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ELEMENTS OF GOOD ECONOMIC GOVERNANCE

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ELEMENTS OF GOOD ECONOMIC GOVERNANCE

By

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The economic literature has traditionally emphasised the rate of expansion in physical inputs like capital and labor as being the principal source of growth. However, most of the empirical work has demonstrated that this explains only part of the growth achieved by most economies. The large unexplained residual of growth has been attributed to improvements in factor productivity arising from technical progress and increase in human capital endowments of the labor force. More recently the literature has begun the emphasise the role of institutions and policies in either fostering or restoring the process of economic growth.

Given the growing importance being attached to economic institutions and policies in determining the economic performance of countries, this paper focuses on the issue of what constitutes good economic governance. Based on this an effort is made to assess the quality of economic governance in Pakistan. It appears that there are at least nine elements of good economic governance, which are discussed below.

1 ACHIEVEMENT OF GROWTH WITH EQUITY

The basic goal and purpose of economic governance must be to achieve through the process of policy making and management the full harnassing of the productive potential of human and physical resources and generating a broad-based, equitable (and sustainable) process of growth. Sustainability is important because it may be possible to artificially stimulate growth in the short run but the key test is the ability to maintain the momentum once created.

A good example of this is the strong supply-side stimuli provided in Pakistan by the newly elected government in early 1997. Major cuts were made in virtually all taxes to promote quick revival of the large-scale manufacturing sector[1]. Simultaneously, aggressive pricing policies were adopted in agriculture and quantum jumps were announced in the procurement or support prices of commodities like wheat and sugar[2] in order to boost production. The growth rates of manufacturing and agriculture[3] did pick up significantly in 1997-98 but the growth momentum could not be subsequently maintained.

Promotion of growth and economic revival has therefore to be based on sustainable policies. Following the recent crisis in Pakistan and faced with a falling tax-to-GDP ratio, tax rates have had to be enhanced once again to almost the pre-97 levels. There is now pressure again on the government to achieve quick economic revival given growing unemployment and poverty. Given growing perceptions of a relatively inadequate economic performance, the Nawaz Sharif government towards the end hurriedly adopted populist solutions like large-scale subsidised[4] micro credit schemes for self-employment, urban transport and

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housing. These schemes promised to raise incomes and employment in the short run but they run the risk of creating distortions in the allocation of resources and possibly increasing the quantum of bad debt in an already weakened banking system, especially if political patronage entered into the process of allocation of credit. The new government has also announced on Economic Revival Plan, but serious doubts persist about the viability of such pump-priming the economy, given the precarious nature of the balance of payments following expiry of the period of debt relief in December 2000. Clearly, there is no alternative for economic managers but to pursue tough structural reforms, which also boost investor confidence, and provide ultimately for sustainable growth in the long run.

Based on the most global measure of good economic governance, that is, achievement of growth with equity we find that Pakistan's economy has performed relatively poorly during the 90s. The growth rate has fallen significantly from 6.1 percent during the 80s to 4.6 percent in the 90s **(see Table 1)**. It has been accompanied by virtual doubling in poverty from about 17 percent to 34 percent of the population. The high growth rate in the 80s was based on a higher rate of investment, especially by the public sector, largely financed by big budget deficits. In addition, effective demand was fueled by the high and growing level of remittances, especially from the Middle East. Clearly, such growth was not sustainable in the long run and as the country found itself increasingly in the debt trap and as the process of return migration from the Middle East started the growth momentum was bound to falter. This takes us to the next criterion of good economic governance.

TABLE 1
Key Macroeconomic Indicators for Pakistan

	Indicator	Unit	Decade of 80s	Decade of 90s
1	GDP Growth Rate	%	6.1	4.6
2	Growth Rate of Real Per Capita Income	%	2.9	1.2
3	Unemployment Rate	%	3.5	5.6
4	Rate of Inflation	%	7.3	9.2
5	Incidence of Poverty	%[a]	17.3	34.0
6	Investment	% of GDP	17.5	18.4
7	National Savings	% of GDP	13.8	13.6
8	Current Account Deficit	% of GDP	3.9	4.6
9	Tax Revenues	% of GDP	13.4	13.4
10	Public Expenditure	% of GDP	24.8	23.5
11	Budget Deficit	% of GDP	7.0	6.4

[a]end of period

Source: Pakistan Economic Survey.

2 FISCAL DISCIPLINE

Perhaps the most commonly used and traditional test of the quality of economic management of a government is its ability to discharge its functions and obligations from its own resources without recourse to borrowings. This may, of course, be too stringent a test of economic management in developing countries which have to borrow initially to finance development and get out of the low level equilibrium trap.

Therefore, in a more dynamic sense, government borrowings to finance fiscal deficits are not necessarily bad if the build up of debt is sustainable in terms of a corresponding growth in debt servicing capacity. As such, more valid measures are perhaps the ratio of debt servicing to revenues or external debt servicing to foreign exchange earnings.

These magnitudes for Pakistan are presented in **Table 2**. Here again, the indicators show a major deterioration. The debt–related ratios reveal a sharply rising tendency in the 90s. The rise in the ratio of debt servicing to revenue can be attributed to relatively high levels of borrowing accompanied by rising interest rates and stagnant revenues, especially in the second half of the decade. As highlighted earlier, the budget deficit has declined in relation to the average for the 80s but there continue to be significant primary budget deficits. The rising external debt service ratio to foreign exchange earnings is attributable to continuing large current account deficits and increasing share of short- and medium-term commercial debt along with a lack of buoyancy in merchandise exports, especially after 1994-95, and declining home remittances.

TABLE 2
DEBT CARRYING CAPACITY OF PAKISTAN'S ECONOMY

(%)

	Total Debt Servicing as % of Revenues	External Debt Servicing as % of Foreign Exchange Earning
1979 - 1980	33.4	11.9
1989 - 1990	40.4	21.4
1998 - 1999	63.2	34.9

Source: Pakistan Economic Survey
SBP Annual Report

The issue is also one of how the fiscal deficit reduction is being achieved. This is happening not because of higher resource mobilisation but because of cut backs **(see Table 3)** in public expenditure. In Pakistan's case much of the improvement has been achieved by reduction in the level of military and development expenditures in relation to the GDP. It is reassuring to note that almost half the fiscal deficit reduction in the 90s is due to cutbacks in military expenditure. Consequently, the ratio between social sector and military expenditure has improved from 64 per cent in 1990-91 to 83 per cent in 1998-99.

TABLE 3
KEY PUBLIC FINANCE MAGNITUDES FOR PAKISTAN

(% of GDP)

	1979-80	1989-90	1998-99
REVENUES			
Tax Revenues	14.1	13.8	13.1
Non-Tax Revenues	2.2	3.9	3.8
Total	16.3	17.7	16.9
EXPENDITURE			

One of the key problems hindering efficient economic management is that the government is too big in unproductive areas and too small in essential areas. The over-involvement in regulation and in directly productive and trading activities is attributed to the presence of greater opportunities for political patronage and rent seeking. In contrast, the government looks fragile in its performance in areas that are deemed essential such as providing social services, redistributing resources through the taxation system and social safety nets, ensuring macroeconomic stability and instituting fundamental reforms.

It is clear now that the essential agenda of the state must be limited to the provision of collective goods (like defence) and goods with large positive externalities (like primary health care), and to equity considerations like preventing and ameliorating poverty and development of backward areas. If this agenda is followed carefully then wasteful expenditure can be avoided which will simultaneously enable diversion of resources to priority areas and further reductions in the fiscal deficit.

3 INSTITUTIONAL CAPACITY

The basic issue here is the extent to which the process of economic policy making has been institutionalised or not. Is there effective inter-ministerial co-ordination among economic ministries and with line ministries? How are emerging problems identified and is there adequate analysis of the costs and benefits of different policy options to resolve these problems? Is there sufficient and open dialogue with the different stake holders in a particular problem area? What kind of fora exist for decisions on the actual choice of policy? Are there sufficient checks and balances to ensure that policy excesses are avoided?

Institutional Arrangements

In Pakistan, there do exist a number of institutional arrangements for economic policy making. At the apex is the National Economic Council (NEC), a constitutionally mandated body[5], which is chaired by the Prime Minister and includes a number of federal ministers. In addition, provincial Chief Ministers and Finance Ministers usually sit in the NEC alongwith top level federal and provincial bureaucrats. Despite the wide ranging powers and terms of reference of the NEC, during the last few years it has met usually only once a year before the Budget to finalise the Annual Plan and the size and composition of the Public Sector Development Program (PSDP), prepared and presented by the Planning Commission. Below the NEC is the Executive Committee of the National Economic Council (ECNEC) which is chaired by the Finance Minister and is primarily responsible for approval of public sector projects for inclusion in the PSDP. It meets five to six times a year.

There is also an Economic Co-ordination Committee (ECC) which meets regularly (almost once a week) and has the option of considering a wide range of issues. Membership includes some federal ministers and most federal secretaries. The Cabinet Division acts as the Secretariat for the ECC. Despite its mandate, the ECC deals mostly with routine agenda regarding the price situation of some sensitive items and supply conditions of some key commodities. The ECC has emerged as the body which takes decisions on special fiscal concessions, regulatory tariffs on some industrial imports and on the level of agricultural support prices. In its presence, matters of economic policy are seldom considered by the cabinet of ministers.

There are other cabinet committees for investment, privatisation, etc. However, most of the statutory councils and committees essentially deal with micro issues at either the individual project or sectoral level. There exists no body where serious discussion takes place on macro policy issues. The annual budget which is considered to be the prime policy instrument for fiscal matters (of taxation and expenditure) is submitted in the form of a Money Bill (containing the taxation proposals) to the Parliament for approval. Members of the parliament seldom focus on macroeconomic policy issues and are more concerned with ‘constituency politics,’ that is, whether the budget allocates enough funds or not for their respective constituencies. The Nawaz Sharif government established a new healthy tradition of placing before the Parliament the Policy

Framework Paper (PFP) agreed with the IMF and the World Bank for the revived ESAF/EFF program. This document clearly indicated the structural reforms agenda upto the year 2001. However, there was little or no discussion on the proposed reforms by MNAs. Had this happened the country would perhaps have been spared the convulsions it is currently going through in trying to implement the conditionalities embodied in the program.

How then in this vacuum are major economic policy decisions taken? The Ministry of Finance has emerged as the principal arbiter of the economic future of Pakistan and other economic ministries of planning, commerce, etc. have been relegated to a secondary role. While this has ensured that there is greater adherence to the discipline imposed by the annual budget, it has led to a much more short-term orientation in the process of policy making. The long term implications of policy decisions are seldom focused upon. The centralisation of economic decision making has also had other unfavourable consequences. The process of transparency and dialogue with stakeholders has been largely lost and there is little public involvement.

A number of proposals could be put forward for improving the process of economic policy making. The apex body of the National Economic Council needs to be activated to meet at least once a quarter to focus on important and fundamental areas of policy and reform like export growth, resource mobilisation, etc. Prior to this, specific proposals should be technically examined and discussed by a Council of Economic Advisors, chaired by the Finance or Planning Minister, including representation of outside economic experts (including expatriate Pakistani professionals), bankers, corporate leaders, etc. The present government has constituted an Economic Advisory Board to perform these functions. This Board performed a significant role in preparation of the Economic Revival Plan announced by the Chief Executive but it remains to be seen if the EAB will be consulted on a routine basis or not.

The next area of concern is whether there are enough institutional checks and balances to ensure that policy excesses are avoided. Traditionally, there has always been the danger that the government would pursue an expansionary fiscal policy by increasing the size of the budget deficit in order to achieve its growth objectives or of transferring benefits to favoured target groups like large farmers, industrialists, traders, etc. This prospect has been heightened in the presence of a subordinate Central Bank which would feel obliged to adopt a correspondingly expansionary monetary policy in order to accommodate the larger borrowing needs of government while simultaneously keeping credit flowing into the private sector. The consequence would be loss of macroeconomic stability, currency depreciation and higher inflation.

It goes to the credit of the Nawaz Sharif government that soon after its induction into power it legislated the SBP Act, thereby giving it considerable autonomy in the conduct of monetary policy and regulation of the banking system. Consequently, the annual credit plan is now approved by the Central Board of Directors of the SBP and the government is compelled to restrict its bank borrowings within the limits imposed by the plan. The process of financial sector reforms has been greatly facilitated since 1997 by this development. However, this separation of functions was threatened as the Nawaz Sharif government moved for faster economic revival by pumping more credit into the economy for various schemes mentioned earlier.

I turn now to the issue of the ability of the government machinery to undertake systematic analysis of the costs and benefits of different policy options. This capacity appears to have been seriously eroded in recent years. First, the primacy of the Ministry of Finance, which is frequently pre-occupied with some form of crisis management, has meant that there is little time generally for a serious and objective analysis of various options. The logical choice is the Planning Commission which needs to be converted from being largely a project approving agency currently to an in-house policy think tank for government. Also, while the Ninth Five Year Plan has not been announced due to uncertainties about the international environment and domestic availability of resources there is need for development of at least a medium-term macroeconomic framework and long-term sectoral plans within the context of which individual policies could be analysed.

Policy Mistakes

Overall the consequence of over-centralisation, a lack of openness in policy making, non-involvement of stakeholders, absence of specialist inputs and serious technical analysis of different policy options is that over the last few years a number of fundamental 'mistakes' have been made in the design, sequencing or implementation of economic policies which have had a major negative impact on the future prospects for economic growth and macroeconomic stability. Some of these mistakes have also occurred because of adherance to some faulty paradigm or on the behest of international agencies. These almost 'fatal errors' of policy include the following:

- Liberalisation of the financial sector and switch to market based interest rates without prior fiscal reforms to reduce the budget deficit, and thereby the quantum of government borrowing, has led to mushroom growth in debt servicing liabilities and crowded out other high priority expenditures.
- Trade liberalisation involving import tariff reductions and removal of quota restrictions without accompanying institutional improvements in the export sector, more pro-active exchange rate management and development of alternate revenue sources has led to an increase in the trade deficit and a fall in the tax-to-GDP ratio.
- Capital account convertability, in the absence of adequate foreign exchange reserves, has led to foreign exchange crises, for example, after the imposition of sanctions following the nuclear blasts, which have necessitated emergency actions liking freezing of foreign currency accounts (FCAs) and imposition of capital controls. These have, more or less, permanently damaged investor confidence and affected the inflow of home remittances.
- Taxation reforms, involving broad-basing of taxes to hitherto difficult-to-tax sectors like wholesale and retail trade, professional services, small-scale manufacturing and agriculture without an adequately equipped tax administration and the ability to enforce laws, has only led to greater tax evasion.

Institutional Capacity for Reforms

The next area of concern is the institutional capacity for undertaking structural reforms. This is one of the most critical constraints to implementation of reforms. For change to occur, there must be an understanding not only of what type of change is required, but also the process of change has to be carefully managed so as to pre-empt action by vested interests to preserve the status quo. For this purpose, effective 'change agents' have to be found with the necessary leadership qualities to motivate the process and create a sense of 'ownership' of the reform.

Two examples highlight how under different circumstances important structural reforms can succeed or fail badly. The first area is banking and financial sector reforms in which there has been significant success in the last few years. The nationalised banks[6] have been restructured and downsized, some recapitalisation of equity has taken place, prudential regulations have been put in place, growth in non-performing debt has been reduced and from a loss-making position, profits are being made for the first time. How did this happen? First, the government adopted a hands-off policy in the banking sector by granting autonomy to the Central Bank, banks' corporate governance was improved by the appointment of professional chief executives and constitution of independent boards of directors with no government representation. The new chief executives brought in 'change teams' at the top to lead the process of change. Generous golden hand shakes were offered and the remaining staff was subsequently given a big increase in remuneration. Overheads were trimmed and the number of bank branches drastically reduced. Special laws and tribunals were also put in place to enable greater recovery of bad debt.

As opposed to this, the vital reform of federal tax administration (the Central Board of Revenue) has got nowhere since 1997. The proposal to form an autonomous Pakistan Revenue Authority (PRA) and to create a separate service cadre for tax officials, with higher remuneration but less security of service, has been effectively blocked by a coalition of interests. The rest of the bureaucracy has been jealous of the possibility of special treatment to tax officials and has resisted changes in the service structure and rules. Within CBR many of the senior officials have been opposed to the reform because it could make them more accountable and increase the probability of removal from service for inefficiency or corruption following the general loss of tenure. Business and political interests have been wary of the change because a more effective and autonomous tax administration which is less prone to patronage may be more even-handed in its treatment of tax payers.

The important lesson to learn for economic governance is that the process of structural reform, especially involving institutional change, is extremely complex and difficult to manage. It has to be properly planned, executed and monitored. There should be little expectation of early success. Given the limited commitment and institutional capacity for reform within government, both at the political and bureaucratic levels, it is necessary to avoid spreading the reform effort too thin and concentrating only on areas where the prospects for success are greater and/or the returns are higher. It is in this context that I feel that the typical structural adjustment program with the IMF is too ambitious and does not recognise adequately the limited capacity for implementing reforms in a developing country. It becomes crucial, as such, to prioritise the reform program.

4 CREDIBILITY AND CONSISTENCY

A seldom emphasised but potentially important element of economic governance is the credibility and consistency of policy. In their absence, policy announcements are likely to be seen as, more or less, temporary in character and thereby fail to induce the desired change in behaviour of economic agents. A continuous reversal of policy decisions under pressure of special interest groups eventually erodes the administrative fiat of government and leads to the effective abdication of the task of economic management. It is, therefore, that much more necessary for major policy changes to be carefully thought through and only announced after a broad-based coalition of support has been built.

Consistency of economic policy is especially important from the viewpoint of promoting medium-and long-term decisions by economic agents on the nature of their participation in the economy. Continuity, in particular, is essential in taxation and trade policies, related to the degree of protection, for potential investors to project likely levels of profitability of projects under consideration. It is not surprising that business surveys generally find that foreign investors have a stronger preference for countries which demonstrate a consistency in their economic policies over time. This is frequently considered more important than the regime of fiscal incentives in place to attract FDI.

Discontinuity in economic policies is likely to be the most pronounced at the time of transition from one government to another. This is motivated by a number of factors. First, the new government sees the change as a way of discrediting the previous government for following the wrong set of policies. Second, the base of support for the in-coming government may be different and changes in policy are deemed essential to reward particular target groups. However, this has the consequence of creating a great deal of medium-term uncertainty about the conduct and nature of economic policy.

In the Pakistani context, this is epitomised, for example, by the reversal of the policy on Independent Power Producers (IPP) of the Benazir Bhutto Government by the Nawaz Sharif government. According to this policy, long term memoranda of agreement were signed specifying the formula for pricing of electricity sold to WAPDA. There was a sizeable investment response and today about 25 per cent of the capacity for electricity generation in the country is with the IPPs (including HUBCO and KAPCO). The Nawaz Sharif government soon after its induction into power proceeded to re-negotiate the contracts on the grounds that the price set was too high. Simultaneously, proceedings were started by the Ehtesab (Accountability) Bureau to determine if money had exchanged hands illegally in the signing of these agreements. Two years have elapsed and the process of negotiation with the largest private power producer, HUBCO, have yet to come to an end. The new government had made a commitment to resolve this problem by the 14th of January 2000 but has been unsuccessful in reaching a settlement with HUBCO by this date.

The lack of consistency is also manifest in the short run. This relates, for example, to the practice of announcing mini-budgets. Clearly, changes in fiscal policy are justified during a particular financial year in the event of unanticipated, exogenous shocks like a major crop failure, rise in international prices, etc. In 1998-99, after the imposition of sanctions the Government of Pakistan was compelled to announce draconian measures including a 25 per cent hike in petrol prices. But mini-budgets become a serious problem in normal times when a government follows a strategy of announcing a soft tax-free budget initially and then, more or less, surreptiously announces taxation proposals over the year.

Rapid changes in taxation or protection policies create a perpetual state of uncertainty in markets. They promote rent seeking and speculative behaviour and ultimately damage the prospects for investment and growth. It is essential that in the larger national interest there is consensus on a minimum economic agenda to ensure continuity of policies in key areas. Also, as a way of discouraging mid-year changes in taxation policy it is essential that each individual proposal should not be promulgated through SROs (Statutory Regulatory Orders) but through proper legal amendments after due process. The Chief Executive has announced in his ERP the end of the 'SRO Culture'.

5 PROTECTION OF THE PUBLIC INTEREST

We move now to the political economy of the reform process. A key test of the quality of economic governance is whether policies are oriented towards powerful special interest groups or are motivated by the objective of protecting what can be called broadly 'the public interest'. The political economy of reforms relates to the identification of gainers and losers. If it becomes clear that most of the time the government is catering to particular interest groups then the quality of economic governance becomes suspect. For sound and neutral policies it is enough that the welfare loss to losers should be less than the welfare gain to gainers, irrespective of who the gainers and losers are. But a bias in policy making becomes visible when a government appears to be concerned only about the gains to a particular segment of society and ignores the costs that it may confer on people at large.

TABLE 4
TAX EXPENDITURES ? IN PAKISTAN
1998-99

(Rs in Billion)

Tax	Tax Expenditure
Income Tax	40
Customs Duty	35
Sales Tax	25
TOTAL	**100**

State capture by special interest groups is most acutely manifest in the level and nature of tax expenditures (representing the revenue foregone in granting of tax exemptions or concessions) and subsidies from the exchequer, both implicit and explicit. Tax expenditures in Pakistan are estimated conservatively in excess of Rs 100 billion **(see Table 4)**. This is equivalent to as much as one thirds of the actual tax revenues collected. Almost 40 per cent are in the income tax and include the exemption on capital gains; on income from bearer financial instruments; on income from foreign currency accounts; on profits from IPPs and statutory public corporations; on bonus shares, on business income of various trusts, chambers of commerce, elite clubs; on perquisites in kind and in cash of high level public officials, etc., and tax holidays for specific areas and industries. In addition there is immunity from assessment of sources of income for money invested in acquiring assets through privatisation or public auction or original purchase of shares. Most of the tax expenditures benefit the potential income tax payers, who by definition belong to the upper income groups. The new government has made some effort to curb tax expenditures. The income tax exemption on FCAs and whitener schemes have been with drawn. But a lot more needs to be done.

Perhaps the best example of subsidies are those targeted primarily to the feudal elite. Not only is their income tax liability marginal, but they also have access to a wide range of subsidies on inputs including irrigation, electricity for tubewells, agricultural credit, tractors, etc. The total subsidy bill on these inputs aggregates to about Rs 40 billion. In addition, subsidies on secondary and higher education, on curative health, on supply of drinking water, on consumptionof gas, etc., which primarily benefit the rich segments of society exceed Rs. 50 billion.

Beyond this, the privilaged access of some groups to the inner circles of policy making is demonstrated by particular decisions taken to protect their interest. Some recent examples will demonstrate this point:

! The agricultural income tax is a contentious issue in Pakistan with the farming lobby jealously guarding its privilege of tax exemption and frustrating any moves for levy of agricultural income tax. The tax has been legislated in at least two provinces but collections are only about one tenths of the potential level. The new government has recognised that agricultural income should be treated like any other form of income but has delayed implementation of a meaningful AIT nationwide till after June 2000.

! Special concessions are widespread in the cotton and textiles sector of Pakistan. The All Pakistan Textile Manufacturers Association (APTMA), one of the strongest lobbies in Pakistan, was able to get permission of the Nawaz Sharif government to import one million bales of cotton earlier in 1999. Beyond this, the new government has also revealed its vulnerability to APTMA pressures. The abandonment of the cotton price support policy has led to a precipitous fall in prices to the benefit of textile manufacturers and the detriment of growers.

! The wholesale and retail trade sector is the largest component of the informal economy and compares favourably in size with the large-scale manufacturing sector. It has largely remained outside the tax net. Any meaningful extension of the sales and income taxes would have to cover this sector. The trading community, with a strong political voice within the Pakistan Muslim League had been able to frustrate moves by the Nawaz Sharif government to extend the GST to the sector. The new government has also succumbed to pressure of the traders and postponed the extension of GST on the basis of proper documentation.

The problem is that whenever any particular interest group is able to extract a concession from the government the burden automatically falls on the exchequer. This necessitates either higher taxation elsewhere, usually regressive in incidence, or cut back in expenditures in areas which are generally pro-poor. In this respect the larger public interest is sacrificed. This is why I place such a high premium on this element of economic governance.

6 ABILITY TO MANAGE CRISIS

In some sense the litmus test of good economic governance is how crises when they come are handled. This requires the presence of early warning systems, quick policy response times and a willingness at both the political and bureaucratic levels to take strong actions to mitigate against the impact of crisis. Perhaps, more importantly, it requires the adoption of a long term development strategy which insulates the economy to the extent possible from external shocks caused by fluctuations in the global economy. It is in the latter respect where the recent experience of the Asian financial crisis has demonstrated the inherent resilience of South Asian economies, including Pakistan. There has been only minor impact of the contagion effects of the crisis on the growth rates in the region in 1997 and 1998 **(see Table 5)**.

TABLE 5
REGIONAL GROWTH RATES

(%)

	Average for 1993 to 1996	1997	1998
Newly Industrialising Economies[a]	6.9	6.0	-1.4
South East Asia[b]	7.6	4.0	-6.9
South Asia[c]	6.2	4.7	5.7

[a]*Pakistan, Hong Kong (China), Korea (Rep of), Taipei (China)*
[b]*Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand, Vietnam*
[c]*Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka*
Source: Asian Development Outlook, Asian Development Bank, 1999

What explains the apparent ability of most South Asian countries to emerge relatively unscathed from this crisis, which has ravaged some economies like Indonesia and Thailand? I believe the answer for this lies in the fact that historically most governments in the region have opted for a more conservative and safer growth strategy, which implied less growth but also reduced the vulnerability to external shocks. One of the primary elements of such a strategy was a policy of import substitution rather than export promotion. This reduced dependence on external markets and limited the degree of openness of the economies.

Other factors which have reduced the propensity for crisis include, first, less dependence historically on potentially destabilising short-term private capital inflows[7], second, better financial sector governance in terms of the composition of the asset portfolios, with substantially less exposure to real estate[8], third, less reliance on foreign sources for corporate debt, fourth, smaller component of short or medium-term commercial debt in external public and publicly guaranteed debt and, fifth, greater diversification of export markets.[9]

The ability to manage crises well is also demonstrated by the response to the sanctions imposed upon India and Pakistan following the nuclear blasts in 1998. There was a general expectation that the short run impact on India would be minimal in lieu of its large foreign exchange reserves[10] but that Pakistan's economy would not be able to stand up for too long in view of the poor reserves position even prior to the sanctions. It was feared that the exchange rate would tumble and prices of essential commodities would escalate rapidly. In any event this did not happen and the economy held up reasonably well in the intervening seven month period between the imposition of sanctions and the receipt of balance of payments support from the IMF.

This was achieved due to a combination of some positive underlying factors and strong policy moves. Among the former was a favourable food supply situation due to the bumper wheat crop in the previous year, the steep fall in import prices, especially of petroleum products, momentum of the informal economy and a modicum of support from friendly countries. The strong, almost draconian, policy measures to manage the crisis included the freezing of foreign currency accounts, imposition of tight capital controls, introduction of import margin requirements, transition to a dual exchange rate regime with the lower official rate applying on essential imports,[11] a large increase in the tax on petrol, sharp cut backs in public expenditure, deferment of public sector imports, non-repayment of debt (except to multi lateral preferred creditors) and so on. Pakistan closed the year 1998-99 with some growth in the GDP of about 3 per cent such that there was no fall in real per capita income. The inflation rate actually came down to 6 per cent while the currency depreciated by not more than 16 per cent. However, it needs to be said that Pakistan will continue to pay a price for the sanctions in the medium run due to the loss of confidence arising from some of the policy actions.

Altogether, I would be inclined to give relatively high marks to economic governance in South Asia in terms of the ability to either prevent or manage crisis. As opposed to this, the high flying East Asian economies revealed for the first time their inherent vulnerability to financial crisis. But credit must also be given to most governments in these countries for having taken such strong measures to emerge fairly quickly from a very deep crisis.

Also, there is temptation to conclude that Pakistan should not open up its economy to prevent the recurrence of another crisis. But I believe that this is not the answer. Instead, we should pursue the path of gradual liberalisation, especially of the capital account of the balance of payments. This way we will able to capture some of the benefits of globalisation while insulating the economy from major external shocks.

I come now to the elements of good economic governance in the delivery of services and performance of public functions.

7 EFFECTIVE DELIVERY OF SERVICES

The paper has already identified as one of the problems of economic governance the choice of wrong priorities in the allocation of public expenditure whereby expenditures, in particular, on development, social services and safety nets have suffered. Superimposed on this is the fact that whatever expenditures are incurred in these areas are not spent in an efficient and cost effective manner. In addition in the case of services provided publicly which are of a private nature there is little emphasis on adequate direct cost recovery. This has further restricted operating and maintenance outlays and led to a progressive decline in the quality of services provided.

Public utilities can be viewed as microcosms of the wider financial management problem. State enterprises have been primary targets for political patronage resulting in massive over employment and unsustainably large subsidies to favoured target groups. Rampant corruption, inefficient management and large revenue leakages have eroded financial viability even further.

In Pakistan, the typical public utility now employs three to four times the number it should. WAPDA is beset with serious financial and management problems which threaten to even have macroeconomic consequences. Costs of power generation have risen rapidly due to increasing reliance on thermal power, commissioning of IPPs and rise in the price of furnace oil. Serious management and technical inefficiencies exist in transmission and distribution and overall system (including billing) losses have approached one thirds. On top of this are serious problems in the setting of tariffs and in collection of receivables. Large numbers of consumers remain heavily subsidised. It is estimated that subsidies to domestic, agricultural and public sector consumers and to consumers in some designated areas imply a subsidy (difference between the tariff and marginal cost) of as much as Rs 30 billion, as compared to actual revenues of about Rs 130 billion. Not only are tariffs low in many cases but there are serious problems of theft, undercharging and recovery of bills. Receivables stand at over Rs 30 billion, primarily from government entities. This has contributed to a problem of circular debt whereby WAPDA has defaulted on its payments to its suppliers. Recent attempts at enhancing tariffs, especially for industrial consumers who constitute the biggest source of revenue, have largely proved to be counter-productive in the presence of an economic recession and the growing viability of captive power generation by industrial units.

In the context of social services, starting from a low level, expenditures have grown rapidly until recently by about 20 per cent per annum, due in particular to the impetus provided by enhanced donor contributions to the Social Action Program (SAP), the largest program ever undertaken for provision of basic social services in Pakistan. But after over six years of SAP there is a general feeling that the large expenditure (of over Rs 200 billion) on the program has not been matched by outcomes in terms of the impact on social indicators. Gross enrollment rates have actually fallen for boys while there has been only a modest increase in the case of girls and in health standards generally.[12]

The question is why SAP has not performed as well as was initially anticipated. The answers are to be found in the slow pace of institutional reforms, the presence of vested political interests at various levels who remain strong enough to frustrate reform, bureaucratic delays and political interference in selection/location of projects and recruitment, excessive centralisation of the management of services which has precluded community and beneficiary involvement, weak implementation capacity, lack of adequate non-salary inputs and growing worries of the provincial governments about the financial sustainability of SAP.

As far as social safety sets are concerned, there is very limited involvement of the government in poverty alleviation directly, even though there is strong evidence that poverty is rising rapidly. Most schemes have weak institutional structures, their funding is uncertain and the coverage is very limited. The income value of the transfers is less than one per cent of the GDP. This percentage is likely to shrink further as the food subsidy is withdrawn, as public contributions to the Bait ul Maal and the Employees Old Age Benefits (EOBI) scheme shrink in the presence of fiscal constraints and as deductions of Zakat diminish following the recent Supreme Court judgement.

There is need for a stronger commitment of government and donor agencies to the process of poverty alleviation in Pakistan. Institutional arrangements need to be strengthened for better targeting in schemes such as Zakat and Bait ul Maal while at the same time making the procedures transparent and more simple. The new government appears to have recognised the problem of growing poverty and has proposed a nationwide Public Works Program to provide employment opportunities to low paid workers and a program of micro-credit including the establishment of a separate bank for this purpose. One of the key tests of the economic performance of the present government will be its ability to move fast in implementing its reform agenda, especially the establishment of social safety nets on an emergency basis.

8 INTEGRITY

We come now to an important element of economic governance relating to the level of corruption in the discharge of government functions. The HDC report [1999] has rightly referred to corruption as a 'menace' and emphasised that it is one of the most damaging features of poor governance. When corruption becomes deeply entrenched it can devastate the entire economic, political and social fabric of a country. There is, in fact, a mutually reinforcing vicious cycle between corruption and human development. Corruption hinders human development directly by limiting access to basic social services and indirectly by reducing economic growth due to loss of investment. Low levels of human development contribute to an environment which breeds corruption and reduces governance still further.

Corruption in developing countries including Pakistan has a number of distinctive features. First, it also occurs upstream at the highest levels of government thereby distorting fundamental decisions about development priorities, policies and projects. Second, corruption moneys are usually smuggled out to safe havens abroad and in this sense there is no local multiplier effect. Third, there are no effective accountability mechanisms against corruption. Fourth, corruption occurs generally in an environment of deprivation. These features make corruption more damaging.

There are essentially three types of corruption. The first is petty corruption mostly by low level personnel in the performance of some regulatory function (e.g., traffic police) or provision of some service (e.g., black marketing of drinking water through tankers). Middle level corruption normally takes place at the enterprise level by bureaucrats in areas like industrial licencing, award of contracts, allocation of quotas and tax evasion. Grand corruption occurs at the highest levels of the state and frequently involves foreign money (e.g., SGS-Cotechna case in the last PPP government).

Corruption can be equated with monopoly power plus discretion minus accountability and low government salaries. Exclusive provision of a service and greater discretion in the discharge of the function leads to more corruption. Trade restrictions, government subsidies, price controls, etc. are well-known sources of corruption. Accountability has traditionally been low in Pakistan at all levels – state, judicial and civil society. With poorly paid public officials, Pakistan is also more susceptible to corruption.

The extent of corruption is particularly difficult to quantify because by definition it is unobserved. The HDC report makes a first estimate of corruption in Pakistan of Rs 100 billion, with the caveat that this is a conservative estimate. The big areas of corruption in Pakistan include tax evasion in connivance with the tax collector; illicit trade across borders with the tacit approval of security forces; theft and underpayment of public utility bills in collaboration with meter readers; bribes on the award of engineering contracts for development or maintenance works in the public sector; corruption in the granting of bank loans; judicial and police corruption.

There are indications, however, the level of corruption has been changing in Pakistan. The Corruption Perceptions Index of Transparency International had ranked Pakistan as being second in the sample of countries included in 1996. Pakistan's ranking fell subsequently. It was ranked fifth in 1997 and fourteenth in 1998. In 1999 there is a deterioration in the ranking to twelfth in light of the perception that towards the end the Nawaz Sharif government had also become vulnerable to high levels of corruption.

It must be remembered that the Corruption Perceptions Index is based primarily on the views of foreign and local businessmen on the amount of corruption involved in conducting their activities in a particular country. As such, this index is probably geared more towards measuring the level of middle level and grand corruption rather than petty corruption. In 1996, the perception of grand corruption in Pakistan was at its peak and this explains why Pakistan was ranked second that year.

Despite the improvement of Pakistan in the Transparency International's Index, corruption continues to be perceived by the people as a major problem and there is growing clamour for establishing strong, independent and even-handed mechanisms of anti-corruption and accountability in the country. This process has commenced under the new government although there is a feeling that the process is being selectively applied and proceeding more slowly than anticipated. I believe that while grand and middle level corruption may have declined, there continues to be high and possibly rising level of petty corruption in the country. The former explains the improvement of Pakistan in the international ranking. Petty corruption impacts the lives of the largest number of people, and this explains the growing public frustration.

There are a number of factors which explain why grand and middle level corruption may be on the decline. First, a number of important policy initiatives have reduced opportunities for and gains from rent seeking in Pakistan. This includes efforts at simplification of the tax code, rationalisation of tax rates (especially income tax and customs duties),[13] introduction of withholding and presumptive tax regime[14] and reduction in the multiplicity of taxes.[15] The adoption of a liberalisation agenda in the trade and investment regime has also reduced the quantum of rent seeking activities. Of prime importance here is the withdrawal of import quotas, deregulation of investment sanctioning and approval procedures and improvement in the management of textile quotas. In addition, the greater autonomy granted to the banking sector, professionalisation of managements and reduction in schemes of concessionary finance have probably reduced the element of graft and corruption in the sanctioning of bank loans. On top of all this, the opportunities for grand corruption have been diminished by the overall decline in the level of public investment, foreign direct investment and overseas military purchases during the last few years. In other words, opportunities for grand corruption have become fewer.

The rise in petty corruption is a reflection of the systemic nature of corruption. It has been further reinforced by falling real incomes of low level public officials in the absence of regular upward adjustments in salaries. In addition, as shortages have emerged in key public services due to lack of adequate maintenance and investment the rents from access have increased. Perhaps one of the best examples is in the provision of drinking water in metropolitan areas, where in the presence of supply shortages, a large and entrenched tanker mafia has come into existence. In other services, sharp increases in tariffs, for example, in electricity, have increased the potential gains from theft or underpayment.

Altogether, integrity in the formulation and conduct of economic policy and in the discharging of government functions of regulation and provision of services remains a vital element of economic governance. A wide ranging program for elimination of corruption has become absolutely essential. Given the systemic nature that corruption has acquired, it is necessary that strong symbolic actions must 'pave the path' for sending a shock to jolt it out of the corruption trap. The government must identify and give exemplary punishments to major tax evaders, a few dishonest judges and corrupt officials of public utilities. This is clearly the peoples expectation from the present government.

9 SOVEREIGNTY

Last but not the least, I take up the issue of sovereignty of governments in the process of policy and decision making. Given its persistent balance of payments problem Pakistan has been forced periodically since 1988 to seek program assistance from the IMF and other international agencies. Funding has been made conditional frequently on a number of reforms. Most governments have abdicated from the task of identifying home grown reforms and have passively accepted the set recipe of measures from the Fund and the World Bank. This has created a number of problems. First, at the purely technical level the set recipe (referred to as the Washington consensus) essentially involving hikes in interest rates, tax rates and utility tariffs alongwith currency depreciation has been shown to be defective in achieving the desired macroeconomic stabilisation. This has been most acutely highlighted by the consequences of the IMF programs implemented by South East and East Asian countries during the recent financial crisis. Interest rate hikes have deepened the recession and throttled investment. Currency depreciation alongwith withdrawal of food subsidies have greatly exacerbated the problem of growing poverty and so on.

Second, there has been little 'ownership' of the reforms by government. Virtually all IMF programs in Pakistan have floundered on the grounds of partial, delayed and defective implementation. There has been some flurry of action around the time of mission reviews and release of tranches followed by inactivity subsequently. In fact, Pakistan is frequently referred to as a 'first tranche' country. The revived IMF

ESAF/EFF program which provided significant up front financing and debt relief from the Club of Paris has also run into problems since June 99. The Nawaz Sharif government failed to implement key conditionalities related to enhancement of petrol prices, resolution of the IPP problem and broad-basing of the GST. The new government has raised petrol prices but has not succeeded to date on other fronts. Consequently, the program remains in a state of limbo.

Clearly, Pakistan has to take a fundamental decision if it wants financial assistance from IMF and other international agencies. If it does and the Chief Executive has hinted that the country will be seeking a second round of debt relief after the expiry of the first round on 31st December 2000 in view of the unsustainability of the balance of payments position beyond this date, then the government must seize the initiative by pursuing vigorously the reform agenda and starting re-negotiations with the Fund on perhaps a new and expanded facility. The best way to assert sovereignty is to get agreement on program targets and then develop a truly home grown reform package to achieve the agreed targets after careful technical analysis and evolution of a national consensus on the package. Of course, implicit in this approach is the assumption that if the Fund does not think that the reforms are adequate then it can withhold program financing. However, this approach will lead to the reassertation of self-confidence and a commitment to the process of reforms by government. Once agreed, the program will have a greater chance of successful implementation.

10 CONCLUSIONS

The paper has identified nine elements of good economic governance as achievement of growth with equity, fiscal discipline, institutional capacity, credibility and consistency, protection of the public interest, ability to manage crisis, effective delivery of services, integrity and sovereignty. Based on these dimensions, the track record of economic governance in Pakistan appears to be a mixed one, with visible signs of deterioration in the 90s.

The military government has also adopted a reforms agenda which is not as strong and far reaching as was expected given the deep-rooted structural problems of the economy. Areas which not have been accorded sufficiently high short-run priority include measures for restoration of investor confidence, export promotion and resource mobilisation. It has also shown hesitation in quickly and effectively implementing whatever its reform agenda is. Clearly if Pakistan's economy is to emerge once again as a relatively high growth performer the quality of economic governance will have to be of the highest level. This perhaps the greatest challenge that Pakistan's leadership faces today.

NOTES

[1]The maximum personal income tax rate was reduced from 38½ per cent to 20 per cent, the maximum import tariff from 65 per cent to 45 per cent and the standard general sales tax (GST) rate from 18 per cent to 12½ per cent.

[2]The procurement price of wheat was increased by 39 per cent and the support price of sugarcane by 46 per cent.

[3]The growth rate of manufacturing increased from 1.3 per cent to 7.9 per cent and that of agriculture from 0.1 per cent to 3.8 per cent in 1997-98.

[4]While interest rates charged will probably remain close to market levels other subsidies were offered. For the housing scheme, public land was to be made available free while customs duty exemptions were being given in the urban transport scheme.

[5]According to article 156 of the Constitution of Pakistan, 'the President shall constitute a National Economic council consisting of the Prime Minister, who shall be its Chairman and such other members as the President may determine:

Provided that the President shall nominate one member from each Province on the recommendation of the Government of the province.

(2) the National Economic council shall review the overall economic condition of the country and shall, for advising the federal government and the provincial governments, formulate plans in respect of financial, commercial, social and economic policies; and in formulating such plans, it shall be guided by the Principles of Policy set out in Chapter 2 of part II'.

[6]This includes the three largest commercial banks of Pakistan) Habib Bank, United Bank and the National Bank of Pakistan-whose collective share in advances is about 65 per cent.

[7]In 1995 inflows of private portfolio capital are estimated at 3.6 per cent of the GDP for South East Asia and only 0.6 per cent of the GDP for South Asia, according to the Asian Development Bank.

[8]The component of bank advances for construction of real estate is only 1 per cent while the use of land and buildings as collateral against loans is about 12 per cent in Pakistan.

[9]In 1997, 53 per cent of export from Newly Industrializing Economies, 54 per cent from South East Asia and only 25 per cent from South Asia was destined for Asian markets.

[10]India had over $ 26 billion of reserves while Pakistan had reserves of only about $ 1 billion at the time of imposition of sanctions.

[11]Official exchange rate imports included wheat, petroleum products, edible oil, fertilizer, pharmaceuticals and pulses.

[12]The primary gross enrollment rate for boys fell from 86 per cent in 1991 to 80 per cent in 1997. During the same period, the primary gross enrollment rate for girls rose from 59 per cent to 64 per cent. Full immunisation coverage increased from 25 per cent to 51 per cent while the incidence of diarrhoea fell from 26 per cent to 15 per cent.

[13]The number of slabs of customs duty has been brought down from 13 to 4.

[14]Withholding and presumptive taxes account for about 70 per cent of total revenues from income tax.

[15]In a major move in the budget of 1999-2000 the federal government has announced the abolition of octroi/ export tax, the primary local source of revenue and instead instituted a system of grants in lieu of the revenue loss. This tax had become notorious for harassment and corruption. Earlier, federal taxes which encroached on the provincial domain were withdrawn.

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ELEMENTS OF GOOD ECONOMIC GOVERNANCE

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