Governance Reforms in Government, Public Sector and Regulatory Bodies[1]

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Let me begin by setting the context in which the discussion of this topic should be focused. Eighty percent of national economic output is generated by the private sector. Government however plays a critical role in the generation of this output through its overwhelming role in the polity, economy and international relations. So a prior question that needs to be addressed before delving in the topic:

What should be the appropriate relationship between government and private business in Pakistan? In my view, the government has at least five functions to perform – an Enabler and Regulator, Protector of Life and Property, Enforcer of Rule, Law and Contract, Provider of Infrastructure and Investor in Human Capital. I would take up each of these roles and dwell on them briefly.

Government as an Enabler, Promoter and Regulator

Past track record since 1970s clearly shows that in Pakistan at least. Government has no business in doing business. The politicians and bureaucrats in Pakistan are neither equipped nor have the appetite for risk taking in running businesses. The poor record of nationalized companies since 1973 corroborates this assertion. In contrast, the pre-1970 period in which Pakistan had almost reached an economic take off point provides strong evidence that when the government acts as an enabler, promote and regulator the economy does make impressive progress. The strain on our public finances due to losses of public entries is a matter of common knowledge. Suffice to say that the production, distribution, marketing, trading of goals and services should be carried out by the private sector. What the Government can do is to ensure a level playing field for all market participants. If the market structure is monopoly, oligopoly, cartel or in other wawy imperfect the welfare of the public who buy these goods and services will be hurt. The Government through Competition, Commission, Regulation, Legislation and oversight has to protect the consumers from the abuse of market power. A private monopoly, in my

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view, is worse than a public monopoly and should be shunned. The cost of regulation should not be so overbearing that it stifles innovation and risk taking and the accountability of regulatory agencies should be built in its mandate. Regulatory arbitrage is a risk that has to be kept under constant watch.

Protector of Life and Property

The second important function of the government is well known – national defense, internal security and protection of life and property of citizens. This is an area where there has been a gradual deterioration over time and until recently, the residents of Karachi for example, lived in a perpetual state of fear for our physical safety and protection of property. Thousands of civilians had lost their lives in terrorist attacks in the last seven years. The recent action by the Rangers against terrorists and criminal elements has restored the confidence of domestic and foreign investors but this needs to be sustained as a matter of routine rather than exception. A complete restructuring and reform of the Police Force, Investigation, Prosecution agencies and the prisons and the lower judiciary is the only way to achieve a credible system of administration of justice.

Enforcer of Rule of Law and Contracts.

The third function of the government is to have an impartial system of adjudication of disputes and enforcement of contracts. Private markets cannot function if property rights are not protected, contracts are not honored and disputes are not settled through an open system of the courts of law. Alternate Dispute Resolution (ADR) mechanism and small causes counts, Municipal courts and other similar costs effective processes should be put in place. If land disputes linger on for over decades in the courts, how can you expect businesses to enter into long term investments? If bank loans worth billions of rupees are stuck because of the protracted litigation, how can you expect banks to make loans liberally? If billion of taxes cannot be recovered because of the stay orders and unending appeals and adjournments how can a culture of tax enforcement be nurtured. PEW Global Attitudes Survey of 2010 reported that the court system in Pakistan had approval rating of only 55 percent – the fourth after the Military (84 percent), the Media (76 percent) and Religious leaders (62 percent). This does not show an elevated sense of confidence in our lower judiciary. The related issue of competence is equally serious. Legal practioners and judicial officers who are well versed in Commercial Law, Corporate Law etc. are few and far between leading to unnecessary adjournments, protracted proceeding, postponed decision and pilling up of cases in the courts. Pakistan's percentile rank in the World Bank's rule of Law indicator has deteriorated from 65 to 81 and among the 20 most populous countries Pakistan ranks 19th followed by Nigeria.

Provider of Infrastructure

The fourth area of government responsibility is the provision of physical infrastructure – roads, bridges, highways, ports, terminals, pipelines, railways, power, gas dams, irrigation water etc. these are basically public goods who benefits cannot be appropriated exclusively by an one group of citizens. They are lumpy investments which involve issues of Right of Way, land acquisition, resettlement, compensation that are beyond the reach of the private investors. Therefore, provision of these public goods reduce the unit costs of production and distribution for the private sector and enhance the competitiveness of a country's tradable goods. In Pakistan, the opposite has taken place. A shortfall of 6000 MW power has made Pakistani exporters lose their orders as they could not produce the goods according to the agreed delivery dates. Other countries have successfully experimented with Public-Private Partnership to meet infrastructure deficiencies and although every government in Pakistan has paid lip service to it but the record is quite mixed. Even the utilization of the existing capacity in the private sector is sub-optimal because of the circular debt problem.

Investing in Human Capital

The fifth area of responsibility for the government is to invest in human development – schools, colleges, universities, technical and vocational institutions. Pakistan ranks among the Low Human Development countries according to the Human Development Index. Adult literacy and average schooling of labor force are dismally low – almost half of the population is illiterate. Only 20 percent of females participate in employable workforce. Infant mortality and child malnutrition indicators are the worst in South Asia. Considering the fact that there is a close connection between human development and overall rate of growth the social returns on these activities are quite high. The private benefits from the investment in human development leak out because of what the economist called “externalities”. Vocational and technical training that can benefit the bulging youth population of the country has an enrollment of only 1 percent of the age cohort. Skilled manpower can meet the requirements of the economy as well as that of the Gulf States. Simply increasing Government’s allocation education and health towards Education and Health would not make any difference unless the governance and delivery of services are set right particularly to the rural female, privileged sections of the population.

To perform the above mentioned multiple roles there are two essential prerequisites that the government should possess. The bureaucracy administering laws, rules and regulations, protecting life and property or building infrastructure or running schools and health center should be efficient, and free from large scale corruption. Inefficiency and corruption cause heavy damage to the economy and stifle growth of businesses. Pakistan’s rank in Transparency International Perception survey now falls below Bangladesh – once perceived as the most corrupt country in the world. Second, there should be continuity and consistency in public policies. Sharp twists and turn with each change in the government erode the credibility of the country. With every incoming government reversing the policies, projects and programs of its predecessor, uncertainty about the country’s long term commitment gets worse.

I would now turn to the salient features of Government’s internal organization, structure and functioning. The three functions of policy making, ownership of the assets and regulatory oversight should be totally separated. Until the beginning of this decade all these varied functions in Pakistan were bundled together and carried out by each Ministry. In early 2000s the Cabinet decided to unbundle these functions to avoid conflict of interest, protect consumers and provide a level playing field for both the public and private sectors. The concern was: How can a private firm compete with a public sector firm in the same field when the Government owned firm enjoys substantial advantages. For example, the Ministry can always alter the policies to favor its own firm, it can arrange tax concession specific for that firm, it can finance the losses of the firm from the public exchequer, provide subsidies for underpricing the products the firm sells and it can create many hurdles to stifle the growth of the competing private firms. The Cabinet therefore set up an independent regulatory agency not answerable to the Ministry to carry out regulatory functions, it established autonomous Boards of Directors consisting mainly of independent non-executive Directors to govern the public sector firms and made the Ministry responsible for policy making only. This pilot experiment was carried out in the case of the Ministry of Petroleum and Natural Resources (MPNR). Oil and Gas Regulatory Authority (OGRA) was set up to regulate the oil and gas sector. State owned companies such as OGDC, PSO, PPL, SNGPL, Sui Southern were given their own Boards of Directors which carried out the governance of these entities and the MPNR was left to focus on policy making. This experiment, in my view, proved successful and should have been extended to other Ministries also. Some half-hearted attempts were made but fierce resistance by the Ministries and the bureaucrats who were clearly losing power and authority due to this separation have not so far allowed the whole water front to be covered. As a matter of fact there has been reversal of these reforms and open conflicts between the ministers and the regulatory bodies.

At this point, I would like to clarify a few popular misconceptions. First, independence of the regulatory agencies cannot be and should not be misconstrued as independence from the Government. All regulatory agencies will have to act within the policy framework set by the Executive branch under the laws formulated by the legislature. All actions of the regulators are open to scrutiny by the judiciary. Second, it is the governance structure that has to be carefully thought through. If the Boards of the state owned companies are saddled with too many bureaucrats representing various ministries then there won't be much qualitative difference between the direct control of the Ministry in-charge of the SoE and the Board so constituted. Independent non-executive directors who bring expertise and knowledge in the areas of finance, accounting, law, strategy, marketing, sectoral expertise should be invited to serve on these Boards. Third, the management of regulatory agencies should not be entrusted to loyal government servants as sinecure for their post-retirement life. Competence and demonstrated track record of performance in the sector or leadership qualities exhibited in their professional life should form the basis for selection. An open, transparent process for selecting the Chief Executive of the regulatory agencies and major state-owned companies and corporations should be followed. It would be desirable if the selection is endorsed by the relevant parliamentary committees to assure bipartisan support and continuity even after the government is changed. Capacity building of the regulatory agency is a sine quo non for its strength and effectiveness. Only professionals well versed in economics, finance, engineering, technology, law should be inducted and sent for attachment to similar agencies all over the world for short durations. Fourth, the regulatory agency should be accountable to the Parliament. Each agency should submit an Annual Performance Report to the relevant committees of the National Assembly and the Senate. These committees should have the powers to summon the heads of the regulatory agencies and hold public hearing. As most of the agencies raise their own funds their budgets must also be approved by the Parliamentary Committees.

The next point I would like to make is that the sloganeering or ideology-driven dichotomy between Regulation vs Deregulation is totally false and devoid of any meaningful content. As I would show the Government and the regulators have multiple roles to play under different market structures and situations. AT times they may be regulating some activities while deregulating others. In some instances they may be exercising a light regulatory oversight while in others they may come up with strong hands. It is the empirics and not ideology that should determine as to what is the most appropriate role for the Government.

In the realm of policy the most important instrument through which the State can influence the private sector behavior is through taxation. If the existing well performing businesses such as Telecommunications and IT, Banking, Oil and Gas are penalized by heavy taxation this acts as a disincentive for further investment, expansion and growth of those sectors. Economic policy making through a taxation dominant thrust creates market distortions, and suppresses growth. On the other hand, equity demands that other undertaxed and low tax incidence sectors and activities should be brought into the tax net so that the burden is shared widely and equitably. Let me illustrate the problem with the help of a present day example.

The SBP in its recent report has attributed high tax incidence in the telecom sector as one of the reasons for the low penetration of internet users and *broadband connections in the country. The World Bank has ranked Pakistan among the five least connected countries in the world despite being among the top 10 countries in the terms of number of mobile phone users. It is not realized by our tax policy makers that this myopic approach has huge economic costs. For every 10 percent increase in the penetration of broadband services there is an increase in economic growth of 1.3 percent. We already have the record of lowest growth rate in the region and any other country in our place would have simulated those sectors which would accelerate the growth rate. Instead of stimulus we are suppressing the potential of those sectors from being realized.*

Studies on sectoral incidences show that industry bears more than two-thirds of the tax – while the services sector bears about 21 percent and agriculture 3 percent. About 90 percent of farm facilities have subsistence holdings. Of the remaining, only a third holding more than 50 acres of land would cross the threshold of taxable income. To expect the agriculture sector (20 percent of the GDP) to make an equi-proportional contribution to national tax revenues is unrealistic. The yield s from farm income are unlikely to exceed 1 percent or 2 percent of the current tax revenue collection. The filing of tax returns by agriculture will, however, stop the leakages from non-agricultural incomes and bring a sense of equitable burden sharing among all classes of tax payers.

In the services sector, transportation and trade together account for one-third of GDP. Most transport movement takes place via roads and except for a few companies the sub-sector is dominated by small and medium-size operators. Only air and shipping yield some revenues. Similarly, out of 1.5 million wholesale and retail trade units (employing a population of nine million) 85 percent are small family-run stores. The entire direct and sales tax collection from the trade sub-sector constitutes 0.5 percent of federal taxes. The scope from the services sector also remains limited.

As two-third of the tax collected is in the forms of indirect taxes and one-fourth of the entire amount comes from petroleum products at various stages (which is passed on two consumers) the overall incidence is regressive. Even where direct taxes are concerned, two-thirds consists of withholding taxes which are deemed to be the full and final settlement of tax liability. So, in terms of the impact on different income groups the burden falls disproportionately on the poor and middle-income groups.

On top of this, policy makers, in their attempt to attain revenue targets, impose additional levies on existing taxpayers. This disincentive leads to the quest for various loopholes in the complex tax code – saddled with enormous discretionary regulations – to understate incomes, claim exemptions and paying full taxes.

The analysis here shows that the present taxation regime that is highly skewed towards the urban, industry and formal sectors in narrow, inequitable, regressive and distortive. Unless a structural transformation of the economy take place – one that expands the formal sector, makes the rural sector and agriculture more efficient, raises middle class numbers and makes taxes more progressive and less patronage ridden – attempts to reform the tax regime will continue to produce unimpressive results.