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Improving institutional quality determinants

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Pakistan recently entered into an Extended Fund Facility (EFF) programme with International Monetary Fund (IMF). The programme has a medium-term (39-month) horizon, and in terms of goals and supporting conditionalities goes beyond the usual Stand-By Arrangement (SBA; a shorter-term IMF lending facility), to focus on not just meeting issues regarding balance of payments crisis, but also structural and institutional reforms of the economy. In the words of David Lipton, Acting Managing Director of the IMF, whereby the current programme being 'An ambitious agenda to strengthen institutions and remove impediments to growth will allow Pakistan to reach its full economic potential.'

The programme document has limited structural reforms suggestion, and even fewer institutional improving conditionalities. This indeed is in line with the overall trend of reform packages negotiated by the IMF with recipient countries. So nothing new here as such, which should not have been the case given the rethink in economic thought process towards political economy and within it heterodox approaches, especially after the global financial crisis of 2007/08.

The global financial crisis presented itself as a watershed situation, which exposed the wrong assumptions of economic policy based on neoclassical or neoliberal thought process. Primarily, under this rethink, a broader function of government and regulation is being suggested, with an overall greater role assigned to institutions in an endogenous way for positively impacting macroeconomic stability and economic growth. Here, research has also indicated - after making counter-factual studies of IMF programme countries in which economic policy focused more on improving institutional quality determinants - that IMF programmes were more successful in countries that had an initial better quality of economic institutions.

Otherwise, in countries where institutional quality was poor at the start of the programme, and when the focus also remained limited in improving such determinants, then the efficacy of policy instruments - like policy rate, exchange rate, taxes, or government expenditure - remained too limited to allow the programme to either achieve stability goals, or put economic growth on a stable upward trajectory. In fact, one of the consistent results coming out of this type of research is that IMF programmes during the last three decades or so had overall a neutral impact on economic growth, and that one of the main reasons for this was a lack of focus of programmes on improving institutional quality in recipient countries.

Yet this lesson has not penetrated much into the current IMF programme, where little focus is placed in improving institutional quality determinants. My own doctoral research indicates that during 1980-2009, by improving institutional quality determinants in Pakistan, economic growth could have been greater than what was achieved on average during those 30 years, while at the same time macroeconomic instability could have been lower. But such institutional focus was missing from both policy in general, and also one practiced under IMF programmes - where in decades of the 1990s and 2000s, the country remained a prolonged user of IMF resources. Sadly, the current programme also retains this lack of institutional focus attribute.

Therefore, the government should look to both revise the current programme with IMF to bring-in this missing focus, and also introduce broader institutional reforms outside of the programme; given the abysmal level of institutions in the country. The additional reason for doing this is because without improved economic institutions the programme targets of fixing macroeconomic imbalances, like high inflation, cannot be properly tackled. This is because, on the monetary side, better monetary transmission mechanism requires improved financial institutions and underlying organisations and markets, while inflation since being at least equally a fiscal phenomenon in developing countries, controlling it requires better performance of fiscal institutions to lower market failures on the real sector side.

At the same time, as indicated above, economic policy needs to be approached from the perspective of political economy, which means that both the political and economic institutional quality determinants are focused. In economic literature, determinants of Economic Freedom Index (EFI) are widely taken as a broad benchmark for improving institutional quality. Hence, in addition to focusing and tracking United Nations Sustainable Development Indicators, the government needs to focus and track these indicators, which are produced by the Cato Institute.

Hence, there are five sub-components of EFI, which are i) size of government; ii) legal system and property rights; iii) sound money; iv) freedom to trade internationally; and v) regulation; where each sub-component in turn has sub-indicators for measuring economic institutional quality.

Overall, the economic institutional quality has been falling according to EFI ranking, whereby out of 162 countries currently that have been ranked - where the country coverage has increased to the current level over the years - Pakistan in 1980 stood at the rank of being the 80th country in terms of economic institutional quality. Sadly, over the years a slide in rankings set in, whereby in 1990 the country had been downgraded to 81st position, in 2000 to 105th position, in 2005 it had slightly improved to 103rd position and after that it slipped quite drastically. Hence, in just five years in 2010, the ranking had already gone down to 120th position, in 2015 to 130th and in 2016 to 132nd; the most recent available ranking in this regard.

It is strange all the more then, as to why institutional quality determinants have neither been tracked on the lines indicated above, nor publicised as policy targets under various governments' or IMF's programmes. It therefore, needs to be made an agenda item of national economic authorities - led by Ministry of Planning and related provincial departments - to actively track and focus on improving these economic institutional determinants. Moreover, legislation may be brought to share the same in parliament for making available both greater accountability of government's performance, and creating broader channels for receiving feedback on institutional reform strategy.

Improving political institutional quality, at the same time, should be taken very seriously for improving both the quality of economy and its underlying institutions, but also for improving the quality of democracy and democratic processes. Here, in literature, political institutional quality is mostly brought into policy focus through the database generated internationally by Polity IV project. This dataset focuses on political institutional quality determinants that target areas of 'political structure and regime change.'

Other determinants that could be focused and tracked by government to improve political institutional quality, could include the ones produced by the World Bank in its Database of Political Institutions, and cover a host of political/governance-related variables. In addition, there are other indicators as well that could be referred to by government in evolving policy in this regard, and include Democratic Accountability (produced by International Country Risk Guide), Corruption Perception Index (produced by Transparency International), and the ones produced under the Political Terror Scale project.

The above can be taken as a sound starting point for Pakistan to understand the importance of focusing and tracking economic and political institutional quality. Without improving institutional quality determinants, policy effectiveness will remain limited - both within and outside of an IMF programme.