

# Some Reflections on Income Redistributive Intermediation in Pakistan

by

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## INTRODUCTION

Mobilization of domestic saving for economic development may be attempted by alternative methods, namely, through taxation and public revenue surplus, through higher incentives to savers and financial intermediation, and through income redistribution in favour of sectors which are provided high incentives to save and invest. In view of the lack of an active financial sector, fiscal weaknesses and other market imperfections, Pakistan primarily depended on the last strategy to mobilize domestic saving. This paper elucidates the mechanics of this strategy and some of its effects on sectoral resource transfer, aggregate savings, financial intermediation and resource allocation.

### The Mechanics of the Strategy

The building blocks of the policy have been as follows: One, the domestic currency has been kept overvalued and all exporters were required to surrender the foreign exchange to the exchange-control authority at the official rate of exchange. Two, this 'taxation' of traditional exports has been further reinforced in certain cases by additional export duties. In the case of raw jute, the foreign demand for which is said to be inelastic, the burden of this taxation may have been partly on the foreign buyers. Three, import demand, at this overvalued rate of exchange for domestic currency, is by definition in excess of the country's capacity to finance. Import licensing has been adopted to delimit the total volume of imports and to ration the permitted imports among users,

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without levying any import surcharge. Thus, the taxation of the income of the producers of traditional exports showed up as excess profits for the importers and served as a major source of investible fund in the private sector.

The excess demand generated by the restrictive import control on certain commodities, mainly consumer goods, further opened up artificially high profit opportunities for the industrial investors in import-substituting industries. The excess demands were augmented more by the inflationary financing of government investment in social overheads and other public-sector projects. The industrial investors further received 'tax holidays', high depreciation allowances, liberal import licences for industrial inputs at the low price of foreign exchange, and their wage cost was kept low by rationing and price controls of wage goods in urban areas. Thus, even very inefficient producers were assured of high profits and internal finance for reinvestment. The rates of profit received in certain cases were fantastic, reaching over 100 per cent. The initial sources of finance were profits made in import trade, existing reserves of the firms, personal savings of rich traders and landlords and the bank loans provided at low rates of interest by the private commercial banks and public financial intermediaries.

#### **Extracting a Surplus from Agriculture and the Aggregate Savings**

The strategy has been instrumental in affecting a transfer of income from the rural sector to the urban sector. On the one hand the result of overvalued currency, additional export duties on agricultural products and subsidization of food prices in urban areas through imports and compulsory procurement from agricultural sector kept down the prices received by the farmers below world prices. On the other hand, the prices the agricultural sector had to pay for its imports from the nonagricultural sector were much higher than the world price due to the restrictive import quotas and the high cost of domestic industries. Apart from the adverse terms-of-trade loss, resources from the rural sector have also flowed into the urban sector in the form of an export surplus maintained by this sector, as a result of depressed profit opportunities within this sector.

An estimate of this resource transfer made by Griffin puts it as high as 15 per cent of rural income in 1964/65 [4]. What Griffin measures is the difference between the current-price exports from the sector and current-price imports made by this sector at domestic prices. This does not reflect the terms-of-trade loss we are referring to. Even if there is no resource transfer from the agricultural sector according to the measure used by Griffin, there can be a significant transfer due to the terms-of-trade loss. The total resource transfer from agriculture in terms of world prices may be expressed by the following relation:

$$\frac{E}{P_e} - \frac{M}{P_m} = \frac{E - M}{P_e} + \frac{M}{P_m} \left( \frac{P_m}{P_e} - 1 \right)$$

Where  $E$  and  $M$  are the exports and imports of the agricultural sector, respectively, valued at current domestic prices.  $P_e$  and  $P_m$  are the ratios of domestic prices of exports and imports to corresponding indices of world prices. Thus, if  $E = M$ , the first term in the right-hand side will be zero, but still there can be significant resource transfer due to the second term (terms-of-trade loss) if the ratio of  $P_m$  to  $P_e$  exceeds unity.

We do not have any estimate of  $P_m$  and  $P_e$  for Pakistan. Some studies of the terms of trade between agriculture and nonagriculture in Pakistan made so far concentrate on temporal shifts in the domestic terms of trade [6 ; 8]. From these we cannot infer about the terms of trade at world prices. In terms of the diagram (Figure 1) what they measure is the shift of the  $AM$  line (the domestic terms of trade) towards or away from the  $AM'$  line (the terms of trade at world prices) over time. But this does not indicate whether the length of  $MM'$  (the terms-of-trade loss of the agricultural sector in terms of manufactured product) is increasing or decreasing, since  $AM'$  itself may be shifting. Only when  $AM'$  remains fixed or becomes more unfavourable for agriculture, the meaning of a favourable shift of  $AM$  will be unambiguous. The terms-of-trade loss for agriculture in our sense will be negative only when  $AM$  falls to the right of  $AM'$ . The estimates of better terms of trade for agriculture in recent years, shown by Lewis and others, simply mean that  $AM$  has shifted to the right during certain years.

In view of the formidable problem of collecting world and domestic prices of the numerous commodities involved in the sectoral trade, the difficulties of selecting comparable products in domestic and world market and determining the individual weights of each item, we cannot attempt any empirical estimate of the  $P_m$  and  $P_e$  as defined in this section. But it is a common knowledge in Pakistan that agriculture buys its purchases from the nonagricultural sector, on the average, at a price much higher than the world prices and sells its products to the nonagricultural sector, again on the average, at a much lower price. Some evidence of the excess of domestic prices over *c.i.f.* prices of imported goods is provided by Pal and Alamgir [1 ; 15], and the excess cost of domestic industries is shown in the study by Islam and Malik [7]. The actual divergences of the domestic prices paid and received by the agricultural sector from the corresponding world prices must have differed from year to year. For instance, these were much more unfavourable during early fifties than they are at present. Also, it should be remembered that both  $P_m$  and  $P_e$  are ratios of weighted price indices. Though there are instances of prices paid and received by the agricultural sector domestically which are favourable compared to those prevailing internationally, our judgment is that the weights for such items in the total purchases and sales for the agricultural sector are unimportant.

To provide a broad range of the magnitude of total resource transfer from agriculture, we make four alternative assumptions about  $P_m$  and  $P_e$ , and

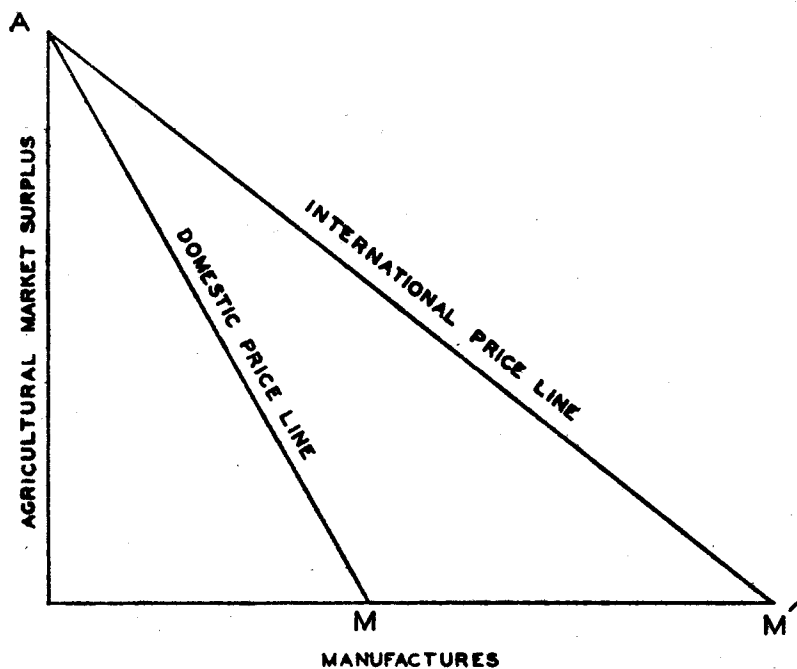


Figure 1. Loss due to the Divergence of Domestic Terms of Trade from the International Terms of Trade

use the Griffin estimates of sectoral sales and purchases. The result is shown in Table I.

TABLE I  
ALTERNATIVE ESTIMATES OF RESOURCE TRANSFER FROM  
THE AGRICULTURAL SECTOR

(in million rupees)

Estimate No.	E — M	P <sub>m</sub>	P <sub>e</sub>	$\frac{P_m}{P_e}$	$\frac{E-M}{P_e}$	$M \left( \frac{P_m}{P_e} - 1 \right)$	Total of cols. (5) and (6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
0	3,662	1	1	1	3,662	0	3,662 (100)
1	„	1.50	0.75	2	4,883	7,175	12,058 (329)
2	„	1.573	0.90	1.75	4,069	5,126	9,195 (251)
3	„	1.425	0.95	1.50	3,858	3,777	7,615 (208)
4	„	1.25	1	1.25	3,662	2,153	5,815 (159)

*Note:* Griffin's estimate will be identical with our estimate, if we assume  $P_m = P_e = 1$ , as is shown in estimate 0. Figures within parentheses show our estimate as per cent of Griffin's estimate.

If we take the second estimate in Table I, then the resource transfer from agriculture on account of the terms-of-trade loss alone will be as high as 67 per cent of agriculture's total value of imports measured at world prices and this estimate blows up Griffin's estimate of resource transfer by 229 per cent<sup>1</sup>. Even the very modest estimate (4) gives the total transfer from agriculture to be 59 per cent higher than Griffin's estimate<sup>2</sup>.

The contribution of this income transfer to saving in the urban sector is dependent on the marginal propensity to save maintained by (or enforced on) the new recipients of income gain in the urban sector. A portion of the income transfer will necessarily go to support higher consumption in the urban sector, unless the marginal propensity to save is 100 per cent in the case of all recipients of income gain. The higher the marginal propensity to consume of this class, the greater will be the leakage. In Pakistan this leakage was high.

The rate of reinvestment maintained by the industrial sector in Pakistan is reported to be high. But the 70 to 80 per cent figures often mentioned are probably gross overestimates, since the profit figures used in the denominator

<sup>1</sup>Griffin estimates  $E = 14,425$  million rupees and  $M = 10,763$  million rupees. His estimate of resource transfer,  $E - M$ , therefore, is 3,662 million rupees. Using the above given relation and assumptions makes the total transfer 12,052 million rupees at world prices.

<sup>2</sup>A recent study gives estimates of implicit exchange rates for agriculture and industry in Pakistan. These suggest estimates of  $P_m/P_e$  close to those assumed in our estimates (2) and (3). See, [9].

are highly underestimated because of the incentive to the industrialists to inflate their costs and conceal their profits. Profits are concealed to evade taxes and costs are inflated to influence the quota allocation of inputs. Besides, many recipients of income gain in the urban sector were not high savers and they lacked the opportunity for productive investment. The real return on financial assets was very low or even negative. Therefore, the potential surplus of these spending units was used up to consume more, to buy ornaments, jewelry and consumer durables and to bid up the prices of real estate and farm lands, helping their owners to disinvest. Often such surplus was devoted to luxury house construction or to open up one more retail store in the already crowded streets and bazaars. A sample survey in Dacca reveals that as much as 42.5 per cent of personal "savings" in the urban sector is in the form of gold, ornaments, consumer durables and housing [5]<sup>3</sup>. Savings released for investment purposes are only a little over half of total savings done by these recipients of income.

It is sometimes suggested that an adverse terms of trade for agriculture is favourable to increasing the marketable surplus from a subsistence agriculture. This is so, according to the proponents of this thesis, because the farmers in these economies have fixed cash requirements or inelastic demand for the goods and services of the nonagricultural sector and are compelled to sell more of their output to meet these demands when their terms of trade with the nonagricultural sector deteriorate [10]. But we believe this argument ceases to hold as the economy develops beyond the very primitive stage and disincentive effects of adverse terms of trade become predominant. An unfavourable terms of trade hinders the commercialization of the agricultural sector and retards investment in agricultural improvements.

Besides, such extraction of agricultural surplus reduces agricultural income and, therefore, savings in agriculture. The net contribution of the income transfer to aggregate savings will be positive only if the saving out of this transfer in the nonagricultural sector exceeds what otherwise would be done in the agricultural sector. If Narain's thesis of fixed demand for nonagricultural goods in the agricultural sector is correct, this implies a high marginal propensity to save out of agricultural income. In that case, a redistribution of income favouring agriculture may be advisable from the growth point of view and an income redistribution against agriculture will lead to a sharp fall in the saving of this sector and aggregate saving in the economy. This can be shown using a simple model.

$$\text{Let, } C_n = a + B_{na} Y_n + B_{nn} Y_n \quad \dots\dots\dots (1)$$

$$C_a = a' + B_{aa} Y_a + B_{an} Y_a \quad \dots\dots\dots (2)$$

<sup>3</sup>This disposal of personal saving in Pakistan may not be out of line with what happens in other countries. But this will then show that this intermediation through income redistribution will have high spill-over effect in any country.

Where, C and Y stand for consumption and income, respectively, and subscripts a and n stand for agricultural sector and nonagricultural sector, respectively.  $B_{na}$ , etc., should be read as follows:  $B_{na}$  is sector n's marginal propensity to consume the product of sector a.

According to Narain's thesis, we can rewrite equation (2) as

$$C_a = a' + B_{aa}Y_a$$

$$\text{since, } B_{an} = 0$$

$$\text{therefore, } \frac{dC}{dY_n} = B_{na} + B_{nn} \text{ and } \frac{dC_a}{dY_a} = B_{aa}$$

It follows that an increase in nonagricultural income by 1 unit will increase consumption by  $B_{na} + B_{nn}$  and a decrease in income of the agricultural sector by the same unit will reduce consumption by  $B_{aa}$ . The total change in consumption as a result of this income redistribution will be  $(B_{na} - B_{aa}) + B_{nn}$ . If we assume  $B_{na} = B_{aa}$  the aggregate consumption will increase, since  $B_{nn}$  is positive. Therefore, aggregate saving must decline. In fact, aggregate saving will decline so long as  $B_{aa}$  is not greater than  $B_{na}$  by an amount  $B_{nn}$ , which is unlikely. It follows that, under this hypothesis, such sectoral redistribution of income cannot increase the aggregate saving by itself. Any contribution to net saving can come only as a result of a further redistribution of the income transfer within the nonagricultural sector. Thus, income redistributive method is not a powerful device to contribute to aggregate savings. Also, there is the socially unpalatable implication that under this strategy the contribution to aggregate saving can be increased only through a very skewed redistribution of income in the economy.

#### **The Divorce of Savings from Rewards**

One aspect of this intermediation through income redistributive method is that the act of real saving is divorced from who gets the reward. While the burden of savings borne by the agricultural sector is heavy, the reward accruing to this sector is very meagre.

For that portion of agricultural savings which is forced through the terms-of-trade loss the agricultural sector of course can earn no return. The recipients of income gain in the nonagricultural sector also receive the return on that part which is saved by them in turn. Agriculture also receives a low return on that part of its savings which is transferred to the nonagricultural sector in the form of its sectoral export surplus both because it is undervalued at domestic prices and because the return on financial assets in the economy is generally kept low partly as a result of intermediation through income redistribution itself.

The nonagricultural sector suffers from an illusion of maintaining a high rate of savings. The real burden of savings borne by this sector is actually the gross savings in this sector less the income transfer from the agricultural sector. If one further takes into account the fact that due to overvaluation of currency foreign saving is undervalued and deducts the windfall gain received by the nonagricultural sector due to this, the real burden of savings on the nonagricultural sector will be certainly negative<sup>4</sup>. Even within the nonagricultural sector, the gains from reward to savings are concentrated in the hand of those groups who can acquire rights to invest in productive capacity catering to the protected market. Other groups, employees, urban rentiers, professionals, traders, *etc.*, who come to gain in the income transfer and have surplus funds but do not have opportunity to invest directly, receive scanty reward on their financial assets or non-income generating hoards of real assets. This makes it difficult to raise the real rate of return to financial assets in the economy at large even if policy is oriented in this direction, unless general profitability of investment is improved and privileged pockets of profiteering are done away with.

#### **Foreign Direct Investors: Unintended Beneficiaries**

An unintended beneficiary of the rewards of social saving is the foreign direct investors in the modern sector, reaping the protection-created abnormal profits. If the repatriation of profits by them exceeds their contribution to real output and the initial capital inflow, the contribution of such foreign direct investment to domestic savings may as well be negative. This partly explains why the capital-poor underdeveloped countries are wary of direct foreign investment in most cases and why this source of foreign finance is playing such a small role in the case of less developed countries in general.

But restrictions imposed on foreign direct investment are not the correct remedy. It is like throwing away the baby with the bathwater. A less developed country should welcome the inflow of capital from abroad to correct its structural disequilibrium at factor level. Moreover, the real benefit of direct foreign investment is not only that it provides additional investible fund, which can be obtained through portfolio investment as well, but that it establishes a channel of communication for innovations resulting from expenditures on research and development made by such investors in their home country, provides better information about market opportunities abroad, utilizes the services of parent bodies or subsidiaries for distribution of the product and makes available scarce managerial and technical expertise. So the correct remedy is to abandon a policy-mix which creates the possibility of artificial gains through

<sup>4</sup>In Table I, our estimate (1) of income transfer from agriculture, hypothetical as it is, is 12,052 million rupees and the total private domestic savings in 1964/65 was only 3,516 million rupees. Even if we take our estimate (4), the net saving by the nonagricultural sector will be negative. The total private domestic savings has not been done by the nonagricultural sector alone and the public savings in that year was only another 1,092 million rupees.



internal income redistribution and then allow complete freeplay to foreign investors so long they conform to broad policy objectives of the country with respect to income and employment.

#### **Implication for Investment Allocation**

Income redistributive method of intermediation creates problems of the worst sort for optimal investment allocation. The returns to investors in those sectors against which the redistributive mechanism works, namely, agriculture and export sectors, become low even though the real contribution to output in these sectors may be relatively higher. Therefore, investors will not be attracted to these sectors. Investment allocation will be distorted in favour of low productivity sectors. Even within the favoured sectors, investment may not be distributed in relatively high productivity uses. The relative effective protection accorded to various sectors by the vagaries of a welter of corrupt and inefficient administrative controls has hardly any relation to their capacity to contribute to real domestic value added. Moreover, in the absence of financial intermediation, income redistributive intermediation leads to a locking-in effect: investible funds get reinvested where they are generated even though that may not be the best use of such funds. In Pakistan, the Zaibatsu-type growth of industrial organization alleviated this effect to some extent. A few families commanded control of many lines of economic activities, thus allowing intrafamily intermediation of investment funds in some cases.

#### **Effects of Licensing Restrictions on Rates of Return on Financial Assets**

Low rate of interest in a capital-poor economy like Pakistan's is a paradox partly created by the income redistributive intermediation. This hindered an active capital market in two ways. One, this method of mobilizing savings bypasses the financial sector. Investors depend mainly on the internal finance generated by excess profits. Two, scarcity of resources under licensing control, such as obtaining permission to invest for expansion of capacity and issuance of new capital, increasing import quotas, getting tax concessions and other forms of increased protection, is the major constraint on individual profit maximization, not capital as such. So the high returns on investment are considered to be in the nature of rents to superior entrepreneurial ability in securing official favours.

Other influences tending to keep down the returns on financial assets are the desire of the government to keep low its cost of borrowing in financing its deficits and the usury laws prompted by a false notion of protecting the small man and supported by a pseudo-religious argument<sup>5</sup>.

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<sup>5</sup>The notion of protecting the small men is false, since in fact they have been denied credit as a result. The religious argument is untenable, because the Islamic position on the issue is that all payment of contractually fixed charges on borrowed fund is sinful. Payment of a lower interest does not make it any less so.

It is true that given unsatisfied demand, attempts are made to circumvent the barriers. It has been witnessed that an unorganized money market usually develops to cater to the sectors bypassed by the organized money market. However, this is not true in the case of Pakistan. Two important characteristics of the Pakistani financial system are that a curb market is virtually non-existent and insofar as it exists, it is not linked with the organized sector. It is worthwhile to try to explain why it has been so.

Traditionally, Muslims of most of the region comprising Pakistan would look down upon any Muslim who would charge interest on money lent. Only a stranger or a very important person or one unconcerned about local social approval would practise the trade of money-lenders. Therefore, the business of money lending in the unorganized market was mainly in the hand of the non-Muslim community. Many of these people migrated out of Pakistan and others reduced or discontinued their business as they felt the insecurity of lending to the majority community by a member of the minority community, in an environment of communal tension, was too great. With the withering away of this important segment of the traditional money market, the remaining segment is only vestigial. The important sources of credit at present to people without any access to the organized money market are friends and relatives, rural landlords, shopkeepers and the dealers. There is no reliable estimate of the total volume of credit available from these sources. The interest charged is usually high though often covert in nature.

The second characteristic noted is the absence of any link with the organized market. The expectation that in the absence of credit facilities provided by the organized market, some institutions and individuals will try to borrow from the organized sector and operate in the curb market is not generally fulfilled in Pakistan. We feel our hypothesis that the controls on profitability exercised by the direct controls on trade in Pakistan make the marginal efficiency of investment in the traditional sector low goes to explain this phenomenon. As a result of the low profitability of investment, there is no excess *effective demand* for credit in the traditional market at a price high enough to cover the cost and risk of such intermediation between the traditional sector and the organized market for loanable fund.

#### **Savings Propensities**

On the experience of the developed countries, it is debatable whether savings propensities depend on rate of returns on financial assets. It may be that in a situation where spending units have diverse forms of financial assets already available to them in terms of which to hold their savings and the rate of return on these assets are already high, the savings decisions of the spending units are more influenced by expectations about future income and their future target of spending. Savings may be inelastic to changes in rates of interest paid

in this situation. But this experience is irrelevant to Pakistan. In Pakistan savers may be deterred from saving sheerly due to the nonavailability of safe and profitable ways to keep their savings. The nominal rate of interest paid to the depositors is extremely low. To quote from the Third Five-Year Plan, "The average weighted deposit rate is at present 1.3 per cent per annum which, after an allowance is made for price increase at the rate of 2 to 3 per cent per annum, leaves the depositor with a negative net return" [13, p.123]. In recent years there has been some improvement in the nominal rates of interest on scheduled bank deposits. Table II shows that the weighted average of nominal rates on deposits went up to 2.65 per cent in 1967/68. But this improvement is illusory. If we consider the real rates of return, adjusting for the higher rates of inflation, there has been in fact a deterioration in recent years. The last column of the table shows that the average real rates of return on deposits for the four years 1964/65 to 1967/68 was — 3.11 per cent while the same for the four years 1960/61 to 1963/64 was — 0.05 per cent.

**TABLE II**  
**RATES OF RETURN ON BANK DEPOSITS, 1960-68**

Year	Percentage change in price level	Rates of interest on deposits	
		Nominal in %	Real in %
	(1)	(2)	(3)
1960/61	5.10	1.15	— 3.95
1961/62	— 0.95	1.14	2.09
1962/63	2.31	1.33	— .98
1963/64	— 1.31	1.35	2.66
1964/65	5.52	1.45	— 4.07
1965/66	4.24	2.02	— 2.22
1966/67	11.59	2.34	— 9.25
1967/68	— 0.47	2.65	3.12

*Notes:* Col. (1) refers to change in the GNP deflator implicit in the constant price GNP estimates of the Central Statistical Office of Pakistan.

Col. (2) refers to weighted average of rates on deposits by the scheduled banks in Pakistan.

Col. (3) equals Col. (2) minus Col. (1).

Another instance of low rates of return on financial assets is the dividends received by the shareholders in corporate sector. Table III shows that dividends paid were only about 5 per cent of the net worth of the corporate sector.

**TABLE III**  
**DIVIDENDS PAID AND THE NET WORTH OF THE CORPORATE**  
**SECTOR, 1959-63**

(in million rupees)

Year	Net worth	Dividend	Col. (2) as % of Col. (1)
	(1)	(2)	(3)
1959	982	56	5.7
1960	1202	71	5.9
1961	1463	75	5.1
1962	1774	84	4.7
1963	2053	93	4.5

Source: [2, pp. 28-36]

In this situation, not saving is the surest way to avoid income losses. Financial intermediaries could not emerge on the basis of a positive margin after providing a fair return to the depositors and diverse forms of assets to suit the needs of various classes of savers. Hence, it is highly plausible that saving propensities of spending units in the economy are being depressed at present. Even the savings that take place are channelled to acquisition of less productive forms of real assets to avoid the loss due to inflation. The amount released for real investment tends to be lowered even more.

#### Capital Flight Out: Direct Foreign Investment in

The low rates of return on domestic financial assets make the holding of foreign assets attractive to the domestic surplus units. This creates the threat of capital flight from the economy. On the other hand, the creation of artificial profit opportunities in highly protected sectors invites foreign direct investment to reap these profits which are really in the nature of income transfers from domestic traditional sector. Thus, one witnesses the paradox of fighting the threat of capital outflow and inflow at the same time, both of which result in leakage from domestic savings. This requires the use of detailed supervision of all external transactions on both capital account and current account through import licensing and exchange controls. But direct controls on foreign trade are not that fool proof in preventing capital flight when the incentive for such

movements exists. Under a martial law regulation in 1959, a sum of 82 million rupees of foreign-exchange holdings of Pakistani nationals was declared which must have been only a fraction of the actual amounts involved, since only the most panicky ones or those most likely to be caught cared to declare their illegal holdings. Also, there has been considerable flight of capital owned by the Hindus, despite the presence of detailed restriction. According to an estimate, this was as high as 400 million rupees per annum from East Pakistan alone up to 1954 [16].

#### **The Payments System and Monetary Mechanism — Captive Banks**

In this situation, domestic financial intermediaries, owned by the privileged industrial patriarchs, remain content with advancing loans to businesses under the same control or to other "safe" clients, at low rates of interest. Small entrepreneurs with less access to official favours or those operating in sectors against which the income redistributive mechanism works are not found credit worthy. Credit needs of the economy at large get denied. The supply of loanable fund from the banks gets extremely concentrated in a few hands.

Some evidence of the concentration of bank credit is contained in the *Credit Inquiry Commission Report* of 1959. According to the Report, 63 per cent of the total bank credit outstanding went to 222 accounts of sizes 1 million rupees or more. Our calculations for 1967 show that so far as absolute numbers are concerned, there has been some deconcentration. Loan accounts of sizes 1 million rupees or more numbered 1021 and received 49 per cent of the total credit outstanding. This is partly the result of growing importance of public financial intermediaries. Partly this may have been a sheer window-dressing in the sense of the same business group or family operating greater number of accounts. Moreover, if we correct for the growth in the size of the economy and consider relative degree of concentration in the two periods, the concentration seems to have increased. Figure 2 gives the Lorenz distribution of percentage of loan received against percentage of loan accounts for the two years, 1959 and 1967<sup>6</sup>. The curve for 1967 is below that for 1959 till the percentage share of loans received reaches 64.

Thus, the financial intermediaries simply served as a sort of outpost of internal finance for their privileged clients out of the deposits that would be forthcoming despite the unfavourable returns and that could be created by the banking system.

#### **Interaction with Income Distribution Effect**

Income redistributive intermediation, we suggested, keeps down the rates of return on financial assets by making the investors independent of external

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<sup>6</sup>The data on distribution of scheduled-bank advances by size of accounts are obtained from [14].

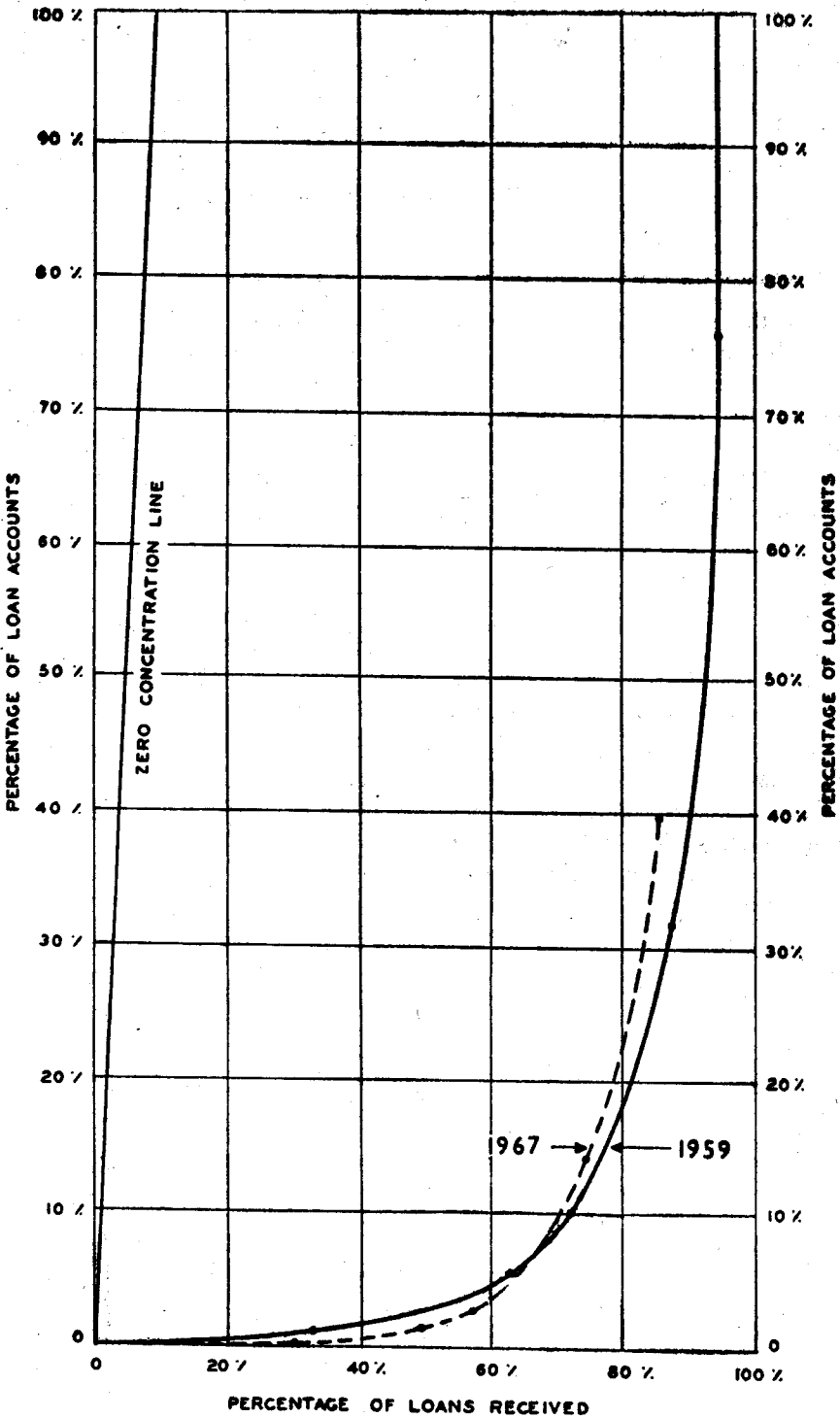


Figure 2. Lorenz Distribution of Banks' Advances and Number of Accounts

finance. The relationship also works the other way. The maintenance of low rates of interest (which were even negative) also serves to distribute income in favour of the debtors and against the creditors. This in turn makes the investors (who are net debtors) less dependent on external finance.

### CONCLUSION

We may briefly conclude this short note. Economic policy pursued in Pakistan involved huge redistribution of income between rural and urban sectors. The contribution of this income transfer to real saving is far short of the burden of saving imposed on the rural sector. This method of intermediation is basically weak because of the high spill-over effect, because of the divorce of the act of saving from its rewards and because of the adverse repercussions on growth of financial intermediaries and allocation of resources.

Only extreme fiscal and market imperfections in Pakistan made the use of this method of resource mobilization justifiable at the initial stage of development. But with the growth of market institutions and the progress in the fiscal fronts, a more optimal strategy of mobilizing resources for development through the financial sector and the fiscal arm of the government is warranted as well as feasible. The proper milieu for such a new strategy can be provided only by completely abandoning the direct controls on foreign trade, removing the disequilibrium in the foreign trade and financial sectors of the economy, and rationalizing the tariff and tax structure to provide optimum pattern of protection to real domestic value added<sup>7</sup>.

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<sup>7</sup>The main features of this alternative policy-mix are elaborated in [3, Section VIII].

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