at least the following.

First, the country must focus on developing its human resources. With a median age of only 22 years, Pakistan has one of the youngest populations in the world. How can this population be turned into an economic and social asset rather than becoming a burden on the economy and society? The answer lies in human development. Both the youth and illiterate adult populations need to be provided with appropriate education and skills development to ensure they can become productive participants in the economy. Similarly, healthcare services must also be improved to augment the quality of human capital.

Second, for human development efforts to succeed, they must be anchored in systems of governance that reach the people. This has been the experience in other parts of the world where certain segments of society were left behind, creating acute resentment against the state as well as against groups that were economically better off. In several Latin American nations, this resentment was the basis for the rise of terrorism. Controlling and ultimately mainstreaming these segments became possible only when institutions of local government were sufficiently developed to reach people and remote regions.

Pakistan has been exceptionally negligent in this area. From the time of its creation as an independent state, it has experimented with a number of local government systems, discarding one after the other. The political elite have remained reluctant to give up the control of power that any development of local governments would necessarily entail. This is a shortsighted view of social, economic, and political development. Renewed commitment needs to be made at the federal and provincial levels to allow the devolution of authority to the local level. This has to be part of the new development paradigm we have advocated in this report.

CONCLUSION

The new government has begun to tackle some of the problems it has inherited in the attempt to transform Pakistan into a fast growing, modern, and moderate country. In this context, important steps include establishing a new political order that will facilitate economic revival; defining external relations on the basis of economic benefits rather than perceived threats; stemming the tide of extremism; and encouraging the private sector to play a greater role in reviving the economy and moving it onto a sustainable, high-growth trajectory.

One of the biggest challenges will be to raise the growth rate gradually from around 4 percent per annum to a more sustainable level of at least 6–6.5 percent over the next five years. However, this growth revival must be accompanied by steps to reduce the critical gaps in longer-term investments in water, power, and human development, while laying the basis for a more equitable distribution of the benefits of growth.

Previous patterns of economic growth and development in Pakistan have been deeply flawed. Economic rents and public corruption, rather than genuine entrepreneurship and initiative, have too frequently been the source of economic gain with the state as benefactor. The distribution of growth benefits has also been inequitable. Job creation has lagged, public education has been neglected, fiscal policy has failed to play a role in redistributing income, and the heavy reliance on external assistance and flows has meant that periods of high growth were rarely sustainable.

Avoiding a financial meltdown, runaway inflation, and the impact of a sharply declining rupee will be a necessary but not sufficient condition for economic revival with a new face. The attempt to nearly double the GDP growth rate from its 2012/13 level over the next four or five years and ensure a more balanced distribution of the benefits of growth will require fundamental and structural shifts in both governance and economic policy.

Hopefully, the political order will continue to shift toward greater power sharing among state institutions and levels of government, greater accountability of public officials enforced by the rule of law, a vigilant judiciary, an informed and free media, and an increasingly robust civil society. All this will facilitate a wider acceptance of austerity and a national discourse on development approaches and strategy.

Chapter - 1

Setting the Stage

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Setting the Stage*

This, the first chapter in the Institute of Public Policy's 2014 annual report, follows a different approach from those taken in the previous six documents.[1] The difference, as we explain later, lies in the way this report was prepared. This is the seventh report in the series that began in 2008 on the state of the Pakistani economy. All six reports focused on the content of public policy that, in the authors' view, Pakistan needed to adopt in order to deal with two sets of issues: first, quickening the pace of economic growth and sustaining it over time and, second, addressing in greater depth some of the obstacles the economy faced. The first subject was covered in all the annual reports: achieving macroeconomic stability as the first step toward moving the country onto a higher growth plane. In the second part of each report, our focus shifted among different subjects, such as the economic and social cost of extremism and terrorism, the economic cost of interrupted energy supplies, decentralization and its challenges, and the backwardness of some districts in southern Punjab.

The previous six reports were published while the rate of growth was slowing down. The period they covered was the longest recession in Pakistan's history. The rate of growth had averaged a little over 3 percent a year – three percentage points lower than what the consensus view held should be the structural rate of increase in national income. In other words, Pakistan's gross domestic product (GDP) is 20 percent smaller than what should have been the case had public policies created the conditions for realizing its potential. The thrust of the past six reports – and that of the seventh – was to restore health to an increasingly ailing economy.

THE PAST ANNUAL REPORTS

Reading the Institute's past six annual reports back-to-back leads one to the unhappy conclusion that little has changed since 2007/08 as to the economic problems Pakistan faces in 2014/15. We are also forced to conclude that the reports did not find an audience among the policymakers of the day. Having had obviously little impact on policymaking is one reason that, as explained later, we have adopted a different approach to writing and disseminating the 2014 report.

The sentiment expressed in the first six reports was reflected in their subtitles. The first report, published in 2008, recognized the challenges the economy faced but expressed hope that, by

*This chapter was contributed by Shahid Javed Burki.

adopting the right sets of policies, growth could be restored: "Pakistan's economy is once again at a critical juncture. After a period of strong economic expansion, relative economic stability and foreign investor confidence over the years 2003-2006, the country is facing very serious economic strains and social challenges 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 years of high single digit inflation," read the report's opening paragraphs.[2] History, in other words, was repeating itself. Pakistan was once again failing to sustain a bump in economic activity.

As the World Bank's (2013) country economic memorandum states: "The stylized facts of Pakistan's growth are typical of an underperforming economy. Its growth accelerations tend to be short-lived – since 1961 the country has seen only three episodes of at least four years of successive GDP per capita growth above 3 percent: 1963-66, 1980-83, and 2004-07." Each of these three economic booms lasted only three years. Unfortunately, the country's "long-term – structural growth is declining – from an average of 6–7 percent in the 1980s to 3 percent in the late 2000s," continued the World Bank report.[3]

The Institute of Public Policy's 2008 report set out to define the problems that had kept Pakistan from sustaining periodic growth bursts. Its list of identified problems was a familiar one:

> … large and virtually unsustainable twin fiscal and balance of payments deficits; a high and rising rate of inflation, especially in food and energy prices; power deficit and water scarcity; slowing down of the rate of growth of manufacturing; widespread poverty incidence and growing income disparities among income groups and across regions; and 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.

The report attributed part of the economic slowdown to factors over which policymakers had little control: "The negative shocks – devastating earthquake in 2005, the inexorable rise in international oil and food prices, especially 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 percent per annum during the last four years." That said, the report's authors assigned blame for the economy's problems to policymakers. For instance, "the central policy lesson of the economic performance of the Musharraf regime is that poverty levels increased in spite of the 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."

Nevertheless, the mood was somewhat buoyant, in part because of the political transition that had begun to take place. The report was finalized three months after the elections of 2008 brought to power the parties that had opposed military rule. The governments led by the Pakistan People's Party (PPP) in Islamabad and by the Pakistan Muslim League (Nawaz) (PML-N) in Lahore were committed to the restoration of democratic rule. The report's authors had bought into the argument made by a number of social scientists the idea that political and economic developments were closely intertwined, one influencing the other.[4] Viewing this relationship from the perspective of Pakistan's tortuous political and economic history seemed to indicate that the causality ran from politics to economics. If the 2008 elections could bring political stability, there would certainly be a positive impact on the country's economy.

There were other reasons for optimism. The Institute of Public Policy had carried out an intensive review of Punjab's economy and found reason to believe that, if the right public policy choices were made, the province could see its economy grow at 10 percent a year – a rate that could be reached in about a decade's time.[5] This would bring Punjab's rate of growth to the level achieved by the more rapidly growing states of India. Since Punjab accounted for 58 percent of the country's GDP, such a sharp pickup in the province's economy would also pull up the national economy. The report's authors were optimistic that such an outcome was possible: "We believe that, notwithstanding 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."

The new development paradigm suggested by the authors covered a number of areas: the "gradual elimination of energy and wheat subsidies, a sharp cut-back and restructuring of public spending, a determined effort to mobilize tax revenues from the segments of society whose incidence of taxation has come down sharply and those who escape the tax net, improving incentives for savings and discouraging luxury consumption." The paradigm also included a substantial expansion in safety nets for the poor. Islamabad was advised to take advantage of the rapid structural changes in the global economy that had created new opportunities for Pakistan. In this context, the government was counseled to borrow from the experience of other fast-growing economies by using international trade as an important driver of growth. No developing country had grown rapidly without increasing its participation in international commerce.

The report dealt with another perennial issue: that of governance. It recommended strengthening the process of devolution begun during the Musharraf period "by decentralizing governance and expenditure from the center to the provinces and from provinces to local governments." Finally, considerable emphasis was placed on improving human capital by "expanding education at all levels, 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." In other words, the country could obtain a higher rate of growth even with a modest increase in investment by improving the economy's efficiency. In the language of economics, there was need to focus on lowering the incremental capital-output ratio to gain greater growth out of investment.

The subsequent report, subtitled *Emerging from the Crisis*, maintained this sense of optimism and the belief that correct public policy choices could rescue the economy from the enduring crisis. As the subtitle suggests, we felt the economy had begun to emerge from the crisis it had faced for a few years. That, of course, did not happen and in the 2010 report that followed – subtitled *Pulling Back from the Abyss* – we saw the economic situation deteriorate. By our reckoning, the economy was teetering on the edge of an abyss.

By the time the third report was written, the PPP-led governments in Islamabad and Sindh had been in office for two years. They had settled down to a style of governance in which personal rewards for people in senior positions were given higher precedence than national gain. Stories had begun to circulate in the press, which was now indulging in uninhibited investigative journalism on corruption among senior position holders in the two administrations. No matter how substantial these stories may have been, they harmed people's faith in the future of the economy. There was a serious loss of confidence and domestic investment began to falter, putting the economy under great pressure.

The fourth report, subtitled *Devolution in Pakistan*, drew hope for the economy's longer-term prospects from two developments: the November 2009 announcement of the Seventh National Finance Commission (NFC) Award and the subsequent passage of the 18th Amendment to the Constitution. Both political moves were analyzed at some length in the document. The two initiatives had brought about fundamental changes in the political structure by transferring much greater authority to the provinces. In theory at least, the country had moved toward real – rather than promised – federalism.

The NFC award gave the provinces a much larger share of the "divisible pool" – the resources collected by the federal government for the purpose of sharing them with the provinces – while the 18th Amendment brought government closer to the people. Although a large number of responsibilities were transferred to the provinces, they did not have the institutional capacity to make full and effective use of the powers they could now exercise. In a study for the United States Agency for International Development (USAID), the Institute of Public Policy analyzed the administrative capacity of the provinces under this new dispensation. The study's findings informed the conclusions drawn in the 2011 report.[6]

The 2012 report, the fifth in the series, told what we called the "Punjab story", analyzing in some detail the economic and social performance of Pakistan's largest province. Of special significance was the report's finding that several districts in southern Punjab lagged seriously behind those in central and northern Punjab. We attributed this to a combination of factors, among them the highly skewed distribution of landholdings – this is the only part of the province in which large estates dominate the agriculture sector – and poor maintenance of the area's well-developed irrigation infrastructure. Although it would take detailed sociological surveys to suggest a link between backwardness and extremism, it was nevertheless worrying that the movement that called itself the "Punjabi Taliban" had roots in the province's southern districts.

The sixth report, subtitled *From Survival to Revival*, assumed the most somber tone of all the reports published thus far. The report was launched in Lahore a few days before the country went to the polls and in Islamabad three months after the new government, headed by Prime Minister Mian Nawaz Sharif, took office. The chief guest at the Islamabad launch was Finance Minister Ishaq Dar who detailed the problems his administration faced but was confident that it would succeed in pulling the country out of the recession that had lasted six years. He agreed with the report's approach that Pakistan had first to address the issue of economic survival before it could embark on a program to revive its battered economy.

As indicated, in addition to reflecting on the state of the economy, the annual reports also examined several structural problems that required the attention of policymakers. Some of these are discussed above. The authors believed that Pakistan could add a couple of points to the rate of growth of national income if some of its economic fault-lines were resolved. The policy agenda for these was based on analytical work done at the Institute of Public Policy. Among the several areas on which the Institute had presented policy maps were (i) the problems of energy, (ii) the opportunities created by the devolution of authority from the federal to the provincial governments after the passage of the 18th Amendment, (iii) continuing to bring government closer to the people by creating a viable system of local government, (iv) the development of serious regional income disparities in Punjab, and (v) the benefits the country could draw from opening up the economy to trade with India. A running theme in all six reports was that of making the economy more export-oriented and suggesting how this could be achieved.

The seventh report is based on an extensive program of policy analysis initiated in late 2013 with the generous assistance of the Asia Foundation. This support made it possible for the Institute of Public Policy to initiate policy studies in areas on which the new government needed to focus. There is one major difference between the previous six reports and the present report: in preparing it, we have been in conversation with the authorities in Islamabad and Lahore. Our policy work will focus not only on what we believe should be the federal government's policy priorities, but also on what needs to be done by the provinces. We will also begin the process of drawing policy maps for the provinces, starting with Punjab in the 2015 report. In preparing the 2014 report, we were in continual dialogue with the most senior policymakers responsible for economic matters in the administration that assumed office in June 2013. We were also in touch with senior members of the bureaucracy working in the economic ministries. We had several exchanges with the multilateral institutions aiding Pakistan as our views developed. These conversations took place during the Washington-based authors' visits to Pakistan.

In the past, we did not consult policymakers while writing the reports. It was our hope then that, by releasing the annual reports while the federal and provincial budgets were being prepared, we might have some influence on the making of fiscal and trade policies. By inviting senior leaders to each report's formal launch, we hoped that people in the federal as well as provincial governments would read the document. Four of the previous six launches were chaired by the finance minister of the day and twice by the present minister, Ishaq Dar. However, this strategy of making decision-makers aware of our policy work and policy proposals did not have a palpable impact. For the 2014 and 2015 reports, we have, as it were, moved from the ex-post to the ex-ante. By engaging with policymakers all through the analytical process, we hope for a greater buy-in by those responsible in the government for economic policymaking.

The report's opening chapter lays the ground for what follows by analyzing in some detail the way a new political order is taking shape. We believe that a great deal of effort is needed to improve the quality of governance and to solve the dozen or so additional problems the country currently confronts. Even for a crisis-prone country such as Pakistan, 2013/14 has been one of the most – if not the most – difficult years in its nearly 67-year history. Given that we believe that a different development paradigm needs to be adopted that addresses each problem separately, we do not favor (as explained later) the idea of writing a grand strategy for economic revival. The time needed to resolve these problems will differ from crisis to crisis. Therefore, they cannot be lumped together in one time-bound policy framework.

One example of the "micro-planning" on which the government should focus comes from the work being done by the European multinational, Unilever Pakistan. According to one newspaper account, the company plans its operations by segmenting its market "not by income, but by different spending profiles – carefully measuring everything from how many fans, or scooters or cars people own to how often they replace their toothbrushes. It finds the most affluent are of less interest, because they are more likely to buy luxury products rather than Unilever's Dove soap or Clear shampoo."[7] We use this example from the corporate world to underscore the important point that an "economic revival" strategy, in addition to setting the macroeconomic house in order, must pay detailed attention to some of the areas that that pose problems for the economy as well as those that hold promise for the future.

2013/14: A TURNING POINT IN THE COUNTRY'S HISTORY?

This report will be released when the Sharif government is just short of completing its first year in office. There is no doubt that, with the elections of May 2013, Pakistan crossed an important milestone in its tortuous political journey. That journey began in 1947, when the country gained independence, and has moved through many ups and downs. In a period of almost seven decades, Pakistan has experimented with several different political models. It underwent military rule for almost 32 years, and promulgated and dispensed with two constitutions. The first constitution – a federal parliamentary form of government – adopted in 1958 was abrogated two years later. The second – a highly centralized presidential system with very little popular participation – promulgated in 1962 by a military regime was abolished seven years later. The third – again, a parliamentary form – has lasted 41 years. It was adopted in 1973 but has been shaped, reshaped, and distorted a number of times.

These wide swings of the pendulum have meant that political institutions did not settle down long enough to allow policymakers to focus adequately on economic matters. The only exception was the eleven-year rule by Muhammad Ayub Khan, Pakistan's first military ruler. The economic model his government adopted then was widely praised by development economists,[8] but its deep flaws became apparent once Ayub Khan had passed from the scene.

In other words, Pakistan's progress toward creating a democratic order has been a halting one. Short periods of quasi-democratic rule were interrupted by long spells of rule by the military. However, in 2008, more than 60 years after the country's birth, Pakistan appeared to be moving toward a durable democratic order. Its progress will not be linear – there will ups and downs – but what has motivated the change is people's realization that, despite its many faults, democracy is the preferred form of government. *The Economist* wrote a review on the progress of democracy just as the Ukraine was passing through a difficult time in early 2014. To the question why people yearned for democracy, the magazine had a convincing answer:

> It is easy to understand why. Democracies are on the average richer than non-democracies, are less likely to go to war and have a better record of fighting

> corruption. More fundamentally, democracy lets people speak their minds and shape their children's futures. That so many people in so many parts of the world are prepared to risk so much for this idea is testimony to its enduring appeal… All this has demonstrated that building institutions needed to sustain democracy is very slow work indeed, and has dispelled the once popular notion that democracy will blossom rapidly and spontaneously once the seed is planted.[9]

That hope was cited as one of the reasons for US military intervention in Iraq and Afghanistan. This approach failed in both cases. That said, it is not wrong to argue that democracy is a "universal aspiration." In 2000, Freedom House, an American think-tank, classified 120 countries (63 percent of the world's total) as democracies. The organization has developed indices for measuring freedom, classifying people as free, partly free, and not free. The proportion of the first two in the world's total population has increased from 58 percent in 1972 to 78 percent in 2013. The proportion of free people is now estimated at 42 percent of the total. Pakistan is part of this trend. The country moved toward establishing a democratic order some years ago and has continued to head in that direction without hesitation. But the trend, as suggested earlier, is not linear: Pakistan's progress toward democracy has not been without hiccups. Freedom House reckons that 2013 was the eighth consecutive year in which global freedom declined and that its forward-march peaked around the beginning of the century. The cause of democracy experienced a few setbacks between 1980 and 2000, but there have been many more since then.[10]

In the summer of 2014, it can be said with some confidence that Pakistan has climbed out of the political rollercoaster it had ridden for almost half a century – from 1958 when the military first intervened in politics to 2008 when the men-in-uniform began their journey back to their barracks. As suggested, 2013/14 will occupy a very important place in the evolution of Pakistan's political system. A number of "firsts" were achieved. In May 2013, an elected government completed its first full five-year term in office. Elected in February 2008, it handed over power to a different political party and a long-term rival. The six general elections held before 2008 – in 1985, 1988, 1990, 1993, 1997, and 1999 – put administrations in place that saw their terms truncated in 1988, 1990, 1993, 1996, and 1999. The first four of these resulted from the exercise of powers that were given to the President by constitutional amendments introduced by various military rulers. The fifth was the consequence of a military coup d'état. The average tenure of any elected government was slightly over two and a half years. As we argue later in the report, continuity is an important element of good governance.

The second first was scored in September 2013 when President Asif Ali Zardari, co-chairperson of the PPP, completed his term in office, making him the first elected president to do so. The third was achieved in November when General Ashfaq Parvez Kayani handed over his baton to General Raheel Sharif after serving six years in office. He was one of the few army commanders to give up office at the appointed time. In mid-December, the country saw the fourth change of considerable significance: after completing eight tumultuous years as chief justice of the Supreme Court, Iftikhar Muhammad Chaudhry vacated in favor of the court's senior-most judge. This, too, was a peaceful transfer of authority that had not always occurred so in the past – on one occasion, the appointment of the chief justice by the executive authority bypassed the seniority rule and created a major constitutional crisis. The fifth change occurred in the spring of 2014 when a round of local government elections began in the provinces, with Balochistan taking the lead.

These were not the only important events in the evolution of what promises to be durable political order. Elections, as political scientists and policy analysts have emphasized in recent years, do not guarantee the establishment of a democratic political structure per se. Pakistan serves as a good example for this conclusion. In spite of many general elections – nine in 28 years or one every three years – it is still in the process of creating a well-functioning political order. As Fareed Zakaria wrote in *The Future of Freedom*, his seminal work on the evolution of the political order, "democracy means 'liberal democracy': a political system marked not only by free and fair elections but also by the rule of law, a separation of powers, and the protection of basic liberties of speech, assembly, religion, and property. But this bundle of freedoms – what might be termed 'constitutional liberalism' – has nothing intrinsically to do with democracy and the two have not always gone together, even in the West."[11]

It was only after 2008 – in particular, after a series of constitutional amendments had been passed – that the country was set on a democratic trajectory. Among the more significant changes in this area was the creation of a number of institutions that are considered critical for ensuring that a fully representative political order becomes the norm. After suffering under military rule for three decades, the political establishment correctly concluded that a working democratic order must have the full support of the citizenry. This is possible only if citizens develop confidence in the working of institutions that are critical components of a democratic infrastructure. Public acceptance of the political order depends on how autonomous these institutions are seen to be of the government's executive branch.

The first step in achieving this objective is to appoint independent people to run and staff these institutions. Of those that received attention in the various amendments to the Constitution in

2010-12 were the higher courts and the Election Commission. Since good governance is critical for both political and economic development, the infrastructure that has been created over time to ensure it must have full autonomy and be able to inspire public confidence. In the present structure, the National Accountability Bureau (NAB) is the apex body responsible for ensuring public transparency. As we suggest in Chapter 4, the selection of NAB's senior management could also follow the processes adopted for the courts and election authority. Delivering good governance to the citizenry is important for economic and political success.

The process of developing a political order has not gone entirely smoothly. Two problems that remained unresolved concern the role of the military in the political order and the place of Islam in the political system. Pakistan is not alone in dealing with these issues: they are also being addressed in other large Muslim countries in the western part of the Muslim world. Egypt and Turkey, for instance, which also seemed set on a course leading to the development of a durable political order, have suffered setbacks.

The Arab Spring of 2011 forced a long-enduring government headed by Hosni Mubarak, a military man, out office. The Arab public showed its power to bring about change that would – or so it seemed at the time – usher in a representative political system. A constitution was drafted, elections were held and, for the first time in the country's history, an elected president took office. But the Muslim Brotherhood's Mohammad Morsi moved fast to formally introduce Islam into the system of governance. He went much further than the public wanted, bringing people back onto the streets, this time to ensure that Egypt did not opt for an Islamic system. This brought back the question of the role of Islam in politics, which remains unresolved in the western part of the Muslim world. The military, which seemed to have been pushed back into the barracks, roared back. Morsi was removed from office, incarcerated, and charged with a number of offenses committed while in office. The Muslim Brotherhood was banned once again and another military man, General Abdel Fatah el Sisi, is now in command of the country. He is most likely to win the presidential election and be installed as the country's head of state. Egypt is back to square one.

Turkey, the other large Muslim country, has also stumbled on the way to establishing a durable political order. An Islamic party under the leadership of Recep Tayyip Erdogan, a talented and charismatic politician, won three elections, each time with a larger share of the vote. Under his watch, Turkey became one of the fastest growing economies in the world. The military was sent back to the barracks with a number of senior officers put behind bars for allegedly plotting a coup against the government. A confident Ankara began to play a role in stabilizing the Middle East, much of which was in turmoil. Then, in the summer of 2013, the Turkish also rebelled. The public did not approve of the Prime Minister's increasingly authoritarian ways. A minor issue – the conversion of a popular public square in the heart of Istanbul into a site for a building complex designed to celebrate the country's past – became a national crisis. The Islamic movement that was behind Erdogan's rise to power split as the Prime Minister became more assertive.

From the documents that began to leak into the press in early 2014, it appears that the followers of Fetullah Gelen, an Islamic preacher living in exile in Pennsylvania, were behind the move against the military. Erdogan's supporters claim that the powerful Gelenists had created a parallel state in the country with deep inroads into the judiciary and other components of the state. According to Tim Arango of *The New York Times*,

> The reassessment of the evidence that supported the military trials is putting new light on what has been hailed, here and abroad, as Mr Erdogan's most important achievement: securing civilian control over the military. The way it was done, however, is now increasingly viewed as an act of revenge by Turkey's Islamists against their former oppressors in the military, once the guardians of the secular tradition laid down by Mustafa Kemal Ataturk, the founder of modern Turkey.[12]

History need not repeat itself, especially if it is from other places. The examples of Egypt and Turkey suggest that even rapid strides in the right direction in evolving a democratic political order do not ensure that a clear path for the future has been set and will continue to be followed. Reversals can take place as happened in Egypt and Turkey, two large Muslim countries that are attempting to walk the same path as Pakistan. Some of the problems that have occupied Prime Minister Nawaz Sharif in his first year in office are reminiscent of what is happening in other Muslim countries. There was pressure on him to send a strong message to the military leadership indicating that the judicial system was now capable of dealing with erring officers. There was also the question of the role of Islam in the country's political evolution. How these matters are resolved will have enormous consequences for Pakistan's political and economic future.

In December 2013, the judicial system caught up with former President Pervez Musharraf who had twice violated the Constitution. In October 1999, he removed Prime Minister Nawaz Sharif from office and brought the military back to politics, which stayed for almost nine years. In November 2007, irked by the increasing independence shown by the Supreme Court and provincial high courts, Musharraf decided to take a radical step. Using the power he claimed he had as chief of army staff, he suspended the Constitution on 3 November and removed dozens of offending senior judges.

The second action became the focus of judicial attention in the winter of 2013/14. A three-member panel of judges was set up by the Supreme Court to determine if the former President should be tried under the “high treason” Clause 6 of the Constitution. On his way to appear before the panel, the general dodged the proceedings by checking into a military hospital in Rawalpindi, claiming chest pains. He remained in hospital for weeks while the political and military leaderships attempted to find a solution to the problem.

The second development that has disrupted political progress is Prime Minister Nawaz Sharif’s unexpected decision in late January 2014 to begin negotiations with the banned terrorist outfit, Tehrik-e-Taliban Pakistan (TTP). The government appointed a four-member team to negotiate with the TTP, which countered by appointing a different three-member committee drawn not from its own ranks but from the Islamic parties that are sympathetic to its demand for bringing the Sharia into the Constitution, thus dispensing with the common law system inherited from the British. Although these developments have created some uncertainty about the country’s political future, Pakistan may finally have achieved the beginning of political stability.

Democracy as an institution does not stand still. It continues to evolve. There appear to be three stages involved in this evolution – getting there, staying there, and dealing with the challenges that are thrown its way as it proceeds from one stage to the next. Pakistan is at the first stage. India, its neighbor, is at the second stage, where the system in place is being challenged in several different ways. Pakistan will also get to the same point as India, but there are lessons to be learned from the experience of its neighbor.

Two problems facing the Indian political system at this time are of considerable significance for Pakistan: regionalism and dynastic politics. Regionalism or state power is a big factor in Indian politics. A democratic system is defined by the structure of the political parties that function within it. For several decades, politics in India was dominated by the Congress Party, which governed from New Delhi as well as from most state capitals. Its authority was ultimately challenged by the Hindu nationalist Bharatiya Janata Party (BJP), which, like the Congress Party, also claims a national following. Challenges have also emerged from several regional and geographically narrow-based political organizations. For several decades, important states such as Tamil Nadu, Uttar Pradesh, West Bengal, and Punjab have been ruled by parties whose influence does not extend beyond the states they dominate.

This development has weakened the central government. There is considerable public resentment that the political system has become excessively dynastic. Patrick French, a British historian, notes that every member under the age of 30 in India’s lower house is a member of a political party. Dynastic policy is a symptom of political underdevelopment: those who hold positions of power find it difficult to trust those with whom they have no personal links.[13] The same suspicion is preventing Pakistan from proceeding to the next phase of bringing government closer to the people. As the above cited survey in *The Economist* notes, democratic systems in both developed and developing nations face challenges that need to be dealt with.

That a democratic order – even at an early stage of development, as in Pakistan's case – can evolve to people's satisfaction was demonstrated by the success of the May 2013 elections. Voters came together to rid the government of leaders who had performed poorly. As the experience of numerous African states – most notably Zimbabwe – shows, entrenched leaders with even a poor record for governance are hard to remove. This was achieved, however, by the 2013 elections in Pakistan. The elections also brought to power a set of leaders who have eschewed what in political science is referred to as "majoritarianism" – the notion that winning an election entitles the majority to do whatever it pleases. This was the main reason that the generals in Egypt were able to oust the Muslim Brotherhood administration that came to power after a convincing electoral win. Morsi believed his victory had given him the right to impose a political system that an articulate and politically savvy minority did not want. In Turkey, Erdogan is now under the same kind of pressure. He cannot override the wishes of the minority even if repeated electoral victories have given him the mandate to govern strongly. His party's success in the local government elections held on 30 May 2014, in which it won easy victories in Istanbul and Ankara, may have strengthened Erdogan's hand but not the Turkish democratic system.

With the PML-N having scored decisive victories at the national as well as provincial level (in Punjab), Sharif was in a position to translate these mandates into firm rule. The PML-N won 166 seats in the National Assembly – 77 more than it had held in the 2008–13 legislature. The PPP won only 45 seats, dropping its presence by 74 seats. The Pakistan Tehreek-e-Insaf (PTI), a newcomer, came in third place with 35 seats; it did not have a presence in the previous house. Party positions were even more lopsided in the Punjab provincial assembly, with the PML-N claiming 214 out of 297 seats. Even with this kind of comfortable position in both Islamabad and Lahore, the Prime Minister chose to build a consensus on what will very likely prove to be the most important decision his government has taken in the first year of its term. It chose to use the mechanism of an "all-party conference" or APC to gain support for its strategy to deal with the rise of extremism in the country. While building a consensus outside parliament might mean not using majoritarianism as a way of governing, such an approach may have weakened the role of the legislature in governance.

Democracy's success in Pakistan also depends on two other challenges: delegating up and down the structure of society. Globalization has meant losing some control over policymaking not only to international institutions but also to bodies that are not entirely under the control of the executive. The Sharif government's performance has been mixed in both areas. It has allowed the International Monetary Fund (IMF) to play an important role in determining policy priorities for reviving the economy. At the same time, it has been less willing to surrender control of the monetary policy to the State Bank of Pakistan (SBP). The departure of the SBP's governor – a holdover from the days of the PPP-led government – before he had completed his three-year term was not a good sign. It was certainly not an indication that Islamabad was prepared to give the central bank a free hand in monetary matters.

At the other end, the PML-N has shown indifference toward allowing government to move closer to the people by developing local councils. In this context, it is useful to recall what was achieved by an earlier administration. One of the important legacies that Ayub Khan's system could have left behind was a well-ordered system of local government that gave a significant amount of authority to local councilors (the "basic democrats"). The system had four tiers, each with elected representatives and functionaries of the government at the local level. They were provided with resources they could use for their respective areas, responding to the public's expressed wishes. Looked at from the perspective of economic development, the system was a success. It helped create jobs in the local communities and contributed to the widespread use of high-yield rice and wheat varieties that, in the late 1960s, ushered in Pakistan's first green revolution.[14]

However, the system was discarded when Ayub Khan was deposed and replaced by another military president. A succession of different structures followed, none of which was allowed to stay in place long enough to bring about sustained development to local communities. As discussed later in this report, the opportunity to develop governance at this level – the third tier below the federal and provincial structures – has reemerged. To quote once again from *The Economist*'s survey of democracy,

> … delegation upwards towards grandees and technocrats must be balanced by delegation downwards, handing some decisions to ordinary people. The trick is to harness the twin forces of globalism and localism, rather than try to ignore or resist them. With the right balance of these two approaches, the same forces that threaten established democracies from above, through globalization, and below, through the rise of micro-powers, can reinforce rather than undermine democracy.[15]

CONCLUSION

The main message of this report is that a number of welcome political changes are now in place that are most likely to provide the country with a durable political order it has taken decades to develop. With this development, Islamabad's policymakers are now in a position to address the many structural problems that have plagued the country since 1947. In moving forward, they must also bring with them all four provinces. Following the passage of the 18th Amendment to the Constitution, these administrative units now have considerable economic autonomy.

We recognize that the Sharif government needed to move quickly to find external resources to meet the country's foreign obligations. It was appropriate to approach the IMF for an immediate infusion of external financing, without which, the government would have found it exceedingly difficult to service its earlier loan from the institution. The Pakistan government has also used diplomacy to obtain funding from other governments that have been friendly to the country. However, these steps should be treated as emergency measures. In order to move the country onto a high and sustainable GDP growth trajectory, Pakistan will have to find resources from within the economy and by increasing significantly its exports earnings. A serious effort is being made to mend relations with India in order to achieve the latter. This may produce tangible results once the Indian elections of April–May 2014 produce a new administration in New Delhi.

Among the many problems that need to be tackled, we focus in particular on four, providing policy advice on each: (i) the mobilization of domestic resources to ensure sustained economic growth, (ii) finding a satisfactory solution to overcome critical energy shortages, (iii) improving the quality of governance at all levels, and (iv) overcoming the challenge posed by the rise of Islamic extremism. This is a formidable agenda but it can be tackled, given the impressive mandate granted to the ruling party, which not only governs from Islamabad but also has control over Punjab, the country's largest province in terms of its share of the population and national income.

Chapter - 2

The State of the Economy 2014

Chapter - 2

The State of the Economy 2014*

A DISMAL ECONOMIC RECORD: 2008–13

Pakistan's economic record during 2008–13 was dismal. GDP growth (a little over 3 percent per annum) appeared to have been the slowest of any five-year period in the last half-century[1] and had seriously compounded the country's unemployment situation. The danger of relative economic stagnation had become real. Table 2.1 gives the GDP, gross national product (GNP), and gross national income (GNI) for this period.

Table 2.1
Growth Rates of GDP, GNP, and GNI

Percent per annum at a constant factor cost for 2005/06

Indicator	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
GDP	5.0	0.4	2.6	3.7	4.4	3.6
GNP	5.0	0.9	3.8	4.2	4.3	3.4
GNI	0.7	2.5	5.1	3.4	4.0	5.8

Source: State Bank of Pakistan.

Inflation, whether measured by the GDP deflator or the consumer price index, had clearly accelerated: the GDP deflator increased by 12.6 percent per annum and consumer prices rose by 11.8 percent per annum over 2008–13. The only period in which the inflation rate had been somewhat higher was 1973–77. The rise in food inflation (14.3 percent per annum) hit the urban poor, the middle classes, and rural nonfarm workers.

The deterioration in the macroeconomic situation was reflected in a large, unsustainable fiscal deficit – averaging 7 percent of GDP (see Table 2.2) – and in the halving of gross foreign exchange reserves to $6 billion in five years despite substantial net use of IMF resources (see Table 2.3). In the first half of 2013 alone, gross foreign exchange reserves declined by $3 billion.

Table 2.2
Fiscal Ttrends

As a percentage of GDP

Indicator	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Tax Revenue	9.8	10.2	10.0	9.2	10.0	9.4	9.9	9.6
Total Revenue	14.0	14.9	14.3	14.1	14.2	12.5	12.4	13.0
Total Expenditure	18.2	19.2	21.7	19.3	20.5	19.1	19.1	21.0
Current Expenditure	14.5	15.8	17.7	15.6	16.3	16.1	15.1	16.0
Development Expenditure	4.8	4.9	4.0	3.5	4.5	2.8	3.6	5.0
Overall Deficit	4.2	4.3	7.4	5.2	6.3	6.6	8.5	8.0
Revenue Deficit	0.5	1.7	3.4	1.5	2.1	3.6	2.7	3.0

Source: Pakistan Fiscal Operations, Ministry of Finance.

*This chapter was contributed by Dr Parvez Hasan with the assistance of Atr-un-Nisa

Table 2.3
Major Macroeconomic Indicators

Indicator	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
GDP Growth Per Annum (%)	5.8	5.5	5.0	0.4	2.6	3.7	4.4	3.6
Fiscal Deficit (as % of GDP)	4.2	4.3	7.4	5.2	6.3	6.6	8.5	8.0
Current Account Balance (as % of GDP)	-3.9	-4.8	-8.4	-5.5	-2.3	+0.1	-2.1	-1.0
GDP Deflator Change (%)	10.5	7.2	12.9	20.7	10.8	19.5	5.3	7.5
Consumer Price Change (%)	7.9	7.8	12.0	17.0	10.1	13.7	11.0	7.4
Change in Net Domestic Assets of Monetary System (%)	12.4	11.3	23.2	12.8	12.7	13.1	20.2	20.8
M2 Change	14.9	19.3	15.3	9.6	12.5	15.9	14.1	15.9
Level of Foreign Exchange Reserves (US$ Million at the end of the period)	13,122	15,647	11,399	12,425	16,750	18,244	15,289	11,020
Gross Total Investment (as % of GDP)	19.3	18.8	19.2	17.5	15.8	14.1	14.9	14.2
Gross National Savings (as % of GDP)	15.2	14.0	11.0	12.0	13.6	14.2	12.8	13.5
Ratios of Investment and Savings are in Current Prices: Gross Capital Formation (excluding inventories) as % of GDP in 2005-2006 Prices								
	17.7	**17.4**	**17.9**	**16.7**	**15.6**	**14.3**	**13.9**	**13.2**

Source: State Bank of Pakistan and Pakistan Economic Survey (various issues).

An especially troubling aspect of the fiscal situation was that an increasing portion of the deficit reflected negative government savings (averaging at least 3 percent of GDP over 2008–13). Current expenditures far exceeded current revenues as the tax-to-GDP ratio had stagnated while real public consumption – reflecting energy subsidies, administrative expenditures, security spending, and public enterprise losses – grew by 32 percent over this period.

Perhaps the most worrying economic development from the point of view of future growth was the decline in the ratio of gross fixed capital formation to GDP from 17.9 percent in 2007/08 to 13.2 percent in 2012/13 – the steepest decline on record (see also Table 2.4). Real fixed capital formation declined more than 12 percent. If the depreciation of fixed capital is taken into account, the net addition to capital was less than 5 percent of GDP annually both in 2011/12 and 2012/13.[2]

Table 2.4
Domestic Absorption of Resources

Rs billion in constant prices for 2005/06

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Consumption	7,499	7,723	7,780	7,894	8,203	8,695	9,098
of Which Private	(6,650)	(6,882)	(6,833)	(6,952)	(7,261)	(7,684)	(7,990)
Investment, Including Stocks	1,634	1,710	1,652	1,578	1,493	1,519	1,539
of Which Gross Fixed Capital Formation	(1,496)	(1,570)	(1,508)	(1,432)	(1,342)	(1,362)	(1,373)
Total	**(9,133)**	**(9,433)**	**(9,432)**	**(9,472)**	**(9,696)**	**(10,214)**	**(10,637)**

Source: Pakistan Economic Survey (Various Issues)

RESILIENCE VERSUS FUNDAMENTALS

The economy and the public did not bear the full brunt of deteriorating governance, poor economic policies, and slow growth partly because a number of exogenous factors cushioned the immediate impact on economic activity. These included a spurt in workers' remittances (both through official and nonofficial channels), the infusion of coalition funds, the large spillover of resources from Afghanistan (as many Afghans had acquired businesses and property and educated their children in Pakistan), and the clandestine transfer of funds from abroad in support of terrorism and ethnic conflicts.

These additions to national income meant two things. First the official GNI growth rate – a better indicator of national welfare – was, at over 4 percent, more than 20 percent higher than the GDP growth rate. Second, the official GNI numbers do not fully reflect the economic activity generated by the transfer of funds to the country from unofficial sources and the growth in the informal economy. The informal economy, which had always been substantial, reportedly gathered momentum[3] that partly reflected growing corruption and increasing tax avoidance.

The resilience of some segments of the economy notwithstanding, the Institute of Public Policy's (2013) annual report discusses in detail a long list of negatives.[4] The stock market continued to rise and, in recent years, has been one of the best performers in the world. Official figures showed a growth of 16.1 percent in private consumption over the fiscal years 2008–13. However, because of more rapid growth in the informal economy, the real growth in private consumption was clearly higher – probably around 20 percent, suggesting an average annual per capita growth in consumption of around 2 percent in an otherwise difficult economic period. The consumption-led growth, fueled by increasing corruption, was, however, very unevenly shared because, as noted above, food inflation hit low-income groups very hard and employment growth was very slow.

BORROWING FROM THE FUTURE

This apparent resilience does not take account of the heavy economic and social costs incurred, deepening macroeconomic imbalances, the serious erosion of investment levels, critical shortages of infrastructure (especially energy), eroding institutional capacity, growing income disparities, poor employment opportunities, and – not entirely unrelated to the uneven distribution of economic gains and social progress – growing extremism and terrorism. One might say that Pakistan has, in the last several years, borrowed heavily from its future and thus greatly imperiled it.

MAJOR CHALLENGES

To the credit of the Sharif government, it seems fully aware of the deep-seated challenges it faces. Several members of the administration have referred to the “three E’s” – economy, energy, and extremism – as shorthand for the several problems they must deal with, all of which were inherited from the previous government headed by Asif Ali Zardari. On the domestic front, the present government is also focusing on youth employment and strengthening social safety nets by enlarging the Benazir Income Support Program.

While the government has focused on the economy and on energy, it has also actively reached out to all major countries that matter to Pakistan’s economy – notably the US, Afghanistan, China, Turkey, and India – and to its security and control of terrorism. It is very conscious of the difficult external environment that will emerge with the imminent departure of most or all International Security Assistance Force (ISAF) troops at the end of 2014. Whatever else happens, the withdrawal of foreign troops from Afghanistan will mean less political stability and a sharp decline in economic resources and activity in that country, at least in the near term. Both these fallouts will have a negative impact on Pakistan. Its present trade surplus of around $2 billion annually could disappear because of financial constraints in Afghanistan. In addition, the drop in coalition payments will also affect the country’s budgetary position, although the withdrawal of military and other equipment through Pakistan – if allowed – might bring a substantial short-term windfall.

The Planning Commission is working on its Economic Vision 2025 policy statement to provide a perspective on longer-term issues and a five-year plan that will focus on immediate issues. The intended vision statement will clearly define the objectives that policymakers should seek to achieve over a stipulated period. It will also lay down the path that should be traveled to arrive at the defined goals and indicate clearly how the two major economic players – the public and private sectors – should work together.

The remaining chapter focuses mainly on the progress made in handling key economic issues under the fairly broad program agreed with the IMF in September 2013, with special attention to macroeconomic developments.

PAKISTAN’S PROGRAM WITH THE IMF

As mentioned earlier, there was a serious deterioration in Pakistan’s foreign exchange position during 2011/12 and 2012/13: gross foreign exchange reserves declined by 60 percent over these two years to $6 billion by the middle of 2013. This was despite the cushioning effect of an increase in foreign currency deposits by foreign governments with the SBP and other swap arrangements. According to the IMF definition, the SBP's net international reserves were negative to the tune of nearly $3 billion at the end of September 2013.

The loss of gross foreign exchange reserves of $4.8 billion during 2012/13 greatly exceeded the current account deficit because net inflows to the capital account were barely positive and there were large repayments to the IMF ($2.5 billion). The decline in foreign exchange reserves accelerated as the current account deficit widened. The prospect of large repayments due to the IMF (nearly $3 billion) over the 18-month period from mid-2013 to end-2014 also created uncertainty in the foreign exchange market. Even with the IMF's initial disbursement in early September 2013, the nominal exchange rate by the end of September was down year over year by around 10 percent. It recovered somewhat in early October 2013 and has even appreciated significantly since then.

Pakistan had no real choice, therefore, except to go to the IMF early, even though the finance minister had already signaled the initiation of a strong fiscal adjustment in the budget for 2013/14. Friendly countries that could provide breathing space probably also encouraged the government to seek IMF assistance sooner rather than later. A good seal of housekeeping was also important for triggering other flows from the World Bank and other sources. More importantly, the government probably felt that tough decisions on electricity pricing could, politically, be handled better under the IMF program umbrella.

The IMF support was to be provided through a 36-month program under the Extended Fund Facility – a total amount of SDR 4.4 billion (about $6.6 billion). The first tranche of $553 million was released in early September 2013 when the IMF board approved the three-year program. Another two installments of SDR 360 million each were released in December 2013 and March 2014 following a satisfactory economic performance review in the first two quarters of 2013/14. The remaining ten installments are to be disbursed over the next two and a half years after satisfactory quarterly reviews. Almost all program releases by mid-2015 will be offset by sizable repayments due to the IMF on the 2009 program. The level of credit outstanding to the IMF in mid-2015 will be at the same level as in mid 2013 – roughly $4.5 billion. However, if the program is successfully completed, there will be net inflows of about $2 billion in 2015/16.

The precondition of satisfactory quarterly reviews for the release of tranches suggests that the IMF will keep Pakistan on a tight leash in light of its experience – rarely has an agreed program been completed satisfactorily. The large upfront release under the 2009 program also proved unproductive. As discussed below, the conditionality of the IMF program is fairly tough and broad-based, although its central focus is strong fiscal adjustment accompanied by a large build-up of international reserves. However, it is not correct, as the press has asserted, that the IMF program fails to address structural issues.

Critical structural measures in the energy sector have been given high priority. As discussed elsewhere, substantial upfront increases in electricity tariffs were made even before the program with the IMF was finalized. During the program period, tariff differential subsidies will be phased out and tariffs will be brought to cost-recovery levels. Tariff adjustments will improve resource allocation and efficiency, and encourage conservation. Cost-cutting and efficiency measures will also be undertaken both in generation and distribution. Legal changes will be undertaken to tackle electricity theft by enhancing investigation, prosecution, and penalties.

As part of the gas price rationalization plan, a gas infrastructure development cess (GIDC) has been imposed, facilities to import gas are being developed, and incentives for higher domestic production of gas have been strengthened. Trade policy reforms envisage phasing out trade-related statutory regulatory orders (SROs) over three years with the design of the plan to be completed by the end of May 2014. There are also plans to simplify the import tariff and move to a four-slab system and 0–25 rates.

A major stocktaking of all key loss-making public enterprises is being undertaken and the privatization of 26 percent of Pakistan International Airlines shares to a strategic investor has been initiated. This will be followed by the implementation of medium-term action plans to privatize firms, restructure those with prospects of profitability that the government wishes to retain in the public sector, and close nonviable firms.

Other benchmarks of structural reforms aim to bring more independence to the SBP – revising the regulatory and supervisory frameworks, developing a new bankruptcy law (the Corporate Rehabilitation Act) to revamp recovery mechanisms, and defining financial sector benchmarks that will initially focus on mitigating the short-term risks posed by undercapitalized banks and ensuring that the necessary institutions are set up to protect medium-term financial stability.

FISCAL ADJUSTMENT

It is true, however, that, as always, the IMF's major emphasis is on a drastic fiscal adjustment over the two fiscal years through a combination of tax measures and expenditure control. The government has committed to a fiscal consolidation of 4.5 percent over a three-year period, bringing the fiscal deficit (including grants) to 3.4 percent of GDP by 2015/16. This is clearly an ambitious target: it will require improving the tax-to-GDP ratio from 9.7 percent to 12.4 percent over three years and reducing government expenditures (excluding net lending) from 20.3 percent to 18.9 percent of GDP.

The critical target is a sharp reduction in the fiscal deficit to 5.5 percent of GDP in the current year 2013/14. The government has already taken a number of steps to improve revenues and reduce electricity subsidies. The budget for 2013/14 aims to increase revenues by 0.75 percent of GDP by raising the general sales tax rate and several withholding taxes, introducing several new withholding rates, and imposing a higher excise on cigarettes and a new levy on movable assets. The GIDC is expected to raise revenues of 0.4 percent of GDP.

Nevertheless, there are risks associated with these revenue projections, given the slow progress in eliminating SROs and because the Federal Board of Revenue (FBR) is finding it difficult to improve tax collection and broaden the tax net (especially income tax collection) by strengthening the administration. The provinces are also dragging their feet in mobilizing one of the most promising sources of provincial revenue, i.e., property taxation.

PROGRESS UNDER THE IMF PROGRAM

The IMF has judged the program's progress to be satisfactory after the first two quarterly reviews and has indicated that it expects the benchmarks set for the end of March 2014 will be met. The latest IMF review documents notes: "While there is room for improvement in some areas, overall the authorities have made commendable progress in stabilizing the economy and launching important structural reforms. Core program targets on fiscal consolidation and international reserves have been met and authorities have taken corrective action to address missed performance criteria."[5] The review also adds that, while there are signs of improvement, economic conditions remains challenging and the risks remain high and tilted to the downside.

The IMF seems particularly satisfied that the fiscal target of 5.5 percent of GDP for 2013/14 will be met: an increase in electricity tariffs has helped reduce subsidies and the gas levy will create space for increased spending. The IMF's concerns, however, are as follows:

- The balance of payments (BOP) situation remains difficult. Delays in the expected large realization of official and private flows (more than $4 billion from the auction of 3G licenses, privatization receipts, the Coalition Support Fund, and sharply increased inflows through foreign loans and market borrowing) in the last quarter of 2013/14 could put further pressure on the BOP. (However, the successful large sale of Pakistani bonds on the international market (totaling $2 billion) and the grant of $1.5 billion from Saudi Arabia have greatly strengthened the reserve position.)
- Inflation will remain at or near the double-digit level as the impact of the administered price changes and previously accommodative policy works through the system.
- Efforts to broaden the revenue base and improve tax administration should be stepped up.

The recently introduced investment incentive package to induce more individuals to file their income tax returns runs counter to the efforts to strengthen tax administration. Similar future schemes should be avoided and the authorities should mobilize the anti-money laundering framework to mitigate abuse of the tax amnesty scheme and generally help improve compliance.

WEAKNESSES IN TAX ADMINISTRATION

No doubt the fiscal adjustment the government will achieve during 2013/14 will be substantial. However, the pattern of adjustment has involved a less-than-robust revenue performance and a greater squeeze on development spending. It should also be noted that much of the growth in revenue has come from raising the sales tax and instituting the GIDC.

As yet, it is not clear whether improvements in tax administration have yielded any significant increase in tax revenues. The transfer of the Research and Development Fund from the Ministry of Information to the Federal Consolidated Fund was a factor in the healthy growth of nontax revenues. Additionally, in a setback to the government's efforts to reduce the accumulation of new energy sector losses, the National Electric Power Regulatory Authority (NEPRA) declined the former's proposal to add the servicing cost of the syndicated term credit finance facility to settle arrears in the tariff determined for 2013/14. The idea was that the cost of servicing borrowing to settle the large circular debt in 2013 should be recovered by further adjusting electricity tariffs. The government is now considering incorporating this as a capital expenditure.[6]

EXCHANGE RATE POLICY

The IMF has only gingerly touched on the recent large real appreciation in the exchange rate, mentioning in its latest second review report that "reserves remain dangerously low and the central bank should take every opportunity to accelerate reserves accumulation further. In these efforts greater exchange rate flexibility and a higher policy rate should play a role."[7]

The original IMF program document did not address the question of the exchange rate level directly or openly. However, Table 1 on selected economic indicators in the IMF's September 2013 document on Pakistan compares estimates of the 2013/14 GDP in US dollars with GDP estimates in Pakistani rupees. The data imply an average exchange rate of Rs 110.3 per US dollar for the current year compared to the nominal rate average of Rs 97 per US dollar in 2011/12.

Allowing for an expected average inflation rate of 10–11 percent (as per the SBP's first quarterly report for 2013/14) and inflation of less than 2 percent in the US, the implied nominal exchange rate indicates a real depreciation of 4–5 percent year over year. To some extent, this was the policy intent. The rupee had depreciated by 6 percent in July–September 2013 compared to only 0.3 percent in the first quarter of 2012 as a result of the external deficit and the SBP's purchases at the interbank rate required by the IMF. However, there was further speculative pressure on the exchange rate when the IMF released its detailed letter of intent in September 2013 – the market focused on future foreign exchange purchases by the SBP to meet subsequent net international reserve targets. This even caused the interbank rate to touch a record high of 110.5 on 26 September 2013 before closing at 105.35 the same day.[8]

Since then, the rupee has strengthened for a number of reasons: the finance minister's declared intention to keep the US dollar rate at less than Rs 100, the inflow of funds of $1.5 billion from Saudi Arabia, and probably the panic among speculators as the rupee rate dropped below Rs 100 to Rs 98 on 4 April 2014.

Whether Pakistan should have had an effective real devaluation of 4–5 percent during 2013/14 compared to the previous year is debatable. However, there was little rationale for the present rate of Rs 98, which, if it persists for the rest of the year 2013/14, will mean that the rupee will have appreciated substantially in real terms – perhaps as much as 6–7 percent by June 2014 compared to June 2013 when the rate averaged nearly Rs 99. This will hurt competitiveness and export development. Undoubtedly, competitiveness can be strengthened by improving productivity but the cost disadvantage caused by a higher rate of domestic inflation compared to international inflation must be reflected in the adjustment of the nominal rate. In other words, even though the need for real depreciation might be debated, avoided, or mitigated by other measures, letting the rupee appreciate in nominal terms could be very harmful, especially if this move is supported by large but temporary inflows.

THE IMF'S MEDIUM-TERM MACROECONOMIC FRAMEWORK

It is necessary to examine the IMF's macroeconomic medium-term projections because they not only provide a perspective for its conditionality on fiscal deficits and foreign exchange reserves but also its view of Pakistan's growth prospects. These projections are, of course, revised from time to time in light of the developing situation. Indeed, the IMF's estimate of GDP growth in 2013/14 has been revised sharply upward from 2.5 percent to 3.1 percent over the last six months. Table 2.5 provides the IMF's latest medium-term macroeconomic projections, which are also listed below:

- GDP growth will rise gradually over the next four years to 5 percent in 2017–18 averaging a little over 4 percent per annum over 2013–18 compared to a little over 3 percent during 2008–13.
- The overall fiscal deficit (including grants) will come down to 4.2 percent of GDP during 2014/15 and average 3.2 percent of GDP in 2017–18.

- Tax revenues will rise from 10.4 percent of GDP in 2013/14 to 12.3 percent in 2017–18.
- The current account BOP deficit will average 1.3 percent of GDP over 2013–18.
- Gross foreign exchange reserves will rise from $4.9 billion at the end of March 2014 to $19.2 billion by the end of June 2018.
- The nominal rate of growth in merchandise exports over 2013–18 will be 7 percent per annum while merchandise imports are expected to grow by a little over 6 percent per annum over this period.

Table 2.5
Medium-Term Macroeconomic Framework, 2010/11–2018/19

	2010/11	2011/12	2012/13	2013/14 First Review	2013/14 Program	2014/15	2015/16	2016/17	2017/18	2018/19
								Projections		
(Annual Percentage Change)										
Output and Prices										
Real GDP at Factor Cost	3.7	4.4	3.6	2.8	3.1	3.7	3.9	4.7	5.0	5.0
Consumer Prices (period average)	13.7	11.0	7.4	7.9	8.8	9.0	7.0	6.0	6.0	6.0
(In Percent of GDP)										
Saving and Investment Balance	0.1	-2.1	-1.0	-0.6	-0.9	-1.0	-1.0	-1.3	-1.0	-1.0
Government	-6.7	-8.4	-7.8	-5.5	-5.3	-4.2	-3.4	-3.2	-3.2	`-3.2
Nongovernment (including Public Sector Enterprises)	6.8	6.3	6.8	4.9	4.4	3.2	2.3	2.0	2.2	2.3
Gross National Savings	14.2	12.9	13.2	14.2	14.2	15.3	17.3	18.0	18.8	19.7
Government	-4.2	-5.1	-4.8	-2.2	-2.0	-1.1	0.2	0.6	0.8	1.0
Nongovernment (including Public Sector Enterprises)	18.4	17.9	18.0	16.5	16.2	16.4	17.1	17.4	17.9	18.7
Gross Capital Formation	14.1	14.9	14.2	14.8	15.1	16.3	18.3	19.3	19.8	20.6
Government	2.5	3.3	3.0	3.3	3.2	3.2	3.5	3.9	4.1	4.2
Nongovernment (including Public Sector Enterprises)	11.6	11.6	11.2	11.5	11.8	13.2	14.8	15.4	15.7	16.4
Balance of Payments										
(In US$ Billion)										
Current Account Balance	0.2	-4.7	-2.5	-2.3	-2.2	-3.3	-3.5	-4.5	-4.0	-4.2
Net Capital Flows [a]	2.3	1.4	0.5	6.5	5.8	5.8	4.9	5.5	5.8	5.0
Of which: Foreign Direct Investment [b]	1.6	0.8	1.5	2.6	2.3	1.7	2.2	3.8	4.9	4.5
Gross Official Reserves	14.8	10.8	6.0	9.4	9.3	12.7	16.3	17.5	19.2	20.0
In Months of Imports [c]	3.6	2.7	1.4	2.1	2.0	2.6	3.1	3.1	3.2	3.3
External Debt (in percent of GDP)	31.1	29.0	25.0	27.7	26.5	26.5	25.9	24.1	21.9	19.7
Public Finances										
(In Percent of GDP)										
Revenues and Grants	12.6	13.1	13.2	14.9	14.9	15.0	15.4	15.4	15.3	15.3
of which: Tax Revenue	9.5	10.3	9.7	10.6	10.4	11.2	11.7	12.3	12.3	12.3
Expenditure (including Statistical Discrepancies), of Which:	19.5	21.5	21.0	20.4	20.2	19.3	18.7	18.6	18.6	18.5
Current	16.5	17.8	16.3	16.8	17.1	16.1	15.2	14.7	14.5	14.3
Development (including net lending)	2.6	3.4	4.6	3.6	3.1	3.2	3.6	3.9	4.1	4.3
Primary Balance [d]	-3.1	-4.0	-3.5	-0.8	-0.6	0.5	0.6	0.4	0.2	0.1
Overall Fiscal Balance[d]	-6.9	-8.4	-7.8	-5.5	-5.3	-4.2	-3.4	-3.2	-3.2	-3.2
Total Public Debt (including obligations to the IMF)	9.5	63.8	63.1	65.9	64.0	62.7	61.2	59.2	56.6	54.5

[a] Difference between overall balance and current account balance.
[b] Including privatization.
[c] In months of next year's imports of goods and services.
[d] Including grants.
Source: IMF (March 2014).

The IMF's projections are almost by definition cautious and conservative and, as mentioned above, subject to revision. However, they are of some concern because they will influence government policy over the next two years. A sharper acceleration in economic growth than envisaged by the IMF – to an average of 5 percent over 2013–18 and at least 6 percent by 2017-18 – is essential not only for improving employment and generating confidence in the economy but also for strengthening macroeconomic fundamentals, especially the tax-to-GDP ratio.

Surprisingly, in its latest iteration, the IMF has sharply raised its expectations concerning the revival of savings and investment over the next few years, but has left growth rate projections unchanged. On one hand, the IMF's new projections that investment and savings will rise to 19.8 percent and 18.8 percent of GDP, respectively, by 2017/18 appear optimistic. On the other hand, there is now an apparent inconsistency between the growth and investment estimates.

The next chapter discusses a growth scenario in which growth can be accelerated to 6–6.5 percent per annum not only by reviving investment but also by focusing on productivity improvements, reversing the decline in governance, and improving the security situation. A strong expansion in exports is essential for reviving growth. The nominal growth of exports assumed by the IMF implies real growth of only about 5 percent, which would not much improve the stagnant exports-to-GDP ratio. The General System of Preferences (GSP) Plus provided by the European Union (EU), good chances of opening up trade with India, closer trade relations with China, and greater policy focus on promoting exports should make possible a faster real growth rate of 9–10 percent (see Chapter 3). The point also is that stronger exports should provide a firm basis for inducting large inflows of loans and investments. Otherwise, foreign exchange crises will recur.

A salient feature of the IMF's medium-term fiscal framework is that the large gap between revenues and current expenditures, which leads to borrowing for nondevelopment spending, will disappear in 2015/16. This means that Pakistan could return relatively quickly to the condition in the Fiscal Sustainability Law that negative savings on the general government account are eliminated.

If, as forecast, negative government savings disappear in a couple of years, there can and should be greater flexibility in setting the overall fiscal target. Other things being equal, Pakistan could run a larger fiscal deficit if all of it were to finance investment and/or development spending. There would then be no urgent need to limit the fiscal deficit to 3.2 percent of GDP in 2017–19. An annual fiscal deficit of 4–4.5 percent of GDP for these years, which only finances worthwhile development spending and contributes to higher capital formation and growth, would then be more appropriate.

EXTERNAL FINANCES

While the fiscal adjustment planned for 2013-14 is likely to remain mostly on track, the ambitious foreign exchange reserve targets suggested by the IMF might be difficult to meet. The original IMF estimates of the current account BOP deficit of only $1.3 billion and $1.7 billion for 2013-14 and 2014-15 were clearly off the mark. The 2013-14 estimate has now been revised to the more realistic figure of $2.3 billion or 1 percent of GDP. The latest figures, however, suggest that the deficit will be even larger. Thus, the deficits projected for the two subsequent years, 2014-15 and 2015-16, at the modest level of less than 1 percent, are clearly unrealistic.

BUILDING UP RESERVES VERSUS FINANCING THE CURRENT ACCOUNT DEFICIT

While building up reserves is an important element of ensuring financial stability and increasing confidence in the economy, the reserve accumulation must not come at the cost of unduly restricting the current account BOP deficit and constraining overall growth. The projected level of the BOP current account deficits for the next two years means that, despite an expected improvement in the national savings rate, real investment will recover only modestly from the lowest level it has been in half a century. This seems inconsistent with government plans to initiate a large number of new projects with help from China, the World Bank, and Asian Development Bank (ADB) – and indeed with the IMF's own recent projections of investment growth.

Import growth over the next few years is also likely to be higher than IMF estimates due to higher overall growth and strong expansion in foreign exchange intensive-investment in the energy sector. A current account deficit of around 2 percent of GDP would be appropriate for inducting the much needed foreign private investment. By providing a better balance between reserve buildup and the current account deficit, the IMF's GDP growth projections, which are probably deliberately conservative, can and should be exceeded. Otherwise, the slump in employment and investment will continue, deepening social discontent.

CONCLUSION

By and large, the Pakistan government is implementing a tough but necessary stabilization program effectively. It has taken bold and decisive steps to reduce the fiscal deficit by raising taxes and controlling expenditures. Plans to increase electric power production by diversifying the sources of generation and eliminating large energy subsidies over three years are being pursued resolutely.

Economic activity and investment appears to be reviving, though the government's growth target of 4.4 percent in 2013/14 is not likely to be achieved. However, the IMF's revised estimate of 3.1

percent is likely to be exceeded with GDP growth in the current year expected to be in the range of 3.5–4.0 percent. The fiscal adjustment is proceeding well. However, the projected figure for the fiscal deficit, 5.5 percent of GDP, might be adjusted upward as account is taken of liabilities assumed under circular debt and full account of public enterprise losses incurred during the year. The especially encouraging part of the fiscal adjustment now underway is that negative government savings – the excess of current government expenditures over revenues and grants – is likely to be eliminated in 2015–16. This should enable the government to run fiscal deficits of 4.0–4.5 percent of GDP in subsequent years – somewhat higher than the 3.5 percent suggested by the IMF.

However, progress in improving the effectiveness of tax administration, especially in relation to income tax, has been disappointing. Much of the significant increase in tax revenues in the current year was from higher rates or new taxes. Far stronger political will is needed to identify and punish wrongdoers. Raising the ratio of taxes to GDP and increasing the elasticity of the tax system are among the most vital structural improvements needed to revive and sustain high growth.

The IMF's medium-term projections for economic growth, exports, and imports are excessively conservative. They envisage that GDP growth will accelerate to only 5 percent by 2017-18 while real growth in exports and imports over 2013–18 will be, respectively, 5 percent and 4 percent annually.

The next chapter argues that the government should aim to revive growth to 6–6.5 percent per annum by 2017–18 while ensuring the better distribution of growth benefits and putting macroeconomic fundamentals on a strong footing. A strong export-oriented strategy is recommended to exploit the export opportunities offered both by the EU-preferred access for textiles and by expanding trade with India and China. In the shorter term, effectively managing energy shortages, improving energy efficiency and the effectiveness of public expenditures, and strengthening economic governance will be as critical as investment revival.

Chapter - 3

Reviving Economic Growth: Overcoming Constraints and Exploiting Potential

Chapter - 3
Reviving Economic Growth: Overcoming Constraints and Exploiting Potential*

INTRODUCTION

As the previous chapter has indicated, Pakistan's economic growth over the last five years is probably the lowest on record in the last half-century. To some extent, however, the adverse impact of slow growth on employment and poverty has been cushioned by very large formal and informal external flows – workers' remittances (through official and unofficial channels), coalition payments, and a large unrecorded spillover of resources from Afghanistan.

Looking ahead, the imminent departure of most or all ISAF troops from Afghanistan at the end of 2014 will have a negative impact on the external resources available to Pakistan. This reinforces the need to revive domestic growth not only to create greater employment opportunities but also to reduce poverty and recover some of the ground lost to other major developing countries during the last quarter-century.

A LAGGING ECONOMY

Table 3.1 below shows that Pakistan's annual GDP growth per capita was 1.8 percent over the last 25 years. This puts Pakistan near the bottom of the list of the dozen or so major developing countries, next only to Brazil but below Nigeria and Bangladesh. Table 3.2 highlights the steadily growing income gap between Pakistan and all major developing countries, with the exception of Brazil, since 1988. It is almost hard to believe that, a quarter of a century ago, Pakistan's per capita income was significantly higher than that of either China or India. Now, China's income per

Table 3.1
GDP Per Capita Growth Rates

Percent per annum in purchasing power parity terms in constant 2005 international US$

Country	1988–2013	2008–2013
Bangladesh	3.4	4.0
Brazil	1.3	1.4
China	8.4	6.9
Egypt	2.6	1.4
India	4.4	4.6
Indonesia	3.5	3.6
Malaysia	3.6	1.8
Mexico	1.1	–0.1
Nigeria	2.9	2.9
Pakistan	1.8	1.6
The Philippines	1.8	2.4
Sri Lanka	4.2	5.1
Thailand	3.9	2.1
Turkey	2.4	1.9
Vietnam	4.9	2.6

Source: World Economic Forum, IMF.

*This chapter was contributed by Dr Parvez Hasan.

head is more than three times that of Pakistan while India's is more than a third higher.

Table 3.2
Per Capita GNI in Purchasing Power Parity
In Constant 2005 international US$

Country	1988	2008	2013
Bangladesh	708	1,333	1,623
Brazil	7,520	9,573	10,264
China	1,050	5,712	7,958
Egypt	3,071	5,412	5,795
India	1,134	2,672	3,341
Indonesia	1,808	3,581	4,272
Malaysia	6,121	13,510	14,775
Mexico	9,537	12,711	12,617
Nigeria	1,128	1,988	2,294
Pakistan	1,580	2,306	2,491
The Philippines	2,441	3,375	3,803
Sri Lanka	1,911	4,203	5,384
Thailand	3,275	7,610	8,459
Turkey	7,665	12,504	13,737
Vietnam	938	2,759	3,133

Source: World Development Indicators (World Bank) and World Economic Forum, IMF

Undoubtedly, Pakistan's growth over the last several years has suffered a number of special setbacks: the worsening security situation, poor governance, and a crippling energy crisis. However, a number of deep structural problems that have persisted for decades are also to blame: the country's weak financial position rooted in very low tax revenues on the one hand and limited export growth on the other; grossly insufficient investment in human capital development, infrastructure, and economic activity at large; and steadily deteriorating governance.

While external shocks have also had an adverse impact on the economy's performance, the palpable decline in the rate of growth is a consequence of poor policy choices. The long-term annual growth rate appears to have declined and, at present, is probably not higher than 4 percent.

THE CHALLENGES OF REVIVING GROWTH

While the reversal of polices can and will produce an economic bounce, it will not last long unless there is a fundamental change in economic policies and governance. Still, raising the growth rate gradually to a sustainable level of at least 6–6.5 percent will take time, say, four or five years. Reducing financial vulnerabilities and ensuring a better distribution of growth benefits represent both a tremendous challenge and a unique opportunity. Meeting the suggested targets would mark a huge achievement and a clear break from the past. However, merely increasing the annual growth rate will not be enough. The growth revival must also aim to substantially reduce the critical gaps in longer-term investments in water, power, and human development and lay the basis for a more equitable distribution of the benefits of growth. Failure to revive sustainable and more inclusive growth in the medium term will relegate Pakistan to the group of poorly performing economies in the coming decade.

Sustainable growth will also require increasing the country's self-reliance. It is both desirable and necessary that at least 85 percent of the targeted growth in investment comes from an increase in national savings and that the exports-to-GDP ratio expands significantly. This will help maintain the burden of external debt servicing and meet foreign investment obligations within safe limits.

The key goals of inclusive development should be (i) an increase in employment of at least 3 percent per annum (the creation of about 2 million jobs annually); (ii) growth in the real wage rate roughly in line with per capita income growth; (iii) a sharp increase in levels of education, adult literacy, and labor skills; (iv) to make fiscal policy at least a moderate instrument of income redistribution through effective direct taxation; and (v) to increase the level of the Benazir Income Support Program to 1 percent of GDP over the next five years.

How can all this be achieved?

IMMEDIATE CONSTRAINTS

The immediate constraints to reviving growth include (i) the lack of full confidence in the country's future, given the current security situation, (ii) the likely persistence of energy shortages, and (iii) concerns about the negative fallout of ISAF troops leaving Afghanistan. As discussed in some detail in Chapter 1, however, the present government is seeking a regional peace by focusing on better relations with key neighbors such as India and Afghanistan. It has also made strengthening the economy a central plank of its foreign policy and is giving high priority to resolving the energy sector's problems. While it is necessary to develop a comprehensive energy policy and strengthen the arrangements for implementing and monitoring Pakistan's very ambitious energy sector program, the government's determination to eliminate energy shortages and reduce energy costs from the present high levels must not be in any doubt (see Chapter 6).

FUNDAMENTAL ISSUES OF STRATEGY

As discussed in Chapter 7, there is reasonable hope that Pakistan's security situation will gradually be brought under control. The energy constraint to industry and agriculture is also expected to become increasingly less important. However, if the country is to move onto a sustainable and equitable path of high growth, it must resolutely tackle three fundamental and interrelated issues that are at the root of its failed economic promise:

- The inadequate mobilization of resources for development, highlighted by a very narrow tax base and low level of exports and reflecting a deep-seated bias in favor of consumption over investment and exports

- An uneasy relationship between the private and public sectors, where the public sector has often aspired to own and control what it regards as strategic national enterprises and where the private sector has relied too heavily and too often on government largesse to collect economic rents
- Weakening governance and a declining institutional capability to deliver effective public services, including law and order and justice; these are reflected in growing corruption, the increasing cost of doing business, and less effective public spending.

As pointed out by the Institute of Public Policy (2013),

> In a real sense, improving governance must be key element in a growth strategy. If the quality of governance had not deteriorated as much as it did in the last several years, if the strength of public institutions not eroded over time, if adequate resources had been mobilized through taxation to provide basic public services especially law and order and education, the growth challenges would have been less severe. Over time, growth and governance problems became increasingly intertwined. Because growth benefits were not widely shared, the quality of public services especially education deteriorated and the pace of poverty reduction slowed. Consequently, there was a palpable increase in social tension, with increasing frequency in ethnic, sectarian and random violence.[1]

This report, therefore, devotes a separate chapter to how governance can be improved.

Another fundamental challenge is to change the culture of consumption and external dependence by increasing confidence in the country's future, and in the state and its institutions. This will help increase tax collection and saving rates and enable much needed investments. At the same time, the required external inflows should not become a crutch and an export-oriented strategy should secure the basic health of Pakistan's foreign exchange position.

Finally, we need a new compact with the private sector that broadly defines the respective roles of the state and private sector but also provides policy guidelines for private sector involvement not only in education, health, and vocational training, but also in some segments of infrastructure, such as power and transport. At the same time, the regulatory framework must be thoroughly examined to weed out irrelevant and ineffective regulations while strengthening agencies such as the Securities and Exchange Commission of Pakistan (SECP), the Competition Commission of Pakistan (CCP), the Oil and Gas Regulatory Authority (OGRA), and NEPRA.

THE CRITICAL IMPORTANCE OF INCREASING NATIONAL SAVINGS

Table 3.3 indicates that, but for a few exceptional years, Pakistan's national savings rate has never exceeded 13–14 percent of GDP. There has been no clear upward trend in the savings rate in the last half-century and marginal savings remain below 15 percent.

Table 3.3
Trends in Savings, Consumption, and Investment

As a percentage of GDP

Year	Public Savings	Private Savings	National Savings	Private Consump.	Public Consump.	Total Consump.	Gross Fixed Capital Formation	Fiscal Deficit
1960	–	–	7.5	82.2	10.3	92.5	10.0	2.1
1965	–	–	12.8	76.3	10.9	87.2	21.5	–
1970	–	–	13.1	76.8	10.1	86.9	14.3	5.3
1985	0.4	12.5	12.9	81.6	12.1	93.7	16.5	8.0
1990	2.8	11.4	14.2	71.4	15.1	86.5	17.3	7.1
2000	0.1	15.9	15.8	75.2	8.7	83.9	16.0	5.1
2005	3.5	13.8	17.4	76.4	7.8	84.2	17.3	3.4
2008	-1.8	15.2	13.4	76.5	12.5	89.0	15.9	7.4
2010	0.0	13.6	13.6	79.7	10.3	90.3	14.2	6.3
2011	-1.3	15.5	14.2	81.1	9.7	90.8	12.5	6.6
2012	-0.5	13.4	12.9	82.5	10.5	92.9	13.3	8.5
2013	-0.1	13.9	13.8	81.0	10.8	91.9	12.6	8.0

Note: The figures for 1960–70 (national savings and gross fixed capital formation) are the author's own estimates.
Source: State Bank of Pakistan.
Economic Survey

Pakistan's savings performance has been dismal, especially when compared with high-performing countries in East Asia and, recently, India. Many factors and the complex interplay of sources have contributed to the country's low savings rate: (i) a high rate of population growth and the subsequently high number of dependents as a percentage of the working-age population; (ii) a political leadership and social attitudes that have not demanded or promoted the idea of making sacrifices for the future; (iii) the relative ease with which external resources could be obtained; (iv) fiscal policy failure to meet the government's current expenditure from revenues, given the low growth of tax revenues on the one hand and great pressure to spend more on defense on the other; and (v) the absence of a clear framework for private sector development through much of the country's history. At a more basic level, the low measured savings rate reflects low confidence in the future, although it is worth noting that the estimated savings are understated because of considerable capital flight.

Pakistan has received an enormous volume of external inflows over the last six decades. Large volumes of foreign aid in the 1960s and 1970s, workers' remittances in the 1980s, resident foreign currency deposits in the 1990s, and direct private investment in 2003–08 have all helped sustain economic growth without a major domestic saving effort. Indeed, it is not an exaggeration to say that Pakistan has, to an extent, used external resources to substitute for the domestic effort. In any case, the large external flows diminished the incentive to develop exports on the one hand and, on the other, allowed policymakers to avoid the difficult choices between consumption and saving and defense and development. The point is that large temporary inflows can support the exchange rate at an unsustainable long-term level and hinder a stable foreign exchange position.

While foreign investment and, to an extent, foreign borrowing will be needed for decades to come, they should be used to supplement rather than supplant domestic effort. Large foreign investment, if used to support the production of home goods (as against exports), can actually worsen the country's foreign exchange position if it is not accompanied by an export expansion that strengthens the ability to service larger profit remittances. Foreign investment in independent power plants (IPPs) (foreign-owned and -operated electricity generating companies) and telecommunications in the last two decades are good examples of how a country does not pay enough attention to future liabilities in terms of investment income payments.

What can be done to improve Pakistan's savings performance significantly while continuing to attract the sizable external resources that are needed – in the form of foreign investment and loans – without jeopardizing the external payments situation?

ELIMINATING NEGATIVE GOVERNMENT SAVINGS

An important instrument that could be used to raise the national savings rate is the elimination of general government negative savings. This refers to the excess of government expenditure over government revenues, which, with a few exceptions, has remained a feature of Pakistan's fiscal situation for nearly three decades, averaging 3 percent of GDP in most years. The Debt Committee[2] highlighted this problem in its 2001 report and recommended that the revenue deficit, which had averaged over 3 percent of GDP during 1996–99, be eliminated by 2003/04.[3] Later, the provision that there should be no borrowing for current public consumption was made a legal requirement under the Fiscal Sustainability and Debt Limitation Law, under which the revenue deficit was to be phased out by June 2007. In fact, the law has been ignored and negative government savings have persisted, averaging at least 3 percent of GDP over the period 2008–13.

It is often not realized that government borrowing for public consumption has aggravated the economic impact of Pakistan's large fiscal deficit. The low and stagnant ratio of taxes to GDP (less than 10 percent in FY2013) is the root cause of government negative savings, although in recent years, energy subsidies and mounting public enterprise losses have added to the revenue deficit. It should also be stressed that the excess of current government expenditure over revenue is notwithstanding woefully inadequate spending on health and education.

Evidently, a fundamental restructuring of public finances is needed. This could be done over a period of three years to ease the inevitable pain of the transition. The focus should be on raising tax revenues while sharply reducing energy subsidies and public enterprises losses. The aim should also be to provide for much larger social sector spending while eliminating the revenue deficit.

TAX STRUCTURE AND TAX POLICY[4]

There is broad agreement that, in Pakistan's circumstances, a steadily rising tax-to-GDP ratio is the best guarantee of a viable fiscal adjustment and sound finances – a desired goal that has been missed for decades. There is also a consensus that the main problem concerning taxation is not the rates of taxation but in fact poor enforcement resulting from a tax code that is riddled with loopholes and a tax administration that is both inefficient and corrupt. Since a good deal of additional revenue from curbing evasion must come at the cost of reduced bribes to the tax collector, the taxation machinery itself has become, to an extent, a constraint – as well as an instrument – of tax mobilization.

While the tax administration needs to be greatly improved, a clearer statement of the national tax policy – on which both the federal and provincial governments can agree and attempt to build a national consensus – must underpin any administrative overhaul. Without a framework of taxation that defines goals and the relative importance of various taxes, ad hoc approaches to transforming the tax machinery will continue to falter. A genuine income tax – one that is independent of withholding taxes, which do not really constitute direct taxation – combined with a meaningful capital gains tax and a wealth tax or estate duties has become both a fiscal and moral imperative.

In 2012/13, of the reported individual tax collection of Rs 652.8 billion (2.8 percent of GDP), over two thirds was from withholding taxes. This implies that the genuine income tax paid by 0.7 million income recipients was less than 1 percent of GDP. It is little wonder that cynics have called for income tax to be abolished because it neither collects much revenue nor is it an effective instrument for income redistribution.

WHO SHOULD PAY INCOME TAX?

Unless the rich start paying their fair share of taxes, government efforts to reduce subsidies for the middle classes and collect full charges for water, electricity, and gas will not succeed. A broad change in values is required both toward taxation and savings if Pakistan is to achieve savings and investment levels of, say, 20 percent of GDP over the next eight to ten years.

Of the 0.7 million persons/households that pay income tax, a little over 0.5 million are nonsalaried individuals – the group on which the income tax authorities should focus. What constitutes a reasonable target for bringing additional nonsalaried individuals into the income tax net over the next five years?

Pakistan has a population of 180 million, with about 30 million households. A good guess is that the top 10 percent of income recipients account for 30–35 percent of the national income: the average annual income of six-person households in this group was at least Rs 2 million–2.5 million annually in 2013, with a probable threshold of more than Rs 1 million. It is these three million households that should eventually pay the bulk of income tax. In the next three to five years, a reasonable aim would be to add 500,000 to one million households to the nonsalaried taxpayer base. This will still mean that less than half the target group will be in the tax net by 2018.

The IMF's suggestion to target an increase of 300,000 households is not ambitious enough because press accounts indicate that the National Database and Registration Authority (NADRA) has profiled over two million possible offenders, based on use of cars, houses, bank accounts, and overseas travel.[5] A "naming and shaming" policy that was suggested by a former chairperson of the FBR might help toward resolving this issue.

Small changes in the individual income tax return format could help crosscheck expenditure information and facilitate income audits. For instance, filers should be asked to identify any income they or their spouses earn, even if nontaxable; any tax-free income earned from sources such as national savings certificates; the amount of exempt agricultural income claimed; and any children studying abroad with details of their university and course of study.

UNDER-TAXED SECTORS[6]

Any discussion on Pakistan's taxation issues must also touch on the large informal sector, which, as noted above, appears to be growing more rapidly than the formal economy. It is not clear whether the tax authorities have enough information on or outreach in various segments of the informal economy, small industrial and commercial enterprises, the high-end fashion industry, and various services sector providers. Small-scale enterprises not only escape the tax net but also perpetuate a less-than-optimum scale and inhibit large-scale units from achieving full economies of scale. Clearly, the playing field needs to be leveled.

NATIONAL TAX POLICY OFFICE

Ad hoc approaches may work up to a point, although their past record is not encouraging. It is necessary to have a conceptual framework that outlines the objectives and roles of various taxes, both provincial and federal. On the technical level and given the need for a coherent national tax strategy, a National Tax Policy Office (NTPO) should be established to prepare the groundwork for policy direction and taxation choices at the federal and provincial levels. The Taxation Committee recommended such a body as far back as 2002.[7] The NTPO should be located directly under the minister for finance and be responsible for coordination policy analysis and approaches with the provinces. It should be supported by a tax policy research institute that could be funded jointly by the government and the private sector. At the same time, it is worth considering the establishment of a high-level tax reform commission to guide not only tax policy but also tax administration issues.

There is substantial scope for raising large revenues by phasing out SROs and developing both value-added taxation and property taxation. Raising a significant part of this additional revenue through direct taxation is, however, a moral imperative, and could be done through an effective individual income tax, capital gains tax, and estate duties or a wealth tax. The redistributive effects of income taxation cannot be ignored in a free-market economy where growing income equality has become a pressing issue. This approach would also enhance the government's public credibility.

Specifically, raising the tax-to-GDP ratio from the present 10 percent to 13 percent by FY2018 should be a major instrument of pursuing fiscal adjustment. Careful tax policy analysis should provide options for policymakers on the proper mix of taxation. However, a priori, raising genuine income tax collection from the present level of 1 percent of GDP to 2 percent and roughly doubling the number of nonsalaried households that pay income tax to 1 million over the next four or five years is both feasible and imperative.

Achieving the suggested tax target should help eliminate the revenue deficit by FY2018. However, a significant increase in the level of education and health spending from the present 2.5 percent to 3.5–4 percent of GDP will be possible only if public enterprise deficits and energy subsidies are cut sharply. There is a clear tradeoff between the two sets of policies: reducing subsidies and public enterprise losses and increasing social spending. Privatization will take time and changing the energy mix and increasing the sector's efficiency to produce and distribute electric power more cheaply will not be easy in the medium term. The government needs to prepare consumers and the public for some hard choices between higher energy prices and the availability of power and gas on one hand, while doubling its efforts to improve efficiency and control theft on the other (see Chapter 5 for more detail).

CONTAINING THE PUBLIC DEBT BURDEN

Sound fiscal management must also focus on keeping public debt and public debt servicing within manageable limits. The Fiscal Responsibility Law places a 60 percent limit on the public-debt-to-GDP ratio, which rose moderately to 61.2 percent at the end of 2012-13 from 56.7 percent in FY2008. Significant though the deterioration in the debt burden ratio is, it understates the extent of Pakistan's worsening debt burden for two reasons.

First, the rise in the debt burden has been contained greatly by the negative real interest rates paid on domestic debt during the last few years. The average nominal interest rate of 11–12 percent has remained below the average rate of inflation measured either by consumer prices or the GDP deflator (see Table 3.4). As inflation is brought under control, as it should be, the real burden of interest rates is likely to rise as they revert to norm – as happened in the second half of the 1990s.[8]

Table 3.4
Trends in Inflation Rate and Nominal Interest Rate

Year	Inflation Rate (GDP Deflator, in Percent)	Inflation Rate (CPI, in Percent)	Average Nominal Rate on Domestic Debt (in Percent)	Interest Payment on Domestic Debt (PRs Billion)
2008/09	20.7	17.0	14.8	571
2009/10	10.7	10.1	12.4	578
2010/11	19.5	13.7	10.8	650
2011/12	5.3	11.0	10.7	817
2012/13	7.5	7.4	9.6	910

Sources: IMF (March 2014)
Annual Report 2012/13; State Bank of Pakistan.

Second, as the Debt Reduction and Management Committee's (2001) report points out, "it makes more sense to use the yardstick of government revenues for monitoring changes in public debt burden… after all, GDP changes do not automatically translate into revenues, particularly in developing countries like Pakistan where the tax machinery is weak and taxation systems are inelastic."[9]

Using the yardstick of government revenues, the public debt burden has risen even more sharply than the ratio of public debt to GDP indicates. Table 3.5 shows that, as a percentage of revenues, the public debt ratio rose from 399 percent in mid-2009 to 472 percent in 2012/13; it is not expected to show much improvement by mid-2014 despite the significant increase in government revenues in the current year.

Table 3.5
Pakistan's Public Debt Burden

	Public Debt as % of GDP	Public Debt as % of Revenue
2008/09	60.7	393.4
2009/10	61.5	396.6
2010/11	59.5	438.4
2011/12	63.8	459.2
2012/13	63.1	485.2

Source: IMF (March 2014).

The public debt limits laid down in the Fiscal Sustainability Law should be refined and taken seriously. Unfortunately, the Debt Policy Coordination Office set up in 2002 on the recommendation of the Debt Committee has not evolved as an effective institution for monitoring the debt situation or even providing authentic data on the latest debt position. It needs to be strengthened and in future charged with carefully reviewing Pakistan's external debt and net investment position (see the discussion below).

THE BROADER ISSUE OF RAISING NATIONAL SAVINGS

Eliminating general government dissaving – indeed, hopefully generating moderate revenue surpluses eventually – would help considerably in raising national savings. However, raising the national savings rate from its present level of 13–14 percent of GDP to, say, 20 percent will require intensive efforts. At the political level, the country's leadership needs to set an example of austerity by curbing ostentatious consumption and tremendously wasteful expenditure on, for instance, weddings. At the same time, an improvement in the investment climate and appropriate incentives for investment would aid the shift from consumption to investment. Better returns to savers, including holders of fixed bank deposits, and greater access to capital markets for small savers, including the market for medium- and long-term government paper would also help promote savings.

An improvement in Pakistan's security situation, greater confidence in its political and economic stability, and efforts to strengthen its external finances would also reduce capital flight, which is a serious drain on national resources. More rapid growth in the corporate sector would help increase business savings. The government could consider issuing a national call for higher savings and investment or at least initiate a debate on this important subject. A peaceful and prosperous Pakistan can also hope to attract significant savings and investment by its very affluent diaspora.

REDUCING EXTERNAL VULNERABILITY AND ENCOURAGING FOREIGN CAPITAL

In the foreseeable future, Pakistan will continue to need substantial inflows of foreign investment and aid to revive the economy and build up its official foreign exchange reserves. Due to stabilization policies and large expected receipts ($1.2 billion) from the sale of 3G and 4G telecom licenses in the fourth quarter, the current account's BOP deficit is likely to be limited to a little over 1 percent of GDP during 2013/14. However, as economic activity and especially investment revives, the current account deficit is likely to increase to an average of 2 percent of GDP over the next four years. At the same time, the policy objective is to increase gross foreign exchange reserves (excluding gold and foreign currency deposits held with the SBP as a cash reserve requirement) from the present level of around $4 billion to over $16 billion by mid-2018. Using somewhat lower current account BOP deficit projections, the IMF estimates Pakistan's gross external financing needs at around $37 billion over the five fiscal years 2013–18.

While large external inflows are greatly needed, the viability of servicing additional external obligations needs carefully scrutiny. Pakistan's external debt, presently $62 billion, represents 250 percent of its exports. Including services receipts and workers' remittances, the external debt is about 180 percent of total foreign exchange earnings. More importantly, much of the debt is on soft terms. The annual interest payment on external debt in 2012/13 was $1.2 billion; this is only 2 percent of the country's total debt obligations and the proportion is likely to remain low unless Pakistan resorts to large-scale borrowing on international market terms.

Income payments on private direct investment, however, have risen steadily: at $2.7 billion in 2012/13, they were more than double the level of interest payments on external debt. Direct investment has increased fourfold over the last decade to $28.8 billion in mid-2013. The IMF has projected that direct investment will increase by another $18 billion over 2013–18 to $46.8 billion while portfolio investment will double to $11.2 billion in this time.

At present, Pakistan sorely needs foreign direct investment (FDI) in two areas: export development (diversifying markets and products, upgrading skills, and moving up the value chain) and oil and gas development. At the same time, as mentioned earlier, its experience with independent power plants in the 1990s and excessive focus on the telecom and financial sectors during the Musharraf years suggest that caution is needed when inducting foreign investment into the production of home goods.

In any case, one should avoid the tendency to underestimate the cost of foreign investment in terms of profit remittances. The present IMF projections of income payments on direct investment, which average $3.1 billion annually over the three years 2016–18, imply an annual rate of return on foreign investment in nominal terms of 7.5 percent. This appears to be a serious underestimate and if our conclusion is correct the current account BOP deficit could be substantially larger than assumed.

The main point is that foreign investment has benefits as well as costs, and without a strongly bolstered export-oriented strategy, Pakistan's BOP difficulties will not be easily resolved.

EXPORT DEVELOPMENT

From its very first annual report issued in 2008, the Institute of Public Policy has vigorously and consistently argued in favor of adopting an export-oriented strategy. Indeed, the first report had a separate chapter on the subject, titled “Promise and potential of Pakistan’s exports: Developing a new paradigm.” The key messages discussed to various degrees in the last six reports are as follows:

- In terms of drivers of growth, two important but related factors have adversely affected our development record. The first is the low growth of total factor productivity (TFP). The second is that Pakistan has missed out on the tremendous opportunities offered by almost explosive growth in international trade – especially in manufactured goods – made possible not only by the liberalization of trade and reduction of tariffs but also by technological changes that sharply lowered transport costs, greatly increased information flows, and increasingly shifted international trade from final goods to intermediates as part of the supply chain.
- Even excluding China, manufactured exports from the major developing countries expanded more than 25-fold over 1980–2010. In this group, only Brazil and Pakistan lost their share to their competitors (excluding China).[10]
- Pakistan remains a major world exporter in textiles but its share in this relatively slow-growing sector is under pressure – not only from China but also from India, Turkey, Indonesia, and Vietnam. In the faster growing garments sector, Pakistan is now well behind not only Bangladesh but also Turkey, India, and Vietnam. Its world share in the fastest growing area of manufactured goods – excluding textiles and clothing – is minuscule: less than 0.04 percent compared to 8 percent for India, 6 percent for Turkey, and 0.2 percent for Vietnam.
- China and most other East Asian countries are in a league of their own, but even traditionally inward-looking economies such as India, Turkey, and Bangladesh have increased their export orientation remarkably in the last 30 years. In 1980, India’s export-to-GDP ratio (6 percent) was half that of Pakistan (12 percent); now, at 23 percent, its ratio far exceeds that of Pakistan. Even Bangladesh has moved ahead in this respect.
- Some will argue that the boom in world exports is over and that, in any case, Pakistan has a very steep hill to climb in terms of competitiveness. This pessimism about further globalization is not, however, justified. International comparative advantage will continue to shift. Like Japan earlier, the share of many East Asian countries in labor-intensive manufactured goods has been declining. Recently, the rate of exports from China has also slowed down, reflecting cost pressures emanating from higher wages.

- Possibilities for expanding trade with India need to be followed up urgently and diligently. While this trade expansion may result in losers and winners, the overall impact on Pakistan will most certainly be very positive.
- At the same time, in order to deal with the large negative trade balance with China, public policy should aim to develop supply chains that can link up with the latter's large industrial sector. These chains should take advantage of the entrepreneurship that exists in the small- and medium-scale engineering sector.
- Even with a slowdown in international trade, Pakistan can hope to gain market share, provided it follows policies that strengthen competitiveness, improve the base of technology, diversify the product mix, and move up the value chain.

Specific measures to promote exports were detailed in the Institute of Public Policy's (2013) annual report, but they are worth repeating even though they include the points made above concerning trade with India and China. Pakistan needs to:

- Maintain an exchange rate that fully reflects the differential between the movement in Pakistani prices and the international price level.
- Review all SROs and eliminate them over a three-year period because most SROs increase domestic protection and thus increase the anti-export bias.
- Offer strong incentives for new investment and for upgrading skills in the textiles sector to increase scale and upgrade its technological base while encouraging the exit of enterprises with low productivity and profitability.
- Strongly encourage small and medium industries to expand and diversify exports in areas other than textiles.
- Initiate joint public and private sector efforts to promote foreign investment in textiles, clothing, and other promising export sectors from economies such as the Republic of Korea, Hong Kong, Malaysia, Taiwan, and China, which are losing ground in labor-intensive industries due to high and rising wage costs. Specifically, these efforts should focus on encouraging foreign investment that will help upgrade skills and technology and make use of established export channels.
- Focus especially on expanding exports to regional partners, especially to China and India – the two fastest growing economies in the world. The large negative trade balance with these countries could provide some leverage.
- Carry out a special and speedy implementation review of the free trade agreement and establishment of free trade zones with China, and assess their likely impact on exports in the near term.

- Carry out a similar review of the key constraints to and principal opportunities for expanding trade with India.
- Develop export supply chains based on the work being done in the context of the National Trade Corridor Improvement Project.
- Strengthen monitoring mechanisms, including a quarterly meeting of the high-level Export Board.
- Implement the recommendations in the Strategic Trade Policy Framework 2009–12 to reduce anti-export bias by withdrawing protection from inefficient industries, minimizing taxation at the investment stage, and eliminating or zero-rating customs duty on important inputs to textiles and clothing exports.

Achieving an annual real growth rate in the export of goods and services of 9–10 percent on average over the next five to seven years will be central to raising GDP growth to a sustainable rate of 6–6.5 percent per annum and creating employment opportunities and real wage growth. This, in turn, will help spread the benefits of growth more widely. Such export growth has never been achieved in the past for any length of time. Even if achieved, it will raise the ratio of the export of goods and services only moderately from the present low level of 14 percent to 16–17 percent by 2018.

THE ROLE OF THE PRIVATE SECTOR

The Pakistani state has had a long history of ambivalence toward the private sector, particularly after Bhutto's rule in the 1970s. Only in the late 1980s and early 1990s did a more favorable climate for the private sector emerge – under the pressure of severe shortages of public resources even for power generation and a generally more positive international view of markets under the Thatcher-Reagan leaderships. The political lead was provided by the first Nawaz Sharif government (1990–92), which initiated large-scale privatization, greatly relaxed investment controls, and practically abolished strict foreign exchange controls. During the Musharraf period, private investment revived and FDI flourished although it was unfortunately concentrated in the telecom and financial sectors. However, the Supreme Court's decision to block steel mill privatization in 2006 was a great setback. With Sharif's return to power in 2013, the private sector has received a new lease of life and the government has launched a broad drive to privatize state enterprises, particularly those incurring huge losses.

However, there is resistance to the idea of large-scale privatization in some political circles, segments of the bureaucracy, and the public, including entrenched unions. Apart from their ideological predisposition, critics of divesting public assets ignore two fundamental facts: (i) the precarious nature of public finances and (ii) the greatly weakened capacity of the state to administer even its normal functions. As the earlier discussion on major tax and fiscal problems suggests, realism demands that the private sector must be responsible for meeting 75–80 percent of the country's investment needs; it must also work in close partnership with the public sector to improve the quality of services, not only in the social sectors but also in key infrastructure areas such as power distribution.

In return for a broad assurance that it can lead participation in all major areas of economic activity, the private sector must agree to cooperate in phasing out the economic rents it enjoys as a result of either limited competition or SROs. It should also assist the government drive to raise tax revenues in an equitable manner. Public-private partnerships need to be actively pursued, especially in two main areas: education and skills development.

The challenges to the education sector are immense. It is a matter of great concern that any improvement in social indicators over most of the last decade appears to have slowed down in the last two or three years, presumably under financial pressure and slow economic growth. About 43 percent of school-age children were still not in school in 2012. The literacy rate among 15-year-olds and above, which had improved from 44 percent in 1998 to 57 percent in 2009, was only 58 percent in 2012 – this, despite a continued rise in female literacy, which now stands at 47 percent. Clearly, Pakistan will be unable to achieve its Millennium Development Goals in education and literacy.

The crisis in education is centered on the public sector not only because of its declining share in enrollment but also given the persistent problem of declining quality. Even at the primary level, the increase in private school enrollment has outstripped the growth in government schools: the private sector's share grew from 35 percent to 39 percent over a short period of four years (2008–12).[11]

The private sector is now doing well by providing low-cost education in slums and villages. Many such schools operate in the homes of families whose female members have received a decent education and are prepared to put it to use to earn a living. Other models, too, are working equally well. In other words, while the demand for education has outpaced the state's financial and organizational capacity to meet this basic need, the private sector has shown it can fill the void. The government needs to take advantage of this and develop effective partnerships both with purely private schools and the growing number of schools run by civil society.

Direct efforts to improve the outreach and effectiveness of public education are also needed. Public clamor for greater access to education and deep concerns over the quality of public education have led all major parties to emphasize education on their election platforms. However, the promises made to raise public expenditure from a paltry 2 percent of GDP to 5–6 percent are completely unrealistic. Given Pakistan's financial constraints, an increase to 3 percent in the next few years would be quite an achievement. A substantial part of the improvement in education must come from improving the efficiency of public expenditures. Eliminating fictitious expenditures ("ghost" schools and "phantom" teachers), steps to increase teacher training and reduce teacher absenteeism, and greater teacher accountability fall largely in the domain of improved governance. Thus, improved governance in the sector, including the transfer of responsibilities to local governments, remains as important as increasing its public funding.

Finally, the neglected area of adult literacy needs urgent attention. There are no large programs for dealing with this growing problem; the latest figure for 2012 estimates the literacy rate among 15-year-olds and above at 58 percent. This means that, out of an estimated population of well over 100 million adults (above the age of 15), at least 50 million are illiterate. Given that the average life expectancy is at least 30 years, this mass of illiterate people will remain a drag on national productivity for a long time. To make matters worse, a large portion of youth – perhaps as many as 35 percent – entering adulthood in the near future will also be illiterate. So, while the adult literacy ratio continues to grow, albeit slowly, so does the total number of illiterates. This is an alarming prospect and will make social and economic progress difficult.

There is a need to address this issue by making a broad appeal to all groups in society, especially by involving civil society and local-level leaders if this mounting problem is to be tackled.

INCREASING PRODUCTIVITY

Over the next five years (2013–18), even with determined efforts to mobilize resources – both domestic and foreign – it will be difficult to raise the fixed-investment-to-GDP ratio from its low level of 12.6 percent to even 18–19 percent. The latter would involve almost doubling the level of real capital formation over the next five years. Undoubtedly, Pakistan needs a sharp acceleration in investment. However, in addition to security problems and energy shortages, resources will remain constrained partly because of the need to replenish the country's low level of foreign exchange reserves.

A substantial part of growth in the near to medium term must come, therefore, from raising the present low level of factor productivity, especially as more fixed investment will be concentrated in longer-gestation projects in energy and water. Fortunately, there is substantial scope for raising the contribution of TFP to economic growth; this share has steadily declined and, by 2010, was only about a quarter of its level in 1980.

The important drivers of growth discussed above – export expansion, better governance, and vigorous private sector development – are all major and interrelated sources of improved economic efficiency. Promoting labor-intensive exports – both manufactured goods and agricultural products such as fruits and vegetables – could yield a large payoff in terms of a lower unit of investment needed per unit of output. Similarly, moving up the value chain in textiles and clothing – which are Pakistan's principal exports – and in other exports would yield productivity gains.

One way to ensure that economic incentives do not protect low value-added sectors is to phase out SROs as planned. This will not only raise government revenues but also improve social equality and encourage entrepreneurial behavior. Most SROs provide domestic protection, which increases the anti-export bias. On the other hand, underinvested areas such as agricultural processing, marketing, and storage could be provided investment incentives. In addition, several sets of policies focusing on (i) improving the use of inputs in agriculture, notably water, fertilizer, and seed; and (ii) increasing the effectiveness of public spending would yield major gains in productivity. Nothing in agriculture is quite as important as improving the efficiency of irrigation water use.

THE EFFICIENCY OF WATER USE

Unless it pays immediate attention to the proper use of water, Pakistan will face a serious problem in the near future. Water availability has declined from about 5,000 cubic meters per capita in the early 1950s to less than 1,500 cubic meters in 2010. According to 2008 data from the Food and Agriculture Organization, Pakistan ranked last in a list of 26 Asian countries in terms of water availability. Moreover, it is expected to become "water-scarce," which is defined as a country with an annual availability of below 1,000 cubic meters by 2035 (although some experts project that this could happen as soon as 2020).[12]

Much of the decline is a result of global warming. Few areas in the world are suffering as much from climate change as the Himalayas, where the glacial cover is estimated to be receding by as much as 1 m a year. A recent report by the International Food Policy Research Institute (IFPRI) has reached a number of worrying conclusions based on productivity declines for most major South Asian crops. It projects that wheat yields could decline by as much as one half in the next quarter-century.[13] Even more than most countries at its stage of development, Pakistan uses most of its available water for agriculture and does so poorly. An estimated 90 percent of the available water is used on farms, leaving only 10 percent for other purposes. Consequently, “anywhere from around 40 to 55 million Pakistanis – about a quarter to a third of the country’s total population – do not have access to safe drinking water.”[14]

In the animated discussions that prevail on the need for additional water storage and hydroelectric development, what is often forgotten is that even two large reservoirs, however necessary – adding 6 million–7 million acre feet of net additional water – would increase the availability of irrigation water (presently 100 million acre feet) only marginally because other uses of water would be increasing.

The solutions to the water problem are as well known as the problem itself. Two important ones are worth recalling. The first is that properly pricing water would reflect its scarcity; the second, that better management of the vast irrigation system would reduce wastage. Both solutions should be taken together: the resources generated from increased water charges could be earmarked for system maintenance. While economists might not favor “earmarking,” it does help create constituencies for raising additional incomes from taxation.

The proper pricing of water would also create an incentive structure that will influence the pattern of cropping and bring in new water-saving technologies. Cheap water has meant that Pakistan has allowed the extensive cultivation of water-intensive crops such as sugarcane. These need to be replaced by crops that use less water. A changed water-pricing structure should also create incentives for the farming community to start using technologies such as drip irrigation, which delivers immediate benefits. Finally, end-users need to be educated on the immediacy of the water issue and the urgent need for more water efficiency.[15]

THE EFFECTIVENESS OF PUBLIC SPENDING

The government has already launched a program to privatize many public enterprises but the process is bound to be slow; special efforts are thus needed to stem current losses in these enterprises as well as in railways. As discussed elsewhere in the report, the weakening capacity of the government and increasing corruption has led to a decline in the effectiveness of public spending – both in terms of public service delivery and in the execution of public sector development programs. With an institution for strong oversight and accountability mechanisms and by strengthening the civil service, these trends could be reversed.

Public sector spending accounts for about 20 percent of Pakistan’s GDP. This proportion is likely to decline in the near term: the much needed increase in the tax-to-GDP ratio and reduction in subsidies will be offset by the necessary reduction in the very high overall fiscal deficits and at least modest increases in social spending. The effectiveness of public spending is, therefore, a central issue. At present, there are several problems with the structure of spending. Some of these, such as the generous subsidies provided to the nonpoor and the large losses made by major public enterprises, are being addressed under the IMF program. There has also been an effort to contain administrative expenditure in the current budget.

However, there is a greatly overextended development program involving both low-priority projects and long gestation periods, which yield suboptimal economic impacts. Resources are thinly spread over a large and unwieldy number of projects, many of which have huge cost overruns and are many years behind their original completion date. Delays in the completion of priority projects and, in many cases, increases in their cost have obviously limited their potential economic return. Meanwhile, a large number of new and necessary projects are being approved.

Given the large overhang of projects, it is essential to thoroughly review all projects with a view to eliminating low-priority spending, setting new timetables for early completion, and adequately funding restructured programs. These reviews should be completed before the next budget is finalized. Allowing for inflation, the increase in general government expenditures – including subsidies but excluding defense and interest payments – was of the order of 30–35 percent over the three-year period 2010–13. Against this background, instituting an austerity regime for a couple of years and enforcing strict salary controls and administrative expenditures should not be a particular hardship.

Chapter - 4

Governance and Development

Chapter - 4
Governance and Development*

Development economists and experts agree that, for economic progress to become sustainable, countries must go beyond the efficient use of factors of production such as labor and capital. A few decades ago, they began to include technological progress and human development in their growth equations. Later still, they identified institutional development as an important contributor to economic development. Now, there is considerable focus on a contributing factor broadly defined as "governance." In fact, good governance and the quality of governance have come to be recognized as one of the more important reasons that economic growth in Pakistan has stalled in the last six or so years. All political parties marked governance as a priority area in their pre-election manifestoes of May 2013, promising to improve the quality of governance. However, none went much beyond this in indicating how they would handle the matter were they to gain power. The manifestoes had no serious policy content aimed at improving the quality of governance.

Corruption – "rent seeking" by officials in positions of power – has long been a problem in Pakistan. Petty corruption was built into the administrative system devised by the British when they governed India. There is evidence to suggest that they deliberately fixed low salaries for such junior officials as the *patwaris* (clerks who kept land records) and local police officers. This was done to keep the cost of administering the Indian colony low but in full knowledge that junior officials would extract "rents" from the public for the services they provided.

The British adopted a similar approach when they established two important government departments in the areas that are now parts of Pakistan. The Public Works Department and the Irrigation Department were charged with quickly developing the much-needed physical infrastructure in the relatively underdeveloped and sparsely populated provinces of northwest India. These departments were expected to keep the cost of their projects low while the officials they employed were expected to augment their low salaries by charging rents from those who would benefit from the government's investments. These officials came to be known as "ten presenters."

*This chapter was contributed by Shahid Javed Burki.

High-level corruption seeped into the system as Pakistan undertook the immense task of resettling eight million refugees who flooded the country when the British decided to partition their colony and create two countries – India and Pakistan. Six million Hindus and Sikhs moved in the opposite direction, leaving behind land, houses, businesses, and other physical assets. These were used to resettle Pakistani refugees by several "resettlement departments" that were set up across the county.

The officials responsible for this function had the discretion to allot these assets to newcomers. Many of them charged recipients for performing this function. Members of the national and provincial legislatures joined this enterprise and influenced "resettlement officers" to grant favors to them, their families, and friends. There was enough unhappiness with this development for the military government headed by Ayub Khan to promulgate the Elective Bodies Disqualification Order (EBDO) in 1959 to take action against such members of the legislatures.

Ayub Khan's government introduced a comprehensive system of licensing in the industrial sector that regulated new investments or the expansion of existing enterprises. No new capital could be committed without a license from the departments of industries in the two provinces – East and West Pakistan. This gave enormous authority to the bureaucrats who administered the system. Some of it was misused and there were rumors that large amounts were solicited and given in return for the issuance of licenses. At the end of Ayub Khan's period (1969), there was enough concern about bureaucratic corruption for his successor, General Muhammad Yahya Khan, to take radical action. Without much investigation and no formal proceedings, his administration removed 303 senior officials from employment, a large number of who belonged to the Civil Service of Pakistan.

The extensive program of nationalization undertaken by Prime Minister Zulfikar Ali Bhutto brought all large industrial, commercial, and financial enterprises under state control. The bureaucrats now had to manage an extensive economic empire under the control of the government. It is not surprising that some of this power over economic assets was used to generate rents, consequently increasing the incidence of corruption. Pakistan's rating on a number of "corruption indices" produced by institutions such as Transparency International began to plunge. In 1990, Mian Nawaz Sharif's first government decided to create a dedicated institution for dealing with corruption. An Ehtisab (Accountability) Ordinance was promulgated and Saifur Rahman, a close associate of the Prime Minister, was appointed to oversee its implementation from a cell within the latter's office. However, this approach to corruption was itself corrupted as a number of cases investigated seemingly involved political victimization. The effort was thoroughly discredited.

Soon after taking office, General Pervez Musharraf established the NAB, which was given the authority to investigate, prosecute, and try cases of corruption. A system of “accountability” was set up to perform the third function. The NAB suffered the same fate as its predecessor: it was also politicized and some of its own officials were suspected of seeking rents.

Pakistan continued to perform poorly in terms of various corruption indices, particularly during the five years of the PPP-led administration of President Asif Ali Zardari. The President himself and the two Prime Ministers he had inducted into office – Yousuf Raza Gilani and Raja Pervaiz Ashraf – faced corruption investigations that were suspended as long as they held office. Dealing with corruption figured prominently in the pre-election manifestoes of the major political parties in 2013.

It is not surprising that the quality of governance received so much attention as the country headed toward the elections of May 2013. There was consensus among analysts in the country that the PPP government, which had been in office for five years, had failed on this score. There was also agreement that the quality of governance had to improve before Pakistan could hope to move onto a higher growth trajectory than it had been on in recent years. Even though there is consensus on these issues – the importance of good governance and Pakistan’s failure to provide it – the term is poorly understood. We need to answer at least the following three questions: What is good governance? How has Pakistan fared in this area compared to other emerging economies? What should policymakers do to improve it?

AN EXPANDED MEANING OF GOVERNANCE

One way of understanding the governance challenges that countries such as Pakistan face is through their impact on effectiveness, efficiency, continuity, and accountability. These criteria should be applied to the delivery of all services expected of the government by the citizenry. We will take each of these by turn. However, before dealing with these aspects of governance, it is useful to put them in historical context. One way of doing this is to tell the story of governance in Pakistan by focusing on the role of the state.

Throughout its history, Pakistan has struggled to define a meaningful role for the state. The pendulum has swung between two extreme positions, sometimes stopping in between the two. At times, the state has stepped aside, leaving most of the economic space to private enterprise. This was the case in the decade immediately following the country’s birth in 1947. Such an approach made sense then, since Pakistan was born without a functioning state apparatus. At the same time, India, whose leadership took time to accept the idea of Pakistan, was placing a great deal of pressure on the nascent state.

Early Indian actions suggest that New Delhi followed a strategy to economically cripple Pakistan before the newly founded state had had time to stand on its own feet. This was perhaps done in the hope that the Muslim state, dealing with the pangs of birth, would seek reentry into the larger Indian union. Obviously, the first generation of Pakistani leadership was not likely to grant the Indian rulers that satisfaction. The former correctly reasoned that if Pakistan had to establish an economy that was independent of India, it had to encourage the small private sector – made up mostly of the trading community – to come forward and invest in the development of the new country.

The first military government, headed by General Ayub Khan from October 1958 to March 1969, maintained this stance. Although it restructured the political system completely, it left the private sector largely in command of the economy. Some constraints were introduced, however, such as an industrial licensing system (similar to the notorious "license raj" system in India). Some incentives were provided through the availability of easy capital to encourage enterprises to locate in less developed regions of the country. This brought about some dispersal of economic assets in relatively backward areas. The government also introduced a system of dual exchange that rewarded exporters of certain products.

The most important change brought about by the Ayub Khan government was the discipline instilled in the state's role in the economy. The Planning Commission developed a system that took a careful look at the Public Sector Development Program (PSDP). Projects included in the PSDP were carefully reviewed with some responsibility assigned to the two provinces' planning and development departments. The provincial role depended on the project size. The PSDP was designed to serve the broader development strategy that originated with the Planning Commission and expanded as large amounts of external development assistance became available.

The pendulum swung in the other direction during the period of Prime Minister Zulfikar Ali Bhutto (1971–77) when the state, seeking to climb the economy's commanding heights, expropriated all large-scale industrial, commercial, and financial enterprises. Nationalizing private assets was one of the strategies followed to bring about a better distribution of income. Expropriation was, in fact, a heavy tax on capital, which was to be used to improve workers' wellbeing. Very little of that actually happened. Instead, the state used the regulatory system to improve the conditions of the working class. The government's strategy incorporated labor laws and provisions for healthcare and pensions for the working class to improve its economic situation. The state also invested heavily in some of the sectors in which it had monopoly power.

After Bhutto's departure from the scene, political managers sought to restore what they thought should be the balance between the state and the private sector. It took several years to undo what was done in a couple of years by the Bhutto administration. By then, strong vested interests had developed that resisted a return to the status quo ante. Slowly, the state began to climb down from its commanding heights – sometimes gradually, as in the period of President Zia-ul-Haq (1977–88) and sometimes more briskly, as in the alternating premierships of Benazir Bhutto and Mian Nawaz Sharif in the 1990s. The pace quickened somewhat during the period of President Pervez Musharraf.

This withdrawal left a great deal of economic power in the hands of bureaucrats. A World Bank study (1994) provides empirical evidence to demonstrate that public sector enterprises generally do less well than those run by the private sector.[1] It advocated a new approach that left private enterprise largely to its own devices as long as the sector played by the rules of the game established by the political authority. To this was added the strong belief that some enterprises were strategically too important to be handed over to the private sector. Most enterprises that were left to the government to manage were in the transport and services sectors, such as telecommunications (initially), the railways, and airlines.

Despite giving up direct ownership, the state empowered itself by acquiring a great deal of authority over private enterprise. This expansion in the role of the state did not always produce the desired results. The bureaucratic structure supporting regulation was weak and created space within which corruption, malpractices, and poor governance flourished. The state ceased to be effective in many operational areas. Poor political development also meant that elected officials were able to use their access to government departments and enterprises to find employment for family members, friends, and political supporters. Read from this perspective, the quality of governance deteriorated sharply during the five years of the PPP-led government (2008–13). President Asif Ali Zardari and his two Prime Ministers, Yousuf Raza Gilani and Raja Pervaiz Ashraf, left office with charges of corruption pending against them.

Levels of employment in all the major public enterprises increased to the point where they could not pay their wage bills without being periodically bailed out by the government. There was an equal indifference to government expenditure. As discussed earlier in Chapter 2, the government was running a significant deficit on the current account, which meant that the cost of running the government was being met by internal and external borrowing.

Given this record of governance and as underscored by a number of studies and surveys carried out by various international organizations and bilateral aid agencies, Pakistan's rating according to dozens of measures deteriorated sharply (see Table 4.1). The country's reputation declined in both domestic and international markets, which resulted in reductions in the level of domestic and foreign investment. For levels of investment to increase – a necessary condition for bringing the country out of recession – Pakistan must change the perception of how it is governed. This is where the situation stands as the Sharif government begins the task of reviving the economy. A great deal hinges on how effectively the state can perform its role to better serve the citizenry.

Table 4.1
Comparative Scores on Six Governance Indicators, 2011

Region or Country	Rule of Law	Control of Corruption	Political Stability	Voice and Accountability	Government Effectivenes	Regulatory Quality	Average
East Asia	0.13	0.00	0.37	0.08	-0.06	-0.17	0.06
Latin America	0.05	0.24	0.25	0.39	0.22	0.18	0.22
Middle East and North Africa	-0.17	-0.26	-0.65	-0.90	-0.15	-0.15	-0.38
Sub-Saharan Africa	-0.17	-0.59	-0.54	-0.60	-0.75	-0.67	-0.64
South Asia	-0.62	-0.65	-1.17	-0.50	-0.47	-0.71	-0.69
Afghanistan	-1.94	-1.55	-2.51	-1.49	-1.46	-1.54	-1.75
Bangladesh	-0.72	-1.00	-1.50	-0.31	-0.85	-0.81	-0.87
Bhutan	0.13	0.74	0.87	-0.48	0.62	-1.17	0.12
India	-0.08	-0.56	-1.20	0.41	-0.03	-0.34	-0.30
Nepal	-0.99	-0.77	-1.55	-0.53	-0.79	-0.72	-0.89
Pakistan	-0.90	-1.00	-2.70	-0.83	-0.82	-0.61	-1.14
Sri Lanka	-0.07	-0.42	-0.54	-0.53	-0.08	-0.09	-0.29

Note: Scores ranges from –2.5 (weak) to 2.5 (strong).

Source: J Lopez-Calix and I Touqeer (forthcoming), *Revisiting the constraints to Pakistan's growth* (Pakistan Policy Paper Series), World Bank, Washington, DC (based on World Governance Indicators data for 2011).

MAKING THE STATE EFFECTIVE

An important step in the revival process is to increase public confidence in the state's functioning. People's reading will depend on the performance of the state: its ability to deliver services that meet their needs. For instance, if the state cannot provide security, as is the case in most areas of Pakistan at this time, it is not being effective.

A number of issues stand out when we address the question, how effective is the Pakistani state and how can its performance be improved so that it can better serve the citizenry. The most important of these is the conflict between two powerful value systems: patronage politics and issue-based politics. As Anatol Lieven (2011) has discussed, most political parties draw their power from client-patron relationships, also known as the "*biradari* system."[2] Most politicians are elected on the basis of promises they have made to close-knit groups. Once in office, these pledges are carried out even if that means not following sanctioned government promises. The most usual constituent demand is to have people they trust positioned where they can help the community that has supported the elected politician. Constituents may also demand their patrons find government jobs for their community – which is done mostly by expanding the payroll of state-owned enterprises. This weakens the civil service system as well as the enterprises themselves.

Pakistan inherited a strong civil service from the British. At the center of this system was what Philip Mason (1953) has called the "steel frame."[3] However, as the political system evolved while political institutions remained weak, politicians reduced the autonomy of the civil service. In 1974, Prime Minister Zulfikar Ali Bhutto abolished the Civil Service of Pakistan, which was at the center of the country's powerful bureaucratic system. What followed was a continuous weakening of the system, a trend recorded by the Ishrat Husain Commission established by the Musharraf government to suggest how the effectiveness of the civil service could be improved.[4]

A patronage-based system of politics also compromises the economic planning process. The constituents of elected politicians expect successful candidates to find a way to build the infrastructure, schools, and clinics their community needs.

The World Bank's recent work on efficiency offers some interesting insights. In a collection of essays by some of the economists familiar with the Pakistani scene, the World Bank (2013) explains what is implied by the government's efficiency. This refers to the "manner in which the state functions, specifically to its ability to mobilize revenue and its ability to use that money in a way that minimizes waste and corruption – and maximizes results."[5] Pakistan has performed poorly on all these counts. It has one of the world's lowest tax-to-GDP ratios. The government does not have enough resources of its own to pay for its current expenditure, let alone to finance development. In planning development, projects financed by the government are often brought on the books to hire vehicles for project managers and pay them additional allowances. The level of corruption has also increased over the years. In other words, the government's development program does not maximize citizen welfare.

Lack of continuity has also been a problem. There are several reasons for this, among them, a lack of understanding of the role the state should play in promoting economic development and managing the economy. The pendulum has swung widely in the past between allowing the private sector a great deal of space and having a highly intrusive state. The former was the case during the governments of Ayub Khan and Pervez Musharraf; the latter, when Zulfikar Ali Bhutto brought much of Pakistan's large-scale industry and finance under state control. These oscillations have meant that consistent signals were not sent out to potential investors to commit their capital in the long term.

Accountability, the fourth leg of the good-governance stool, has been an issue in Pakistan for decades. Of the several attempts made to create an institutional infrastructure, none was able to withstand politicization. When the institutions created for the purpose were given substantial power and authority, the government in place found it difficult to resist the temptation to use them for political ends.

The fragmentation of the accountability system is also a problem. While much public attention is focused on the NAB, there are several other institutions that make up the system, including the Public Accounts Committee, Judicial Commission, Election Commission, Ombudsman, Federal Investigation Agency, and various provincial agencies. For economic governance, there is another set of institutions: the SBP, the CCP and SECP. The main problem with these institutions is not only government interference but also the absence of financial autonomy. Lack of transparency is yet another issue in the area of accountability.

Given this definition of "governance" – dividing its functions into effectiveness, efficiency, continuity, and accountability – what public policy choices are available to a government interested in improving it? The agenda is vast and must cover a number of fronts. Three areas of action stand out. The first of these is to bring government closer to the people. This will mean strengthening not only provincial governments but also governments at the local level. Second, information on what the government does to provide public services should be readily available. Third, there is an urgent need to improve the human and financial capacity of the more critical parts of the existing large institutional structure.

THE MEANING OF ACCOUNTABILITY

Pakistan has long grappled with the issue of accountability but it has not found a solution to the problem. One reason for this failure was the inability to define precisely what "accountability" meant. The feeling that a number of those who occupied public office were corrupt goes back to Pakistan's formative years. Those suspected of such behavior included elected officials as well as those belonging to various branches of the government. If that was the case, what should those who held the reins of power do to address the problem? Two answers were found to this important question: (i) cleanse the system by ridding it of people who have abused their power, and (ii) set up an institution that deals systematically with those suspected of corrupt practices.

This approach was applied over a period of six decades. Those purged from the system included both elected officials as well as bureaucrats. One example of this approach was the EBDO, which barred a number of politicians from holding public office. This method of handling accountability contributed a verb to the use of English in Pakistan: those prevented from holding office were said to have been "EBDO-ed." The bureaucratic system was cleansed under military rulers. At one point, the ruler of the day dismissed 303 senior civil servants. The government worked on the basis of suspicion produced by talk in the corridors of power. People who lost their jobs included those who were suspected of seeking rents – charging those who benefitted from the actions of officials with the power to dispense favors.

When the problem was not resolved by these actions – disqualification and purges – the government changed its approach. Beginning with the first Sharif administration, governments opted to establish specialized agencies to deal with corruption. The original institutional mechanism reflecting this approach was called "*ehtisab*." Later, under General Pervez Musharraf, the institution's scope and reach was vastly expanded. The NAB was given enormous power to identify those whose behavior needed investigation. People against whom there seemed to be sufficient evidence to proceed were tried in the NAB's own courts.

This approach also failed to deliver satisfactory results. As is evident from the work of Transparency International, a nongovernment organization that carries out "perception surveys" across many countries, Pakistan has not become less corrupt over the years. It continues to occupy the bottom rung of the international corruption ladder. There was a palpable deterioration in the quality of governance during the PPP's five-year rule. The impression that it had provided exceptionally poor governance led it to fare very poorly in the elections of May 2013. These elections resulted in the establishment of four governments with different political orientations. The province of Sindh is the only place where change did not occur.

If poor governance can produce punishing electoral consequences, there is an obvious lesson to be drawn for those who currently hold power. They have a limited amount of time within which to establish a system of governance that wins popular confidence. The May 2013 elections produced a swing vote – those who had left the PPP opted for either the PML-N, which had a record of governance in Punjab, or for the PTI, a relative newcomer in the political field. In the absence of serious investigation into the socioeconomic dynamics behind the 2013 election results, it can be said that they reflected the sentiment of the urban youth. As is well recognized, Pakistan has a very young population; the Planning Commission estimates it at 50.6 million or 29.3 percent of the total. Of this, 36 percent are urban and another 64 percent are rural. This is where the swing vote came from.

For the quality of governance to improve and for accountability to become an effective contributing instrument, it is clear that past approaches have to change. Previous attempts were very narrowly focused. Corruption and misbehavior in public office were always dealt with on an ex-post basis. Crimes allegedly committed in the past were looked at and those involved were investigated; if found guilty, they were to be appropriately punished.

A more effective approach would have been to deal with the issue as ex ante: taking steps to prevent actions – or lack of them – before poor governance occurs. This approach can be explained with an example that, in usual discourse, would not figure as poor governance. It is recognized not only in Pakistan but also in several other developing nations that teacher absenteeism is a major reason for the low quality of education offered by institutions in the public sector. Teachers draw salaries but do not go to their regular jobs, instead spending their time on activities that bring them additional income. They are able to do this because of poor oversight by the educational authorities. Poor governance and accountability, therefore, has to be looked at from a much wider angle than in the past.

Chapter - 5

The Energy Crisis: Dimensions, Roots, and Major Policy Shifts Needed

Chapter - 5
The Energy Crisis: Dimensions, Roots, and Major Policy Shifts Needed*

INTRODUCTION

Pakistan is now in its sixth year of the energy crisis. In May 2013, virtually relentless load-shedding peaked at more than 50 percent as the grave shortage of electricity generation capacity was compounded by the large circular debt, which kept even the available capacity from being fully utilized. The incoming government retired the entire circular debt in one go. Initially, the improvement in capacity utilization helped reduce load-shedding by five hours a day. At the same time, the government has taken strong steps to reduce electricity subsidies and plans to eliminate all power subsidies by 2015/16.[1]

The first phase entailed eliminating almost all the subsidy for industrial, commercial, and bulk users. This was accomplished by increasing the tariff by about 50 percent at the end of July 2013. The government has also adopted the National Power Policy (NPP), which gives especially high priority to increasing the electricity supply using low-cost sources, notably coal and hydropower. The NPP aims to eliminate the present gap between electric power demand and supply – estimated at 5,000 MW – within four to five years.

This chapter attempts the following:

- It explores the nature and dimensions of the energy crisis. Apart from the electric power shortfall, the crisis is characterized by even larger shortages of natural gas and an inherently large government subsidy, given the high cost of thermal power generation from residual fuel oil (RFO) and high-speed diesel (HSD). It also involves inefficient distribution systems, electricity theft, and a tariff structure that neglects costs and perpetuates inefficiencies.
- The chapter traces the deep-seated roots of the energy crisis, which in some cases go back to the 1960s and 1970s. We note that multiple policy failures over the decades are responsible for current shortages, high costs, and increasing energy import dependence.
- Finally, it assesses the strengths and weakness of present policies and plans, and argues for a comprehensive energy policy that prioritizes domestic gas development and

*This chapter was contributed by Dr Parvez Hasan with the assistance of Muhammad Imran.

allocation as well as hydropower and coal-based power. We also address demand management issues, including appropriate tariffs and policies for natural gas development and use.

DIMENSIONS OF THE ENERGY CRISIS

The most visible sign of energy shortages has been the inability of the power system to meet the growing demand for electricity, leading to major load-shedding. This, in turn, has caused not only widespread distress to millions of household consumers, but also loss of production in the commercial and industrial sectors. As Table 5.1 below shows, load-shedding rose steadily after 2006/07 and became acute after 2011/12. As mentioned above, it peaked at more than 50 percent in May 2013.

Table 5.1
Trends in Peak Electricity Demand, Generation and Load Management (PEPCO System)

(MW)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Peak Demand Load	15,838	17,398	17,852	18,467	18,521	18,940	18,827
Peak Generation Load	13,645	14,151	14,055	14,309	14,468	15,062	14,756
Peak Load Management	2,645	5,454	7,018	6,408	6,151	8,393	–
Percent of Peak Demand	16.7	31.3	39.3	34.7	33.2	44.3	–

Source: National Transmission and Distribution Company (NTDC). Analysts' estimates as quoted in SBP's annual report for 2011/12 and in NTDC, Power statistics of Pakistan, 2012/13.

The lack of any large investments in power generation after the completion of the large Ghazi Barotha hydroelectric plant in 2002 slowed down growth in generation capacity. Peak generation capacity over the period 2004–12 increased by only 16 percent while peak demand increased by 27.5 percent.

Quite independent of the difficulties created by inadequate investment in power development is the serious problem that energy sector receipts do not cover total costs. This gap has resulted in circular debt – the nonpayment of arrears over a chain of suppliers. Pakistan's circular debt grew steadily after 2005/06 but assumed critical proportions in 2010/11 when firms' financial problems began to result in the existing capacity not being utilized, thus leading to further load-shedding.

There are several reasons for why energy entities have been unable to cover their costs. The noncollection of receivables from some government departments (both provincial and federal), the Federally Administered Tribal Areas (FATA), and private consumers totaled Rs 100 billion at the end of 2011/12, despite a large injection by the federal government of over Rs 80 billion in 2009/10 to cover nonpayments in FATA. In the last four or five years, the circular debt has built up largely due to delays in the notification of tariffs and the incomplete pass-through of the sharp increase in oil prices to end-consumers. In 2011/12, the banks stopped lending to energy entities, which threatened the normal running of power generating capacity. The government was compelled to step in and, in two deals, assumed Rs 450 billion (2.2 percent of GDP) of the debt owed by various entities.

However, by the end of May 2013, the circular debt had built up once again to Rs 503 billion. The incoming government cleared this amount by issuing government securities against it. Despite a 50 percent increase in the electricity tariff this year, the circular debt had reportedly crept up to Rs 300 billion by the end of March 2014.[2] Obviously, the circular debt is not a problem in itself but merely a symptom of the problem that the energy sector, for various reasons, cannot recover its full costs. A lasting solution to the problem must address this basic issue.

On the supply side, this will require reducing the cost of power generation by changing the mix of production away from RFO- and HSD-based thermal production, which is very expensive, toward hydropower and coal-based power. It will also mean using more domestic and imported natural gas to generate power. At present, IPPs and generation companies (GENCOs) that use gas as a fuel incur a production cost that is, typically, in the range of Rs 4–6 per kWh, while companies using RFO and HSD incur a cost of around Rs 15–18 per kWh. Historically, the cost of hydropower has been Rs 2–3 per kWh. Since hydropower generation has increased only modestly over time and coal-based power has been negligible, the share of petroleum-based power generation increased sharply to 37 percent in 2012/13 compared to the surprisingly low level of only 1–2 percent in 1981 (see Table 5.2).[3]

It is not just an issue of greater reliance on imported oil, but also that the real price of oil – while fluctuating widely over decades – has increased exorbitantly, especially in the last decade. Pakistan's oil import bill went up from 2.6 percent of GDP in 1995 to 6.1 percent in 2012/13. Inefficiencies in generation (indicated by the wide differences among IPPs and GENCOs) and distribution (reflected in high system losses and power theft) have also aggravated the cost of producing and selling electricity.

Table 5.2
Sources of Power Generation, 2012/13

(GWh)

Source	Actual Generation	Percentage Share
Hydel	30,032	30.81
Natural Gas	27,038	27.74
Oil	35,774	36.70
Nuclear	4,181	4.29
Coal	40	0.04
Wind	32	0.03
Imported	375	0.38
Total	**98,894**	**100.0**

Source: NTDC, Power system statistics 2012–13.

On the demand side, there have been serious lags in adjusting tariffs, especially in response to the very steep rise in international oil prices since 2003. As discussed later, Pakistan's energy problems might have been contained had the country managed to avoid gas wastage at the household level, and implemented appropriate policies encouraging new gas exploration and development while developing hydroelectric power more forcefully. At present, the gap between gas demand and supply is around 50 percent – this is even larger than the gap in electric power demand and supply and will not be easily closed in the near future.

Table 5.3
Gas Consumption, 2012
Million cubic feet

Consumer	Actual	Percentage Share
Domestic	261,915	20.3
Industry	286,055	22.2
Commertial	39,627	3.1
Power Generation	358,381	27.8
Transport	119,000	9.2
Cement	1,266	0.1
Fertilizer	211,828	16.4
Total	**1,288,198**	**100.0**

Source: Pakistan Energy Year Book, 2012.

THE ECONOMIC IMPACT OF THE ENERGY CRISIS

The continuing and deepening energy crisis has had a major adverse impact on the investment climate, the country's fiscal and BOP position, and consequently on economic growth. The sharp real increase in international oil prices over the last decade has compounded both Pakistan's energy and finance problems. After a relatively placid period in the 1990s during which real international oil prices remained depressed, they escalated from an average of $36 per barrel in 2003 to $94 in 2008 (in 2010 $ prices; see Table 5.4).[4] Pakistan's oil bill went up from $3 billion in 2003/04 to $11.5 billion in 2007/08. Currently, the annual oil import bill is $15 billion and every $10 increase in the price of oil per barrel increases this amount by nearly $1.5 billion.

Table 5.4
Long Term Trends in Crude Oil Prices
Average spot price in US $/barrel

Year	Real Price(2010 $)	Nominal Price
1970	5.2	1.2
1975	25.0	10.4
1980	56.5	36.9
1985	45.5	27.2
1990	27.7	22.9
1995	18.7	17.2
2000	35.5	28.2
2003	36.3	28.9
2008	94.3	97.0
2013	98.1	104.1

Source: World Commodity Database, World Bank.

There are various estimates of the cost of load-shedding.[5] The Institute of Public Policy's (2013) report uses three different approaches and concludes that the cost of load-shedding to the economy was Rs 1,272 billion or 6 percent of GDP in 2011/12. In other words, the average growth rate of GDP over the four fiscal years 2009–12 could have been 1.5 percent per annum higher (i.e., 4.5 percent rather than 3.0 percent per annum). On the other hand, it is also clear that the imbalance between energy sector receipts and payments added at least 5–6 percent of GDP to the fiscal deficit either directly or indirectly during 2011/12 and 2012/13; at least 1 percent will likely be added to the fiscal deficit during the current year 2013/14.

THE ROOTS OF THE ENERGY CRISIS

As mentioned above, the present government is giving high priority to electric power development over the next decade with a special focus on eliminating the gap between demand and supply in the next four or five years. There remains the need, however, for a comprehensive energy policy that draws lessons from past policy failures and aims to correct the structural weaknesses in the energy sector. As mentioned earlier, the roots of the energy crisis go well into the past and are, to an extent, attributable to policy decisions taken as early as the 1960s and 1970s.

Slow Adjustments to Rising International Oil Prices

One of the fundamental failures of energy policy over long periods has been the resistance to adjustment to oil price shocks and the lack of a considered response to the almost secular increase in international oil prices over the last four decades. In December 1973, the Organization of the Petroleum Exporting Countries (OPEC) quadrupled international oil prices, setting the stage for a break with the past. Instead of adjusting its energy prices quickly, Pakistan relied on a mixture of grants and loans to subsidize consumers. In contrast, other countries – notably the Republic of Korea, India, and Brazil – made relatively quick adjustments to their domestic energy prices.

Indeed, Pakistan's government pricing policies maintained the final consumer prices of electricity and natural gas at well below the economic cost of supply for nearly two decades. This had two consequences. First, as Hasan (1998) explains, "Combined with the high rates of overall growth, rapid urbanization, and increased mechanization of agriculture, this kept commercial energy consumption growth high. Household consumption of gas and electricity quadrupled in a short period of ten years before 1990, indicating an annual growth rate of 15 percent. Total electricity consumption expanded by close to 11 percent per annum even though demand (after mid-1980s) was being increasingly frustrated by shortages of electricity and load-shedding."[6]

Second, holding back the necessary energy price adjustment greatly squeezed the profits of the relatively well-functioning Water and Power Development Authority (WAPDA) in the early 1970s. As a result, retained earnings, a key source of new investment, dropped dramatically.

In retrospect, Pakistan failed to learn important lessons from the sharp rise in international oil prices over 1973–82, i.e., that its economy was very vulnerable to the upward movement of international oil prices, and that alternative domestic sources of energy (including natural gas, hydropower, and coal) should be aggressively explored. This problem may have been partly due to the fact that oil prices declined after 1985 and remained low for more than a decade. However, the second surge in international oil prices after 2003 also failed to register both on the national psyche and the government till very recently, when load-shedding reached unprecedented levels.

Successive governments have paid limited attention to tackling the energy sector's fundamental problems. The long-term consequences of higher oil prices for the energy mix – the need to reduce dependence on oil, conserve energy better, and accelerate energy production from domestic sources – were not fully perceived, and thus not translated into action.

The main set of policies that were adopted in response to large-scale load-shedding in the late 1980s, the acute shortage of public resources for energy development, and pressure from major donors – notably the World Bank – included a comprehensive framework for attracting private investment for the development of the power sector. One aspect of this was the induction of foreign private investors, starting with the large Hub project (1,292 MW) in 1991. Ultimately, 45 IPPs[7] with a capacity of 8,537 MW[8] and foreign investment worth an estimated $13 billion were approved between 1992 and 2012.[9] The bulk of this investment was oil-based. As far as we know, no sensitivity analysis of variations in the international price of oil was carried out.

While the IPPs did help eliminate the serious power shortage, it was at the cost of a fairly sharp rise in profit remittance obligations: generally, a 20 percent rate of return on investment, based on a fixed price of 6.5 cents per kWh indexed for various cost elements, was guaranteed, as was the off-take. The realization that the incentives offered to the private sector were too generous came too late. Surprisingly, the government assumed the full risks related to any rise in international oil prices. A third weakness was that large fixed foreign exchange obligations were undertaken for the production of what was essentially a home good.

In the early 1990s, the government approved WAPDA's strategic plan for privatizing the power sector and the 1994 policy announced a package of incentives. Unfortunately, progress in divesting WAPDA of its power distribution responsibilities has made little headway.

Equally importantly, inadequate energy investments in the public sector over the last decade were the result of a flawed power sector policy adopted under pressure from the World Bank. The policy had set the unrealistic goal of ensuring that the private sector should meet the needs of the power sector without recourse to public funds, except for hydroelectric development and transmission. Although there was little progress toward privatizing utilities, the public expenditure program largely neglected WAPDA's needs.

Neglect of Hydroelectric Development

Since Tarbela was completed in the late 1970s, no other large multipurpose dam has been built. Originally, the plan was to develop a large storage facility at Kalabagh by the early 1980s, which would have provided an initial capacity of 3,600 MW and 6.5 million acre feet of water storage. However, there was never enough political consensus at the national level to develop this project and even General Musharraf's concerted efforts to muster support for it in the early 2000s did not succeed.

Belatedly, initial work on the Diamer-Bhasha dam has begun but it will take nearly a decade to complete. Once started, it will cost a total of $12 billion, providing 4,500 MW of electricity generating capacity and 6.4 million acre feet of water storage. Financing remains a major problem: over the past several years, the World Bank has been reluctant to finance the dam, requesting a no-objection certificate from India first. The ADB, too, has attached numerous conditions to the project, including seeking a consensus resolution from the Council of Common Interests before asking for a loan. Recently, it has also raised resettlement and environmental issues resulting from the dam's construction.

Pakistan desperately needs at least one large storage dam to deal with its emerging water shortage and in order to supply additional hydroelectric power at low cost.[10] However, there is no relief clearly in sight within the next decade. In the absence of any rapid and somewhat uncertain progress on a large storage project, Pakistan has had to opt for run-of-the-river hydroelectric power. Ghazi Barotha, a run-of-the-river project with a capacity of 1,450 MW, took seven years to complete (by 2004) and cost nearly $2 billion.

Fortunately, the large addition in capacity at Tarbela over time from 1,400 MW to 3,450 MW has been the main source of additional low-cost hydropower for the last three decades. Still, the share of hydropower capacity in total capacity has fallen from 58 percent in 1980 to 31 percent at present.

Lack of a Coherent Gas Policy

The country has also suffered from the lack of a coherent gas policy, for which it is now paying a heavy price. The huge natural gas shortage has meant that the current supply meets only half the demand, fundamentally due to mispricing.[11] The SBP (2012) points out that, "natural gas has been too cheap for too long. And this has led to overconsumption and under production. In 2011–12 households consumed 5.4 million tonnes of oil equivalent (TOE) in the form of natural gas. This is 72 percent higher than the amount of energy that households consumed in the same period." One result of the domestic structure of gas pricing has been the low rate of gas exploration. At present, "exploratory prices are linked to crude oil, but impact of changes in reference crude prices is not fully passed on to the investors … exploration and production companies accrue only 50 percent of any upside price movements – with the remainder collected by the government in the form of a windfall levy. Producer (well-head) prices of gas therefore do not incentivize exploration of the commodity, and production companies receive prices below import parity."[12]

The country's gas policy needs to be urgently revised to reduce the high priority given to households, eliminate over time the relatively wasteful use of CNG for transport, and offer stronger incentives for gas exploration and development (this is discussed in detail later in the chapter).

NATIONAL POWER POLICY

It is no exaggeration to say that the present government has inherited a grim energy situation, with people revolting against the unprecedented load-shedding of twelve or more hours a day. In response, it has tried to take strong measures to provide some immediate improvement in power supply while reducing the burden of crippling energy subsidies on the budget. More importantly, it has moved quickly to develop the ambitious NPP in order to address the country's current and future energy needs. The NPP will also address the key challenges of the power sector to provide people with much-needed relief.

Challenges

The NPP has correctly identified that Pakistan's power sector faces a number of challenges that have led to the present crisis. The policy document outlines these below:[13]

- "A yawning supply-demand gap where the demand for electricity far outstrips the current generation capacity leading to gaps of up to 4,500 – 5,500 MW. Such an enormous gap has led to load-shedding of 12–16 hours across the country.
- Highly expensive generation of electricity (~Rs 12/unit) due to an increased dependence on expensive thermal fuel sources (44 percent of total generation). RFO, HSD, and mixed are the biggest sources of thermal electricity generation in Pakistan and range in price from ~Rs 12/unit for mixed, to ~Rs 17/unit for RFO, and a tremendously expensive ~Rs 23/unit for HSD. Dependence on such expensive fuel sources has forced Pakistan to create electricity at rates that are not affordable to the nation and its populace.
- A terribly inefficient power transmission and distribution system that currently records losses of 23–25 percent due to poor infrastructure, mismanagement, and theft of electricity. The cost of delivering a unit of electricity to the end-consumer has been

estimated at Rs 14.70 by the NEPRA. This means that the inefficiencies are costing the taxpayers additional 2.70 rupees per unit over and above the cost of generation (~Rs 12). The Ministry of Water and Power has estimated the true cost of delivering a unit of electricity to the end-consumer at greater than Rs 15.60 after taking into account the collection losses and the real losses to the distribution companies. If the system assumes the NEPRA suggested transmission and distribution loss of 16 percent, the theft alone is estimated to be costing the national exchequer over Rs 140 billion annually.

- The aforementioned inefficiencies, theft, and high cost of generation are resulting in debilitating levels of subsidies and circular debt. Reducing these losses would lead to significant improvement in the bankability and profitability of the network as a whole."

Policy Goals

To achieve its long-term vision for the power sector and overcome the challenges listed above, the government has set the following nine goals:[14]

(i) Build a power generation capacity that can meet Pakistan's energy needs in a sustainable manner
(ii) Create a culture of energy conservation and responsibility
(iii) Ensure the generation of inexpensive and affordable electricity for domestic, commercial, and industrial use by using indigenous resources such as coal (Thar coal) and hydropower.
(iv) Minimize pilferage and adulteration in fuel supply
(v) Promote world-class efficiency in power generation
(vi) Create a cutting-edge transmission network
(vii) Minimize inefficiencies in the distribution system
(viii) Minimize financial losses across the system
(ix) Align the ministries involved in the energy sector and improve the governance of all related federal and provincial departments as well as regulators.

Another important goal is to entirely eliminate the present supply-demand gap of 4,500–5,000 MW so as to obviate the need for load-shedding.

The rest of this chapter attempts to critique the NPP in light of experience and policy mistakes, and identifies the major implementation hurdles and constraints that are likely to arise.

Shortcomings

At a strategic level, one weakness of the NPP is that it does not discuss the gas shortage, production, imports, and allocation choices in any detail. While the policy correctly emphasizes the need to use more gas for power production (such as by identifying expensive RFO and HSD plants that could be converted to gas or coal plants) and stresses that the price of gas should be increased for all users except poor households, it does not highlight the fact that the present gas shortage is even more acute than the power shortage. Among the cheaper sources of energy, gas imports from either Qatar or Iran probably offer a speedier prospect of supply than any large hydroelectric project (which, in any case is currently not under construction). That said, gas imports from Qatar or Iran would be far more expensive than the present cost of domestic production.

As stressed earlier, the NPP must evolve into a more comprehensive policy and consider different scenarios of domestic gas production and import as well as other sources of power generation. In order to prepare all gas consumers, the likely price of imported gas and domestic supply needs to be estimated and shared with the public. The government also needs to announce a clear decision that past anomalies in gas pricing will be removed and that future prices will fully reflect costs.

Eliminating the use of CNG for transport – which is very inefficient – is highly desirable. It may be a difficult political decision but the gravity of the gas supply-demand situation makes it imperative. The NPP, however, appears ambivalent on this and suggests only a moderate decline in CNG use.

The policy has three other key weaknesses. First, the long-term demand for electricity, estimated at 5 percent per annum, is an underestimate. At Pakistan's present stage of development, the per capita income elasticity of demand for electricity in relation to economic growth would be at least somewhat greater than 1. In other words, if long-term growth is projected at 6–7 percent per annum, electricity demand could easily grow by 8–9 percent per annum. An important factor in this would be the likely move from noncommercial energy use to commercial energy use as the country becomes more urbanized and prosperous.[15]

Second, even rough cost estimates of the proposed power development program are not given. These need to be estimated for five-, ten-, and 15-year periods and related to the macroeconomic availability of resources both in the public sector and the economy as a whole. Clearly, water and power development will require a much larger share of investment in the next decade, much like the 1960s and 1970s. The consequences of this shift for other sectors, however, need to be outlined and studied.

Third, the future organizational structure of the power sector is not well defined. The policy pays no attention to decentralization to the private sector and to the provinces, and there appears to be too much authority centered on the federal government.

A POWER SUPPLY STRATEGY

The commitment to phasing out power subsidies to all except the abject poor over a period of three years is greatly welcome. The emphasis on giving priority to pipeline and other projects that can be brought online in two to three years is also correct. The rapid development of hydroelectric and coal-based power, and steps to explore the potential of wind power are also worthwhile goals.

Since the NPP was issued, the government has announced the establishment of two nuclear power plants of 600 MW each. The plants are to be built in Karachi with assistance from China, which has also announced additional financial support of $50 billion (with $35 billion allocated to energy). However, as yet, we have no information on the projects' composition and total estimated costs, or on the unit cost of supply of this large induction of foreign investment/loans. The initial press report seems to suggest that these commitments will be made by 2017.[16]

Hydroelectric Power

The present installed hydroelectric capacity is 6,612 MW[17] against a potential of over 40,000 MW, making hydropower from large dams the ideal solution to Pakistan's energy crisis. However, the long duration of implementation and complex safeguard issues mean that this is a long-term option. Meanwhile, the lack of a national consensus on building a large multipurpose dam at Kalabagh and difficulties in lining up financial support for Diamer-Bhasha have hampered hydropower development.

Fortunately, two large projects, Tarbela 4th Extension (1,450 MW) and Jhelum-Neelum (969 MW), are expected to be completed within the next two to three years and will add significantly to hydropower capacity. More recently, the government has decided to proceed with another run-of-the-river hydropower project at Dasu with assistance from the World Bank. Dasu will ultimately have a capacity of 4,320 MW but will be developed in four phases. The first phase will provide 1,080 MW of power, cost $3.34 billion, and take six years to complete.[18] However, the third and fourth phases cannot be made operational unless Diamer-Bhasha is in place. In addition, another two large public-private partnership projects are undergoing feasibility assessments: Lower Palas Valley (665 MW) and Lower Spat Gah (496 MW).

The hydroelectric projects under completion will help substantially in eliminating the present demand and supply gap over the next four years. They will raise the total hydroelectricity capacity to 9,571 MW by 2018 and thus reduce the average cost of generation. However, other than Dasu (first and second phase), there are as yet no firm plans that will make major additions to hydroelectric capacity over 2018–25. A desirable accelerated hydropower program in the context of the Indus Cascade points to an urgent focus on Bhasha, even though it seems that, despite the best efforts, it will not be completed for another decade.

Coal Power

The present government has emphasized the need to develop coal-powered generation quickly. Major projects have been initiated or are planned in Thar, the Gadani enclave near Karachi, and in Punjab. Meanwhile, the Jamshoro Power Company has launched a large 600 MW (net) supercritical coal-fired unit, using an 80/20 blend of imported sub-bituminous coal and domestic lignite. Supported by $900 million in assistance from the ADB, the project will enable a more efficient energy mix by diversifying from expensive HFO to less expensive coal. It will enhance the capacity of the GENCO Holding Company and Jamshoro Power Company, and promote education in coal-fired plant operation by providing on-the-job training. The infrastructure developed will also support the government's plan to build an additional 600 MW unit at the same site.

It is understood that China is strongly interested in financing coal-powered development in Pakistan, provided that Chinese companies are given direct contracts. Given China's immense experience in the field and its record of rapid development (about three years), the idea is attractive. Power generation using imported coal on a large scale also raises issues of port and rail capacity, which need to be examined and the necessary additional investments undertaken.

Wind Power

The NPP is fairly enthusiastic about the prospects of wind power. Letters of support have been issued for 450 MW of wind energy, and an additional 2,276 MW are currently undergoing feasibility assessments. Although it is hoped that a significant number of these units could start operating by 2016, this aim is clearly unrealistic.

Oil-Fired Power

Oil-fired power generation is expensive and is used for less than 5 percent of the world's total generation. To remain economically competitive, Pakistan cannot afford to rely continually on expensive imported oil for power generation. At present, there are also large inefficiencies in the country's thermal plants. However, an aggressive program of rehabilitation and expansion is underway at various GENCOs, which will add 747 MW of capacity at Guddu and 700 MW at Muzaffargarh.

In the future, it is highly desirable that new fuel oil-based capacity is not added to the system, except selectively to balance the loss of hydropower in lean months and indeed to retire some inefficient plants. However, this will be possible only if accelerated hydroelectric development yields large additions to capacity in the next decade or so – which is not yet on the cards – and if power generation based on natural gas increases sharply – again, a major challenge.

Natural Gas-Based Power

In economic terms, the use of natural gas to generate power has the highest return. Pakistan's gas allocation policy, however, gives highest priority to households, which also enjoy a substantial economic subsidy. The gas allocation for power has declined in the last few years as production has tended to stagnate and household consumption and transport use have expanded due to the unfortunate decision to allow motor vehicles to use CNG. As mentioned earlier, the shortage of gas is even more acute than that of electricity, and the prospect of quickly eliminating the gap between demand and supply is even more daunting.

However, the government has taken a number of steps to improve supply and rationalize prices and allocation. The new Petroleum Exploration and Production Policy offers better incentives for producers to enhance their existing production and develop new fields, with price increases from $2.8–3.0 per MMBTU to $6–10 per MMBTU.[19]

The arrangements for importing liquefied natural gas (LNG) are near completion. The LNG terminal in Karachi will be ready by November 2014 and will have an initial capacity of 200,000 MMBTU. The government has also committed to limiting further expansion of the gas distribution networks for domestic consumption.[20] As part of its gas rationalization policy, the government has also imposed a GIDC, which has increased consumer gas prices by an average of 10 percent. As new production and additional supply from gas imports becomes available, the cost of this gas will be fully reflected in the base tariff on a semi-annual basis.

It is essential that most of, if not all, the additional gas supply that becomes available should be allocated for power generation. Whether this will be politically possible is not clear. In any case, efforts to increase the supply of gas through domestic production and imports must be as high a priority as accelerated hydroelectric development.

DEMAND MANAGEMENT

The government must be given credit for sharply adjusting power prices in the current year. It remains committed to a three-year phase-out of the tariff differential subsidy and plans to announce tariff adjustments for 2014/15 with the budget. The structure and level of household tariffs, however, needs special attention. As the SBP's very useful analysis shows, the average household tariff is well below the tariff for industrial and commercial consumers, and a large part of the economic subsidy goes to heavy users of electricity:

> Taking into account that heavy users benefit from the cheaper rates attached to lower slabs and given the quantum of power consumed by heavier users, over 51 percent of the subsidy is realized by users who average more than 301 KWh/month – these are the households that use air-conditioners and a number of

> luxury appliances … Lifeline users, on the other hand, only get 1.6 percent of total household subsidies … For the average household in each slab, the heaviest users are subsidized by Rs 6,631 per month, while lifeline users only get Rs 420.19.[21]

CONCLUSION AND RECOMMENDATIONS

As a consequence of policy failures over a long period, Pakistan faces a deep and multifaceted energy crisis. There are large demand and supply gaps in the provision of natural gas and electric power. Equally important, the cost of producing electricity has skyrocketed as a result of heavy and growing dependence on fuel oil. Low-cost sources of power, notably hydroelectric and gas, have not been developed as they should over the last several decades. The priority given to household consumption of gas, combined with very low prices charged for domestic use, have led to insufficient incentives for producers to develop this source. Low international oil prices in the 1990s may also have contributed to the relaxed attitude toward thermal power generation based on fuel oil.

The quadrupling of international oil prices over the last decade or so, combined with inefficiencies in power production and distribution, have meant that, despite very large tariff increases, the burden of energy subsidies has grown enormously. Pakistan's present weak fiscal and foreign exchange position can be attributed to a significant degree to its problems in the energy sector. Resolving the energy crisis, reducing energy costs, and adopting realistic pricing policies will not only improve the macroeconomic situation but also help revive economic growth.

There is little doubt that the present government is giving high priority to resolving the energy crisis and to setting the energy sector on a sound footing for the future. Its immediate attention has focused on eliminating the 4,000–5,000 MW shortage in electric power and the resulting widespread load-shedding. At the same time, tough decisions are being made to align power tariffs more closely with costs.

The NPP sets a direction for the long run, covering a range of issues. While this is an important start, the policy should be treated as a work in progress. Several areas need immediate attention.

- Given that natural gas is a scarce resource and the development of gas-based power generation is a low-cost alternative, issues of gas production, import, allocation, and prices cannot and should not be separated from issues of national power. The NPP should be converted into a comprehensive energy policy that takes into account different scenarios of domestic gas production, allocation, and imports, along with other options for power generation.

- While incentives for domestic producers of gas have been strengthened, they are still well below international levels. The likely cost of imported LNG is probably nearly three times the average price given to domestic gas producers.
- While it is understandable in political terms that households are given first priority, it does not follow that domestic gas prices be kept so low as to offer practically no incentive to economize the use of this very valuable resource. The prospect of importing much more expensive gas, the supply of which will rise over time, should provide the context for removing past anomalies in gas pricing. The public needs to be educated concerning the trade-off between assured supply and a sustainable price.
- In the context of a comprehensive energy policy, it would be operationally very helpful and facilitate both implementation and monitoring if energy plans were defined for three periods: five years, ten years, and 25 years. A five-year plan would, naturally, focus on implementing decisions already made and ensure that resources and capacity are free of bottlenecks. Longer-term plans could then focus increasingly on low-cost alternatives, project choice, and private-public alternatives.
- More accurate estimates of future demand are also necessary that take into account not only the impact of price adjustments but also the likely move from noncommercial energy use to commercial energy use as the country becomes more urbanized and prosperous. Prima facie, the figure for long-term demand for electricity, 5 percent per annum, appears to be an underestimate.
- The power sector’s organizational structure needs to be better defined. More attention should be paid to the sector’s decentralization to the private sector and the provinces. At present, too much authority is centered on the federal government.

In terms of specific policies, the present plans do not offer a clear or particularly hopeful picture of substantial increases in the share of hydroelectric or gas-based power generation over the next 10–15 years. On the hydroelectric side, unless a decision on a major dam such as Diamer-Bhasha is made in the next year or so, completion cannot be expected before 2025. On the gas side, major pricing decisions hold the key to more gas-powered generation. Large-scale power generation based on imported coal also raises issues of port and rail capacity.

Additionally, even if a single energy ministry cannot be created, there is an urgent need for a strong, capable, high-level, and empowered mechanism to review progress, monitor implementation, take course-correction decisions, and remove bottlenecks for the entire energy sector. Such a mechanism – a high-powered inter-ministerial committee with a small but independent secretariat, for instance – should also be charged with periodically checking that energy plans are consistent with the total resource envelope, the institutional capacities of WAPDA and distribution companies, and coordination with the private sector and provincial governments.

Annexure
Trends in Plant Utilization Rate for Thermal Plants
Plants with a maximum load of 200 MW or more

Plant	2008/09	2009/10	2010/11	2011/12	2012/13
GENCOs					
TPS Jamshoro (GENCO-I)					
Maximum Load	635	700	645	510	520
Utilization Factor (%)	49.8	67.0	43.9	27.0	37.0
TPS Guddu (Unit 1-4) (GENCO-II)					
Maximum Load	440	445	355	370	392
Utilization Factor (%)	81.5	71.2	54.0	51.0	67.0
TPS Guddu (Unit 1-4) (GENCO-II)					
Maximum Load	700	715	766	813	687
Utilization Factor (%)	78.7	69.9	70.6	87.0	90.0
TPS Muzaffargarh (GENCO-III)					
Maximum Load	1120	920	785	865	1115
Utilization Factor (%)	62.3	63.4	43.0	37.9	61.0
Karachi Electric Supply Company (KESC)					
Bin-Qasim TPS-I					
Maximum Load	1107	1080	1095	1040	1030
Utilization Factor (%)	58.0	49.9	45.9	83.0	82.0
Bin-Qasim TPS-II					
Maximum Load	-	-	-	529	566
Utilization Factor (%)	-	-	-	94.0	100.0
Korangi CCPP					
Maximum Load	128	205	203	190	191
Utilization Factor (%)	49.5	62.1	63.6	83.0	87.0
(IPPs					
L.al Pir Power					
Maximum Load	348	350	351	350	350
Utilization Factor (%)	56.0	71.0	57.6	58.3	51.8
Pak Generation Power					
Maximum Load	348	349	344	350	350
Utilization Factor (%)	64.6	32.3	52.9	55.2	60.6
HUBCO					
Maximum Load	1200	1200	1200	1200	1200
Utilization Factor (%)	93.3	93.0	86.7	69.4	73.0
KAPCO					
Maximum Load	1475	1526	1361	1342	1342
Utilization Factor (%)	75.7	83.4	56.1	58.1	38.5
Rousch Power					
Maximum Load	445	451	443	395	395
Utilization Factor (%)	97.7	97.7	97.0	97.4	64.3
TNB Liberty Power					
Maximum Load	223	220	219	212	212
Utilization Factor (%)	88.4	84.0	92.5	86.1	43.3
Uch Power					
Maximum Load	610	589	590	551	551
Utilization Factor (%)	94.3	87.3	87.5	88.6	74.0
Atlas Power					
Maximum Load	-	215	215	214	214
Utilization Factor (%)	-	93.0	91.0	n.p	n.p
Sapphire Electric Power					
Maximum Load	-	-	-	212	212
Utilization Factor (%)	-	-	-	48.1	-
Orient Power					
Maximum Load	-	n.p	224	213	213
Utilization Factor (%)	-	n.p	98.0	36.6	n.p

Source: State of the Industry Report 2013, NEPRA

Chapter - 6

Pakistan’s External Relations and Foreign Resources Dilemma

Chapter - 6
Pakistan's External Relations and Foreign Resources Dilemma*

INTRODUCTION

Pakistan faces a serious resource dilemma to which there is no easy solution. There are two components of this dilemma: one, raising domestic resources to achieve high rates of growth that can be sustained over time; and two, ensuring that a steady flow of foreign funds will be available to meet the country's external obligations. Chapter 3 addresses the first part of the dilemma; this chapter is concerned with the second part. Its analysis is built on the assumption that Pakistan will have to fashion its external relations in a way that eases its access to foreign funds. In doing so, however, Islamabad must learn to rely on external resources as a last resort, focusing on domestic resource generation to produce sustained growth in the long run. That said, FDI will remain an important contributor to growth and development, and Pakistan should seek as much of it as possible.

For almost its entire life as a sovereign state, Pakistan has relied heavily on foreign assistance to expand its economy. Aid arrived not as a gentle and steady flow but in large and short bursts. Whenever the capital flows were large, they produced economic booms, as was the case on three occasions – in 1964–66, 1984–87, and 2004–07. These spurts could not be sustained because they were not supported by domestic resource mobilization. Each of these boom periods lasted no more than three years. Meanwhile, the Pakistani political establishment's ability to obtain help during difficult periods postponed the needed structural changes at home.

The world of finance has a term for this way of managing the economy, which applies to personal finance as well as that of a firm or state – the "moral hazard" approach. Pakistan, convinced that it was too large an entity located in too sensitive a region of the world to be allowed to fail, knew that help would arrive when it was needed. The US often helped, as did China once in 1996, making a deposit in Pakistan's account at the Federal Reserve Bank in New York.

The latest example of this is the decision made by the Kingdom of Saudi Arabia in March 2014 to deposit $1.5 billion in the Pakistan Development Fund, which had been set up by President Asif Ali Zardari's administration soon after it assumed power. The Zardari administration did not succeed noticeably in this effort. Several countries were approached, very few obliged. While

*This chapter was contributed by Shahid Javed Burki.

relying on foreign flows – and because of this reliance – the country was unable to build a fiscal system that could generate finance from domestic resources to achieve rapid and sustainable economic growth.

FEAR AS THE FOUNDATION OF EXTERNAL RELATIONS

For several decades, Pakistan based its dealings with the world on an equation comprising two variables – fear and economic need. The first was rooted in its apprehension concerning perceived Indian designs on a country that had been founded in spite of the Congress leadership's hard-fought but unsuccessful campaign to keep British India united. The second component was the American fear that the new ideology of Communism, which had transformed the Soviet Union, might take hold in Eastern Europe and much of Asia.

Various Pakistani administrations worked on these two fears in designing their approach toward both economic and security policies. Pakistan was born in a world that had begun to take shape after the conclusion of the Second World War in 1945. The Allies may have won, but the US was the real victor. But for the Soviet Union, Washington would have wanted to preside over a unipolar world. The challenge from Moscow emerged not in the form of renewed and massive conflict but in the shape of smaller proxy wars that pitched two very different economic and political ideologies against one another. The "Cold War" continued for more than four decades and it was in this environment of perpetual conflict that Pakistan's leaders fashioned their country's external policies. As we note later, the country is now operating in a very different global environment.

The first generation of Pakistani leaders felt that the country they had founded faced two serious problems. The Indian leadership's attitude toward the new state posed a grave issue for Karachi, the first seat of Pakistan's central government. The partition of British India was the price the Indian National Congress, headed by Jawaharlal Nehru, had been prepared to pay in order to secure London's withdrawal from the former colony.

Many in the top echelons of the new Indian government were convinced that the act of division could be reversed. This had happened once before. In 1904, the British Indian government had agreed to partition the province of Bengal along communal lines, creating a Hindu-dominant West Bengal and a Muslim-majority East Bengal. This partition was reversed under pressure from the Congress in 1911. History may have persuaded British Prime Minister Clement Attlee to convey to the House of Commons in July 1947 his hope that "this severance may not endure." Attlee expected that the new dominions of India and Pakistan would, "in course of time, come together to form one great Member State of the British Commonwealth of Nations."[1] This, of course, the government in Karachi was not prepared to let happen.

At its birth, Pakistan was an exceptionally weak state. It had no government, no capital city, and practically no resources. The funds it had inherited from the British – the "sterling balances" – were locked in the treasury in New Delhi, which Prime Minister Nehru's government was unwilling to release. Accordingly, the Pakistani leadership felt it needed external help to keep in place the line of partition drawn by the departing British. Very early on, Muhammad Ali Jinnah and his associates turned to the US for help.

There was good reason for this early tilt toward Washington. The Second World War had resulted in a massive restructuring of the global political order. Although Britain was one of the victors, it had been seriously weakened by the long war effort. The US emerged as a clear winner, especially after the Soviet Union stayed out of the deliberations to fashion a new economic and financial system at Bretton Woods, New Hampshire. The conferees at the Bretton Woods meeting agreed to create two institutions to rebuild war-ravaged Europe and to develop those nations that were emerging from decades of colonial domination. It was clear from the outset that, notwithstanding the participation of British economist John Maynard Keynes, Washington would dominate the Bretton Woods system, which comprised the IMF and the International Bank for Reconstruction and Development (IBRD) (now the World Bank Group).

However, in 1947, the Pakistani leadership was not thinking of assistance from these two institutions. Instead, it looked directly to the US for help on geopolitical grounds. In a revealing interview given by Jinnah to Margaret Bourke-White, a writer for the now-defunct *Life* magazine, Pakistan's first Governor General declared that, "America needs Pakistan more than Pakistan needs America." With a flourish that was uncharacteristic of his demeanor and temperament, Jinnah described Pakistan as "the pivot of the world" given that the country was on "the frontier on which the future position of the world revolves." This, as we note later, turned out to be an exceptionally prescient statement.

In writing about this interview, Bourke-White described Pakistan as the "creation of one clever man," commenting further that, "in Jinnah's mind the brave new nation had no other claim on America than this – that across a wild tumble of road-less mountain ranges lay the land of the Bolsheviks. I wondered whether the Quaid-e-Azam considered his new state only as an armored buffer between opposing powers." That road-less mountain range was to cause Pakistan a great deal of trouble throughout its existence and may do so again.

Jinnah, and after his death Prime Minister Liaquat Ali Khan, attempted to forge a relationship with the US based on their concern about India's perceived intentions toward Pakistan and the perception that the US could be made to take an interest in the wellbeing of the new state. They, and the generations of leaders that followed them, looked for two types of help from the US: economic assistance for developing a country that was woefully short of domestic resources and help in building up the military to keep India at bay.

A relationship based on this fear of India and perceptions about the likely interest of the US was to govern the association between the two countries for almost seven decades. As Husain Haqqani, Pakistan's former ambassador to the US, has put it: "Amid frequent Pakistani charges of American betrayal, few Americans remember that Pakistan initiated the US-Pakistan alliance primarily to compensate for its economic and political disadvantages."[2] This was a transactional relationship on the part of Washington and a strategic one on the part of Islamabad. It is not surprising that the relationship has remained on a rollercoaster from 1947 to the present, with the US engaging with the country whenever it needed Islamabad's help. For Pakistan, however, given the resources Washington could send its way, it made strategic sense to cultivate America.

US involvement in Pakistan has produced, as indicated, three economic booms. An element common to all three periods was that they occurred on the military's watch. The military's way of doing business is to rely on a highly structured and centralized command system. Generals Ayub Khan, Zia-ul-Haq, and Pervez Musharraf did what they believed was good for the country and, by extension, what was good for them. Democratic governments, however, cannot act this way. An administration put in power through a political process has to keep its people in mind all the time. In the absence of reliable opinion polls, policymakers have to feel their way.

This is largely the reason that the PPP government led by President Asif Ali Zardari was unable to maintain amicable relations with the US, especially after a series of unpleasant events in 2011, which began with the murder of two Pakistanis in broad daylight on a busy Lahore street in January. The killer was a CIA operative. On 2 May, a unit of US Special Forces penetrated deep into Pakistani territory and killed Osama bin Laden; Pakistan was not informed of the raid. In late November, US forces attacked a Pakistani military post near the Afghan border, killing two-dozen soldiers. As a result, public opinion in Pakistan turned decisively against America and remained thus until Prime Minister Nawaz Sharif took office in 2013.

OPERATING IN A NEW WORLD AND THE INDIA FACTOR

The establishment of a democratic political order was not the only change policymakers have had to contend with. The world in which Prime Minister Nawaz Sharif and his associates now operate is very different from the one in which Generals Ayub Khan, Zia-ul-Haq, and Pervez Musharraf functioned. The US is no longer the power it was then, having lost some of its international preeminence. Pakistan, ever reliant on external financial assistance, faces a very different international situation as the Sharif government completes its first year in office. In addition to these changes, there are the personal preferences of senior leaders at play. Sharif's focus on economics as the basis of Pakistan's dealings has begun to change the orientation and basis of the country's external relations.

By adopting this approach, the government has moved away from its preoccupation with India and the perceived threat associated with the latter as the sole determinant of foreign relations. It is clear that the administration wants to repair Pakistan's relations with India, convinced that the country would be better served if close economic relations were established with its much larger and economically more vibrant neighbor. There is hope in Islamabad that India will respond more positively to Pakistan's many overtures once the cycle of state and national elections currently underway in the country are completed in May 2014. A few weeks after this report is released to the public, a new government will be in place in New Delhi. It is likely to be led by the Hindu nationalist BJP. The party's ascendancy could pose difficulties for Prime Minister Sharif's effort to build economic relations with Pakistan, but it might also produce a “Nixon-in-China” moment, where a conservative party may be in a better position to improve relations with neighboring Pakistan.

The attempt to reconcile with India and build a new relationship on the basis of mutual economic advantage appears to have the support of a number of important social and political groups in the country. Table 6.1 reports on the attitude toward reforming relations with India, using economics as the basis, and the perceived benefits and costs of the groups surveyed. Of the 17 groups and institutions sampled (the latter includes the federal and Punjab governments), ten approve of the effort being made to improve relations with India. Their view is positive because they see benefits for themselves in such a relationship. What is encouraging is that, of the positively inclined groups, seven are seen to have a strong influence over the making of public policy.

The survey identifies only two groups that take a negative view of reopening trade with India. Both groups – automobile and pharmaceutical manufacturers – are concerned that they will not be able to compete with Indian industry and will lose their market share in Pakistan. However, both are seen to have a “medium” influence over the making of public policy and a “low” ability to generate political action. If the Sharif government succeeds in reaching out to India, this could lay the ground for meeting a significant part of Pakistan's external resource needs through trade. The structural change in the economy that this will induce is bound to help Pakistani exporters in other markets.

Table 6.1
Reopening Trade Between India and Pakistan: Winners and Losers

Winner or Loser	Attitude to Reform	Net Benefit/ Cost of Supporting/ Opposing Reform	Level of Influence	Ability to Generate Political Action
Government of Pakistan	Positive	Benefits	Very High	High
Government of Punjab	Positive	Benefits	High	High
Major Political Parties	Positive	Benefits	Very High	High
Military	Neutral	Unclear	Very High	High
Big Business	Positive	Benefits	High	High
Chambers,Ffederations and Councils of Business	Positive	Benefits	High	High
Automobile, Manufacturers and Parts Suppliers	Negative	Costs	Medium	Low
Domestic Pharmaceutical Industry	Negative	Costs	Medium	Low
Textile Industry	Mixed	Unclear	High	Moderate
Commertial Impoters	Positive	Benefits	Low	Low
Media	Neutral	Unclear	Very high	High
Exporters	Positive	Benefits	Low	Low
Raw Material Supporters	Positive	Benefits	Low	Low
Academic	Positive	Benefits	Low	Low
Public	Neutral/mixed	Unclear	Very high	High
Logistics Industry	Positive	Benefits	Low	Low
Retailers and Wholesalers	Positive	Benefits	High	High

Source: Husain (2013)

"TRADE VERSUS AID"

The economic world immediately after the postcolonial period was a different place from what it is now. Without delving too deeply into the evolution of development economics as a separate discipline, it is appropriate for our purpose to recall some of the main elements that were incorporated over time into growth economics.[3]

Initially, the emphasis was on increasing investment to accelerate the rate of growth. Since savings rates were very low in what came to be known euphemistically as the "developing" world, the consensus among experts and policymakers was that developing nations should be provided "official development assistance" to augment their savings. Early on, rich countries set a target of 0.7 percent of their GDP to be allocated toward annual resource transfers to developing nations. The importance of trade was also recognized and with it came the willingness to grant the developing world greater access to the markets of rich countries by lowering import tariffs. This was done by adopting the GSP. Several developing countries in East Asia took a very different route to using trade as a driver of growth. They used government incentives to encourage the production of exports. Some of them, in particular China, used a depressed rate of exchange to encourage exports.

Most developing nations used to peg their exchange rate to the US dollar and keep it in place for long periods. Now, for most of the world, exchange rates change daily depending on markets' perception of currency values. This is based on a number of considerations, not just the relative price of the domestic output compared to those on offer from competing suppliers. If only two countries were involved in international trade – one buyer and one seller – the rate of exchange would reflect their relative price levels. Thus, if Pakistan was the only supplier and the US the only buyer and there was a ten-percentage point difference in their rates of inflation – with prices in Pakistan increasing more rapidly – the Pakistani rupee would be devalued by 10 percent with respect to the US dollar. The two-country model can be expanded by estimating the weighted index of prices by bringing all the buyers into the equation.

In other words, the exchange rate must reflect economic fundamentals and not be tinkered with by bringing in large foreign inflows. This does not mean that the recent Saudi gift of $1.5 billion should not be welcomed. It has certainly helped stabilize the rupee and speculators who were betting on the continuous weakness of the rupee must have incurred heavy losses. Capital that had flown the country or been stored under the mattresses might also return to the domestic economy and be put to productive use. However, a determined effort is required to increase exports by focusing on the development of new product lines and new markets. This has been a recurrent theme in the Institute of Public Policy's annual reports since its inception.

As several analysts have emphasized over the years, Pakistan has never really looked at international commerce as a driver of growth. This way an opportunity lost. Studies on the more rapidly growing emerging economies find that their common ground was policymakers' focus on international trade.

From the perspective of the development of economic thought, there is nothing new in this emphasis. After all, Adam Smith, the founder of modern economics, identified two factors that could move economies forward: specialization and market expansion. The former increased workers' productivity and the competiveness of their products. When domestic output increased as a result of more efficient production, as envisaged by Smith, the additional output could not be absorbed by domestic markets. The new markets needed were to be found beyond the country's borders. This approach, according to Smith, was critical for climbing out of backwardness. Productivity increases and international trade became central to the development models used by the "miracle" economies of East Asia, including China.

Unfortunately, Pakistan neglected both elements in the growth model. Even when the country's policymakers thought about international trade, they tended to focus on the wrong set of priorities. They sought markets for products that were surplus to the needs of the domestic economy and targeted such markets in countries that had a relatively large demand for these products. The result was that, for decades, low value-added cotton and leather products became staples for industrial enterprises engaged in international trade.

Much of the state's attention was focused on improving market access in North America, the EU, and Japan for cotton and leather products. There was much jubilation recently when Brussels granted Pakistani textiles privileged access to the European market by lowering the duties charged on imports from Pakistan. This measure was adopted under the GSP Plus provision and will no doubt increase the value of Pakistan's exports and help narrow the trade gap in its external accounts. However, it could also have negative long-term consequences if it atrophies the development of the Pakistani export industry. If producers become complacent, more capital may be attracted to established industries and not enough effort put into developing new markets.

That said, there is growing recognition that Pakistan should trade more with its immediate neighbors. Two of these – China and India – have large and growing markets. The Middle East continues to invite investment in sectors with which Pakistan could link itself. Trade with Afghanistan developed rapidly when the latter had foreign money to spend on consumer goods and construction material. The development paradigm we are advocating, however, should look at new markets and new exportable products.

Let us start with products. At this time, trade in "parts and components" is the fastest growing element in international commerce. Pakistan should make an effort to develop supplier chains that could feed into, for instance, the automobile industries of China and India. There are reasonably well-developed centers of engineering in the "golden triangle" that comprises the production centers of Gujranwala, Gujrat, and Sialkot.

The country's information technology (IT) industry is also developing well. The sector has enormous export potential and some Pakistan companies have made positive moves. Instead of focusing on providing services to established industries in the West as India has done, these firms have concentrated on developing new products. The Lahore-based Netsol Technologies is an example of an enterprise that has developed one high-demand product – leasing software for the automobile industry. The company's revenue per employer is much higher than in large Indian firms such as Infosys and Tata Consulting. State policy has also bolstered Netsol's impressive growth since computer imports are allowed into the country duty-free and no tax is paid on income from exports.

Agricultural processing and packaging is another area in which the country can draw high returns. The development of the couture cottage industry is a little-known and little-analyzed export-oriented activity that has begun to provide decent incomes to its entrepreneurs – mostly upper-class women. The more successful operators in this area have good contacts with Pakistani expatriates who have the income to purchase their high-quality products.

Insofar as the search for new markets is concerned, it might not hurt to borrow from the Indian initiative in Africa, which has begun to rise economically. "Indian investors may be gloomy about their domestic economy after a sharp slowdown in growth to less than 5 percent a year, but they seem to have lost none of their enthusiasm for Africa's emerging markets across the Indian Ocean," says a recent *Financial Times* blog post.[4] According to the McKinsey Asia Center (2014), "Indian companies should be able to quadruple export earnings from Africa to $160 billion by 2025 by focusing on information technology services, agriculture, infrastructure, pharmaceuticals, and consumer goods."[5] These are also some of the items we have included in our list of those that have enormous potential for Pakistan. Public policy, therefore, should be formulated by making such initiatives central to it. Opening up to India (discussed earlier in this chapter) will also help Pakistan move in that direction.

FORMS OF FOREIGN CAPITAL FLOWS

Policymakers in Islamabad must not rely on external savings to reignite growth. This, as history has shown, is not sustainable. However, in order to make the transition to a new growth paradigm that places greater emphasis on domestic resource generation, Pakistan will need foreign help in the short term. What strategy should it adopt for seeking resources abroad to augment the small amounts that are available from within the economy at this point in time?

The Sharif government is following a path travelled by previous administrations. It has been able to marshal an impressive volume of resources from multilateral institutions such as the IMF, the World Bank, and ADB. A program agreed with the IMF within the new government's first few weeks is injecting about half a billion dollars into state coffers every three months. This flow will last as long as Islamabad continues to satisfy the IMF that it is following the policy path prescribed for Pakistan. The amounts being provided are sufficient for the country to service its previous loan from the IMF, acquired during President Asif Ali Zardari's tenure. For the time being, the IMF is not injecting new money into Pakistan.

The World Bank and ADB have also indicated that they are prepared to provide the country with significant resources, primarily to finance a number of large infrastructure projects. Since Pakistan's creditworthiness does not qualify it to borrow from the IBRD, for the moment, any credits will come on very soft terms. This would be a highly welcome supply, but the amounts are likely to be relatively small compared to what IBRD loans on nonconcessional terms could provide. Even then, the terms on which the country can borrow will be considerably lower than what Islamabad has committed to pay for the recently floated Eurobonds. Unlike borrowing from the IMF, the World Bank lending will not burden the country with large amounts of external debt. The same is true for the amounts coming in from several other bilateral sources.

Saudi Arabia has deposited $1.5 billion in the Pakistan Development Fund established by the Zardari government. His administration had expected generous support from the international community and, soon after taking office, had targeted a group of nations it identified as "friends of Pakistan." The assumption was that such countries would be prepared to support an elected government and thus strengthen democracy in Pakistan. This expectation was not met and, subsequently, the rapid deterioration of relations with the US reduced funds from that particular source.

Under Prime Minister Sharif, there has been a significant improvement in Pakistan's relations with the US. This has helped steady the flow of funds promised to Pakistan under the US Senate's Kerry-Lugar-Berman bill, signed into law by President Barack Obama in October 2009. The bill had promised a steady annual flow of $1.5 billion over a five-year period. This flow was interrupted by the palpable deterioration of Islamabad-Washington relations in 2011. In the US financial system, the government's executive branch only proposes while the legislature disposes. Congress did not support the idea of providing financial help to Pakistan, given the widespread impression among its legislators that Islamabad was playing a double game in the war against terror.

Husain Haqqani, Pakistan's ambassador to Washington at the time, has confirmed this impression and lent considerable credence to the American belief that Islamabad was continuously reneging on its repeated promises to rein in extremist groups operating out of sanctuaries in Pakistan.[6] These groups were doing considerable damage to the American war effort in Afghanistan. The new government's efforts, led by Prime Minister Sharif and his advisor Sartaj Aziz, have somewhat repaired Pakistan's tattered relations with the US in addition to resetting the Kerry-Lugar flows back on track. There are indications that the US is prepared to help Pakistan improve its under-stress energy sector by providing resources for large power generation projects.

Islamabad has made a concerted effort to acquire China's help in building a number of major infrastructure projects. Senior leaders have visited China three times: Prime Minister Sharif having been twice, and Shahbaz Sharif, chief minister of Punjab, once. Press reports have indicated Beijing's willingness to provide tens of billions of dollars in project assistance. One example of this is the proposed "China-Pakistan economic corridor," which will use the already operational Karakoram Highway as its main artery. The highway will be extended to the port of Gwadar on the Balochistan coast. Ultimately, a railway line, gas and oil pipelines, and a fiber-optic cable will also be laid along the highway. Several industrial parks will be built along the corridor in which Chinese firms will employ Pakistan's abundant cheap labor to reposition some of their labor-intensive industrial enterprises.

The planned corridor can be seen as part of China's "look-West" policy. It will not only open the country's landlocked western provinces to the sea but also provide access to the oil, gas, and mineral wealth of the Middle East and Central Asia.[7] This megaproject will need financing that is well beyond Pakistan's limited means. In looking for resources, Islamabad could explore the possibility of "structured finance," which would involve the private sector and multilateral and bilateral development agencies. In tapping the private sector, Pakistan could also look at the possible role its diaspora has to play.

Islamabad has yet to give an official account of exactly what the Chinese are providing: the projects for which they are willing to lend and the terms on which these funds will be made available. Only then can one make an informed judgment about the likely benefits of this flow of funds and the long-term cost to the economy.

This approach to inundating the economy with funds from bilateral sources has been followed in the past, in particular by military-dominated governments. Altruism is not the only reason that rich countries provide financial assistance to those that are relatively poor. Bilateral aid usually comes with (often not very visible) political strings attached. Recipients of foreign aid may face expectations they cannot always fulfill, which may be the case with today's Pakistan. Are there other, less politically encumbered ways of meeting the resource gap?

There are three problems with an approach aimed at increased reliance on external resources – a significant part of which will come from bilateral sources – for dealing with economic strain. It would help if Islamabad's policymakers were fully cognizant of these.

First, the dependence on external savings should be limited to the very short term. Ultimately, it is domestic resource generation that can sustain rates of growth at the desired levels. Second, in the rapidly shifting political global order, continued dependence on bilateral relations might call for making foreign policy choices that are not to the country's long-term advantage. Pakistan will have to move beyond such bilateral equations as Islamabad–Washington, Islamabad–London, Islamabad–Beijing, and Islamabad–Riyadh to obtain the external resources it needs. What is evolving is a multipolar world in which it may be difficult to include the old form of bilateralism. Third, Pakistan needs to focus quickly and resolutely on obtaining increased FDI flows. These do more for the economy than conditional bilateral flows, which are often provided in pursuit of the giver's interests, not necessarily in those of the recipient.

FDI can take several different forms, entering a particular country as portfolio investments, for instance, when foreign investors conclude that its stock market offers good short-term rewards compared to those available in rich countries. Over the last several months, Pakistan's capital market has performed relatively well, no doubt due in part to foreign money inflows. These are fickle flows, however, and can go out as quickly as they come in.

As Raghuram Rajan, governor of the Reserve Bank of India, has pointed out,[8] several emerging markets came under heavy stress when the US Federal Reserve announced that it was "tapering" down its bond purchases. This policy of "quantitative easing" had kept US interest rates near zero and attracted investments in the high-yielding markets of the developing world. By announcing a gradual move away from the policy, the Federal Reserve produced a sharp reversal of capital flow from emerging markets. In both India and Pakistan, this put pressure on the rate of exchange.

Two other types of FDI are more suited to the needs of emerging markets such as Pakistan. One takes the form of mergers and acquisitions (M&A). With the globalization of financial markets, M&A activity between developed and developing countries has increased. Established firms have acquired assets in emerging economies to expand their market share. Pakistan has had this type of investment in two services sectors – banking and telecommunications. Most firms that have taken advantage of the opportunities available in Pakistan are from the Middle East, perhaps being less intimidated by the country's poor security situation.

"Greenfield" investments are the other more stable form of foreign capital flows, and refer to the establishment of new enterprises. Foods and beverages are popular areas for foreign investment. However, since the income from this type of investment is in local currency and the profits are repatriated in foreign currency, this creates contingent liabilities for the government and increases pressure on external finances. Oil and gas are also areas of potential FDI involvement, and would have a positive impact on external finances.

Box 6.1
The Exit of MNCs from Pakistan

The economic hurt being caused to Pakistan by the exit of multinational corporations (MNCs) is well illustrated by the case of the pharmaceutical industry. According to a report in *Dawn*, four MNCs have left the country in recent months and three more are considering "calling it a day." [a] Some of these have relocated their operations in Bangladesh and Sri Lanka while others have added capacity to their projects in India. In other words, their departure is not meant to give up their share of the Pakistani market but to meet the demand for their products from other South Asian countries.

MNCs' loss of interest in operating from Pakistan has continued for several years. Their investments in the country "including up-gradation, expansion and setting up of new plants fell to Rs 4 bn in 2010–2013 from Rs 14 bn in 2007–2010… According to a multinational drug maker, only 4 MNCs are currently listed in the Karachi Stock Exchange compared to more than 15 a few years back [*sic*]."

The poor security situation in the country – in particular in Karachi, which was the center of the pharmaceutical industry in Pakistan – is an important reason for the exit of MNCs. Foreigners also cite policies adopted by the Drug Regulatory Authority of Pakistan (DRAP) as an inhibiting factor. According to a foreign manufacturer, "global giants prefer India in the region for business opportunities as DRAP's failure to promote growth-oriented industry-friendly laws and regulations has turned Pakistan into an unfavorable option for foreign investment."

MNCs cite Pakistan's lack of interest in adopting "good manufacturing practices" as the reason for the poor performance of local pharmaceuticals in the export business. Not a single domestic plant meets the standards set by the US Food and Drug Administration (FDA). India, in contrast, has 150 FDA-approved plants, while Bangladesh has four. Pakistan's pharmaceutical exports are estimated at between $145 million and $180 million a year. India's exports were estimated at $10 billion to $50 billion in 2010–13.

[a] AS Khan, 'Local drug makers cashing on MNC's departure', *Dawn*, 19 April 2014, p. 9.

As indicated earlier, while FDI is a more stable form of capital flows, it too can depart. This has happened in the case of American and European firms that had operated in Pakistan's banking sector for decades but opted to leave when the security situation worsened on account of growing extremism. Some foreign manufacturing firms have also sold their operations for the same reason. FDI can only play an important role in the country if the security situation improves.

CONCLUSION

While Prime Minister Sharif was refocusing the country's external relations to help revive the battered economy – something that could only be done initially with foreign assistance – the world seemed to be moving in a different direction. Pakistan itself is a part of this change. It is shifting away from an India-centric world outlook. China, India, Iran, and Russia are showing interest in Afghanistan and their actions there will affect how Pakistan shapes its Afghan policy. This is one of the many manifestations of the environment of uncertainty in which Islamabad will be acting. The old relationships that were the basis of copious flows of foreign assistance can no longer be counted on to continue.

It will take considerable imaginative diplomacy to continue to attract bilateral assistance. Pakistan needs these flows to manage the difficult period of transition from an aid-dependent economy to one that relies on domestic resource generation. Multilateral institutions will help only if they develop confidence in the economic model Pakistan is pursuing to end its economic slowdown and climb to a high-growth trajectory. That, along with the ability to bring extremism and terrorism under control, will determine the quantum of FDI flows. In sum, Pakistan's ability to attract the foreign flows it needs will depend on whether the managers in Islamabad are able to navigate a much more complex world than was the case in 1947.

Chapter - 7

Extremism in Pakistan: In Search of a Solution

Chapter - 7
Extremism in Pakistan: In Search of a Solution*

Pakistan is in agony. In almost 67 years of sovereignty, it has never had a political leadership that could foster national feeling among its citizens. Now, a relatively small segment of the population has taken up arms to challenge the authority of the state. When viewed through a wide-angle lens, the rise and stubborn persistence of extremism in Pakistan appears to be a consequence of complex circumstances coming together. It is also clear that the country will not be able to make economic progress or continue with the delicate task of creating a viable political order unless the various groups that have taken up arms against the state are brought under its control and made to obey the law of the land.

History has played an important role, as has public policy, in bringing about this situation. International developments have been equally important. Although the Sharif government has identified the three "E's" of extremism, economy, and energy as priority areas for public policy, it has wavered in dealing with the first. Extremism and terrorism constitute the country's greatest challenge at this time; bringing them under control is the test by which the electorate will judge the government in power. The Sharif administration will need a well-defined approach to which it must adhere until this existential threat to Pakistan is fully addressed.

THE ROLE OF HISTORY

While history has created the circumstances enabling extremism, it is state failure that has ultimately set the country on fire. Let us turn to the former for a moment. The way in which British India was partitioned into the states of India and Pakistan proved to be an unsettling demographic event. It produced a wave of migration that resulted in an exchange of population between the two new countries. Some 14 million people moved in either direction: 8 million Muslims came to Pakistan while 6 million Hindus and Sikhs left for India.[1]

This transfer of population changed the demographic profile of Karachi. It was then followed by other waves of in-migration that the country's political system could not handle. Contending ethnic groups unable to settle their differences through political institutions resorted to violence.

*This chapter was contributed by Shahid Javed Burki.

The absence of political development meant that Karachi became an increasingly violent city. The use of violence as a form of political expression may have appeared initially in Karachi but did not remain confined to it, instead spreading to other parts of the country.

The 1947 transfer of population had one other important consequence. It was effectively a form of ethnic cleansing before the term entered political discourse. Non-Muslim segments of the population were replaced by Muslims; by the time the dust had settled, Pakistan was 95 percent Muslim as against 70–75 percent before independence. This “Muslimization” changed social mores, making the population increasingly intolerant of other religious expressions or sectarian affiliations. Had large Hindu and Sikh minorities stayed behind, they would have undoubtedly exercised a moderating influence on the country that Jinnah had founded.

Not having anticipated the exchange of populations that would accompany Partition, Jinnah had famously talked about a time in the near future when “Hindus would cease to be Hindus and Muslims would cease to be Muslims” – not, of course, in the religious sense but in the sense that they would become citizens of one state. This speech was made on 11 August 1947, three days before Pakistan became formally independent.

One of the more long-term contributions to the rise of extremism was made during the eleven-year rule of the military president, General Zia-ul-Haq. From his perspective, the Soviet invasion of Afghanistan in 1979 (two years after he had assumed power) offered him an opportunity to Islamize Pakistan. The Americans wanted to expel the Soviets from Afghanistan and Zia-ul-Haq was able to convince them that using the idea of Islamic jihad would help them achieve their objective. With Saudi financial assistance, he turned scores of schools that had been established along the Afghanistan-Pakistan border for the millions of refuges pouring into Pakistan into recruiting grounds for Islamic fighters. The young men attending these schools were trained, equipped, and sent to Soviet-occupied Afghanistan. However, even after the mission of ridding Afghanistan of Soviet forces had been accomplished, these schools remained, ultimately supporting the rise of the Taliban in the post-Soviet period.

The Zia government went much further than simply helping to create a mujahideen force to fight the Soviet Union. His administration tinkered with the country’s educational and judicial systems, creating an environment that lent support to the rise of Islamic extremism, Islamic militarism, disrespect for the established legal system, and a complete absence of tolerance for people of faiths other than Islam. The curriculum taught in public schools instilled a system of values that went against modernization and promoted intolerance toward minority communities. The legal system was altered with the introduction of the Hudood and blasphemy laws, which sought to regulate social behavior and made any criticism of Islam or disrespect toward the Prophet grave offenses. A Sharia bench was introduced in the Supreme Court that was empowered to review whether the laws passed by the legislatures conformed to the teachings of Islam.

Additionally, Pakistan sits atop a number of geopolitical fault-lines and any slight movement in one produces tremors that are felt across the country. Pakistan is where Central Asian Sufistic Islam meets the highly puritan Arab faith, each attempting to influence the other. Pakistan and Afghanistan were also the site of the Great Game between the nineteenth-century British and Russian empires; the two countries are now likely to become one of the grounds where the growing rivalry between the US and China will be played out in a new "Great Game."

Pakistan is also where an increasingly assertive China will meet India, with the latter inclined to view all of South Asia as its sphere of influence. Moreover, a newly assertive Russia has not only claimed the Crimean Peninsula – once an integral part of Ukraine – but also reinserted territory into its own domain. Moscow has begun to exert influence over the Muslim states of Central Asia and reappeared in Afghanistan. This latest Russian advance could lead to another series of jihadi battles on the border with Pakistan.

Finally, Pakistan has the largest Shia population in the world after Iran. The changing shape of the Arab Spring of early 2011 has increased tension between the Sunni and Shia sects and exacerbated extremist sectarianism in Pakistan. In light of the complex origins of extremist behavior, how should our policymakers address the problem? Before we take up this question, we will briefly discuss the cost of terrorism that has already been paid by the country.

THE HEAVY ECONOMIC AND SOCIAL TOLL OF EXTREMISM

A number of disturbing details about the extent of terrorism in the country and the damage it had done to the economy emerged in an 86-page report prepared by the Ministry of Interior – the National Internal Security Policy, 2013–2018. According to one account detailing the content of the report, "from 2001 to 2013, there were 13,271 [terrorist] incidents in Pakistan. From 2001 to 2005, there were 523 incidents but from 2007 to November 2013, the total number of incidents had risen to 13,198." During this time, extremist organizations changed their tactics for more effective attacks: the number of suicide bombings increased from 15 in 2001–07 to 358 in 2013 – "the highest in the world." Suicide as a weapon of war can only be used by people who have committed themselves deeply to the cause they are pursuing.[2]

The number of people killed in the 12-year period between 2001 and 2013 was estimated at 48,994, including 5,272 security personnel. Most casualties occurred between 2011 and 2013 when 17,642 people were killed of which 2,114 belonged to the security forces. What might explain this increase? There could be two reasons. First, with the elections of May 2013, Pakistan seemed to be settling down politically, with a political order based on Western democratic liberalism. This was not acceptable to Islamic extremists who were bent on creating a political system that would have worked according to what they saw as the dictates of Islam. Second, as the date for the withdrawal of ISAF forces from Afghanistan drew closer, the Taliban on both sides of the Afghanistan-Pakistan border saw an opportunity to increase their influence over the Pashtun areas of the two countries.

Terrorism had also created an environment that encouraged general lawlessness. The country was spending Rs 150 billion ($1.4 billion or 0.6 percent of GDP) on policing, but this had not reduced the number of reported cases of crime, which occurred mostly in the urban areas. The crime rate increased greatly post-2008, with the number of reported cases standing at 64,554. These included petty larceny, robbery, car-jacking, and bank hold-ups in most major cities. The crime wave also increased the number of people working for private security agencies – a development we will discuss later in some detail.

The Interior Ministry document provides estimates of the economic loss incurred as a result of the disruption and loss of life caused by terrorism. The total loss since 9/11 was estimated at $7.8 billion or about 3.5 percent of an estimated GDP of $225 billion in 2012/13. This figure does not include the amount the state spent on maintaining a large armed force (estimated at over 600,000 and translating into a ratio of three men or women in uniform for every 100,000 citizens – one of the highest ratios in the world).

Khyber Pakhtunkhwa (KP) bore the brunt, with 33 percent of the attacks, making it the most affected region in the country, followed by Balochistan at 23 percent, FATA at 20 percent, and Sindh at 18 percent. Punjab, the largest province, was the least affected, accounting for 4 percent. That it was largely spared by terrorists may be one reason that the governing PML-N, a Punjab-based party, has seemed reluctant to move against the perpetrators of this challenge to state authority.[3]

According to an editorial in *Dawn*, the interior ministry document was

> … an eye opener and a confirmation of long-held suspicions. The cities of Pakistan – not just faraway FATA or obscure corners – have thoroughly been infiltrated by militants of every stripe, local or foreign. The names are as familiar as they are scary – Al Qaeda, Taliban, Lashkar-e-Jhangvi. So are the targets: ethnic, sectarian, provincial, sub-national. It had long been known that some of

> these groups had infiltrated the main political parties. In Punjab, nearly every political party has followed the lead of PML(N) in learning how to buy off or co-opt sectarian elements for electoral purposes.[4]

There was also fear in Lahore, Punjab's capital, that military action by the government in the tribal areas would induce retaliation by the militants in the province's larger cities. As if to prove the point, terrorists struck Islamabad on 3 March 2014 – a day after the government and the TTP had agreed to a month-long suspension of hostilities.

ANALYTICAL WORK ON THE COST OF TERRORISM

The work done by the interior ministry notwithstanding, there has been little research on the economic cost of prolonged terrorism in Pakistan. The Institute of Public Policy included the subject in one of its annual reports[5] and some Islamabad-based institutions have collected and disseminated data on the number of terrorist attacks, their geographic distribution, and human toll. However, detailed analyses of economic and social costs remain to be done. Here, we deal briefly with four issues: the definition of terrorism, various types of cost to the economy of what are designated as terrorist activities, the Institute of Public Policy's findings, and one example of identifying the causes of terrorism using econometric tools.

To discuss the economic and social consequences of extremism and associated terrorism, we must first understand what these terms mean. The United Nations' 1999 International Convention for the Suspension of the Financing of Terrorism define terrorism as any "act intended to cause death or serious injury to a civilian, or to any other person not taking an active part in the hostilities in a situation of armed conflict, when the purpose of such an act, by its nature or context, is to intimidate a population, or to compel a government or an international organization to do or abstain from any such act."[6] This carefully worded definition focuses on attacks carried out on civilians with the aim of intimidating those in positions of power. The TTP's activities fit well into this definition.

The direct costs of terrorist activities are not too difficult to measure. As is the case with natural disasters, the value of physical assets harmed or destroyed can be readily estimated. The indirect costs are, however, harder to measure. Klein (2007) observes that terrorists can hope to harm economies in various indirect ways, for instance, by

> reducing consumers' and firms' expectations for the future; [by] forcing the governments and the private sector to invest in security measures, which reduce efficiency in vulnerable industries (such as transportation and trade) and redirect investment away from productive economic uses; [and by] altering behavior by

> inducing economic actors (consumers, investors, businesses) to avoid areas of perceived risk (either sectors, such as tourism, or geographic areas affected by terrorism).[7]

The Institute of Public Policy's report used both direct and indirect costs to calculate the cost of terrorism up to 2009. However, as the Ministry of Interior report indicates, both the level of violence and its spread have increased significantly since 2011.

Economics also helps to identify some of the factors that have contributed to the rise of extremism in the country. Most analysts now recognize that income inequality has become a prominent feature of Pakistan's economic landscape. The Gini coefficient – one of the most frequently used measures of inequality – is not especially troubling for Pakistan. This is the case particularly when we compare the country's situation with that of other South Asian countries. However, official numbers and estimates do not tell the full story, for which we need to delve into the country's economic past.

Pakistan's three economic booms – 1963–66, 1984–87, and 2004–07 – all resulted from large foreign capital inflows, a good part of which went into activities that favored the relatively well-to-do segments of society and relatively better-off regions of the country. Each boom period was the result of public policy that favored the rich over the poor. Capital and consumption were rewarded over savings and labor. In the last five years, while the economy grew by only a little over 3 percent a year, consumption increased by about 20 percent per annum (not taking into account growth in the informal economy; see Chapter 2). This increase in consumption came from the withdrawal of capital from investment.

The poor and deprived do not look at Gini coefficients; they see what is in front of them – in this case, lavish consumption. Let us look at just one example of this. The string of wedding halls in the Lahore cantonment's Garrison Club are lit up even when the city is in the throes of load-shedding. This does not go unnoticed by those who have to deal with high rates of food inflation, an irregular supply of gas and electricity, and lack of job opportunities. There cannot be any doubt that this attracts the poor and the unemployed to the ranks of the terrorists. If the economy will not reward the poor, some of them are likely to vent their frustration by resorting to violence.

Problems with security have a negative impact on the economy in many other ways. One interesting insight is offered by the economists Samuel Bowles and Arjun Jayadev. While their work is concerned with developed countries, some of its conclusions apply to countries such as Pakistan that face a serious security problem. Correlating what they call "guard labor" per 10,000 workers with the incidence of inequality, they find that,

> However one totes up guard labor in the United States, there is a lot of it, and it seems to go along with economic inequality. States with high levels of income inequality employ twice as many security workers as less unequal states. When we look across more advanced industrialized countries we see the same pattern: the more inequality the more guard labor. Social spending, also, is strongly correlated with guard labor across the nations. There is a simple economic reason here: A nation whose policies result in substantial inequalities may end up spending more on guns and getting less butter as a result.[8]

With a Gini coefficient of 0.35, the US has the highest income inequality among developed countries; Denmark, with 0.23, and Sweden, with 0.24, have the lowest. The US has 160 people engaged as guard labor per 10,000 workers – the highest ratio among this group of nations. Sweden, with 55, has the lowest.

A similar pattern is evident in Pakistan. There are no firm estimates for the number of workers who belong to the category of "guard labor," but they are virtually ubiquitous in all the large cities. In addition to check-posts on the roads in the more well-to-do cities, gated communities protected by their own guards are becoming a common sight. Security firms are growing in number and size; this is one part of the services sector that is outperforming all others. To those who provide these functions, we must also add public sector security services – workers employed in the military and the police.

Guard labor does not add to the economy's overall productivity and efficiency, both of which are very low for Pakistan. The larger the proportion of people hired by security firms, the lower will be the number engaging in productive economic activities. As economists have long argued, an economy develops when workers engaged in low-productivity activities move to those that are more efficient in terms of the contribution they make to the economy. Those engaged in providing security may be well rewarded, but they make little or no contribution to economic welfare. This is another way in which extremism and terrorism damage the economy. There are, in other words, very good reasons for policymakers to see extremism as a serious economic issue and to focus on ways of making the country more secure. Bringing sustained growth to the economy and distributing its rewards evenly among different segments of the population and different regions of the country must rank high on policymakers' "to-do" list.

Extremism and associated terrorism has produced a vicious cycle that hurts the economy by reducing the incentive to invest. This, in turn, lowers the rate of GDP growth, making it more difficult to address the problem of poverty and income inequality. Pakistan's long-term growth trend has been downward, creating what appears to be an intractable security problem.

THE SHARIF GOVERNMENT'S WAVERING APPROACH

There are two seemingly short-term solutions and three that will take longer to yield satisfactory results. Negotiations with extremists and the use of overwhelming force – "shock and awe" in the American language – are two options at the opposite ends of the policy spectrum. The All Parties Conference held on 9 September 2013 appeared to reach a consensus agreeing to the first. This approach was given operational meaning by Prime Minister Nawaz Sharif in his long-awaited address to the National Assembly on 29 January 2014. After building the case against extremism and emphasizing the need for the government to assert its authority, Sharif decided to give the militants "another chance." He appointed a four-person committee of mostly former bureaucrats to negotiate with the TTP, the umbrella organization comprising various Islamist militant groups based in Pakistan.

The TTP's response was a clever one: initially, it nominated a five-person committee from among the ranks of the leadership of the established right-wing or Islamic parties that had some sympathy for the terrorist organization's list of demands. The original list included Imran Khan, president of the PTI, which had done well in the elections of May 2013 and headed the provincial government in KP. Khan turned down the TTP's offer, as did one other individual on the proposed roster. Those who accepted belonged to the religious groups and parties that believe the Sharia should be formally inducted into the Constitution as the form of governance for the country to follow.

The two negotiating groups held meetings starting on 6 February; the TTP-nominated team was taken to meet the TTP *shura* by government helicopter and returned with a long list of demands that included the withdrawal of military forces from FATA, the release of all militant prisoners, and the cessation of US drone strikes. On the government's side was the expectation that the TTP would reduce its terrorist activities. This did not happen and, if anything, the intensity of violence increased. On 13 February, the TTP took responsibility for carrying out an attack on a police van in Karachi in which 13 personnel were killed. Two days later, a Taliban-associated group in the Mohmand Agency killed 23 Frontier Constabulary soldiers who had been kidnapped a couple of years earlier. The killing of an army major followed in a gun battle near Peshawar. The terrorist organization gave its reason for these killings as follows:

> They said that the Pakistani military had illegally killed suspects in custody in Karachi and Peshawar, and that the 23 captured paramilitary soldiers had been killed in retaliation for that… Over all, Pakistani officials said on [19 February 2014], 460 people have been killed in violence connected to militant activity over the last five months, the period when the government was trying to engage the Taliban in peace talks.[9]

These incidents exhausted the patience of the military and initially that of the civilian authorities. In a meeting on 18 February chaired by the Prime Minister, the government-nominated negotiating committee stated that it could not carry on with its task unless the TTP declared an unconditional ceasefire. The latter responded by demanding that the government move first with a ceasefire.

On 20 February, Prime Minister Nawaz Sharif ordered the military to use fighter planes and helicopter gunships to pound militants' hideouts in North Waziristan and the Khyber tribal agencies. The government reported that 35 militants were killed on the first day of strikes but stopped short of announcing a full-fledged military offensive. General Raheel Sharif, who had taken command of the army in late November, was "described by Pakistani and Western officials as robust in comparison with his predecessor, General Ashfaq Kayani, who was seen as more circumspect and cautious."[10] The attacks continued the following day when new hideouts were targeted and more casualties suffered by the militants.

The Sharif government, frustrated by the TTP's response to its offer to negotiate an end to militant activities, seemed to have decided to use force. A front-page story in the *Washington Post* observed that "the Pakistani government was on the verge of launching a major military offensive in the North Waziristan tribal region after brutal Taliban attacks in recent weeks and the apparent failure of peace talks with the militants."[11] The story quoted a military official as saying that the operation could begin any day and that "military plans have been shared with the top US officials who have long urged an offensive."[12]

Islamabad had recently received CIA Director John Brennan and General Lloyd J. Johnson III, head of the US Central Command. The *Washington Post* reported that, "with 150,000 troops already based in the tribal regions, … the government is prepared to begin a full-fledged clearing operation."[13] A senior Pakistani official was quoted as saying that "'We really don't have to start from scratch.' He said an official evacuation had yet to begin but noted that tens of thousands of residents, who he said were 'spooked' by reports of an imminent government attack, had left on their own."[14] Even Imran Khan indicated that military action was inevitable although he contended that talks would have been a better option. The Sindh-based Muttahida Qaumi Movement, too, had been consulted and was on board.

The slow pace at which the government moved after having decided to use force to bring the extremists in line was frustrating for those who had clamored for military action for some time. Islamabad felt it needed to plan carefully before launching a full-fledged military operation in areas that the extremist groups had held for a long time with ample opportunity to consolidate their position. While the government's initial response was in the form of air attacks, military strategists advised that "boots on the ground" would be needed to clear the targeted areas. According to Spearhead, a Lahore-based think-tank operated by General (Retired) Jehangir Karamat, a former chief of army staff,

> The air strikes being carried out are effective. All reports indicate disarray within TTP ranks. A boots on the ground military operation, however, has to be undertaken and it is this realization that is prompting armchair specialists to speculate [about the nature of the operation]. Guaranteed success of such an operation is absolutely vital. For this reason a joint political-military-foreign policy preparatory maneuver is important. This must ensure the support, or failing that then at least non-interference of the US, the Afghan government, Iran, India and the Middle Eastern countries that fund different entities. This maneuver must bring in the US presence in Afghanistan and the Afghan government forces in support of the military by taking mutually coordinated steps on the Afghan side of the Afghan-Pak border. Iran's cooperation and support is especially important. The military operation itself will involve stopping and interdicting all inter – and intra-agency movement in FATA, into Afghanistan and into mainland Pakistan as multiple directions are used to clear areas and establish the writ of the government. The care of internally displaced persons (IDPs) and the [establishment of] follow-up civil administration to control and rehabilitate the cleared areas will have to be part of the overall plan.[15]

Such an operation, regardless of form, is likely to take a long time to bring about the required results. It will also incur economic costs, not just in terms of the damage that terrorists are likely to inflict when they retaliate, but also in diverting the attention of senior policymakers away from economic matters.

Fearful of a large-scale military operation, the TTP decided to play for time. On 1 March, TTP spokesperson Shahidullah Shahid announced that the group was going to observe a month-long ceasefire to resume the suspended negotiations. "The senior leadership directs all constituents and groups to respect and fully abide by the ceasefire declaration and restrain themselves from all kinds of jihadist activities,"[16] read the statement posted on the Internet. While there was no formal government response, Irfan Siddiqui, a member of the government-appointed peace committee, called it a "welcome move." The truce was announced just hours after two bombings killed 13 people and wounded 10 in an attack on a polio vaccination team in KP.

Several analysts have tried to explain why the Taliban offered a ceasefire. In a report in the *New*

York Times, General (Retd.) Talat Masood was quoted as saying that “the military [had] showed its resolve with surgical strikes and there was every likelihood of a military offensive in subsequent weeks.”[17] Masood also suggested that the Taliban had come under pressure from Hafiz Gul Bahadur, a local warlord, and the Haqqani network, “a feared militant group that operates in Pakistan and Afghanistan and is involved in attacks on American troops in Afghanistan.”[18]

Washington had long pressured Islamabad to move against this group to ease the pressure on US forces operating in southeastern Afghanistan. The Pakistan government had resisted, largely because of the strong relationship the group had with the ISI. The intelligence agency wanted to keep the Haqqani forces in reserve in case the ISAF withdrawal in 2014 plunged Afghanistan into civil war once again. Bahadar, the other possible source of pressure on the TTP, has maintained a truce with the Pakistani military since 2009.

A day after the TTP’s announcement, the interior minister said that the air campaign was being suspended in response. However, it was not clear whether the TTP was in full control of the various groups that operate under its umbrella. A day after the ceasefire was declared, a major operation was carried out in Islamabad, by far the most heavily guarded urban area. At least 11 people were killed and 25 injured when unidentified gunmen opened fire and detonated explosives in the Islamabad district courts. The motive behind the attack was unclear. The TTP’s spokesperson, Shahidullah Shahid, said that his organization had “nothing to do with the attack… We have announced a ceasefire, and we will follow it for one month.”[19]

The fact that two suicide bombers engaged in the attack suggests the involvement of a well-organized, well-resourced group. That the attackers had shot and killed a young female lawyer at pointblank was also cause for concern and reminiscent of the attack on Malala Yousafzai in Swat in 2011 – an episode for which the TTP head, Mullah Fazlullah,[20] had taken full responsibility.

There were other indications that the attack was well thought through. The main target was an additional district and sessions court judge, Rafaqat Ahmed Khan, who had shown a liberal bent in several cases. In April 2014, he dismissed a petition filed by the son of Lal Masjid cleric Abdul Rashid Ghazi, who asked that a “first information report” be registered against former President Pervez Musharraf for launching the 2007 military operation on the mosque. In dismissing the request, the judge said that the petition had no substance since it was filed six years after the incident had occurred: the purpose was to gain publicity.

Eventually, an obscure cell calling itself Ahrar-ul-Hind – thought to be a splinter group from the TTP – claimed responsibility for the Islamabad attack. The group issued a statement saying that it had carried out the attack to show its displeasure with the peace process. "Our fight will continue," said its spokesperson Asad Mansoor, and "we will carry on attacks on urban areas, police and markets until there is complete imposition of sharia law."[21]

The *New York Times* reported that, "Afterward, Prime Minister Nawaz Sharif held an emergency meeting with the army chief, General Raheel Sharif, and the head of the Inter-Services Intelligence directorate, Lt. Gen. Zahir ul Islam. No details of the meeting were made public, and it was unclear what effect the attack might have on often-derailed efforts to open negotiations with the Pakistani Taliban."[22] There was no doubt that the government faced a daunting task, given that some 40 militant groups are thought to be operating across the country. The attack on a supposedly secure site had sent shockwaves through the city. According to one assessment, "although there were numerous attacks in Islamabad from 2006 to 2009, including the 2008 bombing of the Marriott Hotel, which killed 56 people, Islamabad has been relatively secure in recent years. It is home to government ministries and foreign embassies, and Pakistani security officials, visible throughout the city, closely scrutinize the movements of Pakistanis who do not reside in the capital."[23]

The Prime Minister was not, however, prepared to change course. He met with the team that had been working with the TTP representatives and ordered them back to the negotiating table. The two sides then met at Akora Khattak, the site of a number of well-established seminaries, and seemed to agree on the modalities of the dialogue. Nonetheless, this off-and-on approach is bound to lose the government the political support – in particular, that of the middle class – on which basis it won a massive victory in May 2013.

The Economist offers a correct appreciation of the situation Pakistan faces. A recent story about the Taliban is accompanied by a cartoon that shows Nawaz Sharif bowling to a bearded and turbaned Taliban who is aiming to hit the ball not with a bat but with an AK 47 rifle. The cartoon is a play on a remark made (presumably in jest) by Interior Minister Chaudhry Nisar Ali Khan, who suggested the TTP might like to participate in a cricket match to foster peace rather than continue their attacks. A Taliban spokesman demurred, saying that they considered the game un-Islamic. But cricket was not on people's minds, and as *The Economist* notes:

> The country's army, and many civilian critics, say that, with almost 500 people killed since September, Pakistan's domestic terrorism is out of hand and that [the prime minister] must take a hard line. The prime minister's hope of reviving the economy with the help of foreign investment will also be jeopardized by continued violence, they warn. And yet Mr Sharif and many members of his party fear

> confrontation will trigger horrific retaliation in their political heartland of Punjab, the rich, populous province so far unscathed by militant attacks. They may be right.[24]

This wavering on the government's part has worsened the situation and persuaded the extremists that the state does not have the stomach or political will to take them on with full force. The impression that the Punjab-based ruling party is inclined to protect its province, even when many other parts of the country are under severe terrorist assault, could pose another existential threat – further weakening the state and compromising nationhood.

There are many reasons why extremism has such deep roots in Pakistan. As discussed earlier, economic deprivation and growing income equality are two of the more important ones. Also important, however, is indoctrination, which has played a major role in Pakistan. Over the last several decades – especially after the end of the Soviet Union's occupation of Afghanistan – a highly motivated, indoctrinated, and well-trained segment of the population has turned its attention inward rather than to its perceived enemies across the border. Members and sympathizers of such groups have been led to believe that their future depends on their ability to change social structures and laws. They want to see the state and its institutions conform to a romantic notion of what they believe is the Islamic way. Moreover, they are willing to use violence, often indiscriminately, to bring about such a change.

While the new government has given considerable attention to the problem of extremism, it has focused largely on groups operating from the tribal areas bordering Afghanistan. The problem of violence in Karachi has received some attention but not as much as the activities of the Taliban. Sectarian violence has been largely ignored, in part because of the close relations between the Saudis and the Sharif family. There have been several high-level visits by the Saudis to Islamabad, giving credence to the impression that Pakistan – with the largest army in the Muslim world – was being asked by Riyadh to lend support to its favored groups in the civil war in Syria. A positive response from Islamabad to these overtures will plunge the country deep into the Middle East quagmire when it already has so many problems of its own.

A SUGGESTED RESPONSE FOR THE STATE

The state's response to the challenge posed by extremism has been hesitant, tepid, and ambiguous. This has only encouraged the forces of extremism to intensify their activities, expand their ambitions, and become even less accommodating. They see an opportunity in the state's weak resolve, which has encouraged them to do more and demand more. This has left a vicious cycle in place that can only be broken if the state develops a comprehensive program it is prepared to implement with total resolve. It will also need to stay the course and not fall into the traps the terrorists have laid and will continue to lay. One such trap was the month-long ceasefire announced by the TTP on 1 March 2014.

As indicated in the Ministry of Interior report, the rise of extremism has cost the economy dearly and in several different ways. There is also now an appreciation that efforts to revive the economy will come to naught unless extremist forces are brought under control and peace returns to all parts of the country. Examples from other parts of the world show that widespread violence has a highly negative impact on economic progress. Only by bringing it under control can a stalled economy be made to move again. What economic historians have called the “lost decades” in Latin America – the 1980s and 1990s – were, in large part, a consequence of uncontrolled (and seemingly uncontrollable) violence.

What should be the main elements of the state’s strategy aimed at checking the rise of extremism? We believe it should focus on at least the following six policy sub-sets, followed by some long-term initiatives.

First, a clear message has to be given to all segments of society that any defiance of the state’s authority and the laws of the land will not go unpunished. This is why negotiating with those who have systematically defied the state can be counterproductive: it shows the state does not feel it is strong enough to enforce the laws on which its own existence depends. The state cannot “play cricket” with those who are operating outside the established legal order.

Second, the public should be fully apprised of the various aspects of extremism. For some reason, the interior ministry has chosen to keep under wraps the report it has completed, parts of which have been discussed in the National Assembly. Making it public will increase people’s awareness of the damage that extremism has already caused. Increasing this awareness will also prepare the public for problems they will have to deal with at an early stage of a well thought-out plan against extremism. Terrorists are bound to hit back hard once they come under pressure from the security forces.

Third, it is important to recognize that the rise of extremism was a consequence of the weakening of the state. In this context, the meaning of the state has to be interpreted more widely. It should include not only the working of the executive branch but also the judiciary. The lower-level judiciary, for instance, has not played a constructive role in enforcing the laws that terrorists routinely violate. Terrorists and extremists have been able to intimidate magistrates and judges. The 3 March attack on Islamabad’s district courts has made the judiciary even more hesitant to deal with terrorism.

Fourth, maintaining law and order has to be the responsibility of the police; experience in the developed world indicates that those police forces are effective that are responsible to the elected local authorities. In Pakistan, police management is highly centralized with little stake in preserving peace in the local jurisdictions to which its personnel are sent. In Punjab, for instance, the provincial police force is under the control of the inspector general – an official located in Lahore and belonging to the Police Service of Pakistan.

Fifth, it should be clearly indicated to all citizens that any changes in the state's structure and the laws and regulations on which they are based can only be brought about through legislative action. The use of force cannot be accepted as the means to achieving this end. The Constitution is a document that all citizens must respect.

Sixth, the government must move as close to the people as possible. The provincial governments are still too removed from their local communities to effectively deliver public services. A serious and sustained effort needs to be made to satisfy people's aspirations. In a society where youth account for a significant proportion of the total, opportunities must be created to provide productive employment. Only community-based organizations can develop and implement programs for the economic and social uplift of the local population. Unfortunately, Punjab, the country's most populous province, has moved in the opposite direction. It has abandoned the system of devolution introduced under the Local Government Ordinance of 2001 in favor of a structure that will allow the provincial capital almost complete authority over local councils. In contrast, the devolution system had created the office of the *nazim*, an elected official who had full authority over officials sent out to his area by the provincial government.

The long-term approach has three elements that could help change the prevailing system of beliefs and social values, provide economic opportunities for youth, and reduce personal and regional income disparities. The first will involve modernizing the system of education and bringing about a fundamental change in the way seminaries operate. The curriculum they follow must conform to those taught in secular schools. A major effort will have to be made to produce textbooks that accurately reflect the country's history; instill respect for all belief and value systems; and emphasize the teaching of science, mathematics, and English.

Second, in designing public policies for rescuing the economy – an effort in which the Planning Commission is currently engaged as it prepares its "2025 Vision" document – job creation must be given high priority. Third, the government needs to redefine the role of the state by limiting it essentially to large infrastructure projects and the regulation of private enterprise. Most of the enterprises currently under state control should be handed over to the private sector. This will help shed employees who were recruited in the public sector for political reasons or in return for "rents" charged by their employers. If the economy picks up – as it should – this will create opportunities for the temporarily unemployed.

CONCLUSION

The government's initial approach in favor of dialogue with extremist outfits was a nonstarter. Negotiations can produce results only when the contending parties each have something to give. By definition, extremists are unlikely to yield ground and the state cannot possibly compromise and yield space that would weaken it. The state, after all, represents the will of the large majority of the population. It must demand total allegiance to the basic law (the Constitution) under which it operates. Any challenge to the state, such as that posed by the TTP, cannot be accepted. The use of force is necessary to ensure that those operating outside the accepted legal framework either enter it or are completely pushed out.

While the national debate continues as to the wisdom of the government's decision to negotiate peace with a banned terrorist organization, it would be appropriate to reflect on why a group of backward, mostly illiterate, leaders have managed to acquire so much power. Those who oppose the idea of negotiating peace with a group that refuses to swear allegiance to the Constitution correctly argue that the mere fact of sitting down at the table with them gives them a status they do not deserve. If Pakistan fails to bring extremism and violence under control, it will end up paying a heavy price in terms of the state's integrity.

The way the Sharif government has handled the problem of extremism could have broader political consequences. There are signs of growing military impatience with Islamabad's methods in this area. Our contention is that one of the positives of the country's current situation might not hold if the seeming tension between the military and civilian leadership increases.

Finally, unless it brings extremism under control, Pakistan will continue to be treated as an outlier in the international community. It will be shunned by foreign investors whose capital and technology it badly needs to modernize the economy and move forward. The absence of security has isolated the country. The fact that no Western airline flies to Pakistan is just one indication of this isolation. Some analysts have even suggested that the country has begun to unravel.

Statistical Appendix

Key Indicators

Statistical Appendix
Key Indicators

Table A-1
Level and Pattern of Growth
(Base Year 2005/06)

	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	9.88	-2.2	6.33	0.78
2001/02	3.1	6.10	-0.2	4.37	0.88
2002/03	4.7	4.06	1.4	4.10	1.14
2003/04	7.5	2.30	3.9	10.19	0.59
2004/05	9.0	2.03	4.8	11.62	0.92
2005/06	5.8	3.43	0.6	17.38	0.74
2006/07	5.5	3.50	-0.5	3.38	0.86
2007/08	5.0	3.86	-1.5	5.43	0.83
2008/09	0.4	7.02	-6.2	5.82	3.90
2009/10	2.6	6.47	-2.6	3.73	1.07
2010/11	3.7	4.16	-0.2	8.89	0.96
2011/12	4.4	3.42	0.9	3.21	0.97
2012/13	3.6	4.02	0.4	1.75	1.01
Average	**4.4**	**4.63**	**-0.1**	**6.63**	**1.13**

n.c. = not computed

Source: Pakistan Economic Survey (various issues)

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

b Computed as the weighted (share of value added in 2005-06) standard deviation of the growth rates of individual sectors during a particular year. The larger the magnitude of this indicator the less the extent of balanced growth

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

Table A-2
Level and Pattern of Investment
(Base Year 2005/06)

	Gross Domestic Capital Formation (% of GDP)	National Savings as % of Investment	Private Investment as % of Total Fixed Investment	Share of Private Investment in Labor Intensive Sectors (%)
1999/2000	17.4	91.0	65.0	51.6
2000/01	17.2	95.8	64.6	46.0
2001/02	16.8	110.7	72.9	39.8
2002/03	16.9	123.1	73.9	38.6
2003/04	16.6	107.8	72.7	38.6
2004/05	19.1	91.5	74.9	42.9
2005/06	19.3	78.8	76.3	34.3
2006/07	18.8	74.5	73.3	35.4
2007/08	19.2	57.3	72.7	35.2
2008/09	17.5	68.6	73.6	39.7
2009/10	15.8	86.1	73.9	45.4
2010/11	14.1	100.7	74.4	49.8
2011/12	14.9	85.9	72.2	51.4
2012/13	14.2	95.1	69.0	55.5
Average	**17.0**	**90.5**	**72.1**	**43.2**

Source: Pakistan Economic Survey (various issues)

Table A-3
Agricultural Growth and Profitability
(Base Year 2005/06)

	Growth Rate (%)	Share of Growth in Crop Sector (%)	Volatility in Agriculture Growth[a] (%)	Change in Ratio of Output Prices to Fertilizer Prices (%)	Change in Agriculture Terms of Trade with Manufacturing (%)
1999/2000	n.a.	n.a.	1.1	6.6	n.a.
2000/01	-2.2	n.c.	-7.1	-3.8	4.6
2001/02	0.1	n.c.	-2.0	-5.4	0.0
2002/03	4.1	57.8	2.0	-0.3	-0.8
2003/04	2.4	42.4	0.4	-0.3	0.2
2004/05	6.5	90.9	4.4	-4.8	-2.1
2005/06	6.3	n.c.	4.1	-4.1	-6.7
2006/07	3.4	55.8	-0.5	10.2	4.2
2007/08	1.8	n.c.	-2.7	-20.6	-4.2
2008/09	3.5	62.5	-0.6	-10.0	9.6
2009/10	0.2	n.c	-4.1	17.3	1.0
2010/11	2.0	20.8	-1.1	-4.9	3.3
2011/12	3.5	33.8	1.3	-48.4	-8.8
2012/13	3.3	38.7	1.2	13.7	8.3
Average	**2.7**	**n.c**	**-0.3**	**-3.9**	**0.7**

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
(Base Year 2005/06)

	Growth Rate (%)	Growth Rate of Export Oriented Industries (%)	Growth Rate of Import Substituting Industries (%)	Share of Growth in Large-Scale Manufacturing (%)	Growth Rate of Manufactured Exports (%)
1999/2000	1.5				
2000/01	9.3	27.6	4.6	76.3	6.2
2001/02	4.5	9.7	3.1	52.0	1.5
2002/03	6.9	4.3	7.6	68.2	22.2
2003/04	14	8.0	15.5	84.6	11.6
2004/05	15.5	26.5	12.7	87.0	15.6
2005/06	8.7	5.9	11.1	75.2	14.4
2006/07	9.0	9.9	7.5	74.3	3.4
2007/08	6.1	12.8	2.3	58.9	12.2
2008/09	-4.2	4.3	-2.4	n.c.	3.3
2009/10	1.4	6.5	14.8	24.9	0.4
2010/11	2.5	4.7	3.8	54.8	20.3
2011/12	2.1	0.5	4.5	45.3	1.2
2012/13	4.3	1.9	6.3	65.7	0.6
Average	**6.2**	**9.4**	**7.0**	**63.9**	**9.1**

n.c. = not computed

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

Table A-5
Growth in Employment by Sector

	Employment (000)					2001/02 to 2012/13		
	2001/02	2005/06	2007/08	2009/10	2012/13	Employment Growth Rate (%)	Value Added Growth Rate (%)	Employment Elasticity
Agriculture	20474	19075	21894	23945	24476	1.6	3.4	0.48
Manufacturing and Mining	4982	5421	6382	7024	7897	4.3	5.7	0.76
Electricity and Gas [a]	299	296	n.a	n.a	n.a	-0.3	3.9	-0.07
Construction	2757	3579	3093	3565	4145	3.8	3.9	0.96
Wholesale and Retail Trade	5090	6635	7167	8673	8065	4.3	3.6	1.19
Transport and Communication	2216	2452	2700	2820	3081	3.0	4.6	0.66
Finance and Insurance [a]	247	491	n.a	n.a	n.a	18.7	17.9	1.05
Public Administration and Community Services	7151	8405	6725	5960	7449	0.4	6.1	0.07
Total	**43286**	**46365**	**49090**	**53210**	**56010**	**2.4**	**4.7**	**0.51**

n.a = not available

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

[a] Period of estimation for these two sectors is 2001-02 to 2005-06, mainly because LFS has stopped giving numbers for them

Table A-6
Inflationary Trends

	Rate of Inflation (Consumer Prices) (%)	Rate of Inflation (Food Prices) (%)	Core Rate of Inflation (Non-Food Non-energy) (%)	Rate of Inflation in Import Prices (%)	Rate of Monetary Expansion less GDP Growth (%)
1999/2000	3.6	-	n.a	16.0	5.5
2000/01	4.4	3.6	n.a	15.2	7.0
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	9.4
2006/07	7.8	10.3	6.9	7.6	13.8
2007/08	12.0	17.6	10.2	27.7	10.3
2008/09	17.0	23.5	11.4	25.1	9.2
2009/10	10.1	12.6	7.6	6.2	9.9
2010/11	13.7	18.3	9.4	20.7	12.2
2011/12	11.0	11.0	10.6	21.8	9.8
2012/13	7.4	7.1	9.6	7.8	12.3
Average	**8.2**	**10.4**	**9.3**	**13.9**	**10.5**

n.a = not available

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

Table A-7
Fiscal Policy

(*Percentage of GDP*)

	Revenues[a]	Expenditure[b]	Non-Interest Current Expenditure[c]	Budget Balance[d]	Revenue Deficit/Surplus[e]
1999/2000	13.4	18.5	9.5	-5.1	-3.0
2000/01	13.1	17.1	9.4	-4.0	-2.2
2001/02	14.0	18.6	9.6	-4.6	-1.7
2002/03	14.8	18.4	11.4	-3.6	-1.5
2003/04	14.1	16.9	9.8	-2.8	0.3
2004/05	13.8	17.2	9.7	-3.4	0.5
2005/06	14.0	18.2	10.2	-4.2	-0.5
2006/07	14.9	19.2	11.4	-4.3	-0.9
2007/08	14.3	21.7	13.1	-7.4	-3.5
2008/09	14.1	19.3	10.9	-5.2	-1.5
2009/10	14.2	20.5	12.3	-6.3	-2.7
2010/11	12.5	19.1	12.2	-6.6	-3.6
2011/12	12.4	19.1	10.8	-8.5	-2.7
2012/13	13.0	21.0	11.7	-8.0	-3.0
Average	**13.8**	**18.9**	**10.9**	**-5.3**	**-1.8**

Source: Pakistan Economic Survey (various issues)
SBP, Annual Reports (various issues)
MofF, Fiscal Operations

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

Table A-8
Fiscal Policy
(Base Year 2005/06)

	Primary Balance[a] (% of GDP)	Total Government Debt[b] (% of GDP)	Effective Interest Rate on Domestic Debt[c] (%)	% of Deficit Financed by Bank Borrowing (%)
1999/2000	n.a	77.7	14.1	19.3
2000/01	1.3	82.4	11.3	-18.4
2001/02	0.1	73.1	12.4	7.4
2002/03	0.4	68.9	10.2	-30.5
2003/04	1.1	62.3	9.4	47.4
2004/05	0.3	58.0	8.5	27.7
2005/06	-0.9	53.1	10.2	21.8
2006/07	-1.3	52.1	13.8	37.5
2007/08	-2.6	56.8	13.7	80.5
2008/09	-0.2	57.8	12.9	54.2
2009/10	-1.8	59.9	12.4	32.8
2010/11	-2.7	58.5	10.5	51.5
2011/12	-2.4	63.0	10.7	52.0
2012/13	-3.7	62.7	9.7	79.5
Average	**-1.0**	**63.3**	**11.4**	**33.1**

n.a = not available

Source: Pakistan Economic Survey (various issues)
SBP, Annual Reports (various issues)
Ministry of Finance, Fiscal Operations
Ministry of Finance, Debt Policy Statements

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

Table A-9

Effective Tax Rates

(Tax Revenues as percentage of Tax Base[a])

	Income Tax (%)	Customs Duty (%)	Excise Duty (%)	Sales Tax (%)	Total FBR Taxes (%)
1999/2000	4.3	19.1	6.4	11.6	9.1
2000/01	4.2	17.8	4.7	13.1	9.3
2001/02	4.5	12.0	4.3	14.1	9.1
2002/03	4.4	14.8	3.6	14.8	9.4
2003/04	4.0	14.3	3.1	12.7	9.2
2004/05	3.8	11.2	2.9	10.0	9.1
2005/06	3.9	12.1	2.4	10.3	9.4
2006/07	5.0	10.5	2.7	9.9	9.7
2007/08	4.9	7.6	2.9	10.0	9.8
2008/09	4.6	5.7	5.7	10.0	9.1
2009/10	4.8	5.7	5.0	10.1	8.9
2010/11	4.4	5.6	4.3	10.3	8.6
2011/12	4.6	5.6	3.3	11.0	9.1
2012/13	4.4	6.2	3.2	10.8	9.7
Average	**4.4**	**10.6**	**3.9**	**11.3**	**9.3**

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

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

Table A-10

Monetary Policy

	Net Foreign Assets[a] (% Change of broad money)	Net Domestic Assets[b] (% Change of broad money)	Private Credit Growth (%)	Interest Rate on Six Month Treasury Bill (%)	Broad Money Growth (%)	Interest Rate Spread[c] (%)
1999/2000	2.0	7.4	1.4	8.8	9.4	8.0
2000/01	5.1	3.9	4.0	10.4	9.0	8.3
2001/02	13.4	2.0	4.8	8.2	15.4	9.6
2002/03	17.5	0.5	18.9	4.1	18.0	7.8
2003/04	2.1	17.5	29.8	1.7	19.6	6.3
2004/05	2.2	17.1	33.2	4.7	19.3	7.4
2005/06	2.5	12.4	23.2	8.5	14.9	8.7
2006/07	8.1	11.3	17.2	8.9	19.3	9.0
2007/08	-7.8	23.2	16.4	11.5	15.3	8.4
2008/09	-3.2	12.8	0.7	12.0	9.6	9.8
2009/10	-6.9	0.8	3.9	12.3	12.5	9.3
2010/11	23.5	-2.4	4.0	13.7	15.9	9.0
2011/12	-40.2	5.3	7.5	11.9	14.1	8.3
2012/13	-56.4	4.2	-0.6	8.9	15.9	7.3
Average	**-2.7**	**8.3**	**11.7**	**9.0**	**14.9**	**8.4**

Source: State Bank of Pakistan, Annual Report (various issues)
IMF Article 4 Consultation's Press Releases

[a]Growth rate of net foreign assets/broad money ratio
[b]Growth rate of net domestic assets/broad money ratio
[c]Difference between the interest rate on advances and deposits

Table A-11

Level and Pattern of Trade

	Merchandise Export Growth (US $; %)	Extent of Product Diversification of Exports[a]	Extent of Market Diversification of Exports[a]	Merchandise Import Growth (US $; %)
1999/2000	11.2	0.801	0.23	13.1
2000/01	12.5	0.798	0.221	14.3
2001/02	2.3	0.786	0.221	-7.5
2002/03	20.1	0.791	0.223	20.1
2003/04	13.5	0.782	0.232	21.2
2004/05	16.2	0.778	0.218	38.3
2005/06	14.3	0.769	0.229	31.7
2006/07	3.2	0.737	0.228	8.0
2007/08	16.5	0.722	0.210	31.2
2008/09	-6.4	0.709	0.202	-10.3
2009/10	2.9	0.717	0.199	-1.7
2010/11	28.9	0.697	0.184	14.9
2011/12	-2.6	0.722	0.183	12.8
2012/13	0.4	n.a	n.a	-0.6
Average	**9.5**	**0.763**	**0.214**	**13.3**

n.a = not available

Source: Pakistan Economic Survey (Various issues)
United Nations Conference on Trade and Development

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

Table A-11 (Contd.)

Level and Pattern of Trade

	Change in Terms of Trade (%)	Share of Essential Imports[a] (%)
1999/2000	-15.3	39.3
2000/01	-7.1	39.3
2001/02	-0.2	36.7
2002/03	-9.6	35.0
2003/04	-4.1	28.8
2004/05	-6.5	25.0
2005/06	-11.7	30.7
2006/07	-3.7	29.1
2007/08	-11.5	38.9
2008/09	2.8	41.9
2009/10	0.0	42.3
2010/11	2.8	42.7
2011/12	-5.9	45.8
2012/13	-2.4	42.6
Average	**-5.2**	**37.0**

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	Net Reserves (US $ Million)	Gross Reserves (In months of next years imports of goods and services)	Change in Value of Pakistani Rupee per US $ (%)	Change in Real Effective Exchange Rate (%)
1999/2000	-1.6	322.1	908	0.9	3.0	-0.6
2000/01	-2.7	309.4	1679	1.7	12.8	-2.5
2001/02	3.9	282.0	4337	3.7	5.1	-2.6
2002/03	4.9	229.0	9529	6.5	-4.7	-0.1
2003/04	1.8	209.5	10564	5.0	-1.5	-1.8
2004/05	-1.4	183.7	9805	3.5	3.1	0.3
2005/06	-3.9	167.2	10760	3.7	0.8	5.3
2006/07	-4.8	169.2	13345	4.5	1.3	0.5
2007/08	-8.4	169.7	8577	2.7	3.2	-1.12
2008/09	-5.5	212.9	9118	2.8	25.5	-1.0
2009/10	-2.3	218.9	12958	2.9	6.8	1.0
2010/11	0.1	204.9	14784	3.6	2.0	6.5
2011/12	-2.1	212.2	10803	2.9	4.4	3.1
2012/13	-1.0	182.3	6008	1.5	8.4	-1.3
Average	**-1.6**	**219.5**	**8798**	**3.3**	**5.0**	**0.4**

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

Table A-13
Trend in Income Inequality Growth in Real Per Capita Income by Quintile
(At real prices of 2007/08)

(*Annual Growth Rate, percent*)

	QUINTILE					
	Total	1st	2nd	3rd	4th	5th
2001/02 to 2005/06						
Pakistan	**7.8**	**4.8**	**6.0**	**6.7**	**7.7**	**9.6**
Urban	4.4	0.5	1.7	3.0	2.1	5.0
Rural	9.3	5.7	7.2	8.0	10.6	14.2
2005/06 to 2007/08						
Pakistan	**-1.0**	**-1.3**	**0.7**	**-1.8**	**-1.6**	**-0.6**
Urban	-0.2	3.7	2.1	-0.9	0.7	-0.4
Rural	-1.5	-2.2	-1.6	-2.3	-2.8	-0.7
2001/02 to 2007/08						
Pakistan	**4.7**	**2.5**	**3.6**	**3.4**	**4.2**	**5.9**
Urban	2.8	2.2	2.2	1.5	1.7	3.1
Rural	5.3	2.6	3.9	4.1	5.4	8.9
2007/08 to 2010/11						
Pakistan	**1.5**	**1.3**	**1.5**	**1.6**	**1.5**	**1.2**
Urban	3.2	1.0	-0.9	2.5	2.0	3.2
Rural	0.1	1.4	2.3	1.2	1.2	-2.5
2001/02 to 2011/12						
Pakistan	**3.7**	**2.0**	**2.6**	**3.0**	**3.9**	**4.5**
Urban	3.5	1.0	1.2	1.9	3.3	13.8
Rural	3.3	2.2	3.0	3.3	4.0	4.3

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

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

	1998/99	2001/02	2006/07	2007/08	2008/09	2010/11	2012/13
Gross Primary Enrolment Rate							
Punjab	75	76	100	97	97	98	98
Sindh	64	63	79	80	84	84	81
K-PK	70	77	82	83	87	89	91
Balochistan	64	62	72	75	75	74	73
Max/Min Ratio	**1.172**	**1.242**	**1.389**	**1.293**	**1.293**	**1.324**	**1.342**
Net Primary Enrolment Rate							
Punjab	44	45	62	61	62	61	62
Sindh	41	40	50	51	54	53	52
K-PK	39	41	49	49	52	51	54
Balochistan	36	32	41	41	44	47	45
Max/Min Ratio	**1.222**	**1.406**	**1.512**	**1.488**	**1.409**	**1.298**	**1.378**
Gross Middle Enrolment Rate							
Punjab	43	45	55	59	57	58	60
Sindh	38	34	43	46	49	48	48
K-PK	37	38	53	52	54	57	61
Balochistan	29	33	34	35	36	35	39
Max/Min Ratio	**1.483**	**1.364**	**1.618**	**1.686**	**1.583**	**1.657**	**1.564**
Net Middle Enrolment Rate							
Punjab	19	18	20	19	22	23	25
Sindh	17	14	17	18	18	19	19
Khyber-Pakhtunkhwa	11	12	16	14	17	17	21
Balochistan	9	8	9	12	11	13	14
Max/Min Ratio	**2.111**	**2.250**	**2.222**	**1.583**	**2.000**	**1.769**	**1.786**
Gross Matric Enrolment Rate							
Punjab	37	44	51	54	57	61	62
Sindh	51	42	45	44	50	55	54
K-PK	36	41	45	48	51	54	58
Balochistan	41	29	33	34	34	38	37
Max/Min Ratio	**1.244**	**1.517**	**1.545**	**1.588**	**1.676**	**1.605**	**1.676**
Net Matric Enrolment Rate							
Punjab	12	12	11	13	13	14	15
Sindh	10	13	10	11	11	11	12
K-PK	6	10	6	6	8	7	10
Balochistan	3	6	5	5	5	6	6
Max/Min Ratio	**4.000**	**2.000**	**2.200**	**2.600**	**2.600**	**2.333**	**2.500**
Literacy Rate (10 +)							
Punjab	46	47	58	59	59	60	62
Sindh	51	46	55	56	59	59	60
K-PK	37	38	47	49	50	50	52
Balochistan	36	36	42	46	45	41	44
Max/Min Ratio	**1.417**	**1.306**	**1.381**	**1.283**	**1.311**	**1.463**	**1.409**
Full Immunisation							
Punjab	55	57	83	76	85	86	89
Sindh	38	45	65	67	69	75	74
K-PK	54	57	76	74	73	77	76
Balochistan	34	24	54	57	43	56	53
Max/Min Ratio	**1.618**	**2.375**	**1.537**	**1.333**	**1.977**	**1.536**	**1.679**

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

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

Source	Type	INDICATORS: EARLIEST YEAR[a] Year	Number of Countires	Ranking[c]	LATEST YEAR[b] Year	Number of Countries	Ranking[c]
1 Transparency International (TI)	Corruption Perception Index (CPI)	1995	41	39	2013	177	134
2 Freedom House (Freedom in the World)	Political Rights Score	2002	151	131	2013	195	126
	Civil Liberties Score	2002	151	135	2013	195	142
	Status	2002	Not Free	-	2013	Partly Free	-
3 Freedom House (Countries at the Crossroads)	Civil Liberties	2004	30	28	2011	35	28
	Rule of Law	2004	30	27	2011	35	21
	Anticorruption and Transparency	2004	30	22	2011	35	24
	Accountability and Public Voice	2004	30	27	2011	35	12
4 Freedom House (Countries at the Crossroads)	Voice & Accountability	1996	191	123	2008	197	138
5 Freedom House (Press Freedom Survey)	Status	2002	Not Free	-	2009	Not Free	-
	Legal Environment	2002	187	172	2009	195	174
	Political Environment	2002	187	177	2009	195	178
	Economic Environment	2002	187	176	2009	195	172
	Total Score	2002	187	172	2009	195	175
6 World Bank Institute (Governance Matters)	Voice & Accountability	1996	194	139	2012	214	158
	Political Stability and Absence of Violence	1996	180	162	2012	213	212
	Government Effectiveness	1996	182	120	2012	212	165
	Regulatory Quality	1996	183	130	2012	212	149
	Rule of Law	1996	171	105	2012	214	170
	Control of Corruption	1996	154	127	2012	214	179
7 World Bank - World Development Indicators [Country Policy and Institutional Assessment (CPIA)	CPIA Building Human Resources Rating	2005	76	46	2012	80	54
	CPIA Business Regulatory Environment Rating	2005	76	15	2012	80	51
	CPIA Debt Policy Rating	2005	76	12	2012	80	41
	CPIA Economic Management Cluster Average	2005	76	15	2012	80	68
	CPIA Efficiency of Revenue Mobilisation Rating	2005	76	40	2012	80	68
	CPIA Equity of Public Resource Use Rating	2005	76	38	2012	80	43
	CPIA Financial Sector Rating	2005	76	1	2012	80	21
	CPIA Fiscal Policy Rating	2005	76	41	2012	80	71
	CPIA Gender Equality Rating	2005	76	75	2012	80	75
	CPIA Macroeconomic Management Rating	2005	76	17	2012	80	76
	CPIA Policies for Social Inclusion/Equity Cluster Average	2005	76	54	2012	80	53
	CPIA Policy and Institutions For Environmental Sustainability Rating	2005	76	22	2012	80	72
	CPIA Property Rights and Rule-Based Governance Rating	2005	76	41	2012	80	62
	CPIA Public Sector Management and Institutions Cluster Average	2005	76	39	2012	80	46
	CPIA Quality of Budgetary and Financial Management Rating	2005	76	34	2012	80	32
	CPIA Quality of Public Administration Rating	2005	76	19	2012	80	15
	CPIA Social Protection Rating	2005	76	55	2012	80	28
	CPIA Structural Policies Cluster Average	2005	76	2	2012	80	44
	CPIA Trade Rating	2005	76	37	2012	80	62
	CPIA Transparency, Accountability, and Corruption In The Public Sector Rating	2005	76	63	2012	80	61

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

		INDICATORS					
		EARLIEST YEAR[a]			LATEST YEAR[b]		
Source	Type	Year	Number of Countires	Ranking[c]	Year	Number of Countires	Ranking[c]
8 UNDP Human Development Report	Gender Empowerment Measure	1996	104	101	2007	109	99
9 Overseas Development Institute (World Governance Assessment)	Civil Society	1996	16	15	2000	16	16
	Political Society	1996	16	16	2000	16	16
	Government	1996	16	15	2000	16	16
	Bureaucracy	1996	16	14	2000	16	12
	Economic Society	1996	16	15	2000	16	13
	Judiciary	1996	16	16	2000	16	16
	Total	1996	16	15	2000	16	15
10 Human Rights Commitment (Danish Centre for Human Rights)	CPR Violations	2000	72	30	na		
	Formal Commitment	2000	72	15	na		
	Social Commitment	2000	72	41	na		
	Gender Commitment	2000	72	42	na		
11 Data on Governance Indicators (IADB/DIFID)	Freedom of the Press	1993	92	80	2008	211	180
	Political Rights	1993	92	85	2008	211	162
	Political Stability and Absence of Violence	1993	92	72	2008	211	195
	Voice and Accountability	1993	92	60	2008	211	185
12 Center for Global Development	Commitment to Development Index	n.a	n.a	n.a	n.a	n.a	n.a
13 Democracy Index Economist Intelligence Unit (EIU)	Overall Score	2006	167	113	2012	167	108
	Electoral Process and Pluralism	2006			2012	167	104
	Functioning of Government	2006			2012	167	83
	Political Participation	2006			2012	167	148
	Political Culture	2006			2012	167	142
	Civil Liberties	2006			2012	167	106
14 Polity IV Country Reports (University of Maryland - Center for International Development and Conflict Management)	Polity	1972	154	112	2007	163	145
	Democracy	1972	154	121	2007	163	129
	Autocracy	1972	154	110	2007	163	134
	Durable	1972	154	135	2007	163	148
	Tentative	1972	Not	-	2007	Yes	-
15 Business Environment Risk Intelligence (BERI)	Political Stability and Absence of Violence	1996	101	47	2008	101	92
	Government Effectiveness	1996	101	84	2008	119	87
	Rule of Law	1996	119	87	2008	119	52
	Control of Corruption	1996	119	59	2008	119	57
16 Gallup International (Gallup World Poll)	Voice & Accountability	2006	122	80	2008	143	102
	Government Effectiveness	2006	122	61	2008	143	53
	Rule of Law	2006	122	62	2008	143	94
	Control of Corruption	2006	122	75	2008	143	62
17 Index of Economic Freedom (Heritage Foundation and Wall Street Journal)	Business Freedom	1995	101	88	2014	184	82
	Trade Freedom	1995	101	87	2014	180	144
	Fiscal Freedom	1995	101	63	2014	183	77
	Government Size	1995	101	35	2014	183	21
	Monetary Freedom	1995	101	48	2014	183	149
	Investment Freedom	1995	101	33	2014	184	139
	Financial Freedom	1995	101	21	2014	181	116
	Property Rights	1995	101	32	2014	182	119
	Freedom from Corruption	1995	101	90	2014	184	145
	Labor Freedom	1995	155	88	2014	184	148
	Overall Index	1995	101	52	2014	186	126

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

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

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

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

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

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

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

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

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CHAPTER 2

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CHAPTER 5

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3. According to the International Energy Database, in 1980, the shares of power production of natural gas and hydropower were 40 percent and 58 percent, respectively.
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6. P Hasan, *Pakistan's economy at the crossroads*, Oxford University Press, Karachi, 1998, p. 193.
7. See www.nepra.org.pk
8. NEPRA, *State of the industry report 2013*, NEPRA, Islamabad, 2013.
9. World Development Indicators, World Bank.
10. Rana Assad Amin, spokesperson for the finance ministry, has said that initiating work on Dasu would not mean that the government has abandoned the Diamer-Bhasha project. He has claimed that the government will implement both projects simultaneously. In response to a question on how Pakistan would manage to arrange up to $25 billion in funds for carrying out activities simultaneously, Amin said that the Dasu project would be completed in eight years while Diamer-Bhasha would take at least 10 to 12 years, giving the country time to raise funds (*Express Tribune*, 5 November 2013).
11. See: SBP, *Annual report 2011–12*, SBP, Karachi, 2012.
12. Ibid.
13. See: Government of Pakistan, *National Power Policy 2013*, Ministry of Water and Power, Islamabad, 2013.
14. Ibid.
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18. The first phase is critical and will cost more as much of the infrastructure (e.g., site preparation) and social and environmental safeguards will be developed under this phase. The high upfront cost of this phase will be offset by high generation, which,

despite the front-loading of dam and other social and environmental management costs, will yield sound returns of more than 20 percent (excluding environmental benefits).

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CHAPTER 6

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CHAPTER 7

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