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Domestic Resource Mobilisation: A Structural Approach*

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The Mobilisation of domestic resources and their efficient utilisation are two of the most crucial tasks in revitalising the economy of Pakistan. Historically, low saving formation and relatively higher targets of investment and economic growth made it imperative to depend on external resources. Despite heavy domestic borrowing from both private and public sectors, there still has remained an unmet resource gap that has necessitated dependence on foreign capital.[1] In recent years, the sources of foreign assistance have become scarce due to a growing shortage in world saving and growing domestic demand for budget appropriations in the western countries. If economic growth in Pakistan is to be sustained and self-generating, investment in physical and human development must be increased and mad more efficient. To meet this challenge, most of the capital will have to come from domestic sources. Hence, the focus of this paper is on harnessing domestic efforts to increase saving formation and to enhance efficiency of capital investments.

Traditionally, the government of Pakistan has relied on conventional approaches to increasing domestic saving. First, the government has been encouraging greater saving by the private sector through a package of national saving schemes and by allowing financial institutions to introduce saving incentives. Saving-schemes and saving incentives have not produced satisfying results. Table 1 shows saving and investment in selected South Asian countries. Saving in Pakistan is very low and, indeed, among the lowest even when compared with neighbouring and other developing countries. Explanations of this failure include the low levels of income and high rate of inflation in the country.[2] Moreover, the financial institutions have in general remained inefficient.

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[1]The domestic investment rates have been sustained above the domestic saving rates by workers' remittances, official development assistance, and multilateral and bilateral assistance. Total external debt at present is approximately $18 billion.

[2]Pakistan is a low income country and its GDP per capita is $380. Average annual rate of inflation during 1965–80 remained over 10 percent. More recently it has been somewhat lower, averaging about 7 percent per year.

The second approach is to increase saving through taxation and incomes policies. In its taxation efforts, the government has not been able to enlarge revenues adequately from private sector incomes. This failure is due to the inelastic character of the tax system and a heavy reliance on indirect taxation, the latter causing the tax system to be inequitable.

Incomes policies have been only marginally successful. In its wage and price policies, the government adopted impelled methods of saving formation. The working population and the urban consumers have been paying for the savings in the country.[3] The public sector's contributions to domestic saving have remained negligible, mainly due to the inefficiency of state enterprises, rising defense budgets, non-development expenditure, and high inflation.

Table 1

Savings and Investment Percentage of GDP

	Gross Domestic Investment			Gross Domestic Savings		
Country	1960	1980	1990	1960	1980	1990
Afghanistan	16	14	–	13	11	–
India	17	23	23	14	20	23
Pakistan	12	18	19	5	6	12
Sri Lanka	14	36	22	9	14	15

Source: World Bank, World Development Report 1982, 1992 Oxford University Press, New York, 1982. pp. 118-119, p. 234.

The shortcomings of traditional approaches to mobilise domestic resources and a decline in the availability of foreign assistance make it urgent to search for solutions to the problems of resource mobilisation outside the scope of conventional strategies and foreign sources. The world of economics has already entered into the age of restructuring and openness. It appears that the time is ripe for Pakistan, as well, to develop a structural change for efficient domestic resource mobilisation and free the economy from bureaucratic control. A blueprint of such an approach and its implementation targeted over a period of ten years is outlined in Chart 1.

With an early start on the transition of the economy from a bureaucratic toward a decentralised economic system, the pace of efficient mobilisation of domestic resources will be expected to accelerate. The resultant investments and

[3]In the early periods, there is strong evidence that the real wages of the industrial workers had been declining due to strict labour laws. The peasants' incomes were kept low because of adverse terms of trade against agriculture. Besides, the system of state trading corporations (which purchase farm products such as rice and cotton at relatively low prices and sell them in the world markets at higher prices) has helped the government in its revenue collection drives. The urban consumers, too, were paying prices above those in the world market for domestic manufactures.

Chart 1

Domestic Resource Mobilisation: A Structural Approach

	Models/Sectors	Constraints	New Strategy and its Outcomes		
			Innovations/Instruments	Economic Outcomes	Resource-Mobilisation
1.	Development/ Growth Model	Regime of direct controls; bureaucratic managements imbulanced growth; dismal/unproductive relationship between the economy and society	Economic/Pricing reforms: socially desirable pattern of growth; investments in human development and manufacturing sectors	Efficient allocation and utilisation of resources; robust and people-oriented economic growth; higher productivity and creativity gains	Efficient saving formation
2.	Market Sectors				
	Agriculture	Feudal structure of land ownership; market imperfections; poor crop and water management	Land ownership rights on the basis of cultivation only; pricing reforms; introduction of advanced methods for crop and water management	A modern and highly productive agricultural sector; higher farm output/ incomes; food self-sufficiency/ exports	Agriculture–a surplus producing sector
	Industry	Regulations; state control/protection; slow expansion in manufacturing capacity; industrial power and concentration	Price and regulatory reforms; open competition; a vigorous investment strategy for capital goods industries	Rigorous competition; industrial efficiency; increase in output, income and investments	Enhanced industry-wide saving

Continued–

Chart 1 – (*Continued*)

	Models/Sectors	Constraints	New Strategy and Its Outcomes: Innovations/Instruments	Economic Outcomes	Resource-Mobilisation
3.	Government Sectors: State Enterprises/ Semi-public Enterprises	State ownership/ control; bureaucratic management; subsidies; revenue leakages	Selective privatisation; corporate management; gradual withdrawal of subsidies; opening up state companies to competition	Efficiency gains; profitability; balanced sectoral development	Enhanced revenue generation
4.	Fiscal System: Revenue Regime	Inequitable and inelastic tax system; narrow tax base; tax loopholes; poor tax collection	Fundamental reforms in tax system; introduction of agricultural income tax; broad general sales tax; better tax collection	Equitable and efficient tax system; progress toward balanced budget	Improved revenue performance
	Expenditure Regime	Unrestricted growth of non-development expenditures; high defense spending; inefficient budget allocations	Cap on non-development expenditure; internal shift in resource use in favour of development expenditures	Marked reduction in budget deficit; increased allocations for development expenditure	Saving formation in public spending; increased resources for development
5.	Monetary/ Financial Systems	Credit controls; tight regulatory environment; underdeveloped capital markets	Central bank independence; flexible credit control system; regulatory reforms; computer-inspired technological changes	Improved management and increased competition; efficient banking system and financial markets	Greater saving by private sector

Continued–

Chart 1 – (*Continued*)

6.	External Sectors: Trade	Narrow export base; quality control problems; non-essential imports; in-efficient import-substitution	Expansion and diversification in high value exports; quality control; emphasis on capital goods imports; selective sectors for imports substitution	Better export performance; improved balance of payment; competitive trading position in world markets	Enhanced potential for trading surplus; increase in foreign exchange reserves
7.	External Assistance	Perpetual cycle of dependency; questionable type and quality; conditionality	Emphasis on productive credit; external borrowing as a "last resort"; borrowing primarily to finance development projects	Promotion of domestic reliance on investment needs; cap on growth in foreign debt; early termination of aid	Saving in debt-servicing charges, potential for foreign exchange saving

rapid growth will enhance the rates of saving formation in the country. To analyse these issues, this paper, therefore, deals first with a general framework of structural reforms and second with efficient utilisation of resources.

I. GENERAL FRAMEWORK OF STRUCTURAL REFORMS

The dominant features of the development pattern of Pakistan so far, listed under "model" and "constraints" in the chart, have been its long-term economic planning, direct controls, bureaucratic management, and others. Close association of the government with the development process and its management have adversely affected the sectoral balance of the economy and have led to an inefficient use of scarce resources.

These and other constraints have hampered the economy from reaching its productive potential. To revitalise the economy and broaden its potential, specific structural changes and policies are listed under "innovations/instruments" in the chart and briefly discussed below.

Structural Changes/Policy and Growth

Structural changes and policies to promote stability and growth in Pakistan should be two-fold: strategies of stabilisation in the short-run and growth policies in the long-run. Stabilisation can be achieved through fiscal and monetary policies, and growth through investment policies focusing on physical and human capital. These strategies and policies go hand in hand.

Pakistan should adopt stabilisation strategy through an active use of fiscal and monetary measures. To promote employment government should channel increased public spending into employment-oriented economic projects and provide investment incentives to businesses. To control inflation, along with fiscal measures, monetary authorities should tighten the money supply. Moreover, the State Bank of Pakistan should be made independent so that it can make monetary policy free from political influences. These monetary measures can help secure higher levels of employment and stable prices.

Promotion of long-run growth in Pakistan depends on effective investment policies with macroeconomic perspective, development of human resources, and trade expansion. Macroeconomic policy in the context of Pakistani problems of growth involves two fundamental decisions: how aggregate demand should be managed, and how output should be allocated between consumption and various forms of investment. Increased investment in physical capital such as equipment and machinery would significantly boost productivity growth. Regarding human resource development, investment in education, job training, and skill development will contribute to improvements in labour productivity and economic growth. The gains from structural changes/policies are summarised under "economic outcomes" and "resource mobilisation" in the chart. The restructuring of trade is necessary

through establishing high value export industries and promoting regional economic integration (SAARC).[4]

Financial/Monetary Reforms

Central to the issue of domestic saving mobilisation is the state of the financial system. It is widely recognised that an efficient and well-developed financial system in a country is a prerequisite for: first, the growth and stability of an economy; second, mobilising a country's saving; and, third, channelling saving into the most productive investments. This process is, indeed, the very lifeblood of economic development and rising standards of living.

The state of the banking and financial systems in Pakistan has have been lack of public confidence, inefficient management, and low capital-risk assets ratios.

Public control of the commercial banks and political interference in their decision-making have adversely affected their performance. For instance, nationalisation of banks involvement of the authorities in credit decisions, heavy borrowing by the government at "artificially low rates," and government underwriting of "non-performing loans" have undermined public confidence, increased mismanagement, and brought capital-risk assets ratios lower to a crisis level–Table 2.

Table 2

Capital–Risk Assets Ratio–Scheduled Banks

(Billion of Rupees)

	1970	1980	1990
(1) Capital	466	1,135	11,366
(2) Risk Assets*	20,711	97,719	608,842
(3) Ratio (1)/(2)	2.3	1.2	1.7

Source: Annual Reports, State Bank of Pakistan, 1979-80, 1987-88, and 1990-91.
*Risk Assets consist of total asset minus cash items and investment in government securities and shares.

Indeed, in the light of the crisis in the financial sector, the confidence factor will become all the more important over time as the ownership of the formerly nationalised banks and financial institutions shifts to private hands. Any worthwhile package of reforms must deal with these fundamental problems.

[4]The trade sector in Pakistan is subject to "trade limit". The country has a narrow export base, and even after four decades of development continues exporting traditional goods. The export sector needs structural changes to develop efficient industries with export potential, such as high value manufactures. The import policy must encourage import of capital goods, while inefficient import-substitution must be abandoned.

No matter what the precise legal and institutional financial framework in a particular country, there are certain preconditions for the banking system to be able to perform its functions of mobilising and allocating savings. In Pakistan the reform package must include three fundamental elements: restoration of public confidence, efficient management of liability and assets, and maintenance of a high capital-risk asset ratio.

Restoration of public confidence is necessary because the functions banks perform entail risk, and confidence is a key to the public's decision to entrust its saving to banks. Minimising the effects of risk-taking and improvement in the performance of the commercial banks will be a big step forward in restoring public confidence. This goal can be met by instituting prudent deregulation of the banking industry on the one hand and tightening the monetary authorities' supervision of the banks on the other.

Efficient management of assets and liabilities and independent credit decision-making by the bankers are essential. Decisions regarding management of investment portfolios, for instance, and who gets credit and who does not, must be left to bank managers. However, managers should be made accountable for their decisions and should have a major stake in it–their own jobs.

A high capital-risk asset ratio is the evidence of a bank's strength and its longevity. Large capital accounts representing ownership interests serves two main objectives: first, they are a source of funding, and second, they provide a buffer for absorbing losses. Therefore, laws should be enacted to require banks to maintain a relatively high capital-risk assets ratio.

Fiscal Reforms

The fiscal system needs structural reforms on both the revenue side and the expenditure side. On the revenue side, a package of comprehensive tax reforms that addresses the issues of equity and the "elasticity" of the present tax system must be given top priority. The present narrow base for direct taxes, yielding tax revenue of about 2.0 percent of GDP, can be broadened by the elimination of about 180 income tax exemptions and by gradually phasing out numerous tax credits and area- and industry-specific tax holidays. These measures, according to the Seventh Plan document (Seventh Five-Year Plan 1988–1993), will not only increase tax receipts, but also reduce the dispersion in effective income tax rates among industries, thus improving the efficiency of resource allocation. The addition to tax revenues from these changes could amount to 1 percent of the GDP. The base for indirect taxation, which contributes revenues of about 11 percent of GDP, comprises primarily consumption taxes such as sales taxes, and excise and import duties. The coverage of sales taxes on both domestic and imported luxury and semi-luxury items must be broadened not only by withdrawing exemptions, but also by increasing specific tax rates. These measures could yield additional revenues amounting to 1 percent of GDP.

Often discussed and repeatedly recommended by the economists, an agriculture income tax awaits enactment in Pakistan. The argument that agriculture is already heavily taxed via export taxes overlooks the relief provided in the form of highly subsidised prices of farm inputs such as fertilizer, seeds, and water. An agriculture income tax or a kind of land tax is justified on economic grounds. To maintain the equity from the "incidence" of new tax, small land owners would need protection and should be exempted. This new tax can contribute about 1 percent of GDP to public revenue.

Other problems causing low tax receipts are the widespread practice of tax evasion, official irregularities, and poor tax collection. An efficient and honest tax administration committed to a strict enforcement of anti-tax evasion laws and good conduct is necessary. Strengthening the collection machinery could also enhance the revenue performance of the tax system. These additional steps could raise revenues by about 1 percent of GDP.

Additional revenue potential lies in competitive functioning of state and semi-public enterprises. Reassessment of official pricing policies and evaluation of the management style of these enterprises will force them to become competitive, efficient, and profitable. Moreover, an immediate overhaul of management and appropriation of the financial resources in these enterprises is essential. Reforms in this sector can increase public enterprise performance and add about 1 percent of GDP. A summary of saving formation from various sectors is given in Table 3.

Table 3

Sector-wise Estimates of Potential Saving Formation

Sector	Saving Formation (Percentage of GDP)
Market Reforms Investment	2
Physical Capital	1
Human Capital	2
Financial Monetary Sectors	2
Fiscal Sector	
Revenue Side	
Direct Taxation Reforms	1
Indirect Taxation Reforms	1
Agriculture Income Tax	1
Efficient Tax Collection	1
State and Semi-public Enterprises	1
Expenditure-side	
Internal Shift in Resource Use	2
Efficiency of Investment (Capital)	3

Source: Staff estimate of the World Bank and Ministry of Finance, Government of Pakistan.

On the expenditure side, a substantial increase in real resources for development is highly desirable. A strategy of internal shift of resource use toward investments will not only raise productivity and growth, but also will contribute to public revenues. Even modest cuts in administrative, defense, and subsidy expenditures will improve the resources position. In 1988-89, the government spend 6.6 percent of GDP on defense alone, compared to 6.3 percent on development. Fiscal reforms can have a significant impact on shifts in resource use. Freeing of resources from non-development spending can add to saving formation another 2 percent of GDP that could raise the development expenditure from 6.3 to 8.4 percent of GDP. Resource mobilisation is a necessary condition but not an adequate one. Stimulation of growth also depends on the efficient utilisation of resources.

II. EFFICIENT UTILISATION OF RESOURCES

Equal in importance to high savings and investment for rapid development is the key issue of efficient utilisation of resources, or the efficiency of investment. The efficiency of investment is generally measured by the incremental capital-output ratio (ICOR), defined as the ratio of change in capital stock to change in output. Other measures of economic efficiency in use are net investments as a percentage of GDP and the average capital-output ratio (COR).[5] These indicators are presented in the Table 4.

Table 4

Percentage of GDP

	First Plan 55–60	Second Plan 61–65	Third Plan 65–70	Fourth Plan 73–78	Fifth Plan 78–83	Sixth Plan 83–88	Seventh Plan 88–93
Gross Investment	9.0	11.9	15.8	19.8	22.2	23.5	18.5
Net Investment	4.0	7.7	11.1	14.1	15.5	15.7	–
Depreciation	5	4.2	4.7	5.7	6.7	7.8	–
GDP (Growth Rate)	3.1	6.8	6.7	5.0	6.5	6.6	6.5
Net Capital-Output Ratio	2.0	2.1	2.5	2.7	3.0	2.6	2.8

Source: Planning Commission, various planning documents, Government of Pakistan.

[5] ICOR $\frac{\Delta k}{\Delta y} = \frac{I}{\Delta y}$ and net COR = $\frac{I}{Y}$

Theoretically, ICOR seems to be a better measure of the efficiency of investment (MEC) than the net COR (average). However, the experiences of different studies can, certainly, throw more light on this ambivalence.

Over successive Five-Year Plans, despite rises in ratios of net investments to GDP from 4.0 to 15.7, net (incremental) capital-output ratio (ICOR) have gradually increased from 2.0 in 1955–60 to 3.0 in 1985–90. These numbers need to be observed carefully. Apart from the unreliable character of the statistics, the overall ICOR for the economy reflects, and hides, many complex economic facts and relationships. First, there is the issue of inevitable lag between capital investments and actual production. These lags, though, may be relatively shorter for the services sector. Due to the time lag, a rise in investment ratio must be expected to raise the ICOR for some time. Second, temporary external shocks, such as domestic repressions of a fall in the terms of trade, will result in higher ICOR. Usually, lower ICOR and COR imply greater efficiency of investment. Does this mean resources utilisation is really efficient in Pakistan, as suggested by the lower ICOR? To answer this question authoritatively, a comprehensive research study on the subject is needed.[6] However, in the absence of such information one can depend on some leads in the development economics literature to analyse the issues of efficiency.

The ICOR for the whole economy may not only change because of changes in the productivity of individual sectors or industries due to technical progress or improvements in organisation, but also because of structural changes in favour or against high-ICOR sectors or industries. All of these factors appear to have some significance in analysing the issue of efficiency of resource utilisation in Pakistan. Because of time lags, deterioration in terms of trade, and changes in the productivity of individual industries, ICOR should have been high, rather than low. Some possible explanations for consistently low ICOR figures in Pakistan may be such factors as increases in investments in service industries, sporadic market-based reforms, export promotion, and other policy initiatives aimed at enhancing competition and improving efficiency. Recent steps toward privatisation, relaxation of direct controls, an expanded role for private sector, and some evidence of shift in the sectoral composition of aggregate investment in favour of more efficient industries may eventually produce positive results. But these changes may not be adequate explanations for the low ICOR. Besides, it is desirable to supplement investments in human resources, a key factor in economic development that would go a long way to increase the productivity of resource utilisation. Hence, efficiency of investment have the potential of at least 2 percent increase in saving formation. In summary, a comprehensive programme of structural changes has the potential of raising the saving formation to approximately 17 percent of GDP–Table 3.

[6]Sundrum (1987) had studied the causes of India's high ICORs during 1950s and 1970s. The finding of his study suggests that high ICORs were due to the large portions of fixed investment in buildings, primarily residential, which did not contribute much to growth of GDP, and shifts in sectoral composition of investments toward highly capital-intensive programmes.

III. CONCLUSIONS

Pakistan is a poor country, and its development agenda includes improvements in economic and social conditions. A successful economic strategy to secure the goals of the development requires heavy investments in physical and human capital. This challenging task cannot be accomplished without concerted efforts toward domestic resource mobilisation and their efficient utilisation, a fact that underscores the need for structural reforms.

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