Pakistan's Development Challenge

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Pakistan's biggest development challenge to day is to reduce its debt burden in order to pursue a path that leads towards sustainable and equitable growth for poverty reduction. The main plank of the present government to meet this challenge is its Debt Burden Reduction Strategy popularly characterized as debt Exit Strategy. It is not the intention to stop borrowing but to borrow for productive purposes, use the loans judiciously, contact them at soft terms and reduce the overall burden of debt in relation to income. The idea behind this strategy is to reduce reliance on International Financial Institutions (IFIs) for balance of payments support. A question therefore arises : What are the factors that will determine whether this strategy is going to be successful or not. I would submit that at-least five major factors --- initial conditions, nature of reforms and policy framework, institutional capacity, external environment and the response of private economic agents -- will largely determine if this strategy will succeed or not.

Cross – Sectional evidence in development economics literature suggests that initial conditions substantially determine subsequent growth performance. Countries that overcame unfavorable starting points by resolute commitment to reforms reaped substantial benefits in terms of economic growth. Panel data results also confirm that reforms have a strong pay – off as the effect of the initial conditions on growth declines overtime. Empirical studies do provide the evidence that reforms in the current period are negatively associated with growth but the effect is outweighed by the positive effect of lagged reforms. As the reforms are implemented and sustained the negative effect of initial conditions on growth disappears and higher rates of growth are achieved. This happens due to the non-linearity in the relationship between initial conditions and growth.

As the initial conditions facing Pakistan were severely unfavorable in terms of debt burden, poverty incidence, fiscal and external imbalances, stagnant investment and growth, the first order of business was to adopt a reform package and policy framework whereby the adverse effects of these initial conditions could be neutralized through a set of sensible reforms and consistent policies. What does this course of action involve and what measures have been taken so far and will be continued in the future ?

The current account deficit in the 1990 – 99 period averaged over 6 percent of GDP (if the Resident Foreign Currency Deposits are taken as borrowing rather than earning). During the past two years this deficit has been brought down to 1.6 percent of GDP and non-interest current account has turned surplus. The trade imbalance in the future can be contained within manageable limits by a large turn around in the value of exports. The last two years have witnessed an addition of about $ 1.5 billion in the total exports and this fiscal year we expect another $ 1 billion. This performance is by no means spectacular but it should be recognized that the volume growth has been much more rapid in these two years. Had the Unit value of major exports persisted at their 1998-99 levels the actual increase would have been closer to $ 2.5 billion and by 2000-2001 the country would have reached the $ 10 billion mark. The Export Strategy is aimed at diversifying markets and products and vigorous efforts have been initiated in this regard. The growth rate of non-traditional manufactured exports last year was 24 percent showing a marked response to incentives. If this trend persists, many of the irritants facing the exporters are removed, the incentives are not tampered with and promotional activities are stepped up the projected 50 percent expansion in exports over the next four year does not appear too onerous. But it is imperative that the present system of duty draw back and sales tax refunds would have to be completely revamped if this target is to be attained. On the basis of this outcome, the Debt Committee's projection of $ 3.8 billion as the contribution of non-interest current account surplus appears quite reasonable.

The assumptions which are outside the control of the policy makers relate to (a) Exceptional quick disbursing assistance from International Financial Institutions - $ 6 billion (b) Debt rescheduling - $ 5.1 billion (c) Net Foreign Private Investment - $ 2.5 billion, and (d) Disbursements of long and medium term loan - $ 6.2 billion. This amount totals about $ 20 billion out of $ 24 billion assumed as sources of foreign exchange by the Debt Committee for successful completion of Debt Exit Strategy. If there is a significant shortfall in these inflows the probability of attaining the objective is likely to be low. There are apprehensions in some quarters that non-economic considerations may be attached to this particular stream of inflows. The risk mitigation strategy then will be to stretch the time period for exit, reduce the incremental reserve accumulation or resort to assistance from other sources such as China, Saudi Arabia, UAE, Kuwait etc.

Similarly, for the past two years the government has been able to generate primary surplus in its fiscal accounts. This amounted to 2.5 percent of GDP in the 2000-2001. The public debt burden reduction work out proposed by the Debt Committee is premised on major efforts in mobilizing tax revenues and raising it from 12.8 % of GDP to 14.7 % in 2003-04. This implies that the revenue must increase at 12.8 percent annually over the next four years. This postulated growth rate is akin to the actual outcomes in the past two years and thus lies within the realm of realistic expectations.

The emphasis on raising Tax-GDP ratio, in my view, is right as the fiscal adjustment so far has taken place entirely by reducing development expenditure. The composition of consolidated government expenditure is quite inflexible and growth enhancement and employment generation can only come through increased public sector development expenditure on infrastructure and human development. This requires a larger revenue pool which should not be expanded by taxing the existing tax payers but by widening the tax net and bringing in other eligible persons and firms within this net. At some time it should be seriously considered whether the tax rates should not be reduced from their present levels.

The other avenue for reallocation and increased development expenditure is that the losses of public enterprises are eliminated either by turning them around or privatizing them. For example, if the projected losses of public sector corporations were wiped out in 2000-01, the development expenditure would have been higher by 30 percent.

In the interim, however, the existing debt servicing obligations should be rescheduled to bring it in line with the payment capacity of the country. In addition, the volume, terms and maturity of new debt should be structured in a way that it creates repayment stream over an extended period of time and at highly concessional rates after a long grace period. These actions therefore necessitate negotiations with the IMF for a Poverty Reduction and Growth Facility. This intervening period of 3-4 years should be utilized to reduce the fiscal and current account imbalances, build up foreign reserves and generate carrying capacity to service the debt.

This brings me to the next determinant of Debt Exit Strategy i.e. capacity of non-market institutions in Pakistan and quality of governance has to be improved. The turn around in the key institutions in the short term is the pre-requisite for efficient allocation and equitable distribution of benefits from growth. Structural reforms in the areas of Civil Service, Police, Judiciary, Tax Administration, Financial Sector Management, Labor Laws have to be deepened despite the noise from the vocal elements who want to maintain status quo. Privatization of public sector enterprises such as nationalized Commercial banks, oil and gas companies, power utilities will help in providing fiscal space to the government and improvement in the delivery of services to the consumers. In the meanwhile, public sector institutions such as Railways, Steel Mill and PIA have to be restructured to make them financially viable and reduce the haemorage on public finances.

External environment affects the speed of adjustment of Pakistani economy in terms of flows of financial resources, demand for Pakistani goods and services, labor migration and transfer of technology. Until recently, the credibility of Pakistan vis a vis international financial institutions and donor community was very poor. It was believed that Pakistan entered into contractual obligations with foreign investors but these were reneged without due process of law with change in governments. This lack of credibility had resulted in drying up of flow of official and private finances to Pakistan, causing a major setback to the prospects of economic growth. The successful completion of the recent agreements with the IMF, World Bank and Asian Development Bank and the resolution of Independent Power Producers (IPP) issues have certainly helped create a more positive image of Pakistan. But this has not yet translated into large flows of private direct investment or portfolio investment.

In the area of international trade, the declining unit values of Pakistan's export, slowing down in the world economy, preferential treatment to a group of developing countries competing with Pakistan, the significant rise in prices of petroleum products have not been particularly conducive despite a continued program of unilateral trade liberalization embarked by Pakistan.

Labor migration which acted as the safety valve for absorbing additions to the labor force and a conduit for foreign exchange earnings through workers' remittances has also not been that forceful influence on the economy as in the past. Migration to Canada, Australia etc. is attracting the well-to-do classes without any consequential impact on remittances.

Information technology and Inter net related services which have helped a number of developing countries are just beginning to take some shape in Pakistan.

Thus, the external environment so far been, by and large negative and made it more difficult for growth to resume.

The last success factor for External debt Strategy i.e. the response of domestic economic agents is more complex and very difficult to disentangle. It is widely believed that accountability, tax survey and documentation, monitoring by Army at the grass roots level, elimination of avenues for whitening black economy and other reforms at improved governance have muted the response of the traditional investors who were fuelling the unrecorded economy. Bank Loans are no longer awarded on the basis of connections and *sifarish*, utility companies are coming hard on those indulging in pilferage, opportunities for evading taxes are being plugged in, the risk premium on corrupt practices has risen, the manipulation of SROs for gaining personal benefits is no longer widespread, the discretionary grant of urban plots and land to the privileged few has been discontinued and the award of contracts and concessions is relatively more transparent than before. But these were precisely the sources of funds which were invested in real estate, construction, housing, transport, trade and services sectors. As these sources are becoming more scarce the rate of investment in the economy is falling with negative consequences for growth and employment generation.

Under this scenario of withdrawal of private investors from the scene it becomes incumbent upon the public sector to take up the slack and hike up investment. But in its quest to achieve fiscal stability and reduce external borrowing requirements of the public sector the government cannot adopt an expansionary fiscal path. The coming year is expected to witness a surge in public sector development expenditure of about 30 percent. The pattern of investment is such that it should crowd-in private investment and ease some of the infrastructural bottlenecks in the short run.

This shows the dilemma faced by the government in accelerating economic growth rate. If it steps up the pedal on public sector investment in order to boost growth it will worsen the debt situation, lead to higher inflation and macro economic instability. Private investors will be put off under these circumstances and unwilling to undertake any investment under this scenario. This spurt in growth may be politically expedient but will be unsustainable and cause more harm in the medium term. The only prudent choice is to stay the course, implement the difficult and painful structural reforms and then derive the benefits from higher growth but growth with a difference. The future growth should benefit the widest segments of the population and not only a minuscule minority which has been the case in the past.