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Second Annual Conference on the Management of the Pakistan Economy At the Lahore School of Economics, 2-3 May 2006 – Overview

Moazam Mahmood*

The Second Annual Conference on the Management of the Pakistan Economy opened with the Rector of the Lahore School of Economics, Dr. Shahid Amjad Chaudhry, recalling that the first conference last year had seen a good gathering of policy makers led by the Governor of the State Bank Dr. Ishrat Hussain, the private sector comprising bankers and industrialists, and academia. The dialogue generated on public policy had been both intense and diverse, ranging across macro, sectoral and institutional issues, especially edifying for the student body of the School. Dr. Shahid Amjad discussed how this experience warranted the institutionalisation of an annual conference, hence this second conference. The tradition had also been set for the Governor of the State Bank of Pakistan to deliver the inaugural address at the conference.

1. The Macroeconomy and Policy

At this second conference, the Deputy Governor of the State Bank delivered the inaugural address on the state of the economy. He emphasized that GDP growth was fundamentally on track although a little below the expected 7% target due to commodity sector weaknesses. The rising trend in unemployment had been reversed over 2002-2004. Longer trend growth over the decade was expected at over 6%. However, three macro imbalances needed to be managed while they still could be handled at their present relatively lower levels.

First, the current account had gone from a surplus of 1.9% of GDP in 2004 to a deficit of 1.4% in 2005, fortunately financed by the high capital flows. The surge in oil prices has contributed to the rise in the

* Senior Technical Specialist, Policy Group, Policy Integration Department, International Labour Office.

import bill, but so have capital and intermediate goods, and curtailing the second will affect growth.

Second, there is a widening savings investment gap, resulting from sluggish savings, the financing of the surge in imports from capital inflows, and the widening current account deficit.

Third, inflationary pressures continue, although falling from 12% in 2005 to an expected 8% in 2006. This inflation threatens incomes, competitiveness, and savings incentives. The reduction in inflationary pressures has been brought about by a tight monetary policy, although aggregate demand remains strong. Private sector credit fell from 25% last year to a still substantive 18% this year.

The Deputy Governor also stated that fiscal prudence is also needed, with fiscal deficits creeping up after several years of discipline. Revenue side risks include a nearly fifty percent dependence on import taxes, which could fall, and the volatility of non-tax revenues. The future outlook for 2006 was a growth rate of between 6.3%-6.8%, inflation between 7.7%-8.3%, a current account deficit of 4.7%, while the tight monetary stance will continue, and structural rigidities would be addressed.

Mr. Saqib Sherani, the Chief Economist of ABN AMRO Bank, followed this discussion by addressing the structural rigidities in the fiscal system. The primary fiscal rigidity lay in the narrow direct tax base, focused on industry for nearly two-thirds of its revenues, and services for another quarter, while agriculture contributed only 1%. Mr. Ashraf Janjua, a discussant for this presentation and the former Deputy Governor of the State Bank pointed out that agriculture's share of indirect taxes was enormous. Further the personal tax base was limited to 2.5 million people, with wage earners having been found to account for a half in past surveys. As a result Pakistan's tax-GDP ratio of 9% was amongst the lowest in the world. Subsequent discussion also clarified that Pakistan's revision of its GDP upwards to $800 per capita had simultaneously lowered the tax-GDP ratio.

Mr. Sherani also discussed how this fiscal rigidity resulted in a fiscal overhang over the monetary policy of the State Bank of Pakistan (SBP). The SBP was torn between the opposing objectives of price control and growth. It was also torn between lending for government needs and non government needs, although since the mid 1990s the non governmental sector had not been excessively squeezed for credit. His policy conclusions accordingly were to reduce the fiscal tax burden on the formal sector and to reduce the fiscal domination over monetary policy.

Mr. Sartaj Aziz, the former Finance Minister, went on to set the context between these three often opposed objectives of public policy, growth, price stabilization, and exchange rate stabilization. All three objectives could not be met simultaneously and had to be juggled. In Pakistan's case he attributed the current dynamic to an exogenous shock of remittance increases due to the 9/11 effect. The excess liquidity forced banking credit for consumption to increase, which raised demand for manufacturing and led to its growth. Since growth was import intensive, this led to a deficit in the current account balance. The liquidity also fuelled inflation through speculative investment in land and the stock market. To beat this exogenous impact on prices, he recommended stronger real estate taxation.

The presentation of Dr. Ashfaque Hassan Khan, Economic Advisor to the Ministry of Finance on Debt Management, pointed to strong gains in the macro economic environment. He estimated Pakistan's total financial requirements for the current year to be $6.8 billion, while total inflows amounted to $8.5 billion. This gives a comfortable BOP surplus of $1.7 billion, which would be added to the current reserves of $13 billion. He also stressed that the total debt as a percentage of GDP had declined from 100% in 2000 to 61% by 2005. This had resulted from a debt restructuring with the Paris Club in 2001 which postponed non-ODA for 23 years and ODA for 38 years, giving a NPV reduction of 27% or $2.7 billion. The discussion pointed to some of this debt reduction being due to the re-appraisal of the GDP, which also lowered the debt burden.

The macro debate was rounded off with the continuation of the fiscal question, with Dr. Zubair Khan former Commerce Minister addressing the question of inter governmental resource transfers. The question of these transfers arises because of an asymmetry between revenues and expenditures. Since the federal government earns 90% of the revenues, while the provincial governments spend 25% of the revenues, this necessitates transfers from the federal to the provincial governments under the aegis of the National Finance Commission. The allocations through the NFC had increased substantively over time. However, there were always competing criteria for the awards, for instance between revenue capacity which favors the richer provinces and improving equity which favors the poorer provinces. He illustrated the differences between the provincial and federal governments through two cases. The NWFP contested earnings by WAPDA which was under independent arbitration. Also, Balochistan and Sindh contested the formula for the gas development surcharge, which was paid to them as the difference between well head price and cost. The provinces contested that the well head prices used did not favor them.

2. Sectoral Issues

The presentations and discussion then moved from the macro context to sectoral issues. Dr. A.R. Kemal set problems in the manufacturing sector against some of the conundrums emerging from the macro policy discussion. One macro puzzle was that while growth had recently risen to 8%, investment levels as a ratio of GDP appeared to have fallen. This is partly explained by the re-evaluation upwards of the GDP. But the same issue emerges in manufacturing with very high growth rates of 12%-18%, coinciding with falling investment levels coming down to 2.9% of GDP. While part of the problem may be an accounting one, at least part was a real sector issue. The declining investment levels could be due to a number of factors including high production costs, transaction costs, policy continuity risks, skills and wages, and changes in the demand structure.

Dr. Kemal showed that manufacturing now accounts for 18% of GDP. The high growth in manufacturing has been based very interestingly on domestic demand accounting for 75%, and exports for the remaining 25%. So the buoyancy of the economy through increased liquidity seen at the macro level has fed through to increased aggregate demand for manufacturing.

However, Dr. Kemal stated that there are major issues of competitiveness that the manufacturing sector confronts. The Domestic Resource Cost (DRC) which is one measure of protection, for the entire sector is 1.2 implying a degree of protection, though not high. Within the sector however consumer goods are very highly protected with a DRC of 6.0, while capital goods and intermediate goods are not, with DRCs of 0.2 to 0.8. Therefore one policy implication that emerges is that consumer goods protection could decrease while some protection could be afforded to capital and intermediate goods. Second, Total Factor Productivity growth, which measures technical change has gone down from 3.2% to 1.5%. And Pakistan's reliance on food and textiles continues to be very high with 40% of the value added in the sector.

It is this high dependence on cotton and textiles which Dr. Rashid Amjad, from the International Labour Organization (ILO), called cottonomics that becomes the priority challenge to be confronted. Dr. Amjad emphasized that this was the juncture in Pakistan's economic trajectory for it to learn to leap frog technologically from a labor intensive economy, skipping the intermediate stages of resource based and scale based activities to a knowledge based economy. A knowledge based economy is one that bases its growth not on increasing capital or land or labor inputs, but on knowledge. While the Medium Term Development Framework (MTDF) for 2005-2010 declares its objective to be the development of a competitive, technology driven knowledge economy, the leap required is considerable.

Dr. Amjad showed that at present Pakistan's exports of technologically intensive products is very low, much below India, Malaysia, or Thailand. Further, enrollment in higher education to feed this technology driven economy is also commensurately low at 4%, although planned to increase to 8% by 2010. As a result Pakistan produces barely 8000 ICT professionals per year, and another 5000 graduates in ICT. Compared to this India produces 1 million ICT professionals per year.

Dr. Amjad concluded that the solution then lies in both increasing the supply of technology professionals, but it also implies improving conditions in the labor market. Two factors which work against investment inhuman Resource Development (HRD) while on the job are the high levels of contract labor with no affinity to the enterprise and labor mobility. If labor has stronger links to the enterprise through greater security, investment in their HRD will also pay off for the firm.

3. Local and Institutional Development

The presentations and discussion then moved very logically from the meso sectoral level to the local level. Mr. Shahid Kardar, former Finance Minister for the Punjab, made a strong plea for financial devolution from the federal and provincial levels to the local level. His argument was that the current high degree of centralization had failed to deliver anywhere near an adequate level of social services. Further, while the more important services like education, health, and water supply had devolved to the local level, higher levels of government imposed constraints on their financial expenditures. For instance water supply schemes had been transferred to the Local Governments (LGs) in Balochistan, but the budget was kept by the provincial government.

As a result LGs were constrained by three factors: their own taxes were extremely limited at 0.1% of GDP, with Pakistan much below most other comparable countries. Second, their tax base was very narrow and inelastic. Third, LGs had no incentive to increase their revenues, because this increase had to be surrendered to provincial governments. His major policy recommendations were that the agricultural income tax be transferred to the district government and the property tax to the Tehsil Municipal Administrations (TMAs). There should be increased resources for LGs. There should be award incentives for District Governments (DGs) performing well. Finally, LGs should be protected from the imprudence of DGs.

Mr. Javaid Hasan Aly, former Secretary Establishment Division rounded off the conference with a presentation on the institutional structures of the civil service. He essentially traced four periods in this service, pre 1971, 1972-77, 1978-99, and 2000 onwards. In the first period the service worked well. In the second period the paradigm was vitiated. In the third period the anarchy continued by default. And in the fourth period anarachy continued by accident. The typology was meant to illustrate the growing disincentives in the paradigm for efficiency.