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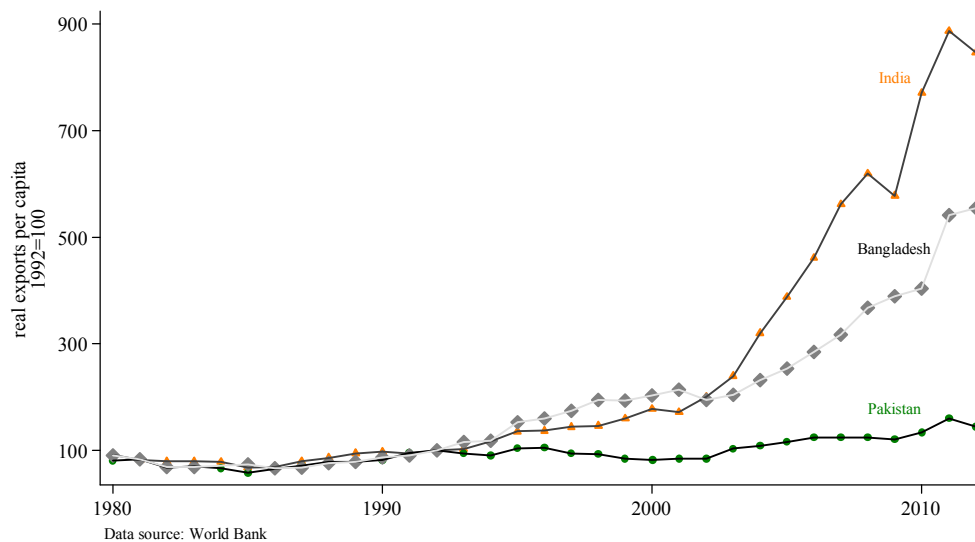
Title: Growing pains

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How effective were the PMLN government's economic policies during its first year in office? In order to answer this question, we first need to understand Pakistan's long-term economic challenge and then evaluate the extent to which government's policies address this challenge.

Shallow roots

Exports offer a window into how globally competitive a country is. Export data are also more useful since they are less susceptible to the manipulations that sometimes scar GDP estimates. The accompanying graph plots Pakistan's total exports per capita (in real terms) against India's and Bangladesh's since 1980, with exports per capita normalised to 100 in the beginning of the sample.



There is a stunning divergence in exports between Pakistan and the other countries. Since 1993, Indian and Bangladeshi exports have grown 5.8 and 3.8 times higher than Pakistan's respectively.

Pakistan's exports have continued to lag behind regardless of whether the country had a democratic government or military dictatorship. Exports continued to struggle despite economic liberalisation and privatisation, and despite a sustained period of exchange rate stability with no energy shortage between 2001 and 2005. These facts suggest that the reasons for Pakistan's poor export performance are deep and structural. Pakistan must find a way to enhance its productive capacity, and it is from this perspective that we must evaluate PMLN's policy choices.

Means and measures

The first, and perhaps most visible, government policy has been its attempt to stabilise the exchange rate. The recent strengthening of the rupee to below 100 against the dollar has been hailed by the government as a major success. However, this change in exchange rate has been engineered through borrowed funds and is unlikely to change Pakistan's long-term growth trajectory.

A strengthening of the rupee against the dollar would have been welcome news if it were driven by a positive change in fundamentals such as the expectation of higher export productivity going forward, or a reversal of the government's tendency to finance its deficit via printing money. Unfortunately this was not the case as the rupee strengthened due to short-term and somewhat artificial capital flows. First, the IMF approved a 6.6 billion dollar-loan facility in September 2013, then Saudi Arabia "gifted" a rather suspicious 1.5 billion dollars to Pakistan in March 2014, and finally the government raised another 2 billion dollars from international capital markets.

The bottom line is that unless Pakistan gains a real competitive advantage in the export market, efforts to stabilise the currency through short-term borrowing will be exactly that – short term. One proof of this argument is that while the rupee strengthened against the dollar between 2001 and 2005 due to capital flows into Pakistan in the post-9/11 political scenario, the strengthening of the rupee was short lived. More importantly, stabilising the exchange rate and building reserves did not translate into significantly better export performance.

The second major policy initiative of PMLN is privatisation. The government plans to divest its shares in sectors such as banking, petroleum and aviation. There is nothing inherently wrong with the idea of privatisation per se. There is broad-based evidence – including from Pakistan – that government ownership can be grossly inefficient. However, privatisation only makes sense when there is a vibrant private sector that can significantly increase productivity for the privatised sectors. Unfortunately the performance of Pakistan's private sector itself leaves much to be desired.

Consider Pakistan's prominent export sectors such as textile, agriculture and sporting goods. These sectors are essentially all in private hands. So how have they performed over the last couple of decades? The export numbers shown earlier do not inspire much confidence in the productive capacity of Pakistan's private sector. While the private sectors in other emerging countries such as India, China and Brazil have produced powerful multinational companies such as China Mobile, Embraer, Mahindra and Mahindra, Reliance Industries and Tata, the private sector in Pakistan does not have a single company in the same league.

It is important for the government to realise that there are fundamental constraints facing businesses in Pakistan. Unless the government seriously tries to figure out what these constraints are and develops a comprehensive strategy to mitigate these constraints, privatisation is not going to solve Pakistan's growth conundrum.

The third leg of PMLN's economic agenda has been populous programs such as the Prime Ministers' youth loan scheme that offers business loans of up to 2 million rupees, and the laptop scheme that aims to distribute 100,000 laptops among the youth. This is not the first time PMLN has initiated such programs.

In its previous tenures in office, PMLN has run similar programmes, offering subsidised loans to small businesses, imported cars under the 'yellow cab scheme', and distributed free laptops to students.

One would have hoped that the government would at least evaluate the previous schemes before repeating them a second time. The score card for PMLN's previous such schemes does not look good. For example, the previous loan programme resulted in significant losses for public banks without much macro-economic benefit. Similarly, the previous 'yellow cab scheme' resulted in the import of thousands of cars at subsidised prices for personal use only. However, for some inexplicable reason, the government decided to launch yet another yellow cab scheme.

Perhaps a more practical justification of programs that distribute loans and laptops is political. Politicians may think that they can earn the goodwill of voters by handing out freebies. But here too the evidence is not supportive. Despite the initiation of multiple such schemes, voter apathy with respect to PMLN has only increased according to *Herald's* latest survey. I report these results below.

The people are not pleased

How does the population at large view PMLN's first year in office? The national survey conducted by *Herald* provides some fascinating answers. According to the survey, 26 per cent of respondents rate the federal government's economic performance as "good" or better, 44 per cent classify it as "average" and 20 per cent as "poor". The most often praised aspect of government's economic performance is the strengthening of Pakistani rupee, with 57.7 per cent of respondents choosing this answer. The most frequent complaints are about unemployment, energy shortage and inflation, with 70.5 per cent, 67.4 per cent and 64.2 per cent of respondents highlighting these issues respectively.

The clearest indictment of PMLN's first year in office is provided by PMLN's supporters themselves. 79 per cent of respondents report that they voted in the 2013 elections. Of those who voted in the elections, 30 per cent, 24 per cent and 23 per cent voted for PMLN, PTI and PPP respectively. Thus PMLN received the largest share of votes within the survey respondents. However, when survey participants are asked about which party they will vote in the next election, a large fraction of those who voted for the PMLN in 2013 say that they will vote for another party in the next election.

In particular, only 17 per cent of respondents says that they will vote for the PMLN at the centre in the next election, a decline of 13 per cent. PTI is the biggest beneficiary of the decline in PMLN support. 33 per cent of respondents say that they will vote for PTI in the next election, followed by PPP at 19 per cent. Of the people who voted for PMLN in the 2013 elections, a whopping 53.25 per cent say that they will *not* vote for PMLN in the next election. No other party has lost as high a percentage of its 2013 electorate. The large decline in PMLN's vote bank in the span of just one year reflects the public's disenchantment with the party's performance.

Why are voters becoming disillusioned with PMLN? A statistical analysis of survey responses reveals two main reasons. First, survey participants were not happy with the government's decision to try General Pervez Musharraf. 47 per cent of overall respondents disapproved of the government's decision to try General Musharraf, while only 36 per cent approved. Among those respondents who voted for PMLN in the 2013 elections, 41.7 per cent disapproved of Musharraf trial and 40.8 per cent approved. Most importantly, disapproval of Musharraf trial within PMLN voters is strongly correlated with the voters'

switching away from PMLN. While 40 per cent of PMLN voters who do not disapprove of the Musharraf trial plan to vote for a different party in the next election, the number increases to 72 per cent for PMLN voters who disapprove of Musharraf trial.

Second, individuals who give a worse grade to the federal government or the Prime Minister are more likely to switch their vote away from the PMLN in the next election. In particular, 90.5 per cent of PMLN voters who classify the federal government's overall performance as "poor" or worse plan to vote for a different party in the next election. Similarly, 88 per cent and 76 per cent of PMLN voters who classify the Prime Minister's performance and the government's economic performance as "poor" plan to vote for a different party in the next election respectively.

While there is strong disapproval of the government's performance by its own voters, the good news for PMLN is that it has four more years in office to convince the electorate otherwise. How should government's policies be realigned? Some broad suggestions are given below.

Importing progress

The core objective of any economic policy should be to promote growth. Growth is only possible if a country expands its *domestic* capacity to produce high-value goods and services. For example, a high growth economy is able to graduate from baking bricks to building subways and high speed trains; and from exporting manual workers to exporting high-tech software and financial services. The key in all of this is the ability to produce *locally* an increasingly advanced variety of goods and services that can compete globally. The sub-par performance of our exports suggests that Pakistan's domestic production capacity has failed to keep pace with global competition.

In terms of policy, the government must choose to use its resources intelligently. Instead of throwing money away at ill-conceived ideas such as youth loans, free laptops and subsidised car imports, the government needs to think seriously about designing effective mechanisms that relax the constraints facing Pakistan's domestic production. More generally, the government should focus on teaching people how to fish instead of handing out fish to them.

For example, it would be much better if instead of handing out free laptops to students, the government would bring world-class computer scientists to Pakistani colleges to teach students how to program. Once a college student is technically competent enough, firms will willingly hire them and buy laptops for them. In fact the best students would not even need to be hired as they will create their own software companies, exporting software to the rest of the world in the process. Government policy should be aimed at creating these kinds of positive feedback chains.

The laptop example illustrates a broader concern with government's economic policy. The policy is biased towards giving subsidies and cash-giveaways to the public instead of investments that enhance the future productive capacity of the country. How long can the government import metro buses from Turkey, railway engines from China, motorway and buses from Korea, but not build any capacity for Pakistanis to design, build and operate a transportation system on their own?

Our singular focus should be on expanding the domestic capacity to produce high value-added industries, rather than trying to import our way to progress. Economic research tells us that two factors are critical

for achieving this goal: human capital acquisition, and institutions that protect property rights and personal freedoms. I discuss these two factors in the context of Pakistan below.

Human capital is about the acquisition of knowledge and technology. It should be obvious why human capital is a necessary ingredient for growth. The person who can design an airplane will always be richer than the one who only knows how to manufacture a bicycle; after all, it requires years of education and technical training to be able to design airplanes. Thus countries that are able to effectively educate their workforce will always exceed others in economic prosperity.

Unfortunately Pakistan continues to lag behind in human capital acquisition. Primary school enrollment rate is only 61 per cent in Pakistan compared to 90 per cent in India. Those fortunate enough to enroll in school receive a very poor quality of education. An excellent study of student learning outcomes in rural Punjab shows that by the end of Class III only about 50 percent of children have mastered the Mathematics curriculum designed for Class I. Three quarters of students in class III could not read time off a clock properly. Less than 20 percent are able to comprehend a simple paragraph. The differences between public and private schools are so large that it will take government school students between 1.5 to 2.5 years of additional schooling just to catch up to where private school students were in Class 3¹.

The situation in colleges and universities does not inspire much confidence either. Punjab University is more famous for its gangsters, who intimidate women and threaten critical thinking, than for creating scientists and entrepreneurs. These problems are endemic in many universities and such an environment is hardly conducive for learning. Future growth is dependent upon having a robust, highly-trained workforce, but unfortunately students coming out of universities in Pakistan have a tough time competing globally for Ph.D. admissions.

The second important factor for growth is the existence of sound institutions. Institutions refer to the collective environment in a country that determines the extent of property rights, incentives and freedoms for its people. Unfortunately this is an area that has seen continuous decline in Pakistan and most likely reflects the prime reason growth has failed to pick up in the country.

The biggest contribution towards failing institutions has been the rise of extremism and the concomitant decline in law and order. Growth requires investment, and investment requires an assurance of safety that the investor's capital will not be destroyed or stolen by someone else in the future. Unfortunately, today an investor in Pakistan faces threats to his investment from multiple sources.

First, corrupt government officials demand bribes at almost every stage of interaction with the government. This naturally lowers the return on investment from the investor's perspective. Second, if the investor is successful, he faces the risk of extortion from criminal gangs that routinely collude with extremist groups. Third, if the investor belongs to an ever-expanding group of vulnerable communities – Ahmadis, Christians and Shias, to name a few – then there is an added risk that he may be targeted for his faith or background.

¹ All these statistics are from, "LEAPS: Insights to inform the education policy debate", by Tahir Andrabi, Jishnu Das, Asim Ijaz Khwaja, Tara Vishwanath and Tristan Zajonc (2007).

Given such an environment, it should not be of any surprise that Pakistan has one of the lowest investment rates in the region. Unless the government takes sustained and aggressive steps to roll back corruption and extremism, growth prospects remain grim.

Besides capital investment, a second and equally important requirement for growth is the availability of a well-trained and professional workforce. The reality of today's global connectivity is that a qualified professional such as an engineer, a surgeon, a scientist or a manager can find a job practically anywhere in the world. Thus Karachi competes with Dubai, London and Toronto for talent in a very real sense. What is the government doing to attract its best and the brightest citizens?

There is a close connection between the increasingly intolerant and hostile environment that has pervaded Pakistan's cities and the difficulty in attracting and retaining Pakistan's top talent. Today's urban professional demands a multi-cultural, pluralistic and inclusive environment, where critical thinking is not only accepted but encouraged. Unfortunately the political and social environment in Pakistan has increasingly gone in the opposite direction.

If a country wants to encourage the acquisition of knowledge and the development of scientific thought then it must resist the forces of dogma and repression. It is not a coincidence that the most scientifically advanced countries also promote freedom of thought and the right to peacefully disagree among its population. In the increasingly scientific and globalised world of today, an open environment that promotes critical thinking and peaceful coexistence is necessary for advancement. Let us hope our governments understand this point and Pakistan begins moving in that direction soon.