REFORMS IN PAKISTAN

Dr Zafar Mueen Nasir
Chief of Research

Pakistan Institute of Development Economics
Islamabad, Pakistan

Distortions in the Economy

- Over time distortions have been introduced in various sectors of the economy resulting in loss of efficiency

To remove these distortions, reforms were required in *microeconomic and macro-economic policies* and *institutions of the economy to enhance the efficiency of resource use.*

What To Reform

Adjustment is required in various fields including

- ***Size of the government***
- ***Fiscal system***
- ***Financial system***
- ***International trade***
- ***Foreign exchange market***
- ***Agriculture and industrial production***
- ***Utilities***

Absorption Approach

- The current account balance of payments deficit arises because the country absorbs more output thane the GDP
- The country will have to pursue the expenditure reduction and expenditure switching policies to overcome the balance of payments problem
- Devaluation can help in reducing the absorptions as well as switching the demand towards domestic market
- If the absorption can be reduced to the levels of GDP plus long term loans the structural problem is resolved
- The absorption approach deals mainly with the current account deficit but to some extent also with the capital account deficit

The Transmission Mechanism

- The creation of credit (C) at a rate in excess of the growth in demand for money will create excess real balance;
- Demand will then rise as individuals try to reduce the excess balances to the desired levels.
- Part of the demand will be for traded goods
- Assuming that economy is operating at or near full capacity output level, the increased demand for traded goods will be met through imports.
- Excess money balances will result in higher demand for non-traded goods, resulting in a rise in their domestic prices.

The Transmission Mechanism

- This is turn will lead to rise in wages, and a fall in the supply of traded goods to the external market.
- The BOPs is thereby accentuated since both exports fall and imports rise with the transfer of resources into the production on non-traded goods.
- In a small open economy the monetary authorities cannot control the money supply
- If the monetary authorities pursue an expansionary domestic credit policy the public can adjust by exporting money supply and thereby generating a BOPs deficit;
- An acceleration of domestic credit will only worsen the BOPs which will be reflected in and increase in the international reserves.

The monetarist approach

Balance of payments is exclusively explained in terms of domestic monetary disequilibrium, i.e. excess of money supply compared to money demand. It is criticized due to two strong assumptions;

- The stability of the demand and supply functions of money may not be stable especially in developing economies
- The time dimension of the theoretical mechanism is not clear, it implies very direct and almost instantaneous adjustments
- The dichotomy between money and other financial claims is very sharp. Similarly reserves and other external assets are analogous
- The assumptions relating to capital mobility, substitutability of goods and services produced between different countries or sectors, and the existence of full employment conditions are unrealistic
- The direct implication of symmetrical application of stabilization policies does not hold in real world.

The First Generation Reforms

- Major objective of the first generation reforms has been to eliminate or at least reduce government control, direct and indirect, in all the areas where private sector is better organized to provide the goods and services
- Some of the areas where reforms were introduced are:
  - Significant reduction of tariff and non-tariff barriers
  - Liberalization of foreign exchange regime
  - Elimination of administrative control over domestic and foreign investors
  - Privatization

Impact of reforms

- Rationalized tariff structure has lead to allocative efficiency, improved levels of productivity and competitiveness in the export market
- The removal of investment controls has led to reduction in the transaction cost and improved profitability
- The reforms were expected to increase the investment levels but due to inconsistency of the policies over time there had been reduction in the investment levels and growth rate initially but in recent years both investment and output has increased sharply

The Second Generation Reforms

- Three areas of second generation reforms include:
  - Economic governance
  - Efficiency of factor markets
  - Provision of infrastructure services
- Basic objective of the reforms is a thriving market that
  - Rewards innovation and risk-taking
  - Penalizes activities which distort proper functioning of markets
- Second generation reforms would impact on the productivity levels

Economic Governance

- Regulatory and institutional reform to create a more certain and predictable environment for commercial transactions
- Institutional development to instill and enforce market discipline and certainty in investment returns
- Better economic governance requires effective
  - Functioning government institutions
  - Quality regulation
  - Lack of political uncertainty
  - Rule of law
  - Consistency of policies

Economic Governance

- Whereas Pakistan has made steady progress in governance covering tax, customs, financial institutions, labor, public procurement and utility regulation, it needs to be expanded to
  – Modernizing business laws and processes to improve entry, corporate governance and exit
  – Improvement in the access to, and efficiency of, the justice, particularly in commercial areas
  – Strengthened and transparent enforcement mechanisms
  – Capacity building for reengineering processes in public sector entities, particularly those which have business and citizen interface

Efficiency of Factor Markets

- Functioning factor markets are central to optimal resource allocation. The four areas or reforms would include:
  - Deepening of financial markets
  - A more competitive environment through continued privatization, rationalized regulatory constraints and improved corporate governance
  - Codifying, rationalizing and liberalizing national labor legislation governing labor compensation, industrial relations, working conditions, health and safety requirements and human resource development
  - Developing land markets through improving land records, divesting public lands and establishing robust property rights

Physical Infrastructure and Transport Logistics

- Power, telecommunications and oil & gas sectors are being restructured and opened to private sector operations
- Whereas government has increased its investments in infrastructure, regulators are building their own capacity to govern private participation
- Strengthening of transport, trade logistics and municipal services based on private participation
- Improvement in government interface and coordination among the federal, provincial and local levels

FISCAL POLICY

- Three major considerations of Fiscal Policy in 1990s
  - Reduction of fiscal deficit to a sustainable level
  - Removal of distortions in the tax structure and the tax administration
  - Reduction in the role of government in the economy necessitating rationalisation of public expenditure

TAXATION POLICY

- Weaknesses in the Pakistan’s tax structure:
  - Narrow and distorted base
  - Over-reliance on indirect taxes
  - Weak tax administration
- These have resulted into
  - Low and stagnant tax-to-GDP ratio
  - Low tax elasticity
  - Lack of Progressivity

CHANGES IN THE TAX STRUCTURE AND TAX ADMINISTRATION

- A modern system built around voluntary compliance supported by effective, trusted and well-targeted audit
- Withdrawal of tax whitener schemes
- Bringing employees benefits in kind within the ambit of income tax
- Imposing of income tax on national saving schemes
- Imposing taxes on agricultural input
- Rationalization of corporate income taxes
- Rationalization of import duties
- Tinkering with the rates of sales taxes

TAX BURDEN

Groups	1987-88	1992-93	1997-98	2007-08
GI	7.94	8.97	8.60	8.24
GII	8.11	9.13	8.67	8.18
GIII	8.63	9.42	8.63	8.18
GIV	8.18	8.89	8.20	7.81
GV	8.18	8.89	8.10	7.65
GVI	8.24	8.95	8.00	7.54
GVII	8.10	8.64	7.67	7.29
GVIII	8.29	8.69	7.68	7.33
GIX	8.03	8.49	7.43	7.13
GX	8.87	9.42	8.14	7.69
GXI	8.70	8.92	7.65	7.33
GXII	10.17	10.14	8.59	8.14

PUBLIC EXPENDITURE

- The public expenditure affects the poverty levels in at least four major ways:
  - employment creation
  - basic infrastructure needed by poor farmers, micro entrepreneurs, and labour-intensive manufacturers to provide livelihoods
  - primary education, basic health care, safe water and sanitation
  - cash and food transfers to reduce the vulnerability of the marginalized segments of the society.

MONETARY POLICY

- Major reforms in the financial sector
  - Autonomy of State Bank of Pakistan
  - Use of Market-based instruments to control the money supply
  - Auction of government securities through bids
  - Development of secondary security markets
  - Withdrawing restrictions on the maximum and minimum rates of return on deposits
  - Improvement in the State Bank regulatory and surveling capacity.

MONETARY POLICY (Continued)

- Three main questions in monetary policy:
  - Whether the monetary policy has been contractionary
  - Why in spite of prudential regulations there has been a high proportion of infected portfolio investment
  - Impact of non-bank borrowing on the banking sector and the interest rate structure.

Growth of GDP

Period	GDP	Agriculture	Industry	Manfacturing	Services
1950s	3.5	1.7	8.2	7.7	3.1
1960s	6.8	5.1	10.9	9.9	6.7
1970s	4.8	2.4	6.1	5.5	6.3
1980s	6.5	5.4	7.6	8.2	6.7
1990s	4.6	4.4	4.3	4.8	4.6
2000-01	1.8	-2.2	4.1	9.3	3.1
2001-02	3.1	0.1	2.7	4.5	4.8
2002-03	4.7	4.1	4.2	6.9	5.2
2003-04	7.5	2.4	16.3	14.0	5.8
2004-05	9.0	6.5	12.1	15.5	8.5
2005-06	6.6	1.6	5.0	10.0	9.6
2006-07	7.0	5.0	7.3	8.4	8.0
2007-08	4.1	1.1	4.8	5.4	6.6
1950-2008	5.4	3.7	6.8	7.5	5.6

Growth Rates of Manufacturing

Year	Small Scale	Large Scale	Total
2000-01	7.5	11.0	9.3
2001-02	7.5	3.5	4.5
2002-03	7.5	7.2	6.9
2003-04	7.5	18.1	14.0
2004-05	7.5	19.9	15.5
2005-06	8.7	8.3	8.7
2006-07	8.1	8.6	8.2
2007-08	7.5	4.8	5.4
2008-09	7.5	-7.7	-3.5

Growth and trickle down

Growth does not necessarily trickle down:

- High growth accompanied with rising poverty levels in the 1960s;
- Slow growth accompanied with falling levels of poverty in the 1970s;
- High growth accompanied with falling poverty levels in the 1980s; and
- Slow but positive growth of per capita incomes in the 1990s were accompanied with a sharp increase in poverty
- The recent poverty estimates indicate that growth may have trickle down
- These estimates also show an increase in income inequality

Poverty in Pakistan

Year	Overall	Rural	Urban
1998-99	30.6	34.7	20.9
2000-01	32.1	39.3	22.7
2004-05	23.9	28.1	14.9
2005-06	22.3	27	13.1
2007-08	17.5	27	13.1

Determinants of Poor
Time Series Analysis Elasticity

Explanatory Variables	Elasticity with Respect to Explanatory Variables
Per Capita GDP	-0.927
Unemployment	0.824
Remittances	-0.131

BUDGETARY DEFICIT IN PAKISTAN

(as percentage of GDP)

Year	Total Revenues	Tax Revenues	Public Expenditures				Budget Deficits	Primary Surplus(Non intrest-total revenue)
			Total	Non-Development	Interest Payments	Develop-ment		
1987-88	**17.3**	**13.8**	**26.7**	**19.8**	**6.9**	**6.9**	**8.5**	**-1.6**
1992-93	**18.0**	**13.3**	**26.0**	**20.3**	**5.9**	**5.7**	**8.0**	**-2.1**
1994-95	**17.3**	**13.8**	**22.9**	**18.5**	**5.2**	**4.4**	**5.6**	**-0.4**
1996-97	**15.6**	**13.4**	**22.3**	**18.8**	**6.6**	**3.5**	**6.4**	**0.2**
1997-98	**16.0**	**13.2**	**23.7**	**19.8**	**7.6**	**3.9**	**7.7**	**-0.1**
1998-99	**15.9**	**13.2**	**22.0**	**18.6**	**7.5**	**3.4**	**6.1**	**1.3**
1999-00	**17.1**	**12.9**	**23.6**	**20.3**	**8.2**	**3.3**	**6.6**	**2.2**
1999-00	**13.5**	**10.7**	**18.9**	**16.5**	**6.9**	**2.5**	**5.4**	**1.5**
2000-01	**13.3**	**10.6**	**17.6**	**15.5**	**6.0**	**2.2**	**4.3**	**1.7**

BUDGETARY DEFICIT IN PAKISTAN

(as percentage of GDP)

Year	Total Revenues	Tax Revenues	Public Expenditures					Budget Deficits
			Total	Non-Development	Interest Payments	Develop-ment		
2001-02	**14.2**	**10.9**	**18.5**	**15.9**	**6.2**	**2.9**		**4.3**
2002-03	**14.9**	**11.5**	**18.7**	**16.3**	**5.3**	**2.2**		**3.7**
2003-04	**14.3**	**11.0**	**16.7**	**13.5**	**4.1**	**3.1**		**2.4**
2004-05	**13.7**	**10.0**	**18.2**	**13.1**	**3.9**	**3.6**		**3.3**
2005-06	**14.2**	**10.4**	**18.4**	**14.2**	**3.5**	**4.2**		**4.2**
2006-07	**14.9**	**11**	**20.2**	**15.8**	**4.2**	**4.4**		**4.3**
2007-08	**14.8**	**11**	**18.8**	**13.8**	**3.8**	**5**		**4.0**
2008-09	**14.6**	**11.3**	**18.6**	**15.8**	**4.8**	**2.8**		**4.3**

TAX STRUCTURE OF PAKISTAN

(%age share of tax revenues)

	Direct Taxes	Indirect Taxes			
		Total	Tariffs	Sales	Excise Duties
1996-97	30.1	69.9	26.5	17.1	17.3
1997-98	35.0	65.0			
1998-99	35.8	64.2	20.1	17.6	16.0
1999-00	32.5	67.5	15.2	28.8	14.0
2000-01	31.8	68.2	14.7	34.8	11.4
2001-02	35.3	64.7	10.0	34.8	10.1
2002-03	32.2	67.8	12.4	35.1	8.2
2003-04	31.9	68.1	14.8	36.0	7.6
2004-05	30.1	68.9	17.8	35.7	9.2
2005-06	31.5	68.5	17.0	36.8	7.7
2006-07	39.4	60.6	15.6	36.5	8.5
2007-08	39.6	60.4	15.0	36.6	8.9
2008-09	39.6	60.4	13.6	37.8	9.0

GROWTH RATE OF MONEY SUPPLY

(Percent)

	Public Sector Borrowing	Budgetary Support	Private Sector	Money Supply (M2)
1987-88	17.3	13.3	13.4	12.2
1990-91	24.7	33.2	9.0	17.4
1991-92	34.3	32.2	12.0	26.2
1992-93	27.8	25.6	20.7	17.8
1993-94	8.2	7.2	10.1	18.1
1997-98	8.4	9.5	13.8	14.5
1998-99	-11.8	-13.6	17.1	6.2
1999-00	13.3	7.9	3.2	9.4
2000-01	-7.1	-6.0	8.2	9.0
2001-02	3.4	2.9	2.1	15.4
2002-03	-11.6	-9.9	16.1	18.0
2003-04	9.7	12.5	30.1	19.6
2004-05	14.6	11.8	34.4	19.3
2005-06	12.1	11.0	23.5	15.2
2006-07	11.1	11.4	17.3	19.3

INFLATION RATES

Period	Consumer Price Index	Wholesale Price Index	GDP Deflator
1987-88	6.3	10.0	9.6
1996-97	11.8	13.0	13.3
1997-98	7.8	6.6	7.7
1998-99	5.7	6.3	5.9
1999-00	3.6	1.8	2.8
2000-01	4.4	6.2	7.8
2001-02	3.5	2.1	2.5
2002-03	3.1	5.6	4.5
2003-04	4.6	7.9	9.0
2004-05	9.3	6.8	8.8
2005-06	7.9	10.1	10.3
2006-07	7.8	6.9	7.9
2007-08	12.0	13.7	16.21
2008-09	22.35	21.44	22.63

Rising Investment levels (% GDP)

Year	Total Investment	Fixed Investment	Public Investment	Private Investment	Share of private sector
1999-00	17.4	16.0	5.6	10.4	65.0
2000-01	17.2	15.8	5.7	10.2	64.6
2001-02	16.8	15.5	4.2	11.3	72.9
2002-03	**16.9**	**14.3**	**4.0**	**11.3**	**79.0**
2003-04	**16.6**	**15.0**	**4.0**	**10.9**	**72.7**
2004-05	**19.1**	**17.5**	**4.0**	**13.1**	**73.3**
2005-06	**22.1**	**20.5**	**4.8**	**15.7**	**73.9**
2006-07	**22.9**	**21.3**	**5.7**	**15.6**	**71.9**
2007-08	**22.0**	**20.4**	**5.7**	**15.0**	**70.2**
2008-09	**19.7**	**18.1**	**4.9**	**13.2**	**72.7**

Foreign Private Investment

Years	Direct	Portfolio	Total
1999-00	469.9	73.5	543.4
2000-01	322.4	-140.4	182.0
2001-02	484.7	-10.0	474.7
2002-03	**798.0**	**18.2**	**816.3**
2003-04	**949.6**	**-27.7**	**921.7**
2004-05	**1524.0**	**152.6**	**1676.6**
2005-06	**3521.0**	**351.5**	**3872.5**
2006-07	**5152.8**	**40.1**	**5192.9**
2007-08	**3719.1**	**98.9**	**3818.0**
2008-09	**3205.4**	**-451.5**	**2753.9**

Employment generation

Year	Labor Force	Employed persons	Unemployment	
			Persons	Rate
1997-98	38.20	36.94	2.25	5.89
2000-01	39.40	37.32	3.08	7.82
2002-03	39.64	39.64	3.28	8.27
2004-05	42.39	42.24	3.50	7.69
2005-06	50.05	46.95	3.10	6.19
2006-07	50.33	47.65	2.68	5.33
2007-08	51.78	49.09	2.69	5.20

Foreign sector (Million$)

Year	Exports	Remittances
1999-00	8190	983
2000-01	8933	1087
2001-02	9140	2389
2002-03	10889	4237
2003-04	12396	3871
2004-05	14482	4169
2005-06	16506	4600
2006-07	17119	5494
2007-08	20207	6451
2008-09	14328	5658

Degree of Openness

(% of GDP)

Period	Exports	Imports	Openness
1999-00	11.7	14.1	25.8
2000-01	12.9	15.1	28.0
2001-02	12.8	14.4	27.2
2002-03	**13.5**	**14.8**	**28.3**
2003-04	**12.5**	**15.9**	**28.4**
2004-05	**13.0**	**18.5**	**31.5**
2005-06	**12.8**	**22.3**	**35.1**
2006-07	**11.8**	**21.2**	**33.0**
2007-08	**11.7**	**24.3**	**36.0**
2008-09	**8.9**	**17.4**	**26.3**

Foreign exchange reserves (Million$)

Year	With State Bank	With banks	Total
June 2001	1,689	1,555	3,244
June 2002	4,337	2,061	6,398
June 2003	9,529	1,218	10,747
June 2004	10,564	1,760	12,324
June 2005	9,805	2,616	12,421
June 2006	10,765	2,537	13,302
June 2007	11,651	1,288	12,939
June 2008	14,435	1,366	15,801
June 2009	9,476	1,957	11,433

TRENDS IN BALANCE OF PAYMENTS (Million $)

Years	Exports	Imports	Trade Deficit	Remitts	C A Deficit
1987-88	4362	6919	2557	2013	1682
1995-96	8311	12015	3704	1461	4575
1998-99	7528	9613	2085	1060	2429
1999-00	8190	9602	1412	983	1143
2000-01	8933	10202	1269	1087	513
2001-02	9140	9434	294	2389	-1338
2002-03	10889	11333	444	4237	-3028
2003-04	12396	13604	1208	3871	-1313
2004-05	14482	18996	4514	4169	1534
2005-06	16506	24948	8442	4600	4999
2006-07	17119	30540	13564	5494	6878
2007-08	20207	39966	20914	6451	13735
2008-09	14328	28922	14160	5658	8547

PROFILE OF DOMESTIC AND EXTERNAL DEBT

(Rs. Billion)

	FY 99	FY 00	FY01	FY02	FY03	FY04	FY05	FY06
Total Debt	3,077	3,334	3,886	3,783	3,824	3,950	4,191	4,457
Domestic Debt	1,392	1,579	1,731	1,718	1,854	1979	2,133	2,293
External Debt	1,614.4	1,680	2,061	2,006	1,928	1938	2,032	2,148
Explicit liabilities	70	75	94	59	43	33	26	15
As Percent of GDP								
Total Debt	104.7	88	93.3	85.9	79.3	70.0	63.7	57.8
Domestic Debt	47.4	41.6	41.6	39.0	38.4	35.1	32.4	29.8
External Debt	54.9	44.3	49.5	45.6	40.0	34.4	30.9	27.9
Explicit Liabilities	2.4	2.0	2.3	1.4	0.9	0.6	0.4	0.2

PROFILE OF DOMESTIC AND EXTERNAL DEBT

	FY 99	FY 00	FY01	FY02	FY03	FY04	FY05	FY06
Ratio of External Debt Servicing to								
Export Earnings	31.6	36.5	32.7	36.7	22.8	32.5	14.9	13.3
Foreign Exchange Earnings	23.6	23.4	20.4	26.5	16.0	23.2	10.2	9.1
Ratio of Total Public Debt Servicing to								
Tax revenue	87.8	91.5	78.3	91.8	53.9	49.3	47.5	39.6
Total revenue	73.2	72.4	62.5	70.3	41.6	37.9	34.8	29.6
Total expenditure	53.0	52.3	48.1	53.1	33.3	31.4	28.0	22.7
Current expenditure	62.7	59.2	53.5	62.7	37.8	38.7	33.2	28.4

LEADING FACTORS FOR REDUCTION IN DEBT

- Writing off some debt and converting some into debt-social sector spending swap. Pakistan got a debt relief amounting to $ 1495 from USA;
- Receipt of grants as budget support;
- Rising remittances have allowed the government to pay back the expensive loans;
- Appreciation of rupee against dollar meant a reduction in the foreign debt denominated in the local currency;
- Smaller budget deficit; and
- Reduction in the interest rates.

THE WAY FORWARD

- For sustainability of growth, investment rates would have to increase and the investment in commodity producing sector and the power sector is absolutely necessary
- The growth would not trickle down unless efforts are made to generate productive and remunerative jobs
- The debt has been kept low but as the interest rates would rise and there are little assets to privatize, debt would rise
- The financing of deficit with foreign private investment in the import substitution industries have long run implications in terms of deficit in the invisible account
- Efforts need to be made to make the investment in export oriented industries more attractive

THE WAY FORWARD

- The primary deficit needs to be kept low. However, the public expenditure, both development and non-development, will have to rise
- This requires massive resource mobilisation; higher growth must result in more than proportional increase in tax revenues
- In monetary policy the choice between low inflation and higher levels of interest rate is difficult but if the fiscal deficit is low then both the objectives can be realised
- The growing trade and balance of payments deficit though may not be posing an immediate problem has long run severe implications for the economy
- Improving productivity levels would help in higher growth and improved levels of competitiveness and that is not possible without the human resource development

THE WAY FORWARD

- Reducing the cost of doing business:
  - ✓ Checking corruption
  - ✓ Improvements in regulatory environment in all aspects of commercial laws and regulations
  - ✓ Development of operational rules procedures and monitoring system universally accepted
  - ✓ Development of a dispute resolution system for commercial adjudication
  - ✓ Improvements in infrastructure especially in the power sector
  - ✓ Consolidation of financial reforms
  - ✓ Defining and demarcating role and responsibilities of different agencies and strengthening the institutions

Thank You