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Beyond Planning and Mercantilism: An Evaluation of Pakistan's Growth Strategy

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"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back".

John Maynard Keynes (1883-1946) The General Theory of Employment, Interest and Money, ch. 24 (1936)

INTRODUCTION

Through the nineties Pakistan remained preoccupied with crisis management. All debate and policy was, as a result, involved with current policy and our coping with the IMF programmes. Adjustment was the main theme leaving little room for growth initiatives.[1] A lively debate has raged on the distributional impacts of adjustment policy on which the government and the thinking community have adopted opposing stances, often with much emotion. With this focus of economic and political discussion on critiquing of the current government and its policies, there has been little effort put in understanding and reviewing the country's growth strategy. This paper attempts to assess the evolution of Pakistan's long-term growth strategy.[2]

It is my contention that the growth strategy remains inertia-ridden because of the lack of an academic community and debate.[3] The paper will also attempt to

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[1]See Hasan (1998).

[2]Haque and Sheikh (1994) and Samad (1993) have argued that the economics profession and research are both severely underdeveloped. Debate on critical issues, such as long-term growth strategy, is very thin.

[3]This is the reason for putting Keynes's famous statement on economists at the beginning of the paper.

identify the actors who influence and shape this strategy. This will be followed by what changes should be made in that strategy, based on more recent developments in economic thinking and experience in the world. For long-run sustained growth that will lead us to join the club of the more advanced countries, a new strategy based on the latest research findings will be needed. Finally, I shall point to the factors that impede the adoption of such a strategy, and especially to our owning such a strategy.

1. POST-INDEPENDENCE PARADIGM OF DEVELOPMENT

When Pakistan attained independence, most of the developing world was either a colony or behind the iron curtain. In this immediate post-war era, Keynesian policies of activist government were in force and Lord Keynes's brainchildren, the new Bretonwoods institutions, were beginning their mission of managing the world economy and eradicating poverty. Economists of that time turned very confidently to develop the poor countries. Pakistan, which lacked any real economic profession, quickly accepted most of the new development prescriptions. At that time, expectations were high from this country.

Haque and Khan (1998) have noted that the expatriate economist filled the policy vacuum created by the lack of indigenous economists in Pakistan's early days. The Harvard advisory group, which set the county's economic policies at that time, based them on the economic thinking of the time. Development economics of the time basically rested on five propositions:[4]

First, was a desire for a "big push for development" based on the widespread levels of poverty, which at that time appeared to be fuelling the global demand for communism.

Second, this was an era of Keynes when markets were mistrusted and governments had discovered new tools of planning and activist monetary policies.

Third, early development economics strongly believed in dualism where there was a traditional, non-market sector and a modern global sector. The latter was obviously more productive than the former and an important task for policy and government intervention was to move people out of the traditional sector into the modern. Hence, development poverty levels, economic development must be given priority over all other activities.[5]

[4]See Lal (1997) and Ranis (2004) for a survey of development thinking of that time.

[5]Basically, the poor agrarian economic base of developing countries was considered to be irrational, unable to develop markets and respond to price incentives. Consequently, the economy and economic actors were unable to self-organise, which is a fundamental principle of Smithian and neoclassical economics. Once again, a large role of government was envisaged.

Fourth, developing countries were labour-abundant and capital-poor. In addition, they would not be able to save enough for their capital requirements. Hence for their governments it was necessary to conserve their capital through capital controls and seek capital from overseas.[6] But since the modern sector was very small and even the government had no international credit-worthiness, IFI-lending with its conditionality was the main vehicle for capital accumulation. The development economist was therefore to develop new theories for developing modern, productive sectors. These would be financed by the IFI and the government would implement policy in a highly regulated closed economy. This was the birth of the government-led planning models.[7]

Fifth, in keeping with the dualistic conceptualisation, emphasis was placed on industrial production.[8] Agricultural productivity increases were to finance a move to modernisation and industry. Industrialisation was considered an important indicator of progress.[9]

These assumptions led to a model of economic development that would be based on three important actors that would determine the future of Pakistan—the government, the external donor, and the external expert.[10] The last would supply policy thinking, the second the required funding, and the first would be an implementing agency.[11] Given the view of backwardness, existing markets and economic relationships were looked on with suspicion.[12]

The model also had explicit mercantilist overtones inherent in the planning approaches adopted (see box). Policy sought to boost production and exports through controls on the domestic market. Controls included curbs on domestic consumption, resource utilisation and allocation and market development. Under growing IFI pressure these controls have been relaxed but the growth strategy continues to rely on the spirit of mercantilism.

[6]Recall the choice of techniques literature where even the capital-labour ratio was treated as a policy variable.

[7]Harrod-Domar growth model, where growth was a simple process of capital accumulation based on a simple relationship between production and capital, was mainly used in these new planning models.

[8]This is not surprising since manufacturing activity was at its zenith in this period of global history.

[9]The early planning model focused entirely on industrial development through protection and subsidies. The terms of trade were fixed towards industrial production by the policy-maker. Within industry, policy tried to foster export through subsidy regimes and protect import-substitution industry. Import for consumption was always discouraged. Essentially, this approach mounts to the eighteenth-century 'mercantilism'.

[10]This was not peculiar to Pakistan. Almost all developing countries followed this model.

[11]Recall these were also the days of socialist and Marxist thinking, where the market was held under suspicion. It is not surprising then that markets and openness played little role in those days.

[12]Later research did vindicate the economic rationality of the traditional sectors many years later. Schultz (1964) and McCloskey (1991) showed that the peasant was rational even in land fragmentation; and Akerloff (1970) showed that the money-lender was not the monopolist that he was normally assumed to be. The traditional sectors did indeed respond to market incentives.

Box 1

Mercantilism

Mercantilism is a form of economic nationalism, the main objective of which is to build a wealthy and powerful state. In this system, policy attempts to generate external surpluses through controlling the flow of imports while actively promoting exports.

Mercantilism played a dominant role in the economic thought of Europe covering the period from the 16^{th} century to the late 18^{th} century. The objective was to bring gold and silver into a country through maximising export and minimising imports. In the early nation state, merchants and traders influenced governments to a policy of protection of domestic industry and trade often at the expense of consumers.

Typically mercantilist policies have sought to provide capital to establish new industries, grant tax exemptions to these industries, establish monopolies over local and colonial markets (e.g. The East India Company), impose tariffs and quotas on imports, prohibit the import of goods produced domestically etc. On the export side, governments have banned the export of tools and capital equipments as well as the emigration of skilled labour. In short, the domestic economy was protected from foreign competition.

The most important mercantilist policy-maker in France was Jean-Baptiste Colbert who used protectionist policies to encourage exports while limiting imports at the cost of the consumer. In England, mercantilism was supported by Robert Walpole. Tariffs on imports were imposed to control trade, English goods could only be carried in English ships etc.— colonies could only trade with their mother country which was another restriction.

(a) Growth of Government and Decline of Governance

To understand the political economy of Pakistan, it is important to understand and analyse the impact of this early development thinking. The combination of the external donor and government and a deep suspicion of the market led to the development of the planning model that formed the basis of our economic policy for many decades.

In this new planning model, the government took on more and more of the market and social functions in the economy. The British war economy had already put in a large number of controls in place. These included capital and current account controls, financial repression, constraints on movements of goods, especially food, and a system of agricultural procurement. The new planning model intensified these controls to conserve resources for development. We see then the rise of a "developmental government".

The new "big push for development" claimed more and more resources for development activities—the many infrastructure boards, the mushrooming educational institutions, the many offices of development, and not to mention the various nation-building and defence establishments. The government grew rapidly both in size and influence; it became the largest employer in the country.

Fiscal resources began to be thinly spread and the governance sectors—justice, law and order, and security—were further squeezed. Thus began the new game of the government attempting to squeeze more resources from the population through many clever schemes of taxation, which the people resisted by moving into informal sectors that lay beyond the pale of the government. This continuous tussle between a government hungry for resources to spend on goods that society did not value and a people attempting an escape from "unjust" taxation eroded the social contract and faith in the government.

As the fiscal crunch deepened, cuts were employed across the board, often to the detriment of organisational efficiency. Maintenance and development expenditures were reduced; real wages were frozen; at times employment growth was also frozen. While organisations began to look depreciated with cuts in maintenance budgets, government servants began to claw for a living wage and more [Haque and Sahay (1996)]. They responded to the situation by expanding their perks, by legitimising rent-seeking and corruption and reducing accountability standards. The bulk of a government servant's earnings over time was derived from non-income sources such as perks and his/her pension depended purely on the acquisition of off-balance sheet, state-subsidised assets. This was done through making land development a major activity of the state, and marketing land through a subsidised sale to government functionaries.[13] In the same vein, public sector corporations were means of maximising fiefdoms and perks. The result is a government machinery that lacks high-powered incentives,[14] controls distorted land and goods markets, and enjoys reduced standards of work and accountability in the country.[15]

Recall that the new development thinking came packaged with resources from the IFIs and the official lenders and expatriate foreign advisers to fill the perceived skill gaps.[16] Over time, all policy formulation functions were transferred to the donor.[17] New governments or ministers who now seek fresh initiatives appeal to

[13]The army has learnt it well and uses this device effectively to keep its members happy.

[14]High-powered incentives are those that relate payment directly to job objectives.

[15]While the new tasks of economic development and market regulation required many new professional skills, the old civil service continued to operate on lifetime tenures to general administrators, who are then rotated in various positions.

[16]The expatriate adviser was given a large role from the very beginning because of the needs of the new development paradigm and because the country lacked economic skills [see Haque and Khan (1998)].

[17]The civil service, which did engage in some research and inquiry in colonial and early postcolonial times [see Braibanti (1966)], now appears to be quite limited in such activities.

donors for research. Government functionaries were therefore marginalised from policy analysis while being poorly paid and retaining the power of large government.

Basically, the "big push for economic development" led to an over-extended government manned by an unmotivated manpower that increasingly became unaccountable and engaged in rent-seeking and perk-maximisation. As these trends took hold, the quality of governance declined and market development and regulation increasingly became hostage to public sector rent-seeking. Merit, which even the colonials recognised, was now totally disregarded, leading to a flight of human capital from the government.

Markets, civil society, and openness played little or no role in this model. The government's role expansion into economic development took place at the expense of the government's ability to develop social contract goods such as justice, law and order, security of person, etc. The result was a secular decline in governance, to which the new so-called "developmental" government and its advisers remained blissfully unaware until the 1990s.

(b) Business and Enterprise Development

The theory of the times spoke of two gaps—domestic saving-investment gap and the shortfall of foreign exchange supply from what was required for domestic capital formation.[18] For the first gap, the government borrowed (on behalf of the people) from official creditors and the IFIs. For the second gap, it was assumed that the country had limited foreign exchange earning capacity while the needs of the 'big push for industrialisation' required large amounts of imported inputs. Thus a policy was configured to earn foreign exchange by encouraging exports and by conserving it through curbs on imports and capital outflows.[19]

Given the two gaps—the savings and foreign exchange—it was natural for policy to prioritise the use of resources.[20] For achieving a "take-off" the government and its experts were expected to know the priorities, which were set to be an emphasis on industrial development for accelerated export growth and import

[18]Measured savings have always been low for Pakistan—much lower than in comparator countries such as India. For years this inadequacy of Pakistani savings has haunted our policy and our economists, and all manner of government savings schemes, dreamt up for increasing savings, have further exacerbated the fiscal deficit. Papanek (1967) argues for the need to generate inequality to enable the rich to generate savings. People reacted to an expanding government looking for resources, with large amounts of capital flight and informal savings especially in real estate.

[19]Thus developed the paranoia towards openness and a desire for control: even foreign travel and education abroad were privileges, to be severely restricted.

[20]"When technological maturity is reached, and the nation has at its command a modernised and differentiated industrial machine, to what ends should it be put, and in what proportions: to increase social security, through the welfare state; to expand mass-consumption into the range of durable consumers' goods and services; to increase the nation's stature and power on the world scene; or to increase leisure?" [Rostow (1960)].

substitution. A variety of policies were used for this objective, but all of them amounted to a subsidy to industry. Infant industry arguments still continue to be used for protection to industry. Licensing, concessional financing schemes, and other subsidy regimes were also offered.

These restrictions did not develop entrepreneurship in the sense that modern economics and business has come to know. Schumpeter (1950), Knight (1921), and Drucker (1970) have defined an entrepreneur to be an innovator, a risk-taker, and a builder. Incentives of the type that were offered in Pakistan could not develop entrepreneurship of the Schumpeter-Knight-Drucker variety. The incentive regime has created more of a rent-seeking businessman used to gaming and (mis)using policy. It can be said that the business environment that this policy created was too protective of businessmen.[21] Entrepreneurship was stifled as a result, while rent-seeking became the main form of business. This class of businessmen rather than entrepreneurs acquired wealth and learnt ways to manipulate the government to have policy set in their favour.[22]

These policies contributed to slow growth in indigenous enterprise. As a result, wealth remained concentrated in the hands of those that the government favoured. Consequently, even in private enterprise, merit gave way to government discretion. Social mobility was sharply arrested![23]

An interesting ramification of this industry-focused mercantilist approach was the neglect of the service sector and internal commerce. Retail sector, which was probably the largest employer in the country, was really not regarded as contributing to growth and production. Many internal commercial activities were severely constrained because of the view favouring industrial production. City regulation came to offer space only to housing—that too for the very rich—small shops, government offices in city centres, and large industrial areas on the outskirts. Even schooling was an afterthought. There was no room for entertainment, hotels, shopping malls, even other commercial activities such offices, warehouses, storage and wholesale activities. The result was that a growth of a host of activities such as construction, warehousing, hotelling, entertainment and retail was stunted.[24]

(c) Summing Up the Early Themes

Thus, several themes were established in the early design of policy in Pakistan:

[21]Since there was no bankruptcy law, the government essentially took over industries that ran into difficult under the rubric of 'sick industries'.

[22]Costs of business surveys have been pointing to the amount of time and resources that business is using to interface with government.

[23]To his credit, Mahbub ul Haq, the only Pakistani economist to develop a public image, noted increasing inequality and rising monopolies and raised the slogan of '22 [controlling] families'.

[24]For more on this important theme of neglected domestic commerce and stifled city development, see Haque (2004) and Haque and Waqar (2006).

- A domineering government relying on controls;
- A dependence on external capital which was to be rationed through some government policy—accompanying the funding was donor technical assistance, which offered policy advice sometimes in competition with domestic thinking;
- A production-focused economy seeking to industrialise;
- A mercantilist approach relying on export promotion, protection of import-substitution industry, and high-priced consumer imports;
- The establishment of a rent-seeking, non-entrepreneurial culture, which, with its resources, would seek to perpetuate itself.

It is these themes that Pakistani society and government would later have to contend with. Much of what happened later was the response of the society to these themes.

2. PATH-DEPENDENCE: HAS THE PARADIGM CHANGED?

The current paradigm has evolved like all other human activities. The economy is more open than it used to be: exchange controls have been eliminated as have import licensing and most non-tariff barriers. The average tariff is now virtually in keeping with the WTO norms. Banking and financial sectors have created a more globally integrated financial market. Privatisation has reduced the government's involvement in the goods and financial sector.

These reforms notwithstanding, the government's policy announcements and policies continue to be based on the earlier themes (see Box 2). In the most recent Medium-term Strategy articulated by the government, there seems to be a limited role for financial markets and domestic commercial activities. Points 1 and 2 emphasise production in the traditional manner and seem to also base it on a traditional stages of industry where heavy and technology-based industry is preferred. There is also a target for expanding the share of industry. It is not clear what instruments will be used. However, if past practice is an indicator, it will be a mix of subsidy and tariff protection. The only mention of services is in Point 5, and then it is only to generate employment. Point 7 once again notes the need for resources and savings with no mention of financial markets.[25]

The schematics (Figure 1) that the MTDP produces to show its conceptualisation of the economy one again neglects the areas of markets, finance, and commerce. It is a production-oriented schematics in keeping with the original growth strategy.

[25]Recent growth literature has emphasised the role of finance in growth [see Demirguc-Kunt and Levine (2004), among others].

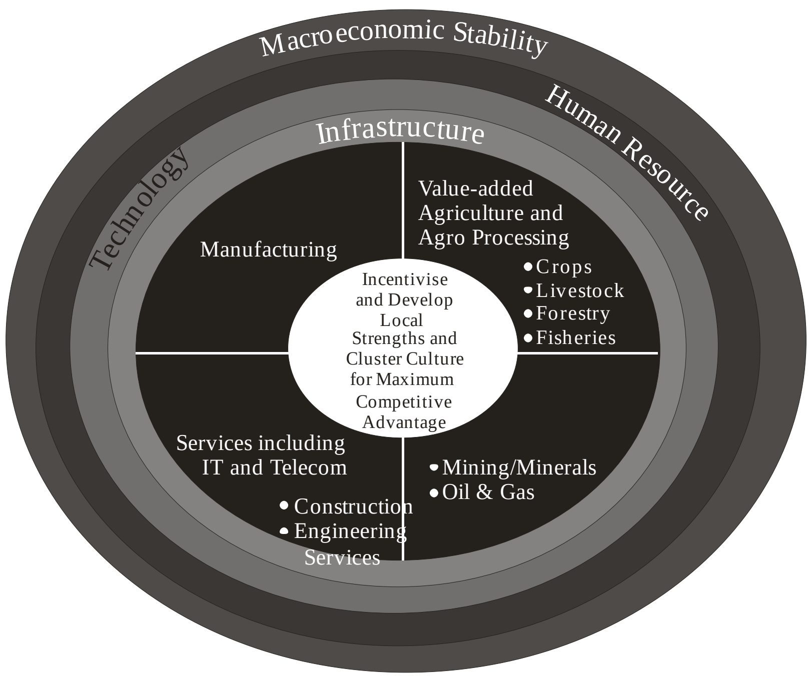
Box 2

The medium term framework—2005-10

"The key elements of the MTDF strategy are as under:

1. In agriculture, not only crops but livestock and fisheries will also be developed, where a substantial improvements in yields, product quality and market efficiency are required to meet the growing demand for domestic consumption and exports.
2. In manufacturing, the production base would be expanded through the development of engineering goods, electronics, chemicals and other high technology-based and value added industries. Its share in GDP will be increased from 18.3 percent in 2004-05 to 21.9 percent in 2009-10.
3. The social and physical infrastructure would be expanded by investing more in water, energy, education and health and encouraging private sector to move into these sectors.
4. Adequate infrastructure and supply of trained and skilled manpower would be ensured to meet the requirements of a fast growing economy.
5. To generate employment and to reduce poverty, investment will be encouraged in agriculture and livestock, SMEs, housing and construction sectors.
6. In the export sector, efforts will be made to increase the role of technology and improve comparative export sophistication.
7. To encourage higher investment and savings, efforts would be made to provide the enabling environment to foster local and foreign investment and enhance both public and private savings."

Medium Term Development Framework 2005–10, p. 5



(a) The Slow Pace of Reform

The perception in Pakistan is that these early themes continue and change only under pressure of the IFIs. From time to time, economic inefficiencies show up in terms of a build-up of macroeconomic imbalances such as an unserviceable debt build-up, rising inflation, and slowing growth. In such periods, the government tries intensifying controls and other administrative measures. When these fail and a sort of a crisis emerges, the IFIs are called upon to help. It is at such times that the agenda for reform moves up to the point where the crisis is averted and a comfort zone has been reached.

Thus motivated by crises, the IFIs' conditionality has been moving the agenda for reform. But this reform has been mainly concerned with improving the macroeconomic situation. Although the scope of the conditionality was expanded to deal with more fundamental problems when the crisis conditions proved to be stubborn, there has been little departure from the fundamental design established in earlier times. The following examples will clarify the point.

- Despite privatisation, the government remains dominant, as regulation and market intervention continue to grow.
- Protection remains intact for engineering goods; the basic mercantilist approach remains in place.
- Faith in openness and the market remains weak, though opposition is slowly being eroded.
- The framework of governance, including the bureaucracy, judiciary, and politics, remains virtually unreformed.
- Entrepreneurship/rent-seeking continues to be fostered through government policy.
- Pakistani media and intelligentsia still cling to an excessively large role of the government, a suspicion of the market, a bias towards industry backed by excessive protection.

Clearly, then, thinking remains path-dependant and the constituency for reform seems to be very small. Let us examine why.[26]

3. EXPLAINING INERTIA

There is limited ideological challenge to these early themes. Five factors may be responsible for this inertia in development and growth strategy.

[26]Surprisingly, despite the fall of the Soviet Union, the extended Japanese recession, as well as the East Asian crisis, the Pakistani economist and the debate in Pakistan continued to argue for a large government role, a planned economy, and mercantilism. They cling dearly to their suspicion of the market despite much evidence on efficient markets and the information aggregation and signalling role of markets that the economics profession has been developing internationally.

First, the stunted development of the economics profession meant that there was no research and debate to help evolve the framework of policy-making of the early years. As noted by Haque and Khan (1998), the economics profession was started by scholarships and government jobs according to the design of the donor experts. Primarily it was hosted in the Planning Commission and the Pakistan Institute of Development Economics as an adjunct to the government bureaucracy, which would deliver development. The role of economics in this model was considered to be mainly the assistance of the bureaucracy in Planning. Little investment was made in either theoretical economics or behavioural empiricism, which might overturn the assumptions of policy. This design has not delivered any independent research or discussion of policy.

Second, education investments have been inadequate in our early planning model.[27] All areas have suffered, but one area that particularly suffered has been higher education and research. Economics faculties did not develop in universities, syllabi did not evolve much, and no research challenged the early thinking discussed above.[28,29] The research sector that could possibly challenge or inform the development paradigm did not develop.[30]

Third, vested interests like the protected engineering goods lobby and the subsidised textiles lobby also continued to feed the earlier thinking of a domineering government and mercantilism.

Fourth, colonial bureaucracy has been maintained without reform and modernisation while their incentives have eroded. The colonial civil service system was designed to maintain administrative order of a colony. With new development

[27]An unintended consequence of the production-oriented, mercantilist growth strategy was the neglect of human development; as a percentage of GDP, Pakistan has always allocated less for education than the average for developing countries [see Haq (1963) and Hussain (2003)].

[28]Expert advice also maintained that higher education and research were considered luxury goods, activities to be pursued by more advanced countries. The World Bank argued in the 1970s and 1980s that the social rates of return to primary education were higher than those obtained in university education. There was a strong policy bias towards primary education away from higher education. [See Psacharopoulos and Woodhall (1985)].

[29]Unlike India, where the IITs and the IIMs were set up as harsh meritocracies with a serious intent to compete with the advanced countries in research and learning, the bureaucracy in Pakistan effectively colonised Pakistani universities. Even today, no public sector university has any autonomy; government nominees and bureaucrats continue to serve on governing bodies, and the government determines appointments and transfers of university professors and management.

[30]All academic and university appointments are regarded as part of the bureaucracy. All government servants—and the academia—are regarded as such. They are subject to the traditional human resource management and slotted into the uniform national pay-scales. A colonial legacy! Thus an academic can win international research awards but can only be promoted when the right seniority can be attained; and even then, according to the national pay-scales, a professor can never rise to the level of a federal secretary, the most senior rank in the bureaucracy. Needless to say, talent flew out of the academic sector, and it continues to do so.

and national functions—project management, market regulation, media operation and management, operating economic units—added on, more responsibilities and power has been handed to them. It is expected that this bureaucracy will perform both governance and development functions. While the governance function depends on the domestic fiscal situation and remains starved for funds, donor funding is amply available for the development. The bureaucracy has an incentive to be engaged in development projects at the expense of governance.

In addition public service human resource management has not changed since Independence. While the new demands on government required professionalisation, specialisation, and technical analysis, the civil service system continued to develop generalists who were fungible in all government business.[31] A rapid and mandatory transfer system was maintained at the cost of specialisation, and as a disciplining device that served to politicise the civil service. The system is entirely based on seniority and political favours with no room for merit. Finally, the public service system is relatively closed; entry is only possible at a young age.[32, 33]

Fiscal crises in the past have required restraining the wage bill. Money wages of civil servants have been declining in real terms for a long time. All the incentives of the civil servant lie in the perks that go with the job, and these have increased over time. Since the money wage is now a minor part of the public servant's wage, perks and rent management have become an important element of survival. Consequently, any reform that reduces perks and rents without adequate compensation in terms of cash will fail.

Fifth, the dominance of the government that was a part of the original growth strategy may now be impeding the evolution of the strategy. The design of development based on planning, licensing, and controls meant that the government determined market competition and success. As accountability and quality standards declined in government, economic and political success came to be measured in terms of whimsical benefits, such as land allotments, procurement contracts, monopolies, and arbitrary protection, of course derived from government regulation and dispensations. Competition for these has intensified over time, raising the cost of criticism and a demand for reform. Even well-intentioned political change finds the spoils of success quite tempting and often abandons reform.

[31]The technical work was handed out in the form of consulting contracts with no quality control. This has set up a new rent-seeking game, which contributes to further perverting incentives for both researchers and civil servants [see Haque and Khan (1998)].

[32]Reform of the civil service, wider governance reform, as well as deeper structural reform required for economic efficiency have been discussed from time to time, especially at times of regime change.

[33]Donors who initially had not thought these areas to be of importance have now put such reform on their list.

4. PARADIGM SHIFT: THE NEW DEVELOPMENT THINKING

In thinking of a new strategy, we must draw on fresh developments in economic thinking around the world. Some lessons from the large amount of research that has been done internationally are as follows.[34]

(1) Important determinants of economic growth are knowledge, creativity, and innovation. Societies that progress foster such activities.

(2) For economic growth to take place, institutions must be configured to foster security of life, property, and contract, and to facilitate market development.

(3) Economic activity grows in open competitive markets. Economic activity and innovation is chaotic and cannot be planned by government and, hence, must be left to markets. [35]

(4) Growth takes place in creative cities where individual liberty and economic freedom are maximised and community space developed to allow individuals to come together. Such cities are based on limited regulation since they encourage mixed use and commerce. Such cities foster knowledge clusters.

(5) The role of government is not to plan and attempt mercantilist sector and industry picking, but to provide the institutions that will foster the four activities outlined above.

The new economics defines very clearly the distinct roles of the government and the marketplace. By managing its role well, the government defines incentives within society for creativity and innovation. Social mobility is determined by creativity and knowledge creation and not by government policy. Instead of rewarding rent-seekers, policy seeks to reward talent and innovation.

Clearly, 'the early design' that has been adhered to—a domineering role of the government, planning, and mercantilism—is inimical to the new economics. One major flaw in the path-dependant growth policies that we have been following has been the neglect of institutions and governance.

5. WHAT IS TO BE DONE?

(a) Accepting Markets and Globalisation

The key point to note is that an acceptance of globalisation means integration into the global economy and discarding the current approach of choosing areas in which to engage.[36] Globalisation is the linkage of markets across national

[34]In many developing countries, considerable inertia in thinking is displayed despite attempts at liberalisation and advancing global communication. Inderjit Coomaraswamy, of the Commonwealth Secretariat says: "We seem to have liberalised our economies but not our minds".

[35]For evidence of benefits of globalisation, see Bhagwati (2004) and Friedman (2000). Stiglitz (2003), whom many *dirigiste* thinkers quote, has some reservations on the international architecture but is quite accepting of most other aspects of globalisation.

[36]This will mean a change in trade policy that seeks to protect favourites and to promote exports.

boundaries. Therefore, the benefits from globalisation can only be realised through market development. The domineering role of government has stifled market development [see Haque and Waqar (2006)].[37]

If this approach is accepted, current emphasis on production would be replaced by market development. With this emphasis, a whole host of new approaches to economic policy will need to be developed. For example, every planned government intervention in the marketplace, including revenue initiatives, would need careful scrutiny at the technical level by a broad group of professional economists, think-tanks, and universities to understand their market implications before they are implemented. The yardstick for such an analysis and debate would have to be "all government intervention must be market-neutral and minimal".

In market development, the issue of regulation would have to be faced. Two important points on regulation need to be recognised. *First*, that markets are self-organising and self-regulating. Regulation only affects areas of market failure where self-regulation does not work.[38] *Second*, each market is specialised and needs specialists with the requisite skills to regulate the market. Generalists being transferred from a government department most often will not do.[39]

(b) Re-aligning Government to the Social Contract

Public policy research has clarified the role of the government to be one of correcting market failure and providing security to individuals and markets.[40] Government activity beyond the social contract needs to be carefully thought through. In this view, the role of the government is to provide governance first. Development can only be done by a government that can provide governance. Even government activities within the social contract need to be conducted with as much transparency and accountability as possible. Government efficiency and output must always be monitored.[41, 42]

[37]For example, agricultural procurement and storage currently remains dominated by government; subsidies to industry or exorbitant protection to some leads to a distortion in the marketplace.

[38]That development is a chaotic and messy business best conducted through the market taking its own head is well-understood and has to be accepted. Policy must give this process space and be ready to help clean up where it can in an informed manner.

[39]The dictum that 'every market needs government regulation' is convenient for rent-seeking and ignores all economic theory and empirical evidence. Often, regulation is built on bureaucratic lines and run by generalist bureaucrats.

[40]All tasks of the government derive from this mandate of providing individual security and liberty and safeguarding the contracts and transactions conducted by sovereign individuals. Development projects and arranging for welfare and distribution are dimensions of improving welfare.

[41]One important function of parliament from its inception has been the monitoring of government.

[42]An important part of the new governance movement started by Margaret Thatcher and the New Zealand reform has been the measurement of the quality of government and the continuous reporting of such governance. Of course, this assumes an open and transparent government where citizens have a right to know.

(c) Building Institutions and Governance

There is now widespread acceptance that institutions and governance need to be built for growth.[43] In reality, this has remained little more than wishful thinking since most often the effort of building institutions has relied on very expensive donor-funded projects driven by costly consultants with little impact on the efficiency or the quality of governance or institutions. The focus of most of this work is the importing of 'best practice', which incumbents with their current poor incentives are supposed to implement.

Institutions are the rules and norms accepted by the society as ones under which if will operate. [North (1990)]. This sets up a huge agenda—from the constitution to the norms and culture in society. Constitutions define the checks and balances which incorporate the basic incentives under which the society functions. Economists like Hayek (1978) contend that even this basic document needs to be aligned with economic efficiency, individual liberty, and maximum welfare of all.[44]

Civilisation is based on two very important institutions—property rights and the rule of law—that need to be carefully developed and nurtured. The state guarantees property rights, the definition of which is continuously expanding with technology and population density. The former creates new goods and services as well as new uses for existing goods and services leading to possible rights conflicts or re-definitions and re-interpretations. Related contracting mechanisms also seek to define property rights and claims that again require informed and appropriate state intervention.

Similarly, with increasing population density, individual property rights have to be traded off with community welfare as crowded urban spaces increase social externalities. Space and environment need to be shared so that individual freedom and privacy are maximised while increasing community welfare. Public goods infrastructure, such as roads, sewers, and wiring will require the assertion of eminent domain. Unless an informed and thinking approach is used, 'eminent domain' can convey too much power to the executive and be used for rent-seeking.[45]

[43]See Acemoglu, *et al.* (2005) for a recent analysis of the impact of institutions on growth.

[44]Constitutional economics is an important subject and should be taken into account at moments of constitutional deliberations. One reason that we run into a constitutional hiatus is that in both the framing of the constitution and its amendments, no expert of this field was consulted. [See Cooter (2000) and Hayek (1978)]. *The Federalist Papers* (2003) has a very good discussion of constitutional issues. Lord Acton's famous dictum 'power corrupts' remains true, and hence an important role of the constitution is to distribute power through checks and balances so that it does not concentrate anywhere.

[45]There is another interesting area for research and reform here. Currently, land development takes place under the Cooperative Societies Act (c. 1912 and its amendments) and the Land Acquisition Act (c. 1894 and its amendments). The former has no legal entity or assets to give claimants any resource while the latter should not be used for development of housing for the rich.

An important ingredient for building governance is the establishment of the rule of law, which means an end of privilege and ‘network rent-seeking’.[46] Experience of development in many countries has shown that ensuring justice and the rule of law leads to good market development and enhances growth. Establishing the rule of law and a good system of justice has now become a matter of priority.[47] A resource-constrained government must therefore use its resources wisely, and ensure that the key institutions of governance that are required for security and market development must be properly developed.[48]

(d) Developing Creativity and Social Mobility: From Rent-seeking to Merit

Much recent research has emphasised that the key difference between the developing and the advanced countries is the creation and use of knowledge and creativity. In such an environment, merit must be incentivised at every level. This would happen if, as suggested earlier, the role of government is re-aligned, globalisation is accepted, and institutions built. What sort of institutions will allow this creativity to be unleashed?

(i) *Shift to a consumer-oriented society.* Creativity can be built with a change in policy stance and regulation that sees all activity—and not just production—as equally valuable. This will require a change in emphasis from the current focus of policy-makers on supporting producers through essentially mercantilist policies to an economy that allows consumers more choices and greater weight in the economy. Policy will then have to allow more space, both metaphorically and physically, to services, and especially domestic commerce, currently stifled.[49]

[46]There is little sociological research in Pakistan even though much work is required. One area that has important ramifications for our economy as well as polity is what I would term as ‘network rent-seeking’. People are now working very hard to be a part of some important network to be able to engage in rent-seeking. Not only is this wasteful activity, it also destroys the socio-political fabric of the country and destroys the rule of law.

[47]The principle of ‘equality before law’ is maintained by an independent, competent, and quality judiciary. The law must also show its responsiveness to change in society. Hence the legal system must also be capable of reform and innovation. The legal process must be fit for rapid enactment of needed laws and not be always dependant on a crisis or the external donor forcing a change.

[48]In building institutions on the principles required by modern economic and legal thinking, competent research needs to be conducted and widely debated to enable a consensus for well-understood reform.

[49]With better retail, warehousing, and leisure activities, the markets, output, and employment will expand. In an open economy, consumers will exert their preferences in the market through these activities. Economic activity will then take place according to the price signals conveyed by final consumer demand [Hayek (1945)]. Products will be developed to satisfy consumer demand. Chances of high-quality products and brand-names being developed will increase. And it is these products that will move overseas to increase domestic wealth.

(ii) *Urban regulation for creative cities*. For this consumer-focused broader model, policy and regulation should accommodate the market development even though at times it may not be as orderly as the planners may like. Most important, regulation for city and land development and utilisation will have to be more accommodative of more city activities than are currently allowed. Currently, cities primarily allow for high-income single-family housing, small retail, and some industry. This approach also shuns urban density and values large open spaces with suburban housing. In the new model, much more density will need to be accommodated, including multiple family dwellings [see Haque (2004)].[50]

5. SEQUENCING OF REFORM AND POLITICAL ECONOMY

With this deregulation and reorientation of the role of the government, a huge growth dividend may be expected.[51] Yet there are opponents of this reform!

Is there a critical reform that will unleash other reform? Obviously, those favoured by current policy will not favour reform.[52]

One important point of entry could be aligning the incentives of a key group with reform. One such group could be the public servants! Let us see why.

Given the prevalence of rent-seeking/perk-management in government, the incumbents probably self-select themselves on the basis of their ability to play this game. To such individuals, gains from reform may not outweigh those from rent-seeking/perk-management. The approach should then be to change the rules so as to allow people who are more invested in reform to come into positions where reform can be made.

To break the current hold, incentives have to be changed to allow individuals who would choose reform over rent-seeking to enter key public positions. This can only happen if—

(a) the current closed civil service is opened up at all levels, i.e., all positions face external competition;
(b) the generalist approach is discarded and appointments of professionals with the requisite skills are made;

[50]In addition, city regulation should allow far more room for hotels, leisure activities, large retail, event management, office and other commercial space (see Appendix 1 for more details).

[51]Re-allocation of land resources within cities alone will open up many opportunities. New commercial activities, leisure, hotelling, and land development will absorb large amounts of investment, which multinationals will hungrily provide.

[52]Complete opening of the economy and a wholesale deregulation that develops strong competition will be one important approach to moving in the direction of the new strategy. But the two most powerful groups—current favoured industrialists and government machinery—will strongly resist such a move and will convert *de jure* liberalisation into *de facto* closure.

(c) reasonable security of tenure is given, i.e., transfer is discarded as a weapon of control;
(d) mobility into and out of the public sector is encouraged;
(e) perks are abolished and all payment is in cash and totally transparent; (performance-based bonuses are used; payments are competitive with the private sector;)
(f) reform is rewarded with honours and payment at market levels.

With this approach, the government employees (judges, civil servants, public service delivery employees) can all hope to invest in reform and gain from it. Over time, the incumbents engaged in rent-seeking will be outnumbered. Such a public service will be able to take on the vested interests and align society's incentives with economic efficiency and growth.

From a political economy standpoint, it seems that the critical measure to trigger wider economic efficiency reform would be the reform of the public sector on the lines suggested here.[53,54]

CONCLUSION

There is an urgent need to shift the growth paradigm in Pakistan. Much has been learnt about the growth process in the world, and this knowledge needs to be applied in Pakistan. The earlier approach based on government-centred planning, reliance on foreign resources, and mercantilism, has not worked because the structure of incentives that resulted from this approach led to a neglect of governance and the development of rent-seeking. Talent and merit were disregarded by that system.

Economists are now emphasising that for self-sustaining growth, such institutions need to be built that preserve individual freedom, provide security, and facilitate market transactions; the government merely provides these institutions, allowing markets to determine where economic activity goes. This is a meritocratic framework where success is determined purely by the marketplace, and where government efficiency is also judged by how well it develops the governance infrastructure that facilitates the market.

[53]A complimentary reform would be catalysing thinking and debate on reform. This can best be done through a vibrant academia.

[54]Unfortunately, the Pakistani media cannot be counted on the side of reform and progress. Contrary to Sen's famous argument that media is always an ally of reform and progress [Sen (2001)], the media in Pakistan has always been controlled by the government to more or less freeze out any debate, especially debates on alternative strategies or reform. Through the country's history, the government has found ways of controlling the media. Overt controls—licensing and direct censorship—were in place for many years. When these were given up, rationing of newsprint was used as a control device. When the media gained independence, the government had also grown to be the largest advertiser and hence retained control on the media. In Pakistan, the academia, through their interface with globalisation, will probably create the awareness and lead the media to publicise reform.

Given these new findings in economic research, Pakistan's growth strategy should be the subject of some debate. There may be a case for moving away from the current focus on government planning, production, and mercantilism to a more market- and commerce-based approach. The new approach would be more aligned with globalisation, creativity, and innovation.

Obviously, vested interests will block such reform. However, one possible intervention identified could help break the control of vested interests. The change has to take place at the level of acceptance of this new thinking, which can perhaps best happen through academic freedom and the development of a research culture. That will only come about when the education system, which currently is subservient to the government machinery, is completely autonomised and professionalised.

For reform to take hold, public service, which stands at the heart of the system, will need to be modernised in a manner that invests it in reform and takes it away from rent- and perk-management. My contention here has been that the crux of this reform of government will lie in the management of public service personnel—a management that allows open competition of a professional kind to be established.

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Comments

SHAHID JAVED BURKI

Nadeem ul Haque's paper on the strategy of growth followed by Pakistan over the last almost six decades and what are the public policy options currently available to Islamabad [Haque (2006)] is a timely contribution to an understanding of Pakistan's economic history and public policy-making. Its main purpose is to initiate debate among thinking people working in Pakistan or living abroad and interested in Pakistan's development. The assumption is that such a debate would result in a better informed strategy for economic development. As such the paper and the debate it should generate could significantly influence the choices policy-makers may make in Islamabad.

Haque's paper has two interwoven themes. One, the growth model followed in the past in Pakistan was based on two assumptions. Growth would result from a mercantilist approach that promoted production and exports while protecting domestic markets from both internal and external competition. This policy stance was expected to provide resources for development to close the two gaps—the savings-investment gap and the foreign exchange gap. The first gap would be narrowed by the rapid growth of the industrial sector. Industrial entrepreneurs had demonstrated their much larger propensity to save compared to the national average. The foreign exchange gap would be narrowed by rapid growth in exports and rigorous constraints on imports.

Haque's second theme deals with the role of the state. There was a belief then that the additional resources that became available as a result of growth and augmented by foreign capital flows, mostly foreign aid, could be used intelligently only by the government. The private sector could not be trusted with their use. The case for such an approach was developed by a number of foreign advisers who worked in the Planning Commission and in the two provincial planning departments. The most notable among them was Gustav Papanek who, after returning from Pakistan to Harvard University, went on to write a book on Pakistan's economic development. [Papanek (1967)]. This approach was incorporated in the Second Five Year Plan (1960-65) prepared by the Planning Commission under the direction of its Chief Economist, Mahbub ul Haq [Haq (1969)].

The most important consequence of this model of growth was to emphasise production over market development. An intricate system of incentives and licenses was developed to increase production. This in turn produced what Haque calls

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"networked rent seeking" behaviour which prevented reforms. This behaviour is now deeply embedded in the country's psyche and needs to be changed if Pakistan is to develop into a modern economy on the lines of a number of successful countries in Asia. Change can only be possible if the state redefines its economic role. This leads to an obvious question. How to create a constituency for reform? Haque's recommendation: align "the incentives of a key group with reform. One such group could be the public servant!" (p. 24).

I have no problem with the suggestion that a new model needs to be put in place to address the many economic and social problems Pakistan currently faces and that market development with a small regulatory role for the government must be the central element in this approach. However, the choice of the public servant as an instrument of change is problematic given the history of economic decision-making in the country.

Before suggesting why the Haque approach would not necessarily work, I should say a word about the way I have looked at Pakistan's economic development in my own work. In the books, articles and columns I have written and published over the last quarter century, my effort has been to understand what motivated various policy-makers in the country. This is also the approach Haque follows but there is one important difference. Whereas I did not treat Pakistan's economic history as one long continuum, uninterrupted by changes in those who peopled the corridors of power, Haque looks at the country's sixty year history as a single episode. This is a mistake. Pakistan's economic history can only be understood if we carefully view the role of various groups that held power at various times.

Haque is right in assigning the role the government played in developing Pakistan. But what is "the government"? It was very different in 1947-58 when the first generation of Pakistani leaders tried to establish a new state while attempting to deal with the various challenges thrown at them by the leaders in India. "The government" that took office when General Ayub Khan first brought the military to power was very different from the one it succeeded. In my first book on Pakistan [Burki (1980)] I analysed what I called the "politics of economic decision-making" in the country's economic history. Haque does not entirely ignore this subject. But his focus is narrow. Pakistan followed "a model of economic development that would be based on three important actors that would determine the future [of the country]—the government, the external donor, and the external expert," he writes (p. 6). This is a very narrow focus; as I have already indicated above, "the government" was made up of several players and they changed over time.

Central to the dynamic aspects of the approach suggested by Haque is the identification of what I would call the "wedge"—a group of people who would throw open the system that has become closed because of the mutual and supporting interests that dominate it. Pakistan's economic system is like an accordion; it opens and closes depending on the quantum of power wielded by various groups that are its main beneficiaries. The civil service is a part of this closed system. Does it still have the power attributed to it by Haque? If it does—I believe that it does not—could it be entrusted with the task of mounting a palace coup and bring about change from within? Haque addresses this question only indirectly by suggesting that investment in higher education would help to bring about a fundamental change in the behaviour and interests pursued by public servants. This is why I have labelled this line of thinking "dynamic" since change is contemplated over a fairly long period of time.

Let me get back to the point made earlier by identifying the various "wedges" that have brought about changes in public policy-making in the past. Their identification, the roles they played and the influence they had in developing the economic strategy put in place at that time would help in determining how change could be brought about in the early 2000s. It is useful to identify three episodes in our history to underscore an important point: that the character of the wedge differed from period to period.

The first discontinuity in Pakistan's economic history occurred in October 1958 when General Ayub Khan, the Commander-in-Chief of the Pakistani army, led the military into politics. This was the military's first incursion into the political system; the men in uniform were outsiders and were prepared to bring about fairly significant changes in the status quo. It was under the military that the model of economic development that is the focus of Haque's paper took shape.

It was during this period that economic policy-making power was entrusted to the Planning Commission. The Commission was able to secure technical assistance from foreign aid giving agencies in the form of resident economic advisors. These advisors helped it to formulate a strategy for development that focused on the allocative role of the state in assigning the resources it garnered from the domestic economy and from donor agencies. The Planning Commission also built a system of licenses and controls that favoured a small group of entrepreneurs who developed the industrial sector. It was also during the period of Ayub Khan that the industrial class developed as a strong vested interest prepared to defend the "rents" it collected from the economy. Having been opened by the military wedge in the late 1950s and early 1960s, the system became closed over time. Those who wished to see the system remain closed included the military, the civil service, the landed aristocracy and new industrial entrepreneurs. A system of rewards was put in place that included industrial licenses, transport permits and land grants in both urban and rural areas.[1]

There was a deep reaction against the Ayubian system and the model of economic development it had espoused once the opposition gathered enough strength and courage to challenge the president. While the opposition was able to cohere on the issue of Kashmir and the peace treaty signed with India by Ayub Khan following the short war in September 1965, economics also played a part. There was a perception that the model of economic development had benefited a

[1]How this system worked was explored in some detail by me in my book, *Pakistan Under Bhutto, 1971-77* [Burki (1980)].

small group of people. In a historic speech in 1968, Mahbub ul Haq identified "twenty-two" families as the main beneficiaries of the "decade of development" the Ayub regime was celebrating.[2] The analytical work Haq used to lay out his claim was flawed but that mattered little. Haq had succeeded in throwing a spanner in the works.

The growing discontent against the regime of Ayub Khan brought a new political force to the fore. Zulfikar Ali Bhutto, Ayub Khan's erstwhile foreign minister, was able to use populist politics to produce another wedge in the system. He was extraordinarily successful in mobilising the urban poor who found a voice within the political system. They made the unexpected electoral triumph in December 1970 of the Pakistan People's Party that had been launched by Bhutto and a number of politicians of the left only two years earlier.[3] This is not the place to discuss how the electoral victory by PPP in one of the two provinces of Pakistan finally led to the assumption of near-dictatorial power by Bhutto in 1971. For our purpose it is enough to underscore that the new president/prime minister used his populist base as a wedge to thoroughly restructure the country's economy through several acts of nationalisation. Under Bhutto, both the power of the state and the proportion of the economy's total assets owned by the state expanded enormously. The incentive structure that supported the system included jobs in the expanded public sector including opportunities in the superior services and labour laws for urban workers.

The third wedge that opened the system once again was produced by the government of General Pervez Musharraf when it took over power in October 1999. The new military leader turned over the management of the economy to a group of professionals, bankers as well as economists, who, guided by the International Monetary Fund, aggressively pursued a programme of privatisation and encouragement of the private sector. Under Musharraf, a small group of industrial houses were able to increase their presence in the economy. They were able to create monopolies in a number of industries unchecked by a weak and dysfunctional regulatory system. The Musharraf economic system has seriously exacerbated income inequality and reduced the capacity to affect the level of poverty through economic growth. Once again, the system is in danger of being closed around a structure of incentives and rewards that has been built up. And, once again, land grants, in particular in the urban areas, are an important part of this system. Jobs for senior members of the military in civil administration is a part of the system of rewards.

This brief recounting of the economic history of Pakistan highlights two features: one, that a number of different wedges opened closed systems at various points in history; two, the state helped to drive each wedge into the system. The

[2]President Ayub Khan wrote about his own role in making Pakistan an economic success in his autobiography, *Friends not Masters*, published a few months before he was forced out of office. [Khan (1967)].

[3]The rise of the PPP as a political force in the country was a remarkable phenomenon. It has well told in a lengthy study by the political scientists, Philip Jones [Jones (2004)].

state in turn, drew its strength from the military during the periods of Ayub Khan and Pervez Musharraf and from the urban street during the time of Zulfikar Ali Bhutto. If change need to be engineered now, what will be the wedge that will open the system and how will it derive its power?

As was the case in the early 1970s, the push for change will need come once again from the street—the street in the country's large and small cities. The system as presently constituted has its discontents and these could take the country in two very different directions. They could place religious parties and groups if not in power then in position of great strength. At this time, the Muttahida Majlis-e-Amal, the MMA, has enough political clout to stymie government action on a number of fronts. As the turmoil in the Muslim world increases it is conceivable that Pakistan may also develop its version of Hamas and Hizbollah as entities that would initially operate outside the state. Neither Hizbollah nor Hamas have developed economic programmes other than the need to reach the poor and disadvantaged through social work. It is, therefore, not clear as to how they will organise the economy once they are placed in position of power within the state.

The other direction in which the country can go is towards liberalisation of politics and the opening of the economy. Such a move could be led by the professional classes who will look to the rapidly growing middle class for political support. However, this would only happen if the military under General Pervez Musharraf is prepared to liberalise politics. The elections promised for 2007 may offer such an opportunity.

If a liberal political force is able to enter and dominate the corridors of power what are the policies it should pursue in the domains of economics? Three areas must receive immediate and serious attention. First, equitable distribution of assets in both urban and rural areas. In the urban economy, a robust regulatory system must be put in place that should be answerable to the legislature. Preventing the development of monopolies should be one important part of the regulatory system. Second, adoption of land use policies in large and medium sized cities that would encourage appropriate use of land for residential, commercial and industrial purposes. A robust zoning system must have an important component of this policy. Third, development of skills suitable for a modernising economy by encouraging the private sector to further increase its role in education. Once again, a robust regulatory system with the active participation of the private sector must oversee the development of entrepreneurship in the area.

In conclusion, I would agree with Haque that Pakistan is at a stage where it must carefully devise an economic growth strategy that would serve it for a number of years. Such a strategy is not in place at this time. In undertaking this task policy-makers must learn from the country's history and, at the same time, recognise the links between economic policy-making and politics.

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Comments

PERVEZ HASAN

It is privilege to be asked to comment on the inaugural lecture by Nadeem ul Haque as the new Director of the Pakistan Institute of Development Economics. Haque's broad ranging essay on past policy shortcomings and future challenges facing Pakistan is scholarly, thought provoking and, not entirely unexpectedly, provocative.

There is much in the essay that I agree with. Several ideas are new and refreshing. The government is over-extended and governance has declined. While the economy has been liberalised there is not sufficient attention to market development including domestic commerce. Mitigation of rent seeking behaviour has still some ways to go. Without improvement in the provision of services that are the central responsibility of the government i.e. law and order, speedy justice, protection of property rights, development of private sector and a market economy would remain hampered. Government policies must help develop a culture of creativity and entrepreneurship. Public support for higher education and research and is necessary. The institution building in the public sector and a fresh compact with the private sector require a change in the incentive structure. This cannot be accomplished without a thorough going reform of the civil service including adequate compensation, mobility into and out of public sector, especially opening up entry at higher levels of civil service.

In my comment, however, I want to focus on four areas where I have differences with either Haque's reading of the past or his priority concerns for the future. First, I feel that, in a sweeping look at the historical record, Haque is too dismissive of the effectiveness of development strategy and planning successes in Pakistan especially in the period when political support for the planning process was strong. Also he gives too much credit to the influence of both expatriate foreign advisers and the conditionality of the IFIs.[1] Second, despite his advocacy of accepting markets and globalisation, Haque is at best ambivalent on the importance of export development which I believe remains a critical challenge. Thirdly, I find the essay essentially silent on the issues of equity and distribution which have been at the root of our development failures and have become even more acute over time. Fourth, mobilisation of public sector resources, for funding governance adequately, providing public services for the poor and creating basic infrastructure, remains a

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[1]See Pervez Hasan, *Pakistan's Economy at the Crossroads*, Oxford University Press, Karachi, 1998, pp.303–309.

central issue for both growth and distribution—another issue which does receive attention in the essay.

If one looks at the course of economic policies in Pakistan over the long haul,[2] one is struck both by the weaknesses and strengths of development strategy especially in the earlier decades before Zulfiqar Ali Bhutto's unfortunate experiment with socialism.

First the big push, export pessimism, protection of domestic industry, excessive faith in public sector solutions, concern with capital scarcity and need for large foreign assistance were hardly unique to Pakistan in the setting of the 1950s development paradigm.

More importantly, Pakistan's development strategy worked quite well up to a point. Pakistan was able to raise its investment rate from a paltry 4 percent of GDP in 1949-50 to a peak of 21 percent in 1964-65, just before the war with India. More than half of the investment in the 1960s was in the private sector.[3] Admittedly, the reliance on foreign savings to the extent of 50 percent was excessive. But it can be argued that, had the war with India not taken place, the near doubling of real defense spending between 1960-65 and 1965-70 would not have been required and a cutback in US economic and military assistance would have been avoided. Thus the momentum of growth would have been protected and the serious competition between defense and development greatly moderated.

The relative neglect of agriculture in the 1950s which led to the emergence of large scale food grain imports was quickly remedied in the 1960s when it became clear that large PL 480 imports from US would not continue. Indeed Pakistan was one of the most successful countries in spreading the Green revolution. Agriculture growth rate in the 1960s exceeded 5 percent and has averaged nearly 4 percent since then even though the trend is probably declining.

No doubt major economic policy mistakes were also made in the 1960s. One was the perpetuation of the industrial and trade policies of the 1950s long after they had outlived their usefulness. Manufacturing sector was protected on the one hand by a high rate of effective protection and on the other hand by a high rate of export subsidy on exports financed by a system of multiple exchange rates. The other was a rather uncritical and an excessive reliance on external assistance. But distortions in industry took a back seat because private sector development was greatly set back during the Bhutto period. Furthermore, the nationalisation of banks which was reversed only three decades later did deepen and perpetuate the culture of rent seeking.

Pakistan no doubt missed great economic opportunities especially in deepening and diversifying its industrial and export structure, neglected investments in human capital, and not gave sufficient attention to job creation. But the onus of all

[2]For a history of economic policies, see Hasan, 1998.
[3]The historical comparisons are for the then West Pakistan. For details see Hasan, 1998.

this cannot be placed on the failures of planning and the development model. It is a broader societal failure in which non-economic factors such as relations with India, large defense spending, and the whims of political leaders, both civil and military, have played an important role. It is also worth remembering that despite a great deal of political instability, periods of substantial economic mismanagement, and worsening governance, Pakistan has been able to nearly treble its average living standard over the last five decades, a quadrupling of population notwithstanding. The policy assessments thus need to be much more nuanced.

Still, excessive protection to industry, lack of a competitive environment, continued reliance on large external assistance and neglect of investments in education have remained the bane of economic policies and for this planners must take their share of the blame. But the large increase in defense spending both under Bhutto and Ziaul Haque limited technocratic choices and by 1990s the large build up of public and external debt liabilities during the 1980s left no room for expansion of non-interest public spending.

Can the robber baron approach to industrialisation that allowed phenomenal profits in industry be pinned on the expatriate advisers. Not really. In the 1960s both Mahbub ul Haq[4] and Gustav Papanek[5] justified large profit accumulation as a vehicle for boosting savings and reinvestment. (By 1968, however, Mahbub ul Haq had become seriously concerned with the concentration of economic power in Pakistan). But there were other foreign advisers notably John H. Power[6] who were cautioning against the high cost of industrialisation and excessive dependence on external assistance and consequent neglect of domestic savings.

Harvard Advisory Group did play an important role in persuading President Ayub Khan in expanding the role of economists in government mainly through empowering the Planning Commission. PIDE was similarly supported effectively by external donors in initial years. These actions did have positive effects on the development of economic profession though I agree that with Haque that the Universities did not get commensurate support for higher economics training. But it must be realised that at the time the best and brightest of economics graduates opted for public service mainly because society did not place a high value on academic pursuits. One must also realise that the shortage of good Pakistani economists has been compounded by exodus to international institutions largely because of domestic political conditions.

Whatever influence expatriate advisers, especially the Harvard Advisory Group, had during early 1960s waned quickly specially after the 1965 war and tensions with the US. From my own experience in West Pakistan planning (1965-

[4]Mahbub ul Haq, *The Strategy of Economic Planning*, Oxford University Press, 1963.

[5]Gustav F. Papanek, *Pakistan's Development*, Harvard University Press, 1967.

[6]John H. Power, Industrialisation: A Case of Frustrated Take-off, *The Pakistan Development Review* 3(3) and Keith Griffin and Azizur Rahman Khan, *Growth and Inequality in Pakistan*, St. Martin Press, 1972.

70), I can strongly assert that all major planning decisions, including cutbacks in large public sector programmes in water and industry, development of a strategy for self-sufficiency in food grains, privatisation of fertiliser trade and *sadly* containing of longer term investments in education, were all home grown and were a response to a shrinking resource envelope which actually led to a decline in real public development spending in West Pakistan during the second half of the 1960s.

Looking ahead, I am concerned that Haque does not have a very clear vision about the role exports (including exports of services) must play in future development. Indeed I am a little confused about his terming the past model mercantilist. Though Mercantilism as a whole was not a unified doctrine and did stress state interventions, import protection, government controls and emphasis on production rather than consumption, its central tenet was the achievement of a positive balance of trade through large exports and low imports. In that sense Pakistan development model can hardly be termed Mercantilist.

Despite early promise, export growth has lagged in Pakistan. Even after the substantial export expansion of the last few years, the ratio of exports to GDP remains at 14 percent very much below the range of 25-50 percent of GDP in the successful East Asian economies. Failure of Pakistan to develop a large and diversified base of exports is one of the fundamental factors why it has not matched the growth and poverty reduction performance of not only the first generation of Asian tigers, South Korea, Hong Kong and Singapore but also relative late comers to the field, Thailand, Malaysia and above all China. The relatively slow growth in manufactured exports in Pakistan is highlighted by the continued heavy reliance on cotton based exports and the failure to enter new lines of production, synthetic textiles in the 1950s, electronics in the 1970s and 1980s and information technology exports in the 1990s.

Future development strategy needs to emphasise exports sufficiently and help remove, the trade policy distortions that remain. Special policy support might be needed to diversifying the export base and to develop information technology exports.

By being silent on distribution issues Haque leaves the impression that he is not in favour of public interventions to reduce poverty including the use of fiscal policy as a redistributive tool. If this is his position I do not agree. Sustained growth and political stability do require a better distribution of growth benefits than in the past.

There are several factors that suggest that the current high growth is deepening inequalities more dramatically than was the case in the earlier high growth periods of 1960s and 1980s. First, the growth of incomes of the relatively well to do is being fuelled greatly by extraordinary booms in the real estate and stock market and there is not even a modest capture of the windfall profits because of a total absence of capital gains taxation. USA, even after the tax cuts of recent years, has a 15 percent capital gains tax rate.

Second, unlike 1960s and 1980s, the periods that witnessed at least a moderate growth in the ratio of taxes to GDP, the taxation effort currently appears stalled with tax to GDP ratio stagnating at the rather low level of around 10 percent. Third, unlike the earlier periods rural poverty is now much more deeply grounded among the landless poor and non-farm households. These are groups that are hard to reach because they do not benefit significantly from even robust agricultural growth. It is doubtful that market developments alone will reduce their number.

I fully agree with Haque that improvements in governance and further economic reforms will depend critically on management of public service personnel. But I doubt that improved governance, better delivery of public services, and a vibrant civil service can be delivered without expanding the base of government revenues. The over extension of government terms of its functions should not obscure the woeful inadequacy of its financial capacity. In Pakistan non-interest non-defense public spending, a key indicator of the size of government is barely 11 per-cent of GDP, much lower than almost all developing countries. Raising tax revenue is both a moral and a practical imperative.

You cannot run an effective government, however circumscribed its functions, on a shoestring. But the expansion in real spending in support of social and economic development must focus on de-centralised programmes supporting the important devolution initiative which remains seriously under funded.

Regardless of some differences of view, I want to congratulate Nadeem Ul Haque on his important efforts to promote serious debate among economists. I hope the new PDR will become an important vehicle of this debate.

Comments

AKMAL HUSSAIN

Dr Haque's inaugural lecture begins by incisively identifying the conceptual framework of the government regulated economic growth process of earlier decades, to set the stage for his central contention that "development…. is best conducted through the market taking its own head". He argues that government restrictions and the implied disincentives in the earlier economic regime prevented the emergence of the dynamic, innovative and risk taking entrepreneurship in Pakistan that he believes can alone ensure self-sustained economic growth. He suggests that a new approach is required, to achieve "market development". He believes that this can be done by providing incentives for entrepreneurial innovation, and an "economy that allows consumers more choices", presumably through the availability of a larger volume and wider range of goods and services. The strength of the lecture lies in the sharpness of its propositions. Its weakness lies in the deadly thinness of the analysis and the inadequacy of the evidence from Pakistan to support these propositions.

Dr Haque formulates four main propositions. I will comment on each of them very briefly:

Proposition 1: *Growth of the government (in terms of the size of public expenditure and the range of governmental activities) has led to a decline of governance*.

Dr Haque argues that "fiscal resources began to be thinly spread and the governance sectors—justice, law and order, and security— were further squeezed", and that this eroded "the social contract and faith in the government".

This proposition implies that governance is merely a financial resource issue and that if more finance had been available, justice, law and order and security would have been established, and 'good governance' achieved. This proposition ignores the possibility that the evident failure to establish a stable constitutional order, the persistence of authoritarian forms of government whether in a civilian or an explicitly military garb, rampant corruption in the top echelons of government and the failure to provide the minimum conditions of civilised existence to the majority of the people, may have been relevant factors in the erosion of the "social contract and loss of faith in government". It is the persistence of authoritarian forms of government that could be a factor in explaining the progressive weakening of the

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judiciary.[1] Similarly the failure to subordinate military and security institutions to representative political institutions led to the state sponsoring of armed militant groups during the Zia regime who subsequently became the single biggest factor in undermining "law and order", and the security of citizens.[2] These factors signify a model of governance that has a structural propensity to weaken justice and citizens' security. Thus it can be argued that poor governance emanates from the nature of the power structure within which governance is exercised rather than from a presumed error in financial resource allocation.

Proposition 2: *The earlier growth model did not develop entrepreneurship because it provided incentives for rent seeking rather than innovation and risk taking.*

This proposition of course assumes the historical contra factual that if the government had provided incentives for innovation and risk taking in the earlier period that ipso facto dynamic, entrepreneurs would have emerged, who would have undertaken adequate savings, investment and innovation thereby making foreign aid unnecessary and would have placed Pakistan on a path of self-sustained growth. Quite apart from the absence of evidence, even at a conceptual level, this proposition has only a tenuous link with the new literature on institutional economics. Consider. Entrepreneurs respond not simply to incentives signified by government policy but to a matrix of institutions, which embody both formal rules and informal constraints. The latter are contained in norms and culture that change much more slowly than government policy. The economic elite in the areas that now constitute Pakistan has historically functioned within a patron-client model of governance since the late 18th century.[3] Underlying the apparent discourse of modernity, neither the polity nor the economy has made a fundamental break from the past.[4] Without a change in the norms and cultural propensities of entrepreneurs a change in formal rules (in this case government policy) will have only a limited effect. The new literature on institutional economics still does not have a theory of cultural change. As Douglass C. North says, "How do informal constraints change? …..we are not yet able to explain precisely the forces that shape cultural evolution". However, what institutional economics is confident about is that "the persistence of cultural traits in the face of changes in relative prices, formal rules, or political status makes informal constraints change at a different rate than formal rules".[5]

[1]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.

[2]Akmal Hussain, "Terrorism, Development and Democracy: The Case of Pakistan", *Terrorism in South Asia: Impact on Development and Democratic Process*, edited by Sridhar K. Khatri and Gert W. Kueck, Shipra Publications, Delhi, 2003.

[3]Akmal Hussain, *op.cit*.

[4]Imran Ali, "Government Patronage and Rent Seeking Elites: A Longer Historical Perspective", Background paper (Mimeo) for the *Pakistan National Human Development Report*, UNDP, 2003.

[5]Douglass C. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990. Page 87.

Dr Haque's argument about incorrect government incentives leading to rent seeking behaviour of entrepreneurs in the preceding decades ignores the possibility that rent seeking behaviour may be deeply rooted in Pakistan's cultural history and may therefore persist for some time even if government incentives were to be corrected. This perhaps explains Dr Haque's observation that inspite of the fact that the present government has implemented the IFI's agenda of reform, there has been "little departure from the fundamental design established in earlier times". The real question therefore is not about correcting government incentives (they ought to be), but rather what are the institutional mechanisms, the social and political processes through which a cultural change for dynamic entrepreneurship can be initiated. The agenda for 'market reforms' must therefore become a more wide-ranging agenda of social and political reforms. Market reforms were formulated by international financial institutions (IFIs) and implemented by the state. The agenda for social reform by contrast must be articulated and conducted by civil society.

Proposition 3: *Shift of focus to market development will lead to self-sustained economic growth*.

In moving towards the presumed efficacy of the market mechanism Dr Haque identifies three inter-related principles that are essential to his argument: (i) "Markets are self organising and self regulating", (ii) Development within the market framework "is a messy and chaotic business best conducted through the market taking its own head", (iii) "Regulation only affects areas of market failure where self regulation does not work". The first principle, (i) implies a physiology of markets where the dynamics of the market organism, in so far as it is *necessarily* "self organising and self regulating", are independent of the specific history, institutional framework and the process of cultural change of any particular country. Yet the process implied by the second principle, (ii) namely that the self-regulation is a messy and chaotic business, would necessarily occur in the concrete historical and cultural context of a particular country. How long the mess would last and what the magnitude of the chaos would be, cannot be predicted by the 'market developers', but would be discovered by the people of that country. The cost of course would be paid by the most vulnerable sections of that society. Pakistan's socio-economic fabric are quite fragile and the country is already under acute stress from external and internal political pressures. Under these circumstances, the prescription of leaving the country to the tender mercies of markets as they conduct the "messy and chaotic business" of self regulation, a process whose nature and temporal extent are unknown, can only be considered with a certain degree of trepidation.

Apart from the assumed self organising mechanism in markets in Pakistan, Dr Haque's proposition-3 suggests that government regulation should be restricted only to areas of market failure. This assumes that "market failure" is a discrete phenomenon, which is marginal rather than central to the market space. In Pakistan there is evidence to show that a substantial part of markets are mediated by local structures of power consisting of political elements, various strata of the state apparatus, the economic elite and in some cases even criminal elements. My work for the UNDP, *Pakistan National Human Development Report* 2003, for example, suggests that because of such power mediation, rural markets are asymmetric with respect to the rich and poor farmers. The poor farmers pay a higher price for their inputs and a lower price for their output compared to the large farmers. At the same time a significant proportion of landless peasantry is locked into a structure of dependence on the landlord through debt and his power to bring the local state to bear against them. The consequent leverage obliges as many as 57.4 percent of the extremely poor to work on the landlord's farm without a wage and as many as 28 percent of the extremely poor work at a wage rate substantially below the market rate.

The above evidence suggests that what are referred to in the literature as "market distortions" are not marginal but may be central to the functioning of a significant part of the market space in Pakistan. The asymmetric nature of factor and product markets and the consequent allocative and distributional inefficiency may be organic to the nature of markets as they exist in the specific historical and social context of Pakistan. Therefore moving towards "market development" is not simply a question of regulating at the margin and letting the main market space self organise. Rather it is a question of restructuring the system of power at both the national and local levels, which have made market distortions endemic. At the same time the challenge is to set into motion a social, cultural and political process through which the critical minimum set of institutions could be established which can make purely market-based growth efficacious for society.

Proposition 4: *Institutions and governance need to be built for achieving growth and indeed, civilisation. This is because civilisation is based on the institutions of private property rights and rule of law, which need to be developed through good governance.*

There are two dimensions to this proposition: First, while it is true in a general sense that institutions need to be built for growth, the question is which particular set of institutions need to be built first in a specific country like Pakistan? This is important because merely setting up a few institutions haphazardly could do more harm than good. The latest work by Avner Greif argues that for markets to lead to efficient outcomes a minimum interactive *cluster* of institutions is necessary. If less than the required cluster of institutions is established and markets deregulated then inefficient outcomes will result.[6]

Greif has made considerable advances in our understanding of institutional trajectories. He argues that cultural beliefs inherited from the past affect the nature and trajectory of institutional change. "Past cultural beliefs provide focal points and

[6]Avner Greif, *Institutions and the Path to the Modern Economy: Lessons from Medieval Trade.* Cambridge University Press, March 2005.

coordinate expectations, thereby influencing equilibrium selection and the new institutions of which they become an integral part". Further more, "distinct cultural beliefs induce different trajectories of endogenous institutional change".[7]

The problem of building "institutions for growth" as Dr Haque proposes has a two fold complexity: (i) the specific historical and cultural context of Pakistan has to be examined through new research to determine what is the minimum necessary cluster of institutions required for self sustained economic growth. (ii) What is the trajectory of institutional change that is possible given the specific cultural contexts in the different regions of Pakistan; and what type of cultural change is necessary and possible to proceed along the chosen trajectory of institutional change.

Finally, there is the question of the principal agent or the initial organisations who will initiate the process of political and institutional change.

Let us consider the second dimension of proposition-4. Civilisation cannot simply be defined in terms of property rights and the rule of law as Dr Haque has done. More fundamentally, civilisation is based on the recognition that freedom is vital to human existence. Yet freedom can only be actualised through our sociality, which is essential to being human. If we take this more overarching concept of civilisation, then social responsibility, fraternity and equality become central to politics and development. The regulation of markets would then be conducted in the context not simply of building a "consumer oriented society" (as Dr Haque would have it), but rather in the context of building a richer human civilisation.

[7]Avner Greif, *op.cit.*

Comments

Khalid Ikram

Let me divide my comments into four broad parts.

(1) I am not convinced that the dichotomy set up in the paper, namely, mercantilism versus free trade, is the best way of posing the problem that you tackle in your lecture. The issue that you actually address is a good deal wider. Mercantilism, as I understand the term—and I have gone back to consult the standard histories of economic thought, such as Schumpeter, Robbins, Gray, as well as Adam Smith (Book 4)—essentially meant a set of policies that would give rise to a favourable balance of payments. This meant encouraging exports and discouraging imports (by all sorts of means), so that the country could pile up "specie," i.e., foreign exchange reserves. The piling up of these reserves was supposed to enable the country to field a larger army and navy, and mercantilist policies were thus seen as policies to strengthen the country.

In Pakistan's case, one can hardly say that the policy-makers were intent on piling up reserves. Measures to encourage exports were motivated by a compulsion to try to close the foreign exchange gap; for most of Pakistan's history, we were very lucky to have a level of reserves that could cover three months of imports. The issues that you deal with in your lecture go considerably further than those connected with Pakistan's trade policies, and therefore I believe that you are selling its scope short by directing the reader's attention towards the red herring of mercantilism.

There is another reason why I think that you should formulate the problem differently. Your lecture emphasises that Pakistan's planners concentrated far too much on measures to increase physical production and ignored the social sectors. But if one equates these policies with "mercantilism," as the lecture appears to do, one runs into the following problem.

Perhaps the most mercantilist countries in modern times have been the East Asian tigers—the range and variety of the methods that they used to bolster exports and restrict imports are quite staggering. However, that did not stop any of them from investing very heavily in education and health and other social sectors. There is therefore no necessary conflict between generating a surplus on the balance of payments and developing the social sectors. In fact, it can quite easily be argued from the East Asian case that developing an educated labour force was a necessary

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condition for boosting exports, and especially for moving from the lower value added items such as human hair wigs and soft toys (which formed staples of Korea's exports in the 1950s) to the cars, computers, industrial equipment, and 500,000 ton tankers that form such a large part today.

I think that your basic thesis should be formulated in some such way as the following: "Even in order to secure its goal of greater production, Pakistan must pay much more attention to institutional development and to go in for what might be called 'second stage reforms'".

I have no doubt that you could express your thesis more elegantly than my off-the-top-of-my-head phrasing, but it should capture two essential points. The first is the strengthening of institutions, under which rubric would fall matters such as empowering citizens and improving accountability; this would address an issue that you have dealt with quite brilliantly, namely, the rent-seeking predilections of our politicians and officials. The second point is that Pakistan has gone, or can relatively easily go, beyond the first generation of reforms. By this I mean that what is to be done in the big picture—adjust the exchange rate, ensure that real interest rates are positive, collect taxes that are already on the books, privatise as many of the bloated public enterprises as possible, and so on—is quite clear and doable. Some of it is already being done. However, once we get beyond these issues that could, given a modicum of political will, be tackled in a relatively straightforward manner, we start getting into a more difficult area.

This is the area of "second stage" reforms. These are measures that will (a) encounter more political resistance (for example, land and labour market reforms); and (b) require much more detailed work and much more time. Thus, for example, Pakistan's educational problems cannot be solved simply by throwing money at the sector, but will require a comprehensive reform of the syllabi for each class from the very lowest up to the MA level, the training of literally thousands of teachers before any upgraded educational syllabus can be made effective, and a good deal of planning and discussion to work out how a much better quality system of education could be paid for. Again, in Pakistan's situation, property rights cannot be properly adjudicated without a major reform of the judicial system nor fully enforced without reforms to the bureaucracy (including the police) to implement the decisions that have been handed down. These matters are going to take a serious amount of time, resources, and training. Much of your lecture, for example, the discussion of ownership rights and the use of urban property, addresses the importance of these reforms.

A rephrasing of your thesis will bring out more clearly the broader argument you are laying out in the paper.

(2) The second main suggestion that I have on your lecture is that it should be used to develop an agenda for research. In the area of institutional reform, I would suggest the following:

- ***The working of the bureaucracy***. I don not know the results for Pakistan, but those for Egypt are sobering. In Egypt, establishing a firm typically required 17 procedures compared with two in Canada; it took 132 days in Egypt to establish a firm, compared again with two in Canada; the procedures cost an average of 2 .2 times per capita GDP in Egypt, compared with 0.0096 times per capita GDP in the USA. An idea of the costs imposed on the economy by such procedures can be gauged from the benefits of reducing their number. It was estimated that if Egypt were to reduce the number of procedures to 13 (as in Tunisia), industry markups would be reduced by 18 percent, while the reduction of the number to 11 (as in Korea) would further lower markups by 38 percent.
- ***The functioning of the judicial system, with particular reference to the commercial judicial system.*** It would be useful to get an estimate of the average length of a commercial case and the increase in costs this leads to. It would also be useful to find out why law cases in Pakistan are so drawn out. You could make a start by drawing on the ADB's work on "Accessing Justice".

Again taking the case of Egypt, studies by USAID, the IMF, and the World Bank found that in recent years the average commercial dispute took six years to be decided. The cassation phase (in Egypt's highest court) normally took another five years, while enforcement upon immovable could add another two to five years. The average time to collect on a dishonoured cheque was three years, with cases of five years not unknown. As a result of such delays, the court costs associated with settling a commercial dispute amounted on average to about 7½ percent of the judgment amount, and were very high relative to those in industrialised countries. Essentially, the cases took this length of time because they are conducted using written materials which are gathered incrementally and slowly, and because of the procedure regarding appeals. In Egyptian courts, appeals need not be based on fresh evidence; this effectively turns the appeal into a second trial. Almost 80 percent of cases in Egypt are appealed. Of course, the length of the case also means that lawyers' fees and other costs also mount up.

I believe that the Mahbub ul Haq Centre a few years ago did a quick examination of the state of the judicial systems in South Asia. You might want to combine that with the more detailed base for Pakistan in the "Accessing Justice" study by the ADB. You might also want to discuss these issues with some of the more thoughtful lawyers and judges, such as Nasser Zahid, Sajjad Ali Shah, Umar Bandial, Sharifuddin Pirzada, Khalid Anwer, Kamal Azfar, Pervez Hasan, and others.

- ***The ability of the tax system to mobilise revenues efficiently and equitably.*** How is the system working at present? What indicators would measure improvements in the administration of the tax system? Can we get a fix on the degree of corruption in the system? As Finance Minister, Mahbub ul Haq had suggested that the larger income tax audits should be carried out by teams of officials selected randomly from the pool of income tax officers. This way the assessee would not know who was going to conduct the audit in any year, and if the officers dealing with a particular large taxpayer were not continuously in the same jurisdiction, then the assessee would be less likely to know them and to be able to build relationships (based on bribes or friendship) with them. What happened to that idea? Is it still workable? Which taxes—income, sales, excise, or other—show the least buoyancy? What can be done to put the system to rights? What will be the likely experience if one of these taxes is allocated to the provinces? What is the fairest tax on agricultural income? Should the inter-generational distribution of assets be made more equitable through an inheritance tax?
- ***The development and functioning of the labour market.*** This is a large subject in itself, and should be linked to an examination of whether the system of education and training is producing the sort of labour that is demanded by the private sector.
- ***The functioning of the grey economy and how to bring it into the formal fold***. A good bit of this would deal with the complexity of property rights and the costs of establishing such rights. In Egypt, De Soto estimated that obtaining the necessary permission to build on formerly agricultural land could require six to more than 11 years; trying to acquire and legally register a lot on desert land could take at least 77 bureaucratic procedures at 31 public and private agencies, and consume between five and 14 years. This provides a disincentive for registration. The Egyptian Centre for Economic Studies estimates that the real estate assets of a staggering 92 percent of Egyptian property owners were unregistered and untitled.

This, of course, means that the property owner cannot use the savings embodied in the dwelling as collateral for a loan, or as a share against an investment, or trade these assets outside a very narrow circle of friends and family. De Soto estimated that this “dead capital” (dead because it cannot be used to generate fresh assets) in Egyptian real estate at $240 billion, which was 30 times the total value of shares at that time on the Cairo Stock Exchange. This gives an idea of how much capital can be rendered inaccessible for productive purposes simply from the absence of legally enforceable transactions on property rights. It is high time that a similar study was done for Pakistan. You may be able to get USAID financing to do this in conjunction with De Soto 's institute; this is what the ECES did.

I believe that the PIDE has already done some studies on the size of the grey economy. Perhaps it's time that these were updated and we also saw whether the grey economy moves pro-cyclically or counter-cyclically with the formal economy. Which income class stands to gain the most from the existence of the grey economy? Acharya's detailed study of the grey economy in India suggested that it was the higher income classes that benefited the most. Let's get an idea for Pakistan.

- ***The system of economic management, particularly at a time when privatisation and globalisation are reducing the space for planning by fiat.*** Under these conditions, what sort of planning (if any) do we need? Would a system of indicative planning (à la France) be appropriate? What resources in terms of trained personnel, data, and connections with the private sector will be required to set up such a system?

(3) My third broad comment has to do with the difference between "what to do" versus "how to do it." Your lecture provides a nice capsule of what is to be done. I think you should now focus on questions such as: why has it not been done already? Are there any reasons to suppose that the policy-makers are more amenable now to changing direction? What is the cost of the change? Who will be the winners and who the losers? How will the winners compensate/overcome the losers? And so on.

If you look at the East Asian experience, you find that in many cases the changed direction of policies was brought about by special circumstances. For example, in Korea the land reform occurred after the conclusion of the Second World War. The Korean authorities were able to enforce a drastic land reform because large chunks of the land, and certainly the best land, had been appropriated by the Japanese occupiers (from 1910 to 1945) and their Korean collaborators. The Japanese had, of course, left following their defeat in the war, and it was politically popular to dispossess the collaborators. Moreover, the Korean government changed the rules of the game and provided even less compensation than had originally been promised to the owners of the land that had been confiscated. This plus price inflation during the period of compensation greatly reduced the fiscal burden of these measures. These policies laid the basis for reducing poverty and increasing equity in the rural areas, by providing many more farmers with the most important agricultural asset, namely, land. Almost exactly similar factors obtained in the case of Taiwan.

The second major factor in Korea's case was the question of security. For the first few years after Chung Hee Park had seized power in 1961, the development strategy continued to emphasise import substitution. However, from about the mid-1960s, his advisers persuaded him of the following argument.

> The first priority facing Korea is defense against North Korea. For this, we cannot rely indefinitely on the Americans; therefore, we have to become self-reliant as quickly as possible. However, modern warfare requires a great deal of resources, which means that it must be supported by a strong economy. A strong economy requires investment and technology, which Korea does not have. Korea will therefore have to borrow from abroad in order to fill these gaps. But this external borrowing will have to be repaid in foreign exchange. The only way Korea can obtain this foreign exchange is through exports. Therefore, for the sake of its security, Korea must go all out to export.

This reasoning provided the justification for Korea's export-oriented strategy, which really took off from the second five-year plan (1967 to 1971). It is a measure of the importance that President Park attached to the strategy that he personally presided over monthly export promotion meetings. At these meetings he heard reports and suggestions from business leaders, immediately resolved problems that had arisen because of bureaucratic hindrances, and made decisions on allocating resources to promote investment and exports.

Are there any factors in Pakistan's case that would lead one to think that major changes in strategy are possible? Would the new strategy be likely to recruit political and administrative commitment at the highest levels?

I am skeptical that in Pakistan we shall soon see the level of commitment to economic development that occurred in the Korean case. The reason is that Korea adopted one overriding objective (export-led economic development); concentrated single-mindedly on it; harnessed the efforts of government, business, and labour to attaining this aim; and subordinated virtually everything else to this goal. The President himself chaired meetings of exporters. Korean ambassadors were called back to Seoul at least once a year for a meeting in which they were required to demonstrate what they had done to further Korea's export drive in the countries of their accreditation. Resources were allocated to, or withheld from, enterprises depending on their export performance. The benefits and the penalties could be very heavy. Ju-yong Chong, the founder of the Hyundai Group, and the presidents of Hyundai Heavy Industries and Daewoo Heavy Industries told me of the benefits[1] that

[1]Such as credit from banks at 4 percent when the curb rate was 30 percent, indemnification by the government if any of the ship building projects went bad, liberal access to foreign exchange, large government contracts for the products of their firms, facilitation of overseas training for their engineers and permission to hire engineers from abroad.

their corporations obtained from the government by furthering its objectives. At the same time, the president of the Kukje Group said to me that his conglomerate had been punished for failing to recognise and pursue what the then government had wanted.[2] The country really pursued one overriding objective, and government and business worked together to attain that end; there was indeed a "Korea Inc" in operation.

Pakistan, on the other hand, has diffused its energies by simultaneously following several different aims: a leader of the Muslim world, a major player in the Asian region, a confronter of India, a controller of events in Afghanistan, an important nuclear power, etc., etc. Each of these aims may be laudable in itself, and is of course the right of any sovereign country. However, each choice carries a cost, and Pakistan does not have the resources to do all these things at the same time. We have to prioritise, and it is not clear where serious economic development appears in the list of priorities; i.e., which of the other goals will be relinquished or downgraded in order to have more development. One should also note that, despite the continuing tension, in more than 50 years there has been only one "shooting war" between North and South Korea; in the same period, Pakistan has been involved in three with India (and an eleven-year support to guerrilla action in Afghanistan).

Moreover, in both Korea and Taiwan, despite these countries' preoccupation with security, the structure of the army and the role that it played *vis-à-vis* the economy differed from what it does in Pakistan. In these countries (one can for the moment ignore Singapore and Hong Kong, the other tigers, because of their small size), the army was largely composed of conscripts; there was only a rather small permanent component. This meant that the numbers that had to be given special perks was quite small, and the rents did not constitute a large burden on the economy even when the countries were effectively under military dictatorship. In Pakistan, on the other hand, the entire armed forces are voluntary and permanent. The amount of rents involved is thus very large.

Furthermore, in the East Asian countries the main source of income growth was industry; earnings from agriculture lagged far behind. Therefore, there was not an all-consuming passion for owning agricultural land. In Pakistan, on the other hand, the desire to own land has reached an almost mystical dimension. This has affected the army at least as much as the rest of the country. As someone has put it, the army is in effect trying to join the feudals. Its enthusiasm for supporting land reform or other changes (such as a progressive agricultural income tax or death duties on agricultural land) that would provide greater equity in the rural areas will naturally be limited.

PIDE could provide very valuable analysis of this problem, namely, why does one think (if one does) that a change in policy direction is more feasible and likely at the present time than it was earlier? How would the changed strategy be brought

[2]Kukje was forced to sell its shoemaking enterprise at throwaway prices.

about? What basic factors have altered? Who would be the "champions" of the new strategy? How would the present "haves" be persuaded to surrender a significant part of their advantages to the "have-nots," so that a more equitable development strategy could be pursued?

(4) Finally, let me make a few minor comments on some of the details in your paper. The second of the five basic propositions on which development economics of the time is said to have rested, was that markets were mistrusted and governments had discovered new tools of planning. Perhaps you should point out that planning was not "one size fits all." The methods of planning adopted by France differed from those in the Netherlands (to take just two examples of mixed economies with serious planning), and were still different from that in Yugoslavia, and very, very different from those in the Soviet Union and other communist countries.

Similarly, the fourth of these propositions also needs to be nuanced. Modern, productive sectors would indeed be financed to a degree by the IFIs, but this financing was not restricted to closed economies. In Asia, one has only to look at Korea, Taiwan, Malaysia, and Thailand starting in the mid 1960s, and China when it joined the World Bank. Don not also forget that Japan was a borrower both from IDA and the World Bank, and did not finish repaying its loans until the 1960s. [France and Finland were also borrowers.] One could no doubt also provide examples from Latin America of sectors in open economies being financed by the IFIs.

The role of foreign aid to Pakistan needs a little more elaboration. Essentially, it was needed because Pakistan's reach exceeded its grasp. The biggest sector of the economy was agriculture, which was dominated by large landowners who paid only a minimal amount of taxes. The rest of the country was almost equally adept at tax evasion, with the result that for virtually its entire history Pakistan had the lowest ratio of tax revenue to GDP of any country at its level of development. We also had a budget of which perhaps 40 percent, in one form or another, was allocated to defense. Once one added the normal administrative expenses of running a country whose population reached 150 million (once combined with East Pakistan and now on its own) and of servicing whatever debt had already been incurred, there was very little left. In the preferences of private decision-makers also, consumption was more important than saving, so that Pakistan's saving ratio for most of its history has seldom exceeded about 10 percent of GDP.[3]

[3]This pathetic performance was not simply because of Pakistan's defense requirements; let us note that Korea faced an even bigger threat from North Korea and China, but from the 1970s consistently generated savings of 35 percent and higher of GDP.

As a simple arithmetical matter, therefore, if Pakistan preferred consumption to saving, but at the same time wanted to take on a country that before 1971 was four times its size and after 1971 eight times, pursue the other goals that I mentioned earlier, and also develop its economy, then its own resources were insufficient and it would have to supplement them with funds from abroad. Matters were made worse because, apart from the fortuitous period of the Korean War, the country's foreign exchange earnings were insufficient to meet its import requirements. In short, foreign assistance was made necessary by the consumption/savings choices of Pakistan's policy-makers, and was required to plug both the domestic resource gap and the foreign exchange gap that were the consequences of these choices.

In conclusion, let me congratulate you on a thought-provoking paper which should indeed form the basis of a serious discussion.