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Abstract

Pakistan has been experiencing robust economic growth for the past few years. The macroeconomic position as exhibited by the real sector growth, fiscal indicators and external balance has reasonably improved. However the big question remains; will Pakistan be able to sustain these growth levels? Preserving the momentum becomes difficult when growth is consumption-based. Prosperity if measured by the increased sale of consumer durables gives a partial impression of the underlying economic changes. Promoting luxuries at the opportunity cost of necessities does not promote a pro-savings attitude at the national level and has deeper sociological consequences as well. Pakistan being a small open economy has limited or no control over the consumer or producer price levels. The vulnerability of the economy is again being tested in the face of global energy price increases and food shortages. We try to revisit the stop-go cycle of economic growth in Pakistan, the missing link between sources of growth and meso-micro level development and the knee-jerk reaction type(s) that we adopt as an answer to every economic crises.

1. INTRODUCTION

It is not surprising to note that after every short-lived stint of prosperity, the same questions come back to haunt the economic managers in developing economies; questions that point towards chronic problems and have answers entangled between political economy, governance and global changes. Thomas Carlyle in the 19th century described economics as a dismal science partly because economics as a discipline could not solve economic problems on its own, rather it could only point in the direction of further problems.

Pakistan is one of the most interesting stories as far as its economic evolution is concerned. The country has a large stock of labour force, which can be termed relatively more educated in comparison to comparable developing countries. Pakistan has remained one of the largest recipients of aid and grants through bilateral and multilateral sources. This aid has translated in to short but intensive growth periods followed by worse than pre-growth phases. The country has gained dividends from its strategic geographic location during 1960s, 80s and in the past 7 years. It is ironic that these endowments could not be sustained in the medium to long-run periods. While issues beyond pure economics also played their role, however the decisions taken by economic agents during the different phases of the economic evolution can also not be ignored.

In this paper we take a top-down approach to identify the development paradox in Pakistan. We try to find the answers to micro-level problems in macro and meso level policies over a 59 year time period (1948 – 2007). In the next section we try to identify some of the key dilemmas of Pakistan economy. In section 3 we give a quantitative explanation of complimentary relationship between various economic challenges. In section 4 we try to subjectively state; how the paradox repeats itself? Finally we discuss the pre-requisites for an economy such as Pakistan, for resolving the repeatedly occurring economic problems.

2. PARADOX REVEALED

On 18th November 1988, Pakistan signed the Structural Adjustment Facility with the International Monetary Fund. During the lost decade of 1990s there were many who attributed the economic decline during the decade to the so-called tough

conditionalities under the abovementioned facility. By the end of 1990s a fair prediction was that it will take almost two decade for Pakistan to bridge its twin-deficits. However now we know that the current account was converted in to surplus in the post 9/11 period in a record time with Pakistan achieving growth levels second only to China and India. Then the concern developed whether the country will be able to sustain its performance: a) in the long run, b) without foreign assistances, c) in the absence of United States pro-Pakistan foreign policy, d) with a currency position strongest in recent history, and e) with pattern of growth skewed towards consumption.

These are very similar concerns and have been under discussion during the end of both Ayub Khan and Zia-ul-Haq administrations. Questions of sustainability were extensively debated however in the end Pakistan's economic policy was left at the mercy of foreign policy of the western world. Both the regimes mentioned above enjoyed immense favour from the west and therefore the achievement of growth was mainly debt-backed. There is nothing wrong in following a debt-backed growth model only if it can be ascertained with some extent of surety that growth can be converted into development. In most of the prosperous phases of Pakistan economy reduced unemployment was termed as increased development which is entirely wrong. All periods of high growth were accompanied with increased inequality in the country; a fact which is fairly well established through out the developing world.

The data itself has interesting revelations. Starting from the real sector we see that the economy has made a pre-mature transition from agriculture to services sector. The industrial base remains narrow, which is partially also the reason for lack of diversification of exports. The economy has very less resilience to import (price and output) shocks. The imported-content in Pakistani exports also hinders the current account performance. The domestic resource mobilisation has been unsatisfactory due to which savings-driven investment has also not show any improvement². This also creates caveats in the public finances. Due to the low direct tax to GDP ratio, the reliance on indirect taxes is bound to become heavier. Despite a loose monetary policy investment could not be channelled effectively into capital accumulating

² Domestic savings.

sectors producing goods with increased value addition. Finally the micro impacts of abovementioned shortcomings have translated in to both poverty and inequality.

Targeting of the government spending is the only short-run fiscal measure available with the economic managers to trigger the aggregate demand. While different governments had their own vision, however there is a big trade-off in the short-run between spending on infrastructure on one hand and social sectors on the other hand. Infrastructure sectors are deemed important for a growing economy's integration with the rest of the world. But it is worth noting that infrastructure projects have long gestation periods and their cash flow only turns in to profits in the medium term. However social sector expenditures particularly those related to health, and education suffer from weak absorption and can at times lead to economic distortions especially in case of pro-poor grants. Physical and financial monitoring of public sector projects is a very recent phenomenon in Pakistan and it needs to be made a regular feature. The quality of governance is the single most important factor in the effectiveness of fiscal policy.

On the monetary policy front, it is an enigma to many as to why does the central bank reduces the interest rates and allows the money supply to swell up in times of higher private sector expenditure on consumable items, which ultimately leads to an everlasting inflationary dent in the domestic price structure. In recent times it was seen that despite of an over-heated economy central bank allowed the services sectors to benefit at the expense of commodity producing sectors. The result was increase retail trade (owing to banking loans, leasing and hire purchase opportunities) with very little gains on the industrial front. Monetary policy should have followed a fix-flex approach where the expenditure on consumable (luxury) items could be curtailed so that the surplus stock of money in the economy could be channelled to capital-creating ventures. Still there are those who feel that when it comes to investment; McDonald arrives before Microsoft and under this illusion they allow the debt-financed consumption expenditure to distort the socio-economy at the household-level. It is true in the case of developing countries that social habits also play a role in a sudden surge in ownership of consumer items such as automobiles, imported cell phones and other luxury items. It is for this phenomenon that government has to come forward and initiate a national drive towards austerity.

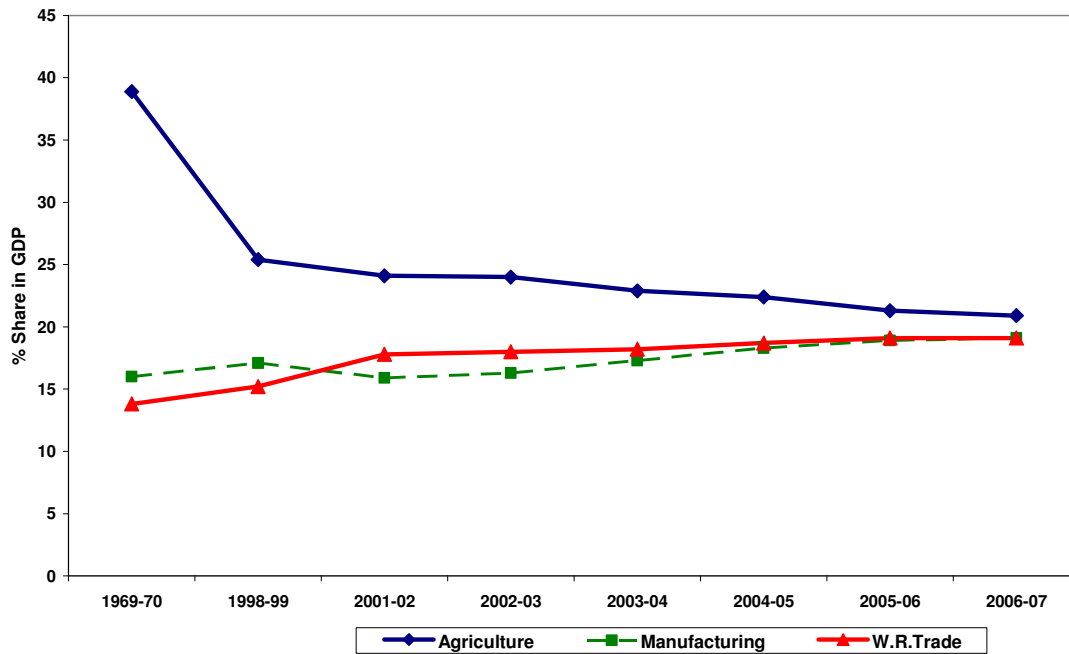
What can explain the supply-side of Pakistan economy? The recent food shortages (not only in Pakistan but across the developing world) indicate the wrongness of *not* treating food as a strategic commodity and leaving it to the market forces. The slogans of self-sufficiency in agriculture have long been forgotten. The late federal minister for agriculture Abdul Sattar Laleka used to remind the economic managers of their misdeed of giving repeated incentives to the industrial sector at the cost of agriculture sector despite the fact that industrial sector was not delivering its promised share throughout the history of this country. The administrative issues in agricultural price management have also posed multifarious challenges hitting the purchasing power of the lower tier of the society whose budget share going towards food is relatively higher.

Did we get the wrong advice? Did we make the wrong choices? What we might have done had we known the consequences? What can be done now? How can we ensure that today's policy decisions will not be halted tomorrow (until their implementation is complete)? These are questions with in which the issue of development paradox rests.

3. PARADOX SUSTAINED

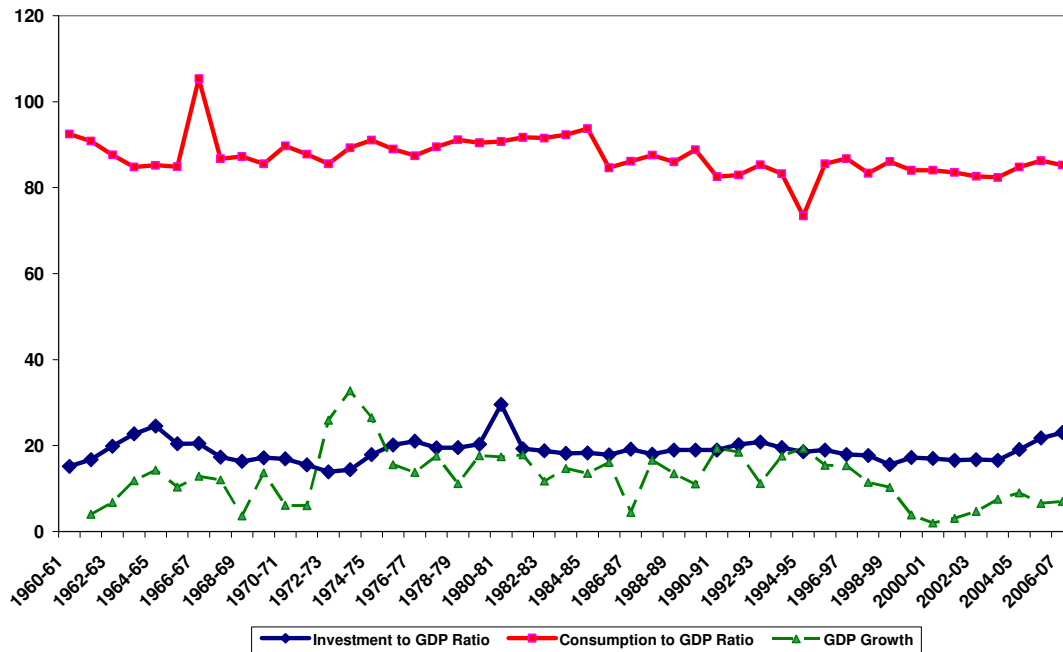
In this section we analyse the economic indicators in retrospect and try to identify broad issues that remain impediments to long term development. Taking a sequential approach we start with the real sector where we try to see the sectoral contribution in the overall GDP. Whatever the quality of the data, it is now clearly established that the share of agriculture has drastically declined in the overall GDP (see Figure 1) however as explained above the manufacturing sector did not bridge this gap consequently leading to an overall decline in the sectoral contribution of commodity producing sectors in GDP. The industrial clan has often forwarded their opinion on this structural change. The most fundamental issue seems to be the rising cost of inputs in Pakistan. The slow movement towards upgrading of infrastructure in the country now means increased transaction costs for the real sector.

Figure 1 Sectoral Shares in GDP



However Pakistan's movement towards the services sectors has been fast to a dangerous extent. We can observe that the contribution of wholesale and retail trade now stands almost equal to the manufacturing sector. A retail economy will not be able to keep the momentum of the growth alive in the medium term. An interesting question here will be to find out if retail economy is a recent phenomenon or has its seeds been incubating since long. This can be seen in Figure 2. It is the consumption to GDP ratio in Pakistan that has kept the GDP growth more or less at a constant long run rate between the periods 1961 to 2007. It is not surprising that Pakistan failed to create a culture of entrepreneurship domestically and also could not attract long-term commitments from foreign investors. This is clearly observable in the flat investment to GDP pattern shown in Figure 2.

Figure 2 Growth Identity

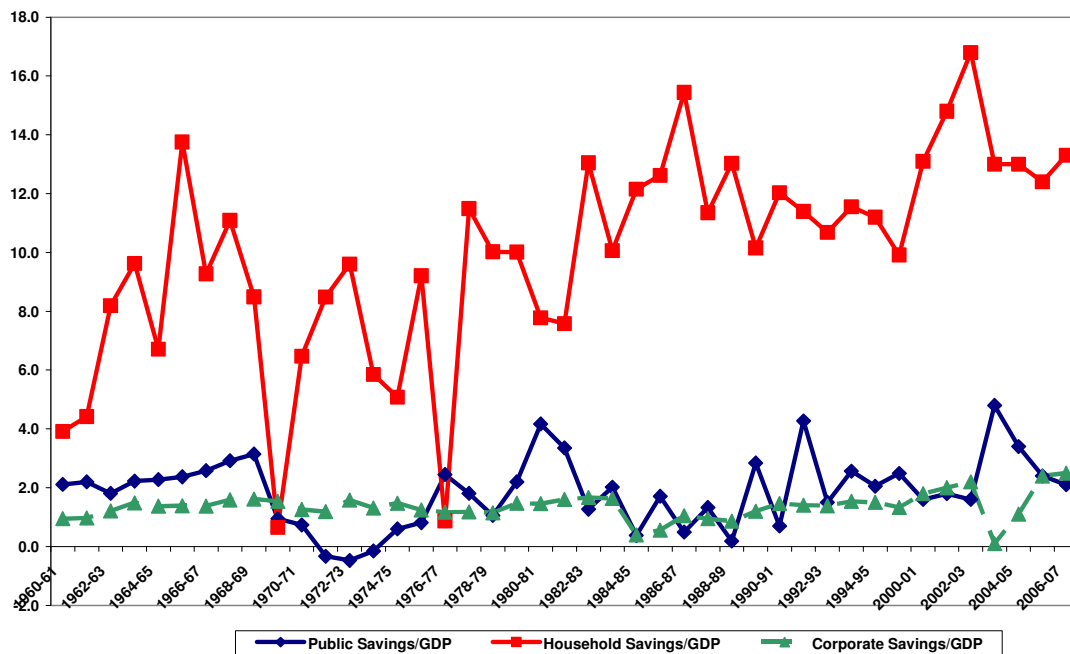


Are these national habits that prevent us from curtailing the consumption expenditure? Or do we have a serious structural issue which is keeping the economy running on low value-added, consumer-centric goods and services. It is often said that it is difficult for Pakistan to attract investment due to a) image problem, b) law and order situation in the country. However we forget that there are countries which have much more penetrating political conflicts (for example Sri Lanka and Iran) that have successfully managed to keep the investment levels throbbing. It is a mystery how Pakistan recently achieved above 7 percent growth rates with less than 25 percent investment to GDP ratio. China accomplished a 9 percent growth rate with around 40 percent investment to GDP ratio. With the data on capital stock (in Pakistan) still not available we may not readily be able to answer this question.

Nevertheless investment levels cannot be made predictable until and unless we improve the domestic resource mobilisation. The reliance on foreign savings (current account deficit) has been very expensive and has cost many downturns over the past history. Overall saving in Pakistan are low because of relatively high spending of rich class mostly on luxury goods and poor class inability to save due to their lower income. However improvement in domestic savings may be another very challenging task. In Figure 3 we can see that household savings exhibit an unstable pattern. These

have been very much dependent upon the remittances and domestic price levels. In the developing economies the budget shares for necessity items such as food and shelter are relatively higher. Due to which there is little scope of a sudden increase in household savings until and unless and above 5 percent growth rate is maintained with controlled inflation levels in the medium term. Public savings have been dependent on tax revenues and foreign assistance. However given the lesser role of government in modern day economics, this component of savings is now being governed by a rule-based fiscal policy. Corporate savings also hold little hope as we can see in Figure 3 that they have remained constant between the time periods 1961 to 2007. These are subject to increase in direct and portfolio investments and reflect the retained earnings of the enterprises.

Figure 3 Savings Dilemma

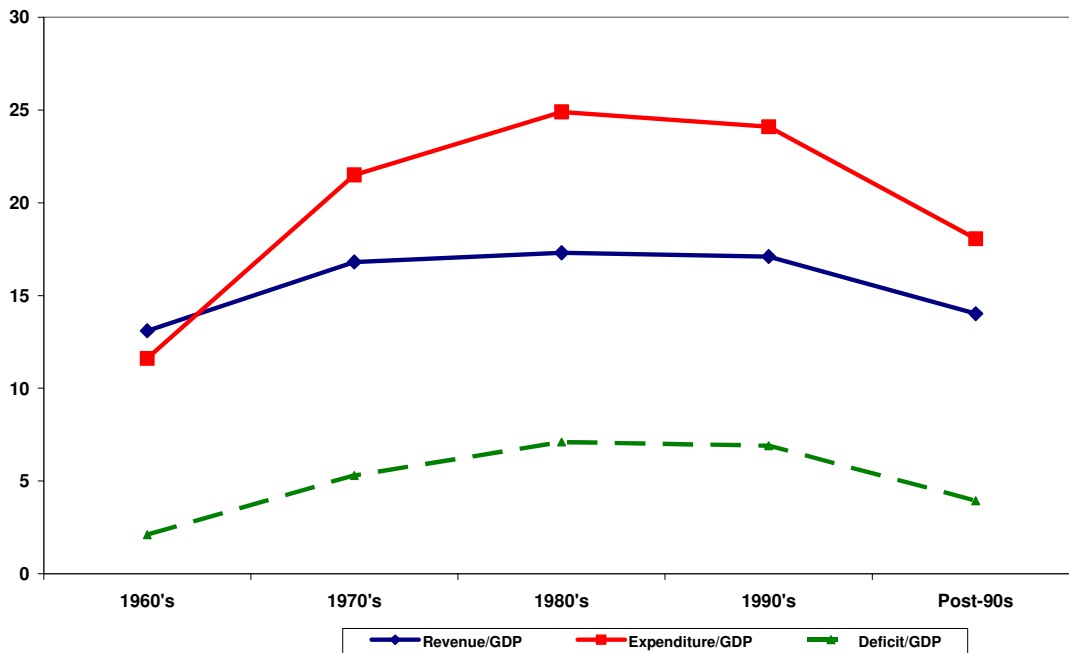


It is also not surprising now to state another paradox at this stage. The tax collection in Pakistan has failed to make substantial gains even during exceptionally high growth periods (attributable mainly to the inelastic taxation structure).

Figure 4 indicates almost the same level of revenue to GDP ratio during post-1990s as was observed during 1960s. Progressivity in taxation when complimented with prudent governance measures, leads to an increase in tax to GDP ratios. However in Pakistan this hasn't been the case. Despite all the textbook fiscal incentives, the

collection levels have not been responsive to rising growth levels. On the expenditure side one it is noticeable that during 1960's the expenditure to GDP ratio was lower than revenue to GDP ratio (perhaps the only time in history), after which the former peaked during 1980s and started to decline during 1990s amid dangers of national bankruptcy.

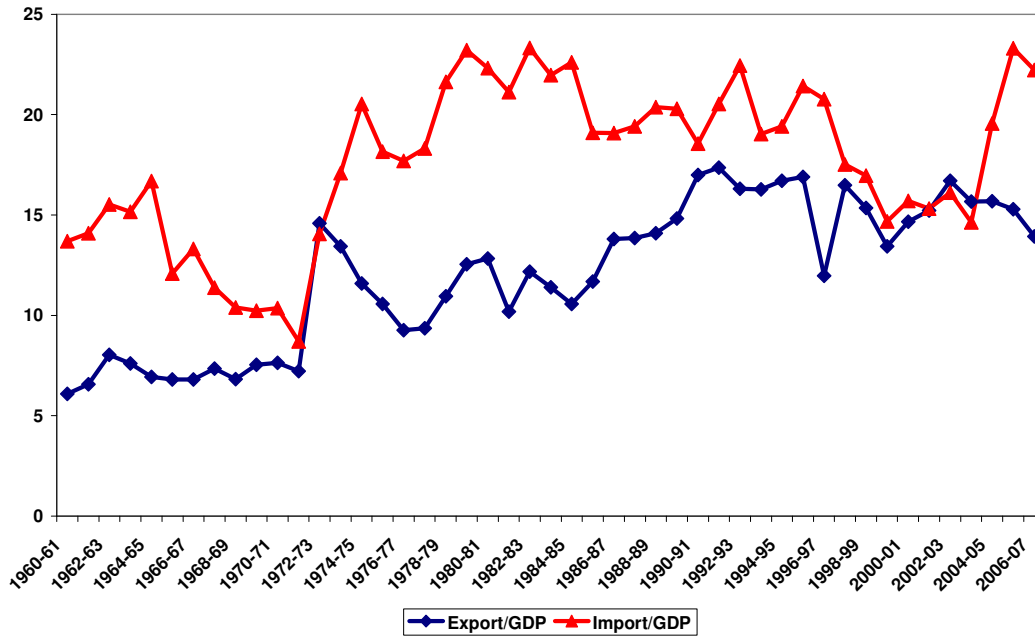
Figure 4 Fiscal Position



Another concern that carries formidable importance for the current account position in Pakistan is the lack of self-sufficiency in the creation of exportable surplus. Pakistan's exports are reliant on imported inputs such as petroleum, machinery and sector-specific raw materials. Through out the time period shown in

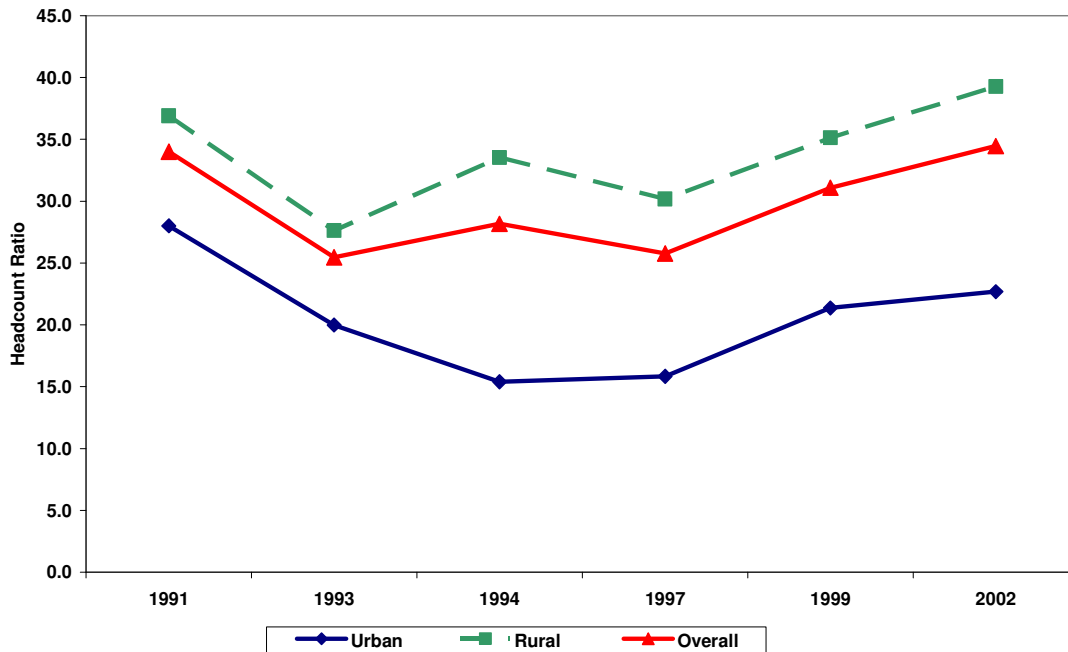
Figure 5 we can see that the import needs of a developing country have been on the rise. While exports have not been able to keep pace with the growth of imports, however a matter of greater concern is the volatility of exports to import price shocks (given the increased imported-content in Pakistani exports). The exports are mainly concentrated in textiles, which in turn are very narrowly based. The lack of diversification also indicates the sluggishness of the manufacturing sector as a whole towards innovation and productivity.

Figure 5 Trade Anomalies



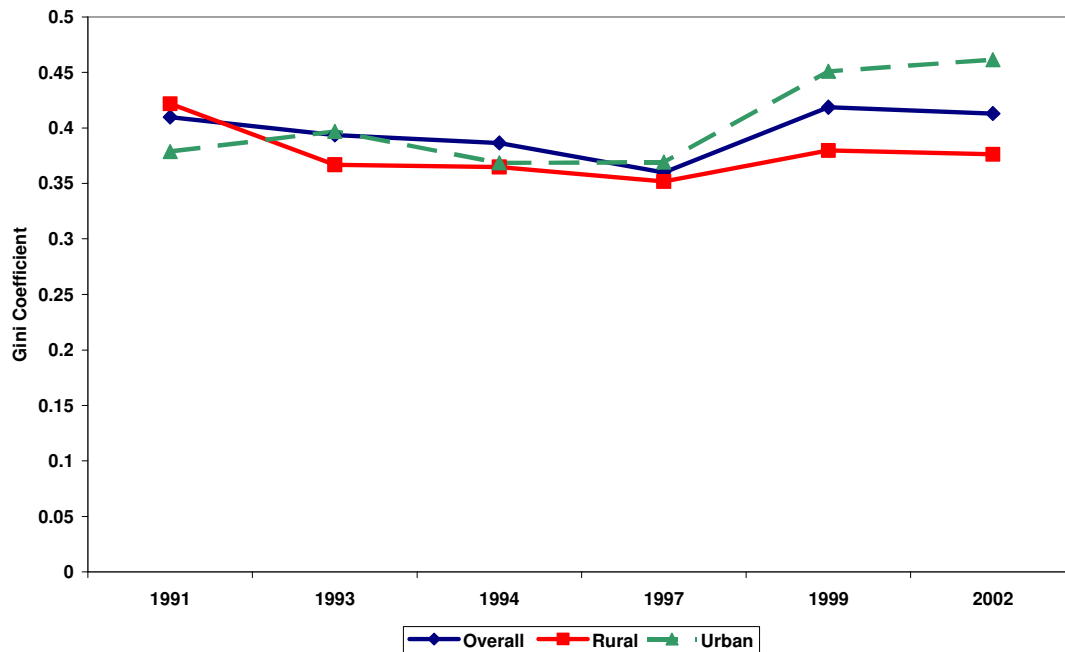
How has the relatively constant nature of the macroeconomy impacted at the micro level? We look at the welfare indicators at the household level, where one observes that poverty has come back to the early 1990s position which is on the higher side even by regional standards. In Figure 6 we see that the overall headcount ratio (i.e. proportion of poor below the poverty line) decreases between 1990 and 1994 after which it again has an increasing trend. Once again this explains the previously established fact that growth content alone cannot prevent poverty indicators from deterioration. The quality of economic growth must be pro-poor and geared towards the physical and intellectual empowerment of those falling in the lower tier of the society.

Figure 6 Poverty Situation 1991 - 2002



In recent times in fact the composition of growth in Pakistan has led to the widening of gap between the have and have-nots. Figure 7 illustrates the inequality position in Pakistan as indicated by the Gini coefficient. While poverty was higher in the rural areas, the inequality on the other hand remained higher in urban regions of the country. Even in urban areas the households or individuals more likely to fall below the poverty line are those who have migrated from rural parts. This has implications for the social sectors as well because the pace of migration is often greater than the pace of development in social sectors. This is particularly true for periods with lower than expected growth in agriculture sector. Given that those below the poverty line are more likely to encounter ill-health and lack of mobility owing to a limited skills-base, increased importance has to be attached to social safety nets along with strongly implemented social protection policies.

Figure 7 Inequality Situation (1991 – 2002)



4. REVISITING THE DEVELOPMENT AGENDA

So far there are five traditional leading theories of economic development³ and some other development model which discuss certain issues and guidelines for the developing countries. But, these all have certain limitations in terms of their scope and time frame. On the whole, they miss certain ground realities prevailing in most of the developing countries. So, no theory or the model is considered as universal. Almost all economic policies in developing countries are planned and executed with the assumption that the pre-requisites for free-market economics (such as availability of knowledge, safeguard of entrepreneurial activity, less or no barriers to entry/exit etc.) prevail. However Nobel Laureate Joseph Stiglitz, has summarised the ground reality as follows:

³ These are 1) The Linear-Stages Theory; a) The Rostow's Stages of Growth, b) Harrod-Domar Growth Model. 2) Structural Change Models; a) Lewis Theory of Development, b) Empirical Structural change Model by Chennary and others. 3) The International Dependence Revolutions; a) The Neocolonial Dependence Model, b) The False Paradigm Model, c) The Dualistic Development Thesis. 4) The New Classical Counter Revolution, and 5) The New Growth Theory.

“Whenever the information is imperfect and markets incomplete, which is to say always, and especially in developing countries, then the invisible hand works most imperfectly.... The market system requires clearly established property rights and the courts to enforce them; but often these are absent in developing countries. The market system requires competition and perfect information. But competition is limited and information is far from perfect – and well functioning competitive markets can’t be established overnight”.

Once again in this section we commit the mistake of assuming that all governance related assumptions have been fulfilled and we move on to review sectoral strategies proposed by national governments in coordination with the stake holders. It should be highlighted that Pakistan economy will remain consumer-centric until the time the commodity producing sectors are made productive enough to cater foreign demand. This particularly stands true for the industrial sectors.

On the agricultural front, Pakistan will have to grow crops having lesser water demand, develop high-yielding varieties of crops, improve pest and agronomic management. The share of livestock is now substantial in the overall GDP and it is important that improved breeding should be carried out, increase the nutrition content of feeds along with enhancing production of fodder.

In large-scale manufacturing, the focus should be on achieving economies of scale and an incentive structure should be designed for dynamic sectors such as light engineering, electronics and bio-technology. This will help towards industrial diversification and attracting foreign investment in new sectors in turn enabling technology transfer. SMEs have a potential to reduce unemployment and targeted incentive mechanism’s such as micro-finance facility should be available in the long run. Investment from overseas Pakistanis should be encouraged in areas that have; a) export potential, and b) employment generation opportunities. Barriers to domestic trade should be addressed immediately in order for producers to expand their markets. A sound infrastructure goes a long way in sustaining the economic growth. Emphasis should be given to those projects that have maximum economic benefits toward production and employment. Public sector development programme should be geared in such a manner that promotes crowding-in of the private investment.

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