

Pakistan: Country Operational Strategy Study

? **Strategic Objectives**

- A. Increase Capital Accumulation;
- B. Upgrade Human Capital Development;
- C. Enhance Economic Efficiency;
- D. Improve Social and Macroeconomic Stability; and
- E. Protect Environment and Natural Resources.

I. Recent Economic and Governance Developments

A. Macroeconomic Performance

1. In recent years, Pakistan's economy has been suffering discouragingly low growth, increasing macroeconomic imbalances, growing public sector indebtedness, high inflation rates, and underlying structural weaknesses, which have impeded improvement of economic welfare of the people as well as aggravated socioeconomic stability. Since FY1993, real gross domestic product (GDP) has grown by only 3-5 percent annually, substantially below the growth potential of the country and little over its population growth. While the agriculture sector fluctuated to an excessive degree, partly because of extremely low productivity growth coupled with natural changes and cotton viruses, the principal factor for the poor growth performance was the backwardness and lethargy of the industrial sector and low capital formation. The GDP of the industry sector has increased by 4.1 percent annually over the past four years and gross national investment as a percent of gross national product (GNP) (at current market prices) was only 18-19 percent and even declined in FY1997. These developments have adversely affected Bank operations in Pakistan.

2. Large budgetary deficits ranging from 6 to 8 percent of GDP in the 1990s have impaired policy efforts to achieve macroeconomic stability in the country, while crowding out financial resources for the private sector as well as preventing the deepening of the financial sector. The Government streamlined the development plans and projects by cutting PRs20 billion from the Public Sector Development Plan in FY1997 and PRs14.7 billion in FY1998. While

the cutting was expected to contribute to reduction of the budget deficit, it significantly weakened the public sector investment through the shortage in development funds and absorptive capacity for foreign assistance including the Bank's. Due to very low growth in exports, the current account deficit underwent an unsustainable level at 6-7 percent of GDP in FY1996 and FY1997, which undermined the country's foreign exchange reserves. Low rates of savings were a continuing source of the underlying economic weaknesses. Pakistan's national savings rate is one of the lowest in the Region, remaining at 11-12 percent of GNP.

3. In order to assist the Government in addressing the economic facilities through supporting its medium-term adjustment and reform program, the IMF approved a three-year ESAF/EFF Program for Pakistan equivalent to SDR1,137.3 million (about US\$1,558 million). The macroeconomic objectives for the program period (FY1998-FY2000) are: (i) to raise the average annual growth rate of real GDP to the 5-6 percent range from a 3 percent level; (ii) to progressively reduce annual inflation to about 7 percent from about 12 percent; and (iii) to reduce the external current account deficit to the range of 4.0-4.5 percent of GDP with a view to substantially strengthen the external reserve position. Policy actions in the key fiscal area are designed to cut the overall budget deficit to 4.0 percent of GDP by the third year of the program.

4. The Government's structural adjustment program, particularly reduction of fiscal deficit under the IMF program will have important implications for the Bank operations in Pakistan over the next few years for this operational strategy. Government's Economic Revival Package announced in March 1997 made drastic cuts in the rates of major taxes and tariffs, and there is possibility for a shortfall in revenue mobilization for the Government. Under the circumstances, there is a clear signal that the Government attempts to reduce development expenditure to meet the IMF target. The development budget for FY1997/98 decreased by 14.0 percent compared to the revised budget for FY1996/97. Agriculture, water, and social sectors are major areas suffering a decrease, all of which the focus of the Bank operations are on.

B. Governance Developments

5. Inefficient and weak governance is among the most important factors that impede economic progress and modernization in Pakistan. If the core of good governance lies at establishing a foundation of law, maintaining a nondiscretionary policy environment including

macroeconomic stability, basic social services and infrastructure, protecting the vulnerable, and protecting the environment, all of these are formidable challenges in Pakistan. The poor governance is found particularly in such areas as civil services, institutional, legal and regulatory frameworks, corruption¹, judicial system, centralization of decision making, and urban violence.

6. Since as early as in the late 1940s, the Government has been taking various governance reform measures in civil service, law, accountability registration, corruption, decentralization, etc. For the civil service reform, a number of committees/commissions/individual reports² recommended improvement of the reward system and service structure, but neglected administrative structure and regulatory aspects. The law reforms also had been dealt with by several commissions, the latest of which was the Commission on the Reform of Civil Law of 1993 that recommended the following measures: scrutiny of pleadings by the judicial officers, alternative means of servicing summons, reducing the time period of submission of written statements, implementing a system of continuous trial, reducing the number of appeals and revisions allowed, discouraging the issuance of interim injunctions, enhancing the amount of compensatory costs and exploring alternative dispute resolution methods. The Ehtesab Act of 1997 seeks to eradicate corruption and corrupt practices from public services. The Act assigns responsibility for conducting enquiry and investigation exclusively to the Ehtesab Cell which is required to complete the enquiry and investigation within one month and communicate its findings to the Chief Ehtesab Commissioner. For the fiscal decentralization, the Caretaker Government established the National Finance Commission in December 1996 which gave a new award under which new parameters of resource distribution, subvention and development grants were laid down for federal and provincial governments. The development in 1997 was, however, a retreat in fiscal decentralization. Previously the fiscal divisible pool was shared in the ratio of 80 percent for the provinces and 20 percent for the federation but the 1997 formulas prescribed the ratio of 37.5 percent and 62.6 percent respectively.

¹ The Transparency International, which is a Berlin-based governance campaigning organization, reported that Pakistan is considered to be one of the most corrupt countries.

² They are Pay Commission of 1949 (Munir Commission), Egger Report of 1953, Gladeux Report of 1955, Cornelius Report of 1969, Mumtaz Hassan Commission of 1970, Administrative Reforms of 1973, and the Pay Commission of 1970.

7. The Bank, under the general guidance of the Governance Policy prepared in March 1995¹, has made enormous efforts to address the issues related to sound development management in Pakistan. Particular attention was paid to fiscal management, public sector management, beneficiaries participation, natural resources management and environmental protection, private sector participation and capacity building of various ministries and projects executing agencies. However, these were all project-related, and the Bank has not been directly involved in such governance issues as stated above. It is therefore a big challenge that the Bank should provide its operational assistance to the Government in addressing the issues in the period under the coverage of this strategy.

II. Development Issues and Challenges

- ? Effective and Efficient Governance;
- ? Macroeconomic Stabilization;
- ? Gaining Growth Momentum;
- ? Private Sector and Financial Market Development;
- ? Integration of the Informal Sector into the Formal Economy;
- ? Infrastructure Development;
- ? Human Resource Development; and
- ? Environmental Concern.

A. Gaining Growth Momentum

8. From FY1980 to FY1992, Pakistan's economy expanded at an average annual growth rate of about 6.5 percent, which is higher than most of developing member countries (DMCs) except for the high-growing East and Southeast Asian economies. "Growth was achieved, however, with a low level of investment, which even then could not be financed out of national savings. Since the early 1980s, investment has averaged 18-19 percent of GDP, while national savings remained at about 14-15 percent. Relatively high growth was thus attained amid

¹ Doc. 01-95 "Governance: Sound Development Management", 15 August 1995 (Asian Development Bank).

increasing macroeconomic imbalances and structural problems, which become major impediments to long-term sustained growth.”¹

9. The low investment in the 1980s caused serious infrastructure problem (deficiency and outdatedness) in the 1990s. However, the low investment did not pick up even in the 1990s, adding to infrastructure problems. Large investment-saving gap was not narrowed in the 1990s, which aggravated the current account deficit and inflation. It is therefore vital to increase capital accumulation and rehabilitate existing infrastructure in order to gain growth momentum. Given that the public sector investment has been reduced and most of state-owned enterprises (SOEs) has been and will be privatized, the private sector investment should play the key role in expanding capital accumulation.

10. Before the privatization initiative in 1991, SOEs accounted for more than half of the national investment and around 40 percent of industrial output. Extensive public sector involvement was on cement, fertilizer, steel, engineering, textiles and agrobusiness. All infrastructure activity and all commercial banking were also included in the public sector. Changes are occurring in the 1990s but only slowly. Pakistan’s private sector continues to be dominated by firms, both large and small, which are very traditional in business approach and which are responding slowly to the new challenges and opportunities. Many firms remain cautious about initiating new business or expanding existing business partly because of policy uncertainty and lack of financial resources. Total private investment remains at around 8-9 percent of GDP, a level much lower than 20-30 percent in the East and Southeast Asian countries. Over the last 7 years since FY1990, private sector investment in real terms has been increasing by only 4.5 percent each year and even decreased by 0.4 percent in FY1997.

B. Ameliorating Macroeconomic Stability

11. Coupled with the low growth, economic instability was not mitigated in the 1990s. The fiscal and external imbalances had grown rapidly in the 1980s. Budget deficit rose to over 8 percent of GDP and was financed primarily through the creation of domestic debt which had doubled from 20 percent to over 40 percent of GDP over this decade. The current account deficit

¹ Country Operational Strategy Study for Pakistan (July 1995), Programs Department (West), Asian Development Bank; see para. 12.

had also increased to over 4 percent of GDP towards end of the decade as a result of falling remittances and stagnant exports. Increased debt servicing also contributed to a significant extent to the deterioration of the balance of payments. Towards the end of the decade, high fiscal deficits and Government's borrowings from the financial markets to finance them crowded out the financial resources which otherwise would have been channeled to private sector investment.

12. The 1990s had witnessed any improvements in the macroeconomic instability. The fiscal deficit remained at 6-8 percent of GDP and the current account deficit at 4-7 percent. Over the last two years, foreign exchange reserves have not picked up from a precarious level that affords only an average of about four weeks of importation. Debt service ratio (DSR) reached about 37 percent of foreign exchange earnings (exports of goods and service), one of the highest in the Region. At present, total outstanding external debt stood at \$29.0 billion and domestic debt at PRs986.2 billion, totaling PRs2,150.9 billion or about 85.9 percent of GDP. Pakistan's national savings rate is one of the lowest in the Region, remaining at 11-12 percent, and has continued to decline over the last 3 years, resulting in large I-S gaps.

13. In order to address the macroeconomic instability, since the late 1980s, a range of structural adjustment programs have been introduced under the assistance of the Bank, the World Bank, and the IMF.¹ The key areas supported by these adjustment programs were on: (i) establishment of fiscal discipline and redetermining the roles of the public and private sectors; (ii) improving external account; (iii) developing social sectors; and (iv) strengthening governance.

14. However, the results of all these reforms have not been in favor of significant improvements in fiscal, external, financial and industrial, and social sectors. Therefore, all these areas require Bank's continued assistance over the next 3-4 years at least.

C. Effective and Efficient Governance

¹ These include Industrial Sector Program Loan (\$200 million;1988)/Capital Market Development Program Loan (\$250 million;1997) by the Bank; Structural Adjustment Facility (SDR382 million;1988)/Stand-by Arrangement (SDR273 million;1988)/Enhanced Structural Adjustment Facility (SDR682.4 million;1997) and Extended Fund Facility (SDR454.9 million;1997) by the IMF; and Agricultural Sector Adjustment Loan and Credit (\$250 million;1994)/Banking Sector Adjustment Loan (\$200 million;1997) by the World Bank.

15. The nature of the governance weakness is multi-dimensional in that the weakness is general and not causally attributable to the failure of any particular institution or set of institutions. The effects of weak governance include:

- (i) policy ineffectiveness;
- (ii) poor targeting of policies to relevant groups;
- (iii) stagnant economic production;
- (iv) low social indicators;
- (v) environmental degradation;
- (vi) corruption; and
- (vii) social conflict, instability and insecurity.

16. Three obstacles appear to prevent effective and efficient governance in Pakistan¹. First, is perverse incentives which do not discourage self-seeking, inefficient behavior. The system of perverse incentives contributes substantially to the governance weakness and results in public functionalities failure to act in the public interest. Second obstacle, is the growing inequality. In the 1980s, the percentage of the absolute poor in the population declined from an estimated 38 percent to 20 percent, mainly due to remittances from lower middle class workers in the Middle East. In the 1990s, this trend reversed steeply. The incidence of absolute poverty rose to 30 percent by 1995.¹ The economic inequality is also reflected in (and perpetuated by) the social structure. Pakistan's land ownership is skewed: over half of the cultivable land is held by landlords in plots of more than 50 acres. Third, a lack of social cohesion in Pakistan has caused a severe gap between the modernizing, industrializing elements of Pakistan's civil society and the more traditional, religious, rural elements. Such a diverse group or visions presents a significant challenge for good governance.

17. The Central Plan of the restoration of governance would be the reform of the civil service. It is a pre-condition for improved public sector practice and performance. Civil service reform must encompass personnel, systems, and organizational structures. Personnel includes the structure of services, conditions of employment, staff recruitment procedures, discipline and incentives for efficiency. Staffing patterns face problems that hiring does not meet job

¹ "An Agenda for Effective Governance" (draft Final), Pakistan 2010: Long-term Perspective Study, Asian Development Bank (October 1997).

descriptions; employees are systematically misplaced at inappropriate positions; and employment on a permit basis is preferred, blocking full competition and preventing professionalism among civil servants. The structure of the civil service, comprising systems and organizational issues, causes acute inefficiency. The structure is characterized by confused flows of information, responsibility, supervision, compensation, and promotion. The civil service structure has to be performance-oriented and based on clear job descriptions and the regulatory framework should be simple, transparent, and decentralized.

18. Successive governments in Pakistan have been in favor of the idea of decentralization, but it was not followed by proper actions. The constitution briefly mentions local governments, without providing any constitutional protection. Therefore, local bodies fall within the exclusive jurisdiction of the provincial governments. A number of underlying flaws are found in the local government structure: (i) there is no relationship between various local bodies; (ii) local bodies do not have functional autonomy so their considered scope for interference by the provincial government in fiscal as well as political matters; (iii) development plans are generally prepared by provincial governments and handed to the local bodies; (iv) local bodies have limited powers to tax and are reliant on unreliable provincial or federal government grants; and (v) the status and prestige of local government employment is low.

19. Judicial reform is another urgent reform to improve governance. An effective and independent judiciary is essential for strengthening the rule of law and good governance. Judicial personnel particularly are inadequately trained, so investing in pre-service and in-service training is essential, providing more resources and greater financial autonomy to the judiciary and improving judicial salaries and facilities are critical in that the judiciary is resource-poor both in terms of salaries and facilities.

D. Private Sector (and Financial Sector) Development

E. Integration of the Informal Sector into the Formal Economy

¹ Mahbub ul Haq, Human Development in South Asia 1997 (Oxford University Press), p. 17.

20. The informal sector grew rapidly from about PRs15 billion in 1973 to PRs1,115 billion in 1996, rising as a percent of GDP from 20.2 percent in 1973 to as high as 51.3 percent in 1996.¹ Tax evasion also increased tremendously from PRs65 billion in 1973 to PRs152 billion in 1996. There was a clear positive relationship between the growth rates of underground economy and tax evasion during the period. The informal economy has grown faster than the formal economy over the 1973-96 period, and the discrepancy was especially high in the 1990s. The relatively faster growth in the informal economy appears to be a major contributing factor for the increasing budget deficit in that tax revenue income grew at the slower rate of the formal economy while government expenditure grew with the overall economy. By sector, income from underground activities in the foreign trade sector was higher than the domestic tax sector.

21. The ____ and the intensity of informal economic activities are emerging as a major policy issue. The large size of the informal economy implies a loss in tax revenues while it increases demand for public services. Economic activities of the informal economy fall outside the reporting system and are beyond the reach of the tax net. This causes large fiscal losses to the State. The informal economy also distorts the incentive structure and the growth path of the economic system. A substantial ____ market exists financed from the funds of the informal economy. The borrowing costs from the market are roughly 50 percent higher than those from the commercial banks. It is therefore critical to integrate the informal economy into the formal, documented economy.

F. Infrastructure Development

22. The supply of infrastructure services has not grown sufficiently fast to prevent the gross shortages and inadequacy, which are likely to constrain the economy's growth potential and to adversely affect the quality of life. In Pakistan, the provision of infrastructure services is not adequate in all sectors. Only 60 percent and 30 percent of the population have access to water and sanitation, respectively. Only about 15-20 percent of roads are in good conditions and roads are generally overcrowded. The volume of passenger and freight handling by railway systems has declined by 30 to 60 percent since the early 1980s. Telecommunications system is outdated and does not suffice the demand. Relative to its level of per capita income and growth

¹ "Creating Change Through Private Sector-led Industrialization", as part of the Pakistan 2010 Long-term Perspective Study (draft Final), Asian Development Bank (November 1997).

rates, Pakistan lags behind in terms of the quality and supply amount of services in all infrastructure sectors.

23. Infrastructure sectors have been almost entirely owned and operated by the public sector, while private sector participation in most infrastructure sectors has been limited. The Government was the sole investor in telecommunications, roads, and railways and the private sector played an insignificant role in water supply, sewerage, and power. Over the last few years, private sector participation was conspicuous in power generation, cellular telephones and other peripheral telecommunications services. In the irrigation sector, private investment in tubewells has increased gradually over the last two decades and currently covers about 25-30 percent of the irrigated area. Public organizations responsible for infrastructure are generally inefficient, bureaucratic, overstaffed and insufficiently funded. Root cause for the financial problem is due to service charges which are far below production costs, coupled with a huge amount of account receivables.

24. Presuming that real GDP should grow by 5-6 percent over the next 5-10 years, infrastructure must increase by 15-20 percent annually to keep up with the growth, while maintenance must substantially improve. Expanding the quantity and enhancing quality of infrastructure services in Pakistan require that a huge amount of resources be mobilized, more private sector participation needed incentives for operational efficiency and maintenance be strengthened, and sufficient investment made in rural areas and small cities.