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FAILED ECONOMIC TAKE-OFFS AND TERRORISM IN PAKISTAN

Conceptualizing a Proper Role for U.S. Assistance

===== Robert Looney
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Abstract

What are the causes of terrorism? Of the various theories put forth, the analysis below suggests that failed economic take-offs, in addition to the usual factors suggested, are an important element. This finding has a number of implications for Pakistan's economic reform programs. In addition, foreign aid programs to the country will have to be modified if their effectiveness in reducing the attractiveness of terrorism is to be increased.

Introduction

During the 1990s, Pakistan's economy suffered on two accounts. First, civilian ruling elites lacked a vision to make efficient use of public financial resources to boost economic growth, contain poverty, and develop human resources. Second, their governments (led, respectively, by Benazir Bhutto and Nawaz Sharif) were unable to check unbridled corruption and cronyism. This failure resulted in the political use of public resources, the bending of rules and regulations to benefit a select few, and the erosion of institutional accountability. Four key economic breakdowns evolved out of this environment: (1) high fiscal deficits, (2) unsustainable public debt (domestic

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and foreign), (3) a sharp deterioration in the distribution of income, and (4) a disturbing rise in the level of unemployment¹ and poverty.²

Under the Musharraf administration, led by General Pervez Musharraf, considerable progress was made in correcting 1 and 2 above, but possibly at the expense of a sizable increase in the number of people living below the poverty line. In part, economic performance under Musharraf stems from the emphasis placed, over the past three years, on macroeconomic stabilization as a key to fighting poverty. This strategy hinges on the premise that stability will result in higher rates of investment, eventually restoring the growth rates of over 6% per annum³ achieved during the 1960s and through most of the 1980s. In turn, high growth will pull large segments of the population over the poverty line. The hope is that, in the near future, sustained growth rates of over 6% will again be the norm.

Is this a realistic goal for the Pakistani economy? Historically, Pakistan grew faster than the South Asian average by an average of 2% in the 1960s and 1970s and at similar rates through the 1980s.⁴ Since 1993, Pakistan's growth has been below the regional average. In contrast, after starting slowly, growth in South Asia as a whole has been steadily accelerating for four decades. In short, with the exception of a spurt in the 1980s, growth trends in Pakistan have been steadily slowing since the 1960s from very high initial levels. Toward the late 1960s, many observers thought the country had taken off⁵ in the Rostow⁶ (1960) sense—industrialization was proceeding rapidly and the agricultural sector was experiencing a revolution in productivity gains. To a lesser extent, the 1980s also represents a failed take-off.

In the short run, continuing with the International Monetary Fund's (IMF) macro-stabilization program is probably the best thing the country can do to restore investor confidence. In this regard, at present there are the beginnings of some encouraging signs of increased investor confidence in the country.⁷

1. Unemployment more than doubled during the 1990s. See Edward Gardner, "Wanted More Jobs," *Finance and Development*, 40:1 (March 2003), <<http://www.imf.org/external/pubs/ft/fandd/2003/03/gard.htm>>.

2. Detailed in *Poverty in Pakistan: Vulnerabilities, Social Gaps, and Rural Dynamics* (Washington, D.C.: World Bank, October 28, 2002).

3. Nadeem Malik, "Shaukat Sets 6% GDP Growth Target," *News International* (January 14, 2003), <<http://www.jang.com.pk/thenews/jan2003-daily/14-01-2003/main/main16.htm>>.

4. Cf. Robert E. Looney, *The Pakistani Economy: Economic Growth and Structural Reform* (Westport, Conn.: Praeger Publishers, 1997), ch. 3.

5. Shahid Javed Burki, "Finance Sector's Key Role," *Dawn* (January 21, 2003), <<http://www.dawn.com/2003/01/21/op.htm#2>>.

6. Walt W. Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto* (London: Cambridge University Press, 1960).

7. "FDI Records 164 Percent Rise in First Half," *News International* (January 19, 2003), <<http://www.jang.com.pk/thenews/jan2003-daily/19-01-2003/business/b3.htm>>.

However, in the longer term, the country must address its domestic terrorism problem if it is to draw high, sustainable amounts of foreign investment.

Given this background, the sections below address the following questions: What factors appear to limit rapid, sustained growth in Pakistan? Have these changed significantly over time? Is the increase in domestic terrorism and widespread sympathy for terrorist groups⁸ related to past patterns of economic growth and development? If so, is it possible for the United States and other donor nations to construct an aid strategy for Pakistan capable of simultaneously attacking the country's two greatest contemporary problems, increasing terrorism and an underperforming economy?

Factors Underlying Pakistan's Patterns of Failed Take-offs and Decline

The main factors underlying Pakistan's growth are increased supplies of labor and capital along with overall efficiency, or total factor productivity (TFP). Changes in TFP represent increased efficiency brought about by market-oriented economic reforms, more competition, increased globalization, innovation, and technology transfer owing to increased foreign direct investment. Conversely, declines in TFP can come about because of such factors as erosion in governance, increased protectionism, a slowdown in globalization, and corruption. As a standard for comparison, about half of the growth in the industrial democracies stems from TFP. Economies isolated from the global economy, such as the former Soviet Union and the Latin American economies at the height of their import substitution policies in the 1960s, derived no growth from TFP.

The IMF's recent study of total factor productivity in Pakistan paints a telling picture.⁹ The IMF found that for 1961–2001 as a whole, Pakistan experienced only moderate TFP growth (0.5% annually). This finding suggests that most of the country's growth can be accounted for by increased amounts of labor and capital, with efficiency gains playing a relatively minor role. An interesting pattern emerges when looking at sub-periods. In the 1960s, Pakistan's TFP experienced negative growth (on average, -2.2%). Beginning in the 1970s, TFP growth became positive, peaking in the 1980s (2.4%), only to become negative again in the second half of the 1990s, when it declined to -0.4% per annum.

The 1960s

The IMF attributes Pakistan's strong growth performance of 6.6% per annum in the 1960s to rapid increases in investment, both physical and human. Many

8. Farhan Bokhari, "Islam Flexes Muscles in North West Frontier," *Financial Times* (January 2, 2003).

9. *Pakistan: Selected Issues and Statistical Appendix* (Washington, D.C.: International Monetary Fund, November 2002), ch. II.

observers point to the 1960s as the period of the country's greatest economic success, resulting in a Rostow-type take-off for the economy. However, there were forces at work that eventually constrained and decelerated growth.¹⁰ In addition to low rates of domestic savings that forced an eventual decline in investment, the rapid growth of the 1960s was not broad-based. More tellingly, it generated a great deal of economic tension: Regional and class inequalities increased, while large segments of the population experienced falling standards of living. The concentration of incomes was particularly disturbing. Twenty-two families owned 66% of industry, 97% of the insurance sector, and 80% of banking. Only 0.1% of landlords owned 500 acres or more, yet they owned 15% of Pakistan's total land.

It is likely that a number of other factors contributed to the termination of rapid growth in the 1960s. In particular, the high share of the country's resources allocated to defense is often cited as creating a drag on economic growth, ultimately stalling this first potential take-off.¹¹ Empirical research sheds some light on this issue. Since independence, defense expenditures have had periods of both negative and positive impact on the country's overall rate of economic growth. The periods of negative impact occurred mainly from 1958–73 and, no doubt, stemmed from short-run accelerations in expenditures to counter Indian defense build-ups, especially during the two India-Pakistan wars (1965 and 1971).¹² These spurts in increased allocations to the military most likely diverted critical resources from the civilian sector, thus reducing the overall rate of growth. At least in a statistical sense, these patterns have not been present on a significant scale since the 1971 war.

Over the longer term, defense expenditures no doubt place a damper on the economy, making take-offs harder to initiate and sustain through the cooptation of resources that would ordinarily be available for growth-enhancing investments. For instance, the literature has identified a link between defense expenditures and fiscal stress.¹³ Specifically, defense expenditures in Pakistan have strongly impacted the country's external indebtedness.¹⁴ This effect has

10. Robert Looney, "Pakistan's Economy: Achievements, Progress, Constraints, and Progress," in Hafeez Malik, ed., *Pakistan: Founders' Aspirations and Today's Realities* (Oxford: Oxford University Press, 2001), p. 235.

11. Cf. Robert Looney, "Excessive Defense Expenditures and Economic Stabilization: The Case of Pakistan," *Journal of Policy Modeling*, 19:4 (August 1997), pp. 381–406.

12. Robert Looney, "Budgetary Dilemmas in Pakistan: Costs and Benefits of Sustained Defense Expenditures," *Asian Survey*, 34:5 (May 1994), pp. 417–29.

13. Robert Looney and Peter C. Frederiksen, "Budgetary Consequences of Defense Expenditures in Pakistan: Short-Run Impacts and Long-Run Adjustments," *Journal of Peace Research*, 31:1 (February 1994), pp. 11–18.

14. Robert Looney, "Pakistan, Defense Expenditures and External Debt: Patterns of Causation and Constraint," *Rivista Internazionale di Scienze Economiche e commerciali*, 42:7–8 (July/August 1995), pp. 619–34.

shifted over time. The country's allotment to the military clearly expanded external debt in 1958–73. But since 1973, this link has weakened and, if anything, the debt accrued in the earlier period is currently acting as a constraining force on the country's allocations to the military. In effect, the debt accrued through defense expenditures has reduced the overall flexibility of government finances, making it even more difficult to sustain high rates of growth.

Finally, to the extent that defense expenditures have led to increased fiscal deficits, educational expenditures have suffered directly—education spending and the country's fiscal deficit are negatively associated. Austerity in educational programs stemming from larger deficits has been concentrated in tertiary education.¹⁵ Over time, the deterioration in Pakistan's system of higher education has no doubt taken a toll on productivity, and hence on sustainable economic growth rates.

The 1970s

The 1970s were a turbulent time in Pakistan's history, as the administration of Zulfikar Ali Bhutto attempted to correct some of the distortions noted above. Perhaps because this was such an uncertain time, there were declines in the growth rates of gross domestic product (GDP) and almost all factor inputs.

Causation is always difficult to sort out in the social sciences—do political crises cause poor economic performance or do floundering economies result in political crises, or are the two interrelated through some sort of feedback mechanism? Whatever the chain of linkages, Shahid Javed Burki notes that a recurring pattern in Pakistani politics is that democracies fail because they are not able to

design a set of institutions that could prevail over the interest of a narrow elite. The first experiment with democracy, from 1947 to 1958, floundered as a result of a conflict between two social groups that sought to dominate the political stage. The first group had worked hard to create Pakistan. Most of the people who belonged to it lived outside the boundaries of the new country; a significant number of them migrated to Pakistan once the country was born; and once there they began to compete with the indigenous economic and social elite for a place on the political stage. . . . Most of the indigenous elite had opposed the creation of Pakistan. The conflict between these two groups delayed the process of giving the country a permanent and durable framework to the point that the economy came to a near collapse and gave the military the opportunity and a reason to intervene.¹⁶

15. Looney and Frederiksen, "Budgetary Consequences of Defense Expenditures in Pakistan," p. 15.

16. Shahid Javed Burki, "Democracy & Development," *Dawn* (July 3, 2001), <<http://www.dawn.com/2001/07/03/op.htm#2>>.

Burki notes that the second experiment with democracy, conducted between 1971 and 1977, saw the landed aristocracy battle with social groups that wanted to be recognized as legitimate political players: "The old establishment led by large landlords showed little respect for the constitutional order and the institutions established under it. This conflict once again brought the economy on [*sic*] its knees and provided an excuse for the military to intervene again."¹⁷ In short, democratic governments in Pakistan have not created the institutions needed to sustain growth, while military governments, though providing temporary stability, are also unable to generate sustained growth owing to a lack of necessary supporting institutions.

The 1980s

Pakistan's economy expanded again in the 1980s, with the average annual GDP growth rate of 6.1% only slightly below that of the 1960s. Total factor productivity rose to an average of 2.5% per annum.¹⁸ The country's initial attempts at market-oriented reforms, including deregulation and privatization, no doubt contributed to increased efficiency. One might imagine that the 1979 cutoff of economic and military aid to Pakistan by the United States because of concerns over Pakistan's nuclear program might have suppressed growth during this period. But the sanctions against Pakistan were more than offset by much larger aid flows following the Soviet invasion of Afghanistan in 1970.¹⁹

Despite rapid growth, the economy showed an increasing number of structural weaknesses toward the end of the 1980s. These included (1) heavy regulation of economic activity through price controls, industrial licensing, and government ownership; (2) a trade regime with a high level of distortion-creating protections, inhibiting competitiveness and export growth; (3) a weak public-resource position owing to a narrow and inelastic revenue base, high consumption expenditure, and inadequate development expenditure, resulting in excessive budget deficits; (4) an inefficient financial sector with mostly public ownership, directed credit, and weak commercial banks; and (5) a high and growing debt-service burden resulting from the country's heavy reliance on external borrowing to finance its economic growth.²⁰

17. Ibid.

18. *Pakistan: Selected Issues and Statistical Appendix*, p. 11.

19. *Case Studies in Sanctions and Terrorism: Case 79-2 US v. Pakistan, Nuclear Missile Proliferation* (Washington, D.C.: Institute for International Economics, 1998), <<http://www.iie.com/research/topics/sanctions/pakistan3.htm>>.

20. Robert Looney, "Pakistan's Economy: Achievements, Progress, Constraints, and Progress," p. 210.

Once the flow of foreign capital and external assistance ceased, it became apparent that the growth rate of the 1980s was not sustainable. As Burki notes, the country could have undertaken serious structural reforms to make economic growth self-sustaining, improve the quality of its human resources through education and training, improve the efficiency of the economy, and build a strong export sector.²¹ “None of this was done. However, the access to billions of dollars of largely unaccountable capital—since a good proportion of it came from intelligence agencies—encouraged corruption on a vast scale. It also encouraged a cavalier attitude towards the management of public sector resources. All the institutions that had been developed in the 1960s to help guide public funds into the most productive sectors of the economy were now ignored.”²²

The 1990s

As a result of these factors, growth decelerated again in the 1990s, with average trend GDP growth of 3.9% per year for the period 1991–2001, but only 3.2% during the 1996–2001 period. The fall in total factor productivity was particularly dramatic, declining to –0.5% per annum from 1996 to 2001. The growth rate of the physical capital stock also decelerated somewhat to an average of 4.4%. Human capital growth decreased to 3% despite the acceleration in labor force growth. The economy was simply not able to sustain the high rates of growth needed to take off and to eradicate poverty.

Compounding the country’s problems during this period, the ongoing sanctions by the United States against Pakistan stemming from the country’s nuclear program were no longer offset by Afghanistan/Cold-War-related foreign aid. The net losses stemming from this factor have been estimated at \$405 million over 1991–98.²³ In addition, the country suffered a sharp drop in worker remittances in the early 1990s, stemming from the Iraqi invasion of Kuwait.

Summing up, it appears that Pakistan had two failed take-offs, one in the 1960s and one in the 1980s. These were periods during which growth and investment and, in the 1980s, total factor productivity, accelerated—only to run into constraints imposed by low savings rates, macroeconomic imbalances, and lack of supporting institutional development and proper governance structures. In particular, the 1980s exposed the economy’s dependence on favorable external circumstances.

21. Shahid Javed Burki, “Pakistan Comes Full Circle,” *Dawn* (October 2, 2001), <<http://www.dawn.com/2001/10/02/op.htm#1>>.

22. *Ibid.*

23. See *Case Studies in Sanctions and Terrorism*.

Key Factors Limiting Economic Take-Off in Pakistan

William Easterly has termed Pakistan's experience as an illustration of "growth without development." Easterly contends that the country's poor social indicators have lowered the productive potential of the economy and its ability to service its high debt.²⁴ His observations, along with the patterns of total factor productivity, suggest possible explanations for Pakistan's failed take-offs together with a fairly respectable overall growth rate of 5.4% over 1961–2001. Namely, a certain degree of development and growth was attainable with a skilled managerial elite and unskilled workers, but over time, this strategy generated diminishing returns, as human capital did not grow at the same rate as the capital stock. Combined with weak governance and limited economic reforms, this caused a slowdown in growth from the late 1980s to the present.

More bluntly, Shahid Husain has attributed the country's inability to sustain high growth to the following factors:

- An increase in the role of the state has coincided with a decline in governance.
- Non-competitive political and economic regimes have resulted in rampant corruption and stagnation—subversion of competitiveness was the central feature of Pakistani governments.
- There has been a continuous redistribution of wealth in favor of privileged groups.
- A hard crust of economic monopoly has stifled new growth and creativity.
- An erosion in the provision of public services has resulted in a decline in the public's trust in government, which is seen as predatory. This, in turn, is linked to non-payment of taxes, corruption in tax administration, and a massive increase in borrowing.
- The quality of the civil bureaucracy is falling rapidly. A majority of civil servants are not even paid a living wage. This is tantamount to an incentive for corruption.
- The irrelevance of the state in the lives of the people is exemplified by the total breakdown of law and order.
- The inability and unwillingness of the state to discharge its social services have meant a vacuum in social services. Pakistan's literacy rate has remained almost unchanged since independence. Hence, the dependence on *madrasahs* (religious schools) is understandable.²⁵

From this, Husain correctly concludes that little economic progress, let alone a take-off, is possible until the government is able to reestablish its presence in the political, social, and economic lives of its citizens.

24. William Easterly, "The Political Economy of Growth Without Development: A Case Study of Pakistan" (Washington: World Bank, June 2001).

25. "Pakistan's Future and U.S. Policy Options" (Washington: Center for Strategic & International Studies, November 27, 2001), p. 2.

These factors can all be grouped into a system characterized by the dominance of diversion over production. As Aqdas Ali Kazmi notes in the following:

This dominance results in the unfettered exploitation of the real producers of goods and services and unchecked accumulation of wealth and resources by the “diverters” in the society. The chief characteristics of the diversion based societies can be identified as the unjust property rights, the outdated judicial and legal framework, powerlessness of the working classes, the ascendancy of feudalistic norms and a highly inefficient and corrupt government machinery.²⁶

Finally, there is empirical evidence that the diversionary economy suffers from low productivity capable of stifling long periods of high growth. Robert Hall and Charles Jones have developed an index of anti-diversionary policy consisting of five main components.²⁷ Two of the categories relate to the government’s role in protecting against private diversion: law and order and bureaucratic quality. Three categories relate to the government’s possible role as a diverter: corruption, risk of expropriation, and government repudiation of contracts. Hall and Jones find that an equal-weighted index is highly correlated with output per worker. Bureaucratic quality, law and order, and corruption remain a problem in Pakistan, with the other two of these five elements presenting lesser challenges.

Attempts at Reform

For its part, the Musharraf administration appears to have had a sound conceptual grasp of the structural impediments to economic growth that have built up over the years. Soon after taking power in October 1999, the new government initiated a comprehensive macroeconomic stabilization program, as well as a series of reforms designed to address many of the economic and institutional constraints limiting the country’s ability to sustain an economic take-off.

The Musharraf Reforms

Specifically, the strategy envisaged four key goals:

1. Macroeconomic stability and the restoration of a working relationship with international financial institutions, mainly, the IMF, the World Bank, and the Asian Development Bank (ADB);
2. Structural reforms to remove distortions in the economy;

26. Aqdas Ali Kazmi, “Production, Distribution or Diversion,” *Dawn* (July 28, 2003), <<http://www.dawn.com/2003/07/28/abr2.htm>>.

27. Robert E. Hall and Charles I. Jones, “Levels of Economic Activity across Countries,” Department of Economics, Stanford University Working Paper, January 7, 1997.

3. Improving governance, especially in the economic sphere, and reviving key national institutions;
4. Poverty alleviation measures.

The main thrust of the Musharraf reforms is to improve not only the country's economy but its governance and key institutions as well. The agenda for improving governance is based on the devolution of power, improved public financial management and accountability, anti-corruption measures, and civil service, judicial, and police reforms.

The implicit interdependent priorities underlying this approach are straightforward: good governance, economic revival based on strong fundamentals, freedom from debt, and social harmony. The overriding philosophy of the Musharraf government is that distortions in the economy are great inhibitors in achieving these objectives and must be removed. The government's economic team and IMF and World Bank staff shared Musharraf's diagnosis of the problems confronting the economy and the prescriptions required to fix them.

The Musharraf reforms need to be seen as a process unfolding over time. The first phase is to restore growth through macroeconomic stability and market reforms focused on increasing total factor productivity and globalization. The second stage is to develop a governance structure capable of sustaining growth over a longer period.

IMF Medicine

IMF involvement in these reforms was not immediate. The relationship between Pakistan and the IMF in the early days of the Musharraf regime was strained. The IMF and its major contributors did not take lightly the dismissal of a democratically elected government and takeover by a military leader. In addition, the new government had to inform the Fund about Pakistan's misreporting of the official deficit data for fiscal year 1998–99. As a result of these factors and the failed programs of the 1990s, the government lacked credibility. The failed programs in the 1990s only compounded the Fund's suspicion that the country was incapable of delivering on its commitments.

Approximately one year after the military coup that had brought President Musharraf to power in Pakistan, the executive board of the IMF approved a standby credit of US\$596 million. The program was to run until the end of September 2001, supporting the government's economic program for 2000–01. The program, completed on schedule, was aimed to move Pakistan onto a high and sustainable growth path by strengthening its balance of payments position, rebuilding official reserves, and reducing public sector indebtedness. To support these objectives, the government strengthened macroeconomic policies and, as noted above, developed a wide-ranging structural reform agenda that emphasizes

revenue mobilization, improving investor confidence, poverty alleviation, and good governance. The IMF credit was subject to the following requirements:

- A reduction in the overall budget deficit in 2000–01 to 5.2% of GDP from 6.4% in 1999–2000, with further consolidation over the medium term. This was to be achieved through increased tax collections, with a widening of the tax base, improved tax administration, and strict expenditure controls. Because there is sufficient uncertainty surrounding the short-term impact of revenue measures on the budgetary position, the authorities should stand ready to take additional measures if revenues fall short of expectations.
- A spending boost of nearly one-third for poverty reduction and decreases in less-productive spending.
- An increase in gross official reserves from \$1.114 billion at the start of the program to \$1.74 billion at the end of June 2001, equivalent to 7.3 weeks of imports of goods and services, to be achieved through a flexible exchange rate policy, monetary tightening, fiscal adjustment, substantial exceptional financing, increased exports, and sharply reduced private sector capital outflows brought about by a restoration of investor confidence.

Adequate expenditure control mechanisms were put in place to help ensure that the defense budget remained within the agreed limit. The IMF terms were quite strict, but after the many failures of the 1990s, Pakistan was in a very poor bargaining position. The country was on the verge of a serious financial collapse, and the new government had assumed power with a commitment to avert such a crisis.

The IMF's Stand-by Agreement (SBA) was fully implemented without any problems. The country's improved standing with the IMF enabled the government to qualify for another IMF program, a three-year Poverty Reduction and Growth Facility (PRGF), which was approved in 2001 and is well underway.

As noted above, the Musharraf administration's economic strategy from the beginning has been relatively straightforward: First stabilize the economy and then restructure. It was assumed that growth would return with stabilization. There are several implicit assumptions here: (1) Pakistan's tricky economic situation could not be addressed unless the donor community helped reduce the country's burden of debt; (2) to get donors to help Pakistan, the country had to first successfully complete an IMF stabilization program; and (3) once the burden of debt had lightened, Pakistan would have the resources needed to jump-start the economy.

This strategy was predicated on creating an environment that would attract high inflows of private foreign investment. Without these foreign funds to supplement low domestic rates of savings, the country would not be able to return to respectable rates of economic growth. The presumption was that once economic growth was reestablished in Pakistan, there would likely be adequate funds to combat terrorism on two fronts: (1) poverty reduction and improved

governance; and (2) increased allocations for security and force modernization. With improved growth and modernization of institutions, the attractiveness of terrorism would diminish. In turn, this would create an environment more conducive to further inflows of capital. In this manner, the IMF programs and the war on terrorism would complement each other.

Initial Assessments

Evaluating the country's recent economic performance is difficult because a mixed picture emerges. Or, as Saeed Ahmad Qureshi notes, objectivity on recent developments in Pakistan has been colored by divergent perceptions—the product of a sharply polarized political environment.²⁸ The schools of thought that deliver these judgments fall into two broad categories: the take-off school and the structuralist school.²⁹

The Take-Off School

With the above considerations in mind, the take-off school, or supporters of the Musharraf Reforms³⁰ and the IMF,³¹ point to a number of recent successes. Most important, economic growth has been exceeding targets and is expected to reach 6.4% in 2003 (July–June). Growth is broad-based, but most pronounced in the export-oriented large scale manufacturing sectors. Despite increased domestic demand, growth is occurring in an environment of relatively low inflation (6% per annum).

Significantly, many of the country's external problems are lessening, with strong export growth helping to maintain a balance of payments equilibrium surplus of about 2% of GDP. By early 2004, Pakistan's official foreign exchange reserves had grown to about \$11 billion. In 2004, the country's improved external position has enabled the authorities to reduce Pakistan's public and publicly guaranteed debt by around four percentage points to 43%. A good indicator of progress was Pakistan's return to the international capital markets through the issue of a \$500 million five-year Eurobond. The government's budgetary position has also improved considerably, with revenues in 2004 exceeding expectations.

Based on these favorable developments, the government has confidently forecast rising rates of growth over the next several years, led by an expansion

28. Saeed Ahmad Qureshi, "Two Views on Economic Performance," *Dawn* (June 9, 2003), <<http://www.dawn.com/2003/06/09/eb1.htm>>.

29. Stressing inflexibilities and rigidities in the economy.

30. See, for example, Ashfaq H. Khan, "The Economy at Take-Off Stage," *Dawn* (May 5, 2003), <<http://www.dawn.com/2003/05/05/eb3.htm>>.

31. "Pakistan: Eighth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility" (Washington: International Monetary Fund, July 2004).

in textile manufacturing and construction. In short, the take-off school contends that macroeconomic stability has been achieved to a large extent, investment and growth are rising, interest rates are falling, inflation is low, private sector credit has picked up, both domestic and external debts are declining, exports are picking up, tax collection is rising, the current account balance is in surplus, and the exchange rate is stable.³²

The Structuralist Interpretation

The structuralist school acknowledges the improved economic picture noted above. However, structuralists contend that many of these results simply derived from unusual external events and cannot be directly attributable to the government's reform programs. In particular, they contend that the country's improved reserve position and reduced indebtedness have come about largely because of a windfall following the events of September 11. Other points emphasized by this school are discussed here.

The structural fault lines of the economy have persisted, and even worsened. Social indicators such as the United Nations' Human Development Index (HDI) place Pakistan near the bottom of world rankings, along with some of the African countries.³³ Infant mortality per 1,000 live births is 136, compared with 107 for Nepal, 96 for Bangladesh, 83 for India, and 18 for Sri Lanka.

Studies by the ADB show that more than 12 million people were added to the ranks of the poor in Pakistan between 1993 and 1999.³⁴ During this period, the proportion of the population below the poverty line worsened from 26% in 1993 to 32% in 1999. Despite rapid growth in the last several years, there is little indication that the level of poverty has been significantly reduced. Thus, it would not be an exaggeration to say that more than one-third of the country's population is currently living in poverty.

Pakistan's primary school enrollment rate is the lowest in South Asia. Educational expenditures have fallen from 1.8% of GDP in 1998 to 1.6% in 2001—also the lowest level in South Asia. At 7%, unemployment has reached a record level. If underemployment is factored in, the figure increases to 10.4%.

On the macroeconomic front, structuralists often cite the poor record of growth, 3.3%, in the first three years of the Musharraf government. In addition, they note that the ratio of investment to GDP has declined from 20% in the early 1990s to 15% in the early 2000s, further dropping to 13.8% in 2002. They attribute improvement in large-scale manufacturing production mainly

32. Khan, "The Economy at Take-Off Stage."

33. Qureshi, "Two Views on Economic Performance."

34. ADB, *Poverty in Pakistan: Issues, Causes, and Institutional Responses* (Manila: Asian Development Bank, August 2002).

to the expansion in the output of automobiles and electronics, whose demand has been spurred by the provision of consumer credit.³⁵

Critics of the Musharraf reforms³⁶ also contend that the program's whole orientation is inappropriate: in addition to the growing level of poverty noted above, 60% of the population has no access to education, 50% has no access to basic health services, and 50% lacks access to sanitation facilities. At the same time, Pakistan has one of the world's highest population growth rates, at 2.8%. The growing unemployment of youth has led to their increased frustration and, more important, has created an environment upon which radical Islamists have been able to capitalize, as evidenced by their striking gains in the last election, in 2002.

In sum, while many macroeconomic stabilization indices targeted by the IMF show encouraging improvement, many critical indicators of the actual standard of living of the great majority of the population—poverty rate, GDP growth, investment, health and education levels, and so on—have not shown much of an advance, and in some cases have deteriorated. This has led the structuralists to conclude that the reforms are fundamentally flawed because the IMF and Pakistan have been unable to learn from past mistakes, most notably redistributing income toward elites while failing to promote economic growth and attack poverty.³⁷

Members of the take-off school note that empirical studies on Pakistan's poverty largely point to low growth during the 1990s as the main source of poverty's rapid increase. Haroon Jamal, for instance, notes that most poverty growth following the 1988 Structural Adjustment Lending (SAL) package from the World Bank and IMF up to 1999 was caused by low economic growth, as opposed to redistribution effects.³⁸ With the population increasing at 2.8% per annum, the recent 5.1% increase in GDP translates into per capita income growth of 2.6% per year. The general rule for developing countries is that the economy must grow at twice the rate of population increase to begin reducing the incidence of poverty.³⁹ This bolsters the take-off school's argument that the chief objective of economic policy should be higher sustained rates of growth.

35. Jawaid Bokhari, "Consumer Focused Growth: 'Frozen Mind-Sets'," *Dawn* (August 25, 2003), <<http://www.dawn.com/2003/08/25/eb4.htm>>.

36. Masooda Bano, "What Reforms?" *News International* (November 15, 2002), <<http://www.jang.com.pk/thenews/nov2002-daily/15-11-2002/oped/o2.htm>>.

37. James Vreeland, "Pakistan's Debt of Gratitude," *Foreign Policy* (March/April 2002), pp. 72–73.

38. Haroon Jamal, *Poverty and Inequality during the Adjustment Decade: Empirical Findings from Household Surveys* (Karachi: Social Policy and Development Center, 2003).

39. Shahid Javed Burki, "On the Verge of Take-Off?" *Dawn* (July 15, 2003), <<http://www.dawn.com/2003/07/15/op.htm#2>>.

The ADB's position is that poor governance is the key underlying cause of poverty in Pakistan.⁴⁰ Corruption and political instability, both manifestations of governance problems, have resulted in waning business confidence, deteriorating economic growth, declining public expenditures on basic entitlements, low efficiency in delivery of public services, and a serious undermining of state institutions and the rule of law, which in turn translate into lower investment levels and growth.

The effects of poor governance have compounded the economic causes of rising poverty, such as a decline in the GDP growth rate, increasing indebtedness, inflation, falling public investment, and the poor state of physical infrastructure. At the same time, social factors, such as the highly unequal distribution of land, low levels of human development, and persistent ethnic and sectarian conflicts, are also obstacles to the achievement of long-term sustained development.

Still, a careful reading of the government's reform programs suggests that they are roughly consistent with the ADB's poverty assessment. Foremost among the government's governance-related reforms is its Devolution Plan. Under this plan, delivery of services in the social and other poverty-focused sectors has been decentralized, with elected local governments given the mandate and responsibility to manage and run these services. The government has also introduced important reforms to improve the functioning of judicial institutions and enhance equitable access for the citizenry to justice.

In sum, the structuralists make a number of good points; however, the Musharraf reforms appear sound and well-intended. Still, the jury is still out on the reforms' ultimate success. Accelerating growth rates may be driven by a series of favorable external, exogenous events, rather than by the reforms themselves. Clearly, the inflow of foreign aid, higher remittances, and debt re-scheduling by the Paris Club of bilateral donors, following Pakistan's decision to join the U.S.-led coalition against terrorism, have all given the economy a significant boost that is unlikely to be repeated on a sustained basis.

Given the difficulty Pakistan has had over the years sustaining high rates of growth, the reforms will no doubt be ultimately judged on the quality of the institutions put in place. Are these institutions capable of fairly resolving many of the conflicts that have repeatedly derailed the economy? Will they permit continuity in economic policy? Will they strengthen democracy, enabling all segments of society better access to public services and opportunities? Will they enable the country to finally have a successful economic transition to high sustained growth?

40. *Poverty in Pakistan: Issues, Causes, and Institutional Responses.*

Links to Pakistan's War on Terrorism

One thing is clear. The progress made in implementing the Musharraf reforms will have tremendous implications for terrorism in Pakistan. Burki notes that the important question is not what kind of presence al-Qaeda has established in Pakistan. Rather, "the real issue is how some segments of society can be weaned away from the type of thinking represented by al-Qaeda. Unless that is done, Pakistan will not be able to achieve either economic or political stability."⁴¹ At issue, then, is which objectives the reform process should focus on? Does terrorism breed within an environment of dire poverty, as is now quite prevalent in Pakistan? Or is it more likely to take hold in an environment of dashed expectations and limited opportunities for economic success, not only for ordinary people but for the educated as well? This is an environment also experienced by many Pakistanis. Or is terrorism simply a reflection of militant Islam, stemming from the rapid expansion of *madrasahs*?⁴² In 1947, about 150 *madrasahs* existed in Pakistan. By 1971, this number had increased to 562. Another 30 years later, there were about 20,000.

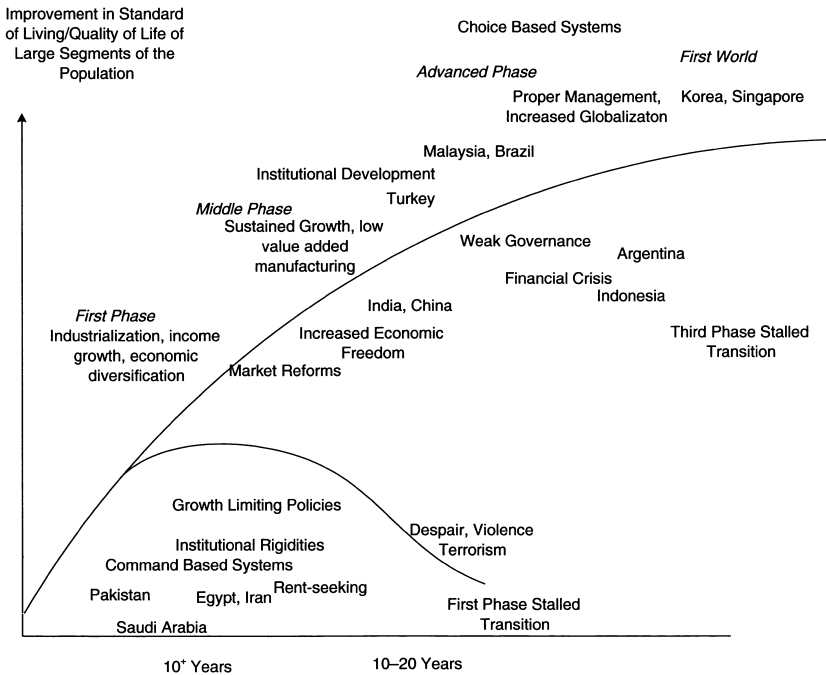
Initial post-9/11 speculation has focused on poverty and low educational attainment as underlying causes of terrorism. With time and more rigorous research, a different picture has emerged. Alan Krueger and Jitka Maleckova's detailed in-depth review of the evidence, for instance, provides little reason for optimism that a reduction in poverty in and of itself, or an increase in educational attainment, would meaningfully reduce international terrorism.⁴³ Their main finding is that any connection between poverty, education, and terrorism is indirect, complicated, and probably quite weak. Instead of viewing terrorism as a direct response to limited market opportunities or ignorance, they suggest that terrorism is a response to political conditions and long-standing feelings, either perceived or real, of indignity and frustration.

The growth and productivity patterns noted above certainly suggest that Pakistan is a classic example of a country fulfilling Krueger and Maleckova's description of a terrorist breeding ground. Large segments of the population have become weary and frustrated with the country's lack of economic progress, especially now that the Indian economy is pulling away with a much higher and accelerating rate of growth. The country's patterns of growth, productivity,

41. Shahid Javed Burki, "Terrorism & Development," *Dawn* (May 21, 2002), <<http://www.dawn.com/2002/05/21/op.htm#1>>.

42. Robert Looney, "A U.S. Strategy for Achieving Stability in Pakistan: Expanding Educational Opportunities," *Strategic Insight* (September 2, 2002), <<http://www.ccc.nps.navy.mil/rsepResources/si/sept02/southAsia.asp>>.

43. Alan Krueger and Jitka Maleckova, *Education, Poverty, Political Violence, and Terrorism: Is There a Causal Connection?* (Cambridge, Mass.: National Bureau of Economic Research, July 2002).

FIGURE 1 *New Second World Transitions*

and institutional failure seem to fit a more formal model of terrorist development recently developed by Jennifer Bremer and John Kasarda.⁴⁴

Failed Take-Offs, Transitions, and Terrorism

Bremer and Kasarda's main conceptual construct is what they term "The New Second World." This is a group of about three dozen countries that have reached middle-income status over the past two decades and are now in the midst of accomplishing critical economic and political transitions as they move from the third world to the first.

The New Second World transition has three phases (see Figure 1). The first or early phase typically begins when a low-income country starts to industrialize rapidly, launching an agrarian-industrial transition and the complex transformations, urbanization, income growth, and economic diversification

44. Jennifer Bremer and John Kasarda, "The Origins of Terror: Implications for U.S. Foreign Policy," *Milken Institute Review* (Fourth Quarter 2002), pp. 34-48.

accompanying it. A process similar but not identical to Rostow's take-off occurs if growth continues for a decade or more. In that case, the country reaches the middle New Second World phase. In the second phase, industrial production per capita may now be around three times what it was when the transition started, and growth in low-value-added manufacturing is rapid and sustained. Incomes rise and a middle class emerges. Bremer and Kasarda note that if this middle phase continues for 10 to 20 years, the country would likely reach the advanced phase, often a time of recurring economic crisis and political turmoil. Countries currently in this advanced group include Brazil, Poland, Russia, and Turkey.

Since Pakistan is in the first stage along with countries such as Egypt, Iran, and Saudi Arabia (Figure 1), our attention is focused mainly on the problems encountered by that group. These countries have failed to move forward to the middle stage, largely because of growth-limiting policies and institutional rigidities. As Bremer and Kasarda note, "History suggests that failure to make steady progress through the New Second World transition's early phase to the middle period is extremely dangerous. If the transition stalls here—as it did in post-World War I Russia, and as it has now in much of the Middle East—failure can lead to revolution and Al Qaeda-style international violence."⁴⁵ The one thing that the nations stuck in the early phase have in common is slowness in adopting choice-based systems. Bremer and Kasarda define "choice-based" systems as encompassing both market-based economies and democratic political institutions and organizations.⁴⁶

No indexes of the prevalence of choice-based systems exist. However, the annual publication of an Economic Freedom Index by Gwartney and Associates (1995) is no doubt a good proxy.⁴⁷ Stripped to its essentials, economic freedom is concerned with property rights and choice. It follows that to measure freedom, one must find appropriate measures of the ways in which these elements are restricted by governments.

Gwartney et al. chose 17 such measures in four broad areas: (1) money and inflation, (2) government operations and regulations, (3) takings (levies) and discriminatory taxation, and (4) international exchange. Indexes vary based on the weights given to the 17 components. Countries are ranked from 0 (no freedom) to 10 (extremely high levels of freedom). On this basis, Pakistan improved from a very low 2.3 in 1975 to 5.4, or mid-range, by the mid-1990s. The improvement in the country's ranking was not based on across-the-board improvements but on improvements in just a few components in the index:

45. Ibid., p. 36.

46. Ibid., p. 37.

47. James Gwartney and Robert A Lawson, *Economic Freedom of the World: 2003* (Vancouver: Fraser Institute, 2003).

Marginal tax rates were reduced, and the black market exchange premium was eliminated.⁴⁸ There were no appreciable improvements in the government operations components.

In sum, there has been some movement toward increased economic freedom in Pakistan over the past several decades. However, it is clear that if the country is to escape from its initial stage of transition, it must not only attack corruption but also improve its bureaucratic capabilities, regulatory environment, and legal system. Historically, the unfortunate fact is that despite the high payoff to economic liberalization, the process in Pakistan has proceeded unevenly across the various sectors. Clearly, shaky governments and powerful interests have caused the reform process to proceed at an uncertain pace.

Implications for U.S. Aid

While the analysis above makes a strong case for Pakistan's terrorism problems being an outgrowth of widespread frustration and anger over the country's inability to break out of the first phase of the New Second World, the two other commonly cited sources of terrorism—poverty and militant Islam—no doubt are contributing factors and need to be addressed. However, it is unlikely that focusing on them exclusively will significantly reduce the attractiveness of terrorism.

Instead, assistance needs to focus on the policy changes and institution-building required to navigate out of the first development stage currently trapping the country. Here, United States aid can make a significant contribution by assisting the Pakistani government's attack on the root causes of terrorism, those elements that define the diversionary economy and currently suppress economic freedom. In targeting these areas, contributions (see the dotted lines in Figure 2) toward reducing poverty and the numbers of Islamic militants would occur simultaneously. Ordinarily, expanded efforts at institution building and bolstered anti-corruption programs might face strong domestic obstacles. However, in Pakistan's case, the Musharraf anti-corruption and institutional strengthening reforms are already in place and appropriate for the war against terrorism; they simply need to be adequately funded and implemented. Because of this, the United States has not been perceived as trying to impose a foreign set of institutions on the country. The overall guideline for allocating assistance should be simple and direct: Is this program assisting Pakistan in moving toward a choice-based system?

This approach is consistent with the objectives laid out in Pakistan's new Five Year Plan to raise the GDP growth rate to 6% by June 30, 2005.⁴⁹ To

48. Robert Looney, "Pakistan's Progress Towards Economic Freedom," *Contemporary South Asia*, 6:1 (1997), pp. 79–98.

49. M. B. Naqvi, "The New Five Year Plan," *News International* (January 20, 2003), <<http://www.jang.com.pk/thenews/jan2003-weekly/busrev-20-01-2003/p2.htm>>.

achieve this, the government has targeted six key areas: (1) political stability; (2) regional stability; (3) improved law and order; (4) continued fiscal responsibility, with tight control over budget deficits; (5) transparency and consistency in economic policies; and (6) full implementation of structural reforms.

The key remaining issue surrounds the type of assistance Pakistan should receive: Should it be in the form of aid, with a stipulated rate of interest or an outright grant? Here, the U.S. should consider the recommendation of the Meltzer Report⁵⁰ for substituting grants for aid as a more effective means of monitoring projects and providing performance incentives to the recipients. For the type of institutional loans under consideration here, the situation is more complicated because output is harder to measure, and there would be no real scope for competitive bids to provide the contracted outputs.

Traditional aid often failed in these situations because there was no means to enforce penalties for failure to perform and often no real incentives on the part of the recipient country to continue or even start the reform process. One alternative in the current context would be to make short-term concessional loans conditional on institutional reform. Progress, as judged by annual independent audit, could be rewarded with an extension of the concessional loan. Poor implementation would trigger immediate repayment. Because the grant element of a concessional loan increases as the loan's maturity increases, the Pakistani government would have a real incentive to follow through to successful implementation. As an added incentive, a clause could be included converting the concessional loan into a grant upon successful completion of the reform.

Conclusions

Pakistan's economic future, while brighter than at any time in years, is far from secure. As noted above, the critical question is whether the country will be able to build on the reforms undertaken since 1999. The reforms appear to be the correct response to both the economic malaise of the 1990s as well as to the increasing terrorist threat from within. If successfully implemented, these reforms should enable the country to sustain take-off and transformation into a modern economic society. In turn, this transformation would tend to stifle the growth of domestic terrorists and terrorist threats to the Pakistani economy and society. Furthermore, implementation of the reforms should present no real conceptual or, with proper management, insurmountable financial challenge.

From an economic perspective, the success of the reforms largely relies on investors, both domestic and foreign, taking advantage of the new opportunities afforded by the macroeconomic stabilization programs. Ultimately therefore,

50. Alan H. Meltzer, *Report of the International Financial Institution Advisory Commission* (Washington, D.C.: U.S. Congress, March 2000).

the key element for success is the political stability needed to nurture the reform process and maintain continuity of policies. Because of doubts over political stability or the political will of the government to press ahead with the reform program, seasoned Pakistani observers have put forward few optimistic scenarios for the country. Even here "optimistic" is usually in the context of a calamity avoided, rather than anything positive occurring. For example, in 2002, Stephen Cohen suggested probabilities for some of the standard scenarios as follows:⁵¹

- The breakup of Pakistan is very unlikely for the foreseeable future.
- The triumph of radical Islam in Pakistan is as improbable as Islam's dissolution there.
- The only likely dramatic change in Pakistani politics would be the emergence of a demagogic or radical political movement.
- The full restoration of democratic government and the efficient rebuilding of the Pakistani state is a future that would fall somewhere between the improbable and the impossible.
- The present arrangement of a military-led or -influenced government will prevail indefinitely but will not transform Pakistan.

By 2003, Cohen appeared to be taking the threat from radical Islam more seriously, although he still did not see a grave threat, at least in the near term.⁵²

That leaves the last item above, the status quo, as the likely political environment for reform in the foreseeable future. Here lies the real dilemma and main source of uncertainty over the degree of implementation of the reforms and thus their ultimate success in transforming the economy. Will economic success enable the military to break down the barriers limiting Pakistan's transformation? Will the military even want to continue pursuing the reforms if setbacks begin to slow the expansion?

Further complicating the situation, the Pakistan military has long given strategic and overt support to the country's Islamic fundamentalists, but that policy appears to be backfiring as religious radicals mount a challenge to central power. As it stands, Islamic and secular opposition parties are disrupting much of parliament's work. This, coupled with President Musharraf's failure to win parliamentary support for the military's continuing political dominance, has led to fears that he may be on the verge of dissolving democratic legislatures and reimposing military rule. "The present army leadership has developed utter contempt for civilians and democracy," says a retired general who used to be close to Musharraf. "It's a very dangerous situation for Pakistan and the region."⁵³

51. Stephen Philip Cohen, "The Nation and the State of Pakistan," *Washington Quarterly*, 25:3 (Summer 2002), pp. 119–20.

52. Stephen Philip Cohen, "The Jihadist Threat to Pakistan," *ibid.*, 26:3 (Summer 2003), pp. 7–26.

53. Quoted in Ahmed Rashid, "Musharraf's Morass," *Far Eastern Economic Review* (June 19, 2003).

Beside the threat to democracy, the current political crisis in Pakistan will continue to deter both foreign and domestic investment. In fact, an increasingly asked question is, "Why is domestic investment not coming up in sizeable measure despite the steadily improving environment for it?"⁵⁴ Economic success to date has no doubt been aided by a set of very favorable, and probably not sustainable, external developments.

In this regard, a structuralist, Farhan Bokhari, sounds a very ominous note:

The true litmus test of Pakistan's economic future lies not across the robustly rising share prices on the Karachi Stock Market, but in fact across the country's investment horizon where persistent lethargy is a telling indicator of times to come. In a country where direct investment remains lackluster and prospective new foreign and domestic investors remain wary on account of reasons ranging from internal security conditions to the danger of recurring political uncertainty to the many gaps in facilitation of entrepreneurs, claiming success in turning around the economy must remain in danger of being premature.⁵⁵

Similarly, says take-off school advocate Burki:⁵⁶

Given Pakistan's past history, there is a real danger that politics may cause the economy to stumble again. And, given the fact that after three years of hard work by Islamabad the economy is on the verge of a possible take-off, it would be unfortunate if this opportunity is sacrificed at the altar of politics. If the military under the direction of President Musharraf has to choose between economic stability and growth on the one hand and a quick return to democracy on the other, it must choose the former.

54. Sultan Ahmed, "Why the Private Sector Is Not Investing," *Dawn* (August 11, 2003), <<http://www.dawn.com/2003/08/11/eb3.htm>>, also provides a number of reasons for the reluctance of private investors to increase their capital formation in Pakistan.

55. Farhan Bokhari, "Failure to Agree," *News International* (August 24, 2003), <<http://www.jang.com.pk/thenews/aug2003-daily/21-08-2003/oped/o3.htm>>.

56. Shahid Javed Burki, "Some Possible Pitfalls," *Dawn* (July 22, 2003), <<http://www.dawn.com/2003/07/22/op.htm>>.