

The Pakistan Development Review
37 : 4 Part I (Winter 1998) pp. 37:4, 85–122

The Mahbub ul Haq Memorial Lecture

Pakistan at the Threshold of the 21st Century: How to Shape a Better Economic Future?

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Pakistan has been facing a deep-seated economic and financial crisis and seemingly intractable governance issues for the last few years. Factors such as international sanctions and global economic slowdown, which have worsened Pakistan's economic difficulties, were beyond Pakistan's control. But by and large, the country's economic and financial difficulties are the result of economic mismanagement in key areas over long periods. Bad governance, as reflected in widespread corruption and poor delivery of public services, and especially poor law and order have given birth to a crisis of confidence in the state. It is argued here that despite this scenario, a long and arduous process of building institutions, setting the policies right, and enforcing a rule-based governance stressing both merit and accountability can put Pakistan back on the road to shared prosperity. Resolving financial problems, accelerating demographic transition, exploiting tremendous agricultural potential, improving both availability and quality of education, increasing competitiveness and bringing about structural change in exports and industry, and reforming the government are crucial policy actions that can help shape a better future for the country and end the economic drift.

It is a great honour to be asked to give the first Mahbub ul Haq memorial lecture to The Pakistan Society of Development Economists. Mahbub's sudden and untimely death in the summer of 1998 is still a source of great shock. His passing away has deprived Pakistan of one of its most illustrious sons and robbed the world community of one of the most effective spokesmen for just development. Mahbub's path breaking contributions to the concept of human development will be long remembered and his influence on economic and social policies is being felt globally. For me Mahbub was a close personal friend for nearly half a century. It was also a source of great pleasure to work closely with him in Pakistan's planning in the 1960s and at the World Bank in the 1970s and to see him operate with such boldness and conviction in dealing with issues of poverty. For all his internationalism, Mahbub's first and lasting love was Pakistan. I know that he was frustrated and troubled that Pakistan's economic and social performance had not lived up to the earlier promise and had fallen much short of the very considerable potential. In honouring Mahbub ul Haq's memory, therefore, I will devote my lecture to conditions and policies which are needed for an economic turnaround in Pakistan. I believe better governance and more effective economic management can ensure not only higher growth than in the past but more just distribution of growth benefits, a broader human development and greater self reliance.

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PRESENT POSITION

There can be little argument that Pakistan has been facing a deep seated economic and financial crisis and seemingly intractable governance issues for the last few years. The financial crisis manifested itself in a near default on external loans in 1996-97, freezing of resident foreign currency deposits in late May 1998, and a technical default on many external debt payment after August 1998, latter triggered by imposition of sanctions following India and Pakistan's nuclear explosions. A new IMF agreement and agreement by the Paris and London clubs to reschedule substantial amount of debt payments due in 1998-99 and possibly in 1999-2000 has staved off danger of debt default but there is a consensus that these agreements have provided breathing room only. The macro-economic imbalances, both fiscal and external still remain rather large. The overhang of public debt is how huge. By mid 1999 the ratio of public debt to GDP was over 95 percent (the comparable figures for India is 55 percent) and any significant reduction of debt burden will require a combination of strong financial discipline and good economic policies stretched over several years. Meanwhile the financial constraint is aggravating the structural economic problems notably in industry and exports and is depressing investment in physical and human capital so badly needed to rectify Pakistan's serious lag, in infrastructure and social development. In 1998-99 both public investment and total fixed capital formation as a percentage of GDP were at the lowest level in more than two decades: total investment was only 14.9 percent of GDP in 1998-99 compared to the average of 18.8 percent during 1990-98. It is hardly surprising that the per capita GNP growth which had already slowed to 1.1 percent annum during the first half of the 1990's from over 3 percent per annum during 1960-90 has nearly stagnated during the last three years.

The governance issue are highlighted by the crisis of confidence in the state which is resulting from poor delivery of public services especially law and order. This along with wide spread corruption is leading to a breakdown of the compact between the people and the state. This makes it difficult among other things to collect taxes. At the political level, the divisions in the country remain large notwithstanding the unprecedented political mandate given to Nawaz Sharif's Muslim League in February 1997 and notwithstanding the large majority of the government in the Parliament. Indeed, the Government's standing in the smaller provinces has suffered as it lost its coalition partners ANP and MQM . There is a sense that politics are being dominated by the Punjab and the Prime Minister's inner circle.

From a geo-political point of view, the fact that Pakistan has gone from being the best performing country on the sub-continent in terms of growth rate of GNP per capita during 1960-85 to the worst in the 1990s is bound to have consequences for handling of foreign policy and defence issues. In per capita GNP terms, India now seems to be growing three to four times as fast as Pakistan. This is bound to upset the balance of power considered so vital in South Asia. Thus notwithstanding Pakistan's acquisition of the nuclear capability, the strategic edge seems to belong to India.

On the external side, the crisis in East Asia, subsequent large devaluations of East Asian Currencies, prospect of slowdown in global economic growth, sharp curtailment in availability of international capital flows to the not so strong borrowers has also adversely effected Pakistan's exports and the balance of payments position. Finally the deterioration in the climate for foreign private investment in Pakistan due to the dispute with IPPs (Independent Power Producers) has also clouded economic outlook. Clearly some of the factors which have deepened Pakistan's economic difficulties i.e. international sanctions and global economic slowdown were beyond Pakistan's control. But by and large, the country's economic and financial difficulties have been building up over decades and are the result of economic mismanagement in key areas over long periods. For instance successive government downplayed the need for more self reliant growth, tended to ignore the growing competition between defence and development, invested inadequately in social and human capital and in making economic choices often opted for the easier short term solutions. Unfortunately, the present political and economic leadership has been no exception. It has not recognised the serious bind in which the past policies have placed Pakistan and the time it will take to put the economy on a sound footing. It has not taken the public into confidence about the tough choices the country faces and thus it has not sought to develop a truly national consensus on key issues such as savings, exports, population control, education, the role of government and the relations with India. It has instead held out prospects for quick and relatively painless recovery.

POLICY AND INSTITUTIONAL FAILURES

Let me elaborate on the policy and the institutional failures. Some policy problems have persisted over decades. Excessive reliance on foreign capital, low domestic savings, inadequate investment in the social sectors and heavy protection to domestic industry, can all be traced back to the 1960s, otherwise considered a golden era of development. The 1970 nationalisations by Bhutto of a segment of industry, banking, insurance and private educational institutions dealt a major blow to the emerging private sector and even twenty five years later large part of the financial and insurance sectors are still owned by the public sector. At the same time, following the separation of East Pakistan and emergence of Bangladesh, defence spending was increased and large fiscal deficits began to be incurred. Under Zia, none of the difficult policy issues which had emerged during the 1960s and the 1970s, unsustainable fiscal deficits, lag in social development, unbalanced industrial development were tackled resolutely. Indeed defence spending accelerated sharply and development spending was squeezed seriously upsetting the balance between the two.

After ten years of democracy following Zia, macro-economic adjustment still remains incomplete, the relative allocations between defence and development have become even more unbalanced and progress towards universal primary education and adult literacy remains limited. While there has been an important policy shift towards

the private sector and greater reliance on market signals rather than administered prices, the privatisation efforts have made limited head way and the losses of the large public enterprises notably WAPDA have grown. The response of the domestic private sector to the liberalisation of foreign exchange and investment controls has been very inadequate. In face of the challenges of resource mobilisation, export development and structural changes in the industrial sector, private sector has been floundering. Indeed the relative dependence of the private sector on borrowing has grown and the textile industry has found it difficult to cope with the phasing out of the subsidies on raw cotton. As the export taxation of cotton, which had provided a strong but unnecessary cushion to the profitability of the Pakistan textile industry for several decades was phased out, cotton based exports have stagnated in the 1990s pulling down the entire export performance because of their dominant weight in total exports.

Two biggest failures of public policy and institutions during the last ten years have been the sharp deterioration in the effectiveness of resource use in the public sector and the growing abuses in the largely public sector controlled financial system. Over the period 1990–98, real public spending, excluding interest payments, actually declined. But the problems arising from shortages of public sector resources for development were made worse by the way public sector programme was managed in the post-Zia period. The effectiveness of public sector development and non-development suffered because political pressures in the choice of projects and implementation arrangements became quite overt, the institutional capacity for review and appraisal of projects was further weakened and diffused, and the economic policy coordination arrangements for setting economic priorities tended to be bypassed. The institutional capability of Pakistan's planing institutions, especially the Planning Commission, was in decline for a long time, but the decisions to bypass the Planning Commission's approval process for important programmes, such as highways and energy development and politically-motivated development like the People's Work Programme, were extremely unfortunate. All democratic governments, starting with Junejo's in 1985, found have it difficult to resist political pressures from regional and local interests for low priority public spending. The ad hoc nature of decision-making appeared, however, to reach its nadir during Benazir Bhutto's second administration (1993–96) and proved particularly costly in terms of its macro-economic consequences. That prime minister Benazir Bhutto also was the finance minister contributed to diluting the force of internal procedures and processes.

Some tightening of public spending has taken place during the last two years. The problems with leakages in government spending have continued to persist, however, as demonstrated by wide spread abuses such as ghost schools and phantom teachers. Also, decisions on many development projects continue to be made on an ad hoc basis.

The further deterioration in the health of the domestic banking system is reflected in the rise in overdue and bad loans from Rs 80 billion or about 25 percent of outstanding loans in August 1993 to Rs 143 billion or about one-third of total outstanding loans in 1998. That the highest default ratio occurred in the case of nationalised banks suggests both greater inefficiencies in public sector owned banks and their greater susceptibility to political pressures and corrupt practices.

The present government in its first two years has certainly been able to reign in corruption at the higher levels of government, has reduced government administrative spending, and, as mentioned above, made some progress in improving the effectiveness of spending. It has, by and large reaffirmed support for the liberal economic policies, speedy privatisation and major financial sector reform though the actual progress on privatisation of public enterprises and public owned banks remains painfully slow. But it has also made major economic policy mistakes and has not even begun the difficult task of rebuilding public institutions for development.

THREE RECENT POLICY MISTAKES

Among the policy mistakes three that stand out are, the timing of the tax reform, and the handling of the resident foreign currency deposits and the IPPs. The not well thought out major reduction in income tax, sales tax and customs duty rates in March 1997 led to a decline in the already low ratio of tax to GDP to 13 percent in 1997-98 notwithstanding the windfall in form of higher taxes on petroleum reflecting lower international oil prices. The expectations that low income tax rates will lead to an enlargement of the base of tax payers and that lower trade taxes will reduce smuggling have not materialised. The basic philosophy of extending the base of taxation and reducing the immense tax leakage and evasion through a more moderate level of taxation might have been sound but the timing and sequencing of tax reform measures was wrong. The loss of revenue is estimated at about 1.5 percent of GDP. The second mistake was to resist the needed up front devaluation following the imposition of economic sanctions and the deterioration in the foreign exchange position in May 1997 and instead to opt for the freezing of resident foreign currency deposits to forestall a run on these deposits. Eight months later, the government found itself in the worst of all possible worlds, a large de-facto devaluation, a critical loss of trust in its ability to honour commitments, and a surrender to the demands of the holders of the deposits to convert them to foreign exchange obligations albeit medium term bonds with a minimum maturity of three years. Similarly the handling of the disputes with the IPPs has left much to be desired. While the allegedly serious corruption by the IPPs had to be investigated, the high profile fashion in which the government has gone about it has seriously damaged the foreign investment climate in Pakistan.

It is not surprising that the persistent weaknesses in investment, policies and

institutions have resulted in a growth crisis. There is a growth crisis in the sense that significant increases in the per capita income which were enjoyed for long periods can no longer be taken for granted. The unsustainability of the past pattern of Pakistan's development with its excessive reliance on foreign resources, neglect of human development and equity issues is patently clear. That we have lost economic momentum in relation to both India and Bangladesh is also sadly true.

In short, there cannot be too much dispute that Pakistan at the threshold of the 21st century finds itself in deep economic and political trouble. Under the circumstances it is not easy to reflect on the economic future and certainly impossible to predict it. But depth of the present crisis and the widespread pessimism about the future can and must provide the seeds of positive thinking. I will argue that since most of the Pakistan economic problems are the result of economic mismanagement and poor governance setting the policies right and starting the long and arduous process of building back institutions, enforcing a rule based governance, stressing both merit and accountability, can put Pakistan on the road to shared prosperity. After a painful period of adjustment and transition lasting perhaps three to five years Pakistan can recover to healthy average rates of per capita GNP growth and unlike the past combine it with a broader distribution of growth benefits and strong progress towards human development.

NEED TO DEVELOP A LONG TERM VISION

Indeed one can go further and present the hypothesis that with improved political governance and moderately good economic management, Pakistan can have a much better economic and social record during the next twenty five years than in the past quarter or half century. But one must hasten to add that in retrospect the overall economic performance in the past cannot be considered very satisfactory. Contrary to general impressions, even on the narrow criteria of per capita GNP growth, Pakistan's increase of 2.1 percent per annum over 1973-98 was about average in South Asia. On many other measures of performance i.e. human development, structural change (especially development of new dynamic exports and a modern industrial sector), domestic savings, self reliance, and avoidance of external debt difficulties, Pakistan's record does not compare favourably with either India or Bangladesh. In my judgement, it will be feasible for Pakistan to attain an average GNP per capita growth of 4 percent per annum during the next twenty five years double the 2 percent per annum growth achieved during the last fifty years. More importantly, higher growth with broader distribution of growth benefits and greater self reliance will be possible if development strategy emphasises savings, exports, human development and agricultural and industrial modernisation and de-emphasises rent seeking and makes the tax and expenditure system both more effective and fairer.

To sum, the long term target of 4 percent per capita GNP growth may appear too modest and inconsistent with the desire to join the ranks of Asian Tigers in economic performance. Here two points are relevant. First, the past neglect of investment in human capital and low levels of educational attainment in Pakistan will continue to constrain growth for quite sometime especially in the present circumstances where growth in productivity as well as expansion in international trade is increasingly related to knowledge based advances in information technology. Pakistan cannot easily emulate countries like Korea and Malaysia because these countries had already in the 1960s or the 1970s attained educational standards higher than Pakistan enjoys to-day. In Korea essentially full enrolment at the primary level was achieved in the early 1960s. By 1975 three fourth of the relevant age group was completing middle school [Hasan and Rao (1979)]. In Malaysia primary level enrolment was 90 percent in 1974 and secondary level enrolment was 40 percent [Young, Bussink and Hasan (1980)]. In Pakistan universal primary enrolment could take another decade.¹ At present, the mean years of schooling of workers aged 25 and over is only around 2.5.² Second, even with good policies and strong political determination, the acceleration of growth from the present level of barely 1 per capita per annum will take time. The recovery from the present economic crisis, in growth terms, cannot be quick if due attention is to be given to putting finances in order, shifting the focus of investment towards the social sectors and restructuring industry to face the competitive pressures of globalisation.

The main point is that in Pakistan's context where the past pattern of development has proven to be totally unsustainable because of its extraordinary dependence on foreign savings and its inequitable sharing of growth benefits, a longer run economic vision is absolutely necessary. This vision should concern itself not only with growth but also equity and greater financial self reliance. Unless long term goals are defined in these broader terms, short term costs, trade offs and sacrifices will not be either understood or accepted. A twenty five year time horizon might be anathema to most politicians but hopefully public opinion and the private sector can be persuaded to take the long view instead of considering our present predicament hopeless? I recognise that Keynes said that in the long run we are all dead but his context was not development and structural change in a pre-modern society. Pakistan's problems are deep seated and the government undermines its own credibility when it promises a quick recovery in growth and a relatively quick resolution of structural and financial issues. While the general directions of change suggested in the programme Pakistan 2010 make sense, the growth, savings and investment targets indicated are totally unrealistic. For instance,

¹The government has set an ambitious target of universal primary education by the year 2006. But this target is likely to be missed not so much because of financial difficulties but rather institutional capacity and managerial constraints.

²Pakistan (1997-98). The male and female data has been combined using their ratio in the labour force.

Pakistan 2010 implies a target of nearly 8 percent per annum GDP growth over the next decade or so against the actual growth of 3.7 percent per annum during 1993–98. This kind of framework not only raises unrealistic expectations but also distorts likely resource availability and investment priorities. Realism and patience are qualities both our politicians and planners will need in great measure at least for the next Plan period (1998–2003) which will at best be a period of adjustment and transition.

CONDITIONS FOR AN ECONOMIC TURNAROUND

I think I have said enough to indicate that in aiming to treble per capita GNP over the next twenty five to thirty years and to achieve this with greater equity and more financial self reliance, the sights are not being set too low.³ But while the goals are not unambitious, their achievement will require clearly better political governance than seen in the last decade, a much more forceful pursuit of necessary economic adjustments and much greater attention to institutional reforms and implementation issues.

A strong, enlightened and honest political leadership which can build a national consensus not only on economic priorities but also on the more difficult issues of relations with India, the priority of defence spending, and power sharing arrangements with the provinces is vital for better economic performance. The record of democracy in Pakistan during the last decade is not an encouraging one. But one hopes that the present leadership will learn from its mistakes, not ignore professional advice and have the political will to stay the course of unpopular and painful economic decisions.

The governance problems of deteriorating law and order, widespread corruption and misuse of public resources, and ineffective bureaucracy are looming rather large in Pakistan at present and are acting as a strong disincentive to both foreign and domestic private investment and have the effect of lowering economic growth. But to an extent, the present governance problems have their roots in the pattern of economic development over the last fifty years. The uneven distribution of growth benefits and increasing dualism in the society are reflected in the sharp contrast between the growing numbers of poor and illiterate, on the one hand, and increasing wealth and sophistication and wealth of the elite and the upper middle classes, on the other hand. The divergence in the life style between the rich and the poor is to some extent unavoidable in the early stages of capitalist development. In Pakistan, however, this divergence has become especially pronounced in recent years as economic growth has slowed down, real wages have tended to fall and the incidence of poverty has tended to increase. Equally important, government policies which have neglected the social sectors and bestowed unearned benefits on industrialists and entrepreneurs have aggravated income disparities. It is not, therefore, entirely surprising that tensions within the society have

³With an annual average growth of 4 percent per annum, it will take per capita GNP twenty eight years to treble.

grown over time and have begun to erupt with increasing frequency in ethnic, sectarian, and random violence. While an improvement in the law and order situation is necessary for stimulating growth, the pattern of future growth must also ensure that some of the underlying causes of tensions in the society, i.e., poverty, illiteracy, growing income disparities are removed or mitigated over time. As Pakistan looks to the future the growth and governance agendas appear to be intertwined. Without an improvement in the quality of governance and a reversal in the decline in public institutions it will be difficult to revive economic growth. But the challenge also is to ensure that economic policies in the future will correct the imbalances of the past, seek to greater harmony in the society, and help deal with the governance issues such as corruption and law and order. The political leadership can also help to promote the much needed changes in values and attitudes by accepting the need for a rule based society in which hard work, thrift, innovation and merit are the criteria which guide both the civil service reform and the relations with the private sector.

In the remaining part of this paper, I will abstract from the political governance issues except to the extent that they are directly relevant to economic policy reform and implementation. Thus I will focus mainly on the structural elements, crucial economic policy actions and institutional issues which can help shape a better future and end the economic drift of the 1990s, with GDP growth rate of less than 4 percent per annum, which has brought increasing unrest, growing poverty and major financial difficulties. I will dwell on six aspects of economic management which appear crucial to me. These are (1) resolving the financial problems, (2) accelerating the demographic transition, (3) exploiting the tremendous agricultural potential, (4) accelerating the level of and improving the quality of education, (5) developing a new compact with the private sector to increase competitiveness and bring about structural change in exports and industry, and (6) last but not least strengthening implementation at all levels of government thus creating a culture of accountability and performance.

RESTORING FINANCIAL EQUILIBRIUM

The viability of all other long term policies will be vitiated if Pakistan does not restore financial equilibrium. Pakistan's financial difficulties have several dimensions. First, notwithstanding some progress in the last two years, the underlying macro-imbalances remain large. Before the external debt relief, the fiscal deficit in 1998-99 was still 4.7 percent of GDP (3.4 percent after debt relief) compared to 6 and 5.4 percent respectively in 1996-97 and 1997-98. Furthermore, the fiscal deficit does not include the losses and potential losses of public sector corporations and banks. The estimated current account balance of payments deficit of \$2.5 billion or 3.8 percent of GDP in 1998-99 was sustained only by extraordinary debt relief. Second, the reduction in the fiscal and balance of payments deficit during

the last two years have been brought about mainly by reduction in the investment rate which seriously threatens the future growth of the economy. Thirdly, there is a correct perception in the press and in the public that the current agreement between Pakistan government and the IMF while helping to avoid default on external debt will at best provide only a breather from our difficult indeed dire economic and financial problems. The ability of the real economy to withstand progressive financial shocks has been greatly weakened and economic uncertainty is already playing havoc with investment and growth. But the more fundamental point is that even with a successful implementation of the IMF assisted programme, the financial adjustment, both fiscal and external, will be far from complete by the middle of 2000. The final and related point is because both the domestic and external debt has risen to extraordinary heights; the bringing down of this debt burden to manageable levels is no simple matter and will take several years of sustained and disciplined fiscal and external resource management.

DEBT OVERHANG

According to my estimates, total public debt in mid 1999 was over Rs 2800 billion (the external debt has been converted by using the latest exchange rate) and exceeded 95 percent of GDP. This ratio has risen from 60 percent of GDP in 1985 and 80 percent in 1990. The economic programme even if implemented aggressively over the next twelve months can at best bring down this ratio only marginally whereas the need is to reduce it to at least 70 percent of GDP if Pakistan wants to get out of the debt trap and indeed if it wants to get meaningful control of its economic policies which will inevitably be dictated by creditors as long as emergency infusions of external capital are needed.

The government, therefore, needs to develop and the public and the press should debate the elements of a viable strategy of debt work out reduction over the medium term. One must begin with outlining the nature of Pakistan debt problem and distinguish between related but nonetheless separate issues of external and internal debt. Till the late 1980s, the external debt of Pakistan was more or less manageable. In the 1990s, the burden of external debt has grown because while current account balance of payments deficits increased (totalling \$17 billion alone during the four years ending June 1988) exports have tended to stagnate in recent years and GDP growth slowed down. The real depreciation of the currency in 1998 necessitated by the serious foreign exchange crisis has also increased the burden of external debt. The ratio of foreign debt to GDP, after debt relief, in mid 1999 was approaching 60 percent (compared with 35 percent in 1990) and the share of relatively short-term debt in the total has grown. As a percentage of foreign exchange earnings including remittances, Pakistan's external debt is now close to 300 percent. The high external debt-service payments have meant that the gross annual external financing requirements reached the totally unsustainable level

of \$9.5 billion during the last three years (1995–98). Even after annual average the accruals to resident foreign currency deposits of \$1.2 billion, the requirements were far excess of normal sources of finance. This is the background against which the debt re-scheduling had to be sought from the London and the Paris clubs. Clearly, Pakistan's external payments difficulties were exacerbated by the imposition of sanctions but their root cause lies in the payments imbalances of the last few years and rather reckless reliance on financing these imbalances with short-term resident foreign currency deposits (RFCD) and other short-term borrowing.

The foreign exchange crisis forced the balance of payments adjustment which has brought down the current account balance of payments deficit (before accruals to RFCD) from the peak of \$5.3 billion in 1995-96 or 8 percent of GDP to \$2.5 billion or 3.8 percent of GDP in 1998-99. But clearly further reduction in external deficit will be necessary. In my view, it should be the goal of policy to reduce the deficit to around 2 percent of GDP and to maintain it at that level in the foreseeable future or till such time that the ratio of external debt to GDP is brought back to reasonable level of say 40 percent.

The magnitude of external adjustment needed in Pakistan is as great as the fiscal adjustment which has been the focus of most previous IMF agreements. In the past, the balance of payments targets suggested by IMF were much less stringent than fiscal targets. Indeed the relatively recent 1997 IMF agreement considered a current account balance of payments deficit (*after* accrual to RFCD) of 4 percent of GDP or roughly 6 percent of GDP (*before* accrual to RFCD) quite feasible for 1997-98. Both the government and the IMF were too sanguine about the prospects of large additions to resident foreign currency deposits though it has been evident for some time that a major factor in their increase was the large implicit subsidy provided by the State Bank of Pakistan through foreign exchange risk cover at a rate much below the expected depreciation of the rupee. The stagnation in export earnings since 1995 should have also sent up a cautionary signal about the desirability of large further increases in external obligations. No doubt the government handling of IPPs has effected creditor confidence and made the roll over of short-term credit much more difficult. But fundamentally, Pakistan's balance of payments position has been precarious for a number of years because not only were the deficit large but also the sizeable external inflows were short-term and not financing investment but rather sustaining consumption levels.

Because the need for external adjustment was not foreseen by policy-makers and international institutions the adjustment that has taken place this past year has been disorderly reflected in sharp compression of imports. Effects of this on investment level and medium term growth will be unavoidable. But as mentioned above, the balance of payments adjustment will need to go further to ensure a more self-reliant growth path.

Can the future adjustment necessary to put external finances on a sound footing and bringing Pakistan closer to a more self-reliant growth path be made without major disruptive effects on growth and investment? Certainly limiting the current account balance of payments deficit to around 2 percent of GDP during the next four or five years compared to 6-7 percent of GDP during the last five years will not be easy. The impact on investment and growth will depend in large part on whether additional domestic savings can be mobilised for investment, whether exports expansion or import substitution (especially in food grains and edible oils) can help to ensure adequate availability of capital goods imports. It will be desirable to obtain a greater degree of equilibrium in the balance of payments while protecting and if possible enhancing economic growth. If a reduction in the balance of payments deficit is achieved mainly by a further reduction in the already low rate of investment (or further squeeze on social spending), the long term growth will suffer seriously. The aim should be to increase domestic savings to make up for reduced foreign inflows. But these domestic savings must also be translated into earnings or savings of foreign exchange.

While export, agricultural and industrial policies have all a role to play in strengthening the balance of payments, the need for a realistic exchange rate remains paramount. Unfortunately, devaluation remains an emotive issue for most Pakistanis, an evil forced on them by the IMF. By raising prices of foreign goods and other expenditures in foreign exchange such as travel and education, devaluation puts pressure on real consumption and investment. But precisely because it succeeds in reducing real expenditures and switching of expenditures from foreign to domestic goods, devaluation helps the balance of payments positively. It is true that devaluation does not always work especially if monetary and fiscal policies are not supportive. But the types of arguments being frequently used in the debate on the exchange rate in Pakistan do not withstand close examination.

For instance, it is argued that devaluation adds to inflationary pressure and therefore the hoped for competitive advantage is quickly eroded. However, the cost push effects of devaluation through raising of import prices can be easily exaggerated. Imports at present account for only 15 percent of GDP. Inflation in Pakistan is largely a monetary phenomenon driven by sizeable fiscal deficits. Another argument is that in the short run the response of exports and imports may be limited because of non-price factors. Certainly a significant part of the export problems facing Pakistan are structural and must be addressed by special measures. But it is not true that Pakistan's experience suggests a low response to devaluation. The relatively good export performance of the 1980s owed a great deal to the large depreciation of real effective exchange rate after 1982. In contrast, the nominal devaluations of the Rupee over 1990-97 merely compensated for the higher rate of inflation in Pakistan and there was no change in the real effective exchange rate. Given this and the serious structural problems facing

exports especially the heavy dependence on cotton based exports, it is not altogether surprising that exports have stagnated during the last three or four years. Another argument against devaluation is that it negatively effects the fiscal situation because of the large burden of external debt. Fortunately, the significant debt rescheduling from the Paris and London club of external debt payments in the current year and the next will prevent exchange rate adjustments from aggravating the fiscal position. Finally, real devaluation does put pressure on real wages as it transfers income to exporters. In Pakistan's case the best long run guarantee for minimising the impact on the most vulnerable groups in the society will be the drive for self-sufficiency in wheat and edible oils which will indeed be helped by the exchange rate depreciation.

To some extent the debate on the exchange rate has been overtaken by events. The effective unification of the various exchange rates through the market mechanism in the first half of 1999 has resulted in an exchange rate of Rs 51.5 per U.S. dollar compared to the rupee parity of Rs 44 per U.S. dollar in May 1998. This means that, for the first time in the 1990s, there has been a significant real exchange rate adjustment during 1998-99. This real depreciation has been necessitated indeed forced by a change in Pakistan's external circumstances and a delayed realisation both at the international and national level that past balance of payments were not sustainable. Instead of this change being resisted, it should be welcomed as an important instrument for progress towards greater self-reliance. Paradoxical though it may seem, a realistic value of the rupee and a reduction in the scarcity premium in the free market is more likely than anything else to reverse the capital flight which has been underway since the summer of 1998. For the future also, small adjustments in the nominal exchange rate if warranted by the differential of inflation rate between Pakistan and her major trading partners should be made more or less automatically or least on a regular basis so that the trauma of a major periodic adjustment can be avoided.

External adjustment must go hand in hand with domestic financial adjustment. Among the economic issues, nothing is quite as critical as the need for raising the domestic saving rate. The task of raising domestic savings is broader than the goal of reducing fiscal deficit, though the fiscal adjustment will certainly contribute to higher domestic savings. Hemmed in by the IMF conditionality, however, fiscal adjustment has been viewed too narrowly. No doubt, Pakistan has run large and unsustainable fiscal deficits for a long time and violated close to dozen IMF agreements. But as mentioned above, much of the reduction in the fiscal deficit in recent years has been achieved through compression in expenditures. That squeezing of government expenditures in the 1990s has already taken a heavy toll on development spending is well known. But it is not widely recognised, that total real public spending (excluding interest) over 1991-98 actually declined, falling from 20.6 to 14.9 as a percentage of GDP. Over this period defence spending has dropped from 6.3 to 4.8 percent of GDP while development

spending fell from 6.4 to 3.2 percent of GDP. It is doubtful that social spending has risen significantly. Indeed implementation of the Social Action Programme may be in jeopardy. Certainly adequate allocations are not being made for operation and maintenance expenditure. Since the size of the government and military establishment has not been reduced, the cuts in spending must be further hampering the effective delivery of services. No doubt there is a great deal of waste in government and substantial downsizing is warranted. But on the other hand, public pay is declining and development outlays are seriously under funded. There is great danger that tough decisions on size of government payroll will be postponed while further cuts will be made in important discretionary spending reducing the effectiveness of government services further and increasing the resistance to tax collection by the public.

Greater revenue mobilisation is of course the key to fiscal adjustment. As mentioned above, as a result of not very well thought out reduction in tax rates in March 1997 and depressed imports the tax to GDP ratio, already low, fell to 13 percent in 1997-98 notwithstanding the large windfall gain due to lower import prices of oil. The problem is not, however, simply that substantially higher revenues are needed but they must be mobilised with due regards to their incidence. The strong negative reaction to the modest increase in general sales tax from 12.5 to 15 percent must be seen in this light.

The major failing of the tax system is the total inadequacy of personal income tax collections which are around 10 percent of tax revenues or barely 1.3 percent of GDP. The sharp reduction in personal income tax rates has led to loss of revenue as it did not result in any greater compliance. The tax base has remained very narrow. For sake of both fairness and elasticity of the tax system, personal income taxation must be made more effective. This is the single most important test of new Pakistan Revenue Service. But even under the best of circumstances the ratio of personal income tax to GDP will rise only slowly because the maximum rate has been reduced to 20 percent. It will be difficult to improve the redistribute effects of tax policies unless new steps are taken to tax the rich more effectively.

Four measures which can yield additional revenue and improve redistribution while not effecting negatively the economic incentives and the level of domestic economic activity are capital gains taxation, estate taxes (death duties), the extension of income tax to global incomes and agricultural taxation. First, Pakistan is one of the few countries that does not have a tax on capital gains. The exemption from capital gains tax which was due to expire at the end of June 1997 was extended for another three years. Now that Pakistan has a low income tax rate there is no justification for exempting capital gains from the normal income tax; there can be some allowance (say 25–50 percent) for the impact of inflation on assets held longer than five or ten years. The taxation of capital gains, which in real estate have been phenomenal in recent years,

will not only be socially just but will also tend to curb purely speculative investments and help direct investments to longer term productive uses.

Second, large inherited wealth should also be subject to taxation in the interest of equity. The introduction of progressive estate duties ranging from 10 to 30 percent on estates in excess of Rs 5 million could help to moderate the growing income disparities in the long run. In the short run, it will be an important political gesture for a government which faces the danger of being over-identified with business interests. Care has to be taken, however, that estate taxation is more effective than the present wealth taxation which yields relatively little revenue.

Third, Pakistan should extend the coverage of income tax to income derived from all world sources. Most countries tax the global income of their residents. Pakistan also did in the 1960s but tax on income from sources outside Pakistan was effectively diluted over time. Now that maximum income tax has been lowered to 20 percent, there is even less justification for exempting any income from outside Pakistan sources from tax. The present situation actually encourages residents to transfer savings and hold assets abroad and thus acts against domestic investment. But as in all tax administration, enforcement will be important.

Fourth agricultural income tax must be made effective. Dramatic increase in revenue from this source should not be expected but a working agricultural income tax is highly necessary to improve fairness, plug leakages in the tax system and increase the tax base of provincial governments. Alternatively, serious consideration should be given to the imposition of a land tax. (see the discussion below.)

The broader issue is that greater freedom for the private sector and relatively low tax regime must be accompanied by fiscal responsibility and a reasonable degree of equity if the new capitalist orientation of the economy is to be made acceptable to the general public. The tax system needs to be made more efficient as well as more equitable.

The pre-occupation with reducing the persistently large fiscal deficits has obscured the need for increasing government savings which at present are substantially negative. The problem with Pakistan's fiscal deficits has been not only that they have been large but also that a significant part of them have been financing public consumption. For nearly twenty five years, consolidated current public expenditures have exceeded public revenues. The difference represents negative government savings which averaging about 2 percent of GDP have been a major factor in depressing national savings. The situation is not getting any better. During the last three fiscal years (1996-98) total government dissaving was Rs 185 billion or over 2.5 percent of GDP. Fiscal choices must be debated in the context of turning government dissaving into a surplus of at least 2 percent of GDP. This necessary and drastic shift must come about by a combination of higher revenues, lower interest payments and reduced non-

development spending. But the scope for the latter is somewhat limited because possible further savings in defence will be offset by increases in social spending.

In the short-run, the possibility of large external debt rescheduling offers the scope for retiring expensive domestic debt. The commentary in the press that external debt re-scheduling will provide fiscal space is highly irresponsible. The net effect of external debt re-scheduling will be to raise total outstanding external debt. The counterpart resources released, therefore, must be used for corresponding reduction in domestic debt. If any part of them are used for expenditures, the total debt to GDP ratio will increase further. But because the interest rate on domestic debt is substantially higher than on external debt, some relief will be available for the budget in the medium term. Use of privatisation proceeds for retiring external and/or internal debt will also help to lower interest payments in the budget.

Table 1

Two Scenarios of Economic and Financial Adjustment Figures as Percent of GDP

Years	1989-90	1997-98	1998-99	2003-2004 1999-2004	
				A	B
GDP Growth	4.6	5.4	3.1	4.0 ¹	5.0
Investment	18.1	17.2	14.9	16.0	16.8
National Savings	13.6	12.0	11.1	14.0	14.8
Foreign Savings ²	4.5	5.4	3.8	2.0	2.0
Public Savings ³	-0.6	-2.0	-1.7	0.5	2.0
Private Savings	14.2	14.0	12.6	13.5	12.8
Government Revenues	18.6	16.0	16.5	17.5	19.0
Tax Revenues	14.0	13.0	12.0	14.5	15.5
Total Public Spending	25.7	21.5	21.2	21.0	22.0
Defence	6.8	4.8	4.5	4.0	3.8
Interest	5.4	6.9	7.0	5.7	5.6
General Administration	1.4	1.4	1.3	1.3	1.3
Other Non-Development	5.6	5.4	5.4	6.0	6.3
Development	6.5	3.0	3.0	4.0	5.0
Fiscal Deficit	6.5	5.5	4.7	3.5	3.0

Sources: *Economic Survey 1997-98* and author's estimates and assumptions. The marginal saving rate is assumed at 20 percent in the scenario A and 25 percent in scenario B. See also footnote 8.

¹The GDP growth rates figures in both scenarios A and B are assumptions relating to the five year period 1999-2000 to 2003-4.

²Defined as current account balance of payments deficit.

³Defined as excess of consolidated public revenues over current expenditures.

While the precise nature of fiscal adjustment can and must be debated i.e. scope for raising taxation, reducing defence spending, retiring debt, funding social expenditures, these should be no ambiguity about two medium term fiscal goals: significantly positive government savings and a sharply lower debt to GDP ratio. Whatever the pattern of fiscal adjustment, it will be painful.

But provided government savings can swing from a negative 2 percent of GDP to a positive 2 percent, the domestic savings picture will improve dramatically. Control of government finances will increase confidence in currency, reduce the need for periodic devaluations and create conditions for reversal of capital flight. The present domestic saving rate of 12-13 of GDP is only half the rate in India. Pakistan's economic survival may depend on narrowing this gap.

The above Table 1 illustrates the tough financial choices Pakistan faces. Both scenarios assume that the reduction in the ratio of national debt to GDP will be given a very high priority and thus the fiscal and the current account balance of payments deficits deficit will be maintained at 3.0-3.5 and 2 percent of GDP respectively during 1998-2003 as a policy variable. Total public spending remains greatly constrained and does not much exceed the low relative level reached in 1997-98 even in the high growth scenario B. Even then, the ratio of debt to GDP will drop only moderately from 97 in mid 1999 to 78 in mid 2004 and the ratio of foreign debt to GDP will remain close to 50.⁴ This ratio could be further reduced to around 70, the minimum desired level, if sizeable privatisation revenues accrue to the government and are earmarked for debt reduction.

The scenarios bring out the central importance of increasing public savings. Positive public savings are essential for raising the very inadequate level of development spending. As we discussed above, the scope for reducing current expenditures is relatively limited. As it is, it has been assumed that real absolute level of defence spending will rise only marginally in the next few years. Savings from reduced interest payments, resulting from a declining debt to GDP ratio will be largely offset by the needs of higher social sector spending. The success of Pakistan's fiscal adjustment will depend critically on whether the government can tax the well to do and the rich through direct taxation. But even in the higher growth, higher taxation and higher development spending scenario, the investment rate will in 2004 remain well below the average level in the 1990s mainly because of the constraint on foreign borrowing. Investment resources should thus be spent very carefully and growth enhancing efficiency improvements, discussed below, will be critically important.

⁴The analysis behind these calculations makes the further assumptions of 8 percent domestic inflation and an average devaluation of 6 percent per annum to compensate for the difference between Pakistan and international inflation rates.

MANAGING THE DEMOGRAPHIC TRANSITION

The factor which provides the greatest source of my relative optimism about the long term future is the slowing population growth and the possibility that through aggressive policy actions aimed especially at female education and supporting health and family planning services, the decline in the rate of this growth can be accelerated.

The preliminary results of 1998 census suggest that population has grown at an annual rate of 2.6 percent per annum since 1981 and is estimated to be growing currently at an annual rate of 2–2.2 percent per annum now.⁵ This suggests that the demographic transition has already begun in Pakistan though both the fertility rate and natural rate of growth of population remain substantially higher than both India and Bangladesh: the current population growth rate in India and Bangladesh is estimated at 1.5 and 1.3 percent respectively and their total fertility rate is around 3 compared with 4.8 in Pakistan. Since the total fertility rate in Pakistan, though declining, is still quite high, the future demographic trends can be strongly influenced by policy measures in education, health, and family planning. A paramount need is to strengthen policies especially female education and literacy so as to reduce desired family size. Reflecting the high rates of illiteracy among women (75 percent) and low rate of participation of women in the labour force (less than 15 percent), the desired number of children in Pakistan is still 4 compared to only 2 in Bangladesh.⁶ A dramatic improvement in women's education and status in society will help to lower the desired family size and thus increase the demand for family planning services. But even at present there is substantial unmet demand for family planning services. The number of currently married women that are users of contraceptives has risen from 12 to 24 percent over 1991–98 [NIPS (1998)]. Still the unmet need for family planning (both spacing and limiting) is estimated is high. Only 39 percent of the total demand for family planning is satisfied. [NIPS (1998), p. 47.] There remains substantial scope for expansion of family planning services even with the present attitudes towards family size.

Learning from the experience of Bangladesh, public policy should set the ambitious goals of achieving replacement level fertility over the next twenty five years. The effective implementation of the second phase of the Social Action Programme (SAP) 1997–2002 will be an important first step towards the achievement of this goal. If total fertility rate can be reduced to 2 by 2025, the annual population growth will drop to around 1 percent. This suggests that with proper policies there are good prospects of limiting the annual average growth rate of population to around 1.5 percent during the next twenty five years. Even this rate of growth will be very much higher than what is likely in India and Bangladesh.

⁵This analysis is based on discussion with Sultan Hashmi, a Pakistan authority on demographic trends.

⁶These numbers were quoted by Attiya Inayatullah, a leading figure in family planning in Pakistan, at a conference held at the Human Development Centre in Islamabad in April 1997.

In any event, Pakistan population growth rate is likely to be dramatically lower over the next quarter century than in the past twenty five years when it averaged close to 3 percent per annum. In the past, the very high population growth has meant great pressures on social services (especially education) and has adversely affected domestic resource mobilisation, poverty alleviation and income distribution. A sharp reduction in the population growth rate in coming decades will ease both pressures on financial resources and help a better distribution of growth benefits by contributing to the gradual tightening of the labour market, though the effects of the slowing population growth rate on the rate of labour force growth and thus need very high employment growth will not be significant for at least a decade. An annual population growth rate of 1.5 percent over 2000–25 will also mean that an annual GDP growth of around 5.5 percent will be sufficient to achieve the economic goal of roughly trebling per capita GNP in twenty five to thirty years suggested above.⁷

IMPROVING AGRICULTURAL PRODUCTIVITY

Agriculture has been a bright spot in Pakistan's economic performance since the 1960s. The average agricultural growth rate of nearly 4 percent annually over nearly four decades has been exceeded internationally, among large countries, only by Malaysia and Thailand [Hasan (1998)]. The trend has been maintained in the 1990s despite the setbacks in cotton production. It has been argued that the agricultural growth could have been even higher in the 1970s and 1980s if the government price interventions had, on the whole not depressed the prices received by the farmers [Hamid, Nabi and Nasim (1990)].

Substantial potential for agricultural growth still exists because a large part of the increase in agricultural output in the past has come from enormous increases in availability of inputs, especially water and fertiliser. On the demand side the substantial scope for import substitutions in wheat and edible oil will help overcome the constraint from slow growing economy. The improvements in efficiency have been relatively limited and irrigated yields per hectare have shown only modest increases over long periods. The important exceptions were the dramatic increase in cotton yields during the 1980s and wheat and rice yield improvements in the second half of the 1960s.

Pakistan's reliance on an extensive pattern of development in agriculture becomes clear from large increase in water availability of over 3 percent per annum during the three decades 1960–90 attributable both to the extensive use of private tube-wells to exploit ground water resources and large public investments in water storage and irrigation. The construction of Mangla and Tarbela Dams and the large-scale Indus Basin replacement works in the 1960s and early 1970s not only reduced

⁷See footnote 3 in Table 1.

the variability in water availability but also added to total supplies from the irrigation system.

Sustainability of past pattern of agricultural growth is in serious doubt because Pakistan cannot expect major increases in water availability in the foreseeable future. No investments in storage of water are underway at the moment and, in any case, large projects like Kalabagh Dam would take a decade to complete once initiated. Ground water development through private tube-wells may be reaching a saturation point. Future agricultural growth will have to come from improving the efficient use of major inputs such as water and fertiliser as well as greater agricultural diversification.

What can the state do to promote productivity growth and better allocation within agriculture?⁸

In terms of incentives, there is still moderate negative effective protection for wheat and very high positive protection for sugarcane. The continuation of support prices for wheat, cotton and rice makes some sense because the system does, by and large, work. In case of smaller crops the price supports are not effective. In the case of sugarcane the government intervention is definitely harmful to national interests and serves mainly the interests of sugar mills. A dismantling of the entire system of sugarcane supports, at least as national policy, will improve efficiency of resource use in agriculture though it will meet tough resistance from vested interests

More effective use of water resources would require substantial increases in water charges, coupled with investments in improvement of delivery, efficiency of irrigation, and appropriate on-farm investments in land levelling, etc. At present, water charges cover less than 50 percent of operations and maintenance costs of irrigation system, let alone recovery of capital cost. Thus, there are insufficient incentives to conserve water and undertake on-farm investments. A sharp increase in water charges and an earmarking of these additional funds for better maintenance of canals will have a high economic pay-off.

There are serious problems with the quality of inputs especially seed and pesticides distributed by the private sector. This is an ideal area where more effective government regulation will be helpful.

Last but not least, improvement in the technical efficiency with which agricultural inputs are used would also require strengthening of human resource base in agriculture. Low rate of literacy and low levels of education are a major drag on agricultural productivity.

The two broader issues relating to agriculture i.e. land reform and agricultural taxation need also to be mentioned. Land reform, however, desirable from the point of view of longer term productivity and equity in agriculture is simply not likely to

⁸In making the following suggestions, I have benefited from a discussion with Shafi Niaz, a well-known expert on agricultural policies in Pakistan.

happen because of current political realities and the power of landed interests. Pakistan's experience under the last two land reforms also is not very encouraging in terms of land that could actually be release for redistribution. It is, therefore, more fruitful for public policy to focus on the issues of agricultural taxation. If income taxation of agriculture, which is a provincial subject, cannot be made effective and chances are that it cannot be the Federal government must give serious consideration to the imposition of a sizeable land tax on all holdings above 25 acres both to mobilise revenue and to force a more efficient use of land resources under large holdings. Strong discrimination in favour of small and medium scale farmers in the provision of credit will also further the interests of equity and growth.

REMEDYING THE PAST NEGLECT OF EDUCATION

Pakistan has seriously neglected investment in human capital and has paid the price for it not only in persistently high population growth for a long period but also slowing rate of growth. As a result of slow progress in education especially basic education, the adult literacy rate is only 37 percent and the illiteracy among women is as high as 75 percent. Current gross primary enrolment ratio of about two-thirds compares unfavourably with both India and Bangladesh. Furthermore, the quality of primary education is extremely unsatisfactory. Drop out rates are high and among those who complete primary school less than half can actually read, write, and do arithmetic. The low level of literacy is a major drag on modernisation of agriculture and industry and a constraint on the efforts to reduce population growth.

To exploit fully the elements of Pakistan's long term economic strength mentioned above (a declining population growth rate and greatly underutilised agricultural potential) a much greater commitment to human development and much more effective public interventions in education are required. Remedying the past neglect of education is an important goal in itself but has become absolutely critical in the context of global economic challenges of an information age.

There has been a notable acceleration in primary enrolments and a substantial narrowing of the gender gap in basic education during the last decade and policy actions and investment allocations have become more focused as a result of SAPI (1994-98). But as the stories about ghost schools and phantom teachers suggest, there are substantial leakages from the expenditures. More generally, the government does not recognises the financial, management and institutional capacity constraints which stand in the way of expanding and improving the quality of education. It therefore, does not appear to be ready to deal with them forcefully and once again the goals may be frustrated. For instance, the new education policy has set the totally unrealistic target of raising the present 2.2 percent allocation of GDP for education to 4 percent by 2003, assuming in addition that the GDP will grow at an average rate of

7 percent per annum over 1998–2003. The 20 percent annual growth in real education spending is totally beyond reach because of fiscal problems and slow growing economy.

Fortunately, at least elementary education (up to grade 8) requires relatively modest resources: the present spending on elementary education is only 1.3 percent of GDP. A growth in real spending of 8-9 percent annually on elementary education will be sufficient to meet the goal of universal primary education in ten years.⁹ This will require only a modest increase of 0.5 percent of GDP in public spending on elementary education.¹⁰

The organisational and management problems in basic education are much more critical than the mobilisation of additional resources. The present policies have four major weaknesses: a centralist bias, overemphasis on buildings on buildings, overloading of the curriculum and last but not least lack of continuity and high professional excellence of managers in education. The experience with SAP I clearly indicates that the efficiency of resource use remains a major problem. A better balance between the recurrent expenditures (teachers' salaries, text books, and teaching aids) non-recurrent spending (buildings and equipment), rationalisation of staff deployment, adjustment of teachers' staffing to changes in enrolment, reduction in teacher absenteeism can go a long way in improving the effectiveness of public education spending at all levels. But these necessary improvements can be achieved only with a high degree of political commitment and excellence and continuity of administrative leadership in education, the two conditions which are not met yet.

Increasing the basic level of education, improving its quality and, increasing literacy are the most urgent social goals. But Pakistan cannot ignore the problems with the higher level of education which remain the key constraint on development of new industries such as electronics and information technology. Improvement in the coverage and quality of higher education requires a three-pronged attack: further development of institutions of excellence; greater autonomy and/or privatisation of public institutions, especially beyond the secondary level; and increasing effective competition between the private and public sectors in provision of education beyond the middle school level. There are a few institutions of higher learning in Pakistan which have attained international standards and acceptance. But their number is woefully inadequate and their impact on the society is rather limited. Government should remove obstacles in the way of development of further private universities and should give them some preference in the allocation of land. The management load on public sector education is generally extremely heavy. There is no reason why in the spirit of decentralisation financially viable or potentially viable public sector

⁹See footnote 3 above.

¹⁰It is assumed that annual GDP growth over the next decade will average a modest 5 percent.

colleges should not be made autonomous or turned over to non-profit NGOs. This will ensure greater community involvement as well assist in mobilisation of resources for the future. Finally, there is little effective competition between the educational institutions in the private and public sectors. Public sector institutions charge extremely low fees and provide low quality education. Private colleges and universities, on the other hand, assure a minimum quality of education but charge fees which can be hundred times that of public sector institutions. Under the present circumstances, there may be an element of monopoly rent enjoyed by many private educational institutions, especially those run on commercial lines. Raising both the level of fees and the quality of education in the public sector institutions will help to increase the competition between the public and private sectors. Greater efficiencies in both sectors would help lower the present high cost of private education.

DEFINING A NEW COMPACT WITH THE PRIVATE SECTOR

Perhaps for the first time in Pakistan's history there is a clear consensus within the government that the private sector is pivotal for development because the state sector is seriously over extended financially, has become increasingly inefficient and cannot provide the effective leadership for modernisation of the economy. While increased public investment in physical infrastructure and human capital will be needed it is private sector investment (both domestic and foreign) which will be the engine of growth. But there is much less recognition both within the government and the private sector that a well-defined new framework is needed for long term cooperation between the public and private sectors. Indeed, just as in the past, the private sector appears to have been pre-occupied in obtaining tax and other concessions from the government to revive industrial capacity, which may no longer be economic. Meanwhile the government has been pushing ahead with privatisation, financial sector reform, and export and tax policy changes, many of the elements needed for a re-invigorated private sector but without defining the latter's new responsibilities.

In our view a new compact needs to make it explicit that private sector performance will be judged not only by the expansion in output and exports but also by its contribution to savings, creation of jobs, tax revenues and the modernisation of the economy. The present private sector appears to be ill equipped to think in strategic terms and paradoxically may need help from and a dialogue with the government to develop the necessary capabilities and remove constraints. In the short to medium term the private and public sectors need to work jointly on defining and agreeing on policy goals and strategies in areas such as export development, modernisation of agriculture and industry, skills development, legal and regulatory framework, an effective and elastic tax system and development of financial sector

and capital markets. Hopefully in due course the private sector will gather strength and sophistication and the state role in economic areas can be limited to setting broad directions of policy, macro-economic management, and all forms of regulation (including utilities, environmental and financial regulation).

For the near future the public and the private sector need to develop a new partnership to foster the country's economic and social goals. This will not be easy given the past history of public sector mistrust of the private sector and private sector heavy reliance on the patronage of the government for subsidies and economic rents. What is required is a change in the mindset on both sides so that an effective new relationship can evolve. The Nawaz Sharif Government with its pro business bias has excellent credentials for setting the tone of the new relationship but it needs to make sure that the private sector clearly understands that the strong policy and institutional support for its activities will have to be balanced with a new respect for and conformance to tax laws and financial, environmental, and other regulation. Also, though the private sector cannot be formally held responsible for the social goals such as adequate job creation, skills development, and environmentally friendly growth, it must recognise that the range of economic freedoms it will like to enjoy will endure only if the society can deliver sustained and equitable growth. A backlash from unbridled capitalism cannot be ruled out in Pakistan. There need not be any major conflict between national objectives and self-interest of the private sector in the long run. But in the past the private sector in Pakistan has been excessively concerned with short run profitability. This has been partly the result of political instability and unpredictability of policies but the private sector has also not always concerned itself with structural problems or long term possibilities. The present circumstances present a unique opportunity to make a new beginning.

Liberal economic policies, which are a central element of a new framework for the private sector are largely already in place. But the experience of the 1990s suggests that the domestic private sector has moved slowly to bring about structural changes in industry and exports, has increased relative dependence on borrowing to finance investments, and has continued to look to state patronage to make easy profits [Hasan (1998)]. Hopefully this will change with a clearer articulation of the new relationship between the state and the private sector. However, more direct attention should also be paid to the issues, which may stand in the way of rapid modernisation of both agriculture and industry. One factor, which could hold back progress towards rapid development of labour intensive, manufactured goods exports is the present built in bias against large-scale production. Modern sector industrial employment has grown little during the last few decades. Large scale production is not necessarily superior to small scale operations but in Pakistan's case the flight from large scale industry has not been triggered by efficiency considerations but

rather has been motivated by the desire to evade labour and other regulations which were perceived to have become excessively stringent. In the process not only tax collection but also productivity and quality control have suffered hampering exports. There is urgently need for analysis and review which will remove any policy obstacles in the way of expansion of the large scale sector. Such a review of the regulatory framework should include small and medium scale industries which also remains excessively regulated.

In terms of broad regulation and control of the private sector, three critical areas are banking sector, the capital markets, and tax administration. In the area of financial and capital markets regulation, the Nawaz Sharif government has followed the lead of the caretaker government and greatly increased the independence of the State Bank of Pakistan in formulating monetary policy and strengthened its powers for control and regulation of the financial institutions and has created an independent Securities and Exchange Commission to oversee joint stock companies and the capital markets institutions such as the stock exchanges. Meanwhile, the new managements of remaining state owned commercial banks have been charged to prepare them for speedy privatisation. Hopefully a financial system which is largely private owned but strongly regulated by the central bank will accelerate the mobilisation of financial savings and improve the allocation of credit by cutting costs of financial intermediation and reducing bank losses resulting from politically motivated lending. But a change in the financial system will also require a change in culture which can only be brought out gradually. The State Bank of Pakistan will have a crucial leadership role in creating this new culture of independence with accountability in the financial sector because of its large regulatory authority. Similarly the new Securities and Exchange Commission can through the exercise of its regulatory authority can help to increase confidence in the functioning of joint stock companies and capital market institutions and thus help direct savings to the modern sector. A strong and politically independent tax authority should be the third institutional pillar of the regulation of the private sector. Such an authority, by fair but forceful implementation of tax laws and policy, can not only ensure a steady revenue growth but can through increased insistence on documentation and reduced tax evasion help promote a greater measure of trust in the accounts (balance sheets and profit and loss statements) of the domestic companies thus further supporting the processes of effective mobilisation and use of domestic savings.

FOCUSING ON IMPLEMENTATION AND INSTITUTIONAL REFORM

A measure of agreement on broad priorities, discussed above, already exists among policy-makers, the principal exception being the macro-economic adjustment

path because there remains a great a lack of realism on growth, savings and investment targets. But even an agreement in principle on reform in key areas such as education, family planning, and tax administration is not very meaningful without a forceful implementation of the reform programme. In Pakistan failures of plan and programme implementation have been frequent and even more serious than policy failures. How can implementation and monitoring be made more effective in the future especially in areas such as education and tax administration?

First and foremost there must be the political will to stay the course of unpopular and painful economic decisions. However, this political will cannot exist without a broad national consensus on economic and social priorities. This will require that public leaders take the public in confidence, educate them about economic realities and assure them that the costs of adjustments will not be disproportionately placed on the lower income groups. It also requires that economic adjustment programmes enjoy bi-partisan support and difficult economic issues such as downsizing of government adjustments of administered prices and tightening of tax administration are not unduly exploited for political purposes.

Second, public institutions dealing with development must be given new respect and authority. The measures to reduce corruption and enforce accountability must not be allowed to further undermine the morale of honest and hardworking civil servants. Reduced political interference in day to day administration of public bodies can go a long way in improving their effectiveness.

Third, the analytical capacity to examine policy options and monitor progress must be strengthened across the board, in public and private sectors, universities, and research institutes. Pakistan has not developed strong traditions of academic freedom and excellence. The economic and social reform agenda was driven excessively by international agencies and their research financing during the last decade. As a result, continuity in analytical work was not assured, domestic ownership of the programmes remained weak and the task of public education was not given must attention. In the age of globalisation and rapid technological change, the transfer of ideas and learning from experience abroad have become increasingly important. However, the quick assimilation of international experience and effective utilisation of foreign advice can be done only if the indigenous research and policy institutions are strong and independent. At present, the development of adequate analytical capacity in economic and social fields is either seriously hindered by lack of resources or driven largely by foreign funding. Just as in physical investments, Pakistan needs both to raise the level of investments in intellectual, research and policy endeavours and become more self-sufficient in financing them. Policy reform is an ongoing process which requires close monitoring and frequent adjustments. Without a strong analytical base in domestic institutions, Pakistan's reform drive will not have strong chances of success.

Fourth, the balance of government effort between planning and goal-setting, on the one hand, and monitoring and implementation on the other, needs to be tilted in favour of the latter. At present, there is excessive preoccupation with goal-setting and the little attention is being given to effective follow up, redressal, and course adjustment. Enormous amount of energies continue to be devoted to the preparation of five-year plans and related documents and not enough resources are available to ensure that implementation problems are solved in a timely fashion. After more than forty years of five-year plans, the credibility of the planning processes is low not only in the public but also in the bureaucracy. Successive plans have clearly not succeeded in solving deep-rooted structural problems. In order to restore the credibility of planning mechanisms and government goals, it is essential to adopt realistic targets and to focus the implementation efforts on critical policy areas such as savings, exports, education, and population control where policy failures have been endemic.

Finally, on the institutional front progress will be closely tied to the resolution of governance issues. Civil service reforms, steps to curb corruption, and decentralisation efforts will all contribute to increasing the efficiency of public servants while reducing the leakage of public funds and waste of public resources. Improving the effectiveness of the use of public resources will in turn make a direct contribution to relieving the financial constraints which have become so binding in recent years.

SUMMING UP

Pakistan's economic crisis is much more deep seated than the government appears willing to admit. Both the structural and the financial problems have been building up for a long time. The heavy burden of debt, reflected in the debt to GDP ratio of nearly 100 percent, the low level of educational attainments, and major weaknesses in the structure of industry and exports are problems which will continue to influence economic prospects adversely for a number of years.

The gravity of these problems must be recognised by policy-makers and it should be realised that there are no quick fixes to the predicament in which Pakistan finds itself. The government undercuts its own credibility both at home and abroad when it promises a quick and relatively painless economic turn around because the nature of economic difficulties i.e. unsustainable level of dependence on external resources, an inequitable pattern of growth, neglect of longer term investments in human and physical capital, and broad institutional decline are widely known and understood.

Pakistan needs a longer term economic vision not only to deal effectively and confidently with short-term difficulties but also to carefully choose the priorities

which will shape a better and more equitable economic future. But it also needs to come to terms with its past of missed opportunities and inequitable pattern of growth. It also has to brace itself for a difficult period of economic and financial adjustment.

If short term costs are accepted by the society and political governance can be improved, two big ifs, it would be quite feasible for Pakistan to achieve per capita GNP growth of 4 percent per annum over the next twenty five years, double the average rate in the last half century, and combine it with a better distribution of growth benefits.

No long term economic policies will work if Pakistan does not restore financial equilibrium. The reduction of the ratio of national debt to GDP from nearly 100 to around 70 percent over the next five years needs to be made a top national priority. This will mean keeping fiscal and current account balance of payments deficits to very low levels at least till 2005 and overall investment rate is likely to stagnate. Whether the fiscal and balance of payments adjustment can be made consistent with longer term goals and reasonable GDP growth in the medium term will depend on three things, the ability of the tax system to mobilise large additional resources through direct and expenditure taxation, the greater effectiveness in the use of resources in the public sector and the ability of the industrial sector to use the substantial real exchange rate adjustment in 1998-99 for diversifying and expanding exports. The form of fiscal and balance of payment adjustment will be as important as the reduction in deficits. Fiscal deficit reduction should not come at the cost of development spending. Thus, a dramatic improvement in public savings is needed (from a negative 2 percent of GDP to a positive 2 percent over the next few years) and this can happen only with a sharp improvement in the tax: GDP ratio and continued restraint on defence spending. Similarly, the containment of balance of payments deficit, will prove consistent with increase in imports and recovery in growth only if exports expand.

Declining population growth rate, which is likely (with strongly supportive policies) to average 1.5 percent annually over 2000–25, almost half the rate of the last twenty five years and the considerable potential for improving factor productivity in agriculture (which in the past has relied heavily on increasing supplies of irrigated water and fertiliser) are two fundamental reasons for my optimism.

The success in agriculture, family planning as well as modernisation and diversification of exports and industry will depend critically on investments in education. Plan for the education sector need to show greater financial realism and much more awareness of the serious problems with the quality of education at all levels. While resources for elementary education should be found at all cost to

ensure speedy attainment of universal primary education, the managerial problems are even more serious even at the basic education level.

Increasing the basic level of education, improving its quality and, increasing literacy are the most urgent social goals. But Pakistan cannot ignore the problems with the higher level of education which remain the key constraint on development of new industries such as electronics and information technology. Improvement in the coverage and quality of higher education requires a three-pronged attack: further development of institutions of excellence; greater autonomy and/or privatisation of public institutions, especially beyond the secondary level; and increasing effective competition between the private and public sectors in provision of education beyond the middle school level.

Liberal economic policies, which are a central element of a new framework for the private sector are largely already in place. But the experience of the 1990s suggests that the domestic private sector has moved slowly to bring about structural changes in industry and exports, has increased relative dependence on borrowing to finance investments, and has continued to look to state patronage to make easy profits. The present private sector appears to be ill equipped to think in strategic terms and paradoxically may need help from and a dialogue with the government to develop the necessary capabilities and remove constraints. In the short to medium term the private and public sectors need to work jointly on defining and agreeing on policy goals and strategies in areas such as export development, modernisation of agriculture and industry, skills development, legal and regulatory framework, an effective and elastic tax system and development of financial sector and capital markets.

Effective management and implementation of policies is even more important than plans as such. In Pakistan failures of plan and programme implementation have been frequent and even more serious than policy failures. Unless implementation and monitoring can be made more effective in the future especially in areas such as education and tax administration, there cannot be much hope for achieving economic goals, however sensible. This requires progress on the institutional front which is closely tied to the resolution of governance issues; civil service reforms, steps to curb corruption, and decentralisation efforts will all contribute to increasing the efficiency of public servants while reducing the leakage of public funds and wastage of public resources

The final point is that while future policies need to focus both on growth and distribution issues, many economic and social policies can have a positive impact on both growth and distribution and good results can often be mutually reinforcing. The reduction of population growth will increase per capita income growth, reduce poverty and help future growth through its positive impact on savings. Investments

in human capital (especially the education of women) will contribute to slowing population growth, will have salutary effects on growth and exports (through raising productivity), and will help poverty alleviation by reducing the number of dependent children. Financial sector reform will stimulate savings and improve the allocative efficiency but also will prevent the abuse of the credit system which bestowed unearned benefits on those with preferred access. Better tax policies and administration will help resource mobilisation but through creating a fair and elastic tax system can provide the underpinnings of a much-needed expansion in social expenditures and also contribute to moderating income disparities. Exports of labour intensive manufactured goods will create jobs, increase export earnings, help growth and reduce reliance on foreign capital.

If the Pakistan elite and politicians manage to do a better job of political governance and economic management in the first two decades of the 21st century than in the last half century, the past policy mistakes can be written off to experience.

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