BY ROBERT LOONEY

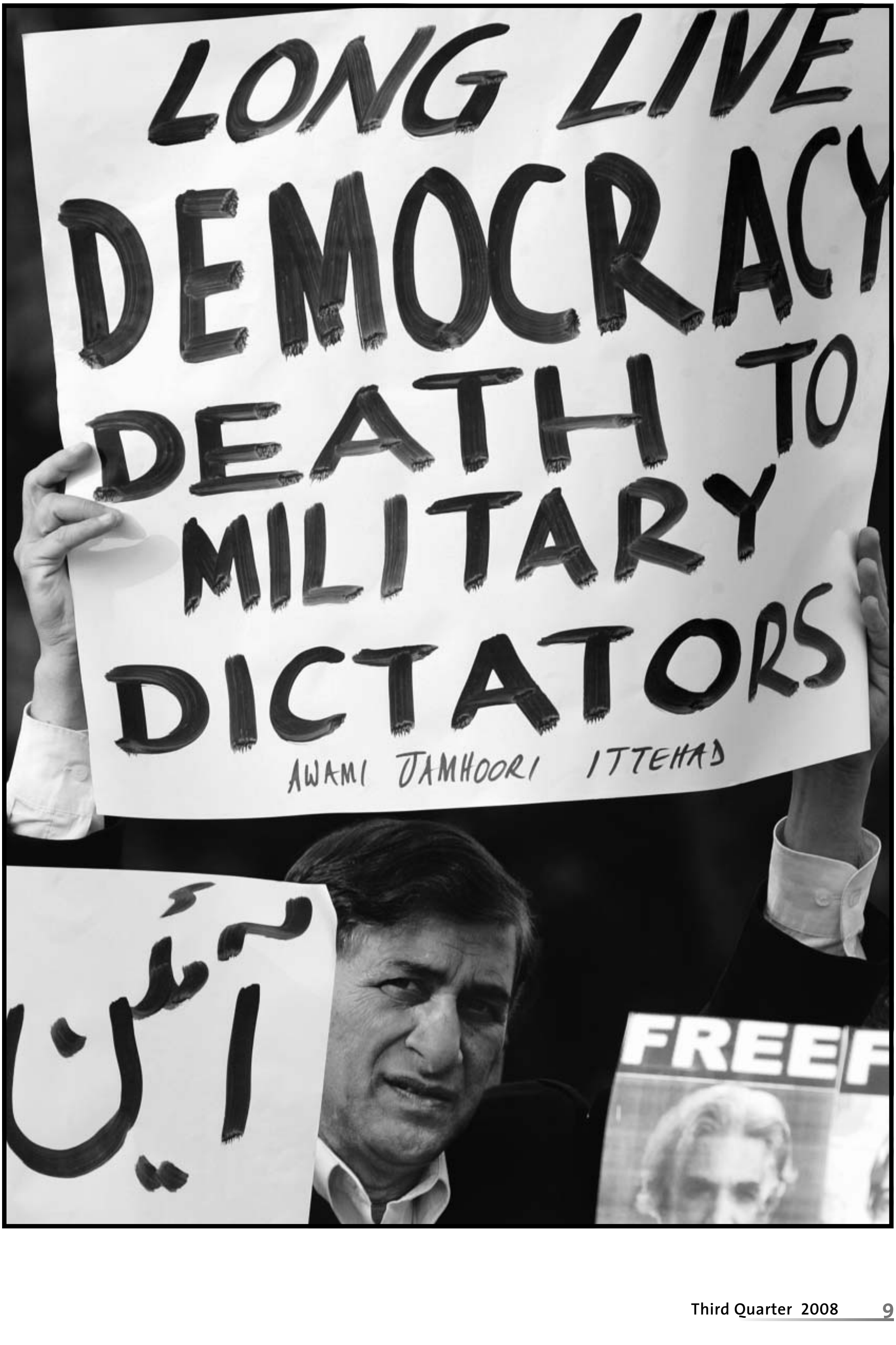
**The overwhelming** defeat of President Pervez Musharraf's party in parliamentary elections earlier this year was no surprise, inside Pakistan or out. But explanations for his thumping at the polls vary, and how one interprets the return to democracy matters a lot in predicting how this politically unstable, ethnically divided, nuclear-armed country will react to continuing stresses.

To outside observers, Musharraf's fall from electoral grace was apparently triggered by his (second) unconstitutional grab for power – the declaration of martial law, the sacking of the country's top judges, the failure to protect Benazir Bhutto from assassination – along with his increasingly unpopular alliance with the United States in seeking to drive ethnic Pashtun Islamic fundamentalists from their refuges along the border with Afghanistan. But while no one disputes that these events all mattered, analysts close to the ground argue that the proximate cause of Musharraf's humbling was his inability to contain food and fuel inflation – and, more generally, his failure to improve the living standards of the great majority of Pakistanis who have yet to share in the bounty from Asia's economic awakening.

The reason, I suspect, that foreigners have largely overlooked the influence of economic factors in the president's defeat is that Pakistan has paradoxically experienced one of the best economic growth records in the region over the past eight years – a sharp contrast to decades of doldrums under his predecessors, Benazir Bhutto and Nawaz Sharif. They ran up huge foreign debts, frittered away public resources on a bloated military establishment, and aided the country's tiny economic elite in corrupting public life. Both unemployment and poverty rose in the 1990s, undermining the efforts of Pakistan's middle class to modernize the economy and fueling religious extremism in the countryside.

After General Musharraf seized power in a coup in October 1999, he nominally committed his government to reforms intended to address stagnation. And by gross measures, they seem to have worked: the economy has grown by almost 50 percent since his ascension to power, with income per capita rising by nearly 25 percent.

What's more, under Musharraf, foreign direct investment quadrupled and (measured) unemployment declined from 8.3 percent in 2001-2 to 6.2 percent in 2005-6. Inflation, which had been running in double digits through most of the 1990s, averaged just 5.6 percent. Even the war in Afghanistan in 2001, the discovery that Pakistani scientists had been selling nuclear weapons technology to the highest bidders, and a devastating 2005 earthquake failed to derail what until recently

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appeared to many to be the beginning of a sustained period of East-Asian-style growth. What, then, has recently gone so badly wrong?

### POTEMKIN REFORMS

Soon after taking power, the new government initiated a macroeconomic stabilization program as well as a series of institutional reforms aimed at the constraints that weighed heavily on the economy. The strategy had four sensible goals:

**1. Improving fiscal and monetary discipline**, as well as restoring working relationships with key foreign lenders, including the International Monetary Fund, the World Bank and the Asian Development Bank.

**2. Attacking market-distorting regulation** that enriched Pakistan's parasitic crony capitalist class.

**3. Improving governance** in a country burdened with a huge and incompetent bureaucracy, a culture of corruption and a rapacious economic elite.

**4. Reducing poverty**, especially poverty in the countryside, where landless workers all too often must survive on the equivalent of a few dollars a day.

Musharraf's first economic priority (apart from tilting the government patronage machine toward his allies) was to attract private foreign investment, both to supplement inadequate domestic savings and to modernize industry. Once growth was jump-started, the reasoning went, resources would become available to contain terrorism and to satiate the military's appetite for good living and high-tech weaponry. Even more important, the surplus generated by rapid growth could be spent on reducing poverty and building critically needed infrastructure, thus diminishing the attractions of extremism to Pakistanis at the bottom of the pecking order.

All told, Musharraf's supporters argued that this process would lead to a virtuous circle in which a decline in extremism and poverty would lead to even greater inflows of capital. The economic reform agenda and the government's commitment to containing extremism were thus sold to foreign donors and to anxious Pakistanis as complements.

Evaluating the country's economic performance during the Musharraf years is difficult because the analysts closest to the ground are often bitterly partisan. But one approach is to use the World Bank's more objective, quantitative approach to measuring progress in institutional reform. To achieve sustainable growth, the World Bank says that governance must be adequate by six key measures: (1) voice and accountability, (2) political stability, (3) government effectiveness, (4) regulatory quality, (5) rule of law, and (6) control of corruption.

Although Musharraf was able to realize gains in government effectiveness and regulatory quality, much of this progress was neutralized by increased corruption. In addition, Pakistan under Musharraf experienced a major decline in voice and accountability, falling from the 27th percentile among nations in 1998 by World Bank measure to the 13th in 2006. Political stability, which started in the bottom 10 percent worldwide, declined to a truly wretched bottom 5 percent in 2006.

A similarly inconsistent pattern is seen in measures of economic freedom. Major gains were made in the ability to start, operate and close businesses. And while the corporate tax rate remained high, tax revenue and government spending were low relative to GDP. Trade liberalization progressed in fits and starts, but tariff- and non-tariff barriers to

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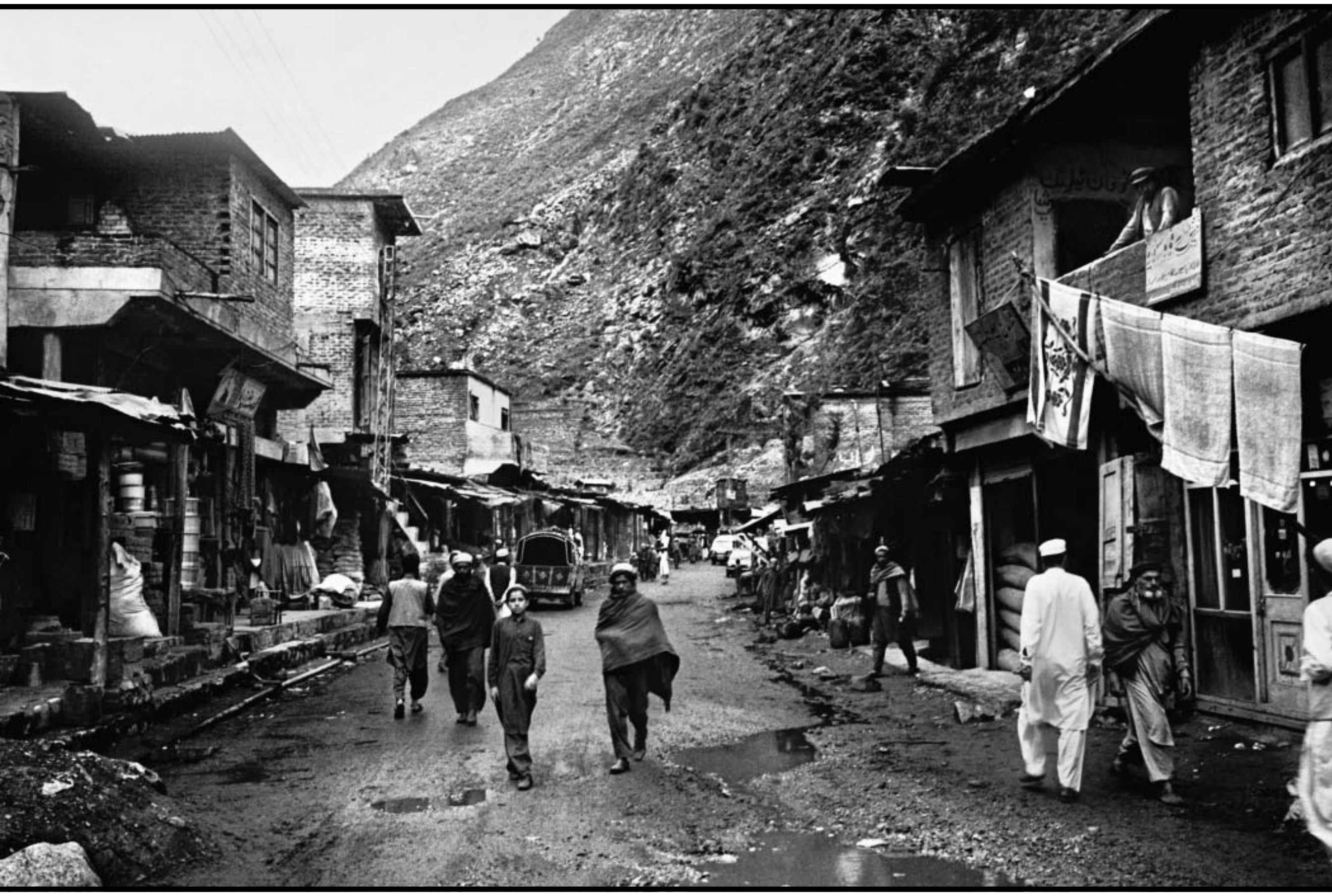

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imports, inconsistent administration of product standards, non-transparent government procurement, highly selective export subsidies, weak enforcement of intellectual property rights and rampant corruption added considerably to the cost of trade. The net effect, alas, undermined the government's efforts to integrate the country into the world economy: Pakistan (by the World Bank's reckoning) declined from the 50th most globalized country in 2003 to 63rd in 2007.

Pakistan fared no better on the Milken Institute's Capital Access Index. Over all, the economy slipped from 65th place worldwide in 2003 to 72nd in 2007, among 122 economies. Pakistan's rankings for separate components of the index only accent the decline. While the macroeconomic environment ranking improved marginally (from 112th in 2005 to 104th by 2007), it plummeted in equity market development (15th to 40th) and bond market development (52nd to 63rd).

Pakistan did attract more foreign investment, but most of the funds went to build capacity to meet domestic demand rather than going into export-oriented businesses. The Musharraf regime also failed to address the supply bottlenecks that inevitably result from a growth spurt. In particular, the government had no plan for meeting increased demand for electricity and gas – or the will to parse limited capacity in a rational way. By 2006-7, the situation had developed into a full-blown crisis, as power shortages led many companies to reduce working hours.

**Among other, nearly intractable problems, the country's powerful armed forces is wed to the status quo – and in the past, has not hesitated to push back hard when challenged by civilians.**

More broadly, the World Bank concluded that Pakistan suffered from a dearth of water, irrigation, power and transportation infrastructure. Indeed, the bank presciently warned that the gaps could lead to increased social discontent, as well as conflict between the central government and the provinces.

The Musharraf government failed to undertake the major reforms in the tax system. As a result, the tax base remains narrow and the impact of taxation is deeply regressive. Just 2 percent of the population pays direct (income-determined) taxes, with most of the revenue that is generated coming from the middle class. All told, about 70 percent of Pakistan's revenues are from regressive sales and transaction taxes. And the rapacious land-owning class escapes almost scot-free: agriculture represents 23 percent of GDP, but carries just 1 percent of the tax burden. Manufacturing, the sector that must grow rapidly if Pakistan is to prosper, contributes 18 percent of GDP but generates 62 percent of taxes. Adding salt to the wound, the poor benefited only modestly from the economic expansion because most of the growth in GDP came from sectors – largely skilled services – that provided few jobs for lower income groups.

Another area in which Musharraf has failed to make progress is in containment of the economic power of the military. Over the years, Pakistan's army has expanded its sprawling property holdings with the goal of ensuring that it retains both organizational autonomy and the income with which to butter the bread of the officer class. For example, the armed forces control some 11.6 million acres of land, much of it leased at trivial rent to favored personnel. Estimates of total wealth of this (literal) military-industrial complex range as high as $100 billion.

Finally, the country is once again facing the risk of running chronic current account deficits. During the Musharraf years, efforts to increase private investment achieved some success, with the rate increasing from 14 percent of GDP in 2001-2 to 18 percent in 2006-7. During this period, however, national savings declined from 19 percent of GDP to 18 percent, implying that the economy has become became increasingly dependent on foreign capital. This is likely to become a major problem, as foreign investors respond warily to the country's political instability and imports of $130-a-barrel oil consume an ever-increasing portion of foreign exchange earnings.

The signal advantage of Musharraf's economic policies was their pro-business tilt, which gave companies a bit more room to operate. Yet, while this policy unleashed considerable entrepreneurial activity in the cities, it was not supported by a lightening of the burden of economic regulation, improvements in financial regulation, or a dedication to the rule of law – all of which are necessary to transform a spasm of growth into sustained development.

Seen in this light, the best explanation for Musharraf's early economic successes comes down to good luck and transient factors – a combination of a windfall in American aid designed to keep Pakistan in line on Afghanistan, good weather for agriculture, and a flood of remittances from Pakistanis working in the booming Gulf countries. Pakistan's subsequent bad luck – disappointments in agricultural productivity, increased global competition in textile exports, and global commodity price inflation – has seemingly returned the economy to stagnation-as-usual.

## WHAT NEXT?

In most countries, the slowing of growth does not cause political convulsions. But in Pakistan, growth did little to bind the body politic because the institutions of the *ancien regime* never really changed and the fruits of growth were so inequitably distributed. While no rigorous studies of income distribution are available for the last several years, a former Pakistani finance minister, Shahid Javed Burki, estimates that around 10 million Pakistanis – out of a population of about 160 million – benefited from the economic growth and the modest successes at restructuring under Musharraf. Furthermore, he noted, growth has been geographically concentrated in the industrialized belt of central and northern Punjab and in the large cities, increasing ethnic tensions and leaving much of the country to stew in poverty and Islamic fundamentalism.

Hilton Root of George Mason University argues that Pakistan is most unstable toward the end of failed cyclical efforts to bring the economy out of stagnation. In 1970, such failure under General Ayub Khan led to the civil war between East Pakistan, home to the country's economic elite, and West Pakistan, home to ethnic Bengalis. Similar, but less dramatic, changes took place in the late 1980s with the violent end to the corrupt, authoritarian rule of General Zia-ul-Haq. Fortunately, this time around, the bloodshed was relatively modest.

There's no compelling reason to believe, then, that the rejection of President Musharraf's party and its replacement with a democratically elected civilian government means Pakistan is about to embark on the sorts of governance reform and institution building that it never managed before. Among other, nearly intractable problems, the country's powerful armed forces is wed to the status quo – and in the past, has not hesitated to push back hard when challenged by civilians. Pakistan, in short, is a failed state. And failed states rarely have happy endings.

### PAKISTAN AT A GLANCE

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| GDP per capita (purchasing power, 2007) | $2,600 |
| GDP per capita (at exchange rate, 2007) | $770 |
| Inflation rate July '07–Feb '08 | 8.9% |
| Life expectancy at birth | 65 years |
| Average children per female | 3.7 |
| Infant mortality (under age 1) | 6.8% |
| Population under 15 | 37% |
| Male literacy (age 15–24) | 77% |
| Female literacy (age 15–24) | 51% |
| Male primary school attendance | 62% |
| Female primary school attendance | 51% |
| Population with clean water | 91% |

**SOURCES:** Unicef; CIA World Factbook; Government of Pakistan