CHAPTER 4

PAKISTAN'S ECONOMY: ITS PERFORMANCE, PRESENT SITUATION, AND PROSPECTS

Shahid Javed Burki

INTRODUCTION

Pakistan currently faces a grim economic situation. There is likely to be a sharp reduction in the rate of economic growth, an unprecedented increase in the rate of inflation, a significant increase in the incidence of poverty, and a widening in the already large regional income gap while the fiscal and balance of payments gaps increase to unsustainable levels. The country has been though many crises before, but the one that it is currently experiencing is uniquely severe. Should the economic situation continue to deteriorate, the country could be plunged into social and economic chaos that would affect the rest of the world. Pakistan is already considered to be the center of Islamic extremism, so how should it tackle this situation?

In an article published by *Dawn* on July 22, 2008,[1] I suggested that Pakistan should not approach the donor community with a begging bowl in hand and ask for help to resolve the current economic crisis. I did not advocate going to the International Monetary Fund (IMF) for support since that would compromise the effort to keep the economy growing. This is what the country did in 1999 and gave up growth in favor of stabilization. In an effort to increase growth, the Musharraf administration loosened fiscal and monetary controls over the economy and laid the foundation of the current crisis. It is not good for the economy to go through such deceleration and acceleration in growth; repeated shifts are destabilizing, and it would not be prudent to send the economy through such a cycle again.

Instead, I suggested that the country should seek help on the basis of a well-thought-out program of economic reform and focus on bringing about structural changes that have long been postponed. An important structural change would be to make the economy less dependent on external help for sustaining growth. This will take time, but the process must begin.

By initiating a program of structural reform, the country may be able to secure long-term finance, perhaps as much as $40 to $50 billion for a 5-year period. Financing should be equally shared between the donor community and Pakistan, with the donors requested to front-load the effort with $20 to $25 billion provided in the first 2 to 3 years, and the Pakistani government providing a matching amount at the end of the program period. However, the Pakistani authorities should clearly and persuasively describe how it would raise this amount of money.

I cannot tell whether my thinking influenced the policymakers in Islamabad, but I am struck by two developments. First, Pakistani Finance Minister Naveed Qamar made a statement on September 19, 2008, that his government had no intention of going to the IMF for support and that instead it would develop its own package of reform. To reinforce the point, he announced the withdrawal of a number of consumer subsidies that weighed heavily on the federal budget. Secondly, President Asif Ali Zardari, while on a visit to New York to attend the opening session of the United Nations (UN) General Assembly a week later, met with a group of donors he called the "Friends of Pakistan." The group promised support but did not elaborate a plan as to how that would be delivered. This is the situation today as the country continues to diminish the respectable level of foreign currency reserves it had built up over the last 8 years. Within a few months, it will run out of reserves and may have to default on its foreign obligations.

Soliciting donations is only half of the solution to the mounting crisis. The second half of the effort would be to develop a strategy to reassure the community of donors that the new leaders are up to the task of bringing the country out of the stiffest challenge it has faced in its history. Such an effort will need a great deal of thought, the full commitment on the part of the leadership, and public support. It will also need the creation and development of the institutional infrastructure that is needed to support a far-reaching program of economic and social restructuring.

Time is running out for Pakistan. The approach to the donor community for help should include the presentation of a well-developed, carefully budgeted, and implementable program of economic change and reform. We need to dispense with the begging bowl approach and adopt one that makes a selected number of countries Pakistan's economic partners rather than providers of charity. At this point, it would be useful to provide a brief historical overview of Pakistan's economic history before examining the current problems the country faces and the policies it could adopt to resolve them.

AN OVERVIEW OF PAKISTAN'S ECONOMIC HISTORY[2]

Pakistan's performance has been fairly impressive in terms of economic growth and development over the last 60 years. If we construct three indices: growth in population, increase in gross domestic product (GDP), and increase in per capita income for the past 60 years (see Table 1), we notice reasonable progress. While the population increased more than five times, from 30 million in 1947 to over 162 million now, both GDP (which increased 18 times) and per capita income (which increased more than 4 times) also grew appreciably.

Year	GDP	Population	GDP/N
1947	100	100	100
1958	134	122	110
1969	257	156	166
1971	288	165	176
1977	362	198	185
1988	725	277	266
1999	1,201	371	330
2007	1,816	445	418
Source: Calculated from Government of Pakistan, Pakistan Economic Survey, various years, Islamabad, Pakistan.			

Table 1. Indexes of Growth in GDP, Population, and Income Per Capita.

However, progress was neither gradual nor even. There were three periods of high growth (1958-69, 1977-88, and 2002-07)—27 years out of 61 years—during which GDP increased by an average of 6.2

percent a year. (See Table 2.) This means that one-half of the GDP expansion came in those 27 years. Before identifying the reasons for the booms and busts of the Pakistani economy, it would be instructive to compare the country's performance with that of its neighbor, India.

Years	GDP Growth Rate	Population Growth Rate	GDP Per Capita Increase
1947-58	2.7	1.8	0.9
1958-69	6.1	2.3	3.8
1969-71	5.8	2.8	3.0
1971-77	3.9	3.1	0.8
1977-88	6.5	3.1	3.4
1988-99	4.7	2.7	2.0
1999-2002	5.3	2.3	3.0
2002-07	7.0	1.8	5.2
Source: Government of Pakistan, Pakistan Economic Survey, various years, Islamabad, Pakistan.			

Table 2. Economic Performance during Various Political Periods (Percent).

Comparing the performance of the Indian and Pakistani economies in terms of the growth in GDP highlights one important conclusion. The acceleration in the rate of growth of India since the mid-1980s represents a paradigm shift. Between 1947-87, the Indian economy registered what Raj Krishna, an Indian economist, famously called the "Hindu rate of growth." This was about 3.5 percent a year and represents a relatively low level of increase in per capita income. Since the mid-1980s, the Indian economy has been growing annually at rates between 6 and 9 percent. It is fair to conclude that the Indian policymakers were able to put the economy through a deep structural change that enabled it to nearly double the rate of the "Hindu" GDP growth and as a result, the country was able to sustain this much higher growth rate over 2 decades. Pakistan's economy, on the other hand, has stayed on a roller coaster with periods of high growth followed by periods of sluggish performance. Today, it is entering another period of low growth.

There are a number of reasons why Pakistan was not able to sustain high growth rates. A significant share of the investment that financed growth spurts came from the influx of foreign capital that augmented the low level of domestic savings, most of it from the United States. External finance became available to compensate the country for the strategic help it provided America. The Pakistani government closely aligned the country with America in the 1960s in support of Washington's efforts to deny additional strategic space to European and Asian communism.[3] The country was rewarded for its loyalty with large amounts of military and economic assistance. In the 1980s,[4] Pakistan chose to become the front-line state in the American effort to expel the Soviet Union from Afghanistan. Once again, the reward was military and economic assistance. More recently, Pakistan was recruited to join America's war on terror and for its support was given an estimated $10 billion of assistance over the 6-year period from 2001 to 2007.[5] In other words, the country did little to generate high rates of economic growth by using its own resources. It also did not improve the quality of governance or ensure continuity in policymaking. These factors have been identified by economists as important contributors to growth.

There is now a vast body of literature that addresses the question: What makes economies grow?[6] Apart from the generation of domestic resources to sustain a high level of investment, two other determinants are very important: well-developed human resources, and institutions that can support development. Successive administrations in Pakistan did little to create these two conditions, resulting in an economy that grew only when large amounts of external capital became available. The rate of growth plunged when, for whatever reasons, the quantity of resources being made available declined. Pakistan has not been through the kind of paradigm shift that made it possible for India to climb on to a high growth trajectory.

Even though the economy has continued to be volatile, it did make considerable progress. Its structure changed quite significantly. As shown in Table 3, since Pakistan's establishment as an independent state, the economy, as well as the society, was basically rural. Agriculture was by far the most important sector of the economy, representing nearly 62 percent of the GDP. Manufacturing contributed a very small amount, less than 7 percent. Now, the share of agriculture has declined to below 22 percent, while that of manufacturing has increased to more than 18 percent. The service sector is now the largest part of the economy by far, contributing more than 50 percent of the GDP.

	1949-50	1969-70	2005-06
Agriculture	61.7	38.9	21.6
Mining and Quarrying	0.1	0.5	2.6
Manufacturing	6.9	16.0	18.2
Large Scale		12.5	12.7
Services	25.5	38.4	52.3
Wholesale-Retail Trade	(9.3)	(13.8)	(19.2)
Finance and Insurance	(0.2)	(1.8)	(4.6)
Public Administration and Defense	(4.7)	6.4	5.8
Construction	(5.8)	4.2	4.3
Electricity and Gas Distribution	—	2.0	3.0
Source: For 1949-50, J. Russel Andrus and Aziz F. Mohammed, Pakistan's Economy, London, UK: Oxford University Press, 1957. For 1969-70 and 2005-06, various issues of Government of Pakistan, Pakistan Economic Survey.			

Table 3. Sectoral Shares of GDP.

While agriculture still remains a significant source of employment, its share has declined. As shown in Table 4 below, it employed over 60 percent of the labor force in 1949-50; 6.7 million out of the total work force of 10.3 million. In 2005-06, agriculture's share of employment had fallen to less than 45 percent. The number of people employed in agriculture tripled in 60 years, from 6.7 million to 21.3 million, but in the same period the number of people in nonagricultural employment increased seven-fold, from 3.6 million to 26.3 million. As a result, the structure of the economy is considerably different from the one the country inherited at the time of independence.

	1949-50 (Million)			1949-50 (Percent)		
	Male	Female	Total	Male	Female	Total
Civilian Labor Force	10.0	0.3	10.3	29.7	1.0	30.7
Agriculture	6.5	0.2	6.7	19.4	0.7	20.1
Nonagriculture	3.5	0.1	3.6	10.3	0.3	10.6
Total Population						
Percent in Labor Force				33.7		

Source: Chap. 7, Pakistan Economic Survey, Islamabad: Government of Pakistan, 2005-07.

Table 4. Economic Distribution of Total Population.

Another change—not as significant as those noted above, but important nevertheless—is the larger role women play in the economy by participating in the work force. As shown in Tables 4 and 5, women were almost totally absent from the work force at the time of Pakistan's birth. In the late 1940s, there were only 300,000 women formally recognized as participants in the labor force, only 3 percent of the total work force. Most women stayed home in this period, one reason why Pakistan, at less than 31 percent of the work force, had one of the lowest worker participation rates in the developing world. That changed over 60 years and the participation rate has increased to nearly 45 percent. There was a 20-fold increase in the number of women taking part in the work force. In 1949-50, only 300,000 women were formally part of the work force; 55 years later, their number had increased to over 9.2 million. It should be stressed, however, that the number of women formally recognized to be working is considerably less than those who actually work. In most economies, not just in the developing world, women's work in the house is not recognized as work in a formal sense. In a country such as Pakistan, women put in hard work in both rural and urban areas, particularly among the lower income groups. Even young girls labor hard to help their mothers take care of their younger siblings. Women put in many hours a day caring for animals, which are an important source of income for poor households.

	2005-06 (Million)			2005-06 (Percent)		
	Male	Female	Total	Male	Female	Total
Agriculture	14.9	6.4	21.3	38.4	69.9	44.8
Manufacturing	5.1	1.3	6.4	13.4	14.0	13.6
Construction	2.8	0.03	2.8	7.4	0.3	5.9
Whole Sale-Retail Trade	6.6	0.17	6.7	17.3	1.8	14.1
Transport	2.8	0.03	2.8	7.2	0.3	
Community, Social and Personal Services	5.2	1.2	6.4	13.9	13.5	13.5
Other	1.1	0.1	1.2			2.0
Total Labor Force	38.4	9.2	47.6			
Population	0.7	79.3	160.0			
Percent in Labor Force	47.5	11.6	29.7			

Source: Chap. 7, Pakistan Economic Survey, Islamabad: Government of Pakistan, 2005-07.

Table 5. Economic Distribution of Labor Force, 2005-06.

The last significant change I would like to recognize is a large increase in the urban population. In 1947, the proportion of Pakistanis living in urban areas was no more than 12 percent, some 3.6 million out of a total population of 30 million. The arrival of 8 million refugees from India, 2 million more than the 6 million Hindus and Sikhs who migrated in the other direction, resulted in a significant increase in urban population. In 1951, when the first population census was taken, 17.6 percent of the population lived in urban areas. By 1972 the proportion of the urban population increased to 22.4 percent, with a further increase to 28.3 percent in 1981. The last census taken in 1998 estimated the proportion of people living in the urban areas at 35.4 percent.

The Current Economic Situation; Macroeconomic Imbalances Return[7]

In 2008, Pakistan's economy is once again at a critical juncture. After a period of strong economic expansion, relative macroeconomic stability, and increased foreign investor confidence during the years 2003-06, the country is facing very serious economic strains and a number of social challenges. Macroeconomic indicators deteriorated very sharply over the last few years. Inflation touched record levels in the first 9 months of 2008 following 3 previous years of high single-digit increases in the level of prices. This is despite the fact that the sharp increases in international oil prices during most of 2008 were not fully passed on to consumers and the price of wheat for urban consumers was subsidized. The burden of high prices, especially of basic food items, became intolerable for poor households. One of the primary causes of inflation since 2004 may have been monetary in character, but in 2008 they acquired a structural nature, given the high dependence on imported energy.

Over the same period, poverty levels increased again.[8] There was some decline in the poverty rates from 1999-2005, but the unprecedented rise in food prices since 2004, along with the shortage of wheat flour and a slowing economy, eliminated any gains that had been made. Also, there was evidence that labor absorption was limited despite rapid economic growth in the 2002-07 timeframe.

Structural problems constraining long-term growth came dramatically to the forefront in the first half of 2008 with major power shortages and large-scale load shedding. In addition, the erosion of the competitiveness of the country's dominant exports, textiles, and clothing, and a sharp slow down in export growth since 2006-07 led to a large increase in the trade imbalance and limited the prospects for growth in labor- intensive manufacturing.

Given this backdrop, I will take stock of the economy by focusing on:

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

In attempting to assess the present position, this chapter analyzes the short-term causes of the unraveling of the economy in the first half of 2008 as well as the underlying longer-term issues that continue to impede economic growth and social progress. Both perspectives are critical because not only is Pakistan quite a distance away from matching the record of the Asian tigers, Hong Kong, Singapore, South Korea and Taiwan, but also is also seriously falling behind India.

The second and central objective of this chapter is to outline a comprehensive and integrated economic and governance strategy that will facilitate the tackling of the previously mentioned challenges and that will require the urgent attention of the new economic and political leadership.

The chapter recognizes that efforts to restore macroeconomic stability from the position of almost uncontrollable fiscal and balance of payments deficits could dampen short-term growth and investment and make the addressing of poverty and distribution issues harder during the period of adjustment. The agony of a sharp adjustment is unavoidable though it should be possible through public policy measures and well-designed interventions to protect the poor who account for around 10-11 percent of total private consumption. In the absence of a strong adjustment the country runs the risk of a deep financial crisis with catastrophic consequences for its citizens.

In the longer run, the goals of financial stability, rapid growth, and fairer income distribution can be achieved. These objectives are not only consistent with each other but can be mutually reinforcing and interdependent with the appropriate public policies and resilient national institutions.

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

The Road to the Present Crisis.

The macroeconomic situation unraveled very quickly. The fiscal deficit (excluding grants) grew eight-fold over the 4-year period between 2004 and 2008, approaching 8 percent of GDP. The first finance minister of the coalition government that took office in March 2008, in fact, projected the fiscal deficit at 9.5 percent of the GDP on the basis of current trends. However, an adjustment of 1.5 percent of the GDP was made by the government in the second quarter of 2008, primarily because of a rationalization of the Public Sector Development Program (PSDP).

The current account of balance of payments which had a surplus of almost 2 percent of the GDP as late as 2003-04 reached the record level of $12 billion or 7.5 percent of GDP in 2007-08. Here again, the then finance minister projected a higher deficit at above 9 percent of the GDP. The large deficit cut into the foreign exchange reserves at a most worrying rate. In the first 4 months of 2008, the decline in reserves accounted for nearly 40 percent of the current deficit. By the end of 2007-08, the foreign exchange reserves had dropped to $11 billion and were $5.5 billion below the level at the end of October 2007. By October 2008, the reserves were estimated at only $6 billion.

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

The negative shocks, including a devastating earthquake in 2005, the inexorable rise in international oil and food prices, especially of grains and edible oil, have all placed a huge tax on the economy and have effectively reduced the real growth of income in Pakistan by about 2.0 percent per annum on average during the last 4 years. Another increase in oil prices could cost Pakistan another 2 percent of its GDP in 2009.

The policy response to this state of affairs has been poor or misguided. These developments required a major adjustment in consumption and possibly investment plans. But the need to reduce aggregate demand, especially by reining in the expansionary monetary policy, was ignored partly because the revenues from the privatization of the economic assets owned by the government and sovereign borrowing in world markets were easily available to finance growing deficits and partly because delivering high growth was considered a political imperative for winning the elections of February 2008. It was a false assumption, and the ruling party lost the elections and the burden on the economy remained.

Domestic absorption of resources increased very sharply from 2004-07. Real consumption and investment collectively increased by 35 percent over the 3 years in contrast to the growth in national income, adjusted for terms of trade loss, which only grew by little more than 25 percent. The imbalance was directly reflected in the deterioration of the balance of payments. Consequently, the propensity to import jumped markedly three times during the last 5 years as the economy sucked in more resources from abroad.

The hardest challenge will be to avoid a balance of payments crisis that would further shake the confidence of foreign investors and citizens and could accelerate capital flight as well as limit Pakistan's access to the international capital markets. The rapid accumulation of foreign assets resulting from the quantitative jump in home remittances and the emergence of a current account surplus after September 11, 2001 (9/11) encouraged the government to resort to an expansionary monetary policy from 2002-03 onwards. This policy was too easy for too long and led to a precipitous fall in interest rates which promoted the rapid growth of consumer financing. By 2004-05 there was evidence that the economy was beginning to overheat, as evidenced by the inflation rate jumping to over 9 percent, even in the absence of international inflation and rising commodity prices. Expansionary policies did succeed in reviving growth, but they put the economy on a highly inflationary path. After nearly 4 years of high single-digit inflation, inflationary expectations have become built into the behavior of economic agents, especially with regard to consumption and savings. Even stronger policy action is now required to counter these expectations.

Superimposed over the history of inflation is the recent upsurge of oil and food prices. This gave rise to upward spiraling prices, even though full domestic adjustments to higher international prices have not yet been made. The inflation of food prices was running at 20 percent in the first half of 2008.

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

Despite the measures taken to tighten monetary policy in 2006-07, broader money grew by over 19 percent during the year, even somewhat higher than the average annual rate in the previous 3 years. During 2007-08, the growth of the money supply was running at approximately 7 percent, but this was mainly due to a decline in foreign assets. Government borrowing from SBP during July-March was at the record level of almost 4.5 percent of the GDP.

The SBP correctly tightened monetary policy in early 2008. The space in which the central bank can maneuver should be expanded by largely eliminating the sizable amount of government borrowing. Market borrowing by the government through the PIBs will help to identify the true cost of public debt service, improve the interest rate structure, and thus encouraging savings and reducing the supply of reserve capital.

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

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

GROWTH: EMERGING AND STRUCTURAL CONSTRAINTS

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

These problems notwithstanding, there are several positive indications that could signal a better economic future for the country. They include changing demographics; liberalization, privatization and reform of the financial system; and increased confidence in the economy, which helped to energize the private sector and increased foreign investment flows for some time, all symbols of increasing economic efficiency. Greater depth in the capital market has enabled it to handle the recent economic crisis well. However, these positive trends will need to be reinforced, something which could have been done when the new government announced its budget proposals for the 2008-09 fiscal year. Unfortunately, this did not happen.

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

The poor in Pakistan continue to face markets, institutions, and local power structures that discriminate against their access to resources and public services and that impede their influence on governance decisions. Due to the unequal access to capital and land and labor markets, inequality and poverty are built into the structure of the growth process itself. On the basis of new estimates, statistics have been provided for the first time on the incidence of poverty from 2005 to 2008, with forward projections for the next 4 years. The evidence shows that after a decline in the poverty rate from 2000 to 2006, poverty levels have since increased neutralizing the earlier gains, as food inflation accelerated and GDP growth declined. For the Musharraf period as a whole (1999-2008), the percentage of population below the poverty line increased from 30 percent in 1998-99 to almost one-third currently, with an additional 16 million people being pushed into poverty during this period. The central policy lesson of the economic performance of the Musharraf regime is that poverty levels increased in spite of high GDP growth in later years because growth was heavily tilted in favor of the rich and high food inflation was not controlled. Recent analyses highlight the importance of controlling food inflation and at the same time bringing about the institutional changes necessary for pro-poor growth.[9]

PLACING THE ECONOMY ON A SUSTAINABLE PATH

If Pakistan is to get on to a sustainable development path, the government has to follow a different route. The main conclusion of this chapter is that growth, equity, and financial soundness must be pursued simultaneously. Listed below are some strategy changes that the government should take:

- Make radical macroeconomic adjustments by eliminating energy and wheat subsidies, significant cutbacks, and a restructuring of public spending, which has grown sharply during the last 5 years. The government should make a determined effort to generalize tax revenue from the segments of the society whose taxation rates have been drastically cut and those who escape the tax net, while improving incentives for savings and discouraging luxury consumption.
- Substantially expand the safety net for the poor by allocating significant resources, perhaps as much as rupees (Rs.) 50 billion, to minimize the impact of the elimination of the wheat subsidy and potential increases in food prices.
- Make the expansion and diversification of exports a key tenet of any growth revival strategy with a special focus on agriculture and promising labor-intensive manufactured exports, based on geographical comparative advantage.
- Strengthen devolution by shifting governance and expenditure from the center to provinces and from provinces to local governments.

- Expand education at all levels, especially by improving the quality of public education and increasing the access by relatively poorer families to the privately run educational institutions.
- Increase outlays for research and development, especially agricultural research in recognition of the fact that high growth in Pakistan will require a faster pace of productivity improvements and efficiency gains because low domestic savings remain a major constraint on investment.

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

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

Policy changes necessary to achieve more sustainable and inclusive growth are elaborated below.

Balance of Payments Adjustment.

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

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

The biggest contribution to reducing the saving-investment gap would be the early elimination of negative savings on the general government revenue account, which reemerged and became very sizable (3.5 percent of GDP) during 2007-08. Strengthening incentives for small savers by improving what are now negative returns on bank deposits and improving returns on government saving schemes should also help to curb consumption.

Some restraints on imported consumer goods, especially luxury goods should also be considered through imposition of moderately higher tariffs, as was done in July 2008. Similarly, in reviewing defense expenditures, the postponement of foreign exchange intensive expenditures on weapon systems should be seriously considered. One proposal that merits serious consideration is the levy of a temporary regulatory import duty on all imports, excluding essential imports like food (wheat and edible oil); fertilizer; and petroleum, oil, and lubricant (POL) products, with a higher rate on luxury goods.

The biggest challenge for short-term balance of payments management is to maintain and restore foreign exchange reserves to a level of around $15 billion over the next few months while financing the substantial uncovered gap in financing. More adequate reserves are necessary to ward off the speculators in the liberal global framework in which Pakistan is operating.

With the recent downward trend in the value of the rupee (in the first 9 months of 2008, the rupee-dollar exchange rate fell by 25 percent to nearly 80 to a dollar), Pakistan's exchange rate does not need any significant once-and-for-all realignment. However, it is important to annunciate the policy that the real effective exchange rate will not be allowed to appreciate in the near future. In other words, the much higher rate of inflation in Pakistan compared to its competitors will be allowed to be reflected in the change in the nominal rate against a variety of currencies. Otherwise, the competitiveness of the country's exports would suffer, and import growth will be artificially stimulated. The approximately 6 percent appreciation of the rupee between 2004-05 and 2006-07 may be one factor explaining the slowdown in exports and continued rapid growth of imports.

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

The major elements in an export-focused strategy should be:

- Strong national commitment at the highest political level.
- Recognition that while textiles and clothing will remain a vital and expanding export sector, it cannot be the future engine of growth. The limits of government support for textiles have been reached, and the industry must learn to be competitive through investments in physical capital and skills.
- Diversification deserves the highest priority, and manufactured goods other than textiles, clothing, and agricultural exports should lead the way and get the necessary government attention and support.
- The role of the state can be crucial in the early stages of export diversification through aggressive targeting of markets and products, improving access, and speedily removing obstacles to trade.
- Foreign direct investment should be especially encouraged in export fields.

Pakistan also needs an external finance strategy and a framework for balance of payment management to complement the Fiscal Responsibility Law passed by the National Assembly in 2006 that put limits on public debt, fiscal deficits, and contingency liabilities. To avoid future balance of payments difficulties, the adoption of a few specific guidelines to implement a viable external finance strategy should be attempted. The first guideline should establish a ceiling of 20 percent of total investment to be financed from foreign savings. A second guideline should place limits on total external debt and foreign investment obligations in relation to total foreign exchange earnings at the present level of 100-110 percent. Another guideline should define the balance between equity and debt financing at 2:1 to meet a given balance of payments gap.

Fiscal Adjustment.

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

The task of fiscal adjustment will require drastic changes in revenue and expenditures if the deficit is to be brought down to the sustainable level of about 4 percent of the GDP. This would help avoid an increase in the public debt-to-GDP ratio and eliminate of any deficit on the revenue account, such borrowing should only be used to finance development projects. Fiscal deficit reduction from 8 percent of the GDP to 4 percent should be completed within 2 years if inflationary pressures are to be contained and there is to be less pressure on the external current account deficit. In 2008-09, the target financial deficit must be brought down to 6 percent of the GDP and in 2009-10 to 4 percent of the GDP, with development expenditure sustained at the minimum level of 4 percent of the GDP each year. This would imply a revenue deficit of about 2 percent of the GDP in 2008-09 which will be eliminated in 2009-10, allowing the economy to get back to a fiscally sustainable path consistent with the Fiscal Responsibility Debt Limitation (FRDL) Act of 2005.

Beyond the concern with the size of the fiscal deficit is the issue of how the deficit is financed, especially with regards to the impact of inflation. During the next 2 years, in the period of fiscal adjustment, the government will have to operate strictly within the safe limits of deficit financing. Earlier studies reveal that the scope for "seignorage" in the Pakistan economy is about 1 to 1 1/2 percent of the GDP,[10] if a low single-digit rate of inflation is to be achieved. Other noninflationary sources of financing will have to be used. Up to 1 percent of the GDP can be mobilized from commercial banks through the market flotation of the PIBs of varying maturities. At this level, there should not be a significant crowding out of credit to the private sector.

Beyond this, the biggest increase in borrowing will have to come from nonbank sources; the national savings schemes. In the face of large reductions in the rate of return on certificates, the net inflow has plummeted to only about half a percent of the GDP in recent years. This will have to be raised substantially to between 1 to 1 1/2 percent of GDP by linking the return to that of PIBs, with the expectation that the return will rise by 2 to 3 percentage points. In addition, an effort must be made to develop a secondary market for the PIBs. The offering of positive real rates of return on savings instruments should help in raising the rate of domestic savings and reducing the dependence on foreign savings. The residual deficit will have to be ameliorated by the continued resort to concessionary external assistance at the more or less unchanged level of about 2 percent of the GDP.

The government's strategy should be focused on eliminating the revenue deficit in the next 2 years, while keeping the PSDP at about 4 percent of the GDP to avoid jeopardizing growth. A balanced and politically acceptable strategy will require the same effort to be directed at the containment of current expenditure and mobilization of resources. If the focus is only on the expenditure side, then this will severely limit the possibility of providing social protection to the poor, especially through an expanded program of food subsidies. On the other hand, if the deficit reduction strategy relies solely on additional taxation, then this could have adverse effects on investment and growth. Consequently, a balance is required.

As highlighted above, noninterest current expenditure has risen rapidly since 1999-2000 by almost 2 percent of the GDP. The fiscal space that was available earlier has been largely taken up by rapidly increasing outlays on general administration, growing subsidies (especially to the power utilities), rising defense expenditure, and buoyant expenditure on services (particularly by the provincial governments). The bloated size of federal and provincial cabinets during the Musharraf period became symbols of extravagance by the government. The hiring of large number of consultants and retired officials on lucrative salaries with perks, the removal of recruitment bans, the import of large fleets of luxury vehicles, and the expensive foreign missions of dignitaries all became signs of systematic government excess.

As a result, there is significant scope for reductions in current expenditure without adversely affecting the delivery of services. The new prime minister announced a reduction in the costs of running his secretariat by 40 percent after taking office. This example of reduction in nonsalary expenditures should guide all federal and provincial governments and all semi-autonomous organizations and attached departments over the next 2 years. This could yield up to 1 percent of the GDP or about Rs. 100 billion by the end of 2009-10.

The large oil subsidy will have to be reduced gradually by the end of 2008, to yield a saving of about Rs. 100 billion. This is essential if demand for POL products is to be contained to maintain the oil import bill at a sustainable level. Of course, the impact on the poor can be limited by a lower increase in the price of products like kerosene oil, high speed diesel oil, and light diesel oil, and a greater increase in the price of gasoline, which is consumed mostly by upper income groups. If the oil price remains at about $100 per barrel, then further adjustments in domestic prices are inevitable if the fiscal and current account deficits are to be contained. This will also release resources for supporting food programs for the poor and bolster social safety nets.

The big disappointment in the area of public finances is that 4 years of continuously high growth did not lead to a rise in the tax-to-GDP ratio in the economy, which remained stagnant at between 10 to 11 percent. This is despite the buoyancy of major tax bases, like value added in large-scale manufacturing and imports. The explanation for the failure of the tax-to-GDP ratio to rise lies in the decline in effective tax rates. Import tariffs have been brought down to a maximum of 25 percent. Concomitantly, this has also affected revenues from the sales tax on imports. Excise duties have been replaced by sales tax in a number of sectors, and the specific rates have not been fully indexed to inflation.

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

Major tax concessions and exemptions have been granted since 2000 starting with the abolition of the wealth tax. The most dramatic example is the continued tax exemption for capital gains at a time when massive unearned incomes were accruing to the relatively well-off due to the exceptional performance of the stock market in 2005-08 and rising property values. By the government's own estimate, as much as Rs. 112 billion in revenue were lost in 2006-07, almost 1.2 percent of GDP. The cost of other exemptions or concessions adds up to another Rs. 200 billion. This includes the cost of exemptions from import duty, income tax holiday and accelerated depreciation allowance, lack of coverage of sales tax on wholesale and retail trade, effective exemption of a large number of services from General Sales Tax (GST), and the effective zero rating of domestic sales of export-oriented sectors like textiles. If all these concessions and exemptions are accounted for, then the aggregate loss of revenue is roughly Rs. 300 billion. This is equivalent to over 3 percent of the GDP and about one-third of the revenue actually collected.

The provincial governments have also demonstrated little fiscal effort. Currently, provincial tax revenues aggregate to only half a percent of the GDP. The agricultural income tax, which was introduced in late 1996, has been languishing as a source of revenue despite the rising incomes of large farmers. Consequently, land taxes represent less than 1 percent of agricultural incomes in the economy. The urban immovable property tax also remains underdeveloped, currently exploiting only one-fourth of its revenue potential. Despite the boom in real estate values, stamp duty revenues remained stagnant during the last 3 years, and a capital gains tax on property was not introduced.

The elite has had unprecedented control of the state and granted itself large tax breaks during the last 8 years.[11] There is no doubt that considerable slack exists in the tax system not only for significantly raising the tax-to-GDP ratio, but also for simultaneously achieving a measure of redistribution through the tax system to arrest the rising inequality between the rich and the poor in the country.

A recent study by the Institute of Public Policy identified a series of taxation proposals for implementation by either the federal or provincial governments over the next 2 years with a potential yield of up to 2 percent of the GDP by 2009-10.[12] These include an excess profits tax, higher tax on private companies; introduction of a capital gains tax; a more progressive personal income tax; higher taxation on imports, especially luxury goods; a broad-based services tax; and development of provincial taxes.

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

PROMOTING INCLUSIVE GROWTH

At this stage it would be useful to consider some structural weaknesses in the growth process and indicate how they could be overcome. The purpose is to understand how high rates of growth could be attained and sustained over time, while ensuring that the benefits are spread more widely.

Sectoral Strategy.

Sectors like banking, telecommunications, and automobiles, which were in the lead during the last 5 years, will not keep the economy on a high growth track for very long. They will also not do enough for the poor. The number of jobs created by these sectors and the types of employment they generated did little to reduce the incidence of poverty, as demonstrated earlier. In addition, the pattern of growth widened interpersonal, interprovincial, and intraprovincial income disparities. Increases in such disparities usually lay the groundwork for social and political instability, a development Pakistan does not need at such a difficult period in its history.

An increased focus on the basic commodity-producing sectors of the economy—agriculture and manufacturing—is needed. This change in sectoral focus will require actions from all three tiers of government—federal, provincial, and the local—as well as from the private sector. This raises the question: how could this be done?

Agriculture.

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

Among the more important ones are the price signals embedded in public policy. These have a profound impact on cropping patterns. The most important price signal the government provides is the wheat procurement price. Wheat is the country's most important crop. The anticipated income that farmers receive from cultivating wheat significantly affects what else they grow. The federal government should continue to handle the procurement price of wheat while monitoring the level and expected trends of international prices. The recent rise in world wheat prices represents a trend caused by the increase in demand for food grains in rapidly growing populations such as China and India and the increasing return given for bio-fuel production by such large consumers of energy as the United States. The rise in the price of wheat has affected the prices of other food grains—commodity prices normally move in tandem—and has changed the sectoral terms of trade in favor of agriculture. The benefit of these should be passed on, to the maximum extent possible, to agricultural producers.[13] For that to happen, there should not be a large difference between the government's procurement price and the price in international markets. In the context of the need to make fiscal adjustment, an increase in the price of wheat will have to be mitigated by directly helping the poor through initiatives such as the Baitul Maal (a Pakistani nongovernmental organization) and Food for Work programs.

The next important area for government promotion of agriculture is in improving the technological base. Here, Pakistan seriously has lagged behind. Very little research and development work gets carried out by the private sector, not surprising given the absence of large commercial operators. The little research that gets done is by the public sector, but it is too widely scattered among too many government departments and agencies to be effective and does not reach the farmers. The result is that Pakistan has developed gaps between average yields and yields obtained by the best farmers; between the best farmers and those obtained by research institutions; and between research institutions and those obtained by farmers in the large agricultural systems in other parts of the world.[14] The role of government must help to close the technology gaps. This can be done in two ways: (1) by focusing on the development of research in agricultural universities (an approach followed by the United States) and (2) by establishing crop or product specific research institutions (as is being done by China). At the same time, incentives should be provided to the private sector to encourage research and development.

The third role of the state in promoting agriculture development is to provide the infrastructure the sector requires. Pakistan has inherited an elaborate irrigation system, and impressive improvements to this network were made as a part of the agreement with India on the distribution of the waters of the Indus River systems. But these were replacement works; they did not result in bringing much additional land under cultivation.[15] However, not enough attention was paid to maintaining this system and for improving it to preserve water. In recent years, the Punjab and Sindh governments, encouraged by the World Bank, have begun to devote sizeable resources to maintenance.

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

Livestock husbandry has become an increasingly important part of the agricultural sector, and the modernization of livestock markets need to be promoted. The sector contributes almost 50 percent of agriculture's gross output, which translates into a contribution of over 10 percent of the GDP. It engages 35 million people in the rural economy and provides almost 40 percent of the total income of the farming community. The sector is dominated by small operators; those owning less than two animals account for slightly more than two-fifths of the total population of cattle and buffaloes. As in the case with the crop sector, yields are low. The government estimates the yield gap—outputs of the current livestock population compared with the output obtained in more developed systems—at between 60 to 80 percent. The reason for low productivity has been identified as inadequate and poor quality feed and fodder, limited animal health coverage, widespread breeding of genetically inferior livestock, poor marketing infrastructure, shortage of trained manpower, inadequate incentives for small producers, and a lack of extension services.

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

Manufacturing.

The other objective of the strategy for developing the real sectors of the economy is to encourage the growth, modernization of, and exports from small and medium-sized enterprises. Numbering some 3.2 million, these enterprises follow a long tradition of entrepreneurship and craftsmanship, particularly in the provinces of Punjab and the Northwest Frontier Province (NWFP). The sector represents almost 30 percent of the manufacturing output, over 5 percent of GDP and 20 percent of nonfarm rural employment. An industrial policy aimed at the development of this sector would also have three components.

The first is the identification of subsectors and enterprises within these subsectors that will receive government assistance. Not only should the chosen enterprises receive subsidies, but they should also be exposed to the opportunities available in the rapidly evolving global systems of production and trade. The second is the facilitation and development of the chosen sectors. The third is to help the chosen sectors with financial support. While the second component of the strategy is in the mandate of the Small and Medium Enterprises Development Authority (SMEDA), a federal corporation established in 1998 to promote the development of the long neglected industries—the first and the third components have not engaged the state. This needs to be remedied.

Underscoring the need to make additional financing available to the SME sector, it is important to note that the government should not provide the subsidized credit, neither should it direct the banking system to finance these enterprises. What is needed is the introduction of relatively new instruments of finance into the sector. These include private equity and venture capital funds that share risks with the owner-entrepreneurs in which they invest while expecting high returns for themselves. Making these finance instruments available to the SME sector would help to liberate the generations of untapped capital potential in small enterprises, while examining the country's underdeveloped capital markets.

Human Resource Development.

The priority areas to be addressed by public policy change will only produce the desired results if the quality of the human resources available in the economy is improved. Concentrating on developing human resources would mean placing focus on at least four areas of public policy. These are improvements in primary and secondary education, increasing literacy rates for women, providing modern skills to a large proportion of the country's youth, and creating synergies between the research and development of the various sectors of the economy. After years of experience with using human resource development as an important contributor to growth, practitioners have realized that they need to promote not only universal primary education but also getting children to stay in school for at least 8 to 10 years. It is only then that children are prepared to enter institutions of higher learning or to make a contribution to the economy by entering the work force. Past emphasis has mostly been on primary education. Such was the case in the World Bank-sponsored Social Action Program (SAP), which was implemented in Pakistan in the early 1990s. While the program increased the rate of enrollment in primary schools, it had a negligible impact on improving the country's human resources. The failure of SAP to achieve its promised results was because of institutional failure at the level of weak education departments in the provinces, which were unable to efficiently absorb the resources that were made available to them. Development experts have reached the conclusion that pupils need much more than 5 years of schooling to change behavior and to prepare themselves for the modern sectors of the economy. As a result, priorities must be shifted more towards secondary education.

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

Poverty Programs.

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

The cash transfer scheme will primarily benefit more vulnerable groups such as the disabled, the elderly, female-headed households, and widows. The employment guarantee program can provide an opportunity for able-bodied workers to earn an income, especially in the off-peak season.

In his 100-day plan, the new Prime Minister announced the intention of his government to launch an employment guarantee program in the underdeveloped districts of the country. Baitul Mal already runs a cash supplement scheme for food support, which can be scaled up to cover a larger proportion of poor households.

In 2006, India was the first country in the world to introduce a national rural employment guarantee program, based on the experience gained in one state, Maharashtra. The program is being run in over 40 percent of the districts with the help of Panchayati Raj (local communal assemblies) institutions. It is estimated that at full coverage, the program could cost up to 2 percent of India's GDP. A similar program should be tested in a few of Pakistan's poorest districts. It would also be appropriate to give this program the characteristics of a food for work initiative, so that the poor workers are automatically protected against inflation.

An ideal cash transfer program should be based on the identification of the poor beneficiaries by the lowest tier of local governments, the Union Councils. Efforts must be made to reduce the transaction costs and program inefficiencies. Initially, Baitul Mal would be given funds to at least double the coverage of the program to about three million households, with cash support per household of about Rs. 1,000 per month. It is expected that the total cost of running the two programs for protecting the poor will be in the vicinity of Rs. 50 billion, and implementation of these programs must proceed on a priority basis.

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

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

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

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

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

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

Reducing Regional Disparities.

Fiscal federalism will play a key role in addressing the issue of regional disparities. There is the need to ensure that the pattern of intergovernmental fiscal relations evolves in such a way that recognizes the need for more support to the more underdeveloped provinces. There is a constitutional requirement that the National Finance Commission (NFC), representing the federal government and the four provinces, be established every 5 years and should issue an award to resolve two problems. It must first address the vertical imbalance in resources between the federal government and the four provincial governments combined and then secondly, the horizontal imbalance among the provincial governments.

Over the last 7 years since 2002, the NFC has failed to arrive at a consensus on a new award to replace the one given in 1997.[16] Consequently, President Musharraf promulgated an interim arrangement for transfers that came into effect in 2006-07. With respect to the 1997 award, there are two significant changes. First, the share of revenues provided to the provinces from the divisible pool of revenues has been increased from 37.5 percent to 41.5 percent in 2006-07, rising to 46.25 percent by 2010-11, and second, these benefits have now been extended to all four provinces on the basis of predetermined shares, whereas in 1997 they were given to NWFP and Balochistan. Overall, it is expected that revenue transfers from the divisible pool and grants-in-aid will constitute 50 percent of the revenues in the divisible pool by 2010-11. The sharing of revenues in the divisible pool on the basis of population and the coverage of straight transfers remains unchanged.[17]

The basic issue is whether over the last 7 years fiscal transfers have been adequate and if the goal of fiscal equalization has been achieved, and the two smaller and less developed provinces, NWFP and Balochistan, have received higher transfers on a per capita basis. Incidentally, in the Pakistani context, straight transfers have historically been performing an equalization function. The NWFP has access to hydroelectricity profits and Balochistan has revenue from natural gas, which raise per capita transfers significantly.

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

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

Over the last 7 years, a review of the process of intergovernmental relations reveals the emergence of serious imbalances. This has been one factor contributing to faster growth of the economies of Sindh and Punjab as compared to Balochistan and NWFP. Clearly, there are justifiable reasons why the smaller provinces are dissatisfied with the workings of the federation during the tenure of the last government.

Now that elected coalition governments are in place in Islamabad, and at least three provincial capitals are led by the Pakistan People's Party (PPP), there is urgent need to arrive at an early consensus award that ensures the following:

1. Further expansion in transfers from the divisible pool to cover the emerging sizeable deficits of the provinces with the understanding that they will

henceforth face tighter budget constraints with only limited access to borrowings. Provision will also have to be made for higher transfers to cover the costs of taking on more functions by the provinces, as required by the constitution.

2. Adoption of multiple criteria for the determination of transfers from the divisible pool to ensure more fiscal equalization. The collection criteria could also be given some, albeit small, weight. Punjab should be willing to support this plan since the collection rate from the province of apportionable taxes (all taxes, excluding taxes on imports) has approached its population share.

3. Higher grants-in-aid to be made to the more underdeveloped provinces (NWFP and Balochistan).

4. Review of the formula for determination of hydroelectricity profits to NWFP, a long standing demand of the province.

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

Decentralizing Governance.

One of the more important elements of the strategy developed in this chapter is to give greater operational space to the provinces and to the institutions of local government. The new Prime Minister Yousaf Raza Gillani made an encouraging start in his initial speech before the newly elected parliament, saying that his administration will, within 1 year, transfer all the subjects listed in the constitution's concurrent list. A great deal of work at the two upper tiers of government will be required for this to be effectively and efficiently done within the current governance structure. This effort should lead to a reduction in consolidated current expenditure by eliminating the duplication of coverage by the government at the federal and provincial levels. In building their own capacity to handle the transferred subjects, the provincial government should place emphasis on the quality rather than the quantity of the staff they employ.

While the decentralization of a significant amount of economic responsibility from the federal government to the provinces would be an important part of the strategy for promoting inclusive growth, it is equally important to continue with the process of devolution to the institutions of local government. A new system established in 2001 is in place and should be continued. However, Pakistan has not been able to develop a viable system of local government because of the continuous experimentation that it has undergone since its independence. Five different systems have been tried in the past. Now, the need is to further develop the existing system rather than create something new from scratch. That said, a number of reforms are needed. The new Prime Minister said that his government will reform the local government system after evaluating how it has performed since 2001. The areas where the structure needs to evolve include the direct election of the *nazims* (indirectly elected managers in the system) to make them more accountable to the people. Governance related services such as law and order should be decentralized, perhaps initially on a trial basis, with responsibility resting with the nazims. District service cadres should also be established.

Budget 2008-09: A Lost Opportunity.

This is a good time for Pakistan's new rulers to make some decisions that will not only heal the economy but also change some of its structures. Policymakers respond in two different ways to serious economic crises. Those who are bold use the opportunity to deal with the causes behind the crises since most of the time crises are produced by structural flaws in the economic system. They correctly assume that it is best to identify the flaws and remove them from the system and prevent problems from recurring. Those who are less bold implement temporary measures and hope that the underlying problems will not reappear.

Pakistan's policymakers have usually opted for the second approach, preferring short-term fixes rather than deep structural changes. Not surprisingly, the result was a recurrence of crises produced by the same fault lines in the economy. Of the many structural problems faced by Pakistan for the past 60 years, two have been particularly important. The first is poor human development; the second is a low domestic savings rate that did not yield enough resources for the economy to invest. If the economy is to grow at 7 to 8 percent a year—a rate of growth sustained by a number of economies in Asia—it must invest close to 30 percent of the GDP. Pakistan has a domestic savings rate of only 22 percent, which can only support a growth rate of less than 6 percent, perhaps no more than 5.5 percent a year.

The country has done well when domestic resources were augmented by foreign capital flows. The reliance on external savings is not a wise policy to follow since foreign investment is unreliable. On a number of occasions, foreigners have reduced the amount of money they were providing the country. Each time that happened, the amount invested and hence the rate of GDP growth declined. If Pakistan is to stop the volatility of GDP growth, it must increase the amount of resources generated from within the economy.

Domestic savings come in three forms—savings by the government, those by the corporate sector, and those by individual households. Public policy influences all three, especially government savings (or dissavings), and this is where budgets become particularly important.

Ever since the state stopped playing a dominant role in the economy—as happened during the period of President Pervez Musharraf—the available policy instruments used to affect the economy have been reduced to basically two, the fiscal and monetary policies. Whereas the monetary policy is controlled by the SBP, the country's central bank, the fiscal policy is the responsibility of the Ministry of Finance. The SBP can change the monetary stance at any time; the Ministry of Finance usually alters the fiscal policy only once a year when it announces the budget for the year that follows. This is one reason why the budget receives so much public attention. (See Table 6.)

	1997 -98	1998 -99	1999 -2000	2000 -01	2001 -02	2002 -03	2003 -04	2004 -05	2005 -06	2006 -07	2007 -08
Total											
Revenue	16.0	15.9	13.4	13.1	14.0	14.8	14.3	13.8	14.2	13.4	14.0
Tax	13.2	13.3	10.6	10.5	10.7	11.4	11.0	10.1	10.6	10.5	11.0
Nontax	2.8	2.7	2.8	2.6	3.3	3.4	3.3	3.7	3.6	2.8	3.0
Expenditure	23.7	22.0	18.8	17.4	18.3	18.5	16.7	17.2	18.5	17.6	19.0
Current	19.8	19.6	18.4	15.3	15.7	16.2	13.5	13.5	13.6	12.7	16.0
Development	3.9	3.3	2.5	2.1	2.8	2.2	3.1	3.9	4.8	4.9	3.0
Deficit	7.7	6.1	5.4	4.3	4.3	3.7	2.4	3.3	4.3	4.3	5.0

Source: Pakistan Economic Survey 2006-07 and my estimates using the budget proposals announced on June 11, 2008.

Table 6. Government Revenues and Expenditures (Percent of GDP).

The budget for the financial year 2008-09, announced by the Finance Minister on June 11, 2008, is a particularly important policy statement for two additional reasons. First, it is the first major policy statement that assumed power following the elections of February 2008. Second, it comes at an exceptionally difficult time for the economy. After a 6-year period of relative calm, the economy has become sluggish and unbalanced. This is evident on three fronts—inflation, fiscal deficit, and balance of payments deficit. The budget can influence all of them. Before examining the policy embedded in this budget, it would be useful to look at the way the fiscal deficit has evolved over the last several years.

Fiscal deficit is the difference between government's revenue and expenditure. Government's revenues come in two forms, tax and nontax. Expenditures also come in two forms, current and development. The data provided Table 6 show some interesting trends over the last decade. The government of President Pervez

Musharraf inherited a difficult fiscal situation in 1999. In the 2 previous years, the fiscal deficit had averaged 7 percent of the GDP; 2 percentage points higher than what experts consider to be the sustainable level for Pakistan. While government revenues were reasonably high—about 16 percent of GDP—expenditures were even higher. The difference was in the order of 7 percent mostly because of current expenditures. Nondevelopment expenditure was close to 20 percent of GDP. It was clear to the new policymakers who took office after General Pervez Musharraf intervened that major adjustments had to be made to restore economic balance. They went to the IMF for assistance and received the advice that significant adjustments had to be made.

This was done over a 3-year period by putting the lid on current expenditures, which declined to an average of 16 percent a year, a reduction of nearly 4 percentage points compared to the levels reached in the late 1990s. The most significant reductions were obtained by constraining government employment and putting a cap on government salaries. Further reductions in nondevelopment expenditures became possible after 9/11 when, led by the United States, the donor community reduced the country's outstanding debt by a significant amount. This lowered the interest payments Islamabad paid to its creditors.

These adjustments, while reducing the fiscal deficit, also made it possible for the Musharraf administration to increase development expenditure. In the last 3 years of the Musharraf period, development expenditure increased to an average 4.5 percent of GDP. This was 1 percentage point higher than in the late 1990s and almost double the share in the first 3 years of the Musharraf period.

The policymakers faced the same type of challenges while preparing the budget for 2008-09 that confronted the Musharraf government in 1999. The fiscal deficit and the balance of payments deficit in terms of the proportion of GDP had reached unsustainable levels. Adjustments needed to be made to reduce the fiscal deficit by raising taxes and constraining government expenditure. Islamabad also had to deal with the pressure on lower income groups as a result of the increase in the prices of food and fuel. However, in preparing their proposals and presenting them to the National Assembly, the policymakers opted for the approach adopted by their predecessors: they did not attempt to bring about structural changes in the economy, preferring to tinker at the margin. That said, there were some attractive features in the budget.

An attempt was made to help the poor by creating a new fund to provide them with cash transfers. On the revenue generation side, some rates were adjusted to increase the burden on the rich. Some luxury items will cost more, and the higher income groups will pay more for some of the services they use, such as cash withdrawals from the banking system. These changes will help to raise some additional tax revenues for the government. I have calculated the impact of these proposals on government revenues and expenditures and the size of the fiscal deficit. These calculations are shown in Table 6. They are more reasonable than the estimates provided in the budget.

The budget proposals may also reduce conspicuous consumption by the rich. The changes, however, will be marginal and will not make much of a difference to one of the most important structural weaknesses in the economy: dependence on external flows for a significant proportion of gross investment.

What could the policymakers have done to deal with the structural problems that continue to affect economic performance? Those who made the budget could have taken four additional measures. One, they could have created fiscal space for the provinces, thus creating the opportunity to both raise additional government revenues and grant greater provincial control over public expenditure. This could have laid the basis for increasing domestic resources by bringing government closer to the people. Two, they could have significantly reduced current government expenditure by eliminating some of the functions it should devolve to the provinces. Three, they could have provided for public works programs for employment-creating opportunities for the poor in both rural and urban areas. And four, they could have further rationalized the tariff structure by levying regulatory duties on imports that feed consumption by the rich without doing much to increase investment in the economy. A quick glance at the budget gives the impression of a glass half full; it could have been filled a bit more to address the problems that continue to produce recurrent crises in the economy, but the policymakers chose not to follow that route.

CONCLUSION

Will the new government be able to address the many economic problems facing the country? This will need political resolve as well as careful planning. A small step in that direction was taken by the appointment of a panel of experts to assist the Planning Commission to come up with a program of change and reform. The panel is made up of the best economists available, and they should be able to recommend a program that focuses on structural reform. The fact that the Planning Commission has taken that step suggests that the new government is empowering the organization that was created for this purpose more than half a century ago. The Commission was overshadowed by the Ministry of Finance during the Musharraf period because the man who headed the ministry did not have the self-confidence to ask for advice. During his tenure, economic policymaking became ad hoc, subject to personal whims and pressures exerted by powerful groups of lobbyists.

What should the panel focus on in attempting to develop a program? It must aim to achieve three goals. First, it must convince those interested in the economy that the country is serious about reform and development. Two, it must devise a plan to rescue the country from the economic meltdown it is currently experiencing. Three, it must put the economy on a trajectory of growth that is not only sustainable but would increase national income at a rate comparable to that of other large Asian economies. A high rate of economic growth is needed to provide employment to those seeking work, bringing women into the work force, and reducing interpersonal and interregional income disparities.

It always helps to focus on the positive when thought is being given to the development of a medium-term growth strategy. All the talk about current economic stress has diverted attention away from what are the positive features of the Pakistani economy. I would like to mention at least three of these. First is the agriculture sector, long neglected by the federal government's policies in favor of some other parts of the economy. I have held the view for a long time that Pakistan's policymakers should give a very high priority to agriculture. The sector should lead the rest of the economy, provide jobs in both rural and urban areas, and increase exports. The second advantage resides in the country's large population that should be educated and trained to become an asset rather than a burden for the economy. The third is Pakistan's location in the middle of the most rapidly growing parts of the global economy.

ENDNOTES - CHAPTER 4

1. Shahid Javed Burki, "Time for Donors to Assist," *Dawn*, July 22, 2008.

2. Among the recent books on Pakistan's economic history, the most useful are Shahid Javed Burki, *Changing Perceptions, Altered Reality, Pakistan's Economy under Musharraf, 1999-2006*, Karachi, Pakistan: Oxford University Press, 2007; S. Akbar Zaidi, *Issues in Pakistan's Economy, 2nd edition*, Karachi, Pakistan: Oxford University Press; and Pervez Hasan, *Pakistan's Economy at Crossroads*, Karachi, Pakistan: Oxford University Press, 1998.

3. President Ayub Khan provided a detailed background of the relationship that was developed with the United States during his tenure in office in his autobiography. See Mohammad Ayub Khan, *Friends, not Masters: A Political Autobiography*, London, UK: Oxford University Press, 1967.

4. The most detailed account of the way this relationship was built is in Steve Coll, *Ghost Wars: The Secret History of the CIA, Afghanistan, and Bin Laden, from the Soviet Invasion to September 10, 2001*, New York, The Penguin Press, 2004. Also see George Crile, *Charlie Wilson's War: The Extraordinary Story of the Largest Covert Operation in History*, New York, Atlantic Monthly Press, 2003.

5. Once again the most detailed account of this relationship is from the head of the Pakistani state during this period. See Pervez Musharraf, *In the Line of Fire: A Biography*, New York, Free Press, 2006.

6. For a recent story of the way the discipline of economics has developed, see David Warsh, *Knowledge and the Wealth of Nations: A Story of Economic Discovery*, New York, W. W. Norton, 2006.

7. This part of the report draws upon the first annual report published by the Institute of Public Policy, Lahore, Pakistan, headed by the author of this chapter. The report was written by a group of six economists that included Sartaj Aziz, Shahid Javed Burki, Aisha Ghaus-Pasha, Pervez Hasan, Akmal Hussain, and Hafiz Ahmed Pasha. See *State of the Economy: Challenges and Opportunities*, Lahore, Pakistan: Institute of Public Policy, 2008.

8. There was intense debate in the country about the incidence of poverty. While the government claimed that the incidence declined by 10 percentage points during the last 4 years of the Musharraf regime from about 35 percent to 25 percent (see Government of Pakistan, *Pakistan Economic Survey, 2006-07*, Islamabad, Pakistan: Finance Division, 2007). Some independent analysts thought that the decline was considerably more modest. See Akmal Hussain, "A policy for Pro-Poor Growth," presented at the seminar Pro-Poor Growth Strategies sponsored by the UNDP and Pakistan Institute of Development Economics, Islamabad, Pakistan, March 17, 2003.

9. *State of the Economy.*

10. Hafiz Pasha and Aisha Ghaus-Pasha, *Growth of Public Debt and Debt Servicing in Pakistan*, Research Report, No. 17, Karachi, Pakistan: Social Policy and Research Center, 1997.

11. This is not a new development. In fact, it was the subject of a book length study by Ishrat Hussain while he was at the World Bank. Hussain was an important player in the team assembled by President Pervez Musharraf to manage the economy. He was Governor of the State Bank of Pakistan, the country's central bank, from 1999 to 2005. See Ishrat Hussain, *Pakistan: The Economy of an Elitist State*, Karachi, Pakistan: Oxford University Press, 1999.

12. *State of the Economy.*

13. This theme was developed by the author in a series of articles written for *Dawn*, Pakistan's largest selling English language newspaper. See Shahid Javed Burki, "Agriculture: A Shift in Paradigm," *Dawn*, June 9, 2008; and "Agriculture: Public Policy Options," *Dawn*, June 23, 2008.

14. For a discussion of the problems in agricultural research, see *Punjab Economic Report, 2007*, Lahore, Pakistan: Government of Punjab, 2007.

15. For a discussion of the Indus Water Treaty, see Aloys A. Michel, *The Indus River*, New Haven, CT: Yale University Press, 1967.

16. The award was given by the NFC that I headed as Minister of Finance in the caretaker government that was in office from November 1996 to February 1997.

17. The new government constituted a new Finance Commission in May 2008.