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A PERSPECTIVE ON PAKISTAN'S ECONOMIC HISTORY: GROWTH, ECONOMIC STRUCTURE AND GOVERNANCE

By

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Pakistan's present policy challenge is to achieve a level and structure of economic growth that can rapidly reduce poverty. Therefore in presenting a perspective on Pakistan's economic history we will examine how an economic structure emerged that on the one hand constrains the achievement of a high GDP growth on a sustainable basis and on the other constrains the capacity of poverty reduction for given GDP growth rates.

Pakistan began life as an independent state with a balance of payments problem (there was only rupees 200 million worth of foreign exchange in the central treasury[1]) as it faced the challenge of wide spread poverty and inadequate infrastructure. The problem continues to persist today.

The emerging architecture of Pakistan's economy is founded in its institutional structure and the nature of governance, which conditioned the economic policies of various regimes in its history[2].

I. The Ayub Regime (1958-69): Following the Korean boom in 1953, the government had introduced a policy framework for inducing the large profits of traders in jute and raw cotton to flow into the manufacturing sector. This was attempted through a policy of encouraging the domestic production of consumer goods through a variety of

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1 Ayesha Jalal, The State of Martial Rule, Cambridge University Press, Cambridge, 1990. Page 37.

2 For a more detailed analysis of the relationship between the practice of political power, the process of institutional decay, and the economic structure, See: Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, South Asia Economic Journal, Volume 5, Number 1, January-June 2004, SAGE Publications, London and Delhi, 2004.

protection measures during the 1950s[3]. This import substitution policy was more systematically pursued during the 1960s.

The decade of the 1960s is seen by many as the 'golden age' in terms of the high growth rates achieved through the provision of subsidies and tariff protection to industry and an elite farmer strategy in agriculture. It was also a period when the mould was set for the emergence of an economic structure that was to lock Pakistan's economy into increasing income inequality, a narrow and inefficient industrial base, and increasing loan dependence, for the next four decades.

The magnitude of protection provided by the government to private sector industry was such that it enabled domestic manufacturers to earn large rupee profits on the production of goods that were not internationally competitive. It has been estimated[4] that during the 1960s, Pakistan's main industries (when input costs and output values are both measured in dollar terms) were producing negative value added[5].

It has been argued that the phenomenon of negative value added in industry was an important reason why during the 1960s, inspite of import substitution and large export volumes, foreign exchange shortages persisted[6]. This set the "mould" for Pakistan's narrow export base (concentration on the low value added end of textiles) and the associated debt problem, which persisted for the next three decades[7].

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3 Consequently the growth in manufacturing industry during the decade of the 1950s was impressive at 8.1 percent, although overall growth in GNP remained at a relatively low level at 3.4 percent. This was primarily because of slow growth in the agriculture sector (2.3 percent), which was the predominant sector in the economy. See: Shahid Javed Burki: Pakistan, Fifty Years of Nationhood, Vanguard, Lahore, 2004, Table 3.3, Page 100.

4 Soligo, and J.J. Stern, Tariff Protection, imports substitution and investment efficiency, The Pakistan Development, 1965, Pages 249-70.

5 Indirect subsidies such as the Bonus Voucher Scheme combined with the overvalued exchange rate, enabled domestic manufacturers to earn large rupee profits on exports that brought no gain to the economy in terms of foreign exchange.

6 Sikander Rahim: Myths of Economic Development, Lahore School of Economics, Occasional Paper No.10, February 2001.

7 For example, the share of the traditional textile industry in total exports far from falling, in fact increased from 30% in the decade of the 1960s to 50% in the decade of the 1990s.

The government during the 1960s adopted a deliberate policy of concentrating national income in the hands of the upper income groups.[8] The economic basis of this policy was the assumption that the rich save a larger proportion of their income and hence a higher national savings rate could be achieved with an unequal distribution of income (the target savings rate being 25% of GDP). In practice while the policy of distributing incomes in favour of the economic elite succeeded, the assumption that it would raise domestic savings over time failed to materialize[9].

The failure of the economic elite to save out of their increased income resulted during the 1960s in a seven-fold increase in the requirement of foreign aid[10]. Consequently the debt-servicing burden rose rapidly: debt servicing as a percentage of total foreign exchange earnings increased from 4.2% in 1960-61 to 34.5% by 1971-72. The magnitude of this figure did not fall for the next three decades.

Given the policy of re-distributing incomes in favour of the rich, it is not surprising that by the end of the 1960s a small group of families with inter-locking directorates dominated industry, banking and insurance in Pakistan[11].

During the process of rapid economic growth in the 1960s, while an exclusive and highly monopolistic class was amassing wealth, the majority of Pakistan's population was suffering an absolute decline in its living standards[12].

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8 "It is clear that the distribution of national production should be such as to favour the savings sectors", Government of Pakistan, Planning Commission, The Third Five Year Plan, 1965-70, Karachi, Page 33.

9 It has been estimated that 15% of the resources annually generated in the rural sector were transferred to the urban industrialists and 63 to 85 percent of these transferred resources went into increased urban consumption. Far from raising the domestic savings rate to 25%, the actual savings rate never rose above 12%. (See: Keith Griffin, Financing Development Plans in Pakistan, in K. Griffin and A.R. Khan, Growth and Inequality in Pakistan, Macmillan, London, Page 41-42).

10 According to official figures gross foreign aid inflows increased from US $ 373 million in 1950-55 to US $ 2,701 million in 1965-70.

11 In terms of value added 46% of the value added in the large scale-manufacturing sector originated in firms controlled by only 43 families. In banking, the degree of concentration was even greater than industry. For example, seven family banks constituted 91.6 percent of private domestic deposits and 84.4 percent of earning assets. For a detailed analysis of this phenomenon, see: Rashid Amjad: Private Industrial Investment in Pakistan, 1960-1970, London, Cambridge University Press, 1982.

The economic strategy of the government, while it induced rapid GDP growth, sharply accentuated not only inter-personal but also inter-regional inequalities[13], which generated explosive political tensions. These tensions erupted in a mass movement against President Ayub Khan in West Pakistan and a national independence movement in East Pakistan that culminated in the emergence of the new state of Bangladesh. The military action against the people of East Pakistan left a wound in the soul of the Pakistani nation. Failure to come to terms with it undermined the moral basis of national policy and in subsequent decades made possible the individual pursuit of power untrammeled by ethical considerations for the people of Pakistan[14].

II. The Bhutto Regime (1973-77): Mr. Z.A. Bhutto in leading a mass movement against Ayub Khan unleashed the latent popular aspirations for a democratic society based on equity and justice. His charismatic political campaign was to have a profound and lasting effect on popular consciousness as the poor for the first time began to feel that they too mattered in history[15]. By 1973 there was a rupturing of the institutional link between the Pakistan People's Party (PPP) and its mass base amongst workers and peasants, and the emergence of the landed elite as a dominant element in the party. This set the stage for Prime Minister Z.A. Bhutto's regime to undertake economic measures

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12 For example, the per capita consumption of food-grain of the poorest 60 percent of Pakistan's urban population declined from an index of 100 in 1963-64 to 96.1 in 1969-70. The decline was even greater over the same period in the case of the poorest 60 percent of rural population. In their case, per capita consumption of food-grain declined from an index of 100 in 1963-64 to only 91 in 1969-70. There was an even larger decline in the real wages in the industry: In the decade and a half ending in 1967, real wages in the industry declined by 25 percent. (See: Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, op.cit.)

13 For an analysis of the economic disparities during this period between East and West Pakistan, see: Keith Griffin and A.R. Khan, Growth and Inequality in Pakistan, op.cit. For an analysis of inter provincial and intra provincial economic disparities within West Pakistan, See: Naved Hamid and Akmal Hussain, Regional Inequalities and Capitalist Development, Pakistan Economic and Social Review, Autumn 1974.

14 For an examination of the pursuit of power and pelf and the use of public office for private gain, (see: Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, op.cit).

15 For an analysis of Bhutto's charisma and its impact on popular consciousness, see: Akmal Hussain, Charismatic Leadership and Pakistan's Politics, Economic and Political Weekly, Vol. XXIV, No. 3, January 21, 1989, Bombay.

that were socialist in form while actually serving to strengthen the landed elite and widening the economic base for state patronage.

One of the most important initiatives of the PPP government was the nationalization in 1972 of 43 large industrial units in the capital and intermediate goods sectors such as cement, fertilizers, oil refining, engineering and chemicals. Just three years later the government nationalized the cooking oil industry and then flour milling, cotton ginning and rice husking mills. While the first set of nationalizations impacted the "monopoly capitalists", the second set of nationalizations in 1976 by contrast hit the medium and small sized entrepreneurs. Therefore nationalization in this regime cannot be seen in terms of state intervention for greater equity. Rather the rapid increase in the size of the public sector served to widen the resource base of the regime for the practice of the traditional form of power through state patronage[16].

There was a decline in total private sector investment as a percentage of GDP during this period but it was more than compensated by an increase in total public sector investment[17]. Thus the overall investment/GDP ratio during the Bhutto period reached 15.5 percent, which was slightly higher than in the preceding period. Yet inspite of this increase in the investment rate the growth rate of GDP declined from 6.3 percent in the period 1960-1973 to 5 percent in the period 1973-77[18]. This is indicative of a decline in the productivity of investment, which was caused by two sets of factors: (a) concentration of public sector investment in the unproductive sectors of defence and administration, and (b) economically inefficient investment decisions in the public sector industries based on political considerations, with respect to technology choice, geographic location, and production management[19].

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16 Omar Noman, The Political Economy of Pakistan, 1947-85, Routledge, Kegan and Paul, London, 1988. Page 80.

17 Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, op.cit. Table 1.

18 Ibid.

19 For a more detailed analysis, see: Omar Noman, The Political Economy of Pakistan, op.cit.

During the Bhutto period the budget deficit, which had begun to increase during the Ayub period, widened further as expenditures on defence and administration increased sharply with the large losses of public sector industries further adding to the fiscal burden. The financial constraints resulting from large non-development expenditures placed a double burden on the people: (a) There was a reduction in the development expenditure, which slowed down employment[20] and (b) sharply increased inflation rates further constricted the real income of middle class households.

The social consequences of these financial measures were to have a profound impact on the political strength of the Bhutto regime. As the real incomes of middle class households were squeezed, it accentuated the resentment amongst them that had followed the nationalization of the small and medium sized food processing units in 1976. These urban petit bourgeois elements had in 1968-69 fueled the anti-Ayub agitation that had catapulted Bhutto into power. They now joined the street demonstrations in 1977 that led to his downfall.

III. The Zia Regime (1977-1989): The Zia-ul-Haq regime sought to institutionalize military rule through the garb of a coercive and obscurantist version of 'Islamic' ideology[21]. This was in sharp contrast to the mainstream tradition of Pakistan's society, which was historically characterized by cultural diversity, democratic aspirations and a

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[20] The financial constraint following the large non-development expenditures, severely restricted the funds available for development, and hence enfeebled the two initiatives that were designed to benefit the poor: the National Development Volunteer Programme (NDVP) and the Peoples Work Programme. The former aimed at providing employment to the educated unemployed and the latter to generate employment for the rural poor through labour intensive projects. Both programmes were marginalized due to budgetary constraints.

[21] In the pursuit of this power objective, the democratic constitution of 1973 was set aside and draconian measures of military courts, arbitrary arrests, amputation of hands and public lashing were introduced.

In attempting to restructure such a state and society into a theocracy, the government undertook two kinds of initiatives: First, measures designed to subordinate to executive authority, institutions of state and civil society such as the judiciary and the press, which if allowed to function independently could check governmental power.

The second set of measures towards a theocratic state sought to inculcate obscurantist views and induced a narrowing of the human mind. It involved a suspension of the sensibility of love and reason underlying the religious tradition signified in Pakistan's folk culture.

religious perspective rooted in tolerance and the universal spirituality of human brotherhood.

Advocacy for a theocratic social order was conducted through the state controlled media and governmental financing of new mosque schools (madrassas) in small towns and rural areas many of which were linked with militant religious organizations engaged in the Afghan war. It was these organizations, which later emerged to wreak extremist violence and challenge the writ of the state with serious adverse consequences for investment and sustainable growth in subsequent years.

The rapidly growing debt servicing burden together with a slow down of GDP growth and government revenues that had occurred at the end of the Bhutto period would have placed crippling fiscal and political pressures on the Zia regime but for two factors: (a) the generous financial support received from the West following Zia ul Haq's agreement to play a front line role in the US supported covert war against Soviet troops in Afghanistan. (b) The acceleration in the inflow of remittances from the Middle East which increased from US $ 0.5 billion in 1978 to US $ 3.2 billion in 1984. These remittances not only eased balance of payments pressures, but also potential political pressures, directly benefiting about 10 million people, predominantly in the lower middle class and working class strata.[22]The increased inflow of foreign aid and foreign remittances eased temporarily the fiscal pressures on Pakistan's economy and enabled an increase in the GDP growth from 4.9 percent in the Bhutto period to 6.6 percent in the Zia period[23].

The higher growth rate during the Zia period could not be expected to be maintained because of continued poor performance of three strategic factors that sustain growth over time: (i) The domestic savings rate continued to remain below 10% compared to a required rate of over 20%. (ii) Exports as a percentage of GDP continued to remain below 10% and did not register any substantial increase (see table 2). (iii)

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22 As many as 78.9% of emigrants to the Middle East were production workers See: Jillani et.al. Labour Migration, PIDE Research Report No. 126.

23 Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, op.cit. Table 3.

Inadequate investment in social and economic infrastructure. As defence and debt servicing expenditure increased, the Annual Development Programme (ADP) through which much of the infrastructure projects were funded, began to get constricted.

It is not surprising that when the cushion of foreign loans and debt relief was withdrawn at the end of the Afghan War, the underlying structural constraints to GDP growth began to manifest themselves: Debt servicing pressures resulting from the low savings rates, balance of payments deficits related with low export growth and poor infrastructure, combined to pull down the GDP growth into a protracted economic recession in the 1990s.

IV. The Democratic Interlude (1989-1999): The decade of the 1990s was marked by democratically elected regimes attempting to practice authoritarian forms of power within an ostensibly democratic order. This was combined with the use of public office for private wealth[24]. These features of governance during the 1990s, intensified to a critical level by the late 1990s, the three key elements of the crisis that threatened the State: (i) A collapsing economy. (ii) The threat to the life and property of citizens resulting from rampant crime, and the emergence of armed militant groups of religious extremists. (iii) The erosion of many of the institutions of effective governance.

During the decade of the 1990s, political instability, historically unprecedented corruption in governance, and the worsening *law and order* situation had a significant adverse effect on private investment and GDP growth[25].

An important factor in the sharp slow down in GDP growth and increase in poverty was the particular way in which the government addressed the fiscal crisis, which reached a critical level during this period. The government having adopted a Structural

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24 For a detailed analysis and estimates of corruption during this period, see: Shahid Javed Burki: Pakistan, Fifty Years of Nationhood, op.cit., chapter 5.

25 For evidence of corruption during the Benazir Bhutto and Nawaz Sharif regimes, see: Shahid Javed Burki, Pakistan, Fifty Years of Nationhood, op.cit. Pages-131-132.

For an analysis of the macro economic impact of corruption during the 1990s, see: Akmal Hussain, Institutions, Economic Structure and Poverty in Pakistan, op.cit.

Adjustment Programme under the auspices of the IMF, undertook the necessary reduction in public expenditure through a sharp reduction in *development* expenditure. (Development expenditure as a percentage of GDP fell from 7.4% in the 1970s to 3.5% in the 1990s. By contrast the government's *unproductive* expenditure remained at the same high level[26]. Yet these factors merely accentuated the tendency for declining growth that was rooted in structural factors, which were manifest even in the 1980s[27]. The severe restriction in urgently needed public investment in infrastructure and poverty reduction projects simultaneously slowed down GDP growth and accentuated poverty.

V. Postscript: The Musharraf Regime and The Echoes Of History: The multifaceted crisis of economy, society and state had reached a critical point by the end of the 1990s. This set the stage for the collapse of the formal democratic structure within which the contention for power between the military and elected political leadership had been conducted during the 1990s. President Musharraf's government formulated a comprehensive set of reforms aimed at reviving the economy, and establishing the institutional basis for improved governance. At the same time through a number of constitutional amendments the political system was restructured. Thus the new political dispensation signifies the institutionalization of military power within a political structure in which an elected government also has a role to play.

During the regime of President Musharraf, economic policies combined with the changed international environment following 9/11, have enabled a substantial improvement in macro economic indicators: The GDP growth rate has accelerated to over

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26 The particular choice of policy instruments used to pursue the reduction in the budget deficit stipulated in the Structural Adjustment Programme, thus contributed to slowing down growth and increasing poverty. Apart from this, the *sequencing* of the measures adopted further exacerbated the adverse effect on GDP growth and poverty. For example the increase in interest rates required by the Structural Adjustment Programme was initiated *before* rather than *after* the reduction in the budget deficit. Consequently, as interest rates rose sharply, so did the government's debt servicing burden and thereby an even more drastic reduction in development expenditure.

27 A 1987 study by Akmal Hussain had argued that the high growth experience of the preceding three decades may not be sustainable in the next decade due to structural constraints rooted in deteriorating infrastructure, low savings rates and slow export growth: "…….if present trends continue, we may be faced with the stark possibility that high GDP growth may not be sustainable over the next *five years*….." (Emphasis added). See: Akmal Hussain: Strategic Issues in Pakistan's Economic Policy, Progressive Publishers, Lahore, 1988. Page xviii.

6 percent in the last three years, the debt servicing burden has become tolerable, the budget deficit has been brought down substantially and State Bank reserves have reached record levels. However, inspite of the recent sharp acceleration in GDP growth there is continued widespread poverty and severe shortage of basic services[28]. At the same time the question remains of whether this high GDP growth can be sustained[29].

The constraint to the sustainability of GDP growth is rooted in three factors: (a) Given the incremental capital output ratio the investment rate required to sustain a GDP growth rate of 7 percent is still much higher (28 percent) than the prevailing investment rate (20 percent)[30]. (b) The structural tendency for slow growth in export earnings has led to intensifying balance of payments pressures, which can become a constraint to GDP growth in the years ahead. (c) A severe shortage of infrastructure and trained man power.

In the perspective of its economic history, three economic challenges confront the country: (1) To restructure the economic growth process so as to enhance its capacity for poverty reduction, (2) To broaden the basis of GDP growth and make it sustainable, (3) To establish the writ of the State, a viable democratic structure and a culture of tolerance. These are necessary conditions for achieving a substantial and sustained increase in private sector investment, both domestic and foreign. They are equally necessary for building a future for the people of Pakistan that is better than the past.

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28 The high GDP growth rate in the large scale manufacturing sector in recent years has been predicated on a narrow base of just three industries: (a) Consumer durables particularly automobiles, (b) Construction, (c) Textiles.

29 For a more detailed discussion on the imperative of achieving equitable growth both as an end itself and as a means for sustaining GDP growth, see: Akmal Hussain, Governance, Growth and Inequality, The Daily Times, Lahore, May 8, 2006.

30 For an elaboration of this point, see: Akmal Hussain, Is GDP Growth Sustainable?, The Daily Times, Lahore, 1st May 2006.

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