

## Preface

This “**Gedenkschrift**” honors Syed Shahid Husain, remembered by many as a very special person, who influenced the lives of countless people around the world in positive ways. As a World Bank official, he was an international civil servant of the highest caliber. He was both an exemplary leader and a superb manager of human and financial resources – clear-minded, strategic, courageous, fair and resolute. He served as Vice President in different parts of the Bank. At various times, he directed the institution’s development support for developing member countries in East Africa, East Asia and Latin America. Aware of the limitations of a project-by-project approach to development, he stressed the need for sound macroeconomic policies, and placed Bank assistance programs in a broader, strategic, context, an approach to development aid he pioneered. In other vice presidential roles, he engineered major improvements in the institution’s internal organization, staff management and some of its global programs, including agricultural research and debt relief for the most highly indebted developing member countries. He served Pakistan, the country of his citizenship, first as a government civil servant (1956-1962), later, as an advisor to Prime Minister Bhutto (1976) on leave of absence from the Bank and several years after retiring from the World Bank, he headed a committee set up by the Pakistan Government in 2001 to reform the tax system.

Several of his friends and former colleagues contributed to this volume. Some of those contributions are more personal in nature; others more scholarly. Two of Shahid Husain’s major speeches and obituaries published in the Washington Post and The Friday Times are also included.

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Pieter Bottelier and Shahid Yusuf  
Editors

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## **Shahid Husain in Africa**

By James Adams<sup>1</sup>

Shahid was promoted from Brazil Division Chief to a Deputy Director position in the Africa region in 1971 and subsequently to one of the Country Programs Director positions in Africa during the McNamara reorganization of 1972. Two years later, on July 1, 1974, he replaced Bernie Bell as the Regional Vice President for East Africa. This rise in the Bank was remarkable from a number of perspectives. At 43 he was the youngest VP in the Bank; his rapid rise from research staff economist to VP in 13 years was exceptional by any measure. In addition, the Bank leadership at that time was almost entirely European and American; his promotion represented the beginning of what would over time become a dramatic shift toward developing country leadership in the Bank.

When asked about this rapid rise, Shahid listed a number of factors. His effective and innovative leadership of the large Brazil program was recognized across the Bank; in his oral history<sup>2</sup> he noted that his regular reporting on economic and political developments was unusual for the time. Brazil's significant operational program required frequent Board appearances; in his oral history Shahid referred to his excellent relationships with the Board and his evolving relationship with Robert McNamara. He accompanied McNamara on his first visit to Brazil as Bank President. During his time at the Bank, McNamara's preference to personally chair Board Meetings meant that he frequently observed Shahid in action. In addition, Shahid often told the story about how his proposal to support lending to the steel industry to Brazil, initially rejected by senior operational management, was subsequently endorsed by McNamara on the basis of his appeal. Shahid's leadership in developing country strategies also impressed McNamara (discussed further below).

In fact, Shahid's Vice Presidency in East Africa would prove to be short-lived, particularly in comparison to his long tenures in East Asia and Latin America. He had served for less than 18 months when he returned to Pakistan as a senior advisor to Prime Minister Bhutto. What I found particularly interesting in reviewing his time in the region were the many examples of behaviors that would mature and emerge in full force in his subsequent positions of regional leadership.

Perhaps most clear were the MANAGEMENT priorities he set, starting from his first day as Deputy Director in Africa. In his oral history for the Bank he noted his immediate impression that his new Department was being "mismanaged" as a result of slow decision-making; he was particularly taken aback by his predecessors focus on fine-tuning written reports. Personnel decisions were

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<sup>1</sup> I had the pleasure of working with Shahid in all three of his regional assignments. I was a loan officer during his tenure in Africa and East Asia and served as Project Division Chief in the Latin America and Caribbean region. My interest in Africa reflects the 17 years I spent working on Africa in the World Bank.

<sup>2</sup> The World Bank has a standard practice of conducting oral histories with all senior managers and other staff involved in significant Bank activities. Shahid participated in the oral history project twice: in 1991/2 contributing to the book *The World Bank – Its First Half Century* and in 1994, discussing his personal career.

long delayed, resulting in many long-standing vacancies. Finally, Shahid saw little delegation of responsibilities – and was struck by the involvement of the entire management team in the negotiation of a Botswana project.

As other chapters in this volume explain more fully, Shahid would prove to be a very different kind of leader. His decisiveness was a strength – his willingness to make clear and quick decisions contrasted with that of many senior Bank managers who, in his words, often suffered from “paralysis through analysis”. Perhaps the most significant challenge Shahid faced in his tenure in Africa was the collapse of the East Africa Community. As some infrastructure operations of the Community were financed by loans (not IDA credits), there was a real concern that this collapse would result in arrears and put the Bank’s AAA rating at risk. Shahid moved quickly to visit the region and led the Bank’s attempt to restore confidence in the Community. This effort secured agreement on transitional payment arrangements, addressing Bank financial concerns, however it did not prevent the subsequent demise of the Community. After Shahid departed for Pakistan the Bank did support the decade long effort by Victor Umbricht to address all the financial issues that emerged from the break-up of the Community.

Shahid also embarked on an aggressive and effective approach to attract and groom staff. He filled positions quickly, seeking out high performers and younger staff interested in Africa. Shahid consciously worked to make his department (and subsequently the regions he led) “places to be” in the Bank. He developed a cadre of loyal staff that would reappear in his later assignments, typically in higher-level positions. To name a few: Stanley Please and Richard Stern worked for him in Africa and then in East Asia, Ping Loh worked for him in those two regions as well as in Latin America; and Pieter Bottelier worked with Shahid in Africa and Latin America. Shahid was particularly proud of his success in identifying staff who rose through the ranks of the Bank (noting that five staff that worked for him on Indonesia subsequently became vice presidents) and his efforts in promoting high potential female professionals in the Bank (Nancy Birdsall and Kathy Sierra in particular).

Third, Shahid believed in delegation. Confident in the staff he hired, he focused on strategy and gave his managers the resources and authority to address the many challenges of Bank bureaucracy. His desk was always remarkable clean, a clear contrast to the piles of files he observed when he was briefed by his predecessor in the Africa region.

Shahid believed that if you felt strongly about an issue and were prepared to fight for it, mobilizing Bank support was possible, indeed likely. He encouraged innovation and was always on the lookout for ways of increasing the effectiveness of the Bank.

From his early days in the Africa region, Shahid also gave clear priority to a number of areas that he felt were critical to successful Bank work. Perhaps most important was his consistent and determined focus on COUNTRY STRATEGY – a marked departure from the Bank traditional focus on individual projects. In his oral history he noted his initial failure to convince the Operational Vice President Burke Knapp that there was a need to establish a “lending program” for Brazil as opposed the “project-by-project” approach. However, his position was subsequently validated -

after McNamara became President and insisted on the development of Country Program Papers (CPPs), Shahid produced the initial Brazil CPP. Its emphasis on country strategy and its explicit longer term lending program was warmly endorsed by McNamara.

Country strategy papers became a center of attention for Shahid during his tenure in Africa and remained so in each of his subsequent regional assignments. Steve O'Brien, lead economist for Tanzania, noted Shahid's personal interest in developing the 1976 Tanzania CPP; given McNamara's support for Tanzania, Shahid wanted to ensure that a larger program would be well-presented and justified. I personally saw Shahid's interest in country strategy in the early 1980s in East Asia when I coordinated work on the Indonesia strategy. Shahid specifically endorsed the "parallel track approach" recommended in the paper – an innovative operational strategy that explicitly separated lending delivery from the broader analytic work on potential policy improvements.

Another feature of Shahid's leadership was that he gave considerable priority to ANALYTIC WORK during his tenure in Africa. He believed that projects could not be sensibly assessed in the absence of a clear understanding of sector policies and the macroeconomic situation. He paid particular attention to expanding the macroeconomic work in the region and there was a rapid expansion of positions for macroeconomists across the region. All the major regional borrowers were the subjects of large and comprehensive "Basic Economic Reports" and regular "Country Economic Memorandums" updating relevant information on all borrowers in the region.

In his oral history Shahid underlined the need to integrate economic work with operational work. Perhaps the most powerful signal to this effect in Africa was his decision to move Stanley Please from the Chief Economist position to a Country Director position. Stanley was a product of the Bank's research establishment and with this reassignment, Shahid made it clear that he expected Bank operational work to be firmly grounded in solid economic analysis.

One of the specific operational consequences of Shahid's increased attention to macroeconomic challenges in Africa was the expansion of regional work on so-called "Program Lending" to address the foreign exchange issues that emerged after the large hike in oil prices in the mid-1970s. Shahid actively supported the country-by-country efforts of Stanley Please to combine macro policy reforms with "exceptional" fast disbursing Bank lending. In many ways this work was an important precursor to the Bank's broader efforts to support "Structural Adjustment" in the 1980s. Shahid and Stanley clearly understood that broader policy reforms were needed to bring about long-term macro balance. They were prepared to shift staff and financial resources from traditional project aid to program lending in order to support such reforms. Stanley subsequently developed this theme in his book on the World Bank; "the Hobbled Giant"; in his later Bank assignments, Shahid would consistently insist on the centrality of sound macroeconomic and sectoral policies for development.

While his focus on country work and macro issues was clear, Shahid also made a point of ensuring the timely DELIVERY of regional lending programs during his tenure in Africa. He fully recognized the resource constraints across the region and sought to ensure that the significant resources

that IDA provided to Africa were fully and effectively deployed. I remember well the compliments he gave to the regional transport group at the end of the fiscal year when they fully met their commitments on project numbers and lending amounts. This emphasis on efficient delivery continued throughout all three of Shahid's regional assignments

Shahid was an early advocate of DECENTRALIZATION of staff to Africa. A number of new offices were opened during his tenure in the region and the Regional Mission in East Africa (Kenya) was the largest field office the Bank had. Shahid felt the Bank staff needed to be more aware of local circumstances to be effective. In his later tenure in East Asia Shahid would retain the unique decentralized position of Director in the Indonesia Office; a good argument can be made that this emerged as the Bank-wide model for Country Directors after the 1997 reorganization of the Bank by Jim Wolfensohn.

During his career in the Bank Shahid spoke with increasing force about the weak INSTITUTIONAL CAPACITY that marked many countries, particularly in Africa. In his oral history he specifically identified differences in institutional capacity between East Asia and Africa and the resulting large gaps in performance. He related this to the much stronger tradition of education in Asia and, to underline his view on how important education was, he personally insisted that the first Bank loan to China would be for an education project focused on strengthening its higher education system. In the oral history he specifically linked the manpower shortages in Africa to poor economic performance, noting the acute shortage of capable local officials to implement the large number of donor program in the region. He also made the point that in agriculture the Bank's attempt to use former colonial civil servants to increase capacity was a failure. He observed that the background of most of these colonial officers was in plantation agriculture, not in dealing with the challenge of addressing the small-holder farmers in the region. He underlined the importance of "ownership" to program success in his oral history and his view on the need to place a higher priority on the development of in-country capacity would prove to be a key theme of the work he led on reforming the Economic Development Institute.

The very limited success of external aid for Tanzania illustrates some of the broader development issues faced by the Bank during Shahid's tenure in East Africa. The story of McNamara's enthusiasm for Julius Nyerere and his efforts at African socialism is well known. McNamara and many others saw in Nyerere a strong leader whose emphasis on poverty reduction, rural development, integrity and nation-building efforts was unique in newly independent Africa. Particularly after the 1973 Annual Meeting in Nairobi and his speech on the priority of rural development, McNamara saw in Nyerere a leader whose priorities jived with his own for Africa. Hence the Tanzania program was rapidly increased with a special emphasis on integrated rural development. When Shahid met Nyerere he was similarly impressed; in his later life Shahid continued to maintain that Nyerere was one of the most impressive leaders he ever met. Reflecting this view, Shahid provided effective leadership to the effort to expand Bank efforts in the country throughout his tenure in East Africa. However, by 1980 the failure of Tanzania's macro policies had become clear; in spite of the large inflows of development aid, the last five years of Nyerere's leadership would be marked by a significant economic collapse.

With the passage of time Shahid made it clear that he did not regret his judgments on Nyerere's integrity or his many accomplishments in nation-building; indeed, he felt that the benefits of Nyerere's leadership in the social areas remained apparent much later.

However, in reflecting on Tanzania's economic performance, Shahid did endorse the view that Tanzania's macro policies were a complete failure and that the Bank's assistance program for that country was largely ineffective in addressing those issues.

More generally, Shahid was very critical of the Bank's failed efforts in agriculture in Africa. He felt that the Bank underestimated the complexity of the agricultural and rural development challenges in Africa. He emphasized the disconnect between the institutional capacity of African countries and the technical/managerial requirements of the Bank's integrated rural development projects. In his oral history, he stated that many of the Bank projects were "alien to African governments", and that the Bank "didn't focus sufficiently on the issues of trade, pricing and marketing which ultimately had to merge with the projects if they were to work".

After leaving the East Africa Region, completing his assignment as economic advisor to PM Bhutto of Pakistan and finishing his five year tenure heading East Asia, Shahid was asked in 1983 to lead the central technical department of the Bank, the Operational Policy Staff (OPS). In his oral history Shahid expressed the view that this assignment involved him in many of the key policy issues in Africa. While noting that this was not his favorite job in the Bank, he added that chairing the Consultative Group on International Agriculture Research (CGIAR) was a rewarding experience. He appreciated the interaction with research scientists and played a key role in organizing the SPAAR, the Special Program for Agriculture Research in Africa.

Shahid's oral history also noted that the OPS policy work on agriculture, population growth and the environment opened his eyes to the challenges facing the continent in each of these areas. He concluded that the Bank efforts in integrated rural development overtaxed the local implementation capacity, leading to a loss of real project ownership, that population growth was leading to significant land degradation and that environment issue had to be a greater focus of Bank analysis. All of these views informed his subsequent work on Latin America. I saw his interest in these issue first hand when he visited Kenya in 1985. His trip focused on the role of the locally based CGIAR institutions in Nairobi and included a field visit that reviewed the extension program and population efforts.

Finally, during his time in OPS a report was produced on debt, which argued that the initial Bank view that development country debt was largely a liquidity issue was incorrect. Using the case study of Cote D'Ivoire (among others) it concluded that the debt problem was structural and therefore required a fresh approach. In his oral history Shahid indicated that while the paper's conclusion proved correct over time, objections by Ernie Stern, SVP of Operations, and Anne Kreuger, the Bank Chief Economist, resulted in it not being discussed by the Board. While the Bank's subsequent work on debt and the resulting HIPC (Highly Indebted Poor Country) Initiative emerged after Shahid's departure from the Bank, the intellectual seed was planted earlier by

OPS. As the major beneficiaries of the HIPC program were in Africa, this clearly had an important impact on that continent.



## **Taxation and Rent-Seeking in Pakistan**

By Ehtisham Ahmad<sup>3</sup>

*The Confucian model administrator and changing incentives to cheat*

Shahid Husain started his distinguished career as a member of an elite “Confucian” band of capable and honest officials, selected through an open and competitive examination process, and promoted on merit. These officials, known as members of the Civil Service of Pakistan (CSP), or successors to the Indian Civil Service (ICS), had been instrumental in consolidating the State of Pakistan after independence, despite a fractious and weak political system. These officials also facilitated the initial emphasis on development and growth, through to the mid-1960s. There was a tremendous esprit du corps, and given the relatively small number of staff, they were subject to strong mentoring and oversight by more senior staff. They were relatively well paid and enjoyed tenure to age 60, and this fact insulated them, albeit in a decreasing manner, from the siren calls of rent-seeking that have now become the norm (see Yusuf, this volume).

The “Confucian model” is crucially dependent on the quality of the recruits, their training and mentoring, as well as a carefully delineated progression based on internal review and feedback mechanisms. This, in a modern world, especially with respect to tax administration places great emphasis on well-defined performance indicators. Chinese history provides examples of both successes and failures of an administrative progression model—and its modern day counterparts being reflected in the design of the State Administration of Taxation (since 1993), as well as needed institutions and monitoring mechanisms to prevent corruption in an administrative progression framework. The interactions with the political masters are extremely important in preventing rent-seeking.

But the rot set in at around the time that Shahid Husain joined the CSP. This happened for a variety of reasons, as successive military and then political leaders imposed their will, real incomes were cut and rents increased with the development strategy adopted. In the run-up to and design of the “much celebrated” Second Five Year Plan promulgated under the military ruler, General Ayub Khan, a senior member of the CSP group (Mr. Muizuddin Ahmad<sup>4</sup>) was Chairman of the East Pakistan Planning Board. Together with his very capable Bengali staff, he opposed

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<sup>3</sup> Senior Fellow, Development Research Center, University of Bonn and Asia Research Center LSE, and Sir Pao Yu-Kong Professor, Zhejiang University. Helpful comments from Pieter Bottelier and Shahid Yusuf and discussion with Nigar Husain are gratefully acknowledged. Nigar Husain also kindly permitted access to Shahid Husain’s papers. All errors are mine.

<sup>4</sup> Mr. Ahmad was a member of the ICS Bengal Cadre (1934) and had also served as Chief Secretary of the NWFP from 1948-1956, so was acutely aware of the needs of lagging provinces.

the disproportionate allocation of resources to West Pakistan, given the very substantial investment and social needs of the more populous East. This infuriated General Ayub, who removed Mr. Ahmad from this key position, but could not dismiss him, given the covenant that the ICS officers had signed with the Crown and which the Government of Pakistan had accepted. Ironically, Mr. Ahmad was reassigned as Federal Home Secretary to chase secessionists.

The overriding of “technical” objections from the majority province by the Ayub regime (and in the absence of a genuinely political determination of resource allocation) was to have disastrous consequences as it inflamed the perception of unfair treatment. Indeed, it gave a huge fillip to the secessionists who argued that an independent East Bengal—or Bangladesh was the only solution to the increasing disparities between the East and West, as much of the wealth of the country lay in the East due to its unique position at the time as a jute producer.<sup>5</sup>

Pakistan’s military masters did not brook opposition from the “independent” mandarins. It also became clear that the way to promotion lay in singing the praises of the President (a relatively junior CSP official was promoted to Federal Secretary for ghost writing the autobiography of the President: “Friends not Masters”). Starting in 1965, Ayub began chipping away at the CSP “covenant” by reducing the retirement age, and encouraging the “old guard” to leave—in a manner that has echoes in the restructurings in the World Bank and the IMF in recent years. When General Yahya Khan removed Ayub in 1969, in yet another military coup, he dispensed with niceties and just fired 303 of the old mandarins (and also briefly imprisoned the young turk who had authored Ayub’s life-story). Direct inductees who would be loyal to the new general in power, but lacked the intellect or moral standards of the old guard, replaced the mandarins.

Two other factors were critical in the interactions of the mandarins and the rent-seeking story in Pakistan.

The first is that the development model adopted relied on import substitution and protection. This generated huge rents for those lucky enough to be granted licenses. Given the class and “*baradari*” (clan) structures of the ruling elites, most of the beneficiaries of the largesse of licenses and preferences happened to be friends and relatives of the cliques in power (mainly in West Pakistan). These lucky few (or 22 families, as popularized by the famous economist, Dr. Mahbub ul Haque) were quite happy to share rents with those who made the Pakistan “miracle” possible.

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<sup>5</sup> See Ahmad (2015) for a historical summary of this critical period.

The disastrous 1965 war with India, led to a tightening of fiscal constraints and the imposition of sanctions. These plus the growing unrest and insurgency in East Pakistan as well as the lagging regions of West Pakistan, meant that there was little scope for increasing the pay and benefits of the mandarins. Consequently, their salaries were frozen in nominal terms. Subsequently, in 1972, a huge real cut in remuneration ensued following the 100% devaluation carried out by Bhutto in the wake of the separation of Bangladesh.

In addition, on coming to power after the separation of Bangladesh, Bhutto inducted hordes of political sycophants into the civil service (and incidentally, also into the ever increasing state-owned enterprises), diluting the quality of professionals and inflating the numbers of lackeys eager to do the bidding of the political masters.

The combination of “temptations”, due to the real cuts in living standards imposed on the civil servants, together with the increased “ability to capture rents” being created especially through the granting of licenses and tax preferences to encourage ‘infant industries’, led to the growing spiral of rent-seeking that has slowly enveloped the country.<sup>6</sup>

It is not surprising that the young mandarins, like Shahid Husain, who entered the CSP in the 1950s and 1960s, would be disheartened by their prospects in Pakistan, and would be attracted to the World Bank (others included S.J. Burki and Ishrat Husain; as well as Arif Zulfikar in the early 1970s). The quality of this group was never in doubt, and they excelled in an international environment, as they would have done in a more stable environment in Pakistan. Their departure was an incalculable loss to Pakistan, but Shahid Husain was to return to Pakistan<sup>7</sup> at two critical junctures in Pakistan’s history.

The first was as Economic Advisor to Bhutto in the 1970s. Bhutto’s nationalist fervor and socialist rhetoric had swept him into power in West Pakistan, with an inexperienced political team. He did the right thing and looked for advice, and turned to Shahid Husain as his personal economic advisor, given that the economic ministers had very little knowledge of economics or of the Pakistan economy. The sharp exchange rate adjustment and fiscal restraint helped stabilize the economy. But Bhutto’s populist promises: “*roti, kapra, makaan*” (bread, clothing and housing for all) remained largely unfulfilled given the growing fiscal constraints. There was also a growing pressure to prop up inefficient public enterprises—as Shahid Husain himself put it:

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<sup>6</sup> Unfortunately, after an initial growth spurt, the infants have turned into geriatric disasters and still on life support requiring continuing tax breaks and preferences.

<sup>7</sup> As did some of the others mentioned above, particularly Ishrat Husain who had two terms as Governor of the State Bank under General Musharraf’s administration, and has played a major institution building role in running Karachi’s Institute of Business Administration since 2008.

“I had a personal experience of this while serving as Special Assistant to the Prime Minister in the mid-seventies. In the Economic Sub-Committee of the Cabinet, too often the Minister of Production would press for import restrictions on commodities which competed with those produced in public enterprises and too often he would win the day. The alternatives of letting the plants be closed or sold were not acceptable to the government and improvement in management and efficiency were tasks for which enterprises were not geared. In the end the society as a whole paid a price in high cost and shoddy products.” (Shahid Husain 1989b).

With a weakening of his main constituency and growing opposition financed by the industrial and banking sectors, Bhutto decided to move quickly with widespread nationalization—going against the thrust of Shahid Husain’s advice. This would cripple the financial support for the opposition, and also provide an opportunity for the PPP to offer jobs to friends and relatives in the newly nationalized industries and banks. The reward and punishment theme came naturally to Bhutto, who came from a *zamindari* (feudal) background. The feudal mentality and autocratic proclivities unfortunately also made Bhutto impervious to advice. This would eventually lead to his downfall, in the aftermath of rigged elections in 1977. When Shahid Husain read about the nationalizations in the newspapers, over his morning bed tea, he packed his bags and returned to the World Bank to resume his stellar career.

*Rewards and punishment—the emergence of a new tax culture?*

The rewards and punishment approach to taxation is ingrained in the psyche of the *zamindari* culture. Indeed, it was the basis for tax farming, and upward revenue sharing, introduced by the Mughals. Local satraps collected their own rents and kept the balance after satisfying the demands of the Emperor in Delhi. This system was retained by the British, who chose to leave residual rents from land, in the hands of local governments. However, following the Government of India Act of 1935 (GOI 1935), which led to elected provincial governments, the split revenue bases were further delineated—both for the income tax, as well as indirect taxes. The crown kept the more important income taxes from growing income sources, as well as customs and excises on production, whereas the elected provincial governments had to make do with the relatively hard to implement single sales tax and the land tax.

As landed interest groups ran most of the newly elected governments, the land tax collapsed following the GOI 1935 (Dharma Kumar, 1983). While high tariffs and excises on tradeables generated revenues, these also added significantly to the cost of doing business, and made exports less competitive. The split revenue bases continued as part of the successor constitutions

in both India and Pakistan, and were unfortunately reinforced in Bhutto's 1973 Constitution.<sup>8</sup> This had the twin effects of generating "cascading", or unintended consequences of the tax system, including adding to the cost of doing business, and potentially creating barriers to domestic trade.

In Pakistan, these "distortive" tax handles had two additional characteristics:

- Exemptions, e.g., through Special Regulatory Orders (SROs) issued by the tax administration, then the Central Board of Revenue, could provide "rewards" or sweeteners to firms and individuals keeping on the right side of the government in power;
- And as a corollary of the above, they could also be used together with additional administrative hurdles and red tape, and a punitive direct tax system to "punish" those who strayed out of line.

Consequently, the Pakistani tax handles provided ample opportunities for rent seeking for the relatively poorly paid and unprofessional tax administration staff—these were typically manned by a junior service largely made up of people who could not make it to the elite "CSP" group in the competitive exams. Indeed, given the tanking domestic revenues, together with the economic sanctions imposed on Pakistan by some major trading partners after the elected PPP regime was overthrown and PM Bhutto executed, led General Zia to appoint a National Tax Reforms Commission, headed by a distinguished "mandarin" of the old order, Mr. Qamar ul-Islam.

In his cover note to the Finance Minister, Mr. Islam described the Pakistan tax system:

"as stated in our letter dated May 15, 1986 transmitting our interim report, the three basic maladies from which Pakistan is suffering at present are tax evasion, smuggling and corruption. These are inter-related and one feeds on the other."<sup>9</sup>

The Commission also referred to the existing complicated and archaic system of tax laws and recommended that the Government consider introducing a VAT in the medium term. In

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<sup>8</sup> It has proved equally difficult to amend the Indian Constitution to achieve a uniform VAT throughout the country, needed to reduce the costs of doing business, remove domestic trade barriers, and to generate information needed to "stop the cheating." The Indian saga continues at the time of writing.

<sup>9</sup> Letter from Chairman Qamar ul-Islam to the Finance Minister, December 31, 1986. Other members of the Commission included Industrialists: Syed Babar Ali, Haneef Adamjee; MNAs: Nawaz Khan Bugti, Gohar Ayub Khan and Sardar Assef Ali; Senator Akram Sultan; HU Baig (Finance Secretary); Hamid Habib (Export Promotion Bureau); Dr. Baqai (Planning Secretary) and Chairman CBR.

particular, the Commission noted that the actual sales tax collection (1982-84) was a shade over 10 percent of the true potential that could be realized if there were no exemptions.

Based on the University of Warwick/LSE (ODA, ESRC and World Bank-financed) research program on tax reforms in developing countries: Pakistan, India and Mexico, Ehtisham Ahmad and Nicholas Stern (later Chief Economist of the World Bank) made submissions to the Commission. These included proposals for the VAT, as well as more effective taxation of agriculture and land.

The tax/GDP ratio that had been 14 percent in 1980/1, or close to the developing country average, had declined to 11.3 percent by 1985—a period of military rule (see Table 1). The system was heavily reliant on the taxation of intermediate inputs, largely collected at the import stage, leading to significant divergences of the true tax element in the price of final goods relative to the tax rates on these goods desired by policy makers. The cascading also led to considerable production distortions and discriminated against exporters. Ahmad and Stern (1991, p.49) also described the tax system as reflecting a colonial heritage, weak administration rife with rent-seeking and incapable of financing the public expenditure levels needed in an independent Pakistan.

It is clear that the Pakistan tax system in the mid-80s compared unfavorably to that in virtually all groups of developing countries—with very weak collections of sales and income taxes. The bulk of the revenue was generated by high and distortionary taxes on tradeables and production—particularly import duties and production excises. This had negative impacts on production and exports, and unintended distributional implications.

Table 1. Pakistan's tax system in 1985 relative to other developing countries

	<b>Pakistan (1985)</b>	<b>All developing</b>	<b>Very Poor &lt;\$ 349</b>	<b>Poor \$350&gt; &lt;\$849</b>	<b>Middle \$850&gt; &lt;\$1699</b>	<b>Better off \$1700&lt;</b>
<b>Customs</b>	5.5	5.0	4.9	6.6	5.3	3.9
<b>Sales</b>	0.9	2.0	1.9	1.4	1.9	3.1
<b>Excises</b>	3.0	2.0	1.6	2.2	1.9	2.2
<b>Income and Corporate</b>	1.9	5.6	2.7	5.5	5.8	8.1
	11.3	14.7	11.1	15.8	14.9	16.5

Note: The tables are in terms of percentage of GDP and ranked by 1985 incomes per capita.  
Source: Ahmad and Stern (1991)

The cascading effect of the tax system was clearly apparent for sectors that were nominally not subject to tax or were subsidized. For instance, the effective subsidy on wheat was a third lower than intended. Further, a number of sectors were not taxed directly—either because the items

were consumed by the poor or were largely exported. For instance, zero taxes were levied on bidis, cotton ginning, small scale cotton textiles, carpets and rugs, made-up garments, printing and publishing, rubber and footwear, pharmaceuticals, sports goods, surgical instruments and bicycles—yet the effective taxes on these sectors were quite significant (see Table 2). The cascading effectively negated the policy design, and created impediments for exports.

Table 2: Nominal and Effective Taxes on Selected Sectors

Sector	Bidis	Cotton ginning	Carpets and rugs	Pharmaceuticals	Footwear	Sports Goods	Surgical Instruments	Printing and Publishing	Glass	Cement
Nominal tax	0	0	0	0	1.4	0	0	0	20.1	12.1
Effective tax	6.5	2.5	9.1	16.8	7.3	6.7	5.5	8.0	40.0	27.1

Source: Ahmad and Stern (1985 for the NTRC), see Ahmad and Stern (1991) Table 6.4.

Recognizing that the tax system discriminated against exports, a system of compensatory export rebates was in force in three slabs—the highest being 12.5 percent which applied *inter alia* to carpets, footwear, sports goods and surgical instruments. As seen in Table 2, this over-compensated for the effective taxes on these sectors, and formed a pure export subsidy, as well as loss of revenues to the exchequer.

Ahmad and Stern (1985 in the submission to the NTRC, see also 1991) argued that the VAT needed to be the centerpiece of the tax reforms in order to ensure that:

- The tax base is widened;
- Revenues are effectively increased;
- Avoid the cascading associated with the cumulative taxation of intermediate goods and raw material inputs;
- Provide an accurate basis for the calculation of refunds for exporters;
- Provide a basis for cross-checking of returns, and assist with the true estimations of the income tax liabilities in order to improve and strengthen income tax collection.

More recent research on tax and social policy in the presence of informality and cheating has shown that a properly designed VAT, by providing information on the value-added chain is one of the most effective instruments to “stop the cheating”, particularly in the income taxes (Ahmad 2015b, on the 2013 fiscal reforms in Mexico

The ramping up of the war against the Soviets in Afghanistan in the mid-1980s, brought a flood of external resources and as a consequence, the tax reform agenda was forgotten and the excellent Qamar-ul Islam Commission Report was buried. As described in Ahmad and Mohammed (2013), with the withdrawal of the Soviets from Afghanistan, and the collapse of the USSR, bilateral external assistance dried up. With the death of General Zia in an unexplained plane crash, political governments took office, and this time had to deal with the IMF as a balance of payments crisis unfolded, and bilateral support evaporated (see Ahmad and Mohammed 2013).

A GST was legislated by the Nawaz Sharif government in 1990, and reluctantly implemented by governments of both parties throughout the decade. The reason for the reluctance is that the penchant for rewarding friends of the party and punishing the others was a very strong incentive, as each of the main parties tried to replenish its election chests during their turns in office. Consequently, the GST was administered like an excise—usually with reliance on “reference prices”, and the advantages of the crediting mechanism were lost. It also became impossible to provide accurate export refunds—and cheating flourished.

Of course, with exemptions and SROs galore in the GST, the value chain was broken in any case. The rent-seeking opportunities for the parties in power as well as staff of the tax administration increased exponentially. Allegations of rent-seeking and incompetence were used to remove both main political parties (twice) during the 1990s, severely weakening the political process and accountability.

It is interesting that the removal of the special tax exemptions and preferences was a cornerstone of 1994 EASF, with the personal assurance made by Benazir Bhutto to Michel Camdessus. Indeed, the 1994 budget made a song and dance about the removal of a myriad of SROs, with only three additions. This was sufficient to fool the IMF for a brief period, and in the August 1994 Program review document the Staff claimed that the structural reform measure had been met. It was only later that the IMF staff discovered that the exemptions removed had been at the six-digit level (or even more detailed), whereas the “few” additions were at the 3-digit sectoral level. By now there was no official of the caliber of Shahid Husain to stand up and say that this deception was not in the interest of the people of Pakistan. Indeed, the officials sought more complex ways to “fool” the IMF staff, as was made clear when the “misreporting” episode was admitted (voluntarily) by the Musharraf administration. One however suspects that this was done largely to discredit the ousted Nawaz Sharif government.

General Musharraf took over a country in financial crisis, exacerbated by the sanctions imposed on Pakistan after it conducted six nuclear tests in 1998. The focus on domestic resource



mobilization resurfaced in a serious manner, and Shahid Husain, who had by now retired from the Bank, was invited to lead a tax administration reforms committee. The objective of the Committee was to restructure the fundamentals of the tax system that had not been addressed during a series of IMF programs and World Bank structural adjustment loans during the 1990s. These had failed because successive governments had not been able to address the issue of domestic resource mobilization, lurching from crisis to crisis (see Ahmad and Mohammed 2013).

*The seminal Shahid Husain report, and continuing challenges of governance*

The Qamar-ul Islam Tax Reform Commission had correctly described the then tax administration (Central Board of Revenue—CBR) as the most corrupt of institutions in the country; and warned that there would be little chance to increase the tax-to-GDP ratio to a desirable 20% of GDP level unless the CBR were reformed.

Recognizing that the weak and self-interested tax administration was one of the main reasons that the tax performance did not improve during the Bank-Fund supported programs in the 1990s, the Shahid Husain Committee<sup>10</sup> recommended a major transformation of the Central Board of Revenue. They proposed a revenue authority on modern functional lines, relying on information flows and audit rather than an administration organized by tax-type—and relying on direct contact with taxpayers. This set of reforms reflected the design of a similar policy framework, including in Argentina, when Shahid Husain had been Vice President for LAC:

“We have recently estimated that a comprehensive tax reform in Argentina that focuses on tax evasion and the elimination of tax exemptions will be able to increase revenues by 6% of GDP; and this is achieved by just maintaining the present (moderate) VAT of 15% and even reducing the very high marginal tax rates on the income tax.” (S. Shahid Husain, 1989, p.8).

The subsequent creation of the modern Argentine Revenue Authority in the 1990s was achieved under its highly qualified President, Carlos Silvani. Mr. Silvani was an experienced tax administration specialist who had held senior positions in the IMF. The revenue authority proposals represented a new way of thinking about the tax administration, linking the main domestic taxes under an integrated framework, and relying on arm’s length administration that used information and risk management. The removal of tax exemptions was central. This clearly also required a somewhat different organizational structure and skill set than the traditional practice of sitting down with taxpayers over a cup of tea and negotiating the tax due (either to

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<sup>10</sup> Government of Pakistan, 2001, *Report of the Task Force on Reform of Tax Administration*, Islamabad, April 14, 2001.

the state, or the tax officials personally). While the Bank had not been involved with this reform, Shahid Husain had learnt from it. The integration of domestic taxes along functional lines was also a key theme in the Shahid Husain report on Pakistan.

The creation of a functional administration facilitates the exchange of information between the VAT/GST and the income and payroll taxes, as the components of value added are wages and profits. A similar reform took place in the UK in 2004—where VAT was removed from Customs and Excise to be integrated with the income taxes under the HMRC (Gus O'Donnell, 2004). It is clear that the success of a tax administration reform depends crucially on the taxes it is meant to administer, as well as the efficiency of exchange and management of information. Conversely, a modern tax policy agenda may fail if the tax administration is incapable of handling the information exchange needed, say for a VAT or its interface with a modern income tax.

One of the most far-reaching mistakes made in the 1973 Constitution was to maintain the 1935 split in revenue bases, particularly for the sales tax. Bhutto had thought of services as comprising largely teashops and haircuts. In the modern world, it has become increasingly difficult to disentangle goods and services. And a key part of any effective VAT/GST program is to generate full information on all aspects of the value chain. This is critical in eventually removing all taxation from exports, and for reducing the costs of doing business. Countries from Mexico to Portugal to China are “fixing” their VATs to reduce taxes that cascade and add to production costs and substitute with the VAT. A proper VAT is also critical in generating information to prevent the evasion of income taxes (Ahmad 2015b). Musharraf’s reforms sought to ensure a unified administration of the GST, which was to be collected on behalf of the provinces by the CBR, thus maintaining the Constitutional division of revenues. However, even this modest advance was undone with the 18<sup>th</sup> Amendment.

Given the sanctions and pressures on financing, there was a major effort undertaken in the early years of the Musharraf regime to “clean up” the tax policy agenda, covering both the GST and the income tax. This included the legislation to permit an integrated operation of the VAT on behalf of federation and provinces (sidestepping the faulty assignments in the GOI 1935 Act as well as the 1973 Constitution). It also included the rationalization of the income tax (with assistance from the IMF’s Fiscal and Legal Departments). There was also an expectation that a reformed set of VAT and income taxes would more than compensate for the revenue loss due to removal of cascading tariffs and production excises—using lessons from the research conducted by Ahmad and Stern (who by then was Senior Vice President and Chief Economist of the World

Bank)<sup>11</sup>, and almost a dozen “red cover” technical assistance reports from the IMF’s Fiscal Affairs Department.

Shahid Husain’s views on tax policy were largely consistent with the corpus of literature on fiscal reforms in developing countries that had been generated including with support from the World Bank (as was the case with the Ahmad-Stern project). In the Pakistan context, Shahid Husain (1989b, p.23) stressed that “as external resources decline and a significant part of own resources are preempted for debt service, accent on domestic resource mobilization and an efficient use of resources would be crucial.....An essential adjunct to increased self-reliance and domestic efficiency will be freer trade and reduction of import restrictions and exchange rates which would make investments and production for exports as economical as for domestic markets.” This advice was not heeded until a decade later with the early Musharraf reforms, but required an additional contribution from Shahid Husain.

None of the tax policy reforms would be feasible without a revamping of the tax administration, and this is where the Shahid Husain report, issued in April 2001, was critical. While the Committee’s terms of reference<sup>12</sup> was narrowly defined to focus on tax administration issues, its context in the sequencing of the policy reforms was important. Speedy implementation of the administrative restructuring was critical to ensure that the policy measures introduced early in the Musharraf administration were “locked” in place.

The World Bank was asked to assist in implementing the tax reform package. However, a \$149m loan for the Pakistan Tax Administration Reform Project (TARP)<sup>13</sup> was only approved in December 2004. Rather than building on the Shahid Husain report, and beginning immediate operations, in time-honored fashion, the Bank loan proceeded to reinvent the wheel, largely ignoring the Shahid Husain report, as well as all the work on tax policy in Pakistan, including by then former Chief Economist Professor Lord Stern (partially financed by the Bank over the previous two decades). It also ignored the set of tax policy reports from the IMF for at least a decade. Indeed, the Bank task managers—rewarded for issuing contracts rather than the effectiveness of the project—initiated fresh assessments in all areas, critically losing time as the political space for the reforms disappeared.

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<sup>11</sup> The lessons of this important research project supported by the UK ESRC and ODA as well as the World Bank, had been extended to other countries, including China.

<sup>12</sup> The focus was on management and organizational structure of the CBR; human resources and compensation to address corruption, focus on processes and procedures with a view to using information for tax administration, and legal and administrative underpinnings of a new revenue authority.

<sup>13</sup> P077306, valid from December 31, 2004 to December 31, 2009.

Unfortunately, in the aftermath of '9/11' and with the resumption of bilateral aid flows, the Musharraf Government lost interest in the tax reforms. Rather than 'fixing the GST', the Musharraf/Shaukat Aziz administration removed all the productive and export-orientated sectors from the ambit of the tax. What is even more shocking is that the tax audit function was abandoned—all in the name of 'improving the business climate'. It is interesting to note that neither the World Bank (the TARP loan was functional by then) nor the IMF objected at the time. By now, Musharraf also had developed political aspirations and the SROs were again a handy tool. Unsurprisingly, with the reduction in tariffs and the failure of the GST reforms, the tax-to-GDP ratio plummeted by 2008 to around 10% of GDP (from around 14% in 2001), heightening the vulnerability of the economy. But the integration of the tax administration suggested by Shahid Husain had not happened, and the World Bank eventually admitted that nothing had been achieved by the TARP although a new FBR building had been constructed in Islamabad, and lots of fancy vehicles purchased. TARP was finally declared to be "unsatisfactory" in February 2008.

Part of the failure with domestic resource mobilization, despite the good start made by Musharraf, was due to the fact that the TARP had not led to the creation of a modern tax administration. The reality is that it did not suit Musharraf to relinquish the power to reward associates and influence people through the use of SROs. Rewards and punishments are as useful to military governments as to weak political regimes. The failure to implement the Shahid Husain Report lay in the incentives for rent-seeking facing the political masters as well as the narrow vested interests of the corrupt bureaucracy.

Indeed, during the Musharraf era, the efficiency of the GST fell drastically. Given that VAT/GST works with self-assessment and an 'arms-length' administration based on information flows and strong audit, the correct implementation of a VAT would have benefits for all the other main taxes. This was very successfully implemented in a range of countries, including China. The argument that VAT would not work well in countries like Pakistan because of informality mixes cause and effect. The VAT could become a tool to stem cheating and tax avoidance provided it is properly designed and implemented in an impartial manner—this is the foundation of the 2013 Mexican reforms.

With the resumption of the political process in 2008 and the effects of the economic crisis in which the Central Bank's largest ever reserves were lost within a matter of months, the newly elected PPP government (President Zardari himself) took a "home grown" program to the Friends of Pakistan meet in New York at the UN General Assembly in September. Reminiscent of Benazir Bhutto's discussion with Michel Camdessus in 1994, the centerpiece of the 2008 reform proposal was to 'fix' the VAT as central to turning around the dismal tax-to-GDP ratio. This was presented as proof of the new government's commitment to domestic resource mobilization and the main

structural measure to ensure its ability to repay a large new loan from the IMF. Again, reminiscent of the 1994 saga, a PPP government promised to revamp the tax administration and to submit a streamlined new VAT law to Parliament by end 2009. Mr. Carlos Silvani was engaged by the World Bank to revise the TARP, which was then extended from end-December 2009 to December 31, 2011.

It soon became clear that the PPP Government had no intention of fixing the VAT—the temptation to provide favours to friends and punish opponents was just too strong for a government dominated by feudal interests and zamindars—despite its populist rhetoric. The government went through the motions of reform to lull the Bank and the IMF into thinking that they were serious (this involved an augmentation of the IMF program by another \$3 bn in August 2009). A team of Pakistani lawyers, led by Supreme Court Advocate Anwar Kamal, was engaged to redraft the VAT law, and this was subjected to a bipartisan review (including by President Zardari’s brother-in-law representing the PPP, and former PMLN Finance Minister Dr. Hafiz Pasha) and a Bank/Fund expert team in Dubai in November 2009. The draft was to be submitted to Parliament by the end of December (a structural benchmark), and the Ministry of Finance bureaucrats reported to the IMF that this benchmark had been met. It had not been submitted as claimed (again reminiscent of 1994). Worse, the government agreed in the National Finance Commission that provinces should administer their own sales taxes on services—highlighting the entire charade that had been played since September 2008 to get the IMF supported loan and World Bank “burden sharing”.

The Zardari administration, following the time-honored precedent, made extensive use of SROs to provide tax exemptions and preferences to individuals, firms and sectors, and friends of the administration without reference to parliament; likewise, cumbersome and corrupt audits were typically used to punish enemies. Neither the Musharraf nor Zardari administrations showed any inclination to relinquish these powers. In 2013 former Minister of Finance Abdul Hafeez Shaikh told Parliament that Rs 650,000m worth of exemptions and tax waivers had been given in the previous four years alone. Such a regime fosters cronyism and negates any notion of a level playing field.

A more fundamental defect in the Pakistan tax system remains the split nature of the tax bases. The Eighteenth Amendment in 2010 unbundled the overlapping spending assignments but reiterated the provisions of the 1973 Constitution regarding the split tax bases (see Ahmad 2013). Unfortunately, this was not a very well informed decision, and as expected, has led to double taxation, potential tax wars across provinces as well as between the center and the provinces. The system does not generate the information that a properly designed VAT would provide to stop the cheating in the income taxes. An uncharitable view would suggest that this is exactly

what the government was trying to achieve, other than narrow and parochial regional and personal interests. Above all, the new arrangement has not succeeded in increasing the overall tax/GDP ratio. The tax-to-GDP ratio, which declined from 14% in the mid-1980s to less than 10% in the Zardari era, has become entrenched.

The World Bank again approved a “successor TARP” of over \$300m. This is tantamount to throwing more money at the perennial problem of a corrupt tax administration without any idea of how to design an integrated administration in the now more complex multilevel environment in Pakistan. This may be nothing more than “burden sharing” for another political IMF program, that astonishingly, and for the first time in 25 years, has dropped the emphasis on “fixing the VAT”!

A sustainable development strategy would build on the Shahid Husain Report’s proposal for a functional administration, but ensure that it administers all the main taxes—including an integrated VAT, PIT and the CIT. This way the synergies between the information generating aspects of the VAT, and preventing evasion of income taxes can be realized. But the administration has to be insulated from the political pressures from the government in power at the center and at the provinces, and requires staff, of the caliber of Shahid Husain who are not subject to political suasion. How the revenues should be assigned and shared would then become a separable issue that should be addressed given political economy constraints. This is an urgent agenda that Pakistan must attend to if it hopes to enjoy sustainable and inclusive development, rather than tinkering around at the margins of a corrupt and inefficient and unjust tax system.

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## **Reflections on Shahid Husain**

By Masood Ahmed

Unlike many of the contributors to this volume, I never had the opportunity to work directly with Shahid. Although he was already an established presence in the World Bank when I joined as a Young Professional in 1979, somehow our paths didn't cross until much later and it is only after he had retired that we became friends. However, even from a distance, I was aware of his reputation as a decisive and visionary manager, a figure held in some awe and to be approached with care and due preparation.

I did have two memorable interactions with him while we were both at the Bank. I share them here, because I think they bring out features of Shahid that are typical of his personality. The first was in 1991 when I had just been offered a position to move to the International Economics Department as a manager. At the time I was enjoying myself enormously working for Kemal Dervis on the Maghreb countries where I felt I could still add value for another year or two. I didn't know Shahid well at the time but we had recently become neighbors in Bethesda and, on the occasional weekend, would walk along the C&O canal. On one of those walks, I mentioned to him that I had been offered this position, but also indicated that I was inclined to stay on in the Maghreb department.

Without breaking his pace, Shahid asked me a few rapid-fire questions. What was I hoping to achieve if I stayed another year? What was the portfolio of responsibilities that I would take on in the new role? Would a stint managing analytical work not complement the operational work I had been doing for quite a few years? Did I know D.C. Rao, who was a highly respected economist and manager?

My answers were followed by two minutes of silent walking. Then a definitive statement: "Take it. Take it. You will be much better off in long run". Nothing further was said. We continued to complete our six mile walk. A couple of weeks later I told him that I had decided to accept the managerial position. He tilted his head in his characteristic manner, smiled and said "Good. You made the right decision."

The second interaction came three years later. By that time, I had become Director of the International Economics Department. I had decided that the work being done in the Bank on international debt needed to be radically revamped to reflect both technology and the changing pattern of international finance. Essentially, we were collecting (mostly manually) only the public sector foreign currency loans of developing countries and publishing the results with a two-year lag. We had little to say about the growing volume of developing countries' private sector



international debt or the public sector local currency debt. And we needed to produce our numbers much more quickly to be relevant. The problem I faced was that a restructuring of this scope would entail a substantial number of redundancies as well as a temporary disruption in the processing of data. Many of the existing staff were naturally opposed to the proposal and the personnel team were wary of the problems that potential redundancies would entail. At that time Shahid had taken on the role of Senior Vice President for Management and Personnel and was spearheading an effort to modernize systems and processes across the Bank. I decided to go and see him and seek institutional support for the restructuring that I wanted to undertake.

It was the first time that I had visited him in his office which was, as reputed, tidy to a fault. The desk was adorned only by empty in and out trays and a copy of the Wall Street journal. I told him what I wanted to do.

He asked me just three questions: What were the risks? How did I propose to tackle them? What support did I want? After my answers he thought silently for a minute and then said "Go ahead. I will support you." The meeting took less than 15 minutes.

I mention these two instances because I believe they reflected Shahid's innate strengths as a leader and manager. He was strategic in his vision, always taking the long view; quick to size up the issue at hand; incisive in probing for risks and weaknesses; and ready to make a decision and to take responsibility. These might seem the attributes that you would expect of any senior manager or leader but they are, unfortunately, they are a rarity. And they are, in my view, the reason why over a long and distinguished career, Shahid was able to command the respect and loyalty of so many talented professionals who chose to work for him and then went on to become distinguished leaders themselves.

Shahid and I got to know each other better on a personal basis after he had retired. In our interactions over the years, the thing that struck me the most was how he managed to retain a sharp and enquiring mind almost to the very end. He read voraciously and was well informed on a wide range of topics: whether it was politics in the UK, the recurrent problems of the Eurozone, productivity growth in East Asia, or the travails in the Middle East. His excellent memory enabled him to draw upon historical references to put current issues in context and offer fresh insights.

Shahid's interests covered everyday events as much as economic policy. His much remarked sartorial elegance continued even when he was increasingly preoccupied by his failing health. His cardinal-red pair of corduroy trousers, matched with argyle socks and a cashmere sweater, were a source of joy to him even when putting them on became a struggle. And he was quick to notice when I had acquired a new pair of shoes or a new tweed jacket, and often right about their provenance.

I was also impressed by how much Shahid cared for - and depended on - his family. Nigar, his wife, was very much the center of their family home and the superb hostess at innumerable fun gatherings of old and new friends. His own contribution focused on the garden: his roses were a

source of pride not just for the family but for the whole neighborhood and often, early in the morning, he could be seen checking them for aphids with his spray bottle in hand.

Shahid spoke proudly of his children, his eyes sparkling when recounting their latest achievements. He was focused on the ongoing health problems of his eldest daughter, Ayesha, and worried how she would cope as time went on. He doted on his granddaughter, who regularly spent time after school with them, and was delighted when a second grandchild came along.

Naturally, our conversations often turned to Pakistan where our personal interest was supplemented by my recent professional oversight of the IMF's work in that country. I found him becoming increasingly disillusioned with the prospect for near-term positive change in Pakistan. He felt that the underlying structure of power and clan loyalties in Pakistani society made it harder to trigger reforms that would improve and sustain development prospects. He was skeptical that the IMF, or any other international organization, would really be able to bring about a lasting improvement in Pakistan's economy absent the necessary political will. I think he was also personally disappointed that the excellent work on tax reform done under his leadership in the nineties had not been taken forward by successive governments. And yet, he was full of admiration and hope for the countless examples of innovation, achievement and entrepreneurship that young Pakistanis produce every year. He would become animated and enthusiastic when recounting the latest example of such a success.

I mentioned at his memorial service, Shahid's determination and strength of will. I want to repeat it here because it really was an exceptional phenomenon. When his Parkinson's was quite advanced, it became very hard for him to initiate a new movement. I remember him coming to visit us one afternoon for tea and found him stuck by the front door because he could not get his brain to send the right message to his leg to step forward. I offered to help but he brushed my arm away and simply kept focusing on trying to take that difficult first step. After about three minutes, the message got through and he was able to then take the subsequent twenty steps to come in to the house and sit down. By this time, he was sweating from exertion but there was also a look of satisfaction on his face from having covered the distance on his own steam.

Finally, I do want to say that it was not all serious with Shahid. Once you got to know him, you were exposed to a sharp and sometimes mischievous sense of humor. He appreciated a witty turn of phrase or the well told joke, and had quite a reservoir of his own to draw upon.

Every life is special and every person extraordinary in some way. Some have a larger impact on the world they live in and leave a bigger footprint when they move on. Shahid Husain was clearly one of those.

## **China's Entry Into the World Bank<sup>14</sup>**

By Pieter Bottelier<sup>15</sup>

Shahid died on 11 May 2015, 4 days short of the 35<sup>th</sup> anniversary of the People's Republic of China "assuming representation as China in the World Bank Group"<sup>16</sup>. He played a key role in the preparations for that historic event and in shaping World Bank-China relations in the early years of the PRC's membership.

The World Bank played a major role in China's economic modernization, especially during the first two decades of Deng Xiaoping's *Reform and Opening* strategy adopted by China's Communist Party in the late 1970s. Under the overall leadership of World Bank President Robert McNamara, Shahid was the original architect of what became perhaps the most consequential partnership the World Bank ever had with a member country. As such he contributed to China's amazing growth – national income increased no less than 25-fold during the first 35 years of reform and opening! Starting from a very low level of development in the late 1970s, China became an upper middle-income country, the world's largest economy (measured on PPP basis – second largest measured by market exchange rates), largest manufacturer and largest exporter, in less than two generations.

China's economic miracle is widely regarded as one of the greatest achievements in economic development ever and a major turning point in world history. The most important part of the World Bank Group's contribution to China's economic success was not financial – though at about \$66bn for about 720 projects<sup>17</sup> by the end of June 2015, it was important – but technical

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<sup>14</sup> Much of the information in this essay on Shahid Husain's early contacts with China (before May 1980) is based on conversations with Nigar Abbasi Husain, Shahid's widow. The author also wishes to thank Edwin Lim, the World Bank's first country economist for China, Caio Koch-Weser, World Bank president Robert McNamara's personal assistant at the time of China's (re) entry into the Bretton Woods institutions (1980), Nicolas Hope, Director of the Stanford Center for International Development and former Director of the World Bank's China Department (1994-1997), who, on behalf of the author, researched the Burke Knapp (1913-2009) files archived at the Hoover Institution for information on how the World Bank dealt with the issue of debt owed by the Republic of China (Taiwan) when China's representation in the Bretton Woods Institutions shifted from the ROC to the PRC (1980) and Natalie Lichtenstein, former Assistant General Counsel of the World Bank and former legal advisor to the US Department of the Treasury.

<sup>15</sup> The author served as Chief of the World Bank's resident mission in China (1993-1997) and worked under Shahid Husain in several World Bank assignments in earlier years.

<sup>16</sup> This unusual phraseology indicated that China, a founding member of the World Bank under the Nationalist government of Chiang-Kai-shek, had been represented in the World Bank by the Republic of China (Taiwan) since the establishment of the People's Republic of China on 1 October 1949 until the World Bank Board decided to shift such representation to the PRC on 15 May 1980. (China's representation in the IMF shifted from the ROC to the PRC about a month earlier and in the UN in October 1971, 3 months after Kissinger's secret visit to China to prepare for President's Nixon official visit in February 1972).

<sup>17</sup> By the end of June 2015 IBRD loans totaled \$45.9bn and IDA credits \$9.9bn for almost 400 projects. By then IFC had invested about \$10bn in 324 projects.

assistance through projects and numerous other vehicles, and policy advice. Except for a one-time drawing on its General Reserve in 1986 (SDR600 million)<sup>18</sup> to shore up its foreign exchange reserves, China never borrowed from the IMF. China's relationship with that institution was mainly centered on macroeconomic policy consultations.

*SSH's first private visit to China (1978)*

Shahid was appointed Vice President for the East Asia and Pacific Region in early 1977, not long after his return from Pakistan, where he had served as economic advisor to PM Zulfikar Ali Bhutto in 1976, while on leave of absence from the World Bank. Bhutto was keenly interested in China, which may have inspired Shahid. As Foreign Minister, Bhutto had persuaded Mao to look at Pakistan as a special friend and ally in 1963. After Mao's death in September 1976, the arrest of the "Gang of Four" shortly thereafter and the return of Deng Xiaoping to a central leadership role in 1977, it became clear to China watchers around the world that the PRC might fundamentally change course in international relations and in its approach to economic development. This is precisely what began to happen after the historic Third Plenary Session of the 11<sup>th</sup> Central Committee of the CPC in December 1978.

At that time China was still isolated from the rest of the world and essentially a *black box* to most western observers. The country was very poor and underdeveloped. For much of their knowledge on conditions and events in mainland China, western observers depended mainly on a handful of journalists in Hong Kong who peered across the border and listened to Chinese radio broadcasts to find out what was happening. In early 1978 Shahid decided that he had to become better acquainted with what was going on in China, but since there was no official relationship between the PRC and the World Bank at that time, he could not visit the country in his capacity as Vice President. It is probably with the knowledge and encouragement of McNamara - but there is no written evidence of this - that he approached Agha Shahi, Pakistan's deputy foreign minister in Islamabad and a family friend, to discuss the possibility of a private visit to China. The visit was arranged by Pakistan's foreign office and took place in the summer of 1978. Shahid and his wife Nigar traveled together to Beijing on Pakistan International Airlines (PIA) via Islamabad and stayed in China for three weeks as guests of the Chinese government. They visited Beijing (where they stayed at the Beijing Hotel, the only hotel for foreigners at the time), Shanghai, Nanjing, Urumqi and Kashgar (known in China as Kashi). Shahid met with a number of Chinese officials, but there are no written records of those meetings (other than, perhaps, in China). Undoubtedly, Shahid briefed McNamara and senior Bank officials upon his return to Washington.

*SSH's second private visit to China (1979)*

About a year later – the precise dates of that visit are not known - Shahid visited China again, this time alone and in his private capacity. The visit was again arranged by Pakistan's foreign office, but this time it was less unofficial in the sense that Shahid was accompanied to the Pakistan-China border by a unit of the Pakistani army and received on the other side by a unit of the People's Liberation Army (PLA), which accompanied him to Beijing. Again, Shahid met with a

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<sup>18</sup> This was a so-called "first-tranche" drawing (worth \$597.7 million at the SDR/USD conversion rate at the time) which did not require approval of the IMF board.

number of senior Chinese officials, but no written records of those meetings are available (except, perhaps in China). He probably discussed how the PRC might join the World Bank (by replacing Taiwan as China's representative) and thus benefit from Bank Group development assistance. It is not known to which extent World Bank President McNamara was involved in Shahid's second visit to China, but it seems highly likely that he was fully aware of all important aspects.

*The real breakthrough in establishing official World Bank–PRC relations*

The real breakthrough came only after the normalization of PRC-US relations on 1 January 1979. It was shortly thereafter that the PRC's first ambassador to the US (Chai Zemin) on the behalf of the government in Beijing, approached McNamara to officially express the wish of his authorities in Beijing to (re)join the World Bank. Since it was clear to the Chinese that they had to be a member of the International Monetary Fund before they could (re)join the World Bank, discussions with the IMF (led by MD Jacques de Larosi re and Tun Thin, director of the Fund's Western Hemisphere department) had already started.

In early March 1980, ambassador Chai invited McNamara to visit China personally as soon as possible to discuss Membership with his government in Beijing. McNamara accepted the invitation in a letter to the ambassador dated 10 March 1980, announcing that he planned to visit Beijing 10-15 April and would be accompanied by Moeen Qureshi (Vice President Finance), Shahid Husain (Vice President EAP), Heribert Golsong (Associate General Counsel) and Caio Koch-Weser (his personal assistant). The timing of McNamara's visit was probably related to a mission to Taipei in late March by Sr. Vice President Burke Knapp and General Counsel Lester Nurick to brief the ROC (Taiwan) on the PRC's wish to join the World Bank and to discuss the issue of Taiwan's debt to the World Bank (about which more later).

One month after McNamara's return to Washington, the World Bank board decided that the PRC would represent China in the World Bank from then on.

*Edwin Lim's early involvement in bringing China into the World Bank*

Ed, a Chinese speaking Philippine economist in the World Bank played an important role in this. Some time after the reunification of North and South Vietnam (1975), he became the Bank's lead economist for Vietnam. (His highest boss in the Bank's East Asia and Pacific Region from 1977 was Shahid Husain.) The easiest way to travel to Hanoi from the U.S. at that time was via Beijing. The PRC's Liaison Office in Washington D.C. issued special transit visas to World Bank staff for that purpose. Since the outside world knew virtually nothing about China's economy then, the opportunity to visit Beijing, even in transit, was very much welcomed by World Bank staff. During one of those visits (in 1979), Ed visited his ancestral village in Fujian Province and was unexpectedly invited to dinner in Beijing with Lin Jixing, director of research at the Bank of China and leader of an interagency team studying the feasibility of the PRC joining the Bretton Woods institutions. The dinner was also attended by Wang Liansheng (who later became China's Director at the World Bank), Dai Qianding (who later became China's Director at the IMF) and Zhang Xiaokang (who later became China's Ambassador to Singapore). As part of their investigations, the Chinese study team had already visited Yugoslavia and Romania to learn about their

experience in dealing with the IMF and the World Bank. Ed's impression from the dinner discussion was that the study team's greatest concern was how to obtain soft loans (at that time interest-free, 50-year maturity) from the World Bank's International Development Association. Ed pointed out that a member country's eligibility for IDA funds had to be established on the basis of the World Bank's analysis of the country's economy. Much of the dinner discussion therefore was focused on procedures for preparing a World Bank study of China's economy.<sup>19</sup>

Ed had also been involved in preparing for China's (re)entry into the World Bank as leader of a study group formed at the request of McNamara, drafting and commissioning briefing papers on China's economy. The group commissioned papers by economic experts who were familiar with China's economy from around the world, including Włodzimierz Bruss, P.C. Chen, Mark Elvin, Shigeru Ishakawa, Nicholas Lardy, Dwight Perkins, Thomas Rawski, Ashwani Sahni, Peter Schran and Christine Wong.

After the May 1980 World Bank Board meeting at which it was decided that the PRC would be recognized as China's representative in the World Bank from then on, Edwin Lim continued to play an important role in shaping the China-World Bank relationship under the leadership of Shahid Husain. He was deputy chief of the World Bank's first economic mission to China in the Fall of 1980 (producing a 1,000-page base-line study of China's economy, which was mainly backward-looking and served as guide to formulating the World Bank's initial assistance program for China and – after translation into Chinese by the government – also as teaching material at many Chinese universities). He was chief of the World Bank's second economic mission to China in 1983 (producing a mainly forward-looking report examining China's economic reform priorities and policy options). These and subsequent World Bank economic reports were also used by other international agencies and governments as a basis for formulating their own development assistance programs for China.

#### *The China-Pakistan connection*

Shahid Husain was not the only senior Pakistani in the World Bank who played an important role in managing the PRC's entry and in shaping initial assistance programs. By coincidence several key positions in the Bank were then occupied by other Pakistanis, including Moeen Qureshi, Sr. Vice President for Finance, Parveez Hasan and Syed Salar Kirmani, respectively Chief Economist and Project Director for the East Asia and Pacific region. Qureshi accompanied McNamara on his mission to China in April 1980 to discuss China's prospective membership with Deng Xiaoping and others. Hasan (with Edwin Lim as deputy) led the Bank's first economic mission to China in the Fall of 1980 – a mission that comprised 32 World Bank experts in various fields and an equal number of Chinese counterparts, including Zhu Rongji, who was already then a lead reformer and later became Prime Minister (1998-2003). Kirmani, who had been co-responsible for the

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<sup>19</sup> Most information in this paragraph is based on the Preface by Edwin Lim to the book "Fifty Economists Look at Thirty Years of Reform and Opening" which was published in 2008 (in Chinese). Ed was invited to write a preface for this book by Mr. Liu He, a contributing author who later became President Xi Jinping's principal economic advisor. Ed prepared an English language translation of his 25-page Preface for his non-Chinese speaking friends and colleagues.

implementation of Pakistan's huge, World Bank-supported Tarbela hydro-electric dam and irrigation project on the Indus River prior to joining the World Bank, persuaded the Chinese to accept international technical assistance for the development of engineering standards,, international and local competitive bidding as a basis for awarding contracts under World Bank-supported projects, the appointment of an *independent engineer* for conflict resolution during project construction, as well as the adoption of standard project accounting and reporting procedures. Shahid Husain, as Regional Vice President, was Kirmani's boss at the time.

Given the friendly relationship and trust that existed between Pakistan and the PRC and McNamara's awareness of those factors, the *Pakistani "mafia"* in the World Bank was enormously important in establishing productive relations between the World Bank and China quickly. It is impossible to determine precisely how important these factors were, but it is likely that it would have taken much longer for the World Bank to become effective in China, and/or that the quality of the relationship would have been lower, otherwise. Of all the Pakistanis in the World Bank who played a role in bringing China into the World Bank and in formulating initial assistance programs, Shahid Husain was the most important.

*The gold equity and Taiwan debt issues as obstacles to the PRC's World Bank membership*<sup>20</sup>

When the PRC was established by Mao Zedong on 1 October 1949, China's membership in the then existing multilateral institutions (UN, GATT, IMF and World Bank) stayed with the Republic of China (Taiwan), because the ROC, governed by the Nationalist government of Chiang Kai-shek was recognized by the US and other major powers as China's legitimate representative in those institutions. In 1950 the ROC was expelled from GATT (on the ground that it had no control over the PRC's customs area) and from the IMF and the World Bank in respectively April and May 1980. Much earlier, on 25 October 1971, a little over three months after Henry Kissinger's secret visit to China to prepare for president Nixon's official visit in February 1972, the UN General Assembly recognized the PRC government in Beijing as China's legitimate representative at the UN, thereby expelling the ROC from all UN organizations, including the Security Council.

Before and after 1971, the government in Beijing made many (unsuccessful) attempts – usually through third parties - to expel Taiwan from the Bretton Woods institutions, claiming that Taiwan was a province of China and that the ROC government was not legitimate. These complex legal-political battles, in which Shahid Husain did not become involved until after his appointment as

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<sup>20</sup> A detailed review of the gold equity and IMF quota issues is provided by Bessma Momani in "China and the International Monetary Fund: Continued Engagement in its Drive for Membership and Added Voice at the IMF Executive Board", *Journal of Chinese Economics*, 2013 Vol. 1, No.1: pp 125-150. Another important source of information on the transition of China's membership in the Bretton Woods institutions from ROC to PRC is a book by Harold K. Jacobson and Michel Oksenberg "China's Participation in the IMF, the World Bank and GATT. Toward a Global Economic Order", *University of Michigan Press* 1990. The Taiwan debt issue was mostly dealt with discreetly by McNamara personally, his Sr. Vice President Burke Knapp and the Bank's General Counsel Lester Nurick. No published information on this important aspect of the membership transition is available. The story on this subject in this essay is based on conversations with Shahid Husain and a few other former World Bank officials, interviews with some of those officials that were published as part of the World Bank's history project, and on Burke Knapp files in the Archives of the Hoover Institution at Stanford.

Vice President for the World Bank's East Asia and Pacific region, focused primarily on IMF membership as that was (and is) a prerequisite for World Bank membership.

Three critical financial issues had to be resolved in connection with membership transition from the ROC to the PRC: (1) what to do with the gold paid into the IMF and World Bank Group organizations by the ROC (Taiwan), (2) how to adjust China's quota in the IMF, and (3) how to ensure that the ROC would continue to pay its debt to the World Bank. Proper management of membership transition was also important for ongoing efforts to replenish the World Bank's International Development Association. The US director on the IMF's executive board (Sam Cross) feared that adverse reactions in the US Congress to an improper handling of the transition by the institutions might have "deleterious effects" on the pending US contribution to IDA. This was an important issue since many of the World Bank's poorest members were/are dependent on IDA credits and the US was/is IDA's largest contributor.

Regarding the gold issue, both the ROC and the PRC claimed ownership of the equity that China had paid into the Bretton Woods institutions. The ROC insisted that its contribution should be restored to Taipei before membership transition could be considered, but the IMF legal department concluded that the board could determine the China representation issue and then decide whether the gold belonged to Taipei, to Beijing, or to both. The US representative on the IMF board lobbied hard for a solution that would allow Taiwan to get most of the gold, which commercially was worth a lot more than it had been when it was paid in, because the Nixon Administration had abandoned the Bretton Woods gold exchange standard in August 1971. In the end it was decided that Taiwan would receive 470,708 ounces<sup>21</sup> of China's original gold contribution to the IMF and 40% of the profit of gold restitution at a higher market value; the remainder of the gold and the profit would go to the PRC. This arrangement was agreed at the last minute, after the mission by Burke Knapp and Lester Nurick to Taiwan late March 1980 and before the IMF board meeting of 17 April. At the PRC's request the IMF did not publicly announce that part of the gold had been restored to Taiwan.

At the IMF board meeting on the transition of membership from the ROC to the PRC (17 April 1980), it was also decided that China's IMF quota would be SDR550 million. Beijing accepted, but announced that it would seek a quota increase soon. An ad-hoc IMF board meeting in August recommended an increase of China's quota to SDR1,200 million, which was approved at the Fall annual meeting. China's quota was further increased to SDR1,800 million after the annual meeting. China received further quota increases at later IMF meetings, but, given the rapidly growing size and global importance of its economy, remained grossly underrepresented in the IMF. Under US leadership, at the G-20 meeting in Seoul (2010), it was decided to significantly increase China's IMF quota (and to also increase the voting power of other emerging economies), but in its (lack of) wisdom, the US Congress has so far declined to ratify the Seoul decision. All

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<sup>21</sup> Since the Nationalist government's original gold contribution to the IMF is reported to have been 25 million ounces, the gold restitution to Taiwan in 1980 represents about 19% of that.



other IMF member countries did ratify the G20 decision. Since the US has de-facto veto power over IMF quota decisions<sup>22</sup>, the G20 decision was not implemented.

#### *The Taiwan debt issue*

This was mainly the concern of the World Bank, though the IMF, as the Bank's sister Bretton Woods institution, was keen to get the issue resolved satisfactorily. At the time of the 1971 UN decision to recognize the PRC instead of the ROC, Taiwan's debt to the World Bank Group was about \$100mn. By the end of 1979 when the transition of China's membership was "written-on-the-wall", it had grown to about \$260mn (\$245mn IBRD, \$15mn IDA, plus a small amount of IFC loans). By then all World Bank loans and credits to the ROC (Taiwan) had been fully disbursed. McNamara was already then concerned that a problem over the Taiwan debt issue might have adverse consequences for the rating of World Bank bonds and hence for its cost of capital.

In the Fall of 1971, after Henry Kissinger's secret mission to China and around the time that the UN General Assembly decided to recognize the PRC, fearing that the Taiwan debt issue might seriously complicate the anticipated membership transition (from ROC to PRC), McNamara sent Ray Goodman, director of the World Bank's East Asia Programs Department, to discuss the issue with China's (the ROC's) embassy in Washington, where the issue was well understood and which was surprisingly cooperative in finding practical solutions.

In December 1971 Goodman and Martin Wong, special advisor to the Chinese (ROC) ambassador, soon to become ambassador to the US himself, signed an Aide Memoire that included the following four key points:

1. China (ROC) would not apply for World Bank loans or credits "for the time being";
2. The World Bank would continue to disburse on existing loan/credit commitments;
3. China (ROC) would service its debt to the World Bank on time "in all circumstances".
4. China (ROC) would buy World Bank bonds in the amount of its debt to the World Bank at any time, if the Bank requested it to do so.

This remarkable document served as the basis for World Bank – China (ROC) relations until 15 May 1980 when, following the IMF board's decision of 17 April, the World Bank board unanimously decided to recognize the PRC as China's legitimate representative in the institution. But earlier, when the transition came close and McNamara had been invited to personally visit China to discuss World Bank membership with the government in Beijing, he sent his Sr. Vice President Burke Knapp, together with the Bank's General Counsel Lester Nurick to Taipei (27-31 March 1980) to brief the ROC government on the likelihood that the World Bank board would soon approve the PRC's request to join the institution. The Knapp/Nurick mission also discussed the Taiwan debt issue and found to its surprise that finance minister Philip C.C. Chang was unaware of the 1971 Aide Memoire and even questioned the authority of Martin Wong to have signed it on behalf of the ROC. He insisted that the IMF gold restitution issue should be resolved first and suggested that the World Bank refrain from making any statements on the Taiwan debt

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<sup>22</sup> Most important IMF board decisions require a super-majority of 85% of the vote; the US is the largest single shareholder, with 16.74% of the vote.

issue until that issue had been settled. McNamara was horrified to hear this and instructed Burke Knapp to discuss the issue as soon as possible with the ROC's ambassador to the US, Martin Wong. (During their late March mission to Taiwan, Knapp and Nurick also met with K.H. Yu, Governor of the Central Bank of China and former finance minister (then minister without portfolio) Li Kwoh Ting<sup>23</sup>.)

Knapp reminded ambassador Wong, who was again understanding and cooperative, of the Aide Memoire he signed on 7 December 1971 and of the need for Taiwan to strictly observe the terms of that agreement, not only to protect the World Bank's standing in global capital markets, but also Taiwan's own creditworthiness. He indicated that McNamara would be willing to recommend to the board that Taiwan remain eligible for procurement under World Bank projects after the membership transition. He is also reported to have pointed out that, should Taiwan renege on its financial obligations to the World Bank, the PRC, as China's representative in the World Bank, would have the legal right to send agents to Taiwan to inspect assets created with the proceeds of World Bank loans to the ROC, which was apparently a "deal clincher".<sup>24</sup> However unhappy ROC officials were with the membership transition, Taiwan continued to service its debt to the World Bank faithfully and the World Bank never exercised the option of requesting Taiwan to buy World Bank bonds in the amount of debt outstanding. The IMF gold restitution issue was resolved only after Knapp's follow up meeting with Ambassador Wong.

#### *Shahid Husain and the China - World Bank partnership after May 1980*

After the board meeting of 15 May 1980, Shahid visited China many times in his capacity as regional Vice President. In June/July 1980 he went to explain the need for a base-line World Bank study of China's economy, to discuss project priorities and procedures for project appraisal, supervision, procurement and the disbursement of funds. There was at that time no bureaucratic infrastructure in China for the processing of World Bank loans. It was agreed that – for the first time since 1949 – a *western* agency – i.e. the World Bank – would undertake a comprehensive study of China's economy, with the active participation of Chinese experts.<sup>25</sup> The size and importance of the Bank's first economic mission to China have few parallels in the history of the institution. Fortunately, the main conclusions and recommendations of the Bank's first and second economic reports on China were consistent with the opinions of leading Chinese

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<sup>23</sup> At the PRC's invitation (arranged unofficially through the World Bank's office in Beijing), Lii visited China in July 1993 as an (unpaid) World Bank consultant to advise Beijing on how to deal with the serious inflation that was plaguing China at the time. He attended a World Bank and IMF-sponsored conference on the economy in Dalian and met for long private discussions with party secretary Jiang Zemin and Deputy PM Zhu Rongji. Li had not been to mainland China since his family had fled to Taiwan in 1948.

<sup>24</sup> It should be emphasized, however, that this colorful story is not part of the written record.

<sup>25</sup> Since the withdrawal of Soviet advisors from China in 1960 until the start of market reforms under Deng Xiaoping in the late 1970s, there had been almost no involvement of foreign advisors in China's economy. Thanks to Deng's leadership and pragmatic decision-making, China's suspicion of western economic advisors was then soon overcome. The World Bank's credibility with Chinese leaders was enhanced by McNamara's evident independence from the US government.

economists at the time such as Xue Muqiao, Yu Guanyuan, Liu Guoguang, Ma Hong and Dong Furen.<sup>26</sup>

The Chinese had indicated to the McNamara mission of April 1980 that they were seeking financial and technical assistance for projects in agriculture, light industry, heavy industry, energy and transport, especially ports and railways. Shahid Husain agreed with the Chinese a few months later that the three top priorities for World Bank assistance should be higher education, agriculture and ports. The Husain mission was encouraged to find that a 10-year Soviet-style heavy industry-oriented development plan was shelved and that China wished to reduce the national investment rate from the (then) unusually high level of 33% of GDP to around 25%, while consumption, agriculture and light industry would be promoted. A follow-up mission to examine China's capacity for preparing and implementing projects suitable for World Bank support – led by Kirmani – found that China had achieved a much higher level of technical capacity for planning, designing and implementing even very large projects, than most World Bank borrowers.

Following this Kirmani mission, the Bank designed its projects to systematically address institutional weaknesses that had been identified. In this way the projects became primary vehicles for a large flow of technical assistance from the Bank to many sectors of the economy. In the process of developing an initial “pipeline” of projects suitable for Bank support, both sides were greatly assisted by training programs for Chinese project staff financed by UNDP. Later, training programs for local staff were included as an integral feature of almost all World Bank-supported projects in China. Shahid was very much involved in all those developments.

The Bank's program for China became quickly very large. In the mid-1990s some 10,000 Chinese were involved full-time in the local administration and management of World Bank-supported projects all over China. Numerous World Bank-supported projects were being implemented almost everywhere. With the exception of one quick disbursing “adjustment” loan in the late 1980s, all World Bank loans for China financed investment projects or technical assistance<sup>27</sup>.

Perhaps the greatest contribution to China's development and modernization through World Bank-supported projects has been institution building, i.e. the development of rules, systems, institutions for the financing, management and supervision of projects in accordance with sound technical and financial standards (including accounting and auditing procedures). In 1993 the Bank provided financial support from a modest grant facility – together with the Ford Foundation – to kick start the China Center for Economic Research at Peking (Beijing) University; CCER has

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<sup>26</sup> A remarkable aspect of China's market reforms after 1978 is that the effort was inspired and supported by Chinese economists who had been trained in Marxist economics.

<sup>27</sup> China is exceptional in this regard. From the early 1980s, quick disbursing “adjustment” loans became common for many other developing member countries. China resisted this trend, because: (a) it did not need balance of payments support; and (b) it considered the technical assistance embodied in World Bank projects as or more important than the loan.

since become a leading economic research and advisory organization in China. This may have been the highest return investment in China's development the World Bank ever made.

Of the hundreds of World Bank people who worked on China since the late 1970s, Shahid Husain probably had the greatest positive impact.

## **My Long Association with Shahid Husain**

By Shahid Javed Burki

This is a brief story of long association with Shahid Husain. We were good friends, colleagues at the World Bank, and started our professional careers in Pakistan in the same part of that country's bureaucratic structure. He and I followed the same route to the World Bank. He and I were members of the Civil Service of Pakistan, the successor to the famed Indian Civil Service (ICS). The ICS was called the "steel frame of the British rule of India." It was made up of mostly British personnel recruited on the basis of a rigorous entrance examination. Most of those who joined came from Cambridge and Oxford Universities. Many stayed in India for long periods, brought their wives from England and raised their families in their Indian colonies. Several ICS officers such as Philip Mason<sup>28</sup>, Malcolm Darling<sup>29</sup> and Olaf Caroe<sup>30</sup> wrote what became classic works on various aspects of life in the Indian sub-Continent.

Pakistan inherited 81 ICS officers, several of them British, who correctly sensed that the civil bureaucracy would have a more prominent role in the politically weak Pakistan as compared to India which was able to quickly develop a viable political order. Mr. M. W. Abbasi, Shahid's father-in-law, belonged to this group. With these officers forming the core, the CSP developed into a formidable force, effectively governing the country up to the military take-over in October 1958. President/General Muhammad Ayub Khan established a bureaucratic state in which the CSP became the steel frame. This was the service both Shahid and I joined. Shahid came in two years before the beginning of the Ayub period; I joined two years after the military dictator began to mold the country into his image of a competent state. He was impressed with Gunnar Myrdal's argument that the South Asian region had been kept backward because of its "soft states."<sup>31</sup>

We went to the CSP four years apart; he joined in 1956, I followed in 1960. We held the same positions in the Government of West Pakistan. Both of us worked as Deputy Secretaries Foreign Aid in the Planning and Development Department. From there Shahid went to Williams College in 1962 for graduate studies in economics and joined the World Bank in 1963 as an economist in the Debt Division headed by the Yugoslav, Drag Avramovic. I joined the Bank in April 1974 after spending seven years at Harvard.

Our CSP careers molded us profoundly. At very young ages we had to be the "mai-bapp" (mother and father in the local language) of hundreds of thousands citizens. One of the several jobs Shahid held before leaving the service and departing from Pakistan was as the Sub-Divisional Magistrate of Kasur, an expanse of agricultural land southeast of Lahore, the capital of West Pakistan. Kasur, at the time Shahid served in the area was also a small-town city about 40 miles from Lahore. It

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<sup>28</sup> Philip Woodruff, *The Men Who Ruled India, The Founders*, London, W. W. Norton, 1953 and *The Men Who Ruled India*, The Guardians, London, W. W. Norton, 1954.

<sup>29</sup> Malcolm Darling, *The Punjab Peasant in Prosperity and Debt*, London, Ulan Press reprint, 2012.

<sup>30</sup> Olaf Caroe, *The Pathans*, 550 B.C. – A.D. 1957, London, Oxford University Press, 1976.

<sup>31</sup> Gunnar Myrdal, *Asian Drama: An Inquiry into the Poverty of Nations*, New York, Random House, 1968.

was close to the border with India. Since then it has grown into a middle-sized city of more than a million people. It was a good example of the way Pakistan is rapidly urbanizing. At a rate of about 6 percent a year, the country has one of the world's highest rates of urban growth. About 100 million of its population of almost 200 million live in towns and cities. Shahid often referred to Kasur's exponential growth as an example of the urban problems Latin American countries – in particular Brazil – were attempting to come to grips with.

The SDM's job was much sought after and was usually landed by the person who had built a reputation for good administration and quick decision-making. "Kasur prepared me well for my career at the Bank," Shahid said to me on several occasions when we took long walks on the tow-path that runs along the Chesapeake and Ohio (C&O) Canal. In the time we spent together on these walks we often reflected on our careers in Pakistan before we left the country and the CSP. He was right in his assessment that in several ways we were the creatures of the CSP. I remember the first lecture through which I sat at the CSP Academy in Lahore given by Mian Aminuddin, the colorful director of the institution. He was one of the 81 ICS officers who had moved to Pakistan and the director's appointment had brought him out of retirement following a long and distinguished career that included governorship of the province of Baluchistan. "You must remember one thing: no decision is worse than a bad decision. Bad decisions can always be reversed. No decision creates confusion," he told the young "probationers" as the new entrants to the service were called. There were 25 of us in the 1956 and 1960 groups, or "batches," as they were called. The groups were evenly divided between East and West Pakistan. Shahid had served as a probationer in the Academy under a different director but fully agreed that the Aminuddin statement was an accurate reflection of the CSP ethos. He would say to me that he was guided by that principle during his remarkably successful career in the Bank. Jim Wolfensohn, the fourth World Bank president under whom Shahid and I served, remarked on our ability to move quickly once the institution decided to adopt a new policy that was good for it and the countries it served.

Had Shahid had his way, I would have come to the Bank half a dozen years earlier. The first time I met him was in December 1967 when I came down from Harvard to spend the holiday period in Washington. Shahid at that time was Division Chief for Brazil. He greeted me with great warmth. The CSP link was strong enough to promote instant camaraderie. He asked me what I was doing at Harvard and I told him that I was on a two-year leave of absence from the government and that the plan was to spend the first year at the Kennedy School preparing for a Masters in Public Administration. Once that was done I planned to move over to the economics department and do the course work for the Ph. D program. "Come over to the Bank; you have enough economics," he said. With that comment he picked up his phone and asked to be connected with some person from another part of the Bank. The official came over, asked me a few questions and then offered me the job of the Country Economist of Sudan. I could join after completing my studies at the Kennedy School, he said. That would have meant my joining the Bank in July 1968. All that happened in about an hour and had I accepted the offer the trajectory of my career at the Bank would have been a very different one. Taken aback at the speed with which Shahid had moved, I finally found my voice. "I am having a great time in Pakistan and I have no intention of leaving the country," I said.

Pakistan at that time was nearing the end of the first decade of Ayub Khan's rule with growth rates averaging 7 percent per annum. I was then a mid-level officer, but with the power and authority to take decisions and implement them that helped hundreds of thousands of people. I didn't think it would be wise for me to opt for a job in the Bank in exchange for what I was doing in Pakistan. Shahid was not pleased with my decision; he had not experienced the excitement of the Ayub period. Khan, unlike his counterpart in India, Pakistan's sibling, had allowed the private sector considerable space in the economy. Whether Pakistan's approach – in particular how Ayub Khan used the state to manage the economy and how he constrained the country's political development – was appropriate for a country in Pakistan's situation was one of the several subjects we discussed repeatedly and at some length during our long walks along the C&O canal.

Shahid and I differed markedly in our assessment of how a succession of regimes had managed the development of Pakistan's political and economic structures. In 1980, In *Pakistan Under Bhutto, 1971-77*, my first book on Pakistan,<sup>32</sup> I focused on the conflict between two groups in the young country's population: "insiders and outsiders." The former was made up of the indigenous population that, once the exchange of population that accompanied the partition of the British India colony into the independent states of India and Pakistan was complete, numbered some 24 million. The outsiders were the 8 million Muslim refugees who left the Hindu majority India for Pakistan. Our two families were part of this mass migration. While the Burkis came from the part of the Punjab that went to India, Shahid's family migrated from the princely state of Hyderabad with a Hindu majority but was ruled by a Muslim, the Nizam of Hyderabad. In that respect Shahid was a muhajir (refugee), a term that acquired political overtones in Pakistan but was not used for those who, such as my family, came to Pakistan from the Indian part of Punjab. Those from Punjab numbered 6 million while those who had left the Urdu speaking areas of Delhi, Uttar Pradesh, Bihar, Madhya Pradesh, Bihar and Hyderabad numbered 2 million. Most of those who came from Punjab were settled in the Pakistani province of the same name. Many were given the agricultural land left by the Sikh community. The British for strategic reasons did not allow the Hindus to own agricultural land in Punjab. Most of the Urdu-speaking refugees settled in Karachi and Hyderabad, two large cities in Sindh province. In 1951, when Pakistan conducted its first population census, one out of every four citizens was a refugee. There is no other instance in human history that such a large number of refugees were accommodated by the host population. The refugees from the Middle East who are being absorbed in Germany at this time will constitute about 1.7 percent of that country's population. In what is today's Pakistan, the proportion was 25 per cent.

The "outsiders" were generally better educated, had modern skills and, unlike the insiders, were largely urbanized. It was inevitable that they would come to dominate the new country's government-in-the-making and its bureaucracy. The "insiders" also wanted a larger role for themselves in the political life of the new state. That would have been likely had Pakistan succeeded in putting together a representative political system. The development of such a system was blocked by the coalition of "outsiders" and the emerging economic entrepreneurial class. This conflict lasted until the advent of the military era that began with the takeover of the

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<sup>32</sup> Shahid Javed Burki, *Pakistan Under Bhutto, 1971-77*, London, Macmillan, 1980.

government by General Ayub Khan in 1958. This laid the basis of what in my book I called the process of “political indigenization.” This process began to gradually sideline the “outsiders”. Some of the “insiders” formed a political group that was initially called the Muhajir Qaumi Mahaz. The MQM dropped the word muhajir from its name and replaced it with the word Mutahida, meaning “united”, thus attempting to broaden its political appeal beyond the descendants of the refugees who came from the Urdu speaking parts of India. That didn’t work and the MQM’s political appeal remained limited to the social group it targeted at the time of its formation. It is behind much of the violence today in the megacity of Karachi.

Shahid did not buy some parts of this analysis. He was persuaded that Pakistan’s political underdevelopment was the result of a different coalition that included the civil and military bureaucracies dominated by Punjabis. These were desperate to continue their grip on political power, which could only happen under the kind of system Ayub Khan had introduced. Later military rulers brought Islam into the picture. Hussein Haqqani developed this argument more fully in his book *Between Mosque and Military*.<sup>33</sup> We differed about one other aspect of Pakistan’s history. Perhaps influenced by my work on China, I believed that economic development could precede political progress. Shahid believed that the causality ran in the opposite direction; from political to economic development. In that view, I now believe, he was correct. His position was developed by the social scientists Daron Acemoglu and James Robinson in their highly regarded work *Why Nations Fail*.<sup>34</sup> Shahid was pleased that his strong views about the process of development had found approval in the academic community.

In addition to the role of the state in economic management we also talked about the future of Asia and its impact on the rapidly growing and changing global economy. By the time we had these conversations we had accumulated rich experience working in various parts of Asia. Both of us knew Pakistan and China well. Shahid had deep knowledge of Indonesia and, in the World Bank’s phrase, the “miracle economies” of East Asia. It was during his tenure that the Bank began to study these economies and published a book that had considerable influence in shaping public policies in the developing world.<sup>35</sup> Both Shahid and I were of the view that Asia will become the driving force of the global economy, even if the 21<sup>st</sup> century did not quite become the Asian century. Some analysts such as the Singaporean Kishore Mahbubani had begun to argue that while Asia was rising, the United States had entered a period of decline.<sup>36</sup> We didn’t subscribe to that view. Both he and I believed that Asia’s rise was not contingent upon America losing its position in the global economy. In fact, a lot of what Asia achieved in the final quarter of the 20<sup>th</sup> century was because of links developed with the strong American economy.

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<sup>33</sup> Hussein Haqqani, *Pakistan: Between Mosque and the Military*, Washington DC, Carnegie Endowment for International Peace, 2005.

<sup>34</sup> Daron Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Prosperity and Poverty*, New York: Crown Books.

<sup>35</sup> The World Bank, *The East Asian Miracle: Economic Growth and Public Policy*, Washington DC, 1993.

<sup>36</sup> Kishore Mahbubani, *The New Asian Hemisphere: The invisible Shift of Power to the East*, New York, New Policy, 2002.



Shahid was a passionate exponent of an active American policy in leading the world towards peaceful development not marred by national interests. Our conversations – while we served at the World Bank and after we retired from the institution – often led us to discuss America’s foreign policy. Both of us admired President Obama’s cerebral approach towards world affairs. The Washington-based Pakistani community of former World Bank staff watched and celebrated Obama’s 2008 victory at a party in a Bethesda home. Shahid and his wife, Nigar, were present along with a dozen other couples. We often commented on the fact that while most of the senior Indians who retired from the Bank went back to India, most Pakistanis stayed on in and around Washington. While we were not directly involved in American politics, US policies were often discussed at parties of the Pakistani community in an around Washington. Shahid was one of the most active participants in these conversations. The advance of Parkinson’s, which affected his speech, did not inhibit him from participating. He was not the type of person who would be deterred by a physical handicap. American foreign policy was an area in which he held strong views.

In defining US strategic interests, Obama’s two predecessors had different geographical priorities. Bill Clinton had focused on Europe. His administration used a bombing campaign to put a stop to the activities of the Serbian government headed by Slobodan Milosevic. The Dayton Accord led to the breakup of Yugoslavia into six states. George W. Bush focused instead on the Muslim world. In October 2001 he started bombing Afghanistan. Three months later American troops aided those from the Northern Alliance to take over Kabul from the Taliban. The American-led invasion of Iraq followed in 2003. While there was justification in invading Afghanistan and removing the Taliban regime from Kabul – it provided sanctuary to al Qaeda that planned and executed the 9/11 attacks – there was no particular reason for moving into Iraq.

Faced with all these complexities, President Obama was correct in reorienting his country’s policy focus away from the Middle East and Europe, towards Asia. But Asia did not evolve in ways that were expected. Its economy suffered a severe setback and a number of inter-country disputes began to take their toll. Although there is a small probability of this happening, the Asian continent has the potential of coming apart, because of several unresolved differences among its many states. Of the world’s nine nuclear states, five are in Asia. Iran has the potential of becoming one if the provisions in the Vienna agreement of July 2015 are not fully met. The continent has the fastest growing nuclear arsenal, with Pakistan adding more than any other country.

I once asked Shahid if he knew, while working with PM Bhutto, that Pakistan had begun to spend vast amounts of resources on a military nuclear program. The Bhutto decision to go that route came after the explosion by India in 1974 of a nuclear device. The test was carried out in the Rajasthan desert close to the border with Pakistan. “There was no discussion of this in senior official circles while I was in Islamabad,” he said. “The program was certainly not discussed in the cabinet.” The story of Pakistan’s progress in that area is well told by Feroz Khan, a senior military officer who was deeply involved in the scientific and technical work that led to Pakistan going

“nuclear.” His book, *Eating Grass*, picks up its title from the phrase Bhutto used to indicate that his nation would make any sacrifice to match India.<sup>37</sup>

The second time I turned down an offer from Shahid to work with him was when I declined to accompany him to Pakistan in 1976. PM Bhutto had called him to be his economic advisor. Shahid wanted me to join his Islamabad office and help him to develop the PM’s economic program. It was difficult for me to take leave from the World Bank where I had only just started. Once, again I disappointed Shahid, whose year in Pakistan was not a happy one. By the time he went to Islamabad, he had become disillusioned with Bhutto’s “activist state” approach to development. After having nationalized large manufacturing, finance and commercial enterprises soon after assuming political power in December 1971, he unexpectedly also brought medium-sized food processing firms under government control. “I was not consulted while this second program of nationalization was being developed,” Shahid recounted. “Bhutto had sensed that I opposed it. He preferred stealth over rational discourse. When the program came up for discussion in the Cabinet, I was strongly critical. Bhutto was not pleased. I decided to resign and return to the Bank.”

For about a dozen years our careers in the Bank followed very different trajectories. Shahid was a star performer on the Bank’s operational side; I had begun a slow ascent on the institution’s policy side. After serving as Division Chief of Policy Planning for five years from 1976 to 1981 I was appointed Economic Advisor to Vice President External Relations. There I came to know William Stanton a Congressman from Ohio, who was a close friend of Barber Conable, a former Congressman. Stanton was brought into the Bank as an advisor on relations with the US. This was particularly important when the Bank negotiated replenishments to the International Development Association. When Conable became the World Bank President in 1986, I became a member of his informal inner circle and served on a team to develop a new structure for the institution, which resulted in the Bank’s 1987 reorganization.

Although the group worked under the direction of Kim Jaycox, we turned to Shahid for advice on the direction we should take. Some members of the team met informally at Shahid’s Bethesda home and were guided by his deep knowledge of the institution’s history and his personal preferences for how it should work. Guided and prodded by him, we decided to give greater attention to the Bank’s country work. Shahid was of the view that Bank staff should have deep knowledge of the countries and regions in which they worked. He often referred to his work on Brazil as a Loan Officer and later as Division Chief. The group recommended the creation of 19 country departments that would work in six “regions” – South and East Asia, Africa, Latin America, the Middle East and North Africa, and Eastern Europe and Central Asia. Three of the 19 departments were to be “single country entities” – Brazil, China and India. Each region would be headed by a Vice President while the country departments would be headed by directors. In the inevitable staff shuffle that resulted from the 1987 reorganization, three senior jobs went to Pakistanis. Moeen Qureshi was appointed Senior Vice President Operations, moving over from the finance side of the institution; Shahid moved from having headed the East Asia region to

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<sup>37</sup> Feroz Khan, *Eating Grass: The Making of the Pakistani Bomb*, Stanford Security Studies, 2012.

become Vice President, Latin America and the Caribbean; I took over as Director of the China Department. This Pakistani group came to be referred to – wrongly, I believe – by Jim Wolfensohn as the “Pakistani mafia.”

The Chinese authorities were interested in the World Bank investing in developing infrastructure in the western part of the country. I decided to study the area – in particular the Xinjiang Autonomous Region which had a large presence of non-Han population. The area’s Uighur population is of Turkish descent and follows the Islamic faith. We organized a visit to Xinjiang by a group of engineers and project experts. We decided to travel by road to Kashgar, not very far from the Chinese border with Pakistan. We could take the Karakorum Highway (KKH) that crossed from Pakistan into China at a place called Khunjerab. This was a pass at a height of 15,387 feet in the Karakorum Mountain range. The construction of KKH was started in 1959 and was opened for traffic in 1979. The highway is 810 miles long and cuts through the collision zone between the Eurasian and Indian tectonic plates and as such is subject to seismic events such as the 2005 earthquake that took 85,000 lives in Pakistan. The earthquake created a permanent lake in the middle of the KKH zone. At the Khunjerab Pass, China, Tajikistan, Afghanistan and Pakistan come within 160 miles of each other.

I mentioned the Xinjiang trip to Shahid during one of our C&O Canal walks. He asked if he could join. He’d take leave from the Bank and make a personal trip, paying for hotel and other expenses. I said that won’t be necessary. He had a long association with China; it was while he was Vice President for East Asia that China took its seat in the Bank. He had played a major role in that move. It would be interesting to have his perspective on developments in China in the decade since it became a member and a beneficiary of large lending and policy reform programs, which were enormously consequential for China’s modernization. It would not be an exaggeration to say that without the World Bank’s involvement, China’s path to economic modernity would have been considerably more rocky. According to the IMF, China’s GDP (measured on the basis of the purchasing power parity (PPP) methodology) surpassed that of the US in 2014.

This was not Shahid’s first visit to Xinjiang. He had visited there when he was Vice President for East Asia, but then he had only been to Urumqi, the capital. This time we walked through the narrow streets of Kashgar, an ancient Central Asian city that had preserved its past cultural, social and business ways. Accompanying us on these walks was Zafer Ecevit, a Turkish economist, who was then Chief of Operations in the China Department. Shahid and I saw several similarities between Kashgar and towns such as Gilgit and Hunza on the Pakistani side of the border. We had spent a night in each of these towns on our way to Kashgar. Zafer saw the same kind of similarities between Xinjiang and Anatolia, a large region in eastern Turkey. It didn’t take us long to conclude that China should use Xinjiang as gateway to the West – through Pakistan to the Middle East, Turkey and Europe. Once in Beijing the three of us made this suggestion in our “wrap-up” discussions with the Finance Minister and his officials. Shahid was particularly excited about China’s opening to the West. The Chinese response was interesting. It became clear to us that Beijing was thinking along the same lines. The Finance Minister said that it was because of

these possibilities that we in the World Bank were invited to visit Xinjiang and assess the vast region's need for infrastructural improvements.

The visit to Xinjiang (and Beijing) was the only World Bank mission I took with Shahid. The next and the last time we traveled together for the institution was in January 1994 after I had taken over from him as Vice President for Latin America and the Caribbean.

On a later visit to Beijing Vice Premier Zhu Rongji, after concluding a session with the Bank team I was heading, invited me to stay back and spend a few moments with him in his office. He spoke some English and pointed to a map of China on the wall behind his desk. He asked me if I found something rather unique about China as shown on the map. I had no idea what he was referring to and asked him to explain what he meant. "We are the only large country in the world that is landlocked on three sides," he said. The United States, Canada, Russia, India, South Africa – all with large landmasses – were open to two or three sides. "We want to open to the West and use Pakistan to gain access to the sea," he said. He asked me if I knew senior people in Pakistan and explain to them the Chinese approach. This conversation took place in the spring of 1993; 22 years later while on a visit to Islamabad (April 2015), President Xi Jinping invited Pakistan to join his "One Belt, One Road" initiative and offered to spend as much as \$45 billion building the "China-Pakistan Economic Corridor."

We were attending the World Bank's annual meeting in Madrid in September 1994 when Shahid told me of his conversation with Lou Preston, the institution's president. He had told Preston that after seven years as Vice President for Latin America it was time for him to move. It was his preference to go to a non-operational job and had expressed some interest in the Bank's Human Resource activities. This was a neglected side of the Bank's management and Shahid thought he could bring in the needed reforms. His move, however, was contingent upon the elevation of the job to the level of a Senior Vice Presidency, which Preston accepted. Shahid had no idea who Preston had in mind to replace him in Latin America. In December 1994 Preston called me to his office and said that he wanted me to take the job: "Kid, I am thinking of sending you to Latin America but I am told that you don't want to give up your China job." I said that while I loved working on China I would not turn down a promotion.

By the time Shahid was nearing the end of his career in Latin America, he had become a strong advocate of private enterprise in the developing world. I knew that from our discussions during our C&O Canal walks. Unlike me, he was an enthusiastic supporter of The Washington Consensus approach to development. This was one of the few areas where we had different points of view. Our biases reflected our separate experiences in the Bank. Initially he was thrilled at the state's involvement in development. He always spoke with great admiration of the way Julius Nyerere, Tanzania's first president, had used the state to improve the lives of his citizens. Later his Pakistan and Indonesian experiences had convinced him that a very active state could retard economic and social progress rather than promote it. He saw the rise of corruption in these two countries the result of the large roles the state had assigned itself. He had opposed the expansion of the state's economic role under Prime Minister Zulfikar Ali Bhutto.

Shahid was particularly critical of the way the state owned oil company in Brazil was managing the energy sector. He was pressing the Brazilians to privatize Petrobras. The company was founded in 1953 and was the largest in the Southern Hemisphere by market capitalization. It owned oil refineries, oil tankers, and was a major distributor of oil products. It was a world leader in development of advanced technology from deep-water and ultra-deep water oil production. I was to learn when I moved to Latin America, that Shahid had blocked the World Bank's participation in building the Bolivia-Brazil-Argentina oil pipeline unless it was done by the private sector. That would have meant privatizing Petrobras. His long association with Brazil had convinced Shahid that the country was performing well below its potential largely because of an overbearing state and poorly performing state-owned companies.

A couple of days after relinquishing his Latin American Vice Presidency in the Bank, Shahid went to New York to speak about the region's prospects. This was a farewell address arranged by the Council of Foreign Relations. He said that while the region had a bright economic future there was a dark cloud hanging over the horizon. That cloud was called Brazil. The moment that comment was made, it was carried on the Brazilian newswires. The Brazilian ambassador in Washington complained to Preston, who asked me to deal with the situation. I did not want to put any pressure on the Brazilians about the role of the state, concentrating instead on managing the large World Bank projects there. Petrobras ceased to be the country's legal monopolist in the oil industry in 1997, but remained a significant oil producer with output of more than 2 million barrels a day. I also paid much greater attention to poverty alleviation in the country's large cities and in the less developed states in the country's northeast.

Shahid was ending his career at the World Bank when the institution's management changed. Lou Preston died of cancer while in office and for a few months Ernest Stern acted as president. On July 1, 1995, James Wolfensohn, an investment banker of Australian origin was appointed president. He and Shahid did not develop a good working relationship. The new president was not unhappy when Shahid announced his intention to leave. That would be in line with his express desire to cut down to size the "Pakistani mafia" to size.

On the morning of Shahid's farewell party in the World Bank's atrium, I got a call from Jim Wolfensohn. He asked me if I could be the master of ceremonies at the function. "I have no idea what Shahid Husain is going to say about me or about our difficult relations. If he says something which I consider not reflecting well on my Bank tenure, I might respond nastily. I want somebody like you – somebody who knows both of us well – to lighten up the proceedings." This was an unusual request but I agreed to play the role. An hour or so later, I got a call from Shahid. He asked me to come to his office. I found him greatly agitated, pacing up and down his office. He was reflecting on what he should say in his speech. "I will be somewhat critical of what Jim Wolfensohn has done in the Bank and the impact of his actions on the institution. These comments may excite him," he said. Could you be the master of ceremonies to keep the event under control," he asked. I said that I had already been approached by Jim for precisely the same reason and asked to the play the MC role. Hearing that he burst into his high pitch infectious laugh. The party went well; it concluded Shahid Husain's long, eventful and extraordinarily successful career in the World Bank.

## **Shahid Husain as a Leader**

By Armeane M. Choksi

Shahid cast a giant shadow in the World Bank. That was not because he was big and tall. He was not. It was the force of his personality and the strength of his intellect that made him tower over others.

My first contact with Shahid was in the East Africa region where I was a young professional and he was the regional vice president. Initially I was surprised by his youthful and immaculate appearance. Later on I came to realize that his sartorial standards were always very high, that he was the "Dapper Don" of the World Bank.

Shahid was not just intellectually robust, he was also widely recognized as a versatile manager capable of managing diverse vice presidencies in the Bank. He was completely at ease running the country regional operations and subsequently managing a vice presidency that focused on policy analysis. He could easily move from the regions to the policy side of the Bank and back again.

In my interactions with him he demonstrated qualities that I did not see in much of the Bank's leadership. He firmly believed in hiring the best staff possible, which he did with a vengeance and determination when he became vice president of the Latin America and Caribbean region and took advantage of the Bank's 1987 reorganization. Because of his reputation, Shahid always attracted and hired first-rate individuals from all over the Bank. And once they were part of his vice presidency, he would give them a free hand subject to the overall policy guidance and instructions, which he provided. He was no micromanager.

Even more unusual for the Bank, he would stand up to governments if he felt that their economic policies needed to be changed. He would not appease them in the name of maintaining good country relations. In the process, he would stand behind his staff that advised on making those difficult, but necessary policy changes. He would counsel his juniors to always do the right thing and to never give up. Once when I was going through a difficult period with a major recalcitrant borrower (Brazil), he advised me to be firm and told me, "At the end of this ordeal, you will come out like fine tempered steel." That was good advice that I have never forgotten.

Over time, I got to know him both professionally and personally. Professionally he was a very strong leader. He was quick-witted and very sharp. He was determined, bold and decisive. And he had a reputation as a risk taker. He never shied away from difficult decisions, nor did he take much time cogitating about them.

Consequently, he garnered much respect and admiration from many in the World Bank. But there were also those, particularly his insecure and risk-averse colleagues, who were either jealous of or spoke disparagingly about his risk-taking, boldness and rapid-fire decision-making. Some

viewed him as being ruthless. That was because Shahid would not suffer fools. One had to be as sharp, alert and quick as he was if you wanted to be on the same wavelength with him. Otherwise he would forge ahead. In many ways, Shahid was like Captain Kirk of the starship Enterprise in Star Trek. He boldly went where no man had gone before, leaving many behind in his wake.

Because of his strong leadership characteristics, he was feared by some, not exactly loved by others, but definitely respected and admired by all, including those who were not his fans. They grudgingly acknowledged his leadership qualities, his penchant for taking risks and his ability to take command and control of all situations. He stood head and shoulders above his colleagues and fellow vice presidents as a commanding leader.

Over the decade that he and I worked together, I saw Shahid's many strengths. Rather than continuing to describe his numerous leadership qualities, four concrete examples of my experiences with him will provide the full flavor of the man and a more complete picture of Shahid as a leader.

*Standing Up to the Indonesian Government.*

My first substantive interaction with him was as a lowly economist working on Indonesia while Shahid was the vice president for the East Asia and Pacific Region. He asked me to undertake a study of government policies towards the private sector. Along with a group of economists, we produced a comprehensive report.

When we met with the economic ministries of the government to discuss the report, they expressed unhappiness, because it was critical of the government's policies and had made far-reaching recommendations. The Finance Minister also objected to us presenting this report to the World Bank's Board, a very unusual move by a government. Furthermore, the chief economics minister, Mr. Widjojo, made a special visit to Washington to complain to Shahid. I went into that meeting fully expecting my head to be handed in my hands. We heard a long list of complaints about the report and numerous flaws in it. There was an extensive discussion between Shahid and Widjojo. I sat quietly in the meeting. Much to my surprise, Shahid did not back off one inch. He concluded by telling Widjojo that he and his ministers should reread this report and seriously consider implementing its recommendations.

There was no consideration or discussion of modifying this report to placate the government. That was extremely unusual, particularly since the Resident Director had put considerable pressure on me to change the report. Needless to say, I was totally taken aback by the strong and uncompromising position that Shahid had taken. This was certainly not the outcome I was expecting, particularly given the pervasive tendency of most Bank managers to appease government ministers. No other vice president would have taken this position and faced down a major Bank borrower and backed up a junior staff member.

This experience made a very strong, positive and lasting impression on me. And this is what made Shahid unique in the Bank. He very much believed in doing the right thing, taking unpopular positions with government officials if he believed it was the appropriate position and he made it

a point of not undermining his staff. This was the first time I had seen him do it. I subsequently saw him behave the same way on several other occasions. He did not shy away from standing up to ministers, and supporting his staff, if he felt that it was appropriate to do so.

#### *Meeting with the Brazilian Military*

Many years later, Shahid was appointed vice president of the Latin America and Caribbean region and he appointed me as a Country Director for Brazil, Peru and Venezuela. His directive to me was to change the Bank culture of lending to Brazil, which at that time was one of the Bank's largest borrowers. At that time, Brazil's interest payments to the World Bank accounted for about 65% of the Bank's net income. The Bank's exposure to Brazil was so high that a highly confidential study that we had undertaken showed that, were Brazil to default, the Bank would be forced to draw upon its callable capital in six to nine months, something the Bank had never done in its entire history.

Consequently managing the Bank's exposure to Brazil, while simultaneously keeping the government sufficiently satisfied with the Bank to continue servicing its debt on a timely basis was a major component of the Bank's strategy. This time period was also that of the Latin American debt crisis and, at that time, Brazil had suspended payments to all international commercial banks, except to the World Bank and the IMF. To complicate matters, Brazil was under tremendous pressure from the international community on Brazil's environmental program in the Amazon—a very sensitive topic with the Brazilian military for national security reasons-- and the Bank was right in the middle of that debate as well.

Balancing this delicate relationship with Brazil, I got word from friends in Brazil, who were close to the military, that some members of the President Sarney's government were very unhappy with the reduction in the World Bank's lending. They had convinced the military, the real power at that time behind the Presidency, that all payments to the World Bank be suspended on the grounds that the Bank's reduced lending was a direct consequence of Brazil's environmental policies. Nothing could have been further from the truth. The Bank was simply over-exposed in Brazil. My friends advised me that I should come to Brazil and meet face-to-face with the five military generals and explain directly to them the World Bank's position. Traditionally, the Bank only dealt with civilian governments and refrained from all contacts with the military.

I did not know what to do. So I took this matter up with Shahid. His initial reaction was what I was expecting and completely normal for a Bank manager: that I could not go to Brazil to meet with the military generals, as this would cause a major rift with the civilian government, our only counterpart in the country.

We then discussed the costs and benefits of meeting with the military generals. We both agreed that this was an extremely risky step. But we also agreed that, even if the civilian government did come to know of the meeting, as we suspected they would, it would now know that we had independent access to the military. Ironically, we would now have some leverage over the government in that we could bypass it and go directly to the real power and make our case. Then he told me, "Let me think about it."



I knew that this was a very difficult decision for him. If he agreed to the meeting, he would be defying all Bank precedents on this matter. Three hours later he called me and told me to go to Brazil, meet with the military generals and return before anybody knew I had left on that trip.

Here was a case of rapid decision-making with a very uncertain outcome. Shahid did not agonize over this decision. He did not take days or weeks evaluating the pros and cons wondering what his position would be if this trip turned out to be a failure. He knew he was playing at brinkmanship and that he was risking his reputation, credibility and judgment. And he was placing a great deal of trust in me. He knew that ultimately the responsibility for any failure would be his and his alone and he was fully aware of the consequences. He also knew that he had enough detractors in the Bank who would use this against him to damage his career and reputation. Yet, it took him only three hours to get back to me because he knew that this was the right thing to do for the Bank.

As it turned out the trip was successful and a potential Brazilian default, which would have been disastrous for the Bank, was avoided. More importantly, because the Bank continued to remain in a precarious financial situation with Brazil, and relations with Brazil remained sensitive, he never mentioned or discussed this matter within the Bank.

#### *Confronting the IMF*

A related event demonstrates Shahid's strength and conviction in holding firm to his beliefs even if it meant bucking established traditions. As mentioned above, managing the Bank's exposure in Brazil was a major focus of our work. Brazil was in the process of implementing a debt workout program with the commercial banks, the World Bank and the IMF. Both the World Bank and the IMF were under tremendous pressure from the Brazilians and the commercial banks to resume significantly higher lending to support the commercial banks' debt restructuring and publicly claim that Brazil had undertaken significant reforms to restructure its economy. Unfortunately, Brazil's poor macroeconomic performance and the lack of structural reforms could neither justify such a statement nor a much higher lending program. However, the IMF had independently decided to undertake a major multi-billion-dollar stabilization program and it insisted on World Bank support backed up by significantly higher lending.

Shahid asked me to have the IMF program evaluated. Our analysis concluded that the IMF program would not succeed. I presented that in the form of a letter from Shahid to his counterpart in the Fund. The letter essentially said that, in our judgment, the IMF program was unlikely to succeed, and while the World Bank would publicly support the IMF, it would not increase its lending to Brazil because the Bank did not find the Brazilian macroeconomic and structural adjustment program sufficiently strong to warrant a change.

As Shahid read the letter I sat opposite his large and pristine clean desk. After he finished reading, he stared at me for about 10 seconds and I clearly remember what he said.

"Are you mad? This is an atom bomb!"

My heart sank; I thought I had overreached. And I knew that I had probably less than five minutes to make my case to Shahid. I knew that his mind worked very fast and that he made decisions very quickly. I was afraid he had already decided. But I also knew that he was a man of substance and substance would prevail if only I could get my message across quickly and succinctly. After listening to me, he agreed to sign the letter. He did not dither. He simply took out his fountain pen (he always used a fountain pen, no ball point pen for the Dapper Don) and signed it.

As it turned out, the IMF program did not succeed, and because of his letter to his counterpart in the IMF, there was no public or private pressure from the IMF to increase the Bank's exposure in Brazil.

While professional disagreements with the IMF were not unusual, it was extremely unusual for a vice president of the World Bank to formally inform his counterpart that the Bank finds the IMF's stabilization program wanting and that the World Bank would not support it. This is just another example of Shahid's focus on substance and leadership in doing what was right for the Bank while risking a rupture with the IMF.

#### *The Reintegration of Peru into the World Economy*

While Shahid was vice president of the Latin America and Caribbean region where there were several high-profile countries like Brazil, Argentina and Mexico. I believe that his crowning achievement in Latin America was the reintegration of Peru into the world economy that significantly turned around and improved the lives of millions of Peruvians.

In the late 80s, Peru was in default to the entire international financial community, including the World Bank and the IMF. In the early 90s, the Finance Minister of Peru visited Shahid in the Bank and offered to resume interest payments to the Bank in return for a resumption of Bank lending. At that time, Peru was about \$1 billion in arrears to the Bank. However, Bank policy precluded any lending to a country that was not fully up-to-date in all its obligations.

So Shahid, in his inimitable way, decided to break all precedents by upending the way the Bank normally dealt with such situations. He had the World Bank's policy on dealing with countries in arrears changed. He organized and convinced the major industrial countries (the G7) to make a short-term bridge loan to Peru of \$1 billion. And then presented to the Board three large loans totaling about \$1.4 billion on the condition that these loans would be disbursed only once Peru had fully repaid the Bank the entire \$1 billion. More importantly, these loans also had significant, major macroeconomic and structural adjustment reforms focusing on economic liberalization including privatization, deregulation, trade reform, foreign investment reform, and financial sector reform.

This was an extremely complicated operation and took over two years to accomplish. It involved bringing together many different parts of the Bank, including a narrowly legalistic Legal Department and the Bank's Board, to approve a major policy change on how the Bank dealt with countries in arrears. Convincing the G7 to provide \$1 billion in short term funding to Peru was

filled with hurdles and obstacles that Shahid masterfully negotiated. This financial transaction also involved some imaginative round-tripping of funds from the G7 to Peru to the World Bank and back again to Peru and the G7. But he convinced all that if Peru successfully implemented the much-needed reforms, it would climb out of its debt hole with all the financial institutions largely intact and be fully reintegrated into the world economy. No other vice-president could have managed such an intricate process that would open the doors of the international financial community to Peru.

As a postscript to this story, and to prove my point above, several years later, after Shahid had left the Bank, the Bank's Legal Department ruled out a similar operation for another country in default to the Bank on the grounds that this approach contravened the Bank's Articles of Agreement. Clearly, there was no Shahid there with his credibility to maneuver through the maze and thicket of Bank regulations and convince the numerous, parties within the Bank on the need to adopt an unusual and innovative approach.

Over the last two decades, as a result of Shahid's accomplishments and the economic reforms required, Peru's economic transformation rivals Chile's economic miracle. Peru has been transformed from a bankrupt poverty-ridden country into one of the, if not the fastest-growing economies in Latin America, significantly improving the lives of the entire population including the rural poor. One recent study indicated that the incomes of the rural poor grew at 7% annually since the implementation of those economic reforms. Visually, Lima, the capital, has been transformed from a third world rundown city into a first world modern city with steel and glass skyscrapers. Peru is now a full-fledged member of the international financial community. The people of Peru owe a huge debt to Shahid.

### *Conclusions*

If one met Shahid in the Bank in a formal meeting, there would be no doubt that this man was a strong leader. He dominated and controlled meetings to ensure the outcome that he felt was the best one. He did not waste people's time, and in return he did not expect others to waste his. His boldness and resolute demeanor left many uneasy. His decisiveness, determination and tenacity garnered a lot of admiration, even from those who had a less favorable view of Shahid than some of us. He never avoided making tough decisions. "Always take your costs upfront," was his repeated mantra to me. He never let wounds fester. If he had to make an unpopular decision, he would unhesitatingly make it. In dealing with governments he was no different. Always polite, but always firm and never compromising his principles.

After leaving the Bank, he remained intellectually alert throughout his life. Conversations with him would range from world economic and political issues to issues in Pakistan, India or China, to the US political system and to the current state of the World Bank and the IMF. He was constantly engaged and up-to-date on economic and political issues across the globe. And he had definite opinions about all of them. As his physical health deteriorated, his mind remained ever alert. And his determination to overcome his physical deterioration was nothing short of astonishing and admirable. He would never give up. He was not willing to admit that he could not conquer his disease. Often, when his doctors had predicted an irreversible decline, he would

astonish them by bouncing right back. After a long hard fight, his disease got the better of him. In my two decades at the World Bank, there was no one who showed the leadership skills, force of personality and intellectual strength that I saw in Shahid. I seriously doubt that the World Bank will ever be fortunate enough to have another Shahid.

## **Shahid Husain as a Manager**

By Richard Gregory

Others have commented on Shahid's strategic vision and intellectual leadership on major issues faced by developing countries, e.g. the debt crisis and its aftermath in Latin America, the need for the World Bank to move to address policy issues beyond projects and its lack of understanding of political constraints to economic development, etc. In this essay I will focus on Shahid's exceptional managerial abilities—he was one of the most effective managers I have had the privilege to work with.

While I knew Shahid by reputation, I first met him when he hired me as his Chief Administrative Officer early in the 1987 reorganization. He was building the exceptional leadership team of his Latin American and Caribbean (LAC) Vice Presidency from scratch.

As an ex Naval Officer and MBA, I had long been interested in the issue of how to achieve results through a large organization. I had worked for a number of the World Bank's distinguished managers, Roger Chaufounier, David Knox, and Willi Wapenhans, all of whom had well-deserved reputations and had achieved major results for the Bank and its member countries. But Shahid's strategic sense, use of management tools, dynamism and decisiveness were exceptional even among this group. He once said he would rather make a quick decision and correct it if he were wrong than dither. And Shahid used all the tools of management to reinforce and implement his strategic vision. He didn't buy the prevailing Bank ethos that it was a unique organization, and sought ideas both from outside and inside the Bank.

### *People Management*

Shahid had a gift for picking and developing talented people, many of whom went on to senior positions in the Bank and Fund. He liked young people with new ideas, recruited able women like Nancy Birdsall and Kathy Sierra, and sought diversity of people and opinions. A dominant and often intimidating intellect, Shahid learned over time to let others come forth with their ideas before revealing his own thoughts. But he also developed back channels like me to ensure the members of his management team had ways of getting ideas to him. Like other good managers, he met with each of his team once a week in a private session to discuss progress and problems. His regular weekly management meetings were brisk, no-nonsense affairs where he tried to bring out the member's opinions before revealing his. He often used me as a foil for ideas that he wanted to put across.

Once he trusted you, he gave you great latitude in carrying out your duties. Periodically, he would ask you in depth about some assignment, provide useful guidance and feedback and just make sure you were on top of the issues. Some found these sessions a bit unsettling. He was particularly sensitive to discrimination against minorities and women and was careful to develop and promote people on merit. And, while he didn't wear his heart on his sleeve and could be brusque if he felt the need for it, he could also be extraordinarily supportive; e.g. when my first

wife was dying of cancer, he called me in and told me to go home and to come in only if I felt up to it. He would ensure my work got done.

Shahid was an excellent, even brilliant extemporaneous speaker. In LAC and MPS (Management and Personal Services – a Senior Vice Presidency for various administrative and personnel functions he headed from 1993 until his retirement in 1996), our annual management retreats with about 50 managers were always a pleasure to attend and observe Shahid at his best. In LAC, he would usually have an outside guest from Latin America to spice things up, e.g. Miguel de la Madrid, a former President of Mexico, who gave us a fascinating take on the Latin American debt crises from the Mexican perspective, a well know Brazilian Senator, the Peruvian Presidential candidate and author, Vargas Llosa, the Finance Ministers of Mexico, Argentina and Chile, etc. He would then lead discussions on current internal issues, e.g. enhancing the role of women. But the highlight at the end of our two-day retreats was always Shahid's absolutely spectacular and apparently extemporaneous summing up of what he wanted us to take away from the sessions. Of course, he did a lot of work behind the scenes to prepare for this.

#### *Strategic Resource Management*

Early in our work relationship, just after the World Bank's 1987 reorganization which created a whole new internal structure for the regions, Shahid asked me to talk to a relatively new staff member that who had come from the consulting and banking world to seek his views on how we should organize ourselves in the new Bank. The key idea that emerged from those discussions was that Shahid, as VP, should focus on strategy while his Directors and Division chiefs should focus on tactics. Whether this was a new idea for Shahid I do not know, but he embraced it and it characterized much of what he did after that.

For example, as the debt crisis in Latin America waned, Shahid began to discuss with his managers and the senior officials of member countries what the Bank should focus on next. The conclusion was that we should shift from policy lending in support of responses to the debt crises to other serious issues in the region such as the environment, health care and education.

The Bank's budgeting process, at least at the regional level, was then a largely a pro-forma process with little strategic or long-term content. The focus was entirely on the next year's increase with no serious discussion of long-term goals. Strategic discussions were typically in the context of Country Programming papers, which presented strategy, lending and economic research programs for each country. Departmental and regional budgets were prepared by specialized junior staff and reviewed by other junior staff in the central Programming and Budgeting Department. Understandably, these relatively junior people seldom had much understanding of the strategic context and focused on numbers of loans, cost per loan and other often meaningless indicators. False precision and focusing on the wrong issues was often the result.

In the various regions I worked for, we would usually decide to seek a modest budget increase for the next year (say 3-4 %) and ask for funds and additional staff positions to carry it out. We

would aggregate the various lending programs of the departments, presumably reflecting country strategies, and submit a massive 50-90 page document meeting all of the data requirements specified by the central Programming and Budgeting department. Discussions of the budget with senior management would largely focus on the number of projects we would submit to the Board (and the total lending amount) and on operational questions such as whether we should open a new office in e.g. Brazil. And since P&B had separate data stems, quite often these discussions wasted a lot of time on differences between our data and theirs.

Shahid began to use the budget process as a tool of strategic management, focusing on how total resources would be used, not just on the annual increase, and on multiyear plans instead of a single year. As the Latin American debt crises of the 1980's was coming to a close, Shahid traveled to many of our member countries to talk to Presidents, Prime Ministers and Finance Ministers about what they wanted us to do next. As mentioned earlier, their main message was that the Bank should shift from macroeconomic policy lending to environmental and social sector lending.

Therefore, he decided to present a strategic medium term budget encompassing these goals to the Bank's new President, Lewis Preston. Our submission covered only three pages, stated that we needed to make this shift and explained that we could pay for most of it by shifting existing resources. But we noted a small amount of additional resources would help accelerate the proposed shift. Mr. Preston approved our budget-- I believe the only one that year that got everything asked for.

Shahid then began to use the tools of management that the Bank provided to carry out this shift. He gave the departments a lot of discretion how to carry out the strategy, essentially freeing them up from staff position controls, (and fending off the center to do so), but holding them to a total dollar amount of budget. He left a lot of the details to them, e.g. whether they would use their budgets for more staff, consultants or travel. But Shahid would continue to ask his managers what their strategies were and how they would achieve them. He fully realized that in making a major change, the message has to be repeated and emphasized.

The initial Departmental strategies were often beautifully written, but the proposed lending programs often had little relationship to the strategies, something Shahid needed only to point out and suggest adjustment.

Up until that time, the Personnel Department had essentially run a parallel and often disconnected planning process for staffing. Shahid folded personnel planning into our overall planning process. Some Departments were still planning to hire more general economists for policy work rather than adjust their focus to hiring the needed environmental or social staff and consultants. Finally, Shahid used the annual performance reviews to reinforce the message that managers were responsible for their budgets and the results.

As the more astute Directors and Division Chiefs caught on, they began to use imaginative solutions to implement the shift, e.g. by using consultants instead of regular staff in untested

areas, by assigning more staff to work in the field to expedite project development, or by developing new solutions for key environmental problems.

As a result, over three years, LAC departments shifted the Bank's lending in Latin America from about 60% policy lending to about 60% environmental and social lending, creating several new divisions in these growing sectors while phasing out some policy divisions. And none of this was top down, but done by front line managers. Shahid's effective strategic leadership from the top reinforced by the use of all management tools at hand resulted in what was, by Bank standards, an unusually rapid adjustment.

#### *Management and Personnel Services*

When Shahid started as Senior Vice President of the newly created Management and Personnel Services, he was responsible for about 50 plus back office businesses from Personnel to Travel, from Training to Technology. There was no obvious coherent strategy for these units, or clear linkage to the Bank's objectives. Shahid's main thrust was to focus these units on better supporting operational objectives, encouraging reforms in front line operations and ensuring that they were actually supporting front line staff. He encouraged all of his direct reports to find better and more efficient ways of doing their business which many of them did.

One of the main reasons Shahid had been brought in to manage MPS (the Bank's central services) was the substantial cost overruns on the construction of the roughly \$320 million (budgeted) new headquarter building complex. Shahid had been on the committee that selected the building's design and he took a strong personal interest in the project and its many problems. To remedy them, a Construction Department was created with professional construction contract managers. A separate specialized accounting system was installed (the Bank's administrative systems were not designed for construction management), and tight controls and standard cost procedures were established for the previously out of control changes to design requested by line managers. He personally ensured that costly change requests from senior managers were reduced to a minimum. For example, when James Wolfensohn, the new Bank President arrived in 1995, he initially wanted to move the Presidential and Managing Director offices to a different floor. The associated construction costs would have run into millions of dollars. Shahid convinced Wolfensohn to drop his proposal. Similar requests from other senior managers had to be rejected to stay on budget.

As mentioned earlier, Shahid didn't believe the Bank was unique in its management problems and issues and he was not afraid to use outside expertise and ideas to reform the Bank. So when he took over MPS, he brought in an outside consultant to work with him and his managers to develop new ideas for reform. A "war room" was set up to track the progress on the ideas that emerged. Other experts and teams began to look at Personnel, Information Systems and other internal bank functions. An expert on management information and control systems led to the development of an electronic "stop light" reporting system to track and report on the dozens of initiatives being implemented.



Having been a Vice President for three different Regions and for central policy, Shahid had long been concerned with the lack of consultation of line managers on major personnel policies and other changes affecting their ability to carry out his mandates. To remedy this situation and to more rapidly gain acceptance for changes, he established a regular meeting with the Bank's Vice Presidents. They met frequently and reviewed all major proposals emerging from the MPS reforms. This was a complementary structure to the Operational VPs meetings under Ernest Stern.

For example, he used this group to get a decision to consolidate all of the Bank's electronic networks onto a single platform. The Bank's many (previously incompatible) electronic networks had their own dedicated staff, who were committed to their particular technology and resisted efforts to standardize. These separate technologies had led to some ridiculous situations. Units could not communicate with each other and staff had to be retrained when they moved between units. Some data systems were incompatible. E.g. To pay staff, the Personnel Department monthly had to run off a tape of the staff on-board, then physically carry the tape across 18<sup>th</sup> Street to the one staff member who could convert it to the payroll system so that checks could be cut and deposits made. By raising this issue with the VPs and presenting the strategic case for a single electronic network, Shahid got the necessary commitments to proceed with the consolidation and standardization of electronic and data systems.

A number of other major changes were presented and approved by the VPs as a group. For example, Shahid's strategic consultant had convinced him that the only way to get Bank managers to think strategically and prioritize their efforts was to implement a large enough budget cut that it would get their attention. So Shahid sent a one copy only memo to Lewis Preston, the President suggesting this.

When a budget cut of 6% was subsequently announced, most senior managers initially thought they could achieve it through attrition. But the Bank is essentially staff, and Shahid had us do an analysis that showed that the only way the 6% budget cut could be achieved was by cutting staff. We made a one-off presentation to the VP's showing this (destroying copies of the presentation afterwards). As the reality sunk in, the VPs as a group concluded that they were going to have to make some strategic judgments as to what staffing they needed. The better managers used the opportunity to make needed shifts.

One of the units in MPS was the Bank's internal consulting group. Shahid convinced the VPs for Africa and Latin America to let him and his internal and external management consultants help them make their operations more effective. He took a strong personal interest in this work and chaired weekly meetings to monitor progress. The group also brought in some of the best change consultants in the world to give presentations and run workshops on managing large scale reforms throughout the Bank. Shahid encouraged and personally used benchmarking with other organizations to learn and apply best practices from around the world to our activities, e.g. personnel, information management, travel, etc. And he continued to press for communications with management and staff on the rationale behind needed changes. There were well over two

dozen major and minor initiatives in the various groups under MPS aimed at better support for the Operational VPUs.

#### *Information Management and Technology*

Unlike most senior Bank managers, Shahid was also interested in technology, not for its own sake but for how it could help the Bank become more efficient and effective. In LAC, he initially received a lot of complaints about our word processing systems, mainly the problems of printing the large Bank reports that taxed the capacity of personal computers of the time. In 1990, he formed a group chaired by Edi Segura, a Country Director, to study the problem. This was the first time an operations business manager had been asked to look at technology, previously left to back office specialists who often did not understand the needs of the operational staff. Nor did many senior operations managers understand the potential of technology, so there was a huge gap in communication between the two.

Edi's task force came up with the first technology strategy based on the business needs of Banks operational units. Essentially, it recommended standardization of equipment and software, networking computers together, and a much greater use of portable computers to enable work in the field. Later it became the model for bank-wide changes.

As a result, the LAC technology budget was tripled and LAC volunteered to be the pilot for Bank networking, which was in a primitive state at the time. Among the first operational impacts was technical support for a 50-person mission to help Mexico deal with the after-effects of its debt crises. The mission was equipped with portables and printers. It produced its report while in the field in time for the new Mexican government to use it. The Government immediately convened a two-day retreat of key ministers to study and discuss the report. The normal Bank procedure was to produce a report six months or more after returning from mission, by which time much of the analysis and conclusions were out of date. Shortening this time with technology had a huge operational impact.

In MPS, Shahid used the Bank's Information Management Department to work on the larger issues of technology and information. Starting with MPS itself, he found for example, that the Personnel Department had three different, incompatible systems for staff, consultants, and temporary assistants. If a consultant became staff, his information could not be transferred to the staff system, but had to be reentered. Each unit was jealously guarding its turf. Outside experts were brought in to work with Bank staff and, among the long-term results, was the move to a standard Bank wide technology (SAS), the development of better systems to communicate with field offices (including video conferencing), and distance learning.

#### *Political skills*

All senior Bank managers, particularly those dealing with member countries, needed to have a political sense of what is politically possible and skills to influence change. Some of the most successful managers, like Roger Chaufounier, were/are masters of persuasion. Whether from his earlier experiences as a District Officer in Pakistan or his personal development and growth

through four World Bank Vice Presidencies, Shahid developed a keen sense of the importance of both external and internal political forces.

He was a persuasive and inspirational leader with exceptional analytical and intellectual skills who could hold his own with Presidents and Prime Ministers. He often lamented his staff's lack of understanding of political forces affecting development in our client countries. And he clearly appreciated the importance of the backing and support from Bank Presidents, notably Robert McNamara, who appointed him as the Bank's youngest VP in 1974 and moved him to several key posts, including East Asia when China was about to become a member. He also had the full support of Lewis Preston who created MPS and put Shahid in charge with a mandate to shake up the Bank's moribund internal culture and deal with the Main Complex Construction cost overruns. Lou once introduced him to an assembly of Latin American leaders as his man in Latin America.

Although I have minimal inside knowledge of his relations with the key players in the Bank and member countries, he clearly had the support of McNamara and Preston in most if not all the efforts and reforms and changes he undertook. In fact, the creation of MPS (from several Vice Presidencies and groups) was most likely designed for Shahid's particular talents and interests.

#### *Summing Up*

Shahid was an inspiring and decisive manager and leader who pushed the boundaries of the Bank's practices to provide better, more responsive, and more efficient services to our member countries. He encouraged the members of his management teams to think more creatively and strategically and used MPS to better support front line staff. A number of major improvements were made during his tenure that made the Bank a more effective institution. In LAC, he managed a major shift in operations and a greater responsiveness to local concerns.

As one director noted, working for Shahid was "my most rewarding and productive period in the Bank." Another agreed "working with him was my best experience at the World Bank. He was not only very professional, but was a very kind person." One of his senior managers in MPS felt his main contribution was to bring an operational focus, while putting in place effective administrative systems support front line operations. Under his leadership, a solid foundation was laid for IT-enabled reform of the Bank's processes. Another of his MPS managers once told me "Shahid accomplished more in 18 months than any of his predecessors had accomplished in 18 years". To give just one example, Shahid and his managers produced savings of \$50 million from the MPS budget, enough to fund a full operational department.

As a Pakistani Newspaper noted on his death, Shahid was "A high-calibre intellectual, he as always strategically focused, prioritizing Bank interventions in the borrower country, balancing his vision with pragmatism. Eager to get involved, he would roll up his sleeves to take up a position in the trenches with his staff, determined to find a constructive way forward on key issues. He was highly regarded as a clear-headed mentor: decisive, excruciatingly hardworking and accessible to even the more junior staff members, engaging constructively with them,

encouraging innovation and advising them never to give up if they believed in their own analysis and reform proposals. He made sure his staff were well taken care of and was ahead of his time as a supporter of women, persistently trying to carve out meaningful career paths for them.”

Personally, I found Shahid the most interesting, challenging and exciting manager I ever worked for. It was always interesting and enjoyable in the best sense of that word. Never a dull moment!

An impressive legacy indeed.

## **The Limits to External Indebtedness of Developing Countries**

By Homi Kharas

### *Introduction*

When I joined the World Bank in 1980, President Robert McNamara had fashioned a truly multilateral organization. Unlike many of the organs of the United Nations, McNamara insisted on full control over staff appointments and developed a management structure that was strictly meritocratic, yet also nationally diverse. In order to accomplish this, McNamara developed and promoted promising young talent from developing countries, a group subsequently known as the “Whiz Kids”. Shahid Husain was one of these, a formidable intellect who mirrored McNamara’s management style. Both were inclined to be aggressive and to take calculated risks, motivated by the needs and expectations of borrowing client countries, rather than appealing to the very conservative capital market investors in World Bank bonds. Both understood that in order to rapidly expand the Bank’s financial role they would have to develop a far better understanding of the quantitative risks involved. Both relied heavily on numbers and a disciplined approach, drawing on the best that academia and practitioners had to offer.

The World Bank of the late 1960’s and 1970’s was an organization where ideas were as important as lending, where economists were encouraged to move between research and operations (and back), and where staff were empowered to act as international civil servants, influenced of course by their own national experiences and loyalties, but providing independent advice and programs that sought to advance individual country progress, through trade, finance, foreign direct investment and other forces of globalization and multi-country collective action.

Early in his World Bank career, Shahid participated in an influential volume edited by Drag Avramovic in 1964 called “Economic Growth and External Debt.” This volume looked at the circumstances relevant to the terms on which lending could be extended to developing countries without creating debt servicing problems, while also providing an analytical frame to help decision-makers quantify their assessments. Shahid contributed the mathematical appendix on how debt, interest, incomes, saving and investment would grow over time, under different assumptions, and derived the steady-state conditions for equi-proportionate growth of debt and GDP. He also wrote or contributed to several essays on topics relevant to growth and indebtedness.

Many of the topics of concern in the 1960s that Shahid worked on would be familiar to development practitioners today. Shahid, I think, would be proud of the fact that multilateralism is still a dominant force in global economic development, as demonstrated by the endorsement of the sustainable development goals in September 2015 by 193 countries at the UN General Assembly; by the 3<sup>rd</sup> financing for development conference held at Addis Ababa in July; and by the agreement on climate change achieved during the COP21 summit in Paris in December. These successes of multilateralism have their roots in the work done by pioneers like Shahid who helped forge multilateral organizations into institutions working to promote global public goods.

*Making difficult choices in financing development*

“Lending to finance international economic development is a continuing problem of difficult choices.” This quote comes from the introduction to the 1964 World Bank volume cited above. Many of the choices being faced by policy-makers today are the same as they were fifty years ago. At that time, there was a question of the rate of capital accumulation needed for the accelerated growth of developing countries (and how this rate varies according to a country’s domestic policy environment and institutions). Today, this issue has again come to the fore with a broad range of discussions on how to finance the sustainable development goals and the transition to low-carbon trajectories.

Another choice is how much public investment to finance domestically, and how to best use these resources. In the 1960s, this issue was behind the development of dependency theory by Prebisch and others, calling for a new trade policy for development. More recently, domestic resource mobilization discussions took center stage at the Addis Ababa conference on development financing.

A third choice that was much debated in the 1960s was to decide on the appropriate mix of debt, foreign direct investment, sovereign borrowing or private external borrowing, and to assess the implications of these choices for structural rigidities and debt servicing capacity. Again today, the issue of debt servicing capacity is at the center, with considerable discussion about how to treat debt-financed infrastructure investment. Does it worsen indebtedness, or improve it?

*Capital investment and economic growth*

The development community is coming full circle on the question of the relevance of capital accumulation to the growth process. The early literature placed considerable emphasis on investment, and many early growth models had investment as the main driver of growth, or at least the main driver that could be influenced by policy—other drivers like total factor productivity growth were understood to be important, but the policy lever to improve this remained unclear.

Belief in this central role of investment in economic growth and of public investment in particular, became the analytical bedrock of the World Bank’s expansion of lending under McNamara and his whiz kids during the 1970s.

Quickly, however, the intellectual climate started to shift. One problem was that the economist definition of investment was different from that used in most systems of national accounting. For an economist, spending on education or health programs, or empowerment of women or of people living in poverty, could be counted as investments, with a measurable return in the form of higher economic growth albeit at some distant future time. Indeed, the World Bank rapidly expanded its lending for these “basic needs” during the 1970s, and Shahid was one of the champions leading the organization in these directions. But these types of investments introduced a long time lag during which debt had to be serviced and before returns emerged. The lags in turn created a structural rigidity in the economies and underlined the need to consider

what used to be known as the transfer problem (would the returns to better education, for example, produce the foreign exchange needed to service the debt, or would countries need to lower the prices of their export goods even further to expand them enough to service the debt).

A separate issue that emerged during the 1980s was a line of thinking that a focus on investment in developing countries deflected attention from the problem of perverse incentives, vested interests and corruption. Governments in developing countries had a comparative advantage in mobilizing resources and indeed organizations like the World Bank only lent to governments or demanded government guarantees on their loans. However, the private sector often had a comparative advantage in identifying and executing development projects, especially in industry and extractives, as well as in banking. The trouble was that in many developing countries the ease with which government could raise finance externally encouraged them to undertake development projects themselves, which they had difficulty implementing effectively.

This problem of bad investment decision-making and poor project execution led to many of the fragilities that would reveal themselves as external debt difficulties during the 1980s, first in Latin America but later throughout the developing world. The World Bank responded by introducing a new instrument- structural adjustment lending - that proffered funds in support of an agreed-upon program of reforms that were intended to improve incentives for investment. In practice, however, structural adjustment had a mixed record. Some countries used it to provide an impetus for desirable reforms, but others accepted the funds while neglecting reform.

The importance of policy reform and getting incentives (and institutions) right came to be known as the Washington Consensus, partly because it was developed by John Williamson, then at a think tank in Washington DC, but also partly because it quickly was embraced by the Bretton Woods institutions based in Washington DC, including the World Bank.

More recently, however, the intellectual pendulum has swung back towards the importance of investment and public spending. The new sustainable development goals and the agreement to limit climate change to less than 2 degrees above pre-industrial levels have brought to the fore the need for massive new investments to put countries on a path towards eventual net zero carbon development. For developing countries, access to finance and technology has been a *sine qua non* for participating in the global climate change agreement, but there is a realization that this funding cannot come in the form of ODA as budgets of developed countries are tight. Hence the discussion has turned to “leverage”, a way of saying that finance will have to be raised on private capital markets. In this environment, the role of governments, in both developed and developing countries, is to use their own good standing in credit markets to reduce the risks faced by private investors. The key issue, then, becomes how to develop the most efficient risk sharing mechanisms and how to price them, rather than the availability of or access to finance.

It is because of their leverage that multilateral institutions are now looked at as a central part of the solution to development finance. The capital provided to multilateral institutions is today about \$680 billion, including callable capital. At the World Bank, paid-in capital is only 6% of total capital subscriptions. From an operational perspective, the World Bank Group has a policy of

maintaining an equity/loans ratio of at least 20%. Leverage therefore comes in two ways: first, the paid-in capital is leveraged with borrowing on international capital markets to raise funds for lending; second, the World Bank makes a profit which it retains to increase its capital (and hence lending) still further. Retained earnings are currently almost double the size of paid-in capital; and because capital is contributed by all countries, the burden on the developed ones is also lessened—again in the case of the World Bank the developed countries only provide about half the total capital.

A final way of increasing leverage is through the use of guarantees and other risk-based instruments, but currently the accounting of these is very conservative and consequently utilization has been low.

This potential for leverage is behind a renewed call for additional capital increases for multilateral institutions. Capital contributions from developed countries could be increased by \$25-30 billion (potentially using their equity in soft loan organizations, rather than new budgetary funds) and unleash annual lending of around \$70 billion per year.

The need for additional public investment also follows findings by the IMF that the level of the public capital stock in developing countries fell by some 20 percentage points in the decade between the 1990s and 2000s. It has also become less effective in generating growth for reasons that vary across countries: in some, planning capability has been dismantled at central and line ministries; in others, project execution seems to have gotten worse; in still others, growing capital stocks have put a burden on operating and maintenance budgets, and spreading these ever more thinly has reduced the effectiveness of the initial investment. IMF staff has estimated that when adjusted for efficiency, the share of public capital stock in GDP in developing countries has fallen steadily since the 1960s.<sup>38</sup> According to their calculations, the level of the efficiency adjusted public capital stock in low income countries is almost half its level in the 1960s.

The case for more public investment to generate growth is not confined to developing countries. It has taken center stage in rich countries as well, with the theories of secular stagnation and deficient demand implying that infrastructure spending could be a “free lunch”.<sup>39</sup>

Thus, the idea that development finance should be sharply increased to permit more infrastructure investment in developing countries, something that was controversial when first developed and implemented by the World Bank in the 1970s is now mainstream thinking in the development community. I am sure Shahid Husain would be well pleased, but also hard-headed and realistic that this is not a solution in all cases, but only helpful when the policy conditions are right.

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<sup>38</sup> S. Gupta et al. “Efficiency-Adjusted Public Capital and Growth”, IMF Working Paper WP/11/217 <https://www.imf.org/external/pubs/ft/wp/2011/wp11217.pdf>

<sup>39</sup> L. Summers, Oct 2014, “Why Public Investment really is a free lunch”, <http://www.ft.com/intl/cms/s/2/9b591f98-4997-11e4-8d68-00144feab7de.html#axzz3wZvemjuZ>



### *Domestic Resource Mobilization*

The Addis Ababa Action Agenda outcome document highlights “For all countries, public policies and the mobilization and effective use of domestic resources, underscored by the principle of national ownership, are central to our common pursuit of sustainable development, including achieving the SDGs.” In fact higher domestic resources, based on the rapid growth achieved in most developing countries since 2000, have been far and away the primary source of new development finance. The World Bank estimated that in 2012, the domestic resources mobilized by developing countries amounted to \$7.7 trillion, up by more than \$6 trillion since 2000. This compares with around \$150 billion in ODA.

Of course, most of the domestic resources were mobilized by middle-income developing countries, but even in sub-Saharan Africa about \$10 in domestic resources is mobilized for every dollar of aid.

The importance of domestic resources has long been recognized as central to the analysis of external debt servicing. Shahid Husain, in 1964, was already emphasizing differences between average and marginal rates of saving as a critical parameter. His was one of the early contributions to the literature. (Indeed, as a parenthesis, I also wrote my doctoral thesis on the long-run creditworthiness of developing countries and focused on the role of the marginal savings rate. There had not been much advance in thinking over the intervening 15 years.)

Public saving remains a central issue in the assessment of debt servicing capacities because it is also an important determinant of balance of payments sustainability. If governments resort to inflationary finance because of a lack of savings, it can complicate their management of the balance of payments and affect the ability to service external debt.

Shahid Husain had long experience of macroeconomic crises in Latin America, and it is in Latin America where public savings is a topic of considerable discussion. In most of East Asia, by contrast, public investment rates are high and so is the level of public savings.

Brazil is one of the countries where low levels of public saving have been a problem for many years. Former Brazilian finance minister Bresser-Perreira, the architect of what became Brady bonds to resolve the 1980s debt crises in Latin America, was a big proponent of the idea that insufficient public savings were a major underlying cause of Brazil’s high real interest rates, chronic inflation, and budget troubles.

The choice for country governments of course is how to achieve higher levels of public savings without raising tax rates so high so as to choke off economic growth. In the case of Brazil, not only were public savings low, but taxes were also rather high, making this choice even more problematic. The focus had to be on bringing down domestic expenditures and, more specifically, domestic transfer payments including pensions that created a structural budget problem.

Many other countries face similar choices. They are often advised by the Bretton Woods institutions to raise public savings using a package of measures including cutting wages and

pensions or other entitlements, or raising taxes. This has earned these institutions the reputation of preaching austerity, but in reality they are simply being conservative. Lenders, unsurprisingly, will make different choices compared to borrowing countries in their assessment of the trade-off between establishing long-term credibility in domestic public finances versus spending, even if the latter takes the form of investment in projects and programs with high returns.

#### *Aid, Debt and FDI*

During the 1960s, the prevailing view of the appropriate mix of foreign capital was that countries moved through a cycle. At low incomes, they needed ODA or grant assistance. When they reached slightly higher income levels they could afford some debt, especially when this was on favorable terms from multilateral agencies, for example. As countries became more developed, they could also access foreign direct investment.

From the perspective of developing countries, this cycle represented a hardening of terms as they became wealthier, in exchange for an expansion in the volume of funds. Because aid was highly restricted, large flows could only come from debt or FDI. From the perspective of providers of capital, grant financing was provided with an explicit understanding that there was no requirement for repayment, but was in short supply because of budget constraints in developed countries. Debt finance was closely tied to the ability to repay and so could be more extensive in middle-income countries, and the risk of repatriating profits earned on FDI was borne by the private provider who also would provide more funds to middle-income countries where this risk was assumed to be lower. It was a cycle that appeared to work well for all parties. Unfortunately, reality was more complex.

One issue that did not fit well with this theory was how to treat amortization. It was clear that longer-term borrowing was less risky than short-term borrowing because problems associated with rollover could not be anticipated and modeled, holding interest rates constant, and so public lenders chose to focus on providing long-term loans despite their higher interest costs. But the projections methodologies that were used to assess debt service could not adequately describe conditions under which roll-over risk would be problematic so judgments were needed about the future state of capital markets and ability to borrow again to smooth repayments over time. Without sound guidance on how to make these judgments, developing countries were restricted to only accessing long-term capital markets.

Another issue of concern was the relationship between FDI and debt service payments. At one level, it was thought that the two could be complements. The conventional wisdom was that returns on equity capital would fluctuate along with export earnings and so it was not necessary to include FDI profit repatriation in external debt service assessments. The higher exports would provide the needed foreign exchange to cover profit repatriation.

Shahid Husain and others at the World Bank were keen to examine the relationship between FDI and debt service. They found very little correlation in most countries, with the exception of a few mineral exporting countries where exports and FDI profits were strongly correlated. These

empirical results cast doubt on how to think about the inclusion of FDI in debt servicing assessments.

As global capital markets have matured, the relationship between the composition of external financing and per capita income has changed. Today some 74 developing countries have credit ratings, allowing them to borrow directly in international capital markets. A dozen of these are low-income countries. FDI has also spread to low income countries. As predicted by the original thesis, FDI is the largest source of capital flowing to developing countries, but unlike the original theory it is not only flowing to upper-middle-income countries. In fact, 12 low income countries today receive more FDI than ODA.

The external funding choices of developing countries have therefore become wider. It is counter-intuitive that many low (and lower-middle) income countries have access to global bond markets and choose to raise funds there rather than trying to borrow from multilateral institutions at what are far better financial terms. Clearly the administrative, timeliness and conditionality costs, what have some termed the transaction costs, of some of the multilaterals are a problem, suggesting that choices on the mix of capital depends on more than just financing costs and risks.

On the other hand, developing countries are still encouraged to accept FDI, even though FDI repatriation cannot be viewed as correlated with export earnings. For example, during the Asian financial crisis in 1998, a single firm is reported to have tried to repatriate \$1 billion in accumulated retained earnings and capital investment overnight. The exposure of a country to FDI outflows during periods of debt crises remains high but unaccounted for in current debt crisis models.

#### *The link between policy and analysis*

As a consequence of the many assumptions that were needed in projections models used to assess creditworthiness, senior managers at the World Bank used models more as scenarios than actual forecasts, with a healthy acknowledgement of the judgments required. Consider the following statement from the 1964 Avramovic volume: “the theory of capacity to service external debt is unlikely to be developed until the basic issues in the theory of economic growth have been resolved...any country can very quickly get into a balance of payments crisis: just a few wrong moves in fiscal, monetary or foreign exchange fields will suffice...the lender has to visualize not only whether payments troubles are likely to emerge and not only how serious they are likely to be, but also how the debtor will react and what priority he will attach to fulfillment of his obligations...some of these questions can be answered by economic analysis; the question of priority cannot...lending is an art and not a science.”

More recently, in 2011, and in very similar vein, Charles Wyplosz<sup>40</sup> concluded: “This paper argues that [ex ante assessment of debt sustainability] is mission impossible. The fundamental reason is that debt sustainability is a forward-looking concept, with a very long horizon. Public debts projections are very sensitive to assumptions about growth, budget outcomes and interest rates.

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<sup>40</sup> C. Wyplosz, 2011, “Debt Sustainability Analysis: Mission Impossible”, Review of Economics and Institutions

Not only it is impossible to achieve any degree of precision for such projections, but also it is generally the case that growth, budget outcomes and interest rates are endogenous to debt sustainability.”

Despite these sentiments, conventional policymaking continues to rely on models for debt analysis. The most widely followed model is that of the IMF’s Debt Sustainability Framework (DSF). The DSF is a hybrid of a model projection and an indicators approach. The projection scenarios are used to derive the current and future values of key parameters, namely debt service as a ratio of exports or revenues and the present value of debt as a percent of exports, GDP and government revenue. These values are then compared to threshold levels that vary depending on an assessment of a country’s policy environment. If any of the thresholds are breached during the time span of the projection period, the recommended macroeconomic variables are revised to develop a path that avoids debt crises.

The DSF is only useful if all creditors use it (or a similar variant) to enforce debt limits on borrowing countries. If one creditor does not comply, the borrowing country may gain access to finance that could then destabilize debt servicing for all creditors in the future. But with more creditors, both public and private, offering sovereign loans, it has become harder to enforce the limits implied by the DSF.

One analytical problem is that the threshold limits of the DSF are highly conservative. Even for countries with the strongest policy environments the DSF threshold for public debt to GDP is 50%, less than the European Union’s suggested 60% threshold used in the Maastricht Treaty, and far lower than levels used in the IMF-supported programs in developed countries after the 2008 crisis.

Other issues also complicate the analysis. There is no agreement on how best to treat debt obligations of state-owned enterprises. On the one hand, they usually entail a contingent liability of the government and so the debt should be counted as if it were public. On the other hand, well-managed SOEs operate as commercial entities and have assets with which to back their debts, yet these assets are not valued.

A range of technical issues abound, like the discount rate to assess the present value of external debt of different currencies, contingent liabilities on banks, sub-national government debt, holdings of foreign assets, and the like. But the most significant issue is that the conventional models and thresholds still rely heavily on interpreting developments on the current account of the balance of payments. Modern debt service crises, however, are as likely to occur as a result of capital movements, including the exchange of domestic money into foreign exchange, as current account deficits. In theory, countries could simply permit the exchange rate to move to balance the supply and demand for foreign exchange in the face of currency flight, but in practice the resulting swings in the exchange rate are too large for many governments to tolerate. They either fear the resulting inflationary pressures or, as happened in Indonesia in 1998, they fear that currencies could overshoot, further damaging the balance sheets of companies or financial institutions with currency exposure.

As a consequence of the need to insure against debt crises, many developing countries resorted to external borrowing simultaneously with an accumulation of foreign exchange reserves. This policy choice poses significant problems for economic analysis as the theory of optimal foreign exchange reserve levels is not well developed. As borrowing costs are typically higher than earnings on foreign exchange reserves, this choice has financial costs, with uncertain economic benefits. Following the East Asian crisis, even more countries have felt compelled to run external payments surpluses and accumulate reserves, although the pace of reserve accumulation appears to exceed any normal understanding of precautionary motives.

The fact that there is little guidance to provide policymakers on the links between monetary policy and external debt would not be a significant issue if monetary and debt strategies were largely unrelated. But as an empirical fact, most developing countries now accumulate foreign exchange reserves in line with their money supply (M2) rather than in line with GDP or trade. With financial deepening in many countries, M2 has risen faster than most other macroeconomic aggregates. The resulting rapid rise of foreign exchange reserves caused concern about over-accumulation in the 2000s, just prior to the 2008 financial crisis.

For the policymaker, then, the analysis of debt strategies remains an art. Just like in the 1960s, when the first computer-generated simulation models were developed at the World Bank, models continue to inform the discussions on the appropriate extent of indebtedness today. But perhaps policymakers were more circumspect in their reliance on models in those days, preferring to think of creditworthiness as more an art of making judgments than a science of modelling. Today the technocratic view has come to dominate. More and more elaborate simulation techniques appear to add sophistication to the methodologies, but there is a real risk of a false precision as the underlying assumptions that are needed remain the same—and are still hard to predict meaning that judgments may be wrong (too much lending to countries that cannot use resources effectively and too little lending to those that can). Shahid would have preferred to make the judgments himself, with his management team, and based on a much broader information set than that captured by macroeconomic variables.

### *Conclusion*

The basic problem in estimating debt servicing capacity is to give substance to the vague formulation of how to measure the increase of debt service payments against the strengthening the borrower's economy. This problem was as relevant in the 1960s when Shahid Husain first worked on it as it is today.

As one of the first truly international civil servants, Shahid would not have approved of the decline of multilateral institutions' financing role or their loss of intellectual leadership in a world that still desperately needs collective action, as the agreements on the SDGs and on climate change suggest. He would also have thoroughly disapproved of the differential treatment of developed and developing countries' crisis-response efforts and the desire by important shareholders to bend the rules of the game to favor their own interests, but he would also not have had any illusions that the powerful can get their way in selected cases. Nevertheless, the

World Bank of McNamara, and indeed of his predecessors, was a far less political institution than the United Nations, for example.

Shahid would have taken a strong stance on the topic of borrowing for infrastructure investment, especially the new issue of building low-carbon infrastructure. This problem, with its attendant financing issues of how to trade-off up-front financing against on-going operating costs, and how to price risk in multi-period contracts involving the private sector, would have been just the sort of issue he reveled in discussing. He would have had strong views on how to balance domestic resource mobilization, public savings, public investments, and debt.

Shahid valued the Bank's contribution to the intellectual debates of the times and was by no means a spokesperson for developing countries at all costs. When repeated attempts to stabilize hyperinflation in Brazil had failed, Shahid quickly came to the conclusion that lending to that country would not serve further development. He orchestrated a program to reduce the Bank's exposure to Brazil until it had fixed its domestic policy framework. The benefits of this were later realized when Brazil was able to access major Bank loans following the East Asian financial crisis, the dot.com crisis, the 2008 financial crisis and the perturbations that resulted. But in other circumstances, when policies were reasonable, Shahid would have taken calculated risks if he saw the potential to strengthen the economy as outweighing the burden of higher debt service payments.

It is as a policy analyst, basing judgments on quantitative indicators, but with a strong dash of theoretical reasoning, accounting for political and social developments, that Shahid will be most remembered. This mix of talents seems to be in ever more scarce supply among international civil servants. Judgments and a comprehension of the overall picture have been replaced by narrow, technical approaches to development, something Shahid would have disdained.

One critical component of judgment that I learned from Shahid is the crucial role played by leadership. At the country level, he focused on this. At the level of the World Bank, he was a model leader for many of us—fair, decisive.

## **Unanticipated Legacies from Argentina**

By Danny M. Leipziger\*

### *Introduction*

One of the basic issues that has bedeviled both donors and aid recipients over the years has been the relationship between the International Monetary Fund and the World Bank in the development histories of developing countries. Nowhere was this issue more poignantly played out than in the case of Argentina in 1988, and this leads us directly to the interesting role of S. Shahid Husain, who at the time was the Bank's Vice President for Latin America and the Caribbean. His actions initiated a string of developments that would engage the two Bretton Woods institutions over the subsequent decades in a delicate balancing act to define roles and responsibilities in a clear and distinct way and yet to force the indispensable cooperation between the two that was needed for successful joint actions with respect to countries in balance of payments trouble. For a thorough investigation of this issue, readers are directed to Leipziger (2014), among others.

### *The Eventful Case of Argentina*

Argentina in 1988 was still reeling from its history of hyper-inflation and the unsuccessful Plan Austral under president Alfonsín, the only non-Peronist President of the Republic since Perón, until 2015 (with the recent election of Mauricio Macri).

Nevertheless, Argentina was making some progress in addressing its abysmal economic performance and the World Bank decided to take a chance on the reform program and extend a Banking Sector Loan for \$400m. (World Bank 1993, AR-2923), originally approved in March 1988. This program loan was part of a package of four Bank loans to Argentina totaling \$1.25b. that was ultimately approved in October 1988, viz., the Banking Sector Loan had to be re-negotiated as government had difficulty complying with the minimal conditions of the loan. The loan was essentially to help bolster foreign exchange reserves and could broadly be classified as a balance of payments support loan with some conditions related to the allocation of domestic credit. Details of the 1988 loan and its context and objectives are sparse, in part, because the loan was never actually disbursed. Ironically, however, this "non-loan" had important ramifications for both the Bank and the Fund.

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### *Some Background on the Bank and Fund*

The International Bank for Reconstruction and Development was created to rebuild Europe and was initially a bricks and mortar bank. Over time, its clientele came to include developing countries and the interventions went beyond reconstruction, thrusting the institution into sectors like agriculture, education, and finance and into areas of family planning and institution-building. Its lending was up until 1973 essentially project-based. In the Bank world of 1988, loans were either project loans, disbursed as the project evolved over many years, or program loans, disbursed in large, chunky disbursements. Program loans or Structural Adjustment Loans (SALs), as they were dubbed after the first oil crisis, provided governments with quickly disbursing funds in support of reforms to foster adjustments and correct flawed policies. IMF loans were extended only to countries in balance of payments difficulties that also agreed to programs of adjustment. But the nature of the adjustments required by the two Bretton Woods sister institutions usually differed, although they were generally intended to be complementary and mutually supporting.

IMF adjustment programs usually focused on curbing fiscal spending, curtailing monetary expansion and controlling inflation in order to deal with balance of payments problems and dwindling reserves, either caused by inappropriate exchange rates policies or capital flight induced by high inflation or both. The World Bank's adjustment loans were aimed at providing financial support during policy transitions--- to higher domestic oil prices, to more liberal trade regimes with lower tariff revenues, to the phasing out of inefficient subsidies and other structural reforms. It is easy to see the complementarity of actions to restore fiscal and payments balance and to also promote more efficient resources allocation and investments for economic growth. The two institutions needed to work together, although the objectives, timeframes, and cultures of the IMF and World Bank differed considerably.

There were always frictions between the two institutions as the Fund wanted to see more rapid adjustment of imbalances, and the Bank wanted to protect past development gains. The Fund wanted the Bank to concentrate on the public investment program and Public Expenditure Reviews and leave macro-economic policies to the Fund. The Bank, for its part, saw a large degree of overlap in the management of the exchange rate, for example, and export prospects, and was often more concerned with the fiscal-incidence of policies in developing countries than just in the overall fiscal stance. Thus, relations across 19<sup>th</sup> street could be difficult at times, especially where the views on specific policy interventions differed.

### *The Argentina Case and Its Consequences*

Argentina in 1988 was entering the final phase of President Alfonsín's tenure. Having restored democracy and dealt with the military on issues such as "los desaparecidos," Alfonsín valiantly introduced the Plan Austral in 1985 that combined some orthodox measures such as fiscal austerity with an incomes policy that tried to control wages, price and the currency in an attempt to halt the hyper-inflation that had reached 6000% that year. The Plan was not endorsed by the Fund because of its heterodox nature, although some academics, such as Rudi Dornbusch praised the attempt as late as 1987 at an NBER



conference (Dornbusch and de Pablo, 1989) that also critiqued the IMF's narrow view of adjustment as only dealing with demand management and ignoring the supply side and economic growth.

The Argentine economy was still struggling in late 1988 with the latest program, Plan Primavera, that would also fail and usher in the Menem administration in 1989. Only after the appointment of Domingo Cavallo as Finance Minister and the introduction of the Convertibility Plan that featured a quasi currency board and strict peg to the US Dollar would inflation be arrested (see Caprio, Dooley, Leipziger and Walsh, 1996). The role of the IMF during this period was to be critiqued later by the Fund's own Independent Evaluation Office (IMF, 2004) on the grounds of not having help prepare Argentina to leave an ultimately insupportable currency arrangement and of neglecting to sufficiently point out the dangers of the fixed exchange rate regime. Ultimately, the manner in which the government exited convertibility was disastrous for the middle class and others who had saved in US dollars only to see their assets first frozen and then devalued by two-thirds.

We don't know whether Shahid Husain was influenced by the academic thinking of the times, the pushback to the Washington Consensus or his affection for Argentina, which was shown in his frequent travels there to learn Spanish, enjoy the country, and watch the famous Argentine polo season. But we do know that he decided to back Argentina when others were not inclined to do so, and the Government of Argentina was at odds, as it frequently was and is, with the International Monetary Fund. This made Husain many friends in Buenos Aires, fewer in Washington, D. C.

The result of Shahid Husain's decision to proceed with a proposed banking loan to Argentina whilst the country did not have an IMF program in place created a huge furor among stakeholders, ultimately forcing the Bank's Chief Economist, Michael Bruno, to come to terms with the Fund in a formalized way to delineate responsibilities and re-affirm the IMF's primacy in macroeconomic management. A consequence of this "Concordat" between the two Bretton Woods institutions was that for the subsequent two decades, any Bank adjustment loan required either that a Fund program be in place or that a "comfort letter" be provided verifying that in the Fund's view macroeconomic management was satisfactory.

In a number of cases where the Bank and Fund disagreed about macroeconomic fundamentals, the Fund's view ultimately prevailed. One need only read the account by former Bank Chief Economist Joseph Stiglitz (*Globalization and Its Discontents*, 2002) to see how vociferous these debates could become. In the case of Korea, which Stiglitz recounts, he and the Bank were correct in arguing that the one-size fits all approach of the Fund, especially raising interest rates to deter capital outflow, had the predictable consequence of bankrupting most Korean conglomerates, the chaebols. Since chaebols were historically characterized by very high leverage (debt to equity) ratios, raising interest rates to prohibitively high levels would unduly punish Korea without achieving any macroeconomic objective. Since Korea had a fiscal surplus going into the crisis, the contagion of East Asia in 1997 caught Korea in a liquidity crisis that only concerted and coordinated debt rescheduling could, and ultimately did, resolve. The Bank's views on

macroeconomic policy actions were disregarded since the IMF had the upper-hand in financial bailouts, although the Bank's Special SAL to South Korea (viz., a 5-year bullet maturity loan with significant front-end fees, priced equivalently to the IMF program), approved in late 1997, was a first for the World Bank.

#### *The Malan Commission*

If we fast forward to 2007, we find relations across 19<sup>th</sup> Street much improved with the Fund ill-equipped to deal with low-income developing country problems, but being forced along with the Bank in the previous decade to support debt relief offered through both the HIPC and the MDRI programs. Even the respective Boards of the two institutions began to request more than letters of comfort from the IMF for IDA Adjustment Credits, and vice versa when Poverty Reduction Strategy Papers (PRSPs) were to be given recognition and be important aspects of Fund Adjustment Programs. The two Departments charged with resolving disputes—the Strategy and Policy Review Department (formerly ETR, which has previously been the custodian of best Fund practice) and the PREM (Poverty Reduction and Economic Management) Group at the Bank that included the Bank's senior economic managers were tasked with sorting out the awkwardness of the “Concordat.” The notion that the agreement between the Pope and the Holy Roman Empire needed to be replicated across 19<sup>th</sup> Street struck some as indicative of larger, but perhaps resolvable, program. Under the leadership of Dominique Strauss-Kahn at the Fund and Robert Zoellick at the Bank, a Commission was formed, led by former Brazilian Minister of Finance, Pedro Malan.

The Committee, consisting of Caio Koch-Weser (Germany), Sri Mulyani Indrawati (Indonesia), Ngozi Okonjo-Iweala (Nigeria), William McDonough (U.S.), and Michael Callahan (Australia) in addition to Malan (Brazil) was backstopped by Mark Allen of the Fund and Danny Leipziger of the Bank, the joint Secretaries of the Committee. Their resulting report tried once and for all to lay to rest the strict division of responsibilities between the Bretton Woods institutions, while recognizing their comparative strengths and mandates. The analogy was made to a “living document” that was open to change and which should contain sufficient flexibility to ensure greater coordination and consistency of policy advice to countries. At the same time, the Malan Committee Report emphasized the folly of drawing hard divisions between immediate adjustment goals and medium term development goals; moreover, the Report argued that rather than focusing on artificial divisions of policy, a more fruitful approach would recognize that *how* the adjustment process is handled has repercussions for future growth, in particular, through better investment decisions, as well as on poverty reduction goals. With the Malan Report, the air was cleared, and a healthier relationship between the World Bank and the International Monetary Fund was encouraged, supported by their respective managements.

#### *The Aftermath and Legacy Issues*

Shahid Husain may have been ahead of his time in arguing for greater equality of policy influence on key macroeconomic variables that determine the fate of countries. The artificiality of division of responsibilities between the Bank and Fund was troubling for decades. The Bank, for example, was prohibited from arguing against the fixed exchange regime of the CFA Franc for Franco-

phone Africa, although this undoubtedly hindered the sub-region's economic development and served a different purpose than economic development. At the same time, the lack of coherence in some country lending programs led to high recurrent project costs that had fiscal consequences that troubled the IMF. Better and more fluid coordination between the Bank and Fund not only requires professional and comfortable working relationships, but also institutional frameworks such as those recommended by the Malan Committee Report. Had those existed earlier, a lot of difficulties might have been avoided.

One cannot help but observe the irony insofar as Argentina being selected as the test case of World Bank independence in 1988; this might not have been the most propitious example insofar as the country has had an unfortunate history of poor economic decision-making and a string of difficult relationships with the IMF. The fact that even with IMF programs in place, adjustment policies were inadequate, is telling. Moreover, over the past decade, without the Fund involved, Argentine policy recidivism has landed the economy in a situation reminiscent of 2001 when the convertibility program was abandoned and economy shrank. It is sometimes remarked at the IMF that more careers have been short-circuited at the Fund by working on Argentina than any other country. We can only speculate on whether this affected Shahid Husain in any way, but my guess is that if he had had to do again, he would have chosen the same course of action.

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## **With Shahid Husain in Latin America: Recollections**

By Marcelo Selowsky

### *Introduction: Manila, a 4 AM phone call*

I was in Manila in July 1987 when the phone rang in my hotel room at 4 AM. It was a call from Washington. I was told very formally that I had lost my job as Division Chief in the Country Policy Department and was offered a secondary job in the same division. Basically I was being demoted. Half an hour later a friend called: "Marcelo, don't worry, you have been appointed Chief Economist by the new Vice-president for Latin America, Shahid Husain."

Still half asleep, I tried to recover from the two shocks. I slowly began to realize how fortunate I was to be offered that job—I had never been in operations or processed a loan. My only experience was leading a mission to the Dominican Republic on behalf of the LAC region.

I had been working with Shahid as Research Advisor in his earlier Vice-presidency and during that time we discussed many analytical and policy issues. But I had never worked with him when he was in operations – on the operational side I must have been a complete unknown quantity to him. He took a big risk with me -- and I will forever be grateful for that opportunity. It had a tremendous influence on the rest of my career. It was also the beginning of a deep professional association and friendship, during which I became aware of his incredible talents and unique abilities to deal with the most complex situations.

### *Putting together a dream team. Labels are irrelevant*

All these changes took place as a result of the so called 1987 Bank-wide reorganization - all appointments had to start from scratch, all staff had to reapply to the new created positions. This was also true for the Latin American Region.

Shahid asked me for names and suggestions on the economist side, irrespective of earlier background or experience on the operational side. He wanted able people who could think clearly and could establish a productive dialogue with countries. Having spent most of my career in the research/policy side of the Bank, I suggested people I knew in that context. Shahid never imposed the criteria, "having operational experience," he just wanted people with analytical talent.

Very telling was the experience with Hans Binswanger who, in my view, is among the best agricultural economists worldwide. Hans was interested in working on Africa, but he was considered, "not operational enough," and was unable to secure a job. He was - I remember the expression at the time - "on the loose." I mentioned this to Shahid, and I never forget his words: "Marcelo, get him, get him." Hans became the Division Chief for Agriculture for Mexico and Central America, eventually making important contributions in assisting major agriculture reform efforts in Mexico — liberalizing prices and moving from price support to targeted direct income transfers for poor farmers.

Eventually the region was able to mobilize a dream team of economists (in no order): John Page, David De Ferranti, Nancy Birdsall, George Psacharopoulos, Gobind Nankani, Dimitri Papageorgiou, Ricardo Lago, Vittorio Corbo, Sweder van Wijnbergen, Armeane Choksi, Hans Binswanger, Lyn Squire, Charlie Blitzer. (If I missed any names, I apologize.) Most came from the research establishment. I don't believe this adversely affected the region's operational capabilities. On the contrary, and I believe this is an important lesson for the World Bank.

#### *The state of Latin America at the time*

At the time, Latin America was going through a major crisis, both on the macroeconomic and structural fronts. Since the 1970's, a continuous expansion of public expenditures and external borrowing had put most of the Latin American countries in a very vulnerable position. It was accompanied by many distortive policies that impacted economic efficiency and investment. Much of the expenditure growth financed increased salaries and over-employment in SOEs, while urgently needed expenditure on infrastructure lagged behind. Social spending also suffered. And industrial protection reduced the competitiveness of agriculture and new exports. Access to foreign exchange was rationed, creating dual exchange rate markets. Heavily subsidized directed credit ended up favoring the most powerful sectors and banks. Rent seeking was rampant.

Shahid studied the situation carefully and calmly. He immersed himself in examining countries' basic data. In many instances he had a better grasp of the key macroeconomic magnitudes than the government officials we were meeting. He was bold and candid in pointing out the social costs of these policies and encouraging counterparts to act. Many times this generated some friction and created sensitivity. However, in the end policy makers realized his good intentions and motivations.

Reform was never easy. Trade liberalization was opposed by many vested interests that did not want to face competition from imports. Movements to better target subsidies and social spending to the poorest had no organized lobby. In contrast, eliminating general subsidies such as for gasoline or bus fares were aggressively opposed. It was fortunate that in most countries there was always a group of leaders, usually young, with the necessary vision with whom we were able to interact.

It was here that having an analytically strong good and cohesive team helped – the team developed significant credibility and receptivity. It helped engage governments in discussing policy options, sequence, and tradeoffs. Lending could help to smooth the adjustment. But Shahid never saw lending as the objective or organizing principle: lending was one of the instruments in the toolkit.

#### *The debt problem*

A continuous increase in external debt and the need for debt rollovers created a major crisis toward the end of the 1980s. The US Government tried to encourage a combination of initiatives and programs for which international private banks were to rollover and provide fresh funds on

the basis of a program of fiscal and structural reforms that would allow the Latin American economies to regain growth. The goal was to “grow out of debt” ---- the reforms were to be strong enough to accelerate growth and more than compensate for the increased indebtedness created by the additional financing. This would eventually allow the ratio of debt to GDP to fall. The problem was more of liquidity problem than a solvency problem. This was at the heart of what was at the time called the “Baker Plan.”

Toward the end of the 1980s it became increasingly evident that in many countries the issue was not liquidity -- the level of external debt was simply too high. It was going to be impossible to recover growth in a reasonable amount of time, even with the best policies. Fiscal adjustment was deflationary in the short run. And it would take time for reforms to be implemented and be credible enough to create the necessary track record to encourage private investment and voluntary external flows.

It became increasingly apparent that some debt reduction had to be incorporated in countries’ reform programs supported by the Bank and the Fund. But this presented some complexities not seen before. What was the level of debt relief to be negotiated with international banks? How would an impartial observer like the Bank and the Fund make a judgment on the magnitude of the needed relief so that it would become acceptable to banks and also generate funding from the World Bank and the IMF? How would burden sharing between the private banks, the official institutions, and the country be determined? How could an evenhanded approach across countries be determined? What instruments could the Bank and the Fund design in order to help implement the initiative? The result was the so called Brady Plan (see below).

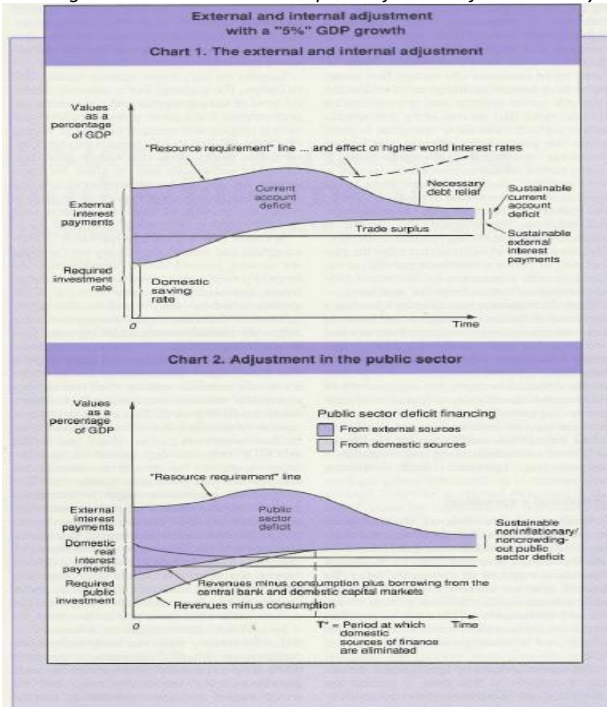
All of this was new –at least for me. To design these operations was not obvious. Shahid provided enormous leadership and clarity in these discussions. Our internal operational discussion on how to design lending, the type of conditionality, how to sequence the debt reduction with the timetable of reforms, etc., became often very heated. Comparability across countries was not easy.

At that point I remember vividly a moment of intense frustration for Shahid. We were in the midst of discussing such a strategy in a specific country when Shahid burst out in anger: “Guys, this is a mess, we are all over the place.” Then he turned to me and said, “Marcelo—you develop by the weekend a framework that can bring some clarity to this.” I turned pale, and I could only murmur, “Yes Shahid.”

I worked the whole weekend and I developed a note for the economists on how to articulate tradeoffs and complementarities, and how these could play out over time. To facilitate the discussion I tried to summarize it in a graphical exposition (see below). The framework is extremely simple; an economics graduate student could have done it. However, the framework was quite useful and pedagogical. I presented it in many international conferences and it was published in Finance and Development. But credit goes to Shahid. He intuitively realized we needed clarity in articulating the trade offs and the timing. . He was not happy about the ad hoc

way we were approaching the issue. I would not have developed the framework without Shahid pushing for it. Again, his instincts were right.

*Shahid gets mad with me: "Develop an adjustment framework by the weekend"*



#### *Using the Bank's instruments to support the Brady Plan*

A major challenge was how to design the Bank's lending instruments to encourage foreign banks to swap existing debtor countries bonds by new ones with a low present value. The idea was that Bank and Fund loans could be used to collateralize the new bonds issued by countries to replace the old ones. Thus the Bank's instruments would provide added security to these bonds and increase the incentives for the banks to do the swap at a discount. It also involved many negotiations with the US Treasury and private banks in order to implement the initiative. These were tense moments. I recall how actively Shahid got involved in the details of the design –he provided huge amounts of intellectual leadership.

*The fall of 1988: Off to Argentina for a month. Giving the benefit of the doubt with heavy back loading of financial support: The Primavera Plan*

A major macroeconomic crisis was brewing in Argentina, stemming from public finances, particularly as the result of deficits in SOEs (alone US \$1 million daily in the rail sector), the provincial governments who were independently issuing debt, and the social security system. It had major structural roots that needed deep institutional reforms. And this required time. More steps could be taken in the near term on the revenue side such as increasing the tax base, reducing exemptions, and improving collections.

The Fund had decided it could not support Argentina without a major fiscal adjustment up front. The Bank, supported by the US Treasury, thought the fiscal adjustment needed more time and the authorities could be given the benefit of the doubt. The expectation was that the fiscal measures could be implemented, albeit more slowly, during the course of a year. Both the Fund and the Bank differed on the matter and the Bank decided to go ahead alone with a program of four loans with an envelope equivalent to US \$1.25 billion. The disbursements however were to be heavily back-loaded, with a little more than 10 percent to be disbursed up front (US 150 million dollars).

In order to negotiate the details of the programs, Shahid, along with a large team of us, visited Buenos Aires in August 1987. I recall Shahid being very involved in the details of the discussions and on each point in the program. He forcefully tried to encourage the authorities to take action in some of the key areas and to take advantage of the program of financial support. He was extremely candid.

The program was put together in the end, but few months later it became clear that President Alfonsín-- the first democratically elected President after the military juntas -- could not muster enough political support for the necessary measures. The industrialists negotiated a major reduction of the value added tax for a commitment to contain price increases during the beginning of the program. This basically sealed the fate of the program on the revenue side. (NO NEED TO BOLD)

The program was controversial but I believe, in retrospect, it had a rational – in a world of uncertainty it is hard to forecast the ability of the authorities to muster enough political support. The Argentinian economic team was a credible team. What was the counterfactual? Not to have had a program and have missed a possible situation where the government may have been able to act? The key was that disbursements were to be heavily back-loaded, and the Bank hardly increased its exposure. The onus was on the country. This type of situation may happen again.

*Tribute*

Shahid was strongly committed to encouraging countries to reform. He did not take the easy road. He saw the immense cost on growth and equity of politicized subsidies and rent seeking. He pressed policy makers to go an extra mile and to muster their political will to act. Many times he embarrassed some public officials in cases of extreme procrastination and inaction. Lending



was not his organizing principle or a goal—it was simply a vehicle to facilitate reform. What a good example for others! It permeated my own instincts when I got a similar job later on in the Europe and Central Asia Region.

But Shahid's courage and his strength of conviction were also accompanied by kindness and empathy: these qualities made Shahid even more unique.

The best tribute to him is to acknowledge how fortunate we are to have been his friends. We admired him then ---we miss him today.

## **Shahid Husain: Some Personal Memories**

By Richard Stern<sup>41</sup>

As many of the contributions to this *Gedenkschrift* volume have noted, Shahid Husain was an outstanding development intellectual, thought leader and innovator with a unique ability to combine incisive economic and social analysis with the *realpolitik* of change. Early in my own career at the World Bank I was lucky to have had three superb mentors: Stanley Please, Ping Loh and Shahid. Stanley emphasized the importance of the country policy environment in ensuring the success of project interventions and development more generally. Ping instilled in me the critical need to concentrate on the art of the practical. Shahid taught me how to put both together; how to stay focused on the operational agendas while seeking and exploiting opportunities to implement key policy and institutional changes.

In contrast to some articles in this volume, which focus on Shahid's professional accomplishments, I would like to focus on his human qualities.

In common with many consequential leaders Shahid was endowed with a unique and complex personality. He was incisive, assertive, action oriented, and often impetuous. Indeed, when outlining policy and operational options to Shahid it was prudent to first make clear your personal preferences, because he would often make a decision before you could finish your presentation! His ability to immediately identify the critical core issues and quickly come to closure sharply contrasted with many of his more bureaucratic and cautious vice presidential Bank colleagues. This quality, in turn, allowed him to attract lots of young up-and-coming, and older, professionals who were keen to work with and learn from him. These loyal, and close-knits bands of brothers (and later also sisters, as the Bank's gender imbalance improved – yet another initiative that he pioneered) were sometimes perceived as Shahid's mafia! However, these unruly tribes were multi-cultural, multi-disciplinary, multi-national and, by and large, outstanding groups of development professionals.

Some perceived Shahid as arrogant. Indeed, he did sometimes give that impression. However, those that knew him well recognized that this trait was a cover for his innate shyness combined with his conviction that we had a collective duty to act rather than to succumb to *paralysis through analysis*.

Some of his judgments on both operational policy and individuals inevitably turned out to be misplaced. However, he was never afraid to listen, absorb feedback and acknowledge errors and then make the necessary mid-course corrections, even at the cost of damaging relations with

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<sup>41</sup> I joined the World Bank as a young professional in 1971 and worked for Shahid in the East Africa region as a loan officer/economist. After 1978 I worked for him as chief of the Indonesia division while he served as regional vice-president for East Asia. I later became chief of the China industry and energy division, director of the Bank's industry, energy and telecommunications department and vice-president for Human Resources. While I did not work directly for Shahid in these latter assignments I did maintain close contact with him.

some of his colleagues. Similarly, in contrast to many of his peers, he was not afraid of taking risks, either in facing up to difficult policy discussions with government clients e.g. transmigration or industrial policy in Indonesia or developing new and often controversial initiatives in the Bank e.g. a *country focus* in the regional projects department well before the 1987 reorganization, or *short lists of one* for key appointments when he was vice president for Human Resources.

Shahid was a true leader with an intellect and a force of personality that was recognized by both his staff and his peers. However, like all of us he was human and fallible. On rare occasions he met his match. I witnessed this twice. Once, with an iconic African president; second with a poor peasant farmer in rural Java.

The first was in 1977. Shahid was vice president for Eastern Africa, Stanley Please was his country director and I was loan officer for Tanzania. Since the late 1960's the country and its President, Julius Nyerere, had become darlings of the international aid community. The government's commitment to poverty eradication, the provision of basic needs in education, health and water, rural development, equitable growth, equality and women's rights was widely recognized and admired. So too was Nyerere's honesty and integrity, as well as his willingness to openly acknowledge domestic problems, vested interests and challenges. However, by the mid 1970's it was also obvious, even to the most committed foreign supporters – including the World Bank, that events were going badly wrong. Growth had become stagnant or negative; the Ujamaa villagization<sup>42</sup> experiment was not working; the rural urban terms of trade had rapidly deteriorated; poverty was intensifying; the inefficient industrial and marketing parastatals had become a significant burden on the population; government institutions were clearly too weak and fragile to implement the ambitious development agenda they had been assigned; the trade deficit was ballooning and; despite the commitment to self-reliance the country was becoming ever more aid dependent. Furthermore, the East African Community was disintegrating as vested interests in Kenya, combined with political tensions with Idi Amin's Uganda, were undermining cooperation.

The Bank had analyzed these problems in numerous studies, reports and project implementation reviews but had made little headway in persuading Tanzania's government to take remedial action. Without clear direction from the top a change in course was not going to happen. Shahid resolved that we had to see the president and present a sympathetic, but honest analysis of the situation together with recommendations for remedial action. This included the need to raise agricultural prices, to modify the Ujamaa program – more concentration on social aspects while leaving production decisions to the farmers, increasing private participation in marketing, and shifts in government expenditure priorities. As the loan officer it was my responsibility to prepare the necessary briefs.

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<sup>42</sup> Ujamaa in Swahili loosely translates as *family, brotherhood or socialism*. As part of the government's Ujamaa program – perhaps inspired by China's rural collectivization under Mao Zedong - forced *villagization* was initiated in 1973. The idea was to make it easier to provide basic services e.g. education, water, and health, to the rural population and to progressively collectivize production.

The meeting was set up, but to my disappointment I could not attend; the rendezvous was held in president Nyerere's modest private residence and only two – Shahid and Stanley could go. I waited at the office for them to return. I waited a long time – at least three hours. I was pleased, because that meant there must have been a substantive discussion.

At last they arrived. Shahid was exultant. "This is the most impressive and honest leader in the developed or the developing world I have ever met," he said. "We talked about the challenges of nation building in a tribal society. We noted the importance of rebuilding African self-confidence, which had been seriously undermined by years of colonial rule. Despite the recent setbacks, we discussed the importance of promoting regional economic integration in Africa if the needed economies of scale were to be attained. We reflected on the difficulty of promoting such economic cooperation given the presence of corrupt leaders in Africa who focused more on collecting rents and dispensing patronage rather than on improving the lives of their own people. We talked about the condescension of the first world leadership to the third and the need to treat each other as equals if meaningful dialogue and cooperation was to evolve." "Nyerere is a true visionary and global statesman," Shahid concluded, "one of the very few in the current generation of world leaders."

After he finished his summary, suitably impressed, I asked how the president reacted to our analysis and recommendations relating to the current economic crisis facing the country. Shahid looked at me and remarked "given the high level nature of their dialogue it would not have been appropriate to raise the more mundane issues on which we had prepared the brief!" While Shahid never admitted that he had been out maneuvered, I did, at that moment, detect a flash of recognition that he had just realized what happened. Needless to say, the Bank's continuing efforts in Tanzania during Nyerere's remaining tenure came to naught.

A few years later we both visited central Java. I was the division chief for Indonesia, Shahid was the regional vice president. Rural development and poverty alleviation were at the core of the Bank's assistance program and Shahid was intent on seeing whether this was delivering results. Bank support was being provided for large irrigation projects, agricultural research, seeds, fertilizer production, rural and SME credit, T&V extension schemes, rural roads, family planning, and education. The government arranged for us to visit several projects including participating in a *regular* meeting of farmers organized under an extension program that the Bank was promoting.

We had naively planned for a small one-on-one meeting. The reality was rather different. After a big and long lunch, our convoy of about 15 vehicles, including officials from all the responsible agencies, from both Jakarta and the province, led by a police car with flashing lights, slowly made its way along a series of earth dykes between the paddy fields. We were many hours behind schedule. Finally, we stopped by a small awning constructed of wood and rice straw, under which, about a dozen farmers, together with their extension agent were waiting. It was very hot and it soon became clear that they had been there since early morning.

Shahid and I, and about 30 others, crowded under the straw shade and were treated to a short presentation by the agent and one of the farmers. Shahid then started on a question and answer session. "How much land do you have? What inputs do you use; do you have access to adequate credit to purchase them? Have your yields increased as a result of the government support programs? Can you easily market your produce? What prices do you get?" He then demonstrated his broader development perspective. "Can you read and write? How many years of school do you have? How many children? Do you use family planning?" Sometimes the government entourage tried to answer the questions on behalf of the farmers, but Shahid insisted that the peasants speak for themselves.

Finally, Shahid asked the group if they had any questions for him. A long embarrassing silence followed. Shahid pressed them again. Finally one sullen-looking, hot and tired member of the group raised his hand and asked a question. The flustered translator turned to the government entourage for guidance. A long discussion in Bahasa Indonesia followed. Finally we were informed that it was an *inappropriate question* for a *high-ranking foreign visitor*. Shahid, being Shahid, then of course stated that nothing was off limits and insisted on hearing the question. A very embarrassed translator then told Shahid that the farmer wanted to know the reason for his visit and what benefit they, the farmers, could expect to receive as a result!

In all my years of working with Shahid it was the only time that I have seen him at a complete loss for words. The long silence which followed was finally broken when I could contain my mirth no more, and broke out in laughter. The rest of the officialdom present nervously followed my lead. Finally, Shahid recovered and mumbled something about learning from them so the Bank could improve its programs for others. There were no more questions and we promptly left.

Shahid was an innovative development visionary and practitioner, a daring leader and a superb mentor. Just as important he was a decent, caring and fallible human being.

## **Pakistan: A weak Predatory State**

Shahid Yusuf<sup>43</sup>

Numerous conversations with Shahid Husain over the course of a decade revolved around the state of Pakistan's economy: its sluggishness, the continued reliance on low tech manufacturing, the persistence of structural macroeconomic imbalances, and the inability of a succession of governments some authoritarian and others democratic, to follow through with reforms that would pull the country out of a low level equilibrium. At times, Shahid felt that Pakistan's predicament was because of the dead hand of its feudal past<sup>44</sup>; at other times he blamed feckless military dictatorships or weak democratic institutions; however, he returned again and again to the characteristics of the Pakistani state. Shahid consistently maintained that governments came and went but the Pakistani state remained weak – that is in its inability to adequately protect life and property and deliver public services - and unremittingly predatory<sup>45</sup>. Neither the democratically elected governments nor the military regimes that supposedly attempted to clean up the mess created by the elected ones, enhanced the developmental capabilities of the state or curbed its "grabbing hand"<sup>46</sup>.

When he juxtaposed Pakistan's growth trajectory with that of the East Asian economies he knew so well – China in particular - Shahid bemoaned the inability of Pakistani governments to realize the promise that was so evident to observers in the 1960s, including visitors who came from Korea to learn about Pakistan's approach to industrialization and its successful start at exporting light manufactures. Korea and other East Asian economies perceived the opportunities offered by incipient globalization and crafted developmental states that mobilized domestic resources and entrepreneurship and achieved export-led growth.

### *Lost Decades*

Following the demise of the Ayub Khan regime in 1969<sup>47</sup> and the dismemberment of Pakistan in 1971, the state largely abandoned its developmental focus and while the economy has grown steadily albeit fitfully since, its performance is a far cry from that of the high-flying East Asian tigers. Between 1960 and 2013, Pakistan's per capita GDP increased fourfold from US\$ 219 to US\$ 790 (in constant 2005 prices) whereas that of South Korea rose twenty two fold and

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<sup>43</sup> The author is chief economist of the Growth Dialogue at George Washington University.

<sup>44</sup> Echoing the views of Acemoglu and Robinson, Nunn and Dell among the host of academics who link economic performance to institutions, mindsets, habits and colonial encounters that have their roots in the distant past.

<sup>45</sup> Mancur Olsen (2000) graphically referred to states run by roving bandits and stationary ones. Presumably the Pakistani bandits are relatively stationary but sometimes their actions resemble those of the roving category: to loot rather than fatten and extract rents. <http://www.economist.com/node/329770>

<sup>46</sup> Shleifer and Vishny (1999) introduced the concept of a grabbing hand alongside the invisible and the helping hands so as to highlight the corrupt, obstructive and exploitative side of the state's activities so visible in many countries. <http://www.hup.harvard.edu/catalog.php?isbn=9780674010147>; <http://www.economist.com/node/186317>

<sup>47</sup> Many believe that the downward economic slide commenced in the mid-1960s after the five-week war with India and following a purportedly rigged election that Ayub Khan won.

Malaysia's grew sevenfold<sup>48</sup>. In the leading East Asian economies, industrialization drove growth with the share of manufacturing in GDP climbing above 30 percent whereas in Pakistan the contribution of manufacturing peaked at 18.5 percent in 2005 and has since declined to 14 percent<sup>49</sup>. Moreover, Pakistan has diversified and upgraded its manufacturing sector and exports at a much slower pace than the East Asian economies. Textiles and garments accounted for 55 percent of exports in 2013. Meanwhile Korea and Malaysia that were once reliant on similar exports had reduced the share of these light manufactures in total exports to 2.6 and 2.8 percent respectively. The 'grabbing' hand of the Pakistani state has been active but the 'guiding' and 'helping' hands that enabled the East Asian economies to forge ahead have seemingly atrophied.

The stark contrast between the capacity of the East Asian state and that of Pakistan's was the underlying theme of many of my discussions with Shahid. The disparity in his view was the reason why sound policies were not implemented, resource mobilization including through the tax system languished resulting in the neglect of many public services crucial for growth, there was a creeping trend towards lawlessness, and corruption flourished.

#### *State capacity deficit*

What accounts for the ascendancy of the grabbing hand in Pakistan and the persistent weakness of state capacity – as the two seem to go together? When it comes to extracting rents, the state seems to be able to marshal the instruments and the means. However, when the state is called upon to do its job of governing the country and promoting development, it appears to be lacking in capabilities and is rightly pilloried for its failure. The research on the determinants of state capacity and functioning is voluminous and enlightening. Although it does not offer neat recipes on improving governance and enhancing state capabilities, it can help to explain Pakistan's predicament. As Angus Deaton recently observed, "The absence of state capacity – that is of the services and protections that people in rich countries take for granted – is one of the major causes of poverty and deprivation around the world"<sup>50</sup>. And one might add it is one of the reasons why Pakistan's economy continues to punch below its weight. Another is the hemorrhaging of the country's resources caused by exploitative elites<sup>51</sup>. There are many others however, given Shahid's preoccupation with state capacity, I will devote the balance of this essay to this topic which in Pakistan's case, might be a precondition for accelerating development and catching-up with East Asian middle-income countries.

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<sup>48</sup> World Development Indicators 2014. World Bank

<sup>49</sup> <http://data.worldbank.org/indicator/NV.IND.MANF.ZS>; According to Dani Rodrik (2015), premature deindustrialization might be in store for many developing countries and if they do in fact experience a decline in the share of manufacturing, they will lose the benefit of an unconditional convergence in productivity that is specific to manufacturing activities. <http://www.voxeu.org/article/premature-deindustrialiation-developing-world>

<sup>50</sup> <https://www.project-syndicate.org/commentary/economic-development-requires-effective-governments-by-angus-deaton>

<sup>51</sup> State dysfunction is also one of the causes of brain drain that is continuously eating into Pakistan's limited supply of quality human capital. Almost 6 million Pakistanis emigrated between 1981 and 2012 and in just 2012, 41,500 technical and professional workers left the country. <http://tribune.com.pk/story/649347/brain-drain-2-7m-pakistanis-have-exited-country-in-last-5-years/>

It is a commonplace that political power gravitates towards the rich, and worsening income inequality privileges rich insiders giving rise to oligarchical states<sup>52</sup> – or worse kleptocracies – that are run for the benefit of the elites, which can include not only the wealthy but also bureaucrats and the military. Pakistan’s elites, old and new<sup>53</sup>, have become accustomed to giving primacy to their own interests and either ignoring or grudgingly acknowledging those of the rest. Acemoglu, Ticchi and Vindigni (2007)<sup>54</sup> make the interesting point that ruling elites need have little interest in creating an efficient meritocratic bureaucracy, which provides the basic underpinning of a “capable” state. Instead, an inefficient state apparatus is to the advantage of the elites and the bureaucrats because by providing too few of the services sought by the electorate, the elite enlarges the opportunities for extending patronage and creating a supportive clientele. In addition, the very same parsimonious supply of services multiplies opportunities for bureaucrats and other state providers to extract rents. An inefficient (and corrupted) bureaucracy also levies and collects fewer taxes from the rich and is not motivated to redistribute income for the benefit of the poor. Thus a large marginally competent bureaucracy is an asset for an amoral ruling elite first because it creates a powerful supportive body with strong vested interest in the kleptocratic status quo, and second because it is an instrument for exerting a degree of control over the public via a plethora of regulations.

A state apparatus with limited capabilities may be advantageous in the medium term for the elites – civilian and military - but it imposes costs. Most serious is the economically debilitating deficit of governance. Avinash Dixit (2015)<sup>55</sup> defines governance viewed from an economist’s perspective as comprised of the institutions “that underpin economic activity and market transactions by protecting property rights, enforcing contracts, regulating market conduct, and providing requisite public goods including physical and organizational infrastructure”. Income and governance are closely correlated and one can see why<sup>56</sup>. When a state is unable or unwilling to deliver adequate governance complete with processes enforcing accountability and ensuring the rule of law, development is likely to be adversely affected, and the weaker the governance the greater the likelihood of a country being caught in low or mid-level development traps<sup>57</sup>. East Asian experience demonstrates that the economies which emerged as the icons of development

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<sup>52</sup> Some see the United States also tending towards an oligarchy that serves the interests of the rich and the well-organized interest groups. Gilens and Page (2014)

<http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=9354310&fileId=S1537592714001595>

<sup>53</sup> New civilian oligarchs have displaced oligarchs from an earlier period and joined the military and bureaucratic elites, which are the two constants among the Pakistani ruling class.

<sup>54</sup> [https://ideas.repec.org/p/rcr/wpaper/07\\_05.html](https://ideas.repec.org/p/rcr/wpaper/07_05.html)

<sup>55</sup> [https://www.princeton.edu/~dixitak/home/GovRef\\_FEC.pdf](https://www.princeton.edu/~dixitak/home/GovRef_FEC.pdf). Apparently it was Harold Wilson who breathed new life into a long disused term.

<sup>56</sup> Kaufman and Kraay 2003. [http://info.worldbank.org/etools/docs/library/18033/growthgov\\_synth.pdf](http://info.worldbank.org/etools/docs/library/18033/growthgov_synth.pdf)

<sup>57</sup> See the discussion in Fukuyama (2014)

<http://us.macmillan.com/politicalorderandpoliticaldecay/franciscufukuyama>; too much accountability as in the U.S. can lead to paralysis and a vetocracy. Too weak and disorganized a civil society can result in an electoral democracy means that a country can end up with an elected government that uses the mandate from the majority to trample over the rights of minorities, as is happening in Pakistan. Unhappily, a peaceable means of aggregating heterogeneous preferences that takes accounts of demands and rights of minority voters has yet to emerge.



recognized very early the necessity of creating competent, technocratic bureaucracies for the purposes of planning, designing and implementing policies, mobilizing resources, coordinating the actions of multiple public and private participants in the development process<sup>58</sup>, evaluating outcomes and absorbing the findings into the next round of policymaking.

As Shahid well knew, Pakistan did have a merit based public bureaucracy in the 1960s. It was the lineal descendant of the colonial era Indian Civil Service and was superior to that which President Park Chung Hee inherited when he took over the reins of government in South Korea in 1963. This bureaucracy could have served as the foundation of a more elaborated system as economic complexity increased and with it the demands on the government. But instead, the elites who took control from the 1970s onwards – military and civilian – initiated the politicization of the merit based selection process and eroded the bureaucracy's esprit de corps, status in society, its handsome pay scales, and its autonomy from political pressures<sup>59</sup>. As a consequence, policymaking and technical skills suffered, the government's capabilities were degraded and public employees became increasingly prone to corruption. This was the beginning of the end of the developmental state in Pakistan and the emergence of a *rentier* state with a remarkably short time horizon.

#### *Deconstructing Pakistan's state incapacity*

The state capacity literature divides this attribute into three interrelated subcategories: first is the coercive, which is the monopoly over the legitimate use of force to impose law and order. A second sub-category is administrative, which is the capacity to make and implement policies, to regulate and to provide public services. And third is extractive, i.e. the capacity to raise revenue to finance the administrative activities, the provision of infrastructure and public goods and the security apparatus. Douglas North prioritized the state's capacity to tax the citizenry.

Pakistan's major cities have become increasingly unsafe and periodic clean up campaigns by paramilitaries notwithstanding, the government has done little to arrive at a durable long-term solution. As a result of chronic neglect, the state has gradually lost the monopoly over violence it once had. In other words, it no longer has the coercive capacity that is the sine qua non of an effective state. Consequently, the Pakistani state is unable to protect the lives and property of citizens or maintain an effective legal system that underpins law and order and is a pillar of the market economy. The result is that mafias, criminal gangs and terrorist organizations have flourished. The elites have their retinue of private guards and are given additional protection by the police<sup>60</sup>. Ordinary people have sought informal (and generally inadequate) means of safeguarding property and settling contracts through patron client relations, kin based and other networks, or by enlisting the services of mobsters and racketeers. The net result is an

<sup>58</sup> The skillful minimizing of coordination failures was one of the hallmarks of good governance. See Rodrik (1996) <https://ideas.repec.org/a/eee/inecon/v40y1996i1-2p1-22.html>

<sup>59</sup> Peter Evans (1995) maintained that embedded autonomy was one of the strengths of the most capable East Asian bureaucracies. <http://press.princeton.edu/titles/5690.html>

<sup>60</sup> In fact, this claim on the meager resource so of the police force amounts to a serious diversion of security resources. In Karachi, a city with a population of 24 million, the police force numbers less than 28,000. Of these, 8,000 guard a small number of VIPs.

undercurrent of fear in the larger cities. Businesses operate in an environment beset with uncertainty (and the latent threat of violence or expropriation) that discourages investment in productive assets and the growth of companies and slows development<sup>61</sup> - an outcome that is damaging for the nation and also disadvantageous for the rent extracting (stationary) elites<sup>62</sup>.

Having willfully allowed bureaucratic capabilities to wither over a forty-five-year period starting in the early 1970s, the state's administrative capacity has been severely weakened. This shortfall is reflected in the findings of the World Bank's Doing Business report<sup>63</sup>, which shows that Pakistan ranked 138<sup>th</sup> (out of 189 countries) in 2016; inevitably the institutions protecting property rights and enforcing contracts are notably weak. Pakistan also has low scores for government effectiveness and regulatory quality as measured by the Worldwide Governance indicators for Pakistan<sup>64</sup>. Widespread corruption further corrodes the performance of public agencies<sup>65</sup>. The culture of corruption is now so pervasive that only the most egregious cases receive much attention or are even condemned. Corruption imposes a tax that the vast majority must incur when they interact with officialdom and it is something that they have come to accept as a normal transaction cost. The outrage expressed in Washingtonian circles does not find an echo in Pakistan.

Bureaucratic lapses of planning and policymaking that would induce the deepening and diversification of the formal economy are compounded by the state's inability to supply essential services, in particular a reliable supply of electricity for businesses and households<sup>66</sup>. According to the data collected by the World Bank, the losses from electricity outages amounted to 22 percent of total sales in 2013<sup>67</sup>; and Pakistani officials estimate that as much as 4 percent of GDP

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<sup>61</sup> It also leads to the flight of capital to safer havens, the Gulf States being among the ones that are preferred because they are close by and offer investment opportunities in real estate and business services. Two years ago the governor of the State Bank made a statement to the effect that US\$ 25 million was being smuggled out in suitcases every day via the four main international airports. <http://www.dawn.com/news/1178828>; <http://www.dawn.com/news/1047015>

<sup>62</sup> Pakistani elites have hedged their bets by sending one or a few family members to live and work abroad, acquiring foreign nationalities, and salting some of their assets overseas just in case they have to make a hurried exit.

<sup>63</sup> <http://www.doingbusiness.org/Reports/Subnational-Reports/~media/giawb/doing%20business/documents/profiles/country/PAK.pdf>

<sup>64</sup> <http://info.worldbank.org/governance/wgi/pdf/c170.pdf>; <http://info.worldbank.org/governance/wgi/index.aspx#reports>

<sup>65</sup> Inevitably this casts "sands in the wheels of growth" as Campos and Dimova (2010) document.

<http://www.voxeu.org/article/does-corruption-sand-or-grease-wheels-economic-growth>

<sup>66</sup> Pakistan has waged a decades long struggle to improve electricity supply with little to show for it and predictably is ranked 157<sup>th</sup> <http://www.doingbusiness.org/Reports/Subnational-Reports/~media/giawb/doing%20business/documents/profiles/country/PAK.pdf>

<sup>67</sup> <http://data.worldbank.org/indicator/IC.FRM.OUTG.ZS>

is lost annually because businesses are starved of electricity<sup>68</sup>. The causes of the shortage<sup>69</sup> have been exhaustively analyzed and there are remedies but they demand actions by the government that bring it into conflict with powerful vested interests several in the public sector. Hence the problem festers and growth is slowed. The electricity supply gap mirrors equally serious gaps in the supply of other services such as water, sanitation, solid waste disposal, transportation, education, and health.

One reason why the volume and quality of public services including security services has declined is because the elites controlling the state have hobbled the extractive capacity of the state. This troubled Shahid deeply. He frequently inveighed against the failure of the state to increase revenue effort through a reform of the tax system that raised the share of direct taxes and penalized evaders especially the wealthy and the well-connected who were the principal culprits. Much like Francis Fukuyama (2015)<sup>70</sup>, Shahid took the view that for tax collection to increase violators had to be jailed. He maintained further that the impartial administration of justice would help legitimize the authority of the state and lead in time to greater voluntary compliance by the majority.

Shahid rightly argued that raising the tax to GDP ratio by several percentage points was feasible, and that it would narrow Pakistan's chronic budgetary deficits, while easing the constraints on public spending on infrastructure and developmental projects more generally. This would be good for growth in the short run as well as the long. Pakistan's central government collects just over 10 percent of GDP through taxes, which is below the average for low and middle-income countries (in 2012)<sup>71</sup>. In principle, gradually increasing the tax take to 15 percent and more should be relatively easy in a country with just 2.5 million registered taxpayers<sup>72</sup>. However, Pakistan's elites practice tax avoidance and evasion with almost religious fervor and their opposition, which is of a piece with their opposition to improving the quality of governance, has stalled all efforts at increasing the mobilization of revenues by the central government<sup>73</sup>. Shahid himself made

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<sup>68</sup> <http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=8816&Cat=13>. This may well be an overestimate.

Research by Alcott et al on India suggests that output losses from power outages reduce output by 5 percent but may be less damaging for productivity. Large plants with their own generators are affected much less. It is the smaller fry that suffer the most. [http://pages.stern.nyu.edu/~acollard/ACO\\_Electricity\\_Shortages\\_in\\_India.pdf](http://pages.stern.nyu.edu/~acollard/ACO_Electricity_Shortages_in_India.pdf)

<sup>69</sup> The shortages persist even though the installed capacity is adequate because some major customers do not compensate suppliers for their services and theft is rampant. There are other reasons also having to do with the state of the transmission and distribution systems that result in high line losses.

<sup>70</sup> [https://fsi.stanford.edu/sites/default/files/ff\\_jod\\_jan2015.pdf](https://fsi.stanford.edu/sites/default/files/ff_jod_jan2015.pdf)

<sup>71</sup> <http://wdi.worldbank.org/table/5.6>; whether Pakistan is an outlier is debatable. Cardenas (2010) finds that the average ratio of taxes to GDP for 127 countries between 1980 and 2006 was 10.5 percent with a maximum value of 51.4 percent. [http://www.brookings.edu/~media/research/files/papers/2010/4/latin-america-cardenas/04\\_latin\\_america\\_cardenas.pdf](http://www.brookings.edu/~media/research/files/papers/2010/4/latin-america-cardenas/04_latin_america_cardenas.pdf)

<sup>72</sup> In principle, 10 million people would be eligible to pay taxes as their earnings exceed \$3,500. This is counting only those in the formal economy; more than a third of the economy is comprised of the informal domain and is off the books. The use of third party information, computerization and selective audits all facilitate compliance and collection of taxes. [http://www.nytimes.com/2010/07/19/world/asia/19taxes.html?\\_r=0](http://www.nytimes.com/2010/07/19/world/asia/19taxes.html?_r=0)

<sup>73</sup> A few years ago, a study by the Pakistan Institute of Legislative Development and Transparency found that the average net worth of members of the national legislative assembly was \$900,00 and the richest was worth \$37 million. Both might be underestimates. The then leader of the opposition and the current PM Mr. Nawaz Sharif a

valiant efforts to move the needle on reform the first during a brief stint as special advisor to Pakistan's PM Mr. Z.A. Bhutto (on leave of absence from the World Bank in 1976-77), to no avail<sup>74</sup>. The World Bank, the IMF and the ADB among others have also added their voices, but elite commitment to a minimalist, regressive and distortionary tax system, and a corrupted collection mechanism has been an effective roadblock and is likely to remain a major hurdle for reformers in the future. Cardenas (2010) showed that the tax to GDP ratio changes slowly if at all over time and raising the share of income taxes – or for that matter property taxes – has proven to be a Sisyphean task for reformers everywhere<sup>75</sup>. Furthermore, income taxes as a share of GDP vary enormously across countries. Some levy no income taxes at all whereas the revenue collected from such levies exceeds 37 percent of GDP in a few<sup>76</sup>.

Alas my discussions with Shahid did not progress sufficiently beyond the diagnosis of the problems of governance in Pakistan to detailed discussions of practical solutions. And now that he is gone, I am unable to try out the ideas that are relevant for Pakistan, many of which I am sure he had reflected upon and formed an opinion.

#### *State capacity in East Asia*

In concluding, let me briefly summarize what the East Asian developmental states got right and Pakistan has not. Even the best such as Singapore fell short of perfection but they did manage to iron out many of the governance problems that they started out with. First, these countries did not burden themselves with an overly ambitious reform agenda that would have exceeded their organizational capabilities and stretched their resources. Avoiding reform overload was a wise strategic decision<sup>77</sup>. Second, from the outset, the successful East Asian economies focused on developing the nation's productive capacity so as to generate employment, exports and growth. This focus guided macroeconomic, meso and microeconomic policies. All used some combination of industrial, financial, trade, labor market, and education policies to build a viable economic engine. Third, the East Asians avoided the trap of income inequality that is correlated with elite capture of the state, weak state capabilities, the inability to mobilize substantial tax revenues, and the inadequate provision of public goods<sup>78</sup>.

Fourth, East Asians built and sustained merit based bureaucracies, which recruited some of the best and brightest by offering attractive salaries and benefits as well as high status in society. The

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multimillionaire paid no personal income taxes having transferred his companies to relatives. Politicians, landowners and business people all vociferously oppose reforms that would increase their tax liabilities.  
[http://www.nytimes.com/2010/07/19/world/asia/19taxes.html?\\_r=0](http://www.nytimes.com/2010/07/19/world/asia/19taxes.html?_r=0)

<sup>74</sup> The second was in the latter half of the 1990s following his retirement from the World Bank.

<sup>75</sup> Those of us who live in the U.S. can have no illusions regarding the difficulty of raising taxes especially direct taxes – and this in a country where there is a semblance of a social contract, voluntary tax compliance is relatively high, the audit process sufficiently threatening, and the government is more accountable than many.

<sup>76</sup> [http://www.brookings.edu/~media/research/files/papers/2010/4/latin-america-cardenas/04\\_latin\\_america\\_cardenas.pdf](http://www.brookings.edu/~media/research/files/papers/2010/4/latin-america-cardenas/04_latin_america_cardenas.pdf)

<sup>77</sup> This is a point rightly stressed by Lant Pritchett et al (2012) <http://bsc.cid.harvard.edu/publications/looking-state-techniques-persistent-failure-state-capability-implementation>

<sup>78</sup> Acemoglu et al (2006) and Sokoloff and Zolt (2006) and Cardenas (2010). <http://economics.mit.edu/files/7003>; [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=985831](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=985831)

national leadership ensured that these bureaucracies enjoyed a substantial measure of autonomy from political interference and could devote their energies to the primary task of development working closely with the private sector.

Fifth and relatedly, the performance of the key bureaucratic agencies and individuals was measured by a simple metric – how effective they were in enabling the economy to meet investment, production, export, and diversification objectives. These straightforward and relatively transparent criteria for measuring effort and effectiveness, yoked the capacities of the state to a single endeavor, accelerated structural change and growth and enlarged the revenue base. This was the start of a virtuous spiral with growth facilitating the increase of government revenues – helped by extractive capacity of an autonomous and powerful bureaucracy – which in turn allowed the state to fund infrastructures and services that crowded in more private investment.

Sixth, corruption was and is an issue for East Asian bureaucracies – with the possible exception of Singapore – but although many were saddled with cultures not too different from that of South Asia, a missionary zeal to develop the country imbued by the national leadership, meritocratic selection processes and decent pay scales, and clear performance criteria contained the incidence of corruption and largely weeded it out of daily, routine transactions. Businesses could get on with the job of making money without having to wade through myriad nuisance regulations and bribe officials at every step. East Asian governments did not strain after transparency or accountability, did not make use of double reporting (of taxes), or benefit from the access to information and better oversight made possible by online procurement. By successfully pursuing growth they managed to climb up the income scale and quickly distance themselves from the earlier stages of development when corruption can be a serious menace. The relationship between income and corruption is strongly negative (Olken 2012)<sup>79</sup>.

Last but not least, the East Asian governments had full coercive powers and a monopoly over violence. Law and order was maintained sometimes ruthlessly. There were external threats – and these might have compelled leaders to pursue the developmental agenda – but internally the authority of the state was unchallenged.

It can be argued that Pakistan is at a stage where the East Asian lessons are of limited relevance. The global environment is unpropitious and Pakistan's immediate neighborhood is becoming less friendly by the day; export-led industrialization is no longer and obvious pathway to rapid growth; the country lacks leadership with a developmental focus; incomes are unequal and becoming more so and as a consequence, democracy has not diminished elite control over the policy

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<sup>79</sup> Olken (2012) reviews the literature on the costs of corruption, which can be high. He also makes the important point that measures to quench corruption sometimes work in the short and medium term but over the longer term, it can seep back in as the corrupt find ways of circumventing rules and procedures introduced to control kickbacks, bribery and absenteeism. <http://www.annualreviews.org/doi/abs/10.1146/annurev-economics-080511-110917>

agenda or the power of the military<sup>80</sup>; internal violence, which the state has difficulty checking and widening social fissures, pose serious threats and actively discourage investment; continuing population growth, water scarcity and climate change suspend questions over longer term prospects. One could go on: and if there is a silver lining under long stretch of clouds, it is well hidden. Pakistan will muddle along for a while but absent an overhaul of governance, even muddling may cease to be an option.

Towards the end of his life, weighed down by ill health, Shahid was prone to pessimism. He saw many problems, few if any bold initiatives. With so much at stake he hoped for the best but that hope was increasingly tinged with despair. It is entirely possible that his pessimism was misplaced and that Pakistan will surprise us all. There is always room for late starters especially ones with an abundance of youthful energy and entrepreneurship. Growth accelerations can happen suddenly and unexpectedly with a push from good policies and good fortune. And a South Asian miracle is long overdue. Secretly that is what Shahid must surely have wanted.

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<sup>80</sup> Acemoglu, Ticchi and Vindigni (2008) make the point that inequality increases the likelihood of military dictatorships and makes it harder for civilian governments to avoid military coups.  
<http://www.nber.org/papers/w13915>

# Washington Post

June 4 2015

## Obituaries

### S. Shahid Husain, World Bank executive, dies at 83



S. Shahid Husain in an undated photo. (Courtesy of the World Bank Group Archives)

By **Bart Barnes**

S. Shahid Husain, an economist and senior vice president of the World Bank who played a key role in economic assistance to countries in Latin America, Africa and East Asia, died May 11 at his home in Bethesda. He was 83.

The cause was Parkinson's disease, the World Bank announced.

In a 33-year career at the international financial institution, Mr. Husain was vice president for Eastern Africa, vice president for East Asia, vice president for operations policy, vice president for Latin America and the Caribbean Region. He spent three years as vice president for management and personnel services before retiring in 1996.

According to the bank, Mr. Husain worked with and advised most of the presidents, prime ministers and finance ministers in Africa, East Asia and Latin America and helped open up the institution's relations with China. He was a critical negotiator in shaping economic reforms that affected Argentina, Peru, Mexico and other Latin American countries amid a debt crisis in the late 1980s.

Syed Shahid Husain was born on April 4, 1932, in Patna, India, and grew up in Hyderabad. He moved to Karachi, Pakistan, following the British partitioning of India into two sovereign countries in 1947. He graduated in 1952 from the University of Karachi and received a master's degree from the London School of Economics in 1956.

He joined the Pakistani civil service in 1956 and, in 1963, received a master's degree in economics from Williams College



in Massachusetts. He then joined the World Bank, where his initial assignment was Brazil.

There, he introduced several innovations in economic analyses, which later would catch the attention of World Bank President Robert S. McNamara, who in 1974 made him vice president for Eastern Africa. At 42 Mr. Husain was the youngest person to have been appointed a vice president of the institution, the World Bank said.

After retiring, Mr. Husain was an adviser to the Islamic Development Bank. In 2002 he was in Pakistan for a year working on tax reform.

Survivors include his wife since 1961, Nigar Abbasi Husain of Bethesda; three children, Ayesha Husain of Bethesda, Aliya Husain of Washington and Ameen Husain of Kensington, Md.; and two grandchildren.

# **The Friday Times**

Obituary, 17 July 2015

## **An unsung icon passes into history**

By Shahid Kardar

It was the autumn of 2002. Walking into the meeting of the Board of Prime Bank, I saw a smiling sharply dressed gentleman whom I immediately recognized from his photographs. I did not know him but had heard of him, because only a handful of Pakistanis have acquired iconic status in agencies of global influence. Shahid Husain, who died recently at the ripe old age of 83, was one of them.

From the first encounter it became patently obvious why he was so widely respected, underlining my misfortune for not having interacted with him earlier. He signposted his formidable presence by the searching questions on the bank's vision, its investment strategy given Pakistan's pattern of economic growth, the lending portfolio not being concentrated in sub-sectors destined to grow faster in rapidly changing international markets and in response to technological evolutions, etc. etc.

Shahid's academic career did not get off to an auspicious start. He enrolled in engineering but failed. He then left home, worked in a coalmine in Balochistan, ran out of money and returned home. Then his life changed. He registered for an Economics degree and excelled in it. He attained his Masters from the London School of Economics, sat the civil service exam in 1956 and became Deputy Secretary in the Planning Department, West Pakistan in 1961.

He joined the World Bank as an Economist in the Debt Division after completing his Masters from Williams College in 1963 and was tasked to work on external debt and economic growth. Based on the quality of the modelling work that he carried out in this position he was asked to consider a position in the more regular departments of the institutions. Despite his training in Economics he always regarded himself as a generalist rather than as an economist-since he did not fancy writing economic reports for the rest of his life.

His first assignment took him to Brazil where he quickly became the chief interlocutor of the Bank with the country, making his name by writing country reports on political and economic developments-not the institutional practice in those times. Since these reports became the basis of discussions on current issues with the country he soon earned recognition as the most knowledgeable person on Brazil at the Bank.

Rated 'Exceptional' every year by his seniors he rose very quickly to become a Division Chief at the tender age of 36. His stellar performance caught the attention of McNamara who elevated him to the position of Vice President for East Africa; at 42 the youngest VP of the institution, becoming the longest serving VP of the organization, with working experience at the highest levels in Latin America, Africa and East Asia.

He leaves behind three children and devoted wife, Nigar, of 55 years, a key figure in the realization of his ambitions.

Shahid was a no-nonsense man of ideas and solid principles. Having his own perspective on key issues he was firm and assertive in his views, anchored in a deep commitment to reform. The striking and abiding features of his person were sheer grit and determination and 'never give up style' which was actively on display right to the last days of his life as he struggled with Parkinson's, never allowing the disease to overwhelm him.

Shahid's accomplishments were many, several pioneering in spirit; his substantive legacy being to wean the World Bank away from a pure investment project institution to one which would also support policy reform.

When he was appointed as the first non-American VP of Latin America he quickly earned the respect of all. He learnt Spanish to gain a better understanding of the country and the objective conditions and to establish his credibility with the client. He believed strongly in working closely with the borrowing country, best manifested in the way he set up a camp office in Brazil, staying there for long periods, being hands on to an extent that would not be expected of a Vice President. Credited with a powerful operational sense and widely acknowledged capability to get things done, his enviable standing attracted the smartest professionals at the Bank to his team, thereby enabling the transformation of the region through active policy engagement during the 1990s.

His work on Argentina in the late 1980s and early 1990s is considered to be a golden chapter in World Bank history because of the major contributions made there over a relatively short duration. His main theme in Latin America was education, based on his belief that a prerequisite for viable economic development was good quality human capital. And today high quality young technocrats are providing the leadership necessary for driving economic change in the region.

He was also an innovator and inventor, being instrumental in the opening up of the World Bank to China. By arranging a private visit to China he lay the ground work for McNamara's visit to China. Inducting China into the Bank's lending system was going to be a tricky affair since Taiwan was a borrower and could have reacted by defaulting on its loans, which would have contributed to a negative rating of the Bank's bonds. The development of the Bank's productive relationship

with China was in large measure to Shahid's influence. He masterminded this formative phase of Bank efforts to establish a longer term association with China, which resulted in it becoming the biggest client of the World Bank.

Again, in Latin America he led the restructuring of the debt of Peru (which had defaulted) to enable its reintegration in the global economy. And Peru is today one of the fastest growing economies in the world.

Shahid was a bit of legend as a manager at the World Bank, universally accepted and fondly remembered by his junior colleagues for exceptional managerial skills, one of the best at the World Bank. A high calibre intellectual, he was always strategically focused, prioritizing Bank interventions in the borrower country, balancing his vision with pragmatism. Eager to get involved he would roll up his sleeves to take up a position in the trenches with his staff, determined to find a constructive way forward on strategically important issues.

He was highly regarded as a clear-headed mentor, fast decision maker, decisive, excruciatingly hard working and accessible to even the more junior staff members, engaging constructively with them, providing them a challenging environment, encouraging innovation and advising them never to give up if they believed in their own analysis and reform proposals. He made sure his staff were well taken care of and was way before his time as a staunch supporter of women, persistently trying to carve out meaningful career paths for them.

Other memorable traits were the ability to delegate responsibility and take full ownership of his team's inputs, thereafter always standing by them. One such member of his team recalled an incident which typified the mettle of the man and his style of motivational and inspirational leadership. This analyst had written a critical report on the economic policies of the Indonesian government, which invited the ire of the

Indonesian government, especially when the report got leaked to the Far Eastern Economic Review. When a key member of the government's economic team came to register a protest on the comments in the report, Shahid, who could never be intimidated by the borrower or the Bank's senior management, called the junior author to his room to introduce him to the complainant. Half expecting to be given the marching orders he was shocked to hear Shahid defending the report and suggesting to the senior member of the Indonesian government to not only read the report carefully but also share it with other colleagues and consider adopting some of the recommendations.

Notwithstanding his relative youth and despite being the first VP from the third world Shahid was never afraid of taking difficult decisions. He was a courageous man who took the kind of risks which most others in this position wouldn't- provided these gambles were consistent with his strategic objectives. His reputation as a doer and the single-mindedness with which he would set out to achieve his goals made him a role model for many young economists at the Bank, in the process becoming a larger than life personality.

Shahid also never shied away from a debate and from challenging even his seniors whenever he disagreed with them or when they took decisions without consulting him in areas that fell in his responsibility domain. One such example was his compellingly worded protest on McNamara's public announcement to not lend to Vietnam without consulting/informing Shahid, thereby undermining the authority of the VP of East Asia, whose office was keen to support such an intervention.

Although he left the country way back in the early 1960s Shahid's mind always engaged with Pakistan since he felt passionately about the country. He followed developments at home and kept himself updated even at the micro level without being blessed with the present day

advantages of access to the internet and news on events as they unfold by the minute.

For these reasons and his professional achievements, he was, understandably, an active and prominent member of the Pakistani community in the US in general and Washington in particular. An engaging personality and a fascinating conversationalist, considering the richness of knowledge and experience that he could bring to a debate. His company and opinions were always sought by his compatriots residing in the US not only for these reasons but also because of his social graces.

His attachment and commitment to Pakistan was such that whenever his country beckoned him he came back, mindful that his views may not be in sync with the leadership of the times. His first such sojourn came when Zulfikar Ali Bhutto wooed him assiduously to join his government in an advisory capacity. He soon found out that Bhutto wasn't really interested in his advice. He merely wanted to use Shahid as a cover to appease the international community. In this instance, he left the country when Bhutto nationalized the agriculture related industries without ever consulting him on this initiative. Next time he came to the country was in 2000 when he was requested to lead a Task Force on Tax Administration Reforms. That he failed to get traction for his ideas on both occasions was because of the lack of commitment of the political leadership to adjustments and reform.

In an interview conducted in 1994 he said "The crisis of development is a manifestation of the crisis of the State which in many developing countries is untenable in its size, management burden and in terms of its role as a redistributive mechanism from the people to a handful of privileged groups-through subsidies, regulations and transfer of wealth through inflation. Hence the need for a smaller State

and greater reliance on the private sector- a means for decentralization of authority and responsibility”.

When benchmarked against his conviction that fairness of fiscal policy was central to the citizen state relationship, the sentiments quoted above underlay his disappointment with the chronic under-performance of Pakistan. He was convinced that the inability of the domestic elite to tax itself was fundamentally compromising the quality of the country's future. For him an equitable tax structure and a fiscal regime that would rationally prioritize its spending to widen the base and value of human capital was the bedrock of any reform for attaining economic sovereignty. He felt particularly disillusioned when he compared Pakistan's progress with Korea and China, countries that he admired most for the importance they gave to education and the high sense of discipline that epitomized them when it came to fulfilling commitments and delivering projects along agreed timelines; these attitudes and value systems being consistent with the great emphasis he placed on people and processes instead of structures.

It's a great pity that he didn't pen a book for posterity sharing his wisdom and the lessons to be learned on policy and governance reform from the variety and depth of his experience.

Rest in peace Shahid. You have enough reasons to be contended with- if not justifiably proud- of your path breaking contributions and the enormous impact that you had on the agenda and processes of the World Bank, your professional home for more than 32 years.



FOUR DECADES OF ECONOMIC DEVELOPMENT

WHAT HAVE WE LEARNED?

SPEECH BY

S. SHAHID HUSAIN

BEFORE THE

ISLAMABAD COUNCIL OF WORLD AFFAIRS

DECEMBER 6, 1989

### A Crisis of Development

At no time since the second World War have economic and political changes been as significant as during the eighties. While Europe moves towards economic unity and prosperity, and Japan maintains its technological and economic progress, we in the developing countries have found that economic development is neither continuous nor homogeneous. There are a handful of countries in East Asia which have grown rapidly, broadened economic opportunity and established themselves as dynamic producers and exporters. The rest of the developing world is in a deep crisis; a crisis of economic management; a crisis of government; a crisis we have seen in the continuous decline of GNP per capita for eight years in Sub-Saharan Africa and five years in Latin America. The present GNP per capita in Sub-Saharan Africa is lower than in 1977 and in Latin America lower than in 1981. Even here in Pakistan, while our statisticians have shown economic growth year after year, literacy is not increasing, peoples' health is not improving, the

infrastructure is breaking down and the lack of jobs manifests itself in "ethnic riots." At no time during the last forty years has the outlook for developing countries been as clouded as now. In many developing countries there has been progress in the production of food, industrial production and human opportunities. But there seems to be an abrupt halt to the process. As the momentum is lost, the shortcomings and the fragility of their achievements seem to be increasingly apparent.

We have to ask why. No doubt, external capital flows have declined and many developing countries are now net exporters of capital. In many the terms of trade, - i.e., the prices they receive for their exports in relation to the prices they pay for their imports, have been worsening for decades. But there is more. We cannot indefinitely maintain a posture of self-pity, blaming outsiders for our problems and asking them to solve them. We have to look within. The crisis of development is not limited to a few issues. It is general. And, therefore, its roots must be in the social, political and economic structures, policies and processes of the countries of the Third world. The state has a large role in the economy of the developing countries. And if there is a crisis of development, there is also a crisis of government. An analysis of the issues of development would, therefore,

not be complete without a review of the functioning of government and its relationship with private entities.

#### Premises of Economic Development

Let me now remind you of some of the basic elements of the theory and practice of economic development during the last forty years. Later, I shall examine how each of these has contributed to development as well as the crisis of development.

First and foremost, the state. Since planned development required changing and accelerating the normal processes, the state had to assume a central role in stimulating and regulating economic activity, investing in social and economic infrastructure and often in direct production. The assumption was that the state had an unlimited managerial and political capacity to expand and perform these roles. It was also assumed that the state was always benign and that its regulatory and stimulant roles were for the common good, rather than sectional interests.

Second, balanced growth. Developing countries had been at a tremendous disadvantage in being exporters of primary products. Hence, the need for industrialization both to diversify production and to provide new employment opportunities. Since developing countries were supposed to have difficulty in competing with producers in

industrial countries, import substitution, with protected markets, was to be the route.

Third, external borrowing. It was assumed that because of the small stock of capital in developing countries, relative to that in industrial countries, the productivity of new capital in developing countries would be higher than in industrial countries. It would, therefore, be advantageous to borrow and borrow as much as possible. Added production would not only serve the country but would also provide for servicing the debt.

So, where are we in respect of each of these?

#### The Role of Government

During the last forty years the government in every developing country has grown massively in absolute terms and relative to the national economy. Governments try to secure law and order and provide education, health services and infrastructure, some unsuccessfully as in our country. Beyond that, they manage financial institutions and run industrial plants. More important, through regulations, permits, tax concessions, subsidies and monopolistic control of services such as telephone, electricity and water, governments have come to have a predominant control of private economic activity; of who will produce and who will not; what will be produced and at what cost; and who will benefit from the largesse that

the government has to confer in terms of licenses, permits, protection and favored finance.

Thus, governments in developing countries are riot merely agents for planning, stimulating and managing economic development; they are at the center of a substantial transfer of wealth and income from the society in general to particular sections of the population. Such transfers are mostly not consistent with the declared economic and social objectives of these governments. Let me give a few examples. In Argentina, until recently the transfers to industrialists in the form of tax concessions were between three and four percent of the national income. In Brazil, similar transfers through the National Development Bank were even higher relative to the national income. I do not have figures for Pakistan, but there are obvious examples -- allotment of urban and agricultural land to favored groups at a fraction of the market value, allocation of industrial permits, favored industrial financing and the large subsidies on fertilizer and irrigation water whose major beneficiaries are the elite of the agriculturalist class and so on.

As the *size*, the functions, the coverage and the control of governments have grown, there have been some interesting changes in four important aspects of governments. First, centralization; second, finances; third, effectiveness and management; and fourth, the

conflict between the government as a large producer of goods and services and government as the policymaker and regulator. All of these have a bearing on how governments are managing economic development and how the process should change if we in the developing countries are to extricate ourselves from our current malaise.

### Centralization

Let us start with the issue of centralization. The state in developing countries has been a great centralizing force; in the public sector, in financial resources, powers and functions of central governments, at the expense of provincial and local governments; vis-a-vis the private sector, in the allocation of resources, control of finance, ability to conduct economic activity, competition and access to market: This centralization has resulted partly from the need in many countries to guard against threats to the unity of the new states. In countries where the military and the central civil service assumed disproportionate power, they themselves become major centralizing forces.

A lot of centralization has been the direct and inevitable result of the pattern of economic development that has been followed. It is the central government which has the authority to levy the taxes which are relatively elastic -- income and sales taxes and import duties. It is the central government that prints money

and it is the central government which borrows abroad. In the name of financing and coordination, central governments control or decisively influence not just the broad economic policy, but education, health, and family planning, where normally management should be decentralized and close to the people. True, there is a proliferation of government organizations and the government's activities in industry and finance have given rise to a variety of public enterprise. But insofar as these enterprises are the result of nationalization or a policy of public monopoly, they represent centralization rather than decentralization. Seldom have governments in developing countries given true autonomy to public enterprise and subjected it to competition from private entities. I have already mentioned how vis-a-vis the private sector in many countries, governments have taken away discretion, responsibility and risk-taking. They have created a large community of hangers-on who live not by innovation, management and risk-taking, but by favor, subsidy and monopoly.

#### Fiscal Management

Let me now go to the second issue, fiscal management. Government expenditures relative to the economy have increased in all developing countries. In Mexico, Peru and Venezuela, public expenditures relative to GDP doubled between 1970 and 1982. Here in Pakistan,



all levels of government and public enterprise represent nearly 30% of national income. By themselves these expenditures may or may not represent social priorities. However, as they increase, they are at the expense of activities in the private sector of the economy. They also establish claims and entitlements which later make it extremely difficult to reduce expenses. With very few exceptions, a facet of the crisis of development is the fiscal crisis. Governments in many countries have lost control of their expenditures.

There are certain important characteristics of these expenditures which I would like to mention. In many countries, defense is a large and growing proportion. Seldom is the question asked what the nation buys for this expenditure and what the tradeoffs are. Then, in practically every developing country the sheer maintenance of the structure of government and the proliferation of governmental and semi-governmental organizations absorbs a large part of government revenue. And, thirdly, the weight of transfers and subsidies, many of them regressive and without an overriding social purpose is heavy. Lastly, public enterprises are often run at a loss because of their internal inefficiency, because they were poor economic propositions to begin with or because government policies and interventions preclude their financial viability. These losses have to be financed by the

exchequer. As these claims on public finances have mounted, tax systems and their administrative capacity have not kept pace.

Large fiscal deficit is a common phenomenon. When this deficit is financed by printing money, inflation, loss of confidence in government and large capital flights are the result, as in Argentina. Where the deficit is largely financed by domestic borrowing, often at high interest rates, a domestic debt crisis is inevitable; a rapidly growing proportion of government revenues is preempted for debt service and other expenditures are financed increasingly from printing money. So is the case with Brazil, where 90% of government revenues go for domestic debt service and salaries. Pakistan is rapidly moving in that direction. In all such cases of fiscal mismanagement, the worst casualty is social development. This issue should be familiar to many of you here in Pakistan. Defense and debt service together appropriate 60% of the central government's revenues, while education, health and family planning together account for a mere 5%. The result is apparent in some of the worst indices on social conditions in developing countries.

#### Management and Effectiveness of Government

An essential result of the expansion of government, proliferation of semi-governmental organizations, centralization and fiscal stringency has

been a decline in the management and effectiveness of government. Underdevelopment is not merely lower per capita income, high mortality and low literacy. It is a social, political and economic condition in which people find great obstacles to organizing and maintaining efficient economic activity. Large and monolithic organizations will inevitably be a part of the general culture of underdevelopment and inefficiency. Where they have power over people and resources, they will inevitably become a host to vested interests and rent seekers. The larger the government the greater these risks. But, in addition, there are the normal and routine problems of the span of control, complexity, issues of management and availability of suitable people.

There is no industrial country outside the centrally planned economies which has assumed the variety and the breadth of management functions centrally which many developing countries have assumed. Had a country done so it also would have faced serious issues of management. In our case, the problem is further complicated by fiscal stringency. In spreading their resources thin, most developing countries' governments have seriously eroded public sector salaries, particularly for higher civil servants, while simultaneously giving them substantial authority to confer or deny financial benefits and costs on the public. Too many developing -

countries have let their public servants and politicians live off the land, in the process discrediting the government and distorting economic incentives and processes.

Another consequence of the growing size and complexity of governments has been their inability to perform effectively and efficiently the functions that only governments can perform. In Pakistan, with the breakdown of law and order and of the rule of law and the virtual absence of government from education and health, we are only too aware of this phenomenon.

Contradiction: Government as Policymaker and Manager of Enterprise

A word now about the growing inconsistency between the need for the government to be the architect of efficient policies and government as owner and manager of enterprises which would benefit or be harmed by those policies. Where governments run industrial enterprises and financial institutions, the profitability and survival of these institutions depend in large measure on government decisions on whether private organizations would be admitted to those sectors and on what terms, whether and how much protection industry would receive from foreign competition and what access industrial institutions would have to financial institutions. It is too easy for issues of efficiency and economy to be

ignored in the process. It is natural for public enterprise to seek protection and survival through public policy that restricts or eliminates competition rather than improvements in management, technology, marketing and efficiency. It is also natural for them to claim and receive subsidized credit from public financial institutions.

I had a personal experience of this while serving as Special Assistant to the Prime Minister in the mid-seventies. In the Economic Sub-Committee of the Cabinet, too often the Minister of Production would press for import restriction on commodities which competed with those produced in public enterprises and too often he would win the day. The alternatives of letting the plants be closed or sold were not acceptable to the government and improvement in management and efficiency were tasks for which the enterprises were not geared. In the end the society as a whole paid the price in high cost and shoddy products. For years a proposal by I.C.I. to establish a plant to manufacture synthetic fiber was not approved because the Production Ministry said they would set up the plant. A country poor in resources was denied foreign investment and technology. The development of the engineering industry was held back because private organizations were excluded and nationalized companies were merely languishing. The private sector was barred

from investment in cement manufacture while there was a shortage of cement and the public cement corporation could just not complete the cement plants under construction.

#### Diseconomy of Large Governments

Before proceeding further, let me take a moment to summarize my thoughts on our experience with the role of government in economic development. The role of government in economic development has been crucial and yet there is growing evidence of the diseconomy of large, complex and centralized governments. Where governments cease to be answerable to the public and where the press *is* muzzled, the scope for mismanagement multiplies many-fold. The self-sufficiency in grains, in India and Indonesia, the economic development of Korea and the industrialization in developing countries would not have been possible without active government management and support. But one can have too much of a good thing. Governments in many developing countries have become excessively large, complex and inefficient. They have lost a broader social purpose. They have become a host to vested interest. Too often their controls, regulations and subsidies merely create rent and vitiate efficiency and social equity. Their finances are shattered and some of them face a time bomb of domestic debt. The *crisis* of government is so grave that the crisis of development is *in fact* the *crisis* of government.

Lest I am misunderstood, I must emphasize that I am not asking for the state to walk out totally from the task of managing economic change. The modern state was created in part to promote human welfare. In many instances it must involve itself directly to achieve this objective. China would not have succeeded in alleviating absolute poverty had not the state involved itself in providing basic human needs to the citizenry. But, in many instances, states have behaved perversely. In Pakistan, the state of social development is below the level reached by many other countries largely on account of misallocation of resources by the state. The conclusion therefore, is not that the state should abandon the field of development altogether but for it to behave responsibly.

#### Import Substitution

Let us now examine the issue of balanced growth and the relationship between developing economies and the international economy. Those of us who read economics in the fifties and sixties grew up on certain deeply held convictions about primary producing countries. First, the real prices of primary products were destined to a secular decline and, therefore, the primary producing countries could extricate themselves from a fundamentally inequitable international economic system only through industrialization. Second, since the industrial countries

had such an edge on the primary producers, industrialization could be got going only if the society subsidized the process by making the foreign goods scarce and expensive and through subsidized funds and services. Third, with the explosion of urban populations agriculture would never solve the employment problem and industrialization would not only diversify production and improve the technological base, but it would also generate employment. Thus, the process would lead to balanced growth. Once a big push had been given, growth and development could be self-sustained and domestic industry could face the cold wind of competition. This was the prescription that developing countries followed, with the exception of the so-called Asian Tigers, Korea, Taiwan, Singapore and Hong Kong. There the focus was on exports:

How have we done? There is no doubt that the industrial and technological base in developing countries has expanded substantially and that it is very impressive in some of the larger economies such as China, India, Brazil and Mexico. Except in Africa, the economic structures and exports of developing countries have been diversified substantially. However, leaving aside the large economies such as Brazil and India, there is a growing concern about the sustainability of the process and hence about the need for change. The limits to the process have come from three factors: social costs, size



of domestic markets and economic and technological stagnation.

When an economic activity is protected from competition and is subsidized, the society as a whole bears the cost. The cost may be justified if this activity can after a while survive without the support. In too many developing countries this is not the case. The protected industries have become organized forces for the perpetuation of protection. Sometimes, as in Brazil, the foreign trade agencies and industry make a common cause. Too often the very policy regimes that create these industries, viz., subsidized credit, undervalued foreign exchange and monopoly or quasi-monopoly of the domestic market lead to high capital intensity and very low employment generation. In fact, in Pakistan and a number of other developing countries, the informal sector and the small manufacturers, which benefit little from government subsidies and protection, have done a far better job of creating employment than the recipients of favors and subsidies. Too often in the developing countries, we see the phenomenon that economists call negative value-added, i.e., at international prices the value of output is less than the value of inputs. The society would have been better off without the economic activity.

So, perhaps the process of import substitution has reached its logical limits and there is need for a greater integration of the economies of developing countries in the international system of trade -- trade with industrial countries and trade with each other. It is no accident that the best experience of growth and development is of countries such as Korea and Taiwan, and now Thailand and Chile, which have taken advantage of the broader international markets and tilted the entire system of incentives in favor of exports and efficient import substitution. The issue is not just exports for foreign exchange; the issue is how efficiently the scarce resources of poor countries are used. Will the producers be exposed to competition and the pressure it brings or will they continue to demand protection which ultimately will perpetuate stagnation?

#### External Capital

The third plank of development has been external capital. Its justification has been humanitarian, economic and political. In every developing country external flows have made major contributions to development. In our own country every major development project built during the last thirty years benefited from external loans or grants. But there are two issues we should examine. What is the cost of external capital? Is external capital addictive?

We used to think that as long as external funds were associated with specific projects, they would be productive and their cost would be worthwhile. But we have found that projects are no better than the environment of economic policy and management in which they are undertaken. Oil countries are littered with misconceived industrial plants and civil works with little economic value. In Nigeria, huge investments were undertaken during the oil boom but throughout the seventies there was no increase in domestic production; in fact, agricultural production declined. There is more. Export credit agencies are concerned with exports, not development. Even international agencies and bilateral aid givers have priorities and doctrines which may not be the country's priorities and doctrines. Too often external financiers give inadequate attention to domestic institutions and their capacity. In the heyday of belief in integrated rural development we in the World Bank thought that deficiencies of local management and technology could be met by imported management and technicians. Consequently, every African country has failed rural development projects. In the days of concern with energy we in the World Bank financed excessive investment in hydroelectric plants in countries such as Honduras and Colombia. In Brazil, a project to produce

alcohol as a substitute for gasoline costs the Government US\$2 billion a year in subsidies.

The question then is: is there overdependence on external capital? Before I answer this question I will present two alternative views of external capital. One is the established orthodoxy. Poor countries have low savings and foreign funds are an essential supplement to these savings so that development and growth can be accelerated. Moreover, they bring with them technology and management. They also permit governments to resolve their fiscal problem without unduly squeezing the private sector or resorting to inflationary financing. The other view is that too often external assistance has sapped domestic effort and tended to perpetuate otherwise nonviable economic policies and structures. There is evidence of both. Let us take the experiences. In countries such as Korea, Indonesia, Thailand, India and Pakistan, the growth and development they have achieved would not have been possible had the external capital they received not been there. On the other hand, in countries such as Egypt, Tanzania and Zambia, external assistance may have prolonged basically erroneous economic policies. In the end the problems of adjustment became even more intractable than before.

A special case is that of countries in Latin America and some in Africa and Europe, which borrowed

heavily during the oil boom. Countries like Mexico and Nigeria, borrowed in the belief that the increase in the price of oil would be unending. Most of this money went into uneconomic projects, capital flight or increased consumption. Oil importing countries like Brazil, borrowed heavily to ease the pains of adjustment but also in the belief that large domestic investments, particularly in energy, would maintain the momentum of development in spite of transfers to the oil exporting countries. The burden that these countries carry is not just debt. Free borrowing led to huge expansions of governments, public enterprises, and subsidies. Now that the money is gone, countries and governments are saddled with major structural problems, which will take years if not decades to resolve, with serious social and political consequences. Their economic growth is stymied and in most of the countries a significant part of the external debt will have to be written off.

#### Looking Ahead

I have dwelt on the impediments to development. Needless to say that the challenges that the developing countries faced were enormous too. Countries that were under colonial rule had to establish the apparatus of government and while many of them had no national unity and identity to begin with. In African countries the colonial powers had done nothing to facilitate a

transition. The new nations had simultaneously to deal with peoples' expectations for better lives and the external environment was not always supportive. So, despite all the difficulties and shortcomings I have mentioned, the achievements are impressive. But merely recounting the achievements of developing countries would not have established the basis for what needs to be done to face the future. As populations increase and peoples' expectations rise, we have to deal with the issues of the future as well as the accumulated baggage of the past.

The accumulated baggage is represented by large and inefficient governments, their poor finances, domestic and external debt, a proliferation of controls that create unproductive rent and distort efficiency of resources, industries that have grown in a protected hothouse, overstretched and sometimes decaying infrastructures and a general failure to develop education and broad institutional structures. The emerging issues for the future are the realignment of relations among industrial countries and decline of capital flows to developing countries.

A fundamental realignment of economic relations between industrial nations is in progress now. In Europe, with economic unification and the opening of Eastern Europe; there is a growing tendency for an inward look, a preoccupation with Europe. The United States is in

relative economic and financial decline. Japan's growing economic and financial strength is not matched by its share in political power and influence. As the East-West tension declines, Europe and the United States are likely to be preoccupied with internal economic issues.

Their economic relationships with the developing countries may be governed more by domestic and regional issues than broader developmental concerns. Multilateralism is on the decline and client-patron relationships are emerging between Africa and Europe, East Asian countries and Japan, and Latin American countries and the United States. Simultaneously, there is an obvious decline in net assistance in real terms from the United States and the major European countries. The only significant increases are from Japan. The institutions of commercial finance are impaired by the debt crisis and it is highly unlikely that in the decades to come we shall see real concessional assistance and commercial flows in the magnitude we saw in the seventies. The limited concessional assistance is likely to go increasingly to Africa and some of the poorest countries like Bangladesh. So, any strategy for the future has to be based on the reality of declining commitment in industrial countries to the development of the Third World.

Drawing on what I have said so far, let me offer some thoughts about elements in the future development on

the developing countries. As external resources decline and a significant part of their own resources are preempted for debt service, accent on domestic resource mobilization and an efficient use of resources would be crucial. Apart from measures within governments to evaluate and enforce economic priorities and withdraw from functions and enterprises which are either uneconomic or which can effectively be performed by the private sectors, efforts would be needed to improve the efficiency and effectiveness of tax structures and collection machineries. The weight of regulations, particularly those that give rise to rent, would have to be eliminated. Governments should particularly focus on establishing a rule and stability of expectations. Substantial investments and improvement in management will be needed in infrastructure and human services, areas where government's role is crucial and cannot be easily substituted.

An essential adjunct to increased self-reliance and domestic efficiency will be freer trade and reduction of import restrictions and exchange rates which would make investments and production for exports as economical as for domestic markets. No doubt there are trade restrictions in industrial countries, but the experience of Korea, Taiwan, Thailand, Brazil, and now Chile and Mexico, is that whenever countries establish domestic



regimes favorable to exports and maintain them, domestic investors do respond with investments and markets are found. In the final analysis, if developing countries are to have effective negotiating power in the international trade negotiations, they should also be substantial participants in trade.

Perhaps the greatest neglect in developing countries has been of education. Every single study on the relationship between education and development shows a close link. Those of us who know Korea will also know that what distinguishes Korea from other developing countries is great emphasis on education and the diversity of private and public educational institutions. Studies also indicate that where resources are limited, general basic education pays highest dividends. It increases the ability of the population to take advantage of technical change. Developing countries should take a deep look at their education policies and institutions. As in other areas, increase in education effort has to go with decentralization both of finance and management.

Let me conclude by saying that the greatest harm to development and, for that matter to any relationship between the government and the people, is done by arbitrariness. In our country and in many other developing countries there are too many changes in economic regimes -- taxes, incentives, restrictions and

government ownership. If the rhythm of development *is* to increase, a liberal system should be accompanied by a reasonable stability of policies and expectations.

What I have said is easier said than done and I am fully aware of the difficulties and limitations of those who have to make decisions. Many changes have to deal with established privileges and interests. The management of change is no less important than the purpose and direction of change. But, above all, we need to recognize that what we have is nonviable and must be adapted to the future.

STATEMENT BY MR. S. SHAHID HUSAIN  
AT THE ANNUAL RETREAT OF THE  
DEVELOPMENT ECONOMICS DEPARTMENT  
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Thank you for inviting me to speak at your annual retreat. I have read economics but do not consider myself a professional economist and therefore I will approach my suggestions tonight with the requisite humility. In doing so, I will draw upon my perception of how development economics has responded to the issues of economic development and my experience as a public servant in Pakistan and here in the World Bank during the last twenty eight years.

I started reading economics exactly forty years ago -- that makes me very old obviously. At that time, there were four fundamental elements in the theory of economic growth: capital accumulation, capital flows, imperfections of the market and external trade. Development economics was largely a descriptive subject, in the nature of economic geography or

economic history. Seldom was an attempt made to integrate into the main body of economic analysis these issues of economic geography and history. For a while, an attempt was made particularly by the structuralists of ECLA to elaborate a system of analysis around some of the key structural issues of the developing countries. But, now, we are back where we were forty years ago. We regard the specific issues of underdevelopment as merely the result of market failures and tampering with the markets. We treat issues such as poverty and basic needs largely in isolation and have not quite integrated them in the broad framework of economic analysis. We treat institutional and social issues in a descriptive fashion, again, without integrating them in the body of economic analysis. Economists remain preoccupied with the optimum. We seldom recognize explicitly that societies never reach the optimum. They remain in transition from one sub-optimum condition to another.

. Our analysis seldom focusses on the issues of transition in the choice of sub-optimum situations. Despite lip service to the influence of potential losers and gainers in economic change, our analysis does not sufficiently recognize the issues of social

weights and vested interests in the functioning of governments and in the economic policy and economic change:

Let me also examine in parallel our experience in the World Bank. After about thirty years of planned economic development supported by external flows, we faced a severe crisis in economic development in the eighties, except in the countries of East Asia. The crisis does not reflect merely the failure of specific economic policies or institutions, but of the entire process that countries in South Asia, Africa and Latin America have pursued. At the heart of this crisis have been three fundamental issues.

First, the state, its growth, the centralization that is inherent in this growth and the conflict of interest that arises when the policymaking and regulating state takes over the management and ownership of productive entities. Second, rent creation and rent receiving which have become endemic in developing societies and, in a number of cases, have choked off economic development.

And, third, the relationship with the external world, particularly the industrial countries. This is a relationship of asymmetry both, in aid and trade, and has brought about a psychology of dependence and, in the extreme cases, the

denationalization of economic management. Let me now elaborate on these issues.

### The State

In much of South Asia and Africa, the nation state is a creation of the imperial and colonial era. The state has been superimposed upon highly diverse and fragmented societies. It will be some time before the state becomes a full-fledged and functioning instruments of social consensus and social contract. Yet, in the name of economic development and economic change,

- the state has acquired tremendous authority and centralized power.

The very strength of central governments has suppressed lower institutions, many of them indigenous, which could have been instruments of consensus. Too often, there is a conflict of interest between the ownership of productive facilities and the state as a regulator. I had a personal experience of this while serving as Special Assistant to the Prime Minister of Pakistan in 1976. Too often, the Minister in charge of nationalized industry would approach the Cabinet, asking for an increase in import duties and prohibitions because his companies were facing competition and making a loss. The Finance Ministry, facing the

prospect of an increased hemorrhage of state finances, would .  
 routinely support his request. And routinely the Cabinet would do  
 the bidding of the Minister of nationalized industry. In a  
 number of cases, investment proposals by private interests.. were  
 vetoed because there would be competition with nationalized  
 industry. In the name of efficiency, the authority of the local  
 bodies in areas such as education, health and family planning, was  
 routinely suppressed and taken over by the central  
 government. This phenomenon was not limited to Pakistan. We  
 find signs of it in almost the entire developing world. And  
 therein lies the seed of the breakdown of management which is one  
 of the fundamental issues in the crisis of economic development.

### Rent Creation and Rent Receiving

I believe that the ultimate crisis in economic  
 development comes when too much of the economic activity  
 revolves around the creation and appropriation of rent. I have seen  
 extreme examples of it in my work in Pakistan as well as in the Bank.  
 Let me cite some of them. In Pakistan, in the last forty years there  
 have been massive public investments in

irrigation and developing agriculture land and in urban housing. Routinely, land has been distributed to public servants, army officers and other privileged groups at highly subsidized prices. Routinely, these people later sell these lands and pocket large gains. The state, which spends shamefully small amounts on social services, has been denied those gains. Hence, land policy has become a source of significant inequality of incomes in Pakistan. In Argentina, in 1988, between subsidized credit, a lot of which was never repaid, tax incentives and "compre-Argentina" policy, the state was effecting a transfer of at least five percent of GNP to industry. If all the state transfers to privileged groups were computed, the figure was in the low teens. Beyond these figures, the issue arises that if a substantial part of the so-called increase in production would be negative value-added at international prices, how viable is this economic development?

#### Relationship with Industrial Countries

We have been too mechanical about the relationship between economic development and external capital. We have given almost a biblical sanctity to the concept of the



gap. But, let me look at the other side of the picture. I am deeply worried about what I call the denationalization of economic management in developing countries.

There are three motivations behind managed external capital flows. First, compassion, particularly in the case of the poorest countries. Second, the white man's burden, namely, that we know best and that we could take to these poor countries not just capital but technology, management and organization that are essential to lift these societies from poverty. And, third, a belief that in poor societies the return on capital investment should be reasonably high. All of these elements have a justification and all countries have benefitted from external capital flows. But, in many countries, the psychological dependence on external capital flows spells serious trouble for the future. The extreme case is Africa, where a sort of neocolonial relationship exists between the governments, the Europeans and the international organizations. The failure of African development has meant not only increased emphasis on aid but a heavy intervention in policies and day-to-day management of institutions and policies. The ultimate question in Africa is, "who

is responsible? There have been too many projects and programs designed by foreigners and managed by foreigners. We see to a much lesser extent the same phenomenon in other countries though I detect in governments all across the feeling that the object of many programs and projects is to please the aid givers and the sense that somehow outsiders share the responsibility for the functioning of the societies. In a way, an effect of external assistance may well be that many societies in developing countries are frozen into adolescence without insufficient pressures and incentives to assume the responsibilities of adulthood.

On trade, on the other hand, there is increasingly a unilateral liberalization by developing countries and a surrender of the little bargaining power that they might have had in international negotiations. The relationship between the developing countries and industrial countries is one of a relationship between supplicants and givers, rather than a relationship of negotiating transactions. A question arises, "how viable is this process?"<sup>11</sup>

My view of the Bank's priorities for research arises from these perceptions. And let me suggest some broad issues for future investigation. First, the role and size of the state. Areas of inquiry are the management implications of the size of the state, the conflict of interest between the state as a regulator and the state as the owner of productive facilities, issues of centralization and decentralization, and their relationship to the financing and management of social services and infrastructure.

The second area of investigation I would suggest is the issue of rent in economic development. There should be an examination of the way particular institutions and structures lead to unsustainable rent creation and how such rent creation vitiates economic development.

There is, of course, the growing question of the physical aspects of economic development and the management of the environment as an integral aspect of the management of economic development. An issue that concerns me and I am sure it concerns all of you is how our traditional economic analysis relates to the growing pressure on resources that we face. Isn't discounting merely a mathematical representation of value

judgment about intertemporal and interpersonal choices and can it really help us with choices about the depletion of exhaustible resources? If this is not so, how does economic analysis cope with the need to integrate the economics of resources with all the other aspects of economic development?

We need to investigate a lot more than we have done the association between capital flows and aid and the denationalization of economic management to which I referred earlier. On trade, we need to investigate the implications of asymmetrical trade liberalization by developing countries.

A word on governance. I suppose we shall hear a lot about this issue in the months and years to come. One of the key questions about governance is the experience of international organizations and agencies with interventions in governments far beyond the lofty issues of democracy and multiparty governments and human rights. The issues of governance that concern us are management of economic policies, programs and projects. The Bank's experience with governance has not been entirely happy. The most far-reaching intervention in governance at the sectoral level has been integrated rural

development where the Bank's naivete on the relationship between organization and tradition and economic change lead to a massive failure of a widely touted initiative. We decided in the early seventies that the problems of rural poverty would not be solved without an integrated and cohesive approach to production, infrastructure and social services at the village level. We thought we had the technology and the ideas, so we ventured forth, and in country after country, particularly in Africa, sold integrated rural development projects to governments. We thought that the technology was known and that if governmental institutions did not exist at the village level, special integrated organizations should be created to formulate and implement programs of rural development. The whole world was enamored with the idea and integrated rural development became a part of the lexicon of economic development. Looking back, it was a massive flop because most of the countries never owned the programs. The organizational arrangements were a cancerous imposition on the local administrative framework and there was excessive dependence on external management. So, before we get too enamored by rhetorics, let us investigate the experience with the

specific issues of governance and the lessons that can be derived from that.

We have made inadequate use in our research and policy work of the Bank's own experience. There is a wealth of information in what we have done and in our successes and failures and I -hope that the Bank's past actions will be a major source of information and analysis in our future research.

In the conduct of research there is need for a closer relationship between .the PRE and the regions. The regions should benefit from the results of the research and provide some of the information and analysis. On our part in the Latin America Region, we would welcome closer collaboration. This to us would be a far more constructive relationship and far more productive for the institution than excessive preoccupation with projection and nuances of the lending program.