**Special Edition** 

# THE LAHORE JOURNAL OF ECONOMICS

## Lahore School of Economics

Papers presented at The Eighth Annual Conference on Management of the Pakistan Economy *Towards Accelerated Economic Growth in Pakistan: Its Need and Feasibility* 16<sup>th</sup> to 17<sup>th</sup> May, 2012 Lahore School of Economics, Lahore, Pakistan.

#### Conference Report Irfan ul Haque and Sahar Amjad Toward a Heterodox Approach: R

Toward a Heterodox Approach: Reconciling Stabilization and Economic Growth in Pakistan

S. Akbar Zaidi

The Captivating Vision of the "New Growth Strategy": The Missing Political Economy Perspective

Rashid Amjad

Stagflation, the Labor Market Impact, and the Poverty Puzzle in Pakistan : A Preliminary Analysis

Kamal A. Munir and Salman Khalid Pakistan's Power Crisis: How Did We Get Here?

Sikander Rahim

Industrialization by Fitting in: Acquiring Technology through Collaboration and Subcontracting

Rashid Amjad, Ejaz Ghani, Musleh ud Din and Tariq Mahmood

Export Barriers in Pakistan: Results of a Firm-Level Survey

*Syed Turab Hussain, Usman Khan, Kashif Zaheer Malik and Adeel Faheem* The Constraints to Industry in Punjab, Pakistan

Azam Chaudhry, Marjan Nasir and Maryiam Haroon The Birthe (Engelse Esterond Scale of Firms

The Birth of Exporters: Entry and Scale of Firms in Punjab's Export Sectors

Matthew McCartney Competitiveness and Pakistan: A Dangerous, Distorting and Dead-End Obsession?

Ijaz Nabi

Pakistan's Quest for a New Growth Vent: Lessons from History

Naved Hamid and Sarah Hayat The Opportunities and Pitfalls of Pakistan's Trade with China and Other Neighbors

Hafiz A. Pasha and Muhammad Imran The Prospects for Indo-Pakistan Trade

Sirimal Abeyratne Sri Lanka's Free Trade Agreements with India and Pakistan: Are They Leading Bilateral Trade Beyond Normalcy?

Aisha Ghaus-Pasha Making Devolution Work in Pakistan

*Ishrat Husain* Adapting Public Sector Services to Local Delivery

Anwar Shah

The 18<sup>th</sup> Constitutional Amendment: Glue or Solvent for Nation Building and Citizenship in Pakistan?

Musharraf Rasool Cyan Civil Service Management in Devolved Government: Reconciling Local Accountability and Career Incentives in Pakistan

Volume 17, SE

September, 2012

# THE LAHORE JOURNAL OF ECONOMICS

#### Editors

Dr. Azam Chaudhry, Editor Dr. Theresa Thompson Chaudhry, Editor Ms. Nina Gera, Associate Editor Ms. Ayesha Khanum, Assistant Editor

#### **Editorial Advisory Board**

Dr. Ahmed Kaleem Dr. Khalid Aftab Dr. Ahmed Kamaly Dr. Khalid Nadvi Dr. Ahmed M. Khalid Dr. Lennart Erickson Dr. Ahmed Mushfiq Mobarak Dr. M. Khalid Azam Dr. Akmal Husain Dr. Mahmood Ahmed Dr. Amirah El-Haddad Dr. Maryam Tanwir Dr. Anwar Shah Dr. Mathew Andrews Dr. Ashish Narain Dr. Matthew McCartney Dr. Aslam Chaudhry Dr. Matthias Cinyabuguma Dr. Atonu Rabbani Dr. Mehboob ul Hassan Dr. Baoyun Qiao Dr. Michal Jerzmanowski Dr. Emmanuel Maliti Dr. Minhaj Mahmud Dr. Eric Verhoogen Dr. Moazam Mahmood Dr. Faroog Chaudhry Dr. Mohammad Arzaghi Dr. Gwendolyn A. Tedeschi Dr. Mona Farid Badran Dr. Inayat Ullah Mangla Dr. Muneer Ahmad Dr. Irfan Ul Haque Dr. Nasim Hasan Shah Dr. Naved Hamid Dr. Jamshed Y. Uppal Dr. Jan Warner Dr. Nawazish Mirza Dr. Javier Arze del Granado Dr. Nuzhat Ahmad Dr. Jawad Syed Dr. Pervez Tahir Dr. John Morrow Dr. Phillip Garner Dr. Kaiser Bengali Dr. Ramani Gunatilaka Dr. Kamal Munir Dr. Ranil Abayasekara Dr. Kazi Iqbal Dr. Rashid Amjad Dr. Kensuke Teshima Dr. Roshan Perera

Dr. S. Ajaz Hussain Dr. Saleem Khan Dr. Salman Ahmad Dr. Sarfraz Qureshi Dr. Sarwat Jahan Dr. Sean Corcoran Dr. Sebastian Eckardt Dr. Serkan Bahceci Dr. Shahid Amjad Chaudhry Dr. Shahrukh Rafi Khan Dr. Sirimal Abeyratne Dr. Sohail Zafar Dr. Tariq Siddiqui Dr. Umar Serajuddin Dr. Zareen Naqvi Mr. Amir Jahan Khan Mr. Paul Ross Ms. Kate Vyborny Ms. Mercyline Kamande Ms. Nazia Mansoor Ms. Smriti Sharma Prof. Mansor Md Isa Prof. Robert Neild Prof. Vigar Ahmed P.P.A Wasantha Athukorala

Editorial Staff:	Tele. No: 0092 - 42 - 36560969
Telefax:	0092 - 42 - 36560905
E-mail:	nina@lahoreschool.edu.pk
Publisher:	Lahore School of Economics, Lahore, Pakistan.

Correspondence relating to subscriptions and changes of address should be sent to *The Lahore Journal of Economics*, 104 -C-2, Gulberg-III, Lahore - 54660 – Pakistan.

Instructions to authors can be found at the end of this issue. No responsibility for the views expressed by authors and reviewers in *The Lahore Journal of Economics* is assumed by the Editors, the Associate Editor and the Publisher.

Copyright by: Lahore School of Economics

17: Special Edition 2012

# THE LAHORE JOURNAL OF ECONOMICS

Contents	Vol. 17, SE, 2012
Conference Report	i
Toward a Heterodox Approach: Reconciling Stabil and Economic Growth in Pakistan <i>Irfan ul Haque and Sahar Amjad</i>	ization 1
The Captivating Vision of the "New Growth Strate The Missing Political Economy Perspective <i>S. Akbar Zaidi</i>	egy": 33
Stagflation, the Labor Market Impact, and the Poverty Puzzle in Pakistan: A Preliminary Analysi <i>Rashid Amjad</i>	s 51
Pakistan's Power Crisis: How Did We Get Here? Kamal A. Munir and Salman Khalid	73
Industrialization by Fitting in: Acquiring Technolo through Collaboration and Subcontracting <i>Sikander Rahim</i>	gy 83
Export Barriers in Pakistan: Results of a Firm-Leve Rashid Amjad, Ejaz Ghani, Musleh ud Din and Tar	-
The Constraints to Industry in Punjab, Pakistan Syed Turab Hussain, Usman Khan, Kashif Zaheer Ma and Adeel Faheem	alik 135
The Birth of Exporters: Entry and Scale of Firms in Export Sectors Azam Chaudhry, Marjan Nasir and Maryiam Harc	

Competitiveness and Pakistan: A Dangerous, Distorting and Dead-End Obsession?	
Matthew McCartney	213
Pakistan's Quest for a New Growth Vent: Lessons from History Ijaz Nabi	243
The Opportunities and Pitfalls of Pakistan's Trade with China and Neighbors	
Naved Hamid and Sarah Hayat	271
The Prospects for Indo-Pakistan Trade Hafiz A. Pasha and Muhammad Imran	293
Sri Lanka's Free Trade Agreements with India and Pakistan: Are They Leading Bilateral Trade Beyond Normalcy? Sirimal Abeyratne	315
Making Devolution Work in Pakistan Aisha Ghaus-Pasha	339
Adapting Public Sector Services to Local Delivery Ishrat Husain	359
The 18 <sup>th</sup> Constitutional Amendment: Glue or Solvent for Nation Building and Citizenship in Pakistan? <i>Anwar Shah</i>	387
Civil Service Management in Devolved Government: Reconciling Local Accountability and Career Incentives in Pakistan	
Musharraf Rasool Cyan	425

#### Notes for Authors

- 1. Manuscripts will be accepted for consideration on the understanding that they are original contributions to the existing knowledge in the fields of Economics, Banking, Current Affairs, Finance, Political Economy, Sociology, and Economic History.
- Manuscripts of research articles, research notes, review articles, comments, rejoinders and book reviews in English only should be sent in duplicate to the Editor, *The Lahore Journal of Economics*, 104, C-2, Gulberg-III, Lahore-54660 Pakistan. Electronic copies of the article in Microsoft Word format should also be submitted as an email attachment to: nina@lahoreschool.edu.pk.
- 3. The first page of the manuscript should have the title of the paper, the names(s) of author(s), and a footnote giving the current affiliation of the author(s) and any acknowledgments.
- 4. Articles submitted to the *Lahore Journal* must include an abstract of about 100 words that summarizes the contents.
- 5. The *Lahore Journal* will publish empirical papers only if the data used in the analyses are clearly and precisely documented and are readily available to the journal reviewer for purposes of replication. At the time of submission of papers that have empirical work, authors must provide to the *Lahore Journal*, the data in Microsoft EXCEL format required for the replication of results.
- 6. Detailed derivations of any main mathematical results reported in the text should be submitted separately along with the articles.
- 7. Each manuscript should be typed and should carry a margin of an inch and a half on the left-hand side and an inch on the right hand side of the typed page.
- 8. The graphic format for each mathematical formula, diagram, figure or chart should be in text mode for further editing.
- 9. Tables for the main text and each of its appendices should be numbered sequentially and separately. The title of each table should clearly describe the contents. The source of the table should be given in a footnote immediately below the line at the bottom of the table.
- 10. Footnotes should be numbered sequentially.

- 11. All references used in the text should be listed in alphabetical order of the authors' surnames at the end of the text. References in the text should include the name(s) of author(s) with the year of publication in parentheses, and all references should conform to the style of the Journal. Further information on questions of style may be obtained from the Associate Editor, *The Lahore Journal of Economics*, Lahore Pakistan.
- 12. Book Reviews should give a description of the contents and a critical evaluation of the book. It should not exceed 5 or 6 typewritten pages.
- 13. Each author will receive two complimentary copies of *The Lahore Journal of Economics*.

# THE LAHORE JOURNAL Of Economics

# Lahore School of Economics

105-C-2, GULBERG III LAHORE, PAKISTAN. TEL: 35714936 FAX: 35714936

## SUBSCRIPTION FOR PUBLICATIONS

1. Kindly enter a subscription for the following publication of the Lahore School of Economics:

Publication	Yearly subscription (within Pakistan)	Yearly subscription (outside Pakistan)	<b>Period</b> (No. of years)	Total Payment
1.The Lahore Journal of Economics	Rs. 600.00	US \$ 50		

2. The subscription is to be in the following name and address:

	Name:	
	Address:	
3.	1	emand draft for the sum of Pakistan Rupees/US \$ is n the name of The Lahore School of Economics to cover the
4.	5	ur order to: Nina Gera, Publications, Lahore School of Gulberg III, Lahore 54660, Pakistan.
	Signature:	
	Name:	
	Date:	

## The Lahore School of Economics

The Lahore School of Economics (established 1993) is one of Pakistan's leading centres of learning for teaching and research in economics, finance and business administration. The Lahore School of Economics' objectives include: (i) The training of young Pakistanis as professional economists, finance managers, accountants, financial analysts, bankers and business executives, and (ii) Undertaking research in economics, management, finance and banking to further deepen understanding of major economic facts, issues and policies.

The Lahore School was granted a Charter in January, 1997 by an Act of the Provincial Assembly of the Punjab: The Lahore School of Economics Act 1997 (Act II of 1997). The Charter vests the powers of an independent degree granting institution to The Lahore School.

The Lahore School has both undergraduate and graduate programs in economics, business information systems and finance. Its postgraduate program leading to the MPhil and PhD degree is administered through the Lahore School's Centre for Research in Economics and Business (CREB). The student body and faculty comprise both national and expatriate Pakistanis and The Lahore School encourages expatriate Pakistanis to join as students or as faculty.

The Lahore School's publication program comprises The Lahore Journal of Economics (a bi-annual publication), Lahore Journal of Policy Studies, a Seminar Paper Series and a Text Book Series. The Program encourages both in-house and external contributors.

For further information, please call (Pakistan 92-42-) 35714936 or 36560969 or visit the Web page: www.lahoreschoolofeconomics.edu.pk

Printed by Lahore School of Economics Press

# Toward a Heterodox Approach: Reconciling Stabilization and Economic Growth in Pakistan

### Irfan ul Haque\* and Sahar Amjad\*\*

#### Abstract

This article attempts to show that a strategy for accelerated growth for Pakistan is both necessary and feasible. Pakistan's macroeconomic conditions are broadly similar to some of its more rapidly growing neighbors. The country's macroeconomic imbalances and inflation need to be brought down, but the required adjustment does not entail precipitate action, which could further depress the economy. We develop a "Heterodox Scenario," which shows that macroeconomic adjustments can be phased in over the next few years and will be easier to make if the economy were to grow more rapidly. For accelerated growth to materialize, as a minimum, determined steps are needed to overcome the energy crisis, sharply raise the investment rate—particularly, private investment—and strengthen Pakistan's competitiveness in the world market. A national strategy is needed toward that end.

Keywords: Growth, inflation, economy, strategy, Pakistan.

JEL classification: O10, E22.

#### 1. Introduction

With continuing political turmoil, rising violence, serious law and order failures, and frequent and prolonged power cuts, the state of Pakistan's economy could hardly be other than parlous. That in these circumstances the country's economic performance can improve and the economy embark on a trajectory of rapid growth can not be taken as a serious proposition. Investment, key to economic growth, requires a stable, predictable, and secure economic environment. Conventional economic wisdom holds that economic—and political—stability precede accelerated economic growth. Thus, before exploring possibilities for economic growth, a measure of economic stability must be achieved and macroeconomic imbalances must be restored to sustainable levels.

<sup>&</sup>lt;sup>\*</sup> Special Advisor, Financing for Development, South Centre, Geneva.

<sup>&</sup>lt;sup>\*</sup> Teaching and Research Fellow, Lahore School of Economics.

But economic instability is a relative, not an absolute, metric. It can relate to fluctuations in output, employment, or prices; though, in the context of developing countries, rising prices and inflationary expectations are the usual concerns of the stabilization programs. Experience, however, shows that, while economic growth under high and accelerating inflation is difficult to sustain, price stability in the absence of adequate economic growth remains an elusive goal when fiscal retrenchment and other contractionary measures take their toll on society. Pakistan's own experience stands testimony to this.

This dilemma gives rise to a number of questions. Is there a tolerable level of price instability for a country? Is there an inflation–growth link? Is inflation inimical to investment and economic growth? Do stabilization measures help or hinder output growth? Is high economic growth compatible with stability? This article attempts to answer these questions with the Pakistani economy in view.

The next section explores the relationship between inflation and economic growth and discusses whether individual countries have a certain optimal inflation level that is conducive to output growth. This is followed by a review, in Section 3, of Pakistan's key macroeconomic indicators in comparison to four high-growth economies in its neighborhood—Bangladesh, India, Indonesia, and Sri Lanka. This discussion examines whether Pakistan's macroeconomic performance is significantly different from that of the other economies. If it is broadly similar, then the country's low growth rate could be due to factors other than inflation and macroeconomic imbalances.

In Section 4, we develop a simple macroeconomic accounting framework where economic growth is made an explicit policy target, which is in contrast to the traditional International Monetary Fund (IMF) stabilization programs that treat it as an outcome. This exercise is an attempt to show that it should be feasible for Pakistan to attain accelerated growth even with the existing high inflation and fiscal deficit. More significantly, we see that accelerated economic growth could actually help improve stability. The question of how Pakistan's economic growth may actually be accelerated and sustained is taken up in Section 5. The final section offers a few concluding remarks.

#### 2. The Inflation–Economic Growth Link

The inflation–growth link is far from straightforward. One reason for the ambiguity is that price rises are normally associated with constrained supply, which economic growth should relieve, thus easing price pressures. The direction of causation is another reason for confusion, i.e., whether the impact of output growth on inflation or its opposite is the concern of policymakers. In advanced countries, monetary policy tends to target the build-up of inflationary pressures as unemployment falls. This phenomenon of inflation accelerating as unemployment declines is captured in the so-called Phillips curve, which, in its different mutations, continues to define policy in advanced countries.

In the context of developing countries, however, inflation is deemed to hinder economic growth, but the exact relationship is unclear. The actual experience of developing countries shows great diversity with respect to the inflation–growth linkage. Table 1 gives data on inflation and economic growth for the world's different regions as well as a few key countries, which indicates wide variations across countries and time periods.

							(Per	centage)
		(	[)			(1)	[)	
		GDP g	growth			Infla	tion	
	1965-	1980-	1990 <b>-</b>	2000-	1965-	1980-	1990 <b>-</b>	2000-
Region/country	80	90	2000	10	80	90	2000	10
Sub-Saharan Africa	4.20	2.10	2.32	4.80	11.40	20.00	9.01	7.03
East Asia/Pacific	7.30	7.80	3.07	3.70	9.30	6.00	3.74	3.43
Korea, Rep. of	9.90	9.70	6.19	4.16	18.40	5.10	6.03	2.63
South Asia	3.60	5.20	5.21	7.12	8.30	8.00	8.10	6.24
Middle East/	6.70	0.50	4.10	4.30	13.60	7.50	5.85	6.68
North Africa								
Latin America/	6.00	1.60	3.24	3.37	31.80	192.1.0	8.08	5.68
Caribbean								
OECD	3.70	3.10	2.63	1.50	7.60	4.20	3.34	2.57
Japan	6.40	4.10	1.19	0.75	7.70	1.50	0.11	-1.20
China	6.67	9.35	10.45	10.5	0.26	5.45	7.24	4.13
India	3.58	5.57	5.48	7.69	7.97	8.61	8.09	6.02

Table 1: GDP growth and inflation (1965–2010)

/**D** 

Source: World Bank (2012).

Japan and Korea, for example, grew rapidly during 1965–80, but also had above-average inflation for that period. The same was true of the Middle Eastern and North African economies. China, on the other hand, had very low inflation but also relatively high economic growth during that period. In subsequent periods, however, Chinese growth accelerated but so did inflation, though remaining moderate by developing-country standards. Latin America had a record of high inflation but economic growth remained generally lower than that of other developing countries. The South Asian experience shows that, as growth accelerated from the lows of the 1965–80 period, inflation generally declined.

Econometric studies of the inflation–growth link have also produced mixed results. Relying on a sample of 101 countries covering the period 1960–89, Fischer (1993) finds a negative relationship between high inflation and output growth, and attributes it to a lowering of investment and productivity growth. Dornbusch and Fisher (1993) show that inflation below 20 percent could be maintained for long periods without serious macroeconomic consequences. The study observes that, during their period of rapid growth, the East Asian economies maintained inflation well within this limit, which would today be considered too high. On the other hand, Bruno and Easterly (1996) note that inflation had little impact on growth at rates below 40 percent.

Pakistan's own experience also suggests no clear link between stability and growth. The scatter diagram in Figure 1, covering data for 1990–2010, shows years of high growth but low inflation; low growth with low inflation; and, in one instance (2009), low growth and very high inflation (over 20 percent). Overall, output growth fluctuated in the range of 2 to 8 percent, while inflation showed stickiness within a band of 8–12 per cent.<sup>1</sup>

<sup>&</sup>lt;sup>1</sup> Thirteen of the 21 observations fell in this range.

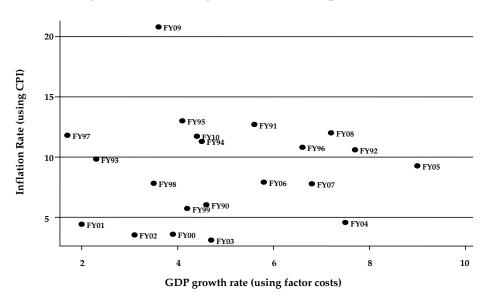


Figure 1: Inflation-growth relationship for Pakistan

In brief, the relationship between inflation and growth is not stable or smooth. While a certain level of inflation helps to grease the economic wheels, beyond a certain point, it begins to hamper investment and productivity growth. The reason is that, at low inflation, relative prices are quite stable and investor and consumer decisions remain, by and large, unaffected. But high and accelerating inflation creates an altogether different situation. Here price adjustments occur at an accelerating pace, resulting in the breakdown of established wage–price contracts and other indexing mechanisms. This causes unpredictable shifts in relative prices and increases overall uncertainty. High inflation, if unchecked, also tends to accelerate and spiral out of control.

The innate dynamics of high- and low-inflationary situations are, therefore, distinctly different (Haque, 1995). In high-inflation situations, what the government might or might not do adds to uncertainty. Because nominal interest rates tend to be sticky, high inflation can turn real interest rates negative and more volatile. This has an impact on savings and investment decisions. Exchange rate management also becomes more difficult and unpredictable: Prompt adjustments of the rate are liable to feed inflation, while delays foment speculation and hurt industries exposed to foreign trade. Balance of payments difficulties typically accompany high inflation because the trade balance worsens as the fiscal deficit rises. Financing of either deficit through foreign borrowing becomes increasingly difficult and costly as lenders become wary of the deteriorating macroeconomic situation. Economies that are heavily dependent on foreign direct investment or on foreign trade are therefore more vulnerable to capital flight and the loss of competitiveness caused by high inflation. Thus, the relative openness of an economy is another factor determining how inflation affects output growth.

In short, while the evidence on the inflation–growth link is conflicting, it does show that inflation beyond a certain point begins to hurt economic growth. In other words, the inflation–growth relationship is characterized by a "kink", i.e., inflation's impact on output growth is inconsequential or could actually be favorable at low rates, but becomes progressively adverse as it accelerates. On the basis of a sample of 165 countries, Espinoza, Leon, and Prasad (2010) estimate that developing economies have an inflation threshold (the point at which the kink appears) of between 7 and 13 percent, but that inflation above 10 percent begins to hurt growth. The threshold for advanced countries is found to be much lower (below 3 percent). For Pakistan during 1973–2000, Mubarik (2005) finds that inflation below 5 percent can be favorable to economic growth, but that if it exceeds the estimated threshold rate of 9 percent, economic growth starts to suffer.

#### 3. Pakistan vs. its Regional Neighbors

Bringing down fiscal deficits and controlling inflation have remained recurrent goals of macroeconomic policy in Pakistan. Over the last two decades, the country entered into eight IMF programs (all but two during the 1990s)—involving stabilizing policies and structural economic reform—but none was taken to completion. Apart from expenditure cuts, the reforms sought to address structural weaknesses, i.e., strengthening tax administration, widening the tax net, and privatizing loss-making stateowned enterprises. The intention was to reduce the government's reliance on monetary expansion through improved public finances while stimulating private investment and productivity growth. Whether or not the measures were adequate, Pakistan's economy was remarkably unaffected. If the periods of rapid growth (2004–07) and high inflation (2008–10) are excluded, output growth remained stubbornly at around 4 percent while inflation stayed at over 8 percent.

This failure of policy gives a very bleak picture of Pakistan's ability to overcome its problems. However, a comparison of key macroeconomic data with other countries in the region suggests that, while Pakistan's problems are serious and call for bold and concerted action, its economic management, while by no means ideal, has not been entirely hopeless. In terms of various macroeconomic indicators, Pakistan is broadly similar to the region's other countries—Bangladesh, India, Indonesia, and Sri Lanka—even as its average growth rate of less than 5 percent is the lowest and average inflation highest. India's growth rate, in contrast, averaged above 8 percent during 2005–10, while growth in the other three economies averaged 6 percent (see Table 2). Because of the sharp downturn in economic activity following the 2008 economic crisis, Pakistan's growth appears also to be much more volatile. The coefficient of variation of growth for Pakistan was 45 percent; while it was about half that magnitude for India and Sri Lanka and much lower for Indonesia and Bangladesh.

								(Percentage)
Country	2005	2006	2007	2008	2009	2010	Average	Coefficient of variation
Bangladesh	6.0	6.6	6.4	6.2	5.7	6.1	6.2	5.1
India	9.4	9.7	9.8	4.9	9.1	8.8	8.6	21.6
Indonesia	5.7	5.5	6.3	6.0	4.6	6.1	5.7	10.7
Pakistan	7.7	6.2	5.7	1.6	3.6	4.1	4.8	44.9
Sri Lanka	6.2	7.7	6.8	6.0	3.5	8.0	6.4	25.3

Table 2: GDP growth rates (2005–10)

Source: World Bank (2012).

Table 3 contains key fiscal performance indicators for Pakistan and its neighboring economies. These indicators are: central government debt, tax revenue, and the public deficit, all given as percentages of GDP. While the public debt ratio in Indonesia is considerably lower (an average of 37 percent) and Sri Lanka's much higher (88 percent), Pakistan's public debt ratio is virtually the same as that of India, if anything, lower. (Data for Bangladesh is not available.)

						(Percent	tage of GDP)
Indicator/country	2005	2006	2007	2008	2009	2010	Average
Central govt. Debt							
India	61.2	59.1	56.5	56.6	53.7	46.1	55.53
Indonesia	47.3	39.0	35.2	33.1	28.4	26.1	34.84
Pakistan	55.8	54.1	57.9	54.6	52.4	-	55.00
Sri Lanka	90.6	88.7	85.0	-	-	-	88.10
Tax revenue							
Bangladesh	8.2	8.2	8.1	8.8	8.6	-	8.4
India	9.9	11.0	11.9	10.8	9.7	9.5	10.5
Indonesia	12.5	12.3	12.4	13.0	11.4	10.9	12.1
Pakistan	9.6	9.4	9.8	9.9	9.3	10.0	9.7
Sri Lanka	13.7	14.6	14.2	13.3	-	-	14.0
Public deficit							
Bangladesh	-1.1	-1.4	-1.3	-1.0	-1.7	-	-1.3
India	-3.2	-2.2	-0.5	-4.9	-5.1	-3.7	-3.3
Indonesia	-0.1	-0.6	-1.0	-0.3	-1.7	-0.6	-0.7
Pakistan	-3.2	-4.2	-4.2	-7.4	-4.8	-5.0	-4.8
Sri Lanka	-7.0	-6.9	-6.5	-6.6	-	-	-6.7
CPIA* rating: Fiscal polic	cy						
Bangladesh	3.5	3.5	3.5	4.0	4.0	4.0	3.8
India	3.0	3.5	3.5	3.5	3.5	3.5	3.4
Pakistan	3.5	3.5	3.5	2.5	3.0	2.5	3.1
Sri Lanka	3.0	3.0	3.0	3.0	3.0	3.0	3.0
CPIA* rating: Budgetary	and fina	ncial ma	nagemer	ıt			
Bangladesh	3.0	3.0	3.0	3.0	3.0	3.0	3.0
India	4.0	4.0	4.0	4.0	4.0	3.5	3.9
Pakistan	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Sri Lanka	4.0	4.0	4.0	4.0	4.0	4.0	4.0

### **Table 3: Fiscal performance indicators**

 $\ast$  CPIA stands for "Country Policy International Assessment" undertaken periodically by the World Bank. The ranking is from 1 to 5.

Source: World Bank (2012).

Pakistan's revenue raising performance is generally regarded as abysmal but, in fact, it is broadly similar to that of other countries. At 9.7 percent of GDP, Pakistan's revenue collection is better than that of Bangladesh and only a little inferior to that of India (10.5 percent). In contrast, Sri Lanka—the top performer in this group—manages to raise some 14 percent of GDP in revenue, which is still not a particularly outstanding achievement. Indonesia's performance, at 12 percent, falls somewhere in the middle.

As part of its monitoring of economic performance, the World Bank ranks countries according to the quality of fiscal policy and budgetary and financial management; this ranking is known as the Country Policy International Assessment or CPIA and is also reported in Table 3. With respect to fiscal policy, Bangladesh emerges as the top performer (with a ranking of 3.8 out of 5) but as the poorest performer in terms of budgetary and financial management. The opposite is the case for Sri Lanka, with a ranking of 3 and 4, respectively. The ranking appears to correspond closely to the two countries' size of budget deficit (the first measure) and ability to raise revenue (the second measure). However, Pakistan's ranking—at 3.1 and 3.5 for the two measures—is only slightly below that of India, whose average ranking is, respectively, 3.4 and 3.9.

Although Pakistan's overall fiscal performance is roughly in line with the region's most rapidly growing economies, there are grounds for concern. Fiscal laxity was reported to have increased in recent months perhaps the abandonment of the IMF standby program was a factor—and the budget deficit for the fiscal year (FY) 2012 was expected to rise above 6 percent of GDP.<sup>2</sup> Reduction of the deficit is obviously a key policy concern but, despite official pronouncements, no significant improvement has occurred. The fact that economic growth has been meager has not helped the fiscal situation. With respect to public expenditures, the authorities do not have much room for maneuver. Further cuts in development expenditures—which have borne the brunt of earlier cuts—are likely to hamper future growth and disproportionately hurt the poor.

Pakistan's external balance paralleled the fiscal situation. Taking the period average (2005–10), the current account deficit was 4.5 percent of GDP, only slightly worse than Sri Lanka's 4.2 percent (see Table 4). On the other hand, Bangladesh and Indonesia enjoyed a surplus of about 1.5 percent, while India's current account deficit averaged below 2 percent. While other countries' external balances were relatively stable, Pakistan's current account

 $<sup>^2</sup>$  This article was prepared before the end of FY2012 and before the budgetary data for the year became available. We believe that the actual numbers would not alter the basic picture of the macroeconomy.

deficit displayed wide fluctuations, from the low of 0.8 percent in 2010 to the high of 9.6 percent in 2008, the year of the economic crisis. However, leaving aside the crisis borrowing from the IMF in late 2008, the country has not, so far, experienced serious external financing difficulties.

Pakistan's savings-investment balance—the domestic counterpart of the external account—provides a sharper contrast with other countries' performance. At 18 percent, its investment rate was the lowest in the group, compared to over 30 percent for India and Indonesia and about 25 percent for Bangladesh and Sri Lanka (Table 4). Even during Pakistan's boom years of 2005–07, investment did not rise much above 20 percent of GDP. The country's savings performance is even more pitiful. While India and Indonesia save virtually one third of their output, Pakistan manages to save only 13 percent. Bangladesh (17 percent) and Sri Lanka (16 percent) cannot be considered high savers, but they too do considerably better than Pakistan.

					(	Percenta	ige of GDP)
Indicator/Country	2005	2006	2007	2008	2009	2010	Average
Current account balance							
Bangladesh	-0.3	1.9	1.3	1.2	4.0	2.1	1.7
India	-1.3	-1.0	-0.6	-2.5	-1.9	-3.0	-1.7
Indonesia	0.1	3.0	2.4	0.0	2.0	0.8	1.4
Pakistan	-3.3	-5.3	-5.8	-9.6	-2.5	-0.8	-4.5
Sri Lanka	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-4.2
Gross domestic savings							
Bangladesh	18.1	18.4	17.5	15.8	17.2	17.8	17.5
India	31.9	32.5	34.1	29.4	31.0	31.5	31.8
Indonesia	29.2	30.8	29.0	28.9	33.8	34.1	31.0
Pakistan	15.2	14.1	15.4	11.0	10.7	10.2	12.8
Sri Lanka	17.9	17.0	17.6	13.9	17.9	18.7	17.2
Gross fixed investment							
Bangladesh	24.5	24.7	24.5	24.2	24.4	24.4	24.4
India	30.3	31.3	32.9	32.0	30.8	-	31.1
Indonesia	23.6	24.1	25.0	27.7	31.1	32.2	27.3
Pakistan	17.5	20.5	21.0	20.5	16.6	13.8	18.3
Sri Lanka	23.4	24.9	24.7	25.3	23.7	25.9	24.7

**Table 4: Key macroeconomic indicators** 

Source: World Bank (2012).

In brief, Pakistan's overall macroeconomic performance over the past several years has been quite mixed. The fiscal deficit and negative current account cannot obviously continue at current levels and must be brought down to sustainable levels. Although domestic public debt is not, at present, unsustainably high, it could become a problem if the fiscal deficit does not come down. Inflation is running high though it does not appear to be accelerating. Similarly, the balance of payments is a vulnerable point, though the current account deficit continues to be financed by the inflow of workers' remittances and other foreign transfers. Thanks to the debt rescheduling agreements of the last decade, the debt burden is not yet onerous, but the situation could change if external borrowing becomes large. Pakistan's foreign exchange reserves at present are barely adequate, and not enough to meet unexpected adverse balance of payments developments.

These considerations indicate that Pakistan's macroeconomy needs to improve significantly and that corrective measures must be pursued vigorously and without delay. But gradual and sustained reforms in public finances are likely to be more effective and credible than a "big bang" approach, for which neither the government nor the country seem to be prepared, leaving aside the question if it would work.

#### 4. Stabilization through Economic Growth

Pakistan's economy is currently operating at well below its potential; continuing with contractionary macroeconomic policies is likely to keep the economy depressed without significantly lowering inflation. Recent stabilization measures have failed to bring down inflation while economic growth has collapsed as a consequence of the public expenditure squeeze, restrictive credit policy, and increased uncertainty and worry in the private sector about the government's policy stance. The power sector crisis has further added to the problem.

Amjad, Din, and Qayyum (2011) initiated a discussion on how Pakistan's economy could break out of its current stagflationary state. At around the same time, the Planning Commission's *Framework for economic growth* (Pakistan, Planning Commission, 2011) was published, with a rather similar theme. It offers a range of ideas on how Pakistan's economic growth could be accelerated with macroeconomic stability:

Accelerating the economic growth rate and sustaining it at a high rate must ... be treated as a national priority. And this

must be achieved when resources are scarce as the country deals with a severe fiscal problem! The old paradigm of project- and government-led growth has to change. This reasoning has led the Planning Commission towards rethinking the traditional growth narrative in Pakistan (p. 3).

The call for "rethinking" entails, among other things, a critical reexamination of the conventional stabilization programs that have underpinned macroeconomic policy in Pakistan, but this the *Framework* fails to do so. Nevertheless, we attempt to propose an alternative to the conventional remedies. This is what the heterodox approach is about.

The essence of heterodoxy is pragmatism, i.e., policies are framed within a country context, rather than following a prescriptive boilerplate. This approach is associated with the 1980s' experiments with direct government interventions (notably, price controls) in a few Latin American countries, though its history is much older. In fact, after the Second World War, Japan was the earliest case where economic policy was targeted at a quick rehabilitation and restoration of economic growth. Significantly, the embrace of pragmatism against economic orthodoxy had the approval of the United States, the occupying power. A more recent example of heterodoxy is that of the East Asian economies—notably Korea and Malaysia—coping with the financial crisis of the late 1990s, when the IMF's prescription of severely restrictive macroeconomic policy was abandoned in favor of measures to restore growth quickly.

#### 4.1. The IMF's Financial Programming Framework

Despite advances in macroeconomic theory over the years, the IMF's financial programming framework—the so-called "Polak model"—has not fundamentally changed since the 1950s, and it continues to serve as the central pillar of macroeconomic policymaking. This framework consists essentially of four equations or definitional identities (Polak, 1997):

- 1. A change in money demand is proportional to the change in money income, implying that the (marginal) velocity of money circulation is a constant.
- 2. Imports are a fixed proportion of the country's income.
- 3. A change in money supply is equal to the change in the country's foreign exchange reserves (in local currency equivalent) plus the change in domestic credit of the country's banking system.

4. A change in the country's foreign exchange reserves is equal to the trade balance (i.e., the difference between exports and imports) and net foreign transfers.

The logic of the model is as follows: The basic aim of the stabilization programs is to keep a country's balance of payments stable and manageable by building up foreign exchange reserves to a "safe" level, depending on the country's circumstances. With exports, foreign financing, and the buildup of reserves determined exogenously, the level of imports that the country can acquire is essentially a residual. Because imports are held to bear a fixed ratio to money income, this determines the level of money income consistent with the required buildup of foreign exchange reserves. Polak (1997) sums up the IMF conditionality thus:

The standard conditionality of the Fund thus evolved toward the inclusion of a double monetary prescription: a ceiling on the expansion of domestic assets of the central bank to achieve an acceptable balance of payments result (flow) and a floor under its holdings of net foreign assets to bring about a satisfactory (stock) reserve outcome and, at the same time, make sure that the central bank would not use excessive intervention to counter market pressures toward a more depreciated exchange rate (p. 11).

The model actually targets the key variable that the country's authorities are expected to control, that is, domestic credit. With the required change in foreign exchange reserves specified, it is basically domestic credit expansion that determines the increase in money supply. Since the IMF is averse to "crowding out" the private sector, the restraint on credit creation applies primarily to the public sector, though tightening monetary policy and other contractionary measures obviously impinge on private consumption and investment. The permissible level of public sector borrowing, thus derived, provides the magnitude of the required fiscal adjustment. How this adjustment is made is left more or less to the national authorities though the IMF is quite explicit in its preferences.

Since the velocity of money is held to be stable, the specified increase in money supply yields also the increase in money income. What the basic IMF model does not provide, however, is how the money income is split between the increase in general prices and the increase in output. The two are in effect left "dangling as quasi-exogenous variables in the Fund's operational model in its projecting mode." (Polak, 1997, p. 8). Here

lies the model's Achilles' heel: The model does not explain the adjustment process itself, i.e., how much and how quickly stability would be achieved through the prescribed fiscal adjustment and credit squeeze. In practice, the distribution of adjustment between a decline in inflation and a change (often a decline) in output is ultimately a staff judgment (or guesstimate). Thus, the projections of the key variables are not really derived by solving a set of equations but are the result of an iterative process of reconciling different constraints. There is nothing fundamentally wrong with this process, except that it does render the projections underpinning the prescribed macroeconomic policy of questionable merit.<sup>3</sup>

The deficiency in the IMF's basic framework with respect to output growth was, however, remedied by the introduction of the concept of "structural reforms," which became a standard accompaniment to stabilization programs. These reforms typically relate to price and trade liberalization, labor market deregulation, the privatization of public enterprises, and general easing of controls and regulations in other economic spheres. These elements of policy are obviously difficult to "model" meaning their consequences are hard to measure—but they are vigorously advocated because of their expected contribution to economic growth.

#### 4.2. A Heterodox Alternative

It is, however, possible to conceive of an alternative to the standard IMF model, which relies on just one modification. Output growth and inflation—instead of being left "dangling" in the system—could be adopted as explicitly specified targets to reach. Thus, given money income (the product of price and output) and the velocity of money (derived from the past data) yields, on one side, the demand for money and, on the other, the required import level. (As in the IMF framework, imports are held as a constant proportion of money income.) With the level of imports thus determined, the optimal level of foreign exchange reserves (in terms of the number of months of imports) can also be derived. With imports, exports, and the buildup of foreign exchange reserves specified, required foreign transfers are treated as the residual in the balance of payments and are

<sup>&</sup>lt;sup>3</sup> The situation is rather different when macroeconomic imbalances arise out of overheating, i.e., when the economy is operating at full capacity with full employment. This was usually the case in advanced countries under the original Bretton Woods system of fixed exchange rates with countries committed to full employment. In such situations, there is no alternative to contractionary policies to bring about the needed macroeconomic adjustment. On the other hand, economic or financial crises in developing countries usually occur on account of external shocks (external debt, commodity prices) even while operating at well below their potential.

therefore endogenous. In the IMF model, they are exogenous. On the domestic front, the demand for money yields the permissible level of domestic credit creation, given the level of foreign exchange reserves. In other words, domestic credit creation is still a policy variable, as in the IMF programming framework.

The rationale for treating output growth as a policy target in Pakistan's context rests on the following stylized facts.

- 1. Although the fiscal deficit needs to be reduced for longer-term macroeconomic viability, its current level does not threaten to accelerate inflation. Other economies in the region that are growing more rapidly have fiscal deficits (relative to GDP) not too different from Pakistan's.
- 2. Inflation is currently running high but it should be possible to bring it down gradually through output growth. An attempt to drastically reduce inflation by discouraging investment and dampening growth could turn a bad situation worse.
- 3. Trade and current account deficits are high but do not appear to pose, at least for the present, serious financing difficulties. Foreign exchange reserves should, ideally, be higher but are currently adequate for dealing with "normal" trade fluctuations.
- 4. Both foreign debt and domestic public debt need to be carefully watched but can be expected to remain manageable so long as Pakistan's economy does not take a sharp turn for the worse (IMF, 2012).
- 5. Pakistan's financial sector remains, on the whole, sound and healthy. Although nonperforming loans have risen for some banks and the recent large increase in the holdings of government securities in bank portfolios carries its own risks, the system-wide capital ratios are deemed adequate (IMF, 2012). This suggests that the risk of a serious banking crisis is on the low side, though the situation could change if the macroeconomy were to further deteriorate.

These stylized facts suggest that the acceleration of Pakistan's growth rate could be accompanied by improvements in the country's macroeconomic balances, and that the economy might break into a virtuous circle of economic growth and stability. At any rate, given the current situation, a drastic move toward macroeconomic tightening might do more harm than good.

Domestic demand has not been a constraint to economic expansion in Pakistan, which suggests that demand stimulus policies would not be required for the economy to reach its potential. There are, of course, risks in opting for a high-growth route, but those should remain manageable, provided the country's external debt burden remains moderate and the banking system by and large stress-free—the two most common sources of financial crises. This diagnostic suggests that macroeconomic adjustment and stabilization could be phased in over a period of time, while conditions are laid for accelerated growth.

#### 4.3. Growth Scenarios

The latest IMF's projections for Pakistan's economy are provided in the staff report on the 2011 Article IV consultations (see IMF, 2012). These projections are a useful starting point for sketching out a macroeconomic scenario that incorporates accelerated growth. The IMF scenarios are derived from its own analytical framework and discussions with the national authorities. It would, therefore, be easier to see where and why the alternative Heterodox Scenario differs from the official projections.

The IMF's projections of the key macroeconomic variables covering the period up to FY2016 are summarized in Table 5, while the results of our exercise are given in Table 6. The IMF offers two scenarios. The Baseline Scenario traces the evolution of Pakistan's economy during FY2013–FY2016, given current trends. Under this scenario, output growth does not rise above 3.5 percent, while inflation persists and slowly accelerates from the current level of 12 percent to 14 percent in FY2016. The budget deficit remains virtually unchanged at about 6 percent of GDP, while the current account deficit gradually rises from a surplus of 0.2 percent in FY2011 to almost 4 percent in FY2016. Throughout the projection period, the country's foreign exchange reserves remain precariously low at less than 2 months of imports. In short, it is a scenario where key economic indicators worsen over time, leading to a clearly unviable and unsustainable situation. The IMF's (2012) staff's assessment is summed up as follows:

Pakistan would face sizeable financing gaps even with low projected official reserves ... public debt remains high throughout the medium term, government refinancing needs remain large, and both public and external debts are particularly sensitive to exchange rate depreciation ... [However,] given large fiscal and external financing requirements, risks relate mostly to potential *liquidity* rather than *solvency* concerns (pp. 13–14, emphasis added).

Indicator	FY11	FY12	FY13	FY14	FY15	FY16
Baseline Scenario						
GDP growth (% change)	2.4	3.4	3.5	3.5	3.5	3.5
Inflation (% change)	13.7	12.0	12.5	13.0	13.5	14.0
Budget deficit (% of GDP)	-6.6	-6.9	-6.3	-6.1	-5.9	-5.8
Trade deficit	-5.9	-7.4	-7.1	-7.7	-7.7	-7.8
Current account (% of GDP)	0.2	-2.0	-2.0	-3.0	-3.3	-3.7
Gross reserves (months of imports)	3.8	2.9	2.3	1.6	1.6	1.7
Reform Scenario						
GDP growth (% change)	2.4	3.8	4.5	5.0	5.5	5.5
Inflation (% change)	13.7	12.0	11.0	10.0	9.0	8.0
Budget deficit (% of GDP)	-6.6	-5.7	-4.4	-3.6	-3.3	-3.0
Current account (% of GDP)	0.2	-2.1	-1.7	-2.5	-2.6	-2.8
Forex reserves (months of imports)	3.8	3.0	3.0	3.0	3.0	3.0

#### **Table 5: IMF scenarios**

*Source*: IMF (2012).

The staff report, however, also contains a "Reform Scenario" (see Table 5). The basic assumptions of this scenario are that the authorities will implement "prudent fiscal and monetary policies and structural reforms" (p. 15). The report states:

Over the medium term, tax policy, energy, business climate, and other structural reforms ... should enable further fiscal consolidation and higher productivity. The scenario assumes much less bank financing of the fiscal deficit and less crowding out of private credit. Together, these policies and reforms would produce higher growth, lower unemployment and inflation, and a more robust reserve cover" (p. 15).

In concrete terms, these measures help to raise GDP growth rate gradually to 5.5 percent while inflation declines to 8 percent. The budget deficit is reduced to 3 percent of GDP and the current account deficit falls below 3 percent by the end of the projected period. Because of the reforms, the country's foreign exchange reserves can be maintained at three months of imports.

In the Heterodox Scenario, as noted, output growth and inflation are exogenously specified targets. In contrast to the IMF projections, this scenario envisages GDP growth to rise slowly to 7 percent as inflation comes down to 6 percent over the projection period<sup>4</sup> (Table 6). This has important implications for the budget and trade deficits. With higher economic growth, government expenditures just need to be contained, not reduced, while a steady improvement in tax collection helps the actual revenues to grow much more rapidly. With public expenditures contained at 20 percent of GDP and revenues steadily rising to 17 percent, the budget deficit is reduced to 3 percent by FY2016. This is the same outcome as that given by the Reform Scenario, except that it is reached through more gradual fiscal adjustment.

With respect to the trade deficit, a comparison can be made only with the Baseline Scenario since the Reform Scenario does not include that information. In the Heterodox Scenario, because of a steady improvement in exports (rising from 14 percent to 17 percent of GDP) and imports held stable at 20.5 percent of GDP, the trade deficit declines to 3.5 percent, as against the Baseline Scenario's projection of nearly 8 percent of GDP. The Reform Scenario does assume an improvement in export performance while the import ratio is held stable, as in our scenario, which suggests that the trade deficit is projected to be in the vicinity of about 5 percent by FY2016.

Domestic investment and savings rates are critically important for economic growth. Again, only the IMF's Baseline Scenario offers projections for the two. In the first scenario, the projections are, as in other respects, highly pessimistic: Gross capital formation remains depressed at about 13.5 percent of GDP while gross savings, derived as a residual, amount to no more than 10 percent by the end of the projection period (IMF, 2012, Table 6) This is a particularly depressing view because the investment rate was some five percentage points higher even during the 2008 crisis. No information is available in the staff report as to the assumptions concerning investment in the Reform Scenario.

In the Heterodox Scenario, on the other hand, GDP growth is held to depend critically on investment, though it is recognized that it would

<sup>&</sup>lt;sup>4</sup> It is to be noted that money income rises at the same rate as in the IMF's Reform Scenario.

not happen quickly. In our projections, gross capital formation is projected to rise to nearly 20 percent by FY2016—about the level achieved during the high-growth period of 2004–07 (see Table 6). If government investment remains at levels projected by the IMF (i.e., under 4 percent), the burden of the increase in investment will have to be borne by the private sector. Thus, in the Heterodox Scenario, nongovernment investment (i.e., including state enterprises) is projected to rise from about 10 percent in the base period (FY2012) to 16 percent in FY2016. This is not an unrealistic expectation; nongovernment investment in FY2009 was about 15 percent, and in the years just before the crisis, even higher. The current low rates are a result of the depressed economic conditions and need not be accepted as something permanent.

	0. 11010	10407.0	centario			
Indicator	FY11	FY12	FY13	FY14	FY15	FY16
GDP growth (% change)	2.4	3.4	4.0	5.0	6.0	7.0
Gross capital formation	13.4	13.4	14.2	15.8	18.0	19.7
Government	2.6	3.1	3.2	3.3	3.5	3.7
Other	10.8	10.3	11.0	12.5	14.5	16.0
Domestic savings	6.5	6.5	8.1	9.7	12.9	15.6
Govt. revenue	12.8	12.8	14.0	15.0	16.0	17.0
Govt. expenditures	19.1	19.5	20.0	20.0	20.0	20.0
Budget deficit	-6.4	-6.8	-6.0	-5.0	-4.0	-3.0
Exports including NFS	14.8	12.9	14.0	15.0	16.0	17.0
Imports including NFS	20.5	20.3	20.5	20.5	20.5	20.5
Trade deficit	-5.9	-7.4	-6.5	-5.5	-4.5	-3.5
Forex reserves (months of	4.2	3.6	3.0	3.0	3.0	3.0
imports)						
Change in money supply (%)	15.9	10.7	11.8	11.3	10.8	11.0
Velocity of circulation (V)	2.7	2.8	2.9	3.0	3.0	3.1
Inflation (%)	13.7	12.0	11.0	9.0	7.0	6.0

	~	TT / 1	· ·
Table	6:	Heterodox	Scenario

Note: Unless otherwise indicated, the data is given as a percentage of GDP. See the Appendix for data details.

As is common to similar exercises, gross domestic savings are derived as a residual. The consequence of rising investment rates and falling foreign transfers (as a proportion of GDP) is that domestic savings must rise very substantially—from 6.5 percent in FY2012 to over 15 percent in FY2016. Given Pakistan's poor past record, this would appear to be a daunting task and could very well frustrate the goal of higher economic growth. However, the projected rate of 15 percent is still considerably lower than the rates achieved in the more rapidly growing economies but broadly similar to Pakistan in terms of per capita income.

There are two reasons why Pakistan's savings performance could improve dramatically with rising investment and accelerating economic growth. First, a high proportion of private investment is usually selffinanced in developing economies. If there are investment opportunities and there is eagerness to exploit them, then investors are seldom deterred for lack of financing; they mobilize their own savings. Second, private consumption tends to lag behind rises in individual incomes for precautionary reasons (individuals may not believe that the increase in income is permanent) and because consumption habits change slowly. That these factors can be important under rapid growth is supported by the experience of other countries. India's savings rate, which was also once quite low, rose from 23 percent in 2000 to 34 percent in 2010, while that of Indonesia rose from 27 to 33 percent over the same period (see Table 2 in Akyüz, 2012). Pakistan's savings rate, too, could therefore rise under conditions of higher investment and higher economic growth.

#### 5. Noninflationary Triggers of Economic Growth

There are several reasons why Pakistan's economic growth must accelerate. The rapidly rising population and labor supply is obviously the most important reason: Adequate economic growth would permit an increase in living standards while keeping unemployment in check. At the same time, social expenditures—on education, health, and social welfare must, as a minimum, keep up with the population increase, which is not possible without commensurate income growth. Then, there is the imperative of keeping the country's external debt burden manageable, which too requires a suitable rise in export earnings as well as national income. Last but not least, Pakistan's economy should seek to keep up with its neighbors because low growth implies lower productivity growth, which, over time, means a loss of competitiveness in markets where its neighbors compete.

Given these considerations, Pakistan should aim to reach a growth rate of at least 7 percent within the next few years and then be expected to sustain it over a period of time. This was the pace of growth that the country reached during 2004–07, and is about the same as others' in the region. India's growth rate was higher, but it seems now to be slowing down. Achieving higher growth would require first that Pakistan's economy move toward its existing potential and then embark on sustainable longer-term growth. What measures and policies would be required to achieve that goal demands extensive discussion among Pakistan's policymakers in order to arrive at a suitable strategy. This section addresses three areas that are likely to be foremost in any discussion on the country's future growth: (i) overcoming the energy crisis, (ii) stimulating private investment, and (iii) improving Pakistan's competitiveness in the world market.

#### 5.1. The Energy Crisis

There are various factors that are responsible for Pakistan's belowpar economic performance—the aftermath of the 2008 crisis, political turbulence, natural and manmade disasters, etc.—but the persisting energy crisis is probably the single most important reason for the underutilization of the existing productive capacity. No firm estimates are available on the cost of power cuts to industry, but there have been press reports of serious losses in certain key industries, notably, textiles and cement. As a rough guess, industrial output could improve by some 10–15 per cent if energy supply—electricity, gas, and other fuels—became adequate.

The problem of power shortage has festered now for several years; despite government promises and pronouncements, there are few signs that the situation will improve in the near future. The energy crisis has become one of the most hotly debated issues in public forums and in the media, but no consensus has emerged as to its causes or solution. Apart from routine pronouncements and handwringing, the government has shown neither the political will nor seriousness to tackle the problem.<sup>5</sup> Pakistan's energy problem is complex and highly politicized, involving contractual obligations with the power suppliers, system inefficiencies, pilferage, and the so-called circular-debt problem. Nevertheless, it obviously has to be overcome if there is to be a turnaround in the country's economic fortunes.

#### 5.2. Private Investment

The Heterodox Scenario discussed in the last section is based on the assumption that fiscal and monetary policies will remain prudent.

<sup>&</sup>lt;sup>5</sup> One account of the bizarre nature of discussions on the energy crisis was recently reported in a newspaper. At an official meeting on the energy crisis, one planning official declared, "Energy crisis is because of an intellectual crisis in the country [*sic*]." When asked to reconsider his position, he taunted the audience by asking, "Is there anybody in the conference hall who can speak proper English?" (Asif, 2012).

Although overall public expenditures will have to be contained, more rapid growth will depend on adequate public investment in infrastructure, education, and health. This will entail a reversal of the past policy of neglect if the deterioration in these critically important sectors is to be arrested. Nevertheless, the upshot is that private investment—rather than public expenditures—will drive accelerated growth and will have to rise sharply over the coming years. In the Heterodox Scenario, nongovernment investment (including public enterprises) is projected to rise from the current level of 10 percent of GDP to 17 percent in FY2016. The question that then arises is, how might this happen?

Private investment in Pakistan, even during the boom periods, has been far from remarkable. It rose somewhat during the Musharraf era, following the loosening of monetary policy in 2003/04, but was channeled mostly to the banking sector, telecommunications, and real estate.

Studies that have addressed the issue of private investment (see Asian Development Bank, 2008) identify the same weaknesses as found in other countries, i.e., the macroeconomic situation, governance, political instability, property rights, labor market rigidities, energy shortages, and infrastructure deficit. While these factors may have held back some investors, they do not quite explain Pakistan's exceptionally low level of private investment as compared to other countries. In terms of the International Finance Corporation and World Bank's Doing Business index, Pakistan has remained ahead of India and Bangladesh for the past several years in many respects. The latest index for the South Asia region (June 2011), ranks Pakistan at 3 with respect to "ease of doing business," 6 with respect to "starting business," and 2 with respect to "getting credit." India's rankings are 6, 8, and 1, respectively; while Bangladesh's rankings for the same are 5, 5, and 4 (see Table 7). In terms of "enforcing contract" and "resolving insolvency," Pakistan is, again, well ahead of India and Bangladesh. Overall, Sri Lanka comes close to the top in the region.

Index	Bangladesh	India	Pakistan	Sri Lanka
Ease of doing business	5	6	3	2
Starting a business	5	8	6	2
Dealing with construction permits	2	8	3	4
Getting electricity	8	2	7	1
Registering property	8	3	4	6
Getting credit	4	1	2	4
Protecting investors	1	3	2	3
Paying taxes	5	6	7	8
Trading across borders	4	3	2	1
Enforcing contracts	7	8	5	3
Resolving insolvency	5	7	3	2

Table 7: Doing Business index economy rankings for South Asia

Source: International Finance Corporation and World Bank (2011, June).

In brief, the investment environment in Pakistan appears to be similar to, if not better than, countries where private investment has been much more active. Sayeed and Memon (2007) in fact argue that conventional tools used in "investment climate" literature—notably institutions, governance, etc.—are not satisfactory in explaining Pakistan's "low investment puzzle." What seems to matter to private investors is the stability and credibility of economic policy rather than its specifics, such as the levels of tax rates or interest rates (Pindyck & Solimano, 1993). It is also the case that private investment decisions are greatly influenced by other investors' actions and behavior. Thus, economic growth—if it could somehow be kick-started—itself could generate a virtuous circle of investment and growth. Conversely, investor timidity and low economic activity feed on each other, which is probably at the root of Pakistan's stagflationary situation.

The conclusion from the discussion above is that, while there is no simple explanation for private investment, expectations concerning the country's future economic performance and the clarity and credibility of policy could be decisive. Thus, if it became established that policymakers were serious and agreed on a strategy of accelerated growth, it might be possible to break into the investment–growth virtuous cycle. At the same time, there is no question that some of the private sector's longstanding concerns—notably power supply, infrastructure bottlenecks, insecurity, etc.—would also have to be addressed.

#### 5.3. International Competitiveness

Pakistan has had bursts of rapid economic growth but they have all sputtered, almost invariably because of the emergence of untenably large trade deficits. Balance of payments viability is, therefore, a sine qua non for the durability and sustainability of growth, which means action on imports as well as exports.

Import growth is now hard to control by means of conventional trade policy because of the prevailing World Trade Organization (WTO) rules. A country might invoke the WTO's balance of payments clause, which allows temporary trade measures when a country is faced with serious balance of payments difficulties, but the IMF must agree. Another possibility is to apply selectively high *domestic* taxes on luxuries and other nonessential imports, which could curb imports while yielding additional public revenue. However, given the government's weak revenue-raising capabilities, this too may not be practical.

The critical determinant of balance of payments viability will, in fact, be export growth. Under the Heterodox Scenario, exports are projected to rise from the current level of about 14 percent to 17 percent of GDP, which represents an annual increase of about 16 percent or more than doubling in value during the projection period. Achieving this goal will require a coordinated, resolute effort on the government's part as well as the private sector's to seek out export opportunities and improve Pakistan's standing in the world market in terms of the quality and cost of its exports.

The exchange rate is commonly regarded as the key determinant of the country's competitiveness and a policy instrument of choice for improving the trade balance (see, for example, Pakistan, Planning Commission, 2008). But the exchange rate is unlikely to do the trick in Pakistan's case. For one thing, the rupee's real effective exchange rate has been, according to the IMF's own assessment, "relatively stable since the end of the 1990s" (2012, p. 12) and minor appreciations were short-lived. For another, the IMF now classifies Pakistan's exchange rate regime as "floating," which means that the currency is no longer actively managed. With a virtually open capital account, the rupee value is likely to be driven more by foreign financial flows than by the state of the country's trade balance (Haque, 2011). In any case, exchange rate depreciation works to improve the trade balance only through a reduction in real wages, which gives at best a temporary cost advantage as wages cannot be kept depressed for long. A durable improvement in competitiveness depends essentially on productivity growth, which is the real driver of production costs and living standards (Haque, 1995). A country's competitive advantage lies in ensuring that its productivity growth at least matches the growth in competitor countries. However, in a world where products and processes are constantly undergoing technological change, this is not easy nor does it automatically follow from competition. Investment in new plants and equipment can contribute to productivity growth through embodied technology. Countries with high investment rates—as is the case in fastgrowing economies—are, therefore, better able to adopt newer production processes and produce new products. But, as the experience of centrally planned economies shows, that is not always enough.

In order to stay competitive, productivity improvement has to become part of routine economic activity. In effect, a culture of creativity a continuous search for improvements in products and processes-has to become pervasive, not just in the modern industry but also in traditional sectors<sup>6</sup> (Haque, 1995). This is what drove the Industrial Revolution in Europe and brought about the technological transformation in East Asia that underpinned the region's phenomenal growth over the past several decades. While the government can create conditions where the search for technological improvements becomes appealing and profitable-e.g., by enforcing intellectual property rights, setting standards, and supporting research and development (R&D) and quality control, etc.-the decisions on how and what to produce, on adopting new technologies, undertaking market research and R&D, and, not least, on training the workforce are ultimately made at the firm level. Competition promotes the search for technological improvements, but its translation into investment and other actions depends on firms taking a longer-term view, rather than searching for a quick return. For this to materialize, a stable economic and political environment is important because instability breeds uncertainty, which in turn tends to make firms shortsighted in their investment decisions.

Bringing about the changes necessary for Pakistan's competitiveness might appear a tall order, but other similar countries have

<sup>&</sup>lt;sup>6</sup> Traditional sectors generally constitute a higher proportion of domestic output, which means productivity improvements there have a greater weight in overall growth. Specifically, in Pakistan, productivity improvements in agriculture would have a far greater impact on overall productivity growth than improvements in modern industry.

been successful and are today ranked as top economic performers.<sup>7</sup> In fact, there is considerable creativity in Pakistan, judging by the innovativeness of firms and individuals in different industries, notably in textiles, software, and surgical goods. There is also a display of brilliance by young Pakistani artists and designers within as well as outside the country. But these are still episodic achievements, and not quite enough to lift a nation of 180 million to join the club of the Asian giants (Green & Sender, 2012).

### 6. Concluding Observations

Under the Heterodox Scenario, Pakistan's economy is projected to achieve higher growth with economic stability, provided public expenditures and imports are contained at permissible levels while public revenues and export earnings rise to keep the macroeconomy stable. This article has identified three triggers of noninflationary economic growth. In the immediate term, a resolution of the energy crisis—arguably the highest priority—is critical to the expansion of output and enabling domestic industry to reach its potential. The pace and sustainability of growth in the longer term, on the other hand, will depend on private investment and productivity growth, which underpins the country's competitiveness in the world market. Although Pakistan's past record is not reassuring with respect to any of these areas, the situation can and should be improved.

Although this article is not intended to provide a strategy for how accelerated growth might actually materialize, we offer below a few ideas on how to proceed. Only the national government can develop a strategy for growth because it can marshal the required technical expertise and other resources to draw up a proper, realistic blueprint and action plan, and then mobilize the critically important political support for its implementation. Because of its expected role, the private sector's commitment to national development is vital, and would require its close involvement in the strategy's development.

The capacity of the government, or more broadly, the public sector, is severely limited in terms of financial resources and administrative capability,

<sup>&</sup>lt;sup>7</sup> The World Bank (1991) notes: "Forty-three years ago an influential government report in an important developing country observed that labor today shunned hard, productive jobs and sought easy, merchant-like work. The report showed that workers' productivity had fallen, wages were too high, and enterprises were inefficient and heavily subsidized. The country ... was overpopulated and becoming more so. This would be the last opportunity, concluded the prime minister in July 1947, to discover whether his country would be able to stand on its own two feet or become a permanent burden for the rest of the world. That country was Japan." (pp. 13–14).

but it still bears the responsibility for getting its policies and programs implemented, ensuring an equitable distribution of the costs and benefits of growth, and providing adequate resources to crucial health, education, and social welfare activities. It is a mistake—even dangerous—to dismiss the public sector as inherently inefficient, as has become fashionable in some policy circles. As noted earlier, in terms of the usual indicators, Pakistan's national economic management is actually no worse than that of some other fast-growing economies, though this is no reason for complacency.

Accelerated growth can be viewed as a virtuous circle, where rising investment and growth feed on each other. But the question that remains is how to jump-start the process. Since the economy is not demandconstrained, the usual stimuli of growth—enlarged public expenditures and loose monetary policy—would be unnecessary. Nevertheless, the fact that, under the Heterodox Scenario, public expenditures rise in step with income growth could be expected to reinforce the growth momentum.

Some sort of spur, however, is still needed to overcome investor timidity and to encourage the private sector to start investing more actively. We believe that resolving the energy crisis could alone make a considerable difference to the investment climate. Improving the currently loss-making public enterprises could also help, because that would not only reduce the drain on public finances but also stimulate economic activity through better provision of critically important infrastructure, notably in surface transportation (Pakistan Railways) and air travel (PIA). Whether the solution lies in privatizing these entities-as often recommended-must be a decision based on a careful weighing of the costs and benefits of different alternatives. There is no certainty that the private sector would run them any better, as has become evident from the power sector's problems and recent incidents concerning safety in the airline industry. There is also a real risk of "asset stripping" in the case of privatization, which would be a serious national loss. As an alternative to privatization, public sector-business partnerships could be exploredalong the lines of the recently launched Pak Business Express-which could also provide the beneficial fillip to overall investment.

Pakistan's continuing difficulties on different fronts have created a general mood of despair and despondency. But its problems are largely homegrown and, in certain respects, quite recent. This article has sought to demonstrate the feasibility of an accelerated growth strategy, which could be regarded as a response to the general lament over Pakistan's poor economic performance. A general rise in living standards and reduction in unemployment resulting from higher growth could conceivably help to lessen the disharmony, insecurity, and pessimism that have come to permeate Pakistani life. This has happened in other countries, notably, Indonesia, Malaysia, and Mauritius during the 1960s. "Nothing succeeds like success" would be a useful dictum to get Pakistan moving.

### References

- Akyüz, Y. (2012). *The staggering rise of the south* (Research Paper No. 44). Geneva, Switzerland: South Centre.
- Amjad, R, Din, M., & Qayyum, A. (2011). Pakistan: Breaking out of stagflation into sustained growth [Special edition]. *Lahore Journal* of Economics, 16, 13–30.
- Asian Development Bank. (2008). *Private sector assessment: Pakistan*. Manila, Philippines: Author.
- Asif, M. (2012, April 20). No answers to energy crisis. Dawn.
- Bruno, M., & Easterly, W. (1996). Inflation and growth: In search of a stable relationship. *Federal Reserve Bank of Saint Louis Review*, 78, 139–146.
- Dornbusch, R., & Fischer, S. (1993). Moderate inflation. *World Bank Economic Review*, 7(1), 44.
- Espinoza, R., Leon, H., & Prasad, A. (2010). *Estimating the inflation-growth nexus: A smooth transition model* (Working Paper WP/10/76). Washington, DC: International Monetary Fund.
- Fischer, S. (1993). The role of macroeconomic factors in growth. *Journal of Money Economics*, 32(3), 485–512.
- Green, M., & Sender, H. (2012, March 1). Pakistan: In the shadow of giants. *The Financial Times*.
- Haque, I. (1995). *Trade, technology, and international competitiveness*. Washington, DC: World Bank, Economic Development Institute.
- Haque, I. (2010). *Pakistan: Causes and management of the 2008 economic crisis* (Global Economy Series 22, Financial Crisis and Asian Developing Countries). Penang, Malaysia: Third World Network.
- Haque, I. (2011). The capital account and Pakistani rupee convertibility: Macroeconomic policy challenges [Special edition]. *Lahore Journal* of Economics, 16, 95–121.

- International Finance Corporation and World Bank. (2011, June). *Economy* rankings. Retrieved from http://www.doingbusiness.org/rankings/
- International Monetary Fund. (2009). *Pakistan: 2009 Article IV consultation* (Country Report No. 09/123). Washington, DC: Author.
- International Monetary Fund. (2012). *Pakistan: 2011 Article IV consultation and proposal for post-program monitoring* (Country Report No. 12/35). Washington, DC: Author.
- Mubarik, Y. A. (2005). Inflation and growth: An estimate of the threshold level of inflation in Pakistan. *State Bank of Pakistan Research Bulletin*, 1, 35–44.
- Pakistan, Planning Commission. (2008). *Economic stabilisation with a human face: Report of the panel of economists*. Islamabad, Pakistan: Author.
- Pakistan, Planning Commission. (2011). *Pakistan: Framework for economic growth*. Islamabad, Pakistan: Author.
- Pindyck, R. S., & Solimano, A. (1993). Economic instability and aggregate investment (Policy Research Working Paper No. 1148). Washington, DC: World Bank.
- Polak, J. (1997). *The IMF monetary model at forty* (Working Paper No. WP/97/49). Washington, DC: International Monetary Fund.
- Sayeed, A., & Memon, R. (2007). *Beyond the investment climate: Understanding the investment conundrum in Pakistan*. Falmer, UK: Institute of Development Studies.
- World Bank. (1991). World development report 1991: The challenge of *development*. Washington, DC: Author.
- World Bank. (2012). World development indicators. Washington, DC: Author.

## Appendix: Heterodox Scenario

							(USD	billion)
	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
				Estimate		Proje	ctions	
GDP (mp)	161.8	176.9	210.6	233.5	268.5	306.1	345.9	390.9
Exports incl. nfs	23.2	24.9	31.1	30.0	37.6	45.9	55.3	66.5
Imports incl. nfs	39.2	38.1	43.5	47.3	55.0	62.8	70.9	80.1
Trade balance	-16.0	-13.2	-12.4	-17.3	-17.5	-16.8	-15.6	-13.7
Net foreign reserves (end period)*	9.1	13.2	15.4	14.3	13.8	15.7	17.7	20.0
Net foreign transfers (required)	16.6	17.3	14.6	16.2	16.9	18.8	17.6	16.0
As a percentage of GDP								
Exports incl. nfs	14.4	14.1	14.8	12.9	14.0	15.0	16.0	17.0
Imports incl. nfs	24.2	21.6	20.5	20.3	20.5	20.5	20.5	20.5
Trade balance	-9.9	-7.5	-5.9	-7.4	-6.5	-5.5	-4.5	-3.5
Net foreign reserves % of imports	23.2	34.5	35.4	30.2	25.0	25.0	25.0	25.0
Foreign reserves (months)	2.8	4.1	4.2	3.6	3.0	3.0	3.0	3.0

### Table A1: Heterodox scenario, part I: Balance of payments

\* IMF (2012) consultations document, Tables 6 and 7. The IMF gross official reserves exclude foreign currency deposits at the SBP.

Assumptions: GDP growth during FY2013–16 is 4, 5, 6, and 7 percent, respectively; while inflation is 11, 9, 7, and 6 percent, respectively. Imports are a constant proportion (20.5 percent) of GDP; foreign exchange reserves are expected to decline to 3 months of imports in FY2013 and stay at that level for the projection period. Exports rise steadily to 17 percent of GDP from a level of 14 percent at the start of the period. The exchange rate is held constant at PKR 90 to USD 1.

### Monetary data

							(PKI	R billion)
	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16
Broad money	5,137	5,777	6,695	7,409	8,284	9,223	10,217	11,340
Velocity of circulation (V)	2.48	2.57	2.70	2.81	2.89	2.96	3.02	3.08
Change in money supply	433	640	918	714	875	939	994	1,123
Net foreign reserves*	752	856	1,137	1,286	1,239	1,412	1,596	1,803
Total domestic claims	4,385	4,921	5,558	6,123	7,045	7,811	8,621	9,537
Change in reserves	-100	104	281	149	-48	173	184	207
Net domestic credit	533	536	637	565	923	766	810	916

\* Foreign reserves converted at PKR 90/USD for the projection period.

							(PKR	billion)
	FY09	FY10	FY11	FY12*	FY13	FY14	FY15	FY16
				Estimate		Proje	ctions	
GDP (mp)	12,724	14,837	18,062	20,844	23,971	27,326	30,879	34,893
General govt. revenue	1,872	2,130	2,306	2,663	3,356	4,099	4,941	5,932
General govt. expenditures	2,531	3,006	3,454	4,070	4,794	5,465	6,176	6,979
Overall budget deficit	-659	-876	-1,148	-1,407	-1,438	-1,366	-1,235	-1,047
As a percentage of GDP								
Govt. revenue	14.7	14.4	12.8	12.8	14.0	15.0	16.0	17.0
Govt. expenditures	19.9	20.3	19.1	19.5	20.0	20.0	20.0	20.0
Overall budget deficit	-5.2	-5.9	-6.4	-6.8	-6.0	-5.0	-4.0	-3.0

# Table A2: Heterodox scenario, part II: Fiscal data

\* IMF baseline.

## Savings/investment balance

							(PKR	billion)
Percentage of GDP	FY09	FY10	FY11	FY12*	FY13	FY14	FY15	FY16
Gross capital formation*	18.2	15.4	13.4	13.4	14.2	15.8	18.0	19.7
Government	3.1	3.5	2.6	3.1	3.2	3.3	3.5	3.7
Other (incl. public enterprises)	15.1	11.9	10.8	10.3	11.0	12.5	14.5	16.0
Net foreign transfers	10.3	9.8	6.9	6.9	6.3	6.1	5.1	4.1
Gross domestic savings (residual)	7.9	5.6	6.5	6.5	8.1	9.7	12.9	15.6
GDP growth rate		16.6	21.7	15.4	15.0	14.0	13.0	13.0

\* IMF (2012), Table 6 for FY2009–12; for government investment, entire data from IMF.

# The Captivating Vision of the "New Growth Strategy": The Missing Political Economy Perspective

# S. Akbar Zaidi\*

### Abstract

One hears little about the Planning Commission's Framework for Economic Growth launched a year ago. This is indicative of its inappropriateness and lack of consideration of Pakistan's economy or its structures and political economy. The Framework avoids tackling the core issues of taxation, distribution, and equity. It privileges the market and free enterprise over the role of the state, and undermines and dismisses the significant role and contribution of the government and state in promoting growth, particularly at a time when market failure has made economists rethink the role of markets after 2008. By ignoring central issues related to politics and the articulation of power, and of issues that fall in the realm of political economy, the Planning Commission constructs a technicist script that has little value to the messy world of realpolitics.

Keywords: Growth, political economy, Planning Commission, Pakistan.

JEL classification: O1, O40.

### 1. Introduction

It is exactly a year since the Planning Commission's *Pakistan: Framework for economic growth* was launched with much fanfare and publicity. This would have been a good juncture to evaluate developments since then, but there seems to be no concrete evidence in the public domain on the basis of which to assess the *Framework*'s contribution—perhaps a telling critique of the composition of the *Framework* itself. One can, therefore, at best reflect on its core elements and assess how it imagines Pakistan's economy and society, and its components. For the most part, the *Framework* and the paraphernalia surrounding it—conferences, blogs, and publications—suggest a highly self-congratulatory and self-promotional endeavor, which suffers from numerous serious flaws that emphasize its elitism and anti-poor bias.

<sup>\*</sup> Visiting Professor, School of International Public Affairs, Columbia University.

Based on an evaluation of the documents surrounding the *Framework for economic growth*, this article offers a critique located in a political economy perspective. It attempts to identify the elitist bias in the *Framework* and also the disregard of numerous factors that could have led to a more realistic framework for growth. Given its vast spread and numerous themes, we will, necessarily, focus on only a subset of them. Nevertheless, what is clear is that, in each of the themes discussed and proposed in the *Framework* and in each of the interventions for growth suggested, there is a particular ideology or way of thinking that underlies the facts, problems, and solutions.

### 2. The "New Growth Strategy" and "Framework for Economic Growth"

The Government of Pakistan's Planning Commission launched its *Framework for economic growth* after the approval by the National Economic Council at its meeting held on 28 May 2011 under the chairmanship of the Prime Minister of Pakistan (see Pakistan, Planning Commission, 2011b). The *Framework* has also been called Pakistan's "New Growth Strategy" by the Planning Commission in its numerous publications and on posts and blogs on its active website (see Pakistan, Planning Commission, 2011a, 2012).<sup>1</sup> There is a great deal of self-praise and a greater deal of self-congratulation celebrated on the Planning Commission's official website and the institution has claimed a major achievement, almost as if nothing had existed before the formulation of the strategy and framework.

The title of this article, 'The Captivating Vision of the "New Growth Strategy",' is drawn from a blog on the Planning Commission's official website posted by a "consultant to the Planning Commission," where the writer argues that the "new growth strategy offers captivating vision for Pakistan" [*sic*]. It is indicative of just one of a very large number of self-congratulatory statements posted on the website as well as in its publications (see "New growth strategy," 2011). Let us now turn to an examination of exactly what this "captivating vision" of the *Framework* is. This section offers a brief summary of many of the arguments made in the documents of the Planning Commission, and presents, primarily, the salient features of both *Pakistan: Framework for economic growth* and its companion publication, the *International conference on "Framework for* 

<sup>&</sup>lt;sup>1</sup> The *Framework for economic growth, Pakistan* was published as the proceedings of the International Conference on the Framework for Economic Growth, Pakistan, hosted by the Planning Commission in collaboration with the United Nations Development Programme on 13–14 July 2011. There are numerous references to the New Growth Strategy and to *Pakistan: Framework for economic growth* on the Planning Commission's website (http://www.pc.gov.pk/).

*economic growth, Pakistan"*. The subsequent sections provide an analysis and critique of the Planning Commission's New Growth Strategy.

One assumes that there is an "Old Growth Strategy" that the Planning Commission's New Growth Strategy replaces, but other than the numerous references to the "traditional" planning approach, one does not get a clear understanding of what Pakistan's growth strategy or strategies have been in the past. Nevertheless, the Planning Commission does deserve a fair amount of appreciation for thinking about a growth strategy and for devising one. The salient features of the New Growth Strategy and the *Framework* are many, and this section merely highlights some key themes and foci raised in the New Growth Strategy found in *Pakistan: Framework for economic growth* and its companion publications.<sup>2</sup>

The list of challenges identified by the Planning Commission that the New Growth Strategy or *Framework* is expected to address and remedy include the following: (i) a decades-long struggle with macroeconomic stabilization arising from unsustainable fiscal policies; (ii) demographic pressure; (iii) a legacy of economic distortions, by which one presumes the Planning Commission means "government interventions;" (iv) the impact of external events, including earthquakes, floods, and a "continuing longstanding low-intensity conflict;" (v) a large and loss-making public sector, which is said to impede market development; (vi) low and declining productivity; and (vii) the population's heightened expectations of a better life from a democratic government. Perhaps for these reasons, the Planning Commission believes, that

> our growth experience of the last four decades has been volatile annual growth and [a] declining trend in long-run growth patterns. In addition, productivity growth (a measure of efficiency) has been low in comparison to our comparators. For the last four years per-capita incomes have not increased in real terms while double-digit inflation has prevailed. Our growth policy has been based on public sector projects and arbitrary incentives—subsidy and protection. The project selection process has considerably blunted the efficiency of infrastructure development while the system of incentives has not allowed the development of a vibrant and competitive marketplace.

<sup>&</sup>lt;sup>2</sup> The summary of the main points of the New Growth Strategy are drawn from the two main documents produced by the Planning Commission—Pakistan, Planning Commission (2011a) and (2011b).

Hence the need for a new approach "to accelerating economic growth and sustaining it." This "coherent approach to growth" goes well beyond projects, and targets public service delivery, productivity, competitive markets, innovation, and entrepreneurship. It "recognizes the severe resource constraint that the country faces and therefore focuses on 'productivity'—improving the efficiency with which assets are used." The thrust of this strategy, therefore, is to focus on the "software" of economic growth-issues of economic governance, institutions, incentives, human resources, etc.—so as to provide an environment in which the "hardware" of growth-physical infrastructure-could be expanded and made more productive at every level. The strategy argues that growth drivers such as entrepreneurship and innovation could be greatly encouraged by reforming and strengthening institutions such as the civil service, legal and judicial framework, the taxation system, etc. The strategy also proposes measures such as reforming the restrictive zoning laws that have impeded the growth of domestic commerce and hampered the role of cities as generators of economic growth.

The Planning Commission's new strategy to raise growth recognizes that the country cannot jump immediately to these high rates of growth from the current low growth rate of about 3 percent per annum. At the first stage, it feels that efforts will be undertaken to revive the economy to its short-term potential gross domestic product (GDP) growth rate of about 5–6 percent a year. If issues regarding energy and governance are resolved and some credible macro-stability reached, this could be achieved in a short time.

In its brief assessment of what constrains Pakistan's economic growth, the *Framework* argues that this is primarily on account of

inadequate market development, (lack of competition, tax, tariff and policy distortions, entry barriers, government involvement, poor regulation, etc.), and lack of efficient public sector management to (a) provide core governance goods such as security of life, property, transaction and contract, (b) facilitate markets and investment with informed policy and competent regulation, and (c) promote deepening of physical, human and social infrastructure (Pakistan, Planning Commission, 2011b).

The New Growth Strategy focuses on a number of areas. Productivity is one such area, where labor productivity in particular is seen to be of significant weakness. The *Framework* identifies a number of reasons for this, which include "market quality, poor governance, limited urban development, inadequate education, lack of competitive goods and factor markets, inadequate foreign competition and limited research and development capacity" (Pakistan, Planning Commission, 2011b).

A second factor identified by the *Framework* is the need to build better government. The Planning Commission considers "poor governance and dysfunctional markets to be among the most important reasons why growth in Pakistan has not achieved a sustained acceleration." The government is seen to be

an active player in every sector, as a direct market participant and competitor, obstructing private sector entry. The footprint of the government has been estimated to be as large as over 50 percent of the national income, making it very difficult for the private sector to expand. Research by the Competition Commission of Pakistan has also established that government intervention is impeding the development of competitive markets. Better government should be established following a two-pronged approach a) reorienting the role of government-which focuses on an exit from markets and deeper deregulation, and b) improving public sector management-which includes reforming civil service, improving resource mobilization, elimination of untargeted subsidies (particularly to lossmaking public sector enterprises), efficient public investment through results-based management (Pakistan, Planning Commission, 2011b).

### The New Growth Strategy advocates the

liberalization of trade and [the] investment regime to be a critical ingredient for sustained economic growth that in turn creates jobs, and raises productivity and wages ... [H]eavy protectionism was reintroduced in Pakistan during the second half of 2000–10, which brought back distortions in the overall trading system. Major distortionary policies adopted include (a) reversal of tariff cuts and increased tariff dispersion, (b) reversal of a number of liberalising reforms in agriculture, notably in wheat, sugar and fertilizer policies, (c) high and steeply escalated tariffs in specific industries, ... (d) active use of WTO compatible regulations to restrict imports—including quasi-import licensing

mechanism, (e) introduction and rapid expansion of antidumping practices, and (f) continuation of the long standing ban on imports from India. The growth strategy recommends a) re-establishment of the unilateral trade liberalization program, b) immediate abolition of the present system of distortive regulatory duties (SROs) that interfere with the tariff structure, c) maintain ... a neutral real exchange rate policy, d) immediate abolition of the adhoc system of quasi-import licensing ... e) thorough review of the economic justification for sectors/industries benefiting from above normal protection and/or subsidies, export subsidies, export taxes, and anti-dumping practices, and f) all economic policies including industrial and trade policies should be in line with the intentions defined in this growth strategy (Pakistan, Planning Commission, 2011a).

As can be ascertained from the above, the New Growth Strategy relies heavily on "vibrant and competitive markets." Openness and city development combined with focused public sector management are said to "go a long way towards developing innovative markets." A key area of focus for the *Framework* is its focus on "creative cities." So that cities might become "hubs of commerce," the strategy proposes (i) easing zoning and building regulations to allow space for mixed-use activities and energy efficiency, and to facilitate the vertical expansion of cities; (ii) privatizing unproductive state-owned land; (iii) encouraging foreign developers to compete in the Pakistani market; and (iv) focusing on research and development in low-cost energy efficient construction techniques.

Along with cities and free markets, the *Framework* also focuses on what it calls "connecting to compete," where such connectivity is seen to be a critical stratagem of the growth framework. There is also focus on "youth and community engagement," where a young population—68 percent under the age of 30—the demographic dividend, is considered a major asset for Pakistan. The Planning Commission argues that

Pakistan has a relatively large proportion (32%) of uneducated youth mostly with no vocational and life skills, who end up in elementary occupations or remain either unemployed or inactive. There is a need to provide for their health, education, and livelihood, and engage them in activities which convert their latent energy into positive outcomes for family, community, state and the global community. This is only possible through provision of quality basic and college education, market-led skills development, instituting National Youth Service Policy Reforms, redesigning and rezoning cities to create space for youth, promoting nano- and micro-youth enterprises at local level through targeted youth entrepreneurship programs in major civic centers, promoting youth citizenship through civic engagement, promotion and continuum of youth sports and activities that encourage and support the development of active and engaged young people.

This strategy is to be implemented through "results-based management," which will monitor and put in place an evaluation system to oversee the main features of the New Growth Strategy, for which a number of guidelines have been provided.

The Planning Commission has "rethought" the "traditional growth narrative" in Pakistan and feels that Pakistan has

more of a "software" (management and productivity) problem than a shortage of "hardware" (physical infrastructure). The strategy emphasizes the need to reduce economic distortions, improve functioning of domestic markets, create space in cities through proper zoning, energizing youth, engaging communities, inducing investment in human and social capital; and enhancing connectivity and interactivity. Vibrant cities in an enabling environment will be the hotspot for entrepreneurship and innovation, assuring better returns through improved productivity on investments for all investors' (N. Haque, cited in Pakistan, Planning Commission, 2011a, p. 4).

In essence, "the private sector must drive economic growth with timely implementation of market reforms which should promote competitiveness" (ibid., p. 5).

The Planning Commission's New Growth Strategy is, therefore, based on the four pillars of

quality governance, vibrant markets, energetic youth and community, and creative cities ... The key areas of the new growth strategy include enhancing the role of the private sector, entrepreneurship and innovation as major drivers of growth, enhancing productivity, improving the quality of governance through Civil Service reforms, making cities hubs of economic activities by relaxing zoning and building regulations, minimizing the role of the government in the economy and restricting it to improving regulation and [the] policy environment. The new approach takes cities as engines of growth in the country. [The] Strategy also focuses on inclusiveness for the development of rural infrastructure and markets for growth and poverty reduction, enhancing competitiveness and productivity by investing in tertiary education, vocational and technical training and development of a knowledge economy' (Pakistan, Planning Commission, 2011a, p. 12).

### 3. From Old to the New Growth Strategy

While attempts to develop new ideas that lead to ways of enhancing and sustaining Pakistan's growth rate beyond the roller-coaster, topsy-turvy, at times dismal, economic growth performance need to be encouraged—not just in the Planning Commission, but also in academic institutions and the mushrooming donor-funded and supported "think tanks"—there are a number of unanswered questions that have been unaddressed in the *Framework*. These are foundational if one is to move forward. Perhaps, most importantly, is the absence of any analysis of what explains Pakistan's past economic growth performance. Not having addressed this problem, the Planning Commission has absolved itself of highlighting and explaining patterns where Pakistan's growth rate has actually been particularly impressive.

There seems to be a clear consensus based in the opinions collected in the Planning Commission documents, that the "old" growth theorywhatever that was-does not work. In fact, this is one of the more important factors missing from the Framework and its companion publications and web-posts. By not explaining the failure of Pakistan's old growth strategy, any so-called new growth strategy will remain unable to examine and build on the successes of the past and to avoid repeating previous failures. The fact that Pakistan has had an average growth rate of around 5 percent of GDP for almost five decades-although, as the Framework recognizes, that trend may have fallen over the last two decades or so-is a signal that, at times, some old strategies, despite all the persistent structural problems that the Planning Commission's new ideological trend so likes to dismiss at every opportunity, may have worked. Moreover, the fact that there have been periods of five or even eight to ten years where the GDP growth rate has remained steadily above 6 percent requires serious consideration.

A major question for the Planning Commission and all those who have so enthusiastically endorsed the "New" Growth Strategy is: Why did the old growth strategy work, when it did? One should have accepted an honest answer before the old strategy was scrapped. There was, and continues to be, a need to examine what works and what does not, what has succeeded and what has failed, why growth has been high for up to five-year periods, and so on. There was a need to examine answers to these questions first, before they were supplanted with irrelevant and unrelated international best practices. The Planning Commission has been unfair and disingenuous in condemning all reasons for growth that has occurred in the past.

Platitudes dismissing the unevaluated old and embracing the new growth strategies abound in the Planning Commission documents. The main focus of their criticism of the past - despite its at times admirable success rate and the welcome embrace of the New Growth Strategy - has been an anti-state or anti-government outlook, with an almost unfettered pro-market orientation, and with few checks and balances to curb the most naked and aggressive form of the market dominating transactions, direction, and distribution. Sadly, many of those who endorse the new strategy are unfamiliar with the growth strategies of the past and those in place at the moment. Alan Winters, chief economist at the UK Department for International Development (DFID) states, that "the strategy is correct that space must be made and maintained for private sector development and that reducing the role and improving the efficiency of government is fundamentally important. This requires deep reform rather than funding ..." (cited in Pakistan, Planning Commission, 2011b, p. 1). Anyone familiar with Pakistan's economic development would be well aware that more than ample "space" exists for private sector development. However, there is repeated emphasis in the Planning Commission's policy that it is "the private sector [which] must drive economic growth with timely implementation of market reforms which should promote competitiveness" (N. Haque, cited in Pakistan, Planning Commission, 2011a, p. 4). Although, at times, the Framework and its accompanying documents make some qualifying statements that this is not a case of the "government vs. the market," what comes through repeatedly is not just a domination of the market, but almost a complete disdain for any role of the government, barring that of some oversight and regulation.

According to other economists, the old growth strategy, or the "traditional growth model with its emphasis on public investment and government involvement in economic activity has not yielded the high growth rates the country needs to absorb the expanding young labor

force. Furthermore, the government faces domestic and foreign financing constraints and it simply cannot afford any longer to undertake largescale capital expenditures" (M. S. Khan, cited in Pakistan, Planning Commission, 2011b, p. 1). While clearly any evaluation of Pakistan's economic history will show that the first part of this statement, privileging the private sector over the public sector, especially with reference to the past, is incorrect, it simplifies and ignores some of the core problems that Pakistan's government and its political economy relationship related to "domestic and foreign financing constraints" face (see the section below). A private sector specialist of the World Bank, like many others, endorses this view further by stating that, "growth takes place in the firms, not in the government. Second big driver of the growth strategy is the need to get the government out and to do the right job. Thirdly, firms need the space to breathe and grow on their own" (J. Speakman, cited in Pakistan, Planning Commission, 2011a, p. 97). As any student of economics would know, not only is this a gross exaggeration and simplification, it is also incorrect. This attempt to malign all things related to the government is a core feature of the *Framework*.

The Planning Commission has found the need to praise its own efforts in order to acquire legitimacy over its own *Framework*. Numerous bureaucrats and some economists have been invited to offer comments and, with the exception of only one—Akmal Hussain—almost all have showered praise on the deputy chairman of the Planning Commission and the so-called vision of the *Framework*. This has been done in blogs posted on the Planning Commission's website, but also extensively in the published documents around the *Framework*. There is a plethora of such quotations in the Planning Commission's documents, hence just a short sampling will suffice to make the case that the Planning Commission needs to create some sort of legitimacy and considers these quotes in order to do so.

An unnamed consultant to the Planning Commission states in a blog posted on the institution's website, that, "however farfetched the new growth strategy, produced by the Planning Commission, may seem to traditionalists there is no denying the captivating vision it projects for our cities" ("New growth strategy," 2011). The consultant argues that "we are too scared to think outside the box" and that urban planners in Pakistan, until this new, bold strategy came about, have been "seized by fear" (ibid.), that the "fear that the realities of our country cannot adapt to 21st century ideas has suppressed the potential of our cities. This fear has seized all urban planning and development in Pakistan" (ibid.).

#### 4. The Absence of Political Economy

A claim leveled against the *Framework* is that it is elitist and antipoor, and that it avoids tackling—or even discussing—core issues with a political economy focus, making much of the technicist, pro-market, and anti-state orientation of the New Growth Strategy redundant and seen in a vacuum. The absence of "who" and "how" is going to make some of the *Framework*'s recommendations and many of the ideas seem mere window dressing, and probably accounts for the major reason that one does not hear about this New Growth Strategy one year after its launch. However, one underlying feature of the *Framework*'s documents and the numerous "international experts" who participated and commented on the growth strategies seems to be their complete inability to understand the context of Pakistan and its problems.

The reference points for some of the participants seem to be completely unconnected with the structures, contexts, and constraints that face Pakistan and its growth formulation. John Speakman, the World Bank private sector specialist speaks of his experience of cities in the Middle East and compares them to Pakistan since "cities" form one of the four core pillars of the *Framework*. On being asked where he sees the constraints and challenges with regard to the emphasis on cities in Pakistan and why these cities have been unable to evolve, he addresses a theme that has not been adequately raised in the *Framework*—that of revenue generation. While he shows his lack of familiarity with Pakistani cities in general, he argues that, "cities don't have the money. I previously visited Middle East and have seen very successful cities there. The reason for these cities to be successful was their earning sources, revenue generation and tax collection. But here the cities, generally and specifically in Pakistan, have cash constraints" (cited in Pakistan, Planning Commission, 2011a, p. 97). Although it is quite irrelevant to compare cities in the Middle East with those of Pakistan, Speakman does raise an issue that has been neglected in much of the Framework. Other commentators do not even do that, and raise issues specific to the United Kingdom or other developed countries and expect, given Pakistan's specificity, that anything of substance can be replicated (see A. Rathmell, cited in Pakistan, Planning Commission, 2011a, p. 40).

There are numerous themes and issues that the *Framework* has ignored, side-stepped, dismissed, or given short shrift to, which seem to be fairly obvious to anyone even remotely familiar with Pakistan's economy, let alone at the Planning Commission. Avoiding a host of critical issues greatly diminishes the contribution and importance of the New Growth Strategy and the *Framework*. Some important ones need to be pointed out.

The deputy chairman of the Planning Commission states that the media in Pakistan does not discuss this important subject of growth and that, instead, "we find media and experts discussing issues like Tax-to-GDP ratio and sovereign economy [*sic*] whereas there are many other important issues to discuss like growth and creating opportunities for the youth in the country" (N. Haque, cited in Pakistan, Planning Commission, 2011a, p. 14). He continues, "We have a resource gap in our country. Resource gaps are there everywhere around the world. It is not [a] question of resources but to reorganize ourselves and think differently" (p. 55). Clearly, to dismiss the resource gap and to not put the diminishing tax-to-GDP ratio, which has fallen from near 12 percent in 1999 to nearer 8 percent in 2012, at the forefront of any discussion of reform, really does undermine any sense of honest appraisal that the *Framework* and New Growth Strategy may hold for Pakistan. Thinking differently without a revenue base, is certainly a novel way to articulate Pakistan's growth strategy.

Moreover, the obsession of the Planning Commission and its deputy chairman with privileging the market over the state and government in an era after the 2008 global crash is indeed one of the most startling aspects of the *Framework* and New Growth Strategy. It only reveals the very blinkered ideological position of those responsible for developing and endorsing the *Framework*. Even Chicago, that holy bastion of Friedmanite free market economics, has had to rethink economic strategy and intervention after the economic crises of just a few years ago. The so-called "New" Growth Strategy should have kept itself up-to-date with recent developments in economic theory and practice. The failure of an unbridled free market has not just been recognized in theory and economic textbooks, but also across the "quality of life"—a term that the *Framework* frequently uses—of millions of inhabitants in Europe and the United States.

Along with the Planning Commission's free market bias under its current deputy chairman, no opportunity is missed to dismiss all and any government efforts. In order to propagate its anti-government ideology, the *Framework* insists that Pakistan's problem is one of "software," not of "hardware" such as physical infrastructure. Again, this questions the legitimacy of the New Growth Strategy in light of Pakistan's acute power crisis and the absence of other physical infrastructure, which, while acknowledged in the *Framework*, are considered to be merely problems of governance. Moreover, one of the keynote speakers at the International Conference on the Framework for Economic Growth, Ajay Chhibber, also pointed out that the work of the Growth Commission closely examined 13 cases of sustained high growth—those economies that had achieved 7 percent or above for 25 years or more and found that there was "a *big role*"

for infrastructure in high-growth economies" (cited in Pakistan, Planning Commission, 2011a, p. 17; emphasis added). It is not clear how the free market private sector will play a "big role" in infrastructure development in Pakistan. Perhaps in Korea and Turkey this may be the case, but it is not possible with regard to infrastructure, to completely throw out the state and the government in Pakistan. Other World Bank specialists have also argued on similar lines

The proposed "strategy" of relying upon the private sector to make necessary infrastructure investments (because the public sector essentially has no funds) is essentially a copout. It dodges the real issue—how to create the necessary fiscal space and make the essential public expenditure choices that are the duty of any responsible Government. Fascination with private sector initiatives as the solution to all problems also reminds me of the World Bank's monumental policy mistake along the same lines something it has been forced to reverse recently after more than a decade of costly errors (A. Zulfiqar, e-mail communication, 3 May 2011).

Perhaps it is also this free-market, private-sector orientation of the Planning Commission's New Growth Strategy and *Framework* that does not tackle head on, the problem of political economy, inclusive growth, or state intervention to address those who have been, and will continue to be, excluded, even if growth does take place.

One of the main contributions this New Growth Strategy could have made in order to distance itself from what its documents call the "traditional" approach to growth was to have brought in issues of politics. The *Framework* does acknowledge that Pakistan is a democracy and that democracy does have its own practices and forms. However, the documents' authors need to be reminded that it is now a fairly well established fact even in orthodox economics that "the political or the social are *constitutive* (rather than merely contiguous or contributory) aspects of the economy" (Deshpande, 2012, p. 41). Issues of growth, governance, and cities, which the *Framework* highlights, are all issues of political economy, politics, and power. So is the key issue of distribution, something which does not play an important role in the *Framework* and its companion documents.

This failure to even discuss, leave alone to deal with, the political, is a great flaw in any technicist attempt to create growth, especially as research has shown time and time again, that it is politics and political institutions which create the sort of economic institutions that give rise to inclusive growth (Acemoglu & Robinson, 2012). Research confirms that political institutions shape economic institutions and are shaped by the latter in turn. While attempting to talk about growth or prosperity, but avoiding a discussion on issues of power and politics, much of the New Growth Strategy's analysis becomes just another document produced by the same type of departments and institutions that the Planning Commission so likes to belittle. Sadly, its own efforts, despite great ambitions and good intentions, fall into the same category.

The absence of a discussion on the political and of the articulation of power also necessarily avoids the question of the distribution of wealth, assets, and the nature of growth and its spoils. This is an area neglected in the Planning Commission's documents and since it is beholden to the free market, one presumes that it believes that poverty and the distribution of growth will "take care of itself" through some hidden hand despite ample global evidence suggesting that this does not happen. This is particularly so in the case of *growing regional, provincial, and income inequalities*. The market, or even the dynamic entrepreneurs who form the backbone of the *Framework*, cannot address the question of equality, whether regional or income. In fact, if anything, one can expect this free-market ideology propagated by the Planning Commission to exacerbate income and regional inequality much further. One still needs government to intervene and interfere and to ensure that some rights are delivered to those who demand and deserve them. Nowhere can the market do this adequately.

Since much of the focus of the Planning Commission's documents is on cities as a hub of future growth, one must emphasize these documents' complete lack of understanding of what cities are and how they function in third-world countries. Sadly, the examples given by many of those who propagate the Planning Commission's views are from the Middle East or first-world cities, where issues and problems are markedly different. It is this elitism of the notion of "world-class" or lead cities that exposes the absence of understanding of Pakistani cities. The apparent absence of thinkers and planners who are familiar with Pakistani citiessuch as Arif Hasan and Tasneem Siddiqui, both of whom have changed the lives of many Pakistanis who live in cities—is reflected in how the city is imagined. Unlike those who have written or subscribe to the vision of the Planning Commission on cities, anyone who studies cities in Pakistan would know that they are already the hub of innovation and creativity. The difference, however, is that these aspects of the city are not those that the Planning Commission envisages; the motor of dynamism in third-world cities is the eyesore of the Planning Commission-the informal sector.

An absence of the recognition of how the informal sector leads urban dynamism reveals that those who imagine the cities of the New Growth Strategy live in very different worlds from most Pakistanis. As one of the participants makes clear in his comments, "Islamabad is considered to be one of the best developed cities in Pakistan but, because of slums coming up and informal development taken place around in recent past, [sic] it is not that Islamabad which was dreamed at the time of planning" (T. Shamshad, cited in Pakistan, Planning Commission, 2011a, p. 51). Islamabad is probably the least representative of Pakistan's cities, but here, too, one can see the emergence of the ugly informal sector, where elsewhere, it is considered a motor for development. As one participant from a third-world city at the International Conference on the Framework for Economic Growth reminded urban planners from Pakistan, "The informal city needs to be recognized as what it is, not encroachment, but as a part of the city where people live, work, and create something. The challenge ahead is that how to bring informal part of the city into the overall growth framework and make poor people participate in overall growth effort" (E. A. Wegelin, cited in Pakistan, Planning Commission, 2011a, p. 87).

Nevertheless, the *Framework*'s apolitical stance is also manifest here, since there is no mention of local-level politics. In democracies, governance is an issue of politics and representation as well as vested interests, and cannot be devoid of such influences. Those who understand urban development and cities, however, know better: "[The] important thing is the need for institutions particularly at local level to make this happen which requires more capacity at level of local bodies and sub local levels and a capacity to recognize them as a legal part of the society, deal with the communities and engage them in positive activities (ibid.)." The New Growth Strategy is devoid of any such recognizion or understanding.

#### 5. Conclusions

A private sector-led, free market-oriented New Growth Strategy that does not directly take on issues of tax evasion by the same private sector—which is supposed to be that engine of growth—or a strategy that does not tackle a low tax-to-GDP collection ratio, is committing a criminal offence by continuing to protect and subsidize Pakistan's elite and its private sector. Similarly, by undermining and dismissing the significant if wayward role of government and the state, the Planning Commission does a disservice to its own pro-growth strategy, and also exposes its ideological moorings which, at least globally, have been beaten into a different shape following the 2008 global crisis. The Planning Commission, with its gungho private sector and free-market ideology is far out of step with even those who defend the private sector and the free market.

By ignoring central issues related to politics and the articulation of power, and of issues that fall in the realm of political economy, the Planning Commission writes a highly technicist script that has little value in the messy world of realpolitics. Issues of distribution and inclusive institutions for growth are overlooked. It is exactly one year since the launch of the Framework for Economic Growth. Perhaps it is for these reasons that no one talks about this New Growth Strategy any longer. Like many ill-designed technicist reports and strategies lacking much context to the society in which it is supposed to be placed, this, too, fortunately lies buried in the pile of reports and strategies devised by such institutions. Using the same principles of results-based management so central to how its New Growth Strategy is to be implemented and assessed, and following its distaste for government and its penchant for the private sector, perhaps the lesson post-one year of the New Growth Strategy is that it is the Planning Commission itself that needs a revamp and different orientation, one less ideologically blinkered and more in tune with Pakistan's actual, existing conditions, problems, and reality.

### References

- Acemoglu, D., & Robinson, J. A. (2012). Why nations fail: The origins of power, prosperity and poverty. London, UK: Profile.
- Deshpande, S. (2012, April 21). Capitalism, exclusion, transition: The politics of the present. *Economic and Political Weekly*, 47(16), p. 41.
- New growth strategy offers captivating vision for Pakistan. (2012, December 22). [Web log post]. Retrieved from http://115.186.133.2/nda/Blogs/tabid/56/EntryId/42/Newgrowth-strategy-offers-captivating-vision-for-Pakistan.aspx
- Pakistan, Planning Commission. (2011a). *International conference on "Framework for economic growth, Pakistan"*. Islamabad, Pakistan: Author. Retrieved from http://www.pc.gov.pk/feg/PDFs/2012/FEG-Final-Report\_2-1-2012.pdf
- Pakistan, Planning Commission. (2011b). *Pakistan: Framework for economic* growth. Islamabad, Pakistan: Author. Retrieved from http://www.pc.gov.pk/hot%20links/growth\_document\_english \_version.pdf
- Pakistan, Planning Commission. (2012). *Growth strategy of Pakistan, 2011: Infographics* [Presentation slides]. Retrieved from http://www.pc.gov.pk/feg/PDFs/Infographics%20of%20Growt h%20Strategy%20of%20Pakistan.pdf

# Stagflation, the Labor Market Impact, and the Poverty Puzzle in Pakistan: A Preliminary Analysis

# **Rashid Amjad<sup>\*</sup>**

## Abstract

This article discusses the impact of the current stagflation in Pakistan on the labor market and poverty. The paper presents a preliminary explanation of why the labor market and poverty impact of the current stagflation may be far smaller than projected in recent studies, especially for the rural economy. The main conclusions that emerge are that (1) The overwhelming expected negative impact of low economic growth, high double-digit inflation, and crippling energy shortages on poverty and the labor market appear to have been cushioned by the large increase in remittances, rising wages in agriculture and services, and social safety nets; (2) there is, however, no reason for complacency since over 20 million people live in absolute poverty and that the economy remains in deep stagflation, (3) the PSLM (HIES) 2010/11 data should be made publicly available so that it can be subject to more critical analysis and (4) studies on poverty should be based on a close integration of macro-sectoral–micro-factors to fully capture the underlying "poverty dynamics."

Keywords: Macro-dynamics, economic growth, cycles, Pakistan.

### JEL classification: P46, F43.

### 1. Introduction

Over most of the last 65 years, Pakistan has grown in stop-go cycles. The macro-dynamics underlying these cycles have been subject to close examination.<sup>1</sup> More recently, attention has focused on explaining a new phenomenon—a prolonged stagnation over the last five years, 2007–12, characterized by low economic growth and high double-digit inflation—and on the measures attempting to overcome it, albeit with little success so far (see Amjad, Din, & Qayyum, 2011).

<sup>\*</sup> Vice Chancellor, Pakistan Institute of Development Economics, Pakistan.

<sup>&</sup>lt;sup>1</sup> For an exhaustive review, see McCartney (2011). See also the Appendix for differences between more recent stagflation and past stop-go cycles post-1980.

Understandably, studies analyzing the expected impact of this prolonged stagflation projected a sharp increase in both unemployment and poverty. These studies have drawn on the results of earlier studies that had estimated the impact of economic growth and inflation (mainly food inflation) on unemployment and poverty. However, little attention has been paid to the specific features and dynamics of the current stagflation, which may be significantly different from the conditions prevailing in the time periods covered in the earlier studies. More importantly, the estimated coefficients and elasticity of the relationship between poverty and economic growth and other variables derived in the earlier studies could significantly change and, hence, distort the results of more recent studies.

It is not, therefore, surprising that, when data began to emerge on recent trends in unemployment and poverty, which in most cases was quite contrary to what recent studies had predicted, these studies were met with considerable disbelief and finger pointing.<sup>2</sup>

This article wants to mark a beginning of a serious debate on the impact of the current stagflation on the labor market and poverty, drawing on not just macroeconomic developments that have been seen as major explanatory variables in the current debate, but combining them with a more in-depth understanding of the macro-sectoral–micro- (mainly labor market) dynamics of the current situation.<sup>3</sup>

Such an approach is also dictated by Pakistan's historical experience, where the relationship between growth and poverty has not been straightforward. It has witnessed periods of high growth with little decline in poverty, as in the 1960s. By contrast, in the 1970s low economic growth was accompanied by a fall in poverty. Post-1980, however, periods of high growth have been positively related to a decline in poverty as in the 1980s and 2001–07, while low economic growth in the 1990s witnessed a rise in poverty. Interestingly, when growth declined significantly in 2007/08, poverty continued to decline and unemployment continued to fall (see Naseem, 2012).

 $<sup>^2</sup>$  Indeed this has been true not just for the recent debate on poverty trends, but going back to changes in poverty levels since the 1960s. For an excellent review of past studies and debates, see Naseem (2012).

<sup>&</sup>lt;sup>3</sup> See Bourguignon, Bussolo, and da Silva (2008) who present macro-micro evaluation techniques and tools to analyze the impact of macroeconomic policies on poverty and income distribution. As their introduction states, "In fact, the application of variants of a single modeling framework—a macro model linked with household level micro—is the unifying methodological theme of this volume." Although the current study does not carry out any modeling exercise, this is clearly a field open for further study.

The remaining article is divided into five main sections. Section 2 presents a brief review of studies projecting the impact of the current stagflation on unemployment and poverty. Section 3 then presents the evidence based on recent data on movements of key labor market and poverty-related variables. Section 4 presents the results of previous studies that have estimated the impact of key economic variables on poverty and on which recent studies have mainly relied. Section 5 attempts a preliminary explanation of why the labor market and poverty impact of the current stagflation could have been far smaller than projected in recent studies, especially for the rural economy. Here, we explore the macrosectoral–micro dynamics of the current stagflation. The concluding section summarizes our main findings and makes some suggestions on how best to carry forward this debate.

# 2. A Review of Selected Studies on the Impact of the Economic Slowdown and Inflation on Unemployment and Poverty

("He who has not sinned throw the first stone"!)

The results of four important studies on Pakistan are discussed here, together with the results of a World Bank (2012) update on global estimates of poverty. As we shall see, all four studies projected a sharp increase in poverty post-2008. The World Bank study, in contrast, presented preliminary global updated estimates for 2010, which indicated that poverty in developing countries based on a smaller sample (which probably did not include Pakistan) continued to fall, as it had done over 2005–08.

# 2.1. The Panel of Economists: Interim Report on Economic Stabilization with a Human Face<sup>4</sup>

The Panel of Economists set up by the Planning Commission in September 2008 consisted of eminent economists who were to recommend measures to overcome the economic crisis resulting from unsustainable current account and fiscal deficit. These deficits had reached 8 and 9 percent of GDP, respectively, as a result of the unprecedented increase in oil and food prices accentuated by a policy of "inaction and neglect" adopted by the last government. The Panel's recommended stabilization measures to restore macro-stability and avoid default were accepted by the government, which saw them as an endorsement of the standby-

<sup>&</sup>lt;sup>4</sup> The author was a member/convener of this panel and shared the views expressed in its report.

arrangement it had negotiated with the International Monetary Fund (IMF) to stabilize the economy (see Pakistan, Planning Commission, 2008). The Panel, as indeed did the IMF, strongly advocated adopting cost-effective social safety nets to help cushion the negative impact of stabilization on the poor and the vulnerable—hence, stabilization with a "human face."

The Panel had undertaken a simulation exercise to determine the impact of stabilization measures on key economic variables, based on an abridged version of the integrated social policy and macroeconomic model (SPMM) developed by the Social Policy and Development Centre and the Planning Commission's consistency model–macroeconomic framework. The main results in relation to unemployment and poverty were as follows.

- 1. The unemployment level would increase further in 2008/09, due to the deepening of the economic downturn, and the unemployment rate would increase cumulatively by 3 percentage points over 2008/09 and 2009/10, reaching a level of well over 8 percent. These estimates were based on an employment elasticity of 0.45, based on past trends applied to projected economic growth over these years.
- 2. The proportion of those below the poverty line would increase by 3.5 percentage points in 2007/08 (mainly due to the explosion in food prices), 2.7 percentage points in 2008/09, and 2.0 percentage points in 2009/10.
- 3. Based on informed judgment, as the Panel's report put it, combining the inflation and unemployment effects would add 6 percentage points to poverty incidence in 2004/05, raising the poverty level to 35 percent in 2008/09 if the level in 2004/05 was taken as 29 percent (or to 31 percent if the 2004/05 level was taken as 25 percent). This would, it claimed, translate into an additional 15 million people falling below the poverty line by 2008/09.

It must be said that the Panel was aware of the shortcomings of the exercise carried out—mainly the lack of more recent data, which precluded a more systematic and rigorous exercise being undertaken. But, clearly, the message was that both unemployment and poverty would increase as a result of stabilization, the global financial crisis and the resulting global recession accentuated by a sharp increase in prices as subsidies were cut back to restore the macro-balance.

#### 2.2. Institute of Public Policy: Annual Reports on the State of the Economy

The Institute of Public Policy (IPP)'s first annual report, *State of the Economy* (2008) was released just before the budget in June 2008 (as was to be done in subsequent years), soon after the newly elected government had taken office earlier in March. The report claimed that poverty had risen substantially to 33.8 percent in 2007/08 due to food inflation and the slowdown in economic growth, with the level increasing from 29.2 percent in 2004/05 (taken as the base year using the World Bank's re-estimated poverty estimates compared to the 25.2 percent claimed by the government, using the same dataset for 2004/05.)

The IPP report projected a continuing rise in poverty (see Table 1) if the increase in food prices and low growth was to persist, rising to as high as 43 percent of the population or 80 million people falling below the poverty line by 2011/12.

	Headcount ratio	Impact of food inflation					
Year	World Bank estimates (%)	Headcount ratio (%)	Number of poor (millions)				
1998/99	30.0	30.00	40.35				
2001/02	34.4	34.40	50.21				
2004/05	29.2	29.20	45.48				
2005/06		28.68	45.74				
2006/07		29.47	48.12				
2007/08		33.81	56.55				
2008/09		36.11	61.84				
2009/10		38.41	67.35				
2010/11		40.70	73.10				
2011/12		43.01	79.08				

Table 1: IPP estimates of p	poverty incidence, 1999–2012
-----------------------------	------------------------------

Source: IPP. (2008). State of the economy, Table 4.7.

The report does not clearly spell out the detailed methodology adopted to project poverty for the period 2005/06 to 2011/12, but states that it was based on the coefficients of the elasticity of poverty with respect to food inflation, adjusted for growth in per capita income, estimated by Akhtar and Ahmed (1999). These coefficients must then have been applied to the projected growth and inflation figures used in the report. The IPP's subsequent three annual reports continued to claim a rising and high level of poverty, but it would appear that no new exercise was undertaken, and that these were drawn from the 2008 report as economic conditions had not changed and high inflation and low growth persisted. In its latest annual report (2012), the IPP turns its attention from poverty to worsening income distribution, based on a comparison of the latest Household Integrated Economic Survey (HIES) for 2010/11 and 2007/08 data (as reported in the Pakistan Economic Survey for 2011). However, the reports presents no new estimates of poverty, presumably because the raw HIES 2010/11 data had not been released. The report expresses its concern about the conditions of the lower-income group as follows:

> Even though we believe that the HIES surveys understate income inequality, it is noteworthy that they report that inequality has continued to increase during the last three years. Overall, the lowest two quintiles of household have suffered a drop in their real incomes, while significant increases have been recorded in the case of upper-income households. *This also implies that the incidence of poverty have increased during the last three years* (italics added) (IPP, 2012, p. 32).

### 2.3. Asian Development Bank: Food Poverty and Inflation in Developing Asia: Is Poverty Reduction Coming to an End? (2008)

As food inflation rose in response to the steep rise in oil and commodity prices in 2007/08, international agencies including the Food and Agriculture Organization, the World Bank, and the Asian Development Bank (ADB) all warned of an impending crisis due to large expected increases in poverty and malnutrition, given that the poor spend a large proportion of their income on food grains. Many of these agencies also released data on the numbers that would fall into poverty and suffer malnutrition.

Somewhat dramatically, the ADB (2008) questioned whether the poverty reduction achieved in the recent past was coming to an end with rising food inflation. Comparing the impact of the rise in food prices on poverty in the Philippines and Pakistan, the ADB showed that the impact on the latter was much larger (almost three times) due to its lower per capita income, thus illustrating the vulnerability of the low-income developing countries. Applying these estimates to Pakistan, where food inflation increased by almost 80 percent in the four years post-2007/08,

would imply that the number of people in poverty more than doubled by 2010/11—a figure near that estimated by the IPP.<sup>5</sup>

Table 2: Changes in number of poor (millions) with increase in food prices

Country	10%	20%	30%
Philippines	2.72	5.65	8.87
Pakistan	7.05	14.67	21.96

Note: To estimate the number of additional poor, national poverty lines were used. These estimates are concerned only with the price effect on consumers, i.e., they do not take into account the impact of prices changes on producers.

*Source*: ADB. (2008). Food prices and inflation in developing Asia: Is poverty reduction coming to an end?

#### 2.4. ADB: Global Food Price Inflation and Developing Asia (2011)

With the re-emergence of a spike in global food prices in 2011, which had increased by more than 30 percent year on year, the ADB (2011) undertook a fresh exercise to estimate its impact on poverty. The results for Pakistan projected a 2.2 percentage point increase in the percentage of the poor for a 10 percent increase in food prices, and an increase of 3.47 million people in the number of the poor. It is interesting to note that these estimates are almost half of the earlier estimates, and bring out the sensitivity of such analysis to the methodology used.<sup>6</sup>

While the government still did not officially acknowledge the poverty estimates for 2007/08, it is interesting that the Pakistan Economic Survey for 2010/11 cites the ADB (2011) study in detail. The latter's numbers are used to state that, if they were true, poverty would increase by almost 50 percent, given a food inflation rate of around 70 percent in the preceding three years. Clearly, the government was taking international agencies' estimates seriously.

### 2.5. World Bank: Global Poverty Update (2012)

Like the ADB, the World Bank had also drawn attention through press and other statements to the vulnerability of developing countries to

<sup>&</sup>lt;sup>5</sup> With an 80 percent increase in food inflation between 2007 and 2012, the ADB's estimates would imply an increase of 56 million people in poverty.

<sup>&</sup>lt;sup>6</sup> These estimates were derived using the price elasticity of poverty, which was estimated for both the headcount ratio and poverty gap ratio (see ADB, 2011).

the spike in food prices, emphasizing that extreme poverty levels would, in consequence, substantially increase post-2008. It therefore came as a surprise to many when the World Bank announced that its preliminary estimates for 2010 indicated that poverty had continued to fall despite the global economic crisis and other shocks, and that the first Millennium Development Goal had been met. As for the earlier ones for 2005–08, these estimates were based on a poverty line of USD 1.25 a day, but were drawn from a smaller sample of developing countries than for the 2005–08 estimates (World Bank, 2012).

It may be important to note here that these were perhaps the first estimates by an international agency to suggest that poverty levels had not been impacted to the extent that many of them had predicted as a result of the global economic crisis and food inflation. However, these results caught little global attention and indeed have not been cited in the recent poverty debate in Pakistan.

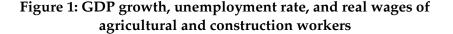
# 3. The Impact of Stagflation on the Labor Market and Poverty: What Actually Happened (or What the Data Suggests Happened)

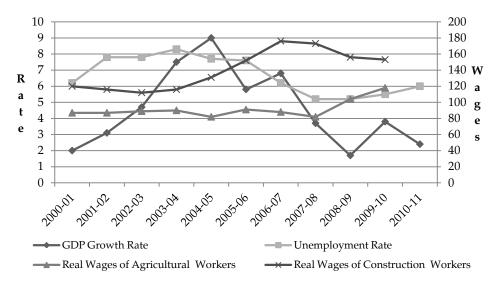
#### 3.1. Labor Market Developments

Let us start by examining what happened in the labor market. The Panel of Economists had projected a sharp increase in unemployment, and though the exact increase projected varies somewhat in different sections of the report, the broad conclusion was that it would increase from around 6 percent in 2006/07 to well over 8 percent by 2009/10, adding almost 2 million to the unemployed (see Pakistan, Planning Commission, 2008).

The more recent data based on the Pakistan government's Labour Force Surveys shows that, while unemployment did go up, the increase was far smaller than what the Panel had projected. As Figure 1 shows, unemployment increased from around 5 percent in 2007/08 to 6 percent in 2010/11, not to well over 8 percent as the Panel's projections had implied. Interestingly, unemployment continued to decline between 2006/07 and 2007/08, while the Panel (and other analysts) had expected an increase due to the slowdown in economic growth. (Indeed, other studies—including that by the World Bank—have used this decline to justify the decrease shown in the 2007/08 poverty estimates.)

This study further explores the impact of the economic slowdown on the labor market by examining the behavior of real wages during this period. According to our estimates, the real wages of agricultural workers showed a substantial increase between 2007/08 and 2009/10. These estimates are based on wage data given in the annual reports of the Agriculture Policy Institute (API). The findings are supported by preliminary studies at the Pakistan Institute of Development Economics (PIDE), which, based on Labour Force Survey data, also show an increase in real wages in agriculture during these years, though the suggested increase is smaller than that implied by the API data.<sup>7</sup>





*Sources*: Pakistan Economic Survey (2001–2011); Labour Force Survey (2001–2011); Agriculture Policy Institute (2001–2011), Support price policy for wheat: Annual report.

For urban areas, the daily real wages of construction workers show a decline of around 15 percent between 2007/08 and 2009/10 in contrast to rural agricultural workers. In the services sector, which reflects more urban than rural, PIDE's preliminary estimates (based on Labour Force Survey data) show an increase.

In examining these labor markets developments, it is important to bear in mind that unemployment rates may not fully capture the state of the labor market—in the absence of any effective or comprehensive social safety nets, most people in developing countries have to work for a living.

<sup>&</sup>lt;sup>7</sup> I am grateful to Dr M. Irfan for carrying out this exercise based on the Labor Force Survey data available at PIDE.

Therefore, in the context of developing countries, it is important to interpret unemployment as an indicator of the labor market along with other variables—such as what is happening to real wages—to better gauge the extent to which the labor market might have slackened or tightened. A similar problem arises with elasticity-of-employment estimates—being the reverse of labor productivity, they may show an increase as people move from higher-productivity to lower-productivity jobs, and fail to capture the slackening in the labor market.

#### 3.2. Recent Estimates of Poverty

It is in predicting what would happen to poverty in the face of a prolonged stagflation that—at least on the basis of the latest Pakistan Social and Living Standards Measurement Survey (PSLM/HIES) 2010/11 poverty estimates—the studies reviewed, and indeed many analysts, appear to have really got it wrong.

The Arif Commission, set up by the Planning Commission to calculate the level of poverty, use the same 2,350 caloric poverty line as for earlier years to estimate a further decline in poverty from 17.2 percent in 2007/08 to 12.4 percent in 2010/11, based on the PSLM (HIES) data for the latter year.<sup>8</sup> Its results also suggest that poverty has declined in both urban and rural areas, with the former falling to just over 7 percent and the latter at around 16 percent.

The second important set of poverty estimates to have recently emerged are from PIDE's Pakistan Panel Household Survey (PPHS) conducted in 2010. These results are not strictly comparable with the PSLM (HIES) data as the PPHS panel is slightly biased toward poorer districts in Pakistan. Moreover, the PPHS only covers rural poverty till 2004 and only the Punjab and Sindh provinces in that year. Nonetheless, the results are revealing. Based on the same poverty line of 2,350 calories, the data shows that, while rural poverty did increase in Punjab and Sindh between 2004 and 2010, it did so marginally—from around 24 to 27 percent. Rural poverty for 2010 for all provinces is estimated at 22.4 percent (Arif & Farooq, 2012).

These findings on poverty based on the two most recent surveys conducted in 2010 and 2010/11 clearly indicate that there was, at best, a slight increase in poverty; indeed, there could have even been a

<sup>&</sup>lt;sup>8</sup> See Khan (2012, May 8). These results have been frequently cited in the press and are now generally accepted as reflecting the results derived by the Arif Commission.

significant decline. These results are quite contrary to what the four studies we have analyzed had projected. The only exception to these results is the World Bank global estimates for developing countries, which had projected a continuation of the declining trend in poverty witnessed during 2005–08 to 2010. However, the World Bank's figures did not, in all probability, cover Pakistan.

### 4. Factors Impacting Poverty in Pakistan: Results of Selected Past Studies

In examining these recent results on poverty and coming up with a possible explanation for how this could have happened, let us briefly review the results of three important studies that identify explanatory variables and their coefficients in determining poverty movements in Pakistan. (For a more detailed review, see Naseem, 2012.)

Amjad and Kemal (1997) cover the period between 1963/64 and 1992/93, and identify real per capita income (-1.01), remittances per capita (-0.23), and real wages (-0.22) as significant variables. Interestingly, they do not find inflation to be significant.<sup>9</sup> Akhtar and Ahmed (1999) extend Amjad and Kemal's study, mainly by increasing the number of observations for poverty by extrapolating poverty figures for years not available. The important variables they identify are real per capita income (-1.87), remittances per capita (-0.09), increases in food prices (0.52), the human capital index (-0.80), and decline in unemployment (-0.11).

A key variable that is not incorporated by the studies analyzed in Section 2 is remittances, which, we have seen, is identified as a significant variable in explaining the poverty decline in Pakistan (Akhtar & Ahmed, 1999; Amjad & Kemal, 1997). Remittances have increased by just over USD 1 billion in 2000/01 to nearly USD 13 billion in 2011/12 (Pakistan, Ministry of Finance, 2012). A recent study by Amjad, Arif, and Irfan (2012) identifies a rise in the number of Pakistanis abroad and higher-skilled migrants as important factors for this increase (besides the tightening of laws to reduce money laundering, i.e., sending remittances through unofficial or "hawala" channels). The study also suggests that these remittances are from not just Pakistani workers abroad but from the entire Pakistani diaspora, which is estimated at around 8 million.

In the context of the impact of remittances on poverty, Amjad's (2010) study for the recent period is important because it shows that this

<sup>&</sup>lt;sup>9</sup> Figures in parentheses are elasticities.

impact depends critically on two factors. The first is whether remittances are sent through official or unofficial channels, with the former having a far greater impact on the economy and, through it, on poverty, compared to far smaller impact of unofficial flows, which represent transfer payments within Pakistan rather than actual inflows into the country. The second factor concerns the sender of the remittances, with the impact on poverty being much greater if remittances are sent by semi-skilled and unskilled workers to their families back home compared to those sent by professionals or middle- to high-income earners or by those permanently settled abroad. Siddiqui (2011) also shows that, in Pakistan's case, the share of remittances from the Middle East has had the highest negative impact on poverty while remittances from industrialized developed countries appear to have had little or no impact on poverty.

More recently, Arif and Farooq (2012) have analyzed the results of the three rounds of the PIDE/PPHS in rural areas conducted in 2001, 2004, and 2010. They also offer some very important insights into poverty dynamics in Pakistan. According to their analysis, only 9 percent of Pakistan's rural population lives in chronic poverty, while almost 50 percent move in and out of poverty, showing their extreme vulnerability to economic shocks such as a rise in food prices, illness, and natural disasters such as floods or earthquakes. Arif and Farooq also identify land ownership, number of livestock, education levels, and family size as important explanatory variables determining those who live in poverty and those who do not. Their preliminary study has not yet explored factors such as remittances (though data is available) and their impact will be discussed in later reports.

Two important conclusions emerge from this brief review. The first is that, besides economic growth and food inflation, there are other important variables—especially remittances and changes in the labor market (the unemployment rate, real wages)—that impact poverty. The second is that measuring this impact in terms of elasticity coefficients, i.e., the elasticity of poverty with respect to these variables, is sensitive to both the time periods covered as well as the methodology used.

## 5. Toward Explaining the Impact of Stagflation on Poverty and the Labor Market

In the face of both national and regional studies that strongly advocated that the slowdown in economic growth and high food inflation would lead to a very large increase in poverty (as discussed in Section 2), can there be any plausible defense of the contrary results emerging from the recent surveys put forward in Section 4?

A simple option would be to say that the data is unreliable or, worse, doctored, and put an end to the debate.

Alternatively, can one probe deeper into the dynamics of the current stagflation and explore how the macro-developments worked themselves through the economy and impacted people's lives? Were some sectors of the economy—especially those in which the poor are concentrated—shielded from the economic slowdown? Was the rural economy doing better than the urban economy? Was the informal economy still managing to grow while the formal economy bore the brunt of the economic slowdown? Did remittances protect the poor from high inflation? Were the government's social protection initiatives, e.g., the Benazir Income Support Programme (BISP), and the large increases in public expenditure on social protection able to provide an effective safety net that protected people from falling into poverty? Is Pakistan a "two-speed economy"?

These are important questions that analysts have raised in the context of the continuing stagflation and the so-called "resilience" of the Pakistan economy in the face of a host of adversities. Clearly, it is not possible to do justice to all these issues in this article. Nonetheless, even a somewhat partial and preliminary analysis can help find important clues that might well provide some justification for the recent results on poverty.

Let us first, however, put the data issue to rest.

#### 5.1. The Poverty Data

An important premise of this paper is that very little is gained by taking the view that the data is not accurate. Most data in developing countries, whether on poverty or national income, is not, being at best robust and reflecting broad changes rather than very accurately capturing them. To suggest that the data has been tampered with is also not very helpful, for again there is no reason to believe that one government is less or more honest than the other. In any case, the data results of the PSLM (HIES) 2010/11 were derived by a team headed by an independent expert on poverty. If economists were to discard data on the basis of these two explanations, they would not have any time-series data or, for that matter, any data with which to work.

This view does not preclude the possibility that the methodology used to work out a consistent poverty line could be subject to debate and, indeed, controversy, as has happened in the past. This issue is important, given the extreme sensitivity of poverty estimates to the poverty line and that a large number of households are clustered just below or above the poverty line.

#### 5.1.1. The Rural vs. Urban Economy

The agriculture sector grew at only around 2.5 percent on average over 2007–12, with wide fluctuations resulting from weather conditions and floods. This would mean that there was little growth in productivity. However, the rural economy received a strong stimulus when the new democratic government doubled the procurement price of wheat from PKR 450/40 kg to PKR 950/40 kg during the course of 2008/09. Wheat is the major crop grown during the winter months (the "rabi" season), and though fertilizer and energy prices also increased, farmers' profits received a major boost. The support price of rice was also increased to reflect rising world prices. The prices of other crops also rose. On the whole, these increases led to a major shift in the domestic terms of trade in favor of agriculture.

This, together with the healthy growth of the livestock sector, which now contributes just over 50 percent of value-added to agriculture, led to a spurt in consumer spending. This was reflected in high growth in rural demand for goods such as food and beverages and for consumer durables, including motor vehicles and motorcycles.<sup>10</sup>

Was this boom restricted to large and medium-size farmers and food merchants, while small farmers and landless labor—who account for 30 percent of the rural labor force and who are net buyers of food grains—lose out? The data on agricultural workers' real wages does not support this viewpoint as these increased substantially (see Section 4). This makes sense for, clearly, farm laborers were aware of the price hike and, even if no longer paid mostly in kind, appear to have been able to bargain for a higher wage.

<sup>&</sup>lt;sup>10</sup> To quote from the *Pakistan Economic Survey* for 2010/11 (Pakistan, Ministry of Finance, 2011, p. 36) describing economic changes during that year: "Initial spurt in large scale manufacturing was supported by enormous raise in and allowances of public sector employees, and huge transfer of resources to rural areas owing to higher prices of agriculture. Moreover, significant rise in worker's remittances as well as public/private transfers to the flood affected areas has strongly impacted on the consumer demand for consumer durables [*sic*]."

In contrast, the urban economy was, clearly, badly hit by the global recession and energy shortages. This was especially true of manufacturing, where not just large- and medium-scale industry but also the small-scale sector, which could not afford captive power, was badly affected. The services sector, however, appears to have shown signs of healthy growth, and here remittances may well have played an important part. Real wages in services, which is more urban than rural, increased during this period. A substantial increase in the wages of public sector employees—raised by 50 percent in July 2010—and increases of about half this amount in other years, would have provided protection against inflation.

The large cuts in public sector expenditures as part of the stabilization program adversely affected the construction sector. This, together with a slump in private sector housing, is reflected in the decline construction workers' wages.

#### 5.1.2. The Formal vs. Informal Economy

The State Bank of Pakistan's (2012)<sup>11</sup> view is that, while the formal sector was badly hit as a result of the global recession and power outages, the informal economy—which contributes about one third in value-added to the overall urban economy but employs nearly 70 percent of the urban labor force—remained resilient, growing apparently by its "bootstraps." This view ignores the linkages between the formal and informal economies; if the former had been badly hit, it is difficult to see the informal economy growing simply on its own. Again, remittances could counter this argument.

To sum up, it would appear that there were sectors that managed to grow despite the overall slowdown in economic growth. There were two major factors responsible for this. The first was the stimulus to the rural economy, spurred by a large increase in the prices of major food crops and steady growth in the nonfarm sector, which led to a growth in demand for selected manufactures and the growth of the services sector. The second factor was the massive increase in remittances, which doubled during these five years to over USD 13 billion in 2011/12, and raised consumption demand as little of it flowed into investment due to economic uncertainty and the deteriorating law-and-order situation. This view is supported by the fact that consumption levels increased throughout this period, while

<sup>&</sup>lt;sup>11</sup> To quote, "There is a growing sense that Pakistan's undocumented economy (the informal economy) is vibrant. In effect there seems to be a disconnect" (State Bank of Pakistan, 2012, p. 5).

investment bore the brunt of low growth, falling from nearly 20 percent of GDP to around 11 percent during 2007–12 (see Amjad et al., 2011).

#### 5.2. Movement of Key Variables Impacting Poverty, 2007–12

A more rigorous, econometric analysis attempting to explain the decline in poverty during the last five years could establish whether the factors that impact increasing poverty outweighed those that lead to a decline in poverty.

While we have not undertaken such an analysis, we examine the movement of key variables that may have been important in impacting poverty, and then draw a more tentative conclusion, i.e., what this suggests in terms of an increase or fall in poverty levels during this period.

- **Per capita income** growth was low in this period, on average, around 2.5 percent, but still slightly higher than the growth in population at 2.1 percent per annum. Its overall impact could, therefore, be taken at best as neutral.
- Food inflation increased by nearly 80 percent over these five years, and is thus rightly identified as the most important factor that would have led to a significant increase in poverty. As per the ADB's (2008) projections, this could have doubled poverty to nearer 35 or 40 percent of the population, as indeed the IPP's projections also suggest.
- **Real wages** increased for agricultural workers but declined for the construction sector; wages overall increased in the services sector. Given that poverty is higher in rural areas and that the landless are the most vulnerable overall, these movements could have led to a decline in poverty.
- **Remittances per capita** showed a continuing phenomenal increase between 2007 and 2012, doubling in volume to just over USD 13 billion in 2011/12. This massive increase would have had a strong impact on reducing poverty. The impact would have been greater during this period as Amjad et al. (in press) show that there has been (i) a significant shift in remittances toward rural areas, (ii) a large increase in the number of Pakistani workers going abroad, and (iii) an increase in remittances coming through formal rather than informal channels.
- The **human capital index**, though still low, has improved slightly in recent years, especially in relation to the youth population (15–24 years), implying that it had a marginal impact on reducing poverty.

- **Unemployment** increased by around one percentage point and would have led to a rise in poverty, but this impact may have been negated to some extent by rising real wages.
- There has been a very significant increase in both federal and provincial expenditures on measures to protect the poor through **safety nets/social protection**. At the federal level these increased from around PKR 10 billion in 2007/08 to PKR 80 billion in subsequent years. The major increase was direct income support to the female household head under the BISP, which was to cover 5 million households. Even accounting for shortfalls in coverage in earlier years and flaws in targeting the really poor and vulnerable, these expenditures would have significantly helped cushion the impact of the increase in food inflation on the poor.

If one were now to apply the elasticities of each of these variables with respect to poverty as estimated in earlier studies and other developments specific to this period, there is reason to believe that the negative factors were outweighed by the positive factors and that poverty could well have declined. In any case, this analysis clearly establishes that even if there was an increase, it was certainly not as high as earlier studies have claimed.

In drawing these still tentative conclusions, one needs to keep in mind that Pakistan is not an exception in being able to cushion the impact on poverty of the unprecedented increase in oil and commodity prices and ensuing global recession. The World Bank's global estimates of poverty cited earlier also point in the same direction, though clearly Pakistan's economy has fared much worse than most developing economies, especially compared to its South Asian neighbors.

The analysis clearly shows, however, that the methodology applied by the earlier studies was seriously flawed. To merely relate food inflation to poverty was to ignore the many other important developments taking place in the economy, which both cushion and mitigate its impact. There is an inherent dynamic in all economies where different actors, including the state, adjust in different ways to a price or other shock to the economy. Analyzing this macro-sectoral–micro-interaction provides a far better understanding of what is happening to poverty in Pakistan than just identifying one variable, however important it may be, and coming up with sensational results.

#### 6. Conclusions

The main conclusions that emerge from this study are given below.

- The overwhelming expected negative impact of low economic growth, high double-digit inflation, and crippling energy shortages on poverty and the labor market appear to have been cushioned by the large increase in remittances, rising wages in agriculture and services, and social safety nets.
- There is, however, no reason for complacency and it should be kept in mind that, even today, over 20 million people live in absolute poverty—less than PKR 1,750 per person per month or just over PKR 55 per day in 2010/11 prices—and that the economy remains in deep stagflation.
- The PSLM (HIES) 2010/11 data should be made publicly available so that it can be subject to more critical analysis.
- Perhaps this article's most important message is that studies on poverty should be based on a close integration of macro-sectoral-micro-factors to fully capture the underlying "poverty dynamics" and begin with an "open mind" rather than the pre-conceived, fixed positions that appear to mark much of the public debate on poverty in recent months.

Even if these conclusions on poverty are indeed true, it is important to point out that the Pakistan economy has been very poorly managed in recent years, and it would be a big mistake to take solace in the fact that poverty did not increase in this period.

#### References

- Agriculture Policy Institute. (2001–2011). *Support price policy for wheat: Annual report*. Islamabad, Pakistan: Author.
- Akhtar, S., & Ahmed, M. (1999). Modeling poverty trends in Pakistan: Some additional empirical evidence (Research Report No. 27). Karachi, Pakistan: Social Policy and Development Centre.
- Amjad, R. (2010). Remittances and poverty in Pakistan: A note. In L. Banerjee, A. Dasgupta, & R. Islam (Eds.), *Development, equity and poverty: Essays in honor of Azizur Rehman Khan*. New Delhi, India: Macmillan.
- Amjad, R., & Kemal, A. R. (1997). Macroeconomic policies and their impact on poverty alleviation. *Pakistan Development Review*, 36(1), 39–68.
- Amjad, R., Arif, G. M., & Irfan, M. (2012). Preliminary study: Explaining the ten-fold increase in remittances to Pakistan 2001–2012. PIDE Working Paper, 2012:86, Islamabad, Pakistan: Pakistan Institute of Development Economics.
- Amjad, R., Din, M., & Qayyum, A. (2011). Pakistan: Breaking out of stagflation into sustained growth [Special edition]. *Lahore Journal of Economics*, 16, 13–30.
- Arif, G. M., & Farooq, S. (2012). Dynamics of rural poverty in Pakistan: Evidence from three waves of the panel survey. Islamabad, Pakistan: Pakistan Institute of Development Economics.
- Asian Development Bank. (2008). *Food prices and inflation in developing Asia: Is poverty reduction coming to an end?* Manila, Philippines: Author.
- Asian Development Bank. (2011). *Global food price inflation and developing Asia*. Manila, Philippines: Author.
- Bourguignon, F., Bussolo, M., & da Silvia, L. A. P. (Eds.). (2008). The impact of macroeconomic policies on poverty and income distribution: Macromicro evaluation techniques and tools. Washington, DC: World Bank.
- Institute of Policy Studies. (2008). *State of the economy: Challenges and opportunities*. Lahore, Pakistan: Author.

- Institute of Policy Studies. (2009). *State of the economy: Emerging from the crises*. Lahore, Pakistan: Author.
- Institute of Policy Studies. (2010). *State of the economy: Pulling back from the abyss.* Lahore, Pakistan: Author.
- Institute of Policy Studies. (2011). *State of the economy: Devolution in Pakistan*. Lahore, Pakistan: Author.
- Institute of Policy Studies. (2012). *State of the economy: The Punjab story*. Lahore, Pakistan: Author.
- Khan, A. H. (2012, May 8). Poverty number revisited. The News.
- McCartney, M. (2011). *Pakistan: The political economy of growth, stagnation and the state, 1951–2009* (Routledge Studies in the Growth Economies of Asia). Abingdon, UK: Routledge.
- Naseem, S. M. (2012). A review of studies on poverty in Pakistan: Origin, evolution, thematic content and future directions (History of PIDE Series 6). Islamabad, Pakistan: Pakistan Institute of Development Economics.
- Pakistan, Federal Bureau of Statistics. (2001–2011). *Labour force survey*. Islamabad, Pakistan: Author.
- Pakistan, Ministry of Finance. (1981–2011). *Pakistan economic survey*. Islamabad, Pakistan: Author.
- Pakistan, Planning Commission. (2008). *Report of the Panel of Economists: Interim report on economic stabilization with a human face*. Islamabad, Pakistan: Author.
- Siddiqui, R. (2011). Pakistan: Migration, remittances and development. In S. Kelegama (Ed.), *Migration, remittances and development in South Asia*. New Delhi, India: SAGE Publications.
- State Bank of Pakistan. (2012). *The state of Pakistan's economy: Third quarterly report 2011–12*. Karachi: Pakistan: Author.
- World Bank. (2012). An update to the World Bank's estimates of consumption poverty in the developing word. Retrieved from http://siteresources.worldbank.org/INTPOVCALNET/Resources /Global\_Poverty\_Update\_2012\_02-29-12.pdf

## Appendix

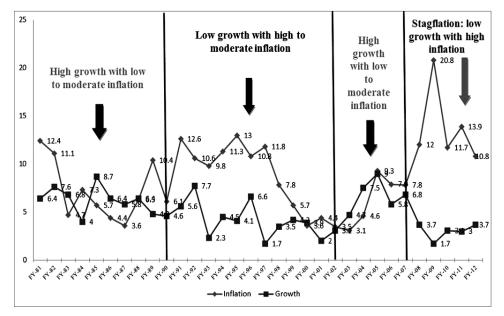


Figure A1: Pakistan's macroeconomic performance, 1980/81 to 2011/12

*Source:* Amjad, Din, and Qayyum (2011) (updated for 2011/12) and Pakistan Economic Survey.

## Pakistan's Power Crisis: How Did We Get Here?

## Kamal A. Munir\* and Salman Khalid\*\*

### Abstract

This article has a rather modest aim. In contrast to most analyses that abound, it submits that Pakistan's energy crisis stems primarily from a suboptimal policy and only secondarily from governance issues. This does not mean that governance is not an important issue. With around 20 different organizations involved in the power sector—e.g., WAPDA, PEPCO, PPIB, AEDB, GENCOs, and IPPs—there is much scope for governance failures. In addition, there is much malfeasance perpetrated by political and other interests. Still, since governance mechanisms are significantly shaped by incentive systems and operating policy regimes, we will argue that the problem lies primarily in policy choices made earlier, and focus in particular on two elements of the policy that need to be revisited.

Keywords: Power crisis, policy, governance, Pakistan.

#### **JEL classification**: G30.

#### 1. Introduction

In Pakistan, 2012 is proving to be the Year of Energy Summits. Typically, it all starts with a large mob emerging onto the streets of Lahore, Faisalabad, or another major city of the country, demanding an end to the rampant load-shedding that has been plunging entire cities into darkness for over 12 hours a day and rural areas for 18–20 hours a day, with the electricity shortfall reaching 7,000 MW in May 2011 (Malik, 2012). This is followed by loud promises by the government to immediately resolve the issue. Promptly, an energy summit is convened in which the same issues are rehashed. It produces no tangible results apart from (occasionally) a curious drop in load-shedding for a week or two due to the release of some payments to the independent power producers (IPPs). Almost invariably, however, the problem is treated as one of governance—issues of corruption in distribution companies (DISCOs), their failure to collect bill payments, the government's inability to pass on the full costs of energy production, or its failure to meet its obligations to investors who are left with no choice

<sup>&</sup>lt;sup>\*</sup> Judge Business School, University of Cambridge, United Kingdom.

<sup>\*\*</sup> Emerging markets investments professional.

but to stop producing electricity, hog the headlines. Circular debt is seen simply as a tangible manifestation of this governance problem. Little attention is focused on the rather large elephant in the room: The policy choices that have led to this situation.

#### 2. The Antecedents of the Current Crisis

To trace the roots of the problem, one has to go back almost 25 years. Until the mid-1980s, the Water and Power Development Authority (WAPDA) and Karachi Electric Supply Company (KESC), the two public sector organizations responsible for the generation, transmission, and distribution of electricity were faring quite well (Malik, 2012, p. 2). Electricity was produced primarily through hydropower projects, keeping the production cost minimal, even when one took on board the much-maligned "public sector inefficiencies." Since the cost of production and demand were low, so inevitably were the subsidies in absolute terms.

With an increase in demand in sight, it was felt that additional generation capacity was required. However, rather than adding it in the public sector, the opportunity was taken to privatize the sector, with much encouragement from the World Bank (Fraser, 2005). The move was justified on the basis that privatization would (i) lead to better, wider, more reliable service delivery; and (ii) free up government resources to spend on health and education. It was argued that cutting the subsidies would be good because they were not helping the poor anyway as they were mostly not connected to the grid (ironically, according to Malik (2012), the rural poor majority is still only receiving 0.42 percent of the tariff differential subsidy).

The first big step in this direction was the Hub Power Project (or HUBCO), a 1,292 MW, USD 1.6 billion project that was celebrated widely among global investors. Euromoney Institutional Investor first hailed the impressive Hubco deal as "Deal of the Year," and later as "Deal of the Decade" (Fraser, 2005). The generous terms offered to investors in the Hubco deal became the basis of the 1994 power policy. The policy was lauded by investors as well as by the then United States Secretary of Energy, Hazel O'Leary, who described it as "the best energy policy in the whole world" (Hill, 1999). The US Congressional Record has this to report on O'Leary's mission to Pakistan in 1994: "Energy Secretary Hazel O'Leary has just returned from a highly successful mission to Pakistan, which has opened new doors to American business leaders and may represent as well an important turning point in our diplomatic relationship with Pakistan" (Ackerman, 1994). On this "highly successful mission," the Record suggests that O'Leary was accompanied by 80

American business executives, primarily from the energy sector. O'Leary's trip resulted in the signing of 16 contracts worth nearly USD 4 billion (Ackerman, 1994), and led to the Government of Pakistan contracting another 3,400 MW of power at a time when the future shortfall was assessed to be between 1,000 and 1,500 MW (Aziz, 1994).<sup>1</sup>

#### 3. The Terms of the 1994 Power Policy

Structurally, the 1994 power policy (and later its 2002 version) was built on a cost-plus-return basis in US dollar terms. Investors were to be provided a US dollar-based internal rate of return of 15-18 percent over the 25-30-year-period of the power purchase agreement (in HUBCO's case, however, 18 percent was initially agreed)<sup>2</sup> after covering for operational costs. This was further backed by sovereign guarantees from the Government of Pakistan. In addition, the IPPs could be built using up to 80:20 debt-equity ratios, although most opted for a 75:25 ratio. The IPPs were to be paid every month in two parts, i.e., a capacity payment and an energy payment.<sup>3</sup> The capacity payment reimbursed the IPP for all the fixed costs of the power plant, including debt servicing (remember the 80:20 debt-equity ratio) and provided the investor's equity return on top. These payments were to be made *irrespective* of whether or not the IPP was asked to produce electricity. This stipulation also made sure that the off-takers, WAPDA/the Pakistan Electric Power Company (PEPCO)/KESC became contractually liable to repay the debt (and its interest payments) taken to finance up to 80 percent of the project cost whether or not electricity was produced.

The energy payment reimbursed the IPP for all variable costs of production, e.g., fuel costs, regardless of the type of fuel employed and its market price. All payments were indexed (if relevant) to the USD/PKR exchange rate and inflation (local or foreign) changes. Thus, if the fixed foreign operation and maintenance (O&M) cost of USD 1/kWh was to be paid in Year 1 and USD 1 was equivalent to PKR 60, then the IPP would be paid PKR 60/kWh for that fixed foreign O&M component in Year 1. However, if in Year 2, the rupee devalued to PKR 80 per US dollar and US inflation was 2 percent, then the IPP would be paid PKR 81.6/kWh

<sup>&</sup>lt;sup>1</sup> In two articles in *The Nation* (November 28 and 29, 1994) former finance minister, Sartaj Aziz, wondered aloud: "Why are so many agreements, MOIs, MOUs and LOS being issued at such frightening speed for power generation up to 13,000 MW, which is four times the capacity recommended by the government's own task force on energy?"

<sup>&</sup>lt;sup>2</sup> Later to be decreased to 12.06 percent in 2000 under pressure from corruption investigations and court litigation.

<sup>&</sup>lt;sup>3</sup> Fraser (2005) provides a simple description of the various terms of the policy.

(USD 1.02 multiplied by PKR 80). Furthermore, IPPs were exempted from corporate income tax, customs duties, sales tax, and other surcharges on imported equipment. Permission was also granted for power generation companies to issue corporate bonds and shares at discounted prices (Fraser, 2005).

To understand the ramifications of the above structure, let us take a stylized<sup>4</sup> example. Let us compare a hypothetical but typical 100 MW thermal (oil-fired) power plant in the public and private sectors, respectively. To keep things simple, let us assume that it will cost USD 100 million to set up a thermal IPP. Under the 1994 and 2002 power policies, 20-25 percent of the project cost has to be provided by the investor as equity while the rest is financed through the banks against the backdrop of sovereign guarantees because of which the government is contractually liable to pay the principal and interest costs through the monthly capacity payments. Since banks typically charge the IPPs 2–3 percent spread on top of government lending rates,5 a private power-producer will end up paying 15 percent in interest (in rupee terms) as opposed to the 12 percent that a state-owned producer (e.g., a WAPDA one) would have to pay. Assuming a 10-year equal repayment and no exchange rate variation, cumulative interest payments for the IPP will be approximately USD 56 million, and approximately USD 45 million in the public sector-a difference of USD 11 million.

Either way, the government will be financing both loans through its own coffers. On top of that, the government pays an equity return of 15 percent per annum for the entire 25-year life of the plant, which comes to approximately USD 4 million per annum and cumulatively USD 97 million (the net present value when discounted on an approximate 8 percent<sup>6</sup> Pakistani long-term Eurobond coupon comes to USD 40 million). So, essentially, for the sake of the 25 percent equity (USD 25 million) that the IPP investors bring in, the government ends up spending approximately

<sup>&</sup>lt;sup>4</sup> The example is stylized because the figures are hypothetical, and we have simplified it to make a theoretical point. It merely posits that, ceteris paribus, the cost of installing and operating the same plant should be lower in the public sector.

<sup>&</sup>lt;sup>5</sup> There may be occasions when some leading business groups, e.g., Engro Corporation, can borrow at the same rate as the government, if not less. However, this is generally atypical.

<sup>&</sup>lt;sup>6</sup> The 30 30-year Pakistani Eurobond issued in 2006 (maturing in 2036) had a coupon of 7.875 %. percent. The yield has been fluctuating with the world markets but given that new IPP contracts were being given out on these terms back in 2006 allows us to compare the coupon to the IPP returns

USD 83 million (97+11-25) or, in net present value terms, USD 21.42 million<sup>7</sup> more through the life of a 100 MW thermal IPP (Munir & Khalid, 2012).<sup>8</sup>

Some might argue that the above analysis does not take into account the true cost of producing power in the public sector due to the inefficiency and corruption that may be present (in other words, an economic subsidy being provided by the state). Often, the current cost of production of public sector generation companies (GENCOs) is compared to the IPPs as evidence that the former incur higher production costs (Malik, 2012). However, such comparisons are not entirely fair as the GENCOs came online in the 1960s and 1970s (Malik, 2012) and most have long outlived their plant life and are operating with obsolete technology. The IPPs under the 1994 and 2002 power policies are not more than 17 years old at most and many came online less than a decade ago (typical thermal plants have a life of around 30 years). With WAPDA a picture of neglect and with the government choosing not to invest in upgradation, it is not surprising to know that such plants have become inefficient. Similar plants in both locations would offer a fairer comparison.9 Furthermore, this comparison ignores the financing cost differential and equity returns required for IPPs versus GENCOs and focuses purely on the operational metrics of the ancient GENCOs to the much newer IPPs.

Setting up and running power plants is not "rocket science" and there is no theoretical reason why WAPDA should suddenly find itself unable to run a power plant relatively efficiently. Indeed, many of the groups running IPPs currently have no prior experience of running plants. If they can do it, WAPDA with all its experience of the sector and technologies is in a far better position to do the same. Either way, running a simple power plant in the public sector is a management or governance issue, and one that must be tackled just like other government-related governance issue.

While the public sector in Pakistan undoubtedly faces serious issues, criticism of it should be grounded in facts.<sup>10</sup> As with most instances

<sup>&</sup>lt;sup>7</sup> The cumulative result of discounting equity returns, investor equity investment, and the interest payment differential.

<sup>&</sup>lt;sup>8</sup> This difference would be approximately USD 55 million if we were to use the long-term US treasury rate of 2.5 percent instead.

<sup>&</sup>lt;sup>9</sup> A former managing director of PEPCO confided that, in his experience, HUBCO never delivered on the capacity for which it was being paid.

<sup>&</sup>lt;sup>10</sup> If the state has already decided on ideological grounds that it should not be in the business of running things, then that is a separate matter. Unfair comparisons, however, must be avoided where possible to justify such a decision.

of privatization, the energy sector, too, seems to be left holding the short end of the stick. The most difficult tasks in the power value chain are more or less all in the public sector's domain at the moment, i.e., bill collection, and transmission and distribution (T&D), while the IPPs have conveniently kept the "easy" bit, i.e., generation. Indeed, the private sector's performance in T&D has not been any better. Consider the KESC, the only privatized distribution company in the country. With 34.89 percent T&D losses in 2009/10—as compared to 9.81 percent for the Islamabad Electric Supply Company (IESCO), 13.78 percent for the Lahore Electric Supply Company (LESCO) (National Electric Power Regulatory Authority, 2010, 2011), and 27 percent for neighboring India (Malik, 2012)—the KESC has not been able to make any significant dent in T&D losses due to legacy issues for a decade under the control of two different private sector player, i.e., Al-Jomaih (KSA) and Abraaj Capital (UAE) as of 2010.

#### 4. Policy-Engendered Fuel Mix

Let us now move to an even more troubling aspect of the private power policy in Pakistan, i.e., its complete lack of concern for the source of fuel for energy generation. In the 1980s, the country's electricity generation relied on a fuel mix of approximately 60:40 in favor of hydropower versus thermal. This changed dramatically over the next decade with the fuel mix going to 30 percent hydropower and almost 70 percent thermal by the end of 2010. According to a recent World Bank report, oil now accounts for nearly 40 percent of electricity generation with gas and hydropower at 29 percent each (Trimble, Yoshida, & Sakib, 2011). This dramatic shift in generation source occurred because the 1994 power policy (and later the 2002 power policy) did not discriminate on the fuel source being employed and made the country hostage to fluctuations in international oil prices.<sup>11</sup>

The cost of this strategic policy-level folly can be understood with the following comparison. As per the National Power System Expansion Plan 2010–2030, as of 2010, WAPDA (employing hydropower production) generated electricity at PKR 1.03/kWh (1.2 cents/kWh) while public sector thermal power plants provided the same at PKR 8.5/kWh (10 cents/kwh). However, the IPPs (primarily thermal) provided the same at PKR 9.58/kWh (11.2 cents/kWh). As a result, the average blended cost of generation was PKR 6.6/kWh (7.7 cents/kWh) in 2010, which further increased to PKR 9.81/kWh (11.5 cents/kWh) for the end consumer due to line losses and theft in the T&D systems (SNC-Lavalin International Inc., 2011). It is tragic

<sup>&</sup>lt;sup>11</sup> Oil prices increased from USD 18 per barrel to USD 145 per barrel between 1994 and 2008.

that the private sector with arguably far higher costs is responsible for generating almost 52 percent of the total production (Malik, 2012).

It should be noted that the above numbers underestimate the true cost, which in a financial sense might be lower since all debt has probably been paid off since, between 1990 and 2010, tariffs in rupee terms have climbed up approximately 530 percent for the median domestic consumer. Indeed, tariffs increased by almost 50 percent further in rupee terms during 2011/12 (Khan, 2012). Most new thermal IPPs are charging in the range of 15–18 cents/kWh at current oil prices. As a result, tariffs might increase further if oil prices jump.

Even after adjusting for debt repayment, power can be generated far better using indigenous hydropower resources than what we are given to believe. The estimated cost of energy stands at 1.6 cents/kWh for Kalabagh dam with a vast majority of new hydros expected to come under 4.5 cents/kWh (SNC-Lavalin International Inc., 2011). Furthermore, the country has so far completely failed to develop its coal reserves (only 30 MW of power come from coal), which are estimated at 175 billion tonnes (the second largest in the world). Engro estimates a tariff of 10–12 cents/kWh for Thar coal-based power production based on the current policy. Incredibly, the world average for coal-based power production in the energy mix is 40 percent while it is only 0.1 percent in Pakistan.

To make matters worse, many of the thermal IPPs set up under both the 1994 and 2002 power policy are of inefficient design<sup>12</sup> since these policies provided a cost-plus-equity return of 15 percent irrespective of the efficiency of the technology/fuel source being used in the power plant. Reportedly, China closed down all its oil-based power plants under 200 MW for precisely this reason a few years ago. Many of these IPPs would normally be used for load-balancing (matching sudden jumps in demand, etc.) in other countries and would fall low in the merit order for power plants used, but are instead employed to satisfy standard base demand in Pakistan.

#### 5. Conclusion

It is not our intention to prescribe a particular course of action. Instead, we merely wish to alert policymakers to some elements of the existing policy framework that seems to have been counter-productive.

<sup>&</sup>lt;sup>12</sup> These IPPs are under 200 MW in size and sometimes employ single-cycle rather than the more efficient combined-cycle technology, hence using more fuel to generate the same amount of electricity.

Specifically, it is the perverse incentives regarding the energy mix and guaranteed equity returns that are most problematic.

The right incentives with respect to an optimal energy mix are crucial. The ideal scenario is to shift to hydropower and indigenous coal resources, and continue to develop other renewable sources such as wind and solar power. In the short term, shifting to imported coal or gas might be one solution. However, changing the energy mix provides only a partial answer. The arrangement under which private or public providers of energy come online is equally important.

The private sector delivers through competition. Businesses compete with each other and in this process value gets passed on to the consumer. The existing power policy clearly does not foster such an environment. Instead, it encourages inefficiency in the system since private power has been given no incentive to utilize more efficient technology, optimize fuel, or scale choices.

For the private sector to lead the charge in this domain, the state has to be very strong—able and willing to protect the public interest—and this is certainly not the case right now. To begin with, it might consider moving away from the current policy and contracting all future IPPs (regardless of source) in the form of a hybrid merchant market: They will not be provided any guaranteed return-apart from ensuring that debt repayments can be made-with profitability depending squarely on their cost of production. This implies that the power off-taker (the National Transmission and Despatch Company) must only despatch them in order of merit based on their cost of production (and, hence, investors' equity returns will be inversely proportional to their cost of production). This will force the new IPPs coming online to look at issues of fuel mix/scale/technology upfront. However, for the merchant market to work properly, there has to be sufficient, low-cost generation capacity in place in the public sector so that the merchant plants do not end up charging their pound of flesh, which would defeat the whole purpose.

To conclude, even if getting prices "right" seems to be the only sensible solution to many economists, such a decision ignores the imperative to set the policy right in the first place. Moreover, it is fraught with danger. Increasing tariffs beyond what they are right now—a major proportion of a poor person's monthly wages—and imposing tougher collection methods will only produce more social unrest.<sup>13</sup> Addressing the real cause of high costs is a wiser policy. Already, industrial output is down by up to 37 percent (Siddiqui, Jalil, Nasir, Malik, & Khalid, 2011) and Pakistan's poor are being continuously burdened by increasing tariffs and taxed via inflation with each new bailout for the circular debt as the government happily prints money when problems become untenable. The problem is by no means insurmountable. All it requires is putting the public interest first, something the past few regimes have singularly failed to do.

<sup>&</sup>lt;sup>13</sup> According to Trimble et al. (2011), nearly 90 percent of Pakistan's consumers benefit from a subsidy. However, a majority of these are "lifeline" consumers with absolutely minimal usage for mere survival. The government has imposed a further burden on these consumers by imposing a minimum charge.

#### References

- Ackerman, Sen. [NY]. (1994, October 6). New opportunities abroad for American businesses. In *Congressional Record* 140, No. 144, E203.
- Aziz, S. (1994, November 28). The perils of high cost imported energy I, *The Nation*.
- Fraser, J. (2005). Lessons from the independent private power experience in Pakistan (Energy and Mining Sector Board Discussion Paper No. 14). Washington, DC: World Bank Group.
- Hill, C. (1999, November 1). Power failure. Institutional Investor.
- Khan, M. (2012, July 3). Last fiscal year saw 11pc inflation. *Dawn*.
- Malik, A. (2012). *Power crisis in Pakistan: A crisis in governance?* (PIDE Monograph Series). Islamabad, Pakistan: Pakistan Institute of Development Economics.
- Munir, K., & Khalid, S. (2012, June 23). Pakistan's power politics. *Economic* and Political Weekly, 47(25), 24–27.
- National Electric Power Regulatory Authority. (2010). *State of industry report*. Islamabad, Pakistan: Author.
- National Electric Power Regulatory Authority. (2011). *State of industry report*. Islamabad, Pakistan: Author.
- Siddiqui, R., Jalil, H. H., Nasir, M., Malik, W. S., & Khalid, M. (2011). The cost of unserved energy: Evidence from selected industrial cities of Pakistan (Working Paper No. 2011:75). Islamabad, Pakistan: Pakistan Institute of Development Economics.
- SNC-Lavalin International Inc. (2011). *National power system expansion plan* 2011–2030 (Report prepared for National Transmission and Despatch Company). Pakistan: Author.
- Trimble, C., Yoshida, N., & Sakib, M. (2011). Rethinking electricity tariffs and subsidies in Pakistan (Report No. 62971-PK). Washington, DC: World Bank.

# Industrialization by Fitting in: Acquiring Technology through Collaboration and Subcontracting

## Sikander Rahim\*

## Abstract

Since the 1950s, Pakistan has been trying to industrialize by investing in industries that have low value-added, notably cotton textiles. Here, low valueadded means that the export value of the cotton textiles less the value of the raw cotton used to make them was low relative to the cost of the investment needed to make the textiles, i.e., contrary to the usual assumption, cotton textile manufacture was capital-intensive. The cause was the protection of the importing countries. But goods with high value-added in this sense required advanced technical knowledge, which is mostly the proprietary knowledge of the firms whose research and development (R&D) has generated it. Over time, all the production of goods that do not require such technical knowledge has passed to low-wage countries whose mutual competition keeps the value-added low. Since Pakistan cannot compete in high-value-added goods, it must emulate the East Asian economies by collaborating with firms in high-wage countries—i.e., subcontracting them to make simple components—and progress through such collaboration to receiving the knowledge and training to making components with higher value-added.

Keywords: Pakistan, textiles, protection, value-added, subcontracting.

## JEL classification: O14.

## 1. Pakistan's Industrial Start

Few would dispute that income growth in the long run has to be obtained through industrial development. At the same time, most would agree that there has been a fair amount of industrial development in Pakistan and that it has given rise to disappointingly little increase of income. A third point, one that most people would take as obvious, is that industry in Pakistan has, with few exceptions, been confined to activities that have low value-added and, hence, yield little income. This paper is an attempt to explain these assertions more fully, to describe Pakistan's industrialization in the past in this light, and to discuss alternative patterns of industrial development.

<sup>&</sup>lt;sup>\*</sup> Former Principal Economist, World Bank.

At Partition in 1947, there was almost no industrial manufacture in Pakistan. Both East and West Pakistan were agricultural economies that exported some agricultural products to other areas. East Pakistan was the world's main grower of jute and, since the jute mills to which the crop used to go were in India, jute became an export—for many years Pakistan's main export. West Pakistan had become a provider of wheat to India in the 19<sup>th</sup> century, but now exported little other than raw cotton.

Until the end of the Korean War (1950–53), there had been little effort to industrialize. It could not be expected in the early years. Besides, the war caused a commodity boom that allowed some prosperity and seemed to reduce the urgency for action in this respect. But the end of the war led to a fall in the prices of the commodities that Pakistan had been exporting, and the ensuing shortage of foreign exchange was so severe that it seemed that there was no alternative to industrializing quickly. Export receipts fell to a fraction of what they had been and imports had to be reduced accordingly. To the political leaders and government officials, it was obvious that industry had to begin with the raw materials at hand; instead of exporting raw cotton and jute, Pakistan should produce cotton textiles and jute bags.

With cotton this was simple. Virtually all cotton textiles were imported or hand woven. By banning textile imports in 1954, any new textile mills were assured a market with high prices. At first, the scarcity of cotton textiles was so great that new mills recovered their costs in one or two years. The government tried to temper the scarcity pricing with price controls, it seems, with some success, but it also wanted the investment to be so profitable that it would generate a new industrial entrepreneurship. As to be expected, the demand to invest in cotton manufacturing was well in excess of what could be met; since all the plant and machinery had to be imported, the investment was constrained by the shortage of foreign exchange.

Jute could not provide a similarly profitable market for long unlike cotton goods, jute goods were not a necessity of daily life, and there was small scope for substituting domestically made jute bags for imported bags. Moreover, a scarcity of jute bags and high prices would have affected farmers and other producers. Jute manufacture did not, therefore, have the same attractiveness as cotton in the first stages.

In theory, the substitution of domestically made cotton textiles for imports saved foreign exchange equal to the value-added from transforming the cotton that would otherwise have been exported. This should have relieved the scarcity of foreign exchange and allowed the investment to continue. In practice, it did not. By 1957, the foreign exchange scarcity had become extreme and the country was close to defaulting on its external payments, despite the severity of the foreign exchange rationing.

There were two reasons for this. One, which is no longer relevant but was tragic at the time, was the destruction of the handloom sector. Modern power looms did not just replace imports; they put the handloom weavers, who had been providing a large part of the domestic supply of cotton cloth, out of work. These weavers' looms were made entirely in the country of local raw materials and had no discernible foreign exchange cost. Since foreign exchange was, at the time, the binding constraint to increases in textile production—to the extent that power loom production displaced handloom production rather than imports—there was no saving of foreign exchange or gain of production and income.

It would be plausible to argue that the handloom weavers were displaced because they could not compete with the power looms on price. But this seems not to have been true. The mere fact that they had plied their trade in large numbers until then, despite the liberal import of textiles and the lower rupee prices before 1954, is evidence that they could compete. There were official enquiries into the situation of the handloom sector and analyses of its costs<sup>1</sup> that indicate that handloom weaving was competitive on price. Moreover, there had been some technical progress in the design of handlooms, since they had been so important and widespread in the Subcontinent, and, apart from the traditional handlooms, more advanced designs with greater output were available. One difficulty the weavers faced at the time, according to some of the reports, was obtaining yarn. Handloom spinning, though still common in the Subcontinent, could not meet demand, and machine-spun yarn was kept for the power looms. Another difficulty of the weavers was obtaining dyes, which were mainly imported. Within a few years the handlooms had virtually disappeared, at least around the towns, and weavers had to find work in the modern mills.

The second reason that the foreign exchange shortages persisted was that cotton manufacture yielded little more foreign exchange than raw cotton. The value-added in terms of foreign exchange—meaning the amount by which the foreign exchange value of the manufacture exceeded that of the raw cotton and other traded inputs needed for it, such as dyes, bleach, and fuel—was low in relation to the foreign exchange cost of the investment, i.e., the plant and machinery that had to be imported.

<sup>&</sup>lt;sup>1</sup> Several documents of this kind were in the library of the Pakistan Institute of Development Economics (PIDE) in 1968.

Comparing this value-added to the foreign exchange cost of the investment gives the equivalent of a capital–output ratio. A high capital–output ratio means the activity is capital-intensive. As a rule, the capital–output ratio of an industry suited to a country like Pakistan, with little capital and much unemployed labor, was considered to be around 2 or 3. Estimates for various years from 1954 to 1959/60 of the capital–output ratio as defined here vary from 7 to 14, depending on the year and the relative prices of cotton and cloth that year. That this was purely the result of protection can be seen from comparison with calculation using British prices for the same types of cloth, which gives a ratio of 2.5.

The reasons for the low value-added were obvious: When Pakistan exported textiles, the countries to which the exports went had their own textile industries to protect and used tariffs and quotas to protect them. This was not just true of Pakistan or of cotton textiles, but held for practically all manufactures and agricultural products that the low-wage countries exported to the high-wage countries of Western Europe and North America. In the case of cotton, the importing countries put tariffs on the manufactures but not on the raw cotton. They lowered the price the exporter received below that of the competing domestic producer by the amount of the tariff, without lowering the price of the raw cotton. In all the importing countries, competition among textile manufacturers was not lacking, nor did there seem to have been oligopolies or cartels, so the prices the exporters received were not inflated by lack of competition. Nonetheless the cotton textile lobbies in the importing countries were obviously effective in obtaining protection.

This protection of their cotton manufacture by high-wage countries contravened the General Agreement on Tariffs and Trade (GATT), which allowed only temporary protection against market disruption. It began in the mid-1950s and was formalized in the Short-Term Cotton Textile Arrangement. This was followed in 1960 by the Long-Term Arrangement, and then in 1965 by the Multi-Fibre Agreement (MFA), which extended the protection to fibers other than cotton. Only in 2005 did the MFA come to an end, although countries have been allowed to continue some of their protection.

#### 2. Mistaken Comparative Advantage

This raises three questions. First, why did economists and planners, at least in Pakistan, not take account of the protection against the country's main export? Second, what have the consequences for the economy been and, third, what does it imply for future economic development?

The answer to the first question is, simply, dogma. Pakistan was a poor country with little capital and much unemployment, textiles were supposed to be a labor-intensive industry, and theory dictated that the country's comparative advantage lay in labor-intensive activities. Moreover, the raw material was produced in the country and the technical level was elementary compared to most manufacturing in high-wage countries. Had economic advisors actually calculated the ratio of the valueadded that Pakistan received against the foreign exchange cost of the investment, they would have discovered that textile manufacture was an exceptionally capital-intensive industry.

There was no incentive for the planners and their advisors to examine the economic productivity of cotton manufacturing more closely, because the industry was profitable enough that the demand to invest in it during the 1960s was constrained only by the scarcity of foreign exchange. But the profitability was artificial. Profit was subsidized through the Export Bonus Scheme (EBS), started in 1959, best known as the bonus voucher system. Under this system, an exporter of cotton manufactures received vouchers that entitled the bearer to buy foreign exchange at the official rate, which was then PRs 4.76 to the US dollar. The vouchers could be sold on the market and the price was, in effect, a premium over the official exchange rate. They were issued for a variety of manufactured exports in proportion to the foreign exchange received, the proportion varying according to the type of export in the range of 10–40 percent, the "bonus rate." Most of the time, the premium varied between 150 and 180 percent. So, a cotton exporter getting a bonus rate of 30 percent when the premium was 150 percent received an additional 45 percent of the rupee value of the export. This was entirely profit because the raw cotton and other traded inputs were exported or imported at the official exchange rate, and was a subsidy paid by those who used bonus vouchers for imports.

Originally, the EBS, which was similar to the exchange certificate scheme used in Taiwan a few years before, had been recommended as an emergency measure; the mistake was to make it permanent. Pakistan's economy was in trouble by 1957 because of the shortage of foreign exchange and the EBS was proposed by a German advisor to stimulate exports quickly, although he emphasized that it was a short-term expedient and had to be temporary. But the temptation of inflating profits so easily was too great. Moreover, the EBS solved the problem of how to make jute manufacturing equally profitable. Something could, therefore, be done for East Pakistan. The scheme thus became permanent and was only ended in 1972, with the new official exchange rate of PRs 9.91 to the US dollar.

87

#### Sikander Rahim

If the industrial policy had been as successful as it appeared to be, Pakistan would gradually have overcome its shortage of foreign exchange and would not have been permanently in need of foreign aid. An indication of how little was achieved in terms of generating income in relation to the investment involved is that in no year before 1970 was the dollar value of exports as much as in 1950/51. The economy continued to depend on foreign aid and its external debt service increased; by 1968, the last year of Ayub Khan's government, it was 18 percent of exports.

In some respects, Pakistan was typical of the low-wage countries in following the advice it received, that it should adhere to its comparative advantages and invest in labor-intensive industries to export to the highwage countries despite the elaborate system of tariffs and quotas the latter imposed on the former's exports. Many development economists and government officials deplored the protectionism of the high-wage countries, but the explanation that influential economists of the time, such as Bela Balassa and Anne Krueger, put forward for the difficulties of the low-wage countries was their own protectionism. They asserted that these countries' production was inefficient because their industries were protected too much against international competition, a conclusion they reached by comparing the countries' value-added at "world prices" with the value-added at domestic prices, the ratio of the latter to the former being the "effective protection rate" (EPR). Calculating EPRs for different industrial activities in a variety of countries became a common exercise among economists and they were nearly always found to be greater than 1, which was interpreted as a sign of inefficiency and "rent seeking", because, in their theory, efficient producers would be competitive at world prices and have EPRs not greater than 1.

The procedure for calculating EPRs had two defects that made them misleading. One was the way the so-called "world prices" were found. Limiting this discussion to the case of most interest to the economy at the time, its jute and cotton manufactures, they were the export unit values (i.e., the value of the exports in a given period as given by the export statistics divided by the quantity of those exports). This took no account of the effect the protection of the importing countries had in lowering the prices the exporters received below those received by competing producers in high-wage countries. There seem to have been no studies of effective protection that used the prices of the high-wage country producers for world prices. Unless the domestic prices in the exporting country were to be below the export unit values, the EPRs were sure to be greater than 1 and, while the EBS lasted, the domestic prices of textiles were naturally higher by the amount of the subsidy. The second defect was the assumption that, when the value-added in a manufacturing activity at domestic prices was higher than that at world prices, it was a sign of inefficiency. No attempts were made to corroborate the conclusion by collecting the physical data from factories. Such data as is available indicates no such inefficiency.<sup>2</sup> Effective protection is not a criterion for the physical or economic efficiency of production. Physical efficiency has to be determined from factory data and economic efficiency has to be measured as the value-added in relation to the investment needed to produce it. Pakistan's cotton and jute factories were physically efficient enough to compete with the factories of the high-wage countries despite trade barriers, but they were economically inefficient because of the trade barriers.

#### 3. Some Economic Consequences of Protection by High-Wage Countries

Since the protectionism of the high-wage countries occurred at the beginning of most low-wage countries' attempts at economic development, it determined much of what happened to these economies later. Some of the consequences are described briefly here.

The first is that almost all textile production has been transferred to the low-wage countries, but the transfer was gradual. The exceptions are some high-quality goods requiring special skills and articles dependent on fashion design specific to the producers. Because the transfer was so gradual, with the various "Arrangements" spread over roughly half a century, the bankruptcies and unemployment that free trade would have caused in the high-wage countries were mostly avoided. The textile industries could disappear slowly and their employees could find other work or retire.

This has had a second consequence, namely, to make textile production a low-value-added activity. It was pointed out above that it always was a low-value-added activity whilst Pakistan exported textiles, but it had a higher value-added in the high-wage countries. Textile producers in the latter had to pay workers nominal wages that were many times the nominal wage in Pakistan, which is why they needed trade protection. The difference in value-added or income between that from producing in Pakistan and that from producing in the high-wage countries was the tariff revenue collected by the importing countries or the extra profit made by importers by lowering prices caused by import quotas (Gresser, 2002).<sup>3</sup> Now it is, with the exceptions mentioned, purely a lowvalue-added activity in which producers in a number of low-wage countries, including Bangladesh, China, Egypt, and India compete.

<sup>2</sup> See Zaidi (1999, pp. 94–95) who quotes Asad Sayeed's calculations of total factor productivity growth.
 <sup>3</sup> What he finds for the US is also true for Western Europe.

Another consequence, following from the earlier profitability of investment in Pakistan, was the neglect of education, especially in science and engineering. Apart from the industries that were highly profitable because of the EBS, some manufacturing was set up to cater to the domestic market with high levels of protection and also required some basic engineering knowledge. Making light bulbs, water pumps, and electric fans involved no technical knowledge that was not readily available, and the capital equipment was imported. Easy profits from simple manufacturing processes of this sort concealed the need to be able to move on to more complex industrial activities. So, when the apparently rapid industrial growth of Ayub Khan's period came to an end, all the industry in the country consisted of this type of simple manufacture and the education system continued to be neglected. This is not to say that the neglect was merely economic, but the social and political complexities behind it are beyond the scope of this article. It suffices to stress two points. One is that these complexities might have had a different result if industrialization had been less easily profitable and, thus, had made the need for a better education system felt. The other is that the desire for education was there-almost all families wanted their children to have an education—but few could afford it and the state did too little.

Finally, the outcome has been failure to diversify out of simple manufacturing; the range of industrial products has not changed much from that of 1968. There has been an improvement of quality in some activities, for instance, surgical instruments (see Chaudhry, 2005; Nadvi 1999), and there has been growth in the production of machinery for textiles and diesel engines, but all these remain by the standards of the present, simple manufactures and, considering the time it has taken, these are modest results.

The example of textiles shows why it is so difficult for low-wage countries to find goods to manufacture that have a high value-added when imported or exported. If low-wage country producers can produce a good that is produced in high-wage countries, they can obtain the same valueadded as high-wage country producers if trade is free, with bigger profit margins making up for lower wage costs. Since low-wage country producers can always lower their prices slightly below those of their highwage country competitors and still have bigger profit margins, they eventually drive these competitors out of business. At that point, with no more high-wage competitors to displace, the competition is among lowwage producers and profit margins fall. Then the good becomes a lowvalue-added good. In the case of textiles and many other articles that lowwage countries manufactured from the 1950s to the 1990s, the process was slowed by the protectionism of the high-wage countries, and low-wage country producers never received the high value-added they would have received with free trade.

Now the problem of the low-wage country producers is to find other goods that they can start producing and for which they can obtain a high value-added. Here, a high value-added implies that the value-added in foreign exchange received from exporting or that saved by substituting for imports is high in relation to the cost of the investment. Such goods have the special characteristic that the technical knowledge required to make them is equally available to all producers. This was the case for most textiles, garments, leather articles, tennis and squash rackets, surgical instruments, and other items that were made in low-wage countries without the need for technical collaboration with high-wage country firms. But the range of such goods is limited and there seem to be none left, the production of which has not been transferred entirely to low-wage countries.

What this implies is that the technical knowledge needed to make tradable goods that are now produced in high-wage countries is not available to low-wage country producers. A specific period of economic history, in which low-wage countries could compete with high-wage countries in the manufacture of tradable goods because the requisite knowledge was available to all, is now over. Such goods are no longer made in high-wage countries, but are confined to low-wage countries and have a low value-added. High-wage countries' tradable manufactures are now all complex goods that require the specific technical knowledge of the high-wage country firms that make them. In other words, they are the results of the R&D of the high-wage country firms, and the technical knowledge generated by that R&D is proprietary, i.e., it is unavailable to others without the owning firms' agreement because it is protected by patents or is secret. Low-wage country firms can try to manufacture motor cars, television sets, printers, and dentists' drills, but, without access to the up-to-date, proprietary knowledge of the high-wage country firms, they can only make models that might have been competitive 10 or 20 years earlier, but are now technically backward. If these goods can be sold, it is at relatively low prices, i.e., they have a low value-added.

#### 4. Patterns of Industrialization

#### 4.1. India and Autarky

In theory, there are two ways of industrializing, apart from continuing along the present lines. One is through protection and some degree of autarky; the other is the way taken by several East Asian economies, i.e., collaboration with advanced economies' firms. For Pakistan, the latter is the only realistic course.

In practice, anything more than a minimal degree of autarky is ruled out by the international agreements to which Pakistan is bound and by the dependence on foreign aid. But it helps to understand how India became a fast growing industrial economy after decades of a high degree of autarky, whilst Pakistan, which has mostly tried to follow what were supposed to be its comparative advantages, has failed to create any comparable industrial structure.

From the start, India became protectionist with the aim of creating its own capital goods industries. Foreign trade and foreign investment were kept to what was needed to supply goods that could not realistically be produced in the country. State enterprises were considered necessary for the production of capital goods and requirements such as steel. The government's initial slogan was that the state should have the "commanding heights" of the economy, partly because it was unlikely at that stage that private firms would, of their own accord, start investing in the production of investment goods; they were more likely to confine themselves to consumer goods for which the market already existed. The government saw that industrialization requires scientists and engineers and it, therefore, put emphasis on the appropriate higher education, including institutions that are now comparable to the best universities in high-wage countries.

Such a system involved much administrative control over firms' decisions—including over foreign exchange, imports and exports, investment, bank credit, prices and so on—which certainly caused much inefficiency and corruption. Apart from that, keeping the country's industry technically behind the comparable industries of high-wage countries had an economic cost. India's planners had intended that the country's research institutions and firms should develop their own technical knowledge without sufficiently appreciating that they were unlikely to keep up with the R&D of high-wage country firms, which had to compete among themselves in this respect. So, their lorries could have been well made, but their design was out of date (Wolf, 1982, p. 66).

This pattern of industrialization could have gone on indefinitely, with India always a few years behind the high-wage countries as regards technology, provided the rest of the world allowed the protectionism to continue and provided the country had enough primary products, tourism, and simple manufactures to export to avoid foreign exchange constraints becoming too severe. It had the drawback that the backward state of its technology would have prevented it from exporting manufactures with a high value-added.

In time, dissatisfaction with the course of the economy, especially its slow growth, the reasons for which are beyond the scope of this article, resulted in gradual abandonment of the semi-autarky, though protection is still there. But India has not yet acquired the export capability of China or Korea. It is not evident that its leaders wish to or know how to. But its investment in higher education has had the unexpected result of an information technology service export using digital communication and independent of physical transport. Added to that, there are the variety of services provided by Indian firms, such as processing medical insurance claims and keeping the books for large organizations in other countries.

Both the government and private firms are conscious of their need to acquire proprietary knowledge from high-wage country firms. One step was the suspension of international patent laws in the country, which seems to have given the pharmaceutical industry the chance to develop its generic business. Some of the bigger firms have also been taking over highwage country firms, which gives them access to the proprietary knowledge of those firms. With the higher education system it has developed, the economy has the scientists and engineers needed to absorb such proprietary knowledge as it can obtain. For a long time, development economists and multilateral institutions criticized the country for its socialism and protectionism and for wasting money on too much university-level education. Now that the economy has been growing rapidly, talk of comparative advantages and reducing emphasis on universities is no longer heard.

#### 4.2. East Asia and Collaboration

East Asia's economies differ in many respects, but their successes have this in common, that their industries were mainly built up through collaboration with the firms of high-wage countries. The simplest form of such collaboration has been that of subcontracting in which a high-wage country firm that produces a complex good gives some technically simple components of that good to be made by a low-wage country firm. The wage cost is lowered and, if the high-wage country firm has full employment, this allows that country's firm to shift workers from making simple components that require little technical knowledge to making components that require more technical knowledge. To the extent that the firm has been constrained by the availability of workers, the constraint is relaxed.

#### Sikander Rahim

This does not require direct investment by the high-wage country firm. In some cases, it has been associated with foreign direct investment (FDI). This was the case for Indonesia, Malaysia, and Thailand in the 1980s, where firms from Europe, Japan, and the US invested in facilities for producing components or carrying out parts of their production processes. The two earliest such investments appear to have occurred in 1961 in Hong Kong, one being American and the other European (Wade, 1990, p. 94). Such investment spread to the other countries mentioned in the 1970s and 1980s. This success in attracting foreign investment was much praised, especially by institutions such as the World Bank and Asian Development Bank. In *The East Asian Miracle* published by the World Bank in 1993, the success of the East Asian economies is held up as an example of correct policies, without an understanding of the economic mechanisms involved.

South Korea's industrialization differed from these countries' in some respects. Its early attempts to attract foreign investment into export processing zones had had little success when the government decided to mend relations with Japan in 1965 with the Japan-Korea Normalization Agreement. Japan's economic planners and political leaders understood the way economic relations between the two countries could develop along the lines described above. They intended that Korea should allow Japan to concentrate increasingly on the technically most advanced production by taking over more and more technically simpler production. In the early stages, this included allowing most textiles manufacturing for the Japanese market to go to Korea. Instead of setting up trade barriers, they helped the process with technical support and financing. Castley (1997) recounts that Japan helped Korea become a producer of capital synthetic fibers while moving "into differentiated synthetic fibers, against which, in terms of quality and costs, Koreans were unable to compete" (p. 246-248). But the main form of industrialization through collaboration was by subcontracting the manufacture of specific components of Japanese goods.

In some of the subcontracting, the Korean firm made something that required no special technical knowledge that the firm did not already have, but much of the subcontracting depended on closer collaboration. The Japanese partner firm provided technical knowledge and training specific to the production arrangement between the two firms. A common complaint of Korean firms was that the technical knowledge and training they received did not go beyond what was needed for that production (see Cyhn, 2002, for examples). For a high-wage country firm providing proprietary knowledge and related training to a firm for subcontracting, there is the risk that the knowledge may be passed on to competitors or that the subcontracting partner eventually becomes able to use that knowledge to compete. One way to reduce the risk is to have a joint venture and, perhaps, to license the knowledge needed to the joint venture. This involves direct investment by the high-wage country firm, which thus finances the specialized capital equipment, and gives the firm a position in the management from where it can supervise the use of its proprietary knowledge. It also gives the low-wage country firm a long-term interest in the collaboration. Japanese firms entered into many such arrangements with Korean firms. Castley gives the number of direct investments by Japanese firms in Korea in the period 1962–79 as 617. The US came second with 97 (Castley, 1997, p. 154). This is not exactly the same as joint ventures, but, given the restrictions on foreign investments, which were not allowed to compete with domestic firms or to be for the domestic consumer goods market, it must have been close (Cyhn, 2002, pp. 88–90).

Such production allowed Korean firms to advance in their technical knowledge. It evolved from more or less simple production by the Korean partner to increasingly complex goods requiring the more advanced proprietary knowledge of the Japanese partner. It was partly a process of growing trust and partly because the collaboration could broaden to include more items. In this form of collaboration, the Japanese firm always kept the most advanced proprietary knowledge to itself, so that the production in Japan became more and more concentrated on the most advanced and technically complex components or processes.

Sometimes the collaboration evolved to "original equipment manufacture" (OEM), which means that the Korean firm produced the final good for another firm that sold it under its own brand name. A simple form of OEM in Pakistan has been the production of garments and towels, etc., for high-wage country firms, which then sell the articles under their brand names. In Korea, the OEM was mostly electronic goods and machinery. Even though the product of an OEM firm is good enough to be sold as the product of a firm with an established brand name, the OEM firm may not want to establish its own brand for two reasons. One is that doing so is costly and uncertain. It can be more uncertain if it antagonizes the partner firm and that creates problems with suppliers, distributors, and banks. The second is that the OEM firm is unlikely to have had the R&D capacity to design the good and is, therefore, unlikely to be able to carry out the R&D to improve it and bring out new models. In that case, the venture to establish a brand name will be a one-shot affair.

Korean firms followed two other patterns of industrialization. One, which was temporary, was to use the technical knowledge the firms had access to independently of foreign partners to produce versions of goods that were technically backward compared to those produced by high-wage country firms and to sell them cheaply. This is like the Indian production of technically backward goods using the technical knowledge available in India, except that it was for export. Korean firms sold low-quality stereo sets in some Asian markets and microwave ovens that did not last in the US at correspondingly low prices. This was a minor aspect of the economy's exports, though such cheap, low-quality versions of goods may have been a more important part of the supply to the domestic market, which was protected against import competition and domestic production by foreigners.

More important for the future, and also harder to distinguish from the acquisition of technical knowledge through collaboration, was the success of some of the conglomerates, the *chaebols*, in building up their own capacity for R&D and becoming as technically advanced as the firms of Japan and Western countries. In developing integrated circuit chips, in building ships, and in designing motor-cars, Korean firms have been well established for some time. But all these firms had long collaborated with Japanese firms and still do. Much of their R&D may have been done separately from foreign firms with the intention of making the Korean firm independent, but, without detailed knowledge it is not possible to know when it was the one and when the other. The difficulty is illustrated by the litigation over patent infringements between Korean and American firms, although such disputes between Korean and Japanese firms seem not to arise or are settled with less trouble.

China is another economy whose government deliberately tried to obtain for it the most advanced technical knowledge and has been successful, though it cannot be discussed at length here. Like India, when it began to open to international trade it started with a wide range of industry that was technically backward compared to that of high-wage countries, and an education system that trained large numbers of scientists and engineers. But, more than India, the government used the low wage level and the abundance of technically trained workers to attract subcontracting. It attracted FDI to its export processing zones, to joint ventures for subcontracting, and to supply the domestic market. The biggest lure for foreign firms, in view of the population size and the speed at which income grew and industry was spreading, was the domestic market.

With these advantages came that of being able to use them to induce foreign firms to transmit proprietary knowledge to Chinese firms or to government institutions. The Chinese authorities showed that they were

adept at this. Import restrictions allowed them to make access to the domestic market conditional on some arrangement with Chinese partners and, with that, the necessity of transferring proprietary knowledge. China's success as an exporter has partly been the result of the attraction of its subcontracting business, which has grown rapidly from simple firms with a few qualified staff or, perhaps, state enterprises in need of modernization, to some of the largest manufacturers of their types of products in the world. From the start it was clear that the government intended to acquire for the economy the most advanced technical knowledge it could in all the manufacturing activities that it wished to promote. The same was true of the Chinese firms that were to acquire the knowledge. The determination with which they went about this is indicated by the prominence in the news of accusations of violations of intellectual property rights and repeated criticism of the ways in which foreign firms wishing to invest in the country or set up joint ventures with Chinese firms have been required to yield proprietary knowledge.

#### 5. A Pattern of Industrialization for Pakistan

The three examples of India, Korea, and China illustrate what can and cannot be done to industrialize beyond producing low-value-added goods. To begin with what cannot be done, there have been changes in international agreements and their enforcement. The "rules of the game" have changed. On paper, they prohibit the various devices that countries have used to give advantages to their own industries or to create incentives that are not the ordinary ones of the free market, although tariffs are still allowed as far as agreed. Pakistan has lost the power to use tariffs to encourage FDI in the country's industry or to provide a high level of protection to domestic industry by agreeing to relatively low tariffs, mostly 5–20 percent. The exception is motor vehicles and parts, although it is unlikely that that can develop into an industry that will export or be competitive with imports in the foreseeable future.

Various other methods that have been used by the East Asian economies and even by Western economies at various stages of their past, are also now prohibited. Export subsidies by the state have been widely used for manufactures and are now banned. These include state subsidies of firms, of bank financing to lower interest rates and research subsidies. How hard it can become to identify such subsidies is shown by the disputes between aircraft makers of the US and Europe. Another device that can be counted as a subsidy is the multiple exchange rate system, which, in any case, the International Monetary Fund (IMF) prohibits. That, Sikander Rahim

too, can be hard to spot, even by the country, and the IMF has a book of rules as to what constitutes multiple exchange rates. Large conglomerate firms can cross-subsidize, using the profits from one activity to subsidize an export at a loss, perhaps with the connivance of the state, which extends concessional financing apparently unrelated to the export or grants contracts. Against this are the anti-dumping rules, which can be quickly invoked and often are, not always justifiably. Performance targets, by which the state gave rewards or penalties to firms according to whether they reached agreed export targets or not, were extensively used in Korea and are also prohibited.

All these methods and others were used frequently and with success, but are no longer available to Pakistan. The rules and their application have been made stricter over the last two decades, and a country that has little bargaining power is forced to observe them. Those who have bargaining power can bend them and often do so through bilateral trade agreements that are outside the official framework of the World Trade Organization (WTO).<sup>4</sup> In practice, observing the rules, obtaining redress when others violate them, circumventing them where possible, and navigating the many bilateral and multilateral agreements require expertise. Countries that take their international trade seriously have large departments in their ministries with hundreds, even thousands of experts, and bring teams of lawyers to the WTO and other organizations to fight their cases. In this respect, Pakistan has surprisingly little.

What Pakistan can do is limited. The principle behind the WTO's rules is that private firms should compete on equal terms. It takes no account of differences in the ability to compete caused by differences in the access to up-to-date technical knowledge, which cannot be offset by lower wages; when lower wages allow competition, the rules allow deviation from the principle. Practically any manufacture that Pakistan can produce that competes with something produced in high-wage countries risks discrimination through tariffs, bilateral agreements, and accusations of dumping. Where there are rival low-wage country exporters, Pakistan is among the least favored, despite its long record of having tried to abide by the advice of its foreign advisors that it should follow its comparative advantages. When the European Union recently proposed granting Pakistan trade concessions for two years on textiles and some ethanol products, it had to overcome objections by Bangladesh and India, among others. These concessions seem to be related to the floods of 2010 and the

<sup>&</sup>lt;sup>4</sup> Haque (2009) gives an overview of how Pakistan is affected by such trading arrangements.

hope is that they will help improve relations ("Brussels to boost Pakistan," 2012). Approval is expected soon.

Subcontracting manufactured components for foreign firms has the advantage that it is difficult to discriminate against the products in the way that textiles and ethanol have been discriminated against because they are parts of other products. In the long run, its advantage is that stable subcontracting relations can expand to the production of more complex articles for which the Pakistani subcontractors get more value-added and to joint ventures with investment by the foreign partners. The foregoing discussion, especially the description of Korea's industrialization, gives a brief account of how varied subcontracting can be and how far it can be taken by diligence and reliability.

There should be no expectations of FDI at first. The FDI that has come into the country has mostly gone toward taking over banks and other existing firms, some retail, and setting up telecommunication services—the easy pickings—rather than to setting up new manufacturing capacity. It is also not certain how much is genuinely foreign and how much Pakistani capital returned to take advantage of favorable terms. Ventures into subcontracting will have to start virtually from scratch, which is to say they will have to decide what they can produce and for which foreign firms they can produce it, and then obtain the contracts. From that, they must establish a partnership that lasts.

One prerequisite is that the firm should have enough technically qualified people. Subcontracting demands that the product meet specifications and that changes of specification and design be made quickly to meet the needs of the foreign partner. Speed, punctuality, and quality control have to be ensured, and workers' technical qualifications have to be adequate to this. If, in producing the subcontracted article, the firm can suggest improvements or additional articles that it is able to produce, the collaboration is likely to improve over the long run.

Pakistan's disadvantage is the effect that long neglect has had on the education system. At present, the government—both at the center and in the provinces—lacks the revenue to improve higher education as much as needed. In part, this is the consequence of trade liberalization since import duties were one of the main revenue sources, and replacing the loss is practically and politically difficult. Both the numbers of people being trained in the natural sciences and engineering at university level and the quality of their training are lacking compared to other countries. Families who can, send their children abroad for their education, but, of those who study the natural sciences and engineering, many remain abroad. In addition, it is now accepted practice that the US and Europe recruit people in the country with the right qualifications, which saves them the education costs. Industrialization at present does not require large numbers of people with higher degrees, so the shortfall may not be so great as to prevent subcontractors with good prospects from obtaining the qualified people they need. It may also be possible to attract back some Pakistanis working abroad. At the beginning of its industrialization, about 80 percent of Korea's students abroad stayed abroad. But when industrialization got going, many returned with improved qualifications, experience and, possibly, technical information that their new employers would not have obtained easily otherwise. There is a possibility of a virtuous cycle.

Some other requirements for subcontracting to become a major industrial activity need only be mentioned quickly. One is that there should be suitable infrastructure, reliable power supplies, good transportation, fast telecommunications, and security, etc. These are most easily assured in industrial zones near ports and airports, but it has to be expected that much subcontracting will, at the start, come from existing producers who may be anywhere. The question of whether any special legislation is needed ought to be studied, but there should be an office for resolving disputes impartially and quickly with the purpose of helping maintain stable relations. To the extent that it resolves disputes without the parties having recourse to courts or international dispute resolution instances, it will help improve confidence in the country. Complementing this would be an institution representing subcontractors and, at the same time, giving them the means to advertise abroad and to safeguard their reputation by dealing with members for actions that hurt their standing.

The question that arises is how to induce firms to look for subcontracting opportunities when practically all exports get all the advantages that can be offered, and manufacturers in the country have done little in this respect so far. Pakistan does not have a Japan as did Korea; it does not have the numbers of well educated scientists and engineers or offer a vast market as do China and India; and it cannot provide the comforts and climate by which Indonesia, Malaysia, Thailand and others attract foreigners. This means that establishing a subcontracting industry of any size will be a gradual process. Subcontracting will grow slowly for a long time before it becomes a major source of income. If it succeeds, there is the prospect of moving into the production of goods with more valueadded at some time in the future. There seem to be no obvious alternatives.

#### References

- Balassa, B. A., & Associates. (1971). The structure of protection in developing countries. Baltimore, MD: Johns Hopkins Press/International Bank for Reconstruction and Development and Inter-American Bank.
- Brussels to boost Pakistan with trade concessions. (2012, January 31). *Financial Times*, p. 6.
- Castley, R. (1997). *Korea's economic miracle: The crucial role of Japan.* Basingstoke, UK: Macmillan.
- Chaudhry, T. T. (2005). Industrial clusters in developing countries: A survey of the literature. *Lahore Journal of Economics*, *10*(2), 15-34.
- Cyhn, J. W. (2002). Technology transfer and international production: The development of the electronics industry in Korea. Cheltenham, UK: Edward Elgar.
- Government of Pakistan. (1957). *Report of the fact finding committee on handlooms*. Karachi, Pakistan: Author.
- Gresser, E. (2002). *America's hidden tax on the poor: The case for reforming US tariff policy* (Policy report). Washington, DC: Progressive Policy Institute.
- Haque, I. (2009, September). *The rise of bilateralism in trade and its implications for Pakistan*. Paper presented at the Lahore School of Economics' Fifth Annual Conference on the Management of the Pakistan Economy, Lahore, Pakistan.
- Krueger, A. O. (1972). Evaluating restrictionist trade regimes: Theory and measurement. *Journal of Political Economy*, *80*(1), 48–62.
- Nadvi, K. (1999). Collective efficiency and collective failure: The response of the Sialkot surgical instrument clusters to global quality pressures. *World Development*, 27(9), 1605–1626.
- Wade, R. (1990). Governing the market: Economic theory and the role of government in East Asian industrialization. Princeton, NJ: Princeton University Press.

- Wolf, M. (1982). *India's exports*. Washington, DC: World Bank/Oxford University Press.
- World Bank. (1993). *The East Asian miracle: Economic growth and public policy*. Washington, DC: Oxford University Press.
- Zaidi, S. A. (1999). *Issues in Pakistan's economy*. Karachi, Pakistan: Oxford University Press.

# Export Barriers in Pakistan: Results of a Firm-Level Survey

# Rashid Amjad<sup>\*</sup>, Ejaz Ghani<sup>\*\*</sup>, Musleh ud Din<sup>\*\*\*</sup> and Tariq Mahmood<sup>\*\*\*\*</sup>

# Abstract

This study attempts to evaluate exporters' perceptions of the problems they face in exploiting their full competitive potential in the international market. Using firm-level survey data, we find that a shortage of skilled labor, the energy crisis, institutional rigidities, market imperfections, and weaknesses in physical infrastructure are the key impediments to achieving export competitiveness. Policies geared toward improving the quality of skilled labor, resolving the energy crisis, and reducing transaction costs by improving the institutional and physical infrastructure are key to expanding Pakistan's exports on a sustained basis.

**Keywords:** Pakistan, export competitiveness, exporting procedures, certifications

# JEL classification: F13.

# 1. Introduction

At a time when many developing countries are rapidly expanding their exports, Pakistan continues to struggle to accelerate the export of manufactured goods. It is generally believed that the country's exports are not competitive in international markets and that Pakistan is, therefore, unable to expand its market share. In particular, firms often complain of the lack of an investment-conducive climate, which impedes business expansion and exports. Against this backdrop, the objective of this study is to carry out a systematic investigation of firms' perceptions of the barriers to exports in various productive sectors of the economy, as well as to suggest possible remedies. This analysis is based on a survey of exporters based in Lahore, complemented by a study of the determinants of export performance at the macro-level.

<sup>\*</sup> Vice-Chancellor, Pakistan Institute of Development Economics, Islamabad.

<sup>\*\*</sup> Chief of Research, Pakistan Institute of Development Economics, Islamabad.

<sup>\*\*\*</sup> Joint Director, Pakistan Institute of Development Economics, Islamabad.

<sup>\*\*\*\*</sup> Senior Research Economist, Pakistan Institute of Development Economics, Islamabad.

The study's conceptual framework is built around the notion of competitiveness, defined as "the set of institutions, policies, and factors that determine the level of productivity of a country" (World Economic Forum, 2009). Thus defined, competitiveness becomes a function of the domestic institutional and policy environment as well as of circumstances prevailing in the global market. In the last three decades, the environment for exporters has changed drastically on both these fronts. In most of the world, the reforms undertaken during the 1980s and later have curtailed government interventions in markets and reduced many forms of trade barriers. This has created a general atmosphere favorable to business activities, competitiveness, and growth.

A substantial body of empirical work has identified factors in domestic and foreign markets that promote or hinder export activities at the micro- and macro-level (see, for example, Aaby & Slater, 1989; Belloca & Di Maiob, 2011; Madsen, 1987; Zou & Stan, 1998). Studies on Pakistan have analyzed export performance at the macro- as well as micro-level. Akbar and Naqvi (2001) analyze the determinants of export performance at the country level; Masakure, Henson, and Cranfield (2009), and Din, Ghani, and Mahmood (2009) take up these issues at the firm level.

There is also a body of empirical literature that emphasizes introspection on the part of firms regarding internal and external problems as an element in assessing the hindrances that exporters face. These studies add firms' perceptions as an important ingredient to their models. Admittedly, perceptions can deeply be influenced by firms' own capabilities and internal circumstances. However, since entrepreneurs are keenly aware of the environment in which they operate, one can safely assume that there is a positive correlation between actual problems and those perceived by the firm as problems. Viewed this way, firms' perceptions can greatly facilitate our understanding of the actual problems they face.

Some researchers analyze the difference between the perceptions of exporting and nonexporting firms as a tool to empirically investigate the constraints to export. For a sample of small exporting and nonexporting US firms, Yaprak (1985) finds that exporters and nonexporters have different perceptions about export barriers. Ahmed, Julian, and Majar (2005), however, find no significant differences in the perceptions of Malaysian exporters and nonexporters concerning different export barriers. Other studies focus on the managerial perceptions of exporting firms alone. For example, Axinn (1988) analyzes how managerial perceptions influence the export performance of machine tool manufacturers in the US and Canada. Specifically, she considers exporters' perceptions of the benefits of exporting rather than selling in the domestic market. She finds that perceptions of the complexities associated with exporting and managers' work experience in foreign countries are related to the percentage of exports relative to firms' total sales.

Khorana, Verousis, and Perdikis (2010) focus on small and medium firms in India. Their study evaluates exporters' perceptions of the problems they face in the EU market. The study covers the leather, footwear, and textile and clothing sectors, and broadly categorizes export problems as either external-foreign or internal-foreign. The first includes customs valuation and clearances, administrative and documentary formalities, foreign regulations and standards, etc. The second problem originates mainly from firms' organizational structure. The study's results show that the problems of exporting firms are largely external-foreign.

Siringoringo, Prihandoko, Tintri, and Kowanda (2009) identify and analyze the problems faced by Indonesian exporters in small and medium enterprises (SMEs). They use data collected through a questionnaire designed to assess the problems perceived by SME owners/managers. These include bureaucracy, product quality, export procedures, lack of promotion, and competition. Respondents were asked to rank their problems from 1 to 5 on a Likert scale. The findings suggest that export barriers are due mainly to inadequate training/information as well as impediments from government authorities and agencies. The authors recommend equipping SMEs' management with training and information to overcome these obstacles.

Our study is in line with the empirical work described above. The main objective is to evaluate exporters' perceptions of the problems they face in exploiting their full competitive potential in export markets. In addition, the study suggests policies that might be required to ensure that Pakistan's exporters are able to take full advantage of the increased market access brought about by the new trading environment. We hope that the recommendations that follow from this analysis help enhance the export competitiveness of Pakistan's manufacturers.

The rest of the study is organized as follows. Section 2 sets out the conceptual framework that helps identify the core issues, and spells out the salient features of the questionnaire used in the survey. Section 3 discusses the main findings of the survey, while Section 4 concludes the discussion.

105

#### 2. Conceptual Framework

Export competitiveness is a complex issue. The factors that affect export competitiveness vary over time, and across sectors and geography. To keep the analysis manageable, we identify some common features that generally help improve the business environment by reducing risks, costs, and time, thus motivating entrepreneurs to invest more in terms of money and effort. The major constraints to creating a good business environment are categorized under:

- Lack of trained labor
- Financial inputs
- Energy
- Physical infrastructure
- Bureaucratic hurdles
- Institutional rigidities

This broadly classifies the obstacles that manufacturers/exporters face in most instances, but these obstacles do not affect all sectors uniformly. As pointed out in Section 1, we adopt an indirect approach to assess how these factors can impact business performance. We have relied on respondents' judgments regarding the intensity of the obstacle, having asked them to rank each issue according to their perception of its severity. We then use the rankings to provide a general assessment of the incidence by sector of these obstacles.

#### 2.1. The Survey and Questionnaire

The study is based on a survey prepared jointly by the Lahore Chamber of Commerce and Industry and the Pakistan Institute of Development Economics. A purposive sampling approach was used to cover 40 firms/companies in the following sectors: textiles, garments, food processing, cement, chemicals, hosiery/bed linen, automobiles, and construction materials. The questionnaire comprised the major components described below (see Appendix 3 for the detailed questionnaire).

## 2.1.1. Firm-Specific Characteristics

This section covers firm-specific characteristics such as major activity, location, and quantitative information on the firm's human resources. Such information provides insights into how firm-specific characteristics can influence the firm's perception of different issues. Information on the number of workers employed makes it possible to classify the firm by size.

# 2.1.2. Activities and Problems Currently Faced in Exporting

Although the World Bank's world trade index emphasizes procedural requirements for exporting goods, it was not possible to prepare a similar index. Instead, firms were asked to indicate their perception of the activities and problems they currently faced in exporting. These activities included pre-shipment activities, inland carriage and handling, customs clearance and release, and international carriage and handling.

# 2.1.3. System of Certification

Many international standards have been developed to ensure quality and a guarantee that goods are produced under satisfactory social and environmental conditions. In our survey, firms were asked to indicate their awareness of these standards. They were also asked whether they were certified to these standards or if such a system was currently being developed or planned. The survey included the following standards (see Appendix 1):

- International Organization for Standardization (ISO) 9000
- ISO 14000
- Hazard Analysis and Critical Control Point (HACCP)
- Social Accountability Standard (SA) 8000
- Occupational Health and Safety Standards (OHSAS)
- EurepGAP
- Traceability

# 2.1.4. WTO-Related Agreements and Negotiations

Most of the World Trade Organization (WTO)'s agreements came into force in early 1995. However, there are wide differences in how different exporting companies reacted toward these agreements. Some companies were quick to respond and promptly engaged in active negotiations, either directly or through umbrella organizations, to draw the full benefits of the WTO arrangements. Many other companies, however, lagged behind in such activities and, consequently, encountered serious obstacles in meeting the criteria set out in these agreements.

The study's questionnaire asked firms to state their position with respect to the following agreements (see Appendix 2):

- Agreement on Technical Barriers to Trade
- Agreement on Sanitary and Phyto-Sanitary Measures
- Agreement on Pre-Shipment Inspection
- Agreement on Intellectual Property Rights

# 2.1.5. Shipping and Logistics

108

Shipping and logistics includes a wide range of areas, such as customs performance, physical infrastructure, inland transport, and efficiency in cargo handling. Their smooth functioning helps provide goods and services on time and at a lower cost. Firms' perceptions of these issues can identify important bottlenecks. The survey also sought firms' suggestions for improving the trade logistics environment.

# 2.1.6. Major Sociopolitical Hindrances

Sociopolitical hindrances pertain to general obstacles that adversely affect the working environment. The survey identified the following constraints and asked for firms' perceptions of them:

- Corruption
- Injustice
- Bribery
- Political interference
- Terrorism
- Lack of infrastructure
- Market imperfections

Most responses to various issues and obstacles are ranked on a Likert scale of 1 to 6, depending on the nature of the problem. This enables us to cluster responses at specific ranks, as shown in Table 1.

		Rank			
Country	2000	2005	2009		
Pakistan	66	67	63		
Singapore	1	3	1		
China	31	6	5		
India	51	42	42		
Bangladesh	76	75	69		
Iran	98	82	83		
Nepal	97	91	94		
Indonesia	38	40	43		
Malaysia	13	20	27		
Thailand	26	27	25		

Table 1: Countries ranked by competitive industrial performance index

Source: UNIDO, Industrial development report for 2009.

Various measures taken to create a business friendly environment have also had an impact. Within the South Asian Association for Regional Cooperation (SAARC) region, Pakistan ranks higher than India, Bangladesh, Nepal, and Bhutan in terms of ease of doing business (Table 2).

Country	2007	2011
Singapore	1	1
Maldives	53	79
Pakistan	74	105
Bangladesh	88	122
Sri Lanka	89	89
Nepal	100	107
India	134	132
Bhutan	138	142
Afghanistan	162	160

Table 2: Economies ranked by ease of doing business

Source: World Bank, Doing business in South Asia for 2007 and 2011.

#### 3. Key Findings of the Survey

## Firms' General Characteristics

Based on the number of workers, 38 percent of the firms surveyed were large-scale enterprises employing 300 workers or more. Twenty-four percent were medium firms employing 101 to 300 workers. The proportion of small firms with up to 100 workers was 38 percent.

Seventy-five percent of the firms surveyed were involved in manufacturing, and 20 percent in trading. Only 2 percent were multinational companies, while 2 percent were involved in other activities.

Textile firms comprised the highest percentage (21 percent) of total firms surveyed, followed by food industries (15 percent), garments (13 percent), and cement (10 percent). Firms engaged in chemicals, hosiery/bed linen, general imports, automobiles, and construction materials each accounted for 5 percent; 15 percent were engaged in other activities.

General importers and cement firms employed the highest percentage of skilled labor, while chemical and textile firms employed the lowest percentage.

## Reasons for Shortage of Skilled Labor

Lack of institutional training was the most frequently reported reason for the shortage of skilled labor (35 percent of firms), followed by the low quality of education (30 percent).

#### Reduction in Cost if Labor Becomes Productive

If high levels of labor productivity are achieved, it can reduce a firm's costs. However, firms have different perceptions of the extent of this cost reduction. The highest percentage (35.5 percent) said that costs would fall by 1–10 percent, 29.1 percent said they would fall by 11–20 percent; and 12.9 percent said that costs would remain unaffected.

#### **Duration of Finance**

The majority of firms (60 percent) appeared to use short-term financing, implying that most of them use it for working capital needs.

Firms using medium-term and long-term finance accounted for 4 and 36 percent, respectively.

#### Importance of Location

A firm's location has an important bearing on its capacity to produce and export. The cheap availability of inputs, good infrastructure, high demand for output, and availability of skilled labor are important factors when deciding where to locate a firm. The survey's figures showed that high demand for output (34 percent) and availability of skilled labor (27 percent) were the most frequently cited reasons for choosing a particular location. Cheap availability of inputs (21 percent), when added to availability of skilled labor, indicates that inputs played a more important role in deciding a firm's location.

## Fuel (Electricity and Gas) as a Percentage of Total Cost

Fuel as a percentage of total cost was highest for cement-producing firms (35 percent), and lowest for garments and automobiles (2.17 and 2.6 percent, respectively).

#### Problems Related to Electric Supply

Frequent load-shedding and power failures seriously affect industrial performance in Pakistan. Some firms have tried to solve this problem by using electricity generators and UPS. The survey showed that about 23 percent of firms used a UPS and 38 percent used generators to meet their electricity requirements.

#### Activities and Problems Related to Exporting

#### **Pre-Shipment Activities**

The percentage distribution of the level of satisfaction with procedures and sub-activities shows that it is lowest (100 percent are not satisfied) for the procedure labeled "Prepare freight forwarding instructions and other documents required for the transfer of cargo to port of departure." About 62.5 percent of firms were satisfied with the procedure labeled "Secure letter of credit."

# Inland Carriage and Handling

Firms satisfied with the procedures labeled "Load cargo on local carriage" and "Arrange a deposit for terminal handling charges" accounted for the highest percentage—57.1 and 63.6 percent, respectively. The highest percentage of firms not satisfied (33.3 percent) occurred in the case of the procedure, "Deliver cargo to port of departure."

## Customs Clearance

In customs clearance activities, the percentage of satisfied firms is highest for "Inspection for technical standard" (62.5 percent). The highest percentage of firms not satisfied is 23.1 percent for "Physical inspection of good to determine if it complies with technical or sanitary or phytosanitary standards."

# Customs Release

Two important activities arise in customs release:

- Discharge of cargo from terminal to export
- Arrangement of payment for terminal handling charges

Here, the level of satisfaction was found to be quite high—only 6.7 and 7.7 percent of firms, respectively, reported being unsatisfied with these procedures. This indicates that the reforms introduced in the last few years to streamline customs procedures are paying off.

# International Carriage and Handling

Firms were asked to report their perceived degree of satisfaction with the following procedures:

- Examination of documents to prove that regulatory procedures have been met
- Cargo loading at port of departure
- Transport of goods to final destination
- Arrangement of payment for international freight charges

The highest percentage of satisfied firms was reported for the procedure labeled "Transport goods to final destination" (58.3 percent).

The percentage of "not satisfied" firms was highest in the case of the procedure, "Load cargo at departure port."

## System of Certification

The Pakistan government has increased support for various quality, environmental, and social certifications when a manufacturing unit obtains four of the specified standards (see Pakistan, Ministry of Commerce, 2009, p. 45). However, exporters' low levels of awareness of these systems make such measures practically ineffective. The percentage of firms who were aware of these systems of certification was highest in the case of the ISO 9000 and ISO 14000, which is not as high as it should be. Only 40.5 percent of firms were completely aware of the ISO 9000 and 25 percent of the ISO 14000. Fifty-five percent—the highest proportion—were unaware of the EurepGAP.

#### *Certification to Standards/ Preparation for certification*

Another issue that has affected exporters in Pakistan involves the WTO-prescribed standards and norms relating to quality certification, and adherence to health, labor, and environment standards. These have posed a significant challenge to firms in developing countries such as Pakistan. The survey's results showed that the highest percentage of firms is certified to the ISO 9000 (66.7 percent). EurepGAP and traceability are the standards least complied with (7.7 and 5.1 percent, respectively).

## Agreements and Negotiations

Questions about firms' awareness of different trade agreements and negotiations showed that 57.6 percent of firms were aware of the Agreement on Technical Barriers to Trade. There was minimal awareness of the Agreement on Sanitary and Phyto-Sanitary Measures.

#### Effect of Agreements on Business

How do firms perceive the effect of trade agreements and negotiations on their business? To assess this, firms were asked to rank their perception from "don't know" to "very positive." The responses show that most firms (57.6 percent) regarded the Agreement on Pre-Shipment Inspection as being very negative. About one third were not clear about most of the agreements and negotiations. Only a small percentage (about 10 percent) had any positive perception of these agreements.

## Perception of Ongoing Dialogues

Firms were asked about dialogues/consultations between their business, or sector representatives/umbrella organizations and ministries in charge of negotiating the rules-based multilateral trading system at the WTO level. The responses show that about 40–45 percent of firms perceived these dialogues as "average." In the case of sanitary and phytosanitary arrangements, 27.2 percent were not even aware that such a dialogue was taking place.

#### Use of Transportation Mode for Shipment

The major mode of transport recorded was roads, except for general importers, whose use of railways accounted for about 57.5 percent. Chemical firms accounted for the maximum use of roads (100 percent), while the auto industry was the biggest user of air transport (52.5 percent).

## Perception of Efficiency of Institutions

Most firms (about 54 percent) believed that banks and chambers of commerce were "efficient," while 37.5 and 28.6 percent reported provincial authorities and the Trade Development Authority of Pakistan, respectively, as being "not efficient."

#### Effect of Hindrances on Firms' Cost

Terrorism and lack of infrastructure were ranked as "highly significant" by 27.3 and 25 percent of the firms surveyed. Corruption was ranked as "slightly significant" by 40 percent, and political interference was ranked as "not significant" by 42.4 percent.

#### Reasons for Failure of Business

About 69.2 and 64.1 percent of firms, respectively, perceived poor planning and weak government policy as the major factors responsible for business failure.

#### *Quality of Trade Logistics*

About 40 to 58 percent of firms regarded the quality of trade logistics as a support for business with respect to saving costs, reducing inventory, improving efficiency, and increasing consumer satisfaction.

115

#### Major Constraints to Improving Trade Logistics Environment

The survey sought firms' opinions on the following constraints to improving the trade logistics environment:

- Many agencies involved
- Many documents required
- Slow processing of customs clearance
- Poor land, road, or rail infrastructure
- Poor transportation service

About 38.2 percent of firms reported "poor land, road, or rail infrastructure" as a "major obstacle" to improving the trade logistics environment.

#### Perception of Policy Recommendations

The ranking of the proposed solutions shows that there is much optimism about the effectiveness of various policy options. Almost half the firms perceived these options as being very important.

#### Reductions in Cost if Proposed Solutions are Implemented

More than 40 percent of firms anticipated an 11–20 percent fall in cost if the solutions listed above were to be implemented.

## Regional Distribution as Destination of Exports

The distribution of exports by region shows that more than 50 percent of average exports go to South Asia. The major destinations of exports with respect to the number of firms surveyed were the EU and East Asia (27.1 and 25.4 percent, respectively).

#### 4. Summary and Conclusions

This study has attempted to analyze firms' perceptions of the various obstacles that hinder export performance in Pakistan. Using the survey data, we have found that firms' responses cluster around specific responses. This indicates the importance of those specific issues, implying that they merit the immediate attention of the government and industrial groups. The shortage of skilled labor is more severe in textiles, chemicals, and hosiery/bed linen. Firms regard inadequate institutional training and the low quality of education as the most important reasons for the lack of labor skills. Most firms believe that, if skilled labor were to become available, they would be able to reduce their costs and thus enhance their competitiveness. In terms of location decisions, the availability of various inputs plays a more decisive role than the presence of an output market.

Most firms did not report availing long-term credit. Whether this is due to demand-side or supply-side problems is an issue that requires further research. It also indicates that firms seek financing primarily for their working capital needs. If this was streamlined, it could lower firms' transaction costs. Fuel costs also put a heavy burden on firms and can adversely affect their competitiveness. The availability of cheap fuel, especially electricity, is essential to boost exports.

Quality certification and adherence to health, labor, and environment standards is still a problem for exporters. There is an urgent need to increase awareness of these standards, and to simplify procedures to avail the facilities provided in this regard. While Pakistan has set up the necessary institutional arrangements for certification, implementation remains limited mainly because exporters are not aware of these standards in the first place. Raising their level of awareness can result in significant gains in certification and quality improvements.

Features commonly perceived by firms as hurdles to export competitiveness include institutional rigidities, market imperfections, weaknesses in physical infrastructure, and the lack of a general business environment. It is therefore essential that such constraints are removed so that an environment conducive to business is created for exporters of manufactured goods. It goes without saying that energy shortages are a binding constraint to manufactured exports and that there is an urgent need to resolve energy-related issues.

#### References

- Aaby, N. E., & Slater, S. F. (1989). Management influences on export performance: A review of the empirical literature 1978–1988. *International Marketing Review*, 6(4), 7–26.
- Ahmed, Z. U., Julian, C. C., & Majar, A. J. (2005, June). Malaysian exporters and non-exporters' perceptions of the various barriers to export. Paper presented at the 10<sup>th</sup> Annual Meeting of the Asia-Pacific Decision Sciences Institute, Taipei, Taiwan. Retrieved from http://iceb.nccu.edu.tw/proceedings/APDSI/2005/SessionIndex/Ma rketing%20Theory/Marketing%20Theory-03.pdf
- Akbar, M., & Naqvi, Z. F. (2001). External market conditions, competitiveness, diversification, and Pakistan's export performance. *Pakistan Development Review*, 40(4), 871–884.
- Asian Development Bank. (2004). *Industrial competitiveness: The challenge for Pakistan*. Manila, Philippines: Author.
- Axinn, C. N. (1988). Export performance: Do managerial perceptions make a difference? *International Marketing Review*, 5(2), 61–71.
- Belloca, M., & Di Maiob, M. (2011). Survey of the literature on successful strategies and practices for export promotion by developing countries (Working Paper No. 11/0248). London, UK: International Growth Centre.
- Din, M., Ghani, E., & Mahmood, T. (2009). Determinants of export performance of Pakistan: Evidence from firm-level data. *Pakistan Development Review*, 48(3), 237–240.
- Granger, C. W. J, & Newbold, P. (1974). Spurious regressions in econometrics. *Journal of Econometrics*, 2(2), 111–120.
- Hoekman, B., & Djankov, S. (1997). Determinants of the export structure of countries in Central and Eastern Europe. World Bank Economic Review, 11(3), 471–487.
- Khorana, S., Verousis, T., & Perdikis, N. (2010, September). *Perceptions of export* problems in EU–India trade: Evidence from small and medium firms. Paper presented at the 12th Annual Conference of the European Trade Study Group, Lausanne, Switzerland. Retrieved from http://www.etsg.org/ETSG2010/ETSG2010Programme.html
- Kumar, N. (1998). Multinational enterprises, regional economic integration, and export-platform production in the host countries: An empirical

analysis for the US and Japanese corporations. *Weltwirtschaftliches-Archiv Review of World Economics*, 134(3), 450–483.

- Madsen, T. K. (1987). Empirical export performance studies: A review of conceptualizations and findings. In S. T. Cavusgil (Ed.), Advances in international marketing (pp. 177–198, vol. 2). Greenwich, CT: JAI Press.
- Masakure, O., Henson, S., & Cranfield, J. (2009). Standards and export performance in developing countries: Evidence from Pakistan. *Journal of International Trade and Economic Development*, 18(3), 395–419.
- Ohlin, B. (1968). On model construction in international trade theory. In W. Eltis, M. F. Scott, & J. N. Wolfe (Eds.), *Induction, growth and trade: Essays in honor of Roy Harrod* (pp. 325–341). Oxford, UK: Clarendon Press.
- Pakistan, Ministry of Commerce. (2009). *Strategic trade policy framework* 2009–12. Islamabad, Pakistan: Author.
- Pfaffermayr, M. (1996). Foreign outward direct investment and exports in Austrian manufacturing: Substitutes or complements? *Weltwirtschaftliches-Archiv*, 132(3), 501–522.
- Siringoringo, H., Prihandoko, Tintri, D., & Kowanda, A. (2009). Problems faced by small and medium business in exporting products. *Delhi Business Review*, 10(2), 49–56.
- United Nations Industrial Development Organization. (2005). *Industrial performance and capabilities of Cameroon: Analysis of the industrial sector*. Vienna, Austria: Author.
- United Nations Industrial Development Organization. (2009). *Industrial development report 2009*. Vienna, Austria: Author.
- World Bank. (2007). Doing business in South Asia 2007. Washington, DC: Author.
- World Economic Forum. (2009). *The global competitiveness report* 2009–2010. Geneva, Switzerland: Author.
- Yaprak, A. (1985). Empirical study of the differences between small exporting and non-exporting US firms. *International Marketing Review*, 2(3), 72–83.
- Zou, S., & Stan, S. (1998). The determinants of export performance: A review of the empirical literature between 1987 and 1997. *International Marketing Review*, 15(5), 333–356.

# Appendix 1

## **Commonly Used Standards**

#### International Organization for Standardization (ISO)

The ISO is an international nongovernment body that was established in 1947. It has 158 member countries and is headquartered in Geneva, Switzerland. The ISO promulgates worldwide industrial and commercial standards, among which the ISO 9000 and ISO 14000 are the most well known. The ISO 9000 family addresses quality management, while the ISO 14000 family addresses environmental management.

#### EurepGAP

EurepGAP was created in the late 1990s by several European supermarket chains and their major suppliers as a common standard for farm management practice. GAP is an acronym for good agricultural practices. Its objective was to bring conformity to different retailers' supplier standards, and it has now become the world's most widely implemented farm certification standard. Most European customers now require EurepGAP certification as a prerequisite for doing business in agricultural products.

#### Hazard Analysis and Critical Control Point (HACCP)

HACCP was conceived in the 1960s when the US National Aeronautics and Space Administration (NASA) felt the need to design and manufacture foods for space flights. Later, it was used as a systematic preventive approach to food safety and pharmaceutical safety. HACCP is now used in the food industry to identify potential food safety hazards. HACCP principles are also included in the ISO 22000.

#### Social Accountability Standard (SA 8000)

The SA 8000 is a standard for decent working conditions, developed and overseen by Social Accountability International. It covers issues such as child labor, forced labor, freedom of association, discrimination, and worker health and safety.

## **Occupational Health and Safety Standards (OHSAS)**

The OHSAS system was developed in January 2000 for organizations to meet their health and safety obligations in an efficient manner. It is the most widely recognized standard on occupational health and safety management. The system enables organizations to identify problems and take appropriate measures to reduce occupational hazards.

## Traceability

120

Traceability refers to the completeness of information about every step in a process through all stages of production, processing, and distribution. Traceability enables firms to verify the history, location, or application of an item by means of documented information. A host of benefits is associated with this standard, e.g., it makes recalls possible in the case of automobiles, it helps ensure safety in food items, and it helps identify counterfeit goods in manufacturing industries. The EPC global Software Certification Program provides information on certified products and the vendors who develop them. The Trade Control and Expert System (TRACES) helps manage the import and export of live animals and animal products to and from the EU.

## Appendix 2

## WTO Agreements

#### Agreement on Technical Barriers to Trade

This agreement tries to ensure that regulations, standards, testing, and certification procedures do not create unnecessary obstacles. However, it gives member countries the right to take measures that may be regarded necessary for the protection of human health and safety, or the environment. The agreement came into force with the establishment of the WTO at the beginning of 1995.

#### Agreement on Sanitary and Phyto-Sanitary Measures

This agreement was negotiated during the Uruguay Round of the General Agreement on Tariffs and Trade. It commits member countries to enforce certain measure to protect public health. These measures are based on internationally established guidelines and risk assessment procedures. Like the Agreement on Technical Barriers to Trade, this agreement also came into force with the establishment of the WTO at the beginning of 1995.

#### **Agreement on Pre-Shipment Inspection**

Pre-shipment inspections are customarily carried out at the place of origin. Their objective is to ensure that the type, quality, price, and customs valuation of goods are as claimed. These inspections are usually performed by authorized private organizations. The Agreement on Pre-Shipment Inspection ensures that this inspection process does not create unnecessary delays or discriminatory treatment. The agreement came into force on 1 January 1995.

#### Agreement on Intellectual Property Rights

The WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) attempts to bring these rights under common international rules. Like other WTO agreements, the Agreement on Intellectual Property Rights took effect on 1 January 1995. However, the time frame for full implementation varied across countries. Developed countries were given one year to implement the agreement. Developing countries were initially given 11 years, but later this period was extended to 2013.

# Appendix 3

# Questionnaire

122

This questionnaire is divided into six sections. The first section asks about the characteristics of the sample firms. Technical efficiencies and cost information issues are included in the second and third sections. The fourth section assesses information about trade logistics. Queries about hindrances to market access are included in the fifth section. The last section asks for firms' suggestions for policy recommendations.

# 1. Firm/Company's Characteristics

Q1. What is the nature of business of the firm/company?

□ Manufacturing □ Trading □ Multinational company □ Other, please specify: .....

Q2. What is the location of the firm/company? Why is this location important from the business point of view?

Location .....

□ Cheap availability of inputs □ High demand for output

 $\Box$  Good infrastructure  $\Box$  Others

□ Availability of skilled labor

Q3. Please indicate the number of people currently employed (full-time and part-time) by your firm.

Regular Employees	Part-time Employees

Q4. What is the current percentage (%) of domestic demand and export share of the firm's product in total output or production?

Domestic demand %	Exports as % of total output

- 2. Firm/Company's Technical Efficiency
- Q5. What is the current share of skilled (professionals) and unskilled workers in total number of employees?
- Q6. Provide details on the leading sources of machinery imports and what type of machinery/ technology your firm/company imports.

Source 1: Region	Type of technology
Source 2: Region	Type of technology
Source 3: Region	Type of technology

- **3.** Cost information
- Q7. Provide information about the capital structure used. Also mention percentage of each mode.

□ Self-financed	% value
Debt-financed	% value
Equity-financed	% value

Q8. What is the percentage (%) of total cost for fuel, gas, water, and electricity?

$\square$ Cost of fuel as % of total cost	
$\square$ Cost of electricity as % of total cost	
$\square$ Cost of gas as % of total cost	
$\Box$ Cost of water as % of total cost	

# 4. Activities and Problems in Exporting

Q9. Please fill in the following table

Procedures and Sub- activities	Time/Days Consumed			Costs (please specify currency unit)	Name of Agency Involved	Degree of Satisfaction (Rate from 1 to 4) as given in key
Pre-shipment activities		Avg.	Max.			
Conclude sales contract						
Secure letter of credit (L/C)						
Packing of goods						
Prepare freight forwarding instruction and						
other documents required for the transfer of cargo to						
port of departure						
Prepare documents for export						
Arrange international freight						
Perform pre- shipment inspection,						
Arrange payment for pre-shipment inspection						
Inland carriage and handling						
Load cargo on local carriage						
Deliver cargo to port of departure						
Wait for customs clearance						
Arrange a deposit for terminal handling charges						
Customs clearance						

124

Procedures and Sub- activities	Time/Days Consumed	Costs (please specify currency unit)	Name of Agency Involved	Satisfaction
Request for				
clearance				
Examination of				
mandatory				
documents				
Physical inspection				
of goods				
Physical inspection				
of goods to determine if it				
complies with				
technical or sanitary				
or phyto-sanitary				
standards				
Arrange payment				
for export taxes,				
tariff, and duties				
Arrange payment				
for technical control charges				
Customs release				
Discharge cargo				
from terminal to				
export				
Arrange a payment				
for terminal				
handling charges				
International				
carriage and				
handling				
Examine documents to prove that				
regulatory				
procedures are met				
Load cargo at port				
of departure				
Transport goods to				
final destination				
Arrange a payment				
for international				
freight charges				

Key for Rating:

1 = Highly Satisfied, 2 = Satisfied, 3 = Somewhat Satisfied, 4 = Not Satisfied

5. System of Certification

Q10. What is your awareness of the following standard? (Please circle)

	Fully unaware	Unaware	Averagely Aware	Aware	Fully Aware
ISO9000					
ISO14000					
HACCP					
SA8000					
OHSAS					
EUREPGAP					
Traceability					

Q11. Please indicate if your company is already certified to the following standards or if the system is currently being developed/planning on being developed (please tick).

	Company Certified to System	System being developed/ planning on being developed
ISO9000		
ISO14000		
HACCP		
SA8000		
OHSAS		
EUREPGAP		
Traceability		

## 6. Agreement and Negotiations

(a) Are you aware of the following WTO agreements? (Please tick)

	Fully unaware	Unaware	Averagely Aware	Aware	Fully Aware
Agreement on Technical					
Barriers to Trade (TBT)					
Agreement on Sanitary and					
Phyto-Sanitary					
Agreement on Pre-Shipment					
Inspection (PSI)					
Agreement on Intellectual					
Property Rights					

	Don't Know	Very Negative	Negative	Neither Negative nor Positive	Positive	Very Positive
Agreement on Technical Barriers to Trade (TBT)						
Agreement on Sanitary and Phyto-Sanitary Measures						
Agreement on Pre- Shipment Inspection (PSI)						
Agreement on Intellectual Property Rights						

(b) How these agreements affect your business?

(C) How much dialogue/consultation is there between your enterprise, or your sector representatives/umbrella organization and the ministries in charge of negotiating the rules-based multilateral trading system at the WTO level? Please tick.

	Don't Know	No Dialogue	Weak Dialogue	Average Dialogue	Strong Dialogue	Very Strong Dialogue
Agreement on Technical Barriers to Trade (TBT)						
Agreement on Sanitary and Phyto-Sanitary						
Agreement on Pre-Shipment Inspection (PSI)						
Agreement on Intellectual Property Rights						

# 7. Shipping and Logistics

Inland transport:

- Q13. What type of transportation mode is your company using for inland transportation? Also mention time for shipment.
  - 1. □Railways
  - 2. □Airways
  - 3. □Roads

Option	selects		Time
Own transportation services	[]		[] days
Public transportation	[]		[] days
Private transportation	[]		[] days
What is the ton/km cost?		Rs	
What is the total cost in Pak rupee?			
Is this mode of transportation easily available?		□Yes	□No
Is it reliable?		□Yes	□No
What is the total cost of loading and unloading?			
Loading and unloading			
Are loading facilities provided by you or not?		□Yes	□No
Are unloading facilities provided by you or not?		□Yes	□No

Total transportation cost

Below give information regarding cost of different processes of inland transportation and time required for completion of these processes.

	Cost (Rs)	Total time (Days)
Documentation	Rs	[] Days
Traveling	Rs	[] Days

Loading	Rs	[] Days
Unloading	Rs	[] Days
Clearance	Rs	[] Days

Total cost and time required for the completion of whole process

Rs	[] Days
----	---------

# 8. Labor

Q14. Is labor with required skills available?	' □† Yes	† ⊐No
---	----------	-------

In case of shortage of skilled labor, specify the reasons

↑ □Low quality education □Lack of training staff

↑ □Lack of training institutions □Low Salary

If any other, then please specify: \_\_\_\_\_

Q15. If the optimum level of labor productivity is achieved, then how much it will reduce firm's cost?

□01–10 % □11–20 % □21–30 % □31–40 % □No Effect

Q16. What type of backup is used to maintain consistent electric supply and what is the total cost of maintaining such equipment?

(Maintenance cost covers those cost which are required without use of this equipment)

Only mention corresponding type which firm uses

Type of Backup	Cost of maintenance	Cost of usage (Rs) per month
UPS		
Fuel generator		
If other, mention		

Q17. If there is no backup for energy, then for how many hours do your workers not work, due to load shedding in a day?

\_\_\_\_Hours in a Day

# Q18. Role of Institutions

Rank the efficiency of the following institutions

	1	2	3	4
Tax Department				
Banks				
TDAP				
Chamber of Commerce				
Provincial Authorities				

Note (1 = highly efficient, 2 = efficient, 3 = slightly efficient, 4 = not efficient)

If the efficiency of institutions is improved, then how much it will reduce firm's cost?

□01---10 % □11---20 % □21---30 % □31---40 % □No Effect

# Q19. Major Hindrances

Rank the effect of following factors on your firm/company's cost.

	1	2	3	4
Corruption				
Injustice				
Bribery				
Political interference				
Terrorism				
Lack of infrastructure				□
Market imperfections				⊐1

Note (1 = highly significant, 2 = significant, 3 = slightly significant, 4 = not significant)

131

Q20. Business Failure

What factors are responsible for failure of a business?

□Bad Planning	□Lack of Finance
□Poor Market Conditions ↑	□Unfair Competition
□Bad Luck	□Lack of Advice
□Bad Government Policy	□No Rules and Regulations

Q21. Trade Logistics

To what extent do logistics affect your business regarding the following factors?

	1	2	3	4
Saving Cost				
Reducing Inventory				
Improving Efficiency				
Consumer Satisfaction				

Note (1 = highly effective, 2 = effective, 3 = slightly effective, 4 = not effective)

What are the major constraints to the trade logistics environment?

	1	2	3	4
Too many agencies are involved				
Too many documents required				
Slow processing of customs clearance				
Poor inland road or rail infrastructure				
Poor transportation service				

Note (1 = no obstacle, 2 = minor obstacle, 3 = moderate obstacle, 4 = major obstacle)

# Q22. Cost of Borrowing

*Provide information about the capital structure used. Also mention percentage of each mode.* 

Self-Financed Firm	% value
Debt Financed Firm	% value
Equity Financed Firm	۲% value
Duration of finance:	
□Short Term	□Medium Term □

□Short Term	□Medium Term		□Long Term
Interest rate varies with time period		□Yes	□No

If yes what is the interest rate for different time period mention in %

Short Term [	] %	Medium Term [] %	Long Term [ ]	%
--------------	-----	------------------	---------------	---

# **Policy Recommendations**

Rank the solution you think will be most effective for improving logistics environment.

	1	2	3	4
Electronics processing of documents				
Coordination between concerned authorities				
One-window operation				
Port infrastructure				
Eliminate corruption				
Inland transportation				
Easy mode of paying customs and port fees				

Note (1 = no effect, 2 = minor importance, 3 = moderately important, 4 = very important)

If these solutions are implemented, how much it will reduce firm's cost?

□01---10 % □11---20 % □21---30 % □31---40 % □No Effect

To what extent is the role of the ministry of trade, export promotion bureau and other trade institutions helpful?

□not helpful □helpful □very helpful

If not helpful, then suggest how the role of these institutions can be improved?

Q23. Future Endeavors

Please share with us your future plans for the development of your business and also how to increase exports of your company.

In this regard, what help do you expect or ask for, from the government side?

Please give your valuable suggestions on how to increase the volume of Pakistani exports to the world.

# Notes:

134

- 1. This questionnaire is part of a survey and joint study, conducted by Lahore Chamber of Commerce & Industry and Pakistan Institute of Development Economics (PIDE), to identify barriers to exports faced by export-oriented firms.
- 2. All the information and inputs provided in this questionnaire will be strictly considered and treated as confidential and will not be shared with others.
- 3. All questions asking for your comments and feedback are openended. Additional sheets of paper can be used to elaborate your point of view or answer.
- 4. Any other.

# The Constraints to Industry in Punjab, Pakistan

# Syed Turab Hussain<sup>\*</sup>, Usman Khan<sup>\*\*</sup>, Kashif Zaheer Malik<sup>\*\*\*</sup> and Adeel Faheem<sup>\*\*\*\*</sup>

# Abstract

This paper identifies the main impediments to investment and industrial productivity in Punjab, which have led to a decline in growth. This is done by analyzing the impediments and constraints to productivity and investment using the World Bank's 2007 Investment Climate Assessment (ICA) data at the level of Punjab's seven main industrial zones. This is followed by an analysis of a pilot survey of 100 firms conducted in the Lahore district. Almost 71 percent of the firms surveyed declared electricity to be the most important constraint and macroeconomic stability was ranked as the second-most important constraint. An inadequate workforce, access to raw materials, and corruption were ranked third, fourth, and fifth, respectively.

Keywords: Industry, constraint, Pakistan.

JEL classification: O10.

# 1. Performance, Structure, and Impediments to Industry in Punjab

### 1.1. Performance of the Economy: Stagnating Growth

Punjab is Pakistan's largest province, both in terms of population and size of the economy. It accounts for almost 60 percent of the country's annual production of goods and services and 55 percent of the latter's population (Punjab Bureau of Statistics). Since Partition in 1947, Punjab has arguably been the country's most economically dynamic and vibrant province, contributing significantly to the national economy. However, gross domestic product (GDP) growth in the province has decreased alarmingly over the last five years and now stagnated to an anemic 2.5 percent. During the last decade, Punjab's gross provincial product (GPP) grew at an average of 5.5 percent—slightly higher than the 4 percent growth rate of the

<sup>\*</sup> Assistant Professor, School of Humanities and Social Sciences, Lahore University of Management Sciences, Lahore, Pakistan.

<sup>\*\*</sup> Development Policy Research Center, Lahore University of Management Sciences, Pakistan.

<sup>\*\*\*</sup> Development Policy Research Center, Lahore University of Management Sciences, Pakistan.

<sup>\*\*\*\*</sup> Development Policy Research Center, Lahore University of Management Sciences, Pakistan.

country's GDP (Punjab Bureau of Statistics). Pakistan's growth performance has been in tandem with that of Punjab, indicative of the fact that the country's economic health is inextricably linked to its largest province (Punjab Bureau of Statistics). Given that industrialization is imperative for income and employment generation and is a necessary condition for sustained economic growth and development, the performance of and issues facing Punjab's industry need to be analyzed in order to address the problem of low growth in the province in particular and the country in general.

The objective of this article is to identify the main impediments to investment and industrial productivity in Punjab, which have contributed to this unprecedented decline in growth. We do this by analyzing the World Bank's 2007 Investment Climate Assessment (ICA) data at the level of Punjab's seven main industrial zones. Manes' (2009) report based on this data analyzes the impediments and constraints to productivity and investment at the country and province level. This article focuses on the top constraints in the seven industrial zones of Punjab—analyzing the key constraint across different clusters, sectors, and firm size—that hamper industrial growth and productivity. This industrial zone analysis is followed by an analysis of a pilot survey of 100 firms conducted by a team from the Lahore University of Management Sciences in the Lahore district. The firm-level analysis is meant to gauge the industry's current situation in terms of the major constraints being faced, the cost of these constraints to firms, and the coping mechanisms they employed in response.

In terms of overall economic performance, there has been a secular decline in the country's GDP growth rate since 2007/08. Looking at Figure 1 below, what is clearly evident is the positive correlation between overall industrial growth and GDP growth. After an impressive surge in 2002, industrial growth waned and fell drastically in 2007, pulling down the national GDP growth rate within a period of two years from 6 percent to just above 2 percent. There have been structural reasons for the fragility of economic growth in Pakistan, leading inexorably to periodic boom-and-bust cycles. Some of the underlying structural weaknesses stem from the country's narrow and domestically oriented industrial base and its highly concentrated export basket, i.e., textiles and garments account for almost 50 percent of exports. However, this time a number of different factors have perversely contributed toward a prolonged recession, the main ones being a deteriorating political and security environment, a binding energy constraint, and macroeconomic instability.<sup>1</sup>

<sup>&</sup>lt;sup>1</sup> Macroeconomic instability results in inflation, exchange rate depreciation, and depletion of foreign exchange reserves.

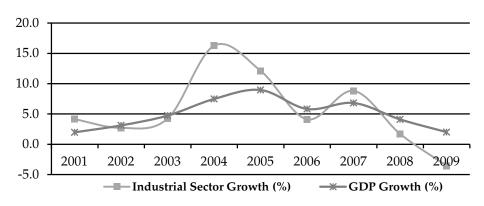
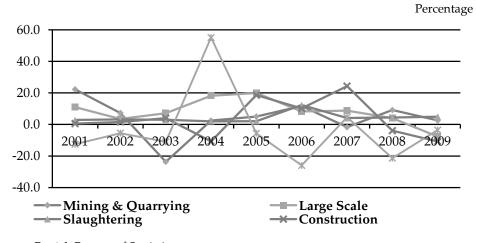


Figure 1: Industrial and GDP growth

The province of Punjab reflects the country's conditions at large. The growth rate in the industrial sector remained strong from 2003 to 2007, with growth in the large-scale sector peaking at almost 20 percent in 2005 (Figure 2). Since 2007, however, there has been a sharp decline in industrial growth—in particular, large-scale manufacturing in the province saw a decrease of 6.7 percent during 2008/09. As mentioned above, a number of factors including political instability, chronic energy shortages, rising input costs, and lower domestic and external demand on account of recessionary conditions both locally and globally have been responsible for this decline. Export-oriented industries have also suffered due to the loss in competitiveness and fall in external demand.





Source: Punjab Bureau of Statistics.

#### 1.2. Constraints to Investment and Productivity: A Brief Review

The economy of Punjab is currently going through a critical period: while population growth remains high, there has been a dramatic slowdown in the growth rate of output. The sluggishness in growth and productivity in manufacturing is fast eroding industrial competitiveness, which is bound to have serious implications for the country's future employment, income, and export earnings. A substantive improvement in the investment climate and a drastic enhancement in industrial productivity are now essential prerequisites to compete in an increasingly globalized and competitive environment of production and trade. In order to shift from the current low-growth equilibrium onto a sustained highgrowth path of economic recovery, it is therefore imperative to reinvigorate the private sector by removing impediments to investment and boosting industrial productivity.

Table 1 depicts changes in firms' perceptions of the constraints identified in the World Bank's ICA in 2002 and 2007. In 2007, more than three quarters of the firms interviewed ranked electricity supply (power shortages) as the most serious obstacle as compared to 2002, when less than 40 percent of firms considered electricity supply a major constraint. Similarly, more than half the firms surveyed identified macroeconomic instability as a serious constraint in 2007 as compared to one third in 2002 (Manes, 2009).

(Percentage of firms who view issue as a severe cons		
Deterioration	2007	2002
Electricity	79.6	39.3
Corruption	56.7	40.3
Macroeconomic instability	56.6	34.5
Political instability	46.8	40.4
Crime, theft, and disorder	32.5	21.4
Improvements		
Tax administration	23.2	39.3
Access to finance	17.6	38.3
Anti-competitive practices	14.1	21.4
Labor regulations	5.9	15.8
Customs regulations	5.8	24.4

Source: ICA 2002 and 2007.

Despite some improvement in business environment, perceptions of crime and corruption worsened in 2007. The results clearly show that governance issues (political, corruption, and crime) coupled with power outages and macroeconomic instability were the major constraints affecting the investment climate in 2007. On the other hand, constraints that in 2007 became relatively less important for firms were tax administration, access to finance, anti-competitive practices, and labor and customs regulations.

The results of the 2007 ICA were also consistent with other surveys such as the Global Competitiveness Report, which in 2008 listed government instability, corruption, an inefficient bureaucracy, and inflation as the major constraints facing the private sector in Pakistan (Porter & Schwab, 2008).

Power sector issues have been ranked as the most important obstacle facing Pakistan's investment climate. In Punjab, almost 77 percent of firms identified electricity as a major impediment to growth. Electricity outages per month were by far the largest in Punjab compared to other provinces. Firms in Punjab have suffered severe financial losses due to power interruptions, with small firms and the textile industry bearing the highest loss. Most firms have had to resort to other means of power generation, which has mitigated the impact to some extent but increased their costs. The resultant financial loss is estimated to be 9 percent of sales in Punjab.

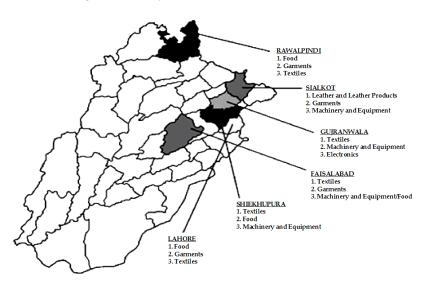
According to the World Bank's ICA for 2007 and the Department for International Development (2010), macroeconomic, political, and governance issues—all of which play a crucial role in strengthening the investment climate-were identified as the second most important set of constraints. Macroeconomic instability, political instability, corruption, and crime, theft, and disorder were ranked after power shortages. More than half the manufacturing firms ranked macroeconomic instability and political instability as a major constraint while 43 percent considered it to be among the top three constraints. Corruption was listed as a major constraint by more than half the firms surveyed, and a third ranked it among the top three obstacles. Although there was some improvement in certain areas, corruption in the business-government interface remained high. The creation of industrial zones, while solving many other problems, has apparently failed to provide a corruption-free business environment. Other important constraints that have hampered investment in Punjab are tax rates and tax administration, business licensing and permits, access to finance, and the functioning of the courts.

#### 1.3. Main Industrial Clusters in Punjab and their Importance

Punjab's centuries-old agrarian dominance tends to eclipse the province's contribution to and potential for industrial development in Pakistan. Manufacturing industries in Punjab contribute almost 58 percent to the country's overall industrial production, and account for about 60 percent of value-added in its manufacturing sector. According to the Economic Census of 2005, there were about 3.3 million economic establishments operating in Pakistan, 95 percent of them in the private sector. The overall industrial structure in Punjab is dominated by small and medium enterprise (SME) clusters. Almost 90 percent of its private enterprises are SMEs, which employ 78 percent of the nonagricultural workforce and contribute approximately 40 percent to GDP (World Bank survey 2010).

Punjab has numerous large industrial concentrations in sectors such as textiles, leather, and light engineering goods. It also has geographically distinct industrial clusters, the most well known of which is the "industrial triangle" comprising Gujranwala, Sialkot, and Gujrat. In total, there are seven industrial zones/clusters in Punjab: Lahore, Gujranwala, Faisalabad, Sialkot, Sheikhupura, Wazirabad, and Islamabad/Rawalpindi.

The Lahore district is one of the most diversified, with industries ranging from food, carpets, automobile parts, textiles, machinery and equipment, furniture, and printing. Faisalabad is the country's textile centre, with an additional concentration in light engineering products. Gujranwala specializes in electronics and textiles, and Wazirabad in the manufacturing of cutlery. Sialkot is perhaps the most dynamic and competitive of all the industrial clusters in the province—it is a manufacturing and export hub, concentrating in leather, surgical, and sports goods. Finally, the three main industries in Sheikhupura district are textiles, food, and machinery and equipment. Figure 3 shows six of these seven industrial zones and their three major industries.



#### Figure 3: Punjab's main industrial clusters

Clusters are a fundamental economic unit in the economy and an important driver of competitiveness. The importance of clusters stems from the "fundamental role" they play in "knowledge creation, innovation, the accumulation of skills, and the development of pools of employees with specialized expertise" (Porter, 2007). In Pakistan, clusters contribute significantly to the country's overall industrial development. However, more recently, cluster-level development and industrial competitiveness has been seriously hindered by chronic electricity shortages and continued macroeconomic and political instability.

Cluster- and sector-level analysis is particularly important since some constraints and issues are only sector- or cluster-specific. For instance, process-based industries incur relatively large losses as a consequence of power outages while other industries are crucially dependant on a trained workforce. A constraint important for one particular industry might not be, therefore, as binding as for another. Hence, cluster-level studies that identify sector-specific obstacles or constraints can help design more specific and targeted policy interventions.

In the following section, we briefly outline the methodology of the World Bank's ICA survey of 2007 and the Lahore pilot survey of 2012. Section 3 identifies the top four major constraints faced by the seven industrial clusters/zones in Punjab and analyses their impact on industrial productivity and output using the ICA 2006/07 data. In addition, the analysis is supplemented by the results of the Lahore pilot survey of 101

firms across various sectors to assess current constraints and their impact, albeit on a smaller sample of industry. The article concludes with a short policy brief for the Punjab government derived from our analysis of both the ICA 2007 cluster-level data and the recent pilot survey in Lahore.

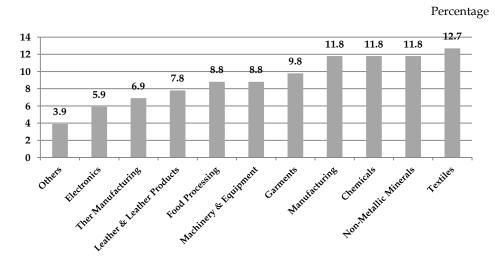
#### 2. Methodology

The ICA survey's main objective was to identify the key constraints faced by industry and ascertain their impact on output and productivity. The methodology was based on a two-pronged approach—a perceptionbased survey of firm managers and an econometric analysis of the impact of the constraints on firm-level productivity. The survey identified 16 constraints that were categorized into four broad areas: (i) infrastructure, (ii) economic governance, (iii) finance, and (iv) labor market and skills. The results of the perception-based survey were corroborated by the more rigorous empirical analysis, that is, the top constraints perceived by firms were also the statistically significant constraints affecting their productivity.

The World Bank conducted an ICA survey in 2002 and then subsequently in 2007 in 13 major cities of Pakistan (see Manes, 2009). The report based on this data analyzed the constraints to industry at the national and provincial level, but the analysis did not go deeper into the industrial clusters within each province. Our study aims to fill that gap by focusing exclusively on Punjab and its seven major industrial clusters by using the ICA's 2006/07 data and supplementing it with a recent pilot survey of industries in Lahore.

Punjab's main industrial clusters contain a diverse range of sectors, from low-value-added food products to high-value-added products such as machinery and equipment. Identifying the constraints that hamper firms' growth and productivity at the cluster level is imperative for designing appropriate and targeted policy interventions. Since these clusters are heterogeneous in terms of industry type, average firm size, legal status, and geographical location, an identical "one-size-fits-all" industrial policy might not be suited to all. Therefore, identifying constraints at the cluster level serves two important purposes: First, it will help policymakers identify and prioritize constraints at the cluster and sector level. Second, this more "microscopic" view can assist in customizing policy for clusters and sectors in order to spur industrial growth and productivity.

In order to assess the current extent and severity of the constraints to industries, we conducted a fresh pilot survey in the Lahore region (the survey questionnaire is available separately). The survey covered 101 enterprises and was focused mainly in and around the Lahore region. The purpose of conducting a fresh survey was, first, to verify the prioritization of constraints identified by the World Bank's ICA 2007; second, to identify and evaluate any changes in the impact of those constraints to industry since 2007. Finally, the survey helped explore and assess the cost and effectiveness of the coping mechanisms adopted by enterprises in the Lahore zone. Figure 4 illustrates the sector composition density of the survey respondents. The survey comprised ten key sectors with maximum concentrations in textiles, nonmetallic minerals, chemicals, manufacturing, and garments.



#### Figure 4: Sector coverage of Lahore pilot survey

Building sector diversity in the sample was crucial as it helped highlight the relative severity of constraints faced by different types of industries. For example, sectors that are heavy consumers of power are likely to suffer more due to load-shedding than those sectors that are not high energy consumers. Furthermore, within each sector, the scale and size of the firm also matter in determining the impact of constraints. In order to make the data sensitive to size, the survey split each sector into small, medium, and large-scale units.

As shown in Figure 5, the survey comprised around 50 percent large-scale manufacturers and around 25 percent medium and small enterprises. Figure 6 shows that, collectively, around 78 percent of the enterprises surveyed were either privately owned or under sole proprietorship.

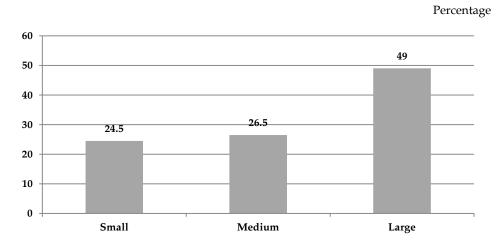
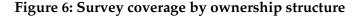


Figure 5: Survey coverage by size of industry



45 40.6 37.6 40 35 30 25 20 15.8 15 10 5.9 5 0 **Publically Listed** Partnership Sole Proprietorship **Privately Held** Company Limited Company

The data collected was also sensitive to the location of firms within or outside an established industrial zone. This information can help determine if there are any significant advantages for firms to locate within an established zone. Figure 7 indicates the survey's coverage in terms of the sampled firms' locations falling within or outside an industrial zone.

Percentage



Figure 7: Survey coverage by location within or outside an industrial zone

#### 3. The Constraints to Industry in the Seven Key Regions of Punjab

The objective of this analysis is to identify the major constraints impeding firms' output and productivity in the major industrial clusters/zones of Punjab. Using the ICA's 2006/07 data, Manes (2009) has analyzed the impediments and constraints to productivity and investment at the country and provincial level. This section focuses on Punjab, taking the analysis deeper into the province's industrial zones; identifying the key constraints hampering growth and productivity across various clusters, industries, and firm sizes; and estimating, where possible, the impact of these constraints on firm/industry output. Given that most of the constraints to industry persist today and, in some cases, have even worsened, this analysis is further supplemented by the Lahore zone analysis of 101 manufacturing firms. This is done to identify the key constraints currently inhibiting firms' growth and productivity and to reassess the impact of those constraints on the zone's manufacturing sector.

# **3.1.** Major Constraints and Challenges Faced by Manufacturers in Key Industrial Zones: An Analysis of the 2006/07 ICA Survey

Electricity supply, macroeconomic instability, and corruption emerge as the highest-rated constraints by the firms that were surveyed in Punjab (Figure 8) in 2006/07. Among the list of constraints, the lack of electricity was considered the first and most serious issue—more than 50 percent of all firms identified electricity shortages as the most serious obstacle out of the given list of 16 business environment obstacles. The huge rating gap between electricity and the other obstacles identified in the list is quite evident.

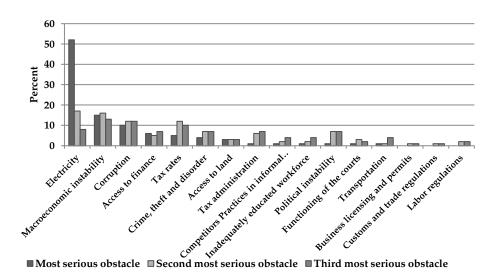


Figure 8: Major constraints faced by firms in Punjab

Source: Authors' calculations based on ICA 2007 survey.

Macroeconomic instability emerges as the second-highest rated constraint by all firms in Punjab. In this category, about 15 percent of firms ranked macroeconomic instability as the most serious constraint while 16 and 13 percent of firms reported it as their second- and third-most serious constraint, respectively. Corruption was considered the third-highest rated constraint, ranked by 10 percent of the firms surveyed as the most serious obstacle. Around 12 percent chose it as the second-most serious constraint and 12 percent as the third-most serious. The other notable constraints that firms identified were access to finance; tax rates; and crime, theft, and disorder. Figure 9 shows the major constraints in each of the six industrial clusters in Punjab.

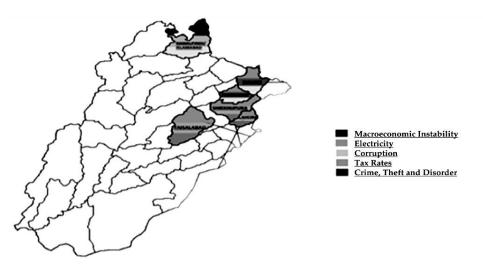


Figure 9: Summary of overall constraints faced by all firms in Punjab

3.2. Major Constraints and Challenges Faced by Lahore-Based Manufacturers: Pilot Survey 2012

At the aggregate level, the pilot survey asked respondents to rank their top-most constraint, second-most serious constraint, and third-most serious constraint. The results show that, at the aggregate level, electricity supply was by far the most critical constraint with over 70 percent of firms classifying it as the most important and about 20 percent as the secondmost important constraint. Table 2 summarizes the aggregate results of constraints prioritization.

Aggregate constraint analysis	Percentage of firms
Top-most constraint	
Electricity supply	71.3
Macroeconomic/political instability	7.9
Inadequate workforce	5.0
Second-most serious constraint	
Electricity supply	20.0
Macroeconomic/political instability	17.0
Inadequate workforce	12.0
Third-most serious constraint	
Access to raw material	18.2
Inadequate workforce	15.2
Corruption	13.1

Table 2: Aggregate constraint prioritization

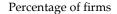
These constraints are consistent with the findings of the ICA 2006/07, with the exception of the inadequate workforce and access to raw material—factors that were not identified as serious constraints at that time. Based on the summary results presented above at the aggregate level, the top five constraints hampering industrial activity in Lahore are in order of priority: (i) electricity/power supply, (ii) macroeconomic and political instability, (iii) inadequate workforce, (iv) access to raw material, and (v) corruption.

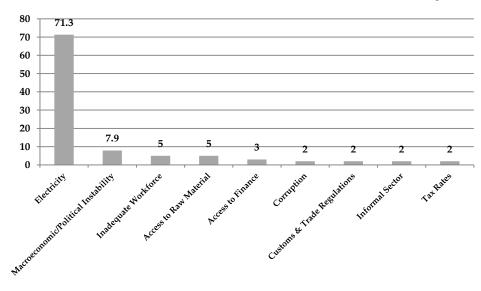
Discussions with the private sector and a large body of recent literature on industrial constraints in Pakistan show that a major impediment to its growth is the lack of skilled labor, particularly that which is highly skilled (technical personnel). The shortages are particularly acute in positions at the level of mechanics, electricians, fitters, foremen, and so on. These shortages afflict large-scale enterprises but are particularly damaging to the prospects of SMEs. Moreover, not only are skills inadequate, an understanding of manufacturing excellence is completely absent. Workers and floor-level supervisors prefer outdated techniques and are reluctant to use modern tools and techniques. The key organization responsible for technical education at this level in Punjab is the Technical Education and Vocational Training Authority (TEVTA). The industry has identified several shortcomings in the way TEVTA operates to provide a skilled workforce to the industry.

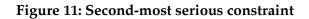
Additionally, the quality, availability, and price variance of raw materials are key factors that distort input costs and the decisions of manufacturers. Industries have to invest heavily to store sufficient amounts of inputs to guard against frequent price hikes and nonavailability. This is more so the case for imported raw materials.

Figures 10, 11, and 12 illustrate the prioritization of all the key constraints that industrialists in Lahore face.

Figure 10: Top-most serious constraint







Percentage of firms

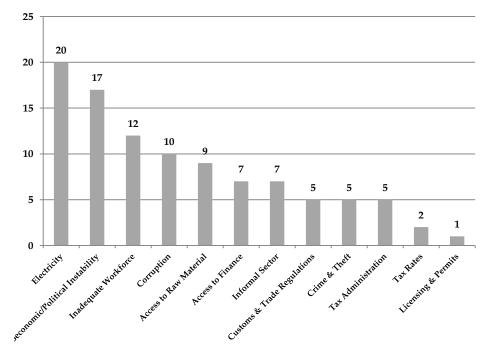
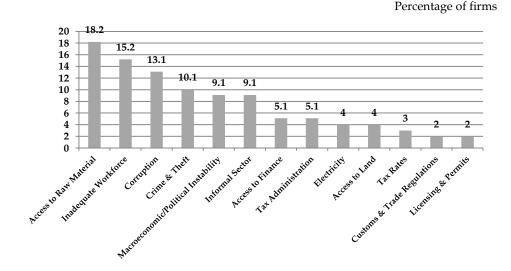


Figure 12: Third-most serious constraint



The following discussion focuses on the five major constraints identified in the ICA 2006/07 survey and in the recent pilot survey of firms in the Lahore zone. For each of the constraints, we provide a detailed comparison of their incidence and impact across the seven clusters, sectors, and firm size using both the ICA 2006/07 data and the Lahore pilot survey.

#### 3.3. Electricity Supply

#### 3.3.1. Introduction

The nationwide electricity shortage is the most damaging and chronic problem facing industry across the country. The impact of electricity shortages on industry in Punjab is acute and needs immediate attention and redress by both the provincial and federal governments. The first part of this section looks at the impact of electricity shortages at the cluster and sector level in Punjab, using the ICA survey for 2006/07. The second part uses the Lahore zone pilot survey of firms to analyze and assess the current situation of industry vis-à-vis electricity shortages.

In the data collected for the World Bank's ICA survey in 2006/07, electricity shortages were consistently reported as the most important obstacle to industrial growth in Punjab across different clusters, sectors, and firm sizes. This is evident from Figure 13, which shows that five out of the six industrial zones in Punjab reported electricity as being the most severe constraint to their growth and productivity.

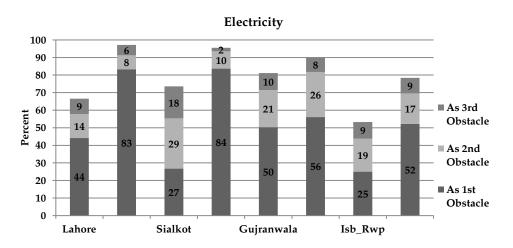


Figure 13: Firms reporting electricity shortages as the most serious constraint

Across Punjab as a whole, almost 80 percent of firms ranked electricity among the top three most serious constraints, of which 52 percent identified it as the most serious one. Across clusters, Sheikhupura and Faisalabad are clear outliers; more than 80 percent of the firms in these industrial zones reported electricity shortages to be the most serious obstacle to their business. They are followed by Wazirabad, Gujranwala, and Lahore, where more than 40 percent of firms indicated electricity as being the most severe constraint. Interestingly, in both Sialkot and Rawalpindi, only a quarter of firms reported electricity as being the most serious obstacle, although more than half in both these clusters still considered it among the top three most severe constraints.

#### 3.3.2. Impact of Electricity Shortages Across Clusters

The severity of the electricity supply problem can be judged by the fact that, on average, firms in Punjab lost more than 10 percent of total annual sales as a result of power outages. The sales loss was most acute among firms located in the Gujranwala zone, which suffered an average loss of around 14 percent—almost half a standard deviation above the Punjab mean. This is followed by Wazirabad, Faisalabad, and Sialkot, where average firm losses were more than 10 percent of annual sales (see Figure 14). Although more than 80 percent of firms in Sheikhupura reported electricity supply as being the most serious constraint, the losses reported by firms in that zone were, on average, around 7 percent, which is the lowest in Punjab. Firms in Lahore and Rawalpindi fared relatively better with reported losses of less than 8 percent of annual sales.

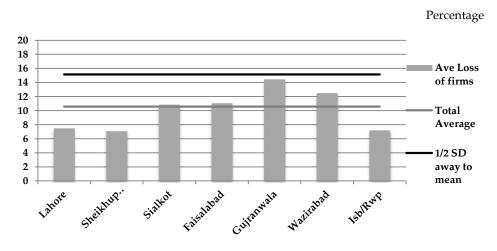
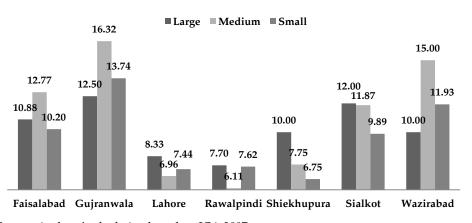
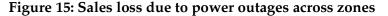


Figure 14: All firms' average loss due to power outages

From Figure 15, it is clear that, across different industrial zones, small and medium-sized firms are more vulnerable to electricity shortages than large firms. In Gujranwala, Faisalabad, and Wazirabad, which constitute the 'golden triangle" of Punjab's industry, the losses incurred by small and medium-sized firms were substantially higher than those incurred by large firms within these zones. This result is not surprising—small and medium-sized firms generally do not have the financial capacity to generate their own power and, hence, rely much more heavily on the national grid.





Percentage

Source: Authors' calculation based on ICA 2007 survey.

#### 3.3.3. Impact of Electricity Shortages Across Sectors

Figure 16 indicates which sector within each of the six clusters has been worst affected by electricity shortages. For example, in Lahore, the pharmaceuticals sector appears to have suffered most, with almost 20 percent of annual sales lost as a consequence of electricity outages. In Sialkot, Gujranwala and Rawalpindi, the garments industry is a clear outlier. In fact, the garments industry in Gujranwala reported, on average, a 50 percent loss as a result of electricity shortages, which is by far the highest among all the sectors. The food sector in both Wazirabad and Faisalabad was the worst hit with average losses of 26 and 40 percent, respectively. Other sectors (not shown in the figure) that also suffered significant losses were electronics and cutlery in Gujranwala and cutlery and machinery/equipment in Wazirabad.

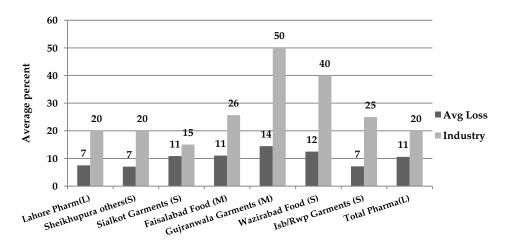


Figure 16: Highest annual sales loss due to power outages

Figure 17 compares losses due to electricity shortages in the five major sectors of Punjab as reported by the 2007 ICA survey—textiles, garments, pharmaceuticals, food, and machinery and equipment. According to the survey, the pharmaceuticals and garments industries reported the highest losses in terms of annual sales. Interestingly, in the pharmaceuticals industry, large firms reported the highest annual losses—amounting to 20 percent of annual sales—while in the garments industry, small and medium enterprises bore the highest losses as a consequence of electricity shortages. Machinery and equipment, textiles, and the food sector reported, on average, losses of around 10 percent of annual sales; the variation of losses across firm size in these industries is not significant. It is

worth noting that the industries reporting the highest losses due to electricity outages are primarily process-based where an unscheduled outage, even for a short duration, is likely to have a large impact on production costs.

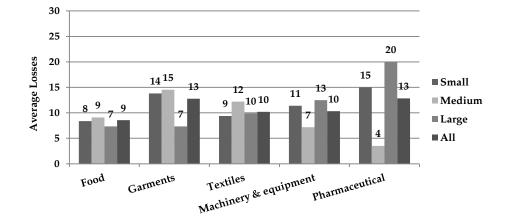


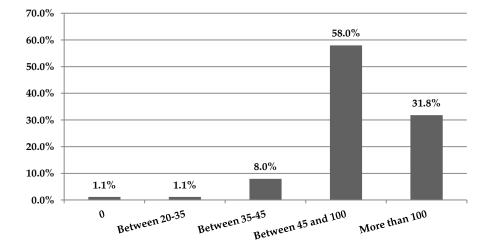
Figure 17: Loss as percent of total annual sales due to power outages

Therefore, according to the 2007 ICA survey, the zones worst affected by electricity shortages were Gujranwala, Wazirabad, and Faisalabad. Within these zones, the sectors that registered the highest annual sales loss were pharmaceuticals, garments, and food. Across the five major industrial sectors of Punjab, the pharmaceuticals industry reported the highest annual losses, followed by the garments industry and the textile sector. Machinery and equipment, and the food sector were fourth and fifth in terms of average annual sales loss.

#### 3.3.4. The Current Situation: An Analysis Based on the Lahore Pilot Survey

The dominant issue of power supply has emerged even more strongly since the ICA survey of 2006/07. Power shortages have multiple impacts on industrial performance. Nonavailability results in loss of production, reducing the amount of output produced by firms. Unannounced outages result in increased wastage and machine wear and tear, especially in sectors involving more automation, such as plastics and chemicals. Sudden power outages can cause more sensitive equipment or machines to break down. In some cases, the damaged equipment may require repair by suppliers located outside Pakistan, resulting in a significant loss of production time. Moreover, the lack of power at workers' homes has a negative impact on workforce efficiency and productivity. Firms have reported that, during the summer months, workers' productivity falls significantly as they feel more tired due to lack of sleep. Finally, it is not only the availability but the increased cost of power that has become a problem for firms, especially those in the SME sector.

Power/electricity shortages have been identified as the key constraint that all major sectors in Lahore face across all firm sizes. In terms of the extent of the problem, some 58 percent (Figure 18) of firms consider that the average number of outages varies between 45 and 100 in a month, i.e., averaging out to more than twice a day.



#### Figure 18: Average number of power outages in a month

This number has worsened slightly since the ICA 2006/07, in which most firms reported there being around 45 power outages per month. Figure 19 breaks down the data on outages at sector level. All the sectors with the exception of printing, food, and textiles, reported that the number of outages per month was between 45 and 100. The majority of firms in the printing and food sector reported that the number of outages was greater than 100, while in the textile sector, the response was evenly split between greater than 100, between 45 and 100, and between 35 and 45.

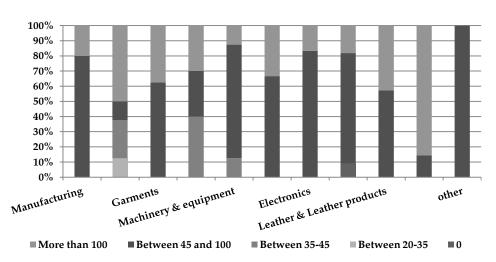


Figure 19: Average number of power outages per month per sector

Interestingly, across all sectors, small firms report the highest number of power outages, averaging more than 100 per month (Figure 20). Small firms are more likely to be located outside industrial zones, implying that the frequency of outages is much higher and also more random in areas outside these zones. In the case of medium and large firms, the majority report the number of outages at between 45 and 100, except for firms in the food and chemical industries, where around 50 percent of firms report the number of outages to be greater than 100 (Figures 21 and 22).

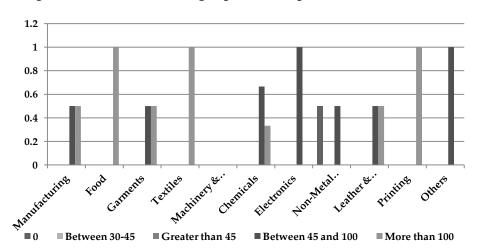


Figure 20: Number of outages per month per sector (Small firms)

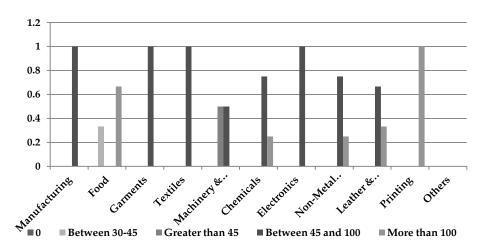
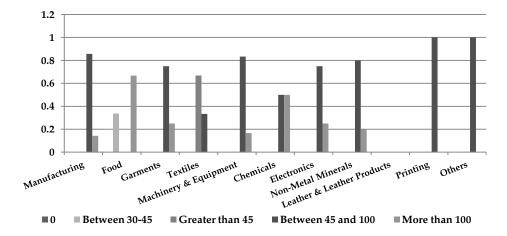


Figure 21: Number of outages per month per sector (Medium firms)

Figure 22: Number of outages per month per sector (Large firms)



#### Impact of Power Outages

In order to assess the impact of the power outages on the performance of industry, the survey estimates the losses to sales experienced by firms in Lahore. Since it was not possible for firms to estimate the exact amount of loss, the survey reports losses in terms of a broad range to identify the maximum and the minimum possible losses experienced. Figure 23 shows the percentage of sales lost due to power outages at the aggregate level. About 43.8 percent of the firms surveyed reported losses of less than 10 percent, about 19 percent reported losses of between 10 and 20 percent, and around 37 percent of firms reported losses

of more than 20 percent of sales. Using conservative weights, this translates into an average of loss of 15 percent of sales. This loss is twice as much compared to 2007, when it was around 7 percent in the Lahore zone.

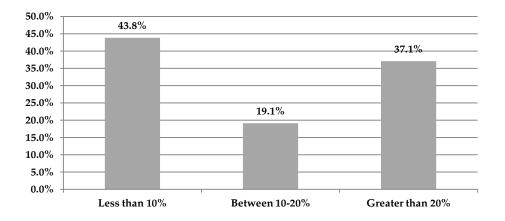


Figure 23: Percentage of sales lost due to power outages

Figure 24 shows that chemicals, nonmetallic minerals (including plastic), printing, and others suffer most from power outages. More than half the firms in each of these sectors have reported that losses due to power outages were greater than 20 percent of sales. This is to be expected, given that the manufacturing processes of all three industries require an uninterrupted power supply. Interruptions result either in a loss of material or in a significant loss as a consequence of increased production downtime.

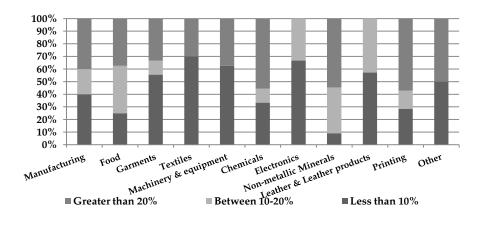
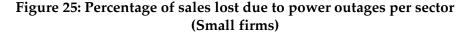
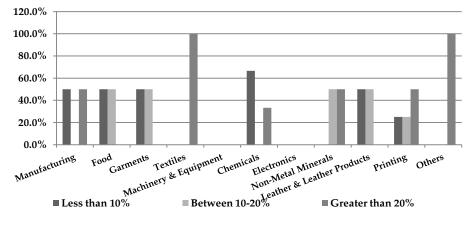


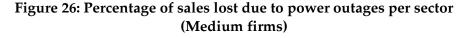
Figure 24: Percentage of sales lost due to power outages per sector

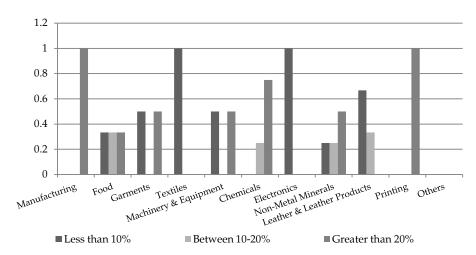
Figure 25 reports data on small firms in various industrial sectors, indicating that textiles, manufacturing, chemicals, nonmetallic minerals, and printing are the most affected by power outages.





Medium-sized firms in manufacturing, garments, machinery and equipment, nonmetallic minerals, and printing tend to suffer losses in sales greater than 20 percent as a result of power outages (Figure 26). In the case of large firms, the food, chemical, and nonmetallic mineral sectors are the most affected, with the greatest proportion of firms reporting losses higher than 20 percent (Figure 27).





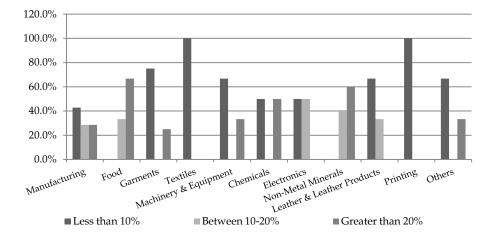
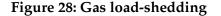
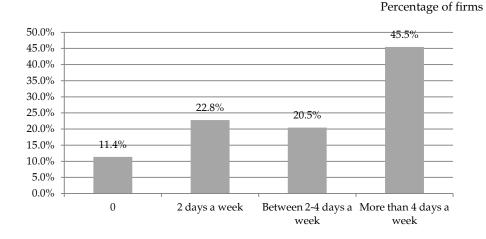


Figure 27: Percentage of sales lost due to power outages per sector (Large firms)

Gas as an Alternative Source of Power

An alternative source of power to electricity is gas. However, even this is in severe shortfall in production and, currently, no new industrial gas connections are being granted. Industries with existing gas connections suffer due to the high level of gas load-shedding. The textile sector is one of the biggest users of gas, and reported having had to face 168 days of gas load-shedding in 2011. Figure 28 shows that more than 45 percent of the firms surveyed reported that gas was not available to the industry for more than four days a week.





In terms of sectors, more than half the firms in the manufacturing, garments, electronics, and nonmetallic minerals sectors reported that gas load-shedding occurred more than four days a week. Figure 29 represents large firms since 90 percent of the small and medium firms surveyed did not have an industrial gas connection, while around 55 percent of the large firms were operating their factories on industrial gas connections.

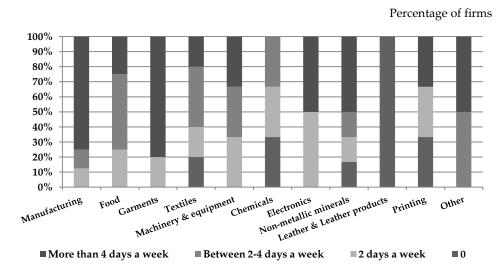
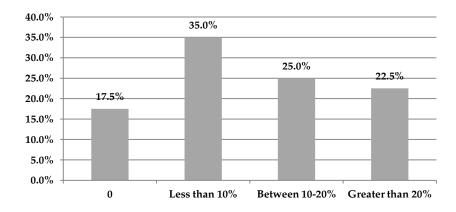


Figure 29: Gas load-shedding per sector

The majority of firms reported (35 percent) that the losses due to gas nonavailability were less than 10 percent of their sales, while about 22.5 percent of firms reported losses that were greater than 20 percent of their sales (Figure 30).

#### Figure 30: Percentage of sales lost due to gas load-shedding



Around half the firms in the manufacturing and printing sectors reported losses due to gas shortages as being greater than 20 percent. Based on discussions with the industry, it is more likely that losses resulting from gas shortages are less than 10 percent of sales. Figure 31 presents aggregate-level data but is more representative of large firms since hardly any of the medium or small firms surveyed had industrial gas connections.

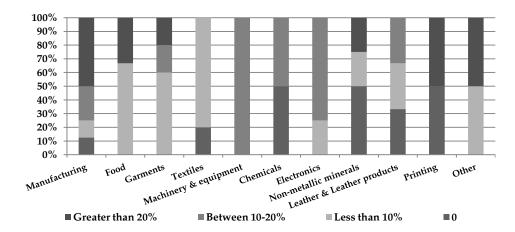
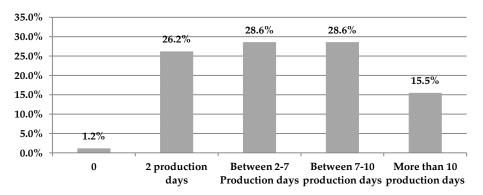


Figure 31: Percentage of sales lost due to gas load-shedding per sector

In order to further assess the impact of power shortages, the survey also reports data on the number of production days lost (Figure 32).

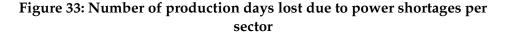
Figure 32: Number of production days lost due to power shortages

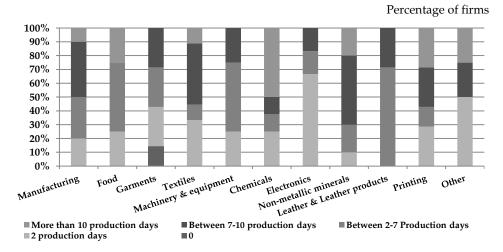


Percentage of firms

More than 28 percent of the firms surveyed reported losing 7–10 days of production time due to power shortfalls. The same percentage reported losing 2–7 days' production time. On average, firms lose around

5–7 days due to power shortage issues. Figure 33 provides a breakdown of the number of production days lost by sector.





#### Key Coping Mechanism

For firms, the key coping mechanism for power shortages is the use of power generators—73 percent reported using generators to meet the power shortfall (Figure 34).

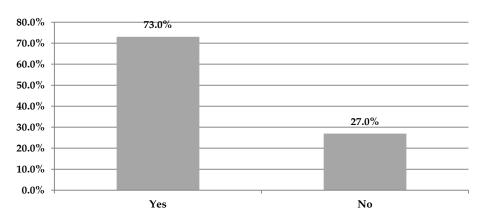


Figure 34: Firms using generators to meet power shortage

Figure 35 shows that, except for chemicals, leather and leather products, and printing, more than 70 percent of firms in all the other sectors owned generators. Moreover, the majority of these (90 percent)

were fuelled by diesel and very few by gas (Figure 36). This has an important implication for the cost of power generation. The cost of using a generator fuelled by diesel is around PKR 48 per unit of electricity, whereas the same unit if consumed from the national grid costs PKR 13. Thus, costs increase more than threefold if generators are used as an alternative power source, and this cost does not vary across firm size or sector.

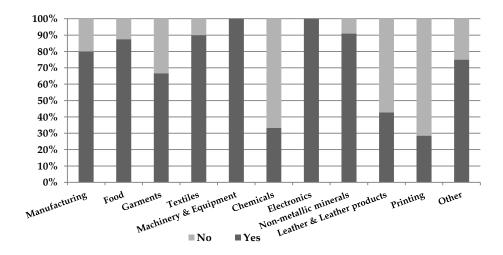
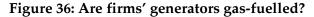
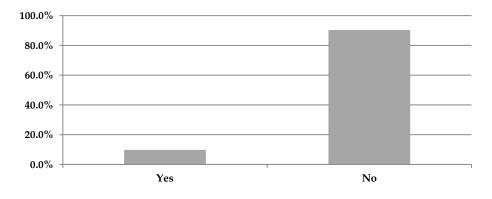
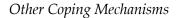


Figure 35: Firms using generators to meet power shortage per sector







In addition to using generators, firms have to resort to alternative means to meet their production targets in the wake of electricity shortfalls. At an aggregate level, over 55 percent of firms across all sectors have to rely on overtime to meet the production shortfall caused by power outages. Other mechanisms include increasing the working week (moving to a seven-day week) or increased standard shift times, all of which result in higher worker costs and larger overheads (see Figures 37 and 38).

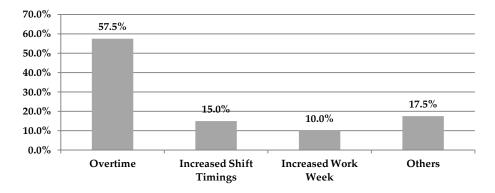


Figure 37: Coping mechanisms

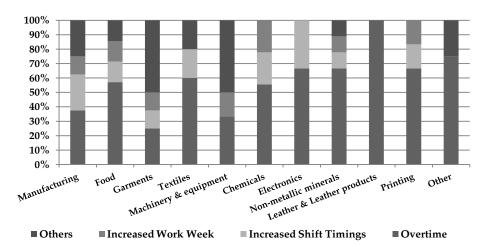
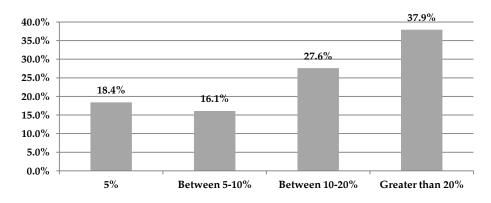


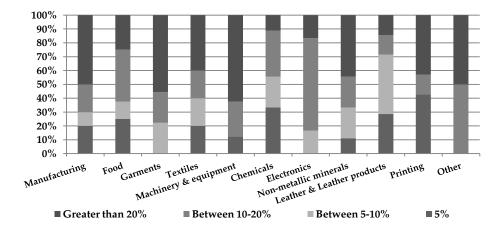
Figure 38: Coping mechanisms per sector

Around 38 percent of the firms surveyed reported that, in implementing these coping mechanisms, their overhead costs had increased by more than 20 percent (Figure 39). In terms of sector, the majority of firms in manufacturing, garments, textiles, machinery and equipment, nonmetallic minerals, and printing reported the greatest increase in overhead costs as a result of implementing the coping mechanisms mentioned above (Figure 40).



# Figure 39: Impact on overhead costs of implementing coping mechanisms

Figure 40: Impact on overhead costs of implementing coping mechanisms per sector



For small firms across all sectors, the impact on costs due to the implementation of coping mechanisms generally varies between 5 and 10 percent (Figure 41). For medium firms, the impact on cost varies between 10 and 20 percent for almost all sectors, whereas for large firms the impact on costs across most sectors is greater than 20 percent (Figures 42 and 43).

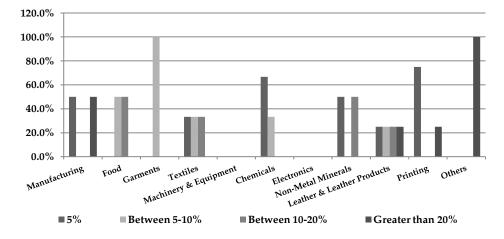
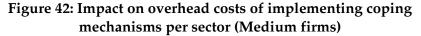
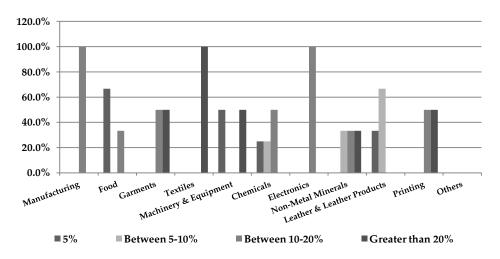


Figure 41: Impact on overhead costs of implementing coping mechanisms per sector (Small firms)





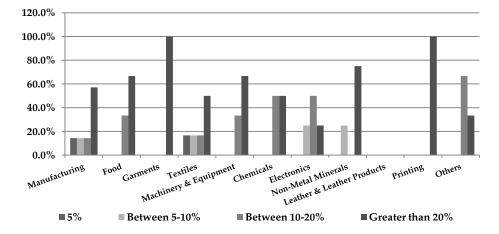


Figure 43: Impact on overhead costs of implementing coping mechanisms per sector (Large firms)

The increasing extent and magnitude of the power shortages faced by Punjab's industry is fast eroding its competitiveness. Industries lose not only valuable production time but, due to the additional costs associated with the coping mechanisms we have described, face significantly higher costs of production. Given the severity of these problems, the industries visited during the survey were running close to full capacity, which demonstrates their resilience in the face of these challenges. They have continued to be innovative in developing techniques to reduce the impact of power shortages on their business. Some have moved to more energyefficient technology, some use more outsourcing, and others simply work harder to "keep the ball rolling."

#### 3.4. Macroeconomic Instability

A strong and viable macroeconomic environment in the country is critically linked with investment and growth in the manufacturing sector. On the other hand, a volatile macroeconomic environment with rising inflation, burgeoning budget deficits, increasing external debt obligations, and an unstable exchange rate can retard investment, manufacturing, and output growth. A country's overall investment climate is negatively affected by macroeconomic instability because it increases the uncertainty of future returns. This uncertainty, which emerges in the form of instability and volatility in demand and relative prices, adds to the cost of doing business. The firms surveyed in the ICA for 2007 ranked macroeconomic instability after electricity as the top constraint obstructing productivity and output growth.

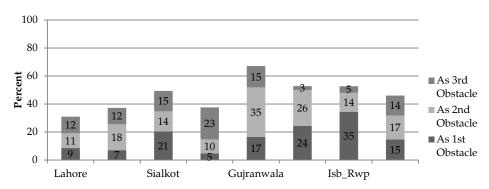


Figure 44: Firms reporting macroeconomic instability as a constraint

Source: Authors' calculations based on ICA 2007 survey.

In Punjab, almost 46 percent of firms declared macroeconomic instability among their top three obstacles. Looking at the variation across the seven industrial clusters, Gujranwala seems to have been the most affected by macroeconomic instability—67 percent of the respondents ranked it among their top three constraints. This is followed by Islamabad and Rawalpindi with 35 percent of firms declaring macroeconomic instability as the top constraint to productivity and business growth. Lahore, Sheikhupura, and Faisalabad were among the least affected by macroeconomic instability. For instance, in Faisalabad only 5 percent of businesses reported macroeconomic instability as being their top constraint. Thus, industrial clusters in Gujranwala, Sialkot, Wazirabad, and Islamabad/Rawalpindi were the most affected zones.

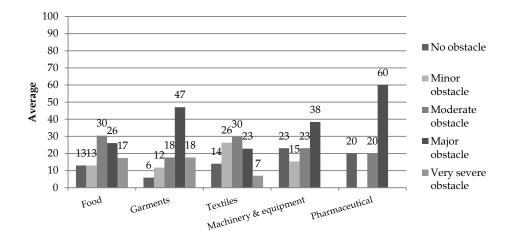


Figure 45: Macroeconomic instability as an obstacle (All firms)

Source: Authors' calculations based on ICA 2007 survey.

In terms of sectoral variations of the constraint, across Punjab the pharmaceuticals industry overwhelmingly declared macroeconomic instability as one of its major constraints. The industry relies heavily on imported raw materials (chemicals) as a primary input, and the continued depreciation of the rupee has significantly increased the price of chemicals, which, in turn, has increased production costs. Garments and machinery/equipment were the other two important sectors that identified macroeconomic instability as the most important constraint. Finally, almost 30 percent of manufacturers in the food and textile sectors ranked macroeconomic instability as a moderate constraint.

While the data on macroeconomic variables affecting business growth reveals no specific information, it is possible to infer that inflation and exchange rate volatility perhaps most affect the business environment. Higher inflation increases the cost of production and decreases demand due to the rise in general price levels. Exchange rate volatility particularly affects the price of tradables. Firms using imported raw materials as intermediate goods pay higher prices, which increases their production costs. As a result of exchange rate instability, the expected prices of goods for export may vary, which might discourage the demand for domestically produced goods in foreign markets.

In the pilot survey of firms in Lahore, macroeconomic stability continued to be identified as one of the major impediments to industrial growth—25 percent of firms ranked macroeconomic instability among their top two constraints. Table 3 shows that the chemical sector and machinery and equipment sector both view macroeconomic and political instability as a key impediment to industrial growth. One reason for this may be the low levels of investment in these sectors since it is perceived as risky in an unstable economic environment characterized by variable and high rates of inflation, an uncertain exchange rate, and high mark-up rates. Most of the other sectors viewed macroeconomic and political instability as moderate obstacles. The survey results estimates that, on average, around 15 percent of productivity is lost due to macroeconomic and political uncertainty. This impact is fairly consistent across sectors as well as firm size.

				Percer	tage of firms
		Does not	Minor	Moderate	Major
Industry	Size	apply	obstacle	obstacle	obstacle
Manufacturing	Small		100.0		
	Large		50.0	50.0	
	Total		66.7	33.3	
Food	Small			100.0	
	Medium			100.0	
	Large			100.0	
	Total			100.0	
Garments	Small	100.0			
	Large			100.0	
	Total	33.3		66.7	
Textiles	Medium		100.0		
	Large			100.0	
	Total		20.0	80.0	
Machinery and equipment	Medium		50.0		50.0
	Total		50.0		50.0
Chemicals	Small				100.0
	Total				100.0
Nonmetallic minerals	Medium			100.0	
	Total			100.0	
Leather and leather products	Small			100.0	
•	Total			100.0	
Other manufacturing	Small		50.0	50.0	
Ũ	Medium				100.0
	Total		33.3	33.3	33.3

Table 3: Impact of	f macroeconomic a	and political	instability	on industrial
	perfo	rmance		

A caveat to the reporting of numbers on perceived losses is that the firms surveyed—in particular the smaller enterprises—were not fully able to understand the exact implications of macroeconomic and political instability. It is quite likely that firms, when responding, may have considered poor security conditions a part of macroeconomic and political instability in the country. The security situation has significantly hurt Punjab's industry, especially export manufacturers and importers are becoming increasingly skeptical about Pakistan's capacity to supply goods on time. This has resulted in several export orders (especially in textiles) shifting from Pakistan to other countries.

#### 3.5. Corruption

After electricity and macroeconomic instability, corruption emerges as the third-most critical constraint faced by Punjab's manufacturing industries. Government officials interfacing with industry normally exploit firms' lack of awareness concerning technical issues in regulations to extract rents. The industry reports that it is forced to bear high costs in the form of informal payments to the officials concerned. Both the ICA 2007 survey and the Lahore pilot survey for 2012 included specific questions designed to gauge the degree and extent of corruption related to industry in Punjab. We discuss below the extent of corruption as well as informal payments made to officials across key clusters and industries.

#### 3.5.1. Findings from ICA 2007 Survey

Across the seven key industrial hubs in Punjab, more than a third of the firms surveyed identified corruption as either their most, second-, or third-most serious constraint (Figure 46). Rawalpindi (50 percent) and Gujranwala (42 percent) are reported to suffer most from corruption, followed by Sialkot and Lahore. Firms reported that the most common method of corruption was inconsistent interpretation and the ad-hoc application of government regulations and policies related to taxation, labor, and other licensing issues. An overwhelming majority of Punjab's manufacturers believe that officials interpret policies and regulations inconsistently. The application of policies by government officials is purposely complicated to extract as much rent as possible by threat or even harassment.

Moreover, the evidence from the survey suggests that there is a strong positive correlation between firm size and contact with various levels of bureaucracy. Hence, medium and large firms report much greater contact both in terms of time and the number of offices with which they have to deal as compared with small firms. A slight anomaly in the ICA 2007 data is that it reports that medium and small firms—rather than large ones—pay more bribes and make informal payments to get things done. This may be the case when it is relatively easy for the lower bureaucracy to extract rents from poorly informed smaller manufacturers than from larger businesses.

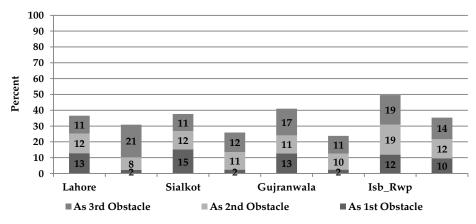
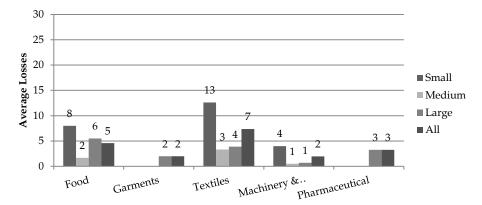


Figure 46: Incidence of corruption across clusters

Source: Authors' calculations based on ICA 2007 survey.

The reported data also suggests variations in the cost of corruption across key sectors (Figure 47). The textile sector reportedly channels around 7 percent of its annual sales into informal payments to get things done, with smaller firms in the sector spending almost 13 percent of annual sales for this purpose. The food sector, especially small firms, bears the second-highest cost of corruption. The results are not surprising—the textile sector is the biggest employer of labor and is subject to the highest frequency of visits by labor inspectors, while the food industry faces the most number of visits by health and quality regulators.

Figure 47: Percentage of total annual sales paid as informal payments



Source: Authors' calculations based on ICA 2007 survey.

In terms of cluster averages, firms in Wazirabad report the highest cost of corruption, paying on average 14 percent of their annual sales as informal payments and gifts to get things done. In terms of size, small firms in textiles and furniture located in Faisalabad and Rawalpindi, respectively, bear the maximum cost of corruption (all above 25 percent). The medium-scale cutlery industry in Wazirabad pays around 20 percent of its annual sales as informal payments. The textile sector in Faisalabad pays the most to labor inspectors while the small- and medium-scale industry in Wazirabad and Rawalpindi seems to suffer due to high levels of illiteracy, which facilitates exploitation by government officials.

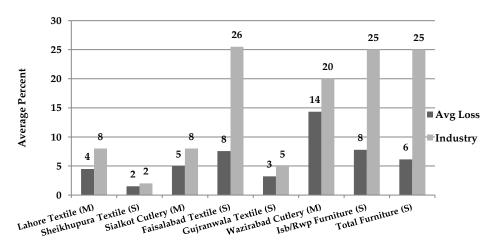


Figure 48: Percentage of total annual sales paid as informal payment per sector and cluster

The section below uses the evidence from the new pilot survey done in Lahore to support the findings from ICA, 2007 presented above.

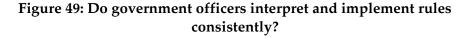
#### 3.5.2. Findings from Lahore Pilot Survey

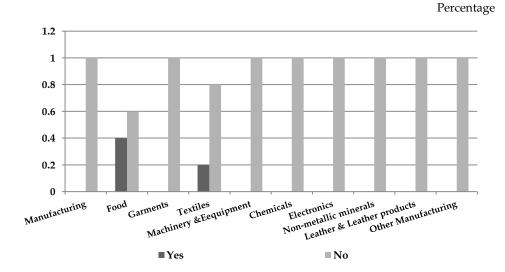
The fourth key obstacle to industrial growth identified in the Lahore-based pilot survey was corruption. As mentioned before, the major source of this corruption is the willfully ambiguous interpretation of rules and regulations by government officers in order to create room and opportunity for corruption. Figure 49 shows that all the sectors surveyed unanimously felt that the government was weak in interpreting and implementing regulations. This held for all firm sizes across all sectors.

A key impact of such behavior by government officials is factories' loss of productive time. All the sectors perceived that engaging repeatedly with government officials to resolve simple matters wasted precious time

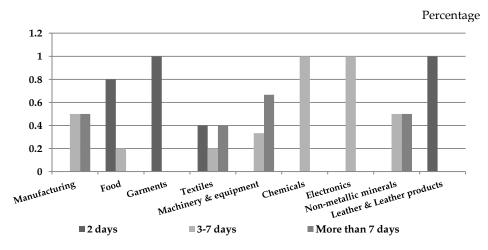
Source: Authors' calculations based on ICA 2007 survey.

and resources that could have been used more productively. Most sectors felt that anywhere between three to seven days could be wasted in dealing with any single issue if having to engage with a government department. The data does not vary much across firm size.









All the sectors across all sizes consistently reported that up to 5 percent of sales are usually spent on bribes to various government departments/officials (Figure 51). Figure 52 shows that most of these

bribes are given to labor inspectors, followed by electricity inspectors. This data is invariant at both the sector and size level.

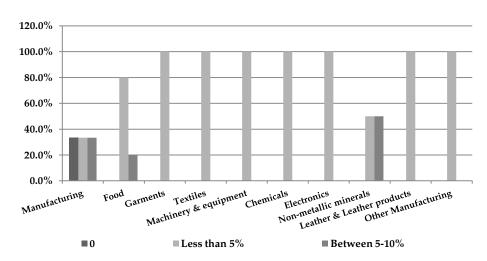
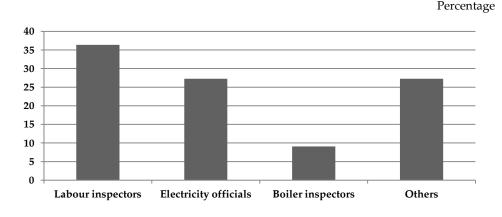


Figure 51: Percentage of sales used in bribes to government officials

Figure 52: Share of bribes given to officials



**3.6.** Access to Finance

Based on data from the World Bank's ICA for 2007, some 7 percent of firms across Punjab listed access to finance as a key constraint to their business. Most of these firms were located in Lahore and Sialkot. The pilot survey of Lahore-based firms reported that around 3 percent of firms categorized access to finance as a key constraint. Both surveys had a significant number of missing entries for questions on access to finance and, hence, it was not possible to provide a quantitative analysis of the problem. However, we attempt to provide a qualitative analysis of the issue and make a case for how a lack of access to finance has impeded industrial performance in Punjab.

#### 3.6.1. The Issue

The pilot survey of Lahore suggests that it is generally mediumsized and small firms—more than large firms—that are constrained by lack of access to viable finance. The problem of larger firms has more to do with higher mark-up costs than access to finance. Through discussions with the SME industrial sector and commercial banks, it is clear that the issues of capital availability and its appropriate utilization stem from inadequate capacities both at the level of firms and commercial banks.

Firms suffer from typical SME-related asymmetric information issues and a limited capacity to manage and provide reliable financial and balance sheet data. Most of their financial transactions are recorded informally, with much of this information residing only with the owner. Banks generally refuse to trust even audited statements, which they assume to be fictitious. Hence, in most cases, the banks secure lending against 100 percent collateral, which small and medium enterprises cannot always provide. Even in cases where firms are willing to fully disclose their information, they do not have the capacity to comply with their bank's documentation requirements. Moreover, the sector is not all that disciplined or scrupulous when it comes to the use of credit—in some cases, working capital limits or short-term business loans may be utilized for personal expenditure. This inappropriate use of capital puts further pressure on businesses as they add up on debt without any addition to revenue generation capacity.

However, the issue concerns not only the industry's capacity. Commercial banks also have a limited capacity to meet the requirements of SME credit in Pakistan. First, they do not have any special schemes for SME development finance and all lending is done on a commercial basis, which is too expensive for the SME sector. Second, there has never been any pressure on commercial banks to extend development/long-term credit to the SME sector. With the large fiscal deficits of the federal and provincial governments and the presence of attractive spreads, commercial banks comfortably maintain large exposures to AAA-rated debt. They also use the broad nature of the SME definition/classification to their advantage.<sup>2</sup> Most of the lending to SMEs includes clients that are on the margin of being classified as an SME.

#### 3.6.2. Impact on Industry

The lack of access to finance has resulted in industry following noninnovative and low-technology production techniques. The major production of the small and medium sector is low-value-added products with little intra-industry differentiation; there is hardly any innovation, resulting in limited international competitiveness. Moreover, the lack of access to long-term loans has resulted in limited investment, if any, in technology, as a result of which most medium and small sector firms in Punjab use outdated machinery and technology. A key consequence of this is that industry has failed to grow and remains uncompetitive due to diseconomies of scale. If this pattern persists, industry in Punjab is likely to fall behind its international competitors and, over time, lose its domestic and export market share to low-cost and more innovative producers in India, China, and Vietnam.

#### 3.7. Inadequate Workforce

Notwithstanding acute shortages of electricity/power and uncertain macroeconomic conditions, one factor that can still drive competitiveness is a skilled labor force. Punjab is endowed with a young and a fast growing labor force. This demographic trend presents an immense challenge for the economy—to both educate and train this young labor force and produce enough jobs to absorb its growing numbers. Keeping this challenge in mind, the Government of Punjab has recently formulated the Youth Skills Development Council, which will work as a regulatory authority in tandem with TEVTA to train the province's workforce. The survey conducted for this study has identified an inadequately trained workforce as one of the key impediments to industrial performance. Figure 53 shows that almost all the sectors surveyed listed an inadequate workforce as being a moderate to major obstacle.

 $<sup>^2</sup>$  To be categorized as an SME in Pakistan, a concern must not employ more than 250 persons in the case of a manufacturing or service concern, and 50 persons in the case of a trading concern. Moreover, its net sales should not exceed PKR 300 million and it must not possess assets worth more than PKR 50 million for a trading concern and PKR 100 million in the case of a manufacturing concern. The State Bank is now working on revising this definition.

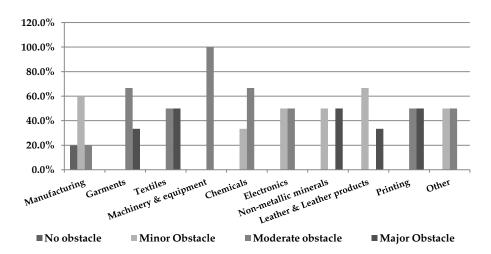


Figure 53: Inadequate workforce as an obstacle

More specifically, Table 4 indicates the diversity of this problem across sectors and across various firm sizes. Textiles and leather/leather products are the two main sectors where, regardless of firm size, an inadequate workforce is considered a major obstacle to industrial performance. Most of the other sectors across different firm sizes view it as a moderate obstacle.

				Percer	ntage of firms
		No	Minor	Moderate	Major
Industry	Size	obstacle	obstacle	obstacle	obstacle
Manufacturing	Small	100.0			
	Medium			100.0	
	Large		100.0		
	Total	20.0	60.0	20.0	
Garments	Medium			100.0	
	Large			50.0	50.0
	Total			66.7	33.3
Textiles	Small				100.0
	Medium				100.0
	Large			100.0	
	Total			50.0	50.0
Machinery and	Large			100.0	
equipment	-				
	Total			100.0	
Chemicals	Medium		50.0	50.0	
	Large			100.0	
	Total		33.3	66.7	
Electronics	Large		50.0	50.0	
	Total		50.0	50.0	
Nonmetallic minerals	Small		50.0		50.0
	Total		50.0		50.0
Leather and leather	Small		66.7		33.3
products					
1	Total		66.7		33.3
Other manufacturing	Medium			100.0	
Ũ	Large				100.0
	Total			50.0	50.0

#### Table 4: Inadequate workforce as an obstacle

The development of worker skills is strongly correlated with basic education attainment. If workers have obtained a good basic education before entering the labor force, they have a greater likelihood of developing stronger skill sets. Figure 54 shows that, across all the sectors surveyed, the majority of firms reported their workers' education as being in the range of 7–12 years. It is likely that most of these workers would have had eight years of education, i.e., passed middle school. This is a critical reason why skills deficiency exists at all levels in Punjab's workforce. School dropout rates in the province are high and the quality of education as indicated by several recent studies is inadequate. Hence, students are academically ill prepared to acquire skills comparable with international benchmarks.

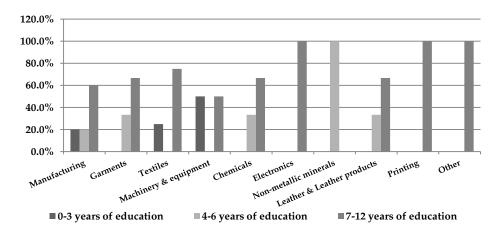
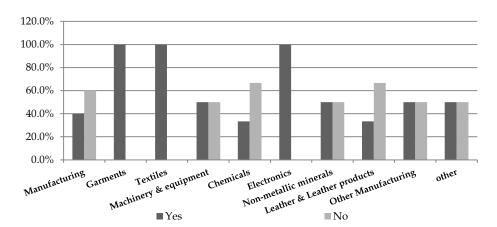


Figure 54: Average education attainment

An example from the textile industry shows that, in Pakistan, the average stitching operator has only completed middle school whereas his or her counterpart in Singapore has at least completed their 'A' levels. The latter, being better educated can easily read the machine operations guide book and acquire operating skills much faster than a worker in Pakistan.

#### 3.7.1. Coping Mechanism

The key coping mechanism that firms use to address the issue of an inadequate workforce is to offer their own or in-house training programs. The data clearly suggests that most firms across all the sectors surveyed—including textiles, garments, and electronics—offer some form of training to their workers.



#### Figure 55: Firms offering training programs

#### 4. Policy Brief

#### 4.1. An Overview

Punjab's population has grown rapidly over the past three decades; according to some projections, it will have increased to 128 million by 2025. A key challenge facing the province is to create a sufficient number of jobs every year to absorb the increasingly large number of entrants into the labor force. A significant and sustained increase in investment and productivity in the manufacturing sector is, therefore, imperative to create employment and income for the province's burgeoning population.

Currently, Punjab's industrial sector employs around 23 percent of the province's labor force and contributes just over 24 percent to GPP. Over the last 10 years, average growth in the manufacturing sector has been over 5 percent per annum with the highest growth registered in the early years of the last decade. However, since 2006/07, industrial performance has shown an unprecedented deterioration, contributing negatively to GPP. This abysmal performance is a consequence of serious domestic issues and constraints that have stunted the sector's contribution to the economy. The ICA 2007 identified power shortages, macroeconomic and political instability, and bureaucratic corruption as the most important constraints to investment and industrial productivity at both the national and provincial level.

Our objective was an in-depth analysis of industry in Punjab by identifying the major constraints impeding the output and productivity of firms located in the seven major industrial clusters/zones of the province. Using data from the World Bank's ICA for 2007, this study has closely analyzed each of the seven major industrial zones in Punjab, identifying in each of these the key constraints hampering growth and productivity across various industries and firm sizes, and estimating, where possible, the impact of these constraints on firm/industry output.

To reassess the findings of the ICA 2007, we conducted a pilot survey in the Lahore region, covering 101 firms across 10 different sectors. The results of the pilot survey are not significantly different from the ICA's findings. Electricity was identified as the most severe obstacle facing industries in the Lahore region. Almost 71 percent of the firms surveyed declared electricity to be the most important constraint. Macroeconomic stability was ranked as the second-most important constraint by 8 percent of the firms surveyed. An inadequate workforce, access to raw materials, and corruption were ranked third, fourth, and fifth, respectively. The most chronic and binding constraint to industry in Punjab is, thus, the nationwide energy crisis. As evident from the recent pilot survey of firms in Lahore, the power shortfall has worsened over the last year and a half with an increase not only in the number of outages but also in the duration of each shutdown. These irregular and unannounced power cuts have an adverse impact on firm output and productivity, and affect process-based industries relatively more than others due to the increased wastage of raw material. Macroeconomic and political instability, which is manifested in the form of high investment risk, inflation, and increased interest rates, are the other two important factors contributing to industrial slowdown. Moreover, industries in Punjab remain hostage to bureaucratic inefficiency and rent seeking. This is especially the case with labor inspectors and low-tier customs officers. Inadequately trained labor has also been identified in the recent pilot survey as a critical factor impeding industrial performance.

For sustainable industrial growth, it is imperative that the government frame appropriate policy interventions that will resolve these issues in the long term. At the same time, the government needs to take immediate steps to mitigate the negative impact of these constraints on industrial output and productivity in the short run. This policy note puts forward the main contours of the Government of Punjab's strategy to address the problems that fall within its ambit. However, some of the key constraints faced by Punjab's industries do not fall under the direct jurisdiction of the provincial government. Fiscal and monetary policy and energy policy, for instance, are in the domain of the federal government. The Punjab government should, therefore, maintain a permanent contact/dialogue with the federal authorities to advise and play an active advocacy role on such issues. A set of constraint-wise policy recommendations for the Punjab government is given below.

#### 4.2. Electricity

In the Lahore zone, industrial sectors that suffer the highest loss due to electricity outages include food processing, plastics, pharmaceuticals, printing, and chemicals. These sectors report that they lose up to 15 percent of their annual sales as a result of power outages and unscheduled power cuts. All these sectors have continuous manufacturing processes and, at any one point in time, a significant amount of raw material is under process. A sudden, unannounced tripping of electricity can result in the wastage of raw materials and increased operation time due to cleaning and process restarting. Moreover, sectors that are more automated face high repair and maintenance costs as sudden electricity outages can damage the more sensitive and costly electronic parts. Most of these parts have to be sent abroad for repair, which adds significantly to costs. This is not a Lahorespecific issue; it affects the other industrial hubs of Punjab as well. For example, in Faisalabad, the food and machining sectors suffer most due to electricity shortages. In Gujranwala, the electronics and cutlery sectors are worst hit while in Sialkot, the leather and garments industries suffer most. Food processing is the worst affected by power outages in Sheikhupura and Wazirabad.

#### Policy Recommendations

In the short term, the Punjab government should work closely with electric supply companies and continuous process sectors to work out a harmonized load-shedding schedule. These sectors, especially those worst hit, should be provided electricity for a continuous stretch depending on their requirements. This schedule must be worked out sector by sector for all the process-based industries identified above.

The provincial government should facilitate linkages between the various university engineering departments to work closely with sectors on prefabricating and developing complicated programmable logic controllers (PLCs) that are used in all automatic machinery. Factories could provide access to university researchers and the government could fund research grants to work on developing PLC technology casted to local requirements.

The Lahore pilot survey suggests that, to some extent, firms located within industrial zones suffer fewer losses due to electricity shortages than those located outside industrial zones. A key reason for this is the strict scheduling of load management in industrial zones. The Punjab government should declare major industrial areas "zones" based on industrial concentration and afford them priority treatment.

#### 4.3. Corruption

Almost all the industrial sectors in the seven industrial hubs have identified corruption among government officials as a key cost to business and an impediment to industrial growth. In Lahore, the pharmaceuticals and chemical sectors appear to be the worst affected by undue contact with government officials. They are apt to receive the most visits by labor inspectors and drug regulatory inspectors, all of which entail some form of gift or even direct payment to the visiting inspector. In Faisalabad, textile industries receive the highest number of visits by labor inspectors and boiler inspectors. The other regions, too, complain about unnecessary visits by labor inspectors and, in most cases, report that inspectors ask directly for bribes or compensation.

On average, the industry loses anywhere between three to seven days resolving a single issue with government officials. The survey also reports that bribes and gifts given throughout the year amount to around 1–5 percent of total annual sales. In terms of the degree of corruption among officials, labor inspectors are considered the most corrupt, followed by electricity officials (mostly lineman and XEN) and boiler inspectors. Electricity officials often threaten to cut power supplies if not compensated appropriately by a firm. Over-billing is also a common problem and cases remain unresolved for several months while every month the industry owner has to pay bribes to have the bill corrected.

#### Policy Recommendations

In the short term, the Government of Punjab should set up an effective monitoring mechanism for labor inspectors devised in consultation with the private sector to reduce the incidence of harassment and bribery. In the medium term, the provincial government will have to devise a more transparent mechanism for collecting labor-related taxes. The system should be fair and simple so that it is easily understandable by the industry, increases incentives to pay taxes, and reduces the industry's interaction with the lower bureaucracy (labor inspectors). One way of simplifying the existing system would be to categorize industries into broad bands and then charge a fixed tax based on the upper value of the band. This would reduce the incentive for industries to hide information and make it easier to pay taxes. The broader band range would also facilitate the verification of industry status for tax collection purposes.

The Government of Punjab's Industries, Commerce, and Investment Department already has a consumer complaints cell, whose role could be further enhanced to cater for violations of the rights of industrial consumers. The cell should collect and receive information from industries concerning unfair treatment and corruption by government inspectors. Where cases pertain to the provincial domain, the provincial government should take direct action; where they pertain to the federal domain, the government should use the evidence to advocate appropriate action. The Government of Punjab needs to develop minimum service standards for industries and ensure that these are displayed in all government offices and circulated widely through mass advertisement campaigns. This would help industries understand their rights and obligations, and clarify the obligations and standards the government has to meet, making it easy to evaluate the performance of government service delivery.

### 4.4. Access to Finance

Given that the provision of finance and managing the banking sector falls under the State Bank's purview, the Government of Punjab can take some direct measures while strongly advocating other measures that would improve and enhance the provision of finance to its industry. Some of these policy interventions are suggested below.

# Policy Recommendations

Through its Department of Industries, Commerce, and Investment and the Punjab Small Industries Corporation, the provincial government could conduct a credit and product need assessment of key sectors located in the seven main industrial hubs of Punjab. Based on this information, it could suggest to the State Bank that the latter initiate product- and program-based lending at single-digit mark-ups in these sectors.

Again, through the Department of Industries, Commerce, and Investment, the Punjab government could also run training and capacity building courses for small and medium industries on formulating financial information in templates that are acceptable to commercial banks for loan processing.

Finally, the Punjab government should strongly advocate the following regulatory changes to the State Bank, to improve access to finance:

- Loans of up to PKR 15 million for plant, machinery, and equipment for registered industries should be approved through a "one-window" operation.
- The State Bank should make it mandatory for at least 50 percent of its lending requirements to SMEs to be fulfilled by including small accounts. The maximum size for an account to qualify as a small account could be set at PKR 20 million.
- Borrowing should be facilitated against guaranteed export orders.

- The State Bank should work with commercial banks to improve and enhance service provision to all industries. This could involve developing new lending guidelines for different sectors and different firms sizes. These guidelines should also include lending principles that clearly set out minimum standards for small, medium, and large businesses.
- Lending targets should be set up for each of the key industries located in Punjab; progress on achieving these targets should be monitored over the next three years.

#### 4.5. Inadequately Trained Workforce

Textiles, garments, and leather are the three main sectors across all seven regions in Punjab that have identified an inadequate workforce as a key constraint to industrial growth. All these sectors are labor-intensive and, moreover, require specific levels of skills. The problem of an inadequately trained workforce has become increasingly serious. As evident from the survey results, in 2006 it was viewed as less important than in 2012, when it was reported as one of the most critical issues that firms were facing.

A key reason for this is both the declining quality and level of school education in Pakistan as well as the introduction of technically advanced and more complicated machinery in factories. Since the workers entering industry have attained only a low level of education, their ability to understand complex machines is fairly limited. Firms have to spend a significant amount of resources to train labor to use newer machines. The TEVTA model has failed because it has not been able to keep pace with the advances in technology at the industry level. Without an appropriately trained workforce, industry in Punjab will find it increasingly difficult to remain internationally competitive.

#### Policy Recommendations

The Punjab government should initiate pilot programs for the textile and leather sectors, both of which suffer the most due to the shortage of skilled labor. The government could develop a model based on the Machine Operators Stitcher Training (MOST) program run by the federal Ministry of Textiles. The TEVTA trainer should work on the factory floor with a group of workers and provide them with classroom-based training while the factory provides on-the-job training. The workers trained under the program could then be contracted to continue working in

the factory for a certain amount of time after having been trained. The program mentioned was piloted for women stitchers and proved to be one of the most successful models of labor training. A similar model could be developed for the leather sector.

In the medium term, the Government of Punjab will have to restructure TEVTA's model entirely by closing down outdated service centers and using the resources saved to upgrade curricula, develop international linkages, and integrate courses with on-the-job (factory floor) training.

#### References

- Department for International Development. (2010). *Private sector development strategy for the Punjab*. Islamabad, Pakistan: Author.
- Manes, E. (2009). Pakistan's investment climate: Laying the foundation for renewed growth. (Vols. 1–3). Washington, DC: World Bank.
- Porter, M. E. (2007). *Clusters and economic policy: Aligning public policy with the new economics of competition* (Institute for Strategy and Competitiveness White Paper). Cambridge, MA: Harvard Business School.
- Porter, M. E., & Schwab, K. (2008). *The global competitiveness report 2008–2009*. Geneva, Switzerland: World Economic Forum.
- Punjab, Planning and Development Department. (2007). *Punjab economic report* 2007. Lahore, Pakistan: Punjab University Press.
- Punjab, Planning and Development Department. (2009). A strategy for accelerating economic growth and improving service delivery. Lahore, Pakistan: Author.
- Small and Medium Enterprise Development Authority. (2010). *Industrial clusters (Punjab): Investors' guide*. Lahore, Pakistan: Author.
- World Bank. (2006). *Pakistan: Growth and export competitiveness* (Report No. 35499-PK). Washington, DC: Author.

# The Birth of Exporters: Entry and Scale of Firms in Punjab's Export Sectors

Azam Chaudhry\*, Marjan Nasir\*\* and Maryiam Haroon\*\*\*

# Abstract

In this paper we analyze which factors affect new firm entry and the scale of new firms in the export clusters of Punjab. Our analysis looks at local conditions (such as the degree of concentration in an industry, the employment of firms of that industry already located in a region, the employment of firms of all industries located in that region) and international conditions (such as the real exchange rates of Pakistan's major trading partners and tariff rates). The results show that more export sector firms will enter highly concentrated industries and that firm entry increases significantly as a result of a depreciation in the trade-weighted real exchange rate, while the impact of changes in trade partner tariffs is not significant.

Keywords: Firm, export clusters, entry, Pakistan.

JEL classification: D22, F14.

# 1. Introduction

Though most economists believe that competitiveness is a critical issue both for countries at a macro-level and firms at a micro-level, very few agree on a formal definition of competitiveness. So, competitive firms enter and survive in both domestic and foreign markets, and competitive countries are those that produce goods and services that can survive the test of similar goods and services being produced in foreign countries. But competitiveness is difficult to pin down: According to standard economic theory, firms gain a competitive advantage through lower comparative costs of production by, for example, lower labor costs. However, recent research suggests that nonprice factors are equally important determinants of competitiveness. These factors include human resource endowment, technical factors such as research and development (R&D) capabilities and the ability to innovate, and managerial and organizational factors (Clark & Guy, 1998). So, in most cases we know that both firms and countries are

<sup>\*</sup> Associate Professor and Dean, Department of Economics, Lahore School of Economics.

<sup>\*\*</sup> Junior Teaching Fellow, Department of Economics, Lahore School of Economics.

<sup>\*\*\*</sup> Junior Teaching Fellow, Department of Economics, Lahore School of Economics.

competitive if they enter domestic and international markets and survive the resulting competition, but are left trying to figure out why they are competitive (or not competitive) after the fact.

In this article, instead of focusing on what makes sectors competitive, we look at the factors that impact the birth of new firms in the Pakistani export sector. Specifically, we determine which factors affect new firm entry and the scale of new firms in the export clusters of Punjab. What makes this analysis unique is that almost none has been conducted of the factors that affect firm entry in Pakistan. Our analysis looks at local and international conditions: The local conditions include the degree of concentration in an industry, the employment of firms of that industry already located in a region, the employment of firms of all industries located in that region, and the socioeconomic characteristics of that region. The international conditions we look at are the real exchange rates of Pakistan's two major trading partners, the US and EU, together with the tariff rates of the three countries under analysis.

The article is divided into the following sections: Section 2 presents graphical illustrations of the clustering of firms and briefly analyzes entry rates and the scale of entrants among firms of the major exporting clusters in Punjab. Section 3 reviews the literature on firm entry and scale. Section 4 presents our models of entry and scale, and Section 5 gives the results of our estimations. Section 6 provides a discussion of these results, and Section 7 concludes the article.

#### 2. Mapping Some Key Export Sectors

Figures 1–6 map the geographical breakdown of some of the major export sector clusters in Pakistan, with new entrants (firms) marked in yellow. The figures illustrate a few important points about the geographic location of export clusters: First, *there is a definite clustering of firms in each of these sectors*, implying that these firms are benefiting from geographical clustering. These benefits potentially include labor pooling, knowledge spillovers, and specialized inputs. Second, in some of these cases, *the clustering is not around just one location but rather multiple locations*. This implies that the benefits of geographical clustering of exporters are not limited to one location. Finally, as the figures show, *new entrants are definitely entering areas where there are already high concentrations of existing firms*.

Tables 1 and 2 show another interesting story about firm entry and scale in the export industries. As Table 1 indicates, *firm entry in the export industries is generally low and when one focuses on the textile sector (the*  *major export industry), one finds that firm entry here is extremely low,* which probably reflects many factors such as competitiveness, barriers to entry, scale of entry, etc. Table 2 shows the scale of new entrants: Here, entrants in the textile sector and cement sector tend to be significantly larger than entrants in other sectors.

Table 3 gives the Herfindahl index of various export industries on the basis of employment, which measures the degree of industry concentration. The index is negatively related to the level of agglomeration, implying that a high value of *H* is obtained when there are few firms in the industry, while a low value of *H* is obtained when there are many firms in the industry. As the figures show, the majority of exporting industries have a relatively low level of concentration or, in other words, are relatively less concentrated.

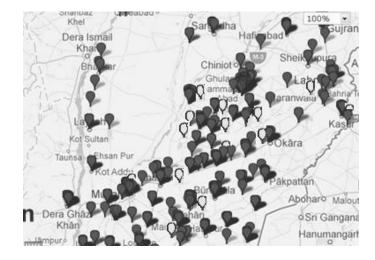


Figure 1: Location of firms in Punjab's textile industry (raw materials)

# Figure 2: Location of firms in Punjab's textile industry (processed materials)

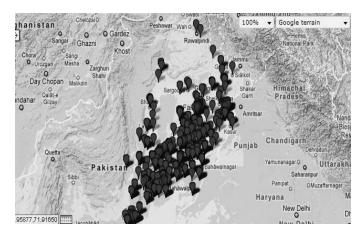
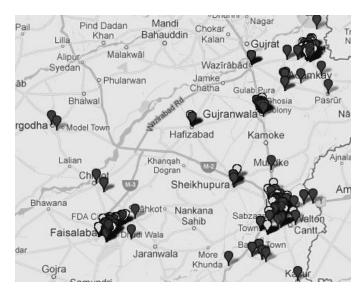


Figure 3: Location of firms in Punjab's textile industry (finished material)



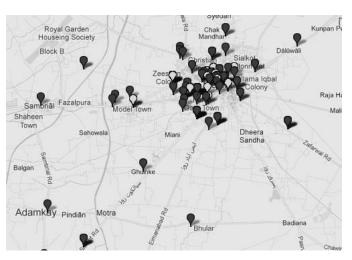
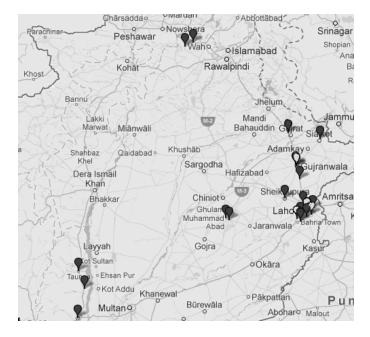


Figure 4: Location of firms in Punjab's sports industry

Figure 5: Location of firms in Punjab's carpet industry



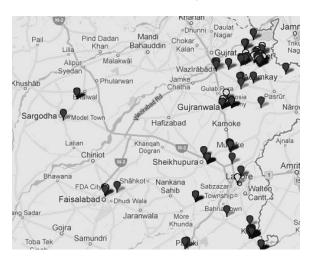


Figure 6: Location of firms in Punjab's leather industry

Industry	Entry in 2010
Arms and ammunition	0.200
Beverages	0.152
Rice	0.127
Cement	0.091
Plastic products	0.087
Chemicals	0.065
Paper and paper board	0.055
Vegetable ghee and cooking oil	0.047
Iron and steel	0.043
Rubber products	0.030
Wood products	0.029
Textiles (processing)	0.026
Textiles (finished goods)	0.026
Footwear	0.026
Sports goods	0.024
Leather	0.024
Glass	0.023
Surgical instruments	0.022
Baked products and confectionery	0.007
Textiles (raw material)	0.002
Carpets and rugs	0.000
Fruit preservation	0.000
Photographic goods	0.000
Spices	0.000

Table 1: Export industries ranked by firm entry, 2010

Note: The entry rate in industry *i* is equal to the number of new firms in industry *i* in 2010 that did not exist in 2006 ( $N_i$ ) divided by the total number of firms in industry *i* in 2010 ( $I_i$ ).

Industry	Scale in 2010	
Textiles (processing)	258	
Cement	167	
Vegetable ghee and cooking oil	97	
Footwear	93	
Beverages	90	
Textiles (finished goods)	82	
Glass	72	
Photographic goods	62	
Fruit preservation	58	
Paper and paper board	56	
Chemicals	55	
Carpets and rugs	53	
Sports goods	46	
Wood products	42	
Textiles (raw material)	31	
Baked products and confectionery	27	
Arms and ammunition	25	
Leather	24	
Rubber products	24	
Surgical instruments	21	
Rice	17	
Iron and steel	15	
Plastic products	14	
Spices	10	

Table 2: Export industries ranked by firm scale, 2010

Note: For the scale of new establishments, we use the employment level of new firms (regarded as arrival in estimation).

Industry	Herfindahl index 2006		
Spices	0.5050000000		
Wood products	0.0395782401		
Paper and paper board	0.0086241590		
Baked products and confectionery	0.0064635573		
Textiles (processing)	0.0007092910		
Sports goods	0.0002201743		
Textiles (finished goods)	0.0001751414		
Footwear	0.0000232100		
Chemicals	0.0000108631		
Beverages	0.0000091648		
Cement	0.0000071000		
Leather	0.0000056170		
Surgical instruments	0.0000053057		
Glass	0.0000038827		
Textiles (raw material)	0.0000027374		
Rice	0.0000015475		
Vegetable ghee and cooking oil	0.0000010848		
Iron and steel	0.000009847		
Rubber products	0.000007609		
Carpets and rugs	0.000007199		
Plastic products	0.000002131		
Arms and ammunition	0.000000089		
Fruit preservation	0.000000000		

Table 3: Export industries ranked by industrial concentration, 2006

Note: Herfindahl Index =  $\sum_{k} Z_{k}^{2}$  where  $Z_{k} = k^{\text{th}}$  firm's share of industry's employment.

#### 3. Literature Review

The literature on firm entry has emphasized the importance of entry rates for regional development. These benefits can either be direct, in the form of job creation, or indirect, such as improvements in supply conditions. Roberts and Thompson (2003) look at how new entrants add to resource flows into their industries by affecting the industry's productivity and contributing to product and technological innovation. They find that these entrants increase competition in the existing market, thus affecting firms' output, pricing, and nonpricing decisions. Caves (1998) shows that the hazard rate of new firms tends to decrease over time, and those that survive initial entry are likely to achieve higher growth rates. A number of authors have studied the impact of agglomeration (or firm concentration) on the entry of new firms (Devereux, Griffith, & Simpson, 2004; Dumais, Ellison, & Glaeser, 2002; Carlton, 1983; Rosenthal & Strange, 2007) and their findings suggest that agglomeration has a significant impact on the entry of small firms and low-tech firms. The basic idea behind this relationship is that new establishments or plants are more likely to locate where their input suppliers are located or where other, similar firms or plants exist, which allows new establishments to take advantage of positive externalities in the form of labor pooling or technological or knowledge spillovers.

These effects can vary across industries as well as geographic areas. Porter (2000) puts forward several reasons for why new businesses are more likely to establish within a cluster rather than a remote area. One of these reasons is the presence of lower barriers to entry and exit. Resources such as assets, skills, and inputs are readily available in a cluster, explaining why entry rates are higher in clusters. Similarly, exit rates are also higher due to smaller requirements for specialized investment. The combination of lower entry and exit barriers, together with intense competition from incumbent firms in a cluster, results in high entry and exit rates of firms in more agglomerated industries. However, some studies have found that agglomeration negatively affects new firm entry, as measured by employment share, especially among large firms as they seem to be more fully integrated than small firms.

Recently, authors have divided agglomeration into two parts: localization and urbanization. Localization describes the impact on firms of locating in a specific region within a specific industry; urbanization looks at the benefits accruing to firms by locating near other firms, regardless of the type of industry to which they belong. While knowledge spillovers (see Parr, 2002) and labor pooling are the major benefits to a firm from localization, some of the benefits of urbanization are the presence of diversified suppliers, specialized labor and suppliers, and diversified production (Bosma, Stel & Suddle, 2006).

Rosenthal and Strange (2007) employ a geographic approach to examine the effect of agglomeration (urbanization and localization) on new firm arrival and the scale of their operation for small, medium, and large establishment levels in the US. They find that urbanization significantly affects arrival and the scale of operation in small establishments in manufacturing industries, while localization affects arrival and the scale of operation in medium establishments within manufacturing industries. Otsuka (2008) performs a similar analysis for new firm formation in Japan, and finds that localization and urbanization positively and significantly affect the creation of new firms in the manufacturing industry, but do not lead to new firm formation in the services industry.

Looking beyond local conditions, some researchers have analyzed the effect of international shocks on firm entry and exit. Baggs, Beaulieu, and Fung (2007) find that an appreciation of the currency reduces sales and, hence, the survival of existing firms, while Head and Reis (1997) conclude that a depreciation of the currency tends to increase the number of establishments as well as the scale of production of existing firms. Another branch of the research has looked at the impact of changes in tariffs on firm entry and survival. Head and Reis (1997) find that a decrease in home tariffs leads to an increase in plant closure and a reduction in the scale of production of existing plants in the home country. A reduction in foreign tariffs results in an increase in scale, but does not induce the entry of firms. Gu, Sawchuk, and Whewell (2003) look at firm size and turnover caused by a reduction in tariffs under the free trade agreement (FTA) between the US and Canada, and find that less productive firms exit after tariff reductions.

#### 4. The Models

#### 4.1. Impact of Industrial Concentration and Trade Factors on Firm Entry

In this section, we present a model of new firm entry similar to that used by other researchers (see Carlton, 1983; Devereux et al., 2004; Dumais et al., 2002). In this model, the entry of new firms in exporting sectors is regressed against industrial concentration and trade variables while controlling for other factors that affect firm entry. Our specific equation looks at the impact of industrial concentration and trade liberalization, following a model used by Baggs et al. (2007), where the entry of new firms in the export sectors is regressed against the real exchange rates of Pakistan's two major trading partners, the US and the EU, together with the tariff rates of the three countries under analysis. Firm-level data is taken on 25 exporting industries for the years 2001–10. The model specification is given below:

$$Entry_{it} = E_{it} = \frac{N_{it}}{T_{it}} = \beta_{0i} + \beta_2 ER_{it} + \beta_3 \Delta tariff_{it}^{PK} + \beta_4 \Delta tariff_{it}^{US} + \beta_5 \Delta tariff_{it}^{EU} + \beta_6 X_{it} + \tau_t + \varepsilon_{it}$$
(1)

 $E_{it}$  is the number of new firms in industry *i* in year *t* ( $N_{it}$ ) divided by the number of incumbent firms in industry *i* in year *t* ( $I_{it}$ );  $ER_{it}$  is the industry-specific trade-weighted real exchange rate;  $\Delta tariff_{it}$  represents

changes in Pakistan, US, and EU tariff rates at the industry level; X is the vector of control factors (firm age, firm size, sunk cost, output growth, and concentration ratio); and  $\tau$  is the time trend.

The variable measuring entry is calculated for two time periods, i.e., 2001–05 and 2006–10, using the year of establishment as an indicator of the firm being a new establishment in the industry as a fraction of the total number of firms in the industry for that year. To measure the entry rate of new firms, we compare data for two years, e.g., firms that existed in 2006 but not in 2002 are considered new entrants.

The vector of control variables includes other industry factors that impact the entry of firms, such as average firm size in the industry, sunk cost or initial investment by the firm, and output growth of the industry.

In order to measure agglomeration, we use the Herfindahl index, which measures industrial concentration. The index is given below for industry *i*:

$$H = \text{Herfindahl index: } \Sigma_k Z_k^2 \tag{2}$$

where  $Z_k$  is the *k*<sup>th</sup> firm's share of the industry's employment.

The index is also a rough indicator of the industry's market structure. It is negatively related to the agglomeration index, implying that a high value of H is obtained when there are few firms in the industry and will result in lower agglomeration; conversely, a high value of H will be associated with a large number of firms in the industry with higher agglomeration.

The trade-weighted real exchange rate variable<sup>1</sup> (*ER*) is constructed using the equation

$$ExchangeRate_{it} = ER_{it} = \sum_{i \in top2} TW_{ii} rer_{it}$$
(3)

where *i* represents industry, *j* represents the top two trading partners of the industry (the US and EU in the case of Pakistan), and *t* represents the time period (2001–10). The trade weight,  $TW_{ij}$ , is estimated by taking the share of the industry's exports and imports with the trading partners as a proportion of the total exports and imports of all the manufacturing industries exposed

<sup>&</sup>lt;sup>1</sup> See Baggs et al. (2007, Appendix).

to trade with the top two trading countries. The other term,  $rer_{jt}$ , refers to the real exchange rate in terms of the two trading countries, which will be normalized for each country using 2000 as the base year.<sup>2</sup>

Changes in tariff rates for all the years between 2000 and 2010 for each industry in the analysis are taken from World Trade Organization data. Initial investment is used as a proxy for sunk costs and other control variables including industry concentration, averages of firm size, age, and output growth in the industry. We also include time and industry fixed effects.

#### 4.2. Impact of Local Conditions on Firm Entry and Scale

In our second analysis we investigate whether industrial agglomeration in a particular district affects firm entry and the scale of exporting industries in Punjab. Specifically, we examine how firm entry and scale in these industries is affected by local environment, which is measured by urbanization, localization, and the socioeconomic indicators of a district. Urbanization is measured by employment in existing establishments within a particular district, while localization is measured using employment in each industry for every district.

We use urbanization to see how the presence of all industries leads to new firm formation in a specific area; we use localization to see how the presence of firms from the same industry leads to new firm formation in a specific area. Our empirical specification follows that of Rosenthal and Strange (2007). The following equations are empirically estimated:

$$Arrival_{id} = A_{id} = \beta_0 + \beta_1 localization_{id} + \beta_2 urbanization_d + \beta_3 X_d + \beta_{4i} + \beta_{5sp} + \varepsilon_{a,id}$$

$$(4)$$

Scaleofoperation<sub>id</sub> = 
$$E_{id} = \alpha_0 + \alpha_1 localization_{id} + \alpha_2 urbanization_d + \alpha_3 X_d + \alpha_{4i} + \alpha_{5sp} + \varepsilon_{e,id}$$
 (5)

We use 2008 manufacturing industry data from Punjab to calculate firm arrival and scale of operation in the following way. First, we analyze the year of establishment of firms, and calculate firm-level arrivals. Then, we aggregate these firms for each industry and district, giving us arrivals  $A_{id}$  in industry *i* and district *d*. Those firms that reported their year of establishment as 2008 are regarded as new establishments. For the scale of

<sup>&</sup>lt;sup>2</sup> This is done to avoid the unit problem, which occurs when bilateral exchange rates have different units.

new establishments, we use the employment level of new firms. The two forces of agglomeration are calculated by aggregating activity in a particular industry in a district and total activity in a district for 2006.

In the equation above,  $\beta_{4i}$  and  $\alpha_{4i}$  are industry fixed effects and  $X_d$  represents the socioeconomic factors of a particular district. Localization includes the employment level of firms in the same industry where arrival occurred within a particular district; urbanization includes the employment level of firms in all industries within a particular district. For our analysis, we also disaggregate localization and urbanization into three levels of establishment: small, medium, and large. Small establishments are limited to firms with fewer than 10 workers, and medium establishments to those with between 10 and 49 workers, while large establishments are characterized as those with 50 or more workers.

Our specification also includes the socioeconomic characteristics of a district,  $X_d$ , such as the average age of the population, percentage of male population, average income, unemployment rate, percentage of population with primary education, percentage of population with secondary education, and percentage of population with more than secondary education. In addition to these variables, we have also incorporated industry fixed effects to account for industry-level characteristics that might affect entry into specific industries, and industry heterogeneity, which may be due to innovation, technological shift-over, new input introduced, etc. Fixed effects at the subprovincial level are also incorporated.

#### 5. Results

#### 5.1. Impact of Industrial Concentration and Trade Factors

Table 4 presents the results of our analysis on the entry of export sector firms in manufacturing industries in Punjab from 2001 to 2010 as affected by industrial concentration and international factors. In this analysis, the firm entry variable is the ratio of new firms that have entered between time period t and t-5 over the total number of firms present in t.

The first thing to note is that the impact of agglomeration is positive and significant, showing that more firms will enter highly concentrated industries, holding other industry factors constant. *Put more simply, more firms enter less competitive industries.* 

The results also show that a higher cost of entry does not have an impact on the entry of new firms into the export industries (where high cost in this analysis is defined as initial investment or a sunk cost of more than PKR 10 million incurred by firms). *This implies that new entrants do not necessarily have to be large investors in their respective sectors.* 

Another interesting result is that the trade-weighted real exchange rate has a significant impact on firm entry. *More specifically, firm entry increases significantly as the result of depreciation in the trade-weighted real exchange rate.* The impact of changes in EU and US tariffs is not significant, but this may be because of the lack in variation in these tariff rates.

	Entry
ER	-24.205**
(Increase = appreciation of PKR)	(9.5196)
Tariff PK	0.002
	(0.0067)
Tariff EU	-0.0445
	(0.0317)
Tariff US	0.0002
	(0.0030)
Concentration index	0.119***
	(0.0401)
Output growth	0.005
1 0	(0.0341)
Firm age	-0.001
0	(0.0053)
Firm size = small	-0.071
(Dummy = 1 if < 49 employees)	(0.7564)
Firm size = medium	-0.099*
(Dummy = 1 if $\geq$ 49 and < 100 employees)	(0.052)
Firm size = large	_
(Dummy= 1 if $\geq$ 100 employees)	
High cost	-0.061
(Dummy = 1 if sunk cost > PKR 10 m)	( 0.1161)
cons	0.566***
_	(0.1664)
	N = 48
	$R^2 = 0.1838$

# Table 4: Trade liberalization results for firm entry

Note: \*\*\* denotes statistical significance at the 1 percent level, \*\* denotes statistical significance at the 5 percent level, and \* denotes statistical significance at the 10 percent level. Robust standard errors are given in parentheses.

# 5.2. Impact of Local Conditions on Firm Entry and Scale

Table 5 shows the impact of local conditions on firm arrivals, using data on local conditions from 2006 and 2004. We have analyzed localization and urbanization both at an aggregated and disaggregated level (where disaggregation is done by establishment size). The aggregated level analysis shows that localization positively and significantly impacts firm arrivals while urbanization has no significant impact. The disaggregated analysis show that localization has a positive and significant impact on arrivals when one focuses on small and large-scale localization (or, in other words, when one looks at the total employment in small- and large-scale firms of the same industry), while urbanization has a positive and significant impact on firm arrival in medium-scale urbanization (or, in other words, when one looks at the employment in all medium firms). These results mean that greater employment in small and large firms from the same industry leads to more new firms entering that area (though the presence of small firms is more attractive to potential new entrants than the presence of large firms). Also, potential new firms are more attracted to districts with more overall employment in medium firms. So, localization and urbanization have a positive impact on firm arrival.

In addition to localization and urbanization, we also look at the impact of district-level socioeconomic characteristics as well as industry fixed effects. *The results show that the average income of a district has a positive and significant impact on arrival, which is as expected since higher income in a district implies a higher level of resources available for new entrepreneurs with which to start their own businesses.* The results continue to hold when local environment is measured using 2004 data.

The analysis is also carried out for the scale of arrivals, which examines how a district's local conditions affect the scale on which new firms operate. The results are presented in Table 6. The aggregated analysis shows that localization positively and significantly affects the scale of operation, while the disaggregated analysis shows that localization positively and significantly impacts the scale of arrival when one focuses on small and large firms, though the impact is greater for small firms while urbanization has a positive impact on the scale of operation in medium firms. *These results mean that greater employment in small and large firms from the same industry leads to larger firms entering that area (though the presence of small firms is more attractive to potential new entrants than the presence of large firms). Also, potential new firms tend to be larger in districts with more* 

*employment in medium firms*. So, localization and urbanization both have a positive impact on the scale of new firms in an area.

We also carry out the estimations by incorporating local activity for 2004. The results are consistent as they were for 2006, and show that average income has a positive impact on the scale of operation of new firms.

#### 6. Discussion

The analysis shows that new firms take advantage of the presence of other firms in their sector (both in terms of the number of entrants and size of new entrants), which makes sense since these firms can benefit from labor pooling, input sharing, and knowledge spillovers from the existing firms. What makes this result more interesting is that these firms benefit both from the existence of small firms *in their own sector* and from large firms *in their own sector*. While the importance of small firms can probably be explained by the advantages gained by positive externalities, large firms might be important because they produce sufficiently skilled workers who decide to open their own businesses after gaining experience.

At the same time, new firms also benefit from the presence of medium firms in general (and not just from medium firms in their own sector). This also makes sense since the presence of more firms in general tends to improve the quality of support industries (such as repair and servicing) while also giving rise to a greater number of vertically integrated firms. However, firm entry is hindered (both in terms of the number and the size of new entrants) by the presence of a greater number of large firms in general, which probably reflects entry barriers, higher costs, and possible constraints to the availability of labor and financing.

Finally, higher average income in a geographic area helps new firms (both in terms of the number and size of new entrants), which makes sense since these areas have more entrepreneurs with the means to start their own businesses and also greater access to external financing.

			Ar	rival		
	2006			2004		
	(1)	(2)	(3)	(4)	(5)	(6)
Aggregated localization	3934.236**			38794**		
Localization at small scale		194281*	205158**		198648*	209833**
Localization at medium scale		21437	13521		20880	13098
Localization at large scale		3027	3659*		2990	3616*
Aggregated urbanization	-550.459	-988.607		-558.94	994.654	
Urbanization at small scale			-19384			-20159*
Urbanization at medium scale			14634*			15188*
Urbanization at large scale			-3571**			-3644**
Socioeconomic characteristics of a distric	t					
Average age of population	0.01596904	0.01085033	0.0115291	0.01598928	0.010627	0.010847
Percent male population	-0.0519539	-0.05499426	-0.018975	-0.051476	-0.05468	-0.018145
Average income	0.0002505619*	0.000203447	0.0029254**	0.00025166*	0.00020324	0.000298505**
Unemployment rate	0.0002505619*	-0.009172229	-8.67733E-05	-0.013586	-0.009151376	0.000418588
Percent pop. with primary education	-0.01832154	-0.01024366	-0.0137946	-0.0183695	-0.01004939	-0.013771
Percent pop. with secondary educ.	0.0019754	-0.020024	0.0076339	0.00217344	-0.020491	0.007152
Percent pop. with higher education	-0.002960593	0.003375783	-0.015986	-0.0029735	0.003723236	-0.01597
Industry fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Sub-provincial regions	Yes	Yes	Yes	Yes	Yes	Yes

## Table 5: Agglomeration results for firm arrivals

		Scale of operation					
		2006			2004		
	(1)	(2)	(3)	(4)	(5)	(6)	
Aggregated localization	17898**			175579**			
Localization at small scale		9430186**	1.10e+07**		9646903**	1.13e+07**	
Localization at medium scale		587514	294886		559391	271627	
Localization at large scale		150407*	192249**		148035*	189612**	
Aggregated urbanization	-5663	-22625		-5955	-22886		
Urbanization at small scale			-1024564*			-1060941*	
Urbanization at medium scale			768114**			792030**	
Urbanization at large scale			-156929**			-159869**	
Socioeconomic characteristics of a distri	ict						
Average age of population	0.724452	0.5131922	0.5503167	0.000722825	0.504726	0.5146129	
Percent male population	-2.447507	-2.646506*	-0.969514	-0.002414107	-2.62501*	-0.928672	
Average income	0.008386	0.00591978	0.011635*	8.3884E-06	0.005880089	0.011874*	
Unemployment rate	-0.89098*	-0.7101415	-0.240239	-0.0008899948*	-0.7090727	-0.2163552	
Percent pop. with primary educ.	-0.500209	-0.1530962	-0.434951	-0.000498685	-0.14317	-0.432097	
Percent pop. with secondary educ.	-0.373646	-1.354276	139.046	-0.000366887	-1.37588	0.126916	
Percent pop. with higher educ.	0.173279	0.4668232	-0.569959	0.00017452	0.4831995	-0.563173	
Industry fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	
Sub-provincial regions	Yes	Yes	Yes	Yes	Yes	Yes	

## Table 6: Agglomeration results for scale of operation

#### 7. Conclusions

The analysis in this paper has shown that more export sector firms will enter highly concentrated industries. The results have also shown that firm entry increases significantly as a result of depreciation in the tradeweighted real exchange rate, while the impact of changes in EU and US tariffs is not significant.

We have also found that greater employment in small and large firms from the same industry leads to more new firms entering that area (though the presence of small firms is more attractive to potential new entrants than the presence of large firms). Also, potential new firms are more attracted to districts with greater overall employment in medium firms. Greater employment in small and large firms from the same industry also leads to larger firms entering that area (though the presence of small firms is more attractive to potential new entrants than the presence of large firms). In this case, potential new firms tend to be larger in districts with more medium firms.

Focusing on district-level characteristics, the results have shown that a district's average income has a positive and significant impact on arrival, which is as expected since higher income in a district implies that there are greater resources available for new entrepreneurs with which to start their own businesses.

From an industrial policy perspective, the results of this analysis imply that the optimal location for new entrants in export industries are the existing clusters for those sectors, but not in areas where there are already a significant number of large industries. Moreover, even though there is an obvious temptation for policymakers to promote industrial development in less-developed regions, higher-income areas are likely to better suit new entrants and existing firms. Finally, while both new and existing firms do benefit from depreciations in the currency, there is insufficient data to say for certain whether they also benefit from reduced tariffs. So, as policymakers look to create new locations to stimulate growth, from the perspective of exporting firms, the old locations are far better.

#### References

- Baggs, J., Beaulieu, E., & Fung, L. (2007). Firm survival, performance, and the exchange rate. *Canadian Journal of Economics*, 42(2), 393–421.
- Bosma, N., Stel, V. A., & Suddle, K. (2006). *The geography of new firm formation: Evidence from independent start-ups and new subsidiaries in the Netherlands* (Working Paper, EIM Business and Policy Research). Bedford, UK: Cranfield University School of Management.
- Carlton, D. W. (1983). The location and employment choices of new firms: An econometric model with discrete and continuous endogenous variables. *Review of Economics and Statistics*, 65(3), 440–449.
- Caves, R. E. (1998). Industrial organization and new findings on the turnover and mobility of firms. *Journal of Economic Literature*, 36(4), 1947–1982.
- Clark, J., & Guy, K. (1998). Innovation and competitiveness: A review. *Technology Analysis and Strategic Management*, 10(3), 363–395.
- Devereux, M. P., Griffith, R., & Simpson, H. (2004). The geographic distribution of production activity in the UK. *Regional Science and Urban Economics*, *34*(5), 533–564.
- Dumais, G., Ellison, G., & Glaeser, E. L. (2002). Geographic concentration as a dynamic process. *Review of Economics and Statistics*, 84(2), 193–204.
- Ellison, G., & Glaeser, E. L. (1997). Geographic concentration in US manufacturing industries: A dartboard approach. *Journal of Political Economy*, 105(51), 889–927.
- Gu, W., Sawchuk, G., & Whewell, L. (2003). The effect of tariff reductions on firm size and firm turnover in Canadian manufacturing. *Review* of World Economics, 139(3), 440–459.
- Head, K., & Reis, J. (1997). Rationalization effects of tariff reductions. *Journal of International Economics*, 47(2), 295–320.
- Otsuka, A. (2008). Determinants of new firm formation in Japan: A comparison of the manufacturing and service sectors. *Economic Bulletin*, *18*(4), 1–7.

- Parr, B. J. (2002). Missing elements in the analysis of agglomeration economies. *International Regional Science Review*, 25(2), 151–168.
- Porter, M. E. (2000). Locations, clusters, and company strategy. In *The Oxford handbook of economic geography* (pp. 253–274). Oxford, UK: Oxford University Press.
- Roberts, B. M., & Thompson, S. (2003). Entry and exit in a transition economy: The case of Poland. *Review of Industrial Organization*, 22(3), 225–243.
- Rosenthal, S. S., & Strange, W. C. (2007). Small establishments/big effects: Agglomeration, industrial organization and entrepreneurship. In E. Glaeser (Ed.), *The economics of agglomeration*. Chicago, IL: University of Chicago Press.

## Competitiveness and Pakistan: A Dangerous, Distorting, and Dead-End Obsession?

### Matthew McCartney\*

#### Abstract

Competitiveness has become a mantra and organizing framework for much government policymaking in Pakistan and beyond. Rarely does anyone question the concept and use of the competitiveness paradigm itself. Krugman (1994) argues that this "obsession with competitiveness is both wrong and dangerous." This article draws from Krugman's work and examines the use (or abuse) of the concept of competitiveness in the context of contemporary Pakistan. We focus on three recent and influential reports on competitiveness in Pakistan by the Asian Development Bank, World Bank, and Competitiveness Support Fund, and agree with Krugman's negative view.

Keywords: Competitiveness, policy, Pakistan.

#### JEL classification: E60.

#### 1. Introduction

In the 1990s, the concern with competitiveness, or more specifically the apparent lack of it, became something of an obsession in the countries of the European Union (EU). Earlier euphoria at the end of the Cold War and the resulting prospects for pan-European integration faded. Anxious governments looked aghast as manufactured exports surged from China while GDP and employment growth stalled through much of the EU. These twin narratives of rising China and stagnant Europe were frequently ascribed to "competitiveness," the abundance of it in rapid growth, disciplined, low-wage, hard working China and the lack of it in slow growing, highly regulated, high-wage, early retirement-addled Europe. In Europe, this combination became known by some as "Eurosclerosis."

These concerns acquired the status of a numerical measure through the Global Competitiveness Report with its index and league table of "competitiveness" published by the World Economic Forum. The report

<sup>\*</sup> Lecturer, Wolfson College, University of Oxford.

had been published since 1979 but by the 1990s was including most of the world in its rankings, and shifts up and down the table became an annual obsession for much of the media in both developed and developing countries. In response to the 2012 Global Competitiveness Report for example, the British *Guardian* excitedly reported that Italy needed a "red tape bonfire before labor reform" ("Italy needs red tape," 2012). The debate in the developed world was nicely captured in Klein's 1996 novel, *Primary colors*. The following is a quote from the character in the book based on Clinton campaigning for the presidency in 1992:

So let me tell you this: No politician can bring these shipyard jobs back. Or make your union strong again. No politician can make it be the way it used to be. Because we're living in a new world now, a world without borders-economically, that is. Guy can push a button in New York and move a billion dollars to Tokyo before you blink an eye. We've got a world market now. And that's good for some. In the end, you've gotta believe it's good for America. We come from everywhere in the world, so we're gonna have a leg up selling to everywhere in the world. Makes sense, right? But muscle jobs are gonna go where muscle labor is cheap—and that's not here. So if you want to compete and do better, you're gonna have to exercise a different set of muscles, the ones between your ears. And anyone who gets up here and says he can do it for you isn't leveling with you. So I'm not gonna insult you by doing that. I'm going to tell you this: This whole country is gonna have to go back to school. We're gonna have to get smarter, learn new skills. And I will work overtime figuring out ways to help you get the skills you need. I'll make you this deal: I will work for you. I'll wake up every morning thinking about you. I'll fight and worry and sweat and bleed to get the money to make education a lifetime thing in this country, to give you the support you need to move on up.

Competitiveness has become a mantra and organizing framework for much of government policymaking in Pakistan and beyond. Arguments that reforms of labor markets, universities, infrastructure, or social legislation are needed to ensure "competitiveness" are frequently heard. There are counter-arguments, which tend to accept the validity of the competitiveness argument, such as whether a given reform will have a significant impact on competitiveness, whether other pro-competitiveness policies are more desirable, or whether the loss in terms of equity or welfare of some group is too much to sacrifice in the pursuit of competitiveness. Rarely does anyone question the concept and use of the competitiveness paradigm itself. Krugman (1994) is an exception—he has noted how the concept is a "growing obsession" and "taken for granted" but ultimately that "competitiveness is a meaningless word when applied to national economies ... the obsession with competitiveness is both wrong and dangerous" (1994, p. 44). This article draws from his work and examines the use (or abuse) of the concept of competitiveness in the context of contemporary Pakistan.

To narrow the analysis to manageable portions, we focus on three recent and influential reports on competitiveness by major organizations: (i) Industrial competitiveness: The challenge for Pakistan, published by the Asian Development Bank in 2004, (ii) The state of Pakistan's competiveness: Report 2010-2011, published by the Competitiveness Support Fund (a partner institution of the World Economic Forum and heavily funded by USAid), and (iii) Pakistan: Growth and export competitiveness, published by the World Bank in 2006. For ease of presentation, these three reports will henceforth be referred to as ADB, CSF, and WB, respectively. The reports should not be viewed as abstract economic commentaries by outsiders but as real and fundamental inputs into the policymaking process. All three donor organizations have a substantial impact on policymaking in Pakistan. Zaidi (2005, Ch. 15), for example, argues that, since 1988, Pakistan's economic policies have been "completely determined by adherence to the IMF/WB, and that Pakistan's government have no independent policies of their own." This may be something of an exaggeration but these reports have an importance beyond anything equivalent in India or China.

The article is organized as follows. Section 2 introduces the three Pakistan-related competiveness reports, in particular their understanding of the term "competitive" and their stated goals, and states how we will evaluate them. Sections 3 to 6 evaluate the three reports using the criteria outlined in the previous section, i.e., "theoretical and empirical consistency," "feasibility of policy recommendations," "use of evidence from comparator countries," and "learning from past policy interventions." Section 7 concludes the article.

#### 2. An Introduction to the Competitiveness Reports

Despite the fanfare with which "competitiveness" is discussed, there is no clearly accepted and unambiguous definition of the concept. CSF draws on the Global Competitiveness Reports, which define competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of a country" (World Economic Forum, 2012, p. 4). For CSF, competitiveness is positively related to productivity, whether relative or absolute is not made clear. The definition ignores the possibility that low levels of productivity can be offset by low domestic costs or devaluation of the exchange rate.

There is no clear definition evident in WB—the report simply lists a number of things that contribute to competitiveness: "an investment friendly business environment" (World Bank, 2006, p. i), "macroeconomic stability" (p. i), "transport logistics and trade facilitation" (p. 5), and on and on. ADB is, however, much clearer: "Competitiveness means the ability to compete with firms at the international frontier of best practice" (Asian Development Bank, 2004, p. xiii). This does not make much sense. Either only a small number of technologically advanced countries are able to compete at the best practice frontier so that "competitiveness" has no general applicability, or else all countries can attain competitiveness in export markets simply by devaluing their currency and maintaining low wages until cost considerations offset quality differences, so attaining competitiveness is something relatively easily accomplished. Without a rigorous measure, it becomes impossible to quantify competitiveness and so prioritize policy interventions. Section 4 of this article shows the real and bewildering implications of this first failing.

In various degrees, the three reports seek to offer guidance to policymakers. For WB, "This report focuses on the goal of accelerating Pakistan's economic growth and on the related challenge of export competitiveness and ways to meet it ... The findings of the report also point to a number of high priority areas where early actions might have high payoffs, some requiring stroke of the pen type policy decisions, some longer term effort" (World Bank, 2006, p. 147). WB contains a detailed list of recommendations for action. ADB is more reticent, concluding that there is a "need for a competitiveness strategy" (Asian Development Bank, 2004, p. 61) and "lessons from East Asia" (p. xx) but "refrain from making detailed policy recommendations" (p. 2). CSF is explicit: "This report is designed to help policymakers ... its objective is not simply to issue a report, but to motivate and stimulate effective action" (Competitiveness Support Fund, 2010, p. vi). As noted above, these reports and the influence

their writers/funders have on the policymaking process in Pakistan gives them an importance in determining policy beyond anything they care to make explicit in the reports.

This article evaluates the reports according to their own stated aims. To what extent are they useful as guides to policymaking? We use the following list of criteria against which to make this judgment. Are the reports theoretically consistent, are the policies they recommend feasible, do they make good use of evidence from comparable countries, are they rooted in a clear understanding of the opportunities and constraints of the Pakistani context, and do they draw on an understanding of the successes and failures of past efforts to promote similar policy reforms? The following sections examine each of these criteria in turn.

#### 3. Theoretical and Empirical Consistency

There are a few criticisms one could make about the compilation of the indices. For example the global competitive index (GCI)-on which CSF is based-draws much of its data from its own "Executive Opinion Survey." The survey for the 2012 report is carried out among 130 executives in Pakistan; 85 of these 130 (65 percent) worked in firms with more than 100 employees. This is not representative of Pakistan's business community where, by the mid-2000s, 70 percent of new jobs in nonagricultural employment were being created in the informal sector (Amjad, 2005) and 98 percent of manufacturing firms were small-scale. Executives are more likely to notice and be concerned with the state of airlines, airports, and centrallevel corruption and not the roads, public transport, public service delivery, and everyday petty corruption that would trouble the mass majority of the (smaller-scale) business community. Some of the sub-indicators used are very puzzling. Why, for example, is infant mortality included and, however desirable, why would reduced infant mortality make an economy more competitive? This article, though, is more concerned with a bigger question-the use and abuse of "competitiveness" as a central organizing theme for policy and governance reform in Pakistan.

The first and rather unfortunate thing about the GCI is that it has no link with economic growth. Table 1 shows that the top ten most competitive countries in the world according to the 2005 Global Competitiveness Report and their GDP growth rates in 2004/05. The table shows that the most competitive countries in the world experienced slow but positive growth rates (before the global financial crisis made their performance noticeably worse).

GCI ranking 2005	Country	GDP growth rate in 2004/05 (%)
1	US	2.5
2	Finland	1.8
3	Denmark	2.8
4	Switzerland	1.2
5	Singapore	3.7
6	Germany	0.9
7	Sweden	2.3
8	Taiwan	4.0
9	UK	1.2
10	Japan	2.6

Table 1: Growth and competitiveness in 2004/05: Top ten GCI rankings

Source: World Bank (2007, pp. 288-289) and World Economic Forum (2006, p. xii).

Table 2 shows the fastest (mainly nonoil) growing countries in 2004/05 and their GCI scores for 2005. The table shows that fast growing countries generally have very low competitiveness scores.

GCI ranking 2005	Country	GDP growth rate in 2004/05 (%)
29	Czech Republic	6.2
34	Lithuania	8.0
39	Latvia	10.8
45	India	7.1
48	China	9.2
71	Turkey	6.0
74	Vietnam	7.4
81	Armenia	14.4
86	Georgia	10.5
89	Moldova	7.3
112	Mozambique	8.7
116	Ethiopia	6.8
125	Angola (2006)	11.5

Table 2: Growth and competitiveness in 2004/05: Fastest growing countries

Source: World Bank (2007:288-9) and World Economic Forum (2006:xii).

This is, admittedly, very limited empirical evidence—that growth in one year is not linked to a country's competitiveness in that same year. More valid perhaps would be to relate a longer-term average of competitiveness against long-term growth. But it is more empirical evidence than either WB or CSF offer. There is a very well developed empirical literature going back to Barro (1991) examining the determinants of economic growth through the use of cross-country regression analysis. This literature has examined the impact of investment, trade liberalization, institutions, political stability, and many others. It is not clear why WB and CSF shy away from including the GCI in such a regression. From the limited empirical evidence above, a good guess would be that it would have (embarrassingly) little link with growth. In truth, there is no good reason to assume that the GCI should have any close link with GDP growth rates. There are two reasons for this: first, the theoretical and empirical complexities linking competitiveness and growth, and second, the problematic issue of causation.

Both WB and CSF assert with strident hubris that all sorts of policy and institutional factors are good for promoting growth. Yet, first, nowhere does either report discuss, reference, or even acknowledge the enduring theoretical and empirical controversies surrounding the causes of economic growth. A good example is that of education—for both WB and CSF, more education is always and everywhere a good thing and always improves the GCI. A large body of theoretical discussion would agree, emphasizing the potential productivity gains for educated workers, indirect impacts on health and fertility, and the strengthening of democratic norms that may result from the greater ability of literate people to participate in debate and discussion.

There is also, though, a well established body of theory that questions such optimism, suggesting that rising educational attainments may reflect intensifying competition for a limited number of poorly paid jobs (a government clerk position that once required high school graduation may now require a Master's degree). It also casts doubt on the quality of much education or its relevance for equipping people with the skills to work in the fields and factories of a developing country. In general, empirical studies find it very difficult to locate any positive impact from education to economic growth. In his 2001 study, Pritchett made a plaintive call, "Where has all the education gone?" Studies looking at the educationgrowth link are mixed for Pakistan. Khan (2005) finds positive and significant results linking literacy rates, average years of schooling, gross secondary school enrolment, and life expectancy and GDP growth. Iqbal and Zahid (1998) find that various measures of education—including primary, secondary, and high school enrolment—are either insignificantly or negatively related to GDP growth. There are similar results for investment, trade openness, and other policy factors (McCartney, 2011, Ch. 2). The empirical ambiguity extends to the case of India and other developing countries (McCartney, 2009, Ch. 2).

A second problem is the issue of causation. Of particular importance—given the epic grandeur of the associated policy recommendations (see Section 4)—is the link between institutional change and economic growth. Acemoglu, Johnson, and Robinson (2001) is a good example of an extremely influential and very widely cited study that went to great lengths to examine the issue of causation, in this case between institutions and long-run economic growth. This and all other theoretical and empirical engagements with the issue of causation are completely ignored in the construction of the GCI and in WB and CSF. Both reports assert unequivocally that institutional reform is necessary to promote growth but fail to acknowledge the large body of historical evidence that shows that institutional reforms associated with increases in growth have been very minor (Rodrik, 2003, 2004).

Democracy, well-enforced private property rights, the protection of intellectual property rights, an independent judiciary, trade liberalization, good governance, tough competition laws, prohibition of child labor, and the protection of labor rights were, historically, not preconditions of economic growth. Institutions in all of today's developed countries including the rapidly growing economies of northern and Southeast Asia were very poor at the start of their periods of rapid growth. Good institutions only emerged with the process of economic growth, urbanization, and development. Full protection of patents, for example, only emerged in today's developed countries by the end of the nineteenth century; and in Switzerland, in its pioneering pharmaceutical industry, by the 1950s (Chang, 2002). Another example, relevant to the preceding discussion is Bils and Klenow (2000) who find that economic growth causes higher educational attainment by raising the return to skilled labor and so increasing the incentive for parents to invest in their children's schooling.

The rhetoric of the competitiveness agenda is that, achieving competitiveness relative to other countries is the key to achieving long-run sustainable economic growth. WB is internally inconsistent—it promotes both this view and a contradictory one. In "Chapter 2: Economic Growth in Pakistan: Sources and International Context," WB conducts a regression analysis to "understand Pakistan's growth performance." The report decomposes the factors responsible for the increase in GDP growth in 2001–

05 relative to 1991–2000, and finds that domestic factors—in particular the initial output gap, public infrastructure, and government burden-explained more than ten times as much of this increase as did trade openness. Projecting growth forward from 2006 to 2015, WB finds, again, that domestic factors under the assumption that strong progress is made in policy reforms (education, financial depth, government burden, and public infrastructure) will explain around 20 times as much GDP growth as will trade openness. It is baffling, then, to read elsewhere in the same report that, "Pakistan needs to improve its microeconomic fundamentals to boost export competitiveness and promote export diversification. Given the relatively small size of its domestic economy, strong export performance will be critical to sustaining high growth" (World Bank, 2006, p. 3). This former empirical finding should not be surprising; it is a widespread and well-established fact. As Krugman (1994) notes, "Even though world trade is larger than before and is increasing, national living standards are overwhelmingly determined by domestic factors rather than competing for world markets." During the acceleration (2003/04-2005/06) in GDP growth in Pakistan, domestic demand (consumption plus investment) was overwhelmingly more important than net exports, which made a negative contribution in both 2003/04 and 2004/05 and only a marginal positive contribution in 2005/06 (McCartney, 2011, p. 200).

The rhetoric of the competitiveness agenda is that the gain in competitiveness for one country must necessarily be at the expense of a loss of (relative) competitiveness for another, and trade is then ultimately a ruthless zero-sum game. This would be a very strange idea to anyone having taken a course in basic international economics. This perspective also represents a stunning theoretical volte-face, being completely contrary to everything the International Monetary Fund (IMF), World Bank, USAid, and World Trade Organization (WTO) have been pushing for decades through structural adjustment programs—the doctrine of comparative advantage—that trade liberalization is mutually beneficial for those countries undertaking it. To find a school of thought in economics advocating the doctrine of zero-sum trade, that growth and development in one country is at the expense of growth and development in another, one must go back to debates among the neo-Marxists of the 1960s and 1970s, most famously Frank, who argues that,

Most of our theory fails to explain the structure and development of the capitalist system as a whole and to account for its simultaneous generation of underdevelopment in some of its parts and of economic development in others (1966, p. 5).

A more reasonable supposition than the idea that the CSF and WB have embraced neo-Marxism is theoretical confusion. Krugman (1994) contends that the notion of competitiveness is applicable for the study of management and business but makes little sense when applied to the study of entire economies. He makes the important point that countries do not compete with each other in the way that firms do. Coca-Cola and Pepsi Cola are pure rivals where the sales of one are likely to be at the expense of market share for the other, so they are engaging in a zero-sum competition. For countries by contrast, while they may sell products that compete with one other, they are also each other's export markets and sources of useful imports—international trade is not a zero-sum game. A rise in productivity in China, for example, is very likely to cause a rise in wages and so stimulate the demand for imports, some of which could be sourced from Pakistan.

It is a very widespread and long-held view that Pakistan remains stuck with a low-technology, low value-added production and export structure. Both WB and ADB are clear on this. Sustained higher growth requires "greater export diversification" (World Bank, 2006, pp. v–xiii) and upgrading to more technologically demanding and higher value-added production techniques; "strategic options for growth of the sector [cotton jeans] in Pakistan are clear ... increased capabilities in research, development, and design" (p. 33), and "sustained global competitiveness in processed marble products will depend on increased outward orientation or higher value added products, exploiting rapidly advancing technologies" (p. 65). Additionally, "it is clear that overwhelming specialization in this [textiles and clothing] industry is not desirable for Pakistan's future competitiveness: it is unlikely to yield sustained growth in a world where dynamism resides increasingly in technology-intensive products" (Asian Development Bank, 2004, p. 47). The responses to this dilemma are different.

WB asserts that upgrading is desirable but nowhere explains the logic beyond muttering about "cost competitiveness." Conventional economic theory suggests that countries should produce and trade according to their patterns of comparative advantage. According to the standard textbook Hecksher-Ohlin theorem, this would mean that a country should export those goods and services that are intensive in its abundant factor and import those that are intensive in its scarce factor. Producing according to comparative advantage, i.e., not upgrading, which requires scarce skilled labor and more complex capital, would therefore minimize costs. The textbook model shows that this leads to mutually advantageous gains from trade. For Pakistan, this would imply exporting unskilled/semi-skilled labor-intensive goods and importing technology or capital-intensive goods. WB does not justify this apparent break with conventional orthodoxy.

ADB likewise produces a barrage of evidence to show that, in the 1980s and 1990s, exports from Pakistan remained stuck in areas of low technology. The report does, however, justify a strategy of upgrading, very simply, "activities with higher 'technological intensity'—those with higher than average expenditures on R&D—are growing faster than other activities" (Asian Development Bank, 2004, p. 13). ADB makes the common mistake—one highlighted by Krugman (1994)—of suggesting that hightechnology sectors are synonymous with sectors of high value-added i.e., industries with a high value-added per worker. The report notes that the growth of manufacturing value-added in Pakistan was below comparator countries in the 1980s and 1990s (p. 28). This is not empirically consistent with the more general argument in favor of focusing more technologically complex industries. Value-added does not, in general, equate to technological complexity. High value-added sectors are typically those sectors with very high ratios of capital to labor in traditional industries such as automobiles, steel, cigarettes, and petroleum refining. The link between high value-added and capital-intensive sectors is entirely consistent with theory: "Capital-intensive industries must earn a normal rate of return on large investments so charge a much higher markup over labor costs than labor-intensive industries so have a high value added per worker" (Krugman, 1994). There is not necessarily a case for deliberate efforts to channel investment resources toward high value-added (capitalintensive) industries; being capital-intensive, a given quantity of investment resources will buy little extra value-added.

Both WB and CSF support further trade liberalization: "Improvements in the trade policy regime have been implemented through tariff cuts and rationalization, as well through the removal of import quotas, import surcharges and the regulatory duties" (World Bank, 2006, p. 119). For CSF, reductions in tariff levels automatically have a positive impact on the competitiveness index. Trade liberalization will lead to production and exports being more determined by the market and relative factor prices—exactly as predicted and advocated by the textbook model of comparative advantage, WB, and the WTO. For Pakistan, being a low-skill/low-wage economy (World Bank, 2006, pp. 111–112) where access to finance is an important constraint (p. 113), this will necessarily mean a shift to low-skill, labor-intensive techniques of production.

In addition much of the WB report is concerned with cost competitiveness. Its value chain analysis of five key production sectors (cotton jeans, fisheries, mining, milk, and light engineering) "make it possible to decide which impediments do the greatest harm to cost competitiveness and what remedial policy actions, institutional changes and other corrective measures deserve priority" (World Bank, 2006, p. v). Such a policy focus would likely undermine the report's aspirations to upgrade the structure of production. Competing on the basis of low costs and, hence, cheap prices emphasizes the advantages of low wages and long hours by a sweated labor force and a depreciating currency—what may be called a low road of competition. Advocating technological upgrading and promoting policies that encourage the use of unskilled, low-wage labor is where the competitiveness reports can lead to a developmental dead end. This is exactly the point made by Amjad (2005) when he argues for a deliberate strategy to boost wages and skills and improve labor market conditions to remove the option of following a low road of competition and instead forcing producers to compete on the basis of higher skills, higher wages, and higher productivity—a high road of competition.

#### 4. Feasibility of Policy Recommendations

Both WB and CSF are clear that the aim of writing the reports was to influence government policymaking and both include detailed policy agendas.

CSF does rate institutional reform as "the most important priority" (Competitiveness Support Fund, 2010, p. 61), but includes within the heading of key objectives for the short term (one year) an incredible list of reforms. These include: "launch integrated programs to regularize informal settlements" (p. 63); "expedite the application and review process for patent filing at IPO" (p. 63); "fast-track SEZ legislation" (p. 65); "finalize and pass a Corporate Rehabilitation Act to provide a legal framework that enables restructuring to be driven by stakeholders in a transparent manner" (p. 65); "introduce modern Agricultural Marketing Law" (p. 66); "ensure egovernment facilitation amongst the business enterprises" (p. 66); "diagnose problems in enforcement of Securities and Exchange Commission Pakistan (SECP) and take steps to improve compliance" (p. 67); the "identification of specific programs for judicial and law enforcement reform" (p. 67); "focus on enhanced resource mobilization through reforms in taxation, revenue administration and collection" (p. 71); "approve the National Governance Plan with consensus of key stakeholders" (p. 72); "implement uniform public procurement rules in all government agencies" (p. 73); a "short-term action to address high-profile instances of corruption" (p. 73); "create and publish a credible strategy for lowering costs of security to businesses" (p. 74); and "improve funding, equipment, transportation, communications and responsiveness of police" (p. 74). The list continues.

WB is more focused, it includes among its list of "high-priority measures" the "preparation of regulations for the New Employment Services Act" (World Bank, 2006, p. 149); and recommends steps be taken to "establish a consistent legal framework, registry, and property tax system" (p. 149) and "improve the legal framework and judicial processes for enforcement of financial contracts" (p. 149). The report also advocates measures to "make intermediate and secondary education more purposeful" (p. 149); to "improve governance in the education sector … to monitor teachers' competencies and absenteeism, implement transparent recruitment procedures for teacher training" (p. 149); as well as "setting an appropriate pricing structure for [electricity] distribution companies" (p. 150); and steps to "highlight SPS (Sanitary and Phytosanitary) management constraints and issues, prioritize them and [an] elaborate action plan" (p. 152).

Both reports are very clear that they are advocating a big-push approach to reform. CSF says a "comprehensive institutional reform program is vital to Pakistan's competitiveness strategy" (Competitiveness Support Fund, 2010, p. 62), and WB sums up its agenda as "broader and deeper investment climate reforms" (World Bank, 2006, p. i). This agenda is at best irrelevant and at worst dangerous. Firstly, WB and CSF are both clearly agreed that the capacity of Pakistan's bureaucracy is low: "The consistency, certainty, and predictability of the economic governance framework—including the laws and regulations, the adjudication mechanisms and their enforcement agencies, and the public agencies involved in government-business interface-still fall far short of minimal standards" (World Bank, 2006, p. 105); and "Pakistan performs poorly in terms of governmental effectiveness in delivering public services, human development, poverty alleviation, and devising policies in an independent, transparent and efficient manner" (Competitiveness Support Fund, 2010, p. 54). Moreover, the bureaucracy's capacity is declining: "Transparency of Government in Policy Making" according to CSF in Pakistan, declined from 105 (from among approximately 140 countries) in 2009/10 to 115th in 2010/11. It would seem reasonable to suppose that, given such agreement on the capacity of the Pakistani state policy, recommendations would be, likewise, careful and measured. This, as described above, is clearly not the case.

Second, the WB report does make some effort in Chapter 2 to gauge the relative impact of policy factors on past and future growth. As noted earlier, the most important were education, public infrastructure, and financial depth. All this is forgotten by Chapter 9, when reforms in these areas are lost amidst a welter of other "priorities." Perhaps this is inherent in the construction of the GCI, which uses 140 indicators to rank countries. The indicators are weighted slightly differently to distinguish between developed and developing countries but otherwise offer an enormous policy menu for countries to improve their ranking and no means to make choices among.

Third, Rodrik (2000), notes that one particular aspect of this reform process—integration into the world economy—has highly demanding institutional prerequisites that could easily crowd out other priorities. Abiding by WTO obligations—including customs valuation, sanitary and phytosanitary measures, and intellectual property rights—he estimates, cost the average LDC USD 150 million, and would place extensive demands on the capacity of developing country governments and overwhelm limited managerial capabilities. Morss (1984) has described how a large number of donor projects have, in the past, wreaked institutional destruction in developing countries.

Finally, lists of recommendations such as these completely ignore history. The possibility of such rapid institutional change is contradicted by the historical experience of today's developed countries, which had experienced, according to Chang (2002), a "long and winding road" of institutional development that took "decades." For example, from full male to universal suffrage, it took France from 1846 to 1946, and Switzerland from 1879 to 1971. The need for a modern professional bureaucracy was first mooted in Britain in the eighteenth century and became a reality only in the early nineteenth century. Such slow development was often because of the widespread realization that many changes were expensive (labor laws and social security) or because of the resistance of those who would lose out (democracy, income tax), lacking supporting changes (the tax revenue needed to pay for professional bureaucracies), or prejudice (female suffrage) (Chang, 2002).

#### 5. Comparative Studies

All three reports are explicit that competition is a relative term competing against whom? So policy guidance must be made through reference to comparable countries: "Evaluation should use quantitative benchmarks against selected comparators" (Asian Development Bank, 2004, p. xx), while "to gain insight into Pakistan's competitiveness rankings, it is useful to compare it to countries with which it shares an economic or geographic proximity" (Competitiveness Support Fund, 2010, p. 7). Moreover, "key constraints to competitiveness ... discourage private investment and make domestic production less competitive in relation to many of Pakistan's competitors" (World Bank, 2006, p. 90). This is inherent to this particular way of considering competitiveness, where competitiveness is not absolute but explicitly considered in comparison to other countries. CSF, for instance, notes some examples of where absolute scores on a number of sub-indicators have not changed, but Pakistan's competitiveness has declined because other countries have improved at a faster rate. The report is replete with examples of where Pakistan performs poorly relative to comparator countries, on "strength of auditing and accounting" (p. 54), "transparency of government policymaking" (p. 54), 'favoritism by government officials" (p. 56), and so on.

ADB likewise benchmarks "indicators of skills and technology in Pakistan" and the "sophistication of exports against other countries and throughout the report accepts the idea that competitiveness is something that needs to be judged relative to other countries. WB is less systematic but the implications are the same: Investment is lower than in other countries and so should be increased (World Bank, 2006, p. 99); governance indicators are lower so should be improved (p. 105); and, again, refers to education attainments (p. 111), infrastructure performance (p. 116), and tariff levels (p. 120), etc. All of these "lessons" are extremely simplistic and of the form "country x is doing well, it has high levels of variable y, therefore Pakistan should improve increase y." Lessons require proper and detailed analysis to gauge their applicability; there are no such studies or references to any such findings in the reports.

A good example of how a proper comparative study could moderate naive calls for reform comes from land use and transfer legislation. CSF called for "fast-track SEZ legislation" (Competitiveness Support Fund, 2010, p. 65), and WB for "a consistent legal framework, registry, and property tax system" (World Bank, 2006, p. 149). There is a massive political problem over the border in India where the state has tried to do just this. The formal power of compulsory acquisition was established in India by the Land Acquisition Act of 1894, which was based on the concept of "eminent domain"-enabling the state to make compulsory purchase of private assets. The Act enabled the acquisition of land for public purposes with compensation linked to market prices. This law was reincarnated as the 2005 Special Economic Zone (SEZ) Act that set a framework for state governments to acquire land for industrial estates. By 2008, 404 SEZs had been approved, covering 54,280 acres. After being launched, many SEZs then stalled in response to massive political protest against the terms of compensation, valuation of assets, forcible eviction of existing land users, and nonpayment of compensation. Suspended or abandoned projects have included the Salim Group's petro-chemical SEZ in Nandigram, West Bengal; the Reliance Group multipurpose SEZ near Mumbai; and the USD 12 billion POSCO steel SEZ in Orissa (Levien, 2011). This process has been extensively discussed, debated, and legislated on in India and utterly ignored by WB and CSF.

There is no excuse for the naive aspirations passing as policy advice in Pakistan. In the WB and CSF reports as well as more widely, Pakistan is often compared unfavorably to and urged to emulate the rapidly growing economies of East Asia. There is rarely if ever a proper considered discussion of the factors that permitted those East Asian countries to boost investment, education, and exports to extremely high levels. These development successes are not something that can be simply chosen by an informed policymaker after reading CSF. There exists an extensive literature on what we may roughly call the "politics of the developmental states"-the political preconditions that enabled mainly-but not exclusively-East Asian states to pursue developmental policies. Leftwich (1995) has constructed a widely circulated list, which includes a determined developmental elite; a state that was autonomous from the rest of society; a powerful, insulated, and competent economic bureaucracy; a weak and subordinated civil society; the effective management of nonstate economic interests; and a state basing its rule on a mix of repression and legitimacy based on successful performance. There is a wide range of works that study the specific internal and external historical and contemporary conditions that enabled developmental states to emerge. These include the experience of Japanese colonialism (Kohli, 1994); severe political crisis; external threat (Levi-Faur, 1998); and waging war (Tilly, 1985). There is an ample, detailed, and well-known literature, none of which is referred to or referenced in either WB or CSF. There is no excuse to base analysis on naive calls to replicate successful comparators.

#### 6. Learning from Past Policy Interventions

Both WB and CSF suffer from historical myopia. They make no reference to past policy interventions or any effort to understand why policy has or has not worked in the past. There is no attempt in either report to understand the political economy context in which reforms have and will operate. Those who forget history, goes the expression, are bound to repeat it.

All three reports mention the dire state of education and skills in Pakistan, both absolutely and relative to comparator countries. It is therefore surprising perhaps that only WB, and then only in passing,

makes any reference to the Social Action Programme (SAP). Launched by the World Bank in 1993, the SAP was a two-phase scheme carried out from 1993 to 1997 and then to 2002, which cost nearly USD 8 billion. The program was a massive and sustained effort to tackle the same problems in education as noted by the competitiveness reports. As a result of the SAP, expenditure on the social sectors increased between 1993 and 1998 and declined subsequently to pre-program levels. There was a marginal improvement in education indicators between 1991 and 1996 and a decline thereafter until 1999. WB acknowledges this failure in passing, and then calls for an extensive list of urgent actions relating to improving governance in education: To better manage and monitor teachers, implement transparent procedures for teacher recruitment and training, expand public-private partnership initiatives to improve access and service delivery, focus on upgrading the quality of primary education, and improve the educational content of intermediate and secondary education (World Bank, 2006, pp. ix–x, 148–149). There is no detailed discussion of the previous failure, only a repetition of the same failed exhortations to reform.

Despite claims in the CSF and WB that they undertook extensive local consultation, there is no sign of any detailed understanding of the Pakistan context—of its political economy. In fact, at an abstract level, the policy recommendations-to improve infrastructure, health, and education—are equally applicable to every developing country and were included in the election manifestos of the major political parties at the last UK general election.<sup>1</sup> A specific understanding of the Pakistani political system, for example, could help explain why service delivery-particularly of health and education—has been so poor in Pakistan. Between 1988 and 1999, the country experienced its longest democratic interlude, yet social services for the majority of voters (the poor) showed negligible improvement. Elected politicians over the 1990s seemed adept at providing patronage/targeted favors to small numbers of privileged groups rather than general public goods that would benefit the majority of citizens, such as clean water or literacy improving basic education.

In Sindh, for example, there was a substantial increase in the number of teachers but a decline in measures of educational quality. Using state-level data, Hasnain (2008) has found that the higher the levels of fragmentation, factionalism, and ethnic/linguistic/religious polarization,

<sup>&</sup>lt;sup>1</sup> WB does include a number of sector-specific case studies. The micro-analysis replicates all the problems discussed in this article. WB lists various problems and argues that all of them should, therefore, be tackled as "policy solutions."

the greater the incentives for patronage and the poorer the quality of general service delivery. His model explains both the low level of provision of general public goods and also the variability in provision across space. The (political) party fragmentation of the 1990s increased the informational demand on voters since there were more candidates and more messages to evaluate during election time, making it harder to link an improvement in service delivery with a particular politician. This increased the incentives on politicians to provide targeted benefits rather than general public goods. The party organization of the Pakistan People's Party and others was highly personalized, and those close to the leadership assumed positions of responsibility rather than those winning internal elections. This personalization promoted factionalism. Such factionalism did not provide party members with stable career prospects and, so, politicians had a greater incentive to focus on targeted public goods to build a personal reputation that would carry across party lines.

There was also a high degree of candidate churning in Pakistani politics during the 1990s. A significant number of incumbents changed constituency or competed as members of other parties in provincial assemblies. This gave incumbents an incentive to establish a reputation for themselves among voters that transcended party identity and, so, created incentives to focus on particularized benefits. Party factionalization was linked to the provision of targeted rather than general public goods. In more ethnically/linguistically/religiously divided parts of Pakistan, the provision of general public services would have provided fewer political benefits than targeted benefits to particular ethnic groups. So, again, polarization was linked to the provision of targeted rather than general public goods.

Such an understanding of the political economy context could direct reform efforts, perhaps to building the organizational structure of political parties or to voter awareness campaigns. An example of a reform effort carefully tailored to the local context is education funding in Uganda—which started with many of the same problems as now experienced in Pakistan. In Uganda, the central government began to publish monthly transfers of public funds to districts in newspapers and required primary schools to post public notices on all inflows of funds. This promoted accountability by giving both schools and parents access to the information needed to understand and monitor the workings of the grant program. Preliminary evidence from an evaluation of the information campaign suggests markedly improved outcomes (Reinikka & Svensson, 2004). Another good example is taxation. CSF and WB both call for a familiar mix of reducing tax evasion and mobilizing revenue by reducing loopholes, rationalizing tax rates, and improving tax administration. Both ignore the IMF's long and ignominious history of tax reform. The following list is of occasions on which the IMF has loaned money to Pakistan between 1995 and 2010, each accompanied by an extract from the IMF website of the (tax-related) conditionality. After this long list comes the result—what happened to tax revenue.

#### 1995 IMF approves \$596m standby credit for Pakistan

The program is designed to cut the budget deficit in relation to GDP through a combination of revenue and expenditure measures.

## 1996 IMF approves extension and augmentation of \$231m standby credit to Pakistan

These policies will be supported by far-reaching actions on the structural front, with emphasis on an improvement in the operations of Pakistan's major banks, broadening of the tax base, and rationalization of government expenditures.

#### 1997 IMF approves combined \$1,558m ESAF/EFF financing for Pakistan

In the public sector, the domestic tax base will be broadened; tax administration strengthened; government expenditure shifted towards the social services and human capital formation; and key public enterprises restructured.

#### 1999 IMF approves \$575m second annual ESAF arrangement

The budget deficit is targeted to decline from 5.5 percent of GDP in 1997/98 to 4.3 percent of GDP in 1998/99, and to 3.3 percent in 1999/2000. To achieve this target, the government has already taken or intends to take several fiscal measures: an increase in the GST rate to 15 percent from 12.5 percent...

#### 2000 IMF approves \$596m standby credit for Pakistan

The program envisages a reduction in the overall budget deficit in 2000/01 to 5.2 percent of GDP, from 6.4 percent

in 1999/2000, with further consolidation over the medium term. The budget target is to be achieved through increased tax collections with a widening of the tax base, improved tax administration, and strict expenditure controls.

#### 2000 IMF approves release of \$133m credit to Pakistan

Another challenge will be to boost revenue collections, a key pre-condition for containing the fiscal deficit while increasing social and pro-poor spending. This will require resolute action to broaden the tax base and strengthen tax administration. The extension of the sales tax coverage, and steadfast implementation by the Central Board of Revenue of the recently adopted short-term action plan to improve tax administration, will be critical.

## 2001 IMF completes last review under Pakistan's standby arrangement, approves \$135m disbursement

At the same time, the broadening of the tax base and a fundamental reform of tax administration are urgently needed.

#### 2001 IMF Executive Board approves \$1.3b PRGF credit to Pakistan

The strategy centers on sustained fiscal adjustment supported by a major reform of tax administration and a widening of the tax net, while increasing public spending for poverty alleviation.

## 2002 IMF completes first review of Pakistan's PRGF-supported program, approves \$107m disbursement

The Executive Board approved two waivers for the nonobservance of performance criteria on tax revenue and credit to public enterprises, and modification of the tax revenue performance criterion for end-March 2002 and of one structural performance criterion on tax issues ... On the fiscal side, a significant improvement in tax revenue remains a key challenge. The recent tax measures taken by the authorities are welcome, but looking ahead, a significant improvement in the fiscal position will be needed to ensure debt sustainability, while raising allocations for basic social services. This will require the further reduction of tax exemptions, subsidies, and unproductive expenditure, and improved tax administration, in particular through a vigorous reform of the Central Board of Revenue.

# 2002 IMF completes second review of Pakistan's PRGF-supported program, approves \$114m disbursement

This will, however, require strong determination in enforcing tax collection, the continued timely implementation of reforms to enhance tax administration, and improved tracking and effective monitoring of social expenditure and related outcomes. The authorities should also stand ready to undertake appropriate corrective fiscal measures, if needed, to achieve the budgetary targets.

# 2003 IMF completes fourth review of Pakistan's PRGF-supported program, approves \$118m disbursement to Pakistan

In approving the disbursement, the Executive Board granted a waiver of Pakistan's non-observance of the continuous structural performance criterion regarding tax exemptions and regulatory import duties ... The removal of a significant number of tax exemptions with the next budget should lead towards a tax system where the burden is more fairly distributed across income earners.

# 2003 IMF completes fifth review of Pakistan's PRGF-supported program, approves \$123m disbursement

This will require forceful pursuit of reforms aimed at simplifying the tax system and broadening the tax base, including through the elimination of a number of tax exemptions, to reduce distortions and the potential for corruption.

#### 2003 IMF Executive Board completes sixth and seventh reviews of Pakistan's PRGF-supported program, grants waivers and approves disbursements amounting to \$247.54m

In this regard, Pakistan's request for waivers for the nonobservance of three structural performance criteria was approved by the Executive Board ... In the fiscal area, this will include efforts to broaden the tax base through an expansion of the general sales tax to services, a reduction of tax exemptions, and an improvement in the capacity of local governments, which administer most poverty-related expenditures.

# 2004 IMF Executive Board completes eighth review under Pakistan's PRGF-supported program and approves disbursement amounting to \$253m

It will be essential to press ahead with the ongoing reforms to simplify the tax system and broaden the tax base.

#### 2008 IMF announces staff-level agreement with Pakistan on \$7.6b loan

This fiscal adjustment will be achieved primarily by phasing out energy subsidies, better prioritizing development spending, and implementing strong tax policy and administration measures.

## 2009 IMF completes second review under standby arrangement for Pakistan and increases financial support to \$11.3b

A durable solution to the problem of low tax revenue should start with the early implementation of VAT and the ongoing tax administration reform.

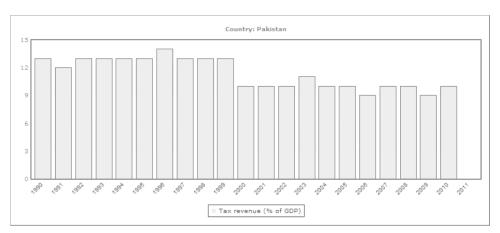
## 2009 IMF completes third review under standby arrangement for Pakistan, approves \$1.2b disbursement

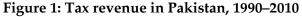
The introduction of the VAT and associated administrative reforms, scheduled for July 1, 2010, is key to strengthening revenue, crucial for reducing poverty and financing needed investment in human and physical capital. Prompt submission of the VAT law to parliament and its passage will therefore be important.

# 2010 IMF completes fourth review under standby arrangement for Pakistan and approves \$1.13 billion disbursement

Achieving the 2009/10 fiscal target will require strong efforts, including from the political leadership. Resolute continuation of tax collection efforts, tax administration reform, and expenditure restraint, together with timely disbursement of the pledged foreign financing will be critical to facilitate fiscal management.

And, as a result of 15 years of cajoling, assisting, pressurizing, enticing, persuading, inveigling, flattering, coaxing, and wheedling Pakistan to reform its tax system—and spending billions of dollars in the process—what happened? Nothing. Figure 1 shows that tax revenue remained essentially unchanged during the 1990s, or if one were being a little unkind, one might say Pakistan did exactly the opposite of what the IMF spent so long requesting, and let tax revenue decline.

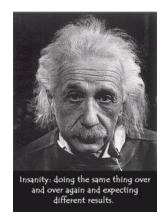




Source: World Bank (2012).

Albert Einstein (Figure 2) famously said that the definition of insanity was doing the same thing over and over again and expecting different results. Could this apply to the IMF? Certainly not. There is no doubting the technical expertise, experience, and high caliber of the IMF. The answer probably lies in the murky waters of politics and international relations and must await another paper.

#### Figure 2: Albert Einstein and insanity



Have the competitiveness reports learnt from this debacle and built a sensible tax reform strategy into their policy advice? No. Instead this hopeless IMF rhetoric has been fully absorbed by CSF and WB. CSF hopes that "tax reforms will help the Government to increase its tax-to-GDP ratio to 15% by 2014" (Competitiveness Support Fund, 2011, p. 33). WB calls for a "comprehensive strategy to increase tax revenues and the implementation of actions to increase tax collections, not only at the federal level, but also at the provincial and local level" (World Bank, 2006, p. 98).

#### 7. Conclusion

This article has shown that competitiveness, despite its intuitive appeal as currently utilized, is a dangerous, distorting and dead-end obsession. It is dangerous because it overwhelms policymakers with incoherent lists of priorities that risk undermining morale among policymakers and increasing distrust by the general public. It is distorting because the competitiveness agenda turns economic theory upside down, abandoning without explanation the widely accepted view of comparative advantage and mutual gains from trade. Finally, it is dead-end because, while advocating upgrading, many of the policy measures the reports espouse will entrench low-skill, labor-intensive sweated labor. Where then to start on an alternative agenda? To start, the notion that international competitiveness is the fundamental constraint to a country's long-term growth prospects should be dropped. The overwhelming impact on growth is and is likely to remain that of domestic factors.

A good place to start in devising an alternative is the work of Rodrik who has written extensively on "rethinking growth policies in the developing world" and "growth strategies." His general argument is summarized as a sequence of logical steps (Rodrik, 2004). The reforms of the 1980s and 1990s-and still being advocated by CSF and WB-produced disappointing results. Despite extensive stabilization, liberalization, and privatization, growth rates in reform countries (including Pakistan) were low in absolute terms and also relative to their own historical experience. Successful growth performers have followed heterodox policies. China and India have become more market-oriented but through unorthodox means. In China, for example, small-scale state- (not private) owned enterprises (township and village enterprises [TVEs]) were the economy's most dynamic sector for the first 20 years of reform. In India, rapid economic growth began in the early 1980s and did so in an environment of *increasing* trade protection. Others, such as South Korea and Taiwan, experienced rapid economic growth with the extensive use of trade and industrial policies.

All successful growth stories have adhered to some basic principles—these have included macroeconomic stability, monetary and fiscal policies that have avoided high inflation or unsustainable debt, prudential regulation of the financial system, providing investors with effective protection of property rights, and maintaining a degree of social cohesion and political stability. These principles of macroeconomic policy do not, though, map onto unique policy agendas. There are multiple ways of achieving them. China, for example, protected property rights not by immediately reforming its legal system to duplicate those in developed countries—as advocated for Pakistan by CSF and WB—but through partnerships between entrepreneurs who ran businesses and local government officials who protected their property rights in return for agreed revenue payments to support local public spending. South Korea and Taiwan did not re-orientate their economies to exporting in the 1960s by liberalizing imports—as advocated by CSF and WB—but by subsidizing exports. Chile, despite its commitment to the free market, retained its largest export industry (copper) under state ownership and retained controls on capital outflows throughout the 1990s.

Macroeconomic stability has proved to be compatible with a vast range of exchange rate regimes and regulations governing central bank functioning. Consequently, policy diversity, experimentation, and scaling up successful local experiments are desirable. A reform agenda should not be based around the desire to emulate developed countries as quickly as possible. Economists should utilize their undoubted training to evaluate their relative scarcity of different growth drivers and the tradeoffs involved in their provision. Economists should stick to economics and not be tempted into management theories about competitiveness. Policy recommendations should be practical to undertake by the Pakistani bureaucracy and political classes; they should be rooted in a careful analysis of potential lessons from comparator countries that recognizes the different constraints and opportunities of those countries, and in a clear understanding of the Pakistan context—its political economy and related analysis of the successes and failures of past policy interventions.

#### References

- Acemoglu, D., Johnson, S., & Robinson, J. (2001). The colonial origins of comparative development: An empirical investigation. *American Economic Review*, 91(5), 1369–1401.
- Amjad, R. (2005). Skills and competitiveness: Can Pakistan break out of the low-level skills trap. *Pakistan Development Review*, 44(4), 387–409.
- Asian Development Bank. (2004). *Industrial competitiveness: The challenge for Pakistan*. Islamabad, Pakistan: Author.
- Barro, R. J. (1991). Economic growth in a cross-section of countries. *Quarterly Journal of Economics*, 106, 407–431.
- Bils, M., & Klenow, P. J. (2000). Does schooling cause growth? American Economic Review, 90(5), 1160–1183.
- Chang, H.-J. (2002). *Kicking away the ladder: Development strategy in historical perspective*. London, UK: Anthem Press.
- Competitiveness Support Fund. (2010). *The state of Pakistan's competitiveness: Report 2010–2011*. Islamabad, Pakistan: Author.
- Frank, A. G. (1966, September 18). The development of underdevelopment. *Monthly Review*, 4–17.
- Hasnain, Z. (2008). The politics of service delivery in Pakistan: Political parties and the incentives for patronage, 1988–1999. *Pakistan Development Review*, 47(2), 129–151.
- International Monetary Fund. (2012). *International Monetary Fund: Home*. Retrieved May 12, 2012, from http://www.imf.org/external/index.htm
- Iqbal, Z., & Zahid, G. M. (1998). Macroeconomic determinants of economic growth in Pakistan. *Pakistan Development Review*, 37(2), 125–148.
- Italy needs red-tape bonfire before labor reform. (2012, April 3). Guardian.
- Khan, M. S. (2005). Human capital and economic growth in Pakistan. *Pakistan Development Review*, 44(4), 455–478.

- Klein, J. (1996). *Primary colors: A novel of politics*. New York, NY: Random House.
- Kohli, A. (1994). Where do high growth political economies come from? The Japanese lineage of Korea's 'developmental state.' *World Development*, 22(9), 1269–1293.
- Krugman, P. (1994). Competitiveness: A dangerous obsession. *Foreign Affairs*, 73(2), 28–44.
- Leftwich, A. (1995). Bringing politics back in: Towards a model of the developmental state. *Journal of Development Studies*, 31(3), 400–427.
- Levi-Faur, D. (1998). The developmental state: Israel, South Korea and Taiwan compared. *Studies in Comparative International Development*, 33(1), 65–93.
- Levien, M. (2011). Special economic zones and accumulation by dispossession in India. *Journal of Agrarian Change*, *11*(4), 454–483.
- McCartney, M. (2009). *India The political economy of growth, stagnation, and the state,* 1951–2007. London, UK: Routledge.
- McCartney, M. (2011). *Pakistan The political economy of growth, stagnation and the state,* 1951–2009. London, UK: Routledge.
- Morss, E. R. (1984). Institutional direction resulting from donor and project proliferation in sub-Saharan African countries. *World Development*, 12(4), 465–470.
- Pritchett, L. (2001). Where has all the education gone? *World Bank Economic Review*, 15(3), 367–391.
- Reinikka, R., & Svensson, J. (2004). Local capture: Evidence from a central government transfer program in Uganda. *Quarterly Journal of Economics*, 119(2). 679–705.
- Rodrik, D. (2000). *Can integration into the world economy substitute for a development strategy*? Cambridge, MA: Harvard University Press.
- Rodrik, D. (2003). *Growth strategies*. Cambridge, MA: Harvard University Press.

- Rodrik, D. (2004). *Rethinking growth policies in the developing world*. Cambridge, MA: Harvard University Press.
- Tilly, C. (1985). War making and state making as organised crime. In P. B. Evans, D. Rueschemeyer, & T. Skocpol (Eds.), *Bringing the state back in*. Cambridge, UK: Cambridge University Press.
- World Bank. (2006). *Pakistan: Growth and export competitiveness*. Washington, DC: Author.
- World Bank. (2007). *World development report 2007: Development and the next generation*. Washington, DC: Author.
- World Bank. (2012). *World development indicators*. Retrieved from http://data.worldbank.org/data-catalog/world-developmentindicators
- World Economic Forum. (2006). *Global competitiveness report* 2005/06. Geneva, Switzerland: Author.
- World Economic Forum. (2012). *Global competitiveness report* 2011/12. Geneva, Switzerland: Author.
- Zaidi, S. A. (2005). *Issues in Pakistan's Economy*. Karachi, Pakistan: Oxford University Press.

#### **Conference Report**\*

The Lahore School's Eighth Annual Conference on Management of the Pakistan Economy took place on 16 – 17 May, 2012 at the school's Main Campus. The topic of this year's conference was: "Towards Accelerated Economic Growth in Pakistan: Its Need and Feasibility". It was attended by the country's leading economists, Pakistani and foreign academics, and renowned researchers from India, Sri Lanka, United Kingdom, and United States. Some 25 research papers and oral presentations were made during the two days of the conference.

The richness of the discussions during the two days of the conference cannot be adequately captured in a short report but, as a record of the salient issues raised, it could be useful for the participants as well as others interested in the subject. Since discussions in different sessions tended to overlap, what is offered here is a composite summing-up rather than a chronological account of the actual proceedings.

#### Key Messages

- 1. A push towards accelerated growth is both feasible and essential to creating employment and alleviating poverty in Pakistan.
- 2. Pakistan's current macroeconomic imbalances are unsustainable and must be corrected, but the required adjustments can be gradual and be brought about as economic growth accelerates.
- 3. The biggest hurdle to accelerated economic growth at present is the acute energy shortage, which calls for a concerted government response at overcoming mismanagement in the power sector, renegotiating contracts with power suppliers, and devising a strategy to rely increasingly on domestic and renewable sources of energy, notably, water and coal.
- 4. Accelerated growth is contingent on higher private investment, though public investment in infrastructure would remain vital to sustaining future growth. Economic uncertainty, credit squeeze due to the large public sector borrowing, the law and order situation, and

<sup>&</sup>lt;sup>\*</sup> The conference report was prepared by Irfan Ul Haque, (Special Advisor, Financing for Development, South Centre, Geneva.) who jointly organized the Eighth Annual Conference on Management of the Pakistan Economy with the Center for Research in Economics and Business, Lahore School of Economics, headed by Naved Hamid.

not least the energy crisis hold back private investment, but economic growth could itself improve the investment climate.

- 5. Sustainability of economic growth depends critically on Pakistan's ability to compete in world markets. Productivity improvement in existing export industries is obviously important, but Pakistan's export base also must be broadened towards higher value added industries. Access to technology and improved worker skills will be critical.
- 6. Pakistan's geo-strategic location is an asset but trade opportunities remain under-exploited. The country has failed to reap benefits from the free-trade agreement with China. Trade with India has considerable potential, but it will depend critically on Pakistan's ability to compete.
- 7. The 18<sup>th</sup> constitutional amendment and the 7<sup>th</sup> NFC award devolved key federal functions to the provinces along with greatly increased federal fiscal transfers. Decentralization is to be welcomed but its actual implementation faces certain challenges, notably, preventing fiscal slackening in provinces and ensuring satisfactory delivery of social services (health and education) at local levels.

#### **Issues Discussed**

#### 1. Feasibility of Accelerated Growth

The conference opened with a discussion on conditions necessary for bringing about accelerated growth in Pakistan. The conventional wisdom is that the macroeconomic imbalances and high inflation constrain the economy's ability to grow, which implies that without significant improvement in these two areas, accelerated growth would not be sustainable. However, Pakistan's current stagflationary state could not be explained in these terms since its macroeconomic imbalances and inflation were broadly similar to those in other but more rapidly growing economies, viz., Bangladesh, India, Indonesia, and Sri Lanka. The country's macroeconomic imbalances and inflation obviously need to be brought down but not too suddenly if the economy is not to be further depressed. A heterodox alternative to the conventional approach to stabilization was proposed, which showed that Pakistan's growth could be accelerated while the required macroeconomic adjustments were phased over the next few years.

The immediate constraint on Pakistan's economic growth in fact is the acute energy shortage that has seriously hurt industrial productivity. However, from the longer-term perspective, Pakistan's low investment rate and weak international competitiveness has held back growth. The heterodox approach is contingent on overcoming these constraints on economic growth.

This approach to accelerated growth is rather different to the one proposed in the Pakistan Planning Commission's *Framework for Economic Growth*, launched May 2011. Although the *Framework* called for "rethinking" Pakistan's growth strategy, no new ground seemed to have been broken. A point was made that, by ignoring Pakistan's own past experience and that of other high growth economies, the *Framework* has uncritically placed faith in the market and private enterprise and is generally dismissive of the role governments routinely play in promoting economic growth. This policy orientation appears to be at odds with the recent calls for greater state activism in the advanced countries, not to mention the state's role in other Asian economies. The *Framework* also did not address the core concerns of mobilizing revenue, income distribution and equity or provide a roadmap of how it would be implemented. In fact, the government has not adopted the *Framework* as a guide to policy.

## 2. Why Accelerated Economic Growth?

The discussion then moved to the basic compulsion behind choosing this path, i.e., alleviating poverty and reducing unemployment. Some 20-30 million people are estimated to be currently living in absolute poverty and about 3.5 million are unemployed. While overall unemployment has risen in the post-2007 period, real wages rose slightly in the agricultural sector but declined in the construction sector. It is somewhat puzzling that the actual situation is not worse considering the combined effect of the natural disasters, high inflation and low economic growth.

The explanation was seen to lie in certain recent developments in the rural economy, viz., a very large increase in worker remittances into rural areas, substantial improvement in wheat procurement price, an increase in non-farm rural activities, and possibly the transfer payments under the Benazir Income Support Programme and other government income-support programmes. Urban areas too have benefited from the growth of the informal sector and the income-support programs.

The poverty picture, however, could be much worse if the absolute poverty measure was raised to the World Bank's definition of \$1.25 per day, which would entail more than doubling the current

poverty cut-off threshold. In order to ensure that the poor do not get hurt through deficit reduction and benefit from economic growth, government will need to invest in maintaining a "social floor". In other words, without appropriate measures to protect the poor and create employment, growth alone will not be enough.

## 3. The Energy Crisis

The energy crisis was seen as the most serious constraint on investment and economic growth, an issue that surfaced in different sessions. Power cuts are the single biggest cause of the underutilized capacity and the rise in production costs in different industries. The problem was held to be the outcome of two policy shifts during the 1990s: (i) The increased reliance on the private sector for the generation and distribution of electricity; and (ii) the reorientation of power generation from the domestic hydroelectric sources to imported fuels, greatly raising the generation costs. The contracts with the independent power producers (IPP) and later rental power producers (RPP) have proved to be highly costly for both the government and the nation. Instead of the promised improvement in power supplies and public finances, the opposite has happened. To deal with the crisis, the immediate steps involve a renegotiation of the earlier contracts.

Despite the substantial increases in electricity tariffs over time, the drain on fiscal resources has continued. The increased budgetary costs have not been due to consumer subsidies, but rather a result of the past contracts, which were highly favorable to power producers. The government now faces a situation where it faces the consumers' wrath at the cost and unreliability of electricity while the power producers cite government's wholesale violation of legally binding commitments. The so-called circular debt problem is just the pile-up of non-payment of electricity bills along the electricity supply chain.

#### 4. Private Investment

That the investment rate in Pakistan must rise substantially to support higher growth was self-evident. That private investment would be the principal trigger of growth was also incontrovertible, though it was frequently stressed that public investment remained critical to improving social and physical infrastructure.

The high fiscal deficit and government borrowing from commercial banks has raised interest rates and "crowded out" private

investment. Nevertheless, after sharply declining in 2009, the private sector off-take of credit has shown signs of weak recovery recently. The fact that private savings have been currently higher than investment is suggestive of capital flight, but in fact it has primarily been a consequence of the fiscal deficit. While Pakistani investors have become more active in overseas investment, there is little evidence of actual capital flight.

Despite the general pessimism, several industries have managed to thrive, and Pakistan's future economic prospects were regarded as fundamentally bright. This is due to a strong consumer base with evident upward social mobility and a rising middle class, falling dependency ratio with the rise in working population, the country's natural resources and, not least, its geo-strategic location. If conditions are to improve and growth picked up, Pakistan's economy – as the other rapidly growing Asian economies – could get into the virtuous circle of high growth-high investment-high savings.

## 5. International Competitiveness

Rapidly growing economies aggressively promote their exports, but Pakistan remains a laggard. The discussion focused on the reasons for poor productivity growth and the failure to broaden the country's industrial base. While there are isolated cases of creativity and technological sophistication, the country has continued to rely heavily on traditional textile exports and low value-added activities. Industrial deepening and a move towards more sophisticated products has been hindered by the barriers to technology transfer. Subcontracting arrangements with foreign firms to locally produce manufacturing components could be one means of accessing foreign technology. This might enable Pakistan to start producing more complex, diversified, and higher value added products.

Apart from the energy shortage, low labor productivity was cited as the pervasive reason for lack of competitiveness. According to one recent survey, a number of firms considered labor productivity to be a major determinant of production costs. The same survey reported serious skill shortages because of poor education and inadequate worker training. Poor infrastructure and market imperfections have also raised production costs but rather surprisingly corruption, injustice, and political interference were not found to be significant factors. The other side of international competitiveness is the quality of products produced. Quality certification and adherence to health, labor, and environmental standards have become highly important in international trade, but have remained neglected in Pakistan.

Firms' ability to survive in the domestic and foreign markets is a key indicator of competitiveness. A study of the factors affecting firm entry, scale and survival in Punjab found that exporting firms have tended to enter highly concentrated industries, that entry and survival have increased with real exchange rate depreciation, and that new firms have tended to be larger in districts with higher concentration of medium sized firms. New entrants in export industries were attracted to existing industrial clusters, though the existing large firms also have had a chilling effect.

Preoccupation with international competitiveness was criticised on the grounds that the concept was ambiguous and liable to result in incoherent and misguided policies. This criticism, however, was not sustained because measures to enhance productivity could benefit Pakistan without hurting other countries. At a time when industrial policy is back on the policy agenda in industrial countries, Pakistan's own approach to industrialisation deserves reconsideration.

## 6. Pakistan's Geo-strategic Location

A corollary of the discussion on international competitiveness was the discussion on Pakistan's strategic importance and international trade relations. An overview of Pakistan's trade relations with its neighbours indicated that there is enormous unexploited potential for trade with India, China, UAE, Iran, and the Central Asian Republics. Contrary to a common perception, Pakistan's non-oil trade within the region has grown very rapidly and now accounts for 25 per cent of its exports and 35 per cent of imports. UAE, Afghanistan and China (with roughly equal weight) account for virtually the entire Pakistani exports to the region, while the share of India and Sri Lanka is barely one per cent.

China and India hold the prospect of becoming Pakistan's key trading partners and could underpin economic expansion, provided a few pressing issues are resolved. Although Pakistan's exports to China have grown rapidly since the signing of the FTA in 2006, their composition (concentrated on cotton yarn) has not been conducive to longer-term growth. On the other hand, the rapid rise in Chinese imports has wiped out many small to medium scale light industries, though consumers have benefited from lower import prices. However, the FTA could benefit Pakistan from China's industrial restructuring resulting from rising wages. Chinese investment into Pakistan could also become a major source of financing and technology, thus helping Pakistan's own industrial restructuring.

The heightened interest in Pakistan to normalize trade relations with India was welcomed. Although trade between the two countries has risen rapidly in recent years, the sharp rise in Pakistan's trade deficit with India (now \$1.5 billion) was a concern. Two sets of questions were raised during the discussions: One, given the experience of the FTA with China, would Pakistani industry not suffer from Indian imports? And, two, while Pakistan's exports had enjoyed MFN treatment in India for some time, why had they failed to grow? On the other hand, India's exports to Pakistan appear not to have been significantly hurt by the absence of MFN. The explanation for the differential trade performance of the two countries was held to lie in the relatively weak competitiveness of Pakistan's industry, differences in tariff structures as applied to what each country exports, and India's high non-tariff barriers.

## 7. Making Devolution Work

The conference's concluding session was devoted to a discussion on making provincial devolution work. The 7<sup>th</sup> National Finance Commission (NFC) Award and the 18<sup>th</sup> amendment to Pakistan's constitution were major steps towards fiscal decentralisation and enhancement of provincial autonomy. The NFC award has brought about a very significant increase in the provinces' share in federally collected taxes and made the sales tax on services a provincial subject. The 18<sup>th</sup> constitutional amendment, at the same time, devolved a great number of government functions to the provinces and granted them enhanced borrowing powers. Although the amendment had the potential of bringing about a fundamental change in governance, little devolution has actually taken place.

A number of concerns were raised. (i) While devolution would require time to become established, key social areas – health and education – could be further neglected. (ii) The consolidated fiscal deficit is liable to rise because federal expenditures would not fall in line with the devolved functions while the revenue-raising effort at the provincial level could slacken. (iii) There is ambiguity with respect to a number of critical areas, notably, registration and pricing of drugs, inter-provincial distribution of wheat and fixing of its procurement price, operation of the national social security scheme, and, perhaps most important, granting of concessions on gas and oil exploration and decentralisation of the power sector. There is also the risk of increased provincialism at the expense of nation building.

While the above-mentioned concerns are real, the devolutionary measures were seen as irreversible and welcomed as a start towards decentralization. As experience is gained, changes and innovations could be introduced to improve the system. The measures have created greater harmony in federal-provincial relations and, by devolving critical services to local levels, have made government accountability more transparent.

## Conference Report\*

The Lahore School's Eighth Annual Conference on Management of the Pakistan Economy took place on 16 – 17 May, 2012 at the school's Main Campus. The topic of this year's conference was: "Towards Accelerated Economic Growth in Pakistan: Its Need and Feasibility". It was attended by the country's leading economists, Pakistani and foreign academics, and renowned researchers from India, Sri Lanka, United Kingdom, and United States. Some 25 research papers and oral presentations were made during the two days of the conference.

The richness of the discussions during the two days of the conference cannot be adequately captured in a short report but, as a record of the salient issues raised, it could be useful for the participants as well as others interested in the subject. Since discussions in different sessions tended to overlap, what is offered here is a composite summing-up rather than a chronological account of the actual proceedings.

## Key Messages

- 1. A push towards accelerated growth is both feasible and essential to creating employment and alleviating poverty in Pakistan.
- 2. Pakistan's current macroeconomic imbalances are unsustainable and must be corrected, but the required adjustments can be gradual and be brought about as economic growth accelerates.
- 3. The biggest hurdle to accelerated economic growth at present is the acute energy shortage, which calls for a concerted government response at overcoming mismanagement in the power sector, renegotiating contracts with power suppliers, and devising a strategy to rely increasingly on domestic and renewable sources of energy, notably, water and coal.
- 4. Accelerated growth is contingent on higher private investment, though public investment in infrastructure would remain vital to sustaining future growth. Economic uncertainty, credit squeeze due to the large public sector borrowing, the law and order situation, and

<sup>&</sup>lt;sup>\*</sup> The conference report was prepared by Irfan Ul Haque, (Special Advisor, Financing for Development, South Centre, Geneva.) who jointly organized the Eighth Annual Conference on Management of the Pakistan Economy with the Center for Research in Economics and Business, Lahore School of Economics, headed by Naved Hamid.

not least the energy crisis hold back private investment, but economic growth could itself improve the investment climate.

- 5. Sustainability of economic growth depends critically on Pakistan's ability to compete in world markets. Productivity improvement in existing export industries is obviously important, but Pakistan's export base also must be broadened towards higher value added industries. Access to technology and improved worker skills will be critical.
- 6. Pakistan's geo-strategic location is an asset but trade opportunities remain under-exploited. The country has failed to reap benefits from the free-trade agreement with China. Trade with India has considerable potential, but it will depend critically on Pakistan's ability to compete.
- 7. The 18<sup>th</sup> constitutional amendment and the 7<sup>th</sup> NFC award devolved key federal functions to the provinces along with greatly increased federal fiscal transfers. Decentralization is to be welcomed but its actual implementation faces certain challenges, notably, preventing fiscal slackening in provinces and ensuring satisfactory delivery of social services (health and education) at local levels.

## **Issues Discussed**

## 1. Feasibility of Accelerated Growth

The conference opened with a discussion on conditions necessary for bringing about accelerated growth in Pakistan. The conventional wisdom is that the macroeconomic imbalances and high inflation constrain the economy's ability to grow, which implies that without significant improvement in these two areas, accelerated growth would not be sustainable. However, Pakistan's current stagflationary state could not be explained in these terms since its macroeconomic imbalances and inflation were broadly similar to those in other but more rapidly growing economies, viz., Bangladesh, India, Indonesia, and Sri Lanka. The country's macroeconomic imbalances and inflation obviously need to be brought down but not too suddenly if the economy is not to be further depressed. A heterodox alternative to the conventional approach to stabilization was proposed, which showed that Pakistan's growth could be accelerated while the required macroeconomic adjustments were phased over the next few years.

The immediate constraint on Pakistan's economic growth in fact is the acute energy shortage that has seriously hurt industrial productivity. However, from the longer-term perspective, Pakistan's low investment rate and weak international competitiveness has held back growth. The heterodox approach is contingent on overcoming these constraints on economic growth.

This approach to accelerated growth is rather different to the one proposed in the Pakistan Planning Commission's *Framework for Economic Growth*, launched May 2011. Although the *Framework* called for "rethinking" Pakistan's growth strategy, no new ground seemed to have been broken. A point was made that, by ignoring Pakistan's own past experience and that of other high growth economies, the *Framework* has uncritically placed faith in the market and private enterprise and is generally dismissive of the role governments routinely play in promoting economic growth. This policy orientation appears to be at odds with the recent calls for greater state activism in the advanced countries, not to mention the state's role in other Asian economies. The *Framework* also did not address the core concerns of mobilizing revenue, income distribution and equity or provide a roadmap of how it would be implemented. In fact, the government has not adopted the *Framework* as a guide to policy.

#### 2. Why Accelerated Economic Growth?

The discussion then moved to the basic compulsion behind choosing this path, i.e., alleviating poverty and reducing unemployment. Some 20-30 million people are estimated to be currently living in absolute poverty and about 3.5 million are unemployed. While overall unemployment has risen in the post-2007 period, real wages rose slightly in the agricultural sector but declined in the construction sector. It is somewhat puzzling that the actual situation is not worse considering the combined effect of the natural disasters, high inflation and low economic growth.

The explanation was seen to lie in certain recent developments in the rural economy, viz., a very large increase in worker remittances into rural areas, substantial improvement in wheat procurement price, an increase in non-farm rural activities, and possibly the transfer payments under the Benazir Income Support Programme and other government income-support programmes. Urban areas too have benefited from the growth of the informal sector and the income-support programs.

The poverty picture, however, could be much worse if the absolute poverty measure was raised to the World Bank's definition of \$1.25 per day, which would entail more than doubling the current

poverty cut-off threshold. In order to ensure that the poor do not get hurt through deficit reduction and benefit from economic growth, government will need to invest in maintaining a "social floor". In other words, without appropriate measures to protect the poor and create employment, growth alone will not be enough.

## 3. The Energy Crisis

The energy crisis was seen as the most serious constraint on investment and economic growth, an issue that surfaced in different sessions. Power cuts are the single biggest cause of the underutilized capacity and the rise in production costs in different industries. The problem was held to be the outcome of two policy shifts during the 1990s: (i) The increased reliance on the private sector for the generation and distribution of electricity; and (ii) the reorientation of power generation from the domestic hydroelectric sources to imported fuels, greatly raising the generation costs. The contracts with the independent power producers (IPP) and later rental power producers (RPP) have proved to be highly costly for both the government and the nation. Instead of the promised improvement in power supplies and public finances, the opposite has happened. To deal with the crisis, the immediate steps involve a renegotiation of the earlier contracts.

Despite the substantial increases in electricity tariffs over time, the drain on fiscal resources has continued. The increased budgetary costs have not been due to consumer subsidies, but rather a result of the past contracts, which were highly favorable to power producers. The government now faces a situation where it faces the consumers' wrath at the cost and unreliability of electricity while the power producers cite government's wholesale violation of legally binding commitments. The so-called circular debt problem is just the pile-up of non-payment of electricity bills along the electricity supply chain.

## 4. Private Investment

That the investment rate in Pakistan must rise substantially to support higher growth was self-evident. That private investment would be the principal trigger of growth was also incontrovertible, though it was frequently stressed that public investment remained critical to improving social and physical infrastructure.

The high fiscal deficit and government borrowing from commercial banks has raised interest rates and "crowded out" private

iv

investment. Nevertheless, after sharply declining in 2009, the private sector off-take of credit has shown signs of weak recovery recently. The fact that private savings have been currently higher than investment is suggestive of capital flight, but in fact it has primarily been a consequence of the fiscal deficit. While Pakistani investors have become more active in overseas investment, there is little evidence of actual capital flight.

Despite the general pessimism, several industries have managed to thrive, and Pakistan's future economic prospects were regarded as fundamentally bright. This is due to a strong consumer base with evident upward social mobility and a rising middle class, falling dependency ratio with the rise in working population, the country's natural resources and, not least, its geo-strategic location. If conditions are to improve and growth picked up, Pakistan's economy – as the other rapidly growing Asian economies – could get into the virtuous circle of high growth-high investment-high savings.

#### 5. International Competitiveness

Rapidly growing economies aggressively promote their exports, but Pakistan remains a laggard. The discussion focused on the reasons for poor productivity growth and the failure to broaden the country's industrial base. While there are isolated cases of creativity and technological sophistication, the country has continued to rely heavily on traditional textile exports and low value-added activities. Industrial deepening and a move towards more sophisticated products has been hindered by the barriers to technology transfer. Subcontracting arrangements with foreign firms to locally produce manufacturing components could be one means of accessing foreign technology. This might enable Pakistan to start producing more complex, diversified, and higher value added products.

Apart from the energy shortage, low labor productivity was cited as the pervasive reason for lack of competitiveness. According to one recent survey, a number of firms considered labor productivity to be a major determinant of production costs. The same survey reported serious skill shortages because of poor education and inadequate worker training. Poor infrastructure and market imperfections have also raised production costs but rather surprisingly corruption, injustice, and political interference were not found to be significant factors. The other side of international competitiveness is the quality of products produced. Quality certification and adherence to health, labor, and environmental standards have become highly important in international trade, but have remained neglected in Pakistan.

Firms' ability to survive in the domestic and foreign markets is a key indicator of competitiveness. A study of the factors affecting firm entry, scale and survival in Punjab found that exporting firms have tended to enter highly concentrated industries, that entry and survival have increased with real exchange rate depreciation, and that new firms have tended to be larger in districts with higher concentration of medium sized firms. New entrants in export industries were attracted to existing industrial clusters, though the existing large firms also have had a chilling effect.

Preoccupation with international competitiveness was criticised on the grounds that the concept was ambiguous and liable to result in incoherent and misguided policies. This criticism, however, was not sustained because measures to enhance productivity could benefit Pakistan without hurting other countries. At a time when industrial policy is back on the policy agenda in industrial countries, Pakistan's own approach to industrialisation deserves reconsideration.

## 6. Pakistan's Geo-strategic Location

A corollary of the discussion on international competitiveness was the discussion on Pakistan's strategic importance and international trade relations. An overview of Pakistan's trade relations with its neighbours indicated that there is enormous unexploited potential for trade with India, China, UAE, Iran, and the Central Asian Republics. Contrary to a common perception, Pakistan's non-oil trade within the region has grown very rapidly and now accounts for 25 per cent of its exports and 35 per cent of imports. UAE, Afghanistan and China (with roughly equal weight) account for virtually the entire Pakistani exports to the region, while the share of India and Sri Lanka is barely one per cent.

China and India hold the prospect of becoming Pakistan's key trading partners and could underpin economic expansion, provided a few pressing issues are resolved. Although Pakistan's exports to China have grown rapidly since the signing of the FTA in 2006, their composition (concentrated on cotton yarn) has not been conducive to longer-term growth. On the other hand, the rapid rise in Chinese imports has wiped out many small to medium scale light industries, though consumers have benefited from lower import prices. However, the FTA could benefit Pakistan from China's industrial restructuring resulting from rising wages. Chinese investment into Pakistan could also become a major source of financing and technology, thus helping Pakistan's own industrial restructuring.

The heightened interest in Pakistan to normalize trade relations with India was welcomed. Although trade between the two countries has risen rapidly in recent years, the sharp rise in Pakistan's trade deficit with India (now \$1.5 billion) was a concern. Two sets of questions were raised during the discussions: One, given the experience of the FTA with China, would Pakistani industry not suffer from Indian imports? And, two, while Pakistan's exports had enjoyed MFN treatment in India for some time, why had they failed to grow? On the other hand, India's exports to Pakistan appear not to have been significantly hurt by the absence of MFN. The explanation for the differential trade performance of the two countries was held to lie in the relatively weak competitiveness of Pakistan's industry, differences in tariff structures as applied to what each country exports, and India's high non-tariff barriers.

## 7. Making Devolution Work

The conference's concluding session was devoted to a discussion on making provincial devolution work. The 7<sup>th</sup> National Finance Commission (NFC) Award and the 18<sup>th</sup> amendment to Pakistan's constitution were major steps towards fiscal decentralisation and enhancement of provincial autonomy. The NFC award has brought about a very significant increase in the provinces' share in federally collected taxes and made the sales tax on services a provincial subject. The 18<sup>th</sup> constitutional amendment, at the same time, devolved a great number of government functions to the provinces and granted them enhanced borrowing powers. Although the amendment had the potential of bringing about a fundamental change in governance, little devolution has actually taken place.

A number of concerns were raised. (i) While devolution would require time to become established, key social areas – health and education – could be further neglected. (ii) The consolidated fiscal deficit is liable to rise because federal expenditures would not fall in line with the devolved functions while the revenue-raising effort at the provincial level could slacken. (iii) There is ambiguity with respect to a number of critical areas, notably, registration and pricing of drugs, inter-provincial distribution of wheat and fixing of its procurement price, operation of the national social security scheme, and, perhaps most important, granting of concessions on gas and oil exploration and decentralisation of the power sector. There is also the risk of increased provincialism at the expense of nation building.

While the above-mentioned concerns are real, the devolutionary measures were seen as irreversible and welcomed as a start towards decentralization. As experience is gained, changes and innovations could be introduced to improve the system. The measures have created greater harmony in federal-provincial relations and, by devolving critical services to local levels, have made government accountability more transparent.

# Pakistan's Quest for a New Growth Vent: Lessons from History

## Ijaz Nabi\*

## Abstract

This article argues that a new growth vent in Pakistan requires tapping into external lucrative markets in a manner that will create multiple entre-ports for growth. Such a growth vent will enable the country to achieve a sustained growth path that is not as susceptible to the political vicissitudes of one mega-growth node. This will be good for regional equity within the country and will also bring new energy to the Indus Basin market. Sustained welfare improvements in this type of regional hub can occur when it transitions from being a transportation hub for goods and energy into a manufacturing hub that creates high-productivity, highwage jobs in multiple regional growth nodes.

Keywords: Regional hub, trade, GDP, Pakistan.

## JEL classification: F43.

## 1. Introduction

Economic growth of 7 percent or more in the coming decades will double Pakistan's GDP every ten years and in four decades will result in a substantial improvement in per capita income. This is not such a tall order, being just 1 percentage point higher than the growth rate that the country has achieved over several decades in the past, and only 2 percentage points higher than the average growth rate since 1947. There is, however, an important caveat. Pakistan has to seek a source of growth, or a "growth vent," that results in geographically balanced growth and can thus be sustained politically for a prolonged period of time. This requires tapping into lucrative markets outside the borders in the neighborhood in a manner that creates several growth nodes, i.e., Karachi, the Arabian Sea coastline of Sindh and Balochistan, Lahore, and Peshawar.

This article reviews Pakistan's recent growth vents and their impact on the economy in terms of creating a vibrant Indus basin market. It then

<sup>&</sup>lt;sup>\*</sup> Visiting Professor, Lahore University of Management Sciences and Country Director of the International Growth Centre, Pakistan.

argues that the new growth vent that Pakistan seeks requires recreating historical trade routes. This will be good for regional equity within the country and will also bring new energy to the Indus Basin market.

## 2. Pakistan's Principal Growth Vents

The region that constitutes Pakistan has seen at least five major vents for economic growth in the last 100 years, as described below.

## 2.1. Canal Irrigation

Starting in the 1860s, the Indian subcontinent saw a remarkable expansion of the irrigation system. For 60 years, the average annual increase in the area under canal irrigation was a phenomenal 50,000 acres (Stone, 1984, p. 340). Punjab, Sindh, and parts of Khyber Pakhtunkhwa benefited substantially from this phase of canal expansion in British India.

Canals were preferred over previous modes of irrigation, not only because of the lower unit costs but also because they extended the range of cropping options for farmers, who could then water crops at their own discretion. These benefits resulted in both intensive and extensive land cultivation, thereby increasing production and, hence, the rate of return to agriculture. Several complementary developments—a legal framework governing land-related transactions, a network of roads and railways, and public services such as education, health, and policing—kick-started economic growth in the regions constituting the Indus Basin market and brought about a substantial increase in income and living standards for nearly 100 years.

#### 2.2. The Korean War and Import-Substituting Industrialization

The second major growth vent is associated with the Korean War. Pakistan's economic managers made a strategic decision in 1949 not to devalue the rupee with respect to the US dollar when Britain devalued the pound and India (the rupee was linked to the British pound) followed suit. Pakistan's rationale was that capital goods had to be imported in order to industrialize and that, therefore, the rupee had to be strong.

The world events that followed supported Pakistan's decision. The Korean War, which broke out soon after the Second World War, led to stockpiling because of the fear of shortages of critical raw material. The jute and cotton produced by Pakistan benefited from the resulting price increase (in four months, the price of 289F Punjab cotton rose by 80.3

percent from PKR 81/maund to PKR 146/maund). This strengthened the rupee and resulted in the accumulation of reserves. India, a major importer of Pakistani cotton and jute, had countered Pakistan's decision not to devalue the rupee by banning imports from Pakistan. This gave Pakistan the opportunity to diversify exports to nontraditional markets and look to foreign trade as a source of sustained economic growth. The fiscal account also became favorable as government revenue increased on account of the export duties imposed, contributing an additional 2 percent of gross national product (GNP) (Hasan, 1998, p. 113).

By not devaluing the rupee, the government kept the cost of imported capital goods low. This was accompanied by import controls, especially on consumer goods, that slanted the incentive regime in favor of industrial production (Zaidi, 2005, p. 93) and launched a period of importsubstituting industrialization in the 1950s. The policy that Pakistan followed has been summarized as "produc(ing) anything that can be reasonably produced domestically... once production has started domestically, ban imports of competing goods so as to save foreign exchange" (Lewis, 1969, p. 70).

Import-substituting industrialization proved to be very successful, particularly in the heavily protected consumption goods industries. Textiles also expanded spectacularly. However, heavy protection exacted a price—the lack of competition resulted in less efficient production (Hasan, 1998, p. 116). The strategy also led to a high concentration of wealth, both regional and interpersonal. At the time, 22 families allegedly controlled 80 percent of the country's assets. Manufacturing was concentrated primarily in Lahore, Karachi, and Faisalabad, which together accounted for 60 percent of the total value-added in 1959/60. This disparity persisted for a decade and contributed to the dissatisfaction that eventually resulted in East Pakistan separating from the federation.

## 2.3. The Green Revolution

Ayub Khan's government began to focus on agriculture in the 1960s, which had stagnated as policy, energy, and incentives (especially via the exchange rate) were directed to implementing import-substituting industrialization. During the first half of the 1960s, there was massive investment in irrigation: Link canals were dug, the Mangla dam was constructed, and the number of tube-wells increased from a few hundred in 1960 to 75,000 by 1968 and a whopping 156,000 by 1975 (Zaidi, 2005, p. 30). The well-timed availability of water was necessary to introduce a

technology package of high-yield varieties of seed, fertilizers, and pesticides, initially focusing on two crops: Mexi-Pak (adapting research from Mexico to Pakistan) and IRRI rice (research based in the Philippines). Between 1960 and 1970, the Mexi-Pak and IRRI output increased by 91 and 141 percent, respectively (Zaidi, 2005, p. 29). Between 1965 and 1970, the average wheat yield rose by around 50 percent per ha (Hamid & Tims, 1990, p. 14). The agricultural growth rate started rising in the early 1960s within the range of 3–6 percent, but after 1966, when all the agricultural inputs had been improved, growth rates jumped to 10 percent per annum.

## 2.4. Overseas Migration and Remittances

The 1970s and 1980s were characterized by a large outflow of labor, both skilled and unskilled, from Pakistan to the Middle East. This was facilitated by a liberal labor export policy. The number of migrant workers increased from 79,000 per annum in the 1970s to 107,000 in the 1980s, and remittances jumped from USD 565 million to USD 2.3 billion per annum, respectively. The high volume of remittance income was geographically spread, benefitting even less well-off regions. At the household level, remittances improved the living standards of recipient families, propelling them to middle-class status. The foreign exchange that workers sent home also had macroeconomic benefits, allowing a high volume of imports at a relatively stable exchange rate.

However, there was a downside. Remittances fuelled consumptionled growth for nearly three decades, contributing to the loss of international competitiveness in manufacturing. This was both because of the high equilibrium exchange rate as well as the broader consumptionfavoring policy environment (energy pricing, credit allocation, tax regime, public investment in transport, etc.; see Nabi, 2010). This manifestation of the "Dutch disease" in Pakistan contributed to the anemic growth of manufacturing and the paucity of high-productivity, high-wage jobs.

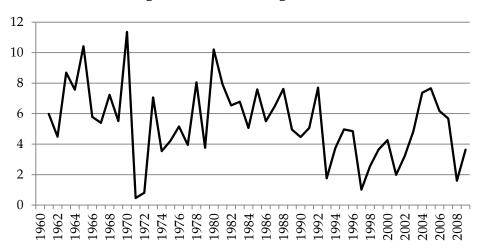
## 2.5. The "War Against Terror"

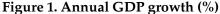
A major growth spurt occurred under Musharraf in 2002–07. For its role in the war against terror, Pakistan was rewarded in terms of concessionary capital from international financial institutions. A substantial portion of the country's external debt was written off and rescheduled, and foreign direct investment (FDI) increased. Remittances, which had fallen sharply in the preceding years, shot up again as confidence in the rupee was restored. This resulted in a substantial improvement in Pakistan's balance of payment, which recorded a surplus of USD 2.7 billion in the early 2000s (Mullick, 2004). GDP growth, which had been at 3.1 percent in 2001/02, began to rise, reaching 6.8 percent by 2006/07. From a deficit of 0.3 percent of GDP in 2000, the current account balance improved to a surplus of 4.9 percent of GDP by 2003.

However, the end years of this growth phase (2006–08) coincided with rising inflation and energy shortfalls. The share of investment and manufacturing in GDP and employment did not show any increase, growth in imports far exceeded that of exports, and the tax-to-GDP ratio stagnated. Growth and its salutary effects were, therefore, short lived.

## 2.6. Assessing Pakistan's Growth Cycles

Figure 1 shows an oscillating growth pattern—the **boom-and-bust cycles** of Pakistan's growth. There appear to be ten-year cycles. The 1960s and 1980s (with growth in most years above 6 percent) were decades of robust growth, while the 1970s and 1990s (with an average growth rate of around 4 percent) saw modest growth. The 2000s experienced high growth in 2001–07, followed by a slump starting in 2008.





Source: World Bank (2010), World development indicators.

Assessing these growth vents in term of their effect on regionally balanced growth, the canal colonies would rank first, followed by the Green Revolution. Protection and industrialization would be a distant third, both because they could not be sustained and because they resulted in unbalanced growth. Migration to the Gulf is fourth, simply because the primary stimulus comes from outside and we have not yet found a way of climbing up the skills ladder; the growth vent is thus vulnerable. The externally financed, geopolitically driven, growth spurts under Zia and Musharraf fail the sustainability criteria; the latter was, geographically, decidedly unbalanced, and also increased inequality across income groups.

Another way to look at the growth of the last six decades is in terms of the creation, perhaps for the first time in history, of an integrated **Indus Basin market**. A strong and interdependent market for products, labor, and financial flows has been created between the Indian border to the east and the Indus River to the west (Figure 2). Pakistan's economic managers wisely invested in a communications infrastructure spanning railways, ports, roads, a postal system, and telephones, which has been key to the development of the Indus Basin market. Spokes in the southwest extend the market to Quetta in Balochistan and in the northeast to the regions of the Karakorams and the Hindu Kush. The market enjoys perhaps the best connectivity of any subregion in South Asia. The National Trade Corridor (NTC) links Peshawar, through Lahore to Karachi and Port Qasim, and "handles the major part of Pakistan's external and internal trade" (World Bank, 2006, p. 8). The World Bank also points out that

the bulk of Pakistan's international trade, about 40 million tons per annum... is transported by road along this main corridor. Almost all of this trade (95 percent) is handled by the two seaports of Karachi and Port Qasim, located about 50 km from each other. Pakistan's trade is characterized by a concentration of movements within the country (mainly along the NTC), a small number of export destinations and import origins (2006, p. 17).

This connectivity has, therefore, facilitated Pakistan's growth spurts and the sharing of welfare from that growth across a wide region.

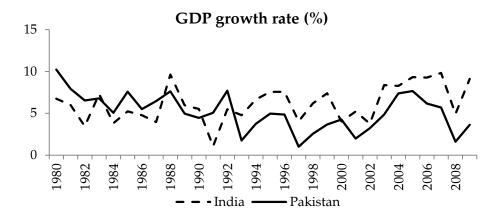


# Figure 2: Pakistan's Indus Basin market along the north–south trade corridor

#### 3. Recent Growth Performance

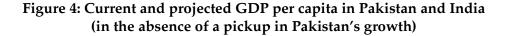
The search for a new growth vent, one that builds on the strengths of the NTC and the Indus Basin market to give Pakistan sustained, high, and regionally balanced economic growth, has to begin with an assessment of the country's recent lackluster growth performance. To that end, a comparison with India's economic performance is useful. India's recent GDP growth rate (averaging 8 percent) is more than twice that of Pakistan (Figure 3). Moreover, because India's population growth is lower, its per capita income is growing even faster (Figure 4).

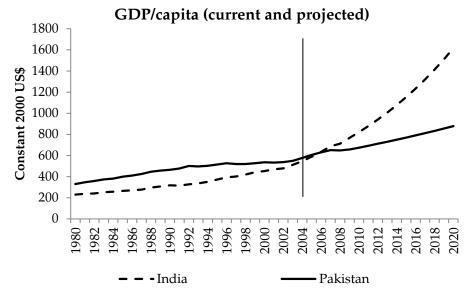
This divergent economic performance has two implications. First, in the not-too-distant future, living standards, including the quality of infrastructure and public services, will be better in India. (See also Table 1.) Significantly, the country will also have a larger lobbying presence at international forums, which will have consequences for Pakistan's ability to maintain parity across a broad range of contested and competing issues. Second, India's capacity to modernize its security establishment will be far greater than Pakistan's.





Source: World Bank (2011), World development indicators.





Note: These projections have been done using growth rates averaged over the last 5 years. *Source:* World Bank (2011), *World development indicators*.

GDP indicator	2006	2020
Pakistan's GDP as a share of India's GDP (%)	14	9
GDP per capita in Pakistan as a proportion of India's (%)	99	54
Value of 1 percent GDP spent on public services in India (USD billion)	7	22
Value of 1 percent GDP spent on public services in Pakistan (USD billion)	1	2

Table 1: Sobering trends in GDP growth

Thus, in its quest for the next growth vent, Pakistan will want to turn India's growing economic capability to its advantage, bridge the income gap, and then overtake India's growth rate, as it did in the 1960s and 1970s. This is not as ambitious as it might seem, given the current performance of the two economies. As Figure 3 shows, in most years in the 1980s, Pakistan's GDP growth was higher than that of India. Furthermore, even now, Pakistan ranks higher than India on many indicators of the cost of doing business (Table 2). Thus, a solid foundation already exists on which to build a mutually beneficial economic relation with India.

Indicators	Pakistan	India
Trade: Cost to export (USD per container)	611.0	1,055.0
Trade: Cost to import (USD per container)	680.0	1,025.0
Trade: Time to import (days)	18.0	20.00
Ease of doing business index (1 = easiest to 183 = most difficult)	83.0	134.0
Cost of starting a business (percent of income per capita)	10.7	56.5
Time required to start a business (days)	21.0	29.0
Procedures required to start a business (number)	10.0	12.0
Total tax rate (percent of profit) <sup>1</sup>	31.6	63.3
Profit tax (%) <sup>2</sup>	14.3	24.0
Other taxes $(\%)^3$	2.3	21.1
Tax payments (number) <sup>4</sup>	47.0	56.0
Time required to enforce a contract (days)	976.0	1,420.0
Cost of enforcing a contract (percent of claim)	23.8	39.6
Procedures required to build a warehouse (number)	12.0	37.0
Closing a business: Cost (percent of estate)	4.0	9.0
Closing a business: Recovery rate (cents on the dollar)	36.5	16.3

Table 2: Comparison of investment and cost-of-doing-business indicators (2010)

<sup>1</sup> The total tax rate (percentage of profit) measures the amount of taxes and mandatory contributions payable by businesses after accounting for allowable deductions and exemptions as a share of commercial profits. Taxes withheld (such as personal income tax) or collected and remitted to tax authorities (such as value added taxes, sales taxes or goods and service taxes) are excluded. http://data.worldbank.org/indicator/IC.TAX.TOTL.CP.ZS

 $^2$  Profit tax (percentage of commercial profits) is the amount of tax on profits paid by a business. http://data.worldbank.org/indicator/IC.TAX.PRFT.CP.ZS

<sup>3</sup> Other taxes payable by businesses (percentage of commercial profits) include the amounts paid for property taxes, turnover taxes, and other small taxes such as municipal fees and vehicle and fuel taxes. http://data.worldbank.org/indicator/IC.TAX.OTHR.CP.ZS

<sup>4</sup> Tax payments (number) by businesses are the total number of taxes they pay, including electronic filing. The tax is counted as paid once a year even if payments are more frequent. http://data.worldbank.org/indicator/IC.TAX.PAYM

Source: World Bank (2009), Doing business 2010.

## 4. Searching for a New Growth Vent

While a strong internal north–south corridor has helped create a vibrant Indus Basin market, it has also turned Pakistan into a lopsided economy. Thus, despite a relatively small coastline relative to its land borders with three major economies (Iran, China, and India) and one

important region (Central Asia), the bulk of Pakistan's economic contact with an increasingly globalizing world is through one port city, Karachi, which is a mega-growth node. This strategy worked well for 60 years, but given the congestion of Karachi's ports and the city's complex and volatile politics, it may now have run its course.

This article argues that a new growth vent, one that will yield a prolonged period of growth as the canal colonies did 100 years ago, requires tapping into external lucrative markets in a manner that will create multiple entre-ports for growth (such as Lahore, Peshawar, and other ports on the Sindh/Balochistan coastline). Such a growth vent will enable the country to achieve a sustained growth path that is not as susceptible to the political vicissitudes of one mega-growth node.

#### 4.1. A Historical Perspective

Pakistan's border regions have shared systems of economic transactions and cultural ties with neighboring regions that lie outside its current political borders. The area that is now Pakistan was home to one of the world's earliest civilizations. For centuries, this region held a central position in relation to the rest of the world, a place where different societies mingled, culturally and economically. Cities such as Lahore, Multan, and Peshawar, and those in upper Sindh lay on trade routes connecting lands to their west—Iran, Central Asia, and China—and those to the east—India (Figure 5). They became centers of trade, commerce, and culture and brought prosperity to the regions they commanded (Figure 6).

Lahore in Punjab was the center of trade, commerce, finance, and education for a region that included Indian Punjab, Haryana, the Jammu and Kashmir valleys, and Himachal Pradesh to its east, and linked these regions with Persia and Central Asia to its west. However, Lahore was cut off from the lands to its west with the coming of the British and from those to the east soon after 1947 as a result of India–Pakistan feuds.

The ancient walled city of Peshawar has cast a large shadow on South Asian culture. A number of famous Indian actors (the Kapurs, Dilip Kumar, and Shahrukh Khan) hail from Peshawar as do several world squash champions. The city's prominence stems from its history—its merchants constituted a prosperous hub of economic transactions between South Asia and the Central Asian territories. The influence of trade on the surrounding Pashtun areas could also have been substantial had imperial rivalry between Russia and Britain not cut off Peshawar from its northern markets and had 1947 not severed access to the Indian market. Subsequently, the pool of economic transactions for Peshawar shrank dramatically. It is also noteworthy that the modern "Silk Route" through Hazara and Gilgit–Baltististan on the Chinese border is an attempt to recreate the ancient trade links that were severed during colonial times.

Sindh has been hugely significant in shaping Pakistan's religious/cultural psyche, which is historically embedded in the venerated Sufi tradition of Islam. The Sufi saints chose to settle in Sindh along the Indus because there were receptive host communities that benefited from the trade routes between markets in territories that now lie in India and Iran through Balochistan.

## Figure 5: The cultural influences that have shaped Pakistan



Back to the future



Figure 6: .... and the east-west trade routes they spawned

Historically, these cultural centers have defined themselves as parts of much larger regions that lie outside the borders of the modern nationstate of Pakistan. Indeed, they were better connected with trade and cultural centers outside modern Pakistan than those that lie within it. This has posed a challenge for the country's nation builders. Hemmed in by colonial borders on one hand and bad relations with India on the other, Pakistan's policymakers have attempted to reshape the country's economic geography. Departing from historical patterns that emerged over centuries, they created the north–south corridor defined by new borders, which, as discussed earlier, facilitated the major growth vents of the last six decades.

## 4.2. The Changing World Around Pakistan's Land Borders

As recently as the 1980s, it did not matter that the old east-west trade routes lay abandoned. China was in a long slumber and performing far below its capabilities as a potential economic giant. Western China, in particular, was mired in low growth and, for Pakistan, that was the more relevant region. Central Asia's mineral wealth was being exploited in Russian interests. India, with its low "Hindu" growth rate, was shackled to a heavy-handed and stifling regulatory framework born of Fabian aspirations and a decaying colonial bureaucratic heritage. In the last 30 years, however, all this has changed.

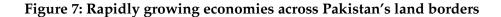
Ijaz Nabi

Under Deng Xiao Peng, China arose from its slumber in the early 1980s and has since become an economic powerhouse with growth rates of 10 percent per annum for over two decades. It is undergoing major restructuring to deepen growth beyond the Pacific coast to western China, which will bring it to Pakistan's northern land border. The rising Chinese middle class constitutes a huge consumer market for Pakistani products. China's high savings could be a deep pool of investment for Pakistan. An economy of over a billion people with the potential to grow at 10 percent for several more decades beckons from across Pakistan's northern border.

India followed China a decade later, with the reforms of Prime Minister Narasimha Rao. Its cumbersome regulatory framework is being dismantled and its spectacular growth in the information technology sector has given India a "techie" shine that has attracted world attention. The country is on an impressive growth trajectory of 7–8 percent growth per annum and is now recognized as a major emerging economic power. In short, another economy of over a billion people, high savings, and rising living standards lies beyond Pakistan's long eastern land border.

Across the northwestern border, beyond troubled Afghanistan and our own volatile tribal belt, are the newly independent Central Asian republics—Turkmenistan, Uzbekistan, Kazakhstan, Kyrgyzstan, and Tajikistan. Rich in natural resources that are no longer being siphoned off by the Soviet behemoth, the Central Asian republics are engaging with the world to exchange their mineral wealth for goods and services that satisfy the growing consumption and rising living standards of their citizens. Finally, beyond Pakistan's western border lies Iran, rich in oil and natural gas that it would be free to sell to needy South Asia in exchange for skilled labor and consumption goods once its strategic interests are allied with its citizens' welfare.

The figures below show the changing economic profiles of the countries discussed above in terms of growth in size of GDP (Figure 7); population (Figure 8); size of crude oil, gas, and currency reserves (Figures 9–11) and the rapid increase in imports by energy-rich Central Asia (Figure 12 and Table 3). The last two are striking in that they reveal how little of the increase in Central Asian imports comes from South Asia. In turn, this underscores the absence of the traditional east–west trade corridor that could have enabled South Asia to take a much larger share of Central Asian imports compared to the current situation.



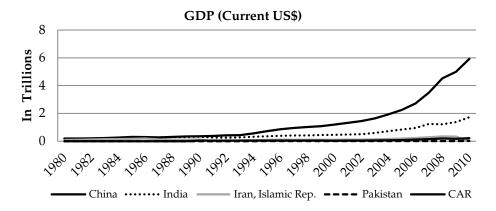


Figure 8: Potential for further growth measured by population

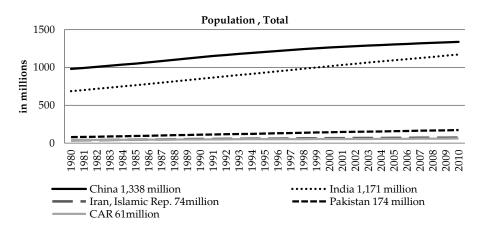
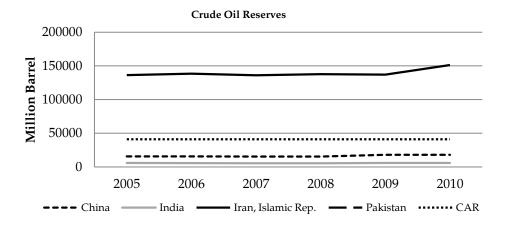


Figure 9: Crude oil reserves in countries across Pakistan's land borders



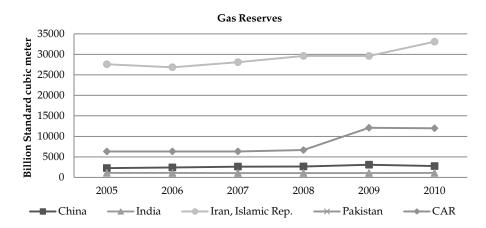
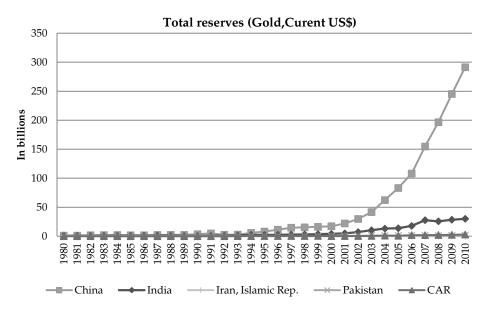


Figure 10: Gas reserves in countries across Pakistan's land borders

Figure 11: International reserves accumulation in countries across Pakistan's land borders



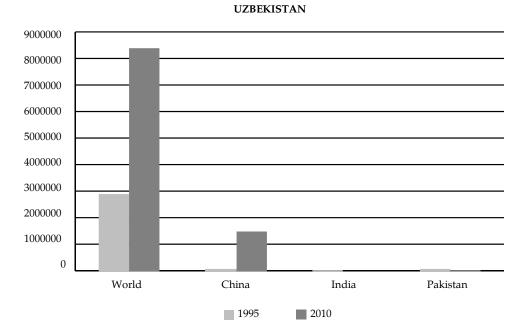


Figure 12: Increase in imports of Central Asian republics

Table 3: Regional sources of Central Asian import
---

	Imports, 2008		Import trading
Country	(USD billion)	Major imports	partners
Kazakhstan	37.530	Machinery and equipment, metal products, foodstuffs	Russia, China, Germany
Kyrgyzstan	3.476	Mineral products, machinery and electrical equipment, chemical products, foods and beverages, textiles	China, Russia, Kazakhstan
Tajikistan	3.200	Fuels, electric power, aluminum oxide	Russia, Kazakhstan, Uzbekistan, China
Turkmenista n	5.291	Machinery and transport equipment, chemicals, foods	United Arab Emirates, Azerbaijan, US
Uzbekistan	6.500	Machinery, chemicals, plastics, foods, and metals	Russia, Rep. of Korea, Germany, China

Sources: Federal Research Division, Library of Congress

(http://memory.loc.gov/frd/cs/profiles/); Central Intelligence Agency (https://www.cia.gov/library/publications/the-world-factbook/); United Nations

(http://data.un.org/).

## 5. What Pakistan Needs

The east-west economic routes—which go beyond trade in goods and include energy flows, the movement of workers, and investment flows—and the growth vent associated with them will not be realized till there is peace in Afghanistan, Pakistan's tribal belt straddling the Afghan border is stabilized, and Balochistan effectively re-engages with the federation. Furthermore, without normalizing trade with India, the Indus Basin will remain a T-junction rather than a crossroads of economic transactions, which will limit the welfare gains from the new growth vent.

## 5.1. Stabilizing the Durand Line

To contribute to peace in Afghanistan, the concept of strategic depth needs to be revisited and cast in terms of deepening economic transactions. Residents on both sides of the Durand Line well understand the welfare gains to be garnered via economic synergies between Peshawar and Jalalabad on one hand and Kandahar and Quetta on the other. Pakistan's light engineering sector can service the rich agricultural lands in Afghanistan and, in turn, become a market for Afghanistan's cash crops, demand for which could extend to all of South Asia. Pakistan's financial sector and flourishing private school networks could provide key services and assist Afghanistan in building its own systems. The extension of roads beyond the Durand Line and trade-facilitating infrastructure on the border would be a precursor to trade in Afghanistan's substantial mineral wealth.

Throughout history, Pakistan's land-poor tribal belt has looked to out-migration for sustenance. Canal irrigation in the Peshawar valley and the plains of Mardan was a major growth vent in the past. Many tribespeople settled on the lands and brought about lasting productivity, improvement, and prosperity. During Pakistan's import-substituting industrialization phase, Karachi became a magnet for jobs and entrepreneurial activity, attracting a large number of tribespeople. As a result, it is today the largest Pathan-populated city where people with strong connections with the tribal belt dominate the transport sector and its networks throughout the Indus Basin market.

As trend economic growth declined in Pakistan and job creation slowed down, people from the tribal belt found opportunities abroad, especially in Saudi Arabia and the oil-rich Gulf states. With the decline in economic dependence on Pakistan, the tribal belt's relationship with the federation weakened, contributing to the ongoing militancy. The relationship of mutual dependence between the federation and tribal belt needs to be restored. This will require higher economic growth in Pakistan, ensuring that the tribal belt benefits from regional trade via the transport networks, and upgrading skills in the area to allow its citizens to secure higher-wage employment in the Middle East.

## 5.2. The Centrality of Balochistan

Balochistan will be central to Pakistan's prospect of becoming a regional hub for trade in goods and energy. The province's strategic location makes it pivotal both for the east-west and north-south trade routes. The historical trade route linking markets in Indian Gujrat, upper Sindh, and Iran traverses Balochistan, as does the trade route to Kandahar in Afghanistan and beyond to Central Asia. Thus, establishing peace in Balochistan and upgrading its infrastructure and transport networks along the east-west routes must become a priority both for the province's development as well as for Pakistan's own overall economic growth.

Balochistan also offers exciting prospects with considerable economic benefits in terms of a second north–south trade corridor. These arise from the province's 800-kilometer-long Makran coastline on the Arabian Sea and Indian Ocean. According to some estimates,

90 percent of inter-continental trade and two thirds of all petroleum supplies travel by sea. Globalization relies ultimately on shipping containers, and the India Ocean accounts for one half of all the world's container traffic. Moreover, the Indian Ocean rim land from the Middle East to the Pacific accounts for 70 percent of the traffic of petroleum products for the entire world. Indian Ocean tanker routes between the Persian Gulf and South and East Asia are becoming clogged, as hundreds of millions of Indians and Chinese join the global middle class, necessitating vast consumption of oil (Kaplan, 2011).

Kaplan goes on to write, "If there are great place names of the past—Carthage, Thebes, Troy, Samarkand, Angkor Wat—and of the present Dubai, Singapore, Tehran, Beijing, Washington—then Gwadar might qualify as a great place name of the future."

Raman (2009) muses:

So imagine now a bustling deepwater port with refuelling and docking facilities at the extreme Southwestern tip of Pakistan, more a part of the Middle East than of the Indian Sub-continent, equipped with highway and oil and natural gas pipelines that extend northeast all the way through Pakistan ---cutting through some of the highest mountains in the world, the Karakorams---into China itself, from where more roads and pipelines connect the flow of consumer goods and hydrocarbons to China's middle class fleshpots farther east.

Wirsing (2008) points out that "the pipelines would also be used to develop China's restive, Muslim far west; indeed, Gwadar looked poised to cement Pakistani and Chinese strategic interests."

Meanwhile, another branch of this road and pipeline network would go from Gwadar north through a future stabilized Afghanistan, and onto Iran and Central Asia. In fact, Gwadar's pipeline network would lead into a network extending from the Pacific Ocean westward to the Caspian Sea. In this way, Gwadar becomes a pulsing hub of a new silk route, both land and maritime: a mega project and gateway to landlocked, hydrocarbon-rich Central Asia—an exotic twenty-first century place name.

Thus, both Islamabad and Quetta have much to gain from a joint strategy of economic growth based on regional trade. This requires strengthening the relationship of mutual dependence and trust. To that end, the 18th Amendment to the Constitution and the supporting 7th National Finance Commission (NFC) Award in 2010 was an important first step. The constitutional amendment virtually eliminates the concurrent list and transfers most of the responsibility for economic development to the provinces. To back this up financially, the NFC award has reduced the federal share of the pool of resources and substantially increased Balochistan's share. This follows from greater weight given to underdevelopment and thin population density (which increases the cost of service delivery) in the distribution formula. In turn, Balochistan needs to develop its capacity to utilize the additional resources more effectively. The NFC award presents opportunities to that end. National investment priorities to promote regional trade could be dovetailed with complementary Balochistan investments via the provincial annual

development plan to implement a comprehensive strategy for upgrading infrastructure that supports larger volumes of regional trade.

The federation also needs to revisit the sensitive issue of natural resource pricing, given the perception that it is skimming off large rents. Natural gas is a case in point. Subsidizing natural gas for urban residential consumers, most of them in Punjab and Karachi, by keeping well-head prices far below international prices fuels resentment in Balochistan.

The land grab in Gwadar has not helped in building trust between the Baloch and the federation. As Gwadar's prospects brightened with the construction of the port, the rich and well-connected from Karachi, Lahore, and other parts of Pakistan are alleged to have bribed low-ranking local officials to allot them land at rock-bottom prices, which they then sold off to developers at much higher prices, thus skimming off huge speculative rents. The Baloch regard this as theft and cite it as an example of the unfair treatment meted out to them by the federation. Solutions such as a turnover tax on each land transaction that is deposited in a fund for the exclusive use of the Baloch in Gwadar would help allay such perceptions.

These examples show that Pakistan must explicitly incorporate regional equity into its national development strategy. The fact that Balochistan has less than 5 percent of the country's total population of 180 million but most of its mineral wealth and coastline should be enough incentive to pursue such strategies.

#### 5.3. Engaging with India

A number of studies (Khan, 2009; Nabi, 2012; Nabi & Nasim, 2001; Naqvi & Nabi, 2008) have estimated the salutary impact of India–Pakistan trade liberalization on Pakistan's economy, both in terms of overall trade volumes as well as on the vast majority of stakeholders. Pakistan's role as a hub of regional trade is incomplete unless the east–west—and north– south—trade routes extend to India.

Figure 13 illustrates trade flows that indicate the greater vibrancy of Indus Basin economic transactions, following the re-establishment of the east–west trade corridors. Liberalizing the country's economic relationship with India takes on greater urgency if Pakistan is to enjoy the current entrypoint comparative advantage in the cost of doing business, and especially the advantage in infrastructure efficiency. This advantage will be eroded as India reduces business costs and improves its infrastructure. Had Pakistan liberalized 20 years ago, it would have enjoyed the entry-point advantage of a far better overall investment climate that has eroded over time.

India's recent (1<sup>st</sup> August 2012) liberalization of its investment regime—lifting the ban on foreign direct investment from Pakistan into India—and Pakistan's earlier announcement that it would move from positive list-based to negative list-based bilateral trade (granting India most favored nation [MFN] status) are welcome developments. However, for trade to resume on a meaningful scale, several remaining stumbling blocks need to be addressed.

The granting of MFN status to India was accompanied by the announcement of a long and unwieldy negative list of 1,200 items. Pakistan has stated that the list will be phased out in a year, and it must adhere to this timetable. In addition, a bilateral commission should be set up to address the issues that are closely tied to India and Pakistan having a normal economic relationship with sustained benefits. The commission should focus on the following areas.

- 1. **Goods- and services-related nontariff barriers (NTBs):** The objective would be to use the WTO framework to address Indian (and Pakistani) NTBs and then bring these into the strategic regional trade policy framework outlined above. The institutional capacity (National Tariff Commission) to address NTBs and antidumping complaints should be developed with a view to promoting rather than hindering trade.
- 2. Land routes: The maximum benefits of a more liberal trade regime with India will come from land routes that minimize response time to market forces. This will require opening up as many overland routes as possible, building on the old road and railway networks all along the border from the Kashmir region to the Arabian Sea.
- 3. **Travel:** Travel (visas, air/road/railway transport) must be facilitated to promote competitive trade in goods and services that will benefit small and medium-sized firms. This will make it possible to tap into the large pool of Indian skilled workers, gain access to Indian farm and other technology, and encourage cross-border tourism.



# Figure 13: Enhancing the vibrancy of north-south (Indus Basin) trade flows by reopening the historical east-west trade routes

To create a sustained momentum for liberalizing trade and investment flows, it would be useful to set up a regional trade forum comprising the private sector, academia, and the media, to monitor the working of the bilateral commission described above. The forum should (i) identify barriers to trade embedded in the trade policy, payment system, and communications (including travel); (ii) help identify the losers from the trade liberalization process and suggest ways of compensating them; and (iii) help formulate a broader regional trade and investment promotion strategy.

### 5.4. India's Role in Promoting Bilateral and Regional Trade<sup>1</sup>

All paths to economic development and prosperity do not have to be routed through sweatshops catering to affluent western consumers. A large and vibrant Asian regional market would constitute a significant and, given demographic shifts, growing part of global demand for products. India's long-term strategic interest is to help create that Asian market. That, in turn, requires strengthening Pakistan as an effective regional hub that would connect the Asia-wide market.

<sup>&</sup>lt;sup>1</sup> This discussion is based on Nabi (2012, March 28).

Successfully managing the new liberalized India–Pakistan trade regime to scale it up to a full-fledged economic relationship will be vital. In the short term, this may well mean exercising voluntary restraint on exports that might hurt small and medium-sized Pakistani manufacturers. It will also require focusing on the export of machinery and technology to Pakistani firms that currently import these at a high cost from more expensive developed country sources. Joint ventures and other investment strategies will need to be developed to set up production units for the Asiawide market. The visa regime will need to be liberalized and travel facilitated so that small entrepreneurs develop cross-border business linkages and the gains from liberalization can be more widely shared.

### 6. Concluding Remarks

Pakistan's recent growth performance is worrisome because it is far below the trend growth rate and, given its population growth, threatens the objective of sustained welfare improvement for the country's citizens. Furthermore, this poor growth performance is in stark contrast to rising prosperity within the region. China, India, the Central Asian republics, and Iran are all doing well. A review of the major growth vents of the last 60 years shows the important role of policy in promoting economic growth. Policy, furthermore, helped create a strong and well-integrated Indus Basin market, perhaps for the first time in history, through investment in communications and a regulatory framework that allowed the market to promote a network of integrating transactions throughout the Indus Basin. The fact that countries outside the region were caught up in internal turmoil and poor economic governance also helped strengthen this market because Karachi became the principal trading hub for all regions of the country.

The present regional outlook is different. While Pakistan's growth vents have run their course, China and India, both billion-people-plus economies, are the world's new growth engines; the Central Asian republics are ready to exploit their mineral wealth for the welfare of their own citizens, and so will Iran as it begins to engage with the world.

These fast improving regional prospects underscore the importance of Pakistan's centrality as a connector of regional markets. We have shown that this is a familiar role. Historically, three regions in Pakistan—the Peshawar valley and Hazara in the north, Lahore and Multan in the center, and upper Sindh in the south—were on the east–west trade routes that connected markets in the east (now India) with markets in the west (now the Central Asian republics and Iran). As regional trading hubs, they enjoyed cultural richness and economic prosperity and were hugely influential in shaping the South Asian identity.

This article argues, furthermore, that reopening the historical eastwest trade routes to trade in goods and energy will give renewed strength to the Indus Basin market by increasing the flow of economic transactions. It will also help restore the economic and cultural vibrancy of the subregions and promote more equitable growth. The new growth vent, one that will give sustained high growth for several decades, thus entails Pakistan reoccupying its centrality as a hub for regional trade.

Becoming a regional hub entails normalizing economic relations with India. The transactions dynamics of a T-junction, i.e., regional trade without India, are different from those of a hub, i.e., regional trade with India included. A good beginning has been made with the resolution of India's MFN status and the liberalization of the bilateral investment regime. This should be followed up by paring down the negative list, addressing NTBs, allowing multiple trade points along the border, and most importantly, facilitating travel for business and tourism. A liberal visa regime will make small businesses stakeholders in regional trade, which is essential to keep the process on track, given the political pitfalls in India– Pakistan relations.

Sustained welfare improvements for the citizens of a regional hub arise when it transitions from being a transportation hub for goods and energy into a manufacturing hub that creates high-productivity, high-wage jobs in multiple regional growth nodes. Such a transition requires strengthening Pakistan's international competitiveness as a manufacturing base. Key to this is a skilled workforce, modern infrastructure (ports, roads, and energy), substantially improved governance to improve service delivery, and a development framework that promotes investment and manufacturing over consumption. Several recent studies detail ongoing/proposed reforms in each of these areas.<sup>2</sup> These need to be distilled to draw up an agenda of reform for the medium term aimed at strengthening Pakistan's international competitiveness. This will help make the transition from a transportation hub to a manufacturing hub that can sustain high growth and create employment opportunities that improve living standards across Pakistan.

<sup>&</sup>lt;sup>2</sup> See Pakistan, Planning Commission (2011); Nabi (2010); Education and Skills, Governance Reform, National Transport Corridor, Fiscal Reform, Industrialization, Provincial Economic Reports and Clusters by World Bank.

### References

Caroe, O. (1958). The Pathans. Karachi, Pakistan: Oxford University Press.

- Hamid, N., & Tims, W. (1990). *Agricultural growth and economic development: The case of Pakistan* (Working Paper No. 13). Paris, France: Organisation for Economic Co-operation and Development.
- Hasan, P. (1998). *Pakistan's economy at the crossroads: Past policies and present imperatives*. Karachi, Pakistan: Oxford University Press.
- Kaplan, R. D. (2011). *Monsoon: The Indian Ocean and the future of American power*. New York, NY: Random House.
- Khan, M. S. (2009). *India–Pakistan trade: A roadmap for enhancing economic relations* (Policy Brief No. PB09-15). Washington, DC: Peterson Institute for International Economics.
- Lewis, S. (1969). *Economic policy and industrial growth in Pakistan*. London, UK: George Allen and Unwin.
- Mullick, H. (2004, June). US foreign aid and economic growth: A post-9/11 case study of Pakistan as a key ally in the war against terrorism. In *Proceedings of the Pennsylvania Economic Association Conference* 2004.
- Nabi, I. (2010). *Economic growth and structural change in South Asia: Miracle or mirage?* (Monograph). Lahore, Pakistan: Lahore University of Management Sciences, Development Policy Research Center.
- Nabi, I. (2012, March 28). Lifting up the India–Pakistan trade game. *The Hindu*.
- Nabi, I. (2012). *Pakistan–India trade: Preparing for a better future*. Washington, DC: Woodrow Wilson Center.
- Nabi, I., & Nasim, A. (2001). Trading with the enemy: A case for liberalizing Pakistan–India trade. In S. Lahiri (Ed.), *Regionalism and globalization: Theory and practice* (pp. 170–197). London, UK: Routledge.
- Naqvi, Z., & Nabi, I. (2008). Pakistan–India trade: The way forward. In M. Kugelman & R. M. Hathaway (Eds.), *Hard sell: Attaining Pakistan's competitiveness in global trade*. Washington, DC: Woodrow Wilson Center.

- Pakistan Business Council. (2011). *Regional trade panel report*. Karachi, Pakistan: Author.
- Pakistan, Ministry of Commerce. (1996). *Pakistan–India trade: Transition to the GATT regime*. Islamabad, Pakistan: Author.
- Pakistan, Planning Commission. (2011). *Pakistan: Framework for economic* growth. Islamabad, Pakistan: Author. Retrieved from http://www.pc.gov.pk/hot links/growth\_document\_english\_version.pdf
- Raman, B. (2009). *Hambantota and Gwadar: An update*. Chennai, India: Institute of Topical Studies.
- Stone, I. (1984). *Canal irrigation in British India: Perspectives on technological change in a peasant economy*. Cambridge, UK: Cambridge University Press.
- Wirsing, R. G. (2008). Baloch nationalism and the geopolitics of energy resources: The changing context of separatism in Pakistan. Carlisle, PA: US Army War College, Strategic Studies Institute.
- World Bank. (2006). *Pakistan: Growth and export competitiveness*. Washington, DC: Author.
- World Bank. (2009). *Doing business* 2010. Washington, DC: Author.
- World Bank. (2011). *Doing business 2012: Doing business in a more transparent world*. Washington, DC: Author.
- World Bank. (2010–2011). *World development indicators*. Retrieved from http://data.worldbank.org/data-catalog/world-development-indicators
- Zaidi, S. A. (2005). *Issues in Pakistan's economy*. Karachi, Pakistan: Oxford University Press.

# The Opportunities and Pitfalls of Pakistan's Trade with China and Other Neighbors

# Naved Hamid\* and Sarah Hayat\*\*

# Abstract

While Pakistani trade with India could give a boost to Pakistan's economy, there are other neighbors with whom trade could be equally important. We look at this aspect of regional trade and show that promoting trade with the rest of Pakistan's neighbors could have a significant positive impact on the country's growth. We show that Pakistan's trade with these neighbors has grown rapidly over the last 10 years and at present they constitute the largest market for Pakistani exports. We also explain how these exports are not only important in terms of absolute value, they have also contributed to the development of new export products. The overall impact on Pakistan's economy could well be to raise the trend growth rate for the next decade or so by 2 to 3 percentage points above the historical trend growth rate of 5 percent per annum.

**Keywords:** Exports, regional trade, Pakistan, China, UAE, Central Asia, Afghanistan

### JEL classification: F13.

## 1. Introduction

There is increasing recognition in Pakistan that regional trade could be an important driver of growth for the country. However, much of this debate has focused on India–Pakistan trade.<sup>1</sup> While, undoubtedly, trade with India could give a tremendous boost to Pakistan's economy, there are other neighbors with whom trade could be equally important. We propose to look at this neglected aspect of regional trade and show that promoting trade with the rest of Pakistan's neighbors could have a significant positive impact on the country's growth over the next decade or more. Trade with

<sup>\*</sup> Director of the Centre for Research in Economics and Business at the Lahore School of Economics, Pakistan.

<sup>\*\*</sup> Research Assistant, Centre for Research in Economics and Business at the Lahore School of Economics, Pakistan.

<sup>&</sup>lt;sup>1</sup> An important exception was a report prepared at the request of Jahangir Khan Tareen, federal minister for industries, production, and special initiatives, for the Government of Pakistan in 2005 by a team of economists led by Ijaz Nabi (see Nabi et al., 2005).

India and trade with the other neighbors are two sides of the same coimpromoting trade with both would have tremendous synergies. The overall impact on Pakistan's economy could well be to raise the trend growth rate for the next decade or so by 2 to 3 percentage points above the historical trend growth rate of 5 percent per annum.

Section 2 provides a review of the trends in growth in trade, particularly exports in the last decade. In the next three sections, we discuss trends in exports at the aggregate and commodity level, as well as the pitfalls, opportunities, and appropriate policies to promote exports with respect to Pakistan's three largest trading partners of its neighboring countries, i.e., China, the United Arab Emirates (UAE), and Afghanistan. Section 6 briefly reviews the potential for trade with Central Asia, overland through Afghanistan. Section 7 concludes the study.

### 2. Regional Trade

There is an impression that Pakistan trades (excluding imported crude oil and petroleum products) primarily with the US and Europe. This was the case for a long time, but it has changed in the last decade. In 2010, about 25 percent of Pakistan's exports and 35 percent of imports were from neighboring countries (UAE, China, Afghanistan, India, and Iran); as a group, these neighbors are now are more important for Pakistan's trade than North America or Europe (Table 1). The fact that trade between Pakistan and its neighbors has increased so rapidly, despite the lack of progress in formal regional economic agreements such as the South Asian Association for Regional Cooperation (SAARC), the SAARC Preferential Trade Agreement (SAPTA), South Asia Free Trade Area (SAFTA), and Economic Cooperation Organization (ECO), is indicative of the potential and dynamics of trading with neighboring countries.

	Exports		Imports		
Country	USD billion	% Share	USD billion	% Share	
Neighbors*	5.4	25.2	13.1	34.9	
North America	3.9	18.2	2.1	5.6	
Europe	5.0	23.5	4.8	12.8	
East Asia (excl. China)	1.2	5.4	6.3	16.8	
Pakistan's total	21.4		37.5		

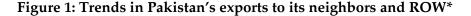
Table 1: Pakistan's trade in 2010

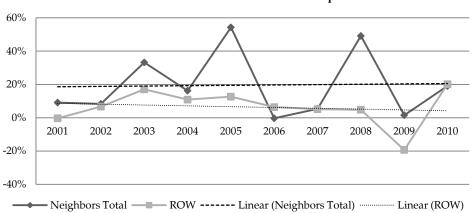
\* China, UAE, Afghanistan, India, and Iran.

Source: United Nations Statistics Division, UN comtrade.

We focus primarily on exports. This is not to imply that imports are not important, but simply that, historically, poor export performance has been Pakistan's Achilles' heel and the main reason for the country's stopgo growth experience since the 1970s. Therefore, it is critical for Pakistan to improve its export performance, and to do that it must diversify its exports both in terms of products and markets. We show that this had already started happening in the last decade (2000–10) due to growing trade with its neighbors. We also argue that these neighbors could provide the dynamic and potentially large export markets that might help resolve Pakistan's historic export dilemma and serve as one of the drivers of its growth for the next decade or more.

In the last decade, although aggregate exports to neighboring countries fluctuated greatly, they grew at an average of more than 19 percent per annum compared to only 6 percent to the rest of the world (Figure 1). As a result, its neighbors' share in Pakistan's total exports increased from less than one tenth to about one fourth in 2010, when three of the world's five top export markets for Pakistan were neighboring countries.





Growth Rates of Pakistan's Exports

\* ROW = exports to world – exports to neighbors

Source: United Nations Statistics Division, UN comtrade.

In the last decade, exports to all neighboring countries grew more rapidly than to the rest of the world, but exports to Afghanistan grew fastest (Table 2). As a result, Afghanistan's share of Pakistan's exports increased sixfold, making it the third most important export market in the world for Pakistan in 2010. The next most rapid growth in exports was to Iran, but this was from a very small base and, consequently, total exports to Iran were still relatively small in 2010. The export shares of the UAE and China both increased by about 2.5 times during this period and, by 2010, they were the second and fourth most important export markets in the world, respectively, for Pakistan. Although exports to India increased more slowly than to the other neighbors, they grew faster than exports to the rest of the world and, as a result, India's export share almost doubled during this period.

	2000		20	10
			USD	
Country	USD million	% Share*	million	% Share*
UAE**	304.5	3.3	1,782.9	8.3
Afghanistan	124.0	1.3	1,684.7	7.9
China	244.6	2.7	1,435.9	6.7
India	65.0	0.7	275.0	1.3
Iran	16.6	0.2	182.2	0.9
Neighbors' total share	754.8	8.2	5,360.7	25.2
Pakistan's total exports	9,201.1		21,413.1	

Table 2: Neighbors' export shares, 2000–10

\* As a percentage of Pakistan's total exports.

\*\* Data for UAE is based on import values reported by UAE.

Source: United Nations Statistics Division, UN Comtrade.

In brief, regional trade expanded rapidly during the last decade with imports and exports from Pakistan's neighbors increasing, on average, by 17 and 19 percent per annum, respectively. However, while the growth in exports to all the neighboring countries was high—ranging from 29 percent per annum for Afghanistan to 15 percent per annum for India the products exported and the factors responsible for this growth were quite different for each country. Therefore, it is necessary to look in more detail at each individual country's experience to get an idea of the nature of expansion in regional trade, as well as the potential opportunities and pitfalls. The next three sections examine in greater detail the trends in export growth in the last decade for China, the UAE, and Afghanistan, both at the aggregate and commodity levels.

### 3. People's Republic of China

China has been the world's fastest-growing major economy for many years; it is now the world's second largest economy, after the US, the largest exporter, and the second largest importer of goods. Its overall trade was close to USD 3 trillion in 2010, with exports and imports of USD 1.6 trillion and 1.4 trillion, respectively (International Monetary Fund, 2011). China's outward foreign direct investment (FDI) has also shown a marked increase in recent years, and was USD 68 billion in 2010 (United Nations Conference on Trade and Development, 2011).

Overland trade ties between Pakistan and China were established in 1979, following the completion of the all-weather Karakoram Highway. However, a very small proportion of Pakistan's trade with China is through this route, and the overland link is seen primarily as enhancing the country's defense. In fact, Pakistan has always looked at China largely from a security perspective—as a counter to political pressure from the US, support in a confrontation with India, and as a source of military hardware. China, as an emerging global economic power, offers immense opportunities to Pakistan, particularly as a neighbor and an old ally.

Pakistan's economic interdependence with China has grown rapidly in the last decade—in 2010, the latter was Pakistan's second largest source of imports and its fourth largest market for exports. Pakistan's exports to China grew rapidly throughout the decade, with growth accelerating sharply following the signing of a free trade agreement (FTA) in 2006. The average annual export growth increased from 19 percent between 2003 and 2006 to 26 percent from 2007 to 2010. As a result, China's share in Pakistan's exports almost doubled in just three years (Table 3).

	20	00	20	03	20	05	20	07	20	10
	<b>T7</b> 1	%	<b>TT</b> 1	%	<b>T</b> T 1	%	<b>T</b> T 1	%	<b>T</b> T 1	%
	Value	Share	Value	Share	Value	Share	Value	Share	Value	Share
Exports	244.6	2.7	259.6	2.2	435.7	2.7	613.8	3.4	1435.9	6.7

Table 3: Pakistan's exports to China (USD million)

Source: United Nations Statistics Division, UN Comtrade.

Even though aggregate exports to China have increased rapidly, one needs to look at the structure of exports to fully understand the dynamics of this change. A review of the structure of exports reveals two things. First, the export structure in 2010 is not encouraging, with raw materials and primary manufactures such as cotton fiber, chromium ores, and cotton yarn accounting for almost two thirds of total exports (Table 4). Second, this structure has not changed much in the last decade—the same six commodities account for over 80 percent of exports in 2000 and 2010.

However, over the ten years, the shares of chromium ores and cotton yarn have increased at the expense of cotton fabrics, a change that most would see as a move backward.

		2000		2010		
			%			
No.	Commodity	USD million	Share*	USD million	% Share*	
1	Cotton yarn, excl. thread	100.0	40.9	737.3	51.3	
2	Chromium ores and concentrates	4.5	1.8	137.6	9.6	
3	Cotton fabrics, woven	56.5	23.1	99.6	6.9	
4	Textile fibers: cotton	10.7	4.4	75.9	5.3	
5	Fish, crustaceans, mollusks	15.3	6.3	67.5	4.7	
6	Leather	15.9	6.5	46.0	3.2	
7	Machinery and transport equip.	0.8	0.3	45.4	3.2	
8	Plastics in primary form	2.5	1.0	38.2	2.7	
	Subtotal	206.2	84.3	1,247.5	86.9	
	Total exports to China	244.6		1,435.9		

### Table 4: Structure of Pakistan's exports to China, 2000–2010

\* As a percentage of Pakistan's total exports to China.

Source: United Nations Statistics Division, UN Comtrade.

Pakistan needs to shift from exporting primary commodities and simple manufactures to higher-value-added products, if export growth is to be sustained and exports are to contribute to expanding employment and GDP in the country. The FTA with China should give Pakistan an edge over other countries in a number of potentially high-growth products as it provides market access at zero duty for cotton fabrics, bed-linen and other home textiles, leather articles, sports goods, and fruits and vegetables among other goods (Pakistan, Ministry of Textile Industry, 2008). However, in almost all these products, Pakistani exporters have failed to make headway because of nontariff barriers. For example, Pakistan is a major exporter of towels and bed-linen to the US and Europe, but exports of these products to China are negligible.<sup>2</sup> Pakistan needs to focus on

<sup>&</sup>lt;sup>2</sup> According to a former chairperson of the Towel Manufactures' Association of Pakistan, "The landed cost of Pakistani towels in China is 15 to 20 percent less than the price of equivalent towels made in China and with zero duty under the FTA we should be able to export substantial quantities to China. But no large store or distributor in China will buy imported towels unless the Chinese Government gives them the go-ahead. Since, thus far, the Chinese Government has not given its okay; Pakistan is unable to export any towels to China" (personal interview with Tahir Jahangir, 22 July 2012).

having these nontariff barriers removed in areas that are its export strengths, such as cotton fabrics, bed-linen, towels, and sports goods.

Besides exports, investment from China could provide a major boost to Pakistan's export industry. According to Eichengreen, Rhee, and Tong (2007), the structure of China's exports has been changing over the years—from "clothing, footwear, other light manufactures and fuels that dominated its trade in the 1980s and early 1990s, toward office machinery, telecommunications, furniture, and industrial supplies in the late 1990s and automated data processing equipment and consumer electronics in recent years" (p. 202). In other words, China has been moving up the value chain, but because of its huge labor force, it has continued to export laborintensive products as well. However, after almost 30 years of rapid growth, most of the surplus labor has now been absorbed and wages are rising rapidly, particularly in the coastal belt. As a result, exporters in China are losing competitiveness in the more labor-intensive industries and beginning to look at the possibility of relocating these industries elsewhere.

In Asia, this has happened many times before, i.e., as wages rose in one country, its export industry tended to move to manufacturing more sophisticated products at home and relocated the labor-intensive product processes to neighboring countries. This started with industry relocating from Japan to Korea, Taiwan, Singapore, and Hong Kong in the 1960s and 1970s, then to Thailand, Malaysia, and Indonesia in the 1980s and to China and Vietnam in the 1990s and 2000s. This process has often been referred to as "the flying geese model of Asian economic development," with Japan in the forefront (Kojima, 2000; Kumagai, 2008).

Owing to China's huge labor force, it has taken much longer for this process to start, but it is beginning to happen, with industries being relocated to Vietnam, Laos, and Cambodia. According to the *World Investment Report 2011*, "A new round of industrial restructuring and upgrading is taking place in China, and some low-end, export-oriented manufacturing activities have been shifting from coastal China to low income countries in South-East Asia and also Africa" (United Nations Conference on Trade and Development, 2011, p. 50). However, the Southeast Asian countries do not have enough population to absorb a significant portion of the labor-intensive industry relocating from China once the process starts in earnest. South Asia, because of its large population, should be the main recipient of this industry and Pakistan should aim to be the leader in this regard.

This is a window of opportunity for Pakistan, which has a large textile sector as well as strong clusters in sports goods, surgical instruments, and light engineering. It therefore needs to develop a strategy to attract Chinese investment in these areas. Thus far, Pakistan's approach has been the traditional one, i.e., trying to attract investment from China in import-substituting industry by providing incentives, including special industrial zones, and corporate income tax and import duty concessions for the manufacture of consumer durables, such as televisions, refrigerators, air conditioners, washing machines, etc. This strategy has failed in the past and it is unlikely to do much better this time since it will only attract investment for assembly plants producing for the domestic market.

Pakistan's strategy should aim to attract Chinese investment into export industries, particularly those labor-intensive industries that are likely to be relocating out of China in the next 10 years and that are also Pakistan's strengths, such as garments, textiles, leather and footwear, surgical goods, cutlery, and sports goods. The strategy needs to be developed in partnership with larger exporters and the representatives of export associations in these industries. Once such a strategy is developed, the government should leverage its long-standing relationship with the Chinese government to garner the latter's support in implementing the key elements of the strategy.

In addition, Pakistan should seize the opportunity provided by China's drive to accelerate development in its western provinces. The Karakoram Highway provides the shortest overland route to the sea for these provinces, and China has indicated an interest in upgrading the highway to handle heavy traffic. If Pakistan were to prioritize this project and control the movement of Islamic militants crossing over into China, the resulting transit trade through Pakistan could provide a tremendous boost to economic activity. It would attract Chinese investment into the northern regions of Pakistan and create opportunities for the export of Pakistani products to western China.

Any discussion on Pakistan's economic relations with China would be incomplete without at least a brief look at the import side. Pakistan's imports from China have grown dramatically from about USD 0.55 billion in 2000 to USD 5.25 billion in 2010. China's share in Pakistan's total imports has increased from less than 5 percent to over 14 percent during this period. This is not surprising since China's exports to the rest of the world have also grown rapidly, but because of Pakistan's security dependence on China, the government tends to turn a blind eye to violations on imports from the latter. This has provided an opportunity for collusion between unscrupulous Pakistani importers and Chinese exporters to misclassify imports from China and understate their value to evade import duties and taxes. As a result, the actual increase in imports has been even greater than that indicated by official figures.

Although there is no way to estimate the full extent of tax evasion, one can get a rough idea of the undervaluation by comparing the value of "imports from China" reported by Pakistan and "exports to Pakistan" reported by China in the UN Comtrade dataset. Exports reported by China exceeded imports reported by Pakistan by 32 percent in 2010 (Table 5). The underreporting is probably even greater since exports are reported on a free-on-board (f.o.b.) basis and imports on a cost-insurance-and-freight (c.i.f.) basis, and the cost of "insurance and freight" is generally between 10 and 20 percent of the import value (see World Bank, n.d.). Even with a conservative 10 percent adjustment for insurance and freight, the underreporting comes to 45 percent. Thus, actual imports from China in 2010 were in the range of USD 7 billion to 8 billion.

The problem is not only the loss in government revenue, but also the impact of this "unfair" competition on domestic industry. The rapid growth in imports from China has decimated a number of industries in Pakistan; generally, these have been industries that were dominated by small to medium firms producing for the local market. This was not because the imported products were of better quality—based on anecdotal evidence and personal experience, they are in many cases of very poor quality and often imitations of established local brands—but because they were extremely cheap due to the evasion of taxes and import duties. Small local producers were unable to compete with these products because the effective tariff (including sales tax) on the final product imported from China is, in many cases, substantially lower than the effective tariff on the raw materials used by small manufacturers in Pakistan. Small producers have to buy raw materials from commercial importers, who have to pay the statutory rates of duties and a 16 percent sales tax on the duty-paid value of imports because they are not eligible for the concessions that large manufacturers enjoy under Pakistan's notorious Statutory Regulatory Order regime (Pursell, Khan, & Gulzar, 2011).

Reporting country	2000	2003	2005	2007	2010
Imports reported by Pakistan	550.1	957.3	2,349.4	4,164.2	5,247.7
Exports reported by China	670.3	1855	3,427.7	5,831.4	6,937.8

Table 5: Pakistan–China trade:	Value unc	<b>derstatement</b> (USD	million)
--------------------------------	-----------	--------------------------	----------

Source: United Nations Statistics Division, UN Comtrade.

However, the impact of Chinese imports has not been all negative. There has been a huge consumer gain in industries where Pakistan did not have any local manufacturing, such as mobile phones. Pakistan would have never achieved the tele-density that it has, if only "full" duty-paid and sales tax-paid phones were available in the market. In the motorcycle industry, which was highly protected and had an oligopolistic structure, Chinese imports have led to huge producer and consumer gains. The opening up of the motorcycle industry by removing entry restrictions on the assembly of motorcycles and allowing the import of parts and components from China in 2006 resulted in a dramatic growth spurt in the industry. The domestic production of motorcycles rose from less than 600,000 in 2004/05 to over 1.6 million in 2010/11 (Association of Pakistan Motorcycle Assemblers, 2010). One of the reasons for the large increase in size of the domestic market for motorcycles was probably the decline in their price in real terms (by about 40 percent) between 2006 and 2012.<sup>3</sup>

Thus, a sensibly designed and implemented trade policy—for example, one that eliminates the distinction between commercial and industrial importers of raw materials and components—would not only mitigate the negative impact of imports on the local industry, but also dramatically improve its prospects. Clearly, the automobile industry in Pakistan is a prime candidate for "motorcycle industry type" opening up to imports from China and India.

### 4. United Arab Emirates

The UAE is Pakistan's closest neighbor by sea (after Oman)—the distance from Karachi to Dubai is almost the same as from Karachi to Islamabad. Estimated to have 8.5 percent of the world's oil reserves and the fifth largest gas reserves, the UAE's economy and exports are obviously dominated by the oil and gas sector. However, around one third of its total merchandise exports are re-exports (World Trade Organization [WTO], 2012), which means that it is also an important trading hub and packaging and distribution center. In 2010, the UAE's total nonoil exports (including re-exports) were USD 126.4 billion, of which India had the highest share (33.7 percent), while Pakistan, with a 2.5 percent share, ranked among the top ten. As for the UAE's imports, the top two countries for nonoil commodity imports are India and China with 17.1 and 10.3 percent,

<sup>&</sup>lt;sup>3</sup> The price of a Honda 70 cc motorcycle, the most popular make and size in Pakistan, increased from PKR 54,000 in 2006 ("Motorcycles sales stagnating," 2007, April 4) to PKR 67,000 in 2012 (Qeemat Prices in Pakistan, 2011), i.e., by less than 25 percent, while the overall price level more than doubled (the consumer price index increased from 132 in 2005/06 to 269 in 2011/12).

respectively (WTO, 2012), while Pakistan's share is about 1 percent (United Nations Statistics Division, n.d.).

The UAE is an important economic partner for Pakistan, and there are many dimensions to the relationship. For example, there are over half a million Pakistanis resident in the UAE, who officially remitted USD 2.6 billion to Pakistan in 2010/11. Most large international banks have regional offices in the UAE with many Pakistani professionals on their staff, including in senior management positions. Most Pakistanis traveling overseas pass through the UAE-there are more than 100 flights a week from Pakistan to the UAE, more than to any other country in the world or between any two destinations in Pakistan. During the civil disturbances in Karachi in the 1990s, many Pakistani business families set up operations in UAE and it became a major destination for Pakistani investors, particularly for real estate. Dubai is an offshore base for many Pakistani businesses that maintain a presence there to meet with foreign buyers, suppliers, investors, and bankers, who for reasons of security or inconvenience are reluctant to travel to Pakistan. Until recently, a substantial part of the India-Pakistan trade was routed through the UAE to circumvent the trade restrictions imposed by the two countries. Finally, the UAE is Pakistan's second largest export market, with a share of 8.3 percent of total exports in 2010.

Having so many linkages also has its pitfalls, since it makes the UAE a convenient base for avoiding or exploiting the Pakistan government's economic regulations. The UAE is the most commonly used channel for capital flight or for taking advantage of arbitrage possibilities created by government policies. For example, when Pakistan has provided product-specific export incentives in the past—such as tax rebates, duty drawbacks, and subsidized credit—Pakistani businesses have mislabeled or overvalued exports to the UAE in order to make windfall gains at the state's expense. This is evident from the large gap between "exports to UAE" as reported by Pakistan and "imports from Pakistan" as reported by the UAE in the UN Comtrade dataset. Between 2003 and 2007, for instance, the former were two to three times the value of the latter (United Nations Statistics Division, n.d.).

It is also the likely explanation for the large year-to-year fluctuations in the value of exports of individual products (in the Pakistan data), since the duty drawbacks on individual items were regularly adjusted (often in response to stories in the press of the misuse of these incentives by exporters). For example, in 2003, "fabrics from man-made fibers" and "household linen" accounted for 12.8 and 16.2 percent, respectively, of Pakistan's total exports to the UAE (as reported by

Pakistan), but these fell to only 2.9 and 6.7 percent in 2005, in which year clothing exports accounted for 16.3 percent of the total. Clothing exports came down to 6.4 percent in 2007.<sup>4</sup> As the government phased out various export incentives after 2007 because of fiscal difficulties, the gap between the numbers reported by Pakistan and the UAE also started to decline and had virtually disappeared by 2009.<sup>5</sup>

This creates a problem in analyzing trends in exports to the UAE. To circumvent this, at least at the aggregate level, we use the value of "imports from Pakistan" for Pakistan's exports to the UAE as reported by the UAE instead of "exports to UAE" as reported by Pakistan. We see that exports so measured increased by almost six times between 2000 and 2010, and growth accelerated after 2005 (Table 6).<sup>6</sup> Thus, in the last decade, exports to the UAE grew at an annual average rate of 18 percent, which resulted in the its share of Pakistan's exports increasing from 3.3 percent in 2000 to 8.3 percent in 2010.

Table 6: Pakistan's export trend to UAE (USD million)

Reporting country	2000	2003	2005	2007	2009	2010
Exports reported by	516.9	1,010.2	1,012.9	1,503.6	1,340.6	1,497.4
Pakistan*						
Imports reported by UAE*	304.5	419.3	520.4	778.7	1,569.7	1,782.9

\* Excluding petroleum exports.

Source: United Nations Statistics Division, UN Comtrade.

This rapid export growth has taken place without any focused effort by the government. However, if Pakistan were to implement a strategy of leveraging the existing advantages—proximity, outstanding connectivity, its extensive banking presence in the UAE, a large Pakistani diaspora as well as those from other South Asian countries with similar cultures and taste, and excellent political relations—to promote exports, it could significantly increase exports further, not only to the UAE but to the entire region. The UAE is potentially a huge market for Pakistani consumer products, such as packaged foods, clothing, furniture, and furnishings, and for entertainment content such as music and television serials. It could also become a showcase for Pakistani products for export to the rest of the world.

<sup>&</sup>lt;sup>4</sup> Calculated by the authors using data from the UN Comtrade dataset (United Nations Statistics Division, n.d.).

<sup>&</sup>lt;sup>5</sup> Keeping in mind the point made earlier that exports are reported on an f.o.b. basis and imports on a c.i.f. basis, it seems that exports are still being overstated by about 10–20 percent.

<sup>&</sup>lt;sup>6</sup> Interestingly, "exports to UAE" as reported by Pakistan, show an opposite trend, i.e., phenomenal growth between 2005 and 2007 and then a collapse.

Some of this may already be happening, but a focused approach by the government to promote the UAE as Pakistan's offshore hub could make a qualitative difference. This may involve establishing a trade and investment liaison office in Dubai, which has high-level representation of all the relevant government ministries and agencies—including the Ministry of Finance, Board of Investment, and Trade Development Authority of Pakistan—and setting up a Pakistan expo-center. The latter should be run as a public–private partnership between the government and major exporters/export associations. It should have, in addition to exhibition halls, common facilities such as office space and business services for exporters' use to reduce their cost of interacting with international buyers (earlier suggested in Ahmad, Mahmud, Hamid, & Rahim, 2010, pp. 43–44). In brief, the strategy's goal should be to make it possible for the UAE to play a role similar for Pakistan as Hong Kong did for China in the 1990s.<sup>7</sup>

# 5. Afghanistan

Historically, Afghanistan has been a major trading partner of Pakistan, though in the past most of this trade was undocumented. Following the Soviet invasion of Afghanistan in 1979, and the subsequent period of civil war, formal trade between Pakistan and Afghanistan ceased but informal trade between the two countries probably remained substantial. However, since the end of the Taliban regime in 2001 and resumption of normal trade relations, documented trade between the two countries has expanded rapidly. Between 2002 and 2010, there was a sevenfold increase in Pakistan's exports to Afghanistan, and by 2010 Afghanistan was Pakistan's third largest export market, accounting for 7.9 percent of the latter's total exports.

Afghanistan is not only an important export market for Pakistan, it has also been instrumental in the development of a number of nontraditional exports that have long-term export potential. For example, Afghanistan accounted for 28 to 55 percent of Pakistan's total exports of vegetables and fruit, petroleum products, cement, and metal manufactures in 2010 (Table 7). These are the documented exports—since informal trade between the two countries was also substantial, Pakistan's exports of nontraditional products to Afghanistan were probably larger and even more diverse. The development of such exports to Afghanistan is important. It is always difficult for a country to develop new export products, but once the export

<sup>&</sup>lt;sup>7</sup> This point was first made by Ashwani Saith in his comments on this paper at the Lahore School's Conference on Management of the Pakistan Economy (May 2012).

capacity, production experience, and domestic supply chains are developed for a particular product, it becomes much easier to export that product to other markets. Therefore, the export of these products to Afghanistan is likely to promote their future export to other countries.

		Value	
No.	Commodity	(USD million)	% Share
1	Rice	95.8	4.2
2	Vegetables and fruit	144.5	35.7
3	Petroleum and petroleum products	658.9	55.0
4	Lime, cement, and construction materials	186.4	39.5
5	Metal manufactures	57.0	27.6
6	Machinery and transport equipment	59.6	10.5
	Subtotal	1,202.2	
	Total exports to Afghanistan	1,684.7	

Table 7: Structure of Pakistan's exports to Afghanistan, 2010

\* As a percentage of Pakistan's total exports of the commodity to the world. *Source:* United Nations Statistics Division, *UN Comtrade.* 

While it is evident that Afghanistan contributed significantly to Pakistan's export growth in the last decade—accounting for 13 percent of the entire increase in exports during this period—it could potentially have an even greater impact in the next decade or so. No doubt, there is some uncertainty about future political developments in Afghanistan, but Pakistan is in a position to create a win-win outcome for both countries. However, this will require Pakistan to switch from looking at Afghanistan through the security lens to an economic one. If Pakistan's decision makers are able to change this mindset, it would greatly improve the prospects of peace. It would also make it possible to invest in appropriate infrastructure, such as roads and truck-ports at the border, which could have a substantial additional impact on trade with Afghanistan.

An increase in Afghanistan–Pakistan trade will promote prosperity in the border regions and beyond, which should help break the cycle of militancy and violence in the region. This, in turn, would make it easier for Pakistani banks and businesses to establish a physical presence in Afghanistan and expand exports of Pakistani products, such as food, textiles and clothing, tractors and transport equipment (motorcycles, rickshaws, etc.), electrical machinery (fans, washing machines, electric motors, etc.), and simple industrial and agricultural machinery (lathes, diesel motors and pumps, grain threshers, etc.). Pakistan should focus on establishing its economic presence in Afghanistan rather than worrying about other countries capturing its markets. Cultural and ethnic linkages are continually demonstrated to be far more powerful drivers of trade than political affiliations; it is therefore likely that products and businesses from Pakistan, particularly from Khyber Pakhtunkhwa, would have an edge over those from most other countries.

As Nabi (2012) elaborates, the areas that now constitute Pakistan were historically important transit hubs for trade routes between Central Asia and Persia on one side and China and India on the other. Peshawar was a great trading city at the time, and it has the potential of once again emerging as a key transit hub for trade in the region. Afghanistan, neighbored by Iran to the west and by Turkmenistan, Uzbekistan, and Tajikistan to the north, is Pakistan's bridge to Central Asia. It is a member of SAARC and ECO and, given its increasing emphasis on regional trade, is undertaking what is termed the "New Silk Road" trade project-a major element of which is the development of infrastructure in the country to facilitate overland trade. The Afghanistan-Tajikistan Bridge, which was completed in 2007, is an important component of the road network for trade between Afghanistan and Central Asia. Similarly, the Afghanistan–Pakistan Transit Trade Agreement, signed in 2010, aims to promote not only the smooth flow of goods between the two countries, but also to provide access to the sea for Afghanistan and ultimately for the rest of Central Asia. Therefore, peace in Afghanistan would not only boost Pakistan's trade with Afghanistan, it would also facilitate exports to Central Asia and the import of gas and power from the latter, which could go a long way toward easing Pakistan's critical energy constraint.

## 6. Central Asian Republics

The Central Asian republics (CARs), i.e., Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan, with a combined population of 61 million and GDP of USD 219 billion, are becoming an increasingly important economic region (Table 8). After a prolonged period of low (or negative) growth, the region has grown at an impressive rate in the last decade. Some of their main advantages have been their abundant natural resources (oil, gas, gold, etc.) and a "reasonable infrastructure and human capital as legacies of Soviet rule" (Dowling & Wignaraja, 2006, p. 10).

	<b>Population</b> <sup>a</sup>	GDP b	Imports <sup>b</sup>	Average growth rate 2000–10	
Country	_			GDP <sup>c</sup>	Imports <sup>c</sup>
	Million	USD billion	USD billion	%	%
Kazakhstan	16	149	33	9	19
Kyrgyzstan	5	5	6	4	26
Tajikistan	7	6	3	8	21
Turkmenistan	5	20	5	14	16
Uzbekistan	28	39	9	7	15
Total	61	219	56		

#### Table 8: Central Asia 2010

*Sources:* a = World Bank (2012), *World dataBank;* b = United Nations Statistics Division, *UN Comtrade;* c = authors' calculations using a and b.

Trade has grown rapidly with the development of the market economy and increasing incomes. In 2010, the CARs' imports were USD 56 billion, having expanded at an average rate of almost 19 percent per annum during 2000-10. Individually, all the countries exhibited an increased demand for imports, with import growth ranging from 15 to 26 percent per annum; in Kazakhstan, the largest of the CAR economies, imports increased by more than six-fold in ten years. The importance of imports from their neighboring countries has also increased in the last decade, the share going up from 47 to 62 percent. In 2000, Russia accounted for the largest share of imports, but imports from China have grown dramatically, and in 2010 it was the most important source, accounting for more than USD 16.5 billion in imports (Table 9). The value of imports from Turkey rose seven-fold during this period, and imports from Iran also increased rapidly. However, imports from Pakistan declined—in 2010, they were less than half that in 2000. The key factor in the decline was the disruption of Pakistan's overland trade with Central Asia because of the war in Afghanistan.

	2000	2010
Country	USD million	USD million
China	767.3	16,530.6
Russia	2,810.6	15,110.0
Turkey	342.4	2,515.4
Iran	249.9	760.6
Pakistan	26.7	12.1
Afghanistan	-	17.1
Subtotal	4,196.9	34,945.7
Total imports from the world	8,800.0	56,000.0

Table 9: The CARs' imports from their neighbors

Note: Export values from partners to CARs reported. *Source:* United Nations Statistics Division, *UN Comtrade.* 

To assess the potential market for Pakistan, it is useful to look at what the CARs are importing from their neighbors. Imports from Russia were primarily petroleum, iron, steel, and different types of heavy machinery and mechanical apparatus. However, more relevant for Pakistan were the imports from China and Turkey. Table 10 summarizes the CARs' major imports from these two countries, and also presents Pakistan's world exports of these commodity groups. We can see that Pakistan actually exports significant quantities of four of the ten main items that the CARs were importing from China and Turkey in 2010. Two items of particular interest are "clothing and accessories" and "textile yarn, fabric, etc."—the CARs' two largest imports from China and also Pakistan's biggest exports to the rest of the world. Nonmetallic mineral manufactures, i.e., cement, and miscellaneous manufactured goods are also potential export items for Pakistan.

No.	Commodity	China	Turkey	Pakistan's exports to world
1	Clothing and accessories	4,874.3	115.4	3,930.2
2	Textile yarn, fabric, etc.	2,204.9	187.1	7,847.7
3	Footwear	1,554.2		92.7
4	Nonmetallic mineral manufactures	631.9		505.7
5	Road vehicles	601.5		56
6	Special industrial machinery	593.6	35.0	124.8
7	Metal manufactures	553.2	301.3	206.2
8	Misc. manuf. goods	548.6	130.8	1,036.1
9	Electric machine apparatus, parts, etc.		290.1	51.6
10	Plastic, nonprimary form		123.9	26.5
	Subtotal	11,562.2	1,183.6	13,877.5
	Total exports to CARs	16,530.6	2,515.4	21,413.1

Table 10: Main exports from China and Turkey to the CARs and Pakistan's exports of these to the world, 2010 (USD million)

Note: Blank cells indicate values of less than USD 0.1 million. *Source:* United Nations Statistics Division, *UN Comtrade.* 

Given the positive growth trajectory of the CARs and the fact that the distance from Peshawar to Tashkent (1,281 km) is even smaller than that from Peshawar to Karachi (1,382 km), Central Asia appears to offer huge economic opportunities for Pakistan, both as a market for the latter's exports and as a low-cost supplier of energy. However, without peace in Afghanistan, which is necessary for the transport of goods overland and for building gas pipelines and power lines between Central Asia and Pakistan, this potential cannot be realized.

## 7. Conclusion

Pakistan's trade with its neighbors has grown rapidly over the last 10 years; together, they constitute the largest market for Pakistani exports. These exports are not only important in terms of absolute value, they have also contributed to the development of new export products such as fruit and vegetables, cement, and metal manufactures to Afghanistan; jewelry to the UAE; and chromium ores to China. Given the growth prospects of most of the neighboring governments, we can expect the potential for Pakistan's exports to continue to expand. It is up to Pakistan to adopt appropriate policies to take advantage of this potential.

This will require a change in policymakers' perspectives, who need to adopt an "economy first" approach. Such a change, together with a strategy to focus in each country on a few areas that are likely to provide the greatest immediate benefits, could significantly accelerate exports. This may, in turn, be a driver of sustained growth for the next decade or more. Policies with respect to China include gaining market access for Pakistan's exports and attracting Chinese investment to the export industries. The UAE should be developed as an offshore center for facilitating exports and investment inflows. Trade with Afghanistan and Central Asia will require a change in mindset to give priority to economic issues, measures to end the conflict in Afghanistan, and building the necessary infrastructure for overland trade and energy imports. If successfully implemented, these policies are likely to result in a significant upward shift in the trend growth rate for exports, which could add 2 to 3 percent to the GDP growth rate. This would, in turn, ease the balance-of-payments constraint and help end the "stop-go" growth cycle in which Pakistan has been trapped since the 1990s.

### References

- Afghanistan, Dehsabz-Barikab City Development Authority. (2012). Welcome to the Kabul new city official website. Retrieved May 7, 2012, from http://www.dcda.gov.af/
- Ahmad, H., Mahmud, M., Hamid, N., & Rahim, T. (2010). A strategy for reversing Pakistan's dismal export performance (Policy Paper No. 01-10). Lahore, Pakistan: Centre for Research in Economics and Business.
- Association of Pakistan Motorcycle Assemblers. (2010). *Eleven years motorcycle production of Pakistani assemblers and non-APMA members* (3-Japanese). Retrieved June 4, 2012, from http://www.motorcycleexport.com/tenyearsmotorcycleproduction.html
- Australia, Department of Foreign Affairs and Trade. (2011). *Afghanistan country brief*. Retrieved May 7, 2012, from http://www.dfat.gov. au/geo/afghanistan/afghanistan\_country\_brief.html
- Dowling, M., & Wignaraja, G. (2006). *Central Asia's economy: Mapping future prospects to 2015* (Silk Road Paper). Baltimore, MD: John Hopkins University, Central Asia–Caucasus Institute.
- Eichengreen, B., Rhee, Y., & Tong, H. (2007). China and the exports of other Asian countries. *Review of World Economics*, 143(2), 201–226.
- Embassy of the United Arab Emirates in Washington, DC. (2012). *Business and trade: Trade and export*. Retrieved May 7, 2012, from http://www.uae-embassy.org/business-trade/trade-export
- International Monetary Fund. (2011). *World economic outlook database* [Data file]. Retrieved April 2012, from http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/ weorept.aspx?sy=2000&ey=2010&scsm=1&ssd=1&sort=country&d s=.&br=1&pr1.x=37&pr1.y=5&c=924&s=NGDP\_RPCH&grp=0&a=
- Kojima, K. (2000). The "flying geese" model of Asian economic development: Origin, theoretical extensions and regional policy implications. *Journal of Asian Economics*, *11*(4), 375–401.
- Kumagai, S. (2008). *A journey through the secret history of the flying geese model* (Discussion Paper No. 158). Chiba, Japan: Institute of Developing Economies.

- Motorcycles sales stagnating. (2007, April 4). *Daily Times*, pp. 5/13. Retrieved August 10, 2012, from http://www.dailytimes.com.pk/ default.asp?page=2007\04\04\story\_4-4-2007\_pg5\_13
- Nabi, I., et al. (2005). *Towards a prosperous Pakistan: A strategy for rapid industrial growth*. Pakistan: Lahore University of Management Sciences.
- Nabi, I. (2012). *Back to the future: Regional trade as a vent for economic growth.* Paper presented at the 8<sup>th</sup> Annual Conference on Management of the Pakistan Economy, Lahore School of Economics, Pakistan.
- Pakistan, Ministry of Commerce. (2010). *Afghanistan–Pakistan transit trade agreement* 2010. Retrieved May 7, 2012, from http://www.commerce.gov.pk/APTTA/APTTA.pdf
- Pakistan, Ministry of Textile Industry. (2008). Pak-China free trade agreement: Analytical report on textiles and clothing. Islamabad, Pakistan: Author. Retrieved April 3, 2012, from www.rdacell.com/Documents/Pakistan-ChinaFree.pdf
- People's Republic of China, Ministry of Commerce. (2012). Brief statistics on China's import and export in December 2011. Retrieved April 3, 2012, from http://english.mofcom.gov.cn/aarticle/statistic/ BriefStatistics/201201/20120107927529.html
- Pursell, G., Khan, A., & Gulzar, S. (2011). Pakistan's trade policies: Future directions (Working Paper No. 11/0361). London, UK: International Growth Centre.
- Qeemat Prices in Pakistan. (2011). *Honda CD70 2012 price in Pakistan*. Retrieved August 10, 2012, from http://www.qeemat.com/hondacd70-2012-price-in-pakistan/
- United Nations Conference on Trade and Development. (2011). *World investment report 2011*. Geneva, Switzerland: Author. Retrieved from http://www.unctad-docs.org/UNCTAD-WIR2011-Full-en.pdf
- United Nations Statistics Division. (n.d.). UN Comtrade [Data file]. Retrieved March–June 2012, from http://comtrade.un.org/db/default.aspx

- US-China Business Council. (2012). US–China trade statistics and China's world trade statistics. Retrieved April 3, 2012, from http://www.uschina.org/statistics/tradetable.html
- World Bank. (2012). World dataBank: World development indicators (WDI) & global development finance (GDF) [Data file]. Retrieved March–June 2012, from http://databank.worldbank.org/ddp/home.do? Step=2&id=4&hActiveDimensionId=WDI\_Series
- World Bank. (n.d.). *World integrated trade solution* [Computer software]. Retrieved June 26, 2012, from http://wits.worldbank.org/WITS/ wits/WITSHELP/Content/Data\_Retrieval/T/Intro/B2.Imports\_E xports\_and\_Mirror.htm
- World Bank and Development Research Center of the State Council. (2012). *China 2030: Building a modern, harmonious and creative high-income economy* (Conference ed.). Washington, DC: World Bank.
- World Trade Organization. (2012). *Trade policy review: United Arab Emirates* (WT/TPR/S/262). Geneva, Switzerland: Author.

# The Prospects for Indo-Pakistan Trade

# Hafiz A. Pasha\* and Muhammad Imran\*\*

# Abstract

This article analyzes the volume and pattern of India–Pakistan trade given the extent of trade complementarity between the two countries and, in the presence of a restricted positive list of imports from India, the tariff regime and nontariff barriers in the two countries. The study also assesses the impact on bilateral trade of granting most-favored nation status to India, the removal of some of the impediments to trade, and the implementation of the final phase of import tariff reduction under the South Asian Free Trade Agreement. Finally, the article highlights emerging opportunities and possible threats to the process of trade normalization between the two countries.

Keywords: exports, tariffs, non-tariff barriers, Pakistan, India.

# **JEL classification:** F19.

# 1. Introduction

Trade between India and Pakistan has been fundamentally influenced by factors that are not purely economic. At the time of Partition in 1947, both economies were heavily interdependent, with the share of the Indian market in Pakistan's exports at close to one fourth, and over half of Pakistan's imports coming from India. Thereafter, bilateral trade has had a chequered history. Trade virtually ceased after the wars of 1965 and 1971.

Some positive steps have been made since 1995, when India announced its decision to grant most favored nation (MFN) status to Pakistan, and the latter established a positive list with respect to imports from India. The signing of the South Asian Free Trade Agreement (SAFTA) in 2004 was a major step forward in the eventual establishment of a customs union in the region. Recently, Pakistan has announced its potentially landmark decision to grant MFN status to India by the end of 2012. In the interim period, a restricted positive list has transitioned to a negative list, which opens up a large percentage of tariff lines for imports from India.

<sup>\*</sup> Dean, School of Liberal Arts and Social Sciences, Beaconhouse National University, Lahore, Pakistan.

<sup>\*\*</sup> Research Associate, Institute of Public Policy, Beaconhouse National University, Lahore, Pakistan.

Further, the two countries have agreed to simplify customs procedures and facilitate the process of goods certification. India has also announced that it welcomes investment by resident Pakistanis and companies.

Clearly, the environment for bilateral trade has greatly improved. This augurs well for future growth in trade between the two countries, who are making an effort to move away from the old view of "peace first, trade later" to "trade now, peace later." It is hoped that the expansion of trade will create stronger constituencies for peace in both countries.

Our objective is to explore the possibilities of Indo–Pakistan trade in the new environment. Section 1 of the article describes the current level and pattern of bilateral trade. Section 2 identifies some basic issues in the context of trade development between the two countries. Section 3 quantifies the degree of trade complementarity between the Indian and Pakistani economies. Section 4 describes the levels of import tariffs in the two countries and their potential impact on the volume of trade. Section 5 assesses the existing nontariff barriers (NTBs), especially with regard to each other, and identifies the particular restrictions that need to be removed for trade to flourish. Section 6 evaluates the prospects for Indo– Pakistan trade, following the India's granting of MFN status and Pakistan's reciprocal gestures in the form of relaxing certain NTBs.

### 2. Trade Between India and Pakistan

Both India and Pakistan have become substantially more open economies over the last four decades. The combined share of global imports and exports in India's GDP was less than 7 percent in 1970, but had risen to almost 32 percent by 2010. In Pakistan's case, the corresponding share has increased from 12 percent to 34 percent. Both countries have clearly realized the gains from global trade and how this can contribute to faster economic growth.

This increase in their degree of global openness is not, however, reflected in the trade between the two countries. As shown in Table 1, Pakistan's exports to India are of a small magnitude—only 1 percent (as compared to over one fourth at the time of Partition) of global exports and an insignificant portion of Indian imports. India's exports to Pakistan constitute only about 1 percent of its total exports, and about 5 percent of the latter's global imports (as compared to over half at the time of Partition). Clearly, any potential gains from trade have been sacrificed due to strained political relations.

Pakistani exports to India					
Year	<b>Exports</b> (USD million)	As percentage of exports	As percentage of Indian imports		
2000/01	56	0.8	0.1		
2006/07	344	2.6	0.1		
2009/10	268	1.9	0.1		
2010/11	264	1.0	0.1		
	Indian	exports to Pakistan			
ExportsAs percentage ofAs percentageYear(USD million)exportsPakistani im					
2000/01	238	0.4	2.7		
2006/07	1,236	1.1	5.1		
2009/10	1,226	0.9	4.2		
2010/11	1,734	0.9	4.9		

Table 1: Trade between Pakistan and India, 2000/01–2010/11

Source: State Bank of Pakistan.

Indian exports to Pakistan have been restricted by the latter's positive list. Only 27 percent of the tariff lines are open for imports from India (Table 2). The restriction is particularly severe in the case of product groups such as prepared foods, footwear and personal articles, textiles, ceramic and glass products, and vehicles and transport equipment. An estimated 77 percent of India's major exports (above USD 500 million) have been excluded from access to the Pakistani market. However, despite limited access, Indian exports have shown significant growth during the last decade, rising from USD 238 million in 2000/01 to USD 1,734 million in 2010/11. At the same time, while Pakistan enjoys MFN status with respect to India, its exports are not only very small, they have also shown a declining trend since 2006/07.

Section of HC	Description	Total tariff lines	Lines in positive list	Percentage of tariff lines
Ι	Live animals, animal products	248	33	13.3
II	Vegetables and products	311	157	50.5
III	Animal, vegetable fats/oils	53	2	3.8
IV	Prepared foodstuffs	228	11	4.8
V	Mineral products	195	74	37.9
VI	Chemicals or allied industries	1,149	574	50.0
VII	Plastics and articles	300	93	31.0
VIII	Hides and skins, leather goods	92	45	48.9
IX	Wood and articles	106	52	49.1
Х	Paper and paper board	182	37	20.3
XI	Textiles and articles	929	104	11.2
XII	Footwear and personal articles	59	2	3.4
XIII	Ceramic and glass products	189	28	14.8
XIV	Jewelry, etc.	55	5	9.1
XV	Metals and articles	744	156	21.0
XVI	Machinery	1,193	353	29.6
XVII	Vehicles and transport equipment	245	15	6.1
XVIII	Optical and precision instruments	269	103	38.3
XIX	Arms and ammunition	52	-	-
XX	Miscellaneous	186	5	2.7
XXI	Works of art	72	1	1.4
	Total	6,857	1,870	27.3

### Table 2: Positive list of items for import from India

HC = Harmonized code.

Note: The percentage of tariff lines may not necessarily correspond to the percentage of imports.

Source: Pakistan, Ministry of Commerce (2012).

Tables 3 and 4 show the two countries' trade composition. As Table 3 indicates, two relatively large Indian exports to Pakistan were cotton (USD 372 million) and sugar (USD 69 million) in 2010/11—the year in which Pakistan was hit by devastating floods that badly affected standing crops. This is a classic example of how shortages can be met by a neighboring country, albeit at commercial terms. Other significant imports from India include soya bean oil cake, vegetables, chemicals, artificial staple fiber, and tea. It is interesting that the share of agricultural exports to

Pakistan is almost 30 percent. This is in contrast to the pattern of trade at the time of Partition when India exported mostly manufactured consumer goods and imported agricultural items, such as cotton and wheat.

	Item description	July-May (USD million)	
HS code		2010/11	2011/12
	(> USD 50 million)		
0702	Tomatoes, fresh or chilled	41	68
0713	Leguminous vegetables	40	52
1701	Sugar	69	0
2304	Soya bean oilcake	122	202
2902	Cyclic hydrocarbons	166	191
5201	Cotton	372	75
	$(> USD 20 million - \leq 50 million)$		
0902	Tea	26	36
1209	Seeds for fruits	20	17
2933	Heterocyclic compounds	25	29
3204	Synthetic organic coloring matter	23	26
3817	Mixed alkyl benzenes	17	24
3901	Polymers of ethylene	3	20
3902	Polymers of propylene	23	35
5504	Artificial staple fiber	11	35
7202	Ferro alloys	25	18
7311	Containers for compressed gas	24	11
Subtotal		982	839
Total		1,367	1,144
Percentag	e of subtotal	72	73

Table 3: Pakistan's major imports from India, 2010/11 and 2011/12

Source: State Bank of Pakistan.

Pakistan's major exports to India are dates, cement, textiles, and certain chemicals. The export volumes are relatively small, as shown in Table 4. As opposed to its substantial imports of cotton from India in 2010/11, Pakistan exported cotton (USD 60 million) to India in 2011/12. There is also evidence of some intra-industry trade in sectors such as chemicals. A further promising sign is the emergence of some new exports to India, such as leather, woven cotton fabrics, and medical and surgical instruments, which are among Pakistan's major global exports.

		July–May (U	JSD million)
HS code	Item description	2010/11	2011/12
	(> USD 10 million)		
0804	Dates	44	48
1006	Rice	13	1
2520	Gypsum	1	11
2523	Cement	39	33
2707	Oils from coal tar	14	0
2710	Oils from petrol	15	11
2917	Polycarboxylic acid	12	16
5201	Cotton	0	60
5205	Cotton yarn	9	11
5209	Woven cotton fabrics	8	10
	$(> USD 5 million - \le 10 million)$		
2903	Halogenated derivatives	8	7
4107	Leather	8	7
5103	Waste from wool	7	4
6305	Sacks/bags of textile material	5	5
9018	Medical and surgical instruments	5	5
Subtotal		203	230
Total		268	311
Percentage of subtotal		76	74

Table 4: Pakistan's major exports to India, 2010/11 and 2011/12

Source: State Bank of Pakistan.

Given its relatively large, growing volume of imports from India, and small, declining volume of exports to India, Pakistan has a relatively large trade deficit with respect to India, estimated at over USD 900 million in 2011/12. This has fueled arguments on the part of opponents of trade liberalization that further opening up will lead to a flood of Indian imports<sup>1</sup> to the detriment of Pakistani industry. It must, however, be recognized that, to the extent that imports from India represent "trade diversion" at lower prices—especially with lower transport costs—from other sources, then while the trade balance with respect to India may deteriorate, the global balance of trade could improve.

<sup>&</sup>lt;sup>1</sup> The same concern was voiced when the Free Trade Agreement (FTA) was signed. However, although Chinese exports have reached USD 4.5 billion, many Pakistani industries have withstood the FTA well.

# 3. Key Issues

The current level, pattern, and balance of trade between India and Pakistan raise a number of key issues. First, why have Pakistani exports performed poorly in India, despite the former's MFN status? There are a number of possible reasons for the low and declining volume of exports to India.

- 1. The trade complementarity between Pakistani exports and Indian imports may be low. In other words, Pakistan is not producing and exporting many of the goods that India imports globally. Therefore, there is low scope for diversion of Indian imports to Pakistan.
- 2. The regime of import tariffs and para-tariffs in India could be providing more effective protection to sectors in which Pakistan might potentially have a relative comparative advantage, for example, in some agricultural items and textiles.
- 3. India has a restrictive trade regime relative to other developing countries in terms of the range and intensity of NTBs. Additionally, it might be applying some of these barriers more rigorously to Pakistan, effectively raising costs for Pakistani exporters and precluding their access to the large Indian market.

As opposed to this, despite the limited positive list, Indian exports to Pakistan have done fairly well and shown rapid growth. This could be for the reasons below.

- 1. Given the two countries' relative level of development, especially in terms of the extent of diversification of the industrial base, there is a high level of trade complementarity between Indian exports and Pakistani imports. Consequently, following Pakistan's granting of MFN status to India, imports could rise substantially, especially due to diversion from more expensive sources.
- 2. Pakistan has a relatively more liberal trade regime. Generally, it has managed its protection policy for different economic activities primarily through import tariffs (and SROs); the presence of NTBs is limited. This has encouraged market penetration by Indian exporters.

Beyond the granting of MFN status to India, the final phase of trade liberalization in South Asia under SAFTA is expected to be completed by 31<sup>st</sup> December 2012. At this stage, items in all tariff lines (except those on each member country's sensitive list) will see import tariffs being reduced

to 5 percent or less.<sup>2</sup> The question is the extent to which this will further improve access for Indian exports to Pakistan. Is there even the possibility of some "trade creation" whereby Indian products begin to displace Pakistani products, and not just Pakistan's imports from other countries? Simultaneously, will lower Indian import tariffs provide greater opportunities to Pakistan exports?

It needs to be emphasized that, in the short- to medium-term, the prospects of raising Pakistani exports, both globally and specifically, to India, are limited by severe supply-side constraints. These include record levels of power load-shedding, and gas and water shortages, which have restricted the extent of capacity utilization. Simultaneously, private investment in Pakistan is at an all-time low.

In the subsequent sections, we try to find some answers to the questions raised above. First, we quantify the extent of trade complementarity between the two countries. This is followed by a comparison of their tariff regimes and incidence of NTBs. Based on these analyses, we assess the prospects for Indo–Pakistan post-31<sup>st</sup> December 2012, following the granting of MFN status to India and completion of the trade liberalization process under SAFTA.

#### 4. The Extent of Trade Complementarity

We develop the following index of trade complementarity between two countries:

$$TCI_{jk} = 1 - \frac{1}{2} \sum |m_{ik} - x_{ik}|, \qquad 0 \le TCI \le 1$$

where TCI = trade complementarity index between countries j and k,  $m_{ik}$  = the share of the *i*th commodity in the total imports of country k, and  $x_{ij}$  = the share of the *i*th commodity in the total exports of country j. The higher the magnitude of TCI, the greater will be the trade complementarity between the two countries.

The TCI has been estimated at the 4-digit HC level of India and Pakistan. The resulting magnitudes are as follows:

1. TCI between Indian exports and Pakistani imports = 0.420

<sup>&</sup>lt;sup>2</sup> Pakistan has already notified vide SRO 558(1)/2004 the schedule of reduction of customs duties under SAFTA on different items by  $31^{st}$  December 2012.

#### 2. TCI between Pakistani exports and Indian imports = 0.082

Therefore, there is clear evidence that India is in a position to potentially export more items to Pakistan than the reverse. This is a major factor explaining the substantially larger volume of exports from India to Pakistan, even in the presence of the positive list. Table 5 lists significant Indian exports (above USD 250 million) that are also significant imports for Pakistan (above USD 100 million) for 2010/11. It shows that ten major Indian exports on Pakistan's positive list had a potential export value of USD 3.7 billion in the latter country. Actual exports in 2010/11 were worth USD 1.1 billion, implying that India's share in these exports was almost 30 percent. This share could increase further after the tariff reductions by Pakistan under SAFTA.

Following its transition to full MFN status and reduction in tariffs under SAFTA, a further market of over USD 11 billion potentially opens up for India in Pakistan, consisting primarily of the trade diversion of previously banned imports. If the market share in the old positive list rises to, say, 50 percent while that for new items reaches 30 percent in the medium term, Indian exports could rise to over USD 5 billion.

There are two other possibilities. The first is the diversion of informal trade—currently routed through the UAE, Singapore, and Iran or smuggled across the border—to formal channels after most items become importable from India. The volume of informal trade was estimated by the Sustainable Development Policy Institute (2007) at USD 500 million, and has by now probably increased to USD 1 billion. The second prospect is that of some "trade creation" with India, especially in products where tariffs are high (currently at 20 to 30 percent), which do not feature on the sensitive list, and which consequently experience a significant reduction in the tariff rate. Estimating the magnitude of trade creation requires detailed micro-studies of different sectors, which is the subject of further research.

			Volume	of global	Pakistan's
			Indian	Pakistani	imports
No.	Code	Description	exports	imports	from India
Inclu	ided in j	positive list*		(USD millio	on)
1	0902	Tea	708	311	24
2	1701	Sugar	1,196	691	335
3	2304	Soya bean oil cake	2,057	142	51
4	2902	Cyclic hydrocarbons	1,594	467	185
5	2933	Heterocyclic compounds	600	113	11
6	3204	Synthetic coloring matter	1,249	162	7
7	3808	Insecticides, etc.	1,140	195	25
8	3902	Polymers of polypropylene	771	435	17
9	4011	New rubber tyres	1,029	144	42
10	5201	Cotton, not carded or combed	2,866	1,031	406
Tota	Total		13,210	3,691	1,103
Not	include	d in positive list			
11	2711	Petroleum products	41,076	8,261	
12	3004	Medicaments n.e.s.	5,637	194	
13	5402	Synthetic filament yarn	774	392	
14	7208	Flat rolled products of steel	862	267	
15	7210	"	1,384	283	
16	8471	Automatic data processing machines	285	103	
17	8502	Electrical generating sets	342	289	
18	8517	Electric apparatus for telephony	3,329	518	
19	8703	Motor vehicles for transporting persons	4,211	477	
20	8704	Motor vehicles for transporting goods	619	142	
21	8708	Parts and accessories for motor vehicles	2,189	120	
22	8711	Motorcycles	856	100	
23	9018	Medical, surgical, and dental instruments	414	125	

Table 5: Simultaneously significant Indian exports and Pakistaniimports, 2010/11 (at 4-digit HC level)

\* Note that not all items at the 8-digit level are part of the positive list.

Items in italics are on Pakistan's sensitive list.

Total

*Sources:* India, Ministry of Commerce and Industry (2012) (figures in last column); State Bank of Pakistan.

61,978

11,271

Within the limited trade complementarity of Pakistani exports and Indian imports, we identify trade prospects following the relaxation of some NTBs (discussed in a subsequent section) and reduction in tariffs by India under SAFTA. Table 6 gives a list of potentially larger exports to India.

			Volume of global		
			Pakistani exports	Indian imports	Potential diversion
No.	Code	Description	$X_i$	$M_i$	to India**
			ז)	USD million)	)
1	0804	Dates, figs, etc.	100	180	100
2	1001	Wheat	310	133	133
3	2523	Cement	496	77	77
4	3004	Medicaments n.e.s.	56	764	56
5	3907	Polyesters, primary	265	1,024	265
6	4102	Leather	79	60	60
7	5007	Woven fabrics of silk	50	129	50
8	5201	Cotton, not carded or combed	519	56	56
9	5208	Woven cotton fabrics	519	159	159
10	5209	Woven cotton fabrics	936	60	60
11	5407	Woven fabrics of synthetic yarn	59	107	59
12	6006	Other knitted fabrics	67	112	67
13	6403	Footwear	72	56	56
14	7113	Articles of jewelry	158	338	158
15	9018	Surgical instruments	295	1,028	295
16	9506	Sports articles	342	118	118
Tota	1		4,323	4,401	1,769

# Table 6: Simultaneously significant\* Pakistani exports and Indianimports\*, 2010/11 (at 4-digit HC level)

\* At least USD 50 million each.

\*\* Corresponding to Min[Xi, Mi] for the *i*th product.

Items in italics are on India's sensitive list.

Source: India, Ministry of Commerce and Industry (2012); State Bank of Pakistan.

Major Pakistani exports that could be further diverted to the Indian market (in view of lower transport costs) include dates, cotton, primary polyester, woven cotton and silk fabrics, jewelry, and sports articles. The quantum of total trade diversion is estimated at USD 1.8 billion (Table 6). If about 50 percent diversion takes place, exports could reach USD 900 million, as compared to USD 350 million currently. The prospect of such

diversion—and possibly some trade creation—would improve if India were to relax some of its NTBs and if present impediments to trade were removed. Moreover, the competitive position of Pakistani exports to India would be enhanced if the SAFTA tariff reductions were implemented.

#### 5. Tariff Policies

The low trade complementarity between Pakistani exports and India exists primarily because Pakistan does not a diversified exports base and its two product groups—agricultural items and textiles—account for 60 percent of its total exports. These are also major exports of India with a share of 17 percent. Of course, if free trade were to take place, a degree of specialization could develop, depending on relative comparative advantage. Pakistan could then find "niche" markets in India for a range of products from the two sectors.

The possibility of intra-industry trade has been largely precluded by the tariff policies pursued by India and support provided in the form of relatively large subsidies, especially to agriculture. Table 7 compares the level and pattern of import tariffs in the two countries, demonstrating that customs duties on agricultural products are significantly higher in India. For example, in cereals, and fruits and vegetables, India's average tariff on imports is 30–32 percent as compared to 18–19 percent in Pakistan. As opposed to this, Pakistan generally offers its domestic industry more protection.

Duty rates on textiles and clothing also appear to be lower in India than in Pakistan. This is the case for ad valorem duties, but India operates a dual tariff structure in these product groups with an ad valorem or specific duty, whichever is higher. Generally, the specific duties appear to be far higher and, in some cases, exceed 100 percent, especially on value-added textiles (see Table 8). These rates are even higher than India's tariff bindings with the World Trade Organization (WTO) in some cases. Pakistan, however, operates a normal ad valorem duty structure in clothing and textiles.

Product group	India	Pakistan
Animal products	33.1	14.6
Dairy products	33.7	30.0
Fruit, vegetables, plants	30.4	18.2
Coffee, tea	56.3	12.8
Cereals and preparations	32.2	18.8
Oilseeds, fats, and oils	18.3	8.8
Sugars and confectionery	34.4	17.2
Beverages and tobacco	70.8	52.5
Cotton	12.0	7.0
Other agricultural products	21.7	6.7
Fish and fish products	29.8	10.6
Minerals and metals	7.5	12.4
Petroleum	3.8	10.7
Chemicals	7.9	9.6
Wood, paper, etc.	9.1	15.5
Textiles	14.7	16.7
Clothing	13.4	24.8
Leather, footwear, etc.	10.2	14.9
Nonelectrical machinery	7.3	9.3
Electrical machinery	7.2	14.7
Transport equipment	20.7	24.7
Manufactures, n.e.s.	8.9	13.1

Table 7: MFN-applied tariffs by product group in India and Pakistan\*

\* For latest year for which information is available.

Source: World Trade Organization, country tariff profiles.

## Table 8: Distribution of effective ad valorem tariffs on textiles in India

Range (%)	<b>Rate</b> (%)	Percentage
0 to 10	35	15.7
Above 10 to 25	83	37.2
Above 25 to 50	61	27.4
Above 50 to 100	31	13.9
Above 100	13	5.8
	223	100.0

Source: Authors' estimates.

India also operates an elaborate subsidy regime in agriculture. Subsidies on agricultural inputs such as fertilizer, power, water, tractors, and seeds, etc., exceed 5 percent of GDP (Institute of Public Policy, 2012). The corresponding magnitude for Pakistan is 1 percent of GDP. It must, of course, be recognized that the agricultural subsidies are WTO-compliant, but their high level in India has served to make domestic production artificially competitive in relation to imports.

Overall, India's tariff and subsidy regimes for agricultural products and tariffs on textiles and clothing have effectively restricted imports. For Pakistan, the consequence has been limited access of its traditional exports to the Indian market. It is worth noting that these two product groups also feature prominently in SAFTA's sensitive list. As such, the process of trade liberalization is unlikely to provide a significant new opening to Pakistani exporters.

As a special concession, India has recently offered Bangladesh dutyfree access to a range of textile products, including readymade garments. This is presumably justified on the grounds that Bangladesh is a leastdeveloped country member and merits special treatment. However, in the negotiations prior to granting India MFN status, Pakistan should seek the withdrawal of the specific duties on textiles and clothing and application only of the ad valorem duties.

#### 6. Nontariff Barriers

The perception in Pakistan is that India operates a generally restrictive trade regime in the form of a wide range of NTBs, some of which are applied more strictly on Pakistani consignments. The following sections list the two countries' NTBs.

#### 6.1. NTBs in India

According to the WTO (2011), India operates the following key NTBs.

- Sanitary and phytosanitary (SPS) measures are harmonized with international standards and cover mostly food items.
- The import licensing and permit regimes are complex, varying according to product or user.

- There are a large number of notifications specifying mainly sampling and testing procedures as well as labeling and packaging requirements for food products, pharmaceuticals, textiles, etc.
- Quarantine is imposed on animals and plants.
- Some goods can only be imported through specified ports and/or by particular agencies.
- Pre-shipment inspection is mandatory for some goods such as metal scrap, textiles, etc.
- India actively uses antidumping duties and countervailing measures.

## 6.2. NTBs in Pakistan

Compared to those listed above, Pakistan operates fewer, less rigorous NTBs, listed below.

- Pakistan's main trade policy instrument is the tariff regime (including SROs) rather than NTBs.
- Pakistan's SPS legislation is outdated and not effectively applied.
- Imports of products such as pharmaceuticals, agricultural products, and engineering goods require clearance by the relevant ministry/agency.
- Import restrictions are applied for health, safety, security, religious, and environmental reasons.
- State trading agencies (such as the TCP) play a dominant role in the import of agricultural inputs and products.
- Pakistan seldom resorts to antidumping and countervailing measures.

The World Bank (2012) has developed an overall trade restrictiveness index (OTRI), which calculates the equivalent uniform tariff of a country's tariff schedule and NTBs that would maintain the overall import level. NTBs covered by the index include price control measures, quantity restrictions, monopolistic practices, SPS and technical regulations, and agricultural support.

Table 9 presents the OTRI for a sample of Asian countries. India has the highest OTRI, not only among countries in South Asia but also in relation to the sample of countries in the rest of Asia. The impact of NTBs on the magnitude of the OTRI also appears to be relatively high in India's case. A comparison with Pakistan reveals clearly that NTBs play a far less dominant role than in India. This point needs to be stressed in ongoing negotiations with India.

		Percentage increase in
Country	OTRI	OTRI due to NTBs
South Asia		
Bangladesh	23.8	0.8
India	46.7	24.5
Nepal	16.1	0.0
Pakistan	22.2	5.1
Sri Lanka	9.9	0.0
East Asia		
China	21.2	9.9
Malaysia	39.7	30.0
Philippines	34.5	30.5
Thailand	22.8	8.1
Rest of Asia		
Turkey	15.1	2.7

#### Table 9: OTRI in a sample of Asian countries

Source: World Bank (2012).

Specific impediments to trade between India and Pakistan include the following.

- 1. Severe visa restrictions by both countries make it difficult for businesspersons from one country to develop contacts/markets in the other.
- 2. Restrictions on the choice of routes that can be used to transport goods constrain trade. For example, Pakistan limits the use of the Atari–Wagah border overland route to 137 goods from India.
- 3. There is limited capacity for transport on overland routes, especially the availability of wagons from Pakistan Railway. In addition, there are no testing or quarantine facilities at the check-post at Atari–Wagah. There is no e-filing system in operation at the border customs, leading to significant delays, frequently for security reasons.
- 4. In some cases, the testing and certification required under SPS measures and technical barriers to trade take considerable time in India.

5. Banking channels remain underdeveloped in the absence of bank branches in one country of banks in the other. This has created problems in honoring letters of credit. Payments through the Asian Clearing Union are also subject to long delays.

These impediments appear to have had a major impact on the volume of trade between the two countries. Fortunately, some steps have recently been taken to improve the situation. The countries have reached a bilateral agreement to expedite customs clearance on accepting each other's certification of goods. There are ongoing discussions on a visa protocol to facilitate longer, more frequent by businesspersons. Overall, it is clear that NTBs are generally more restrictive in India, especially on agricultural items. There are also a number of specific impediments to bilateral trade, which, if removed, could significantly enhance the volume of trade.

#### 7. Prospects for Indo–Pakistan Trade

We have demonstrated above that granting MFN status to India, rationalizing tariffs on Pakistani products by India, and mutual efforts to remove specific impediments to trade could substantially enhance the volume of trade between the two countries. A number of other studies have already reached this conclusion, including those by Batra (2004), Nabi and Nasim (2001), the State Bank of Pakistan (2006), Sayeed (2005), Kemal, Abbas, and Qadir (2002), Hussain (2011), and Taneja (2007). Such studies have adopted different approaches to demonstrate that the potential volume of trade could be a multiple of its present level.

Following the granting of MFN status, there is considerable scope for the diversion of imports by Pakistan to India, especially in product groups such as chemicals, pharmaceuticals, iron and steel, electrical appliances, plant and machinery, motor vehicles, and transport equipment. The gains to Pakistan would be in the form of lower prices (especially due to India's proximity and the resulting lower transport costs). The State Bank of Pakistan (2006) estimates that the diversion of trade to India could confer savings in the import bill of over USD 1 billion.

There is also the likelihood of some "trade creation" following the implementation of SAFTA, especially in items that are currently not imported but could witness the entry of Indian products as the result of a sizeable fall in the rate of customs duty from 20–30 percent to 5 percent. In addition, informal imports through various channels from India could shift to official imports. Overall, in the medium term, it is estimated that imports

from India could rise to almost USD 7 billion to 8 billion, especially if there is significant trade creation. This would more-than-quadruple the present level of imports. If this happens, India could become one of Pakistan's largest trading partners in Asia, along with China and the Middle East countries.

On the export side for Pakistan, the prospects appear somewhat more limited. The outcome depends on the extent to which India eases both general and Pakistan-specific barriers to trade, and rationalizes tariffs, especially on textiles. The reduction of duties under SAFTA may not be of great benefit because its sensitive list protects agriculture and textiles. Indian duties on manufactured goods, except textiles and clothing, are relatively low and, consequently, the extent of tariff reduction under SAFTA will not be so pronounced. Overall, Pakistan would do well if it were able to increase its exports to India to USD 1 billion from the present level of about USD 350 million in the next few years. This would nearly treble its exports to India.

It needs to be emphasized that there are threats to realizing this quantum jump in bilateral trade. First, industries in Pakistan that have traditionally enjoyed high levels of effective protection will lobby for the negative list, including their products, to be retained beyond 31<sup>st</sup> December 2012 on the grounds that they fear "serious injury" due to the opening of trade following full trade normalization with India. While Pakistan adheres to its commitment to grant MFN status, it may be necessary to enhance the institutional capacity of the Ministry of Commerce and National Tariff Commission to investigate complaints of serious injury and take appropriate safeguard measures, if necessary, permissible under the WTO and SAFTA.

Second, there are likely to be elements in India who are opposed to granting any concessions to Pakistan in negotiations on the future bilateral trading regime. This may include not only right-wing political forces, but also, potentially, certain industries such as textiles and clothing.

Third, the prospects of an increase in Pakistan's trade deficit with respect to India will fuel arguments on the part of right-wing elements and industrial lobbies in the country that the process of liberalization has been to India's advantage and that Pakistan has lost the major leverage it had with regard to resolution of the longstanding Kashmir problem. It will be necessary to convey the message that, while the trade deficit with respect to India may worsen, the global balance of trade will simultaneously improve due to cheaper imports from India. A powerful way of establishing this point may be to demonstrate the large consumer welfare gains that could accrue in a range of products, including certain basic food items, medicines, personal care items, electrical goods, and transport equipment (especially for public transport).

Finally, the recent improvement in the trading environment between the two countries can only be sustained if both pursue a policy of reciprocity and mutual cooperation, and if political relations are not strained and security concerns not heightened. It is possible that the expansion of trade between the two countries will facilitates the process of composite dialogue and confer a large peace dividend in the not-so-distant future.

#### References

- Batra, A. (2004). India's global trade potential: The gravity model approach (Working Paper No. 151). New Delhi, India: Indian Council for Research and International Economic Relations.
- Hussain, I. (2011). *Prospects and challenges for increasing India–Pakistan trade.* Washington, DC: Atlantic Council.
- India, Ministry of Commerce and Industry. (2012). *Export import data bank*. Retrieved from http://commerce.nic.in/eidb/default.asp.
- Institute of Public Policy. (2012). *Non-tariff barriers of India and Pakistan and their impact*. Lahore, Pakistan: Author.
- Kemal, A. R., Abbas, M. K., & Qadir, U. (2002). A plan to strengthen regional trade and cooperation in South Asia. In T. N. Srinivasan (Ed.) *Trade, finance and investment in South Asia*. New Delhi, India: Social Science Press.
- Nabi, I., & Nasim, A. (2001). Trading with the enemy: A case for liberalizing India–Pakistan trade. In S. Lahiri (Ed.), *Regionalism and* globalization: Theory and practice. London, UK: Routledge.
- Pakistan, Ministry of Commerce. (2012). *Customs tariffs*. Islamabad, Pakistan: Author.
- Sayeed, A. (2005). *Gains from trade and structural impediments to India–Pakistan trade*. Karachi, Pakistan: Collective for Social Science Research.
- State Bank of Pakistan. (2006). *Implications of liberalizing trade and investment with India*. Karachi, Pakistan: Author.
- State Bank of Pakistan. (2011). *Exports and imports of goods and services - Annual*. Karachi, Pakistan: Author.
- Sustainable Development Policy Institute. (2007). *Quantifying informal trade between Pakistan and India*. Islamabad, Pakistan: Author.
- Taneja, N. (2007). Pakistan–India trade: View from the Indian side. In Z. Naqvi & P. Schuler (Eds.), *The challenges and potential for Pakistan–India trade*. Washington, DC: World Bank.

- World Bank. (2012). *World trade indicators 2009/10: Trade policy*. Retrieved from http://info.worldbank.org/etools/wti/3a.asp.
- World Trade Organization. (2008). *Trade policy review: Pakistan*. Retrieved from http://www.wto.org/english/tratop\_e/tpr\_e/tp\_rep\_e.htm.
- World Trade Organization. (2011). *Trade policy review: India*. Retrieved from http://www.wto.org/english/tratop\_e/tpr\_e/tp\_rep\_e.htm.

# Sri Lanka's Free Trade Agreements with India and Pakistan: Are They Leading Bilateral Trade Beyond Normalcy?

# Sirimal Abeyratne\*

## Abstract

Bilateralism arises as a "second-best" option when countries seek benefits beyond those of regional approaches to free trade and those of unilateral liberalization. In spite of the regional initiatives for free trade in South Asia along with policy reforms in individual countries, Sri Lanka entered into bilateral free trade agreements (FTAs) with India (2000) and Pakistan (2005). In a situation where trade within the South Asian region has been sluggish despite higher economic growth, trade liberalization, and regional initiatives for integration and cooperation, this article examines from the Sri Lankan point of view whether the bilateral FTAs have resulted in above-normal trade performance. The analysis suggests that better performance in bilateral trade cannot be attributed exclusively to the success of the FTAs any more than weak performance can be attributed to their shortcomings. Apart from this, merchandise trade does not appear to have performed in isolation as the extent of overall bilateral connectivity set the groundwork for greater integration. The article confirms that bilateral FTAs that seek reciprocity in integration and cooperation are indeed a "second-best" option, compared to the potential trade performance associated with unilateral liberalization in trading partner countries.

Keywords: Bilateralism, trade agreements, Pakistan.

## JEL Classification: F13, F14, F15, F53.

## 1. Introduction

The paradox of the regional trade and economic growth nexus in South Asia is that, although the region is one of the fastest growing in the world—particularly after the commencement of liberalization policy reforms—intraregional trade does not appear to have performed well (see Abeyratne, 2012; Ahmed, Kelegama, & Ghani, 2010; Banik & Gilbert, 2008; Federation of Indian Chambers of Commerce and Industry [FICCI], 2011). Nevertheless, South Asian countries also have over 25 years' history of

<sup>\*</sup> Professor of Economics, Department of Economics, University of Colombo, Sri Lanka.

regional initiatives for greater integration and cooperation. The South Asian Association for Regional Cooperation (SAARC) was established in 1985, followed by the implementation of two important regional agreements—the SAARC Preferential Trading Agreement (SAPTA) in 1995 and the South Asian Free Trade Area (SAFTA) in 2005 (Soz & Srivastava, 2010).<sup>1</sup> Evidently, the slow progress of the multilateral trade liberalization process under the World Trade Organization (WTO)'s agenda has led to the increasing reliance of countries on regional trade agreements. Additionally, even those countries that considered the progress of regional trade agreements to be too slow have been inclined to enter into bilateral free trade agreements (FTAs).

Given the slow progress of regional initiatives for integration and cooperation, Sri Lanka entered into bilateral FTAs with India and Pakistan. The Indo-Lanka Free Trade Agreement (ILFTA) has been in effect since 2000 and the Pakistan-Lanka Free Trade Agreement (PLFTA) since 2005.<sup>2</sup> The two agreements left SAFTA redundant with respect to Sri Lanka's merchandise trade with India and Pakistan, preserving its trade with other South Asian countries under SAFTA. Which approach to free trade, among the many alternatives, is likely to yield the best outcome is both a theoretical and empirical issue. The bilateral and regional FTAs that take the reciprocity element into account are actually considered to be "second-best" options in the absence of unilateral liberalization programs among the trading-partner countries (Krueger, 1997). There are greater possibilities for trade diversion under bilateral or even regional FTAs, and those possibilities could even lead to greater trade distortions when external trade barriers are high.

The purpose of this article is to examine whether Sri Lanka's bilateral FTAs with India and Pakistan have made a difference to the country's normal trade performance. An assessment of bilateral trade performance under bilateral agreements requires an inquiry into merchandise trade *within and outside* the FTAs, and an analysis of the

<sup>&</sup>lt;sup>1</sup> The *Report of the SAARC group of eminent persons*, a body established at the 9<sup>th</sup> SAARC Summit in 1997, proposed the formation of the South Asian Economic Union by 2020 (see SAARC, 1999). This was conceptualized as an achievement of regional economic cooperation and integration in successive stages—the establishment of SAFTA, followed by the formation of the South Asian Customs Union by 2015 alone, and initiation of the process to reach the proposed South Asian Economic Union 4–5 years earlier than planned.

<sup>&</sup>lt;sup>2</sup> Sri Lanka's bilateral economic integration is expected to move beyond merchandise trade through its proposed comprehensive economic partnership agreement with India in 2003 and another with Pakistan in 2008. However, these agreements, the implementation of which was delayed, envisaged extending bilateral economic integration under all four modes of trade in services.

related structural changes in trade patterns that might be identified as an outcome of the FTAs. The analysis shows that Sri Lanka's bilateral trade performance is peculiar—in cases where trade performance is better, it cannot all be attributed to the effectiveness of the FTAs alone; in cases where trade performance is worse, it cannot all be attributed to the ineffectiveness of the FTAs alone. The article confirms that the role of an FTA in terms of trade expansion is limited and should not be considered the "best" option.

The rest of the article is organized as follows: Section 2 outlines Sri Lanka's bilateral and regional agreements, highlighting how the former have made the latter ineffective. Section 3 presents an analysis of Sri Lanka's bilateral trade with India and Pakistan, identifying the extent of the influence of bilateral FTAs on trade performance. Factors beyond the FTAs that need to be taken into account in analyzing bilateral trade performance are briefed in Section 4. With a summary of the findings, a series of conclusions is drawn in Section 5.

#### 2. Sri Lanka's Regional and Bilateral Trade Agreements

The agreement on SAPTA came into effect in 1995, that is, after 10 years of the establishment of SAARC in 1985. Under SAPTA, SAARC member countries envisaged promoting and sustaining regional trade and economic cooperation through the exchange of trade concessions. Although regional trade was expected to move forward under SAPTA through a reciprocal stage-by-stage approach focusing on the existing trade barriers, its progress was far below expectations, as acknowledged by SAARC (1999).

Perhaps it was not SAPTA but the unilateral trade liberalization process in the SAARC countries that provided the impetus for regional trade expansion. In between the formation of SAARC and the establishment of SAPTA, India and other countries in the SAARC region embarked on their unilateral policy reform process for trade liberalization. While Sri Lanka's economy had been liberalized since 1977, other South Asian countries, such as India, Pakistan, Bangladesh, and Nepal commenced trade liberalization in the early 1990s. Trade within the region increased from 2.4 percent in 1990 to 4.5 percent in 2000 and thereafter to a little over 5 percent in 2009 (FICCI, 2011, p. 5). Compared to this, regional trade accounted for 12 percent in East Asia and the Pacific, 19 percent in Latin America and the Caribbean, and 20 percent in Europe and Central Asia in 2009 (FICCI, 2011, p. 6). Trade liberalization in individual countries

317

was instrumental in expanding regional trade and investment as well as in establishing subsequent multilateral and bilateral agreements.

After considerable delay, the agreement on SAFTA came into effect in 2005—superseding SAPTA—with the objective of promoting trade and economic cooperation among "contracting states" by eliminating trade barriers and facilitating cross-border trade. Member countries also agreed on the need to ensure equitable benefits of free trade among contracting states in order to create an effective mechanism for the implementation of the agreement, and to establish a framework for the deeper integration of the contracting states beyond the premises of SAFTA.

Within the first two years, under SAFTA India, Pakistan, and Sri Lanka (non-least developed contracting states or NLDCs) agreed to reduce tariff rates to 20 percent, and other SAARC countries (least developed contracting states or LDCs) to 30 percent (Table 1). India and Pakistan were expected to further reduce their tariff rates in the range of 0-5 percent within the next five years, Sri Lanka within six years, and the LDCs within eight years. Trading partners were to be allowed to agree on the tariff ceiling of goods on the "sensitive list," which was expected to be revised and reduced every four years. The agreement also envisaged the elimination of quantitative restrictions (QRs) on trade and a review of paratariffs and nontariff barriers (NTBs) by the contracting states. Apart from the above, a series of additional measures was introduced for trade facilitation. According to the SAFTA Rules of Origin, Sri Lanka as a "small" non-LDC country should satisfy the minimum domestic value addition (DVA) of 35 percent of the f.o.b. value. If part of the inputs originated from a contracting country, the aggregate input content should be at least 50 percent of the f.o.b. value as aggregate value addition if part of the inputs originated from other contracting countries.

During the 10-year period between the establishment of SAPTA (1995) and SAFTA (2005), however, Sri Lanka had progressed far ahead in terms of its regional economic integration, leaving little space to be covered by SAFTA. This had been achieved through the unilateral trade liberalization in the region and the bilateral FTAs into which it had entered with India and Pakistan. The scope left for SAFTA to cover was Sri Lanka's economic integration with the other SAARC countries. SAFTA did not, therefore, appear to be particularly effective in strengthening Sri Lanka's economic integration with these countries. Sri Lanka had already established closer ties with the Maldives in terms of trade and investment due to factors beyond the regional agreements in question. There was little

economic integration between Sri Lanka and Nepal and Bangladesh, and an insignificant degree with Bhutan and Afghanistan. In spite of SAFTA, Sri Lanka's weak integration with these countries remained so without any major breakthrough subsequent to the agreement.

	NL	DCs	LDCs
	Sri Lanka	India, Pakistan	Other countries
Tariff reduction	Max. 20% in 2 years (2008)	Max. 20% in 2 years (2008)	Max. 30% in 2 years (2008)
	0–5% in 6 years (2014)	0–5% in 5 years (2013)	0–5% in 8 years (2016)
Sensitive list	1,042 items	India: 480 (LDCs), 868 (NLDCs) Pakistan: 1,169	Afghanistan: 1,072 Bangladesh: 1,233 (LDCs), 1,241 (NLDCs) Bhutan: 150 Maldives: 681 Nepal: 1,257 (LDCs), 1,295 (NLDCs)
Rules of origin	DVA = min. 35% of f.o.b. value	DVA = min. 40% of f.o.b. value	DVA = min. 30% of f.o.b. value
		outs originate from a c ont = 50%, with min. 20	0,

<b>Table 1: Summary</b>	of the agreement on	SAFTA (2005)
-------------------------	---------------------	--------------

Source: SAARC Secretariat. Retrieved from www.saarc-sec.org

Sri Lanka's FTAs with India (ILFTA) and Pakistan (PLFTA) surpass the regional trade agreement (SAFTA) in terms of the depth of free trade, its time span of progress, and rules of origin (Table 2). This means that the country's bilateral trade with both India and Pakistan has performed under the bilateral agreements that made SAFTA ineffective. As we have already seen, Sri Lanka's bilateral trade with the other SAARC countries also made only marginal progress during the second half of the 2000s when SAFTA was effective (Abeyratne, 2012). The country's regional trade performance can, therefore, be explained better in the context of its bilateral trade agreements than its regional agreements.

The ILFTA was operational within 15 months of signing the agreement in December 1998, while the PLFTA came into force within three years of signing the agreement in July 2002, implying that bilateral

agreements are more time-effective than regional or multilateral agreements. At the point of implementation, both trading partners had agreed on achieving zero tariffs for a range of tradable products and on the time duration for phasing out tariffs for the balance of items. In both cases, the agreements granted more "favorable" conditions and longer gestation periods for Sri Lanka than for India or Pakistan. Sri Lanka has also been entitled to a longer sensitive list than either India or Pakistan. In effect, whether or not these conditions actually remained "favorable" is an issue that has not been addressed. Sri Lanka's requirements—retaining "higher" tariffs, offering "shorter" lists of concessions, and receiving "longer" gestation periods—that are seen as "favorable" conditions could have actually led it to miss an opportunity to achieve lower production and consumption costs early.

Tariff reduction	ILFTA (2000)	PLFTA (2005)
(a) Immediate zero tariffs	India: 1,351 items Sri Lanka: 319 items	Pakistan: 206 items Sri Lanka: 102 items
(b) Tariff phasing-out period	3 years for India (2003) 8 years for Sri Lanka (2008)	3 years for Pakistan (2008) 5 years for Sri Lanka (2010)
Sensitive list	India: 431 Sri Lanka: 1220	Pakistan: 540 Sri Lanka: 697
Rules of origin	DVA is 35% of f.o.b. valu In case part of the inputs contracting country, min with min. 25% domestic	originate from a . aggregate content = 35%,

#### Table 2: Summary of Sri Lanka's bilateral FTAs

Source: Department of Commerce, Government of Sri Lanka. Retrieved from www.doc.gov.lk

As usual, the bilateral FTAs and SAFTA agreement were both characterized by "rules of origin" to safeguard the benefits of the agreements solely for their member countries, creating a market for production with greater value addition. On Sri Lanka's part, both the bilateral FTAs and SAFTA agreement do make a distinction for minimum DVA, which is 35 percent of the f.o.b. value of the export product. On the part of India and Pakistan, while domestic, the SAFTA requirement for DVA is 40 percent, which is greater than 35 percent under the bilateral FTAs.

Both FTAs are fully effective now that Sri Lanka has completed the time periods for tariff liberalization under the ILFTA in 2008 and under the PLFTA in 2010. India completed tariff liberalization in 2003 and Pakistan in 2008, allowing Sri Lanka a longer adjustment period. Given this requirement under the bilateral FTAs, Sri Lanka and its trading partners have already moved beyond SAFTA's requirements to slash tariffs to 0–5 percent by 2014 for Sri Lanka and by 2013 for India and Pakistan. Although it was reasonable to anticipate greater trade performance toward the end of the decade with the completion of the tariff liberalization process, Sri Lanka's bilateral trade with India and Pakistan has not reflected a significant change. It is, however, worth noting that the decade's last few years were marked by the adverse effects of external shocks, such as the US financial crisis and EU sovereign debt crisis, both of which affected trade performance in the SAARC region.

#### 3. Sri Lanka's Bilateral Trade with India and Pakistan

Generally, an analysis of Sri Lanka's bilateral trade with India and Pakistan should acknowledge, apart from the bilateral agreements, the role played by the unilateral liberalization process and multilateral agreements for preferential and free trade in both bilateral and regional trade expansion. However slowly, Sri Lanka's trade with South Asian countries has grown in the past. As of 2011, exports to and imports from the South Asian countries account for 7 and 23 percent of the respective totals (Central Bank of Sri Lanka, 2011). The particular pattern of Sri Lanka's regional trade expansion has also led to certain questions in both policy and academic circles (see Abeyratne, 2012; Ahmed et al., 2010; Behera & Mukherji, 2011; Weerakoon, 2009). While the South Asian region has become important as a source market for Sri Lanka's imports but not as a destination market for its exports, an overwhelming bulk of regional trade accounts for trade with India alone. Apart from that, Sri Lanka has significant bilateral trade relations with Pakistan, the Maldives, and Bangladesh. Its trade with Nepal is insignificant; with Bhutan, trivial and sporadic, and with Afghanistan, nonexistent.

#### 3.1. Bilateral Trade Performance

Sri Lanka's regional trade is dominated by its bilateral trade with India, while in recent years the latter has remained among Sri Lanka's top five export destination markets. In fact, India has continued to improve its position as the single most important trading partner of all other countries in the region. During the first half of the 1990s, Sri Lanka's exports to India were lower than its exports to Pakistan. Exports to India, which accounted for about 30 percent of total exports to countries in the region in 2000, rose sharply in the first half of the 2000s, exceeding 80 percent after the implementation of the ILFTA in 2000 (Table 3). The share of exports to Pakistan—accounting for over 40 percent of total exports to SAARC—continued to decline, reaching 6.7 percent of total exports to SAARC in 2005. After the implementation of the PLFTA in 2005, however, exports to Pakistan recorded a slight improvement.

India is Sri Lanka's largest source market for imports, followed by Singapore and China in second and third position, respectively. Imports from India have continued to rise since the mid-1990s and, on average, account for about 90 percent of Sri Lanka's total imports from the SAARC region. This means that the other member countries account for only about 10 percent of Sri Lanka's imports from the region. Two decades ago, however, Pakistan—then, an important source market for Sri Lanka's imports—contributed to over 25 percent of Sri Lanka's total imports from the region. The share of imports from Pakistan recorded a sharp decline in the first half of the 1990s and dropped to around 10 percent in 2001 and 2002. It declined further in the decade's subsequent years, reaching 5 percent by 2008, but later improved.

	Exports to SAARC			Im	ports from S	SAARC
Year	USD mn	India (%)	Pakistan (%)	USD mn	India (%)	Pakistan (%)
1990	71	29.1	45.8	183	64.1	27.6
1995	97	31.3	42.5	516	86.1	9.6
2000	180	30.6	15.7	669	84.8	10.2
2001	151	45.6	15.8	683	84.4	10.4
2002	254	66.5	11.2	925	89.2	7.0
2003	350	70.0	10.5	1,173	91.5	6.1
2004	507	77.3	7.8	1,575	91.4	6.9
2005	653	86.7	6.7	1,981	92.6	5.8
2006	600	81.5	9.7	2,351	92.4	6.3
2007	646	79.7	8.5	2,815	92.7	6.3
2008	561	74.5	12.7	3,667	94.0	5.2
2009	441	73.0	12.5	2,055	88.6	9.6
2010	601	77.5	10.0	2,877	89.3	9.8

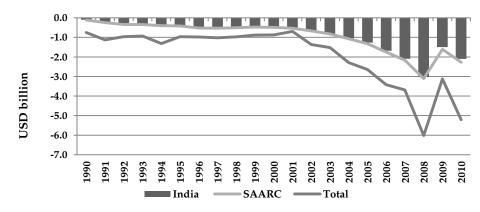
Table 3: Sri Lanka's exports to and imports from SAARC

Source: Central Bank of Sri Lanka (Annual Report for various years).

Sri Lanka's trade expansion in the SAARC region and with India in particular has been accompanied by a growing trade deficit. The evidence indicates that it has never had a trade surplus during its 35-year liberalized trade regime, while the overall trade deficit has increased sharply in the past decade (Figure 1). The movement of the overall trade deficit resembles the country's growing regional trade deficit with the SAARC countries in general and with India in particular. However, Sri Lanka's trade deficit with SAARC has remained cushioned by its trade surplus with the US and EU—its two largest export destinations, which together account for over half the country's total exports.

Sri Lanka also has a trade deficit with Pakistan—the country's second-largest trading partner in the SAARC region. Although this trade deficit is not as large as the trade deficit with India, it appears to have been rising sharply after 2005 (Figure 2). This also coincides with the implementation of the PLFTA, resembling the growing trade deficit with India after the implementation of the ILFTA. This episode does not, however, lead to an early conclusion against Sri Lanka's two bilateral FTAs in the SAARC region. It is possible that growing imports from both India and Pakistan are a result of trade diversion, and may have a positive impact on the country's trade with the rest of the world and on its welfare performance. Moreover, it is too early to suggest that the increase in its bilateral trade deficits with India and Pakistan are an exclusive outcome of the FTAs—an issue with which we deal in the following section.

#### Figure 1: Sri Lanka's trade balance, 1990–2010



Source: Central Bank of Sri Lanka (Annual Report for various years).

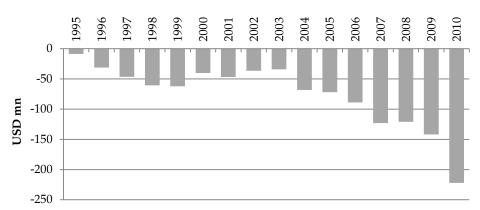


Figure 2: Sri Lanka's Trade Deficit with Pakistan, 1995-2010

Source: Central Bank of Sri Lanka (Annual Report for various years).

#### 3.2. Trade Performance Within and Beyond the FTAs

Sri Lanka's two bilateral FTAs, the ILFTA (2000) and PLFTA (2005) have brought a significant share of the products that were exported to and imported from India and Pakistan under free trade through a gradual process of phasing out tariff barriers. As the Sri Lankan Customs Department (n.d.) reports, 91.8 percent of total imports from India (6,522 products) and 85.7 percent of total exports to India (1,765 products) were covered by the ILFTA (Table 4). Similarly, 80.8 percent of imports from Pakistan (1,492 products) as well as the same percentage of exports to Pakistan (470 products) were covered by the PLFTA.

		Products		Value	
FTA	Imports/exports	No. of products <sup>a</sup>	Percent	USD million	Percent
ILFTA	FTA imports	6,522	91.8	1,418	56.3
	Total imports	7,107	100.0	2,517	100.0
	FTA exports	1,765	85.7	423	88.2
	Total exports	2,059	100.0	480	100.0
PLFTA	FTA imports	1,492	80.8	193	67.2
	Total imports	1,847	100.0	287	100.0
	FTA exports	470	80.8	50	80.7
	Total exports	582	100.0	62	100.0

Table 4: Exports and imports under FTAs with India and Pakistan, 2010

a = HS 6–8-digit classifications, as reported in the data source. *Source:* Sri Lanka Customs Department.

The value of imports covered by the FTAs is, however, not as great as the volume of products they cover. The FTAs cover only 56.3 percent of imports from India and 67.2 percent of imports from Pakistan, indicating that non-FTA imports also remain significant. In fact, under the ILFTA, Sri Lanka's negative list covers 1,220 products (at HS Code 6-digit level), affecting its imports from India, compared to the latter's negative list of 431 products, affecting Sri Lanka's exports to India. In contrast, under the PLFTA, Sri Lanka's negative list covered 697 products while Pakistan's negative list covered 540 products (at HS Code 6-digit level). The value of exports to both India and Pakistan, however, closely resemble the share of export products covered by the respective FTAs.

Sri Lanka's bilateral trade with India and Pakistan before and after entering into their respective FTAs, as well as within and outside those FTAs, reveals some peculiar characteristics of the country's regional trade expansion (Table 5). After the ILFTA's implementation in 2000, trade expansion during the first half of the decade (2000–05) was remarkable on average, per annum exports grew by over 300 percent and imports by nearly 200 percent. During the second half of the decade (2005–10), exports contracted by 2.7 percent while imports grew by only 12.8 percent, presumably due both to internal policy changes and external shocks. The expansion of FTA exports was greater than non-FTA exports in the first half of the decade, but not in the second half. Although Sri Lanka's long negative list affected imports from India, the expansion of non-FTA imports was greater than that of FTA imports throughout the decade.

Trade	1995–2000	2000–05	2005–10
Trade with India	Before FTA	After FTA	After FTA
FTA exports	14.0	308.8	-4.7
Non-FTA exports	0.6	198.8	33.4
Total exports	12.0	301.6	-2.7
FTA imports	5.1	192.3	12.7
Non-FTA imports	4.9	211.8	13.0
Total imports	5.0	199.9	12.8
Trade with Pakistan	Before FTA	Before FTA	After FTA
FTA exports	-7.4	12.8	8.8
Non-FTA exports	-6.9	-1.0	4.1
Total exports	-7.3	8.6	7.7
FTA imports	2.9	19.3	15.0
Non-FTA imports	13.3	-9.0	39.5
Total imports	6.6	10.7	20.3

Table 5: Exports from and imports to India and Pakistan: Average annual rate of growth, 1995–2010

Source: Sri Lanka Customs Department.

It is clear that the ILFTA was more important for export expansion than for import expansion. Abeyratne and Ranasinghe (2004) and Samarajiva and Herath (2009) confirm that Sri Lanka has been diverting its import trade from the rest of the world toward India in the last two decades due to cost differences. Moreover, the policy outcome of post-1990 liberalization reforms in India has been instrumental on its part to meeting this demand. Since Sri Lanka also imports a bulk of intermediate goods and raw materials from India, the particular pattern of production specialization in Sri Lanka could be an underlying factor in the changes in import growth. Compared to the import growth that picked up in the early 2000's and continued to remain high throughout the decade (except in 2009), export growth steadily declined after initially increasing in the early 2000's and remained negative for some years after 2005.

Although it is too early to make a fair assessment, Sri Lanka's bilateral trade with Pakistan has grown rapidly during 2005–10 after the implementation of the PLFTA in 2005, but mostly in areas outside the FTA. The average annual rate of export growth declined to 7.7 percent during 2005–10 from 8.6 percent during 2000–05, with an increase in non-FTA export growth and a decrease in FTA export growth. Between the same

periods, the average annual rate of import growth nearly doubled from 10.7 to 20.3 percent, with an increase in non-FTA import growth and a decrease in FTA import growth. The Sri Lankan experience with the PLFTA also suggests that there was a revival of Sri Lanka's bilateral trade with Pakistan, but factors beyond the PLFTA appear to have had a greater impact on this revival of bilateral trade.

#### 3.3. Changes in Export and Import Structures

Trade expansion under bilateral FTAs has been accompanied by substantial changes in export and import composition. Prior to the ILFTA, Sri Lankan exports to India were dominated by primary goods, paper waste and scrap, and ferrous waste and scrap (Table 6). Subsequent to its implementation, there has been an increase in the share of manufactured exports to India. Some of these manufactured exports include new products entering the Indian market, such as animal feed, fiberboard, furniture, and ships and boats. Some of the fast growing exports, particularly copper and copper products, and fats and oils (vanaspathy in particular) grew in response to the tariff concessions under the ILFTA, but declined after the trade restrictions were reversed. Among non-FTA exports, natural rubber accounted for over 60 percent, and apparel and clothing for nearly 25 percent of total non-FTA exports to India in 2010. In 2000, plastic and rubber articles, and synthetic filament yarn dominated non-FTA exports, accounting for about three fourths of total non-FTA exports to India.

Sri Lanka's import mix from India has always been far more diverse than its export mix. Pharmaceutical products, cotton yarn, woven cotton fabrics, and iron and steel dominated FTA imports in 2000 (Table 7). Even after the implementation of the ILFTA, these imports remained important although their share of total imports appears to have declined. One notable increase in the share of imports has been that of motorcycles, parts, and accessories, which increased from 2 to 10.5 percent of total FTA imports. Among non-FTA imports, the share of petroleum and passenger vehicles has increased significantly, together accounting for more than half of total non-FTA imports by 2010. While the oil price hike as well as the Indian oil industry's entry into the Sri Lankan petroleum sector may have contributed to the increase in share of petroleum imports, the rising demand for cheaper Indian motor vehicles would have caused the increase in share of vehicle imports. In fact, the Indian motor vehicle industry also improved its international competitiveness only after India initiated policy reforms so that the industry was able to promote exports competitively.

Code	Export	1995	2000	2005	2010				
Main FTA e	Main FTA exports (as percentage of total FTA exports)								
0508	Coral products	0.0	1.4	0.1	0.3				
08	Fruits and nuts	7.4	4.1	0.2	0.9				
0902	Теа	1.4	7.5	0.2	0.3				
0904-0910	Spices	7.0	29.1	5.9	16.7				
151-152	Fats and oils	12.3	4.8	26.2	0.0				
180	Cocoa and cocoa preparations	0.0	0.2	0.0	4.4				
2309	Animal feed	0.0	0.0	0.0	10.5				
4011-4015	Rubber products	0.7	1.1	1.1	4.8				
4411	Fiberboard of wood and other	0.0	0.0	1.9	2.6				
4707	Paper waste and scrap	5.6	7.6	2.0	5.0				
5804-5807	Woven fabrics and textiles	0.1	0.4	0.4	1.7				
7204	Ferrous waste and scrap	25.0	10.4	1.9	0.1				
7402-7413	Copper and copper products	4.6	2.2	28.4	5.9				
7801-7802	Lead, unwrought, waste and scrap	0.0	0.1	0.4	2.2				
8418	Machinery	0.2	0.0	0.2	4.7				
8544	Insulated electric conductors	0.2	0.4	3.6	8.9				
89	Ships and boats	0.0	0.0	0.0	4.5				
9403	Furniture	0.0	0.3	1.0	1.7				
Total	(Percentage of total FTA exports)	64.5	69.5	73.2	75.6				
	(USD million)	16.0	33.0	393.0	320.0				
All FTA exp	orts (USD million)	24.0	47.0	537.0	423.0				
Main non-F	TA exports (as percentage of total non-FT	'A export	ts)						
3926	Plastic and rubber articles	1.1	45.8	47.3	2.6				
400121-129	Natural rubber	92.7	8.4	16.8	60.3				
48	Paper and paperboard	1.6	8.9	14.9	4.5				
5402	Synthetic filament yarn	0.0	29.7	0.6	1.9				
61-62	Apparel and clothing	0.1	1.6	3.7	24.9				
Total	(Percentage of total non-FTA exports)	95.5	94.3	83.2	94.2				
	(USD million)	5.0	5.0	11.0	53.0				
All non-FTA	exports (USD million)	6.0	6.0	13.0	57.0				

Table 6: Main FTA and non-FTA exports to India, 1995–2010 (selected years)

Source: Sri Lanka Customs Department.

Code	Import	1995	2000	2005	2010
Main FTA in	ports (as percentage of total FTA imports)				
2304-2308	Oil cakes and solid residues	2.9	3.8	3.5	2.3
2523	Portland cement	12.6	3.7	3.7	5.0
2803	Carbon	1.1	1.5	2.3	1.7
30	Pharmaceutical products	7.0	8.9	7.6	7.5
3303-3307	Cosmetic and toilet preparations	0.2	0.8	0.6	0.7
3401-3402	Soap and washing preparations	0.2	0.2	0.4	0.7
381900	Hydraulic brake and transmission fluids	1.1	1.2	0.9	0.9
390	Plastics	2.8	1.8	3.0	2.4
5205-5207	Cotton yarn	5.6	8.1	3.9	4.7
5208-5212	Woven fabrics of cotton	12.5	12.2	6.7	7.4
5512-5516	Woven fabrics of synthetic and artificial fibers	1.2	3.1	1.5	2.0
6002-6006	Knitted or crocheted fabrics	1.4	0.8	1.7	4.8
72	Iron and steel	9.7	7.0	7.6	6.0
73	Iron and steel products	3.6	3.3	2.8	3.0
74	Copper and copper products	0.4	0.3	4.5	3.
8418	Refrigerators, freezers, and equipment	0.1	0.5	0.7	0.8
8501-8503	Electric motors, generators, and parts	0.3	0.4	0.4	2.3
870422-423	Motor vehicles for goods transport	2.6	1.1	5.3	4.0
8711 & 8714	Motorcycles, parts, and accessories	2.1	2.0	10.9	10.
Total	(Percentage of total FTA imports)	67.6	60.8	68.0	71.0
	(USD million)	193.0	222.0	530.0	1,006.0
All FTA imp	orts (USD million)	286.0	365.0	780.0	1,418.0
Main non-FT	A imports (as percentage of total non-FTA impo	rts)			
070110	Potatoes	1.8	2.9	0.9	1.4
070310	Onions and shallots	0.0	0.0	0.0	5.
0713	Dried leguminous vegetables	3.4	14.3	4.1	1.0
0902	Tea	0.2	0.9	0.7	1.
0904-0910	Spices	7.4	9.2	2.9	5.
170111-199	Sugar	14.2	3.6	0.4	3.
190190	Malt extracts	1.8	0.3	0.6	1.0
2710-2714	Petroleum oils and other products	0.0	0.1	32.7	32.1
4011-4013	Rubber tyres and tubes	2.4	1.7	1.1	1.
4802	Uncoated paper and paperboard	0.0	0.0	4.4	3.
4810	Paper and paperboard	0.0	0.1	2.1	2.4
8544 & 8546	Insulated electric conductors and insulators	0.3	1.8	0.9	1.0
8702-8703	Passenger vehicles	10.7	17.7	16.7	21.2
8704	Motor vehicles for transport of goods	3.1	0.3	1.9	3.
Total	(Percentage of total non-FTA imports)	45.4	53.0	69.4	83.8
	(USD million)	72.0	107.0	415.0	921.0
All non-FTA	imports (USD million)	159.0	203.0	597.0	1,099.0

Table 7: Main FTA and non-FTA imports from India, 1995–2010 (selected years)

Source: Sri Lanka Customs Department.

Exports to Pakistan have concentrated on a few commodities, while more than half of FTA exports in 2010 consisted of natural rubber alone (Table 8). In addition, coconut, spices, and rubber products also form part of Sri Lanka's main FTA exports, the share of which has increased after the implementation of the PLFTA.

Code	Export	1995	2000	2005	2010
Main FTA e	exports (as percentage of total FTA expor	ts)			
071340	Lentils	0.0	0.0	0.0	4.2
080110-19	Coconut	12.5	18.7	8.0	12.4
0904-0910	Spices	2.2	5.7	2.4	7.0
120300	Copra	17.8	39.0	38.8	1.0
230	Bran, sharps, and other residues	0.3	1.6	0.3	4.1
4001	Natural rubber	46.2	19.2	28.2	51.1
400821	Vulcanized rubber products	0.0	0.0	0.1	2.6
4002-4015	Rubber products	0.4	0.3	0.6	5.0
4411	Fiberboard	0.0	0.0	7.5	2.6
550810	Sewing thread	0.0	0.0	0.8	2.6
Total	(Percentage of total FTA exports)	79.5	84.6	86.6	92.8
	(USD million)	21.0	15.0	28.0	46.0
All FTA exp	ports (USD million)	26.0	18.0	33.0	50.0
Main non-F	TA exports (as percentage of total non-F	TA expo	rts)		
0902	Tea	75.5	73.2	62.8	26.4
140490	Beedi and betel leaves	7.9	15.2	25.4	44.0
140490	Coconut ekels	0.0	0.0	0.0	5.3
1511-1513	Coconut and palm oil	3.2	8.2	3.3	15.8
760720	Aluminum foil	0.0	0.0	0.0	2.3
Total	(Percentage of total non-FTA exports)	86.6	96.7	91.5	93.8
	(USD million)	13.0	10.0	9.0	11.0
All non-FT	A exports (USD million)	15.0	10.0	10.0	12.0

### Table 8: Main FTA and non-FTA exports to Pakistan, 1995–2010 (selected years)

Source: Sri Lanka Customs Department.

Non-FTA exports to Pakistan have been concentrated around tea, *beedi* and betel leaves, and coconut, which together accounted for over 86 percent of total non-FTA exports in 2010. Under the PLFTA, however, the importance of tea has declined, while the share of the other two exports has risen.

Yarn and fabrics for Sri Lanka's textile and apparel industry have dominated FTA imports from Pakistan, accounting for about 72 percent of total FTA imports in 2005 (Table 9). The importance of this intermediate group of goods has remained high even after the implementation of the PLFTA, even though its share fell, mainly due to the entry of cement as a newly imported commodity from Pakistan. In the non-FTA category, the import mix continued to be dominated by dried fish, potatoes, onions, and rice.

Code	Import	1995	2000	2005	2010	
Main FTA imports (as percentage of total FTA imports)						
0909	Seeds and spices	0.2	2.9	1.7	2.7	
2523	Cement	0.0	0.0	0.0	15.5	
3002-3004	Pharmaceutical products	7.5	8.7	4.9	4.3	
4101-4112	Leather	6.7	2.6	0.5	1.5	
5201-5207	Cotton and cotton yarn	23.4	16.4	7.3	2.9	
5208-5212	Woven fabrics of cotton	34.3	27.6	58.8	44.5	
5512-5515	Woven fabrics of synthetic fibers	7.5	4.1	2.8	3.2	
6001-6006	Knitted or crocheted fabrics	4.7	3.8	2.5	8.2	
7304-7307	Tubes, pipes, and fittings	0.1	7.0	7.0	7.3	
Total	(Percentage of total FTA imports)	84.9	78.3	89.5	94.8	
	(USD million)	29.0	31.0	86.0	183.0	
All FTA im	ports (USD million)	34.0	40.0	96.0	193.0	
Main non-FTA imports (as percentage of total non-FTA imports)						
0305	Dried fish	84.1	39.6	27.4	3.7	
0701	Potatoes	0.0	33.3	9.0	21.5	
0703	Onions shallots	1.7	12.5	9.3	9.5	
1006	Rice	8.0	6.4	26.7	56.8	
2207	Alcohol and spirits	0.0	0.0	0.0	1.6	
4805	Paper and paperboard	0.0	0.0	0.0	2.3	
Total	(Percentage of total non-FTA imports)	94.4	92.2	80.5	96.6	
	(USD million)	14.0	26.0	14.0	91.0	
All non-FTA imports (USD million)		15.0	29.0	18.0	94.0	

Table 9: Main FTA and non-FTA imports from Pakistan, 1995–2010
(selected years)

Source: Sri Lanka Customs Department.

#### 4. Factors beyond the FTAs

It is clear that Sri Lanka's two FTAs with India and Pakistan do not fully explain the country's bilateral trade performance. Both exports and imports have increased in general, but the expansion has been stronger with India than with Pakistan. Bilateral trade deficits have also increased more rapidly with India than with Pakistan. Sri Lankan exports to India have diversified, but not so in the case of Sri Lankan exports to Pakistan. The changes altering Sri Lanka's bilateral trade with India and Pakistan during the periods that fall under their respective FTAs, therefore, demand a discussion on factors beyond the FTAs.

#### 4.1. Overall Connectivity

The proximity and large size of the market, together with stronger economic relations beyond merchandise trade are important in explaining Sri Lanka's growing trade ties with India with or without the ILFTA. In fact, merchandise trade did not exist in isolation from other forms of growing economic relations between the two countries. Sri Lanka has even stronger relations with India in the services trade, travel and tourism, and investment. India is a growing source market for demand for education and health services by Sri Lanka, while the latter supplies port and aviation services to the former. According to the aviation statistics of Sri Lanka, Indian destinations accounted for 34 percent of weekly flights while the only Pakistani destination, Karachi, accounted for only 2 percent of flights departing from Colombo International Airport in 2011. More than three fourths of container traffic in Colombo Port in 2010 consisted of transshipment cargo portions, but about 90 percent of the transshipment volume originated from India alone, implying that the very existence of Colombo Port rests largely on Indian transshipment activities (Ratnayake, 2011).

Tourism is an important area of the services trade in which Sri Lankan connectivity with India is stronger than that with Pakistan. India emerged as the leading country of tourist origin for Sri Lanka in 2002, ousting traditional Western countries such as the UK and Germany, and continued to be so throughout the 2000s. Compared to 125,000 tourist arrivals from India in 2010, there were only 9,000 Pakistani tourists (Sri Lanka, Tourism Development Authority, 2010). While India is the largest destination for outbound Sri Lankan tourists, their number is, interestingly, much larger than that of Indian tourists visiting Sri Lanka. Sri Lanka is currently India's sixth largest source market, and was third and fourth in the first half of the decade (India, Ministry of Tourism, 2011).

India has been among Sri Lanka's top five sources of foreign direct investment (FDI) in much of the recent past. It was elevated to first position in 2010, contributing 21.4 percent of Sri Lanka's total USD 516.3 million FDI inflow. According to Samarajiva and Herath (2009), Sri Lanka become an attractive destination for Indian FDI particularly after 2000, while about half of India's FDI in the SAARC region is located in Sri Lanka. In fact, Indian FDI in Sri Lanka increased in the early part of the decade due to the implementation of the ILFTA particularly to gain from the bilateral free trade between the two countries. Apart from this, the importance of potential Indian FDI inflows to Sri Lanka has been recognized on various occasions. For instance, Sri Lanka and India entered into the bilateral Investment Promotion and Protection Agreement in 1997, while Sri Lanka set up its Board of Investment's first overseas office in Bangalore in 2005.

Although among the other South Asian countries, Pakistan is also important as a source of FDI for Sri Lanka, its contribution remains at around 0.1 percent of the latter's total FDI inflows. There has, however, been an increase in FDI from Pakistan to Sri Lanka since the mid-2000s, indicating that the PLFTA has had a positive impact on FDI inflows.

#### 4.2. Contemporary Shocks and Policy Changes

In terms of both internal and external shocks affecting domestic economies and their international relations, the second half of the decade (2005–10) did not appear to be normal. Sri Lanka's civil war escalated during 2007–09, followed by a massive program of rehabilitation and reconstruction. Global economic turmoil commenced with world oil and food price hikes, followed by the US financial crisis and the EU debt crisis, which affected the economies in South Asia as elsewhere. Against this backdrop, it was not unusual for trade to perform dismally under the just-initiated PLFTA. Bilateral trade between Sri Lanka and India, which had performed remarkably well during the first half of the decade, also came under pressure during the second half of the decade.

Policy changes, particularly during the Sri Lankan government's post-2005 regime, have also had a bearing on the country's trade performance. The new policy thrust favored domestic production and increased protectionism, which could be justified against both internal and external shocks—intensified war that required expanding government revenues and the global crises that justified increased protectionism and domestic production. This resulted in an increase in the share of domestic production in the output composition and a decline in trade volume as a percentage of GDP (Abeyratne, 2009). As Pursell (2011) argues, Sri Lanka has resorted to para-tariffs and new protectionist measures in the second half of the decade since the tariffs were falling under the WTO and FTA commitments. In a protective environment, the bilateral FTAs might not yield an optimal outcome since they could distort emerging trade patterns.

In addition to the increased transaction costs of economic integration under the numerous FTAs, the conditions laid down could actually restrict trade performance. This is particularly applicable to a "small" country more so than to a "large" country—a point that has been well recognized by the FTAs as well. However, the question is whether the specific country provisions under the FTAs can actually deal with the issue effectively. An obvious example concerns the rules of origin that constrain trade specialization by internationalizing production processes. An important characteristic of trade expansion in the recent past is the increasing tendency to "slice up" the production process into parts, components, and assembly; it is no longer the "unit value" but the "volume" that has become important in international trade (Athukorala, 2011). Therefore, the strict conditions stipulated by the rules of origin can lead not only to inefficient production specialization that contravene the notion of comparative advantage, but also inhibit intraregional trade.

#### 5. Conclusion

The preceding analysis has examined whether Sri Lanka's bilateral FTAs with India (ILFTA) in 2000 and with Pakistan (PLFTA) in 2005 have resulted in a difference to the country's normal trade patterns. Trade performance within the South Asian region is interesting because it represents a growth paradox. Trade within the region has not performed as well as its high economic growth might suggest, despite trade liberalization and initiatives for regional integration—SAPTA and SAFTA. Bilateral arrangements through the ILFTA and PLFTA have made regional arrangements redundant due to deeper tariff reforms, shorter periods of tariff phasing-out, linear rules of origin, and shorter sensitive lists.

The statistical evidence on the issue suggests that Sri Lanka's bilateral trade with India has grown and significantly diversified during the period under the ILFTA, although trade expansion slowed down in the second half of the last decade (2000–10). The country's bilateral trade with Pakistan has not, however, expanded or diversified very much. Sri Lanka's relatively high trade performance with India cannot be considered an exclusive product of the ILFTA, nor can the country's weaker trade performance with Pakistan be attributed to the PLFTA alone.

Unilateral trade liberalization in individual countries and the resulting shift in their production specialization and overall trade expansion have much to do with the changes that have occurred in Sri Lanka's bilateral trade with India and Pakistan. In addition to the notion of a "big market within proximity" dominating bilateral trade expansion with

India, the overall economic connectivity beyond merchandise trade appears to favor Sri Lanka's bilateral trade expansion with India. However, both internal and external shocks as well as crucial policy changes in favor of domestic production and protection appear to have hindered potential bilateral trade expansion during the second half of the last decade.

Our analysis infers that the scope for bilateral free trade alone may not be an adequate condition for better trade performance—trade facilitation, greater connectivity, investment, and services trade are among the important elements of greater trade performance. Even bilateral FTAs could perform better under a low-tariff regime achieved through a unilateral liberalization process than under the FTAs that seek reciprocity and rules of origin. Therefore, greater trade liberalization and facilitation in the region is likely to enhance trade performance even under bilateral FTAs, while such an approach would minimize trade distortions by those FTAs that are implemented in high-protective regimes.

#### References

- Abeyratne, S. (2009). *Economic and social impact of the global financial crisis in Sri Lanka*. Colombo, Sri Lanka: UNDP Asia-Pacific Regional Centre.
- Abeyratne, S. (2011, June). *India as a source market for tourism industry of Sri Lanka: Too big to be ignored.* Paper presented at a public seminar (Sanvada) of the Pathfinder Foundation, Colombo, Sri Lanka.
- Abeyratne, S. (2012). *Regional integration of Sri Lanka and its roadmap towards an economic union*. Country paper submitted to Asian Development Bank, Kathmandu, Nepal.
- Abeyratne, S., & Ranasinghe, A. (2004). Sri Lanka's trade expansion during economic reform. In O. H. Chowdhury & W. van der Geest (Eds.), *Economic reform and trade performance in South Asia*. Dhaka, Bangladesh: Bangladesh Institute of Development Studies.
- Ahmed, S., Kelegama, S., & Ghani, E. (Eds.). (2010). *Promoting economic cooperation in South Asia: Beyond SAFTA*. Washington, DC: World Bank.
- Athukorala, P. (2011). Production networks and trade patterns in East Asia: Regionalization or globalization? *Asian Economic Papers*, 10(1), 65–95.
- Banik, N., & Gilbert, J. (2008). Regional integration and trade costs in South Asia (Working Paper No. 127). Tokyo, Japan: Asian Development Bank Institute. Retrieved from http://www.adbi.org/workingpaper/2008/12/19/2781.regional.integration.trade.costs.south.asia/
- Behera, S. K., & Mukherji, I. N. (2011, July). Indo-Sri Lanka free trade agreement: A decadal assessment. Paper presented at the Seminar on Strategic Partnership for Policy Development and Action to Foster Regional Cooperation in South Asia, Pathfinder Foundation and Asian Development Bank, Colombo, Sri Lanka.
- Central Bank of Sri Lanka. (2011). *Annual report 2011*. Colombo, Sri Lanka: Author.
- Federation of Indian Chambers of Commerce and Industry. (2011, September). *South Asia Forum: Background paper*. Paper presented at the South Asia Forum on Integration in South Asia: Moving Towards a South Asian Economic Union, New Delhi, India.

- India, Ministry of Tourism. (2011). *India tourism statistics at a glance* 2010. Retrieved from IndiaWeb.com: www.tourism.gov.in/
- Krueger, A. O. (1997). Free trade agreements versus customs unions. *Journal of Development Economics*, 54(1), 169–187.
- Pursell, G. (2011, June 18). Para-tariffs and Sri Lanka's new protectionism. *Economic and Political Weekly*, 46(25), 31–34.
- Ratnayake, J. (2011). Future of Sri Lankan ports in the face of current port development saga in India (Mimeo). Colombo, Sri Lanka: Pathfinder Foundation.
- South Asian Association for Regional Cooperation. (1999). SAARC vision beyond the year 2000: Report of the SAARC group of eminent persons. New Delhi, India: Shipra Publications.
- Samarajiva, R., & Herath, P. (2009, January). 1.2 trillion dollar GDP, 1.1 billion people: How best can we grow with India? Paper presented at a public seminar (Sanvada) of the Pathfinder Foundation, Colombo, Sri Lanka.
- Sri Lanka, Customs Department. (n.d.). *Customs tariff guide*. Colombo, Sri Lanka: Author.
- Sri Lanka, Tourism Development Authority. (2010). *Annual statistical report* of Sri Lanka tourism 2010. Colombo, Sri Lanka: Author. Retrieved from www.sltda.gov.lk/
- Soz, S., & Srivastava, R. N. (2010). *SAARC emerging challenges: 25 years of SAARC*. New Delhi, India: Foundation for Peace and Sustainable Development.
- Weerakoon, D. (2009). Bilateral FTAs in South Asia: Recasting the regionalism debate [Special edition]. *Lahore Journal of Economics*, 14, 155–170.

## Making Devolution Work in Pakistan

## Aisha Ghaus-Pasha\*

#### Abstract

This article discusses how the 7<sup>th</sup> National Finance Commission award and the 18<sup>th</sup> Amendment to the Constitution have strengthened the autonomy of the federating units in Pakistan. The former has empowered the provinces by increasing their access to financial resources, but there is the danger that it may increase the consolidated fiscal deficit unless both the federal and provincial governments increase their fiscal efforts and rationalize their expenditures. The 18<sup>th</sup> Amendment has the potential to change the structure of governance, but has been implemented in such a way that effective decentralization has been at least partially rolled back. For devolution to work in Pakistan, financing and the delivery of devolved services will have to be more effectively organized and managed.

Keywords: Fiscal, devolution, 18th amendment, Pakistan.

#### JEL classification: O16.

#### 1. Introduction

The years 2009 and 2010 will be remembered by Pakistanis because the country witnessed two significant developments in the process of fiscal devolution. The first was the announcement of the 7<sup>th</sup> National Finance Commission (NFC) award, which was agreed on in December 2009. The second was the Parliament's unanimous ratification of the 18<sup>th</sup> Amendment to the Constitution in April 2010. Together, these developments have the potential to fundamentally restructure governance in Pakistan.

Intergovernment revenue transfers, which are the lifeline of provincial governments (accounting for 80–90 percent of provincial revenues), take place according to the provisions of the NFC awards. The tenure of the NFC award, according to constitutional provisions, is five years and the award determines the contours of the provincial medium-term financial outlook. Principally, the 7<sup>th</sup> NFC Award enhanced the share of provincial governments in the divisible pool of taxes, thereby substantially improving their fiscal position.

<sup>\*</sup> Professor, Beaconhouse National University (BNU), Lahore, and Director, Institute of Public Policy, BNU, Lahore.

The 18th Amendment, on the other hand, has altered the functional responsibilities of different levels of government. It has abolished the Constitution's concurrent legislative list and changed the federal legislative list (Parts I and II). With the major exception of electricity, the concurrent list's functions have been devolved to the provinces. The amendment has also transferred certain subjects from Part I of the federal legislative list—comprising those functions allocated exclusively to the federal government—to Part II, making them a joint provincial–federal responsibility under the Council of Common Interests (CCI). Consequently, under the 18th Amendment, there is undoubtedly a more balanced distribution of functions between the federal and provincial governments, thereby greatly empowering the latter.

Two years have passed since the NFC award became operative and one year following the implementation of the 18<sup>th</sup> Amendment. The question that arises is whether fiscal devolution is working in Pakistan and if not, can it be made more effective? We address both these questions in this article. Section 2 briefly describes the 7<sup>th</sup> NFC award, and Section 3 analyses some emerging issues in the aftermath of the award. Section 4 describes the 18<sup>th</sup> Amendment and assesses its efficacy. Section 5 discusses the financing of devolved services, while Section 6 identifies emerging issues in the delivery of devolved services and the strengthening, planning, and execution of projects. Finally, Section 7 presents some key conclusions.

### 2. The 7<sup>th</sup> NFC Award

The 7<sup>th</sup> NFC award has significant fiscal implications. Intergovernment transfers from the federal to the provincial governments take place according to the provisions of the NFC awards. These have historically taken three forms: (i) "divisible pool" transfers, (ii) straight transfers, and (iii) grants and subventions.

The 7<sup>th</sup> NFC, reconstituted by the President of Pakistan on 24<sup>th</sup> July 2009 held six meetings before reaching a consensus on the vertical and horizontal sharing of the divisible pool. The award is unique in its design and sensitivity to the needs of the federating units. Its key salient features are described below:

• *Enlarged divisible pool.* The size of the divisible pool has been enhanced because of a reduction in collection charges from an average of 5.2 percent to 1 percent.

- *Provincial sales tax on services*. The NFC recognized that sales tax on services is a provincial subject and accepted the provinces' demand for services taxed within the ambit of federal excise duties to be devolved to the latter. There is provision for general sales tax on services to be collected by the provinces, if they so desire.
- *Larger provincial share in vertical transfers*. The award has increased the provincial share to 56 percent in the first year and 57.5 percent in subsequent years. The award has also eliminated the existing system of subventions—for which the derivation of the distribution formula is not known—and replaced it with fiscal equalization among the provinces through a nondiscretionary, transparent revenue-sharing formula (discussed below). The only exception is a PKR 6 billion grant to Sindh.
- *Diversified bases for horizontal transfers*. Punjab has accommodated the other provinces' longstanding demand for multiple indicators for horizontal distribution. Previously, the divisible pool (excluding one sixteenth of sales taxes) was distributed on the basis of population. The distribution of one sixth of sales taxes, in lieu of the *octroi/zila* taxes transferred to the district governments, occurred on the basis of collection shares determined by the 1996 revenue-sharing arrangements. Accordingly, Punjab received a share of 50 percent; Sindh, 34.85 percent; Khyber-Pakhtunkhwa (KP), 9.93 percent; and Balochistan, 5.22 percent. This distribution arrangement, however, remains disputable.

Under the 7<sup>th</sup> NFC award, all revenue will be distributed according to the provincial shares that have been agreed on—derived using the multiple criteria of poverty, inverse population density, revenue contribution (both collection and proxy generation), and, of course, population. The formula builds in horizontal fiscal equalization by explicitly recognizing backwardness (poverty) and the cost of provision differentials (inverse population density) while allowing provinces some benefit of the revenues collected and generated. Population, however, continues to be the principal basis of distribution, with a weight of 82 percent.

• *Special province-specific considerations*. The award is also unique in that it takes into account special considerations that impact the fiscal requirements of the provinces. First, the federal government and provinces have recognized KP's role as a frontline province in the 'war against terror'. The federal government has undertaken to bear

all expenditures incurred by the war. As a gesture of support, the other provinces have joined the federal government and earmarked 1 percent of the total divisible pool for KP.

Second, both the federation and provinces have recognized the special development needs of Balochistan, and agreed to not only raise the latter's share of the provincial divisible pool to 9.01 percent, but also to underwrite revenue transfers of PKR 83 billion to the province. The federal government will make up any shortfall in this amount from its own resources. Punjab will contribute the largest share by accepting a cut of 1.27 percent in its share, followed by Sindh (0.39 percent), and KP (0.26 percent).

• Enhancement in straight transfers. Royalties on natural gas and gas development surcharges (GDS) have been notionally clubbed under one head; the rate per mmBTU will be worked out. Royalties will be distributed on the existing basis while the GDS will be distributed by making adjustments based on this effective rate. Consequently, the share of Balochistan and Punjab will go up at the expense of Sindh. The federal government has also resolved the longstanding dispute with KP on the arrears of hydel electricity profits and with Balochistan on the arrears of GDS. According to the agreement, KP will receive arrears of PKR 110 billion over five years, while Balochistan will receive PKR 10 billion over the same period.

The budgeted increase in revenue transfers to the provinces in the first year after the implementation of the award is presented in Table 1. These are budgeted to be higher by PKR 222 billion in 2010/11 because of the 7<sup>th</sup> NFC award. In other words, transfers would have been over 27 percent lower had revenue sharing in 2010/11 continued according to the previous arrangements.

Transfer to provinces	2010/11 (RE)
Under previous revenue-sharing arrangements	783.0
(ad-hoc presidential order)	
Under 7 <sup>th</sup> NFC award	997.7
Increase	214.7
Percentage increase	27.3

# Table 1: Budgeted increase in revenue transfer to provinces under 7thNFC award (PKR billion)

### 3. Emerging Issues in the Aftermath of the NFC Award

The 7<sup>th</sup> NFC award has significantly changed the status quo and is, therefore, likely to have substantial and varying implications both for the federal government and the four provincial governments. Some of the consequences of the award have become apparent. H. A. Pasha, Pasha, and Imran (in press) have developed a framework to analyze some of the behavioral implications of the award. Among their key findings is that larger provincial transfers have tended to enhance the federal government's fiscal efforts. However, strong downward rigidities with respect to expenditures on debt servicing, defense, and general administration have meant that the federal government is unable to cut back current expenditures. Consequently, there is a lagged downward adjustment in federal development expenditures to the availability of resources, which implies that the federal Public Sector Development Program (PSDP) will take some time to reduce to the desired size, given the fall in growth of net revenue receipts.

With regard to the provincial governments, Pasha et al. (in press) conclude that the provinces are inclined to slacken their fiscal efforts in the event of a favorable award, such as the latest dispensation. Their current expenditures appear to respond quickly and strongly to larger transfers, and their annual development programs (ADPs) appear to be linked to the size of the revenue surplus, which is likely to be larger when transfers increase. However, there is a process of lagged adjustment, indicating—especially in the case of the smaller provincial governments—that there are short-run limits to absorption capacity in the implementation of a larger portfolio of projects. This may, therefore, lead to some fiscal surplus in the short run.

In line with the results of their empirical analysis, the first two years following the implementation of the 7<sup>th</sup> NFC award were marked by a rise in the consolidated fiscal deficit. This is because (i) there has been no corresponding cutback in federal current expenditure, (ii) the reduction in size of the PSDP was accomplished with a time lag, and (iii) provincial current expenditure increased rapidly in response to larger transfers. This impact has been somewhat moderated by the launching of a more intensive fiscal effort through tax reforms by the federal government. This, at least partially, makes up for the loss in net revenue receipts while provincial ADPs take some time to fully adjust upward. The net impact on the overall fiscal deficit of the award has been estimated at PKR 48 billion in 2010/11, i.e., the fiscal deficit was 0.3 percent of GDP higher than it would have been in the absence of the award.

To sum up, while the 7th NFC award represents a level of fiscal decentralization that may be viewed as a great "opportunity" for the provinces to improve their residents' wellbeing, it has been created by the federal government at some cost to the latter's own finances. Therefore, it is essential that this "opportunity" is translated into welfare gains and not wasted. For this to be achieved, the onus is on the four provincial governments. It is important that, given the larger transfers from the federal government, the provinces do not, first, slacken their own fiscal efforts and that additional transfers should essentially supplement and not substitute for provinces' own revenues.

Second, the provinces must avoid profligate, nonproductive expenditures. A prudent spending strategy is an important prerequisite if the "opportunity" that the 7<sup>th</sup> NFC award has opened up is to be realized. Additional resources should be used increasingly for development and the repair and maintenance of infrastructure. Moreover, these resources should be routed largely toward backward regions and pro-poor sectors.

Third, provinces should develop medium-term development frameworks, taking into account the additional funding available. These will help the provinces strategize and prioritize their development needs and channel their spending accordingly.

The 7<sup>th</sup> NFC award also has significant implications for the federal government. The structural deficit has to be brought down—federal nonproductive current expenditures must be cut back. Sharper prioritization of the federal PSDP is essential. Considering that the focus for development has shifted largely to the provinces, federal-level development programs must be pruned. Finally, the linchpin of the strategy to keep the federal fiscal position sustainable is to enhance the level of resource mobilization. The country is stuck at a tax-to-GDP ratio of less than 10 percent, even when in real terms the tax bases have grown in excess of 7 percent. In fact, the tax-to-GDP ratio has shown a tendency to decline in recent years. A strategy to mobilize resources has to focus on broadening tax bases and improving tax administration.

### 4. The 18<sup>th</sup> Amendment

The devolution process under the 18<sup>th</sup> Amendment was undertaken in three phases. In the first phase, the ministries for special initiatives, zakat and ushr, youth affairs, population welfare, and local government and rural development were devolved. The second phase was completed in April 2011, devolving the ministries for education, social welfare and special welfare, livestock and dairy development, and culture and tourism. The remaining seven divisions of food and agriculture, health, labor, women's development and manpower, sports, environment, and minorities' affairs were devolved in the third phase.

Overall, the size of the federal secretariat was reduced by 15 ministries/17 federal divisions, bringing down the number of federal divisions from 50 to 33. To facilitate the implementation of the devolution process, the federal government established the Implementation Commission, comprising eight members from different political parties, which functioned till 30<sup>th</sup> June 2011. The provincial governments formed their own committees, comprising the political leadership and members of the bureaucracy to determine strategies to absorb the devolved subjects.

Besides the allocation of functional responsibilities, the 18<sup>th</sup> Amendment has also made changes to the special provisions of the Constitution, in the finance, audit and borrowing powers clauses. A key change relates to the composition and functioning of the CCI, which the amendment has greatly strengthened. Very importantly, the provinces have been given borrowing powers (see Section 5).

Table 2 shows that, as of the 2010/11 base of expenditures, the provincial governments' expenditure liability under the 18<sup>th</sup> Amendment is PKR 87 billion. Overall, the implied enhancement in the size of the provincial budgets to accommodate the additional functions is about 7 percent. It is somewhat higher for Sindh and Punjab and lower for KP and Balochistan.

	2010/11	Cost of transferred functions	1
Four provinces combined	(PKR billion)		Percentage
Current expenditure	891.7	45.6ª	5.0
Development expenditure	296.0	41.6	15.7
Total expenditure	1,187.7	87.2	7.3

Table 2: Impact of costs of transferred functions on provinces

<sup>a</sup> On the assumption that there is no change in expenditure.

Has the 18<sup>th</sup> Amendment made this kind of difference, i.e., savings in the federal budget and expansions in the provincial budgets? The answer is influenced by a number of implementation decisions made by the CCI and the political economy pressures binding on the federal government. The CCI's key decisions with financial implications include the following.

- Federal employees of the devolved ministries/divisions will be retained at the federal level. Only employees working in the provinces will be taken over by the provincial governments.
- The federal government will provide funding for vertical programs in population welfare and health for the period of the current NFC award, up to 2014/15.
- The provinces will finance the development projects of the devolved ministries that have been transferred to them, and is at liberty to continue or abandon these projects. The federal government will continue to fund projects/schemes undertaken on the prime minister's/president's directives.
- The Higher Education Commission (HEC) will continue to operate at the federal level till such time as the HEC Act is amended, as per a Supreme Court decision. The federal government will fund expenditure on universities during the tenure of the current NFC award.

Pasha and Pasha (2012) conclude that the federal budget for 2011/12—the first post-18<sup>th</sup> Amendment budget—does not exhibit much in the way of savings in the federal PSDP arising from the amendment, while there is some increase in current expenditure. The principal reason for this is that, while there is no federal PSDP allocation for the ministries/divisions to be devolved, political expediency has impeded the implementation of the amendment as the ruling coalition does not have enough ministerial portfolios for its partners. We see the appearance of nine new ministries/divisions: (i) the Ministry of Human Rights, (ii) Ministry of Inter-Provincial Coordination, (iii) Ministry of Human Resources Development, (iv) Ministry of National Harmony, (v) Ministry of National Heritage and Integration, (vi) Ministry of National Regulation and Services, (vii) Ministry of National Food Security and Research, (viii) Ministry of Professional and Technical Training, and (ix) Ministry of National Disaster Management. Allocations have also been made for two new divisions, the Capital Administration and Development Division and the Inter-Provincial Coordination Division, both of which have been created as a consequence of the 18th Amendment. The latter will effectively act as a secretariat for the CCI.

As far as the funding of devolved subjects is concerned, the provincial budgets for 2011/12 contain limited provisions both for current and development expenditure. Punjab, for example, has allocated PKR 410 million (compared to PKR 7.8 billion as originally envisaged) to meet the current expenditure needs of the offices devolved to its government through the Schedule of New Expenditure and supplementary grants. On the development side, Punjab has allocated PKR 0.5 billion for 30 projects adopted in its ADP for 2011/12. Sindh has allocated a lump sum of PKR 3 billion for all costs of devolution. KP has allocated PKR 0.4 billion for current expenditure and PKR 3 billion for the development projects devolved to the province. Given the way in which the 18<sup>th</sup> Amendment has been implemented, its financial implications for the provincial governments have been hugely minimized.

While both the 7<sup>th</sup> NFC award and the 18<sup>th</sup> Amendment have strengthened the autonomy of the federating units, the former stands in danger of increasing the consolidated fiscal deficit. Meanwhile, the implementation of the latter—with subjects being retained and relocated, and some that continue to be federally funded—has meant that effective decentralization has been effectively postponed.

The next section presents some thoughts on making devolution in Pakistan work, beginning with financing issues, followed by emerging issues on services delivery, planning, and execution.

### 5. Financing the Devolved Functions

As mentioned earlier, the federal government will only transfer funding responsibility for the additional expenditure liabilities after the end of 7<sup>th</sup> NFC award tenure. This arrangement was necessary because the award preceded the 18<sup>th</sup> Amendment and so reflected the allocation of functions at the time. There are two possibilities regarding the new revenue-sharing system once the award's tenure has ended. First, the provinces' share in vertical transfers may be enhanced in line with their additional expenditure needs. An indicative increase in the vertical share can be derived by looking at the expenditures presently incurred by the provincial governments on subjects devolved under the 18<sup>th</sup> Amendment, with, of course, built-in growth provisions.

Second, Article 172(3), while providing for equal federal and provincial ownership of minerals, also implies that the income from these natural resources will be shared on a 50:50 basis. Essentially, the nontax

receipts of dividends and profits of corporations such as the Oil and Gas Development Corporation (OGDC) may have to be shared between the federal and provincial governments. If they agree on a sharing formula, then the additional funding requirements of the 18th Amendment can be partially financed through these nontax revenue sources. Initial estimates indicate that such funding could contribute about PKR 17 billion annually to the four provincial exchequers combined. Clearly, this arrangement would favor the natural resource-rich provinces, Sindh and Balochistan.

Along with larger federal transfers, it is very important that the new revenue-sharing arrangements provide incentive for greater fiscal effort on the part of the provinces. Pasha et al. (in press) use an analytical framework to conclude that a matching grant linked to an increase in self-financed expenditure would reduce the negative effects of an increase in transfers following an award. Such a scheme could be put in place as part of the NFC award. Additionally, research shows that the development of provincial taxes on agriculture, real estate, and services could yield additional revenue of up to 0.8 percent of the GDP, equivalent to almost PKR 126 billion on the current tax base.

Over and above these sources, the provinces will also have to enhance their levels of cost recovery, particularly in economic and community services, and strengthen tax administration. The 11<sup>th</sup> Finance Commission of India has incorporated similar incentives with a view to providing better financial management and greater fiscal discipline (7.5 percent of states' revenues is to be shared on the basis of the measure of financial discipline corresponding to the change in the ratio of own revenue receipts to total revenue expenditure).

The new intergovernment fiscal arrangements will also have to mark a limit to provinces' borrowing powers. Provincial debt levels have not featured in discussions on debt sustainability in Pakistan because of the perception that these governments face a "hard budget constraint" due to constitutional limitations on their borrowing, prior to the 18<sup>th</sup> Amendment. Prior to the 1996 NFC award, the federal government made cash development loans to the provincial governments, but this practice has largely been discontinued because of complaints by the latter that the markup rate was too high. Earlier, the provinces used to float long-term bonds in the capital market, but this practice, too, has largely ceased.

As of end-June 2010, the total provincial debt stands at close to PKR 800 billion, equivalent to about 5 percent of GDP. The bulk of this debt, 77

percent, is foreign debt. Punjab has a share of 61 percent, followed by KP (17 percent), Sindh (13 percent), and Balochistan (9 percent). The burden of interest payments as a percentage of revenue receipts ranges from 2 to 5 percent, while as a percentage of current expenditure, it ranges from 3 to 8 percent. Overall, for the four provinces combined, interest payments in 2010/11 accounted for 5 percent of current expenditure. Therefore, the current provincial debt levels appear to be relatively small and manageable.

Following the 18<sup>th</sup> Amendment, the provinces have been given the powers to raise domestic or foreign loans on conditions indicated in clauses (3) and (4) of Article 167:

(3) A province may not, without the consent of the Federal Government, raise any loan if there is still outstanding any part of a loan made to the Province by the Federal government; or in respect of which guarantee has been given by the Federal government; and consent under this clause may be granted subject to such conditions, if any, as the Federal government may think fit to impose.

(4) A province may raise a domestic or international loan, or give guarantees on the security of the Provincial Consolidated Fund within such limits and subject to such conditions as may be specified by the National Economic Council.

To what extent is the relatively "hard budget constraint" that provincial governments face likely to be softened by these clauses? In 2010/11 and 2011/12, the provinces had recourse to substantially larger transfers under the 7<sup>th</sup> NFC award and, therefore, did not feel the need to target have significantly higher borrowings. What will happen if the fiscal space diminishes in the coming years, especially in the lead-up to the next election in 2013 as the provincial governments embark on populist spending? The temptation to borrow may rise, especially from provincially owned commercial banks such as the Bank of Punjab, Sindh Bank, and the Bank of Khyber. How will the State Bank of Pakistan regulate such borrowing? Is there a need to set up some fiscal rules to ensure that provincial governments' debt is sustainable?

Given the low level of outstanding provincial debt, there is a case for enhancing the access of provincial governments to different sources of finance. This is important in view of their expanded responsibilities, including the need for capital-intensive investment in power generation (such as the development of the Thar coal reserves) and irrigation. However, it is important to ensure that subnational debt is sustainable if the provinces are to avoid problems of financial insolvency in the medium to long run, which might otherwise lead to a situation where the federal government has to engage in bail-out operations as 'lender of the last resort'. Excessive subnational borrowing could also jeopardize adherence to the country's macroeconomic and fiscal framework.

International experience is relevant in this area in terms of defining the limits and conditions for borrowing by subnational governments. As a consequence of debt crises faced by such governments, large consolidated (federal plus subnational) fiscal deficits, and large hidden and contingent liabilities, countries such as Brazil, Argentina, and India have developed safeguard mechanisms and fiscal rules for subnational governments to ensure the long-run sustainability of debt.

The provincial governments may have to deliberate on the case for enacting fiscal responsibility legislation, such as that by the federal government of Pakistan and the state governments of India. The key elements of the model draft legislation will need to quantify targets related to, for example, the following: (i) minimum level of revenue surplus as a percentage of revenue receipts, (ii) maximum level of net borrowing as a percentage of revenue receipts, (iii) ceiling on outstanding debt as a percentage of revenue receipts, and (iv) limit on the level of new guarantees. The first and second rules will ensure that provinces continue to generate enough revenue surpluses to finance their ADPs and that all borrowings are used to finance investment. The second and third rules will prevent outstanding debt from rising to unsustainable levels. The fourth rule will prevent excessive resort to off-budget commitments and thereby avoid the risk of large contingent liabilities on the provincial debt consolidated fund.

### 6. Emerging Issues Related to the Delivery of Services

The complexity of the 18<sup>th</sup> Amendment is highlighted by the number of emerging issues relating to its implementation. We have already seen the intense public debate that surrounded the devolution of the HEC's functions, culminating in a stay order by the Supreme Court of Pakistan, preserving the status quo pending the amendment to the HEC Act.

The implementation commission headed by Senator Rabbani was mandated to complete the devolution process under the 18<sup>th</sup> Amendment

by 30<sup>th</sup> June 2011. This was indeed a very ambitious target. The political leadership appears to have followed a "big bang" approach to quickly completing the process before potentially opposing forces—in the form of the federal bureaucracy and security establishment—could get organized and begin thwarting the move. This strategy has ensured relatively fast implementation but also runs the risk of inadequate preparation and mistakes in implementation, leading to some disruptions in the delivery of services down the road.

We highlight some of the key emerging issues below.

### 6.1. Devolution of the Health Division

The Health Division was devolved in the last phase (by 30<sup>th</sup> June 2011). However, no clear decisions have been made about the extent and nature of the transfer of these functions to the provinces. This is likely to be a complex issue since the division was responsible for diverse functions, including drug control as per the Drugs Act 1976. The law provides for a system of licensing for each manufacturing establishment and the registration of all finished drugs. Quality control is ensured through inspections and laboratory services. The law also controls drug prices in order to ensure the availability of basic drugs at reasonable prices while allowing competition.

Two serious issues emerge from the devolution of the Health Division.

- 1. Will the provinces have the capacity to rigorously perform the regulatory functions of licensing and drug registration? What will happens if one province follows a more liberal drug control policy than the others? Not only is this likely to have negative spillover effects on the other provinces, it may also lead to an overall loss of quality control. Will it be possible to introduce export controls from one province to another?
- 2. The Health Division has performed the drug price-fixing role relatively effectively so far. Here, too, one or more provinces may allow greater price escalation, perhaps in an effort to attract more manufacturing units into their respective jurisdictions. This will not only lead to a jump in the price level of medicines, but also to the suboptimal location of pharmaceutical concerns in the country.

### 6.2. Devolution of the Food and Agriculture Division

The Ministry/Division of Food and Agriculture is responsible mainly for policy formulation, economic coordination, and planning with respect to food grains and agriculture. It has played an important role in national food security by procuring food grains from domestic sources or abroad, if necessary, for federal requirements or inter-provincial supplies. It also exercises import and export controls on food grains, stabilizes prices by fixing procurement/support prices, and issues prices nationally. It undertakes research on agricultural commodities, and is responsible for seed testing and certification, standardization, and the import of fertilizer, pesticides, and aerial sprays to meet provincial requirements.

Given the multitude of important tasks that it performs, there is a real threat that national food security may be jeopardized if the devolution to provincial governments is not managed carefully and rationally. In particular, the issues that emerge are as follows.

- 1. How will inter-provincial supplies of wheat to deficit provinces be managed? Will the private sector be assigned a bigger role in wheat procurement and marketing or will the Pakistan Agricultural Supplies and Storage Corporation be retained as an autonomous entity under some federal ministry (such as commerce)?
- 2. Import requirements (if any) for wheat must be determined early if supply shortages are to be avoided. Who will arrange this import? Will provinces import wheat directly or will the Trading Corporation of Pakistan continue to play the same role? Currently, the import of fertilizers is subsidized. How will it be imported post-devolution, and who will be responsible for financing the subsidy?
- 3. Procurement/support prices, especially for wheat, were fixed nationally on the recommendation of the Ministry of Food and Agriculture. In the future, will the individual provinces fix these prices and will free inter-provincial movement be allowed, or will the CCI set a common price?
- 4. Agricultural research is a case of a classical public good. If it is provincialized, then there is a clear danger of suboptimal allocations and outcomes. Pest control is another area where negative externalities could be conferred to other jurisdictions by a province that does not allocate enough resources to this function.

#### 6.3. Devolution of Labor and Manpower Division

This division was also devolved in the last phase. It performed functions broadly related to policy formulation in the areas of industrial relations, human resource planning, and employment promotion in coordination with the provincial governments. The key concern here is the operation of a national social security scheme for industrial workers and workers' welfare schemes at the federal level through the Employees Old-Age Benefits Institution (EOBI) and the Workers' Welfare Fund (WWF), respectively.

The EOBI was constituted as an autonomous body under the Employees Old-Age Benefits Act 1976. Under this scheme, insured persons are entitled to receive benefits such as old-age pensions (following retirement), invalidity pensions (in cases of permanent disability), and survivors' pensions (in cases where the insured pensioner has expired). The minimum pension is PKR 3,000 per month. A contribution equal to 5 percent of minimum wages is paid by employers of all industrial and commercial organizations to which the act is applicable. Employees are expected to contribute 1 percent of minimum wages. As of May 2011, 52,936 employers and 4.7 million insured persons were registered, and benefits were being given to over 387,000 persons. The EOBI's total assets are estimated at over PKR 180 billion. It appears to be in a sound financial position, with an annual income—consisting of contributions and yields on investments—of PKR 27 billion while outflows in the form of benefits equal PKR 5 billion (2008).

Will the provincial governments accept the continuation of the EOBI as an autonomous national entity? Its large assets and relatively strong financial position may prove it an attractive institution for potential takeover by the provinces. If so, what will be the formula for distribution among the provinces? Will it be linked to the NFC revenue-sharing formula or to percentage shares in contributions or to shares in pension payments? If social security for workers is provincialized, what are the implications of any variation in benefits across provinces?

Similar problems arise in the context of the WWF. Accruals to the fund are in the form of annual contributions by industrial establishments (with an income exceeding PKR 100,000) equivalent to 2 percent of income. In 2009/10, total collection under this head was PKR 4 billion. The contributions can be used to finance projects for workers' benefits, such as housing, schools, and clinics, etc.

Like the EOBI, the WWF is an attractive prospect for provincial takeover. If so, we run into the same problems concerning the sharing of assets, liabilities, and annual contributions. Sindh is inclined to argue that these should be shared on the basis of the origin of the contributions since a large proportion of the head offices of establishments are located in the province. Punjab, on the other hand, will present the case that sharing should be on the basis of the distribution of workers. Another problem that is likely to surface is that WWF contributions have hitherto gone into the federal consolidated fund (as part of direct tax revenues) and not been transferred fully to the WWF.

### 6.4. Sharing Natural Resources

The 18<sup>th</sup> Amendment has inserted the following in Article 172, Clause 3:

Subject to the existing commitments and obligations, mineral oil and natural gas within the Province or the territorial water adjacent thereto shall vest **jointly** and **equally** in the Province and the Federal Government.

The question is whether this clause implies the following:

- 1. The authority to grant concessions for exploration of oil and gas reserves now rests with both the federal and provincial governments combined. Previously, it resided with the federal government alone.
- 2. As highlighted above, will the provincial governments have a 50 percent share in ownership of the government equity of corporations in the oil and gas sector, such as PPL, SNGPL, SSGCL, and OGDC? If so, will they be entitled to receive 50 percent of the dividend income that is currently received by the federal government? There is sizeable incentive for provincial governments to make this claim.

Another latent issue concerns Article 158, which states:

The Province in which a well-head of natural gas is situated shall have **precedence** over other parts of Pakistan in meeting the requirements from that well-head, subject to commitments and obligations as on the commencing day.

Now that there is a pronounced shortage of gas in the country and Sindh is the major province producing gas at present, there is a perception that Punjab, in particular, is being starved of gas supplies while Sindh's demand is given preference. Punjab's chief minister has already indicated that there will be public protests if discrimination in gas supplies to the province continues. There is, perhaps, a case for the deregulation of gas prices such that the allocation promotes economic efficiency.

### 6.5. The 18<sup>th</sup> Amendment and Local Governments

Local governments have gained formal recognition in the Constitution after the 18<sup>th</sup> Amendment with the following clause:

### Clause 140 A

(1) Each Province shall, by law, establish a local government system and devolve political, administrative and financial responsibility and authority to the elected representatives of the local governments.

(2) Elections to the local governments shall be held by the Election Commission of Pakistan.

Despite this recognition, developments on the ground have been adverse, following the return to democracy. The natural expectation was that, with the transfer of more resources and functions to the provincial governments, they would, in turn, be willing to empower local governments and transfer more funds and functions to them. Instead, the opposite has happened: Elected local governments have been dissolved and interim administrators appointed from the bureaucracy. Elections to the local councils have been delayed despite a Supreme Court decision. In Punjab, a new local government ordinance has been finalized with radical changes in relation to the Devolution Plan of 2001. There appears to be a reversion essentially to the Local Government Ordinance 1979. District governments are being abolished and it is proposed that the old municipal structure be reintroduced. Simultaneously, in Punjab, certain functions such as secondary education, curative health, and public safety are being taken back from the local governments and made the responsibility of the provincial government. The process of decentralization appears to have stopped at the intermediate level of the provincial governments, and has not moved any closer to the people through the strengthening of local governments. In Sindh, there is an ongoing tussle between the two major political parties on the extent of devolution to local governments.

There is no doubt that the 18<sup>th</sup> Amendment is a landmark achievement and that, in the short run, it has politically empowered the provinces, thereby strengthening the federation. But in the medium term, emerging issues of the type described above may surface, and could introduce new problems for the federation. Significant work needs to be undertaken, both at the technical level and through consensus building, to ensure that these issues are rationally and amicably resolved to ensure the smooth delivery of services.

### 7. Conclusion

This article has demonstrated that the 7<sup>th</sup> NFC award and the 18<sup>th</sup> Amendment to the Constitution are both key developments that have strengthened the autonomy of the federating units in Pakistan and proven landmark achievements of the democratically elected government. However, both come with caveats.

The 7<sup>th</sup> NFC Award has empowered the provinces by increasing their access to financial resources, but it also stands in danger of increasing the consolidated fiscal deficit. To make the change more meaningful and effective, both the federal and provincial governments must enhance their level of fiscal effort. The federal government will simultaneously need to rationalize and streamline its expenditures. The provinces must avoid wasteful recurrent spending and augment their development activities while developing an effective development framework to maximize gains from additional resources.

The 18<sup>th</sup> Amendment has the potential to change the structure of governance in Pakistan, but its manner of implementation has meant that effective decentralization has been largely postponed or at least partially rolled back in some areas. For devolution to work in Pakistan, the financing and delivery of devolved services at the provincial level will have to be effectively organized and managed.

### References

- Balochistan, Finance Department. (n.d.). *Annual budget statement*. Quetta, Pakistan: Author.
- Braun, M., & Tommasi, M. (2004). Subnational fiscal rules: A game theoretic approach. In G. Kopits (Ed.), *Rules-based fiscal policy in emerging markets: Background, analysis and prospects*. New York, NY: Palgrave.
- Corbacho, A., & Schwartz, G. (2007). Fiscal responsibility laws. In M. S. Kumar & T. Terr-Minassian (Eds.), *Promoting fiscal discipline*. Washington, DC: International Monetary Fund.
- Crivelli, E., & Shah, A. (2009). *Fiscal rules at the local level* (Mimeo).
- Institute of Public Policy. (2010a). *State of the economy: Pulling back from the abyss.* Lahore, Pakistan: Author.
- Institute of Public Policy. (2010b). VAT on services. Lahore, Pakistan: Author.
- Institute of Public Policy. (2011). *State of the economy: Devolution in Pakistan*. Lahore, Pakistan: Author.
- Khyber Pakhtunkhwa, Finance Department. (n.d.). *Annual budget statement*. Peshawar, Pakistan: Author.
- Liu, L., & Waibel, M. (2008). Subnational borrowing, insolvency and regulation. In A. Shah (Ed.), *Macro-federalism and local finance*. Washington, DC: World Bank.
- Pasha, H. A. (2011). From stagflation to growth. The News, Money matters.
- Pasha, H. A., Pasha, A. G., & Imran, M. (in press). Behavioral consequences of the NFC Award. *Pakistan Development Review*.
- Punjab, Finance Department. (n.d.). *Annual budget statement*. Lahore, Pakistan: Author.
- Sindh, Finance Department. (n.d.). *Annual budget statement*. Karachi, Pakistan: Author.

# Adapting Public Sector Services to Local Delivery

## Ishrat Husain\*

## Abstract

This article describes the local government system established in the 2001 Devolution Plan and its evolution over the period 2002-07, with a focus on two essential public services, education and health. We believe that the devolution of service delivery functions, delegation of financial powers, decentralization of authority, and deconcentration of executive powers, can, together, lead to better accountability of results and, hence, to improved public service delivery to the poor and marginalized. The Devolution Plan made inroads toward these goals, particularly in education, but their achievement was incomplete due to a number of factors, among those incomplete fiscal decentralization, limited targeting of backward areas, and centralizing tendencies of the provincial departments and civil service. Recommendations are offered on how to further develop the local government system more generally, with an eye towards increasing accountability and improving coordination both across local governments and between tiers. For this, complementary reforms to simplify business processes and revamp human resource management policies are needed; introducing a district level civil service is among the suggested changes. The article concludes with detailed recommendations on improving the decentralized delivery of education and health services.

# **Keywords:** Devolution, decentralization, service delivery, health, education.

### JEL classification: H75.

### 1. Introduction

Studies have investigated the economic growth–poverty nexus across time and across countries over the last five decades. It is now fairly clear that, while growth is necessary to alleviate poverty, it is not sufficient. Human development and access to social services in a well functioning governance structure distribute the benefits of growth more equitably and helps lift people out of poverty.

<sup>\*</sup> Dean and Director, Institute of Business Administration (IBA), Karachi.

The extent to which the state is successfully able to deliver services across a large spectrum of the population is a function of its tradition, history, mandate, and capability. In Pakistan, the social contract between the state and society as defined in the constitution makes the government responsible for providing education and health to the population. The recent 18<sup>th</sup> Amendment to the constitution has gone a step further and deemed the right to education a fundamental human right of Pakistani citizens.

The empirical literature shows a strong, unconditional, and positive relationship between decentralization and accountability. Bardhan and Mookherjee (2007) suggest that electoral decentralization and the devolution of public service provision complement pro-poor governance reforms in developing countries. The World Bank's World Development Report (2004) argues that the accountability of governments to local communities and marginalized social groups will increase by assigning service delivery functions to politicians who are closer to the people and by making the former electorally accountable. At the micro-level Cheema and Mohmand (2006) analyzed a dataset of 364 households in the rural tehsil (administrative unit) of Jaranwala in Faisalabad district to identify what types of households gain and lose as a result of electoral decentralization and whether the change in post-reform provision between different household types has become equitable. The empirical results of their study show that increased access to development funds and expanded mandates for union nazims (mayors) have significantly increased union-level service provision within a short period. However, the villages to which the nazims belong have enjoyed a relatively substantial increase compared to nonnazim villages. The study also finds that the increase in post-reform provision in nazim villages is less elite-based because it encompasses small peasants, minority peasant biraderis (clans), and nonagricultural castes.

Governments have found a range of methods for delivering these services. The World Bank (2004) catalogues successful examples ranging from direct provision by the government and contracting out to the private sector and nongovernment organizations (NGOs), to decentralization to local governments, community participation, and direct transfers to households. Both the successes and failures of these experiments provide some useful lessons.

First, accountability needs to be strengthened between the poor and service providers, between the poor and government institutions, and between government institutions and service providers. Second, it is necessary to expand poor people's choices and participation in service delivery. Thus, children from poor households should not have to remain limited to substandard instruction at state-run schools when they can be provided financial means by the government to pursue their education at private schools of their choice. The same applies to health clinics and hospitals. Mexico and Brazil have lifted millions out of poverty by making cash transfers to poor households conditional on their education, immunization, vaccination, etc.

Third, it is not the availability of financial resources that alone makes the differences to outcomes. Studies have shown that, of the central government's budget allocation for running a school, the actual amount that reaches the school after passing through various government channels is only a tenth of the original allocation. Exclusive preoccupation with expenditures on education and health while ignoring the myriad problems of the governance of these sectors at all levels is palpably wrong. Reforms in the governance structure of the public sector and regulation of the nongovernment sector will have a much stronger impact on the quality of these services and on access to them by the poor.

There is no doubt that the government is responsible for people's health and education-these are considered fundamental human rightsbut the distinction between its different roles-financier, provider, regulator, policymaker, and planner-should always be kept in mind. Financing responsibilities, whether direct or indirect, should be vested in the government, as should regulatory and planning functions. Separating the roles of policymaker and provider, however, is not always easy. Teachers' unions, health professionals' alliances, and others who benefit from state patronage may attempt to block such efforts. In the delivery of services, the government could invoke the assistance and collaboration of other segments of society that have the requisite expertise and competence but not necessarily the financial means to scale up, such as communities, organizations, NGOs, and the private sector. The state-provider relationship in delivering services can be strengthened if the policymaker is successful in drawing up and enforcing contracts with the providers and monitoring their performance.

In cases where the government takes it upon itself to deliver these services directly, studies show that improving the efficiency of that spending is key to reaping substantial benefits. On average, the relationship between public spending on health and education and its outcomes is weak or inconsistent (see World Bank, 2004). Most public spending on health and education goes to the nonpoor. Government departments construct school buildings at exorbitant costs. Teachers are hired but nepotism, corruption, leakages, weak supervision, and lack of accountability do not allow effective delivery of education to the intended beneficiaries. Both anecdotal evidence and surveys of primary healthcare and educational facilities have consistently pointed to high absentee rates among doctors and teachers. In contrast, examples from nongovernment schools and clinics tend to show teachers and health workers delivering timely, efficient, and courteous services, often in difficult circumstances, and drawing far less monetary and fringe benefits compared to their counterparts in government-run institutions.

For direct delivery by the government, the transfer of responsibility for these services to lower tiers of government improves access by the poor (Devolution Trust for Community Empowerment, 2011). Local government management of schools and hospitals and demand-side subsidies to poor households under monitoring and oversight by the government results in favorable education and health outcomes.

This article focuses on two essential public services, education and health, which are both closely correlated with poverty reduction. A review of other services such as water supply and sanitation, nutrition, social protection, and social safety nets such as the Bait-ul-Mal, Benazir Income Support Program, zakat funds, and private philanthropy, would form an independent study and is, therefore, not attempted here. Progress with respect to skills development, guaranteed rural employment, and works programs in recent years has been insignificant. Microfinance has begun to make a difference to poverty alleviation but does not qualify as a public service.

In light of the empirical evidence, our main argument is that the devolution of service delivery functions, delegation of financial powers, decentralization of authority, and deconcentration of executive powers, can, together, lead to better accountability of results and, hence, to improved public service delivery to the poor and marginalized. Even if the underlying patron–client relationship persists, there will still be wider scope for including clients who were traditionally denied access under a parliamentary member-centered system. The representation of marginalized groups, such as women, peasants, and labor, in electoral politics enhances their chances of improved access to services (Hasnain, 2010).

Citizen participation mechanisms such as citizens' community boards (CCBs) and school councils can also prove powerful instruments for citizen empowerment. In light of this argument, it is regrettable that the 2001 Devolution Plan was prematurely and abruptly abandoned after the national elections in 2008 without any proper assessment of its advantages and disadvantages. No serious effort was made to retain and build on its strengths or to modify or remove its weaknesses. Unnecessary controversies have been initiated on points that have nothing to do with devolution itself. Accordingly, this article presents a balanced analysis of the strengths and weaknesses of the Devolution Plan, and a series of proposals to improve the local government system and delivery of social services.

### 2. Why Local Government?

Pakistan's constitution divides the responsibility for managing the affairs of the federation of Pakistan among three tiers of government—federal, provincial, and local. The 18<sup>th</sup> Amendment to the constitution has transferred a number of subjects that were previously on the Concurrent List to the provinces. This devolution of powers from the federal government to the provinces was accompanied by the National Finance Commission (NFC) Award, which has substantially enhanced the provinces' share in the federal divisible pool.

At the same time as the provinces have been rightly strengthened, there has been a major setback to the local government system with the provinces' abolition of the structures created under the 2001 Devolution Plan. Many members of the national and provincial assemblies are opposed to strengthening local governments and are committed to diluting the administrative and financial powers of this third tier. The question that therefore arises is: What is the justification for a strong local government system?

First, local governments form an integral part of the democratic governance framework that allows greater participation by citizens in the management and control of their day-to-day affairs. Tradeoffs are calculated and priorities assigned among various development projects in a more realistic and pragmatic manner under local governments. Their intimate knowledge of local problems and solutions to resolve those problems lead to better outcomes and more efficient resource utilization than under a more centralized system of resource allocation. Decentralized decision making has proved to be the cornerstone of democratic governance. The benefit–cost analysis and, therefore, allocative efficiency are superior under a decentralized system.

Second, empirical evidence shows that raising taxes or charging user fees for services at a local level is easier—taxpayers can see the visible benefits of such payments whereas they may be reluctant to contribute to a remote central pot whose purpose is not known. With its low tax-to-GDP ratio, Pakistan could mobilize additional resources by raising provincial and local taxes in the form of an urban immovable property tax, capital gains tax, agriculture tax, and user fees and charges.

Third, the deprivation index shows that at least 80 districts in the country are deprived of basic services (Jamal, Khan, Toor, & Amir, 2003). Pakistan's population has risen from 30 million in 1947 to 180 million today, making it impossible for such a large population to be served from Islamabad or the four provincial capitals. The peculiar circumstances and needs of each district require an understanding of its problems and the design of interventions that can address those problems. The criteria of backwardness and poverty should be given due weight in the distribution of resources out of the provincial divisible pool. Districts that are better-off or well endowed do not deserve a share of public resources that is proportionate to their population as their private incomes are reasonably high. Local-level public expenditures should be used to promote equity and welfare.

Fourth, access to basic services in Pakistan can be obtained either through money or by approaching elected representatives. Members of the national and provincial assemblies often remain absent from their constituencies and are not always easily accessible. Local government nazims and councilors, on the contrary, spend most of their time in their constituencies, and ordinary citizens can access them easily.

Access to services improved visibly after the 2001 local government system was implemented. Based on a survey carried out in 2005, Hasnain (2010) reports that, over 60 percent of the households sampled stated that they would approach a union councilor or nazim for help resolving their problems as compared to only 10 percent who said they would approach a provincial or national assembly member. This reflects the increase in accessibility of policymakers post-devolution. A system in which bureaucrats control the development departments provides neither access nor accountability for results. A system of elected nazims and councilors who remain responsive to citizens' needs is superior because they are liable to lose office if they do not fulfill their responsibilities and duties. The best one can do with a recalcitrant bureaucrat is to transfer him or her out of that district, which does not solve the inherent problem of access by the poor.

Fifth, the increased representation of the female population—a neglected segment of society—in the local government system had made participation more broad based. Women's political empowerment is the first step toward generating greater economic opportunity and contributing to economic uplift. Women councilors' interest in the social sectors meant that education, health, water, and sanitation received both more attention and resources. Pakistan has a very low female labor force participation rate, of which women's lack of political empowerment is a precursor.

### 3. The 2001 Devolution Plan

The 2001 Devolution Plan represented a major attempt to bring about fundamental structural changes in the local government apparatus and limit the bureaucracy's powers. Cheema, Khwaja, and Qadir (2005) describe the new system below:

Under devolution, a new elected government was created at the district level and politically linked to local governments at the sub-district level (tehsil and union council). The district government was headed by an elected nazim and the district administration head—the district coordination officer (DCO) reported directly to the elected head of the government. This was a significant departure from the previous system where the de facto head of the district administration, the deputy commissioner (DC), reported to the non-elected provincial secretariat. Moreover, the office of the DC has been abolished and the new head of district administration, the DCO is no longer the district magistrate and the district collector.

The union council (UC) was the directly elected tier of the local government. Nazims, *naib nazims* (deputy mayors), and union councilors were directly elected through adult franchise with reserved seats for women, minorities, laborers, and peasants. Each UC had, on average, a population of 20,000 under its jurisdiction and was thus closest to its citizens. Union nazims, naib nazims, and councilors constituted the electoral college that elected the district's nazims and naib nazims and the tehsil councils and councilors for the reserved seats. The next tier, i.e., the tehsil council

consisted of union naib nazims as its ex-officio members while the district council comprised union nazims as its ex-officio members.

The elected government and provincial administration were integrated at the district and tehsil levels, the divisional tier was abolished altogether, and 12 departments of the provincial administration were devolved to the local level and made accountable to elected officials of the local government. Additionally, the vast majority of public services that had previously been under the provincial administration were transferred to local governments, substantially increasing the latter's responsibilities. Four districts were classified as city districts and entrusted with additional responsibilities for urban planning and municipal functions in the country's metropolitan areas. In all, the Devolution Plan created 107 district governments, 4 city district governments, 396 tehsil/town councils, and 6,125 union councils in the country.

Cheema and Mohmand (2006) focus on three types of changes brought about by the 2001 devolution: (i) changes in the decision-making level of the service, i.e., from provincial bureaucrats to district-level bureaucrats; (ii) changes in decision-makers' accountability, i.e., from bureaucrats to elected representatives at the district level; and (iii) changes in the fiscal resources available to the service.

Education departments, primary healthcare services, and the management of district and tehsil hospitals experienced the first type of change, where decisions that had previously been made by the provincial secretariat and provincial cabinet were now transferred to the district nazim and the executive district officers (EDOs). The municipal services provided by the provincial government's Local Government and Rural Development Department and its Public Health Engineering Department became the sole functional responsibility of the tehsil municipal administration (TMA). This was a fundamental shift because the power to allocate resources, prioritize projects, and deliver results moved away from 48 provincial departments to 6,000 local governments.

Under the second type of change, i.e., accountability-related change, the authors argue that, whereas prior to devolution, the deconcentrated provincial bureaucracy at the district level was accountable to their nonelected provincial secretariat, the 2001 devolution made it accountable to the elected heads of districts and tehsil governments. The de facto head of the district administration under the previous system, the DC—who reported to the nonelected commissioner under the previous system—now reported to the elected district nazim.

Cheema and Mohmand (2006) also point out that the 2001 Devolution Plan established a "rule-based" fiscal transfer system between the provinces and local governments. Approximately 40 percent of the Provincial Consolidated Fund was distributed among local governments, and backwardness given due weight in order to ensure some form of equity across districts in the allocation of development funds. The other innovation was that these budgetary transfers did not lapse at the end of the year but were retained by the local governments concerned, which added to the flexibility and, presumably, efficiency of resource allocation.

In 2006/07, approximately PKR 100 billion was transferred to local governments in Punjab—district governments received PKR 84 billion; TMAs, PKR 12.7 billion; and UCS, PKR 4 billion. In 2002/03, the amount transferred was only PKR 55 billion.

### 4. An Assessment of the Devolution System (2002–07)

The extent of fiscal decentralization remained limited because the districts continued to depend on the province for resources and did not have the power to collect new taxes or the capacity to levy service or user charges. On the expenditure side, both the fixed and growing expenses incurred by staff salaries, wages, and allowances now devolved to the district governments (although staff continued to be provincial servants), not leaving much for maintenance and operation, or for development expenditure.

The functioning of the district governments in the first two years was quite promising, but the conflict between provincial elected representatives and local elected representatives that surfaced after the 2002 provincial and national elections created an adversarial rather than congenial environment. Until then, nazims, under the supervision of army monitoring teams, had been carrying out some useful activities for the welfare of their constituents. However, once the newly elected provincial ministers took office, there was a substantial shift in the power of patronage from them to the district nazims.

This led to a number of amendments, particularly in the Police Ordinance, which diluted the powers of the police command and made the police force once again subservient to the provincial chief minister and Home Department. The proposed Police Rules were not allowed to be finalized, the district services were never established, and the power to recruit, transfer, and post district-level staff remained centralized at the provincial level. Gradually, the balance of power, authority, and resources between the provincial and local governments, in practice, moved away from what had been envisaged under the Devolution Plan. The perpetual state of flux, the unease in political relations, the lack of clarity for civil servants working at the district level, and the incomplete transition all adversely affected service delivery.

Wilder (1999) argues that political parties, when in government at the provincial level, tend to view local governments as a competing tier of patronage and, as a result, make no attempt to empower the local government system. If anything, they may even suspend or abolish established local governments when in power. Thus, any elected government that has followed the military regimes that introduced local governments has, at the very least, ignored these local governments and often suspended them altogether. The repetition of these events after the elections of 2008 lends credence to Wilder's hypothesis.

The internal dynamics that arose due to the flawed design of the local government system also took a toll. The integration of rural and urban areas within a common framework led to lopsided decision-making. District headquarters, for example, which were predominantly urban centers, were neglected because the majority of district council members responsible for deciding allocations for development projects hailed from rural areas. The integration had exactly the opposite effect—the fragmentation of development projects in small schemes catering to the narrow needs of local communities without any sense of priority, linkages, or broad coverage.

Ideally, the transfer of resources from urban to rural areas should be a welcome move, but such a transfer in the absence of a district plan and without specifying the goals to be achieved or assessing the cost–benefits of the schemes approved can be counterproductive. The urban–rural integration did not recognize and cater to the needs of the country's growing urbanization. Urban residents within the districts resented what they termed the "tyranny" of the rural majority that deprived them of the services and infrastructure that they felt they deserved.

The indirect election of the district nazim through the UC and tehsil council nazims reinforced the tendency of development schemes toward fragmentation. According to Hasnain (2010), there were 17,000 development schemes in the development portfolio of Punjab's districts—typically neighborhood-specific schemes involving the construction or rehabilitation of small roads or drains. The average size of a typical scheme

varied between PKR 0.3 million for water and sanitation to PKR 1.5 million for road works. This was not the complete picture because it did not include the block allocation to the UCs and CCB schemes. In order to keep their voters happy, district nazims would have very little choice but to acquiesce to the pressure exerted by the union and tehsil nazims to allocate resources equally.

The difference between "equal" and "equitable" distribution of resources should be understood as the crux of the problem. Under an "equal" distribution scheme, there is no clear relationship between the needs of the community and the intended interventions. Rich and poor communities alike will receive a fixed slice of the pie irrespective of their needs. "Equitable" distribution takes into account the differences in initial endowments and conditions of the intended beneficiaries. Those who are poor, marginalized, live in remote or geographically disadvantaged areas, or cannot earn decent incomes on their own are given higher allocations than those who are better off. Public resources thus supplement the private incomes of the poor and help lift them out of poverty.

It is interesting to note that while the provincial governments took "backwardness" into account when allocating development funds across districts—and the allocations were thus equitable to some extent—the district governments were unable to do the same within their districts due to the inherent design flaw in the system as pointed out earlier. The district nazim would become hostage to blackmailing by members of the district councils, who would either withhold their approval of the budget or threaten to move a vote of no confidence against the nazim. In turn, district nazims were unable to assert their fiduciary responsibilities.

The significant increase in reserved seats for peasants and women was a healthy move under the 2001 Devolution Plan. Greater representation, particularly for women (one third of the total seats) did and could have further changed the quality and composition of expenditures. This might have increased allocations for education, drinking water, health, and sanitation relative to the infrastructure projects generally favored by male representatives. Empirical evidence of this correlation is, however, hard to obtain and, therefore, the assertion remains purely conjectural and is based on casual empiricism based on personal visits to different districts.

The alienation of the powerful District Management Group and provincial civil service cadres caused by the abolition of the posts of commissioner, deputy commissioner, and assistant commissioner also proved a stumbling block in the smooth functioning of the new local government system. On one hand, the police force was perceived to have become much stronger because it was removed from the DCO's supervising ambit and made directly accountable to the district nazim. On the other hand, the DCO's executive authority was weakened since his/her magisterial powers were removed although he/she was still expected to perform duties related to law and order, removal of encroachments, and price control, etc. The provincial secretaries from the District Management Group and provincial civil service cadres retained considerable administrative authority over district bureaucrats and used these powers to make elected nazims ineffective. Thus, a tripartite confrontational mode in which provincial ministers and secretaries aligned themselves against the district nazims was responsible for creating most of the practical difficulties that citizens faced in accessing services.

The debate on the local government system has been muddied by Pakistan's historical experience of military governments who, on assuming power, have always taken legal and constitutional steps to strengthen the local government system. Elected political governments at the national and provincial levels have reversed or weakened these systems when they have come to power, ostensibly because a nonrepresentative (i.e., military) government, had co-opted the local governments to legitimize the latter's rule. This suspicion is not far from the truth—General Ayub Khan's "basic democracy" system was indeed used as an electoral college to elect him to political office. General Zia-ul-Haq's decision to hold national elections on a nonparty basis that debarred the country's established political parties was also perceived in the same light. General Musharraf's 2001 Devolution Plan suffered from the same flaw, i.e., elections were held under a nonparty system and district nazims were indirectly elected by an electoral college consisting of UCs and tehsil nazims. The two major political parties held that the nazims elected in this way were intended to become an instrument of state patronage in order to neutralize the popular appeal and support of the traditional parties.

The result of this stop–go arrangement is that the state has only a weak and ineffective presence at citizens' doorsteps, and that a remotely controlled, highly centralized, but still dysfunctional system of governance—particularly in the delivery of essential public services—has been perpetuated. Had the local government system been allowed to evolve and take its natural course, it would have become responsive to citizens' needs, particularly to those of the poor. The abrupt disruptions to the system have resulted in a continuing struggle to find a workable system after 64 years of the country's existence. At the heart of this struggle lies the strain between the attempts of provincial and national elected politicians to pre-empt favors and patronage for themselves and decentralized decision-making whereby communities and their local representatives make decisions that maximize their collective welfare.

### 5. The Impact of Devolution on Service Delivery

A social audit survey in 2009/10 of 12,000 households drawn from 21 districts from all four provinces found that 56 percent favored the continuation of the local government system, with high proportions in Punjab and Sindh (Devolution Trust for Community Empowerment, 2011). Only 33.8 percent appeared satisfied with the UCs, but support for and the social acceptability of women's political participation seemed to have improved—60 percent of women union councilors said that people in their constituencies were happy with them. Households' satisfaction levels with regard to various public services varied, but by 2009/10 satisfaction with roads, sewerage and sanitation, garbage disposal, water supply, health, and education had improved, although in percentage terms less than half of the households surveyed expressed satisfaction with public services. Public education showed the highest—a 58 percent satisfaction level.

The Social Policy and Development Centre (SPDC)'s (2007) survey of 12 districts across the four provinces found that the rate of enhancement in literacy and access to water supply and sanitation had increased perceptibly during the post-devolution period. However, there were no indications that devolution had had any impact on health indicators. The devolution process did, however, improve primary school enrolment and literacy in the country. The SPDC observed that, "if this effort at enhancing human capabilities is sustained then it augurs well for achieving more reduction in the incidence of poverty during the coming years. However, the lack of significant change to date in the trend of health indicators, gender equality and regional disparities limits the potential impact of local governments on poverty in the post-devolution scenario."

The SPDC (2007) noted that, while most local functions had been devolved to local governments, a number of issues remained to be resolved concerning the design and speed of implementation of the Devolution Plan. These included the following.

• The need for the intermediate tier, i.e., the TMA, was questioned.

- A wide range of services was transferred in one go to local governments, which stretched their capacity to the limit. A more gradual strategy could have minimized such challenges.
- Even after the passage of six years, the provincial governments were not fully prepared to devolve power to the local governments.
- Institutional structures to improve accountability and people's participation in the system were either not operational or not performing according to the mandate given by the Local Government Ordinance 2001.
- "State capture" by local elites was an important and persistent challenge. The overwhelming influence of family, biraderi, and tribal ties, and the political maneuvering of union councilors in return for lucrative benefits were quite evident.
- Over 90 percent of the expenditure of local governments was financed by transfers from the provincial governments. The lack of enhancement of local fiscal powers remained a major weakness in the process of fiscal decentralization. The share of local governments in the provincial allocable pool was about 40 percent, but their share in total public expenditure was only 13 percent.
- Primary and secondary education were allocated the largest shares of local governments' current expenditure budgets—in excess of 60 percent. On the development side, a significant portion was allocated for road construction. Health was the most neglected sector, receiving less than 10 percent of the development allocation in most cases.
- While current transfers did not lead to significant fiscal equalization, development transfers were the prime instruments for removing inter-district differentials in access to services over time. However, their role was limited because they were relatively small.
- Resource mobilization at the provincial and local levels remained substantially underexploited. Land revenue accounted for less than 1 percent of agriculture income, while the effective rate of property tax on rental incomes was about 5 percent as opposed to the statutory rate of 20 percent or more.

Hasnain's (2010) analysis of district development priorities in Punjab reveals four stylized facts. First, physical infrastructure, in particular roads, was by far the district governments' highest priority. Second, these infrastructure schemes were small and largely neighborhood-specific. Third, district policymakers appeared to give lower priority to operation and maintenance than their provincial counterparts. Finally, provincial interventions in education and health appear to have provided additional incentives for districts to prioritize the physical infrastructure sectors.

The devolution to the districts with respect to primary and secondary education and healthcare, although completed on paper, remained incomplete. Through a variety of measures, including control over finances, the actual delivery of these services remained suboptimal due to strained relations between the provincial and district governments. A more supportive rather than intrusive role on the part of the provincial governments, along with effective monitoring and accountability, would have made a difference for the better. The data shows that 21 percent of Punjab's annual development program allocations for education and health remained with their respective provincial departments. Provincial recurrent expenditures in education and health also grew annually by 48 and 16 percent, respectively, during the post-devolution period.

The Punjab government launched the high-profile Punjab Education Sector Reform Program with a number of interventions targeting primary and middle schools. Funding for the provision of missing facilities was transferred to local governments as tied grants. However, centralized decision-making by the provincial education department and local provincial parliamentary members reduced the availability of funds and compromised prioritization by the district governments. Project implementation under this program was entrusted to the National Logistics Corporation in 2006. The districts, therefore, served mainly as a conduit for funds with no role in identifying, planning, or executing these schemes. The same situation prevailed in the Health Sector Reform Program and the Chief Minister Accelerated Program for Social Development.

### 6. Reforming the Local Government System<sup>1</sup>

The 18<sup>th</sup> Amendment and NFC Award have the potential to overcome some of the structural difficulties and microeconomic distortions that have kept Pakistan a social and economic underachiever. In a multiethnic, multi-linguistic society in which one federating unit is more advanced than the others and enjoys political dominance, it makes sense to

<sup>&</sup>lt;sup>1</sup> Most of these recommendations are drawn from the *Report of the National Commission for Government Reforms on reforming the government in Pakistan* submitted to the Prime Minister in May 2008 (see Pakistan, National Commission for Government Reforms, 2008).

deconcentrate power and share resources equitably among the provinces. Just as competitive markets allow decentralized decision-making to unleash entrepreneurial energies and economic growth, the devolved units of a state should be able to ensure the judicious and equitable distribution of economic gains, provided that proper checks and balances are put in place.

In the short term, the transition can prove to be destabilizing for macroeconomic management, but there are viable solutions to these problems. The NFC's enhanced transfers to the provinces and the federal government's retained expenditures of the devolved ministries will create pressure on fiscal balances, but this can be resolved by establishing an integrated fiscal framework in which to anchor the federal and provincial budgets. The Council of Common Interests should discuss, debate, and approve this framework and the budgets of the federation and federating units that it presents (Husain, 2011a). The provinces' tax efforts could be encouraged by providing them a matching grant out of the divisible pool. The setting up of the Sindh Revenue Board is a welcome step—in the future, this board should take over all the province's revenue collection functions. The other provinces should set up similar institutions to mobilize their own revenues.

The transfer of legislative, legal, financial, and administrative powers from the federal government to the provinces will necessitate changes in governance structures, systems, and processes. The relationship between the federal, provincial, and local governments has to be redefined. For these changes to be meaningful and make a difference in the delivery of public services, a number of complementary reforms must be undertaken to simplify business processes, revamp human resource management policies, and set up credible and effective accountability mechanisms.

The devolution process should now extend to create a vibrant local government system that clearly demarcates the responsibilities of the provincial and the local governments, embedded in a permanent legal arrangement. The provincial governments should take steps to revive the Provincial Finance Commissions in order to make further allocations to the district governments.

The following analysis identifies specific flaws in the 2001 system that need to be rectified or removed.

First, as mentioned earlier, district nazims were indirectly elected by the union nazims and were thus beholden to them. Budgetary allocations were often made not on the basis of a district's development priorities but on the union nazim's individual preferences. To avoid this, the distortions created by the indirect, nonparty-based election of district nazims should, therefore, be removed. All political parties should contest elections at each tier, and district nazims should directly contest a districtwide election in which all registered voters should vote. These measures would strengthen political linkages between the district and provincial governments and also free the district nazims of any political obligations to the UC or tehsil nazims.

Second, district nazims should not be vested with the power to make decisions concerning law and order, revenue records, and disaster management since their decisions may be partisan and driven by narrow, parochial considerations. Such functions are best performed by competent, neutral, nonpolitical civil servants who can be trusted by all citizens across the political spectrum.<sup>2</sup> The weakening of the law enforcement system, tampering with land revenue records, and poor management of national disasters became highly apparent after 2001—DCOs rather than district nazims should be assigned these functions. The Police Order 2002 should be implemented in its unadulterated form with some checks built in, accountabilities clearly established, and the police force removed from the disciplinary rules under the Civil Service Act.

Third, there were no administrative linkages between unions, tehsils, and district governments. Each tier was supposed to work independently of the other; consequently, the lack of coordination among various agencies led to inefficient outcomes. As the head of the local government, the district nazim should have the statutory and legal powers to convene, consult, and direct the tehsil nazim or union nazim to resolve problems and conflicts that are cross-jurisdictional.

Fourth, the accountability of local governments proved perfunctory and almost nonexistent. The provincial governments did not exercise effective control of the departments that were devolved to the districts. The provincial departments retained the power to recruit, transfer, and post staff, and carry out any disciplinary action. The diarchy proved fatal to the effective functioning of the devolved departments. Corruption at the district government level could not be contained due to the inadequate

<sup>&</sup>lt;sup>2</sup> This will, of course, involve completely restructuring the civil service. See Pakistan, National Commission for Government Reforms (2008) for a blueprint of this restructuring.

supervisory arrangements put in place by the provincial governments. The 18<sup>th</sup> Amendment has strengthened the office of the auditor general of Pakistan, which the provincial governments should use to strengthen local governments' monitoring and accountability. The provincial governments should also be responsible for all regulatory functions, including setting standards in health, environment, food, agriculture, and education.

Fifth, as urbanization expands - and about half of Pakistan's population is projected to live in cities by 2025 - it is imperative that the management of metropolitan areas and large cities follow a different model than that of the traditional district government. Public transport, city zoning, commercial, industrial, and residential development, water and sanitation, and solid waste disposal and sewerage have to be managed holistically. In some instances, the metropolitan government could delegate certain responsibilities among various tiers and different providers, but it should retain direct control of planning, regulation, oversight, and monitoring.

Sixth, the separation of the provincial and district service cadres had not been implemented by 2008, although it was envisaged in the law and agreed upon by the provincial governments. Most Grade 1–16 functionaries were, in fact, working in the districts<sup>3</sup> and their reallocation to the district service would have removed frictions and made a difference to the effectiveness of basic service delivery.

Each province should design a local government system specific to its needs after holding consultations with all stakeholders and political actors to reach a consensus. The flaws of the 2001 system should be addressed while consolidating its strengths. Service delivery under the proposed system can be improved by introducing reforms, particularly in the education and health sectors. This would minimize the system's chances of being overturned in the future and allow it to survive changes in the political regime.

### 7. Service Delivery under the 2001 Devolution Plan

### 7.1. Education

Under the 2001 Devolution Plan, district governments were made responsible for all primary, secondary, and higher secondary education. They could recruit teachers up to a basic pay scale of 16, while the provincial governments retained authority over staffing—hiring, firing,

<sup>&</sup>lt;sup>3</sup> In Punjab, two thirds of its 1 million employees were employed at the district level.

and transferring—for employees on a basic pay scale of 17 or above. The ban on the wholesale recruitment of teachers by the provincial governments and the authority to relax this ban in individual cases resided with the chief minister. This backdoor tactic meant that the district governments remained wholly dependent on the chief minister's whims. Concessions were granted if the latter belonged to the same political party or was a close political ally of the district nazim. In other cases, nazims were penalized so that posts remained vacant for periods on end. Since many teachers owed their appointments to the provincial or national assembly members, they did not adhere to the discipline enforced by the EDO. Teacher absenteeism was rampant in such cases.

Funding for education came mainly from provincial allocations, but was consumed mostly by salaries and allowances, leaving very little for other expenses. In Sialkot district, as much as 95 percent of budget funds were allocated for salaries and only 5 percent for nonsalary expenses. The physical conditions of schools were found to be poor, with no electricity or water available (Urban Institute, 2006). Teacher training became a popular hobbyhorse for donors to the extent that teachers in Thatta were reported to be spending as many as 17 days on different training courses organized by various donors (Urban Institute, 2006). Yet, despite such heavy investment in teacher training, the outcomes were not very encouraging.

### 7.2. Reforming Education Service Delivery<sup>4</sup>

Reforms in the delivery of public services need to be embedded within broader reforms of public administration, institutions, and incentives. Unless the civil services are broadly restructured, business processes reengineered, information technology tools used to monitor performance, and regulatory bodies put in place to oversee executing agencies, sectoral reforms in education and health will have a limited impact.

First, there is a clear need to delineate the responsibility for provision of education among the various tiers of government. The federal government should deal with financing, standards, and regulations in curricula and higher education; the provincial governments should be responsible for college education, and technical and vocational training; while the district governments should take charge of primary, secondary, and high schools.

<sup>&</sup>lt;sup>4</sup> This section draws on Husain (2009).

Second, a district education board consisting of eminent, reputable persons should be established to ensure coordination and uniform standards among public, private, and nonprofit schools. The district education officer would act as the board's secretary and implement its decisions.

Third, as in Sindh and Khyber-Pakhtunkhwa, the management and teaching cadres in the other provinces should also be separate from one another. While selection to the management cadre will be open to teachers with the right aptitude, all teachers should be allowed to progress in their teaching careers without becoming heads/principals/education officers.

Fourth, the teaching cadre should be de-linked from the National Pay Scales. Educational attainment in backward districts will not improve unless remuneration packages are aligned with local market conditions. If, for example, a science teacher in Musakhel has to be paid PKR 15,000 per month to attract her to work in this backward district, she should be given that package. In contrast, if qualified science teachers in Karachi or Lahore are available at a salary of PKR 12,000 per month, then they should be paid that amount. Otherwise the present distortions—teachers appointed in backward districts being transferred to big cities at their present posts under political influence—will persist. Examples abound: Rural schools might have no mathematics teachers but schools in urban Lahore might have six mathematics teachers for only 60 students.

Fifth, all teachers should be appointed from among candidates domiciled in a particular district, through a test conducted by the district Public Service Commission and based on merit alone. These posts should be nontransferable. Other posts for which suitable candidates are not locally available can be filled from outside the district. The powers to recruit, transfer, promote, and impose disciplinary action should all reside with the district education board.

Sixth, school management committees/parent-teacher associations should be empowered to effectively oversee schools' internal management, i.e., ensuring that school infrastructure is in sound shape and that teachers attend class, and resolving any other problems that the schools might face. School management committees would need to be given budgetary resources, but they would be accountable to the district education board for results. Head teachers/principals would be given the appropriate administrative authority to carry out the day-to-day operation of the school and the power to initiate action against recalcitrant teachers. Seventh, the district education board should be allocated annual funds to carry out approved infrastructure projects, operation and maintenance, and teacher training in all schools. The provincial government would deliver the training, and also annually assess teachers' competency and students' academic achievements. Funds allocated to the district boards would be audited regularly by the audit department.

Eighth, children from low-income households should be given the option to attend private schools, provided these schools meet prescribed eligibility criteria. These schools could be given per capita grants to cover the tuition costs of students from low-income households. The activities of education foundations in the provinces should be expanded and supported to find other suitable means of fostering public–private partnerships.

Ninth, a decentralized and empowered educational network will function efficiently only if it is continuously monitored. A management information system would help the district boards monitor schools' performance. For example, if the primary school in a locality is producing a constant stream of pupils for enrolment in higher classes, it could be immediately upgraded to an elementary school.

Finally, talented students from poor households and backward districts who secure admission to private schools, professional colleges, business administration institutions, and universities should be awarded scholarships to pursue their education. The eligibility criteria should be announced in advance and advertisements placed inviting applications for scholarships.

### 7.3. Health

The Local Government Ordinance 2001 devolved most health services (basic and rural health, child and maternal health, population welfare, and district and tehsil hospitals) to the district governments, with the exception of large teaching hospitals and medical or dental colleges, which remained under the provincial government's direct control. The fundamental structural discrepancy in the system was that both the provincial Health Department and the elected district nazim retained control over health human resources. The EDO for health was answerable to the elected district nazim for service delivery, but to the provincial government for his/her career advancement. All medical staff report to EDO for health but their postings and transfers were controlled by the provincial Health Department. The provincial government was made responsible for the procurement of medical supplies, which resulted in delays, mismatched demand and supply, and the nonavailability of necessary medicines. The district government was not allowed to retain the nominal fees collected by each health facility, even though these were insufficient to cover even a fraction of total costs. Instead, the receipts had to be deposited in the provincial government's account. The system of dual control led to lax supervision and weak accountability, with posts lying vacant and high absenteeism among health staff. These factors limited the impact of devolution on the delivery of health services.

### 7.4. Reforming Health Service Delivery<sup>5</sup>

Health reforms, which are more difficult to enforce because of the medical profession's powerful influence, have to follow multiple tracks. These are described below.

First, each provincial government should establish a separate health management cadre to provide duly trained and experienced managers for hospitals and institutions and for development projects and the district/provincial health administration. The selected personnel would fill all administrative positions at the tehsil and district levels in teaching and specialized health cadre facilities, and act as deputy district officers and EDOs for health and other management positions in the provincial health departments. All cadre personnel should be recruited through an open, transparent, merit-based system based on their satisfactory completion of mandatory training at different levels. The management cadre would be different from the clinical and teaching cadre, and have its own career progression path. Recruitment rules should allow both internal and external recruitment. However, all senior management positions should be advertised and selection based on merit.

Second, the office of the provincial director general for health should be made responsible for developing norms and standards for establishing policy, operational guidelines, and regulatory frameworks for fostering public–private partnerships. An independent, autonomous drug regulatory authority at the federal level should be set up as a priority. Health regulatory authorities should operate at the provincial level to implement these frameworks and to mainstream the role of the private sector into the delivery of healthcare, the services of bona fide NGOs into

<sup>&</sup>lt;sup>5</sup> For a comprehensive review of health systems and reforms, see Nishtar (2010).

the national development process, and to foster public, not-for-profit relationships at an overarching level. The licensing standards prescribed by these authorities should be strictly enforced to prevent unqualified practitioners from practicing medicine.

Third, the health sector's inter-sectoral linkages with social welfare, water and sanitation, and population need strengthening. A district-level coordination mechanism to synergize the roles and contributions of all the actors in the health sector should be established in the form of district health boards, comprising members drawn from the various sectors. National vertical health programs should also be integrated through this district coordination mechanism.

Each district health board would consist of prominent, reputable citizens from the public and private sectors. The EDO for health would be the board secretary and assigned operational responsibilities, and an eminent member either from the public or private sector would be chosen to chair the board. As an oversight body, the board would plan, guide, oversee, and coordinate the delivery of health services within the district in line with local needs, albeit within the ambit of the national health policy framework.

Fourth, to overcome the problem of teaching faculty not paying sufficient attention to their patients, the annual performance reports of members belonging to the teaching cadre should evaluate the proportion of time given to patient care (daily rounds/ward visits/OPD/cases attended); time spent in student training (lectures, thesis supervision, etc.); and contributions to medical research (number of publications in peerreviewed journals rather than local hospital journals). Promotion criteria should be revised; teaching staff should be statutorily bound to contribute both to quality patient care as well as research.

Fifth, the private sector could be allowed to provide medical and vocational training to produce nurses, paramedics, etc., subject to properly regulated compliance concerning the quality of output. Private investors could be given incentives to set up institutions complying with minimum prescribed standards. In areas where the government has a limited absorptive capacity, it could choose to subsidize the private sector in training human resources. The federal government should prepare a five-to-ten-year health human resources plan that could be implemented by the provinces in collaboration with the private sector.

Sixth, health professionals' pay scales should be delinked from the national pay scales. The Pay and Pension Commission (2010) has proposed a separate pay scale for health professionals. This scale should be introduced along with performance-based increments in all the provinces.

#### 8. Conclusion

The 18<sup>th</sup> Amendment to the Constitution, the NFC Award of 2010, and the implementation commission headed by Senator Raza Rabbani have largely helped clarify the structure, roles, and responsibilities of the federal and provincial governments. The missing link is the devolution of responsibilities to local governments—the cornerstone of public service delivery at the grassroots level. This article has recommended measures to fill this gap, based on extensive consultations carried out in 2006–08 with a large number of stakeholders across the country. The creation of a district civil service structure in addition to the existing federal and provincial services, for example, would help improve the effectiveness of service delivery at the local level.

These structural reforms will not be successful, however, unless complementary reforms to simplify business processes, revamp human resource management policies, and establish credible and effective accountability mechanisms are put in place. Specific recommendations in each of these areas have been developed after reaching a broad consensus (see Pakistan, National Commission for Government Reforms, 2008; Pay and Pension Commission, 2010). If the agreed reforms are systematically discussed in an informed manner and subsequently adopted, they will help immensely in moving forward in the right direction. Given that the implementation period required is quite long, it would be advisable to phase in these reforms by first implementing those that have the highest or immediate payoff.

This analytical survey of the 2001 local government reforms shows that the provinces need to retain a number of the reforms' strengths and build them into the new local government system. Despite the short trial period, it is apparent that devolution, decentralization, and deconcentration along with local-level elections do spread benefits more widely, improving the efficiency of service delivery and access to local representatives. Limited micro-level studies have shown that nonelite and marginalized groups have participated in the post-reform provision of services. However, the devolution system also has many weaknesses that have to be removed or neutralized through appropriate policy and institutional changes. The abolition of a neutral, nonpolitical civil service responsible for law and order, revenue records, and disaster management has weakened the writ of the state at the grassroots level and biased the administration of justice, increased discretionary favors, and led to lax enforcement of laws. The need for reforms in the service delivery of education and health in light of the experience gained since 2001 is well established. Previously underprovided villages received services but the spatial and social inequality of provision between villages and social groups have also been reinforced. Patron–client factions organized by influential village members has determined the winners and losers of postreform provision. The proposed reforms would go a long way in overcoming the distortions and deficiencies of the devolution system.

#### References

- Asian Development Bank, Department for International Development, and World Bank. (2004, May). *Devolution in Pakistan: An assessment and recommendations for action*. Islamabad, Pakistan: Authors.
- Bardhan, P., & Mookherjee, D. (Eds.) (2007). Decentralization and local governance in developing countries: A comparative perspective. New Delhi, India: Oxford University Press.
- Cheema, A., & Mohmand, S. K. (2006). *Bringing electoral politics to the doorstep: Who gains, who loses?* (Mimeo). Lahore, Pakistan: Lahore University of Management Sciences.
- Cheema, A., Khwaja, A., & Qadir, A. (2005). Decentralization in Pakistan: Context, content and causes (Research Working Paper No. 05-034). Cambridge, MA: Harvard University, Kennedy School of Government.
- Devolution Trust for Community Empowerment. (2011). Social audit of governance and delivery of public services: National report 2009–10. Islamabad, Pakistan: Author.
- Hasnain, Z. (2010). Devolution, accountability and service delivery in Pakistan. *Pakistan Development Review*, 49(2), 129–152.
- Husain, I. (2009, October 5). Governance reforms in education. Dawn.
- Husain, I. (2011a, July 25). Maximizing benefits from the local government system. *The News*.
- Husain, I. (2011b, July). *Models of local democracy within a federal system: The experience of Pakistan*. Paper presented at the Commonwealth Conference, Karachi, Pakistan.
- Jamal, H., Khan, A. J., Toor, I. A., & Amir, N. (2003). Mapping the spatial deprivation of Pakistan. *Pakistan Development Review*, 42(2), 91–111.
- Manning, N., Porter, D., Charlton, J., Cyan, M., & Hasnain, Z. (2003). Devolution in Pakistan: Preparing for service delivery improvements. Islamabad, Pakistan: World Bank.

- Nishtar, S. (2010). *Choking pipes: Reforming Pakistan's mixed health system*. Karachi, Pakistan: Oxford University Press.
- Pakistan, National Commission for Government Reforms. (2008). Report of the National Commission for Government Reforms on reforming the government in Pakistan (Vols. 1–2). Islamabad, Pakistan: Author.
- Social Policy and Development Centre. (2007). Social Development in Pakistan: Devolution and human development in Pakistan (Annual Review). Karachi, Pakistan: Author.
- Urban Institute. (2006). Assessing the impact of devolution on healthcare and education in Pakistan. Washington, DC, Author.
- Wilder, A. R. (1999). *The Pakistani voter: Electoral politics and voting behavior in the Punjab*. Karachi, Pakistan: Oxford University Press.
- World Bank. (2004). World development report 2004: Making services work for poor people. Washington, DC: Oxford University Press.
- World Bank. (2006). *World development report 2006: Equity and development*. Washington, DC: Oxford University Press.

## The 18<sup>th</sup> Constitutional Amendment: Glue or Solvent for Nation Building and Citizenship in Pakistan?

## Anwar Shah\*

## Abstract

The almost unanimous passage of a landmark consensus constitutional amendment—the  $18^{th}$ Constitutional Amendment—restored Pakistan's constitution to its original intent of a decentralized federation of provinces as envisaged in the 1956 (two provinces) and 1973 (four provinces) constitutions. This article takes a closer look at the provisions of this amendment and highlights both the potentials and pitfalls of the new constitutional order for good governance in Pakistan. It argues that the amendment represents a step forward but encompasses several missteps in creating a harmonious political and economic union. The 18th Amendment has reinforced an outmoded "pot-belly" model (federalism of provinces) whereas an "hourglass" (federalism of local governments) model is more suited to Pakistan's circumstances. Major fundamental reforms are needed that right-size the federal and provincial governments, strengthen local governance, enforce fiscal discipline and citizen-based accountability for service delivery performance on all orders of government, dismantle provincial barriers to factor mobility and internal trade, and restrain beggar-thy-neighbor policies and unaccountable governance by "empowered provinces" to mitigate the unintended adverse consequences of the 18th amendment for nation building and citizenship in Pakistan.

**Keywords:** Governance; fiscal federalism; decentralization; state and local governance; nation and province-building; constitutional division of powers; intergovernmental fiscal relations.

## JEL classification: H10, H11, H83, I31, O10.

## 1. Introduction

On April 20, 2010, Pakistan's parliament passed a landmark consensus constitutional amendment to restore Pakistan's constitution to its original intent of a decentralized federation of provinces as envisaged in

<sup>&</sup>lt;sup>\*</sup> Director, Center for Public Economics, Southwestern University of Finance and Economics, Chengdu/Wenjiang, China, and Advisor to the Asian Development Bank and World Bank.

the 1956 and 1973 constitutions. This development came after several decades of military and autocratic rule, which had dismembered Pakistan's constitution to serve the interests of the ruling elite and, in the process, centralized fiscal powers at the federal level.

Table 1 shows that the division of power in Pakistan has been in flux since the late 1950s. The pendulum has swung in favor of centralized power at the federal level since 1956, until the trend was recently reversed by the 18th Amendment in 2010. Taxing powers were centralized in 1956 at the federal level in the interest of tax harmonization and lower tax collection costs. That year, the provinces voluntarily ceded the power to collect sales taxes in favor of federal collection and a formula-based revenue sharing arrangement that were formalized by the 1956 constitution. The military regime of General Ayub Khan sought legitimacy by introducing the system of "basic democracy" with indirect elections at the local level and enhancing the powers of local councils while keeping them under the strict control of federal bureaucrats. The regime also amalgamated the four provinces of what then comprised West Pakistan into one unit to counterbalance the dominance of East Pakistan in the federal system. The system of basic democracies was dismantled with the fall of the regime in 1968.

During 1968–71, there was movement toward greater provincial autonomy. The 1971 elections returned Sheikh Mujibur Rahman of the Pakistan Awami League to power at the federal level, but the leader of the Pakistan People's Party, Zulfikar Ali Bhutto, in collusion with the Pakistan Army, prevented Mujibur Rahman from assuming the position of prime minister and instead ordered military action in East Pakistan. This culminated in the formation of East Pakistan as the independent state of Bangladesh in 1972, and was followed by the dismantling of one unit in the now truncated country of Pakistan. From 1973 to 1977, Pakistan remained under a pseudo-military-cum-democratic regime. A new constitution was enacted in 1973 but fundamental rights were suspended on the eve of promulgation of the new constitution. The Bhutto regime used emergency powers to wrest control of major industries, businesses, and schools from the private sector. These policies initiated Pakistan's economic decline, a situation that has not been reversed by subsequent regimes.

Government	1955	1965	1985	1995	2005	2010	2011		
Expenditure shares									
Federal	60	60	65	67	70	66	67		
Provincial	35	30	30	29	20	25	28		
Local	5	10	5	4	10	9	5		
All	100	100	100	100	100	100	100		
Revenue share	s								
Federal	70	85	90	90	93	94	93		
Provincial	25	10	5	5	6	5	6		
Local	5	5	5	5	1	1	1		
All	100		100	100	100	100	100		

 Table 1: The shifting sands of power in Pakistan: Expenditure and revenue collection shares by order of government

Source: World Bank staff estimates.

In 1977, the Pakistani military used the pretext of economic decline and war in Afghanistan to stage a coup d'état. General Zia-ul-Haq ruled Pakistan with an iron fist from 1977 to 1987 and centralized powers at the federal level. Local governments were allowed to function under the strict control of federal bureaucrats who, as they assumed greater powers, ensured that most local governments remained dysfunctional and, therefore, under the direct supervision of federal civil servants. With the demise of General Zia, Pakistan returned briefly to democratic control but the system was destabilized by the military. In October 1999, General Pervez Musharraf staged a military coup on the pretext that the popularly elected prime minister did not follow due process in removing him from the position of chief of army staff. In 2001, Musharraf sought to strengthen local governments while keeping control through indirectly elected nazims as an antidote to the return to power of the country's two major national political parties. He was forced to resign in May 2008 and, with his departure, the local government system that had been established was set aside by the provinces.

Table 1 shows that there has been a consistent erosion of provincial taxing and spending powers over the period 1955–2010—this trend has been arrested by the 18th Amendment. However, local government spending powers have typically increased during military regimes and diminished under democratic regimes while their taxing powers were eroded in the late 1990s with the abolishment of the *octroi* tax in return for a

static federal revenue guarantee—a poor bargain that significantly weakened local self-governance in Pakistan. The contrasting attitudes of military and democratic regimes toward local governments can be explained by the argument that the former have tended to support a semblance of local autonomy to seek legitimacy and undercut political parties whereas the latter at the center and in the provinces have perceived local governments as competitive providers that might reduce their own relevance in people's lives. Both types of regimes, however, have perceived empowered and autonomous local governments as liable to undercut their own dominance and control of the political system. As a result, local governments have remained wards of the state in Pakistan.

This centralization of the fiscal system has been accompanied by a deterioration both in law and order and in the quality and quantity of public services. The dysfunction of public governance in Pakistan appears to have reached a tipping point in the first decade of the 21st century, which has prompted the popular western media to label Pakistan rightly or wrongly as a "failing" state. Some Pakistani scholars have already labeled it a "failed state" (Haque, 2010). Will the new constitutional dispensation help Pakistan reverse this course? This article examines the implications of the 18th Amendment for promoting peace, order, good government, and growth. Section 2 reflects on the state of fiscal federalism prior to the 18<sup>th</sup> Amendment. This is followed by a discussion of the amendment and its institutional, fiscal, and service delivery implications (Section 3). Section 4 debates its potential for improving public governance in Pakistan. This is followed by a discussion on several overlooked issues. Section 5 presents a conceptual perspective on multiorder governance in a globalized, interconnected world, and compares it with the governance system envisaged by the 18th Amendment. Section 6 provides a synthesis of the significant potential risks of the proposed political and economic union, inadvertently introduced by the 18th Amendment. Section 7 advocates an hourglass model of federalism for Pakistan. The final section draws some conclusions.

The article concludes that the 18<sup>th</sup> Amendment must be seen as a first step toward the broader agenda of reform in fundamentally restructuring the multi-order public governance system in Pakistan. This is because the amendment offers some potential for improving public governance but also introduces major risks for political and economic union. These risks can be averted by further reforms. The unfinished reform agenda should include reasserting home rule for local governments and treating them as the primary agents responsible for delivering public services, uplifting the local economy, improving economic and social outcomes for its residents, and ensuring their liberty and right to life and property.

Additionally, this reform agenda would include a framework for fiscal responsibility binding on all orders of governments, creating a common economic union by dismantling all barriers to goods and factor mobility, including the provincial residency rules enshrined by the 18th Amendment. It would also include citizens' rights to information and to hold governments accountable for their performance, among other things. important would reforming Another element be intergovernmental finance to introduce results-based accountability while preserving provincial autonomy and flexibility. The article recognizes that this is an ambitious agenda and that the political and bureaucratic impediments may seem overwhelming at present, but an important first step would be for all orders of government to agree on the need for such reforms. Without such a consensus, the centrifugal tendencies unleashed by the 18th Amendment may pose significant risks for the future of political and economic union in Pakistan.

## 2. The State of Fiscal Federalism Prior to the 18th Amendment

The developers of the 1956 Constitution visualized Pakistan as a decentralized federation with significant public spending responsibilities being assumed by lower levels of government. They also gave these governments significant means of revenue to discharge their responsibilities. The federal government, on the other hand, was given greater access to its own revenue bases than that needed for federal direct expenditures alone, so that it could ensure a reasonably comparable level of services across the nation primarily by exercising its spending power (fiscal transfers to the provinces) to influence provincial–local priorities.

The vision of a decentralized federation was set aside in favor of a centralized quasi-federation under military rule from 1958 to 1968. The military regime also tried to introduce a new form of local governance—the so-called "basic democracy" system—that supported a system of indirect elections of local mayors. Most local functions were managed and delivered by elite civil and military bureaucrats with local councilors intended to provide limited popular participation in state affairs at the local level. With the brief departure of the military regime, the basic democracy system was dismantled, and elections under the 1956 constitutional system were held in 1969, which returned Sheikh Mujibur Rahman's Awami League to power. The Pakistan military leadership

refused to respect the electoral outcome and instituted Zulfikar Ali Bhutto as prime minister. This led to political strife and civil war, resulting in the breaking away of East Pakistan and its establishment as the independent state of Bangladesh in 1972. Bhutto convened a constituent assembly in 1973 that adopted a new constitution.

In the interest of administrative efficiency, the 1973 constitution chose to centralize revenue means by bringing sales taxation within the central government's domain. This measure accentuated the centralization tendencies in public spending responsibilities. The 1973 constitution also introduced as part of the Fourth Schedule a concurrent legislative list that enumerated the shared responsibilities of the federal and provincial governments. The intention of this list was to allow the provinces an interim period for preparation prior to their assuming their responsibilities. Instead, the federal government used this list to encroach on provincial and even local government responsibilities. The provinces, in turn, made local governments dysfunctional and took over their responsibilities (see Table 2).

The 1991 National Finance Commission (NFC) Award sought to rectify this by giving the provinces unconditional access to a large pool of federal resources. The award initiated a process of expenditure realignment, which, over time, was expected to give the provinces a greater say in areas of shared responsibilities, such as education and health. Nevertheless, it delinked spending and taxing decisions in a major way, and federal transfers to smaller provinces financed 99 percent of provincial operating expenditures. The military coup in 1999 reversed the trend toward greater provincial autonomy and centralized power, which was used to brutally crush political discontent in Balochistan, nourishing a separatist movement. The military regime also sought to debase the country's major political parties by devolving the responsibility for service delivery from the provinces to local governments. The military junta led by General Musharraf chose an indirect form of elections for local mayors as a for central control. The government vehicle also introduced complementary administrative and police reforms, which the civil service elite strongly resented. These reforms led to service delivery improvements at the local level but weakened provincial control over law and order. However, these reforms were incomplete as there was no attempt to rationalize federal and provincial powers. The federal government continued to encroach on provincial and local responsibilities in contravention of the division of powers laid down by the 1973 constitution (Shah, 1997). The major political parties refused to acknowledge even the positive dimensions of these reforms and, on returning to power, sought to dismantle them in toto.

Democratic rule returned to Pakistan in 2008, and provincial empowerment and the dismantling of military-led reforms became a rallying cry for all political parties. These efforts led first to a consensus 7th NFC Award in 2009, effective from 1 July 2010 to 30 June 2015, which served as a major step toward building provincial harmony. The award placated Balochistan and Khyber-Pakhtunkhwa by including measures of poverty and inverse population density, and Sindh by including a tax effort indicator in the formula. It subsequently forged a momentous political consensus that culminated in the passing of the 18<sup>th</sup> Constitutional Amendment on 9 April 2010. The amendment sought to strengthen provincial powers and weaken the federal government's authority. The latter has, nevertheless, continued to take certain unilateral actions with adverse financial consequences for the provinces. One of the most egregious of these has been to grant federal civil servants a 50 percent salary increase in the face of a major fiscal crisis, in the process adversely impacting provincial finances as the provinces are forced by provincial unions to match such increases.

# 3. Implications of the 18th Amendment: Institutional, Fiscal, and Service Delivery

## 3.1. Institutional Implications

The 18<sup>th</sup> Constitutional Amendment is a landmark in legislation because it has introduced profound changes in the institutions of intergovernmental coordination. The most significant of these changes is the reassertion of two institutions of the federation—the Council of Common Interests (CCI) and the National Economic Council, which aims to strengthen provincial representation as discussed below.

## 3.1.1. The Council of Common Interests

The CCI was initially created by the 1956 constitution. It was chaired by the prime minister or by a federal minister on his/her behalf and comprised equal membership from the provinces and federal government. The CCI had jurisdiction over the federal legislative list and electricity, and was intended to serve as a forum to seek provincial input in the conduct of federal responsibilities. It was not, however, required to meet periodically, and the federal government chose to make the institution dormant as it had little interest in provincial views.

The 18<sup>th</sup> Amendment attempts to reinvigorate this institution to deal with all matters relating to the federation. The CCI is to be chaired by the prime minister and include four provincial chief ministers and three federal government nominees as members. It will have a permanent secretariat and is required to meet at least once every quarter. The CCI has been entrusted with decision making, monitoring, supervision, and control responsibilities over the Federal Legislative List Part II, which includes the following: railways; minerals, oil, and natural gas; hazardous materials; industrial policy; electricity; major ports; federal regulatory authorities; national planning and economic coordination; supervision and management of public debt; censuses; provincial police powers beyond provincial boundaries; legal matters; regulation of the legal, medical, and other professions; standards in education and research; interprovincial coordination; and conflict resolution.

### 3.1.2. National Economic Council

The National Economic Council is also a constitutional body with oversight responsibility for national economic policies and has remained active in the past. Chaired by the prime minister, its membership previously had been left to the president's discretion, provided that at least one member from each province was represented. The 18<sup>th</sup> Amendment has tilted the balance of power on this council in favor of the provinces by mandating two members each, including the chief ministers of each province, and four federal members appointed by the prime minister. The Council must now meet at least once every six months.

In addition to strengthening these two institutions of the federation, the 18<sup>th</sup> Amendment has also introduced significant changes to the division of powers as discussed below.

#### 3.1.3. Constitutional Rearrangements in Pakistan

The 18<sup>th</sup> Amendment has deleted the list of federal/provincial concurrent responsibilities and reassigned selective functions to the federation to be guided by the CCI and devolved others to the provinces. The former list consisted primarily of natural resources, electricity, and regulatory functions (see Table 2). The latter encompasses most economic and social services. Table 2 shows that the federal government has been

completely stripped of its responsibilities in planning, industry, agriculture and rural development, and social services and welfare (including social protection). This has resulted in the abolition of 17 ministries—with a combined budget of PKR 49 billion for the fiscal year (FY) 2011—including the ministries of food and agriculture, education, and health. Table 3 lists these ministries and their FY2011 budgets. These functions have been absorbed on a selective basis by the provinces in existing departments. With the abolition of the ministry of education, Pakistan joins Canada as the only two federal countries with no ministry of education at the federal level. With the abolition of the health ministry, Pakistan assumes a unique status among all federal countries.

The federal government has also been constrained in terms of its authority over banking, finance, and insurance as its regulatory authority no longer extends to provincially owned entities or private entities operating in a single province. The federal government has been mandated to consult the provinces prior to initiating any hydroelectric projects. The provinces, on the other hand, have been given a free hand in all public services delivered within their territory, and control over all local government institutions. All the residual functions not enumerated in the constitution also fall within the provinces' domain. Additionally, a new article has been inserted to provide the right to free education. Article 25A states that, "the state shall provide compulsory education to all children of the age of five to sixteen years in such manner as may be determined by law." Since education is a provincial responsibility, this article mandates the provinces to provide free secondary school education to all citizens seeking this service.

Federation/CCI (joint federal-provincial)	asks (Federal Legislative List Part II)						
Electricity	Provincial police operations beyond provincial boundaries						
Minerals, oil, and natural gas	Industrial policy						
Railways	National planning and national economic coordination						
Major ports	Coordination of scientific and technological research						
Censuses	All regulatory authorities under a federal law						
Public debt	Standards in higher education and research, scientific and technical institutions						
Federal corporate entities, including the Water and Power Development Authority and Pakistan Industrial Development Corporation	Interprovincial matters and coordination						
Legal, medical, and other professions							
Federal functions (Federal Legislative List Part I)							
Defense	International and interprovincial trade						

# Table 2: Reassignment of spending and regulatory functions among different orders of government under the 18<sup>th</sup> Amendment

Federal functions (Federal	Legislative List Part I)					
Defense	International and interprovincial trade					
External affairs and international treaties	Nuclear energy					
Immigration and citizenship	Airports, aircraft, air navigation, air and sea travel and shipment, lighthouses					
Post and telecommunications	Patents, trademarks, copyrights					
Central banking, currency, foreign exchange	Stock exchanges and futures markets					
Corporate regulation, including banking and insurance	National highways and strategic roads					
Fishing beyond territorial waters	Federal geological surveys and meteorological organizations					
Standards of weights and measures	Local government in cantonment areas					
Provincial responsibilities						

## All residual functions

## Local government responsibilities

Determined by provincial government

Source: Constitution of Pakistan (2010). Fourth Schedule.

Rank order	Federal ministry	FY2011 budget (PKR mn)	Rank order	Federal ministry	FY2011 budget (PKR mn)
1	Food and agriculture	19,800	10	Livestock and dairy	486
2	Health	15,711	11	Labor and manpower	434
3	Education	3,093	12	Minorities	220
4	Social welfare and special education	2,130	13	Tourism	218
5	Population welfare	1,969	14	Women development	173
6	Youth affairs	1,569	15	Special initiatives	138
7	Environment	820	16	Local government and rural development	78
8	Sports	654	17	Zakat and usher	26
9	Culture	579		Total (17)	49,099

### Table 3: Federal ministries/divisions abolished\*

\* Effective 1 July 2011.

Source: Pakistan, Ministry of Finance. Federal budget for FY2011.

There has also been a limited reassignment of taxing powers (see Table 4). The federal government has been empowered to levy taxes on the sale of goods and on the capital value of financial assets. In the past, it had exercised these powers because the provinces had voluntarily surrendered the right to sales taxation in the interest of improving the efficiency of tax administration. The federal government has also been asked to cede responsibility for taxes on immovable property, estate and inheritance taxes, value-added tax (VAT) on services, and zakat and usher (religious taxes) to the provinces. The resulting reassignment of taxes is detailed in Table 5. Provincial borrowing privileges have been expanded to include domestic and foreign loans, subject to limits and conditions imposed by the National Economic Council.

# Table 4: Reassignment of taxing powers among different orders of<br/>government under the 18th Amendment

Federal taxing powers					
Added:					
Taxes on the sale and purchase of goods					
Taxes on the capital value of assets, excluding immovable property					
Deleted:					
Estate and inheritance taxes (wealth tax, including agricultural wealth)					
VAT on services					
Zakat and usher					
Provincial taxing and financing powers					
Added:					
VAT on services					
Taxes on immovable property					
Zakat and usher					
International and domestic borrowing, subject to limits and conditions imposed by National Economic Council					
Local government taxing powers					
No change					

Source: Constitution of Pakistan (2010) - Fourth Schedule

## Table 5: Reassignment of taxes to various orders of government\*

	Determination of		Tax collection	Share in revenues (%)			
Tax/fee/surcharge	Base	Rate	and admin.	Federal	Provincial	Local	
Federal							
Personal income and corporation taxes (excl. on agriculture income)	F	F	F	42.5**	57.5**	0	
Customs duties, incl. export duties on cotton and jute	F	F	F	100	0	0	
Excise duties (excl. opium, liquor, narcotics, sugar, tobacco, and gas)	F	F	F	42.5**	57.5**	0	
Excise duties on sugar, tea, tobacco, and betel nut	F	F	F	42.5**	57.5**	0	
Excise duty on natural gas	F	F	F	2	98	0	
Sales tax on goods	F	F	F	42.5**	57.5**	0	

Capital value tax on	F	F	Р	100	0	0
immovable assets						
Royalty on crude oil	F	F	F	2	98	0
Royalty on natural gas	F	F	Р	2	98	0
Air travel tax	F	F	F	100	0	0
Surcharge on natural gas	F	F	Р	0	100	0
Surcharges on mineral oil and electricity	F	F	F	100	0	0
Provincial						
Tax on property transfers	Р	Р	Р	0	15	85
Property tax <sup>4</sup>	Р	P, L	P, L	0	15	85
VAT on services	Р	Р	F, P	0	100	0
Zakat <sup>1</sup>	Р	Р	F	0	100	0
Usher <sup>1</sup>	Р	Р	F	0	100	0
Taxes on professions, callings, and trades <sup>6</sup>	P, L	P, L	P, L	0	100***	100***
Agricultural income tax <sup>2</sup>	Р	Р	Р	0	100	0
Capital gains tax <sup>3</sup>	Р	Р	Р	0	100	0
Excise duties on opium, liquor, and narcotics	Р	Р	Р	0	100	0
Stamp duties	Р	Р	Р	0	100	0
Cotton fee	Р	Р	Р	0	100	0
Betterment tax	Р	Р	Р	0	100	0
Electricity duty	Р	Р	Р	0	100	0
Court fee	Р	Р	Р	0	100	0
Education cess	Р	Р	Р	0	100	0
Motor vehicle taxes <sup>5</sup>	Р	Р	Р	0	100	0
Tolls on roads and bridges	Р	Р	P, N	0	0	100
Taxes on cinemas and hotels	Р	P, L	P, L	0	100***	100***
Arms license fees	Р	Р	Р	0	100	0
Entertainment taxes	Р	P, L	P, L	0	100***	100***
Rates on services (water supply, drainage, lighting)	P, L	P, L	P, L	0	100***	100***
Local						
Export tax	P, L	L	L, N	0	0	100
Market fees	L	L	L	0	0	100
Fees at fairs, agricultural shows, etc.	L	L	L	0	0	100
Fees for specific services	L	L	L	0	0	100

Tax for construction and maintenance of public utilities	L	L	L	0	0	100
Taxes on other-than-motor vehicles	L	L	L	0	0	100
Tax on advertisements	L	L	L	0	0	100
School fees	L	L	L	0	0	100
Fees on sale of cattle at fairs	L	L	L	0	0	100
Tax on lands not subject to local rates	L	L	L	0	0	100
Tax on hearths	L	L	L	0	0	100
Tax on births, marriages, and feasts	L	L	L	0	0	100
Conservancy rate	L	L	L	0	0	100
Fees for erection of buildings	L	L	L	0	0	100
Fees for animal slaughter	L	L	L	0	0	100
Surcharge on any tax levied by the provincial government	L	L	L	0	0	100

\* Effective 1 July 2010.

Notes: F = federal, P = provincial, L = local, N = private.

1 Islamic welfare tax that is not deposited into the Consolidated Fund and does not form part of the budget.

2 So far legislated by the governments of Punjab, Sindh, and NWFP (now Khyber Pakhtunkhwa).

3 Was abolished in 1986 by all provincial governments except Balochistan.

4 In the Lahore metropolitan area, the provincial government retains 57.5 percent of revenues as one half of the 85 percent share of MCL goes to WASA, a provincial agency. In Balochistan, it is shared on a 5:95 basis.

5 In Balochistan, 50 percent of the revenues are shared with local governments.

6 Each government (i.e., provincial and local) retains 100 percent of their portion of collected tax.

\*\* 5 percent of tax revenues are retained by the federal government as administrative charges; the rest is divided up as specified.

\*\* "100,100" sharing indicates that the tax base is co-occupied; each level of government retains its own full share of the tax.

### 3.1.4. Outlook for Provincial Finances

The 18<sup>th</sup> Amendment has expanded the provinces' tax domain to include a dynamic and buoyant tax base—sales tax on services. This base alone, if effectively taxed, could yield revenues equivalent to 0.5–1% of gross domestic product (GDP). The Institute of Public Policy (IPP) (2011) conservatively estimates it at 0.5 percent of GDP for FY2012. Since FY1997,

the provinces have also levied agricultural income taxes but these have extremely low yields. The IPP also notes that both the presumptive tax rate (PKR 150–250 per acre) and penalties for noncompliance (maximum PKR 1,000 in nominal terms) are extremely low. In fact, the penalty for failing to file a return of PKR 1,000 is absurdly low and creates incentives for noncompliance. It has recommended raising the presumptive tax rate to PKR 750-1,250 and the noncompliance penalty to PKR 10,000. The proposed increases are fairly modest and still may not be able to induce compliance. To raise significant revenues, the effective tax rate should be at least 20 percent of income for large farms (more than 25 acres), which would translate into a rate of PKR 3,000 per acre in real terms. The penalty for failure to file a return has to be punitive to ensure voluntary compliance and for large farms must be at least PKR 1,000,000 plus assessed back taxes marked up by the rate of inflation plus 10 percent. Note that, ideally, agricultural income should be taxed as ordinary income in addition to having a local land tax on agricultural lands. These options, however, have been ruled out by the relevant constitutional provisions.

Provinces also have the potential of raising additional revenues through capital value taxes on property and estate, and through inheritance taxes and environmental taxes and charges. All these fields are currently either underexploited or unexploited. Overall, the provinces have the resources needed to raise additional revenues from their own sources but perhaps not the incentive, as they have traditionally happily depended on manna-from-heaven transfers (NFC awards) and clamored for increased revenues from this source rather than raising revenues from their own sources.

The 18<sup>th</sup> Amendment has also opened the door for greater access to capital finance by permitting both internal and external borrowing, subject to limitations imposed by the National Economic Council. Previously, the provinces had been prevented from such access and required federal government approval for such actions so long as they owed it any debt, which they always did.

### 3.2. Fiscal Implications of the 18<sup>th</sup> Amendment

With the 18<sup>th</sup> Amendment, almost all direct public services become a provincial responsibility. As a consequence, 17 central government ministries have been devolved to the provinces. As mentioned earlier, some of the retained functions of the abolished ministries have been reassigned to the remaining ministries. For example, the People's Works Program has been assigned to the Cabinet Division. The newly created Capital Administration and Development Division at the federal level has been entrusted to handle all those functions of the abolished ministries that have been retained by the federal government but not assigned to the remaining ministries.

Expenditure decentralization has also been accompanied by the much more limited decentralization of taxing powers, most notably for VAT on services. This is potentially a buoyant source of revenue. The revenue- and expenditure-related implications of these changes will be moderated by the federal government for the three-year transition period. The federal government has agreed to provide financing for vertical programs in health, such as the National Program for Family Planning and Primary Healthcare, the Expanded Program for Immunization, and the National TB Program for the next three years. It has also assured continued financing for the current and development expenditures of universities and the National Council for Human Development (NCHD).<sup>1</sup> The federal government will also continue to finance, during the transition period, the Planning Commission and the Higher Education Commission—two institutions with unclear mandates.

The federal government will also retain indefinitely about 65,000 employees whose positions have been made redundant as a consequence of the 18<sup>th</sup> Amendment and who the provinces appear reluctant to accept. So far, they have accepted only 15,000 federal employees who were posted to provincial field offices. With the transition arrangements in place, the federal deficit is expected to increase by about 3 percent, and collectively the provinces will be in surplus by the same amount (see Table 6). While Pakistan's federal finances are already in a precarious state, with an operating deficit at about 100 percent of operating revenues, this development will push the federal government further to the brink unless it takes corrective action through privatization and tax reform or by restructuring federal departments. Its past record in dealing with such issues is not admirable, but the situation can be overcome in a fully mature system by FY2015 provided the federal government is able to shed irrelevant structures and is either successful in transferring its redundant employees to the provinces or terminating their services. This is expected to be a difficult issue to resolve in the coming years since the redundant employees typically do not have the knowledge or skills to manage service

<sup>&</sup>lt;sup>1</sup> The NCHD has about 16,000 employees but the provinces have refused to take over its functions and absorb its employees as they contend that the institution has mostly "ghost" employees.

delivery tasks but have significant political clout through their unions/associations.

Fiscal year	Indicator	Federal share (%)	Provincial– local share (%)
FY2010 (2009/10)	Revenue collection	94	6
	Revenues retained	65	35
	Expenditure share	66	34
	Residual fiscal gap after transfers	-1	1
FY2011 (2011/12)	Revenue collection	90	10
	Revenues retained	61	39
	Expenditure share	64	36
	Residual vertical fiscal gap after transfers	-3	3
FY2015 (2014/2015)	Revenue collection	85	15
	Revenues retained	45	55
	Expenditure share	45	55
	Residual vertical fiscal gap after transfers	0	0

Table 6: Fiscal consequences of the 18th Amendment

*Source:* World Bank staff estimates.

By the time the system matures in FY2015, the structure of government in Pakistan will have undergone a profound transformation from centralized federal power to centralization at the provincial level (see Table 7). For all economic and social services, the provinces will assume a dominant role in policymaking and service delivery. For the average citizen, the government that will then matter is the provincial government. The implications of such governance for responsive, responsible, fair, and accountable governance are taken up in the next section.

							Pe	ercentage
Expenditure	Federal	Provin.	Local	Total	Federal	Provin.	Local	Total
function	FY2010	FY2010	FY2010	FY2010	FY2015	FY2015	FY2015	FY2015
General administration	74	25	1	100	20	75	5	100
Defense	100	0	0	100	100	0	0	100
Debt servicing	85	15	0	100	85	15	0	100
Public order and safety	30	70	0	100	30	70	0	100
Economic services	26	50	24	100	10	66	24	100
Environmental protection	3	40	57	100	1	42	57	100
Housing and community services	0	84	16	100	0	84	16	100
Recreation, culture, and religion	53	32	15	100	5	80	15	100
Education	14	23	63	100	5	33	63	100
Health	9	51	40	100	5	55	40	100
Social protection	12	27	61	100	2	37	61	100
All	66	25	9	100	45	55	10	100

Table 7: Fiscal implications of the 18<sup>th</sup> Amendment for direct expenditure by function and order of government\*

\* Pre- and post (matured system in FY2015) 18<sup>th</sup> Amendment. *Source:* World Bank staff estimates.

## 4. The 18th Amendment: Potential and Pitfalls

### 4.1. Potential Payoffs

The 18<sup>th</sup> Amendment has received plaudits from policymakers and scholars alike for its potential to improve the authorizing environment and allow the federal system to better function (see IPP, 2011). While such high expectations may need to be tempered, the amendment, nevertheless, offers a number of positive potential payoffs. These include the following.

• *Reduced threat of military intervention (?)*. Its foremost merit is that it might limit the threat of military adventurism. The Pakistani military has a long tradition of intervening in domestic politics on one pretext or another—the last being that the prime minister did not

follow due process in removing the military chief. Such temptation might be tempered in the event that critical responsibilities and decision-making rest with the provinces rather than the federal government. Thus, by shifting the power locus to the provinces, the 18<sup>th</sup> Amendment may have paved the way for reduced military political adventurism in the future. If this prediction materializes, then it would be considered the crowning achievement of this constitutional reform. It is doubtful, though, that the military will be restrained as they may choose to redefine the division of powers consistent with their own wishes.

- *Greater harmony in federal-provincial relations*. The 18<sup>th</sup> Amendment has reinforced provincial autonomy consistent with the original intent of the 1973 constitution and, in doing so, has removed an important irritant in federal-provincial relations. The amendment has narrowed the opportunity for arbitrary federal intervention in provincial affairs and, therefore, may have gone some distance in limiting provincial discontent with federal policies. The proper working of the CCI provides an opportunity to build trust and harmony in federal-provincial relations in Pakistan and thwart separatist movements spawned by federal unilateralism or by the high-handedness of military regimes.
- *Greater clarity in government accountability.* With the new constitutional order, both policy determination and service delivery responsibilities have been concentrated at the provincial level. This makes it clearer to citizens which order of government to hold to account for dysfunctional service delivery as the buck now clearly stops at the provincial chief minister's doorstep.
- *Moving the government closer to the people (?)*. The 18<sup>th</sup> Amendment has also moved the government a few small steps closer to the people. If this leads to greater citizen participation in public affairs, it has the potential to make governments more responsive and accountable to the people.

## 4.2. Pitfalls and Risks

While the discussion and debate leading up to the passage of 18<sup>th</sup> Amendment represented a unique opportunity—the only one after the enactment of the 1973 constitution—this opportunity has been largely lost as the amendment has failed to address some of the fundamental challenges of fiscal federalism in Pakistan. This is discussed below.

- *Reforming multi-order governance in Pakistan.* This would have required a comprehensive review of the roles and responsibilities of all orders of government—federal, provincial, local, and beyond government—in delivering public services (see Shah, Ahmad, Boadway, Chaudhry, Huther, Mukhtar, & Pasha, 1996; Shah, 1997 for pathways to such reform). Instead, the amendment simply focuses on devolving functions from the federal government to the provinces to the neglect of rationalizing the former's central functions or the latter's provincial functions. It also completely neglects the role of local governments and beyond-local-government entities in public services delivery.
- The federal functions of the federal government. Securing a common economic union; a harmonized tax system; protecting minorities and disadvantaged groups; and dealing with natural disasters, emergencies, and calamities such as floods and earthquakes are considered among the core functions of the federal government but have been left out of federal domain. At the other extreme, a purely local function, such as the People's Works Program, has been centralized to the Prime Minister's Office despite its already being overloaded with work.
- *Natural resource ownership*. For political and economic union, it is important that ownership of the country's natural resources be vested in the nation as a whole, and that the revenues from those resources be invested in a national heritage fund rather than being made available to any order of government for current use. All citizens of Pakistan would hold equal shares in this fund and receive annual dividends as done in Norway. Various orders of government would be eligible to receive a fraction of the fund's earnings for investment in long-lived assets. In Pakistan, ownership of natural resources is currently vested in the provinces, to which current revenues accrue. This creates both the potential for "Dutch disease" as well as interprovincial conflict. Pakistan has already experienced serious interprovincial conflict in water and gas distribution across the provinces.
- *A roadblock to tax reform.* In tax areas, by reasserting the powers of the provinces to tax agricultural income, capital gains, and services, the amendment may have blocked avenues for reform in creating a modern income and sales tax system in Pakistan. Instead, it has strengthened opportunities for tax evasion by enabling tax arbitrage by potential taxpayers who can now shift their income to agriculture and business expenses from higher taxed sectors or sources of income.

- *Finance does not follow function.* A decentralized fiscal system works best when expenditure decentralization is accompanied by tax decentralization so that spending decisions and any associated tax increases have to be presented to the public and defended. This helps control the leviathan tendencies associated with a reliance on higher-level fiscal transfers to finance subnational expenditures. The amendment has missed the opportunity to realign finance with function according to the order of government, which would have allowed greater accountability.
- *Rightsizing the federal government*. Even in the implementation of the amendment, the federal government has failed to seize the opportunity to realign its organizational structure with the new mandate. Instead, it has retained all redundant employees and continues to finance vertical programs as though it was financing its line agencies rather than instituting grant programs with specific objectives and accountability mechanisms. It has also allowed the Planning Commission, Higher Education Commission, and National Centre for Human Development to continue without rethinking their roles and appropriate new institutional structures to perform those roles.
- Federal government's lack of access to financing instruments to secure a common economic union. The amendment does not revisit the financing of the provincial governments through fiscal transfers. The NFC awards have the twin objectives of dealing with the vertical fiscal gap and horizontal equalization. With the devolution of social services and infrastructure responsibilities to the provinces, the federal role in providing financing for these services to set national minimum standards for merit services and to secure common economic union gains prominence. At present, however, there is no instrument available to further the federal government's spending power to advance national objectives.
- Increased risks to macro-stability with provincial government ownership of financial institutions. The 18<sup>th</sup> Amendment has also empowered provinces to borrow from domestic and international sources, subject to conditions imposed by the National Economic Council. However, the Council may not be able to discipline such borrowing as effectively as provinces' own banking and other financial and nonfinancial institutions. Non-arms-length borrowing from such institutions may go undetected as happened in Australia in the 1970s under the (old) Australian Loan Council, in Brazil in the 1990s, and more recently in China. In Brazil, such borrowing led to

state and local government bankruptcies, including in the largest and richest state of Sao Paulo. In China, local governments are prohibited from borrowing but they use their autonomous enterprises to borrow from the financial sector and then make transfers to the local government. Such borrowing is estimated to be worth about one trillion yuan and poses significant risks to China's macro-stability. The Chinese government has recently taken steps to "discover" these loans and reduce the debt burden of local governments.

- Potential for confusing and contradictory regulatory standards with high transaction costs for business and citizens. Even in the areas with which it is concerned, the amendment has created major anomalies. For example, national uniform standards are required for drug approval; pharmaceutical regulations; food and agricultural safety inspection; the control and disposal of hazardous materials and waste; water and air pollution; highway safety standards; consumer product safety standards; and social safety nets. These areas have now all been relegated to the provinces, creating potential for a jungle of confusing and contradictory standards with high compliance and administration costs. Imagine the consequences for businesses and consumers if each province were to decide to set up its own food and drug regulatory agency as stipulated by the amendment.
- Potential for greater barriers to goods and factor mobility. Finally and most importantly, the 18<sup>th</sup> Amendment has failed to institutionalize any constraints on barriers to factor and goods mobility across the country. Instead, it has opened up the potential for such barriers by recognizing provincial authority to discriminate against nonresidents. Article 27(2) of the amendment overrides the safeguard against discrimination in employment by empowering provinces and local governments to institute a three-year local residency requirement. This poses a serious risk to economic union in Pakistan.

## 5. Conceptual Perspectives and Lessons from International Practices on Multi-Order Governance in an Information Age

In this section, we take a step back from the governance model adopted by the 18<sup>th</sup> Amendment, and take a conceptual and international perspective instead. We review the pros and cons of the federalism model adopted by the amendment and its relevance in the information age, and reflect on the new governance structures required for economic success in a globalized, interconnected world. In doing so, we draw heavily on the analysis presented in Shah (2010a) and Boadway and Shah (2009). The genesis of the 18<sup>th</sup> Amendment is the "holding together" view of federalism, also called the "new federalism." It represents an attempt to decentralize responsibilities from the federal government to the states or provinces with a view to overcoming regional discontent with central policies and forestalling secessionist tendencies. This view is the driving force behind the current interest in principles of fiscal federalism in unitary countries, in relatively newer federations such as Brazil, India, and Pakistan, and in emerging federations such as Iraq, Nepal, Spain, Sri Lanka, and South Africa.

In Pakistan, this was the primary motivation for unanimous consent to the recently passed 18<sup>th</sup> Amendment to Pakistan's constitution. The amendment has eliminated the concurrent functions list (overlapping functions), separating and making distinct from each other the responsibilities of the federal and provincial governments. In doing so, it has moved away from the earlier "layer-cake" model of dual federalism to a "coordinate authority" model. In the layer-cake model that had prevailed in Pakistan till 2010, there was a hierarchical relationship among the federal, provincial, and local governments with the federal government at the apex as the dominant player. Under the "coordinate authority" model of dual federalism adopted by the 18<sup>th</sup> Amendment, provincial governments will enjoy significant autonomy from the federal government while local governments will simply be creatures of the provincial government.

### 5.1. The Potential of Pakistan's Dual Federalism Model

The "coordinate authority" model of dual federalism empowers provinces and states. This is considered sound as it moves decision making somewhat closer to the people. It also has the advantage of dealing with ethnic and linguistic conflicts if a country comprises numerous provinces that are small enough geographically and represent populations with relatively homogeneous characteristics for a menu of taxes and public services (as cantons in Switzerland). If provinces are properly delineated as economic regions, then they can enhance the efficiency of the internal common market by exploiting economies of scale and scope. They also have the potential to deal with inter-local spillovers and intra-regional inequities. Provincial governments can also be responsive to citizen preferences if not captured by feudal, industrial, and military elites. Additionally, the absence of a well-developed communication and transportation system and lack of urbanization also makes provinces a virtual necessity for countries that span a large geographic area. The dimensions mentioned above, however, have limited relevance for Pakistan, which comprises only four large provinces with heterogeneous ethnic and linguistic populations and one dominant province in which the majority of the population lives. Historical records from other countries show that federal countries with less than eight constituent units have typically proven politically unstable. The provincial boundaries in Pakistan are not synonymous with economic regions but are historical accidents representing the best wisdom of the British colonial empire for control of the local population. There is also a significant degree of feudal, military, and elite capture of provincial governments. Moreover, Pakistan has a well-developed communications and road infrastructure network, which also diminishes the economic relevance of the provinces.

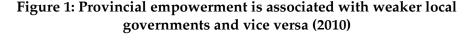
## 5.2. The Pitfalls of Dual Federalism in Pakistan

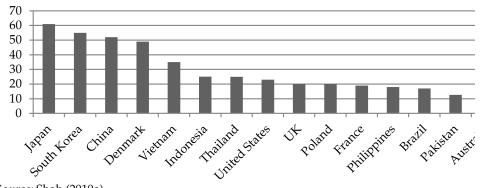
The dual federalism model empowering provinces, nevertheless, has significant conceptual shortcomings. These include the following.

- *Tragedy of the commons associated with common pool resources.* Under dual federalism, both the center and the provinces compete to claim a larger share of the fixed national pie. This accentuates universalism and pork-barrel politics, leading to a tragedy of the commons where all federating units out-compete each other in wasteful spending and giveaways in taxes and subsidies. This tug of war over resources leads to zero-sum games; the resulting swings in the balance of power within nations are a perpetual feature of dual federalism. Pakistan, too, manifests these tendencies, as is evidenced by past negotiations on the NFC awards.
- A leviathan model of governance. Empowering provinces can create potential for the greater duplication of government structures and processes at central and provincial levels, leading to increased costs for the exchequer and higher transaction costs for citizens. This can also lead to overgrazing by politicians and bureaucrats. As a result, the growth in the size of government becomes unrelated to the quality and quantity of service delivery. Opportunism and pork-barrel politics leads to governments acting as employment creation agencies, detracting them from their primary role in financing public services. While there is no recent rigorous study available to refute or document this consideration in Pakistan, Shah et al. (1996) and casual empiricism suggest that, during the last two decades, public sector employment and the associated expenditures on wages and benefits have grown at the expense of reductions in other operating and development expenditures.

- Agency problems with incomplete contracts. In most large countries, empowering provinces does not necessarily imply that decision-making moves closer to the people. Provinces and states are often larger in terms of size/population than small countries—the governments of New York, California, Ontario, Sao Paulo, Punjab, Sindh, Balochistan, Bihar, and Gujarat have jurisdictions exceeding the size of many countries. Having decision-making far removed from the people implies that provincial governments have incomplete contracts with their citizens and cannot be held to account by the latter. In countries such as Pakistan where politics is dominated by feudal, military, and industrial elites, this lack of accountability can completely alienate governments from their people. It is accentuated when voice and exit options are constrained by provincial empowerment.
- Weaker and fragmented local governance. Empowered provinces create incentives for weaker and numerous local governments. The exigencies of provincial politics dictate that local governments are given straitjacket mandates with few resources, and kept under tight provincial reign as in India and Pakistan. Empowered provincial governments typically encourage local fragmentation in the interest of a higher degree of intrusive controls. In India, there are 254,119 local governments responsible for a fraction (5 percent) of national expenditures. Most of these expenditures go toward financing the salaries and allowances of civil servants and three million elected officials, with little left to deliver public services (see Figure 1).

In contrast, in China where the provincial role is restricted and local governments are more empowered, there are only 43,965 local governments accounting for 51.4 percent of national expenditures (Qiao & Shah, 2006). Pakistan's situation is similar to that of India, with few resources and responsibilities at the local level. The modest increase in these resources and the local autonomy granted under the previous military regime has already been formally stripped in Punjab and Sindh, and more informally in the other two provinces. In both Punjab and Sindh, the provincial governments have acted to curb local autonomy and reintroduce provincial controls through the elite civil service. The deteriorating law and order situation has been the primary motivation for these reversals but such moves could also forestall the emergence of good local governance in Pakistan.





Source: Shah (2010a).

- *Stifled local innovations*. Provinces and states are apt to impose onesize-fits-all mandates that constrain local choices and flexibility, and stifle any innovative approaches. In Pakistan, the provincial ordinances of 2000 required all local governments, small or large, to have 16 departments and a fixed number of positions. In the US, outdated state laws rooted in an unjustified distrust of local decisionmaking have stifled successful cities from developing and implementing any coherent vision of their future and from better serving their residents (see Frug & Barron, 2008).
- Constrained good governance and metropolitan growth. Empowered provinces typically block the rationalization of local government functions, especially when empowering local governments implies chipping away at their own powers. A classic example is that of the powers assigned to metropolitan areas under dual federalism. The literature on fiscal federalism suggests that large metropolitan areas should have autonomous two-tier regional governments with powers equivalent to that of a province and direct interface with the center. For this reason, the local governments in Tokyo, Shanghai and Beijing, Bangkok, Seoul, and Helsinki are treated by Japan, China, Thailand, the Republic of Korea, and Finland, respectively, as provinces. In contrast, in India and Pakistan, where provinces are relatively more powerful, metropolitan areas with large populations and significant economic bases such as Mumbai (21 million people with a large and dynamic tax base), New Delhi, Karachi, and Lahore, among others, are treated as typical local governments with limited autonomy. Such treatment deprives residents of the benefits of home rule and constrains their efforts in local economic development.

- *Adverse impact on public service provision.* The concentration of administrative power at the provincial level can create significant inefficiencies in public service provision that may be exacerbated by the breadth of provincial control. These controls may also limit private and not-for-profit sector participation in improving access to public services. Shah et al. (1996) document these concerns in Pakistan's context.
- *Fragmentation of internal common market*. Empowered provinces also have the potential to create internal barriers to trade and factor mobility through domicile (residence) requirements, and by creating protective regulatory and trade barriers across provincial borders. Mature federations such as the US have circumvented these problems by including an interstate commerce clause in the constitution. These barriers are, however, formalized in the political and bureaucratic system of India and Pakistan, resulting in a fragmented common economic union. The 18th Amendment has expanded the powers of the provinces to create barriers to factor mobility by allowing them to enact three years' domicile requirements for access to provincial public employment.
- *Increased threat of succession.* Provincial empowerment can also pose a potential threat to political union, especially in countries with ethnic, linguistic, and religious divides and a small number of provincial jurisdictions with one or more dominant provinces, such as Pakistan. The literature shows that, as a rule of thumb, all dual federalism models with less than ten provincial jurisdictions are likely to face internal conflict and political instability.
- Dual federalism ("federalism of provinces") versus international competitiveness in a globalized, localized, and interconnected world. The new world economic order dictates that the economic relevance of intermediate orders of government (provinces and states) has diminished, while that of local governments has expanded. The dual federalism model was relevant when Pakistan adopted its 1956 and 1973 constitutions but, sadly, constitutional dictums were subsequently ignored and a centralized federal system prevailed. The new economic order requires a more responsive, leaner, efficient, and accountable government structure.

Globalization and the information revolution are working to make the economic role of provinces largely redundant. Globalization empowers supranational regimes and local governments at the expense of national and provincial governments (see Table 8). It also implies that a country's international competitiveness is decoupled from its resource base but directly linked to its knowledge base. This suggests that the national government could play a greater role in financing education and training.

National government also assumes greater importance in social risk management due to the vagaries of the global system and social dumping by corporations to stay internationally competitive. It plays a greater role in securing a common economic union. The provincial economic role, on the other hand, is likely to wane given that the information revolution makes national coordination and oversight over local governments and horizontal coordination at the local level through inter-local partnerships feasible, as done in Finland.

States and provincial governments are, therefore, under growing pressure to reposition their roles to retain their economic relevance. The political role of states and provinces, however, remains strong in all countries and is even on the rise in some, as in Germany, Pakistan, and India. In Germany, the Lander has assumed a central role in implementing European Union directives and in policymaking for regional planning and development. In India, states have effectively blocked the implementation of the 73<sup>rd</sup> and 74<sup>th</sup> amendments to the constitution (passed in 1992), which empower local governments. In Pakistan, the provinces have recently moved to scale back local governments' fiscal and administrative autonomy.

Economic interests in an information age warrant that the modern role of a local government is to deal with market failures as well as government failures. This role requires local government to operate as a purchaser of local services, as a facilitator of networks of government providers and entities beyond governments, and as a gatekeeper and overseer of province/state and national governments in areas of shared rule. Local governments also need to play a mediatory role among various entities and networks to foster greater synergy and harness the untapped energies of the broader community to improve residents' quality of life. Globalization and the information revolution have reinforced these conceptual perspectives, superimposing them on a catalytic role for local governments. This view is especially grounded in the history of developing countries.

20th century	21st century	
Centralized or provincialized	Globalized and localized	
Center that manages	Center that leads	
Citizens as agents, subjects, clients, and consumers	Citizens as governors and principals	
Bureaucratic	Participatory	
Command and control	Responsive and accountable	
Internally dependent	Competitive	
Closed and slow	Open and quick	
Intolerance of risk	Freedom to fail or succeed	
Focus on government	Focus on governance with interactive direct democracy	
Competitive edge for resource-based economies	Competitive edge for human capital-based economies	
Federalism as a tool for coming together or holding together	Global collaborative federalism with a focus on network governance and reaching out	
Local governance based on residuality principle, ultra vires, "Dillon's rule"	Local governance based on community governance principle, subsidiarity principle, home-/self-rule and shared rule	
Limited but expanding role of global regimes with democracy deficits	Wider role of global regimes and networks with improved governance and accountability	
Emerging federal prominence in shared rule	Leaner but caring federal government with an enhanced role in education, training, and social protection	
Strong provincial role	Ever-diminishing economic relevance of provinces; tugs-of-war to retain relevance	
Diminishing role of local government	Pivotal role of local government as the engine of economic growth, primary agent of citizens, gatekeeper of shared rule, and facilitator of network governance. Wider role of "beyond-government" entities, mediator of conflicts, developer of social capital, and purchaser but not necessarily provider of local services	
Tax and expenditure centralization with revenue sharing (NFC awards type) and input based conditional grants to finance subnational expenditures	Tax and expenditure decentralization with fiscal capacity equalization and output- based national minimum standards grants	

# Table 8: The 18th Amendment and comparative models of governance

Source: Adapted from Boadway and Shah (2009).

In the Nordic countries and in ancient civilizations in China, India, and Pakistan, local government was the primary form of government until wars and conquest led to the transfer of local government responsibilities to central and provincial/regional governments. This trend continued unabated until globalization and the information revolution highlighted the weaknesses of centralized rule in improving quality of life and social outcomes. This view is also relevant for carving out and sustaining a competitive edge in international economic relations as demonstrated by China's recent experience. Empowering local governments and strengthening their role in local economic development ushered China into an era of sustained economic growth, and helped lift billions out of the poverty trap (see Box 1).

# Box 1: China is shining on the world economic stage—thanks to its unshackling of its local governments

China is an economic powerhouse poised to assume world economic leadership in the coming decades. It has held a sustained record of economic growth—an average annual growth rate in real per capita GDP of 10 percent over the last three decades, which nearly tripled its per capita income from 1978 to 2010—and prosperity. Its record in alleviating poverty is unparalleled in the economic history of the world—the country has reduced its poverty headcount rate from 31 percent in 1978 to less than 2 percent in 2008. These facts are well known. But what is less well known is that this came about because Deng Shao Peng in 1979 unshackled local governments and unleashed their innovative spirit and energies in pursuit of economic growth and local economic development.

China has one of the most empowered local governments, which serve their residents from cradle to grave. Local governments command an 89 percent share of public sector employment and a 51 percent share of consolidated public expenditures. Other than defense, debt, and foreign affairs—which are the exclusive domain of the center—all other functions, including education, health, and social insurance, are the responsibility of local governments. There is no uniform model and all local governments pursue their own unique approach to service delivery and local economic development. Contracting out service delivery to autonomous service units is widely practiced. The provincial role is weak and largely limited to agriculture and providing coordination and oversight of local governments on behalf of the center.

Thus, China, while it has a unitary constitution, bears an affinity to the hourglass model of federalism. There is strict accountability to citizens at all orders of government through a directly elected people's congress at each level. In addition, Communist Party oversight committees at every level monitor citizen satisfaction as well as dissatisfaction (number of protests). Higher-level oversight of local governments is based on objective results-based criteria that incorporate: (i) local economic development performance; (ii) local service delivery performance; and (iii) citizen satisfaction. Local government success is rewarded by greater local autonomy and sustained failure is punished by reduced autonomy and intrusive oversight and controls by higherorder governments.

Source: Qiao and Shah (2006).

# 6. Province Building and its Incompatibility with Nation Building

The 18<sup>th</sup> Amendment represents both opportunities and challenges. Here, we take stock of the major challenges that could arise from provincial empowerment.

# 6.1. Challenges to Peace and Order

Given that Pakistan has only a handful of unbalanced federating units, there is significant potential for federal–provincial and interprovincial conflict, which could be accentuated by empowered provinces. The CCI may not be in a position to deal with such easily triggered issues. There is even greater potential for intra-province conflict, as is already happening in Sindh. The federal role in the international "war on terror" might also be circumscribed since law and order functions, especially police protection, now rest primarily with the provinces.

# 6.2. Challenges to Good Government

As outlined earlier, the 18<sup>th</sup> Amendment supports a model of multiorder governance that may not be in tune with Pakistan's present needs. For this model to work well, Pakistan needs enlightened leadership and a professional and specialized bureaucracy at the provincial level that will work selflessly in the national interest rather than simply focusing on province building. These traits are not always found, even in developed countries. The risks, as discussed below, in the absence of appropriate checks and balances could be significant in such an environment, as demonstrated by the history of Pakistan and of other countries.

#### Anwar Shah

In the absence of fundamental reforms in political parties' governance, political finance, land reforms, and devolution to the local levels, provincial empowerment may not necessarily lead to greater participation and accountability, while corruption and abuse of power may continue unabated. The provincial political leadership, if operating on a short-term horizon, may choose to use provincial government agencies as employment creation agencies to entrench its support base and, in the process, create a leviathan model of governance. Tendencies to bow to the leadership under political pressure might allow legislators to encroach on executive functions, undermining the integrity, rationality, and accountability of public decision-making. (This role is already pervasive in Pakistan and further entrenched by special allocations for each provincial assembly member.) Pakistan has a civil service culture of rotating appointments, which accentuates this culture of mis-governance and lack of accountability. While several commissions have been mounted to undertake comprehensive civil service reforms, all such efforts have been to no avail. The 18th Amendment may have made the pursuit of such reforms even more difficult.

## 6.3. Challenges to Economic Development and Service Delivery

On economic and service delivery fronts, the prospects for improvements are even more uncertain. The provinces might pursue beggar-thy-neighbor policies and create barriers to trade and factor mobility, thereby fragmenting the internal common market. The 18<sup>th</sup> Amendment has made it easier to pursue such policies by recognizing provincial rights to discriminate against nonresidents based on residence requirements. Given the predominance of manna-from-heaven transfers in provincial financing, the provinces have no incentive to meet national minimum standards in public services, while the federal government has no levers to induce compliance. Standards other than respect for basic human rights are intended to facilitate the integration of slow-growing provinces in the broader national economy by creating a level playing field.

Under the new governance arrangements, land and tax reforms may also be more difficult to accomplish in view of the split of services from goods and of agricultural income from ordinary income. The reform of the revenue sharing system (the NFC awards) to introduce results-based accountability while respecting provincial autonomy might also not be feasible since the provinces are unlikely to have an interest in any arrangements that move them away from the status quo of "autonomy without accountability" that comes with unconditional formula-based revenue-sharing federal transfers (the so-called manna from heaven transfers). In the absence of a legal framework for fiscal responsibility, the risks to macro-stability through provincial non-arms-length access to bank financing can be hardly overstated. Additionally, service delivery disruptions associated with political imperatives cannot be ruled out.

# 7. A New Vision of Federal Governance in Pakistan: An Hourglass Model of Federalism

After more than 60 years of existence, Pakistan still faces existential threats, mostly from within. The 18<sup>th</sup> Amendment may have unintentionally compounded these threats by reasserting a failed and outmoded model of federal governance. In Pakistan, both centralized federal governance and centralized provincial governance have failed to deal with deteriorating law and order and the delivery of basic services. Rather than assuring citizens their security of life, liberty, and property, government agencies are often seen as impediments to these and to citizens' economic advancement.

To overcome this trust deficit, Pakistan sorely needs to fundamentally restructure its political and economic governance. The guiding principles of this restructuring should be that (i) people are sovereign—the governors and masters of all orders of government; (ii) various orders of governments are agents and serve at the behest of the people; (iii) local governments are the primary agents of the people and responsible for securing their interests in ensuring security of life and property, and improving social and economic outcomes; and (iv) there must be a constitutional guarantee that no government can erect barriers to goods and factor mobility, including provincial–local residency requirements, or infringe on the freedom and liberty of its citizens.

This hourglass model of federalism is based on the following division of powers:

- 1. *Federal government*. Responsible for defense, police, currency, foreign affairs, protection of minorities, regulation of internal and international trade, communications, electricity, water, natural gas, equalization, and results-based financing to ensure national minimum standards in merit (education, health, social welfare, unemployment insurance, social security, and infrastructure) services.
- 2. *Provinces*. Inter-local functions (services) and inter-local and central-local coordination.

- 3. *Local governments*. All service delivery responsibilities except those noted above.
- 4. An independent tax authority that administers taxes for all orders of government.

This vision will require a newer and a leaner structure of provincial governance where the provincial legislature is not directly elected but simply comprises ex-officio directly elected heads of local government in the province, providing oversight to a provincial executive comprising a federally appointed governor and locally recruited civil servants. The provincial legislature would further act as an inter-local coordination body. The size of a provincial jurisdiction would also be capped at a maximum of 15 million people or 30,000 square kilometers to create a more balanced federal system.

#### 8. Concluding Remarks

In over 60 years, Pakistan has moved from crisis to crisis. An important reason for its dysfunctional governance is the ruling elite's lack of adherence to constitutional principles. In the words of a Pakistani scholar, successive regimes have transformed the country from a "state" to an "estate" for the ruling elite (Niaz, 2010). While such criticism may be unjustifiably harsh, it nevertheless captures the growing negative perception of public sector performance in Pakistan.

The 18<sup>th</sup> Amendment is well intentioned in its aim to bring greater clarity to the roles and responsibilities of various orders of government, and to ensure greater provincial autonomy to reduce incentives for military interventions in the political system. However, the amendment must be seen as only the first and incomplete step—and in some respects a misstep toward reforming public governance in Pakistan. To complete this process, further fundamental reforms are needed to ensure that the public sector serves the public interest and secures a common political and economic union. Important first steps in this direction would include the devolution of most provincial powers, except those dealing with inter-local coordination and oversight, to local governments; constitutional guarantees to overcome internal barriers to trade and factor mobility; and a framework for fiscal responsibility and fiscal discipline for all orders of government.

This is an enormous unfinished agenda for reform that needs to be undertaken over the coming years. A beginning must be made now by recognizing the need for reforms and developing a strategy to reach a national consensus on the directions for reform. In the words of a Chinese philosopher, "All long journeys start with the first small steps." The 18<sup>th</sup> Amendment must be seen as that first step in the long journey to restore Pakistan to its original glory. Indeed, the reform process is eternal. We may never fully succeed but we must keep trying.

#### References

- Bailey, S. (1999). *Local government economics: Theory, policy, and practice*. Basingstoke, UK: Macmillan.
- Boadway, R., & Shah, A. (2009). *Fiscal federalism: Principles and practice of multi-order governance*. New York, NY: Cambridge University Press.
- Boyne, G. (1998). *Public choice theory and local government*. Basingstoke, UK: Macmillan.
- Breton, A. (1995). *Competitive governments*. Cambridge, UK: Cambridge University Press.
- *The constitution of the Islamic Republic of Pakistan.* (2010). Karachi, Pakistan: Ideal Publishers.
- Dollery, B. E., & Robotti, L. (2008). *The theory and practice of local government reform*. Cheltenham, UK: Edward Elgar.
- Dollery, B. E., & Wallis, J. (2001). *The political economy of local government*. Cheltenham, UK: Edward Elgar.
- Frug, G. E., & Barron, D. J. (2008). *City bound: How states stifle urban innovation*. Ithaca, NY: Cornell University Press.
- Goss, S. (2001). *Making local governance work*. New York, NY: Palgrave.
- Haque, N. (2010). *Pakistan: A failed state*. Presentation at the International Food Policy and Research Institute, Washington, DC.
- Horn, M. (1997). *The political economy of public administration*. Cambridge, UK: Cambridge University Press.
- Institute of Public Policy. (2011). *State of the economy: Devolution in Pakistan Fourth annual report,* 2011. Lahore, Pakistan: Cross Media.
- Ivanyna, M., & Shah, A. (2011a). Citizen-centric governance indicators: Measuring and monitoring governance by listening to the people. *CESifo Forum*, 1, 59–71.
- Ivanyna, M., & Shah, A. (2011b). Decentralization and corruption: New cross-country evidence. *Environment and Planning C: Government and Policy*, 29(2), 344–362.

- Ivanyna, M., & Shah, A. (2012). *How close is your government to its people? Worldwide indicators on localization and decentralization* (Policy Research Working Paper 6138). Washington, DC: World Bank.
- Moisio, A., Loikkanen, H., & Oulasvirta, L. (2010). Public services at the local level: The Finnish way. In A. Moisio (Ed.), *Local public sector in transition: A Nordic perspective* (Chapter 4, pp. 155–184). Helsinki, Finland: Prime Minister's Office.
- Moore, M. (1996). *Creating public value*. Cambridge, MA: Harvard University Press.
- Niaz, I. (2010). *The culture of power and governance of Pakistan* 1947–2008. Karachi, Pakistan: Oxford University Press
- Pakistan, Ministry of Finance. (2011a). *Pakistan budget 2010/11*. Islamabad, Pakistan: Author.
- Pakistan, Ministry of Finance. (2011b). *Pakistan economic survey* 2011–12. Islamabad, Pakistan: Author.
- Qiao, B., & Shah, A. (2006). Local government organization and finance in China. In A. Shah (Ed.), *Local governance in developing countries* (Chapter 4, pp. 137–168). Washington, DC: World Bank.
- Rao, G., & Shah, A. (Eds.). (2009). *States' fiscal management and regional equity: An overview*. New Delhi, India: Oxford University Press.
- Rhodes, R. A. W. (1997). Understanding governance: Policy networks, governance, reflexivity, and accountability. Buckingham, UK: Open University Press.
- Shah, A. (1997). Federalism reform imperatives, restructuring principles and lessons for Pakistan. *Pakistan Development Review*, 36(4), 499–536.
- Shah, A. (1998). Indonesia and Pakistan: Fiscal decentralization An elusive goal? In R. Bird & F. Vaillancourt (Eds.), *Fiscal decentralization in developing countries*. New York, NY: Cambridge University Press.
- Shah, A. (Ed.). (2006a). *Local governance in developing countries*. Washington, DC: World Bank.
- Shah, A. (Ed.). (2006b). *Local governance in industrial countries*. Washington, DC: World Bank.

- Shah, A. (2007a). Institutional arrangements for intergovernmental fiscal transfers and a framework for evaluation. In R. Boadway & A. Shah (Eds.), *Intergovernmental fiscal transfers* (pp. 293–317). Washington, DC: World Bank.
- Shah, A. (Ed.). (2007b). *The practice of fiscal federalism: Comparative perspectives*. Montreal, Canada: McGill-Queen's University Press.
- Shah, A. (2010a). Adapting to a changing world: Reflections on the reform of local governance for the next decade. In A. Moisio (Ed.), *Local public sector in transition: A Nordic perspective* (Chapter 5, pp. 185– 220). Helsinki, Finland: Prime Minister's Office.
- Shah, A. (2010b). Empowering states and provinces or unshackling local governments: Does it matter for peace, good government and growth. *Pakistan Development Review*, 49(4, Pt. I), 333–362.
- Shah, A. (2010c). Sponsoring a race to the top: The case for output-based grants for merit goods. In J. Kim & J. Lotz (Eds.), *Financing local governments*. Copenhagen, Denmark: Ministry of Finance.
- Shah, A., & Shah, F. (2007). Citizen-centric local governance: Strategies to combat democratic deficit. *Development*, *50*, 72–80.
- Shah, A., Ahmad, S., Boadway, R., Chaudhry, S. A., Huther, J., Mukhtar, H., & Pasha, H. (1996). *Fiscal federalism in Pakistan: Challenges and* opportunities. Washington, DC: World Bank.
- Shankar, R., & Shah, A. (2003). Bridging the economic divide within countries: A scorecard on the performance of regional policies in reducing regional income disparities. *World Development*, *31*(8), 1421–1441.
- Stoker, G. (Ed.). (1999). *The new management of British local governance*. London, UK: Macmillan.
- Williamson, O. (1985). *The economic institutions of capitalism*. New York, NY: Free Press.

# Civil Service Management in Devolved Government: Reconciling Local Accountability and Career Incentives in Pakistan

# Musharraf Rasool Cyan\*

# Abstract

This paper looks at the case of Pakistan's decentralization reform of 2001– 09 and its impact on civil service management. A key point made in this paper is that the relationship between organizational change and civil service is, by no means, unidirectional. The issues are viewed in the context of decentralization, its opportunities, and outcomes for efficiency and equity. We then evaluate whether administrative decentralization has enhanced or diminished the potential for political and fiscal decentralization for service delivery in Pakistan.

Keywords: Decentralization, government, civil servant, Pakistan.

# JEL classification: H10.

# 1. Introduction

Decentralization is a reform that creates multiple tiers of governmental authority. As local (or provincial) governments are created or empowered, they gain the attributes of government, including the authority to hire and manage a civil service. This component of government authority is critical to the performance of governments at each level. The civil service is a key instrument in the implementation of public sector policies and programs. Civil servants manage departments that implement policies and programs, monitor inputs and outputs, project government authority as a means of social regulation, and administer tax and expenditure instruments in different subnational jurisdictions. The quality of the civil service often considerably influences service delivery, as well as regulatory and developmental outcomes. Decentralization reform brings about a number of changes, chief among them the dispersal of government authority over a large number of actors and levels. Transition from a centrally managed system of government to a decentralized order

<sup>\*</sup> Research Associate, International Center for Public Policy, Andrew Young School of Public Policy Studies, Georgia State University.

of numerous governments on one hand affects centralized civil service in a major way by creating decentralized authorities for it. On the other hand, decentralization is implemented with the objective of maintaining baseline service levels, which may or may not be suited to transition to a decentralized order of government.

This article discusses primarily the case of a central civil service working in devolved governments, and its half-way mutation into localized civil services. It contributes to the debate on decentralization, using the case of Pakistan's decentralization reform of 2001-09 and its impact on civil service management. The specific study is a case of Weberian bureaucracy adapting to an increase in demand for performance and accountability, while central controls and standards loosen to accommodate its placement in devolved units of government. A key point made in this discussion is that the relationship between organizational change and civil service is, by no means, unidirectional. The issues are viewed in the context of decentralization, its opportunities, and outcomes for efficiency and equity. The analysis applies to management cadres specifically but is also relevant to other public servants. We then evaluate whether administrative decentralization has enhanced or diminished the potential for political and fiscal decentralization for service delivery. Let us say that this is nontrivial—ours is a specific focus and we do not attempt to cover all issues related to decentralization in Pakistan.

In Pakistan, the local government reforms of 2001 created a large number of decentralized governments that inherited their mantle from deconcentrated provincial government units. The major part of the transition took place over a year, but some of the changes took longer. When it was thought that decentralized local governments would be stabilized, in 2009 the decentralization program was rolled back, starting with the provinces and centralizing functions once again. That civil service management moved from centralized to some form of decentralized and then back to centralized organization at the end of this period reveals a number of issues pivotal to decentralization reform.

Section 2 recounts key features of devolution in Pakistan. Section 3 discusses how administrative decentralization is related to devolution in general. Section 4 describes how decentralization affected centrally managed civil services at the provincial and local level in Pakistan and, in turn, how decentralization outcomes were reshaped by the central nature of the civil service. Following this discussion, we summarize some important lessons that emerge from Pakistan's case. Section 5 concludes the article.

#### 2. Decentralization in Pakistan: Another Round of Reform

In 2001, the fourth military government in Pakistan initiated a major decentralization reform—the third round of local government reforms in the country. Major provincial mandates were decentralized to 6,125 newly created local governments. The creation of these local governments was made possible through the near simultaneous adoption of four statutes in the provinces of Punjab, Sindh, the then North West Frontier Province, and Balochistan. Major structural changes took place. The deconcentrated units of provincial service delivery departments were devolved to the new local governments. Each local government had an indirectly elected political executive and a directly elected council—budgetary authorities were vested in the council. The four provinces decentralized education, health, roads, drinking water supply, and a number of regulatory functions to the local governments by enacting centrally crafted legislation.

The local government was established as a three-tier structure with an almost nonhierarchical relationship among the tiers. The first level of local government was the district. Across the country, 109 district government were created by bringing together the deconcentrated units of 11 provincial departments. Of these, four districts were classified as city districts with additional urban planning and municipal functions. Below district level, the second tier comprised 396 tehsil municipal administrations (TMAs). The TMAs were created out of the nodes of earlier local governments established in 1979 by including their surrounding rural hinterland. The lowest tier of local government comprised the union administrations, each with a population of around 25,000. Each of the three tiers of local government had an elected council and an elected executive called a nazim. The union nazim was directly elected but the TMA and district nazims were elected by a college of all the councilors in the jurisdiction. Table 1 shows the number of local governments created from deconcentrated provincial government offices and earlier local governments.

Province/region	Districts/city districts	Tehsils/ towns	Union councils
Punjab	35	144	3,464
Sindh	23	121	1,108
North West Frontier Province	24	54	986
Balochistan	28	77	567
Capital Territory	1		
Total	111	396	6,125

#### Table 1: Local governments in Pakistan

The new local governments inherited the old civil service structures and human resources. Prior to the creation of new local governments in 2001, the deconcentrated districts were managed by provincial or federal cadre officials. Officers with the same or changed responsibilities continued working in the decentralized departmental units. Changes in responsibilities affected mostly general cadre officials. In all cases, reporting responsibilities at the senior-most level in the local governments changed materially, as described below. The level of changes was given in the local government statutes. This provided legal legitimacy as well as incontrovertibility. Compared with certain other countries, administrative decentralization in Pakistan reached an intermediate decentralization with some management functions decentralized to local governments and others retained at the provincial level (Evans & Manning, 2003). The statutes defined the basic structures of local government. Over time, these changes were implemented through regulations and rules. In some cases, practice defined the changes and assigned meaning to them. It is at this level of detail that we focus our discussion to highlight the effects of decentralization reform on the civil service and the ways in which it has, in turn, shaped decentralization outcomes.

Not all local governments were alike. The city district government of Karachi had a population of 15 million—the country's largest local government while the rural district government of Killa Saifullah in Balochistan had a population of 0.5 million. The implementation of decentralization reforms recognized this diversity as an issue that required uniform treatment rather than providing opportunities to evolve a variety of solutions to achieve a qualified civil service for all local governments. Officially, civil servants' salaries remained in the provinces' purview, but were practically determined by the federal government. This meant that civil servants serving in Karachi or Killa Saifullah would expect similar

remuneration on comparable pay scales. This was one of the foremost features of administrative decentralization seeking to provide all types of local governments with equivalent skill levels.

Civil servants were transferable between local governments according to their cadre domains, but with some exceptions to this general dispensation. The positions of district heads of department in city districts were on higher pay scales than in ordinary districts. In handing over controls over civil services, provinces in this manner laid down strict parameters, leaving little room for local governments to adopt locally suitable options. This approach ensured that the services of qualified civil servants were available to even small and poor districts. For rich districts, however, it was an unnecessary constraint that reduced their scope for local initiatives—a key objective of decentralization. For example, the city district government of Karachi could not hire a professionally qualified individual to manage its finance and planning office, although it offered a competitive salary. It was obliged to post a federal or provincial civil service to the position. The quest for uniformity thus guided policy but in fact resulted in widely varying arrangements across districts.

Administrative decentralization moved a large number of civil servants under local government control. On the basis of budgetary data, in 2009 there were a total of 1,018,579 positions in Punjab. Of these, 657,824 moved to 36 district governments,<sup>1</sup> i.e., devolution resulted in the assignment of 64.58 percent of government employees to district governments. This change on the surface was material, where many provincial departments lost their field offices to local governments. In practice, the provinces retained a number of controls over their civil servants while working in the districts. These controls were most heavily exercised over senior civil servants, including the chief district government civil servant or district coordination officer (DCO), sector chiefs or executive district officers (EDO), and other management officers.

Salary budgets were progressively decentralized but still controlled by the provinces through strictly defined salary bands and increments. In many cases, the provincial government also set the size of the local government establishment. From 2004 to 2008, 46,546 teachers were recruited in various districts of Punjab. All the positions were first approved by the provincial government before being incorporated into the local government establishment schedules. From 2001 to 2008, two rounds

<sup>&</sup>lt;sup>1</sup> The total number does not include the TMA positions that were not financed from the provincial budget.

of elections took place. In the first round, 87,000 councilors were elected to local governments; one third of these were women. By the time of the second election in 2005, the number of local council seats was reduced; as a result, 38,000 councilors reached the local councils.

Together, the elected councils and local executive exercised political control over the decentralized civil servants but to varying degrees. As discussed in Section 4, the establishment of political leadership and control over district-level civil services created a new working environment for the centrally managed cadres of the civil service, changing performance incentives and accountability arrangements. The demand for improved services became a common expectation in districts that had previously been concerned with basic public order concerns. The large number of elected councilors with local constituencies exposed the civil service to new pressures for performance—a major break with the past. However, while central controls were considerably weakened, they were not completely obliterated.

Before returning to the specific details of how decentralization created civil service structures at local levels, and how the civil service with lingering centralized management played out in Pakistan, it is useful to lay down the general perspective in which this analysis is carried out. The next section deals with this discussion.

## 3. Major Changes for the Civil Service under Decentralization

Decentralization creates multiple levels of government as well as a number of governments, horizontally. At each level and in each unit, political authority directly accountable to the local citizenry comes into being. Prior to decentralization, the locally based civil service receives policy directions and implementation commands through its own hierarchy, and political control is exercised at the central level. This is one of the most far-reaching changes for the civil service after decentralization. The extent of authority vested in each government determines the roles and responsibilities of the civil service. The political and fiscal dimensions of decentralization make administrative decentralization necessary. The type of decentralization that is actually carried out may vary according to the specific context and objectives of the reform.

Among other things, decentralization disperses authority and creates new responsibilities for the civil service and competition between local autonomy and central standards (World Bank, 2011). Devolution

creates multiple levels of legitimacy to replace the known central authorities.<sup>2</sup> For the civil service, this creates internal pressure to accommodate new definitions. The centrally managed civil service is only accustomed to intra-departmental and interdepartmental dealings. For most of these cases, procedures, rules, and traditions provide a sufficiently comprehensive template for decisions and initiatives. Devolution creates an undefined territory of intergovernmental relations that may not fit very well with the customary norms and traditions of civil service (Parry, 2008). Thus, as happened in Pakistan, mid-career civil servants assigned to the newly created local governments found themselves resolving intergovernmental affairs for which they were not prepared.

The objective of this transition is to get the civil service to report to its new authorities without compromising on centrally sustained standards. If the central standards are weak, then the transition may lead to problems for local governments, but where they constrain local initiatives, in time such weakening may also create opportunities for development. In all Pakistan's four provinces, less regard was paid to maintaining official standards and there was greater focus on assigning officials to districts and TMAs. Although four transition teams with administrative powers were created in each province, the new councils were inexperienced in asserting political control over the newly decentralized civil service. They did not receive much guidance on how to put into operation any of the number of mechanisms narrated in the law to assert policy direction, control, and performance accountability on the devolved district entities.<sup>3</sup> As in other cases of devolution, the civil service gravitated toward retaining central (or provincial) codes for management rather than dealing with the enormous task of devising local codes.<sup>4</sup> The reluctance to open up the possibility of writing new codes was also a result of the civil service's anxiety at facing new challenges to their processes from inexperienced local politicians.

Decentralization or devolution in various countries has been accompanied by changes in centrally managed civil service systems. Some degree of central control and linkages of civil service serve the transition well. Among the advantages is working through complex and evolving intergovernmental relations. Central civil servants assigned to devolved

 $<sup>^{2}</sup>$  See, for example, Goodwin, Jones, and Jones (2005) for a discussion of the complex division of the state following devolution in the United Kingdom.

<sup>&</sup>lt;sup>3</sup> Most of the capacity-building initiatives focused on developing typical civil service capacities. Some program linked with councilors but as they were mostly implemented by NGOs they did not venture into core government capacities.

<sup>&</sup>lt;sup>4</sup> The case of Welsh devolution also kept central civil service codes attempting to keep previous position with ministers (Cole, Jones, & Storer, 2003).

governments can work well with their centrally placed colleagues to resolve issues and find solutions (Parry, 2001). At the same time, civil servants assigned to local governments may face obsolescence of customary administrative norms. Moreover, middle-level civil servants may immediately be assigned to chief positions in local governments. This increases the pressure on civil servants trained to working within the well-defined precincts of centrally controlled departments, and is often inadequately documented (see Pyper, 1999).

#### 4. Decentralization and the Civil Service in Pakistan

This article does not treat the civil service as a passive mechanism with no discretion to react to devolution. It is a key player in decentralization and acts by shaping its outcomes. Like any other player, the civil service does not control the process completely, but through its longevity and persistence, it perhaps plays a more important role than other actors. In the case of Pakistan, the civil service outlasted other actors, namely the military regime (1999–2002), the quasi-military government (2002–08), and the constitutional provisions protecting local governments (2002–09). The creation of local governments in Pakistan was a major change for the political and administrative traditions of Pakistan.<sup>5</sup> In one swathe of reform, the civil service was moved into multiple spheres of authority and responsiveness. This section discusses the transition.

In general, decentralization created a new incentives framework for the civil service. Local governments had two key types of features to enhance citizen control over government. The first type of controls was the ex-ante policymaking role that was passed on to the elected local executive. The second type was ex-post and could be exercised through council committees. The nazims exercised policy control primarily by identifying development projects. In many other areas, their role remained constrained due to informal controls exercised by the provincial departments through budgetary mechanisms or civil service management. The committee reviews remained rare and council committees did not become functional (Asian Development Bank, UK Department for International Development, World Bank, 2004).

The following key changes took shape, changing civil service structures and incentives and, in turn, being reshaped by the civil service.

<sup>&</sup>lt;sup>5</sup> The Pakistani administration is much closer to the Napoleonic administration tradition described in Peters (2008). A relevant discussion of public sector reform discussing the cases of France, Greece, Italy, Portugal, and Spain is given in Ongaro (2008).

#### 4.1. Atomized Authority and Control

The new local governments of 2001 led to the structural recreation of the district- and tehsil-level local governments. For the provincial civil service (and assigned federal civil service), this was a major change. As shown in Table 1, a number of new authorities were created for the civil servants in each province. District and subdistrict offices attuned to centralized control from their departments were placed under the authority of elected offices in each of 505 local governments. The authority to set policies, prioritize programs, make budgetary allocations, and demand performance was allocated to 6,125 local governments, replacing a handful of departments. For the body of civil servants, this created a completely new framework of performance. As a whole, the provincial civil service in each province could no longer respond to unified central control exercised by their provincial government. Partial decentralization of performance evaluation and the authority to transfer civil servants reoriented them toward new nodes of authority.<sup>6</sup>

Had the law had complete sway, this would have meant that civil servants posted in the districts would have been completely submerged by the local legal authority. The law's intent, however, was considerably diminished by the civil service's instruments. In Punjab, the provincial civil service was reorganized paying only scant attention to local governments and the need to establish local accountability. For the reorganized provincial civil service, key positions in local governments were enumerated as career positions, upward mobility toward provincial-level positions was guaranteed, and no mention was made of local performance evaluation.<sup>7</sup> As a result of these two parallel but opposite actions, a compromise between local autonomy and central control was achieved. Atomized authority was accepted but strong incentives were created for looking up to the central authorities for career paths.

#### 4.2. Multiple Controls and Directions

The traditional civil service was enmeshed in rules emanating from a single authority and honed over more than a century. It acted as a vehicle of central policies and was responsible for implementing central programs among local populations. Informal rules and institutions, such as those for dealing with political leaders and reducing the intensity of local conflicts,

<sup>&</sup>lt;sup>6</sup> Through statutory provisions, the performance evaluation reports of senior civil servants assigned to local governments were given to local elected heads of government.

<sup>&</sup>lt;sup>7</sup> For details, see Punjab, Services and General Administration Department (2004).

had emerged over time. The latter overlay the formal rules and, together, created the template for civil servants' behavior. The functional arrangement in the centrally managed districts was not defined by formal rules alone.

Local government reform increased the complexity of this arrangement by introducing multiple controls and policy directions for the civil service. Nazims were invested with formal authority as heads of local government for budget making and management. For the sectoral departments, effective control over postings and transfers and budgetary approvals were vested at the district level. At the same time, departments and provincial government retained formal and informal levers to influence decisions and management in local governments. Between 2007 and 2009, the district heads of sectoral departments were torn between provincial orders and local priorities.<sup>8</sup> With time, the provincial need to retain a major say in the districts was manifested in the time spent by district heads in the provincial capital for meetings and reports. Despite the availability of technological options for monitoring and reports, personal presence was often considered mandatory. This showed that provincial authorities continued to exercise strong controls over decentralized departments.

Interviews with DCOs showed that it was common for nazims' priorities and directions to be at variance with provincial directions and expectations. Since the former's career incentives were linked with the province, in most cases they would find a way to ignore the nazim's priorities and directions. In certain cases, where the nazim was a political ally of the provincial government, he or she could have the provincial directions revoked. DCOs were alert to this possibility and used this channel of communication before making a final decision to comply. DCOs performed functions that were far complex than the traditional development managers.<sup>9</sup> Many times, the district management thrust civil servants into roles that were political rather than traditionally administrative.<sup>10</sup>

A clear case of multiple controls emerged in education and health. Both sectors were decentralized to the districts. With a number of vertical

<sup>&</sup>lt;sup>8</sup> Based on the author's interviews of education and health EDOs in Multan, Faisalabad, and Jhang. DCOs in Lodhran, Multan, Faisalabad, Jhang, and Rawalpindi also reported a long series of meetings being held at the provincial headquarters every month.

<sup>&</sup>lt;sup>9</sup> Gulrajani (2010) presents a discussion on changing roles.

<sup>&</sup>lt;sup>10</sup> This was in line with the political role of civil servants observed in other contexts (for example, see McGregor, 1974). In this case, middle-level civil servants were exposed to this role. The change remained short of politicization seen in another closed career system such as that in Germany (Derlien, 2003).

programs, reporting authorities were created for specific types of sector activities. Many of these programs provided substantial finances to the district sectors, creating potent influences for the local government. Largescale donor programs added to this multi-directionality for the locally placed civil service by defining clear performance targets and reporting obligations for the province-level project offices.

# 4.3. Enhanced Space for Senior Civil Servants in the Interstices of Intergovernmental Relations

The creation of new local governments ushers in the opportunity for initiatives and modernization, which might otherwise take a long time to affect a tradition-bound civil service (Parry, 2005). Decentralization in the European Union was accompanied by the loosening of human resource management rules and regulations, increasing managers' discretion to make decisions (Meyer & Hammerschmid, 2010). In Pakistan, the chief civil servant in the district government, the DCO, became an important office in the decentralized district. The DCO was given a central role in administrative decision making for all departments and budget making for the district government. This level of authority had not been seen in the district office since the colonial administration of the early to late twentieth century, where the district office worked as the fulcrum around which development administration worked.<sup>11</sup>

Intergovernmental relations between the province and local government negotiated many turns and twists between 2001 and 2009. The local government ordinances laid down statutory principles and created space for the evolution and amendment of rules and regulations to populate the mechanics of devolved sectors. The districts were given budgetary authority. Formally, this meant that the council could allocate funds received under the Provincial Finance Commission (PFC) grants and local revenues to district priorities. In practice, however, expenditure autonomy was limited in a number of important ways.

Almost four fifths of the district budget was allocated to salaries (Asian Development Bank, UK Department for International Development, World Bank, 2004). In theory, the district could transfer government servants from the districts and create vacancies to accumulate savings—this could be carried out by the DCO. In practice, DCOs would follow provincial directions. None of the 109 districts opted for layoffs to create fiscal space for

<sup>&</sup>lt;sup>11</sup> The traditional development administration (Brinkerhoff, 2008) and its role was embedded in the district office.

local priorities. Schoolteachers, the largest component of public employment in the district, were not reassigned among schools, and wide-ranging student-teacher ratios continued as before. Recruitments in education were decentralized to the district. DCOs chaired the committees, which followed a selection process and applied merit criteria laid down by the province. The most important function in the district was to obtain additional funds from the province. Despite the PFC awards, this continued to be a negotiated process in the presence of numerous federal and provincial vertical programs. Again, DCOs played a key role in these negotiations.

As they started to function on their own, local governments worked under provincial tutelage for funds, officers, rules and regulations, and even policy directions. The new arrangement created an unchartered territory of relations between provinces and local governments. DCOs were placed in the most important position in these relations, which were conducted mostly through discussions, meetings, and consultations. Civil servants tended to be risk-averse, however, and did not imbibe the spirit of local government reform, remaining bound to provincial policy directions. The overbearing departments did not help either (Williamson, Ahmad, & Smith, 2005). Service providers such as teachers did not receive much support from district-level managers (Pakistan, Ministry of Education, and UNESCO, 2003).

The new space for discretionary work was a positive feature of decentralization, although no systematic data is available to document how this space was used. In some cases where data is available, it shows that initiative and timely action contributed to improved local government outcomes. In Punjab during 2002 and 2008, a total of 48,546 teachers were recruited at district level and placed in schools with vacancies. The entire recruitment and placement process was managed at district level without any major complaints regarding transparency or merit. Moreover, due to the greater discretion with contract appointments available to district-level managers, there was a marked improvement in the availability of doctors and health workers in rural health facilities (Cyan, 2009).

#### 4.4. Multiple Accountability Channels

One of the most important changes that devolution brought about for the centrally managed civil service was the creation of multiple accountability channels. The elected councils and political executive in local governments were empowered to make local decisions. The primary reporting lines for civil servants were redrawn toward the local political executive. Nothing less than specific statutory provisions assigned performance evaluation to the nazim. The councils were mandated to assign a number of committees to oversee the performance of decentralized departments. The most important of these committees was the accounts committee, which had the authority to receive and review audit reports.

The law had originally envisaged a decentralized civil service with local reporting and accountability. DCOs, as the principal accounting officers, would stand before the local committees to respond to audit objections. This was the most important legal provision intended to absorb the central civil service into the local accountability framework, but the situation was diluted by certain management provisions. First, senior provincial civil servants were assigned additional reporting responsibility. For all civil servants in charge of a sector, the departmental secretaries reviewed performance reports from the district and provided their own evaluation. According to the established rules of interpretation, the second evaluation holds sway if the two evaluations do not agree. For the DCO, the authority for the second evaluation was assigned to the provincial chief secretary. In this way, central controls were maintained over the devolved offices.

Second, the law clearly assigned the accounting function to local governments and empowered the local councils' accounts committee to audit reports. This was one of the key provisions establishing a local accountability arrangement for the devolved offices. The provision was, however, not put into practice in spirit. The federal auditor general initially opposed the idea of auditing local governments and then proceeded to establish 27 regional offices across the country to create subordinate field formations to audit local accounts. At the same time, there were attempts to centralize local accounts to the federal level. The audit reports were provided to the provincial governor who was authorized to forward them to the local councils. The weak capacity of the auditors and councils continued to undermine this provision. The provincial government found it more convenient to use the preliminary auditor's observations to lay accusations of unprecedented corruption against local governments in 2009. The accusations were not followed through, and once the expediency of controlling local governments through civil servants was achieved, the issue was forgotten. On the whole, these provisions did not produce the desired results due to their vitiation.

#### 4.5. Varying Standards

Values do not change immediately with a change of civil service regime (Ryan, 2004). However, values-based management can produce positive effects on the public sector (McCourt, 2007). Long-held traditions can also affect developmental and institutional outcomes (Lange, 2004). This was most keenly observable in areas where new local governments in Pakistan were given the opportunity to take initiatives but remained dependent on the skills of the civil service.

Local government ordinances allowed local governments to lay down local regulations. This was an important provision with the potential to encourage innovation and the adoption of locally suited solutions. If used to its fullest intent, local regulations could well create entirely different domains to supplant the uniform civil service codes and sectoral regulations that had evolved over decades. At the same time, the local governments inherited civil servants who had been trained to maintain uniform standards and did not have much incentive to look beyond them. For the civil servants, the expected technical engines of change and support for local initiatives, there was little incentive to experiment with new regulations and innovation. The approach was almost overwhelming in the four provinces, all of which carried a heavy burden of tradition. Even provincial legislation and rules seldom varied much for each other.

The existence of uniform standards can have a two-way relationship with centralized civil service management. Uniform standards are an outcome of a centralized civil service since a central authority regulates both domains. On the other hand, a centralized civil service gains validity through uniform standards and procedures, which reduce the cost of learning and adjustment when central civil servants are posted to subnational jurisdictions. Both outcomes mutually reinforce each other.

The local government reforms of 2001 made a reluctant and somewhat antithetical departure from this practice. The ordinances included provisions for local regulations. In the Sindh Local Government Ordinance, the Fifth Schedule listed 21 items for local rules and 42 subjects for local byelaws.<sup>12</sup> The last provision in each case was a general enabling clause without limiting the subject for such local legislation. These provisions, once put into practice, would create diversified standards across the country. While this was a major step forward, the four local

<sup>&</sup>lt;sup>12</sup> See Sindh, Local Government Department (2001) for details.

governments were themselves centrally prepared at the federal level under a rigid framework aiming at uniformity. This stamp of uniformity continued to inhibit the growth of local initiatives. Central civil servants assigned to the local governments did not help. By training and by inclination, they continued to find solutions to different local problems through their learned behavior of applying narrowly conceived rules and regulations. As a result, local regulations were adopted only in a small number of districts and in areas of little significance.

In the interplay of these opposing forces, local governments did, however, create multiple organizations. Civil servants placed in the districts were much more attuned to local issues than deconcentrated offices implementing provincial policies and programs. A two-way channel of communication was opened between districts and provincial departments. One of the key concerns voiced by senior provincial civil servants in this period was the deterioration in service standards. In many cases, this complaint referred to the weakening of uniform standards under local initiatives rather than deterioration against a universal standard.

Comparative discussions with senior civil servants indicated that this might be the case. For example, comparisons between centrally managed engineering departments such as public health engineering and local government water supply outfits always rated the former as better performing. This was not, however, borne out by the evidence. There were differences between the types and scales of operation. Public health engineering was responsible for drinking water supply in rural areas while the local government water supply was restricted mostly to urban areas, with the exception of large urban centers. Despite these differences, when the local water supply department had accumulated unpaid electricity bills—around PKR 3.5 billion in 2004 for 122 TMAs in Punjab—the public health engineering department lagged far behind in cost recovery and the amount of subsidy was much higher. Most senior civil servants in criticizing local governments standards applied a hypothetical counterfactual instead of the reality of the situation prior to 2001. The analytic conclusion was, therefore, not surprising. At the same time, the increasing concern with deteriorating standards was perhaps indirect evidence that some local initiatives and norms were taking shape.

#### 4.6. Decreased Translucency of Offices

A major change brought about by decentralization and the creation of a large number of elected councils was the demystification of much of the public sector. For the first time, large sectors such as education, health, road building and maintenance, water and sanitation, agriculture extension and, in some cases, land administration became open to review by local councils. The centrally managed civil service had been accustomed to management in the name of the people through the concept of public interest. Now, elected councils' oversight and inputs in major sectors caused hitherto undefined public interest to wither, replacing it with the legitimized intervention of people's representatives.

However, instead of this becoming the engine for civil service activities, direct policy instructions and citizen choices emerging from local political processes provided directions. This process was not linear or error free. It was commonly reported that councilors did not clearly understand what local departments could do. Many councilors complained of a lack of authority, as they could not have teachers transferred when they so desired. In time, this may translate into learning the ways in which departments work, but compared with the district administration of a decade ago, it was still a major change. Citizens became increasingly aware of what different departments did and did not do, generating pressure on the civil service.

In responding to the new demands for service delivery, a fresh set of skills was required. The strong suit of implementation in Pakistan was the central management of training. This helped avoid the pitfalls of decentralized management of training, which might otherwise lead to differential outcomes.<sup>13</sup> The training and retraining of civil servants during this period remained unaffected by the new job descriptions. Only training that credibly addressed the need for new skills for budgeting and financial management was carried out.

#### 4.7. Exposure of Performance at Multiple (Lower) Levels

An unintended consequence of devolved government was the creation of windows of observation that highlighted civil service performance. Not only did districts and TMAs became stages on which civil servants could transparently perform their roles with visible outcomes, but within each of them individual offices were now visibly responsible for sectoral performance and outcomes. Indirect evidence of this consequence of devolved government was the public debate surrounding service delivery failures. Senior provincial civil servants again served as an indirect barometer of the changing outlook. Earlier, only those

<sup>&</sup>lt;sup>13</sup> For a study of this issue with reference to the Ukraine, see Witesman and Wise (2009). They attribute centralization to the higher uptake of training toward democratization and planning capacities.

who had worked in planning and development posts would be concerned with service delivery. Others steeped in general management and its higher concerns would have hardly found it sufficiently interesting or worth their while.

The Social Action Program 1992–2000, for example, could not find champions in deconcentrated offices of civil administration despite repeated attempts to engage them. From 1997 to 1999, in the NWFP, the task of commissioning new schools was decentralized to regional commissioners. Over three years, the purchase of furniture, and obtaining electricity connections and water supply progressed very slowly. In 1996– 1999, the Government of Punjab developed a proposal to post civil service officers as additional deputy commissioners for literacy. This newly created position was designated thus to connect it prestigiously with the civil administration in order to woo civil officers into the management of education department. Despite these efforts, the positions remained unattractive and education did not measure very highly on the list of desirable civil service positions.

The local government reform of 2001 brought about a material change. District positions were solidified and made responsible for service delivery. The largely moribund public order functions of the civil service were assigned to the police as they desired. Without necessarily agreeing with the merit of this abolition, the new institutional arrangement formally conglomerated responsibilities and certain functions under the DCO. This spurred new interest in service delivery. District managers under the local government scheme demanded training to equip them to serve in the enhanced role of service delivery management since their earlier training had focused almost exclusively on the administration of criminal and land administration laws. Provincial departments and local councils demanded improvements in service delivery in measurable ways. Civil service performance methods were given the opportunity for tangible performance to be rewarded and linked with career development. The system, however, did not avail this opportunity.

With the local government reforms, new offices for functions such as finance and planning were created at the district level. Officers with five to eight years of experience were assigned to these offices. The new position of EDO Finance and Planning was a culmination of the efforts of the 1990s to create offices for development planning at the subprovincial level. Under the deconcentrated arrangement, planning officers were created in the provincial divisions, one for each group of districts. The planning offices reported to the Planning and Development Department and did not have the capacity to carry out sectoral planning. They performed limited functions relating to project appraisal, and carried a wider mandate of planning for the district. Earlier officers with this work experience would have had relatively subordinate roles in the Planning and Development Department. The new offices created a demand for careful budgeting processes and decisions at the local level. This followed the argument that public management follows budgeting structures rather than the other way round.<sup>14</sup>

Officers were, however, posted without much preparation. Those with experience of working in the Planning and Development Department were technically qualified for project appraisal and basic capital budgeting, while others with a civil administration background were not well equipped for the role. The new offices did not, therefore, fulfill their potential. The departments continued to work through vertical programs, centralizing much of the planning function assigned to local governments. Compared with the district capital budgets, vertical programs continued to channel larger resources into local functions and their development (Cyan & Porter, 2006).

#### 4.8. Comparative Evaluation and Yardstick Competition

The civil service was unaccustomed to comparative evaluation. Under centralized management, district administrations were, at best, compared in terms of revenue recovery and, earlier, in the disposal of criminal cases. Other administrative aspects were not compared. However, after the local government reforms, districts were compared in terms of education and health outcomes.

A key motivation for district-level comparisons was the insertion of provincial finance commissions in the local government ordinances in July 2002. For the first time in Pakistan, the principle of rational distribution of resources at the subprovincial level was recognized. This generated a demand for district-level statistics and performance measures. The Federal Bureau of Statistics, which had considered compiling district-level survey statistics a very difficult task in 2001, started producing the district-disaggregated Pakistan Living Standards Measures survey by 2008. Other surveys such as the Multiple Indicator Cluster Survey showed different districts' health outcomes in stark relief. Districts also produced education statistics.

<sup>&</sup>lt;sup>14</sup> See Rouban (2008) for a discussion on the effects of decentralization in this regard with reference to the 1986 decentralization reforms in France.

DCOs were held accountable for district performance in education and health, largely at province-level meetings. The horizontal yardstick competition that started with the publication of district statistics for each sector played a stronger influence, however. A civil service that had been used to meeting staid rules and standards in pursuit of an undefined public interest was now exposed to chasing tangible numbers. This generated a demand for management skills, initiative, planning, and decision-making that had earlier been confined mostly to public order situations.

#### 5. Conclusion

The civil service in Pakistan is perceived as an organization capable of effectively implementing government policy and programs. Under decentralization, it was exposed to the twin challenges of meeting programmatic outputs as well as responding to local democracy. It is not necessary to assume that central programmatic goals are very different from the choices that emerge from local democracy. Political process at the local level may vary inputs, levels, the mix of services, and timing. It may enforce a tighter or looser accountability for performance. On the whole, local democracy, where variety is certain, reduces certainty for a centrally attuned civil service. Devolution in Pakistan from 2001 to 2009 changed structures as well incentives for civil servants. In responding to these, civil servants' choices varied from adapting to their new environment to reshaping it. The latter can be seen a form of optimizing behavior rebalancing central versus local control through civil service rules, emerging norms, relationships, and tenures.

Decentralization may change structures and affect incentives for central civil servants in local jurisdictions. On average, civil servants respond by pursuing career paths under changed circumstances. When the process of decentralization is not sufficiently aware of the details, civil servants may redefine decentralization mechanisms in ways that are imperceptible but important. In the case of Pakistan, the redefinitions continued through this period through details of rules and other mechanisms. Finally, decentralization outcomes differed from those initially intended. Local innovation was curtailed due to central influences. Civil servants found their incentives linked with central authorities and program objectives. At the same time, local governments remained weak and unable to benefit from civil servants' expertise and harness it toward locally defined sectoral priorities.

#### References

- Asian Development Bank, UK Department for International Development, World Bank. (2004). *Devolution in Pakistan*. Islamabad, Pakistan: Authors.
- Brinkerhoff, D. W. (2008). The state and international development management: Shifting tides, changing boundaries, and future directions. *Public Administration Review*, *68*(6), 985–1001.
- Cole, A., Jones, B. J., & Storer, A. (2003). Inside the National Assembly for Wales: The Welsh Civil Service under devolution. *Political Quarterly*, 74(2), 223–232.
- Cyan, M. R. (2009). *Contract employment policy review*. Unpublished report prepared for the Asian Development Bank.
- Derlien, H.-U. (2003). Mandarins or managers? The bureaucratic elite in Bonn, 1970 to 1987 and beyond. *Governance*, *16*(3), 401–428.
- Evans, A., & Manning, N. (2003). *Decentralization: A review of staffing practices in eight countries*. Draft paper prepared for the World Bank, Washington, DC.
- Goodwin, M., Jones, M., & Jones, R. (2005). Devolution, constitutional change and economic development: Explaining and understanding the new institutional geography of the British state. *Regional Studies*, *39*(4), 421–436.
- Gulrajani, N. (2010) New vistas for development management: Examining radical-reformist possibilities and potential. *Public Administration and Development*, 30(2), 136–148.
- Lange, M. K. (2004). British colonial legacies and political development. *World Development*, 32(6), 905-922.
- McCourt, W. (2007). Impartiality through bureaucracy? A Sri Lankan approach to managing values. *Journal of International Development*, 19, 429–442.
- McGregor, E. B., Jr. (1974). Politics and the career mobility of bureaucrats. *American Political Science Review*, 68, 18–26.
- Meyer, R. E., & Hammerschmid, G. (2010). The degree of decentralization and individual decision making in central government human

resource management: A European comparative perspective. *Public Administration, 88*(2), 455–478. Ongaro, E. (2008). Introduction: The reform of public management in France, Greece, Italy, Portugal and Spain. *International Journal of Public Sector Management, 21*(2), 101–117.

- Pakistan, Ministry of Education, and UNESCO. (2003). *Quality of primary education in Pakistan*. Islamabad, Pakistan: Authors.
- Parry, R. (2005). The civil service response to modernization in the devolved administration. *Financial Accountability and Management*, 21(1), 57–74.
- Parry, R. (2008). Changing UK governance under devolution. *Public Policy and Administration*, 23(1), 114–120.
- Peters, B. G. (2008). The Napoleonic tradition. *International Journal of Public* Sector Management, 21(2), 118–132.
- Punjab, Services and General Administration Department. (2004). *Punjab* management service rules 2004. Lahore, Pakistan: Author.
- Pyper, R. (1999). The civil service: A neglected dimension of devolution. *Public Money and Management*, 19(June), 45–49.
- Rouban, L. (2008). Reform without doctrine: Public management in France. International Journal of Public Sector Management, 21(2), 133–149.
- Ryan, J. J. (2004). Decentralization and democratic instability: The case of Costa Rica. *Public Administration Review*, 64(1), 53–67.
- Sindh, Local Government Department. (2001). *Sindh local government ordinance* 2001. Karachi, Pakistan: Author.
- Williamson, T., Ahmad, M., & Smith, S. (2005). *Improving devolved social* services in Punjab and NWFP. Islamabad, Pakistan: Asian Development Bank and UK Department for International Development.
- Witesman, E. A., & Wise, C. R. (2009). The centralization/decentralization paradox in civil service reform: How government structure affects democratic training of civil servants. *Public Administration Review*, 69(1), 116–127.
- World Bank. (2004). Civil service reform and decentralization. Retrieved from http://www.ciesin.org/decentralization/English/Issues/CSR.html