

*The Quaid-i-Azam Lecture*

**Economic Reforms in Pakistan: One Step Forward,  
Two Steps Backwards**

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In 1998 I was invited by Dr Sarfraz Qureshi, the then Director of PIDE to deliver a lecture on "The Political Economy of Reforms: A Case Study of Pakistan".<sup>1</sup> This lecture was subsequently published by PIDE as a monograph. A year later, in December 1999, I had the honour of becoming the Governor of the State Bank of Pakistan and actually participated actively in the formulation and implementation of economic reforms. During the six year period of public policy making I realised that my knowledge about the political economy as manifested in my PIDE lecture was incomplete. The narrative was more complex than I had developed as an outsider.

Now, six years later after my retirement from the State Bank of Pakistan I again reflected upon this topic as an observer and analyst rather than a participant. I realised that my learnings have become much richer by applying these different prisms—those of an international development economist, a public policy-maker and now an independent analyst. I am grateful to Dr Rashid Amjad and Dr Musleh ud Din and their colleagues at PIDE for providing me this opportunity to share these learning with my colleagues, peers and other scholars present here today.

The political economy of economic reforms and structural adjustment has become focus of growing attention in the literature drawing at the inter-disciplinary tools of analysis and cross-country comparative perspectives. Detailed case studies of country situations do throw useful insights which are not captured through cross-country studies. The key question that is explored by this group of researchers is: if policy and institutional reforms are associated with high economic pay offs, then why are these reform programmes not sustained and implemented consistently? Why are they derailed? I would like to focus the discussion on Pakistan only and address the following questions:

Why is Pakistan slipping relative to other developing and emerging countries?

Why is the record of reforms so poor and uneven?

Why are policy and institutional changes not sustained over-time?

Before I address these questions I should establish the case as to why economic reform should take place in the first instance. If a country is an equilibrium state with

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<sup>1</sup>Husain, Ishrat (1999). *The Political Economy of Reforms*. Islamabad: Pakistan Institute of Development Economics.

markets functioning well, macroeconomic balances in place institutional framework strong, microeconomic distortions not affecting efficiency of resource allocation then there is hardly any need for economic reforms or institutional restructuring. But if changes in these pre-conditions have displaced the equilibrium then the reforms become necessary to bring the economy back to a new state of equilibrium. The changes in the pre-conditions can be triggered by Unfavourable external (terms of trade, interest rate, abrupt withdrawal of capital flows, worldwide recession) or domestic shocks (large scale foreign borrowing, cumulative effect of unsustainable policies). The shocks can be sudden, abrupt, discrete and large or they can cumulate through slow, gradual, small and continuous changes. These can be anticipated or unanticipated. As I would show the contents of economic policy reform do vary with the passage of time as the intellectual and academic thinking and research findings change in the light of new evidence and cross country experiences over time. For example, the recent IMF mantra<sup>2</sup> is that fiscal multipliers are quite large and therefore expansionary fiscal policies are to be encouraged to stimulate economic growth. Until recently, the conventional wisdom advocated by the Fund was that fiscal consolidation i.e. contractionary fiscal policies were the cornerstone of sound economic management.

There is a widely shared consensus about the nature of reforms that Pakistan should embark upon. This consists of two components stabilisation and long term structural reforms. Under the first component the economy has to be stabilised with the help of fiscal consolidation, widening of tax net and mobilisation of domestic resources, cutting down the losses of state owned corporations, curtailing wasteful development expenditure and assigning priority to removing supply-side bottlenecks such as energy and infrastructure, keeping inflation under control and maintaining exchange rate stability. The second component requires governance reforms in the structure, processes and human resource policies of the Federal, Provincial and Local governments, taxation and tariff reforms, removing microeconomic distortions such as issuing selective Statutory Regulatory Orders (SROs) for specific firms, liberalising and deregulating goods and factor markets, strengthening regulatory architecture, promoting market competitive forces and building human capital particularly in science and technology.

We should now examine the record of last sixty five years in respect to these reforms.

#### THE RECORD 1947-2012

Last five decades have witnessed a remarkable change in the economic fortunes of various countries and continents. The poor, underdeveloped, developing and emerging countries that account for two-fifths of the world population have, by and large, undergone structural transformation of the magnitude that is unprecedented and was not anticipated. The economic power equilibrium is gradually shifting from the advanced countries to developing countries. The distinction between advanced and developing, North and South, First World and Third World is becoming redundant and irrelevant. For the first time since cross-country data on poverty is being compiled all the six continents have recorded a decline in the incidence of poverty. The Millennium Development Goal of

<sup>2</sup>International Monetary Fund (2012) *World Economic Outlook*. Washington, DC: IMF.

reducing poverty by one half has been achieved five years ahead of 2015. The two lagging regions of the World-South Asia and Sub-Saharan Africa-are growing rapidly and lifting millions out of poverty.

In the 1960s Pakistan was considered as a model developing country and its manufactured exports were higher than those of Thailand, Malaysia, Philippines and Indonesia. While our larger neighbour was stuck with 3 percent growth rate Pakistan was averaging six percent annual growth rate. The Eastern wing of the country felt left behind in this rapid progress and decided to become independent in 1971. At that time Bangladesh's economic prospects were dubbed by the international community in most uncharitable terms. In the 1970s Viet Nam was completely devastated by a prolonged war fought against a super power.

Advance the clock forward. Forty years later not only all the four East Asian Countries mentioned above have become economic power house but India, Vietnam and Bangladesh-way behind us in almost all the indicators-have not only caught up but are surging ahead. India, despite its large population and uninterrupted period under democracy, has become one of the drivers of global economic growth momentum. A slowdown in Indian economy is considered with serious trepidation by the rest of the world.

Why has Pakistan ended up in its current economic condition? Conspiracy theories galore that the Americans, Jews and Indians have ganged up on us to destabilise the country. They have got us embroiled in unnecessary wars in Afghanistan, promoted all kinds of ethnic, sectarian, civil-military, religious divisions in the society, made us dependent on foreign aid (IMF and the US particularly) and deprived the country of its sovereignty in decision making. According to them, the last decade has seen intensification of these nefarious activities and the recent economic regression faced by us can be directly attributed to the intensity of these efforts.

The problem with this explanation is that it assumes that we a proud nation of 180 million people are so naive, gullible, easily amenable to manipulation by others and external influences that we are unable to distinguish what is right from the wrong for ourselves and our children.

Setting aside this popular myth, let us try to explore other plausible explanations for this relative economic decline of Pakistan. For this we have to examine the cumulative experience of economic growth and development in various periods of Pakistan's history keeping the changes in academic thinking in different eras in the background.

Economic policies are underpinned by certain intellectual precepts, axioms; theory and evidence. This body of knowledge does not remain static and keeps on changing with the passage of time and emergence of new evidence. The post-colonial independence period of most developing countries was marked by a group of charismatic political leaders who were suspicious of the policies and advice of their erstwhile rulers and wanted to keep themselves at a distance from what the colonial masters were preaching. This period also coincided with the appearance of a new field in economics called Development Economics that focused on the problems of newly independent countries. The academic tradition at that time highly embedded in Post-Keynesian Economics came

<sup>3</sup>World Bank(2002) *Development Policy Review*. Washington, DC: World Bank.

up with the notion of 'Balanced Growth', 'Big Push', 'Controlling Commanding Heights', 'Critical minimum effort', 'Export elasticity pessimism' and 'low level equilibrium trap'. The end result of this strand of literature was advocacy of a dominant role of the State in planning, directing and managing the economy. Under five year plans, State-owned enterprises setting-up new industries became the main instruments of **resource allocation. It was argued that agriculture exports were inherently unstable and could keep the countries in "low level equilibrium" and hence Import Substituting Industrialisation led by the State owned enterprises would maximise economic growth "with emphasis on production of capital goods and primacy to heavy industry" For these embryonic industries to achieve industrial traction they had to be protected from import competition, provided subsidised capital and foreign exchange at preferential exchange rate. The impressive success of Non-Colonial Soviet Union in achieving high rates of economic growth acted as a validation for this inward looking strategy.**

Pakistan in the 1960s did not follow this strategy but had a mixed economy model in which the state set up the industries but then divested them to the private businesses. Profit motive then inspired these private businessmen to invest and expand in other sectors of the economy. **Economic reforms were initiated in Agriculture, Education, Legal, Land and other Trade and Taxation at the same time. The initial results were quite spectacular and the model attracted the attention of outsiders-both the academics as well as policy-makers from other countries.** One of the distinguishing features of the Mixed economy model was that Pakistan had a strong bureaucracy that guided and directed the private sector. Planning Commission of the 1960s was a powerful, technocratic institution assisted by foreign economic experts.<sup>5</sup> Corruption and parochial interests had not permeated the higher level decision making to the degree that subverted the economic progress or institution building,

The academic influence of the state-led industrialisation and control on the commanding heights of the economy by the state spilled over in Pakistan in the late 1960s and in the early 1970s and gave ammunition to the political opponents of the regime. The slogan of "22 families"<sup>6</sup> controlling the wealth of the country and the hue and cry of regional economic disparities from the professional economists of the Eastern wing' strengthened the movement against Ayub Khan. The 1965 War with India also **gave a sense of vulnerability to the people of East Pakistan and economic momentum also suffered a setback.** This combination of events therefore led to a nationwide agitation and subsequent overthrow of the Ayub regime. Along with him the incipient economic and sectoral reforms that were beginning to make positive difference were also **overturned. These reforms would have taken at least another five years to take firm roots.**

**The separation of East Pakistan and the ascendancy of the socialist leaning Pakistan Peoples' Party in power in the new Pakistan gave an abrupt death knell to the reforms of the 1960s.** The PPP, interpreting the economic reforms policies of 1960s as responsible for

<sup>4</sup>For a review of the post World War II academic thinking please see Shahid Yusuf (ed.) (2009) *Development Economics through the Decades*. Washington, DC: The World Bank.

<sup>5</sup>For an insider's review depiction of the planning process in Pakistan see Parvez Hasan, "the Heydays of Planning in Pakistan (1965-70)" in *My Life My Country* (Ferozson Pvt. Ltd.)

<sup>6</sup>This slogan gained respectability as it was coined and popularised by none other than the then Chief Economist of the Planning Commission, Dr Mahbub-ul-Haq.

<sup>7</sup>The *Pakistan Development Review (PDR)* issues of the 1960s contain most of these articles.

concentration of wealth and regional income inequality, and seeing the paradigm shift in academic thinking about development economics turned the tables. All major industries, banks, insurance companies, educational institutions were nationalised overnight without adequate thinking or preparation. Private investment in these industries and sectors was prohibited and the intrusive hands of the bureaucrats in granting licenses, permits, financial resources became too entrenched. Risk taking and enterprise took a back seat and bureaucratic controls, inertia and malfeasance dominated the economic landscape. Government officials with no training or experience in running business were entrusted with the management of multimillion rupee large enterprises so critical for the rest of the economy. Bereft of market competitive pressures and preoccupied mainly with appeasing their political bosses they committed resources to ventures and activities that were neither economically feasible nor commercially viable. In the name of redistribution to the poor, economic growth was sacrificed making the poor worse off. The nationalisation of banks and the proliferation of government-owned and managed development financial institutions (DFIs) opened another major avenue of patronage. Debt capital was provided by these government-controlled institutions to the politically influential borrowers who never repaid the loans. Through over-invoicing, collusion with bank officials and manipulations of accounts these state-spawned industrialists financed their own equity share of the industry (other than those reserved for the state owned enterprises) from these loans. Once the sponsors had recovered their capital several times over, the enterprises were abandoned as 'sick industries' and left in the tender care of the creditors. By the end of the 1990s, more than half of the non-performing loans advanced by the Nationalised Commercial Banks (NCBs) and DFIs were blocked in these sick industries. The losses incurred by the banks and DFIs were, in turn, borne by the tax payers.

This was also a period in which some desirable reforms were also initiated. External trade regime was liberalised and the multiple exchange rate system was replaced by a more unified exchange rate with an effective devaluation of 25 percent for exports and 40 percent for imports. The depreciation of the exchange rate produced a large supply response and helped to divert goods previously exported to East Pakistan to international markets. However, by the 1975, the competitive effect of devaluation was eroded by inflation.<sup>8</sup>

The military regime that took over in July 1977 and lasted until December 1988 did not denationalise the industries or banks or institutions taken over by the previous regime. They carried on with the business as usual with the exception that new investment and industrial expansion was opened up to the private sector. But the continued reliance on state-owned enterprises and nationalised banks created distortions and inefficiencies in the economy. Although growth rates did pick up to the level of the 1960s the structure of the economy was no different from that inherited from the previous regime. The Middle East Oil boom that started in 1970 also favoured Pakistan as the workers employed in those countries remitted foreign exchange which eased the balance of payments situation. The war in Afghanistan to throw out the Soviets also proved to be a boon for Pakistan as international aid flows relaxed the foreign exchange and budgetary constraints. The compulsions for domestic policy reforms therefore became weak.

<sup>8</sup>Naqvi, S. N. H. and Khawaja Sarmad (1997) *External Shocks and Domestic Adjustments* (Oxford University Press).

By the 1980s there was a shift in economic thinking arising from disenchantment with the state-led model of inward looking import industrialisation strategy. "The 1970s were a decade of creeping disillusionment not development". The blame for the crisis of the 1970s was laid primarily on domestic policy errors due to distorted prices. The message distilled from the East Asian economies was that market-guided industrialisation within the milieu of a relatively open economy could result in rapid growth if industries were able to compete in export markets.<sup>10</sup> Empirical cross country studies on foreign trade regimes<sup>11</sup> in developing countries provided the intellectual arguments for abandoning the strategy of Import Substituting Industrialisation. Elements of a new consensus began to appear that emphasised monetary restraint, keeping real interest rates positive, fiscal deficit at a sustainable level, real exchange rate that improved international competitiveness and promote exports, reducing the stock of external debt to manageable levels and structural reforms such as financial sector reforms, remunerative producer pricing; trade liberalisation and tax reforms to make the economy flexible and efficient.

This package of outward-oriented private sector-led development strategy known as Structural Adjustment Programme was widely promoted by the World Bank and International Monetary Fund (IMF). The Washington consensus<sup>12</sup> that weaved the above mentioned elements of policy reforms became the dominant paradigm in developing and emerging economies for the next two decades. Pakistan entered into a programme of this type with the IMF in 1988. This was followed by several other programmes in the decade of 1990s—none of which was completed. Nawaz Sharif Government in 1991 introduced a major reform programme through Economic Reform order consisting of liberalisation, privatisation and deregulation. Foreign exchange regime was liberalised, investment controls were relaxed, state owned enterprises were privatised, and incentives were provided for domestic and foreign private investment.<sup>13</sup> But it is argued that political instability and poor governance acted against these reform efforts. Instead, the greater openness of the economy contributed to the financial crisis.<sup>14</sup>

At the same time, the Congress Government with Dr Manmohan Singh as Finance Minister introduced similar reforms in India. These reforms did not make much impact until they were adopted and continued by the BJP Government that came to power after defeating the Congress party. Indian and global investors realised that the Licence Raj was over and the reforms undertaken in 1991 were irreversible. Nothing of this sort happened in Pakistan although Benazir Government did not reverse these reforms they were unenthusiastic in owning and implementing them because the credit would have gone to their opponents.

Shahid Yusuf- *ibid*.

<sup>10</sup> World Bank (1993) *East Asian Miracle* (Washington, D.C.).

<sup>11</sup> A multivolume study of Foreign trade regimes in several developing countries including Pakistan was commissioned and produced by OECD, Little I.M.D, Scitovsky and Scott.

<sup>12</sup> Williamson, John (1990) *Latin American Adjustment: How much has Happened?* (Washington, – C. Institute of International Economics).

Husain, Ishrat (1999) *Pakistan: The Economy of an Emerging State* (Oxford University Press).

<sup>14</sup> Hasan, Pervez (1998) *Pakistan's Economy at Cross Road* (Oxford University Press).

<sup>15</sup> For a comparative analysis of Structural Reforms in India and Pakistan, see Ishrat Husain and Rajiv Kumar, "Comparing Structural Reforms in India and Pakistan". In Philippa, *Policy Reforms in South Asia* (Routledge De) (ed) (2012).

The period 1988-99 saw frequent changes in government because of four general elections with four interim governments. None of the elected government lasted more than two years on average. The quest for outmanoeuvring the other political party was the **main preoccupation of the successive governments in the 1990s...Economic management** took a back seat. Benazir Government introduced a policy to bring private investment into power generation sector. But this policy was put in the cold storage and inquires against the Independent Power Producers (IPPs) were initiated soon after the Government was dismissed. Had that policy been continued uninterrupted over time along with governance reforms in the energy sector we would not have faced the supply shortages which we are facing today.

The Musharraf Government that assumed power in October 1999 did undertake major economic reforms in the six year period between 2000 and 2006 which slowed down in 2007 due to the impending elections and confrontation with the judiciary. The intensity and frequency of the reforms were high in the initial three year period before the transition to the elected government in end 2002.<sup>16</sup> Pakistan successfully met all the performance criteria under the Stand-by programme and the Poverty Reduction and Growth Facility (PROF) negotiated with the IMF. The major areas of successful reforms were **Tax and Tariff, Financial Sector including the privatisation of nationalised commercial banks, breaking up the monopoly of Pakistan Telecommunication Corporation and opening up the sector to the private sector and Promotion of Higher Education.** Devolution to Local Governments and Police Reforms were highly significant but got embroiled in controversy, back tracking and power struggle between the Provincial Governments and Local Governments. Accountability-transparent and effective-acted as a powerful deterrent against corruption and misuse of public offices in the first three years. But it fell victim to selective use of National Accountability Bureau (NAB) for winning political allies and coercing others to fall in line. Actions were limited only to those who stayed in the opposition. The action against judiciary and the compromises made under the National Reconciliation Order (NRO) precipitated the downfall of the PML-Q led regime at the 2008 general elections. President Musharraf had to resign in August 2008.

The newly elected government that came to power in March 2008 started out as a coalition of all major political parties of the country. This sparked some optimism that the country would be able to steer itself in the right direction. But this coalition lasted for a few months only. Once their common objective of removing President Musharraf from the office was achieved, the coalition fell apart and the survival of the Government became the major policy goal of the majority party. The lingering crisis became quite unmanageable in 2009 forcing Pakistan to approach the IMF in November 20'09. A 'homegrown' reform package consisting mainly of mobilising additional-taxes to bring fiscal deficit under control was agreed upon. Lack of political consensus on General Sales Tax (GST) and Agriculture Income Tax (AIT) among the coalition partners led to the breakdown of the agreement with the Fund but after incurring a heavy financial obligation of \$8 billion to be repaid in 2012 and 2013. Economic growth has been anaemic in the 2008-12 period, public finances have been heavily distressed, and huge

<sup>16</sup>For detailed catalogue and analysis of these reforms, see Ishrat Husain (200) *Economic Management in-Pakistan 1999 to 2002* (Oxford University Press).

borrowing from the banking system to finance widening fiscal deficit resulted in double-digit inflation. Exchange rate depreciated steeply and private domestic and foreign investment dried up. Narrow political considerations of patronage and self have not allowed economic reforms make any headway except the devolution of powers from the Federal to the Provincial Governments under the 18th Constitutional amendment and an enlarged share to the provinces out of Divisible Tax pool under the NFC award. The unintended consequences of these well-meaning reforms have generated some dislocation in the short term. The devolution remains incomplete as the local government reforms have been put on hold.

The above historical survey of the economic reforms and structural policy changes since 1960s to date shows a highly erratic and volatile path. Some analysts have hypothesised that although over the last four decades Pakistan has experienced over 5 percent average GDP growth rate, industry has not been the main engine of Pakistan's growth which has led to, on average, a low and variable growth rate.<sup>17</sup> Meaningful actions with high potential of success were initiated and carried forward some distance. But as soon as a new government—democratic or military—came to power these policies were either reversed, backtracked or not implemented fully. The expected benefits were either postponed or accrued only in dribs and drabs. We, therefore, have to turn to understand the factors that can shed some light in explaining this uneven-one step forward, two step backward record of economic reform implementation.

#### FACTORS IMPEDING SUSTAINABILITY OF REFORMS

One of the critical success factors for reforms is its ownership by the country. In Pakistan with the exception of few occasions, there has never been a broad based ownership of the reforms nor has the reform package been designed and formulated by the economic managers of the country. In almost all cases (except two programmes entered with the IMF that were successfully completed) the main motivation has been to secure infusion of short term liquidity to avert the impending foreign currency crisis. The International Financial Institutions (IFIs), on the other hand, wanted the country to undertake both stabilisation measures and structural reforms that could set the country on the right direction. Pakistan, as a prolonged user of the IMF resources<sup>18</sup> got addicted to this infusion at regular intervals of time. As soon as the liquidity situation improved Pakistan got off the track after receiving a few initial tranches because the Governments found the tough corrective measures agreed with the IFIs politically difficult to implement. Pakistan acquired the reputation among the International Financial Community as a one-tranche country. In a few instances where some painful adjustments had to be made, the policy-makers, in order to avoid the blame, deflected the responsibility towards the IMF. Structural reforms came to be associated in the public mind with the conditionalities of the IMF and IFIs. The political resistance to

<sup>17</sup>Pakistan (2012) *Industrial Policy: Its Spatial Aspects and Cluster Development*. (Islamabad, Ministry of Industry).

<sup>18</sup>A historical review of Pakistan's relations with the IMF can be found in Independent Evaluation Office (2002) *Evaluation of Prolonged Users of IMF Resources* (Washington, D.C. International Monetary Fund). A more recent analysis appeared in Ishrat Husain (2010) *Pakistan's Experience with the International Monetary Fund (IMF) 2000-2004 Business Review* Vol. 5, No. 1 (Karachi, Institute of Business Administration).

implementing quite sensible measures that, otherwise would have helped the country, became fierce as they were considered an externally dictated imposition. This entanglement of what should have been done by the policy-makers in the first place to set the economy on the right path with a popularly held perception that these difficulties and pain were being caused under external influences did not allow Pakistan to build a **consistent and credible track record. The lack of domestic ownership translated into** highly fragile implementation of reforms. There was hardly a genuine and consistent desire to bring about long-term improvement in domestic economic performance.

There is no evidence from the country studies that external actors have tipped the political scales in favour of reform. When the domestic institutional and coalitional environment was unfavourable, lending in such settings postponed adjustment. Studies clearly show that providing support to committed government did, however, increase the **domestic political credibility of the reformers.**<sup>19</sup>

Another factor impeding the progress on reform process, alluded earlier has been the reversal, discontinuity, uneven and lacklustre implementation record. A flip flop in design and implementation is the only feature that has appeared consistently irrespective of the nature of the political regime. Military, democratically elected, quasi-democratic, authoritarian and mixed technocratic-elected have all been found guilty of this behaviour. The time period for the reforms to produce the desirable results goes beyond the normal five year electoral cycle. Assume that the Government that comes to power in 2013 earnestly embarks upon a set of economic reforms and makes some progress in the right direction. But the chances that a successor government that comes in its place in 2018 and had been opposed to the outgoing political party will reverse, by pass or show indifference towards these reforms and associated investments are quite high. With the loss of momentum the country would be worse off as all the costs have been incurred but when the time comes for reaping the dividend the pot has been broken. **The new government will start its own journey ab initio without building on the momentum, nurturing and bringing to fruition the reforms that they had inherited. It is hard to fathom as to why the successors do not capture political credit for themselves by completing the process.** Let me illustrate this point with the example of Higher Education Reforms. Had the Government in 2008 decided to continue and support the ongoing reforms initiated in **2001 by the previous regime the access, quality and output of all universities by 2013** through the cumulative gains of the previous 12 years would simply have been astounding. The ruling party would have taken credit for this performance at the time of elections. Similarly, if instead of abolishing the entire Local Government system the present regime had brought about changes to improve the system they would have earned votes of grateful beneficiaries of the devolved system of delivery of basic public services in 2013: But these examples demonstrate that there has been a setback to both tertiary **education and delivery of basic public at the grass root level and the country is worse off in both these areas. The ruling parties lost an enormous opportunity of translating this** national loss into a political gain for themselves and wide spread benefits to the people of Pakistan. There is also a more deep rooted damage that is done by reversals, and discontinuities of reforms, policies and investments. Credibility and indifference by those committed to reforms sets in and the public-at-large also does not believe the political

<sup>19</sup>Haggard S. and Steven Webb (eds) (1994) *Voting for Reform* (Oxford University Press).

leaders when they announce their own pet policies or reforms or projects. They have heard it all before but have never seen, with some, exceptions, any tangible and perceptible results. The media, in its usual negative mode, further adds fuel to the fire and **the pace of implementation, is retarded or slowed down. Of course, in some instances** there is a time inconsistency problem also. The pains caused by initiating most of the reforms or policy changes are incurred upfront while the benefits accrue over time. The political regime which has to undertake these reforms and thus bears the costs is reluctant because they risk losing popularity by enforcing harsh and painful measures. According to their calculation they have everything at risk while nothing to gain politically within the span of the electoral cycle. They apprehend that they would look bad in the eyes of the public as the beneficiaries of these reforms will attribute the benefits, when they occur, to their opponents who may be in power at that time. This asymmetry in the timing of the incurrance of costs and the appropriation of gains from reforms, in so far as the opponents reap the political dividends and take credit for them politically while the party initiating these reforms bears all the backlash and criticism, therefore, becomes a stumbling block.

Third, each set of reforms has winners and losers.. The losers from reforms are **identifiable, immediate and cohesive. If subsidies are eliminated or imported goods become expensive or wages decline and public sector employment is either frozen or cut down** as a result of reforms, those presently benefitting from these policies would raise hue and cry immediately. They will coalesce, organise public demonstrations, approach their elected representatives, **coerce the media into giving them wide coverage and create** difficult conditions for the ruling party. At times they could become unruly and resort to violence or disruption of public services. Let us take two examples to illustrate this point. The retail and wholesale traders (18,2 percent of GDP) in Pakistan account for as much as agriculture sector (20 percent) in national income. Out of almost 9 million persons employed in this sector only a miniscule proportion pays any tax to the exchequer. Per capita earnings in this sector are about Rs 400,000 annually-much above the income tax **threshold of Rs 350,000. It can be safely estimated that at least one million of those** employed in this sector have taxable incomes above this threshold with the potential to add atleast Rs 60 billion to tax revenues. But every time any attempt is made to bring them into the tax net either by the military government or the democratic government they go on a shutter down..strike disrupting economic activity in the country. The opposition parties and the media come out openly in their sympathy and support. **The Government has to back down and let them remain out of the net. The losers from the tax reforms** are therefore alive and kicking but the winners are unknown, diffused and likely to emerge in the future. They will never group together and come in the forefront in support of reforms. Nowhere in the world where reforms have been successfully implemented there was an identifiable, homogenous group that publically agitated or **demonstrated in favour of reforms such as widening the tax net. It is always a visionary** and committed leadership that weighs the benefits and costs and takes the initiative. To him or her the winner from the tax reform will be the country's fiscal situation as deficit will be brought down, external and domestic borrowings will be reduced and inflation **will be controlled. But have we ever heard of public demonstrations in favour of fiscal discipline.**

The other example is that of privatisation of State-owned enterprises (SOEs). A country that is allocating only 1.7 percent of GDP on education is spending about 2 percent on the losses of SOEs. It is not only the budgetary impact but misallocation of **resources, high priced products to consumers, poor service standards etc.** But privatisation has become a dirty word in Pakistan because the political leaders find them a convenient vehicle for providing employment to their supporters and enjoying many perks conferred upon by them by these enterprises. The very mention of privatisation brings together the alliance between the employees of these SOEs and the politicians. The losers fear loss of employment and loss of privilege respectively and coalesce together to **subvert any attempt to restructure or privatise these enterprises. The winners from this reform will be millions of out-of-school children in the backward districts and regions of Pakistan who will be able to get education and a decent livelihood in the future. Are these children, or their parents going to come out on the streets in favour of privatisation?**

The fourth factor is the capacity issue of implementing the reforms. Civil services inherited from the British era performed extremely well in the early period of Pakistan's history. They were competent, diligent, dedicated and honest. Millions of refugees from India were settled, new businesses and industries were established as the Hindu owners left the country, basic public services were restored throughout the nook and corner of the country **law and order and security of life and property were assured and institutions of governance and economic development were setup and nurtured.**

The Planning Commission in the 1960s enjoyed the stature and autonomy and had **the competence to initiate, and monitor the implementation of various reforms. In China,** this task has been performed by the National Development Reform Commission (NRDC) aided by a think tank the China Society of Economic Reforms (CSER) Malaysia had its Economic Planning Unit (EPU), Indonesia BAPPENAS, Thailand National Economic and Social Development Board (NESDB), the Philippines National Economic Development Authority (NEDA), Korea Economic Planning Board (EPB) and Korea Development Institute (KDI). Pakistan does not have similar institutions in place for a **long time although the Planning Commission does exist on paper but has become primarily a project clearing agency. The East Asian countries had highly meritocratic and insulated bureaucracies with a core of technocratic managers. The high-quality bureaucracies and rules and procedures were institutionalised and insulated from political interventions. In particular, recruitment and promotion were merit based.<sup>20</sup> But in Pakistan since the 1970s the civil services have become politicised, got overstretched and entered areas in which they had little expertise or training. Constitutional guarantee for the security of service was taken away and the compensation and benefits got diluted. Bright and talented young men and women stayed away from civil service and those opting for them were motivated by considerations other than public service. Aligning themselves with the interests of the political party in power became the norm for survival and career progression. This alignment also helped the civil servants in accumulating enormous monetary benefits. Despite many commissions, committees, expert groups etc.** which have made recommendations for the reform of civil services nothing much has happened. As a matter of fact the reforms of 2001 abolishing the posts of Commissioners, Deputy Commissioners and placing the police under the control of District Nazims gave

<sup>20</sup>*The East Asian Miracle, ibid.*

a big blow to the Civil Services. The Intake has deteriorated both in terms of numbers as well as quality: Positions remain unfilled as the Public Service Commission is unable to identify suitable candidates for filling in the vacancies. Only mediocre and those with ulterior motives appear at the competitive examinations. Those who are in the service face many dilemmas. Uncertainty abounds as Secretaries to the Government are pushed **around various ministries every three to six months. There is hardly any institutional memory to guide them in their work or any passion as they are not sure as to how long they will stay on their job. If we can have six Secretaries in key ministry such as Finance or six chairmen of FBR over a four year period what should we expect from them in terms of performance or output?**

**This serious displacement of merit and competency based appointment system has eroded the capacity to formulate policies, implement reforms and execute projects. Even if there is a well-intentioned government that is willing to take the plunge it gets stuck because of these capacity constraints. This problem has become more acute since the 18th amendment and NFC award as most of the administrative powers and financial resources have been devolved to the provincial governments but they do not have the adequate capacity to carry them out. This disconnect between the powers and resource availability on one hand and the limited capacity to implement is going to get worse unless serious efforts are made to reform the structure, processes and human resource management policies at the provincial and local government.**

"The informal asymmetric power relations within the bureaucracy also create an incentive for poor governance. Accountability of the Civil Servants and public sector employees has been limited mostly to the officer class or top and senior managers. In formal terms and according to the distribution of duties within the organisation on paper the responsibility lies on the shoulders of these officers. But in actual practice the informal but effective power resides in lower echelons of bureaucracy. The clerks, **Patwari, SHOs, Inspectors, and Court Readers enjoy enormous discretionary power and indulge in institutionalised corruption. However, they remain unscathed from accountability measures because they do not have any formal authority and cannot be held responsible in strict legal sense. All the purges, screenings and dismissal under the military regimes were targeted at the senior officers and so did the NAB inquiries and prosecutions in the recent years. As their superior officers keep rotating while these lower ranking officials remain entrenched almost semi-permanently in their positions they create deep seated fears among those who wish to complain against their high handedness and extortionary practices. If they lodge a formal complaint against these lower functionaries to their superiors two possible outcomes are likely to ensure. First, if the superiors are in cahoots with the subordinates the complainant may risk harassment and persecution. In the event there is an honest officer at the helm of the affairs the complainant may incur the wrath after the transfer of that officer—a postponed punishment. A resident of the area who depends upon the whims and discretions of the bureaucracy for day to day survival can hardly afford that.**

The next factor pertains to the structure of political institutions, patterns of leadership including type of regime and the dynamics within the political parties including their support bases. Economic reforms imply important shifts in the balance of political powers among contending interests: for example, between the export and import-competing

sectors and between capital and labour. The sharp squeeze on Government resources also spark fundamental debates about the role of the state in the development process.<sup>21</sup> Some analysts have argued that "economic liberalism and political democracy may be in conflict for countries at certain stages of growth. Market-oriented reforms may exacerbate social dislocation as highly unequal distribution of assets and incomes pose threat to political stability".<sup>22</sup> **Pakistan's long experience with the authoritarian rule has proved that the popular and widely held notion that reforms can be carried out only under authoritarian or military regimes has also lost its lustre. Unlike other countries where military governments undertook economic reforms prior to initiating the transition to democracy and those reforms having yielded tangible benefits, policy gains were not reversed by the transition**<sup>23</sup> the opposite has been the case for Pakistan.

The Ayub and Musharraf Governments did undertake some serious economic reforms which, if allowed to continue and sustain over a long time horizon, would have brought about fundamental structural changes. However, these reforms were reversed or disfigured or made inconsequential by the subsequent governments. This observation **suggests that economic accomplishments devoid of political legitimacy, however impressive they maybe, prove to be short-lived in our cultural context. Without the involvement and participation of the people, elegant and technically sound economic solutions developed by authoritarian regimes have a short shelf life as they are quickly replaced once the regimes change, causing irreparable loss to the economy.**<sup>24</sup>

The inner dynamics of political parties also betrays some insights as to why economic reforms are not undertaken by democratically elected regimes and if they are, **do not survive for long. Personality-cult, authoritarian style of leadership, centralised decision making, demand by the leader for absolute loyalty, intolerance of dissent, reliance on a small coterie of sycophants and cronies and nominations rather than elections of the party posts at all level have germinated some unhealthy tendencies within the political parties. Ministers of Finance could be the natural champions for economic reforms. But they fear upsetting their colleagues and leaders and losing their jobs if they vigorously pursue unpopular policies, the constituency for these reforms within the ruling party, therefore, remains weak or non-existent, In absence of a champion, there is hardly any scope for these tough reforms to make any headway.**

The prevalent social and cultural norms in Pakistani society also pose a powerful **detering force to reforms particularly in the area of economic governance. The Pakistani society is characterised by strong bonds of kinship, biradari, class, friendship and familial relations. The operating social behaviour is governed by considerations of 'Lihaz, Sharam and Murawat', ingrained and nurtured right from the childhood. Formal organisations are, on the other hand, driven by edicts, evidence, due processes, neutrality and objectivity. This in-built tension between the appropriate social behaviour required as a member of the society and organisational rules imposed as part of professional responsibilities inhibits practice of good governance. Nepotism and favouritism are the**

<sup>21</sup>Haggard, S. and Robert Kaufman (eds.) (1992) *The Politics of Economic Adjustment* (Princeton University Press).

<sup>22</sup>Haggard and Kaufman – *ibid.*

<sup>23</sup>Haggard S. and Steven Webb (eds.) (1994) *Voting for Reform* (Oxford University Press).

<sup>24</sup>Husain, Ishrat (2009) "The Role of Politics in Pakistan's Economy". *Journal of International Affairs* (New York, Columbia University).

expected outcomes of demand placed by social and cultural norms while, merit and impartiality are expected to reign supreme under the formal organisational rules of business. Constituency politics and coalitions reinforce these social norms. It is only with the spread of urbanisation, nuclear families, expanding middle class, professionalism and weakening of feudal and tribal hold on the society that the balance will shift in favour of the formal organisational rules. No quick fixes are available as even some of the highly educated persons coming from tribal and feudal families do not deviate significantly from these norms.

### CONCLUSION

I now come back to revisit the question. Why is Pakistan slipping relative to other developing countries? In light of the record of last sixty five years and the factors impeding the sustainability of reform I would identify four broad underlying trends. First, sustained economic development does not take place in absence of political stability. In the 1950s we had seven changes of government and in the 1988-99 period eight different governments came and went out of office. In between there were decade-long military rulers in power who disrupted the path of long term stability and evolution of the political system. Second, the popular mind-set in Pakistan has become highly suspicious of private enterprise and markets. Executive branch, Judiciary, Parliamentary committees, Accountability Bureaus and the media have all created an atmosphere in which it has become difficult to make large investments and earn decent returns. We are driving out and discouraging even honest and hardworking businesses by our collective witch-hunting mode. Prices are ordered to be fixed arbitrarily, profits are looked upon with contempt, enforcement is capricious and corruption is rampant. Other countries throw welcome mats to investors for attracting them but not us. Our overzealousness and media frenzy is costing us too much. Third, the battle lines between those who wish Pakistan to become a part of global system and those who want the country to withdraw, isolate and disengage itself from the international arena are being drawn sharply. The isolationists have a very different economic model i.e. an inward looking self-reliance that does not fit in with the prevailing world view of those who think Pakistan can gain immensely from globalisation. Finally, Pakistan hasn't faced a major abrupt and sharp downfall in its economic fortunes. Only twice in its history it has recorded a negative growth rate. Pakistan has never faced an economic collapse despite predictions on many occasions. The private informal sector has always been buoyant providing over all resilience to the economy.

Recent history has shown that most countries have undertaken reforms and adjustment in response to some crisis--domestically induced, or externally precipitated. The Latin American debt crisis of the 1980s, the Indian balance of payments crisis of 1991, the Mexican crisis of 1994, the Asian crisis of 1995-96, the Russian crisis of 1998 and more recent Global financial crisis of 2008-09 have all invoked reforms and adjustments of various degrees and duration. In most cases, the financial assistance of International Monetary Fund was sought to tide over the crisis. Pakistan hasn't faced a deep crisis of the magnitude or intensity faced by these other countries. There has been a "creeping but continuous" crisis that has forced the country to seek IMF's assistance on many occasions. Thus, Pakistan's need for reforms has been distinct from those of the

countries. The volatility and fluctuations in Pakistani economy have been too pronounced but the root cause was not external shocks but domestic mismanagement) poor governance and reluctance to take tough economic decisions.

Crises that are not large or abrupt do not get much attention and the policy-makers do not feel the need for any action. Small doses of good news are exaggerated and bad news are ignored or suppressed in the policy-making circles. It has been argued<sup>25</sup> that a society that faces no major crisis experiences a buildup in the power of pressure groups and a consequent decline in flexibility. Policy-makers become the prisoners of special interest groups. This characterisation fits in well with the case of Pakistan.

What are the prospects of economic reforms in Pakistan in the future? This is a tough question to answer as I do not have a crystal ball. But let me sketch out the broad landscape of development that is being reshaped in the 21st century. Globalisation (trade, investment, people, and ideas) Localisation (fiscal and administrative decentralisation), climate change, rapid urbanisation, demographic transition and shift in economic power equilibrium from advanced to developing countries such as China will be the drivers of change. China's leaders are supposed to have decided to undertake their reform programme when they realised that their neighbours were growing more rapidly than they were. The adjustment initiated by Malaysia in the second half of the 1980s also fits this description." Would our leaders wake up to meet this challenge? Inclusive and pro-poor growth that spreads the benefit to the majority of the population will be the acceptable outcome of a development strategy. The Incoming Government in Pakistan and the visionary leadership if it emerges as a result of the elections have to capitalise on the honeymoon period to shift the direction of economic policies and governance and establish credibility by taking some tough but inevitable decisions during that period. Unless this directional shift takes place the prospects for inclusive rapid economic growth do not look very promising. On the other hand, if this shift is engineered Pakistan can get back to the growth trajectory it had attained in the early and mid-2000s and will be able to catch up with some of the countries which are leading the race at present? -t.

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<sup>25</sup> Olson, M. (1982) *The Rise and Decline of Nations* (New Haven CT, Yale University Press).

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## Comments

Dr Ishrat Hussian has just reviewed the sixty year record of reforms implemented but not sustained in Pakistan. He has identified; among others, two main factors for the failure of these reforms-political economy-considerations and limitations to implementation capacity. I fully agree with this conclusion and, I would like to substantiate this by focusing on tax reforms. The reason for focusing on tax reforms is I feel it is perhaps the biggest failure of reform today. Currently the tax-to-GDP *ratio* in Pakistan is low around 9.1 percent, the lowest compared to other developing countries at the same level of development. Also, not only is the level low, it has fallen from 13.8 percent in 1995-96. Even if we adjust for the GDP debasing, the fall is over two percentage points over the period.

**Let me start by listing some areas of retreat in tax reforms.**

### Customs Duties

- (1) Maximum Rate decreased and then increased.
- (2) More SROs, currently less than half of total imports pay imports duties...
- (3) Withdrawal of Minimum Import Prices (to tackle Under invoicing).
- (4) Concession in Duties on Regulatory Duties an Adhoc Basis.

### Income Tax

- (1) Change in Legislation.
- (2) Reduction in Rates. (3) Tax amnesty Scheme. (4) New tax Expenditures.
- (5) Retreat on Agriculture Income Tax.
- (6) Retreat from the Survey of Tax Payers.

### GST

- (1) Taxation of Export Oriented Sector.
- (2) Failure to Implement RGST.
- (3) Rise in Rate and then fall.

### Administration Reform

- (1) Failure of TARP Project.

The list of unsuccessful reforms is long. Why? Clearly tax reform is an area where there are well defined gainers and losers and therefore there is need to build a coalition of support for reform and find champions of reform. Also, one feels that tax policy in

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Pakistan has been complicated because we have tried to use this instrument to achieve too many objectives. Taxation policy is used:

- .) (1) to rise adequate revenues,
- (2) to influence- pattern of industrialisation through the instrument of effective protection via custom duty, and
- (3) **Income tax has been used as a means .to incentivise and support particular target groups, export growth, regional disparities, and to promote savings.**

i. These objectives, at time conflict with each other and inevitably political economy comes into play and at the end of the day revenues are sacrificed. With all due respects, the tendency to pander to special interests to build a support base is more pronounced in military/autocratic governments to build legitimacy. For example, during the decade of the 80s, the tax-to-GDP declined. so did the share of direct taxes in total taxes. Similarly, despite the fast growth, the tax-to-GDP ratio did not rise significantly during the peak days of the Musharraf regime. This substantiates the point that "taxation without representation"- is difficult. Also during the tenure of the Military governments, when the flow of external financing was high the domestic fiscal effort tended to slacken. The only period when the tax-to-GDP ratio increased significantly was the first half of the decade of the 90s when it increased by almost 2 percent points of the GDP but the increase was not sustained subsequently. The primary reform which brought about this increase was the regime of presumptive/withholding taxes which spread the tax net more widely, reduced evasion and contributed to a quantum jump in income tax revenues, the share of which in total revenues increased from 14 percent to over 30 percent.

The tax breaks in the Musharraf government, both in the form of big reduction in tax rates and special concessions and exemptions eroded the tax base. The best example of this is the exemption (give!) to capital gains on securities at a time when the stock market was booming. At its peak, the exemption represented a tax break to the rich of over Rs 150 billion per annum. In addition there are other examples of tax breaks including abolition of wealth tax, zero-rating of domestic sales of export oriented sectors and a rash of SROS in custom duties for particular sectors like automobiles. The end result is that during the period of fast growth while India was able to increase its tax-to-GDP ratio by percentage points, our tax-to-GDP ratio languished.

During the last four years while we had a democratically elected government, which did take some steps initially like raising the rate of GST, extending the tax to financial services, introducing minimum income tax and special excise duty, its success has been limited by the political economy of a coalition government and the consequent inability to take strong political decisions. This is manifest in the colossal failure to introduce a broad based VAT on goods and services and a failure to catch tax evaders. In addition one feels that the sequencing of some important reforms in Pakistan went wrong. First, at the time when Pakistan started the trade liberalisation process the income tax and GST should already have been developed to substitute for the loss of custom duty revenues but this did not happen. Also, ideally the reforms of tax administration should have preceded major recent tax policy initiatives but at the time the new government assumed power, FBR was in a state of turmoil implementing the Tax Administration Reform Project (TARP) of the World Bank. There was little ownership of this reform

within the hierarchy of FBR and there was strong resistance to change, particularly the restructuring of FBR into the Inland Revenue Services (IRS), and customs separately. Consequently the tax policy reform process was frustrated by problems of implementation capacity.

**Having studied the evolution of Pakistan tax systems for over the last two decades, I have come to the conclusion, like Dr Ishrat Hussain that an understanding of the political economy and issues of implementation capacity along with sequencing of reforms are important determinants of successful reform process. I am also convinced that "taxation with representation," is important but for this we require a democratic government which has a majority", is able to take difficult decisions, is accountable to the people and maintains high standards of governance. This is my pray for the future government of Pakistan.**

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