

whelmingly that current expenditures, excluding interest payments, commanded some three-fifths of central government expenditure for the region. Such dominance has limited the government's ability of focusing on the essential tasks and contributed to the region's notoriously high levels of corruption. India and Pakistan, for example, have repeatedly finished at or near the top of the yearly corruption rankings by Transparency International.

The economic consequences of such skewed governance are severe (see chapter 4). Tax collection is meagre: a mere one per cent of the population pays income taxes. South Asia collects around 10 per cent of GDP in taxes, compared to the average tax revenue collections of 15-20 per cent of GDP in developing countries. Yet a bigger irony is that most of these taxes fall far more heavily on the poor and the middle class than on the rich. Nearly seventy per cent of the region's total tax revenue is obtained through levying indirect taxes.

This crushing burden of taxation on the poor is not only enormous, it is also increasing. In Pakistan, for instance, tax burden on the poorest section of the population has increased by more than 10 per cent even though tax incidence on the rich has declined by more than 4 per cent. Meanwhile, in many countries direct taxes as a proportion of GDP have actually fallen in the last decade, while huge sectors of society—most notably, agriculture—remain under-taxed or untaxed. Last year, the government of Pakistani Punjab collected less than one billion rupees in agricultural taxes, compared to a target of two billion rupees for the year, which in itself was a fraction of the actual potential.

The rich and the powerful continue to buy immunity from the tax system. There is a great deal of competitive tax evasion in South Asia today. The *1998 Global Competitiveness Report* ranks India as among the top five countries noted for tax evasion. In Pakistan, annual tax evasion was nearly equal to the entire fiscal deficit in 1998. On top of this, there

is an elaborate web of tax concessions by the state, variously estimated between 2 and 3 per cent of GDP in most South Asian countries. These tax amnesties are often decided by political imperatives, not economic rationale. While the rich get all sorts of favours from the state, a large part of the society lives outside the formal economy. In nearly all South Asian countries, black economy is equal to or even larger than the agriculture sector, in terms of its contribution to GDP.

Much of the informal sector has no access to formal credit, even though businesses with strong political connections manage to get huge loans from public banks without even the need of paying them back. This has led to the build up of a large stock of non-performing loans. Such infected portfolios of public banks represented 21 per cent of total advances of public banks in South Asia, with a large part of these liabilities held by a few influential borrowers. In Bangladesh, just one per cent of borrowers accounted for 21 per cent of defaulted loans of Nationalized Commercial Banks (NCBs).

Even the low levels of revenue that governments collect largely fail to materialize into pro-poor expenditures. The bulk of public spending in South Asia is directed away from social and development expenditures towards providing non-merit subsidies, making up for losses of public corporations, maintaining a large force of civil servants, and providing for external defence. With the notable exception of Maldives, social sector expenditures in South Asia remain low at less than 5 per cent of GDP. This happens at a time when a large proportion of expenditures is spent on low human priority areas. A few illustrations from South Asia:

- For every dollar spent on social sectors, Pakistan and India spend 4.32 and 1.70 dollars on defense and debt servicing, respectively. Military expenditure in Sri Lanka (as a percentage of total public expenditure) has increased by 450 per cent between the period 1981-97.

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## South Asia at cross-roads

### The Hope

### The Challenge

#### Economic Governance

- Distortionary trade taxes have declined by 24 per cent since 1980.
- Overall budget deficits have declined from 8 per cent to 5.9 per cent of GDP since the implementation of adjustment programmes.
- Military spending as a percentage of combined health and education expenditures has declined by 36 per cent since 1985.
- Annual inflows of foreign direct investment have increased by seven times since 1990.
- The annual growth in government consumption has halved since 1980.

- Only 1 per cent of the population pays income taxes; direct taxes form only 29 per cent of total tax revenues.
- Capital expenditures, including development outlays, have declined from 8 per cent to 5.3 per cent of GDP since adjustment.
- For every dollar of central government expenditure on social sectors, \$8.65 are spent on defence and debt servicing in Pakistan, and \$3.12 in India.
- Non-performing loans constitute 21 per cent of total advances by public sector banks.
- The size of the black economy has been estimated to be around 25-35 per cent of GDP.

#### Political Governance

- 99.9 per cent of people now live under democratic regimes.
- More than 40 per cent of the parliamentarians have a first degree.
- In all South Asian countries, women have had the right to vote for more than 25 years.
- There has been no war between South Asian states for more than a quarter of a century.

- The military has been in power for nearly half of the independent existence of Bangladesh and Pakistan, and commands considerable influence.
- Almost half of the parliamentarians in India and Pakistan are landlords.
- Though women are half the electorate, they hold only 7 per cent of the parliamentary seats and 4 per cent of the national cabinet posts.
- Since 1970, three times as many Pakistanis have been killed in civil strife as the number of casualties in its three wars against India.
- The war with the LTTE costs Sri Lanka \$1 billion and three percentage points of growth every year. Nearly 55,000 people have lost their lives in this battle.

#### Civic Governance

- Technological breakthroughs have considerably reduced state control over the media.
- South Asia has a strong tradition of NGO movements; with well over 100,000 NGOs operating in the region.
- Private-public partnerships like the Citizens' Police Liaison Committee (Karachi) are being encouraged throughout the region.

- All governments exercise varying degrees of control over TV, radio, and the print media.
- NGOs across South Asia tend to be large in number, but small in scale—even in Bangladesh, the largest NGOs reach less than 20 per cent of landless households.
- The private sector's choice of civic activities remains arbitrary and voluntary.
- Tensions between governments and NGOs are yet to be eliminated.

- In 1998, Sri Lanka transferred 2.7 per cent of GDP to public corporations and institutions, with a large part of this transfer being used to cover the deficits of public enterprises. Such losses were around 2 per cent of GDP in Bangladesh and Pakistan.
- The Indian government spends close to 11 per cent of GDP on subsidizing goods whose provision has a limited, if any, impact on poverty reduction. In Sri Lanka, for every one dollar of public expenditures spent on the social sectors, 63 cents are spent on subsidies.

A weak tax effort and non-prioritized expenditures have contributed to the prevailing fiscal crisis. On average, the annual budgetary shortfall in South Asia equals 6 per cent of GDP. To its credit, South Asia has undertaken some structural adjustments in recent years. But even here the burden of adjustment has fallen on the poor. The axe of expenditure cuts has largely fallen on social and development expenditures.

Such endemic deprivations become the breeding grounds for crime and violence in South Asia's increasingly polarized societies. The threat of crime and violence pervades all over South Asia. Besides being ravaged by a two-decade old civil war, Sri Lanka has the region's highest rate of murders and armed robberies with 9 murders and 20 armed robberies per 100,000 people. Similarly, Bangladesh recorded the region's highest rate of car thefts with 261 car thefts per 100,000 vehicles. The most vulnerable in South Asia remain the most abused. Bangladesh had the region's highest rate of rapes with 10 rapes per 100,000 women (1996). Out of all the rape victims in Punjab (Pakistan) last year, more than half were minors. Since 1994, there have been 23,000 dowry deaths in India. Also, there are more than 100,000 child prostitutes in South Asia.

With life so insecure and liberty so vulnerable, South Asia is in need of a new compact between the people and the state. Without such a compact, without an abiding belief by citizens that the

government can fairly provide for them and adjudicate disputes among them, the region has seen in recent years a bewildering maze of battles between competing interests—pitting caste against caste, Muslim against Hindu, Tamil against Sinhalese, 'mohajir' against Sindhi, and, ultimately, the rise of insurgencies and criminality.

The government's ability to deliver the most basic goods is further weakened by endemic corruption. As chapter 5 details, corruption is pervasive in South Asia. It has led to a shift in government priorities away from crucial services and towards areas that afford greater rent-seeking opportunities. Evidence of corruption in South Asia is widespread: in reduced availability and increased cost of basic social services, in allocation of resources for mega-projects, and in the breakdown of rule of law. There is a growing perception in many parts of South Asia that corruption has floated upwards—from petty corruption in the 1950s, to mid-level corruption in the 1960s and 1970s, to corruption at the very highest levels of the state in the 1980s and 1990s.

The huge governance challenges faced by the region have been articulated with clarity and vision by many regional leaders, yet few reform attempts have been successful. The prevailing political factors stood in the way of reforms. Mahbub ul Haq faced that problem himself, first as Chief Economist of Pakistan in the 1960s and then as Finance Minister and Planning Minister during the 1980s. Many of his most-prized goals—the imposition of an agricultural tax, for example, or the establishment of an effective primary-level education system—faced insurmountable political hurdles. Others, such as the development of rural areas or poorer regions like Balochistan, were thwarted by the dominance of a centralized state structure.

It has never been in dispute that economic planning requires the cooperation of political leaders. To see the consequences when governments simply ignore the needs of the poorest,

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