Strategic Insight

Failed Economic Take-Offs and Terrorism: Conceptualizing a Proper Role for U.S. Assistance to Pakistan

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Introduction

During the 1990s Pakistan's economy suffered on two accounts. One, lack of vision by the civilian ruling elites to make efficient use of public financial resources to boost economic growth, contain poverty, and develop human resources. Two, the inability of these governments (B. Bhutto and N. Sharif) 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 selected few and the erosion of any institutional accountability. Four key economic breakdowns evolved out of this environment: (1) high fiscal deficits; (2) an unsustainable public debt (domestic and foreign); (3) a sharp deterioration in the distribution of income; and (4) a disturbing rise in the level of poverty.

Under the Musharraf Administration, considerable progress was made in correcting the first and second problems, but possibly at the expense of a further sizeable increase in the numbers of people below the poverty line. In part, economic performance under Musharraf stems from the emphasis placed over the last three years on macroeconomic stabilization as a key to fighting poverty. The strategy hinges on the premise that stability will result in higher rates of investment and eventually the restoration of rates of growth of over 6% (Malik 2003) per annum achieved during the 1960s, and through most of the 1980s. In turn high growth will pull large segments of the population up over the poverty line. The hope is that in the near future sustained rates of growth of over 6% will again be the norm.

The question that immediately arises is whether this is a realistic goal for the economy. Historically, Pakistan grew faster than the South Asia average by an average of 2 percent in the 1960s and 1970s, and at similar rates through the 1980s. 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 the four decades. In short, with the exception of a spurt in the 1980s, trends in growth in Pakistan have been steadily slowing from initially very high levels since the 1960s. At that time, many observers thought the country had taken off (Burki, 2003) in the Rostow (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.

The December 2002 Strategic Insight "IMF Stabilization Programs and the War on Terrorism: Conflicting or Complementary Objectives in Pakistan?" examined some short-run challenges facing the economy. It concluded that if growth does not materialize soon there is the real danger that Parliament is likely to modify the current set of orthodox IMF-type economic policies to be more populist/inward oriented. If this occurs, it may be extremely hard for the country to attract the foreign capital it needs to restore rates of growth in the 6% range. Continuing with the IMF's macro-stabilization program is probably the best thing the country can do in the short run to restore investor confidence, and in this regard there are some encouraging signs of increased investor confidence in the country (*The News*, January 20, 2003). However, in the longer term, Pakistan must address its domestic terrorism problem if it is to receive high, sustainable amounts of foreign investment. This Strategic Insight now turns to the longer-term challenges facing the economy—even if foreign investment picks up, will the country be able to sustain rates of growth in the 6% range required to make a significant dent in the country's massive poverty?

In short, this essay addresses the following: (a) What factors appear to limit rapid, sustained growth in Pakistan? (b) Have these changed significantly over time? (c) Is the increase in domestic terrorism and wide-spread sympathy for terrorist groups (Bokhari 2003) related to past patterns of economic growth and development? and (d) If so, is it possible or 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: escalating terrorism and an underperforming economy?

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

The main factors underlying the country'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 brought about by increased foreign direct investment. Conversely, declines in TFP can come about because of such factors as erosion in governance, increased protectionism, slow-down in globalization and corruption. As a standard for comparison, about half the growth in the industrial democracies stems from TFP. On the other hand, economies isolated from the global economy such as the former Soviet Union and the Latin American economies at the height of their phase of import substitution in the 1960s derived no growth from TFP.

A recent study (IMF 2002) of total factor productivity in Pakistan paints a telling picture. The IMF found that for 1961-2001 as a whole, Pakistan experienced only moderate TFP growth (0.5 percent 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.

Looking at sub-periods, an interesting pattern emerges. In the 1960s, Pakistan's TFP experienced negative growth (on average -2.2 percent). Beginning in the 1970s, TFP growth became positive, peaking in the 1980s (2.4 percent), only to become negative again in the second half of the 1990s when it declined to -0.4 percent per annum.

The IMF attributes Pakistan's strong growth performance of 6.6 percent per annum in the 1960s to rapid increases in investment, both physical and human. Many observers point to the 1960s as a period of the country's greatest economic success resulting in a Rostow-type take-off. Clearly, however there were forces at work that would eventually constrain and decelerate growth (Looney 2001, p. 203). In addition to low rates of domestic savings forcing an eventual decline in investment the rapid growth during the 1960s was not broad-based. More telling, it generated a great deal of economic tensions: 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 percent of industry, 97 percent of the insurance sector and 80 percent of banking. A mere 0.1 percent of landlords owned 15 percent of the country's total land.

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

The country's economy expanded again in the 1980s, with the average annual rate of GDP growth of 6.1 percent only slightly below that of the 1960s. Total factor productivity expanded up to an average of 2.5 percent. The country's initial attempts at market-oriented reforms including deregulation and privatization no doubt contributed to increased efficiency.

Despite rapid growth, the economy showed an increasing number of structural weaknesses toward the end of the 1980s. These included (Looney, 2001, p. 210): (1) heavy regulation of economic activity through price control, industrial licensing, and Government ownership; (2) a trade regime that provided a high level of protection and created distortions, thus inhibiting competitiveness and export growth; (3) a weak public resource position due 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..

No doubt as a result of these distortions, economic growth decelerated again in the 1990s with average trend GDP growth of 3.9 percent per year for the period 1991-2001, but only 3.2 percent during the 1996-2001 period. The fall in total factor productivity was particularly dramatic, declining to negative 0.5 percent per annum during 1996-2001. The rate of growth of the physical capital stock also decelerated somewhat to average 4.4 percent. Human capital growth also decreased to 3 percent 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 eradicate poverty.

Summing up, it appears that Pakistan had what might be called two failed takeoffs—the 1960s and the 1980s; periods where growth and investment (and in the 1980s total factor productivity) accelerated only to run into constraints imposed by low savings rates, macroeconomic imbalances, and a lack of supporting institutional development and proper governance structures.

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

More bluntly, Shahid Husain (2001) has attributed the country's inability to sustain high growth to the following factors:

1. An increase in the role of the state has coincided with a decline in governance.

2. Non-competitive regimes politically and economically have resulted in rampant corruption and stagnation—the subversion of competitiveness was the central feature of Pakistani governments.

3. There has been a continuous redistribution of wealth in favor of privileged groups

4. A hard crust of economic monopoly has stifled new growth and creativity.

5. An erosion in the provision of public services has resulted in a decline of the public's trust in government which is seen a predatory. This, in turn, is linked to non-payment of taxes, the corruption in tax administration, and the massive increase in borrowing.

6. The quality of the civil bureaucracy is falling rapidly. A majority of civil servants are not even paid a living wage and this is tantamount to an incentive to corruption.

7. The irrelevance of the state in the lives of the people is exemplified by the total breakdown of law and order.

8. The inability and unwillingness of the state to discharge its social services has meant a vacuum in social services. Pakistan's literacy rate has remained almost unchanged since independence. The dependence on madrassahs (religious schools) is hence understandable.

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

These factors can all be grouped into a system characterized by the dominance of diversion over production. As Kazmi (2003) notes:

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.

Finally, there is empirical support that the diversionary economy suffers from low productivity capable of stifling long periods of high growth. Hall and Jones (1996) have developed an index of anti-diversionary policy consisting of five main components. Two of the categories relate to the government's role in protecting against private diversion: (1) law and order, and (2) bureaucratic quality. Three categories relate to the government's possible role as a diverter: (1) corruption, (2) risk of expropriation, and (3) government repudiation of contracts. They find that an equal weighted index is highly correlated with output per worker. Bureaucratic quality, law and order along with corruption remain a problem in Pakistan with the other two elements presenting a lesser challenge.

For its part, the Musharraf administration initiated reforms 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/accountability, fighting corruption and civil service, judicial, and police reforms.

The Musharraf reforms appear sound and well intended, although it is too early to gauge their progress. One thing is certain, however: the country has a long way to go before high rates of growth can be restored. A recent World Bank report on Pakistan, notes that despite the general perception prevailing among the public that governance has improved in the last few years, Pakistan still ranks 74th out of 102 countries in the CPI (Corruption Perception Index).

Sources of Terrorism/Terrorist Support in Pakistan

One thing is clear. The progress made in implementing the Musharraf reforms will have tremendous implications for terrorism in Pakistan. Burki (2002) notes that the important question is not what kind of presence Al Qaeda has established in Pakistan. "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." At issue then is what objectives should the reforms be focused on? Does terrorism breed in 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 opportunity of economic success for not only the common man, but the educated as well—an environment that is also felt by many Pakistanis. Or is terrorism simply a reflection of militant Islam stemming from the rapid expansion of the madrassahs or religious schools? (Looney, 2002) In 1947 around 150 madrassahs existed in Pakistan. By 1971 this number had increased to 562. Another thirty years later in 2002 there were about 20,000.

As for the underlying causes of terrorism, initial post-9/11 speculation focused on poverty and low educational attainment as critical elements. With time and more rigorous research a different picture has emerged. Krueger and Maleckova's detailed and in-depth review of the evidence 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. 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 low market opportunities or ignorance, they suggest terrorism is a response to political conditions and long-standing feelings (either perceived or real) of indignity and frustration.

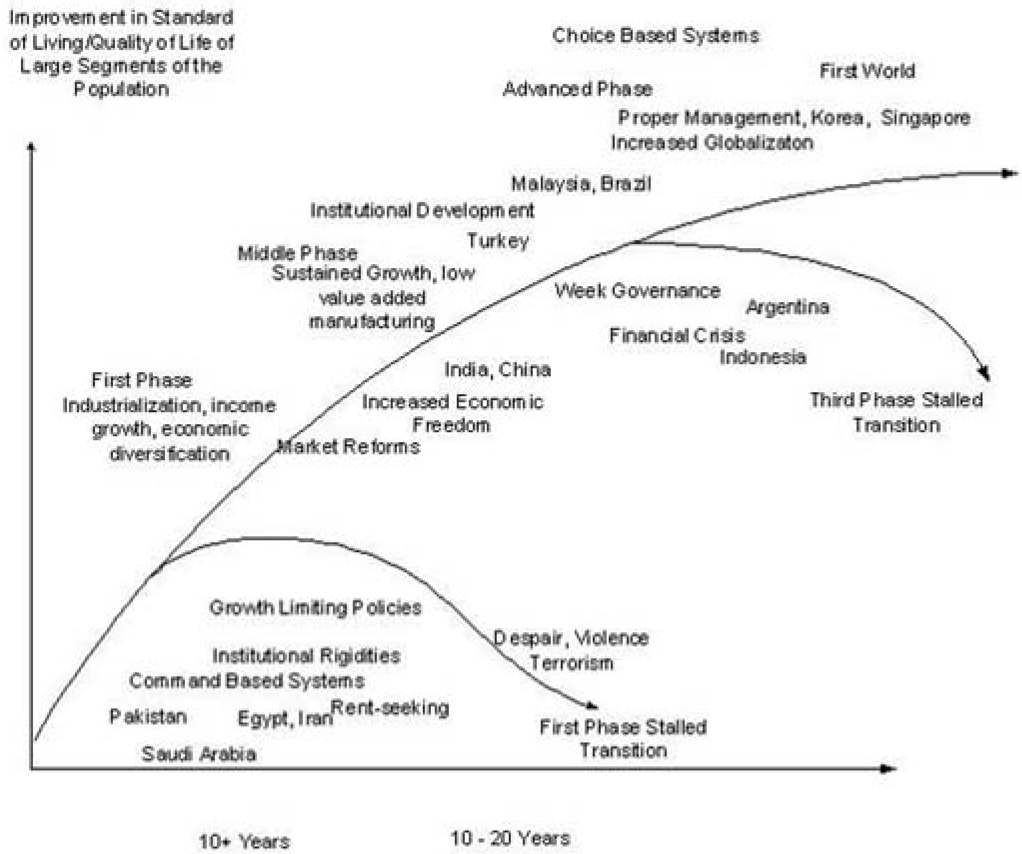
The growth and productivity patterns noted above are certainly suggestive that Pakistan is a classic example of a country fulfilling Krueger and Maleckova's description of a terrorist breeding ground. Clearly, large segments of the population have become weary and frustrated with the country's lack of 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 and institutional failure noted above, seem to fit in well to a more formal model of terrorist development recently devised by Bremer and Kasarda (2002).

Failed Transitions and Terrorism

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

The New Second World transition has three phases (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, economic diversification—that accompany it. In 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.

Figure 1 New Second World Transitions



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 begins to emerge. 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 phase 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. This group has 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."

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.

No indexes of the degree 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. 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 way in which these elements are restricted by governments.

Gwartney et al choose 17 such measures in four broad areas: (1) money and inflation; (2) government operations and regulations; (3) takings and discriminatory taxation; and (4) international exchange. Indexes vary based on the weights given the 17 components. On their index 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 to improvements in just a few components in the index (Looney 1997): marginal tax rates were reduced, the black exchange premium was eliminated. 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 last 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 pay-off 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 also 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 needed to navigate out of the first development stage currently trapping the country. Here, U.S. 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 (Figure 2), contributions (dotted lines in Figure 2) toward reducing poverty and the numbers of Islamic militants would occur simultaneously.

Ordinary aid towards institution building, anti-corruption and the like 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. As a result, the United States would not be 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 the country in moving towards a choice based system?

Figure 1 New Second World Transitions

This approach is also consistent with the objectives laid out in the country's new Five Year Plan to raise the GDP growth rate to 6 percent by June 30, 2005 (Naqvi, 2003). To achieve this the government has targeted six key areas: (1) political stability; (2) regional stability; (3) law and order; (4) the continuance of fiscal responsibility—tight control over budget deficits; (5) economic policies have to remain consistent and transparent; and (6) the structural reforms program must actually be ahered to and completed.

The key remaining issue surrounds the type of assistance—should it be in the form of aid, with a stipulated rate of interest, or an outright grant? An earlier Strategic Insight (Looney, September 2, 2002) suggested that the United States should also consider 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.

See Figure 2 at end of document.

For more topical analysis from the CCC, see our Strategic Insights section.

For related links, see our South Asia Resources and Homeland Security & Terrorism Resources.

For Further Reading

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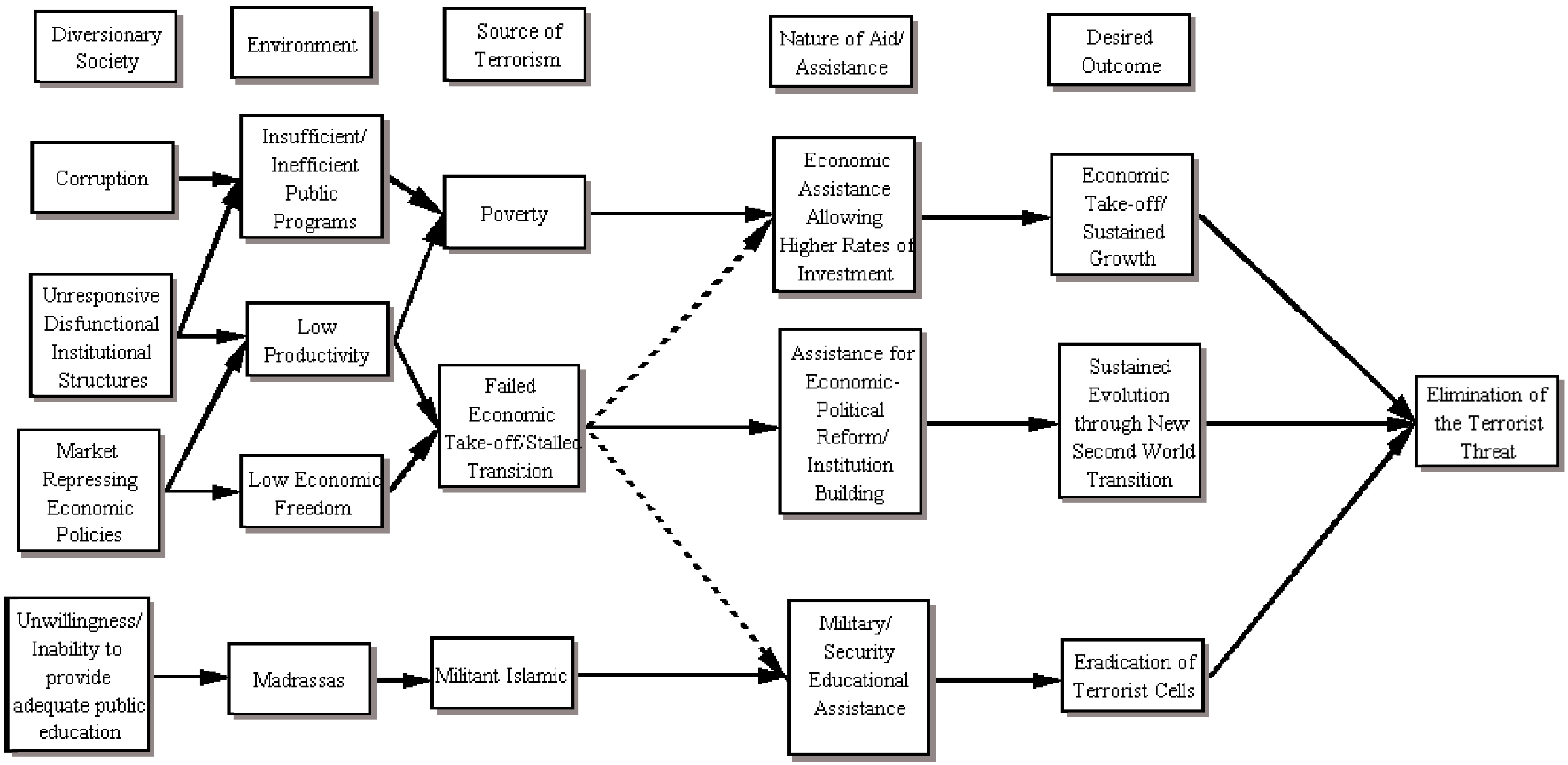
Diversionary Society
Environment
Source of Terrorism
Nature of Aid/ Assistance
Desired Outcome
Corruption
Unresponsive Disfunctional Institutional Structures
Market Repressing Economic Policies
Unwillingness/ Inability to provide adequate public education
Insufficient/ Inefficient Public Programs
Low Productivity
Low Economic Freedom
Madrassas
Poverty
Failed Economic Take-off/Stalled Transition
Militant Islamic
Economic Assistance Allowing Higher Rates of Investment
Assistance for Economic-Political Reform/ Institution Building
Military/ Security Educational Assistance
Economic Take-off/ Sustained Growth
Sustained Evolution through New Second World Transition
Eradication of Terrorist Cells
Elimination of the Terrorist Threat