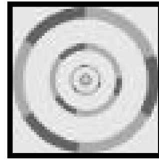


Chapter 4

Economic Dimensions of Governance

Governments in South Asia are getting bigger without getting better

Harnessing the productive potential of its human and physical resources and generating a broad-based and equitable process of growth remain an elusive dream for policy-makers in South Asia. By and large, the South Asian states have not been effective instruments of social and economic development. This is despite the states' pervasive role in the economy through the activities of the central government, provincial and local governments, specialized agencies, public enterprises, and government-owned financial institutions.

The giant's robe

'Now does he feel his title hang loose upon him, like a giant's robe upon a dwarfish thief'

Shakespeare

South Asian states are both giants and dwarfs. They are giants in terms of the number of people they employ, the number of bureaucratic controls they exercise, the amount of rent-seeking they generate, the size of the army they maintain, and the pervasive influence they exercise on economic activities. But they are dwarfs in terms of their ability to generate equitable and sustainable economic growth and to expand social and economic opportunities for their teeming millions.

Table 4.1 The growth of the South Asian state

Country	Total public expenditures (As a % of GDP)			Government consumption (Avg. annual % growth)		Government consumption (As a % of GDP)	
	1980	1995	1998	1980-90	1990-7	1980	1997
Bangladesh	10	14.2	14	5.2	6.3	2	4
Bhutan	34	42	n/a	0.27	0.13	25	17
India	24.5	29	33	7.7	3.5	10	10
Maldives	44	48	51	0.28	n/a	12	n/a
Nepal	15	18	19	7.2	6.0	7	9
Pakistan	18	23	21	10.3	0.8	10	12
Sri Lanka	41	29	26	7.3	7.2	9	10
South Asia	**22.5**	**26**	**29.4**	**8.0**	**3.6**	**9**	**10**

Source: GOM 1998; GOP 1998c; IMF 1998a, 1998d, 1999b; World Bank 1996b, 1998k, and 1998p.

The key problem hindering efficient economic management in South Asia is that the states are too big in unproductive areas and too small in essential areas. South Asian governments have over-extended themselves in production and trade that has created inefficiencies, generated corruption opportunities, and promoted wasteful expenditures. They have also, till recently, relied heavily on economic controls, which have resulted in large economic rents accruing to a few. In contrast, the South Asian states look ever more fragile in their performance in areas that are deemed essential for any responsible state, such as providing social services, redistributing resources, instituting fundamental reforms, ensuring macro-economic stability, managing external shocks, and in coordinating its own policies.

Governments in South Asia are getting bigger without getting better. While per capita government expenditure has increased from $25 in 1975 to $56 in 1995, the number of people in poverty has increased from 270 million in the 1960s to approximately 515 million in 1995. The central government's expenditure (as a per cent of GDP) has increased from 14 per cent to more than 17 per cent in the last twenty-five years, while the number of illiterate adults has increased from 280 million to 395 million over the same period.

Country-level data backs this picture of states that are growing in size but shrinking in effectiveness. Table 4.1 shows the trend in total public expenditure (as a percentage of GDP) in selected South Asian countries. There is a steady increase in the size of the governments across almost all the countries. While there has been some

reduction in central government expenditures (as a percentage of GDP) in India and Pakistan, it has been more than offset by increased spending by state governments. Similarly, while annual growth in government consumption expenditures has, on average, more than halved since 1980 in South Asia, it still remains nearly three times as high as that of Sub-Saharan Africa.

A good deal of these rising expenditures have failed to touch the lives of ordinary people. Not only do expenditures for social and economic development remain inadequate, there is a modest decline in such expenditures as well. Figure 4.1 shows the declining share of development expenditures in total public spending in many South Asian countries. What is more, a large part of these expenditures remains inefficient and open to waste and corruption—as discussed in the subsequent sections of the chapter.

Much of the growth in government consumption comes from increase in the physical size of the government apparatus. For instance, public employment in Bangladesh's civil service has more than doubled since 1971, and the number of government ministries in 1994 were twice as high as those in some of the well-governed countries, such as Japan and the United Kingdom. This is while Bangladesh cannot finance its budget from its own resources and has to depend on foreign aid even for financing consumption expenditures.

South Asian states played a similarly large role in production and trade. Instead of defining an efficient and non-distortionary framework for private enterprise, some states decided to play a direct role in the provision of even small services, such as car rental services and tourist hotels. Thus, the states indiscriminately extended themselves to providing goods and services for consumption, though the original intention was to build a strong industrial base with a particular focus on developing basic industries, where the private sector could offer limited assistance.

The states' massive involvement in production can be gauged from the fact that in 1975 the public sector in Sri Lanka accounted for 63 per cent of the ownership of tea acreage and for 54 per cent of the total value of production in manufacturing. Despite a marked reduction in this role recently, public enterprises still continue to enjoy a dominant influence. In most South Asian countries public enterprises still have a sizeable investment share in total domestic investment. This share is often more than 25 per cent of gross domestic investment. In Nepal it is as high as 50 per cent.

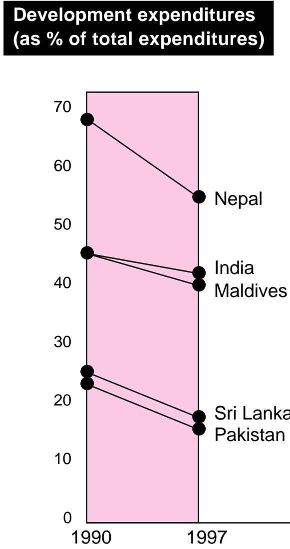
Many of these public enterprises, along with other domestic industries, were protected from global competition through such tools as industrial permits, quotas, import controls, and over-valued exchange rates. Such intrusion into economic activity was so severe that in some countries like India investors were required to obtain licenses from the government for establishing or relocating a plant and even for expanding the production beyond a limit of 5 per cent a year.

However, despite this over-extended role in production and trade, most South Asian countries have an appallingly poor record in the delivery of basic social services. As the 1997 Report on *Human Development in South Asia* illustrates, the region has emerged as the most deprived in the world, with the world's highest levels of illiteracy, malnourishment, and poverty. Though the past five decades have seen improvements in several social indicators, South Asia still faces a huge challenge of providing an overwhelming number of people with the means to meet even the most basic needs of shelter, health, safe drinking water, primary schooling facilities, and sanitation (table 4.2).

What has been the outcome of this growing economic importance of the South Asian states? The states' pervasive influence in economic activities lowered both growth and human development. Paradoxically, many of the objectives for

Most South Asian countries have an appallingly poor record in the delivery of basic social services

Figure 4.1
Shrinking development expenditures



Source: GOP 1998c; GOM 1998; HMG 1998b; IMF 1998d; World Bank 1996b.

this active role of the state, such as preventing industrial concentration and achieving national self-sufficiency, were also defeated. Barriers against foreign competition through the imposition of bureaucratic controls created a systematic bias against the development of agriculture, exports, and the private sector. Over-valued exchange rates and trade controls not only retarded the growth of exports but also ended up transferring resources from agriculture to the non-agricultural sectors. Depressed prices for the farmers took a heavy toll. Pakistan's agricultural sector alone transferred about 11 per cent of GDP in the 1970s, declining to 2.3 per cent of GDP in 1987—just a year prior to economic reforms. Similarly, government's unnecessary involvement in production crippled the development of private sector. The private sector became a 'mirror image of the public sector: inefficient, reliant on subsidies, and forever infant' (Desai 1998).

The private sector became a mirror image of the public sector: inefficient, reliant on subsidies, and forever infant

But the impact of this 'license raj' in South Asia appears even more damaging if the costs of rent-seeking are properly accounted. An elaborate system of bureaucratic controls created self-defending 'iron triangles of interest groups' that fought for their own narrow interests to the detriment of the entire economy (Krugman 1993). Allocations of scarce quotas and permits proved to be a financial boon for industrial giants, powerful bureaucrats, and self-serving politicians. Scarce resources that could have been far better spent on actual production were frittered away in influencing government decisions.

Such policy distortions contributed a great deal in holding down economic growth. Isolation from global markets reduced economic growth in South Asia by 1.2 percentage points annually between the period 1965-90 (ADB 1997). In 1964, the costs of rent-seeking in India were estimated to be roughly 7.3 per cent of GNP. Similarly, in 1963 Pakistan sacrificed more than 6 per cent of GDP due to policies of protectionism. With slippages in economic growth, human development suffered as well. This is clear from recent research that shows how social indicators, such as life expectancy and infant mortality, may deteriorate due to falling growth in incomes (Commander et al. 1997).

The imbalance between an expanding state machinery and decreasing economic growth and human development levels is not unique to South Asia. An examination of cross-country data clearly reveals how certain patterns of government expenditure are directly associated with significantly lower levels of per capita growth in incomes, and how state interventions in the foreign exchange market and the trade sector also lead to a decline in the growth rate. Similar evidence is found in a recent World Bank

Table 4.2 The state and the social sector

Country/Region	Percentage of people without access to				
	Healthcare 1995	Education 1995	Safe drinking water 1995	Sanitation 1995	Child immunisation 1995
Bangladesh	55	62	21	65	9
Bhutan	35	58	42	30	n/a
India	15	48	19	71	14
Maldives	25	7	4	34	n/a
Nepal	58	72	52	80	35
Pakistan	45	62	40	70	42
Sri Lanka	7	10	43	34	9
South Asia (%)	**22**	**51**	**23**	**70**	n/a
South Asia (No. of people)	**272,000,000**	**395,000,000**	**285,000,000**	**86,000,000**	n/a

Source: HDSA Tables; and World Bank 1998q.

study that shows that a country with an inefficient bureaucracy and greater policy distortions would have an annual growth rate that is seven times lower than that of relatively well-governed countries (Commander et al. 1997).

The correct lesson to draw from this evidence is not that the government has no role to play in economic development, but that a positive role requires not an expansion in the scale of government activity, but an increase in its effectiveness and a major reallocation of its resources. Achieving social objectives does not call so much for increased spending as for the reallocation of existing expenditures. It requires that the government should take itself out of the productive sectors and into the social sectors. It also implies that while a large government size may or may not promote economic development, a bloated government with weak institutions is certainly anathema to economic progress.

South Asian states need to re-align their role so that they could actually formulate and implement economic policies in a manner that raises human development and generates equitable economic growth. By reversing their priorities, the states can play a vital role in improving the lives of the people. In fact, there is considerable evidence that when governments act rationally and logically, an increased state role can actually aid sustainable human development.

The most powerful evidence for the key role that the state can play in economic development comes from Japan and several other East Asian industrializing countries. In the 1960s, South and East Asia were at approximately the same level of per capita income. Governments in the two regions were also of roughly similar size. But the economic and social policies of the two regions differed a great deal. East Asian governments focused on high-quality primary education, outward-looking trade strategies, reforms in the land and credit markets, and a stable macro-economic environment.

South Asia, on the other hand, followed an inefficient and inequitable education policy that provided subsidies to higher levels of education, relied a great deal on primary goods exports and infant industry protection, failed to implement land and credit reforms, failed to generate a suitable macro-economic environment for the accumulation of savings, and excluded the private sector from key economic decisions. As a result, GDP in East Asia grew almost two to three times faster than that of South Asia, so that the region now has a per capita income twenty-seven times higher than that of South Asia. The Human Development Index (HDI) and Gender-related Development Index (GDI) of East Asia (excluding China) are also nearly twice as high as that of South Asia.

A positive role requires not an expansion in the scale of government activity, but an increase in its effectiveness

A small but effective state

The successful interventions of East Asian high performers were largely supported by political stability, rule of law, bureaucratic competence, and well-functioning institutions—distinct features of governance which are mostly lacking in South Asia today. The varying economic performance *within* East Asia itself has been attributed to differences in the quality of institutions (Rodrik 1997).

A smart state can 'pick' and create some winners in the industrial sector and provide them with the appropriate incentives to succeed in global markets, as was the case with some highly successful East Asian countries. However, when institutions are weak, even good intentions may not be enough. There are myriad examples of how institutional weaknesses have ruined innovative policies.

In some South Asian countries, many such strategic industrial and trade policy interventions may not succeed, since institutional capacity remains weak. In fact, the region has seen many infant industries picked wrongly as winners by policy-makers. What, then, is the lesson for South Asia? It needs to reform its institutions before emulating East Asia's

industrial and strategic trade initiatives. Table 4.3 envisages a more realistic role for the South Asian states.

There is a need to restructure the economic priorities and to re-focus efforts on the core areas where efficient economic management can lead to improved human development. More specifically, social sector development should move to the top of government's agenda. Not only should the governments spend more on social sectors but also focus on right priorities. But tight budgets may constrain such a major increase in social spending. South Asia is in the midst of a fiscal dilemma today. By and large, it has failed to balance its books and has considerable problems in raising and

Table 4.3 Role of the South Asian states

Essential agenda of a responsible South Asian state	*The provisions of collective goods* Infrastructure goods (roads, cables, irrigation facilities, etc.) Human and military security (external defence and internal order, etc.) Public health Establishment and enforcement of laws of property and contracts Macroeconomic management The production and spread of accurate information Regulatory framework for the efficient functioning of markets *The provision of goods with large externalities* Primary and lower secondary education Protection of common property resources (rivers, forests, common grazing land) *Equity considerations* Preventing abysmal poverty Possible mechanisms: employment schemesl pensions, efficiently targeted food subsidies, etc.
Possible roles of an activist South Asian state	*Intervening in markets with imperfect information* Regulation of monopolies Insurance Consumer protection Financial regulation *Equity-improving social insurance* Redistributional pensions Family allowance Micro financial services *Governing the market* Fostering markets Cluster initiatives *Industrial policy* Enhance competitiveness Identify productive industries Provide specialized help in credit and inputs to selected industries Incentives for foreign investment Risk-sharing for new industrial investment Technological help to small industries *Trade policy* A more open trade regime Export-oriented tax incentives consistent with WTO Selective trade protection to export-oriented industries Ensure minimisation of retaliatory trade sanctions

Source: Dasgupta, P. 1993; Haq 1997; and World Bank 1997g.

managing its resources. This has led to high levels of indebtedness and grave economic distortions. There can be no major hope for social uplift and poverty reduction, unless the key fiscal problems are properly addressed.

The fiscal dilemma

The recurrent dilemma in South Asia is that while the governments are trying to do too many things, they are failing to discharge their most essential economic role—that of managing their finances prudently. In modern times, maintaining a stable macro-economic environment is considered as important a public good as the maintenance of law and order and the provision of basic social services. This is because the macro-economic performance of a country largely determines the economic choices of present and future generations, and has a distinct bearing on the lives of ordinary people.

South Asia is living well beyond its means. It is spending far more borrowed money than it can actually retire through future economic growth. Such borrowing led to growing debt burdens and an increasingly 'captive' influence on the banking sector (see box 4.1). Fiscal discipline has been on the decline in South Asia since 1970. Budget deficits have consistently remained in the region of 5-8 per cent of GDP during most of the time in the last decade. Some countries like India, Pakistan, and Bangladesh have been able to get this deficit to around 6 per cent; others like Sri Lanka are still hovering around 8-12 per cent range.

Such fiscal indiscipline is favourable to neither growth nor human development. Many of the region's persistent economic ills, such as burgeoning debt liabilities, declining real exchange rates, rising interest rates, and greater macro-economic instability, can be attributed, in large part, to years of fiscal indiscipline. What is more, large and unsustainable deficits easily turn an economic regress into a human regress. This is because official response for deficit reduction often comes down hard on the people. Some obvious manifestations are: rising inflationary finance that hampers private investment activities and taxes poor people; frequent devaluationary exercises that increase the general cost of living; tax rate increases on a narrow tax base that reduce the purchasing power of ordinary people; and

Box 4.1 Banks in chains

The banking sector in many South Asian countries has been captivated by the financial demands of the state. Banks have been used for monetizing budget deficits and bearing the inefficiencies of public enterprises. In much of 1980s interest rates were manipulated to meet such credit requirements.

Domestic financing of budget deficits has been large: between 4.5 and 5.5 per cent of GDP. Large budget deficits have been financed by diverting depositors' money into government paper. A huge sum of money is printed to fill such resource gaps.

Public banks have also been holding liabilities of inefficient state owned enterprises. They have indiscriminately extended credit to keep such organizations financially viable. What is more, in many countries public banks are also mandated to lend to priority sectors, such as petty agriculture and small industries. In India, 40 per cent of total advances of public sector banks are earmarked for such priority lending.

This leaves limited resources for the private sector. And even here, those who enjoy political connections get the lion's share. Financial rules are often bypassed to accommodate the credit needs of influential borrowers. This has led to a build-up of a large stock of non-performing loans (see table). Though estimates vary, non-performing loans account for between 18-33 per cent of total assets in Nepal.

A large part of this is a wilful default on loans that are accumulated with the intention of not being returned. Much of this bad debt is concentrated among a small number of influential borrowers. In Pakistan, about 90 per cent of the defaulted loans are owed by the top hundred defaulters. And in Bangladesh the top twenty defaulters accounted for 21 per cent of the non-performing loans of Nationalized Commercial Banks (NCBs). Similarly, about half of non-performing loans in India emanate from lending for the priority sectors, which are open to much political abuse.

Worse still, the system often protects such defaulters. In many cases, loan amnesties are granted instead of stern punishment. In Pakistan, for instance, at least three deadlines have passed in the last two years, yet very few defaulters have actually been taken to task.

What has been the result of such gross financial indiscipline? The financial system has largely failed to effectively intermediate between savers and investors. It has diverted national savings away from the formal sector into dubious activities, reducing the profitability of the banking sector. Such inefficiencies of the banking sector are represented by large differentials between lending and deposit rates. Such differentials range from 0.2 percentage points in Sri Lanka to more than six percentage points in Bangladesh.

Non-performing loans[a], 1998
(as a % of total advances)

Country	NPLs
Bangladesh	37
Pakistan	29
Sri Lanka	21
India	18

a. In public sector banks only.

Source: GOP 1998h; IMF 1998a, 1998d, 1999b; and World Bank 1998k and 1999b.

Table 4.4 Public debt in South Asia, 1997	
Country	Total public debt (As a % of GDP)
India	61.5
Pakistan	91.2
Bangladesh	55
Nepal	64
Sri Lanka	85
Maldives	60
Bhutan	44.5

Source: GOI 1998b; GOP 1998h; GOS 1997a; IMF 1998d, 1999a, and 1999b; NESAC 1998; World Bank 1996b; World Bank and ADB 1998e.

frequent cutbacks in development expenditure that worsen the unemployment situation.

While public deficits (as a percentage of GDP) have declined in most South Asian countries in the last decade, fiscal adjustment is far from complete (figure 4.6). Unless the present fiscal crisis is resolved properly, both economic growth and human development would continue to receive major setbacks. In particular, the way these deficits are financed can have important implications for national economies. Budgets have often been financed through borrowing from home and abroad.

A worrying debt profile

South Asia has fast accumulated a large stock of public debt. Some countries like Pakistan, Nepal, and Sri Lanka have already crossed safe limits: public debt to GDP ratio exceeds 60 per cent in all these countries (table 4.4). But the use of public debt is more of a cause for concern than its size. Debt is more often used for reducing deficits than for enhancing development.

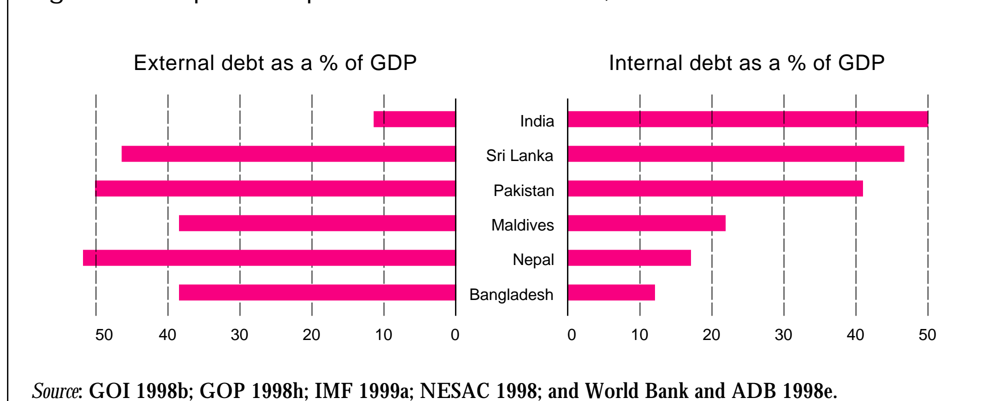
Except India, other countries of South Asia rely a great deal on external resources for financing their budget deficits. Nearly half of the region's budget deficit is financed through foreign borrowing. As a result, some countries have seen an explosive growth in their external debt. External debt (as a percentage of GDP) is 19 per cent higher in Pakistan today than in 1980 and the corresponding increase for Bangladesh is 7 per cent.

Nearly all South Asian countries have seen their domestic debt soar in the last decade. Thanks to a captive banking sector, South Asian governments financed their public deficits rather cheaply by printing and borrowing money domestically. Domestic debt exceeds 40 per cent of GDP in India, Pakistan, and Sri Lanka (figure 4.2). India presents a striking picture with its domestic debt about five times as high as external debt. In fact, internal debt (as a percentage of GDP) has grown by more than 42 per cent in India since 1980.

This increasing claim on a limited pool of domestic resources by the government does not come cheap. It shrinks the investible resources available to the private sector and makes them much more expensive. In 1997, domestic borrowing by the Government of Pakistan constituted about half of total credit expansion.

This significant rise in domestic debt, coupled with an increase in the external debt, has tremendously increased the debt servicing obligations. Interest payments have become the single largest expenditure head in central government budgets in India and Pakistan—often exceeding even the defence expenditures. Servicing past debt is becoming burdensome, since interest payments absorb an increasing proportion of tax revenues and export earnings every year.

Figure 4.2 A profile of public debt in South Asia, 1997



Source: GOI 1998b; GOP 1998h; IMF 1999a; NESAC 1998; and World Bank and ADB 1998e.

Debt servicing consumes 47 and 60 per cent of revenue receipts in India and Pakistan respectively. Similarly, India, Pakistan, and Nepal utilized about two times more export earnings on servicing debt in 1996 than that in 1980.

The situation in Pakistan is particularly worrisome. Since the early 1990s, debt servicing has been the fastest growing item in government expenditure—growing at 21 per cent per annum. All other items have either declined or remained constant in real terms. The unsustainable nature of Pakistan's debt can be realized from the fact that debt servicing has grown four times as fast as GDP during the 1990s. Even in a less indebted country like Maldives, public expenditures on debt servicing have increased by 17 per cent in the last two years alone.

Much of the rise in these interest payments comes from an increasing reliance on costly short-term debt. This is truer of both India and Pakistan, which, unlike other South Asian countries, have increased their reliance on short-term debt between the period 1980-96. In Pakistan, short-term debt has risen by over 100 per cent over the last five years.

Origins of the crisis

What produces these persistently high fiscal deficits that lead to lower growth and a worsening debt profile? Why this perplexing mismatch between resources and expenditures? The answer is reasonably straightforward: political leadership in South Asia has eschewed from fundamental reforms that are often required for mobilizing additional resources and prioritizing existing expenditures.

South Asia's fiscal matrix is an amalgam of sharp inequities and inefficiencies, both in its patterns of resource mobilization and allocation. Any convincing review of South Asia's unjust fiscal policy must first analyse how resources are raised and spent?

Reversal of fortunes: taxing the poor

Governments in South Asia have largely failed to institute a progressive taxation structure that could raise resources from all segments of the society, especially the rich. However, prevailing tax systems reward the rich at the expense of the poor and the middle class.

As discussed below, attempts to raise taxes in South Asia are inadequate, regressive, inefficient, and lack uniformity as well as transparency:

ADEQUACY. South Asia does not collect enough taxes. Tax to GDP ratios, which indicate the ability to tap resources from a growing economy, are low in South Asia. As figure 4.3 shows, compared to international standards, South Asian governments collect a meagre sum by way of taxes. On average, tax revenues in South Asia are only 10.4 per cent of GDP—lower than the developing country average of 15 to 20 per cent and the average of 24 per cent for high-income countries. It is particularly low when compared to several European countries, where tax revenues are between 35-40 per cent of GDP.

But what is even more significant is that these tax ratios are stagnating or declining in many countries. For instance, for the last many years the tax to GDP ratio has remained nearly stagnant in most South Asian countries, particularly India. In Pakistan and Sri Lanka it has recently declined by nearly three percentage points. This is a clear indication of a tax system that remains inelastic and non-responsive to growth in the economy.

South Asia's income tax base remains narrow, since most people refuse to pay taxes and are able to get away with it. Around one per cent of the total population pays income taxes. There are only between 1-1.5 million tax payers in Pakistan and Bangladesh each. Similarly, India has only 8-10 million taxpayers—though it has a sizeable middle class of 0.2 billion people.