

## *The Presidential Address*

### **Economics and Governance**

NADEEM UL HAQUE

Let me begin by thanking the Prime Minister for his continued support to the academic economist community. Despite his busy schedule he has taken the time out to inaugurate the conference. This is the 22nd Annual Meeting of the Pakistan Society of Development Economists. Ladies and Gentlemen, the Prime Minister has been supportive of the PSDE through his years as Finance Minister and as Prime Minister. For that we are thankful to him.

#### **Why Governance and Institutions?**

Ladies and Gentlemen, in the 60 years of postcolonial development, Pakistan and many other poor countries have followed many prescriptions that promised development. These countries went through phases of planning and controls, nationalisations and socialism, industrialisation strategies based on licenses and protection, the Washington consensus and many other prescriptions. Billions of dollars in loans and aid have been consumed. Yet poverty has not been eliminated and any low income countries remain in that category.

For the last 2 decades, researchers have been tirelessly investigating this issue. From this research we have learnt that weak, missing or perverse institutions lie at the heart of underdevelopment. Cross-country regressions persistently demonstrate large and statistically significant correlations between institutional variables and growth. Horse races between variables reveal indexes of institutional quality to be more important in explaining growth than geography. See figures in Appendix.

Countries that achieve progress develop two distinct and not necessarily complementary sets of institutions:

- those that foster exchange by lowering transaction costs and encouraging trust; and
- those that influence the state to protect private property rather than expropriate it.

The first set of institutions includes contracts and contract enforcement mechanisms, commercial norms and rules, and habits and beliefs favouring shared values and the accumulation of human capital. Among the second set of institutions are constitutions, electoral rules, laws governing speech and education, and legal and civic norms.

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Surprisingly despite aid efforts and the promise of development, many poor countries even today have not been able to sustain strong institutions to foster exchange and protect property which research is now showing to be central to economic growth and progress. Contracts are enforced through informal mechanisms such as private armies; kinship associations, ethnic, and other networks. Governments in these countries are either too weak to prevent theft of property, rent-seeking and corruption, or so strong that the state itself becomes predatory and corrupt threatening property rights. In either case, investment in specific knowledge, skills, or capital, become very risky. As a result, entrepreneurial and investment activity is slowed down. It is no wonder that productivity is low, and the economy stagnates.

Why have so few countries been able to create and sustain the rules and norms that foster growth and social progress? Which institutions must function effectively if countries are to develop? How can poorer countries attain well functioning institutions? Can outsiders promote institutional development? Economics has made some progress towards answering these four questions, but much remains unknown.

We know for example that growth is not merely about planning more infrastructure or more industry. The earlier prescription of aid financed projects leading to growth has not worked. Nor is about offering protection or subsidies. As Paul Romer points out, growth is about innovation and entrepreneurship, discovering new products and better processes. Consequently most economists now are for an open, competitive and market-based economy.

Following this logic we know that the government's ability to direct economic activity or lead it is limited. Consequently, the role of the government is to provide what is now known as the "enabling environment". But what is this enabling environment?

We also know that this "enabling environment" means that the role of government is similar to what the social contract philosophers had envisaged in the enlightenment era. To them government's primary duty was to preserve rule of law, provide security of life and property and to dispense blind and impartial justice based on a legal framework that would facilitate economic growth and efficiency. They also believed in the limited government that maximises economic and political freedom.

Twentieth century socialism and Keynesian activism was at its peak when the post colonial era started. It is no wonder that we lost touch with the classical teachings and search for solutions that extended government into markets and areas which severely limited freedoms. But the failure of development policies and recent economic research has shown that development follows good governance based on the principles of limited and efficient government.

### **The Role of Economists**

Despite these new developments in economic research, economic discourse in Pakistan even today follows the development economics of the earlier interventionist era. At most conferences, seminars and meetings, economics is often thought to be prescriptions based on more government. These people expect the government to fix prices, diversify exports, develop modern industry, process fruit and provide cheap transport, health and education to all. In short, the government is becomes central to all economic activity. For them government is benign and market malignant. They overload the government with too many tasks.

Why is the economics profession in Pakistan so preoccupied with interventionism and planning? I have argued that in a paper a few years ago that this is because we have not invested in a research based academic profession. Years of neglect of education and research especially in the social sciences has further retarded the development of research. When I speak to audiences of young economists, I find that economics education remains backward.

What then is the role of the economist if not to pick sectors, plan the economy, or develop industrialisation or export strategy? Economics is about studying incentives and human strategic behaviour in the market place. Institutions, laws and government interventions define the incentive structure that agents face. People will use these systems if they can to gain political and economic power to distort markets in their favour. Thus élites will capture governments, regulators and policy-makers will be corrupted, market liberalisations and open markets will be reversed. Economic investigations keep the institutions and markets under review with a view to designing incentive mechanisms that promote open competitive markets. It is in this sense that economists can help design better incentive systems. In this role the economist is the champion of open and free markets and a buffer against expanding government and market-capturing and rent-seeking élites.

But perhaps the most important change that economists can play is the design of competitive markets and growth-promoting organisations and institutions. They do this by studying incentives and strategic behaviour.

### **Can Change Be Externally Driven?**

Many people who continue to live in the earlier planning paradigm of development economics argue: “Research and inquiry is not necessary, we know it all. We need only to act and not think”. Alternatively, “We know it all! The only problem is that no one will implement what we are suggesting”.

Bill Easterly would argue that this is the view of the donor community. They have advisors and consultants who urge countries to adopt ‘international best practice’. Is development that easy? If so, why has it not worked? Can we just borrow international best practice and plans? Many serious economists like Easterly would now contend this claim.

Sachs and Bono claim that poverty can be eliminated by throwing large sums of money at it. But then World Bank studies themselves admit that aid only works where there are good policy and institutions (Dollar and Burnside). Aid projects try to reform institutions through conditionality: a list of specific changes that the country must enact before funds will be disbursed. But conditionality does not fit well with what is known about institutional change. A World Bank analysis of past projects conclude: “donor financing with strong conditionality but without strong domestic leadership and political support has generally failed to produce lasting change” [World Bank (1998), p. 4].

Once again research guides the way. We have learnt that institutions usually change as the result of a long and often painful process of competition and adaptation, changes that are only sustained if belief systems and norms change as well. Ruling elites often prefer pro forma changes so they can obtain funds without politically costly changes in deep-seated constitutional rules, norms and beliefs.

### **Change and Domestic Ownership**

How then do we achieve change? Many thinkers including North have pointed to the fact the ideas lead change. The enlightenment philosophers and their debates paved the way for the democratic constitutionalism that emerged later. Much of the twentieth century economic policy arose really from the academic debates between Marxists and free marketers. Much of the debate was fairly erudite and scholarly between protagonists such as Keynes and Hayek, and Samuelson and Milton Friedman. Research at universities filtered into think-tanks such as Heritage Foundation, Cato and Brookings. From there, the media picked it up. It was only then that politicians like Maggie Thatcher and Ronald Reagan initiated the reform programme to re-establish the *laissez faire* state.

It is fair to conclude then that academia, think-tanks and professional associations have played a critical role in economic development in countries such as the US. A vibrant scholastic community develops an idea exchange, competitive funding and peer review, incentivising innovative research work. If this activity gets well founded it serves to educate civil society and develop an appropriate reform strategy that is domestically owned.

Unfortunately, in low-income countries, professions, professional associations, think-tanks remain largely undeveloped. Foundations do not exist and are replaced by aid-giving institutions that are run from far off capitals with little vision. Whatever public policy debate takes place is conducted in the relatively closed groups comprising mainly of these aid institutions, their professionals and consultants. In such discussions the only group that has a marginal participation is the government—marginal because the government has neither the capacity nor often the political time to concern itself with longer term implications of public policy. It is no wonder that outdated ideas continue to prevail in these countries and imported “best practice” is considered to be a panacea.

Jane Jacobs says “development is a do-it-yourself” job. We must learn globally but application must be tailor-made locally. To do this once again we must develop our own research and debate. Only then will we be able to seek local solutions.

### **PSDE, PIDE, and the Pakistani Research Community**

Prime Minister it is for the reasons above that serious economists feel that it is important to develop the profession of economics and involve them more in policy-making. With this aim in mind, we at the PIDE have been working very hard to develop the PIDE into a renewed and modernised think-tank. And it is for this reason that we are holding this conference which hopefully will generate a number of fresh ideas and debates over the 3 days. But more importantly we hope that this conference will generate whole new research agenda for our academic community mainstreaming institutional development and governance.

Before I outline a few highlights of the conference, let me recognise Prof. Nawab Haider Naqvi who had the vision to found the Pakistan Society of Development Economists, some 22 years ago. I would also like to commend the PIDE staff and my 2 predecessors, Dr Sarfraz Qureshi and Dr A. R. Kemal for keeping the PIDE and the PSDE alive through some very difficult years when the environment was hostile to research.

Prime Minister, I am happy to report that the PSDE is now becoming a national association of academic social scientists. We are taking many steps to make this happen.

- (1) As you can see, we have started to take the PSDE out of Islamabad. We are taking the annual meetings out of Islamabad. We have come to Lahore. We intend now to go to all the provincial capitals.
- (2) We have also held smaller but very successful conferences in Karachi and Lahore over the summer and fall on issues such as cities, public sector reform and decentralisation.
- (3) I am also very happy to report that we are collaborating with several Pakistani academic institutions. In this conference, NRB, LSE, LUMS, GCU and Punjab University have helped us in many ways. We are very proud of this emerging collaboration and do intend to nurture it.
- (4) I am extremely pleased to tell you that we have initiated a programme of scholarships to allow serious economics students from smaller cities to attend this conference and learn.
- (5) It is also a source of great pleasure and pride to tell you that our call for papers led to about eighty submissions from all over the country of which we have selected about 48 to be presented here. It is heartening to see that papers have submitted from all provinces.
- (6) We are also going to award a prize of Rs 100,000 and another for Rs 50,000 to the best and second best papers that have been selected to be presented at the conference. As always we have eminent international scholars addressing the conference. And they are now busy reviewing these papers to give me candidates for the prize. We think that this healthy competition will over time improve the quality of our work.
- (7) We are also offering a prize to the best economic journalist of the year 2006. Once again our hope is to improve the standard of economic journalism through this competition.
- (8) This year we have worked very hard to try to win the support private sector. I am happy to report that Askari Bank gave us a generous donation of 1 million rupees. Being the major corporate sponsor, Mr Shaheryar Ahmed is here at the head table. Other corporates who supported us are ICI, Muslim Commercial Bank, and Arif Habib. I am sure you will agree that this is a very short list and the amounts contributed are small. I was indeed surprised that some of the bigger banks, our cash rich telephone companies and the recently profitable auto sector chose not to contribute. I remain hopeful that the local corporates will like their counterparts elsewhere sponsor local research in the future.

I must also acknowledge the support of NRB who support us not only financially but also intellectually in research. The major funding for this conference is provided by CIDA and DFID. For that we are thankful. But we remain hopeful that our corporates will one day take up the bulk of our research finding.

Before concluding, let me also highlight some of the important innovations that we are making in this conference. Over the next 4 days we will have about 12 technical sessions in which these selected 48 papers will be presented.

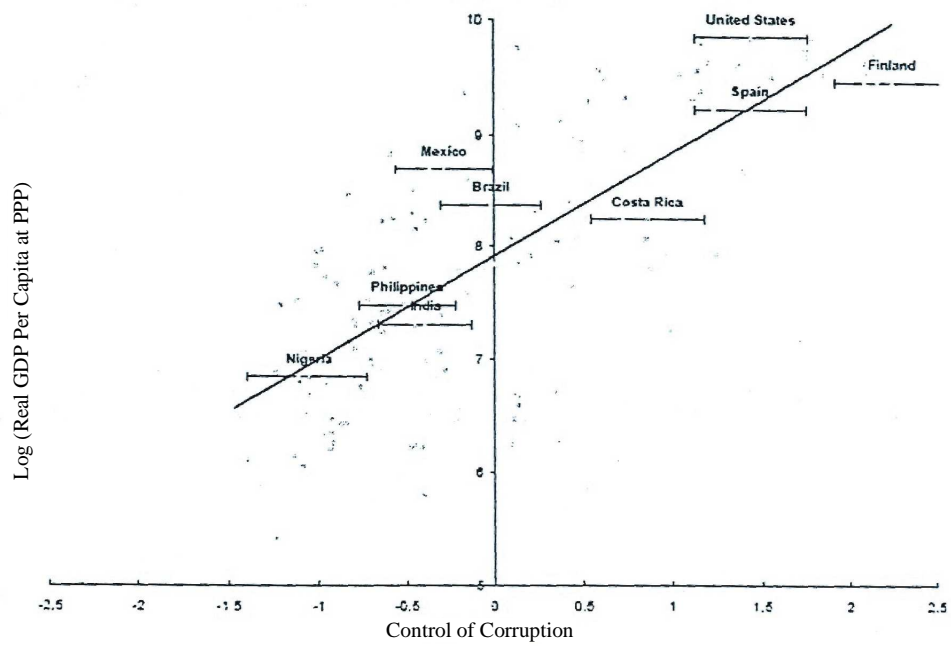
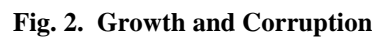
In addition, we shall have about 12 invited panels of experts on several important areas relating to the theme of our conference. I might also add that Prime Minister that these themes are also in keeping with your second generation reform agenda. Let me highlight some of these.

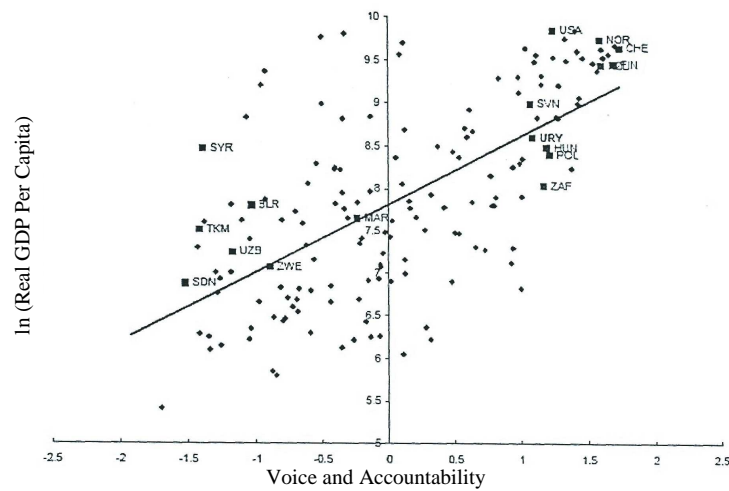
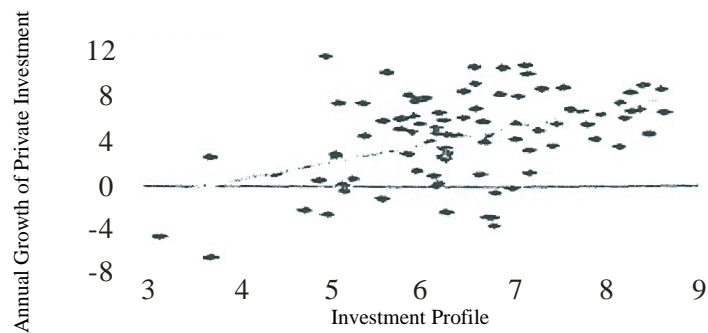
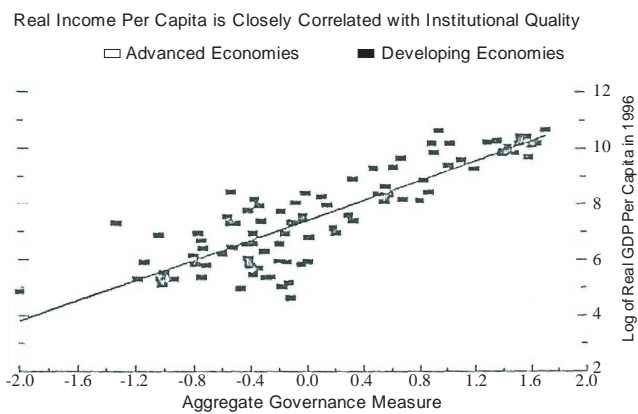
- (1) Recognising the importance of the decentralisation reform, we have planned 2 sessions on decentralisation. We hope to examine the achievements of this reform and examine what incentive mechanisms can be put in place to strengthen this reform.
- (2) We have an extensive session planned on public sector efficiency focusing on civil service reform. The role of the civil service has expanded substantially over the independence era. From an emphasis on magistracy it has now become largely a manager of markets and development. Yet the structure of the service remains largely what we inherited. The incentive structure in particular has not kept pace with times nor has the HRM. We have conducted a survey of civil servants to see what the civil servants think of these issues. We also have several panelists from the civil service who will enlighten us on this important organ of our governance.
- (3) We are also subjecting the police system to scrutiny to see if it is in line with the needs of economic development. Once again we are developing a dialog between policemen and economists on this key issue.
- (4) Another important innovation that we have made is that we are putting lawyers and economists together to examine the economic efficiency of our laws. While this is the first time that this is happening, we intend to start a law and economics research section in the PIDE. I would like your support for it sir. Here we will examine issues such a property rights, commercial and financial laws and other legal aspects that affect transactions.
- (5) While the role of government is going to be a recurring theme in the conference, we also intend to examine the role of the public sector in several key sectors such as agriculture and population planning.

Prime Minister, excellencies, ladies and gentlemen, I have tried to give you a brief overview of why we are doing this conference and highlighted what you can expect over the next 4 days. I have tried to point out to you the importance of developing quality research institutions in the country. But to do that we will have to make a serious effort to integrate our Pakistani economics profession into global research. We must learn from the new economics that I have outlined here. In this way we might be able to develop a new research agenda to understand and shape our institutions to achieve sustained growth and economic development.

This is what we are trying to do at PIDE. The challenge is huge! And we have little support.

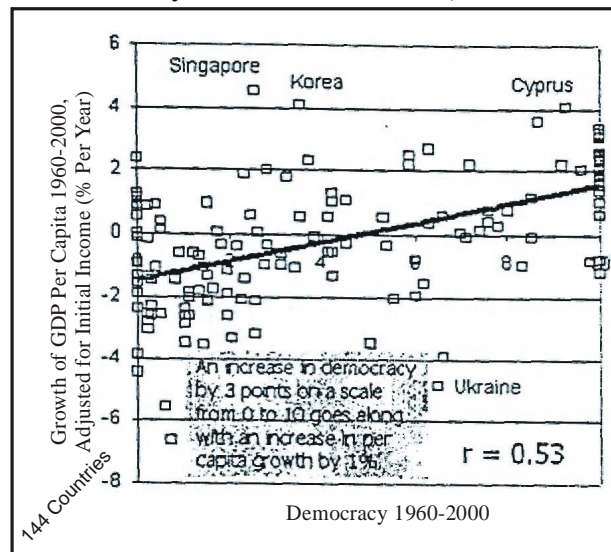
This conference hopefully is the beginning of a new domestic research agenda on the issue of governance and institutions. We hope that it will bear fruit!



**Fig. 3. Voice and Accountability and Growth****Fig. 4. Private Investment Has Grown Faster in Countries with Better Investment Climates****Fig. 4. Relationship between Income and Institutions**



### Democracy and Economic Growth, 1960-2000



*Regulatory Burden*—the relative absence of government controls on goods markets, banking system, and international trade.

### Regulatory Burden

