The Balance-of-Payments Problem in Developing Countries

by

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INTRODUCTION

It is well known that a long-run solution of balance-of-payments problem must also envisage an optimal allocation of domestic resources. Special emphasis is placed in this connection on equilibrating flows of investible resources to the export sector from the rest of the economy as a pre-condition of the success of policy measures taken to rectify balance-of-payments disequilibrium. It will be shown in this paper that the long run balance-of-payments problem of developing countries like Pakistan can be traced to a failure to bring about such equilibrating flows. This, in turn, has led to allocational distortions: in particular, on the margin, export-expansion has suffered by comparison with importsubstitution.

Fundamentally, the failure to secure optimal resource allocation is ascribable to three related factors: Firstly, there has been an exclusive emphasis on maximizing (industrial) growth, mainly via import substitution. The balanceof-payments constraint on economic growth has generally been disregarded, thanks mainly to the ready availability of foreign aid. This is what I have characterised in the ensuing discussion as "unbridled" growthmanship. Secondly, the peculiar strategy of economic development adopted to realize the growth objective has almost universally consisted of a total reliance on the private sector not only to generate sizeable investment, but also to provide the required savings. This strategy, in turn, has necessitated too high a level of profits. The result has been inflation, allocative inefficiency, high capitaloutput ratios and ultimately the creation of an industrial sector too heavily dependent on imports. Thirdly, while these two factors have in general created a large excess demand for imports; export expansion lagged because of import restrictions imposed not only for rectifying balance-of-payments disequilibrium but also for promoting the growth objective. Thus a vicious circle has been created in which every attempt to solve the balance-of-payments problem has deepened allocative inefficiency which, in turn, has blocked a long term balance-of-payments solution.

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Each of these disequilibrating factors causing balance-of-payments difficulties are discussed at some length in Section 'B'. This is followed, in sections 'C' and 'D', by an analysis of the main elements of a long-run solution of the balance-of-payments problem. A final section concludes the discussion. Although the ensuing analysis is closely anchored to Pakistan's case, yet it is of general applicability to other developing countries. For, despite important geographical, climatic, social and political differences, developing countries have by and large confronted similar economic problems and have, as if led by an Invisible Hand, responded to them in like fashion. This is true even though no conscious effort has been made to coordinate economic policy-making among them.

B. THE MAIN-SPRINGS OF THE BALANCE-OF-PAYMENTS PROBLEM

As referred to above, the balance-of-payments problem in developing countries like Pakistan is basically traceable to the following three interrelated causes: (i) "unbridled" growthmanship; (ii) the peculiar strategy of economic growth; and (iii) a sub-optimal policy mix.

(i) Unbridled Growthmanship

In developing countries there has been a tendency to emphasize the maximization of (industrial) growth rate as the sole objective of economic policy. This undue emphasis on achieving high growth rates resulted in levels of investment much higher than domestic saving could possibly support.¹ The general idea has been that the saving-investment gap, or the import-export gap, so created can always be made up by adequate inflows of foreign aid. This has led to a neglect of the balance-of-payments constraint on domestic growth effort. However, even the massive inflow of foreign capital resources on concessionary terms could dodge the balance-of-payments constraint These inflows have in time provoked a reverse outflow only temporarily. of resources from developing countries on account of re-payment and debt servicing liabilities, which have swelled in volume at a compound rate. For instance, thanks to such a neglect of the balance-of-payments constraint, Pakistan's net debt has grown at a compound rate of 27 per cent per annum during 1964 to 1970, and formed 18.2 per cent of GNP in 1970-71. This phenomenal increase in Pakistan's external indebtness has imposed a very heavy burden on her export effort in the form of annual debt-servicing and repayment liabilities. In 1970-71, these liabilities constituted 24.3 per cent of Pakistan's total foreign-exchange earnings; and still more strikingly 29.6 per cent of the total export earnings. This means that Pakistan must continue to receive aid not only for financing the development process but also for meeting the mounting foreign debt-servicing and repayment liabilities. Failing an inflow of foreign aid on such a massive scale, her export effort will soon become practically mortgaged to the servicing and repayment of foreign debt.² Pakistan's case is a typical illustration of similar problems that other developing countries are also facing.

¹It may be said that the saving-investment gap could as well have been the result of low domestic saving as of high investment, or of both high investment and low saving. This is true but does not negate the main point being made in the text, which is that too high an investment level may have been planned relative to domestic saving thanks mainly to the ready availability of foreign aid.

³The extremely serious nature of Pakistan's foreign indebtedness problem is brought out clearly in Naqvi, [14] and [15].

Ready availability of foreign aid has had another unfortunate effect: it has tended to dilute potential domestic saving. By and large it has replaced the domestic resource-mobilization effort rather than complementing it.³ Insofar as this is true, an increasing reliance on foreign aid to finance economic growth has imposed a mounting burden on the balance of payments in the form of mounting debt-servicing and repayment liabilities. For, if a more intensive effort were made in these countries to mobilize domestic resources instead of relying so heavily on foreign aid, then equally high investment levels would not have put as much of a strain on their balance of payments.⁴

(ii) Strategy of Economic Development

The strategy of economic development adopted in developing countries in order to realize high growth rates has given the corporate sector the pivotal role in the development process; investors are not only large-scale investors but also large-scale savers. The idea of letting investment resources concentrate in the hands of those who are thought to be most prone to reinvest them has had an appealing simplicity for the policy-maker. However, the appealing simplicity of this idea has not made it also the most useful one. For this strategy necessitates the generation of very high profits in order to maximize reinvestment in the corporate sector, which has encouraged allocative in efficiency and a steady increase in the conspicuous consumption of the recipients of exorbitant "profits", (i.e. investible surpluses), which were marked for reinvestment in the first place.⁵ Allocative inefficiency has been promoted simply because import-substitution activities become the first recipients of investible funds originating in the corporate sector. Since these industries cater to a highly protected domestic market, the investors could maximise profits without making any serious effort to rationalize their uneconomic cost structures. On the other hand, export activities do not receive as much favour with domestic investors because here inefficiency is promptly penalized by poor competitive performance in a highly competitive international market. Thus, in these countries, import substitution has tended to freeze imports fairly solid at a very high level while export expansion has lagged, aggravating the balance-of-payments disequilibrium.⁶

⁴There has been a general impression in Pakistan that the domestic resource-mobilization effort has not been poor afterall. However, a proper re-evaluation of the foreign-exchange component of domestic saving and investment at the more realistic rate of exchange should discredit this impression. See, Stephan R. Lewis Jr. [10].

^aFor a detailed discussion of the various aspects of such a growth strategy see, Naqvi [16].

⁴As a result of the policy bias in favour of import substitution, the import bill in developing countries reaches an irreducible minimum. This is because with import substitution in an advanced stage, all the easy substitutions having already been made in the pursuit of industrialisation, imports become dependent largely on output rather on real income and are not particularly sensitive to price changes. See, Cooper [3] on this point.

^{*}K.B. Griffin and J. L. Enoss, [4]; Md. A. Rehman, [19]; and Weisskopf, [21]. See also Hirschman and Bird [7], where they explain the behaviour of the aid recipient by reference to the psychological theory of "cognitive dissonance"—i.e., a person engaged in "discrepant behaviour" will readjust his values to reduce the "dissonance" in such a way that harmony is restored. However, the individual may not be induced to readjust his values if "discrepant behaviour" is induced either by carrot or stick. The relevance of this theory to economics, not noted by Hirschman and Bird, is the following: The desire to achieve high growth rates —a "discrepant behaviour" this—should, without aid, lead to a readjustment of social values with respect to saving, consumption levels etc. However, the availability of foreign aid takes away much of the incentive to induce such readjustments. In this way foreign aid may create a psychological environment in the recipient countries where, at least beyond a certain point, it may substitute rather than complement domestic resource-mobilisation effort.

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This growth strategy has compounded the balance-of-payments disequilibrium also insofar as a highly skewed income distribution stimulated a much greater effective demand for imports than would be the case if economic policy had aimed at a more equable distribution of income. Within the framework of the growth strategy adopted in Pakistan, this excess demand for imports has mainly taken the form of capital goods-imports, inflating the capital-output ratio in the corporate sector, again an unfailing evidence of a considerable waste of scarce investible resources. It is, therefore, fair to conclude that if the domestic resource-mobilization effort in developing countries had not taken the route it did—via the corporate sector, that is—and if the distribution of income had been kept more equable, then it is quite probable that equally high investment levels and growth rates would have imposed a much lesser strain on the balance of payments. Needless to add that the growth objective could have been achieved with a considerably smaller sacrifice by the society.

(iii) Sub-Optimal Policy Mix

The policy mix devised to implement the above-mentioned growth strategy has consisted essentially of a low rate of interest at which the corporate sector gets investible funds, and of excessive fiscal concessions and a high level of protection accorded to the domestic investor. The tax concessions have taken such extreme forms as tax holidays for several years on new investment and accelerated depreciation allowances, thereby lowering drastically the effective rate of taxation relevant to the corporate sector. This too liberal a fiscal policy no doubt resulted in the generation of investible funds on a massive scale, but the resulting allocative inefficiency has prevented the industrial sector from making a corresponding contribution to the overall growth rate. The incentive to produce more that these fiscal concessions provided has been dulled by the complete protection accorded to the investor in the form of low import quotas and high tariff restrictions on imports. For, the high level, of protection has spawned a highly lucrative domestic market in which good profits could be made even with low output from installed capacity. The result has been widespread excess capacity in the industrial sector. The over valued rate of exchange, by keeping the prices of imports at an artificially low level, has reinforced protection-induced excess capacity. For, the widespread preference for importing low-priced capital goods in such a milieu pre-empts the foreign exchange that would normally be spent on raw-material imports. Α net strain on balance of payments results because the underutilization of imported capital equipment does not permit the saving in the imports of "final" goods to match the heavy imports of capital goods for the domestic production of these "final" goods.

Even more important from the point of view of the balance of payments is the bias accorded by the system of exchange control and import licensing to import substitution at the expense of export expansion. This is because the limitation of imports raises the prices of import substitutes, thereby increasing the marginal profitability of new investment in import-substitution industries as opposed to investment in export industries. Special export-promotion devices are, therefore, put together to ease the drag of protectionist policies on export expansion. In Pakistan, an export bonus scheme (now abandoned) was introduced primarily to correct this allocative bias of the exchange control and import-licensing system in order to increase the flow of domestic investment resources into the export sector. However, while the export bonus scheme was an improvement over the situation before it was introduced—i.e., with no bonus scheme, the same exchange rate, and sufficient import controls to maintain external equilibrium—compared with devaluation, coupled with the removal of import restrictions it preserved a net margin of protection for the country's import-competing industries. The scheme was a devaluation at different rates for imports and exports and provided two different rates of subsidy to exports and import substitutes. This in turn implied a net subsidy for the import-competing industries. In the course of a comprehensive study of Pakistan's export bonus scheme,⁷ I have shown that this net subsidy for import-competing industries did exist and that it did in fact increase steadily over time since the introduction of the export bonus scheme. Thus, the export sector in Pakistan has consistently suffered on the margin by comparison with the import-substitution sector.

No different has been the fate of other developing countries notwithstanding a plethora of export-promotion devices of all sorts, export expansion has consistently been marked down by comparison with import substitution. And everywhere a grossly overvalued currency has been the monkey wrench obstructing orderly policy-making processes [Little, Scitovsky and Scott, 11].

(C) SOLVING THE BALANCE-OF-PAYMENTS PROBLEM

The main elements of a long run solution to the balance-of-payments problem emerge directly from the analysis presented above.

(i) "Bridled" Growth

It follows logically from the above analysis that society would be better off if, in setting the growth target, due regard is paid to its effects on balance of payments. All the more so, because it will be unwise to rely any longer on substantial inflows of foreign aid to close the large importexport gap that high investment activity has tended to cause. For one thing, these countries have already accumulated a large foreign debt. For another, because of the "hard" terms on which aid is being made available, the net contribution of foreign aid to the domestic development effort has declined sharply. For an example, in Pakistan the net transfer of foreign resources as a percentage of gross aid disbursements declined from 87.3 per cent in 1964-65 to an estimated 33.4 per cent in 1971-72, thanks to the large debtservicing and repayment liabilities, which have grown during the last seven years at a compound rate of 31 per cent per annum. At such a rate the net contribution of gross foreign aid will decline to zero and then become *negative* in the not-too-distant future.

It follows that insofar as a marginal increment in growth rate leads to a net dependence on imports—i.e., generates import requirements in excess of the domestic export effort plus a moderate net inflow of foreign aid—the society may have to pay an unacceptable price for securing additional growth points in the form of an intolerable debt burden on posterity since it requires foreign resource inflows in very large amounts. However, this is not a case for low growth rates *per se*. Most welcome are the additional percentage points that may be added to the growth scoreboard either by a better distribution of income

⁷For a detailed discussion of this point see, Naqvi, [12].

or a more rational allocation of domestic resources. In both these cases a lot of economic waste will be avoided and it will be possible to secure higher growth rates with the same aggregate investment.

(ii) Changing the Growth Strategy

The strategy of relying mainly on the corporate sector not only for inducing large investment but also for mobilizing domestic savings through a combination of high prices and high profits is a sub-optimal policy. It can be shown that, apart from the practical difficulties noted above of operating this peculiar growth strategy, it is also not based on correct theoretical foundations.

The basic assumption of the theory on which this growth strategy is based is that since the capitalist class does all the saving-the so-called "classical" savings function assumption—as large a part of national income as possible should accrue to them to maximize saving and investment.⁸ However, this is a second-best argument and yields no presumption one way or the other whether you get a better outcome with higher saving and less efficient production. The growth rate may not, in fact, be higher with this growth strategy. Although more income may be saved, this may be offset by a lower output-to-capital ratio. Even if a higher growth rate is eventually achieved, a discount will nevertheless be necessary in order to offset the long-term gain in output that growth brings about against the loss of output now from allocative inefficiency. This approach is also of doubtful validity because it is based on the unrealistic assumption that fiscal policy is totally ineffective in extracting savings from wages. This assumption may be true in primitive societies, but it is not right in the case of countries like Pakistan where the fiscal machinery is fairly effective. The problem of promoting saving and investment is, therefore, best taken care of by means of an optimal tax-cum-subsidy on domestic income and output. (This point is more fully discussed in section D).

While the corporate sector should continue to play a vital role in the process of economic development, yet the case is not established of entrusting it with the dual role of the primary saver and the primary investor. Although the growth process in developing countries may yield up high profits in any case, the social desirability of ensuring high, personal returns to capitalists is very low, to induce them to save and invest on a large scale. However, if in fact low personal returns do not induce capitalists to save and invest on a large scale, then this is a case for substituting public investment for private investment. The task of mobilizing domestic savings should instead be achieved by an appropriate combination of fiscal policy and high interest rates, and the capital markets used to channelise these savings to the corporate sector in amounts and in forms which may be socially the most desirable. Such a strategy has been successfully pursued by countries like Mexico and Taiwan, which achieved high growth rates without inducing gross inequalities in income distribution.9 At any rate, in view of the greater political consciousness in the developing countries,

⁸According to the "classical saving function"—i.e., $S=S_p-P$, when S_p is the propensity to save out of profits, p—all savings come out of profits. The most complete application of this approach is set out in Galenson and Leibenstein [5].

^{*}For detailed discusson see, Little, Scitovsky and Scott, [11, especially Pp. 47-59].

it will be most naive to assume that the present policy will not provoke a hostile social response.¹⁰

(iii) Correcting the Policy Bias

The ultimate step taken by these countries to rationalise the suboptimal policy package is usually to devalue the domestic currency. The most recent illustration is Pakistan's decision to devalue the rupee to what is considered to be an equilibrium rate of exchange. Apart from the debatable question regarding the extent of devaluation,¹¹ the most important result of the new exchange-rate policy will be to remove the distortions in resource allocation spawned by the system of import licensing-cum-export bonus scheme. The devaluation subsidizes the export sector at the same rate as it penalises the import sector. Furthermore, devaluation tends to alleviate the export pessimism, widespread in countries like Pakistan, which is due to the fact that a grossly overvalued rate of exchange, by making foreign goods look cheaper than they actually are, promotes the illusion that it is impossible for domestic goods to compete abroad and be exported. Also, while in the post-devaluation situation the effective import rate becomes lower than before, the exporter gets a higher effective rate. This fact by itself alters drastically the allocative biases of the previous exchange rate system in favour of the export-expansion activity and makes an effective contribution to the solution of the balance-of-payments problem.

Paradoxical as it may sound, while devaluation is the optimal policy to correct the resource-distorting effects of import restrictions, *too steep* a devaluation, such as recently took place in Pakistan, may have resource-distorting effects of its own. Firstly, by comparison with the pre-devaluation situation too sharp a devaluation freezes import duties upwards: it actually necessitates a sharp reduction in them, partly in order to keep the prices of imported goods within limits. Secondly, again to contain the price-raising effects of such a sharp devaluation, export taxes become necessary. However, export taxes are generally unpopular and inconsistent with the need for export expansion. For both these reasons a serious domestic revenue problem may arise, particularly because trade taxes constitute a substantial proportion of government revenue.

¹⁰It will be interesting to quote recent French history to illustrate the great danger of loading too heavy a burden on society and in particular on labour in order to secure high growth rates. De Gaulle started the task of salvaging the French economy by two devaluations in 1952 and 1958 and an austerity programme, which relied mainly on keeping labour costs low. Thanks to such a policy package, output in France grew faster than in the rest Western Europe. At the same time, the French worker found himself working the longest hours at the lowest real wage. He was also paying the highest taxes. Soon there were widespread strikes with impressive results: wages increased by 14 percent in a few months, representing a 9-10 per cent increase in real wages; the working week started sliding from 45-8 hours to 40; and trade unions were accorded recognition even in die-hard firms like Citroen.

The moral of this story is clear and most relevant for countries like Pakistan: efforts to finance economic growth by keeping the working class down, denying them proper reward for their work, sooner or later leads to a "big bang" in industrial relations, and eventually destroys the income-generating potential of the industrial sector. For a detailed discussion see, Michael Kidron [9].

¹¹The Pakistani rupee was devalued in May, 1972 from Rs 4.76 to Rs 11.00 for 1 US dollar—implying a devaluation of 131 per cent when measured as the *increase* in the number of domestic currency exchanged for one US dollar; and by 57 per cent when measured as the *fall* (from 21 U.S. cents to 9 cents for one Rupee) in the number of dollars offered for a unit to domestic currency. As noted below, this appears to be a case of "excess' devaluation.

Unable to increase export taxes, the government may ultimately be forced to raise import duties towards the predevaluation level, thereby increasing the net margin of protection to import-substitution industries. Thirdly, insofar as a steep devaluation raises the *general* price level, it may create an excess demand for imports, tempting governments in developing countries to reimpose import restrictions. Thus the allocative distortions of the predevaluation period may re-emerge in the post-devaluation period also. It, therefore, follows that the move towards an "equilibrium" rate of exchange in developing countries should be gradual.

(D) AN OPTIMAL POLICY MIX¹²

Although devaluation is the most important single step towards rationalizing the sub-optimal policy package, this is by no means the end of the story. It must be followed up by an overall effort to devise a practical scheme of optimal state intervention. Here it is fundamental to recognise that although in a general-equilibrium framework each policy instrument has some influence on every possible target, yet to each target there corresponds a specific policy instrument, or a combination of policy instruments that is optimal. Hence, the most important test of policy-making is to choose that policy instrument in a particular situation which achieves a given policy objective at the least cost to the society. As pointed out above, promoting saving by a combination of high profits and high prices is a sub-optimal policy. For, this policy entails unavoidable consumption and production costs on the economy by increasing inequalities in income distribution and by promoting allocative inefficiency. Both these factors in turn impose extra strain on the balance of payments by generating an excess demand for imports of conspicuous consumption goods and capital goods. A better alternative would be to achieve the same result by a combination of high effective tax rates.¹³ and high interest rates. For this policy mix will promote saving without any such adverse side-effects on resource allocation, income distribution and on balance of payments. Equally suboptimal is the policy of promoting saving and investment by protection, which tends to increase both the relative and the absolute reward of capital in a capital-scarce country. This happens even if protection decreases national income by making resource allocation less efficient.¹⁴ This argument obviously admits the possibility that tariffs may promote inefficiency in resource allocation. It is, therefore, not clear whether society would gain on balance even if protection succeeds in raising the saving and investment levels in the corporate sector. For, the potential social gains from a faster growth rate, if at all it comes about, may in this case be offset by the resultant inefficiency in resource allocation. This strategy is particularly wasteful when the same result can also be achieved by means of optimal taxes and subsidies on domestic income and output.

¹²For a detailed discussion of these matters see, Johnson [8] and Naqvi [13].

¹³The idea is that what matters is not the nominal rate of taxation but the *effective* rate of taxation, computed by deducting all exemptions, deductions and tax concessions from the total taxable income. While the former is very high, the latter is quite moderate. What needs to be done is achieving high rates of effective taxation by cutting down the top marginal tax *rate* and expanding the tax *base*. This policy package will ensure greater government revenues without impairing the incentive to invest, which is a function of the *marginal* rate of taxation.

¹⁴This is an obvious application of the well known Stolper-Samuelson Theorem: Protection tends to increase both the relative and the absolute reward of the country's scarce factor. See, Stolper and Samuelson [20].

However, the main justification for protection has been the so-called infant-industry argument. This argument has been used to support the establishment of inherently inefficient industries -i.e. industries which should never have been established. The modern approach to this issue is now well-known. However, it is worth repeating it, because it has somehow escaped the attention of the policy-makers, including some government economists also, in many developing countries. Here it must be borne in mind that, even according to the traditional infant-industry argument, the mere prospect of substantial future benefits is not sufficient to qualify an industry for the infant-industry status. The ultimate saving in cost occasioned by the establishment of an infant industry should compensate the community for the consumption cost and the production cost it will have to bear in the transitional period. Also, this compensation must exceed the cost of protection even after a suitable discount is applied to future returns. However, even if a potential infant industry satisfies all these conditions, it does not follow that protection is the best policy to promote it. For, fundamentally, the infant-industry argument makes productivity a func-tion of learning—referred to by Arrow [1] as "learning-by-doing"—associated with an increasing output of such industries. As a result, according to this argument, investment in an infant industry benefits future investors but such benefit is not paid for by the market. It follows that if an infant industry does in fact exist, the maximum investment in it will be smaller if the government does not provide it with additional incentives.

However, this incentive is not necessarily given, and in fact should not be given, in the form of protection—either by quota restrictions or by prohibitive duties on imports. For, when the potential benefits of establishing an infant industry result from the presence of the learning factor, the optimal government intervention should take the form of a *subsidy on the learning process*. This should be clear since protection, besides imposing additional consumption and production costs on the economy, does not guarantee that the learning accumulated in infant industries will be made available to other domestic producers *without charge*. On the other hand, government's research and technicals training centres will distribute freely to others the fruits of research and training. Also, the government could persuade private investors more effectively by directly undertaking and publishing benefit-cost analyses of the sociallydesirable projects than it could by protection. Furthermore, if the government could do the pioneering job itself, then both the subsidy and protection given to private investment might be inferior to government's direct participation in the production process itself.¹⁵

It may be argued in favour of present protective practices that import duties are afterall a potential source of revenue. However, this argument is fallacious. Firstly, it is not the intent of protective tariffs to raise revenue. Secondly, it is always possible to substitute import duties by domestic taxes. In fact, such a substitution has taken place in Pakistan since 1953 [Radhu, 18]. Thirdly, and this is related to the second point, import duties, besides raising revenue also have important and undesirable side-effects on resource allocation. Pakistan's experience has shown that import restriction, when not associated with appropriate excise taxes on the domestic production of import substitutes, do not curtail the domestic consumption of imported goods, because they also provide a strong incentive to their domestic production [Power, 17]. Thus,

¹⁵See Bhagwati and Ramaswami [2]; Johnson [8]; and Naqvi [13].

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the optimal policy to curtail the domestic consumption of luxury goods will be an excise tax, imposed at the same rate on imports and on the domestic production of these goods.¹⁶ Furthermore, by comparison with import restrictions such an optimal excise tax does not provide a net incentive to import substitution. As a matter of fact, since such an excise tax is not applicable to export industries, it provides them a net subsidy. The important point to note here is that it will not be necessary to actually *pay* any cash subsidies to export industries to encourage them. The mere fact that export industries are taxed at an overall rate lower than that applicable to import-competing industries will be enough to stimulate new investment into the former rather than into the latter.

(E) CONCLUSION

It is now proposed to bring together the various threads of the argument presented so far. The main thesis of this paper is that in order to solve on a long run basis the balance-of-payments problem of developing countries it is necessary to remove all the "distortions" which now block the adequate inflow of investible funds into export-expansion activity. An exclusive emphasis on maximizing (industrial) growth, fed primarily by ever-increasing doses of foreign aid, has led to a disregard of the problems of intersectoral and intra-sectoral allocative efficiency. So long as the industrial growth index inched forward, it mattered little whether the growth impulses emanated from import substitution or from export expansion. As a matter of fact, there has been a definite presumption that a dollar *saved* by import substitution is superior to a dollar *earned* by export expansion.

This bias against export expansion has resulted mainly from a deepseated but entirely misplaced, "export pessimism". For instance, in Pakistan exports of those goods which received proper export incentives have in general increased. The fact that nevertheless export expansion as a whole has lagged has nothing to do with any "outside" factors. This is not denying the potential adverse effects of restrictions imposed by developed countries on manufactured exports from Pakistan. The point is that domestic policies must also bear the blame for the stagnation in the export sector. As pointed out above, the overvalued rate of exchange made imports look artificially cheaper and has induced an inferiority complex in the domestic producer in his ability to export at competitive prices. Furthermore, the fact that more exports are not made lowers the domestic prices of these goods, inducing domestic producers to maximize profits by restricting output to sub-optimal levels (This incidentally also explains the widespread presence of excess capacity in the export industries). The highly protected domestic market has tended to reinforce these monopolistic tendencies. An appropriate devaluation alters the scene practically. It not only eliminates the net margin of protection to import substitution forthcoming under the regime of import restrictions; but, by comparison with the pre-devaluation situation, provides a greater incentive to export expansion than to import substitution. This is because now the effective export rate becomes more favourable than the effective import rate.

However, it is very important to keep in mind the very real problems that too steep a devaluation, such as the recent 131 per cent devaluation of the

¹⁶For a detailed discussion of this point see, Little, Scitovsky and Scott [11].

Pakistani rupee, is bound to create for the policy-maker. The most important of these problems is that the bias *against* export expansion may re-emerge in future if, as is very likely, the government responded positively to the inevitable pressures from chronic infant industries to increase import duties. However, a serious budgetary problem may raise its ugly head if import duties, frozen upwards by a massive devaluation, are not increased to take off some of pressure on domestic prices; and if at the same time the government succumbs, as it should in time, to the popular pressures to lower and ultimately to abolish export taxes which were imposed initially to make up the revenue loss from import duties. The optimal solution of this dilemma is gradually to replace import duties by excise taxes, levied at the same rate on both imports and domestic import substitutes. Any increases in such excise taxes will not have the resource-distorting effects that an upward revision of import duties is bound to have. As an additional bonus, export expansion will be favoured on the margin since it will not be taxed, while import-substitution activities are taxed.¹⁷ These considerations underscore the need for moderation in the extent of exchange reforms.

Hence, moderate exchange reforms must be followed up by efforts to evolve an "optimal" policy mix. In particular, the traditional favour in which import restrictions have so far been held as the primary balance-of-payments policy instrument must now be replaced by an optimal tax-cum-subsidy policy's not only to raise enough revenues for the government but also to "promote" not "protect", industrial growth in a balanced manner, by providing at least as many, if not more, opportunities to export expansion as to import substitution. [Little, Scitovsky and Scott, 11]. The present policy of making the corporate sector not only to invest but also to act as "unofficial" tax collector is undesirable because it entails unacceptable production and consumption costs; and, by making the economy too heavily dependent on imports, aggravates the balance-of-payments problem. Furthermore, because of the requirement of very high profit rates, such a policy, among other things, tends to widen the traditional cleavage between labour and capital. Thus if only for political reasons such a policy must be rejected. It must be replaced by an optimal tax-cum-subsidy policy which preserves all the good points of the policy mix it will replace but avoids its evil effects on balance-of-payments, resource allocation and income distribution.

However, fundamentally, the excessive devotion to "unbridled" growth manship, which can only be sustained by ever increasing doses of foreign aid, must yield place to a more sensible attitude towards economic growth. Such a change in attitudes has become all the more necessary because there are growing signs of aid-weariness on the part of the major donor countries. It can no longer be assumed with impunity that enough foreign aid will always be forthcoming to fill up the domestic resources gap, created by excessively high planned investment rates. Furthermore, the net potential contribution of

¹⁷However, the strong price-raising effect of such a sharp devaluation is most likely, by itself, to discourage export expansion. Thus for a 131 percent devaluation really to conferreal benefits an effective price-control policy will have to be combined with appropriate fiscal and monetary policies. The difficulties of the exact timing of this array of diverse policies suggests that such a steep devaluation was probably ill-advised for Pakistan. It would have been much better, to begin with at any rate, to devalue by a moderate percentage and provide cash subsidies to the export sector. The reduction in import duties would not then have been as drastic and the consequent loss of government revenue much less. Another dose of devaluation could have been administered a couple of years later.

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foreign aid to the domestic development effort of these countries will decline to zero in the not-too-distant future: with the debt-servicing and repayment liabilities on foreign debt incurred in the past rising at a rapid rate, these will soon match gross disbursements of aid. Consequently the governments in developing countries must show a greater sense of responsibility by a more effective utilization of their domestic and foreign-exchange resources. And for this very reason due respect must be paid to considerations of optimal resource allocation among various sectors. It must be recognized that allocative efficiency far from obstructing growth, as has so often been implied by the "growth-versus-allocative-efficiency" debate, is actually helpful in promoting it.

While the policy of "unbridled" growthmanship must be given up, it would be both misleading and dangerous to suggest that one should now put growth on one side and concentrate all efforts on attacking poverty.¹⁸ For, the fault has not been with growth. It is rather that we aimed too high in the sense of trying to invest too much in relation to domestic saving and in doing so the reliance on foreign aid deepened, which incidentally also led to a relaxation in our domestic resource mobilization efforts. Even more important, the peculiar growth strategy of relying too much on the corporate sector has backfired in that it has blocked potential growth that could have been achieved via allocative efficiency and a more equable income distribution.

It is not right to move from one extreme to the other. There was a time when we climbed, one after another, on to the bandwagon of "unbridled" growthmanship, totting horns and waving flags, oblivious of the consequences of such a policy. And our dependence on foreign aid grew at first slowly and then by leaps and bounds. Yet that did nothing to lessen our growth euphoria. Now, all of a sudden, an intellectual turnabout has occurred and it is being suggested that one should forget all about growth and take up arms against the sea of poverty.¹⁹ This attitude is as dangerous as the previous one was shortsighted. It would be more sensible to adopt a middle course between these extreme and start evolving an optimal policy mix, which, by ensuring allocative efficiency would also help growth to the extent permitted by the overall income distribution and balance-of-payments constraints.

¹⁸For instance, see Mahhub-ul-Haq [6]. "We were taught to take care of GNP as this will take care of poverty. Now let us reverse this and take care of poverty first, as the GNP can take care of itself since it is only a convenient summation, and not a motivation, for human efforts."

¹⁹This suggestion to attack poverty "directly" rather than indirectly through promoting economic growth leaves hanging in the mid-air the question as to how to pull this clever trick. For, any non-quixotic attack on poverty must take the form of financial investment which add up to an investment programme. This investment programme multiplied by an appropriate capital-output ratio yields a certain growth rate. Thus any "successful" attack on poverty must involve a minimum growth effort. Hence, rather than saying that we must forget all about growth, a less dramatic but correct statement would be to say that the scarce capital and abour resources must be allocated in an "optimal" fashion (which is what we have been ldvocaing in this paper) so that a higher growth rate is not accompanied by a depravation aof the majority of the society.

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