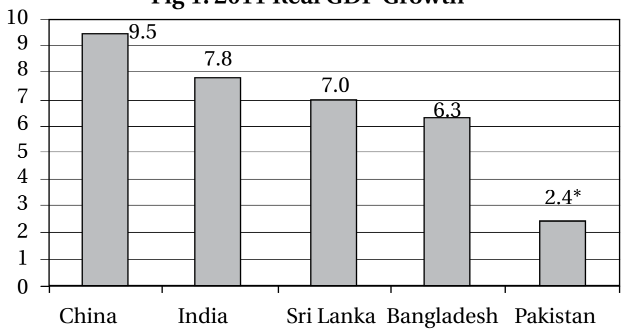
Pakistan's Economic Crisis: On the Road to Perdition

Mohan Guruswamy

According to the International Monetary Fund (IMF), Pakistan's economy grew by only 2.4 percent last year, one of the lowest in the region and way behind that of India, Sri Lanka and Bangladesh. This came after slow increases in the three previous years. This made 2008-11 the longest downturn in Pakistan's economic history. This also means that per capita income increased by only 0.4 percent. Given the sharp deterioration in income and wealth distribution, a good part of the increase was garnered by the well off, expectedly leaving the poor poorer. This low growth of Gross Domestic Product (GDP) means that the pool of poverty has actually expanded by about 10 percent a year, resulting in almost a third of Pakistan being abjectly poverty stricken. This means Pakistan has added 5-6 million to its poverty pool. Its pace of growth makes Pakistan an exception, certainly in South Asia, if not the entire developing world. Fig 1 below gives the growth rates projected in South Asia last year. Indeed, for almost a quarter of a century, Pakistan's GDP grew at a faster pace than India's.

Fig 1: 2011 Real GDP Growth



Source: IMF *World Economic Outlook* (*Actual growth taken from Pakistan Economic Survey).

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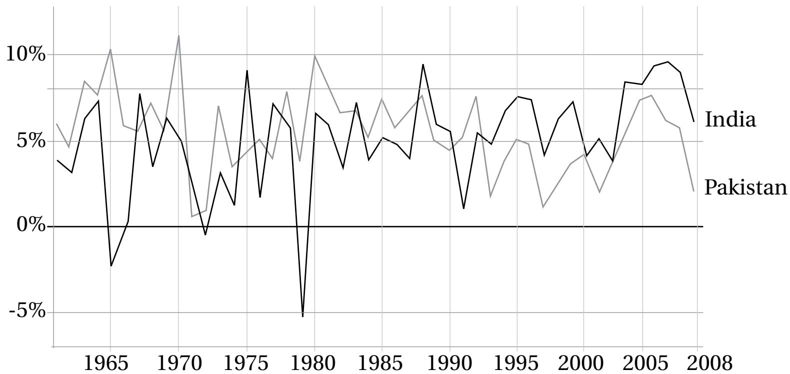
It was not very long ago that Pakistan was held out by many in the West, particularly in the US, as a country to emulate in economic terms. Pakistan was held out as an example of a capitalist state or a free market economy doing better than a state with central planning. Whether Pakistan indeed had a free market economy without democracy is a matter that has not been explored with any seriousness, but what it certainly had was a freewheeling system where crony capitalism prevailed. While it is true that it is only since 1984 that India's GDP has been rising faster than Pakistan's, the fact remains that that this was so even when India was still a centrally planned economy, and had borne the brunt of a savage terrorist campaign let loose by Pakistan in the Punjab, and the assassination of a prime minister. However, it is true that India has been rapidly pulling away from Pakistan since 1993. Fig 2 gives a graphic view of the GDP growth rates of the two countries.

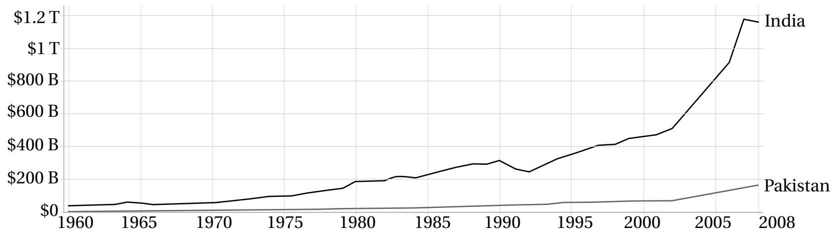
Fig 2: GDP Growth Rate



Source: World Bank Development Indicators, Last updated July 27, 2010.

Growth rates graphics do not tell the story of the growing economic gap between India and Pakistan as well as the overall GDP trends graph reproduced below (Fig 3). India's GDP now is more than seven times that of Pakistan and is growing faster.

Fig 3: Gross Domestic Product



Source: World Bank Development Indicators, Last updated July 27, 2010.

Neither the differences in growth rates nor the differences in GDP tell the tale of the now vast economic and military asymmetry between India and Pakistan, as the tax/GDP ratios indicate. The power of a nation to do good to itself or influence others is essentially a factor of the economic resources the state has at its disposal. Economists generally look for three ratios to tell this tale. One is the tax/GDP ratio. The other two are the investment/GDP and the national budget/GDP ratios. Read together these three ratios reveal a great deal about a country and what it is experiencing. The tax/GDP ratio shows how much a country has to spend on itself, the investment/GDP ratio reveals how much it is able to invest within itself to improve and expand the economy while the national budget/GDP ratio reveals a broader picture of resources being made available by the state to invest in the social sectors, in administering itself and on state investments as economic drivers. Last year, India's tax/GDP ratio was 17.7 percent of a GDP of over $1.3 trillion or almost seven times larger than Pakistan's. *The Economist* of January 11, 2011, very succinctly explains this as follows: "Yet Pakistan's fiscal troubles are antediluvian. It is one of the most lightly taxed countries in the world. Fewer than a quarter of the country's firms declare any taxable revenues, and only 11 out of every 1,000 of its citizens pay tax on their incomes, according to the World Bank. As a result, tax revenues amount to a mere 10 percent of Pakistan's GDP." In 2012, it is actually a mere 8.6 percent of a GDP of about $180 billion. Many like, the Central Intelligence Agency (CIA), actually say the GDP is less – closer to $165 billion. Table 1 below gives a vivid picture of this declining trend in the tax/GDP ratio.

Table 1

	Direct Taxes	Customs Duty	Sates Tax	Central Excise Duty	In-direct Tax	Total FBR Taxes	Sur-chage	Total Federal Taxes	Total Provincial Taxes	Total Taxes
1990-91*	1.49	4.89	1.50	2.07	8.46	9.95	1.01	10.96	0.51	11.47
1994-95*	2.74	3.45	1.94	1.94	7.33	10.07	0.92	10.99	0.50	11.49
1999-2000	2.95	1.61	3.05	1.46	6.12	9.07	1.02	10.09	0.47	10.56
2004-05	2.82	1.78	3.67	0.82	6.26	9.08	0.41	9.49	0.45	9.94
2006-07	3.85	1.52	3.57	0.82	5.91	9.76	0.74	10.50	0.42	10.92
2007-08	3.77	1.47	3.76	0.82	6.05	9.82	0.34	10.16	0.40	10.56
2008-09	3.47	1.16	3.55	0.91	5.62	9.09	0.99	10.08	0.36	10.44
2009-10	3.60	1.10	3.50	0.80	5.40	9.00	0.80	9.80	0.40	10.20

* The GDP has been increased by 20.6 percent following the rabasing of national income accounts.

Source: FBR Year Book
Pakistan Economic Survey
IMF Staff Reports

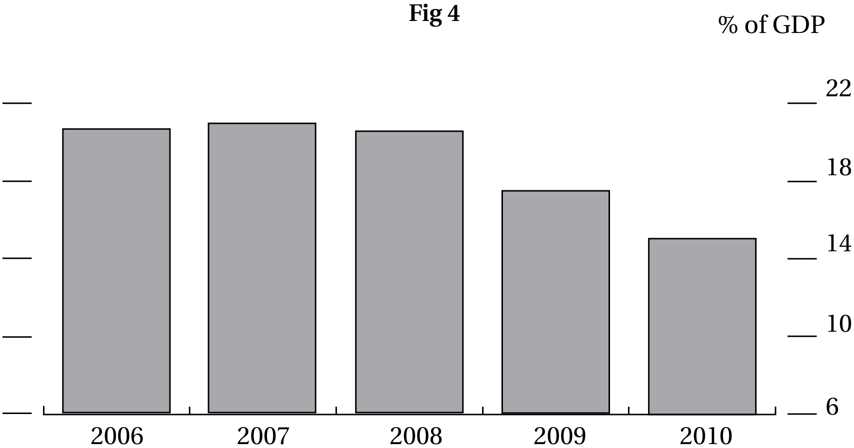
In Pakistan, this ratio has actually been declining, mostly due the increasing incidence of evasion of taxes, signifying certain erosion in the capacity of its public administration as well as values. Tax evasion is widespread. Sabrina Tavernise, writing in *The New York Times* of July 16, 2010, states: "Much of Pakistan's capital city looks like a rich Los Angeles suburb. Shiny sport utility vehicles purr down gated driveways. Elegant multistorey homes are tended by servants. Laundry is never hung out to dry."

"Taxes are the Achilles' heel of Pakistani politicians," said Jahangir Tareen, a businessman and member of Parliament who is trying to put taxes on the public agenda. "If you don't have income, fine, but then don't go and get into a Land Cruiser." As can well be expected, out of more than 170 million Pakistanis, fewer than 2 percent pay income tax, making Pakistan's revenue from taxes among the lowest in the world, a notch below Sierra Leone's as a ratio of tax to GDP.

The consequent effect of this is that the share of public sector development expenditure declined to a little more than 2 percent, the lowest in history. In real terms, expenditure per capita on such basic services as primary education and health care declined to the point where only a quarter of the population was accessed by the public sector.

Investment comes from both domestic and foreign sources. In 2011, Pakistan had an investment/GDP ratio of 18.1, placing it along with very high-income countries like Germany (18.9), Italy (19.2) and the UK (15.0). But the substantially higher GDP of the countries means that in actual terms, the investments are high. In comparison to India's 33.7 percent and China's 42.6 percent, Pakistan really lags behind. It would, however, seem that the World Bank data tends to be somewhat optimistic about investment in Pakistan. Fig 4 below, formulated by its own Finance Ministry, is even more pessimistic.

Fig 4



Source: Ministry of Finance, *Pakistan Economic Survey 2009-10*. http://www.finance.gov.pk

The difference in investment rates should somewhat explain the huge asymmetry between China and India, and India and Pakistan. If India's GDP is seven times that of Pakistan, then China's is about three times that of India. In real terms what this means is that while Pakistan is able to invest only about $18 billion a year, India is able to make an investment of 33.7 percent out of a GDP of $1.3 trillion or about $438 billion. Investments in turn beget taxes and so this gap keeps widening. In 2011, the Government of India had estimated a budgetary expenditure of $311.2 billion, Pakistan's national budget envisaged an expenditure of $39.77 billion. According to the World Bank, in 2010, India had a military expenditure/GDP ratio of about 2.4 percent, while Pakistan's was 3.4 percent. Thus, India's military expenditure is determined to be $31.2 billion as opposed to Pakistan's $6.12 billion, making India's military budget alone equal to about 80 percent of Pakistan's national budget.

Pakistan's problems are compounded by the rate at which its population is growing. When a country's economy is growing, increasing population means an accretion to the available work force, but when its economy is decelerating, a growing population only adds to the country's woes. Pakistan's total fertility rate (TFR) is 4.116, which is the highest in South Asia and among the highest in the world. Some Pakistanis, however, rationalise this failure in a critical aspect of development (reducing the rate of population growth) as a positive advantage (leaving Pakistan with a larger potential work force). It is equally plausible that Pakistan's current high TFR (and high population growth rate of 2.3 percent) will perpetuate the youth bulge, generation after generation, overwhelming the state's capacity to deliver education, health care and jobs to an ever-expanding pool of young people. Without high investment in health and education, and in trade and industry, the economy will just not be able to generate the jobs needed to employ so many additional numbers joining the work force each year. Unemployment among young people makes them easy tinder for dangerous ideologies in addition to becoming prey for demagogues. Table 2 below gives the current and projected population of Pakistan.

Pakistan's economic story is a now seemingly never-ending cycle of low savings, low investment and huge expansion in population. One natural corollary of this would be the fast deteriorating income inequality.

That, in a nutshell, is Pakistan's economic story—a now seemingly never-ending cycle of low savings, low investment and huge expansion in population.

Table 2

Demographic Highlights	
Population Living in Urban Areas of 750,000+, 2005 (%)	18
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Youth Ages 10-24, 2006	54,200,000
Youth Ages 10-24, 2025	64,800,000
Ever-Married Females Ages 15-19 (%)	21
Population Mid-2009	180,808,000
Birth Rate (Annual Number of Births Per 1,000 Total Population)	30
Death Rate (Annual Number of Deaths Per 1,000 Total Population)	7
Rate of Natural Incr. (Birth Rate Minus Death Rate, Expressed as a %)	2.3
Population Mid-2025 (Projected)	246,286,000
Population Mid-2050 (Projected)	335,195,000
Population Change 2009-2050 (Projected %)	85

One natural corollary of this would be the fast deteriorating income inequality. Over the last thirty years, income inequality in Pakistan followed an uneven pattern. The Gini coefficient of the distribution of income rose from 0.36 in 1972

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to 0.41 in 2005. Income inequality widened during the Seventies. The share of the poorest 20 percent in total income decreased during this period while the share of the richest 20 percent increased. The share of poorest 20 percent increased a little bit during the Eighties but it started to decline again in the Nineties and reached 6.37 percent in 2004-05. On the other hand, the share of the richest 20 percent in total income increased during the sample period and reached 50.02 percent in 2004-05. According to a US State Department report, released in 2006, the Gini coefficient for Pakistan is 0.68. According to the same report, the 'Gini Index' for the various countries is thus:

Japan	14.9
Sweden	21.0
Switzerland	21.1
Germany	22.3
United Kingdom	23.0
Canada	23.1
France	32.7
Iran	41.0
United States	46.6
Argentina	52.2
Mexico	54.6
South Africa	57.8
Namibia	70.7

That Pakistan should now be ranked almost alongside Namibia, one of the world's poorest and till recently the most racially exploited country, is testimony to how things have slipped out of control in Pakistan. The one thing most social scientists are agreed upon is that high income inequality is one of the essential prerequisites for disorder.

Table 3

Current Account (US$ Million)							
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Trade Balance	-6,340	-9,647	-10,587	-16,769	-10,372	-13,318	-
14,149							
Goods: Exports FOB	15,433	17,049	18,188	21,328	18,285	18,330	18,494
Goods: Imports FOB	-21,733	-26,696	-28,775	-38,097	28,657	-31,649	-32,643
Services Balance	-3,830	-4,912	-5,044	-5,363	-3,021	-3,199	-
3,568							
Income Balance	-2,514	-3,131	-3,740	-4,294	-1,681	-3,652	-
3,702							
Current Transfers Balance	9,079	10,941	11,085	11,024	12,668	14,664	15,273
Current Account Balance	-3,605	-6,750	-8,286	-15,402	-2,406	-5,505	-
6,146							

All other trends like the growing trade deficit, growing international debt, slowdown in exports, a near absence of foreign investment and the flight of capital, due to social uncertainties, are manifestly evident. The deteriorating current account situation in Pakistan is captured in Table 3. One can easily discern the country's increasing dependence on remittances to keep its head above water.

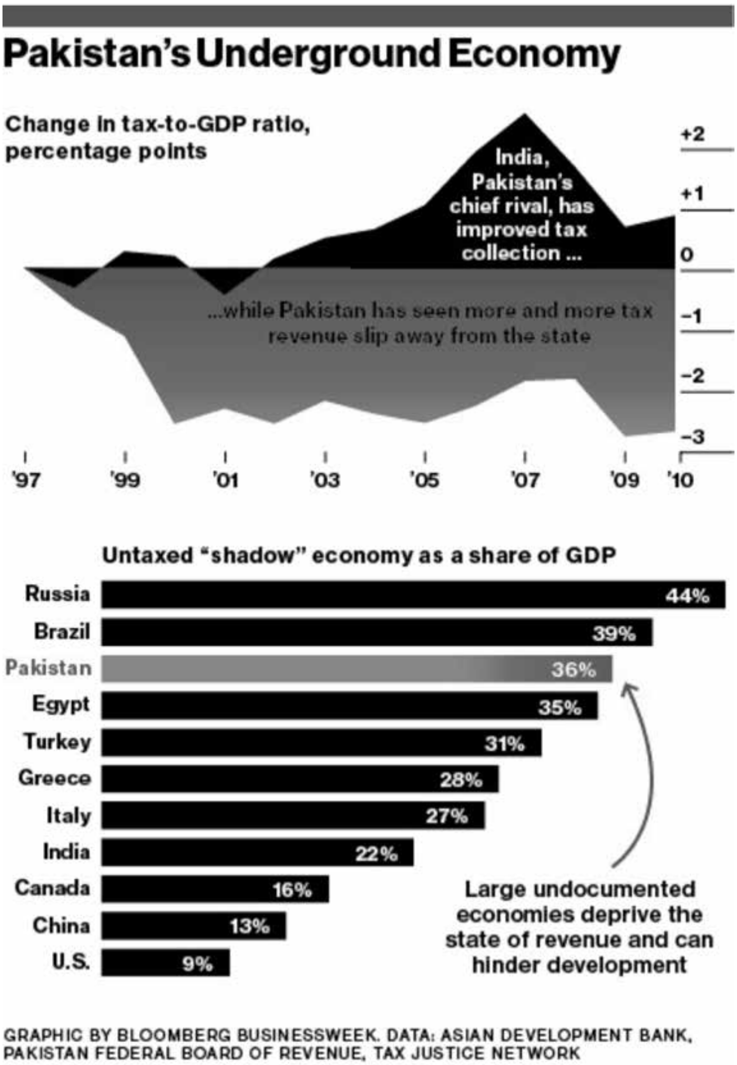
With the formal economy in the doldrums, it is the informal economy that is increasingly sustaining Pakistan. The *Business Week* magazine of April 5, 2012, in a story, "The Secret Strength of Pakistan" captures the essence of what is happening in Pakistan and how it is increasingly the informal sector that is now its mainstay. It describes a typical case as follows:

> It is early morning in Karachi, Pakistan's biggest city, and Muhammad Nasir is outside his makeshift shelter of palm leaves, rags, and bamboo, washing up after breakfast. He uses water stolen from a nearby supply pipe that belongs to the local water utility. The 17-year-old bids farewell to his mother, an unlicensed midwife, and walks to his tire-repair shop, an open-air stand in a residential area, with a table of tools and a wooden bench. He checks to make sure the electricity he's drawing illegally from the overhead power line is on so he can run his tire pump. Then he sends 10-year-old Abid, one of his two employees, along with 12-year-old Irfan, to get tea from a nearby shop.
>
> Nasir's business, his home, his power and water supply, and even the cup of tea Abid brings him don't exist in Pakistan's official figures. They're part of another economy that doesn't pay taxes or heed regulations. It probably employs more than three quarters of the nation's 54 million workers and is worth as much as 50 percent of Pakistan's 18 trillion rupee ($200 billion) official gross domestic product. And while the documented economy had its smallest expansion in

a decade at 2.4 percent in the year ended June 2011, soaring demand for cars, cement for houses, and other goods shows the underground market is thriving.

The same magazine also depicts graphically how serious the slippage in tax collection is now becoming. (Fig 5).

Fig 5



Today, over 36 percent of Pakistan's economy is "informal." The failure to capture taxes means a loss of almost 3 percent of GDP. Translated into other words, the state's ability to provide vital social services to its people is now, quite understandably, severely depleted.

With the withering of the state, informal systems are expanding into that space. When religious institutions like *madrassas* increasingly dominate vital spaces like education, certain outcomes can be well imagined.

Adding to the government's woes is an increasingly criminalised economy due to the unabated export and consumption of heroin. According to an official of the UN Office on Drugs and Crime (UNODC), Afghanistan produces 355 metric tonnes of heroin every year, about 90 percent of the whole world's production. And 42 percent of the heroin production of Afghanistan passes through different routes from Pakistan. Talking to Xinhua, National Research Development Programme Officer at the UNODC, Sher Ali Arbab, said that 150 metric tonnes of heroin come to Pakistan every year, out of which 80 metric tonnes are consumed in Pakistan, and 70 metric tonnes are smuggled outside. He said it is impossible to seal the 2,500-km-long porous border that Pakistan shares with Afghanistan, to curb drug trafficking and other smuggling. So what is the final snapshot of the Pakistan economy? Aqdas Ali Kazmi, former joint chief economist (macro), Planning & Development Division, Government of Pakistan, Islamabad, in his paper "Tax Policy and Resource Mobilization in Pakistan" estimates as follows: "70 percent part of the economy consists of 36 percent pure black economy; 18 percent exempted economy; 9 percent illegal economy; 4.5 percent unrecorded economy; and 2.5 percent informal or unreported economy."

Table 4: Pessimism Regarding Economic Future

					2009-2010
Economy in the next	**2002**	**2008**	**2009**	**2010**	**Change**
12 months will..	%	%	%	%	
Improve	40	53	23	19	-4
Remain the same	18	18	28	20	-8
Worsen	11	16	35	50	+15
DK	30	12	14	11	-3

Source: Pew Research Centre Q13.

Now if you want to have a quick moving picture of Pakistan, you get a country whose economy has seriously slowed down, whose population is rapidly growing and pumping in more and more young people into the social marketplace each year, whose government is unable to raise resources to stimulate new production, improve social services and a climate for investment. With the withering of the state, informal systems are expanding into that space. When religious institutions like *madrassas* increasingly dominate vital spaces like education, certain outcomes can be well imagined. What Pakistanis feel about the state of their nation is reflected in Table 4 based on surveys by the respected Pews Research Centre.

However, this author does not wish to saddle the reader with what is now so widely reported—given that many already consider Pakistan, a failed state. This author has, therefore, focussed on the macro-economic fundamentals. These alone are enough to make the case of a rapidly declining Pakistan. The prospects of how Pakistan can cope with its myriad problems and whether it will be able to climb out of the hole it finds itself in are bleak. But it is seldom nations that go under; it is states that go under.