Economic Reforms and Macroeconomic Management in Pakistan
(1999-2001)

ISHRAT HUSAIN

Pakistan was one of the few developing countries that had achieved an average growth rate of over 5 percent over a four decade period ending 1990. Consequently, the incidence of poverty had declined from 40 percent to 18 percent by the end of 1980s. But the 1990s proved to be a lost decade for Pakistan, Growth in per capita income dropped to slightly over 1 percent. Poverty resurfaced and about one third of the population now lives below the poverty live of $1 per day. Social indicators are worse than other countries with comparable income. The country was turned into one of the heavily indebted countries and was declared as one of the most corrupt country in 1996. The challenge facing the government which assumed power in October 1999 was to put the economy back to its pre 1990 track.

The strategy for economic revival pursued since December 1999 was therefore designed to include four key elements (1) restoration of macroeconomic stability and Pakistan's relationship with the international financial institutions (IFIs), (2) structural reforms to remove distortions (3) improving economic governance and reviving key national institutions, and (4) poverty alleviation. Why have these four elements been chosen as part of the strategy?

The main consideration was to include these elements which come to grips with the legacy of the 1990s, maximize achievement of the strategic objective i.e. economic revival and promote synergies and mutually reinforcing complementarities. The interconnection between economic growth, poverty reduction, structural reforms and improved governance is fairly strong in case of Pakistan.

Macroeconomic stability and the consequent rapid economic growth will help reduce poverty in conjunction with investment in social sectors, targeted interventions and social safety nets. Structural reforms are needed to strengthen the underpinning of macroeconomic policies and to remove microeconomic distortions affecting key sectors of the economy thus paving the way for accelerating economic growth. Improved governance affects the quality of growth by allowing realization of higher returns on investment and is also conducive for poverty reduction through better delivery of social services to the poor. Poverty reduction, as we know by now, can be achieved with rapid economic growth, structural reforms and improved governance.

The implementation of the above strategy has had a mixed record for a variety of reasons. First, the economy was confronted with several exogenous shocks such as the continuation of economic sanctions and imposition of further sanctions after the suspension of

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The author is Governor, State Bank of Pakistan

democracy, an unprecedented drought, synchronized global recession, September 11 and associated hostilities in Afghanistan, and more recently, the border tension between India and Pakistan following the December 13 attack on the Indian Parliament. Secondly, the capacity of state institutions to deliver public goods and services and execute policies and programs has been seriously impaired over time. This has extended the time lag between policy pronouncement and implementation. Thirdly, measures introduced such as the actions taken by the National Accountability Bureau (NAB) against loan defaulters, tax evaders, corrupt officials and businessmen, the tax survey to document the economy, and other efforts to create a level playing field for all economic agents have themselves altered the rules of the game under which the private sector used to operate in Pakistan.

Despite the above difficulties and snags, a significant progress has been achieved on all the four elements mentioned above.

Macroeconomic stability

Macroeconomic stability has been achieved through a reduction in the fiscal deficit, surplus on the current account balance of payments, lowering of inflation and the beginning of a decline in debt/GDP ratio. This stability has been brought about partially though the support of international financial institutions and Paris Club bilateral creditors, which significantly eased the external payments position – a major and consistent risk to the economy since 1998.

Despite this stability, GDP growth during the 1999-2001 period has remained stagnant and per capita incomes have barely inched upwards. In 1999-2000, decline in large scale manufacturing was the main contributory factor to sluggish growth, while the following year negative agriculture sector growth due to a severe drought brought aggregate growth down to 2.6 from 3.9 percent. The current year was moving smoothly until September 11, the aftermath of which has again slowed down the growth rate.

Inflation, on the other hand, has come down to below the 5 percent level from an average of 10 percent recorded between 1990-98. This price stability has come on the back of prudent fiscal management and a tight monetary policy. The fiscal deficit was successfully reduced from the historical average of 7 percent of GDP to 5.2 percent in 2000-01. Tax revenues have grown by 28 percent, from Rs 308 billion ($5 billion) to Rs 394 billion (6.6 billion) during the last two years representing a net addition of Rs 86 billion (1.5 billion). In the preceding three years (1996-99), the incremental tax collected was only Rs 40 billion. Consequently, the tax-GDP ratio has risen from 10.6 percent to 11.3 percent.

Monetary policy has been reasonably tight during the last two years with money supply growth at about 9 percent. Credit to the private sector had picked up in 2000-01 rising almost four fold compared to the previous year, but has slowed down in the first six months of the current fiscal year. By limiting government borrowing to a manageable lend the SBP's discount rate and T-bill rate have been brought down significantly. The benefit has been passed on inform of reduced cost of borrowing to the Government and to borrowers under the Export Finance Scheme.

Pakistan's achievements in the external sector have been better than expected improving the capacity of the economy to absorb external shocks. Liberalization of payment regime and streamlining of FDI and private capital flows have vastly contributed to this improvement. Liberalization of external payment regime and streamlining of foreign direct investment have vastly contributed to this improvements. Foreign exchange reserves which used to hover around US$ 1 billion (3 to 4 weeks' imports) in 1999 have risen to US$ 5.3 billion in March 2002 (5-6 months imports). This is an unprecedented achievement for a country which touched 3 months imports coverage only once in the last ten years and the average level of reserves has been sufficient to cover only 4 weeks imports. Since October 1999, a policy of building reserves by purchasing excess supply of foreign exchange from the kerb market has been the main channel of mobilizing Pakistani worker's remittances from overseas. Until September 11, 2001 there was a premium over and above the exchange rate prevailing in the Inter-bank market, and inter-bank markets has resulted in a increase of US$ 1.7 billion with reserves standing at US$ 3.3 billion by September 11, 2001. This obviated the need for contracting short-term commercial loans to make external payments and accumulate reserves. Since September 11, a number of developments have accelerated the process of reserve building. These include, the lifting of economic sanctions by the US, European countries and Japan, grant assistance from the US and Japan, approval of the PRGF by IMF, sustainable debt relief from bilateral creditors, and a rise in workers' remittances through the banking system. These measures enabled reserves to touch US$ 4.8 billion by the end-December 2001. This higher level was attained despite payments of about $ 2 billion on debt servicing during the first six months.

Pakistan has successfully shifted from a fixed and managed exchange rate to a free floating regime. This policy of flexible exchange rate has begun to pay dividends after initial hiccups. Pakistan has successfully shifted from a fixed and managed exchange rate to a free floating regime. This flexible exchange rate policy has begun to pay divided after initial hiccups. The Rupee-Dollar parity, the key indicator of exchange rate movements, remained stable between July 2001 and September 11, 2001 after witnessing a steep depreciation of 18.5 percent over the preceding twelve month period. This sharp fall was inevitable as the exchange rate had been almost frozen between May 1999 and May 2000, and should be viewed as a market correction of the cumulative over valuation of the Rupee that had taken place over a two year period. In the transition to a free floating exchange rate, an added complication to exchange rate management was speculative pressures and depreciation expectations. The volatility in exchange rate movements was managed by using monetary policy instruments. This, coupled with the build up of reserves, led to some stability in the exchange markets till September 11, 2001 when the Rupee began its appreciation against the US Dollar. Although the exchange rate has moved up to a higher level, the fluctuations in the inter-bank and kerb markets have been relatively subdued, while the premium in the kerb market has narrowed significantly from an average of 4 to 5 percent, to less than 1 percent. This narrowing down of the kerb premium and the strict controls over the Hundi/Hawala business in UAE and the US have led to higher inflows of workers' remittances through the banking channels; during July – February period this year, remittances doubled to US$ 1.4 billion, compared to US$ 780 million in the same period last year.

Till 1999, Pakistan's exports had been stagnant at around US$ 8 billion. Since then, the rate of increase has been 15 percent and 2000-2001 registered exports of about US$ 9.2 billion. Consequently, the export-GDP ratio touched 15 percent in 2000-2001, compared to 13.1 percent for the decade of 1990s. However, the fiscal year 2001-2002 has seen a set back due to the combined effects of a recession-hit world economy, and the aftermath of September 11. It is, therefore, unlikely that the export target of US$ 10 billion set for end-June 2002 will be achieved although the increase in volume of exports particularly textiles has been substantial (over 20 percent in some items).

One factor behind the improvement in current account balance is that imports have not been showing their historical growth pattern. The import-GDP ratio has declined to 15.6 percent from a high of 18 percent in the early 1990s. In the current fiscal year, the decline is even more perceptible as petroleum prices have shown a significant downward trend. As a consequence of this development, the trade deficit has narrowed to 1.7 percent of GDP (down from 4.9 percent in the early 1990s) and the current account deficit to 1.9 percent of GDP in 2000-01 (compared to 4.5 percent during the 1990s). The target for the current fiscal year had been set at 0.9 percent; the outcome of the first six month has been consistent with this target.

Foreign private investment has suffered during the last two years, and is not expected to return to the trend exhibited in the second half of 1990s. Large outflows of portfolio investment have been the major reason for these shortfalls, although foreign direct investment has begun to swing upwards in the current fiscal year.

Pakistan has benefited from debt rescheduling during the last two years as a direct consequence of the resumption of relations with the IFIs. For the first time, Pakistan was able to complete a Stand-By Arrangement with the IMF without any delays or interruptions, and has now entered into a three-year PRGF. As a consequence, the Paris Club has agreed to restructure bilateral debt on an exceptional basis. These favorable developments in the external sector have led to Moody's upgrading Pakistan's credit rating.

To sum up, Pakistan has succeeded in securing stability in its external sector by restructure its debt, reducing current account deficit and building up reserves. President Monetary and flexible exchange rate policies along with liberalization of current account transactions inflows of foreign direct investment and private capital have enabled the country to underpin this stability. At the same time direct controls on contracts short term debt by private and public sectors have insulated the country just like China and India form sudden and abrupt shocks of reversal in investor sentiment.

Structural reforms

Macroeconomic stabilization measures have been accompanied by wide ranging structural reforms which are aimed at removing microeconomic distortions and improving efficiency of resource use. These reforms have been initiated across a broad spectrum but capacity constraints have been an inhibiting factor in their implementation. Diagnosing the problems, formulation of policy options and strategies, and the final delineation of measures to be taken have been completed in almost all sectors. However, the absence of strong commitment at the implementation stage, conflict of interest with vested groups and a lack of appropriate technical know-how at critical levels have not allowed the benefits of these reforms to be fully realized. It will take a few years of continuous hard work and monitoring before tangible results can be produced. However, the following four areas of structural reforms have seen some progress: (a) tax administration and policy (b) trade and tariff reform (c) deregulation and privatization, and (d) the financial sector.

Tax administration and policy

Pakistan's persistent fiscal deficits can be harnessed if a robust and buoyant tax base can be developed. This requires deep rooted reforms to widen the tax base, strengthen tax administration, promote self assessment, eliminate whitener schemes, reduce multiplicity of taxes and tackle the culture of tax evasion and corruption. A task force was formed to examine these issues and has come up with recommendations to simplify assessment processes, promote intensive use of technology, eliminate contact between tax payer and tax collector, reorganize the Central Board of Revenue (CBR) and restructure the service terms and conditions of revenue officials. These recommendations have been accepted and will be implemented over the next 3 years. Additionally, a new Income Tax Ordinance has been introduced in 2001 which allows for universal self-assessment, uniform tax rates, removal of non-adjustable withholding taxes, elimination of exemptions and detailed audit. Moreover, the tax survey and documentation drive during 1999-2000 has allowed CBR to bring in an additional 134,000 income tax payers along with 30,000 new sales tax payers. It has also profiled 600,000 tax payers which will help enhance the effectiveness of tax assessment, and help detect tax evasion and under reporting. CBR reforms are also on the forefront of the conditionalities agreed to with the IMF and other IFIs.

Trade and tariff reforms

Pakistan has made significant efforts in liberalizing its trade regime during the 1990s. The maximum tariff rate has declined from 225 percent in 1990-91 to 30 percent in 2000-01; the average tariff rate stands at just 11 percent compared to 65 percent a decade ago. A further 5 percent reduction of the maximum tariff will take effect from July 1, 2002, while the number of duty slabs will also be reduced to 4. Additionally, quantitative import restrictions have already been eliminated except those relating to security, health, public morals, religious and cultural concerns. The number of statutory orders that exempt certain industries from import duties will be phased out by June 2004. Duties on 4,000 items were reduced in the 2001-02 budget. These measures are aimed at bringing down the effective rates of protection, eliminating the anti-export bias and promoting competitive and efficient industries. A number of laws have also been promulgated to bring the trade regime in conformity with WTO regulations. These include anti-dumping and countervailing measures and intellectual property rights.

A comprehensive range of export finance facilities and guarantee schemes are being provided to facilitate pre-shipment and trade financing to local exporters. The export finance rate has been pegged to the T-bill rate thereby eliminating the subsidy implicit in the previously administered rate.

The unilateral reforms undertaken by Pakistan will have pay-off if major trading partners liberalize market access to Pakistani goods and services. European Union has already taken action in this respect but the response from the United States for entry of Pakistani textile products has not been very encouraging.

Privatization and Deregulation

Public sector corporations have been a constant source of burden on the budget as well as quasi-fiscal accounts. As much as one third of the fiscal deficit can be directly attributed to the losses of public corporations. In addition, nationalized commercial banks have been carrying a large exposure to these corporations. The present Government has publicly announced the time table for privatization of these entities and has also promulgated a law under which privatization will take place. This step was necessary to ensure transparency, provide an institutional and legal framework, avoid unnecessary delays and litigations, and outline the process through which the transactions will be carried out.

Progress has been slow so far for a variety of reasons but the recent 10 percent sale of National Bank of Pakistan through public offerings on the stock exchanges has given a fillip to the efforts of the Privatization Commission. Key public sector units which will be offered to strategic investors include the nationalized commercial banks, Pakistan Telecommunications Company Ltd., power distribution companies, and oil and gas fields/companies.

The public enterprises which are not currently on the privatization agenda (Pakistan Steel Mills, PIA and Pakistan Railways etc) are undergoing substantial downsizing and financial restructuring to make them operationally viable and reduce their budgetary (quasi-fiscal) impact.

As Pakistan embarks on the process of creating competitive markets and eliminating direct or implicit consumer and producer subsidies, a number of steps have been taken to deregulate prices and trading in various sectors. The most far-reaching reform has taken place in the oil and gas sector. Imports and pricing of petroleum products have been deregulated and the private sector is now free to import and fix prices. An automatic price adjustment formula for consumer prices of petroleum products linked with international prices has been adopted. In addition to reforms in the primary freight pool, price distortions in natural gas have also been eliminated and a new pricing framework has been put in place.

The government has freed up agricultural prices by moving towards market based pricing. With a view towards allowing farmers to receive international prices for their produce, all restrictions on the import and export of agricultural commodities have been removed. Wheat procurement and trade, which was until recently an exclusive monopoly of the state, has been opened up to the private sector. Exports of wheat and wheat products have also been allowed to the private sector.

The business community in general, and SMEs in particular, believe that the burden of government intervention in their day to day operations is still too much. The government has therefore constituted a Deregulation Commission headed by a leading businessman to get rid of these irritants and further free up the economy.

Financial Sector and Capital markets

The strategy for financial sector reforms is aimed at developing a market oriented, private sector dominated financial sector performing efficient intermediation. The regulatory and supervision functions of the State Bank have been significantly strengthened and strict enforcement of prudential regulations have led to widespread recapitalization and a consequent improvement in the banking system. The nationalized commercial banks (NCBs) have undertaken major restructuring by downsizing their staff and closing down unprofitable branches. It is envisaged that at least 50 percent of the surplus staff will be eliminated, while more than half of non-profitable branches will be closed. The ratio of gross non-performing loans (NOLs) total advances in Pakistan, prudential regulations have been upgraded and require a loan to be classified as NPL when debt service payments become overdue after 90 days has also declined significantly for the commercial banks and for NCBs in particular. Provisions now cover almost 55 percent of these gross NPLs thus reducing the risk to the banking system. These changes along with improved corporate governance have been made possible by the introduction of professional management and private sector boards. NCBs account for almost 50 percent of the assets of the banking system. Two out of the three remaining NCBs are expected to be privatized by the end of 2002 and thus ending the three decade domination of public sector banks on the financial sector of the country.

The second element of financial sector reforms is a restructuring of Development Financial Institutions (DFIs) through mergers and acquisition, closure, liquidation and reorganization. The largest DFI of the country, the National Development Finance Corporation has been closed and its assets and liabilities taken over by NBP. At present only four DFIs are working in the areas of SMEs, agriculture, housing finance while all others have been liquidated, merged or shut down. DFIs account for a large proportion of bad debts and this restructuring will help clean up the non-bank financial institutions.

As publicly-owned DFIs providing subsidized credit are being phased out, new instruments of supplying long term capital at market-based interest rates are being developed. A benchmark has been established in the form of the Pakistan Investment Board (PIB) by the State Bank which holds regular auctions for tenures of 5 to 10 year government paper. A burgeoning corporate bond market has begun to emerge bringing together long term institutional investors and borrowers interested in long term sources of financing.

The fourth ingredient of these reforms is setting up an asset management company, the Corporate and Industrial Restructuring Corporation (CIRC) which will deal exclusively with the problem of non-performing loans of NCBs and DFIs. The CIRC will also help revive some sick industrial units which are likely to become viable as a result of financial restructuring, rehabilitation and a change in ownership. Some of these units have already been sold at discount through public auction and the process is likely to accelerate in coming months.

The fifth pillar of the financial sector reform strategy is to promote a network of institutions at the district, provincial and national level for micro credit financing. The first institution – Khushali Bank formed by some foreign and domestic banks in collaboration with the Asian Development Bank has already started operations in 30 districts of the country. Another micro finance bank has been established in the private sector by the Aga Khan Network and the International Finance Corporation. The regulatory framework and capital requirements for these MFIs have been relaxed in order to attract capable NGOs and other private sector entities with a proven track record in credit delivery

In the area of capital market development effective regulations for risk management have been introduced for members of stock exchanges; the capability of the Securities and Exchange Commission (SECP) has been strengthened and the T+3 system has been launched whereby all transactions will be settled on the third day. Other notable ingredients of the capital market reforms are operationalization of the National Clearing and Settlement System, a new code of conduct for stock brokers, raising the net capital requirements for brokers, issuing rules against insider trading, regulatory changes to provide for easy mergers, acquisitions, take over and liquidation of public listed companies.

The over all health of the financial sector has improved as consequence of the reforms undertaken since 1997 and this is evident by the capital adequacy, asset quality, profitability and liquidity indicators. However, intermediation costs are still quite and competitive pressures are still weak.

Improving economic governance and reviving key national institutions

Pakistan's main problem in achieving sustained macroeconomic stability, trend economic growth rates, and delivering public services to the poor has been due to weak governance and decline of institutional capacity particularly in the 1990s. Therefore, the agenda for improving governance is based on (1) devolution (2) improved public financial management and accountability (3) fighting corruption (4) civil service, judicial and police reforms.

Devolution: The cornerstone of the governance agenda is the devolution plan which transfers powers and responsibilities, including those related to social services from the federal and provincial governments to local levels. The development effort at the local level will be driven by priorities set by elected local representatives as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power will thus strengthen governance by increasing decentralization, transparency, accountability of administrative operations and people's participation in their local affairs.

This devolution plan is aimed at enhancing public sector efficiency through three principal channels: first, the decentralized system will become a surrogate for competition, bringing to the public sector some of the benefits of the private sector. Second, individuals who are directly responsible to the people for their actions, and have ownership over the outcome will have stronger incentives to perform better. Third, when the cost of providing a service is borne by the local jurisdiction, the service will be provided more efficiently as locals will demand value for money.

The purpose of the devolution plan is to provide a network of broad-based grass root level institutions that undertake developmental activities. One of the main aims of the plan would be to facilitate capacity building of these institutions for the provision of social services such as health, education, family planning, sanitation and clean drinking water. Moreover, such institutions would also undertake operation, maintenance, and income generation activities. This will enable local governments to effect credible development and service delivery at the district, tehsil, and union tier. To involve people more actively in community development, grassroots organizations like Village Councils and Citizen Community Boards will be introduced. These schemes will imply that the functioning and delivery of services is being monitored directly by stakeholders.

The effective functioning of local government structures will depend not only on administrative devolution of powers but also availability of adequate financial resources. For this purpose, district budgets have been prepared in a framework of fiscal devolution, which would operate through the mechanism of a provincial finance award. This will provide adequate resources to new governments to meet their obligations of providing basic services. Second, a lump sum provision of Rs3 billion has been provided this year to meet the transition costs of setting up basic infrastructure expenditures of the new governments.

The devolution plan is an ambitious attempt to dismantle a 150 year old system of administration. Naturally, there are going to be teething problems in its initial stages and tensions between the old administration which has lost power and the newly elected representatives are bound to occur. But there are serious concerns about capacity building, training of new administrators and business processes. There is clearly an opportunity to set up a modern well functioning system and avoid the pitfalls of the old system. However this entails careful planning, system design and resource allocation. Despite these resurvation, this system provides the best hope for a more democratic and accountable system of governance.

Financial Management and Transparency: Other essential ingredients for improving economic governance are separating policy and regulatory functions which were historically combined within the Ministry. The regulatory structures are now independent of the Ministry and enjoy quasi-judicial powers. The Chairman and the Board members enjoy security of tenure and cannot be arbitrarily removed. They are not answerable to any executive authority and hold public hearings and consultations with stakeholders. Regulatory agencies along these lines have been set up for economic activities such as banking, finance, aviation, telecommunications, power, oil, gas etc. The quality and independence of the verdicts announced by some of these agencies have a balance between the interests of service providers and the consumers.

Moreover, as mentioned earlier, easy access to information is critical for eliminating corruption and improving economic governance, while enabling greater participation of all stakeholders. Public access to information on landholdings, projects, government decisions, and any other relevant area of public interest is vital. Therefore, appropriate legal cover will be given to access public information; the Freedom of Information Act is under discussion and will be enacted soon.

Financial decentralization will make more resources available to elected members and functionaries. Though the modus operandi for this is being worked out, fiscal decentralization will require a strengthening of budgeting and auditing functions at all levels in order to stem leakages from the system. The government has promulgated legislation establishing the autonomy of the Auditor General, adopting a modern charter of accounts under accepted international standards, and modernization of overall accounting systems through computerization. Ad-hoc Public Account Committees have been set up at both the federal and provincial levels to take appropriate follow-up action on audit reports. A National Procurement Authority is being established and a new procurement law will be promulgated to improve the process of acquiring goods and services by various government ministries and agencies.

Anti-Corruption measures The National Accountability Bureau (NAB) has been functioning quite effectively for the last two years as the main anti-corruption agency. A large number of high government officials, politicians and businessmen have been sentenced to prison, subjected to heavy fines and disqualified from holding public office for 21 years. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and taxes; about Rs 30 billion ($500 million) has been recovered from these defaulters so far.

Several anti – corruption agencies exist at the Federal and the Provincial government level but they have been ineffective. The successful example of the NAB can be used to build up a strong legal and institutional framework for detecting corrupt practices, investigating and prosecuting those indicted. The deterrent effect of this process will help curb widespread practices.

Civil Service, Judicial and Police reforms: Civil service reforms aimed at improving recruitment, training, performance management, career progression, right sizing of ministries and attached departments and improving compensation for government employees are the foundation for building strong institutions in the country. In the first instance, to depoliticize recruitment, promotions and career development, the independence and responsibilities of the Federal Public Service Commission (FPSC) have been enhanced and its scope of work extended to all posts from Grades 11 to 21. The FPSC is now fully incharge of merit-based recruitment and promotions. The Civil Service Act has been amended to reflect performance based career progression and enable the government to retire civil servants who are inefficient and/or corrupt. The public sector educational training infrastructure is also being restructured to strengthen skill-based training of civil servants at all levels.

The recommendations of the Rightsizing and Restructuring Committee are being implemented; surplus staff is being readjusted, performance benchmarks revamped and structures of federal, provincial and local governments reconstructed.

The reforms in some of the most important federal institutions – the Central Board of Revenue (CBR), Securities and Exchange Commission (SECP), the State Bank of Pakistan (SBP) and Pakistan Railways – are already beginning to take firm hold. Implementation of reforms has already led to the elimination of 40,000 (out of 135,000) positions and 23,000 ghost pensioners.

Reforms in access to justice will deal with delays in the provision of justice, case management, automation, and court formation systems. In addition, human resources, management information systems and the infrastructure supporting judicial system will be revamped and upgraded. Small Causes Courts will be established to provide relief to the poor who have small claims.

Extensive police reforms will separate the law and order, investigation, and prosecution functions of the Police and promote functional specialization. The setting up of Public Safety Commissions at the federal, provincial and district levels will institutionalize the accountability of Pakistan's police force to the public. An independent complaint authority against police excesses will be set up. To improve the overall performance of the police, enhancing efficiency, logistics, communication, mobility and training will be given greater emphasis.

Most of these reforms have just passed the design stage and will take consistent and strenuous follow up work and commitment of the existing incumbents to implement these far –

reaching changes in these main organs of the Executive and Legislative branches of the government.

Poverty reduction

The poverty reduction strategy under implementation since December 1999 is based on macroeconomic stabilization, improved governance, revival of economic growth, targeted interventions, social sector development and social safety nets.

This strategy has been fully articulated and spelled out in detail in the Government's Interim Poverty Reduction Strategy (IPRSP). This strategy has been developed through intensive stakeholder dialogue and has been endorsed by Pakistan's development partners. A review of the first two elements of this strategy has already been presented in an earlier section of this paper. This section will focus on the revival of economic growth, targeted interventions to reduce poverty, social sector development and social safety nets.

<u>Revival of economic growth</u>

Pakistan's growth rate in the past five years has averaged about 3.6 percent per annum (population growth rate is 2.2 percent) which has been inadequate to reduce the incidence of poverty in the country. Therefore, a key element of the poverty reduction strategy is reviving economic growth. Towards this end, the government has identified four major areas: agriculture, small and medium enterprises (SMEs), oil and gas sector, and information technology. With relatively lower investment, these sectors are likely to generate higher employment opportunities and thus have direct impact on poverty reduction.

One-fourth of Pakistan's GDP is derived from the agriculture sector. It employs 44 percent of country's workforce and contributes substantially to export earnings. Therefore, what happens to agriculture has a substantial impact not only on overall economic growth, but also the level of poverty in the country. Agriculture also contributes indirectly to economic growth as a provider of raw materials, and as a market for industrial products. The emphasis on agricultural sector development is on improvements in the productivity of small farmers and the creation of employment opportunities for landless peasants. This increased productivity could also stem the tide of rural-urban migration, which can help in alleviating urban poverty. To increase agricultural output several measures including better utilization of existing water resources through improved canal irrigation and maintenance, conservation and augmentation of water, promoting water efficient cultivation methods through enhanced availability of equipment and better extension work, corporatization of agriculture, deregulating agricultural commodities prices, on farm water management, and several initiatives on livestock development and agro-based industries are at various stages of design and implementation.

Along with agriculture, the SME sector employs the majority of the population in income generating activities both in the urban and rural areas. As SMEs are relatively more labour-intensive they create relatively more jobs, incomes and hence play a major role in reducing poverty. Also being more innovative and flexible, they also encourage personal savings, contribute to exports, and create new industries. Government policy aims to provide support to these institutions for assisting in the financing, technical know how and marketing problems being faced by these businesses. This institutional support is being provided by Small and Medium Enterprise Development Authority (SMEDA) and SME Bank but their outreach remains limited. Private sector groups have to be involved while the regulatory environment has to be set right.

Information technology also has major potential of creating jobs for the educated unemployed. Telecommunications connectivity and large scale training have been identified as the main vehicles through which an expansion in I.T. sector is envisaged. But the base with which the IT sector is expanding is so small that it will take several years before the momentum is felt on the economy.

As a consequence of favorable government policies, the oil and gas sectors have attracted foreign investment in exploration, transmission and distribution of gas in the country. Gas development is aimed at substituting imported furnace oil for power, cement sectors and thus save valuable foreign exchange for the country.

The above policy measures have not yet made any visible impact as their implementation is still at an early stage, but once these measures are put in full effect, equitable growth will follow that will reduce poverty.

Poverty targeted Interventions

Economic growth is a necessary but not sufficient condition for poverty reduction. Where poverty is endemic, high economic growth must be accompanied by direct poverty alleviation measures. Towards this end, poverty targeted intervention programs consisting of several major elements are being introduced. These elements include (i) integrated small public works programme in both urban and rural areas (Khushal Pakistan Program), and the (ii) development of microfinance sector to help improve credit access of the poor.

Khushal Pakistan Program: This program is aimed at generating economic activity through public works in the country. The provinces, in close collaboration with the local authorities and communities, have completed a Rs 20 billion (US$ 330 million) program covering the two year period (January 2000 to December 2001) with the result that 0.5 million job opportunities have been created, along with essential infrastructure in rural and low income urban areas. The program has resulted in construction of farm to market roads, rehabilitating water supply schemes, repairing existing schools, small rural roads, streets, drains, and storm channels in villages. Moreover, the scheme will be directed towards lining watercourses, de-silting canals, and providing civic amenities in towns, municipal committees, and metropolitan corporations.

Micro Finance Sector development: The role of Microfinance in poverty alleviation and employment generation has been widely accepted. The government has therefore established the micro credit bank (Khushali Bank) as a protype institution for providing credit access to poor households. This bank is reaching out to the poor districts and has begun providing loans to small and medium enterprises and self-employed micro enterprises.

Social Sector development

The third key element of the poverty reduction strategy is to develop Pakistan's social sectors, particularly education, health, population and women development.

Education Sector Reforms

Pakistan's poor educational outcomes have become a major constraining influence on its quest for integration in the global economy. High rates of illiteracy, particularly among the female population, low educational attainment of labor force and lack of qualified technical and scientific manpower have also put a brake on economic growth. The education sector reforms in the past have failed to deliver results. Thus the approach and mode of implementation have to change.

The strategic thrust of education sector reforms (ESR) this time around consists of (a) achieving universal primary education and adult literacy from 51 percent to 59 percent by 2004, (b) improving the quality of education, and (c) a renewed focus on technical and vocational education.

ESR recognizes that development of partnerships between the private and public sector and NGOs will be critical for the implementation of this strategy. The proposed package of incentives for private sector, particularly in the rural areas and urban slums, indicates provision of land free of cost and or at concessional rates in rural areas, non-commercial utility rates, liberal grant of charters, exemption of custom duties on import of educational equipment and exemption of 50 percent income tax to private sector institutions for faculty, management and support staff etc. Compulsory primary education is being combined with an incentive package to meet the needs of poor students by providing free text books, uniforms, stipends, nutrition and vouchers.

The most important structural change envisaged is through devolution and decentralization of service delivery from provinces to district governments and below. The Operational responsibility will be exercised by the tiers of the government at the district, tehsil and union levels. All new teachers will be appointed through a selection process involving a competency test. The program of pre-service and in-service training has been revitalized for both new and existing teachers. Additionally, education budgets have been increased and non-salary expenditures are being expanded and protected. Private sector and non-governmental organizations are getting involved in both financing and delivering primary education, text books, schools uniforms, supplies and maintenance of buildings. The primary school curriculum is being revamped along with the text books, while the monopoly of the regional Text Book Boards has been abolished.

The involvement of the private sector and community organizations have renewed the hopes for a vigorous and dynamic expansion in the quality and outreach. But the possibility of exclusion of the poor remains quite strong and public sector has to ensure that the access to the poor is not hindered.

Health Sector reforms

Pakistan has an extensive health delivery system which is a mix of public and private facilities distributed all over the country. The health status of the nation is characterized by a population growth rate of over 2 percent, infant mortality of 90 per thousand live births and maternal mortality rate of 450 per 100,000 live births. The new health policy follows a 'health for all' approach based on accessibility, affordability and acceptability of health services by the general population. The health strategy places greater focus on a continuous shift from curative services to preventive health services by improving the primary health care system. Improvements in health status are taking place mainly through maternal and child health, communicable and infectious disease control and elimination of nutrient deficiencies. The budget for the Expanded Program of Immunization has been increased and coverage is being expanded in rural areas as well as in the female population. A sound tuberculosis control program, HIV/AIDS program, and anti-malaria program are also under implementation.

The shift of public expenditures from tertiary to primary and secondary health care and devolving and decentralizing financial and administrative powers to local tiers form the crux of the health sector reforms. This new approach provides a clear signal that preventive rather than curative health care will be given priority in allocation of expenditures as well as the rural areas of the country. Women Health projects and Family Health Workers Programs have been quite successful in their outreach and intensity. These projects are being expanded and the numbers of FHWs will be further increased. Public-private partnership has turned some of the underutilized facilities at the secondary level into functioning entities and this model is being replicated.

The relative success of the existing health programs during the last five years provides some indication that the health outcomes have a better chance of improvement provided the delivery of services model in use is continuously refined, upgraded and adapted.

Water Supply and Sanitation

Poor access to water supply and sanitation are often associated with poor health outcomes. At present only 63 percent of the country's population has access to safe drinking water, whereas proper sanitation facilities are available to only 39 percent of the total population. The government is planning to increase water supply facilities from 63 percent to 68 percent in 2003-04, and sanitation facilities to 44 percent. Construction of drinking water supply and sanitation facilities is already receiving the utmost importance under the Khushal Pakistan program. At local levels, attention is being given to develop capacity in terms of the design, management, maintenance and operation of these schemes so that benefits are sustained. Community based approaches which have been successful in the NWFP and AJK will be examined for adoption in other areas. In addition, the newly elected city governments are paying attention to solid waste management problems faced by citizens in large metropolitan areas.

Urban centers such as Karachi and Quetta face serious shortages both due to inadequate generation but also poor institutional mechanisms for transmission and distribution private provision of water supply should be considered careful consideration although it is virulently opposed by some civil society organizations.

Social Safety Nets

The implementation of social protection strategy is taking place through a variety of measures. First, the Government has launched direct cash-transfer programs for poor families through medical assistance and educational stipends from the *Bait-ul-Maal* (a public welfare program). The Food Support Program covers 1.2 million of the poorest households with monthly income of up to Rs 2,000 per family. An allocation of Rs 2.5 billion was spent in 2000-01 on this program. A system of needs-testing has been adopted for the identification of beneficiaries by linking the program with the zakat system.

The Zakat program that targets widows, orphans and the disabled has been strengthened. About 2 million beneficiaries receive assistance from the Zakat Fund., of which 0.5 million receive assistance on a regular basis. It is envisaged that an additional 1.5 million will be added to the list of Zakat recipients through rehabilitation schemes which will provide loans of Rs 10,000 to Rs 50,000 each for starting up small business. An allocation of Rs 5 billion has been made for these schemes in addition to the normal stipends to *Mustahqeen* (the needy) out of the Zakat Fund. It is estimated that Zakat contributes 10-15 percent to the government's poverty reduction program.

The school feeding program for female students (Tawana Pakistan program) which was successfully piloted in a few districts will be replicated throughout the country. This program will help address the malnutrition of female students which was resulting in low enrolment, high absenteeism/dropout rate and low cognitive achievement. It is estimated that community mobilization will strengthen the ownership of this program and lead to a 30 percent decrease in the dropout rate.

The Employees Old-age Benefits Institutions (EOBI) and provincial social security institutions provide pension and medical care benefits to private sector employees. About 183,000 beneficiaries receive pension benefits of approximately Rs 0.9 billion annually through these institutions. Sindh and Punjab provide medical care benefits to about 700,000 beneficiaries and their dependents at an annual cost of Rs 1.4 billion. Similarly, the Workers Welfare Fund provides social security support to workers and their families.

The above safety nets are financed and managed by public sector institutions and organizations. The vast bulk of social protection in Pakistan is provided by private philanthropists and charities. It is estimated that Rs 76 billion are funneled by the private sector to assist the poor through a widespread network of individual, family and organized donations.

Challenges facing the economy

It must be conceded that the pace of implementation of these reforms is uneven and highly variable. For example, reforms relating to fiscal transparency, financial sector, accountability, liberalization of prices exchange rate and deregulation of the oil and gas sector, have moved ahead quite swiftly. However, the progress on CBR, privatization of state-owned enterprises, education and health sectors, civil service, judiciary and police are still in early stages and have not made any perceptible impact. Law enforcement agencies, revenue collecting officials and inspectors of various government departments have not yet mended their ways and their harassment and extortion has not receded.

Despite efforts to stabilize the economy, bring about structural changes and create a transparent, predictable environment for businesses, economic growth has faltered, investment (both domestic and foreign) has remained sluggish, unemployment has risen and there hasn't been any appreciable reduction in the incidence of poverty. The recessionary conditions in the economy have not yet given way to buoyancy.

A number of hypotheses can be offered to explain this sluggishness. First, there has been no new investment in the economy for the past six years or so. As a result, the investment to GDP ratio has been on a secular decline limiting the extent to which existing capacity utilization can contribute to GDP growth. In particular, the consistently declining trend of public investment ratio over the past 10 years has given rise to congestion, shortages, lack of reliability and increasing costs of infrastructure services in the country. As public investment is complementary to private investment, the competitiveness of industry has gradually eroded. In addition, Pakistan's human development indicators were already low in relation to other developing countries of comparable income. Under investment in education, health, water supply and other social services has further exacerbated the situation. These physical infrastructure deficiencies and weak human development indicators have retarded growth generating impulses in the economy. Additionally, heavy external and domestic indebtedness has squeezed fiscal space and made it difficult to increase public expenditures. The fiscal space that was expected through debt rescheduling and bilateral grant assistance has shrunk because of lower tax revenue collection.

Second, the gradual decay of institutions and politicization and lack of professionalism among public servants have impaired the capacity for sustained implementation of government policies, programs, projects and the delivery of public services. Poor governance and malfeasance by the elite of public institutions have spawned a culture in which wasteful expenditures, leakages of resources and low efficiency are the norms. Sound policies, improved governance and macroeconomic stability have created conducive but not sufficient conditions to turn the economy around. Restructuring takes a lot of time and energy, and in the short term, economic growth remains low.

Third, the country has faced a series of large exogenous shocks beginning with the nuclear testing in May 1998, the Kargil crisis of June/July 1999, change in the government in October 1999, severe drought in the year 2000, the terrorist attack of September 11, 2001 and the conflict in Afghanistan, tension with India following the December 13 attack on the Indian Parliament, a deepening of the global recession and continued water shortages have played a major role in constraining the economy. It is only in the recent months that external sector position has begun to ease. Workers' remittances through official channels have almost doubled in the first six months and have (to some extent) neutralized the decline in exports. Similarly, a decline in the petroleum import price has helped narrow the trade deficit. Additionally, debt restructuring by the Paris Club, exchange rate stability, comfortable foreign exchange reserves, lower domestic interest rates, further liberalization of the foreign exchange regime, removal of economic sanctions and a ratings upgrade have improved Pakistan's creditworthiness and have reduced country risk. This should make it possible for foreign investors to consider Pakistan as a serious destination for investment. The public pronouncements by the President that economic reforms will continue unabated after the elections should remove the element of political uncertainty. Normally, the sequence is that domestic investors take the lead and foreign investors follow. However, in Pakistan's case, for some reason the psychological barrier of domestic investors is crossed when foreign investors show up. Is it possible therefore that resumption of foreign investment will pave the way for higher growth and employment expansion in the country?

The agenda of unfinished reforms to capitalize on positive external sector developments is still quite arduous. First the on-going restructuring of the tax administration and the CBR have to be completed expeditiously to enhance the scope for larger revenue collection and replace the existing highly arbitrary and discretionary tax collection environment. Pakistan's fiscal balances will remain under severe strain until this restructuring is accomplished. Second, the multiplicity of taxes at the federal, provincial and local government levels, along with the various labor levies imposed on the industrial sector, have to be streamlined. The harassment and extortion by low level functionaries of a host of government agencies is also inimical to the growth of organized business. The frequent resort to the informal sector is in fact an escape valve for the small businesses to avoid these government functionaries. Third, the legal and judicial system is out-of-sync with the requirements of modern business practices; contract enforcement and dispute resolution mechanisms are slow, cumbersome and expensive; training of judges and commercial and banking laws is almost non-existent; while, case management is weak and infrastructure facilities are inadequate. Additionally, existing judicial, business, banking and tax laws have to be simplified. Fourth, the privatization process has to be accelerated to promote efficiency of resource use, to avoid a continued drain on fiscal resources and to improve the delivery of essential public services. It is estimated that roughly 1.5 percent of GDP will be saved annually if large loss making public enterprises and utility companies such as the KESC and WAPDA are transferred to the private sector. Fifth, the civil service and police have to be overhauled through merit based recruitment, professional training, performance linked career promotion, better incentives, easy procedures for disciplinary action and severance. Organizational structure, business processes and staffing levels have to be reviewed and over manning and excessive layering eliminated. Provincial and district governments have been given functional, administrative and financial autonomy in the real sense rather than in a perfunctory manner. Sixth, public investment in infrastructure facilities, education, health and other social sectors has to be stepped up within the limits of manageable fiscal deficits to clear the backlog and cater to emerging needs of the economy. More important than the level of investment are the cost effectiveness and operational efficiency which are critical success factors. Public – private community partnership has proved to be a demonstrably successful model and needs to be applied carefully in Pakistan. Unlike macroeconomic stabilization, relative price changes, exchange rate and interest rate adjustments, the challenges facing the economy are much more complex and time consuming. There are no quick fixes or short cut solutions; a lot of patience and perseverance is required before tangible results start becoming visible.

Finally Pakistan's economic managers are faced with another serious dilemma. The popular expectation is that if governance has improved, policies are moving in the right direction, the country's credit worthiness has been upgraded, why is it that economic growth and buoyancy are still proving elusive?. The truth of the matter is that dysfunctional institutions will take time to turn around, investment – output relationship is always lagged and change in investor sentiment and confidence requires more than just economic considerations. The structural reforms under way have themselves displaced the existing equilibrium, generated tensions and uncertainties associated with the ongoing transition, and forced economic agents to adopt a wait-and-see attitude. Moreover, the external environment has not been particularly conducive either. This disconnect between popular expectations and ground realities poses the greatest risk to the continuation of the reform agenda. It is quite conceivable that a more populist regime could adopt policies that might provide a short term boost to the economy but put country back on an unsustainable path. The commitment of President Musharraf to ensure the sustainability and continuity of economic reforms in the post October 2002 period is critical and assumes the greatest importance.

TABLE I
Pakistan: Macro economic Indicators

	1997/98	1998/99	1999/00	2000/01	2001/02
Output, Prices and Incomes: (growth rates)					
Real GDP (factor cost)	4.3	4.2	3.9	2.6	3.7
Per Capita Income	2.0	1.9	1.2	0.1	1.2
Agriculture	3.5	1.9	6.1	- 2.5	2.0
Large Scale Mfg.	6.9	4.1	- 0.2	7.8	6.5
Consumer Prices	7.8	5.7	3.6	4.4	5.0
Savings and Investment (percent of GDP)					
Gross Capital formation	17.7	15.6	15.6	14.7	15.2
Gross National Savings`	14.7	11.7	13.5	12.8	14.6
Public Finance (percentage of GDP)					
Budgetary Revenue	16.0	15.9	16.9	16.4	17.0
Budgetary Expenditure	23.7	22.0	23.4	21.8	21.3
Fiscal balance	- 7.7	- 6.1	- 6.4	- 5.3	- 5.3
Primary balance	- 0.3	1.3	1.1	1.5	1.5
Net Public Debt	89.4	91.6	89.4	95.4	92.4
External Sector (percent of GDP)					
Merchandise Exports	13.9	12.8	13.3	15.0	15.2
Merchandise Imports	16.3	16.4	15.6	17.1	17.4
Current account balance (official transfers	- 2.7	- 3.8	- 0.4		
Total External Debt	51.7	56.1	55.8	58.4	58.0
Debt Service	5.3	6.1	5.8	5.4	5.6
Gross Reserves (US$ billion)	0.930	1.672	0.908	1.685	2.385
(in weeks of next year imports)	4.8	9.7	3.9	7.2	7.7

TABLE II
Social Indicators

Indicators	Pakistan		All Developing Countries
	1990-98	1999-2000	
Population Growth rate (%)	2.4	2.2	1.8 (1990-98)
Adult literacy rate (%)	44.0	49.0	26.5 (1995)
Primary School Enrolment (%)	74.0	81.0	85.7 (1997)
Life expectancy at birth (years)	63.0	63.0	65.0 (1997)
Infant Mortality Rate (Per 1000)	91.0	89.0	60.0 (1997)
Total Fertility Rate (%)	4.9	4.8	2.9 (1997)
Contraceptive Prevalence Rate (%)	17.0	28.0	56.0 (1995)
Rural Population's access to:			
Safe Water (% Population)	56.0	53.0	71.0 (1995)
Rural Sanitation (% Population)	25.0	27.0	42.0 (1995)