COVER STORY

Economic Growth of Pakistan: Arbitrary Policies in the Past and a Bumpy Road Ahead

Abdul Jalil

Once Benjamin Franklin said, "Without continual growth and progress, such words as improvement, achievement, and success have no meaning". The same is true in the case of economies. Economic growth expands the size of the economy and the living standard of a country's typical citizen. Generally, the word 'economic growth' is associated with growth in the gross domestic product (GDP), and the GDP is the market value of goods and services produced in a country. Therefore, it gives an opportunity to produce, consume and exchange more goods and services. The economic growth further leads to more job creations, industrial diversification, the retentions and expansions of businesses, the fortification of the economy, increased tax revenues, and improved quality of life of human beings. That's why economic growth is one of the most important indicators of the countries improvements.

In this backdrop, it is very safe to claim that economic growth is a delicate process and a subject of the utmost importance for politicians, policymakers, and economists. Notably, the economists had undertaken extensive historical and analytical research over the last two centuries (See Box 1). However, the interest in economic growth was renewed with new vigor after the Second World War. Almost all of the countries narrated their economic growth experiences through the literature produced in several books, scientific articles, and special reports of the recognized institutions. However, despite the availability of superior historical and statistical material combined with a sophisticated theoretical framework, new research contributions had been small, keeping the subject's importance in view. Moses Abramovitz, an economist who is well known for his research on macroeconomic fluctuations and economic growth, documents that this is mainly due to the complexity of the subject and the limitations of economics and other social sciences1.

Pakistan is not a different case. Like the Framework of Economic Growth, several essential documents suggest the roadmap for the economic growth of Pakistan. On the contrary, the growth path of Pakistan is shaky and moderate over the last four decades. The overall trend in economic growth is down due to several reasons. The graph shows that economic growth and total factor productivity are downward (see graph 1A). Within this context, this issue of the magazine attempts to present macro and sectoral perspectives on economic growth in Pakistan. The most important question that will be addressed is why the economic growth and total factor productivity of Pakistan are continuously declining over the past several years. These perspectives are based on the research, which is published under the patronage of the Pakistan Institute of Development Economics (PIDE). The main objectives of these viewpoints are to present narratives of what happened to the economy of Pakistan in the past, what were some of the possible the factors that restrained the economy from moving to a path of sustainable growth, how significant were various sectoral policies for the promotion of growth and what are the lessons to be learned for future policy?

Box 1: Old and New Growth Theories

Among the earliest exponents of economic growth, David Hume found a connection between the volume of international trade i.e., sum of exports plus imports and economic growth. The question of why the pace of growth differs between countries was first dealt by Adam Smith who took Hume's insight further and linked the division of labour, efficiency and the size of the market to wealth creation and growth of nations. Smith emphasized both direct and indirect connections between saving and investment and growth, former via accumulation of capital and letter through labour productivity and interaction with trade and exchange rate.

Later classical economists including Malthus, Ricardo, Mill and Marx expanded Smith's ideas on growth. However, Alfred Marshall added organization as the fourth factor of production and also emphasized the importance of distribution of income and wealth in the growth process. Joseph Schumpeter emphasized the importance of technology, invention, innovation and entrepreneurship. Harrod and Domar enunciated the dynamic relationship of economic growth with the rate of saving, capital output ratio and the rate of depreciation in a single equation.

The neo-classical growth model formulated by Solow (1956) differed significantly with earlier stance of the classical economists on the economic growth. Solow (1956) notes that the long run steady state of economic growth is determined by the growth rate of labour and the growth rate of the labour productivity. Solow (1956) also postulates that the rate of growth is independent of ratio of saving and investment to GDP. Solow (1957) estimated this residual for the US economy to be 87.5 percent of the growth in output per worker during 1909-1949. Consequently, factor accumulation explained only a minor part of growth, whereas the major chunk of growth was explained by the residual, which was labeled as total factor productivity.

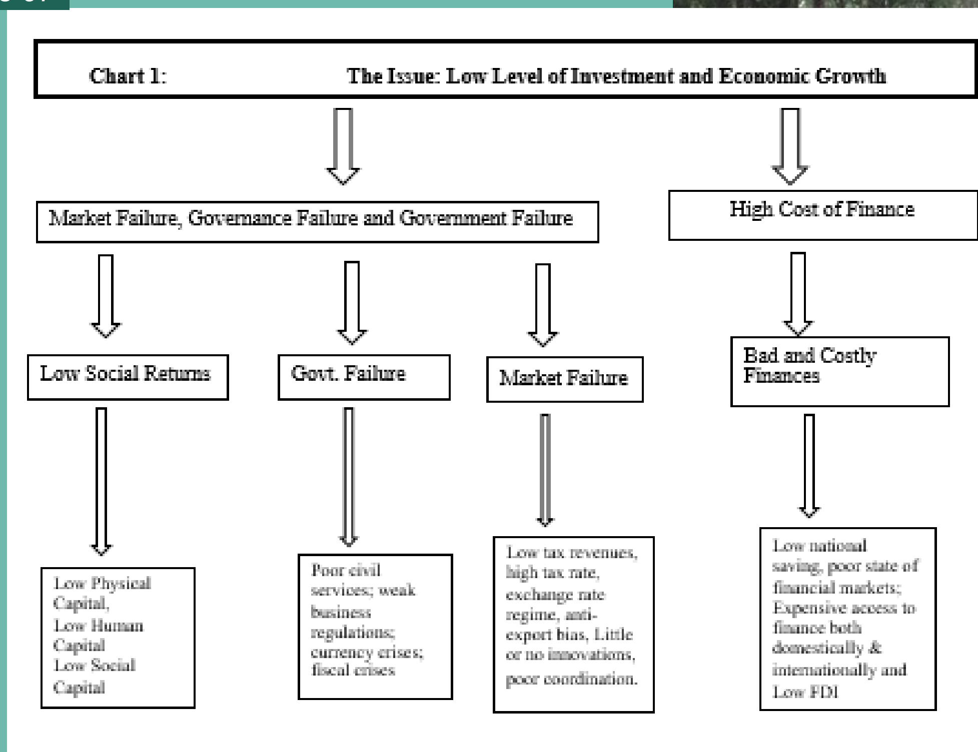
The "new growth" or the "endogenous growth" theories bring "factor productivity" inside the neoclassical model of growth along with "factor accumulation", i.e., residual is endogenised. Romer (1986) first formalized this approach in a model in which per capita income can grow without bound, possibly at a rate that is increasing over time. Proponents of endogenous growth theory emphasize that unlike physical capital, human capital may be augmented by non-diminishing return, which leads the growth to continue indefinitely. Technological progress, rather than being exogenous, occurs with purposeful economic activity when entrepreneurs seek ways to make new and better products and generate new ideas. Economics of new ideas, or innovation have a positive externality that help raise the productivity of all subsequent innovators.

Indeed, despite the available potential, sustainable high economic growth remains a real challenge for Pakistan. The past decades have been seen as a declining trend in actual and potential long-run growth path in Pakistan despite a few growth accelerations. The more worrisome is, the potential growth has been a decline from 7 percent to around 4 percent (see Table 1 and Figure 1A).

The growth performance of Real GDP is summarized in a frequency distribution of growth rates over the past 70 years in Table 1. One is immediately struck by the high modal growth rate between 6 and 7 percent per annum achieved in 12 out of 70 years. The Table is evidence of the poor performance of Pakistan on the front of growth. It is well understood that Pakistan requires at least a 7 percent to 8 percent growth rate for a considerably long period, say for 30 years (Haque 2020). Nevertheless, unfortunately, Pakistan crosses only a 7 percent growth rate, only 10 out of 70 years. Sadly, none of them happened in the last 25 years. Some economists, especially in the corridors of the powers, argue that in 60 out of 70 years, the rate of growth remained considerably higher than the rate of growth of population; therefore, the growth performance is satisfactory in the case of Pakistan.

Sadly, the central focus of the growth policy in Pakistan was the public sector projects, subsidies, protection to industry, and other arbitrary incentives (see Box 2). The literature on economic growth and economic development post that the development is not the name of a few projects, but it is an integrated process that prevails over a more extended period. Therefore, the natural outcome of these random acts that the vibrant and robust markets never developed in the country. Furthermore, the infrastructure remains poor and inadequate.

It is well settled in the policy discussion that one of the major causes of the low economic growth is the lack of private investment in the case of Pakistan. If we consider that this is an issue, then Haque (2020) posts that there are two major constraints to the low level of private investment and then the economic growth.First, market development and second public sector management (See Chart 1).



The second major constrain to economic growth that Haque (2020) points out is the lack or inefficient public sector management. The inefficiencies can be witnessed in almost all core functions of the government. That is the core governance responsibilities like providing the security of property, contracts, transactions, and, most importantly, life. The government is also failed to provide the appropriate physical, human, and social capital, which is the core of economicgrowth.

The other meaningful discussion is related to finances. There is well-established literature that finances causes growth. Therefore, the availability and access to finance are some of the essential elements in the way of economic growth. In the case of Pakistan, the costly and mere access to finance is a common issue. The issue of access to finance is due to several reasons including, but not limited to, low national saving, the poor state of financial markets (see Shahid and Fraz 2020), expensive access to finance both domestically & internationally, and low foreign direct investment. The story of lack of finances ends with an approach to international institutions for the finances like the International monetary fund (IMF). Notably, the literature has a lack of consensus on the role of the IMF for economic growth (Box 3), and Pakistan approached several times to the IMF for the finances [Box 4].

BOX 3

IMF and Economic Growth: Studies Around the World

The IMF has a stance on the economic growth. Particularly, the Articles of Agreement state that the mission of the IMF is to "facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."

However, the literature has a lack of consensus of the role of IMF in promoting the economic growth. For example, Reichmann and Stillson (1978), Connors (1979), Pastor (1987), and Gylfason (1987) reported no effect. While, Conway (1994) and Killick (1995), Dicks-Mireaux et al (2000), Evrensel (2002), Hutchison (2004), and Atoyan and Conway, (2006) found positive and mixed effects, Haque and Khan (1998) found mixed effect. On the other hand, Bordo and Schwartz (2000), Przeworski and Vreeland (2000), Hardoy (2003), Hutchison (2003, 2004), Hutchison and Noy (2003), Vreeland (2003), IEO (2002), Barro and Lee (2005), Butkiewicz and Yanikkaya (2005), Dreher (2006), Eichengreen eat al. (2008) and Marchesi and Sirtori (2011) argued that while growth declines in the first year of a program, the negative effects diminish after that. A useful recent systematic and useful review is done by Bal Gunduz et al. (2013) and Bird and Rowlands (2017)

There are several other reasons for low or costly access to finance, but the tax system and the developments of financial markets are the most important on the domestic front. The tax system and the tax collections are the long-debated issues in Pakistan. The tax to GDP ratio is consistently low according to the requirements of the IMF and, therefore, tax collection remains the central discussion point in the IMF-Led stabilization programs. It is argued that the low saving is due to low tax revenues and the high current (non-development) expenditures. The significant chunk of the expenditures is going to finance the salaries, subsidies, securities concerns, and other contingencies. All these things are crowding out public expenditures. It is also important to mention that the existing tax system is also deteriorating economic activities. Therefore, Nasir et al. (2020) document, Pakistan chasing the tax to GDP targets in arbitrary manners. Furthermore, the study of Nasir et al. (2020) also argues that the arbitrary tax policy is killing the transactions. Indeed, the low number of transactions implies that the low level of economic growth in the country.
The role of financial markets to get comfortable and less expensive access to finance is not appropriate in the case of Pakistan. Particularly, Mahmood, and Fraz (2020) argue that the state of financial markets in Pakistan should be of grave concern to the policymaker. Indeed, the financial sector of Pakistan is driven by the banking sector. Even the banks are not doing the 'banking.' The policy viewpoint of Mahmood and Fraz (2020) posts that out of the 33 banks, only 3 are investment banks, but they hardly issue anything. This serves as an indication of the lack of depth and maturity of the financial markets in Pakistan because leading investment banks have an essential role to perform in the economy.

What previous Literature Diagnosis for Pakistan?

A plethora of empirical research is produced to discover the reasons for the low growth of Pakistan's economy. As mentioned earlier, Pakistan's economic growth constraints are widely discussed in the literature over the last three decades. The most prominent constraints were a low investment in human capital (Ahmed 1991 and Fardoust 1998), inadequate investment in infrastructure (Fardoust 1998 and Burki 2007), weak institutions (Fardoust 1998), poor macroeconomic management (Fardoust 1998), political instability (Husain 2004), lousy governance (Husain 2004, Burki 2007 and Qayyum et al. 2008), and institutional shortcomings (Husain 2004); macroeconomic instability (World Bank 2006); trade imbalances due to trade protectionism (World bank 2006); budget deficit (Iqbal and Zahid 1998), low productivity in agriculture (Lopez-Calix and Touqeer 2013); inadequate investment in energy infrastructure investment (Qayyum et al. 2008 and Favaro and Koehler-Geib (2009), law and order (Favaro and Koehler-Geib (2009), tax collections (Favaro and Koehler-Geib (2009), Nasir et al. (2020) and balance of payments issue (Felipe et al. 2009) and Inadequate market development (Haque 2020).
All these overall results, spread over two decades, are taken into account in this paper. Two important studies attempt to diagnose the constraint to the economic growth of Pakistan. First, Qayyum et al. (2008) and second (Lopez-Calix and Touqeer 2013). Both of them follow Hausmann et al. (2005) methodology to systematically diagnose the constraint to economic growth in Pakistan's case. Lopez-Calix and Touqeer (2013) document that the significant issue with Pakistan's economy is the low level of investments. The low level of investment is fueled by low return on and then the economic activities. Sand the costly access to finance. Haque (2020) notes that Pakistan never learned from history in policymaking but merely repeating the old mistakes.

Regional Comparisons on Economic growth, Saving, and Investment

The most important factor for the production and then the economic growth is an investment, and the savings fuel the investment. It is also a well-known fact that the increasing global challenges and competitions also requires the catchup with, at least, regional competitors. Sadly, the economic growth of Pakistan is diverging from its main competitors. We plot the income ration in figure 1B (see Box 5). The per-capita income of Pakistan was almost double in the early 1990s as compared to China, Pakistan, and Bangladesh. That is, Pakistan was much more productive than the neighboring countries in the 1980s and 1990s. Since then, it is continuously decreasing. This development shows a continuous diverging pattern. This policy brief offers a diagnostic of structural issues of lowering economic growth and then the possible policy interventions in the case of Pakistan (See Figure 1Aand Figure 1B)

Box 5: Income Ratios (IR)

This ratio is calculated to analyse the relative per capita incomes of Pakistan to its competitor counties. *comppakyyIR*=That is:
Where ir= income ratio
ypak= per capita income of Pakistan at Purchasing Power Parity constant 2017 international dollars

ycomp= per capita income of competitor country at Purchasing Power Parity constant 2017 international dollars

There are three possible values.
1= the per capital income of both countries are same
>1= per capita income of Pakistan is greater than the competitor
<1+ per capital income of Pakistan is less than the competitor country.
A falling ratio implies that the per capita income of Pakistan is decreasing as compare to the competitor country.

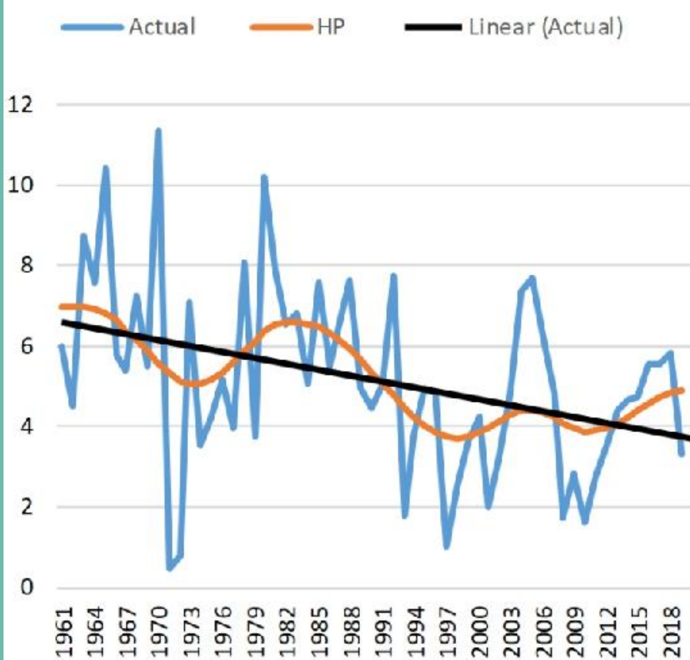


Figure 1A: Long Run Actual and Trend Growth

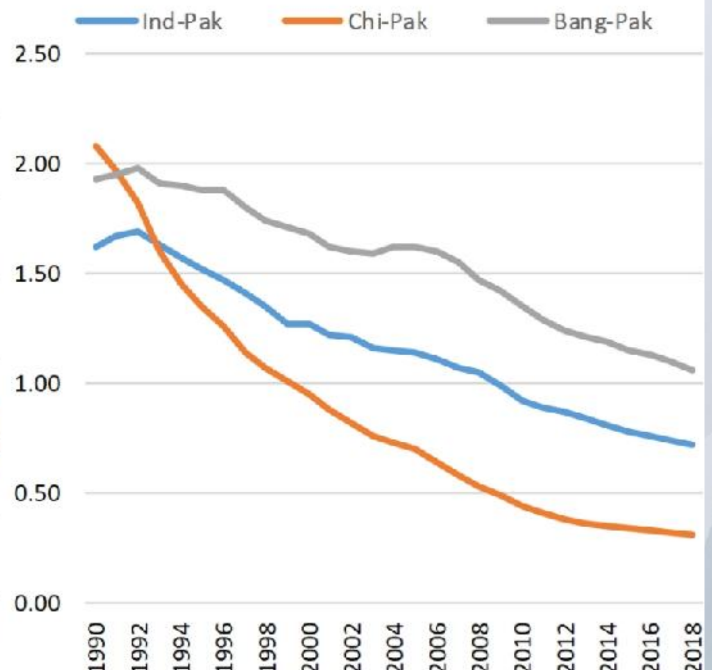
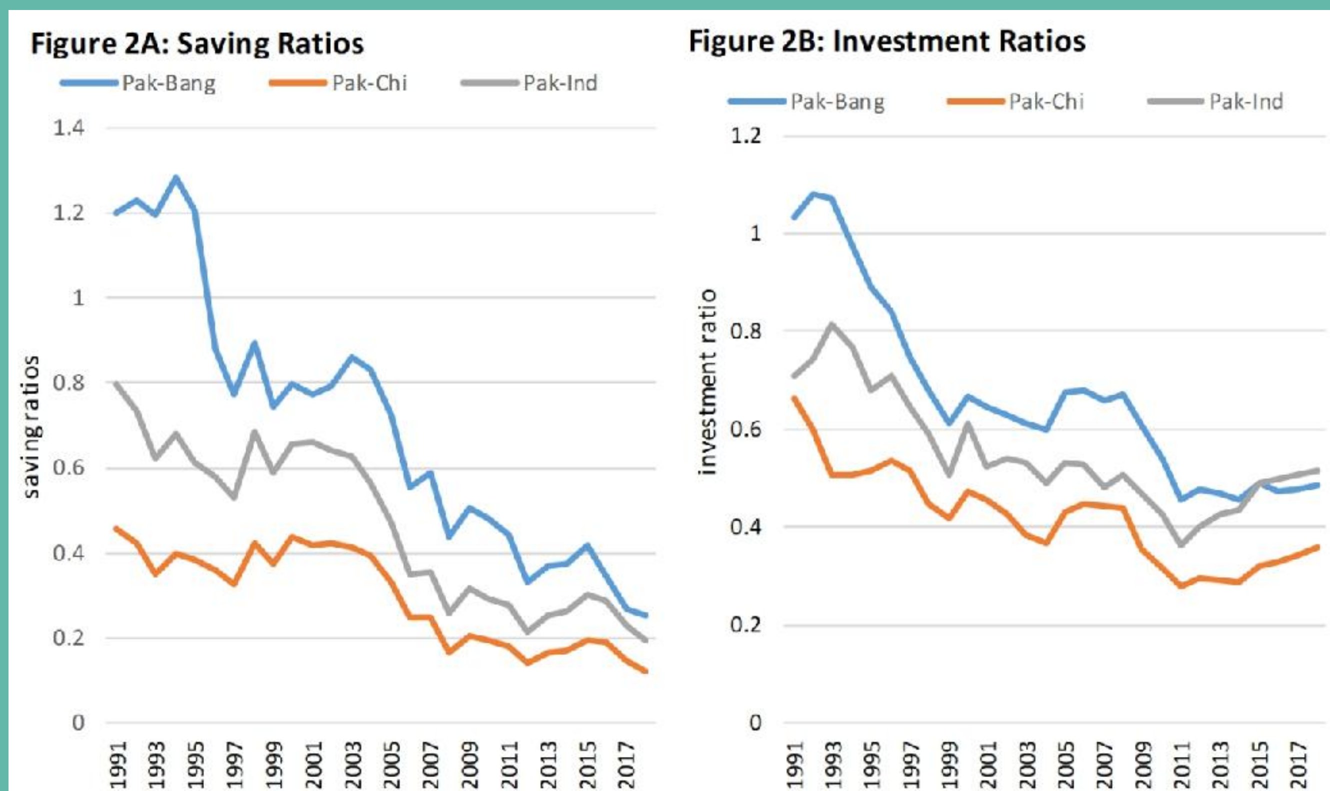


Figure 1B: Ratio between the incomes per-capita

Saving and Investment

The neo-classical economic growth models and endogenous growth models have a consensus that the saving, which are assumed to be the source of an increase in investment and then economic growth, are vital for economic growth (see Klenow and Rodriquez-Clare 1997 and Howitt 2000). Unfortunately, both saving and investment are low and declining, as compared to neighboring countries, in the case of Pakistan.

The saving ratio and investment ratio [see box 1] in Figures 2A and 2B show that the saving and investment as a percent of GDP declined in Pakistan as compared to Bangladesh, India, and China over the last three decades. Interestingly, saving to GDP ratio of Pakistan was equal to the saving to GDP ratio of Bangladesh in the early 1990s, and now it dropped to 30 percent of Bangladesh. The same is true in the case of China and India. Similarly, the investment to GDP ratio is also continuously declining as compared to selected neighboring countries.



Conclusions and Further Readings

The discussion on the economic growth of Pakistan and the growth strategy remains the top agenda in PIDE. Therefore, PIDE published/suggest several pieces for the policymakers to pave the path of economic growth in Pakistan. Recently, Haque (2020) suggest some workable solutions for sustainable economic growth in the country. These may be total factor productivity (TFP) (Siddique 2020), better government (Haque 2020 and Hassan 2006), better governance (Haque 2020 and Qayyum et al.), more trade openness (Khan and Qayyum 2007), vibrant and robust competitive markets, smart and creative cities [Nayab (2007), (Haque and Nayab (2007a, 2007b)], and mobilizing the youth are the few engines of economic growth in the country. There are several other questions are as well. This issue of the magazine will give more details on the issues and solutions regarding the economic growth of Pakistan