1

Overview

Rashid Amjad and Shahid Javed Burki

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

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

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

– The binding constraints to Pakistan's growth need to be overcome to revive the economy and ensure sustainable growth. These include tackling the crippling energy shortage, increasing revenues to regain macroeconomic stability and reduce the current unsustainable fiscal deficit, and ensuring the availability of water to meet the needs of the agricultural economy.

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

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

– Pakistan must aim not only for sustained and higher growth, but also for inclusive growth such that the poor and vulnerable both participate in as well as share the gains of economic growth—allowing the benefits of development to spread to the country's less developed economic regions.

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

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

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

Lessons from the past

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

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

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

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

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

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

Amjad argues that much of the problem that arose as growth first increased and then plummeted stemmed from (i) the Musharraf government's failure to take advantage of the spurt in economic growth, and (ii) the succeeding PPP government's failure to take concerted action necessary to restore macroeconomic stability and revive growth. Indeed, he suggests that by the end of its term, the PPP government could rightly be accused of gross negligence, wanton economic mismanagement, and rampant corruption.

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

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

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

Overcoming major constraints

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

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

The energy crisis

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

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

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

The root causes of the problem can be traced to Pakistan's decision during the 1990s to opt for an energy mix that involved independent power producers (IPPs) who set up oil- and gas-fired energy plants to overcome the country's energy shortages. As the price of oil increased from around USD 15–20 a barrel to USD 100–140, these plants could only supply electricity at high prices, which had to be subsidized for fear of public reaction spilling over into street violence. Prices were not adjusted during 2004–07 till the subsidy became unsustainable; when, eventually, they were adjusted in 2008 and over the years, they were never done so in sufficient measure to overcome the cost and prices charged to consumers. The result has been a widening gap between supply and demand and between costs and prices. The prices also reflect almost 30 per cent worth of losses from theft and technical factors, of which theft comprises almost 60 per cent.

What, then, are some of the more short-term solutions (12 to 18 months) to the problem? Malik (Chapter 5) and Burki (Chapter 4) suggest the following measures:

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

Medium- to long-term solutions include the following:

- Correctly price power consumption to attract private investors.
- Change the country's currently expensive energy mix by utilizing its enormous coal supplies, especially the unexplored 185 billion tonnes of coal reserves in Thar. The shift to coal should be accompanied by measures to reduce its environmental impact.
- Build run-of-the-river hydropower projects.

– Move to alternative environment-friendly energy generating systems, including wind power, biogas, and solar energy.
– Build more major dams: start by raising resources for the construction of the Bhasha-Diamer dam and plan to build two major dams over the next decade and a half.
– Actively pursue the completion of the Iran–Pakistan gas pipeline and establish links with energy networks from Central Asia through Afghanistan.

Macro-stability: Raising revenues and reducing the fiscal deficit

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

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

The package of tax reforms that Pasha and Pasha identify has a focus on direct taxes, which would not only result in an increase in tax yields but also make the tax system more progressive. The measures suggested to achieve this include levying an effective agricultural income tax; reintroducing the wealth tax; instituting a minimum tax on turnover; targeting tax exemptions; rationalizing tax rates; developing property tax; and providing incentives for tax payers to file returns.

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

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

The critical role of tax reforms in making devolution work

In Chapter 14, Ahmad examines whether the major reforms undertaken through the 7th NFC award and the 18th Constitutional Amendment will work effectively and ensure higher living standards for all people in all four provinces. In this context, he also examines in detail the downward slide in Pakistan's tax-to-GDP ratio and argues that unless effective measures are taken to raise revenues, any structural shifts involving significant decentralization to the provincial governments are "of little more consequence than shifting deckchairs on the Titanic."

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

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

Water: Maintaining and harnessing the indus basin irrigation system

Pakistan, it is rightly said, is the gift of the Indus and, as Chaudhry states in Chapter 8, "Pakistan's Indus Basin irrigation system is the strong heart of the country's economy." The chapter provides a historical overview paying tribute to the British irrigation engineers who created the original system (1847–1947) and the Pakistani irrigation engineers and institutions (particularly the Water and Power Development Authority and provincial irrigation departments) who have added new dams and barrages, built new link and branch canals, and maintained the world's most complex and extensive irrigation system.

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

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

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