

## **PIDE-LUMS Seminar on the New Governance Effort Lahore, 30th June, 2006**

Pakistan Institute of Development Economics (PIDE) and Lahore University of Management Sciences (LUMS) jointly organised a seminar to discuss issues pertaining to “Law and Economics” and “Public Choice”, and their relevance for the future growth prospects of Pakistan. Dr Nadeem Ul Haque, Director, PIDE, and Osama Siddique, Head, Department of Law and Policy, LUMS, highlighted the main issues in their welcome remarks, and raised some basic questions: Can Pakistan achieve its growth target of 10 percent under the current legal framework? Does our law support free enterprise? Can the dual target of growth and free enterprise development be realised under our existing constitution? Do we need to review and make amendments to it? The high point of the meeting was the coming together of eminent lawyers and economists (and social scientists) on one forum and approaching the problem from a multidisciplinary point of view. A healthy debate followed in which some of our distinguished participants even turned the debate upside down by posing question as to what form of economic system are we hoping for. The main issues that emerged out of this deliberation are summarised below.

### **Main Research Question: Does Our Legal System Guarantee Rapid Growth and Enterprise Development?**

Economic growth occurs when resources are put into productive activities; the usual efficiency requirement withstanding. While conventional neo-classical growth models assumed an “institution free” economy, it has become very clear now that growth occurs in the context of given institutional environment. Specifically, recent research in this area highlights the importance of well-specified and enforced property-rights and contracts for economic growth, without which people will not be “lured” into economically productive activities. But specification and enforcement of property rights and contracts requires an efficient and impartial legal system. Quick and fair dispensation of justice is necessary for investors to feel secure in possession of their properties and investments.

Realising that “economic development does not take place in a vacuum”, the Government of Pakistan vows to develop an “orderly framework for carrying out its

economic reforms”.<sup>1</sup> The area, however, begs scholarly attention. Does our legal system ensure an environment that is conducive for investment? If not then what are the issues?

Major issues emerged from the discussion at this forum are: political economy issues, issues related to capital market development, to enterprise development, judicial reforms and issues related to the area of “public choice”.

### **(1) Political Economy Concerns**

A number of political economy issues emerged during the course of discussion. These ranged from reservation about the economic system and disenchantment with narrow concept of growth, to concerns with society being besieged by dominating elite. Under this scenario, how does our system protect the rights of the citizens against abuses by powerful elites? Is this a just system? Is capitalism the “right” economic system for us? Do we need to look for alternatives? What are the broad parameters of this discussion? Issues raised in connection with this are summarised below:

**(1.1) Economic System.** What kind of economic system are we hoping for, and what future direction do we want to take? Do we opt for a capitalistic system or should we favour redistribution? Can both coexist? What does society want on a consensual basis? Do we just want a society that attracts foreign investment?

**(1.2) Distributional Issues.** Do we want a society of growth or are we concerned about human welfare? Can we focus on “quality of life” as a yardstick instead of growth? How do we account for distribution?

**(1.3) Power Structures.** How do existing power structures influence our legal system and growth? Do these power structures abuse legal system and undermine implementation of fundamental rights granted under the constitution? Does our law reinforce these structures? Is our legal and political system dominated by them?

### **(2) Capital Market Development**

Investment is a precondition for growth. If we are interested in achieving growth rates of 10 percent then how do we get investments to match up this target? Is our domestic capital market geared up for this kind of investment? Are foreign investors prepared to commit their capital into Pakistan? Does our legal system protect investors (both local and foreign)? What are the hurdles in the way of domestic resource mobilisation? Do foreign investors have any reservation about Pakistani legal system?

<sup>1</sup>Hassan, T. (2000) Legal Framework for Economic Development in Pakistan. *Pakistan and Gulf Economist*. (No. 50) 31 (11 December 2000). <<http://www.finance.gov.pk/law/publications/LegalFrameworkArticle.pdf>>

It is useful to distinguish between alternative sources of external finance; debt and equity. Debt contract is typically a “hard” contract (non-payment of interest or principal amount can lead to legal recourse possibly ending in bankruptcy). In contrast, equity contract is a “soft” contract. Equity financing has an additional benefit of spreading risk over a number of shareholders. Following issues were raised with respect to either type of finance:

**(2.1) Credit Markets.** The major issue in asset based lending is collateral requirement. A large chunk of the capital (almost 90 percent) is in the form of land which can be reliable collateral. Problem arises since land records are complex, inaccurate, and unclear, and allow significant room for manipulation, hence poses a constraint on asset based lending

Unclear property rights also pose problems for title insurance. Title insurance is difficult due to uncertainties invoked by the provision of oral gift (what if somebody orally gifted property to someone?). It amounts to dead capital to the tune of 45 percent of property values (guesstimate).

Access to credit is another area of concern. Is credit easily available to all? If not, what are the constraints on access to credit? Should a survey be conducted to assess these constraints?

**(2.2) Equity Markets.** World over, equity marketing has become a major source of external finance for the corporate sector. It allows corporations to acquire capital much larger than what debt contract could possibly offer, at the same time, spreads risk over larger number of shareholders. In Pakistan, however, listed companies still constitute a small proportion of all registered companies. What holds them back? Why don't companies list themselves on the stock exchange? What impedes risk sharing? Most of the big businesses are family owned with controlling shareholders. What legal protection is there for minority shareholders against private benefits of control by dominant shareholder? How does the system bar against *self-dealing* and/or *entrenchment*?

**(2.3) Legal Protection.** Another area of concern is the extent of legal cover for the investors. Protection of property against expropriation is one important yardstick against which foreign investors assess the risk of investment. Does our legal system protect the investors (both domestic and foreign) against such voluntary seizure? Do foreign investors shy away from our judicial system? What are their concerns in this regard (delays! corruption!)?

### **(3) Corporate Sector Development**

Can an enterprise be free in a country governed by no “rule of law”? Two issues emerged from discussion. First, why don't companies register? Second, what are the hurdles in the way of market consolidation?

**(3.1) Corporatisation.** With regards to corporatisation following issues emerged. Conflicting laws—banking and regulatory laws contradict each other. Lack

of cooperation between different ministries was also identified as an important obstacle. Tax incentives are not lucrative enough. Overall, corporatisation is not attractive option. Other issues of concern are the Code of corporate governance itself, bankruptcy Issues, corporate bail and liability.

**(3.2) Mergers.** Market consolidation is another area of concern. What hinders mergers? Conflicting views prevailed about it. Lawyers think that merger laws are straight forward. Problem, lies with the procedures, e.g., too much judicial oversight. Also, since business is family oriented, it does not lend easily to mergers. Economists, however, hold that law in itself is problematic and poses a strong hindrance to consolidation. There is a need for judicial reform. Where does the problem lie, with law or with procedures?

#### **(4) Judicial Efficiency**

Is there a direct link between law and growth (apart from its effect on market development)? What is the status of current research on judicial reforms? Is there any continuity in the reform process? Are there any missing laws and feedback loops?

**(4.1) Nuisance Laws.** There are a number of laws that produce litigation. Courts are choked because of these litigations, e.g., 60 percent of court cases *rent related* which waste time. *Preemption* is another case in point. Cost of transaction increases exponentially with preemption and it does not exist anywhere else in the world. *Inheritance laws* make coordination difficult as property divided itself over and over again across generations. *Oral gifts*, which were outlawed in UK in 1604, complicate commercial transactions. *Tenancy laws* do not recognise occupancy tenants. Feudal and commercial systems are working simultaneously.

**(4.2) Procedural Issues.** Loopholes in the system promote litigation and cause delays. There are no meaningful cost sanctions (culture of not appearing before courts). Lawyers are a reason who cause delay in dispensation of justice. As a result huge assets are stuck in the legal systems (in trillions of rupees). What is the role of bar in these problems? What is the economic cost of regulation? How do these delays effect market transactions? How can procedural reforms like daily reporting of cases impact efficiency? Who are the users of judicial system (Justice Mafia)? What are the demand side problems? How does lack of information of end users of the system (reliance on touts) and lack of articulation of demand affect the system?

**(4.3) Quality of Judges.** Are our judges competent and safe from corruption? What are their recruitment procedures? What sort of incentive structure do they face? Are there any problems of internal management? Are there any issues of 'time', 'integrity' and 'quality' with the judicial procedures?

**(5) Public Choice**

Issues that were brought up during the discussion are: Does constitution of 1973 guarantee a just economic system? Does it provide for fundamental rights of the citizen? Does it guarantee those rights? Are there any design issues? Do we need to make changes to the constitution? Political parties claim that constitutional amendments will take care of all problems. Is it true? Can we have a debate on reform of political parties? Is the executive too powerful? What are the issues with separation of powers? Are there enough checks and balances within the system?

Participants included Mr Osama Siddique, Mr Abid Hassan Minto, Dr Faisal Bari, Dr Rasool Bakhsh Rais, Mr Tanvir Naqvi, Mr Bilal Hassan Minto, Ms Lubna Hasan, Ms Foqia Sadiq Khan, Ms Izzah Waqar, Mr Moin Cheema, and Dr Nadeem Ul Haque.

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