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Ensuring Stable and Inclusive Growth in Pakistan

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Abstract

The article provides an overview of the Pakistani economy and addresses various sectoral issues currently being faced by the economy. The first and the most critical problem highlighted concerns the protection of the poor. Other issues highlighted relate to education, healthcare, housing, taxation and energy. This paper discusses how the current account deficit needs to be tackled by higher tariffs, exchange rate adjustments, and possible export duties. The paper also discusses the need to reduce the cost of production for industry and upgrade governance through an emphasis on the local government system. Regarding public sector investments, the paper explains how the government needs to be transparent about the Public Sector Development Programme, and allow projects to be executed by the provinces.

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Pakistan is a 150 billion dollar economy, a significant figure among developing countries. However, the boom the country has experienced over the last 6 to 7 years is mainly attributable to a historical accident, in particular a consumption boom occurred that was financed by cash inflows of about 6 to 8 billion dollars per year from various sources: approximately one billion dollars from American bilateral assistance, 2 to 3 billion dollars from multilateral institutions, and 2 to 3 billion dollars from privatization receipts. In addition to the direct cash inflows, a highly overvalued exchange rate contributed to over-consumption by making imports seem inexpensive. Now that these inflows are no longer coming, Pakistan does not have the same level of foreign exchange resources, and the spending boom has ended.

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The immediate consequences of first, the glut, and now scarcity of foreign exchange can be measured by the twin deficits, i.e. the fiscal deficit and the balance of payments or current account deficit. The fiscal deficit, previously at 4-5% of GDP (US$ 6-7 billion) is now running at 7-8% of GDP. On the balance of payments side, the trade deficit and the current account deficit, which normally runs at about 5-6% of GDP (US$5-6 billion), is now running at US$10 billion. The adverse consequences of the foreign exchange reversal has been exacerbated by two other significant events: First, a hike in international oil prices that has doubled Pakistan's import bill on oil alone to about 12 billion a year, and second, the increase in international commodity prices, which while it should be a blessing in disguise can be harmful to the poor, especially the urban poor, due to the effect of rising food prices on the many households near the poverty line.

Looking at sectoral issues, the first and most pressing problem is protecting the poor, who comprise some 50-70% of the population, through income supplements. Suggestions have included: using the minimum wage, direct cash grants to the poor, grants of Rs. 600 to each child a month that attends classes, or to give old age pensions of Rs. 1000 per family. This last method, I believe is the most promising, since most families have elderly members and the elderly are among those most vulnerable to malnutrition. The second part of a plan to protect the poor is to effectively implement an employment generation scheme, as announced by the prime minister. According to some calculations, this will cost between Rs. 100-250 billion.

The second major issue is education. It has become clear that the private sector is providing a much better quality education at the primary level. The public education sector, therefore, needs a transferable voucher program. What is also needed is an aggressive school 'feeding' program which will again cost approximately Rs. 20-30 billion a year. I also support ending the dual system of education; this does not mean taking everybody down to a lower level, but rather bringing everyone to a higher level which can be achieved through a voucher scheme or doubling of resources to education.

The third issue is healthcare. It is a little known fact that one of the leading causes of families falling into poverty is health problems - even for wealthy families. One simple suggestion is to have compulsory coverage for hospitalization for all citizens. While I do not suggest that this policy be implemented overnight, over the next 5 to 20 years Pakistan can move towards hospitalization coverage to cover the most serious illnesses for the bulk of the people.

The fourth issue is housing. Presently, Pakistan does not have a housing policy for public servants or private individuals. The suggestion that I have is that instead of giving public servants a house rent allowance, the government should give them an allowance to finance housing loans. For the poorest public servants, the government should award non-alienable plots, so that the plots can be inherited but not sold.

The fifth issue is taxation. While tax increases are not popular among any group, the government might first consider taxing those who have benefited the most from the recent boom economy. Given that energy prices have doubled and huge windfall gains have accrued to the oil and gas companies, Rs. 25-50 billion in revenue could be generated by taxing them. In addition, the independent power producers (IPPs) were given a 30 year income tax exemption (at a cost of 3-4% of GDP), thus making a case for taxing them. Thirdly, a case can be made for taxing agriculture, as prices have risen so quickly. Other potential tax bases include real estate and the stock exchange (which had Rs. 600 billion worth of transactions last year).

The next issue is that of energy. Pakistan could potentially fulfill 5-10% of its energy needs through bio-fuels, but there is a strong lobby by the oil companies against implementing a bio-fuel policy. In tandem, Pakistan also needs to use renewable energy. Also, any discussion of energy policy in this country must also include the IPI pipeline. Though the promise of the pipeline is generating much discussion, Pakistan should not have to pay the prices presently being offered by Iran and Turkmenistan. And if there is an agreement on the IPI pipeline, a tax should be charged on the value of the gas transported (closer to international pipeline rates) and not at some minimal rate (which I fear) so that the country actually receives some revenue benefit from the pipeline.

The next question is how Pakistan can deal with its current account deficit. While most proposals have focused on exchange rate adjustments, I believe that adjustments to the tariff schedule are also merited. This is because Pakistan has not only opened up its capital account, but also has liberalized the trade regime significantly by reducing tariff rates considerably and signing free trade agreements (FTAs) with China and Malaysia. Though this may be the correct long run strategy, I believe the country needs to increase tariffs, in addition to exchange rate adjustments, and export duties (on for instance cement, cotton, etc.) may also be warranted.

We also need to reduce the cost of production for industry. The main contributors to higher costs are energy and high financial costs of borrowing for investment. While borrowers struggle with interest rates on loans, depositors often receive a negative real interest rate on savings, so that 99% of depositors are essentially receiving no return on their deposits. At the same time, the bankers are compensating themselves handsomely; the average salary of a banker went up by 50% with 4-5 crores as bonuses last year, and 7% of all advances from the banking system are to the banking employees themselves, at a 0-1% interest rate. In its attempts to create a viable commercial banking sector, the NSC, the only institution that gave a decent rate of return in the public sector, was sacrificed.

Also, Pakistan needs to upgrade governance. The government must pay its public servants market wages, modernize processes, and most importantly of all must begin to outsource. I am personally very supportive of the local government system, with the DCO under the local government. What is also needed is to take the police out from under the control of the ***nazims*** and put it firmly under the DC, and to have a district magistracy system.

Finally, it is crucial to discuss and pose questions regarding public sector investment. First, the government needs to be transparent about what is the PSDP. Where should the money go? First 50% of the PSDP (without the provincial shares) should go to the least developed provinces (FATA, Balochistan, the interior of Sindh and southern Punjab) and the government needs to allow the projects to be executed by the provinces. Third, given that electricity falls in the concurrent list of responsibilities, power generation may be passed to the provinces (especially the least developed ones) by giving them the local electricity companies. This way, scarcity in the energy sector, i.e. in power generation and energy exploration, can be handled by them (through private-public partnerships or other arrangements) with the help of federal grants.