

Institutional Reforms in Pakistan

The Missing Piece of the Development Puzzle

Sakib Sherani
November 2017



- After nearly three decades of strong performance in terms of economic growth, Pakistan's economy has floundered since the 1990s. The country's economic performance has deteriorated both with regards to its own historical trend as well as when benchmarked against developing country peers. The deterioration is structural and not cyclical, manifesting itself across a wide front and has persisted for a protracted period.
- The weak secular performance of the economy has occurred in a context of a broad atrophy of the country's institutional framework. Is there a correlation or, indeed, even causality between the two developments? The corpus of growth literature on Pakistan has largely ignored to study the country's historical economic performance, in particular the period of decline from the early 1990s, through an institutional prism.
- This paper attempts to do that, with the caveat that it should be regarded as a preliminary issues paper, laying out the landscape and providing a broad examination of the issues. The study does, however, hint at possible solutions and approaches to institutional reform, in particular relating to institutions of economic governance, and the way forward.

Table of contents

Executive Summary	i
Introduction	1
Weaving institutions into the development narrative	1
Importance of institutions	5
Institutional development in Pakistan	8
Pakistan’s institutional landscape	10
Institutional performance	15
Economic Impact	18
Wider socio-economic impact	24
The Way Forward	31
Navigating the Political Economy of Reforms	41
What needs to be done?	41
Who will do it?	42
Why will they do it?	43
How will they do it?	43
Conclusion	46
Bibliography	47

Abbreviations

ADB	Asian Development Bank
AGP	Auditor General of Pakistan
AIT	Agriculture Income Tax
AJK	Azad Jammu and Kashmir
CCI	Council of Common Interest
CPEC	China-Pakistan Economic Corridor
CPI	Corruption Perceptions Index
DISCOs	Distribution Companies
ECC	Economic Coordination Committee
ECP	Election Commission of Pakistan
EIU	Economist Intelligence Unit
FAB	Frequency Allocation Board
FATA	Federally Administered Tribal Area
FBR	Federal Board of Revenue
FIA	Federal Investigation Agency
FP	Foreign Policy magazine
FRDL	Fiscal Responsibility and Debt Limitation Act
GB	Gilgit-Baltistan
GDP	Gross Domestic Product
HRM	Human Resource Management
IMF	International Monetary Fund
IPPs	Independent Power Producers
KPI	Key Performance Indicator
KPK	Khyber Pakhtunkhwa
MQM	Muttahida Qaumi Movement
NAB	National Accountability Bureau
NADRA	National Database and Registration Authority
NCGR	National Commission for Government Reform
NEC	National Economic Council
NEPRA	National Electric Power Regulatory Authority
NFC	National Finance Commission
NRC	National Reforms Commission
NRO	National Reconciliation Ordinance
OECD	Organisation for Economic Cooperation and Development
OGRA	Oil & Gas Regulatory Authority

PAC	Public Accounts Committee
PAS	Pakistan Administrative Services
PFM	Public Financial Management
PILDAT	Pakistan Institute of Legislative Development and Transparency
PML-N	Pakistan Muslim League-Nawaz
PPP	Pakistan People's Party
PPP	Public-Private Partnership
PPRA	Public Procurement Regulatory Authority
PTA	Pakistan Telecommunication Authority
PTI	Pakistan Tehreek-e-Insaf
PTR	Presumptive Tax Regime
RTI	Right To Information Act
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
TI	Transparency International
VAT	Value Added Tax
WB	World Bank
WEF	World Economic Forum
WGI	Worldwide Governance Indicators

Executive Summary

A modern state has multiple functions to perform. At the core is its developmental role, seeking to better the lives of its citizens and future generations in an inclusive, responsive, responsible and sustainable manner. The state's ability to meaningfully fulfil this role requires institutional capacity. A large corpus of academic literature pertaining to institutional theory over the past four decades has linked weak institutional quality and poor governance with lower private investment, lower economic growth, worse development outcomes, and higher inequality, among other correlations.

In this context, Pakistan's institutional framework — the ability and willingness of the state to frame laws and policies for the public good, to implement these, and to enforce its writ via prosecuting violations of the laws of the land — has *prima facie* weakened over a period of time. The atrophy appears to have started in the 1990s and accelerated since 2008.

A principal manifestation of a weak institutional framework is the ability of the ruling power elites to influence or usurp state institutions and public policy for private gain, effectively resulting in the "privatization of public policy". While individuals or some segments within society benefit, this outcome works against the welfare of a society at large. Corruption, especially large-scale corruption, appears to have increased sharply in this period, imposing a large hidden cost to society apart from its quantifiable financial burden.

Given the large estimated financial costs associated with corruption, any significant reduction in the loss caused by corruption through stronger institutional checks and balances could mean that Pakistan's public education budget can be doubled, or its public spending on healthcare for its citizens increased by over *five-fold* from the current levels. Equally important, it would mean that the quality of spending could potentially

improve, resulting in a substantial improvement in outcomes in the wider social sector.

The damage large-scale and pervasive corruption does to society and the economy, however, goes much deeper than merely its financial impact. Mega-corruption can only flourish in the absence of strong institutional checks and balances. Well-functioning institutions are designed to work for everyone in society, guaranteeing protection of rights, especially of those in the lowest strata of society who are without influence or power and are, therefore, most vulnerable. But, importantly, they also protect investors and businesses from weak property rights, emanating from government excess and/or appropriation, for example.

When institutional checks and balances are systematically undermined to create an ecosystem for mega corruption to thrive in, as a corollary it also weakens property rights — an essential requirement for not only private investment and commerce but also innovation and entrepreneurship in the economy. As collateral damage, if left unchecked over a protracted period, it is more than likely to foster a culture of impunity within society and affect the level of trust as well as social cohesion. Each of these conditions on its own imposes a significant cost to the economy and societal welfare.

The other significant channel through which a weakening of institutions and a thriving of corruption undermine long-term economic development is by the systemic erosion of state capacity. The by-passing of institutionally-governed rules on impartiality, non-discriminatory treatment and application of law, and the creation of privileges for a few, requires the appointment of cronies and loyalists in key positions in state institutions. The systemic undermining of meritocracy becomes a major impediment over a period of time to the overall functioning of the state.

In terms of economic governance, it is manifested in a progressively weaker capacity to plan, formulate, and execute viable policies for the management of the economy. (This state of affairs is providing a strong headwind to long-term planning and implementation of the China-Pakistan Economic Corridor, or CPEC).

This is the state Pakistan finds itself in. While a transition to civilian rule is taking root in Pakistan since 2008, it does not appear to be accompanied by a transition to institutional democracy. This arrested or incomplete transition will undermine Pakistan's economic performance in the long run as well as development outcomes. The absence of a genuine reform constituency in the country — one that is aware, politically mobilised and sufficiently large — is a critical hurdle in the path of reform.

An equally serious impediment is the absence of a strong incentive for political parties in a parliamentary democracy to expend their political capital on an enterprise that is likely to yield some degree of adjustment and pain in the initial years, with the potential benefits accruing beyond the election cycle.

To overcome these headwinds, it is imperative to achieve a broad consensus on reform and

ownership across the political spectrum, by creating wide coalitions for reform, both in the political arena as well as with and within civil society. The initial focus should be on reforming institutions of economic governance, especially those that are less visible in the public eye and require expending minimal political capital for an incumbent government.

Work on formulating the national narrative for reform and shaping a roadmap of what needs to be done and how, should be entrusted to a National Reforms Commission (NRC). The NRC should be a high-powered and permanent body, with representation both from government as well as the private sector, and drawing upon the expertise of a wide range of experts from eclectic disciplines. The objective should be to redraw and "re-imagine" political and economic governance in such a way as to make it more capable, more nimble and effective, and more transparent and accountable.

Without fundamental reform of the institutional framework, Pakistan will remain ill-prepared to respond to emergent challenges stemming from population growth, urbanisation, federal decentralisation, climate change and water scarcity — among other issues within a dynamic, complex, and very likely disruptive environment.

Note: This report was commissioned by Friedrich Ebert Stiftung [FES], and has been authored by Sakib Sherani. The author would like to gratefully acknowledge comprehensive and insightful comments by Senator (retired) Javed Jabbar, a member of the Economy of Tomorrow (EoT) project panel of FES, as also by Dr. Ishrat Husain on an earlier draft (Senior Fellow at Woodrow Wilson Centre at the time), and Abdul Qadir of FES.

Introduction

Weaving *institutions* into the development narrative

For much of recent history, the dominant theories of economic development have focused on a diverse range of factors, ranging from geography and location, natural resource and factor endowments, to degree of adoption of “western” neo-liberal values, the presence or absence of a history of colonial occupation and differences in the stock of human and social capital, among others, to explain the variations in the development paths of nations.

Neoclassical growth models, anchored by the *Harrod-Domar (HD)* and Solow-Swan models, emphasised an “exogenous” determination of growth in an economy in which diminishing returns on labour and capital employed could be overcome by higher rates of savings/investment and by technological progress. However, the potential sources of technological progress were not explained. An implication of this model was that per capita income of developing countries could “catch-up” with richer countries in a process of convergence purely due to higher capital accumulation.

From around the 1980s, neo-classical models began to be challenged by economists propounding *New Growth Theory (NGT)*, led by Paul Romer and Robert Lucas Jr., who posited that economic growth in the developing countries could overcome the constraint imposed by diminishing returns to labour and capital by emphasising “endogenous” factors, such as knowledge, innovation and competition. If governments focused on developing human (and, later, by extension, on “social”) capital and on bridging the gaps in provision of other public goods, such as infrastructure, developing economies could sustain accelerated levels of economic growth for long periods of time.

Unlike physical capital, investment in human capital has increasing rates of return according to endogenous growth models, with positive externalities and large spill-over effects.

However, neither of these essentially neo-classical premises and theories focus on institutions and “time” (or “state capacities” for that matter). In the words of Douglass North, the co-Nobel Laureate in Economic Sciences in 1993 for his foundational work on institutions, institutional change and economic performance, neo-classical theory is “concerned with the operation of markets, not how markets develop”. An extract of his critique, from the Nobel Prize lecture:

“When applied to economic history and development it (neo-classical theory) focused on technological development and, more recently, human capital investment, but ignored the incentive structure embodied in institutions that determined the extent of societal investment in those factors. In the analysis of economic performance through time, it contained two erroneous assumptions: one that institutions do not matter and two that time does not matter.”

To the wide spectrum of potential drivers of economic development and possible explanatory variables for the historical divergence of the development path among different economies, the addition of the nature and quality of “institutions” is a relatively recent phenomenon. While the early foundational work is attributable to economists, such as Ronald Coase, Mancur Olson and, notably, Douglass North, later seminal work exploring the relative importance of institutional design and quality, and its relationship with economic growth, has been conducted by a range of well-known economists, such as Robert Barro, Dani Rodrik, Pranab Bardhan, Daron Acemoglu and Williamson from around the mid-1990s.

An excellent categorisation of the broad corpus

of research on determinants of economic growth and development can be found in Valeriani, Peluso et al. and is presented below¹:

Among all, the most relevant may be summarized in five groups according to the elements taken into account:

a) Deterministic approach: numerous studies have noticed significant correlations between geological, ecological, geographical and historical characteristics and economic performances, showing a sort of pessimistic view embedded with determinism as the characteristics analyzed cannot be changed, for close examination see: Diamond, 1997, "Guns, germs and steel: fates of human societies,"; Gallup, Sachs & Mellinger 1999, "Geography and Economic Development"; Hall & Jones, 1999, "Why do some countries produce so much more output than others?"; Diamond, 2004, "Collapse: how societies choose to fail or succeed; Engerman, Sokolof, 1997, "Factor Endowments, Institutions and differential paths of growth among new world economies: a view from economic historians of the United States"; Acemoglu, Johnson, Robinson 2002, "Reversal of Fortune: geography and institutions in the making of the modern world income distribution"; Engerman e Sokoloff, 2002, "Factor endowments in equity and paths of development among new world economies"; La Porta et al. 1999, "The quality of government"; Acemoglu, Johnson, Robinson 2001, "The colonial origins of comparative development: an empirical investigation"; Hoff 2003, "Paths of institutional development: a view from economic history";

b) Liberal and authoritarian institutions: some studies concentrated on the level of freedom institutions should offer to favor growth. Barro, for example, suggests that democracy increases growth when political liberties are weak but decreases it when some liberties already exist. Rodrik emphasizes the role of democracy in determining quality growth. La Porta et al.

instead affirm that developing countries succeed in obtaining good economic performances under dictatorship and choose democracy only after.

For more on the debate see: La Porta et al., 2004, "Do institutions cause growth?", Barro, 1999, "The determinants of economic growth: a cross-country empirical study", p.61, Persson, 2005, "Forms of democracy, policy and economic development", Keefer, 2004, "What does political economy tell us about economic development- and vice versa?", Rodrik, 2001, "Development strategies for the 21st Century", Besley et al., 2005, "Political competition and economic performance: theory and evidence from the United States", Bardhan, 2005, "Scarcity, conflict and cooperation: essays in political and institutional economics of development", Islam, 2003, "Do more transparent governments govern better?", Rodrik and Waziarg, 2004, "Do democratic transitions produce bad economic outcomes?", Acemoglu, 2003, "Why not a political Coase theorem? Social conflict, commitment and politics".

c) Formal and informal institutions: one of the usual frameworks to investigate the distinction between formal and informal institutions is given by contract management through rules or relationships. In informal institutions, transactions occur between two parties belonging to a same group, based on linguistic, ethnic and cultural bonds and contracts are personal and implicit. When a contract is broken, other members may punish the one who broke it towards social sanctions. In formal institutions based on rules, contracts are protected by authorities with a high cost in terms of legislation, regulation and application. The dialectic of this branch examines whether informal institutions are preferable to formal ones or vice versa. In this regard, see: De Soto, 2004, "Law and property outside the west: a few new ideas about fighting poverty", Rubin, 1994, "Growing a legal system in the post-communist economies", Berglof and Caessens,

1. October 2011.

2004, "Corporate governance and enforcement", Hay and Schleifer, 1998, "Private enforcement of public laws: a theory of legal reform", Li, 2003, "The benefits and costs of relation-based governance: an explanation of the East Asian miracle and crisis", Dixit, 2004, "Lawlessness and economics", Greif, 2004, "Impersonal exchange without impartial law: the community responsibilities system", Widner, 2000, "Are specialized courts the right approach to effective adjudication of commercial disputes in developing countries?", Ensminger, 1997, "Changing social norms: common property, bride wealth and clan exogamy."

d) Institutional change: this orientation of studies focuses on how institutional reforms affect economic performance. The problematic knot concerns the way the change must be conducted, whether fast and global or sequential and gradual. To draw an exhaustive panoramic consult: Aslund, 1995, "The keys of radical reforms", Murrell, 1992, "Evolutionary and radical approaches to reform", Heybey and Murrell, 1999, "The relationship between economic growth and the speed of liberalization", Pritchett, 2003, "A toy collection, a socialist star and a democratic dud?", Olson, 1982, "The rise and decline of nations", Williamson, 2000, "The New Institutional Economics: taking stock, looking ahead", Hsieh, 2000, "Bargaining over reform". World Bank in its World Development report all in all seems to support rapidity but not without prudence and caution.

e) Institutions and governance: at the center of these studies there is a kind of assimilation between governance capacity and institutions as economic growth engine. Countries with unstable governance make economic agents act under uncertain conditions determining weak property right enforcement and protection and, therefore, they fail in attempting to activate a constant growth process. For further information see: Olson et al., 1998, "Governance and growth: a simple hypothesis explaining cross-countries differences

in productivity growth", Perotti, 1996, "Growth, income distribution and democracy: what the data say", Kaufman and Kraay, 2007, "Governance Indicators: Where are we, where should we be going?".

f) Institutions and social conflict: another interesting institutional approach proposed by Rodrick proceeds from the results performed by different economies after the Second World War. The countries that registered better economic results had previously succeeded in elaborating more efficient institutions at internal social conflict management, each of them according to its own model of development, implementing social and security policies, income distribution, law enforcement, democratic delegation, linguistic and ethnic melting. In this regard see: Rodrik, 1999, "Making openness work", 2007, "One economics, many recipes: globalization, institutions and economic growth", 2010, "Development policy and development economics: an introduction".

g) Institutions as social infrastructure: Jones and Hall highlighted the relationship between human capital, productivity and social infrastructure defined as the set of policies and institutions set by the government that determines the economic environment in which agents accumulate specialization, know-how and capital and produce output. The process of accumulation depending on social infrastructure flows into production directly affecting economic growth.

For this reason, countries with weak institutions fail to perform as (compared to) countries with stronger institutions. See: Jones and Hall, 1999, "Why do some countries produce so much more output per worker than others?", Acemoglu, 1995, "Reward structures and the Allocation of Talent".

More recent work by Acemoglu and Robinson has elevated the public attention on institutional factors as key determinants of the development path. In their 2012 book, *Why Nations Fail*, Acemoglu and Robinson posit that, more than

geography, culture, psychology, religion, history etc., it is the presence of “inclusive” institutions that determine the development path of nations. More often than not, “capture” by narrow elites is manifested across the developing world in the presence of “extractive” institutions that serve to perpetuate the parochial economic interests of the elite at the expense of the masses.

In the case of Pakistan, an examination of the disconnect between economic growth and development was done in a seminal paper in 2001 by William Easterly.² Its main finding was that Pakistan has experienced “an egregious failure at promoting social and institutional development under the circumstances of elite domination and ethnic division” and the country faced an “institutional lag” relative to its peers at a similar development stage.

Despite the impressive body of research on the effect of institutional quality on economic growth, fundamental questions remain inconclusively settled. Specifically, the following issues remain open to debate and further research:

- Does a robust “institutional framework” ensure economic growth and development? (i.e. is it both a necessary as well as a sufficient condition for growth as well as development?)
- Does a robust “institutional framework” ensure economic growth or economic development?
- If there is causality with regard to institutional development and economic growth and

development, what is its direction? Do strong institutions generate economic growth, or does economic growth and development over a period of time lead to stronger institutions?³

- What explains the differences in “institutional quality”— or the breadth and depth of the institutional framework — among nations?
- What are the best measures of state capacity?
- Can countries with dissimilar historical experiences and legacies replicate the creation of strong institutions of the more successful countries in this regard? Can countries with “weak” or “extractive” institutions follow any set of policy prescriptions to create a robust institutional framework, or is there path dependence that will prevent this from happening?
- Are some institutions more important than others in generating high rates of economic growth/development in the long run?
- Can success in creating enclaves of strong and capable institutions be achieved via an incremental and piecemeal approach, and if so, can it be replicated across the entire spectrum of a country’s economic and political institutional framework?
- Finally, and importantly, how can the process of institutional reform and change be insulated from reversal?

2. The Political Economy of Growth Without Development: A Case Study of Pakistan (World Bank, June 2001).

3. This issue has been tested in ADB (2010), which finds there is causality from strong institutions to long run economic performance.

Box 1: Defining Institutions and Governance

Institutions and governance have been defined in a number of ways over the years.

Douglass C. North (1990):

Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws and constitutions), informal constraints (norms of behaviour, conventions, and self-imposed codes of conduct) and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies.

Ostrom (1990):

“Institutions” can be defined as the sets of working rules that are used to determine who is eligible to make decisions in some arena, what actions are allowed or constrained, what aggregation rules will be used, what procedures must be followed, what information must or must not be provided, and what payoffs will be assigned to individuals dependent on their actions.

Menard and Shirley (2005):

(...) the definition of institutions will include the provision that institutions are all rules or forms of conduct, which are devised with the intention of reducing uncertainty (as a consequence of imperfect information and limited rationality), controlling the environment/game and lowering transaction costs.

The World Bank:

Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced— the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.

Asian Development Bank:

Governance is the manner in which power is exercised in the management of a country's social and economic resources for development.

Governance – a framework and context

Level	Activity	Concept
Meta	Politics	Governance
Macro	Policy	Policymaking
Meso	Program	Administration
Micro	Project	Management

Hyden, Court and Mease, 2004

Importance of institutions

At its most basic and fundamental level, institutions set out the “rules of the game” under which societies, economies, systems and markets operate. Hence, the importance of institutions in generating and sustaining economic growth and virtuous developmental outcomes involves, essentially, the question of “rule of law,” its formulation for the larger good and its impersonal, consistent and non-discriminatory application within a society.

Even primitive societal forms, centred around early agglomerations of human settlements, exhibited some degree of social institutional structure, such as a social (and as they became larger, quasi-political) hierarchy, the division of labour, the specification of roles and responsibilities, and

some rules for social sanction and regulating social behaviour, including social ostracization, for example, in the case of non-compliance of rules.

Many of the institutional structures in the early non-state societies were social in nature, hence, tended to be informal or less formal. However, with social and political evolution towards “higher-order” states of societal organisation, largely as a response to the conduct of war, the role, importance and complexity of institutions grew — as did their level of formalisation. Social, religious and economic institutional structures were gradually blended into an overarching political framework and order with the creation of nation-states.⁴ The exercise and projection of political power required legal as well as military structures, as did the formalisation of commerce and trade.

According to many sociologists and political historians, notably Charles Tilly, as well as some development economists, such as Paul Collier, “war placed a premium on sources of taxation and created incentives for governments to invest in revenue-raising institutions” (Besley & Perrson, *The origins of state capacity*, 2009).

According to Prof. Tim Besley of LSE, there are three main kinds of state capacity, namely fiscal capacity, legal capacity and collective capacity. These state capacities are “assets” which allow the state to function, and all three are needed for generating growth. Fiscal capacity supports the productive role of the state via investment in infrastructure and education. Legal capacity supports a competitive market sector as well as the protection of property rights.

“Collective capacity” is needed to share the proceeds of growth to increase political sustainability as well as to support investments in human capacities (health and education).⁵

One of the earliest investigations into differences in the wealth and prosperity of nations comes from the fountainheads of classical/neo-liberal capitalism — Adam Smith’s *The Wealth of Nations*. In a passage in the book, Smith defines a “stationary state,” or one that has stopped growing and where one of the hallmarks is the ability of a corrupt and monopolistic elite to exploit the system to their own benefit:

“In a country too where though the rich or the owners of large capitals enjoy a good deal of security, the poor or the owners of small capitals enjoy scarce any, but are liable under the pretence of justice to be pillaged and plundered at any time by the inferior mandarins, the quantity of stock employed in all the different branches of business transacted within it can never be equal to what the nature and extent of that business might admit.

In every different branch the oppression of the poor must establish the monopoly of the rich who by engrossing the whole trade to themselves will be able to make very large profits.”

Hence, countries with a relatively stronger institutional framework should, at least intuitively, tend to exhibit the following characteristics over a period of time:

- A more rule of law-based, responsive, socially responsible, accountable and transparent governance, spanning the political process, public policy formulation and its implementation
- Impersonal, impartial/non-discriminatory, predictable, transparent administration based on a Weberian bureaucracy
- More inclusive and open societies as well as economies, with greater access to economic opportunity and social justice for a larger proportion of the population

4. The Catholic Church dominated the political landscape in Europe till the start of the Renaissance in the sixteenth century. It eventually gave way to the emergence of nation-states in the 17th and 18th centuries that, at least formally, separated religion and state.

5. Adapted from Prof. Tim Besley, *State capacities for delivering higher economic growth*, Zahid Hussain Memorial Lecture, State Bank of Pakistan, 2016.

- Lower economic and political uncertainty
- Lower economic “transaction costs”
- A more stable and predictable business environment

These characteristics, in turn, should lead to a virtuous spiral of higher investment rates and less volatile growth in the long run, and greater participatory economic development.

Support for this hypothesis comes from a range of studies over the last three decades or so. The findings of some studies are presented below.

“Corruption has a negative impact on economic growth through, for example, the over-investment in rent seeking, the under-investment in productive activities, and the perpetuation of inefficient policies, among other things. The economic costs of corruption [...] are substantial. One 2005 study estimated that the global cost of bribery alone could be as high as US\$ 1.5 trillion (in the order of 2 per cent of the world’s current GDP).”(IMF, 2002).

“The empirical analysis shows that developing Asian economies with government effectiveness, regulatory quality, and rule of law scoring above the global means (after controlling for per capita income) in 1998 grew faster on average during 1998-2008 (by 1.6, 2.0 and 1.2 percentage points annually, respectively) than those economies scoring below the global means.” (Asian Development Bank, 2010).

Corruption reduces growth and undermines development by lowering incentives for, and the efficiency of, both domestic and foreign investment. (World Bank, 2006).

The *Global Competitiveness Report* for 2005-06 cites econometric evidence, showing that even a slight (one standard deviation) improvement in governance results in a threefold increase in income per capita in the long run. (World Economic Forum, 2006).

The effects of a progressive weakening of the institutional framework on economic and developmental outcomes are explored in greater detail in the section on Pakistan.

Institutional development in Pakistan

Pakistan's unique history appears to have had a significant bearing on the course of institutional development in the country. It gained independence from Britain on August 14, 1947, and bore the brunt of the largest human migration across borders in history till then. In addition, the newly-created Indian Republic refused to transfer much of the assets of United India that were to be handed over to Pakistan under the partition agreement, in an effort to undermine and weaken the newly-created state of Pakistan.

Hence, Pakistan came into being as a fragile nation faced with daunting challenges as well as a hostile neighbor and a difficult neighborhood. Three wars with India fought between 1948 and 1971, with the last leading to the loss of the country's entire eastern wing (East Pakistan that became independent Bangladesh), which has come to be regarded as an enduring humiliation in Pakistani history, reinforced a sense of uncertainty and a state of perpetual hostility with a much-larger neighbor.

In addition, the dominance of a largely-feudal elite in the movement for the creation of Pakistan and the early demise of the democratic founder of the country and constitutionalist, Muhammad Ali Jinnah, meant that political power came to be concentrated in a narrow elite. The elite utilised their political influence to not only consolidate but also to perpetuate their political hold on the country as well as to propagate their economic interests.⁶ Hence, no serious move was made to provide a constitutional framework for the new country, with Pakistan continuing to be ruled under the colonial India Act of 1935 till March 1956 while at the same time, other institutional and structural reforms such as land reform were not pursued.

A power-equilibrium came to be established between a troika of power elite consisting of the politicians, the bureaucracy, and the military. Pre-independence colonial laws and institutions were perpetuated rather than replaced to consolidate and propagate elite domination and capture.⁷

The foregoing history, coupled with both internal as well as external conditions, had an important influence and bearing on Pakistan's institutional development. It shaped a "security-state" doctrine where military expenditures remained high as did the influence of the security establishment in national policies and affairs, culminating in more-than-occasional intervention by the army. Under such conditions, constitutional democracy with robust institutional checks and balances was not considered a national priority; indeed, it appeared to be considered a strategic liability under perceived conditions of constant external as well as internal threats.

The country's first outright military takeover took place as early as in 1958, with General (and later Field Marshal) Ayub Khan taking a stab at re-writing Pakistan's first constitution. A second constitution was promulgated in March 1962. However, it was only in 1973, twenty six years after independence and three years after the country's first free and fair elections held under universal adult franchise, that Pakistan received a truly democratic and pluralistic Constitution, guaranteeing fundamental rights and economic freedoms. Within days of its promulgation, however, fundamental rights were suspended by the Constitution's chief "architect," Zulfikar Ali Bhutto, in a power grab that culminated in a witch hunt of his political opponents and one of the most sweeping shake-ups of the civil service.

6. Tellingly, the country's first free and fair elections based on adult franchise took place in 1970, a full twenty three years after the country's independence.

7. Some commentators have also attributed Pakistan's abysmal spending on education to the same phenomenon, since a more educated populace can diffuse and dilute the power base of the elite (see, for example, Easterly 2001 quoting Bourignon and Verdier 1999).

Pakistan's second military takeover took place in July 1977, following allegations of, and street protests against rigging in elections by the PPP government of PM Bhutto. The military coup was led by the army chief at the time, General Ziaul Haq. Changes to the constitution followed, aimed mainly at legitimising the military takeover, indemnify its actions, and to consolidate General Ziaul Haq's hold on power.

After the General's sudden death in a plane crash in 1988, the country lurched back towards democracy. However, the period between 1988 and 1999, saw a power struggle by proxy between the army and the Pakistan People's Party led by Bhutto's daughter, Benazir Bhutto. Political governments alternated between the PPP and the PML-N led by Nawaz Sharif, after military-engineered dismissals on the grounds of corruption and maladministration. During this period, four national elections were held and new elected governments took office, with each lasting an average of approximately two years before being sacked.

While the ensuing political instability and uncertainty hit the economy badly, curtailing economic growth and new investment, it also inflicted serious damage to the institutional framework. In a bid to consolidate power, the alternating governments of PPP and PML-N during this period launched witch-hunts against their political opponents. To be able to do so meant politicising the civil service, the police and the judiciary by appointing as well as promoting political favourites and/or party loyalists while penalising and weeding out those appointed by the predecessor administration.

In addition, corruption was rampant during this period — with Pakistan ranked as the second-most corrupt nation in the inaugural Corruption Perceptions Index (CPI) produced by Transparency International (TI) in 1996. — (see next section for more detailed coverage.)

As a result, the decade of the 1990s has come to

be referred to as the "lost decade." By the end of the decade a regime change occurred. In October 1999, the army once again took over the reins of government in a coup led by General Pervez Musharraf. The third coup in Pakistan's history was precipitated by the prime minister's sacking of General Musharraf, the army chief at the time, after a period of friction between the civilian government and the military.

To consolidate the army's hold on power, General Musharraf suspended the constitution initially, and later introduced changes via the Legal Framework Order (LFO). A new institution of accountability, the National Accountability Bureau (NAB), was formed which focused almost exclusively on politicians from the two main political parties and bureaucrats (the judiciary and army were explicitly exempt from its purview). Another new organisation was created, called the National Reconstruction Bureau (NRB), to work on the country's governance structure.

However, by 2002 General Musharraf's regime had gone the tried and tested route adopted by previous military dictators: corralling a group of the country's allegedly most corrupt and "compromised," and therefore malleable, politicians into a so-called "King's party," queering the pitch for less-than-fair elections and presenting a façade of a transition to a democratically-elected civilian government while actual power continued to be vested in and exercised by General Pervez Musharraf.

In 2007, in another bid to consolidate his power and extend his tenure as president, General Musharraf introduced a wide amnesty for politicians indicted for corruption and political party workers for a variety of crimes, including murder, since 1999. Called the National Reconciliation Ordinance, or NRO, this legislation saw the release from prison and from all charges of thousands of people arrested for extortion, political killings, etc. (mainly from the MQM). Its main beneficiary, former prime minister Benazir Bhutto, received a clean "bill of health" to re-enter politics despite indictments in high-profile corruption cases.

These developments severely undermined the institutional framework in the country. The senior judiciary was politicised and co-opted for General Musharraf's ends. The NRO specifically introduced a moral hazard problem whereby corrupt politicians and other holders of public office were sent a clear signal — if one were to side with the powers-that-be, their corruption and past misdeeds could be written off and forgiven, not by due process or application of rule of law but at the discretion, and by the whim, of an autocrat and/or via "negotiation".

With the court cases on corruption charges, and the associated stigma, having been washed off, the leadership of the two mainstream political parties (PPP and PML-N) decided to formally band together against the military. A 'Charter of Democracy (CoD)' was signed in 2006 by ex-prime ministers Benazir Bhutto and Nawaz Sharif that set the stage for a period of political reconciliation, collaboration and cooperation between the two parties. This included, inter alia, dropping of corruption cases against the two leaders, not instituting fresh ones for the period in office after the CoD, and allocating key political governance offices — such as the heads of the institutions of accountability (NAB, PAC) and others — between the two political parties.

This framework was designed to insulate the two political parties against the exercise of political power by the military, and as insurance against truly independent institutions, especially with regards to restraint on exercise of power and accountability of corrupt practices. Since the return to power of the PPP in 2008, and continuing into the first handover of power from one elected civilian government to another in 2013 with the victory of PML-N, the new political system with degraded institutional checks and balances against misuse of power by either of the two main political parties appears to be taking root. If it consolidates, it could have far-reaching adverse consequences for the strengthening of democracy in Pakistan with the requisite constitutionally-designed

institutional checks and balances. If, however, the main political parties decide to sacrifice their short term self-interest, and work towards strengthening the country's institutional framework, Pakistan will have made a significant leap forward towards a truly inclusive and participatory democracy.

Pakistan's institutional landscape

In terms of the democratic exercise of political power, the country's 1973 Constitution was a watershed. It set up a federal parliamentary form of government with a bicameral legislature and four provincial assemblies. It delineated and formalised the separation of powers between the three pillars of the state: the legislature/parliament, judiciary and the executive as well as between the Centre and the provinces.

The important institutions of political governance in Pakistan include:

Legislature:

A bicameral federal parliament (Upper House: Senate; Lower House: National Assembly), along with provincial assemblies, elected on the basis of near-universal adult franchise in a first-past-the-post electoral system. Integral to the working of the parliament and the federal system are parliamentary standing committees on various subjects/areas, including the public watchdog Public Accounts Committee (PAC).

Supporting the conduct of elections is the Election Commission of Pakistan (ECP).

Judiciary:

The judicial system consists of:

- The superior as well as lower tiers of judiciary
- A Supreme Judicial Council
- The Federal Shariat Court
- Appellate courts, special courts (banking, accountability), tribunals, etc.

Executive:

The executive arm of the government consists of, and is supported by, the following branches:

- Civil service (Pakistan Administrative Service, or PAS)
- Federal Public Service Commission
- Auditor General of Pakistan (AGP)
- Accountant General Pakistan Revenue (AGPR)
- Federal Ombudsman
- Police Service of Pakistan
- Federal Investigation Agency
- National Accountability Bureau
- Government divisions and ministries
- Federal Board of Revenue
- Regulatory agencies

The Council of Common Interest (CCI) for coordination between the centre and provinces.

(See Box 3 below).

The institutions of economic governance can be categorised by function as follows:

- Planning, formulation and coordination of economic policies
- Enforcement of government policy, rules and regulations
- Oversight, monitoring and evaluation, accountability
- Public financial management (PFM)
- Regulatory functions, including licensing and registration as well as tariff determination

Overall, the important institutions of economic governance include:

- State Bank of Pakistan (the central bank)
- Planning Commission of Pakistan
- Federal Board of Revenue
- Provincial Revenue Boards/Authorities
- Economic ministries: finance, revenue, statistics and economic affairs; commerce; textiles; industry; water and power
- National Economic Council (NEC)
- Council of Common Interest (CCI)
- Economic Coordination Committee of the Cabinet (ECC)
- Securities and Exchange Commission of Pakistan
- Pakistan Bureau of Statistics
- National Tariff Commission
- Competition Commission of Pakistan
- Privatisation Commission
- Regulators of economic sectors: National Electric Power Regulatory Authority (NEPRA), Oil and Gas Regulatory Authority (OGRA), Pakistan Telecommunications Authority (PTA), Frequency Allocation Board (FAB), Pakistan Procurement Regulatory Authority (PPRA)
- Board of Investment
- Federal Tax Ombudsman
- Parliamentary standing committees on finance and revenue

Other institutions, such as the National Finance Commission (NFC), are not brick and mortar institutions but are nonetheless important elements of the overall institutional framework.

System of government under the 1973 Constitution⁸

Branch	Hierarchy	Appointment	Powers	Removal
Executive	President	Elected by electoral college	Head of State and representative of the Republic; appoints cabinet, veto legislation, dissolve the National Assembly	Impeachment on grounds of physical or mental incapacity, gross misconduct, or violating the Constitution by two thirds of both houses of Parliament
	Prime Minister Cabinet	Elected by National Assembly Appointed by president and prime minister	Appoints cabinet, oversees execution of laws and ensures the "smooth functioning of the state" Makes recommendations to the executives	Upon resignation or upon dissolution of the National Assembly by the President Upon resignation or upon removal by President
Legislative	Senate National Assembly	100 members elected by provincial assemblies 272 members by direct vote	Introduces and passes legislation except finance bills Introduces and passes any legislation	Upon written resignation, if removed or leaves qualifying party, upon death Upon written resignation or upon dissolution of the National Assembly by the President
	Judicial Supreme Court Federal Shariat Court Mohhtasib	Chief Justice appointed by President and Justices appointed by president under recommendation from Chief Justice Chief Justice and Justices selected by the President Appointed by the President for a single 4-year term	Judicial review, advise other branches on the drafting and passing of laws Decides whether laws are repugnant to Islam Enforces administrative accountability and investigates wrongs committed by the government against individuals	Retirement at age 65, resignation or removal by legal proceedings as defined by the Constitution Retirement at age 65, resignation or removal by legal proceedings as defined by the Constitution Term expires after four years, removal by the President

8. Source: <http://www.constitutionnet.org/country/constitutional-history-pakistan>

Box 2: Regulatory framework

The regulatory framework in Pakistan consists of a number of independent/quasi-autonomous regulatory agencies formed over a period of time, such as the central bank, or State Bank of Pakistan (SBP), the Civil Aviation Authority (CAA) and the Securities and Exchange Commission of Pakistan (SECP, formerly the Corporate Law Authority).

Since the 1990s, five additional regulatory bodies were formed in line with the deregulation and liberalisation of some sectors of the economy, such as power generation and telecommunications. These bodies include the National Electric Power Regulatory Authority (NEPRA), the Oil and Gas Regulatory Authority (OGRA), the Pakistan Telecommunications Authority (PTA), Frequency Allocation Board (FAB), and the Public Procurement Regulatory Authority (PPRA).

The main functions prescribed for these bodies include the overall economic regulation of the sector under their authority, the granting of licences, determining tariffs, rates, charges and conditions for operators and investors in the sector, develop uniform industry standards and codes of conduct, issue state of industry reports etc. The role of PPRA is different, given that it is responsible for prescribing regulations and procedures for public procurement by Federal Government owned public sector organizations, and for monitoring the same.

While most if not all of these regulatory bodies were set up through an Act of Parliament, and were envisioned to work independently of the government line ministries and agencies involved in the particular sectors/industries, in reality the regulators' autonomy and independence has been restricted in a number of ways. For example, these regulatory agencies were placed under the Cabinet Division and face considerable "input" from the federal government in hiring the senior management of these bodies, or in their respective financial affairs. In the case of electricity tariffs, the regulator (NEPRA) is allowed to determine the power tariff but not notify the same, only to recommend to the government which reserves the right to adjust tariffs by any amount up to the NEPRA-determined level. The exception, till recently, to this state of affairs of quasi-autonomy was the central bank that has operated independently since 1997.

Rather than granting the regulatory bodies greater independence in their functioning, which should benefit consumers as well as investors in each of these particular industries/sectors, the PML-N government has attempted to roll back completely the concept of independent regulators by notifying on December 19, 2016 the transfer of administrative control of the five regulatory bodies — NEPRA, OGRA, PPRA, PTA and FAB — to their respective "parent" line ministries.

While this notification was subsequently suspended by the Lahore High Court, with the honourable court ruling that the prime minister should have sought approval from the Council of Common Interests (CCI) prior to the move on June 6, 2017, the Cabinet Division issued an Office Memorandum placing the regulatory bodies once again under the administrative control of their respective line ministries. In essence, the federal government has placed administrative control of regulatory agencies under the ministries whose work they are supposed to regulate.

This is a regressive step by the federal government that undermines the process of regulatory reform that had been slowly and gradually implemented since the late 1990s.

Box 3: The Eighteenth Amendment

In a major overhaul of the constitutional framework, the parliament enacted the 18th Amendment in April 2010 which, in essence, decentralised the federal structure of the country and strengthened provincial autonomy. At the same time, the amendment sought to strengthen the parliamentary system and undo amendments to the 1973 constitution introduced under non-civilian set ups of General Ziaul Haq and General Pervez Musharraf that were aimed at concentrating powers in the office of the president as well as indemnifying actions taken by them during their period in office, especially when the constitution was "held in abeyance".

According to UNDP, “[T]his amendment introduced changes to about 36 percent of the 1973 Constitution of Pakistan: 102 out of 280 Articles of the Constitution were amended, inserted, added, substituted or deleted.”⁹ In addition, 47 items on the Concurrent Legislative List have been removed and moved to the provincial legislative domain. As a result, some 17 federal ministries and divisions stand abolished.

A summary of some of the main features of the 18th Amendment include:

- Concurrent legislative list abolished
- Bar on number of terms of prime minister removed
- Article 58-2 (b) removed
- President’s defined powers largely transferred to prime minister
- Parliament given powers in appointment of judges to superior judiciary
- Revenue/tax bases assignment to provinces
- Centre’s ability to impose emergency rule in provinces curtailed
- Provinces allowed to borrow from market/commercial sources, including externally
- North West Frontier Province (NWFP) renamed Khyber Pakhtunkhwa

While on paper the 18th amendment has strengthened the move towards multi-level governance in the country, in practice the move occurred in the absence of critical pre-requisites. First and foremost of the challenges spawned by the somewhat hasty transition to a decentralised federal structure has been the near-complete absence of provincial and lower-tier government capacities to take on the newly-assigned responsibilities. Lack of trained staff, resources and supporting infrastructure to carry out the newly-assigned functions has resulted in a paralysis in the delivery of many services and administrative functions by the devolved tier of government.

An additional challenge has been that in the post-18th amendment scenario, policy coordination issues have been amplified. While previously a major governance concern was resolving coordination failure among federal line ministries and agencies (i.e. horizontally), post-18th amendment coordination has to occur between the centre and the agencies and departments of 4 federating units plus AJK and GB. In some cases, such as ratification of, amendment to or implementation of international treaties and obligations, the abolishment of the Concurrent

List would lead to challenges and difficulties as the executive arm of the government cannot dictate the legislative functions of the provinces.

A major area in which the policy framework has become disjointed and disconnected is tax policy. With the clear demarcation of revenue assignment, each province has set up an autonomous revenue authority. Unfortunately, the absence of an overarching policy framework or better coordinating mechanisms this has led to the same tax base being subjected to multiple taxation across provinces, as well as difficulties in obtaining sales tax refunds. It is also likely to induce a race to the bottom competition among provinces to attract “mobile” tax bases.

9. UNDP, 2015.

Institutional performance

Pakistan's institutional performance till the 1990s was, on the whole, fairly impressive. While the country's path to constitutional democracy may have been fraught with challenges, in an administrative and functional sense, the institutional framework was delivering. The quality of the country's civil service, and its ability to maintain independent judgement was impressive and performance across a range of economic as well as social indicators was above-par when compared to many developing countries.

However, since the start of the 1990s, *prima facie* the institutional framework has progressively frayed, barring a period of a few years in the early 2000s. The reasons are explored in a later section. However, some dimensions of the weakening of the overall institutional set-up, among many (some of which have also been covered in detail later), are as follows:

Tax collection: With barely one million income tax filers in a population of 200 million, tax revenue of the government (federal as well as provincial) amounts to less than 11 per cent of the GDP. Tellingly, personal income tax collection is less than 1.5 per cent of the GDP, amongst the lowest in the world.

Educational attainment: An estimated 25 million school-age children are out of school in Pakistan — one of the highest proportions of relevant cohort in the world. The country's education budget amounts to a paltry 2 per cent of the GDP, much of which is either absorbed by salaries or is subjected to mis-appropriation. In addition, poor institutional arrangements in some provinces lead to widespread cheating and exam paper "leakages" in national board-level exams. The combined effect is that overall educational outcomes and attainment are poor.

Health sector outcomes: Pakistan's total spending on the health sector amounts to an abysmal 0.7 per cent of the GDP, or the equivalent of just US\$ 10.6 per capita per annum. As a result, many of the country's health statistics do not compare favorably with its income cohort.

Civil service quality: The low spending on education and poor educational attainment for the country as a whole has begun to be reflected even in the results of the most competitive examination held — the annual Central Superior Services (CSS) exams to select candidates for recruitment into the civil service.

Progressively, fewer candidates across the country are able to make the mark, with only 202 candidates out of 9,643, appearing in 2016, able to pass (over 90 per cent failed to pass the English exam).

State of the judicial system: With only 3,967 judges in the entire judicial system (in all tiers of courts) for a population of 200 million people, there is 1 judge for over 50,000 citizens. There are over 1.7 million cases pending in the courts,¹⁰ many awaiting judgement for years, if not decades.

Resource management: Poor utilisation of Pakistan's considerable economic potential and endowment of natural resources is underscored by the state of affairs in the energy sector and the management of the country's considerable water resources.¹¹

- Against an identified potential of electricity generation of 56,721 MW using the country's hydel resources, current production (2016) is 6,893 MW — or a utilisation of 12 per cent of potential.
- Using wind power, it is estimated that the country can produce 43,000 MW of electricity, almost twice the current installed capacity. So far, Pakistan has managed to

10. Hussain, 2016.

11. The data in this section has been sourced from the Planning Commission.

produce 106 MW, or less than 0.25% of identified potential.

- Pakistan's water storage capacity is extremely low. While the United States has over 5,000 cubic meters of storage capacity per inhabitant, and China has 2,200 cubic meters, Pakistan has less than 150 cubic meters of storage capacity per capita. According to the World Bank, the dams of the Colorado and Murray-Darling Rivers in the US can hold 900 days of river runoff, while South Africa can store 500 days in its Orange River. India can store between 120 and 220 days of water in its major peninsular rivers. By contrast, Pakistan's storage capacity has declined to less than 30 days of water in the Indus basin.

Implementation: Another area where weak institutional capacity manifests itself is in the inability to complete "transformation" initiatives (such as modernisation of the economy/ diversification of exports, creating the basis for a knowledge-driven economy, etc.), or in the number of years for nationally-important, "strategic" initiatives (increasing the share of renewable energy in the overall mix, for example) to reach fruition.

Three examples demonstrate this.

- Pakistan established the Alternative Energy Board (AEB) in 2007 to facilitate the promotion of renewable energy generation. It has taken 10 years for the first solar and wind power plants to be set up (attributed mainly to lack of capacity to set tariffs for renewable projects). Ten years on, the share of renewables in the total energy mix is a meagre 1.7 per cent. In India, the share has gone up to 17.5 per cent in roughly the same time period, with plans to raise it to 40 per cent by 2030.
- The Pakistan Horticulture Development and Export Board (PHDEB) was set up in 2003 to promote exports from this avenue. In

fourteen years since it has been set up, horticulture exports have moved from US\$ 175 million to an estimated US\$ 641 million (2015-16). Kenya's fresh produce exports, on the other hand, have touched US\$ 1 billion in around the same period from virtually zero, with exports of fresh-cut flowers capturing roughly 30% of world market share.

- To promote the use of the public-private partnership (PPP) model in infrastructure development after a successful experience with Independent Power Producers in the 1990s, an Infrastructure Project Development Facility (IPDF) was set up in the mid-2000s under the Ministry of Finance. However, till date, virtually no major infrastructure project outside power has been successfully undertaken in the PPP mode (barring the Hyderabad-Mirpurkhas highway section). In India, which gave an impetus to infrastructure development under PPP at around the same time as Pakistan (the mid-2000s), over 800 major projects have been undertaken, according to the World Bank with an estimated combined project cost of US\$ 60-80 billion.

Pakistan's institutional performance since 1996 onwards can be analysed using a "standard" measure, such as the World Bank's Worldwide Governance Indicators (WGI). An assessment of the period prior to this can only be done in a somewhat subjective manner in the absence of a robust, widely-used measurement tool.

The main advantage of the WGI data set is that it tracks and measures six components of "governance" using a consistent methodology over a period of time. In addition, by reporting on a wide range of countries, it provides a basis for relative/cross-country comparisons.

Since 1996, Pakistan has performed poorly on all six sub-components of governance measured by the WGI — voice, rule of law, control of

corruption, accountability, regulatory quality and political stability/absence of violence and terrorism. However, its weakest performance on an endogenous (i.e. not externally determined,

as in the case of political stability and terrorism) parameter has been in Control of Corruption (see Table 1).

Table 1: Pakistan's Worldwide Governance Indicators¹²

	1996	1998	2000	2002	2003	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Rule of Law	29	25	20	28	28	22	23	21	19	21	27	20	19	21	24	24
Government Effectiveness	31	36	31	41	40	40	42	39	29	24	25	21	24	23	22	27
Control of Corruption	9	16	22	22	27	14	23	25	22	14	13	14	14	18	22	24
Voice and Accountability	29	31	11	14	13	17	24	20	23	22	26	25	23	25	27	27
Political Stability & Absence of Violence/Terrorism	13	13	14	6	8	5	2	1	1	1	0	0	1	1	3	1
Regulatory Quality	31	28	21	21	23	26	35	32	32	33	31	29	25	25	28	29

Source: WGI, World Bank

The average percentile rank attained by Pakistan on each of the parameters for the 16 years for which data is available shows that for the policy-endogenous parameters (voice, rule of law, control of corruption, accountability and regulatory quality), the average percentile rank over 16 years ranges from just 18 (*Control of Corruption*) to 32 (*Government Effectiveness*). During the period 1996-2015, Pakistan is a perennial under-performer in "Rule of law" and "Control of Corruption", attaining a maximum percentile ranking of 29 in the former (1996), and 27 in the latter (2003).

There is considerable intra-period variance among the percentile ranks of the parameters. An interesting observation from the WGI dataset is that, in four out of the six parameters, Pakistan has recorded its best scores for the 1996-2015 period during the quasi-civilian, quasi-political regime of General Musharraf. These parameters include: *Government effectiveness* (peak year: 2006), *Control of corruption* (peak year: 2003), *Regulatory quality* (peak year: 2006) and *Political stability & absence of violence* (peak year: 2000). Even under Rule of law, the percentile ranking was only slightly higher in 1996 under a political government than during two years (2002-2003) under the nine-year military/quasi-civilian rule of General Musharraf.

In the most recent WGI release, pertaining to 2015, Pakistan has experienced a moderate improvement in 3 out of the 6 indicators compared to the previous year. This is a continuation of the trend from 2012, whereby all indicators have shown a moderate to significant improvement when compared to the lows attained in that year. The indicators on which Pakistan's percentile ranking has increased the most since 2012 are: *Control of Corruption*, *Rule of Law* and *Regulatory Quality*.

Despite the moderate overall improvement, Pakistan's percentile ranking remains below 30th in each of the six indicators. Its worst relative performance (apart from Political stability/absence of violence) is under *Control of Corruption* and *Rule of Law* (both 24th percentile).

The WGI dataset is one among a few available cross-country panel measures of institutional quality. Others indicators/datasets include Transparency International's Corruption Perceptions Index (CPI), the Global Competitiveness Index (GCI) from the World Economic Forum, and those from Freedom House, International Country Risk Guide and Bertelsmann Stiftung's Transformation Index.

The sub-optimal quality of Pakistan's institutional

12. Green shaded areas mark the highest rank attained in each parameter along with year.

framework, specifically its performance with regards to control of corruption, is mirrored in a range of indices — see Table below.

Table 2: Measures of institutional quality

Dataset/Indicator	Source	#/Rank	Year
Worldwide Governance Indicators:			
	WB		2015
Rule of law	Percentile	24	
Voice & Accountability	Percentile	27	
Control of corruption	Percentile	24	
Govt. effectiveness	Percentile	27	
Global Competitiveness Index			
	WEF		2015
Overall	Rank	126	
Institutions	Rank	119	
Public institutions	Rank	121	
Corruption Perceptions Index	TI	Rank	117 2015
Democracy Index	EIU	Rank	111 2016
Fragile States Index	FP	Rank	14 2016

Sources: World Bank; World Economic Forum; Transparency International; Economist Intelligence Unit; Foreign Policy magazine

While the actual relative ranking of Pakistan on different components of institutional quality may differ from dataset to dataset, the overall picture of atrophy and decline is consistent across all. Poor governance and an overall lack of responsiveness is reflected in the persistence of Pakistan’s structural issues and development challenges.

Not surprisingly, the poor performance of Pakistan’s institutions over a long period in serving the interests of state and citizens has led to an erosion of public trust in government (Table 3). The decline in public trust in governments and institutions of democracy is not restricted to Pakistan alone but is a worldwide phenomenon as global surveys have been indicating for the past few years (such as by the OECD or the Edelman Trust Barometer).

Table 3: Public trust by Pakistanis in select civilian institutions

	"Approval rating" *	
	2014	2015
Supreme Court	62%	63%
National Assembly	60%	49%
Civil courts	50%	43%
Election Commission	43%	37%
Political parties	44%	36%

* This is the simple summation of responses under "A lot" as well as "Somewhat".

Source: PILDAT

The following section examines in greater detail the myriad ways in which Pakistan’s stunted institutional development may have affected its economic and developmental outcomes.

Economic Impact

A weak institutional framework and its progressive atrophy has had detrimental results for Pakistan’s developmental outcomes. The following excerpt from Transparency International’s Corruption Perceptions Index 2014 neatly sums up the pernicious effects of an important element of mis-governance, corruption:

“Poorly equipped schools, counterfeit medicine and elections decided by money are just some of the consequences of public sector corruption. Bribes and backroom deals don’t just steal resources from the most vulnerable — they undermine justice and economic development, and destroy public trust in government and leaders.”

The following excerpt from the World Economic Forum’s Global Competitiveness Report 2014 lays out the scale of the challenge posed to one aspect of Pakistan’s economic performance, its international competitiveness, by a weak institutional framework:

“The country obtains low marks in the most critical and basic areas of competitiveness. Its public institutions (rank: 125th) are constrained by red tape, corruption, patronage, and lack of property rights protection.”

The report of the National Commission for Governance Reforms (NCGR, 2008) notes:

“Structural economic reforms to improve Pakistan’s prospects for competing in the globalized economy require stable, functioning, competent and responsive institutions for implementation.”

The long run impact on the economy has been far deeper and broader, however, than captured in the country’s annual competitiveness ranking. A February 2010 Working Paper from the Asian Development Bank analyses cross-country evidence on governance quality as measured by performance on the World Bank Governance Indicators and examines whether “better” or “worse” performance from a designated baseline has had an effect on subsequent development performance of different countries/regions. It finds:

The study finds that government effectiveness, political stability, control of corruption and regulatory quality all have a more significant positive impact on country growth performance than voice and accountability and rule of law. Developing Asian countries with a surplus in government effectiveness, regulatory quality and corruption control are observed to grow faster than those with a deficit in these indicators — up to 2 percentage points annually, while Middle East and North African countries with a surplus in political stability, government effectiveness, and corruption control are observed to grow faster than those with a deficit in these indicators by as much as 2.5percentage points annually. Good

governance is associated with both a higher level of per capita GDP as well as higher rates of GDP growth over time. This suggests that good governance, while important in and of itself, can also help in improving a country’s economic prospects.

Some of the important channels via which the impact of governance can be transmitted to long run economic as well as development performance are as follows:

- **Investment:** One of the foremost long run effects that can be posited is on the level, as well as nature, of private investment in the country over the past few decades. As a result of an environment of deep political uncertainty prevailing in the country for much of the 1970s and 1990s and then again starting from 2007 onwards, it appears reasonable to conclude that actual private investment has been lower than what would have been the case otherwise (i.e., in the counter-factual case).

Private investment has fallen from a peak of around 15 per cent of GDP in the early 2000s to less than 9 per cent of GDP in 2015.

In the presence of political instability and policy uncertainty, “political risk” is deemed to rise, resulting in new investment in a country attracting higher risk premiums. This has the twin effect of raising the required financial return on capital for new projects, while shortening the investment horizon and required payback period for investors.

Investor perceptions of a high-risk scenario alters — as well as constricts — the portfolio of projects that a potential investor would look at, thus, potentially lowering the overall investment envelope of a riskier country as well as affecting the “quality” of investment undertaken. Pakistan’s low and declining investment rate compared to its peers bears testimony to this. The increasingly higher and sovereign-guaranteed nature of returns demanded by private investors for large

green field investment is also indicative of the same phenomenon.

The design and application of Pakistan’s tax policy has exacerbated over a period of time the business as well as investment environment. An excessive burden of taxation on large, formal businesses is increasing “informality” in the economy (see below), while the availability of a large tax arbitrage in capital gains on trading on the equity markets and in real estate are shifting investment away from manufacturing and the real economy to less-productive areas, such as secondary trading (see subsequent discussion on Pakistan’s tax situation).

In addition, the dysfunctional tax system has not been generating enough tax revenue for the state to be able to support the required level of public investment in infrastructure or to avoid “crowding-out” of the private sector from the credit markets. Both of these developments have had a detrimental impact on new private investment.

Widespread smuggling, under-invoicing of imports and mis-declaration as well as the absence of state enforcement against counterfeit goods and violations of intellectual property rights has also hurt domestic manufacturing. With an anti-export policy bias coupled with a progressively import-friendly regime in place since trade liberalisation began in the 1990s, import penetration has increased sharply. This process has also been exacerbated by Pakistan’s signing of a Free Trade Agreement (FTA) with China that was implemented from 2006.

- On a related note, one feature that can be expected to be prominent in countries with market characteristics but a weak institutional framework is “crony capitalism”. Politically-connected insiders are given rents via choice licences and contracts by the government or are beneficiaries of privatisation of state assets or sale of state land at throwaway prices, etc.

This has the twin effect of engendering pervasive allocative inefficiency in the economy while

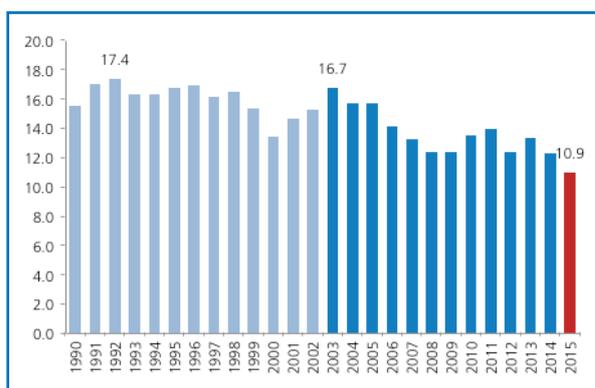
stifling competition and the processes that lead to greater competitiveness. Numerous examples can be found in Pakistan’s history of industrialisation where a combination of subsidised bank credit, preferential access to foreign exchange for imports, a regime of regulatory forbearance and write-offs of bank loans led to a spurt of new “investment” — often with imported plant and machinery that was heavily over-invoiced as a conduit for capital flight.

With no real equity invested in the projects thus set up, the sponsors had little or no incentive to run the projects efficiently or competitively. Over a period of time, these marginal investments became unsustainable. Issues such as these have hurt the overall competitiveness of Pakistan’s economy.

- Structural transformation:** Another area where institutional issues appear to have exerted a strong influence on Pakistan’s development path is the limited extent of structural transformation of its economy in the past four decades.

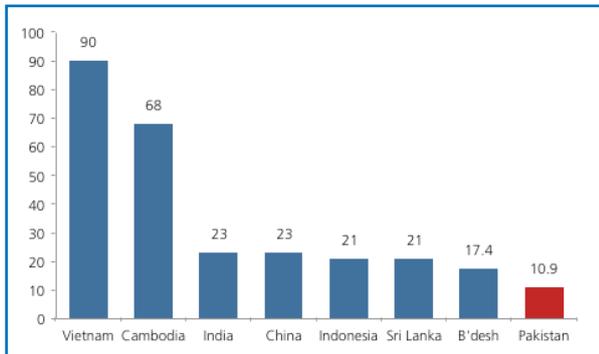
The share of the manufacturing sector has remained comparatively low and more or less stagnant for decades while the export sector has witnessed a dramatic and alarming decline as a share of the economy (see Figures 1 and 2).

Figure 1: Pakistan’s exports (goods and services)



Source: World Bank

Figure 2: Exports (goods and services) of select developing countries



Source: World Bank

The influence or direct effects of the quality of institutions of economic and political governance on the degree of structural transformation in an economy over a period of time may not be immediately or obviously clear. However, if viewed from a political economy prism, it can be posited that, with a concentration of political and economic power in elites (elite capture), the entrenched vested interests are geared towards maintaining the status quo rather than changing it. Structural transformation implies change, a process of “creative destruction,” the emergence of new economic — and eventually political — players.

A direct bearing on the stunted and stalled structural transformation of Pakistan’s economy can be traced back to the issue of land reform. To avoid the diffusion of political power, Pakistan’s elite has successfully avoided meaningful land reform in the country. Hence, land holding and ownership remains concentrated in a political coterie who derive rents from their influence in power and policy-making on the back of their feudal clout. Their interest in a modern, progressive, innovation-and knowledge-based economy with growing opportunities for an ever-larger share of the population is limited or near-absent.¹³

Pakistan’s woeful commitment to educating its citizens, as evidenced both by the pitiful financial commitments made over the past few decades as well as by the governance of the education sector and the low outcomes achieved, reinforces this view. A corollary is the low skill levels of Pakistan’s labour force and its large bearing on the country’s anaemic overall productivity.

- **Agricultural productivity:** In the agriculture sector, Pakistan’s productivity is low and well-below most of its peers in nearly every major crop it grows. This is largely once again due to the progressive decline in emphasis on crop research from the 1970s onwards despite setting up institutions for promoting such research. A major impediment to improving crop productivity and achieving higher value-addition, with its large pay-offs and spill-overs for not just the farm sector but the wider economy, is the atrophying of extension services in agriculture.

Designed to transfer knowledge to farmers and provide technical inputs on new techniques, latest seeds, weather, market prices as well as marketing of produce, vibrant extension services have proven invaluable to increasing farm yields in many parts of the world.

Even in Pakistan, extension services in agriculture were fairly effective till the 1990s-early 2000s. However, a lack of emphasis by successive governments and a change in law during General Musharraf’s tenure which transferred extension services to local governments which themselves have remained in doldrums for the past decade, has sounded the death knell for a vital source of transferring productivity-enhancing latest knowledge and techniques to farmers.

Two other areas where policy neglect and institutional atrophy have adversely impacted productivity in agriculture are the unchecked availability of non-certified seeds and adulterated pesticides. With the involvement of politicians,

13. See e.g. Easterly, 2001.

large land-owners and influential commercial interests in these businesses, enforcement of the law has been absent, hurting the interest of millions of farmers.

In fact, the strong influence of this interest group coupled with policy inertia of successive governments has delayed passage of a modern Seeds Act for nearly ten years. Improving yields of its crops and making a concerted move towards higher value-added agriculture can transform Pakistan's rural sector and the lives of millions of its farm-dependent households. It can also generate an additional surplus that can then be diverted to other sectors of the economy, such as manufacturing and exports.

- Another channel possibly at work in the low structural transformation is the near-absence of an on-going "strategic dialogue" between the government and the private sector as in many of the successful East Asian economies in the 1970s and 1980s. With the private sector constantly striving to protect their existing interests via policy capture and influence through "closed door" interaction with the government, Pakistan has been unable to make the leap its East Asian peers did three decades ago by strategic collaboration between their public and private sectors.

It would appear consistent with observation, experience and literature that countries with a weaker institutional framework are more likely to have a lower level of structural transformation of the economy than for those countries with a stronger-quality one. Because of policy capture, the incentives in an economy with a weaker institutional base are stacked against value addition — be it in agriculture, exports, or overall manufacturing.

- **Atrophy of state's strategic planning:** A fundamental change has occurred over the past two decades that has undermined the management of the economy. Till the 1990s, the country's powerful and capable Planning Commission was the apex public sector institution

charged with the planning function as well as with overall economic management and reporting. It produced a series of Five-year Plans to aid in this function, complemented by Annual Plans and the macroeconomic framework. By virtue of its stewardship of the annual Public Sector Development Plan (PSDP), the Planning Commission was unchallenged in its authority on management of the economy and long-term planning.

However, since the late 1980s, Pakistan's frequent accession to IMF loan programs shifted the center of gravity to the Ministry of Finance. Since the loans acquired from IMF were not developmental in nature but purely for balance of payments support, the Ministry of Finance became the "natural" counter-party to the fund and the sole ministry for negotiating and liaising with IMF, and providing all economic data to it.

Pakistan has signed up to 12 programs with IMF since 1988. IMF programs are designed foremost to achieve "macroeconomic stabilisation" and their conditionality is structured around quarterly targets broken into: performance criteria, structural benchmarks and indicative targets.

The combination of moving from five-year plans to three-month quarterly targets under IMF programs and the transfer of stewardship of economic management and reforms to an agency that operates on a twelve-month budgetary cycle (MoF) has proved to be extremely detrimental to Pakistan's economic well-being.

Pakistan's strategic planning horizon has been reduced to three months from half a decade; economic growth is a "residual" target under IMF programs, subservient to the fiscal deficit target; and, the primary objective (to the exclusion of all other developmental objectives) is to undertake short-run revenue measures and expenditure cutbacks that undermine long run developmental goals (see, for example, the section and box on Pakistan's tax system and its detrimental effects on investment and growth.)

- **Impact on formal economy:** Another manifestation of the shadow of a weak and atrophied institutional framework on the wider economy is the size of the informal, undocumented economy of Pakistan. The informal economy is estimated to be anywhere between 25-90 per cent of the documented/recorded economy. Not only is the informal sector very large but to exacerbate matters, it appears to be growing in size at the expense of the formal, documented economy.

The formal sector in Pakistan is being hit by weak enforcement and uneven as well as discriminatory application of laws by the proliferation of laws/levies and taxes, and by a rising tax as well as regulatory burden. The ease of conducting informal transactions, or ones without disclosing the true identities of the transactors (such as purchase of property, etc., called benami transactions), pervasive smuggling, mis-declaration of imports, the existence of tax arbitrage, are all hurting documented businesses in the formal sector.

This is another important area where the country's fiscal policy and the flawed design of its tax system, combined with a corrupt and weak tax administration, is leading to sub-optimal and perverse outcomes.

The repercussions of rising informality include:

- The growth and competitiveness of firms is hampered as economies of scale are difficult to achieve (or precluded completely) for informal firms in an economy. Overall investment levels in the economy with a large informal sector may also be lower than otherwise.
- The ability to attract FDI inflows is reduced, hurting the economy's competitiveness, its positioning and linkages with global/regional production value chains, and
- Skill development of the workforce is less likely to take place in informal, less-organised firms, or firms that employ less-permanent contract labour. This affects the productivity and international competitiveness of Pakistani firms.

- Ultimately, the social mobility of the labour force can be affected, as they are “trapped” in relatively lower-skill and lower-wage jobs that afford fewer opportunities for on-the-job training and skills-enhancement.

- **Inequality:** There are several dimensions of inequality and ‘non-inclusion’ in the development of large segments of the population in Pakistan that either stem from weaknesses in the institutional framework or are connected. The first dimension emanates from the fact that increasingly economic growth in the country, by its nature and sources, has tended to be more beneficial to higher-income households than those in the lowest quintiles.

The less-affluent and poor are also largely excluded from the development process by government spending priorities. Government expenditures are increasingly being spent on improving physical infrastructure for the urban middle classes — to the detriment of the lower-income and rural population. On the other hand, the taxation system and structure is regressive with large reliance on indirect taxes that get passed on to those less-equipped to bear the burden.

Lack of access to quality public education and health for the less-affluent and poorer segments of the population is also a significant factor in the lack of inclusiveness. One direct source of non-inclusion in socio-economic development of a sizeable chunk of the population is the weaknesses in the institutional framework that exclude them from social justice, from fair treatment by state institutions, such as the police and judicial system, and from financial inclusion.

The ‘alignment’ of the institutional framework to the benefit of a certain segment of society to the exclusion of the majority is underscored in a stark manner by the stopping of publication of national poverty and income inequality statistics by the country's Planning Commission since 2008. The poor and vulnerable are being systematically excluded even from official discourse and measurement.

- **Inflation:** Inflation is a complex inter-play of

a number of external, institutional, structural and policy variables. Nonetheless, one pre-dominant factor is excessive money creation, caused by the failure to collect taxes combined with a failure to rein-in government spending. It is no coincidence that the longest period of high inflation in Pakistan between 2008 and 2012 coincided with one of the weakest fiscal performances in Pakistan’s history.

Between 2008 and 2012, the fiscal deficit averaged 7.2 % of GDP each year. Tax collection as a percentage of GDP averaged a paltry 9%, sinking further to 8.2% in 2012-13. As a direct result of the failure to collect needed tax revenue — that too in the form of direct income tax rather than via indirect taxes that burden the poor — the government borrowed massively. A large part of this was from SBP, with the central bank “printing” a mountain of cash for the government’s deficit financing during this period, stoking inflation significantly.

Hence, the institutional failings on the fiscal side, both with regards to expenditure as well as taxation policy and performance, have had a large spill-over effect on inflation.

The atrophy of Pakistan’s institutional framework has occurred due to a combination of factors. Some of these include:

- A state of disequilibrium, instability and distrust between civilian governments and the military
- Political interference in the working of other organs of the state (judiciary and executive)
- Politicisation of the executive and judiciary
- The undermining of meritocracy through favoritism and nepotism
- *Capture* of institutions of policy, regulation as well as accountability, which has led to forbearance of corruption/rent-seeking behavior and the ability of certain influential actors, groups and segments to privatise profit and socialise losses

- The absence (till recently) of a strong, independent judiciary

Wider socio-economic impact

At a broader level, the country’s weak institutional framework is imposing costs not just on the business environment but has been impairing and eroding the *quality of life* for its citizens. A range of statistics and measures capture the wider impact of an atrophy of institutions. A sampling of the country’s standing on some measures of human development and public safety is depicted in the following Table.

Table 4: Measures of societal “well-being”

	Rank	Year
Human Development Index (rank/year)	147	<u>2016</u>
Spending on education (% GDP)	2.7%	
<i>Global rank</i>	172	
Health spending (% GDP)	0.7%	
<i>Global rank</i>	187	
No. of children out of school	9.2mn	
Persons per hospital bed	1,600	
Legatum Prosperity Index	139	2016
Social Prosperity Index	122	2015
Millennium Development Goals		
No. of MDGs sub-indicators missed (out of 16)	12	2015
Public safety		
Safety ranking of national airline (PIA)	10th worst in world	
No. of deaths in road accidents (rank)	67	

Sources: UNDP, Sky Trax, World Health Rankings

Key institutional challenges with regard to economic governance

1. Collecting tax

Few areas of statecraft and economic management reflect the institutional atrophy in Pakistan as much perhaps as tax collection. Only approx. 0.24 per cent of Pakistanis (around 450,000 people) paid income tax with a filed return in 2015.¹⁴ Personal income tax collection (PIT) amounted to an abysmal around 1 per cent of GDP. Together with Pakistan’s tax-GDP ratio, its tax collection statistics are amongst the lowest in the world. Even by regional as well as its own historical standards, Pakistan’s tax collection performance is poor — and has witnessed a decline in several years from an already low base.

For 2014-15, Pakistan’s tax-GDP ratio stood at 9.5 per cent. The low level of tax collection, combined with weak prioritisation of public sector expenditure and widespread leakages, means that the state is unable to fully fund (or provide for) public mandates, such as delivery of essential services or provision of physical infrastructure. A high rate of population growth and rapid urbanisation is straining not just existing services but the polity at large.

The scale of tax evasion and avoidance in Pakistan is staggering — and has caught world attention in recent years. Some dimensions of the country’s tax situation throw light on the magnitude of the problem:

- The overall “tax gap” was estimated by a background paper for a World Bank-FBR study published in 2008 at nearly 7.5% of GDP (Ahmed, 2006). The *tax gap* refers to the difference between actual collection and the estimated potential, and is a useful indicator of the extent of tax non-compliance (tax evasion + avoidance).

- The undocumented, informal economy is very large and is estimated to be anywhere between 20%-90% of the reported economy, according to different studies. The median estimate of these studies is around 30%-40%. The high level of informality of the economy is compounded by the erosion of tax bases via issuance of widespread exemptions to powerful and connected players and further by weak enforcement and compliance.
- The Federal Revenue Board (FBR) estimates approximately 3.6 million people on its tax register (the number of National Tax Numbers – NTN – issued). However, in total, around 800,000 taxpayers filed a tax return in 2013-14 (or 0.4% of the total population – see Table 4), while nearly 40% of these tax-return filers paid zero tax.¹⁵

Table 5: Tax return filers as % population

Pakistan	.05%
India	4.7%
Argentina	16.5%
France	58.0%
Canada	80.0%

Source: FBR

- Another feature of Pakistan’s tax regime is that the source of tax revenue is heavily skewed towards indirect taxation (approximately 65% of total collection), instead of from direct taxes. Direct income tax collection is only around 3.5 per cent of GDP. Approximately 70 per cent of what is recorded under direct tax collection is

14. Total personal income tax (PIT) filers were recorded at slightly over 1 million in 2015, out of a total registered pool of 3.6 million.

15. For 2015, the government was reporting a significant increase in income tax returns filed to around 1.1 million.

generated by the withholding tax regime, a form of indirect taxation, rather than by tax returns/demands or audits. Hence, actual direct income tax collection due to the federal tax administration's (FBR) effort, adjusted for withholding taxes, was approx. 10.7 per cent of total tax receipts, or only 1.06 per cent of GDP.

- Approximately 75% of the income tax is collected from 5 sectors of the economy, while over 80% of the sales tax is collected from only around 100 registered payers.
- The tax effort by the four provinces is minimal, despite having vibrant tax bases under their jurisdiction. Aggregate tax collection by provinces has remained at less than 0.5% of GDP for decades. However, since around 2015, provincial tax collection has moved up noticeably with greater fiscal effort under newly set up provincial revenue authorities.
- Underscoring the scant respect of the elite for "rule of law" in the country, approximately 70 per cent of Pakistan's parliamentarians were found to be declaring "Nil" taxable income, according to a 2012 study of their annual filings/declarations with the Election Commission of Pakistan.¹⁶

The status quo with regard to the narrow tax base and low tax collection acts as a major reinforcement of existing behavior of tax avoidance and evasion on the part of the wider potential tax base.

The poor outcome with regard to tax has come about despite a number of reform attempts since the mid-1980s. Several of these attempts have been under the aegis of various IMF programs that the country had signed up to. Most recently, an ambitious nearly US\$ 50 million World Bank-funded program, the Tax Administrative Reform

Program (or TARP-1 for short), ran from 2005 to 2011. None of these reform efforts met with success. Indeed, Pakistan's tax situation has gone from bad to worse.

The inability to raise adequate tax revenue compounds Pakistan's development challenges, as it implies that a substantial part of its development requirements in the domain of delivery of public services and physical infrastructure remain unfunded and unaddressed. As a result, Pakistan has run high fiscal deficits since 2008, barring the past two years, to the order of around 8 per cent of GDP, and the public debt burden has tripled in the space of seven years, between 2008 and 2015.

The tax situation is also having a major adverse effect on Pakistan's investment and business environment. In the absence of a meaningful broadening of the tax base, and under pressure to meet collection targets under the IMF program, the tax authorities have resorted to "predatory taxation" — extracting taxes from existing taxpayers using coercive and unfair means.

Table 6: Pakistan's global ranking

Pakistan's global rank:

Ease of doing business	138
Ease of paying taxes	171
No. of tax payments	168
No. of hours spent on tax matters	177

Source: World Bank

The resulting tax burden on the formal sector is preventing new investment, and more perniciously, is creating the incentive for formal businesses to "informalise".

16. Source: Center for Investigative Journalism, 2012. This percentage has improved with the third consecutive year of publication by FBR of the Parliamentarians Tax Directory.

Many factors have come together to produce this unsustainable situation with regards to tax collection. Broadly, Pakistan's tax issue can be deconstructed in the following ways:

- A highly discriminatory tax system, with extreme lack of equity and fairness
- Lack of accountability and transparency in tax administration
- Weak incentives for provinces to collect revenue from the substantial tax bases under their jurisdiction
- Weak enforcement and low compliance due to the above factors, which reinforce a tax culture of non-disclosure and non-payment

2. Reforming Public Financial Management (PFM)

The management of public finances is central in many ways to the conduct of economic as well as political governance. Public financial management (PFM for short) encompasses a wide spectrum of activities, and exerts a large influence on economic decisions and outcomes because it sets the incentives structure in which an economy functions.

The key activity under PFM is the formulation of the federal/provincial/local budgets in a transparent, "relevant", timely, cost-effective and accountable manner. Budget-making encompasses decisions regarding both taxation (who to tax, how to tax, how much to tax, and who to exempt) as well as spending (the sectoral, geographic and income-cohort priorities in the allocation of state resources).

A related feature of PFM is the formulation and management of the public sector development projects' portfolio. The federal public sector development program (PSDP) and the provincial Annual Development Programs (ADPs), at a combined Rs1,400 billion for 2015-16, represent the second largest component of annual government spending after debt-servicing.

The importance of the public sector's development spending (PSDP/ADP/PSEs) can be gauged by its scale. The annual spending under this head amounted to 4.7 per cent of GDP in 2015-16. The cumulative size of the project portfolio, including the unspent amount carried over from unfinished projects that are work-in-progress (referred to in aggregate as the 'throw-forward'), is over Rs 3 trillion, or over 10 per cent of GDP. By comparison, annual private sector investment amounts to around 9 per cent of GDP.

Given the scale and scope of public sector development spending, issues relating to project selection and management, including social, economic and fiscal feasibility, alignment with development objectives, implementation effectiveness, cost-efficiencies, etc., assume critical importance.

Government efforts since the mid-2000s to improve the efficiency of the PSDP portfolio and to introduce a public-private partnership (PPP) model have faltered due to weak commitment, inadequacies in the legal framework and in project documentation as well as due to resistance from the Planning Commission bureaucracy as it would bring greater transparency and accountability in the management of the PSDP.

Another area under PFM that involves substantial allocation each year from budgetary resources and spending of large amounts of money is procurement by the public sector. By virtue of its size and nature, public sector procurement is open to massive misuse and corruption. It requires a strong regulatory framework and oversight mechanisms to minimise abuse and over-spending. While rules governing public procurement were notified and the Public Procurement Regulatory Authority (PPRA) set up, the extent of transparency and savings introduced in this PFM activity as a result remains unclear.

Finally, PFM also involves the management of public debt. This function encompasses the timely and efficient contracting of debt at the

most favorable terms, managing the associated spectrum of risks (interest rate, currency mismatch, roll-over risks, etc.) as well as collating, reporting and coordinating functions.

At its most “macro” level, the management of public debt should also incorporate the adherence to fiscal responsibility and fiscal rules by the government. In this context, Pakistan introduced the Fiscal Responsibility and Debt Limitation (FRDL) Act in 2005, which mandated a clear debt-reduction path and some broad fiscal guidelines. However, the FRDL Act needs to be strengthened in key areas to be more effective in achievement of its primary goal.

3. Reforming the power sector

Pakistan has been facing a mega power crisis since 2008 with massive electricity shortfalls costing approximately 2-3per cent of GDP in lost output each year. The supply-demand deficit has occurred due to a number of reasons, including:

- A sharp increase in electricity demand, especially from the domestic sector (households)
- No matching increase in generation capacity between 1996 and 2006 due to lack of new investment
- Attrition in power generation capacity of state-owned utility due to lack of funds
- Little or no investment in transmission grid and distribution network, resulting in high “line losses”

These long-term problems were compounded by the spike in international oil prices in 2008 and their remaining at elevated levels till 2014, which drastically increased the cost of electricity generation in the country.

With the government hesitant to pass on the sharply higher generation cost into electricity tariffs, it had to absorb the difference in the budget as a subsidy. The mounting differential

between the cost of electricity generation and its distribution, on the one hand, and the tariff effectively charged to consumers, on the other, combined with the lag in release of subsidies by the government triggered inter-company payment arrears in the energy sector (referred to as “circular debt”).

As the payment cycle between the power distribution companies (DISCOs) and their fuel suppliers, and in turn their suppliers, got protracted and faced disruption, the ability to purchase fuel for generation constricted, reducing overall electricity production further.

Over and above these structural reasons for the power crisis, there exist institutional factors contributing to Pakistan’s debilitating power crisis. Approximately 15-20% of the line losses of the sector are estimated to be caused by collusion of utility officials with end consumers. This collusion takes place in a number of ways:

- by installing tampered electricity meters to record lower consumption than actual;
- by abetting in theft via “kundas” or hooks linking unmetered neighborhoods directly to the distribution network;
- by under-billing neighborhoods/factories that make informal payments to these officials, and over-billing other areas in compensation;
- by “parking” line losses due to theft under the head of FATA

Another factor contributing to the inefficiency and losses of the power sector is the non-observance of an economic merit order of despatch. Hence, when a demand for power is logged, instead of allocating the supply to the most efficient plants available in the system, supply is procured from less-efficient private plants (IPPs) that have made informal payments to the Central Power Purchase Agency (CPPA) officials responsible for despatch.

All told, the power sector is incurring an estimated

loss of around Rs 100 billion (approx. US\$ 1.0 billion) each year due to unchecked theft.¹⁷

Similarly, in the case of natural gas, theft and revenue leakage amounting to approx. Rs100 billion a year have been *institutionalised* via the allowance of a high threshold of system losses by the industry regulator, Oil and Gas Regulatory Authority (OGRA), to the gas distribution companies. From a previous threshold of 7.5per cent, OGRA inexplicably raised the *Unaccounted for Gas* (UFG) allowance to 11.5per cent in 2008, widening the losses in the sector.

Given the scale of the losses and the wider ramifications reforming the energy sector should be a foremost priority of the government. While the current government is focusing on a supply-side response by increasing the power generation capacity, the issues of governance in the sector have not been sufficiently or vigorously pursued.

- Increasing accountability in the sector, by a mixture of greater, and more effective, corporate governance practices, such as empowered boards of the power sector companies, with greater external (i.e. from outside the sector) representation, and setting of performance indicators.
- Privatisation of the power distribution companies (DISCOs)
- Instituting/strengthening performance as well as financial audits
- Introduction of IT/greater automation, such as smart grids and meters
- Creation of an integrated Ministry of Energy by merging the existing Ministry of Water and Power (MoWP) with the Ministry of Petroleum and Natural Resources (MNPR)

Institutional challenge: Implementing the China-Pakistan Economic Corridor (CPEC)

The China-Pakistan Economic Corridor (CPEC) is an ambitious US\$ 64 billion initiative announced in April 2015 that seeks to make a series of joint investments in Pakistan to improve connectivity between the two countries as well as to provide a stimulus to the latter's economy. It is part of an even more ambitious plan by China, dubbed the One Belt One Road Initiative (or OBOR) or the Belt and Road Initiative (BRI), to increase its connectivity with the rest of the world.

CPEC is split into two components; the first is a collection of *Early Harvest* projects, focusing mainly on the power sector, highways and development of Gwadar. The second component is the longer term plan consisting of Special Economic Zones, re-laying the main north-south railway artery (ML-1), among other projects.

The main pillars of investments under CPEC are planned to be:

- Investments in Pakistan's power sector totalling nearly US\$ 35 billion;
- Connecting China's western Xinjiang region with Pakistan's Arabian Sea port of Gwadar via a network of highways, roads and rail;
- The setting up of a string of Special Economic Zones (SEZs) across Pakistan;
- Development of Gwadar port into a major deep sea international commercial port;

However, materialising such a mega-project will not be without challenges. The main one will be the atrophied capacity of Pakistani government institutions and agencies to plan, coordinate, and execute a project of this scale and complexity.

Since the overall project is spread across Pakistan and across different economic sectors, it will require coordination between multiple tiers of the

17. Author's estimate.

government as well as a multitude of agencies.

In addition, the capacity of the government and wider public sector to map out the linkages with different areas of economic policymaking (taxation, exchange rate, fiscal, industrial and export promotion policies), conceptualise the potential macroeconomic impacts (on exports, industrial production, new capital formation, public debt, banking system etc.) both in the short

as well as longer term, and to fashion appropriate responses, is weak at best.

A second institutional limitation is likely to be imposed by weak revenue mobilisation in Pakistan, which will constrain the size of the government's development budget (PSDP) while also impacting the availability of bank financing for the private sector.

The Way Forward

The broad institutional atrophy that has occurred over the past few decades makes it difficult to determine a clear path for reform. This difficulty is compounded by two stylised “facts” or “ground realities”:

1. *Insiders* have little or no incentive to change or modify the status quo of a system that is rewarding or benefiting them, and is likely to continue doing so in its present form and arrangement for the foreseeable future;

2. Economic governance is not divorced from political governance. The institutions of economic governance are nested within a political eco-system; hence, expecting to introduce reform in these without wider political reform is unlikely to be realistic.

Wider political reform is likely to require a bigger critical mass of change agents and a stronger impulse from within to alter the status quo. Without a broad consensus on reform and ownership across the political spectrum, no single political party in a parliamentary democracy is likely to expend its political capital on an enterprise that is likely to yield some degree of adjustment and pain in the initial years, with the potential benefits accruing beyond the election cycle.

Nonetheless, keeping the challenges of ownership and implementation, as well as the issue of sequencing, aside for the time being, generating a comprehensive template of proposed reform by itself could be a useful starting point.¹⁸

In this context, the proposed principles or ‘pillars’ for reform should be the following:

1. Ensuring independence/autonomy of key institutions

Insulating key institutions of economic governance, as well as those in the political sphere that exert

a major degree of influence on the performance of such institutions, from the political system is critical. The institutions that matter most in this regard are:

- Economic Coordination Committee of the Cabinet (ECC)
- Federal as well as provincial tax administration
- The central bank, which should have independence by law from the influence of the finance ministry in the conduct of monetary policy, or from the political system as regulator of the banking system
- The Federal Planning Commission (in project selection and implementation of reforms)
- Pakistan Bureau of Statistics
- Securities and Exchange Commission of Pakistan (SECP)
- The Federal Public Services Commission

2. Promoting greater oversight, transparency and accountability

Transparency and accountability are essential pillars of good governance, both in terms of public policy formulation as well as its implementation. On-going oversight at the appropriate level, ideally at the level of parliamentary committees for many government policies and interventions — or by a specially-created high-level “delivery unit” — should generally have preference over *ex post facto* instruments.

A wide variety of instruments are in use around the world for strengthening the level of transparency and accountability in government/the public sector. Some of these include:

18. The report of the National Commission for Government Reforms (NCGR), headed by Dr. Ishrat Husain, elucidates broadly the same principles.

Conflict of Interest law:

A *conflict of interest law* for public office holders ensures there is no direct or indirect personal, beneficial, commercial or other benefit or interest of the office holder in the execution of his or her public trust and duty. Legislation to this effect protects the interest of the ordinary citizen from abuse of power by public office holders.

Right to Information (RTI):

Greater access to information by ordinary citizens on government decisions regarding public policy as well as expenditure matters, increase the transparency and, hence, accountability of the decision-takers and decision-makers.

A well-functioning system backed by law of granting access and full disclosure by the government and its agencies to ordinary citizens and media to all un-classified and non-restricted information is essential in this regard — as is ensuring that the government and state officials do not abuse the right to restrict information in the name of national interest or security.

Use of technology:

Technology-enabled provision of a range of public services, such as filing of taxes, registration of vehicles, obtaining citizenship identification documents, etc., facilitates the ordinary citizen, improves the predictability, speed and timeliness of delivery, reduces the time, wait and informal costs involved while lowering the overall cost of the government.

Importantly, it enhances “arms-length” dealing of ordinary citizens with government officials, reducing the latter’s discretionary powers. By leaving an electronic record and trail, IT-enabled service delivery also enhances transparency and accountability in the process.

Technology can also be used to achieve positive outcomes in at least two areas that are severely constraining Pakistan’s development as well as economic performance and prospects: tax collection as well as energy (see Box).

Box 4: Using technology to nab tax and energy cheats... and delinquent teachers

In 2012, an exercise was conducted by the Federal Board of Revenue (FBR) to identify potential taxpayers in the country using external databases. In this regard, the National Database and Registration Authority (NADRA)’s database, the country’s most comprehensive, was queried along with national databases on vehicles, property, bank accounts, foreign travel and arms licence registration. Based on a set of pre-identified parameters, a list of 3.2 million citizens country-wide was generated who displayed tell-tale signs of affluence but whose names were not on the national tax register.

The importance of this exercise can be gauged from the fact that despite three decades of “effort,” the number of direct income taxpayers in Pakistan totals approximately around 1 million.

Similarly, the use of “smart” power grids and smart (technology-enabled) electricity meters can sharply reduce revenue losses of power utilities that currently total approximately US\$ 1 billion a year from theft alone.

An innovative use of technology is being applied in Punjab where teachers in public schools with high rates of staff delinquency have been provided smart-phones to monitor their presence in schools during academic hours.

Some of the other measures, processes and instruments that can be adopted for greater transparency, oversight and accountability in the management of public funds include:

- Independent monitoring of government procurement and projects over and above a certain “floor” or minimum amount. This could include the full public disclosure/availability on a website of all contract details and of the bids/tenders received, including prices and technical specifications.
- External, third-party audits of large government procurement and projects, over and above the governmental audit conducted by the Auditor General’s office;
- Strengthening public sector procurement rules and the PPRA;
- Setting up public registers/databases of contractors on public sector projects, and a list of “black-listed” entities with full details of ownership, de jure as well as de facto (i.e. beneficial ownership).
- Full public disclosure of statutory reports to parliament from the offices of the Auditor General, Federal Ombudsman and NAB.
- The complete implementation of Right to Information (RTI) laws to government and public sector procurement actions, election declarations and filings by elected public officials, and statements of income, assets and beneficial ownership, etc., by non-elected public officials.

3. Strengthening institutions of accountability

While a number of institutions have been periodically set up in Pakistan for purposes of accountability of public office-holders, and many are currently operating, corruption and leakage of public funds has continued unabated on a large scale, with only a moderate improvement in terms of lower frequency and brazenness.

Currently, the main institutions of accountability include:

- The National Accountability Bureau (NAB)
- Public Accounts Committee (PAC) of the parliament
- Federal Investigation Agency (FIA)
- Auditor General’s office
- Federal Ombudsman’s office
- Federal Tax Ombudsman

Pakistan has seen the accountability process being compromised by political expediency, with selective application to political opponents of the government (civilian or military). More often than not, references and cases are dragged interminably despite evidence to be used as quid pro quo and political bargaining chips.

This aspect of using the accountability process as part of political bargaining or patronage has intensified post-18th Amendment whereby the two main political parties (PML-N and PPP) have distributed the institutions of accountability amongst party loyalists or party office-holders. Hence, successive chairmen of the National Accountability Bureau since 2008, who are appointed by the President and who have been empowered in their individual capacity to decide which case to pursue for investigation and prosecution, have not moved against high-profile corruption cases involving leading politicians and others, as detailed in a list of 150 “mega” financial scams presented to the Supreme Court in July 2015.

Under the political scheme of things crafted under the “Charter of Democracy” signed between the PPP and PML-N in 2006, high-profile cases of corruption against PPP co-Chairman and former President Asif Zardari and current prime minister Nawaz Sharif, leader of PML-N, have either been dropped, weakly prosecuted, or not pursued at all.

Similarly, the powerful Public Accounts Committee (PAC) of parliament is headed by the Opposition leader in the National Assembly (currently a senior PPP leader), who decides the composition of the committee in consultation with the government, and which cases to take up.

The working of another hitherto fairly-independent institution of accountability, the Auditor General's office, has also been short-circuited since the mid-2000s with the elevation of senior finance ministry officials to the position. This has created a potential conflict of interest that weakens the independent audit of financial transactions of government departments and agencies that work

in close coordination with, and financing from, the finance ministry.

The politicisation of the accountability institutions and mechanisms, which gathered pace since 2008, has weakened an important pillar of enforcing rule of law.

4. Professionalising the civil service

The civil service in Pakistan is structured and oriented towards being an "administrative" bureaucracy. It is generalist in nature rather than specialised in its training and qualification, and is in dire need for reform.

Box 5: Reforming the civil service in Pakistan

The civil service in Pakistan is not a "mandarin" civil service with specialised cadres, training and required professional qualification and/or certification, but rather is generalist in nature.

Initial postings and training in the field occur in administrative districts. Once this phase is completed, the officer can be posted in any department or agency, across the broad spectrum of government service, with subsequent transfers also occurring usually without any reference to previous experience or academic qualification.

The academic background and experience of selected cadre is eclectic and diverse rather than specialised. This is not in sync with the requirements of a modern bureaucracy where a specialised cadre is required in areas of economic governance, dealing with public financial management, revenue administration, audit, commerce and trade, corporate affairs and governance, capital markets, and insurance.

In addition to the specialised cadre, one stream of civil servants can be generalist in nature, designed for administrative functions such as district administration, secretariat functions, manning non-specialised line ministries etc.

A number of attempts have been made over the years to introduce civil service reform. A detailed blue-print for civil service reforms was presented in 2008 in the report of the National Commission for Government Reforms (NCGR) headed by Dr. Ishrat Husain. The main recommendations were:

Civil Services

- i. Open, transparent merit – based recruitment to all levels and grades of public services with Regional Representation as laid down in the constitution.
- ii. Performance – based promotions and career progression for all public sector employees with compulsory training at post induction, mid-career and senior management levels.
- iii. Equality of opportunities for career advancement to all employees without preferences or reservations for any particular class.
- iv. Replacement of the concept of Superior Services by equality among all cadres and non-cadres of public servants.

- v. Grant of a living wage and compensation package including decent retirement benefits to all civil servants.
- vi. Strict observance of security of tenure of office for a specified period of time.
- vii. Separate cadre of regular Civil Services at the Federal, Provincial and District levels co-existing with contractual appointments.
- viii. Creation of an All Pakistan National Executive Service (NES) for senior management positions drawn through a competitive process from the Federal, Provincial and District level Civil Servants and outside professionals.
- ix. Introduction of four specialized cadres under the NES for Economic Management, Regulatory, Social Sector Management and General Management.

According to the NCGR report, “The thrust of the proposed reforms is to limit the discretionary powers of the decision makers, simplify the cumbersome procedures and processes and make them transparent and realign the incentives of the individual civil servants with those of the organization.”

Beyond the recommendations of the NCGR, some missing areas that need to be covered in the context of reforming the civil service include the adoption of modern, professional human resource management (HRM) techniques and resources to hire, place, train, motivate, evaluate and remunerate civil servants. This will cover existing gaps in the civil service HRM structure such as formal job descriptions and signing off on Key Performance Indicators (KPIs).

Purely in the context of reforming institutions of economic governance and applying a measure of selectivity for reasons outlined below, the focus of ‘the way forward’ needs to be on the following three major areas:

- The institution(s) of planning, implementation, monitoring and evaluation of government programs and projects
- Public financial management (PFM)
- National statistics

The selection of the foregoing areas is borne out of the fact that, given the political economy which will not be conducive to broad and deep institutional reform in a “big bang” or “shock therapy” approach, reform areas need to be chosen based on the following criteria: **where relatively lower political capital is expended, and where the economic and governance pay-offs are high.**

The importance of initiating institutional reform in these areas and an outline of the broad design of such reform is presented below.

The Federal Planning Commission

The Planning Commission of Pakistan is the apex governmental body for strategic economic planning and monitoring of project-execution under the Public Sector Development Program (PSDP). It is nominally headed by the Prime Minister as Chairman. However, despite a stellar past in terms of importance and performance, the Planning Commission has largely become irrelevant in the scheme of things after Pakistan’s increasing engagement with IMF since the late 1980s.

The short term nature of the “stabilisation” Fund programs Pakistan has entered into with regular frequency have had a two-fold impact: first, the importance of, and emphasis on, long term five-year planning conducted by the PC has been replaced with an emphasis on the fiscal deficit, and associated budgetary measures to contain it within a twelve-month fiscal year; second, as a result of the interaction with IMF primarily relating to short term balance of payments support rather than a long term structural reform agenda, the Ministry of Finance has long replaced the PC as the

central, or “point” agency, for economic matters.

The unintended consequence of the protracted on-off engagement with the IMF has been that the country’s strategic planning horizon of five years on a rolling-basis has virtually disappeared. The country’s economic manager, the Ministry of Finance, now operates on a three-month cycle synchronised with the quarterly conditionality of the IMF program.¹⁹

As a result, long term issues and challenges — such as Pakistan’s international competitiveness or the effects of climate change or civil service reform — are not being adequately focused upon let alone addressed.

Keeping in view the challenges posed by the current de facto state of affairs, it is proposed that:

1. The Planning Commission should be made an independent, fully-autonomous apex economic institution of the country, as it was in the past. The prime minister should continue to be chairman, while the deputy chairman, who is responsible for actually running the Commission, should be accorded the rank of a federal minister and made a core member of the cabinet.²⁰

2. The PC should be removed from the portfolio of the finance minister (and from under the shadow of the finance ministry which exerts an undue influence on its working).

3. The PC should have sole responsibility for the country’s strategic long term socio-economic planning, for policy coordination between various stakeholders, including the center and provinces, for maintaining a “strategic” dialogue with the country’s private sector, and for project formulation, approval, implementation, monitoring and evaluation.

After passage of the 18th Amendment which empowers provinces far more than the central

government in a range of activities from tax collection and debt-raising, to spending on public services, the need has increased for a central, apex institution that not only undertakes strategic planning but policy coordination as well.

4. It should be modelled on the lines of China’s National Development and Reforms Commission (NDRC), with greater authority and a span of responsibility that includes planning as well as initiating economic and structural reform in the country. Currently, there is no central institution or agency within the government with the mandate of instituting economic reform in the country. This task has been left to the Ministry of Finance (MoF) as noted above, which has weak incentives and capacity to pursue longer term structural reform.

The above-proposed restructuring of the role of the Planning Commission will make the government more responsive to emerging challenges while having a more focused and accountable institutional arrangement for implementing economic reform.

Public Financial Management (PFM)

The management of public finances is central in many ways to the conduct of economic as well as political governance. Public financial management (PFM for short) encompasses a wide spectrum of activities, and exerts a large influence on economic decisions and outcomes because it sets the incentives structure in which an economy functions.

Its range includes:

- **Tax policy and administration:** This function includes taking decisions such as who to tax and who to exempt; whether to have a progressive, neutral or regressive taxation system; the mix of tax instruments and their applicability (excises, import duties, income and sales tax); and, what magnitude

19. See Sherani, Sakib <https://www.dawn.com/news/691135/managing-the-economy>, January 27, 2012.

20. Some of these changes have been effected post-May 2013.

of tax incidence to apply to different economic sectors, agents and activities.

- **Expenditure management:** This PFM function determines sectoral as well as geographic priorities for public sector spending (for example, physical infrastructure versus social capital development; level and nature of subsidies, and activities which will be subsidised; whether subsidies will be targeted or untargeted etc.), usually via the instrument of the budget.
- **Public sector procurement:** Procurement by government and its agencies runs into hundreds of billions of rupees annually, with widespread leakages, embezzlement and waste. Improvements in transparency and accountability of government spending can free up vital fiscal resources for under-funded areas of expenditure.
- **Debt management:** With the level of public debt crossing Rs 18 trillion (65 per cent of GDP, equivalent to approx. US\$ 180 billion), and debt servicing accounting for 52 per cent of federal expenditure after transfers to provinces, an effective public debt management system that minimises the associated costs as well as risks is essential.
- **Accounting and reporting:** Recording the myriad public sector transactions taking place in a centralised accounting and reporting system that produces a timely, accurate and flexible/customised MIS is critical to the objectives of an efficient PFM system.
- **Distribution of fiscal resources within federating units:** An important area of PFM is the distribution of fiscal resources between the center and provincial governments (the national, or federal, level government and its sub-national tier). In Pakistan, this distribution is governed by the Constitution via the National Finance Commission

(NFC) Award framework. However, the institutional and technocratic capability required to support these negotiations and decisions is missing, and needs to be built up.

The scope of activities under PFM and their centrality to a range of economic decisions and outcomes, places it at the heart of the economic governance challenge. Within the broad range of activities that PFM encompasses, specific improvements in the following areas can improve fiscal as well as economic governance.

Budget making

Pakistan's budgetary process and documentation ranks 140th in the world in terms of openness, transparency, and inclusion, according to Open Budget Index 2014. There is a dire need for greater transparency, improved relevance, timeliness, cost-effectiveness and accountability across the entire gamut of budget-making activity.

One approach, which is being followed in letter but not entirely in spirit is the introduction of a Medium Term Budgetary Framework (MTBF), at the heart of which is changing the budgetary allocation process from an historical-cum-incremental and annual basis to a "managing by outcomes" (MBO) basis in a three-year rolling timeframe. This approach needs to be broadened in its scope and strengthened.

A key objective of budgetary reform should be greater disclosure to, and discussion in, parliament. Despite the fact that Article 77 of the Constitution grants ultimate authority to parliament to levy taxes, the ministry of finance routinely announces new taxes, surcharges, levies, and changes in import duties without recourse to it.

On the expenditure side, the executive routinely presents "supplementary expenditures" to parliament at the end of each fiscal year for ex post approval. These expenditures, over and above the approved budget, tend to be significant, amounting on average to between 15-20 per cent

of the original approved budget. A ceiling of 10 per cent of the approved budget should be set for supplementary expenditures incurred by the executive without ex ante approval.

Project selection and implementation

A missing piece in the budget process is the alignment of budgetary allocations in the Public Sector Development Program (PSDP) with a Medium Term Development Framework. Projects are often added to the PSDP portfolio on an ad hoc basis, on the basis of political expediency, without any reference to, or analysis of, the underlying economic costs and benefits.

As a result, already-stretched fiscal resources are spread over a large number of projects, many with marginal benefits. The spreading thin of budgetary allocations over a larger number of projects results in project delays and cost over-runs, having negative fiscal as well as social ramifications. Currently, the PSDP portfolio (current + 'throw-forward') is estimated to be over Rs 3 trillion, which at the current pace of allocation and spending, will require around 5 years to complete without any new projects being added.

Use of Public-Private Partnership (PPP) model

Governments around the world, including developing ones, have been using PPP models for building physical infrastructure for several years. However, despite recognition of the PPP approach as useful, especially in the presence of market failures and financing constraints, successive governments in Pakistan have been reluctant to embrace the concept fully.

A large part of the resistance emanates from the potential reduction in rents that is often associated with infrastructure projects executed under public-private partnership mode. (However, there are substantive reservations expressed about this model too, including the impact of user-charges on the poor and the potential for higher project costs).

Mandating a PPP approach for pre-designated types of projects (roads with heavy commercial usage, airports, bridges etc.) can ease the fiscal constraint of the government in providing the requisite physical infrastructure, while providing for increased transparency and potential cost-savings in project implementation.

Tax administration

Tax administration at the federal as well as provincial levels is weak and corrupt. A massive but much needed effort is required to rebuild the trust of taxpayers in these institutions. A necessary starting point would be to insulate tax administration from the political system, making them autonomous and empowered both financially as well as in terms of independence of decision-making.

A full-fledged Organisational Development (OD) should follow to develop the most effective organisational structure and processes aligned with defined objectives. Staff appointments should be merit-based and technocratic, and remuneration market-based.

An essential component of the restructuring should be the revamp of the IT platform(s) of the tax agencies, mainly of the Federal Board of Revenue, for improved performance and greater accountability and transparency. A core objective should be to have an "arms-length" relationship between the tax agency and the taxpayer across all transactions: paying tax, taxpayer audit, enforcement and calculation and payment of refunds.

Strengthening public debt management:

With the level of public debt touching Rs21 trillion (65 per cent of GDP), and debt-servicing accounting for nearly 60 per cent of federal expenditure after transfers to provinces, an effective public debt management system that minimises the associated costs as well as risks is essential.

While building the institutional capacity to manage public debt in a planned, comprehensive and consolidated manner is essential, the legal-cum-policy framework needs to be improved as well. The Fiscal Responsibility and Debt Limitation (FRDL) Act 2005 has important gaps and missing areas, such as:

- Prescribing the ceiling of admissible public debt in terms of Gross Domestic Product (GDP), rather than against a more appropriate measure of repayment capacity, such as government revenue;
- Defining “public debt” in broad, vague and ambiguous terms that allows for exclusion of all government liabilities from the ambit of public debt, including those that are explicit, fixed, pre-determined and contractual in nature;
- Defining the debt ceiling using an arbitrary and ad hoc number (60 per cent of GDP);
- Allowing the government to choose its debt mix, including via central bank borrowing without limit;
- Having weak ‘forward guidance’ on reporting the projected debt path to parliament via the statutory annual statement;

With the passage of the 18th Amendment, provinces have been empowered to undertake direct borrowing on their own; previously the federal government was the sole authorised sovereign borrower in the country. After the easing of the borrowing constraint, each province should put in place Fiscal Responsibility and Debt Limitation (FRDL) legislation to self-impose a measure of fiscal and borrowing discipline. Each province should also create a sub-national Debt Office to replicate the functions of the federal one.

Improving policy coordination:

A weakness in the existing institutional architecture of Public Financial Management (PFM)

is the absence of policy coordination between the Planning Commission, the Ministry of Finance, Economic Affairs Division, and the State Bank of Pakistan.

While the Planning Commission generates the country’s macroeconomic framework, it is generally done in isolation from the ministry of finance which works with the framework laid out by the IMF. In addition, the ministry of finance also produces a medium-term budgetary framework which is not necessarily aligned with the Planning Commission’s estimates.

Another area where better policy coordination between the core economic ministries is required is the reporting and management of public debt. While an empowered Debt Office that is the focal point for all matters relating to public debt needs to be created separately, issues relating to quantum of debt servicing and its timing, and the potential materialisation of risks to the budget framework need to be better coordinated.

To this end, the creation of a macro-fiscal unit housed in the Planning Commission (ideally), or a Macro-Economic Working Group with senior-level representation of all core ministries and agencies that meets regularly, can improve policy coordination. While a Monetary and Fiscal Policies Coordination Board already exists, it is a “high-level” body chaired by the finance minister that in practice does not meet regularly. A more operational-level platform for coordination is required.

National statistics

Credible, accurate, and timely data and statistics, with open access to all citizens, are an essential element of the modern state. Policymakers, investors, voters all require readily available and trustworthy data for taking actions of a fundamental nature relating to governance, investment and exercising the democratic right to vote and choose.

However, national statistics in many parts of the world are open to manipulation to achieve political aims, such as showing higher economic growth, or lower poverty, under a particular government or dispensation.

In addition to these concerns, in Pakistan a particular statistical exercise has become hostage to political expediency. The national population census is required by the constitution to be held once in every ten years. However, the last census was held in 1998 in the country and plans to hold one have been held up for several years.

The census assumes significance because the distribution of national and provincial assembly seats, as well as the horizontal distribution of federal fiscal resources amongst provinces, is predicated on its results. A specific sensitivity surrounds the share of the Sindh urban-based ethno-nationalistic party, Muttahida Qaumi Movement (MQM), and the distribution of power in Sindh between the urban and rural constituencies.²¹

The country's national statistics agency, Pakistan Bureau of Statistics (PBS), is heavily controlled and influenced by the ministry of finance. The nexus between a technocratic agency and the bureaucracy should be severed, with PBS being made into a truly autonomous and independent, professional organisation.

Ultimately, however, economic governance is nested within the political eco-system. It is extremely unlikely that institutions of economic governance can, or will, be reformed within the confines and space of the existing decrepit political system in Pakistan. Without reforming key elements of the political system, achieving higher-order, "virtuous" outcomes in the economic sphere, is unlikely.

Political reform

The atrophy of the political system and in some ways elements of existing political structures

as well has led to the current state of affairs in the economic sphere. If the political system was functioning "honestly" and true to its design, it is improbable that Pakistan's socio-economic performance would have suffered the deterioration over several decades that it has.

Sustained interference from the political system has eroded the technocratic capacity and capability, as well as the freedom of action, of economic institutions in the country. The ultimate objective of political reform should be to:

- Provide a strong filter, and appropriate checks and balances, for candidates for public office
- Mitigate potential conflicts of interest of public office holders
- Ring-fence the civil service and management of economic institutions from undue interference from the political system
- Provide a transparent, responsive, accountable, open and non-discriminatory administration that harnesses available resources for long term, sustainable economic development of all citizens

To achieve these aims, a broad range of reform and action is required. Perhaps the single most important required action over a period of time would be to evolve from the existing system of political and economic patronage that almost guarantees the hold of power elites on the country's resources, policies and development path.

This is, of course, easier said than done. As noted earlier, there is little incentive for "insiders" (beneficiaries of the status quo) to change their behaviour or characteristics of the system. A necessary step towards this direction would be the implementation of existing legislation and rules, or by plugging gaps/missing parameters.

21. Under orders from the Supreme Court, the 6th population and housing census was finally conducted March 15 –May 25 2017.

This is especially true for electoral reform, where “capture” of the existing system by incumbent governments (at the federal as well as provincial level) allows the result of most elections to be heavily influenced.

This occurs first and foremost through exploiting weaknesses in enforcement of election laws as well as by the selective and discriminatory application of the laws of the land. The Election Commission of Pakistan is also not entirely immune from political influence and an accompanying lack of transparency, especially as most of its members are “selected” by the political system. At a more micro-level, elections are influenced through the use of the police, local administration as well as lower-level judicial officers, and the education department bureaucracy (which provides the bulk of the election staff).

Navigating the Political Economy of Reforms

Given how entrenched elite domination and influence has been in Pakistan, and continues to be, and how this state of affairs is in direct conflict with wide-ranging and meaningful institutional reform that is critical to unshackle the country’s economic potential, it is imperative to present a coherent framework for carrying reforms forward.

This is all the more important since past reform efforts have failed to deliver. Pakistan’s reform experience has been unedifying, with efforts that have been weak, sporadic, fitful and almost invariably, external donor-driven.

At its most basic, the key questions that a home-grown, endogenously-developed and indigenously-owned reforms “framework” will need to address are:

- *What* needs to be done?
- *Who* will do it?
- *Why* will they do it?
- *How* will they do it?

What needs to be done?

There is already a growing awareness for the past many years within Pakistan that something needs to be done to shake the polity out of a state of morbidity and stagnation. In terms of economic management, there is frustration at the inability of traditional policy tools such as anti-cyclical policy measures (spending injections, tax cuts, interest rate changes) to reverse the secular decline in economic performance.

While there is a growing recognition that the status quo with regards to economic management appears to be unsustainable in the long run, there is little convergence within the country of what is the way forward. Most efforts at forging a reforms agenda for Pakistan have tended to emphasise the inputs of development – such as education, energy, access to capital – without sufficiently recognising the importance of, or addressing, the framework required to deliver development (state capacity and institutional strength).

An attempt has been made to devise a “minimum common economic agenda” for the political parties from the platform of the association representing large businesses of the country, the Pakistan Business Council (PBC). The incumbent finance minister, Senator Ishaq Dar of PML-N, has also articulated separately the need for political consensus on an economic agenda on a number of occasions but this has not been followed up in a meaningful manner.

The initiative undertaken by PBC since 2013, while laudable and involving a wide range of technical experts, business leaders and representatives of mainstream political parties, has nonetheless not gained traction since the government has kept its involvement minimal.

In addition, even though the PBC initiative has involved an annual consultative event for the past several years, it has been “one-off” and has not been converted into a sustained advocacy platform. Finally, the work done in this regard from the platform of PBC has also not focused

sufficiently on the institutional aspects of reform.

Hence, clearly a multi-stakeholder consensus on the need for institutional reform in Pakistan has to be crafted. This will be the starting point for building a thus far missing “reform constituency”. A *National Reform Agenda* (NRA) can then evolve and take shape.

Studying the political economy of reform:

Given Pakistan’s history of weak, half-hearted, and largely unsuccessful efforts at economic reform, one would expect a large corpus of literature on the political economy of reform in the country. However, barring a few seminal works, this is largely not the case.²² Hence, it is imperative that before a serious, credible and meaningful reform effort is led, this aspect is studied in a fuller fashion.

Why have past efforts failed? What or who failed them? What are the “incentive structures” at work that have hindered reform? Are those conditions still applicable or have societal and economic dynamics changed? Are there new “powerbrokers” or important constituencies that need to be identified and ultimately, co-opted? Who will ultimately benefit or lose from the reforms, and how can the potential losers be “compensated” or their loss mitigated by society to induce their support?

Without a prior, deeper understanding of these issues any reform effort is unlikely to succeed.

Who will do it?

Given the nature of institutions, as a public good that benefits everyone, they face the same challenges as other public goods — the “collective action” problem with lots of *free riding*. Since the benefits of public goods are spread over many people, and are usually inter-generational as well, individuals have little incentive to undertake effort to bring about their provision. They either leave it

to “other people” or the government to provide these.

The problem with most governments, civilian or non-civilian, is that they too have little incentive to provide effective institutions that are more than likely to introduce checks and balances on their working or ability to stay in power.

Overcoming the hurdle of the lack of collective action and the prevalence of free-riding is, therefore, a major challenge in attempting to bring about institutional reform in Pakistan. Effort has to be directed at “seeding” a reform constituency in Pakistan consisting of stakeholders from across the societal spectrum, i.e. a rainbow coalition consisting of politicians, parliamentarians, civil society (media, youth, opinion leaders, academics/experts, think tanks, lawyers, teachers, NGOs), the bureaucracy as well as the military.

This effort will require a structured process (see next section), as well as time, to gain traction. The role of parliament and the political parties is critical. As the insiders within the status quo, reform champions from within the political system have to emerge to ensure success.

While a multi-party “reform caucus” needs to be identified and formed within both the houses of parliament, with the relevant Standing Committees playing a crucial role with increased interaction with experts, the role of the Senate in shaping a national reform agenda on behalf of the political system can be the key.

Apart from the relevant standing committees, the Senate has at least two other platforms that can be useful and should be brought into play: the informal Senate Policy Forum for Reform, which has been set up by the incumbent Chairman of the Senate (Senator Raza Rabbani) to advise on reform measures, and the Senate Committee of the Whole (SCW for short). The latter (SCW) is

22. Among the most well-known is William Easterly’s *The Political Economy of Growth Without Development: A Case Study of Pakistan* (World Bank, June 2001).

convened by the Senate Chairman to discuss an issue deemed of national importance and involves invitation to outside experts to present their views to the entire Senate during its deliberations. It has been convened very rarely since 1973, and only for matters deemed of high significance.

Political parties are extremely important too, especially their next generation leaders and those who may currently be out of parliament. Reform advocacy with political parties is important for another reason: the issue of institutional reform can be mainstreamed into the parties' election manifestoes.

Another prong is to work with the next generation leaders of civil society — currently at universities and schools. The country's business community is potentially another constituency, though some sections may also have conflicting interests.

Initially targeting/mobilising the urban, educated, professional segment of society who understand the issues and are affected more directly by the status quo (by, for example, predatory taxation, corruption, lack of provision of public services, security issues, etc.) can be more rewarding in giving impetus to shaping a reform narrative.

Multilaterals, such as the World Bank, ADB and the IMF, and bilateral development aid agencies, such as UK Aid (formerly DfID), Japan International Cooperation Agency (JICA) and USAID, etc., can all play an important role by making institutional reforms part of the development narrative.

While this was the case till the mid-2000s, especially in the case of the World Bank in areas such as civil service reform and restructuring of tax administration, the interaction of the external development and financing agencies with Pakistan since then has largely become transactional and/or specific project-related. Institutional reform has largely been dropped from the development narrative in the Country Partnership Strategies of most multilaterals (barring active work on governance reform by UNDP).

Why will they do it?

Finding a common motivation for multiple stakeholders with different, and usually conflicting or competing, interests and agendas to converge and agree on a reform path is absolutely critical to success. This is also perhaps the most difficult part.

In this context, studying the political economy of reform by engaging with the multiple stakeholders and understanding their positions, motivations, interests, as well as concerns is the key. The next step is "framing" the issue(s) and challenges that need to be addressed via reform in a way that reflects the concerns and interests of the various stakeholders and provides a strong motivation to act.

In the case of required reforms in governance and management of Pakistan's economy, a potent framing of the issue that could appeal to the power elite is the "sustainability" angle — i.e., the status quo with regards to the economy is unsustainable, especially in the context of a rapidly growing population that is deprived of basic public services; with a weakening social contract, the hold on power by the elite is likely to become increasingly tenuous. Thus, it is in the elite's interest to focus on reforms that allow the economy to grow in a more inclusive manner.

However, continuous engagement with the multiple stakeholders and interest groups is likely to lead to the most suitable "framing" of the issue.

How will they do it?

To be successful, a formal, structured process will need to be put in place for the national, multiple stakeholder engagement to take place. To be able to achieve this, the engagement will need to be undertaken by a source or catalytic agent that is perceived to be impartial and has a strong measure of credibility with all stakeholders and enjoys their deep trust.

In addition, he/she/it (as an organisation or institution) should have "convening power" to

be able to bring all stakeholders to the table for a long engagement. This is important since the engagement will not be a one-off but will need to be regular and sustained over a period of time to be able to gain traction.

In this context, important lessons can be gleaned from efforts undertaken in different parts of the world to bring opposite sides in “intractable” political conflicts to the negotiating table, as a first step in moving towards eventual resolution. One process employed in some of the most difficult

conflicts in modern history — transitioning from apartheid in South Africa, negotiating peace with the FARC in Colombia, seeking a peaceful cohabitation between Israel and the Palestinians etc., — has been dubbed as “transformative scenario planning”. Pioneered by the oil giant Shell for long-term risk assessment of its exploration portfolio, and adapted by other large multinationals with long run, globally diversified investment interests, it has since been adapted for use in resolution of “political” conflicts (see Box).

Box 6: Adopting a formal process — lessons from Transformative Scenario Planning

According to Adam Kahane, author of *Transformative Scenario Planning: Working Together to Change the Future*, transformative scenario planning addresses problematic situations slowly and from the “inside out”.

It involves a five step process in bringing together representatives of the various “factions” and evolving a consensus on the way forward.

1. Convening a team from across “the system” (dubbed Co-initiating)

- Seek out potential allies
- Identify and enrol as convening team and then a scenario team
- Conduct dialogue interviews of scenario team members and other actors
- Make a project plan and mobilise necessary resources
- Build the project container

2. Observing what is happening (dubbed Co-sensing)

- Share and reflect in the scenario team
- Go on learning journeys
- Commission research papers
- Interact with resource people
- Search for structural driving forces
- List certainties and uncertainties

3. Constructing stories about what could happen

- Choose key certainties and uncertainties
- Construct scenarios deductively
- Construct scenarios inductively
- Write logical narratives of hypothetical future events
- Find metaphors, images, and names for each scenario
- Create pictures that compare and contrast the scenarios
- Document the scenarios in different media

4. Discovering what can and must be done (dubbed Co-presencing)

- Take an adaptive stance
- Take a transformative stance
- Consider your strengths and weaknesses in, and the opportunities and threats of, each scenario
- Develop options for joint and separate actions
- Draw conclusions about what you will do

5. Acting to transform the system (dubbed Co-creating and Co-evolving)

- Hold individual, organisational, and public meetings
- Disseminate the scenario using print, broadcast, and social media
- Launch spinoff initiatives
- Cultivate and coordinate an on-going network of inspired and aligned actors

Source: *Transformative Scenario Planning: Working Together to Change The Future*(Kahane, 2012)

Once the national narrative for reform has been thrashed out and broadly agreed to, the roadmap of what needs to be done and how, can be entrusted to a National Reforms Commission (NRC). The NRC should be high-powered and permanent (with fixed tenures for its members), with representation both from government as well as the private sector. The NRC should be chaired by the Deputy Chairman of the Federal Planning Commission, and include senior representatives of the provinces, Gilgit-Baltistan and Azad Kashmir.

It should draw upon expertise from a wide range of eclectic disciplines, such as systems design, physics, computer sciences, social scientists (political scientists, sociologists and social anthropologists, psychologists, political and developmental economists, behavioural economists, change/transformation specialists etc.)

The objective should be to redraw and “re-imagine” political and economic governance in

such a way as to make it more capable, more nimble and effective, and more transparent and accountable. Reducing the regulatory and fiscal burden on businesses, and overall transaction costs in the economy, should be a key underlying objective of the work of the NRC.

Without a new approach involving a diverse set of “rainbow coalition” stakeholders, Pakistan’s attempt at institutional reform — both political as well as economic — is likely to meet the fate of previous efforts.

Finally, an important element of the “How” part will be the need to integrate governance more fully as well as meaningfully into Pakistan’s national and provincial development plans. This will require adopting a set of nationally-owned governance indicators, internalising these across different levels of government, and reporting the same publicly with a regular and predictable frequency for public scrutiny and debate.

Three general purposes for measuring Governance

- It is a *reporting tool* that can track and communicate progress towards goals and/or outcomes
- It is a *policy tool* that can guide evidence-based planning and action to address issues identified as important by citizens and in existing political commitments
- It helps build and strengthen democracy by engaging stakeholders through informed discussions

Dr. Ken Mease, University of Florida (UNDP, 2009)

Conclusion

Pakistan is in dire need of wide-ranging institutional reform. The performance of its institutional framework has deteriorated in important areas, including, for example, in efforts to fight corruption, establish rule of law, and in the conduct of public financial management. The weakening of the institutional framework has had an important, and pernicious, long-term effect on the country's economic performance and development trajectory.

Past economic reform efforts have achieved little, as these have mostly been fitful, supply-side and external-driven, and on the whole lacking 'ambition'. The results have been superficial and cosmetic with the economy mired in the same problems of weak fiscal management, low tax revenue collection, rising public debt and poor delivery of public services.

A significant impediment to meaningful reform is that due to widespread patronage and co-option, a genuine reform constituency has been missing in Pakistan. The middle class till only recently has either not been large enough, or has owed its success to patronage and privileges bestowed by the state, including forbearance by regulatory agencies or of the law.

A glimmer of hope for genuine institutional change and reform has emerged with the rise of a genuine, educated, urban and professional middle class that has started to exert its influence in politics as well. A wider coalition that includes members of the status quo needs to be built, perhaps by framing the issue as an existential one for Pakistan and for current beneficiaries.

Till such time, incremental efforts can focus on critical issues of economic governance that do not require expending large amounts of political capital, such as improvements in public financial management. Without significant progress on institutional reform, at whatever level, however, Pakistan is unlikely to witness an improvement in its socio-economic condition.

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About the author

Mr. Sakib Sherani is a former Economic Advisor of the Ministry of Finance (GoP) and currently heads Macro Economic Insights (Pvt) Ltd., a consultancy firm based in Islamabad.

Imprint

© 2017 Friedrich-Ebert-Stiftung, Pakistan
1st Floor, 66-W, Junaid Plaza, Jinnah Avenue
Blue Area, Islamabad, Pakistan

Responsible:

Rolf Paasch

Resident Representative

Abdul Qadir

Programme Coordinator & Advisor

Phone: +92 51 2803391-4

E-mail: info@fes-pakistan.org

Website: www.fes-pakistan.org

To order publication:

info@fes-pakistan.org

The study is part of a series of publications under the regional and national FES project on Economy of Tomorrow.

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