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Pakistan's Roller-Coaster Economy: Tax Evasion Stifles Growth

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SUMMARY

- Over the last sixty years, Pakistan's economy has seen severe ups and downs. Once considered a model for other developing nations, Pakistan has been unable to sustain solid growth. Furthermore, a third of its population now lives below the poverty line, and its literacy rate is abysmally low.
- Pakistan's economic instability stems in large part from low government revenue resulting from the elite's use of tax evasion, loopholes, and exemptions. Fewer than three million of Pakistan's 175 million citizens pay any income taxes, and the country's tax-to-GDP ratio is only 9 percent. Tax evasion means fewer resources are available for essential social services.
- Pakistan spends too much on defense and too little on development: It has spent twice as much on defense during peacetime as it has on education and health combined.
- The government knows how to increase its revenue through tax reform, but the rich and powerful have resisted such measures for fear of lowering their own incomes.
- Without sufficient revenue the government will continue to be burdened with an unsustainable debt. It needs to end tax exemptions for the wealthy and develop broader, long-term economic plans for sustainable growth.
- In the past, the United States and other Western nations have come to Pakistan's rescue by paying off debts and funding development initiatives. Pakistan's elite has no reason to support reform as long as these bailouts come with no conditions attached.

ABOUT THE AUTHOR

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Once heralded as a beacon for other developing countries, Pakistan's economy bears little worthy of emulation today. For years now, it has fluctuated wildly between periods of impressive growth and dismal slumps. While political competition between the military and civilian politicians has been partly responsible for this instability, Pakistan's lack of a proper tax and revenue regime has resulted in high rates of tax evasion, burdening the country with unsustainable debt and undermining its development priorities. Pakistan's politics may recently have taken a turn for the better with the strengthening of democratic institutions and the judiciary, but the key to the country's economic prosperity—even its survival—is a far-reaching program of tax reform.

A TOPSY-TURVY PAST

On January 18, 1965, the *New York Times* wrote: "Pakistan may be on its way toward" economic success "that so far has been reached by only one other populous country, the United States." A year later the London *Times* struck a similar enthusiastic note, saying that "the survival and development of Pakistan is one of the most remarkable examples of state and nation building in the post-war period."

Forty years later, the press was offering a very different bouquet of sobriquets to describe Pakistan. International newspapers and magazines called it "the most dangerous place in the world," a "failed state," and a "rogue state with a nuclear arsenal," to name just a few. Only a few decades before, several far less developed countries, such as South Korea, Malaysia, China, and India, were considered far less likely than Pakistan to survive, much less thrive. Today, all of those countries and others have surged ahead of Pakistan economically.

Pakistan didn't fall behind because it stood still; rather, its economic history spans six decades of roller-coaster ups and downs. The first decade, 1947–1958, was one of "settling down," in which the new country comprising East and West Pakistan emerged from British India. The second period, 1958–1968, was marked by the rule of General Muhammad Ayub Khan and is now known as the Decade of Development for its high growth rates. Accompanying those high growth rates, however, were high income and regional inequality, which contributed to the

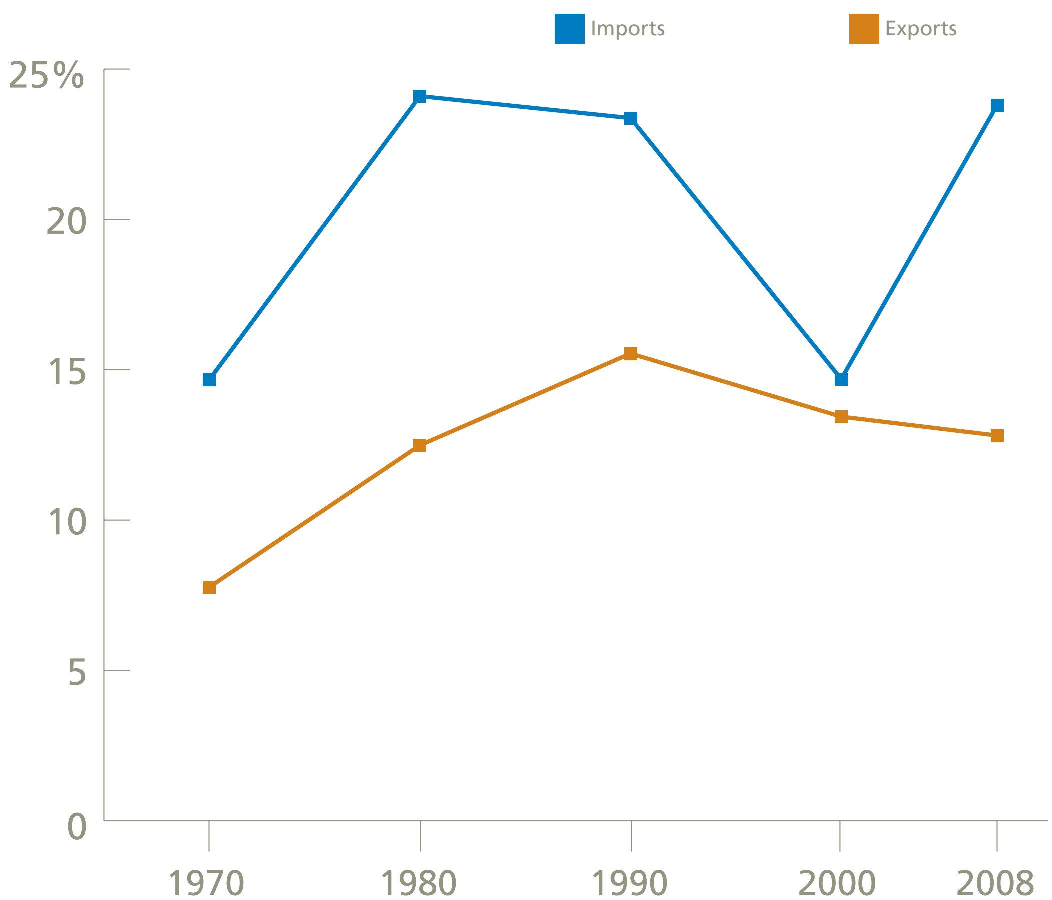
Pakistan and Its Neighbors

Pakistan in Context

Population	169.7 million
Population growth (annual)	2.2%
Life expectancy (years)	65
Adult literacy, male	68%
Adult literacy, female	40%
Aid per capita (in USD)	14
Infant mortality (per 1,000 births)	73
GDP growth	3.7%
GDP per capita growth	1.5%
Urban population (of total population)	36%

Source: World Bank, 2010

EXPORTS AND IMPORTS OF GOODS AND SERVICES (% OF GDP)



secession of East Pakistan and the war that gave birth to Bangladesh.

In 1971 a new Pakistan emerged under the government of the left-of-center Zulfikar Ali Bhutto. Nationalization of private businesses and public sector–led development were the norm for the new regime. Growth was relatively low compared to the decades before and after, but adequate under the dire and constrained circumstances of the time. Following Bhutto's ouster in 1977, General Muhammad Zia ul-Haq inaugurated Pakistan's fourth "era," ruling until 1988. Zia's era saw the return of high growth rates, but it also saw the role of the military increase greatly in the economy, politics, foreign policy, and in society more generally. Zia's death brought a period of active civilian politics and electioneering. "Democracy" is perhaps too generous a term for this process. There

TIMELINE

1947	Pakistan becomes independent nation-state
1958–1968	Ruled by General Ayub Khan; known as the Decade of Development; high growth rates; high income and regional inequality
1971	Growth is relatively low; nationalization of private businesses under Zulfikar Ali Bhutto; public sector–led development the norm
1977–1988	High growth rates under General Muhammad Zia ul-Haq
1988–1999	Numerous governments; debt crisis; high dependence on international loans; economic performance nosedives
1999–2008	Pakistan ruled by its third military dictator, General Pervez Musharraf; economy grows due to debt restructuring and large doses of foreign aid and assistance following the 9/11 terrorist attacks
Dec. 2007	Assassination of former prime minister Benazir Bhutto
Feb. 2008	Prime Minister Yousuf Raza Gillani elected to head a coalition government
Sept. 2008	President Asif Ali Zardari replaces General Musharraf
Nov. 2008	IMF lends Pakistan \$7.6 billion; later increases loan amount to \$11.2 billion
2008–2009	Growth rate of only 1.2%; inflation rate of 21%
2009–2010	Growth rate around 4%
July 2010	Total foreign debt rose to \$55 billion

were numerous governments between 1988 and 1999, and economic performance nose-dived as it never had before. From October 1999 to 2008, Pakistan was ruled by its third military dictator, General Pervez Musharraf. Pakistan's economy grew again during this period, thanks to debt restructuring and large doses of aid and assistance. Several factors gave rise to these benevolent circumstances, the most important of which was the international political atmosphere following 9/11. Since 2008, a democratically elected coalition government has been forced to deal with the collateral damage caused by its predecessor's politics and economics.

Despite the rise-and-fall pattern of GDP growth over the last fifty years, Pakistan's economy has grown on average by more than 5 percent per year. This is no mean achievement. While many comparable countries in the region have also grown at similar or higher rates, Pakistan has the unenviable distinction of inconsistent growth. Other countries such as Malaysia, South Korea, and, of course, China have all had much higher growth rates over the same period, and they generally have been able to sustain those rates over decades. India too, which had a far slower growth rate than Pakistan's from about 1947 to the 1980s, has not only improved its performance fundamentally over the last twenty years, but has also grown consistently for the past two decades, leaving Pakistan far behind. Even Bangladesh, once dismissed as a "basket case" by arrogant Pakistani economists and planners, has recently had several years of stable growth despite political uncertainty. What distinguishes Pakistan from these other countries is its inability to sustain good performance for more than five or six years. While India, China, Malaysia, Vietnam, and numerous other countries east of Pakistan have now emerged as regional and global economic and political powerhouses, Pakistan has barely stumbled along.

EXPLAINING THE UP-AND-DOWN PATTERN

Is Pakistan and its economy forever doomed to instability and stuttering growth? Why has Pakistan's economy been so troubled? Does it have deep-rooted structural features that make it peculiarly susceptible to crises?

A major explanation of Pakistan's volatile economic history is the state's poor revenue generation. Low tax revenues are in turn caused by tax evasion and a legal structure that allows for too many exemptions and loopholes. Pakistan's tax-to-GDP ratio is just 9 percent. This figure puts Pakistan in the 155th position out of 179 nations on the Heritage Foundation's Index of Economic Freedom. Only oil-rich countries that impose few taxes perform worse. Fewer than three million of Pakistan's population of 175 million pay any income tax. A huge and buoyant informal (underground) economy, estimated to be anywhere from 30 to 80 percent of the real economy, goes untaxed and unrecorded. These are the attributes of a rentier state, except that Pakistan lacks the wealth-producing oil and gas reserves normally associated with such states.

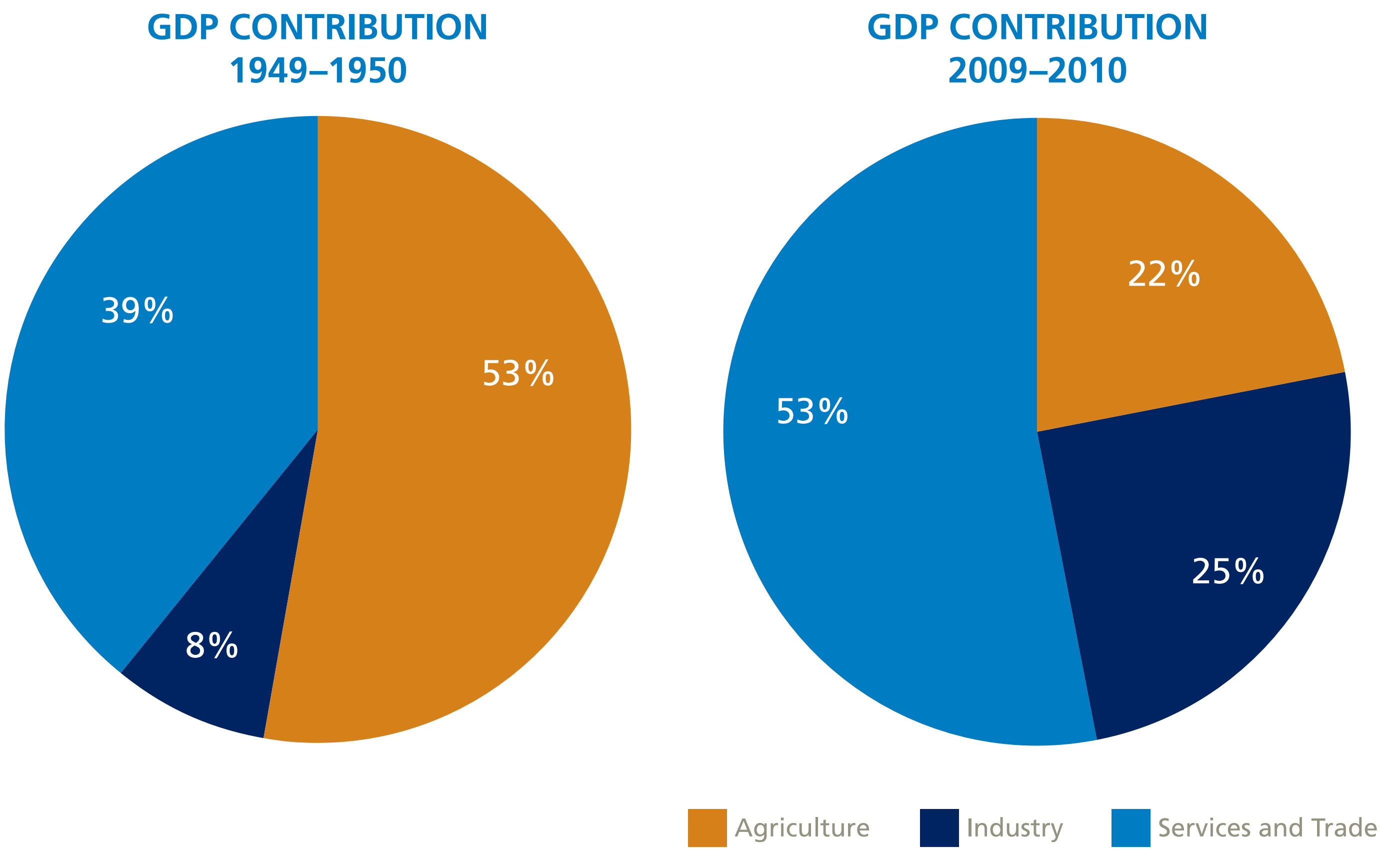
The key to Pakistan's economic prosperity—even its survival—is a far-reaching program of tax reform.

Clearly, tax evasion and the inability of the regime to tax the informal sector mean that it has fewer resources for education, health, infrastructure, and development. A perennial debt crisis has affected Pakistan's economy largely because its expenditures, many of which are justified, are well in excess of revenue, forcing the country to go to foreign (and domestic) borrowers. This indebtedness affects issues of political economy at the domestic and international level.

For example, the severe debt burden had been the single most important attribute of Pakistan's economy through the 1990s. Overall outstanding debt was equal to GDP, and foreign debt servicing alone in 2001–2002 was as much as 10 percent of GDP. Excessive tax evasion was the primary cause of this.

After 9/11, however, the Musharraf regime was able to sign agreements with bilateral and multinational donors to write off or reschedule huge amounts of this debt, giving them unprecedented fiscal space. This fiscal freedom was the main reason the economy turned around so sharply. Growth rose to 7.5 percent in 2003–2004 until maxing out the following year at 9 percent, the highest level in two decades. The fiscal deficit was near its lowest level in almost two decades, remittances were at historic highs, and exports crossed the $17 billion mark for the first time and showed signs of further growth. By 2006–2007, domestic debt had fallen to 30 percent of GDP, and foreign debt servicing was less than 5 percent of GDP. The government claimed that the economy had rebounded, that there had been a "turnaround," and that good times of high growth and high human development had returned. Even the stock market soared to unprecedented levels, shattering records weekly.

Moreover, at some point between 2002 and 2004, Pakistan joined those 90 or so countries that the United Nations Development Programme's (UNDP) Human Development Report (HDR) puts in the category of "Medium Human Development." From the time of the first annual HDR in 1990, Pakistan had consistently been classified as one of the 40 or so countries in the "Low Human Development" category. (By comparison, both India and Bangladesh moved from



the low to the medium category in the late 1990s, well before Pakistan.) Many thought that, after years of being considered a "middle income country with low human development," Pakistan had at last moved into a category that better reflected its economic and social characteristics.

Following the 2002–2007 period, Pakistan seemed set on a course for sustained economic improvement. Yet despite exceptional and unanimous support from the international donor community, little political opposition at home, and uninterrupted political stability and control of government (in sharp contrast to the eleven changes of government between 1985–1999), these few years of remarkable growth quickly unraveled.

REASONS FOR UNRAVELING GROWTH

ABSENCE OF LONG-TERM PLANNING AND INVESTMENT

The boom of the Musharraf years unraveled so quickly because it was built on false foundations: largely, consumer-led growth and investments in the speculative sector (real estate and the stock market) fueled by remittances and foreign aid. What was missing was a longer-term strategy to guide the money being sent to Pakistan into more productive sectors. Banks awash with excess liquidity were all too eager to feed the growing middle class with cheap loans to finance their consumption. This consumer-led boom did prompt the manufacturing sector to ramp up production to meet increasing demand for cars, motorcycles, and other items, but it also helped create a bubble, which eventually burst.

The budgetary maneuvering space created by aid and debt write-offs did enable the government to spend money on much-needed infrastructure. The resulting new roads and communication networks helped Pakistan, although they couldn't keep up with the increase in demand. The extent of the consumer boom had caught the government off guard, leaving it unable to provide the resources that the growing middle class required. The government's inability to meet the huge spurt in demand for electric power, for example, resulted in extensive power shortages that have hurt manufacturing and industry.

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THE ROUNDABOUT OF POLITICS

The governments of Generals Ayub (1958–1968), Zia (1977–1988), and Musharraf (1999–2008) were all, by definition, authoritarian military dictatorships, though each had its own particular hue. Western powers supported all three of them, but for very different reasons. All three were relatively benign compared to the ruthless Latin American dictatorships of the 1960s, 1970s, and early 1980s. One could, moreover, say that Musharraf's rule was "softer" than the first two military dictatorships, with the former even being forced to follow the Constitution on numerous occasions. Nevertheless, the absence of political participation by the major parties marked all three regimes.

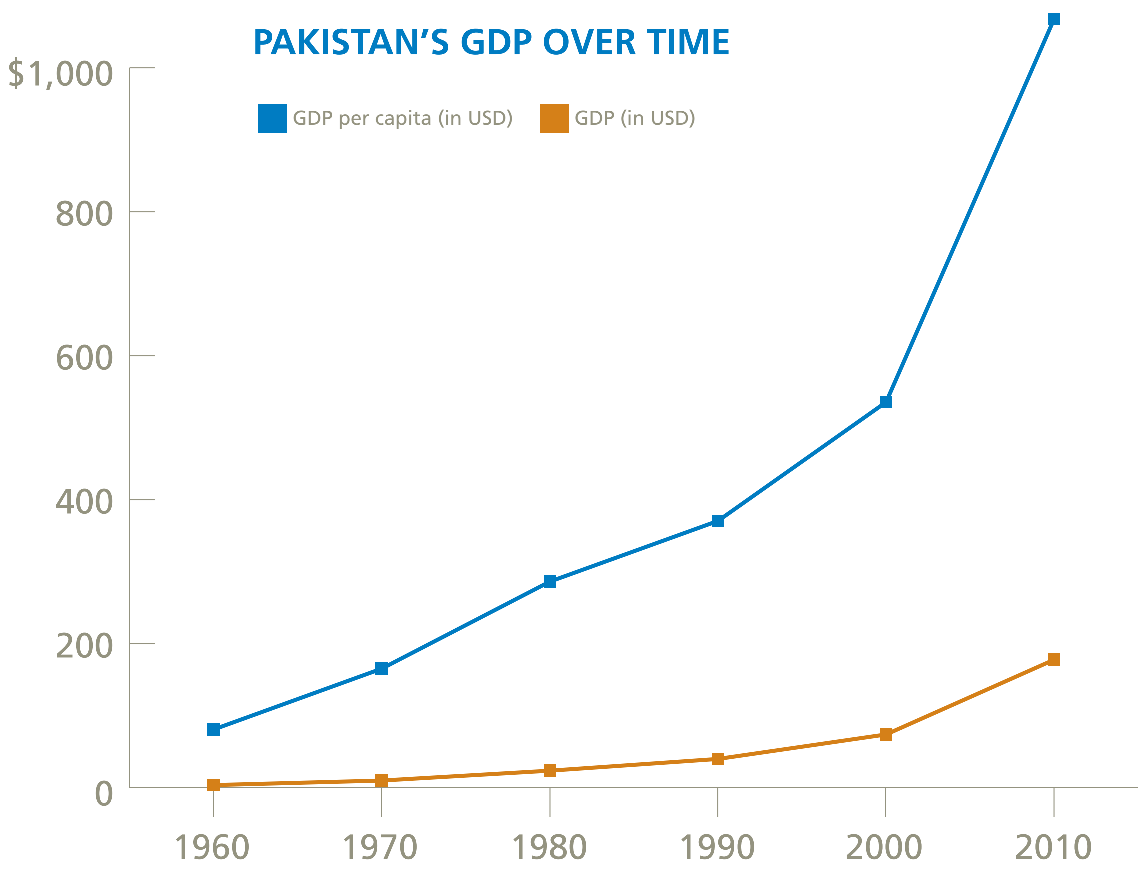
A key factor separating Pakistan's military dictatorships from those of Africa or Latin America is their relatively short life spans. None of them managed to successfully pass off the baton to a military successor. Once political pressure began to emerge, the Ayub and Musharraf regimes crumbled (Zia was killed in a plane crash) because they excluded key civilian political actors.

When civilians regained power, they tended to blame the military for Pakistan's problems, regardless of whether such blame was justified. The threat of yet another military coup hung over these civilian governments, weakening them and thus creating the rationale for the military to intervene. The extremely short tenures of Pakistan's elected governments left them no opportunities to craft long-term strategies.

Pakistani policy makers and politicians need to understand that they cannot go on living on borrowed money forever.

The experiences of Pakistan's neighbor India provide an important point of comparison here. The Indian electorate rejected the "India shining" slogans of the Bharatiya Janata Party (BJP)–led government of 1999–2004 in favor of a Congress-led government. Yet despite the intense antagonism between the Congress Party and the BJP, the political transition was a smooth one. Of course, India is a mature democracy whereas Pakistan's has had little opportunity to grow, but the example nevertheless shows that smooth political transitions and high growth rates are not entirely foreign to the region.

Pakistan's frequent regime changes aren't the only reason that the country has never been able to engage in long-term planning. It is also possible that the system itself, regardless of whether civilians or the military are at the helm, encourages the rentier mentality. Recent events related to profiteers hoarding wheat and sugar, for example, suggest that corruption continues to enjoy support from key elements of Pakistan's society. Such systemic



corruption severely distorts the signaling functions of markets, and thus efficient development as well.

LOW EMPHASIS ON HUMAN CAPITAL

One of the paradoxes of Pakistan's economy is its periodic achievement of high rates of growth despite being burdened with poor social indicators. Pakistan's economic and social profile from 1993 to 2003 looked more like that of an African country, combining an abysmally low literacy rate with a skyrocketing population, poor treatment of women, and endemic poverty. Economic growth has done little to ameliorate Pakistan's social problems.

One reason why investment in human capital has been so low is that defense expenditure has been so high. In peacetime, military expenditure has exceeded 7 percent of GDP, twice the amount allocated to education and health combined. With debt service and defense taking up as much as 75 percent of the government's annual budget throughout the 1980s and 1990s, very little remained for development.

In the age of globalization, such failure to invest in human capital bodes ill for Pakistan's future. While Pakistan's neighbor India, by contrast, has successfully diversified into services such as information technology, Pakistan has failed to do so, despite sharing one of India's biggest advantages: a large English-speaking population.

One of the fundamental reasons Pakistan's elite has failed to invest in human capital is its lack of appreciation for the idea of the public good. Short-term, narrow, and selfish interests, whether class-, institution-, or ethnic-based, override the common good. It's hard to understand why this behavior persists, and hence even more difficult to "solve" the problems it creates, but at least recognizing it is the first step toward a solution.

TAX EVASION—THE CORE ISSUE?

There are at least two sides to Pakistan's overinvestment in defense (and thus its underinvestment in development). On the demand side, defense overinvestment derives from the perception that "national insecurity" is a defining feature of the Pakistani state. This is both a cause and an effect of the military's dominance of the country's political economy. But there is a supply side to this issue, too. Essentially, if government revenues were higher, Pakistan might be able to fund both defense and development at a level more conducive to national well-being. The question remains: Why aren't government revenues higher?

Pakistan's lack of a proper tax and revenue regime has resulted in high rates of tax evasion, burdening the country with unsustainable debt and undermining its development priorities.

The main culprit is tax evasion. Pakistan's tax evasion problem is caused by three things: poor legal frameworks and bureaucratic capabilities with regard to revenue extraction; corruption in the form of a predatory class that privileges certain sectors and vested interests with unjustified tax "exemptions"; and elites who cut deals with the state to avoid taxation, made possible by an anemic agriculture income tax (agriculture makes up 22 percent of Pakistan's GDP, but only 1 percent of its tax revenue). Research suggests that with a more extensive, transparent, progressive, and equitable tax structure, government revenue could easily double, thus closing the huge gap between defense and development expenditures.

The fact that Pakistan—the world's 26th richest country in purchasing power parity—

does so poorly when it comes to revenue generation suggests that deep structural factors are at work. A small elite composed of the military, land owners, and the rising urban upper and middle classes, is loath to give up any of its wealth (some of which is illegally accumulated). Even the apparently forward-looking, enlightened, and modernist military regime headed by General Pervez Musharraf failed to restructure Pakistan's tax regime, and backed down in the face of a massive popular revolt to his proposal to register traders and shop owners. It's unlikely that an elected government will do any better. Given their typically short political tenures, elected governments are too fearful of daggers in the night to propose bold, politically unpopular solutions. And despite their loud protestations to the contrary, opposition parties would be no more likely to champion reform if they came into power.

Pakistan spends too much on defense and too little on development: It has spent twice as much on defense during peacetime as it has on education and health combined.

Thus it isn't that the military and civilian elite of Pakistan don't know how to fix the problem; it's that their short-sightedness and penchant for self-preservation make them not want to. Their certain knowledge that "the West will never let Pakistan fail" also gives the elite tremendous confidence in the status quo.

CONCLUSIONS

Is there anything that can be done? Is Pakistan's economy fated to hover perpetually near the edge of crisis? Perhaps not. Some positive trends suggest that some of Pakistan's liabilities may be receding. One must keep in mind, of course, that predicting Pakistan's economic and political future is a game whose rules are extremely uncertain.

Despite the uncertainties, two observations about the post-Musharraf period stand out. First, while Pakistan's economic growth rate dipped considerably in 2008–2009 to 1.2 percent, it rebounded to about 4 percent the following year. This figure, although still low compared to earlier years, is respectable in a time of increasing internal terrorism and global slowdown, and it suggests that even in difficult times, economic growth is possible in Pakistan. It may also suggest that the underlying structures in the economy have shifted much as they did two decades ago. In sharp contrast to its dismal performance in the 1990s and the period after Pakistan's nuclear tests in 1998, Pakistan's economy may have ascended to a higher, more stable plane. If Pakistan can perform so well when the rest of the world is reeling from a global recession, then a more forceful economic policy might produce truly exceptional results.

The second observation concerns the maturing of the political process, which suggests the possibility of greater continuity, a key requirement for economic stability. Despite numerous attacks, challenges, and tensions from within, Pakistan's democracy has managed to weather the past two-and-a-half years fairly comfortably—so far. An assertive judiciary, a supportive civilian opposition, and a reticent, contemplative military have all helped to strengthen and deepen the political process of democracy.

Ever mindful of uncertainties, and keeping these two observations in mind, it is clear that the government will have to make several decisions to break out of the high-low cycle and place the economy on a more stable footing. First, it must undertake a comprehensive revision of the tax regime if it is ever to seriously tackle development, particularly in the social sectors. This can only happen if there is a political consensus to tax the rich. Given that many of the rich are elected policy makers, this means that the elite will have to look past their strong, vested interests in the status quo. Forging such a consensus will require not just technocratic innovations but political settlements in which members of the civilian, political, and military elite come to some form of agreement on a long-term strategy for Pakistan's political and economic future. The international community has a role to play, too. Multilateral agencies, the United States, and other countries must carefully reconsider their aid and loan packages to avoid creating a moral hazard. If large amounts of foreign assistance are always at hand when Pakistan nears a crisis, then Pakistan's elite will have no incentive to look past the short term.

POLICY RECOMMENDATIONS

- Pakistani policy makers and politicians need to understand that they cannot go on living on borrowed money forever. They must build a partisan consensus to tax the rich and the elite (mostly themselves) if they wish to bring Pakistan up to speed with other developing countries in the region.

- They must eliminate unjustifiable tax exemptions and preferences given to sectors or individuals, and institute in its place a broader policy that taxes earnings and wealth, not activities.

- Pakistan must improve documentation of the economy in order to better estimate taxable income and increase government revenue.

- Pakistan's leadership needs to rise above party politics and, with the advice and consent of a supportive opposition, implement a broader economic framework.

- Donor countries need to recognize that they have bailed out Pakistan too often. They should instead pursue a "do more" approach, emphasizing tax and economic policies that can harness Pakistan's huge underreported revenue potential. ■

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FURTHER READING

Visit **www.CarnegieEndowment.org/pubs** for these and other publications.

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PAKISTAN'S ROLLER-COASTER ECONOMY: TAX EVASION STIFLES GROWTH