Beyond the Investment Climate: Towards Understanding the Investment Conundrum in Pakistan

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Summary

A snapshot glance at investment trends in Pakistan reveals two important phenomena. First, the level of investment in manufacturing itself is low and second, private manufacturing investment has tended to concentrate around the eastern province of the Punjab in the last two decades. This paper seeks to explore these issues with the help of secondary literature. The literature on investment climate is perhaps the most comprehensive toolbox developed in the recent past for this purpose. While useful in its own right, on both empirical and conceptual grounds, this stream of literature appears to have little explanatory power in explaining low levels of investment in Pakistan. We then assess the respective roles of economic policy changes and exogenous factors on investment behaviour in the country. Explanations for investment concentration regionally are then sought in the ethnic make up and changes therein of both the business community as well as structures of the state. In particular, different forms of networking through which state-business relations are conducted and its consequences on investment behaviour are then explored. The paper concludes by proposing further research on the nature of threats that investors face as well as the networks they create to protect their property rights.

Keywords: investment, manufacturing, growth, investment climate, networking, state-business relations, regional differences, ethnicity.

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List of Acronyms

APTMA	All Pakistan Textile Mills Association
FPCCI	Federation of Pakistan Chambers of Commerce and Industry
IC	Investment Climate
ICA	Industrial Climate Assessment
KCCI	Karachi Chambers of Commerce and Industry
NIE	New Institutional Economics
R&D	Research and Development
TVEs	Township and Village Enterprises

Introduction

Pakistan’s economy in general and the manufacturing sector in particular has been beset by low levels of investment. This has been a major impediment in creating a virtuous circle of growth, employment creation and poverty reduction in the country. A closer look shows that private investment in Pakistan has two features: first, the overall level of investment itself has remained low and second, within the country, private sector manufacturing investment has tended to concentrate around the eastern province of the Punjab in the last two decades.

This paper intends to explore these phenomena with the help of secondary literature. Interest in investment has seen a revival of sorts amongst mainstream analysts after the limits of ‘getting prices right’ or in other words the market-state debate had run its course. Virtually all developing countries have reduced the role of the state in industrial as well as infrastructural investments in the last two decades or so with varying degrees of success. This perhaps has prompted the literature to focus once again on what were considered ‘old fashioned’ issues of investment levels and their sustainability.

The recent literature on Investment Climate (henceforth IC) is perhaps the most comprehensive tool box developed in the recent past for this purpose. By developing a set of empirically testable indicators, the IC framework promises to specify the investment climate of a country at any point in time and, by tracking the performance of ‘lagging’ indicators (both over time and across countries), it can readily identify areas where policy should focus. That these indicators are grounded in the New Institutional Economics (NIE) literature provides the IC framework with the requisite institutional focus so often missing in the more economistic mainstream analysis of investment and growth.

Whether this new tool box of ‘investment climate’ indicators provides us with robust and satisfactory answers to the issues of investment behaviour in Pakistan is explored in section 1. On both empirical and conceptual grounds the IC conceptualisation, while useful in its own right, appears to have little explanatory power in explaining low levels of investment in Pakistan.

Section 2 then attempts to answer both the questions of low levels of investment as well as regional concentration through a political economy approach. After discussing the historical trend in the boom-bust cycles of growth, we assess the respective roles of economic policy changes as well as exogenous factors in this regard. Explanations for investment concentration regionally and its implications are then sought in the ethnic make up and changes therein of both the business community in the country as well as structures of the state. In particular, different forms of networking through which state-business relations are conducted and its consequences on investment behaviour are then explored. The paper concludes by proposing further research on the nature of threats that investors face as well as the networks they create to protect their property rights.

1. Does the Investment Climate Approach Explain Investment Trends in Pakistan?

This section will introduce the concept of investment climate as the key contemporary approach for confronting issues of investment and growth in developing countries. We will then compare some of the data generated by IC assessments with special reference to Pakistan to see if the concept stands empirical verification. The third section then moves on to explain what the literature has identified as important reasons for divergence between intended and actual outcomes when the IC framework is applied to the case of Pakistan.

Conceptual Underpinnings of the IC Framework

A positive IC promises to specify the economic and political environment required to create the requisite opportunities and incentives for investment, employment generation and thereby poverty reduction (World Bank, 2005, p2).

At the country level, the country specific IC is identified by an Investment Climate Assessment (ICA) that systematically analyses the conditions for investment and enterprise growth by drawing upon the experiences of local and foreign firms in that country. By asking what business managers and entrepreneurs have to say, through a method of structured surveys, the ICA specifies the obstacles and constraints to investment and doing business in a particular environment/country. It allows the policy makers to highlight problematic areas that require reform, and to set agendas to improve the private sector's productivity and competitiveness (World Bank and SMEDA 2003).

Based on a number of cross-country surveys,[1] World Bank (2005) identifies *three general parameters* of a good IC. These are:

a) Reducing the Cost of Doing Business

The World Bank (2005, pg 4) identifies two components of the costs of doing business. Firstly, governments directly affect the cost of doing business by taxation and subsidy policies, by providing credible mechanisms for conflict resolution and efficient provision of law and order. The costs imposed by an inadequate provision of infrastructure also fall within this category. Secondly, costs of business also have a time dimension. The delays involved in negotiating with agents of the state (for example in filing income tax returns, following industry regulations etc.) and acquiring the requisite infrastructure (such as electricity and telephone connections) also increase the costs of doing business.

b) Reduction in Risk

[1] The World Bank has conducted IC surveys across a range of developing countries. These have been supplemented by the more focused Business Environment and Enterprise Performance Surveys (BEEPS). In addition, a World Business Environment Survey has been carried out by the Institute of Management and Development.

With respect to uncertainty, the World Bank (2005) notes that the risk involved in carrying out business in a particular economic environment also creates perverse incentives. While the Bank agrees that certain risks are inherent in the process of production and firms should bear them, it recommends that governments should limit the effects of risks external to the process of production. These risks could emanate from the general condition of law and order, the ineffective or incomplete protection of property rights, or the general stability of the economic and political environment.

c) Removing Barriers to Competition

Barriers to competition also dull the incentives for new investment. While firms generally want to face less rather than more competition, barriers to competition would tend to tip the scales in favour of a few firms against the many. More importantly, an absence of competition would tend to retard the innovation and adoption of new technology.

Apart from improving the long-term prospects of individual firms, an improved IC creates positive spillovers for the rest of society in the form of job creation, lower prices, and broadening of the tax base. Moreover, it benefits not only the large and politically connected firms, but also the smaller and less influential firms in their nascent stages of growth (World Bank, 2005, p5).

The above described core IC indicators are underpinned by 'enabling' good governance and market efficiency indicators. The importance of these enabling conditions can be gauged from the fact that in the IC surveys and cross-country comparisons these enabling conditions are given as much weight as the core indicators.

1.1.1. 'Good Governance' Basis of the IC Framework

The IC literature emphasises the creation of well defined and stable property rights, efficient contract enforcement mechanisms and the freedom from crime and violence as specific good governance conditions.

Property rights are succinctly defined as control over a set of productive assets from which a stream of income can be derived (North 1990). Well defined and stable property rights are deemed necessary for investment to take place for essentially three reasons. First, the underlying incentive for any investment to take place is the ability to reap the benefits from that investment. Well defined property rights are thus a necessary prerequisite in creating a conducive IC. Secondly, proper titling has been known to improve the terms of acquiring credit. Thirdly, well-defined property rights reduce the uncertainty associated with exchange by reducing the costs of repossession and facilitating contract enforcement.

An important corollary of an efficient property rights structure is the creation of an efficient contract enforcement mechanism. If investors do not have confidence in the judiciary's ability to resolve conflict and enforce laws, they would hesitate to invest.

Enforcement is not only facilitated by an efficient and unbiased judicial system, but also by the creation of organizations that disseminate information regarding reputation of other investors, suppliers and buyers.

The reduction of crime and a general prevalence of law have been shown, by surveys reported by the World Bank (2005), to create a conducive environment for investment. Crime has much to do with expropriation by private agents and is closely linked with the protection of property rights and the effectiveness and efficiency of enforcement.

1.1.2. Creation of Efficient Markets and Regulation

In the IC framework, the existence of efficient markets is an important condition. Particular emphasis is given in the IC literature to the creation of efficient credit and labour markets as well as removal of distortions that promote rent-seeking behaviour.

Access to credit has been defined as one of the key obstacles to growth in the individual country ICA surveys (see World Bank 2003). In World Bank (2005, p 121) information asymmetries are identified as the primary reason for poor access to credit. In line with this, they advocate setting up credit information bureaus and strengthening legal instruments such as bankruptcy laws. The World Bank (op.cit) also emphasizes the enforcement aspect of the credit contract by suggesting that the creation and protection of property right will increase the willingness of creditors to provide equity to firms.

Given its critical role in investment decisions, particularly in developing countries, the nature and structure of labour markets are seen as crucial to the success or otherwise of a country's IC. There are two particular issues around which the labour market proxies in ICAs have revolved. First, human capital formation is deemed critical for increasing productivity as well as technology acquisition. Second, World Bank (2005) advocates a move towards flexible labour markets as a prerequisite to creating an amenable IC.[2]

State created distortions manifest themselves most vividly in the process of rent-seeking. Rent-seeking as a main cause for inefficiencies in resource allocation as well as absolute waste of resources is part of conventional wisdom (see Krueger, 1974 and Bhagwati, 1980). In the context of IC, the World Bank (2005) considers corruption, elite capture and patron client relations as particularly damaging for a conducive IC to emerge. It is therefore recommended by the Bank that reforms be initiated that reduce monopoly power of the public sector, reduce discretionary authority on the part of the state, enhance transparency of government- firm interactions and strengthen accountability mechanisms.

[2] Realizing that such adjustments could, at least initially, reduce workers' welfare, the creation of social safety nets is acknowledged. Conceding, however, that social safety nets would not be possible given the narrow tax-bases in developing countries, the option of extending private insurance market to overcome labour market uncertainties is recommended by the World Bank. See World Bank (2005, chapter 7).

Closely related to minimizing the role of the state in resource allocations is investment friendly taxation policies. While it is recognised that taxes are required for the provision of essential services, the emphasis is on creating a tax policy that does not create perverse incentives.

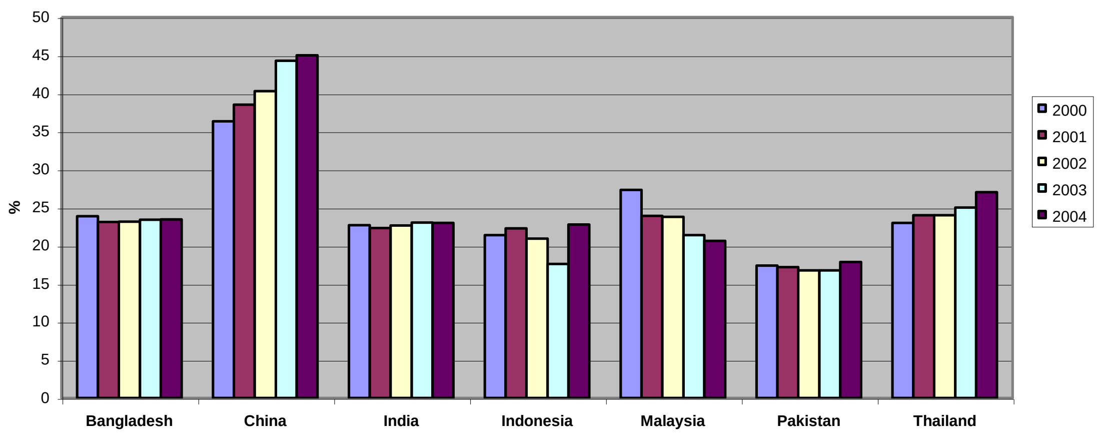
1.2. Cross-Country Comparison of ICAs: Benchmarking Pakistan

The real virtue of the IC framework is billed to be that it is an operationalizable framework where IC s in different countries can be compared. By developing internationally comparable indicators, this method also claims to specify areas where policy action is needed and where countries are doing better with respect to their IC s.

As they say, the proof of the pudding is in the eating. To gauge the empirical veracity of the IC framework, below we benchmark Pakistan's performance in terms of the IC indicators with other comparable countries in the region. [3]

But before we give a comparison on IC indicators across countries, it is important to provide a brief picture of levels of investment in Pakistan compared to other countries in the recent past. As we see in Figure 1, as a proportion of GDP, gross fixed investment in Pakistan has consistently been lower than that of all countries in the region and some other similarly placed ones in terms of their developmental history in the last three decades or so.

Figure 1. Gross Fixed Investment (% of GDP)

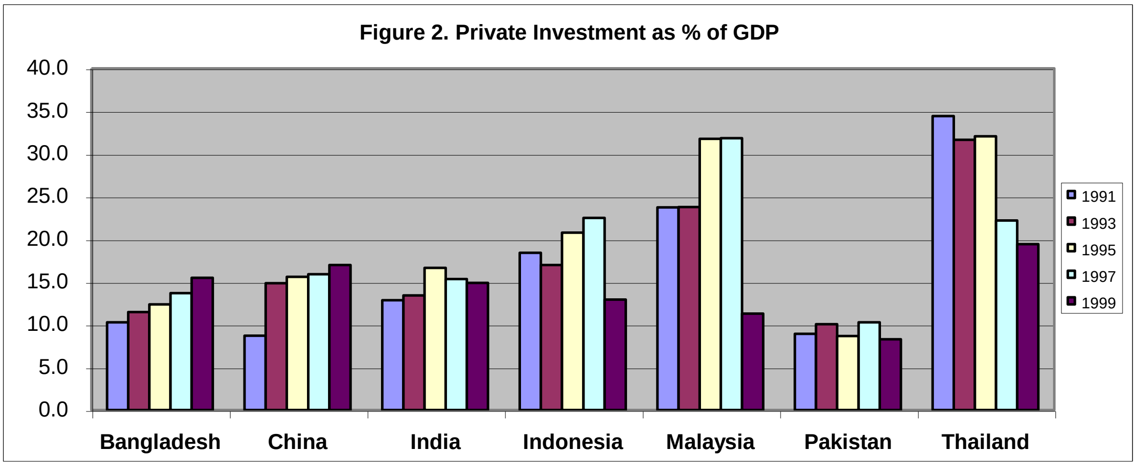


Source: World Bank. http://devdata.worldbank.org/data-query/

Since the focus in this study is on private investment, it is appropriate to compare levels of private, rather than aggregate investment across countries. Although

[3] Data on these indicators is collected at three levels. First, the ICA indicators include levels of perception-based surveys that include access to finance, access to courts, etc. Second, the Doing Business indicators are objectively attained data on the costs of certain procedures such as registering a firm, and the cost of enforcing a contract. The third is the BEEPS (Business Environment and Enterprise Performance Survey) that measures governance indicators such as levels of corruption, state capture and patron-client relations.

comparable data is available only till 1999, a similar picture emerges (as shown in Figure 2) viz. private investment as for gross investment.[4]



Source: IFC, http://ifcln1.ifc.org/ifcext/economics.nsf/Content/DataSets

This comparison on investment levels will give us the requisite benchmark to compare Pakistan with the same set of countries.

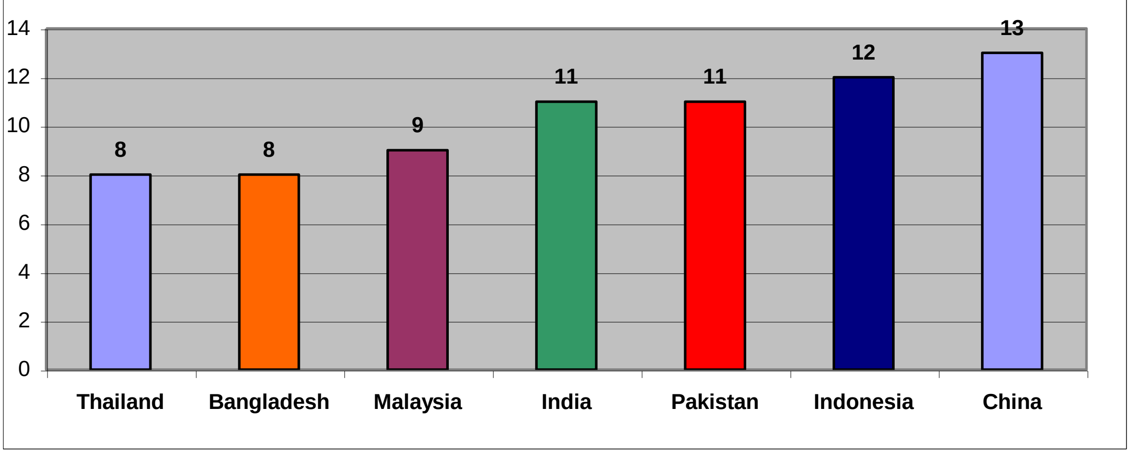
Regulation of Entry and Exit

Data on entry and exit regulations are collected from various government departments dealing with industrial regulation. It is an important IC indicator because entry regulations constitute a cost for the firm in terms of time and money. The larger the number of procedures to be met, the higher the time and pecuniary cost faced by a firm.

Figure 3 suggests that as far as the number of procedures required to start a business are concerned, Pakistan's score is as good as India's and better than Indonesia and China.[5] Pakistan's performance on this indicator, by itself, does not reflect the low levels of investment in the country, vis-à-vis India, Malaysia, China and Thailand. Furthermore, while there seems to be some variation, across countries, in the levels of investment, the variation in the number of procedures is not high. Moreover, the literature does not provide any good reason to explain the difference in the levels of investment between, say Pakistan and Malaysia, based solely on the difference in the number of procedures to start a business in the two countries respectively.

[4] Post 1999, the private investment-GDP ratio in Pakistan has improved somewhat to 10.5% of GDP from 8% of GDP as shown in Figure 2. However, if we assume no significant deceleration has taken place in comparator countries, then private investment levels in Pakistan still significantly lag behind.
[5] Similarly, Pakistan does better than India, Malaysia and Thailand in terms of the days it takes to start a business (World Bank 2006).

Figure 3. Starting a Business : Procedures (Number) -2005

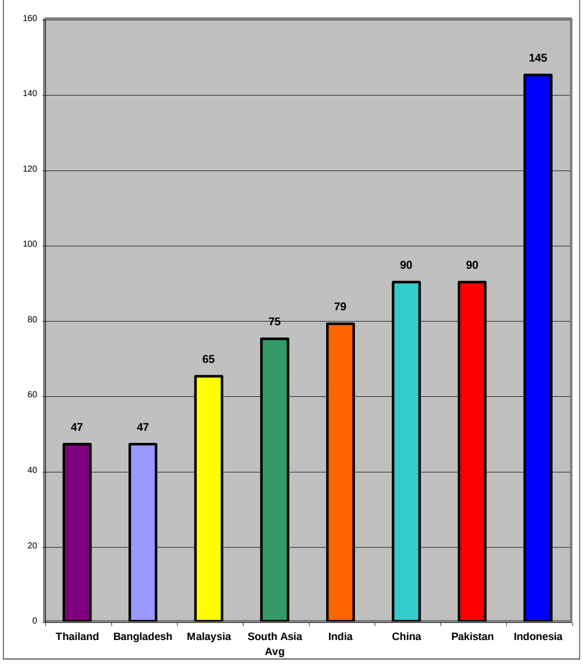


Source: World Bank (2006).

Rigidity of labour laws

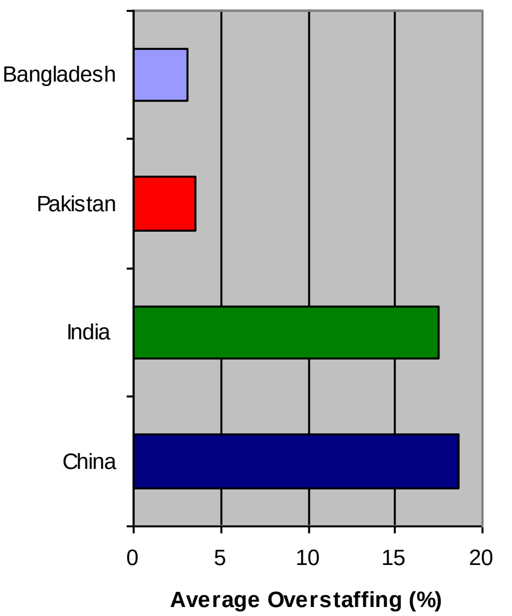
For labour market flexibility, two important indicators used are freedom of firing and overstaffing in firms. The difficulty of firing indicator covers worker's legal protections against dismissal, including the grounds for dismissal, and procedures for dismissal. World Bank (2004) proposes that strict regulatory intervention in the labour market could have many welfare reducing affects including less job creation, less R&D investment and smaller company size.

Figure 4. Firing Cost (Weeks of Wages)-2005



Source: World Bank (2006)

Figure 5. Overstaffing - 2003



Source: World Bank and SMEDA (2003).

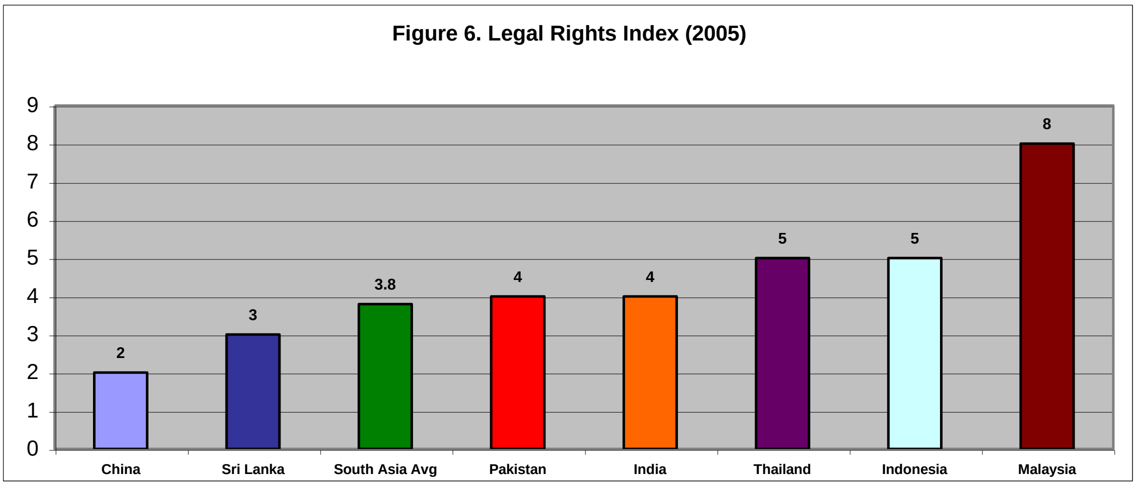
That said, Figure 4 does not support the veracity of the Bank argument. Pakistan and China have the same firing costs, and India and Malaysia have much lower costs relative to China and Indonesia. Again no correlation with investment levels can be discerned on the basis of this indicator. Similarly Figure 5 shows that overstaffing in Pakistan is much less severe than that in China and India; both of whom have higher levels of investment than Pakistan.

Creditor-Borrower Rights

The IC surveys use collateral and bankruptcy laws as proxies to gauge the effectiveness of credit markets. The legal rights indicator generated by the World Bank measures eight powers of borrowers and creditors in collateral and bankruptcy laws.[6] Figure 6 provides a cross-country comparison of this indicator. Again, note that Pakistan and India do much better than China, which scores less than even the South Asian average. This would suggest that firms in China would be much more credit constrained than firms in Pakistan and India. However, World Bank (2003) reports that 76% of firms in China have taken loans as compared to 51% in Pakistan, which suggests otherwise. Interestingly World Bank (op cit) has used the latter figures to

[6] These are: 1) General rather than specific descriptions of assets and debt are permitted in collateral agreements, 2) Any legal or natural persona may grant or take security over business credits, 3) A unified registry including charges over movable property operates, 4) Security provides priority both in and outside bankruptcy, 5) Parties may agree on enforcement procedures by contract, 6) Creditors may both seize and sell collateral out of court, 7) No automatic stay or freeze applies upon bankruptcy and 8) Bankrupt debtor does not retain control of the firm. A minimum score of 0 represents weak legal rights. Data were obtained from examining collateral and bankruptcy laws and legal summaries, and verified through a survey of financial lawyers. (World Bank 2004: pg 14)

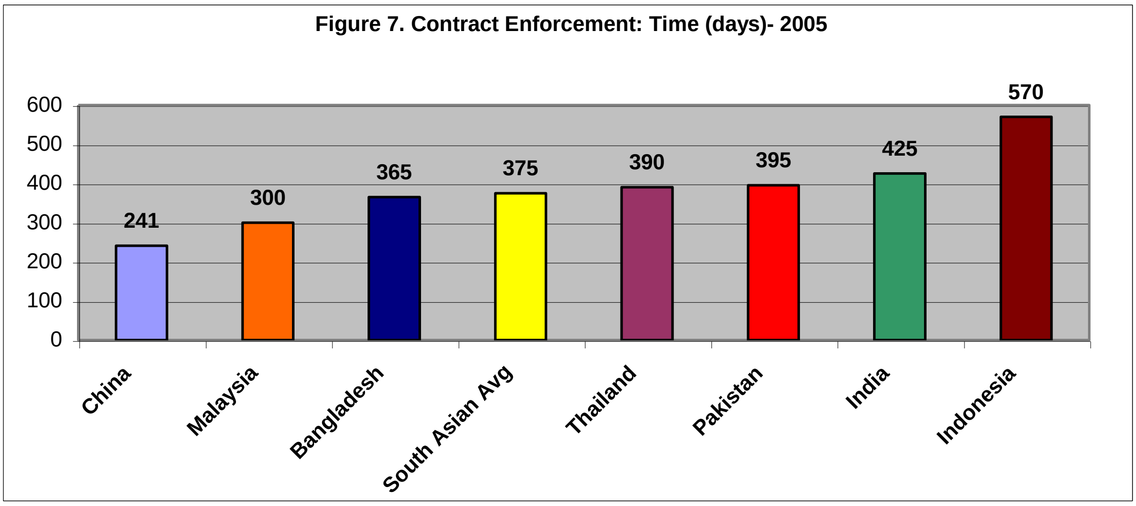
suggest that firms in Pakistan face credit constraints that should be relieved. The legal rights indicator, however, presents contrary evidence.



Source: World Bank (2005).

Contract Enforcement

As mentioned above, contract enforcement is a key ingredient of the IC framework. The World Bank (2005) argues that if firms do not have access to efficient formal sector enforcement mechanisms, they would need to rely on informal mechanisms such as trade associations, social networks, etc. Reliance on such mechanisms, in the Bank's view, restricts the conditions under which exchange can take place, with the result that social value may be lost. The bank uses the time taken to enforce a contract as a proxy of the effectiveness of contract enforcement and enforcement cost. The performance of Pakistan relative to other countries, on this indicator, is shown in Fig. 7.



Source:World Bank (2006).

Pakistan performs worse than the high investment countries such as China and Malaysia. However, it does better than India and Indonesia, both of which have higher levels of investment than Pakistan.[7] That said, the variation across countries in contract enforcement time does not seem to be so great as to warrant much attention: Thailand, for example, does better than Pakistan by only five days. It does not seem reasonable to attribute the differences in investment levels between Pakistan and Thailand to such a minute variation in this indicator.

This admittedly casual empirical comparison between investment levels and variables used to gauge ICs gives a snapshot view of their limited explanatory power in so far as cross country comparisons are concerned. However, this does not mean that the variables used themselves are not valid; all that the above comparison implies is that the proxies used for measuring these variables do not tell us much when compared across a set of countries.

1.3. Causes of Divergence Between the Concept and Outcomes

The literature that explores the divergence between the actual outcomes and the conceptual foundations of the IC framework is analysed in this section. Shortcomings have been identified in the empirical methodology employed to construct IC indices which lead to spurious results. More important, however, is the critique of the underlying assumptions and theoretical basis of the IC framework. In this realm, we explore the literature that is critical of the causality issues associated with the good governance conceptualization with that of economic performance. Some of the institutional reforms recommended by the IC framework, such as creation of stable and inviolable property rights structure and other 'one-size fits all' institutional designs, have also been the subject of critical scrutiny in the literature.

1.3.1. Methodological Limitations of IC Indices

A large component of IC and Doing Business surveys are perception surveys of 'competent observers', constructed through the enumeration of firm level questionnaires. The perceptive nature of these indices leads one to wonder if they necessarily reveal the true quality of governance being provided in surveyed countries. First of all, "corruption, instability and distortions can appear to be less serious in high growth countries even to competent observers, simply because things are working well" (Khan, 2002, p10). Second, are such opinions sufficient to reach important policy conclusions about certain variables? For instance, can one be really sure that if China scores lower on the corruption index than Pakistan, this reflects the better implementation of the rule of law in China? Tao and Zhu (2001), for example, suggest that formal contract enforcement in China is minimal. The authors report that private entrepreneurs are known to bribe agents of state owned enterprises to ensure adherence to formal contracts. Why is this not reflected in subjective rankings? Khan (2005) suggests that a possible reason could be that these rankings may merely signal the feeling that investors are better taken care of while overriding the rights of others.

[7] That contract enforcement in Tunisia takes a mere 27 days compared to the 241 days in China and 395 days in Pakistan further demonstrates the lack of explanatory power of the way the cross-country comparison has been set up. See World Bank (2005 a).

So while the general judicial environment may not be very efficient, *some* investors may not have any problems with contract enforcement.

Rodrik (2004) also suggests that the interviews of businessmen should not be the final word on reforms. Firstly, he suggests that such surveys reflect an emphasis on *obstacles* to investment emanating from either excess or lack of governance. The policy implications that arise from such survey results, then, promote a hands-off approach for the government, and restrict the writ of the state to contract enforcement and service delivery. Rodrik (ibid) argues that one needs to go beyond issues of governance and also scrutinize how market structures create or distort the incentives for investment. Asking businessmen, their views on priorities can be 'helpful' but not 'decisive.' When learning spillovers and coordination failures block economic take-off, "enterprise surveys are unlikely to be revealing unless the questions are very carefully crafted to elicit relevant responses" (Rodrik 2004: pg 25).

1.3.2 The Issue of Causality

The IC paradigm draws its empirical veracity from works such as those of Dollar and Kraay (2000), Calderon and Chong (2000), Acemoglu et al (2001). These researchers have all endeavored to establish a causal link between institutional development and growth using cross-country regression analysis. Institutional quality, in these studies, is proxied by stable property rights and the absence of rent seeking. In this vein, Keefer (2004) concludes: "although there is still room for skepticism, it is nevertheless true that the influence of secure property rights has withstood an unusually large amount of scrutiny."

Critics contend that the time series data that IC indices rely upon may be inadequate for establishing a causal link between growth and investment climate. Rodrik (1997) attempts to link the economic performance of East Asian countries with their institutional performance, using institutional rankings generated by Easterly and Levine (1997). He finds that although economic performance is generally consistent with institutional rankings there are some conspicuous discrepancies. Malaysia, with a high score on institutional quality, does only slightly better than Indonesia which has a very low score on institutional quality. Furthermore, data on institutional quality is only available for the 1980s and 1990s, by which time most East Asian countries had already been on their high growth trajectory for some time. Since one would expect governance to increase with improved levels of development, it would be reasonable to argue that scores for East Asian countries would have been even lower in governance rankings when they started to transform. It is difficult therefore to statistically observe whether the institutions advocated by the investment climate were created *before* these countries took off on their growth trajectories or *after*. Perhaps more importantly, there are no historical examples of countries where an environment of good governance preceded high levels of investment and growth (Chang 2005).

1.3.3. Context Specificity in Institutional Design

Although, the IC does mention incorporating local specificities in policy design (see World Bank, 2005),[8] in practice however, strategies follow a pattern of what Evans (2004) has termed 'institutional monocropping.' Rodrik (2004: 12) suggests that the higher order principles of sound economic management such as appropriate incentives, property rights etc come 'institution-free' i.e. these principles don't necessarily map into unique institutional arrangements.

The Chinese mechanism of property rights protection can be used to illustrate: Tao and Zhu (2001) show that rather than privatize land and industrial assets, the Chinese government implemented a novel system of Household Responsibility[9] and the Township and Village Enterprises (TVEs). Formal ownership of assets was not vested under the federal government or private hands, but rather at the local community level. Since this arrangement generated revenue for the TVEs they had the incentives to ensure their prosperity. Therefore, while, in essence, property rights were protected, the institutional arrangement through which they were protected did not reflect the institutional arrangement promoted by the investment climate paradigm.

It follows then that the overzealous supply of institutions, as emphasised by the IC and Good Governance views will not necessarily result in effective institutional change. A number of authors have argued that the method chosen for initiating institutional change requires a clear understanding of the losers and gainers associated with proposed reforms, the incentives they face and the power they hold.[10]

The interdependence of political and economic institutions is now well acknowledged in the literature (Acemoglu et al, 2004; Rodrik 1996; Sen 2004). This literature suggests that since political institutions are critical in determining economic institutions, the issue of political commitment to bring about this change is at the heart of the problem. Since the IC concept also advises states to reduce the cost of doing business, the commitment issue is the link between investment climate and the political economy of reform.

Khan (1995) and Bates (2004) take this argument further by suggesting that besides commitment, there is also an issue of state capacity to handle reform. According to Khan (op.cit) whether an institutional change comes through depends on the *political* cost losers associated with that change can impose on the winners.

The crux of the above discussion is that overemphasis on supplying certain institutions cannot necessarily guarantee effective institutional change. On the contrary, demand for such institutions has to be created by a far reaching social transformation and the alignment of the incentives of the state and private capital in a given historical and socio-political milieu (MacDonald, 2005).

1.3.4 Persistence of Undesirable Property Rights

One of the foundations of the IC paradigm, as discussed above, is the provision of well defined and stable property rights. While appropriate definition of property rights is necessary, the issue of how well defined and inviolable they ought to be is

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[8] Keefer (2004) also suggests that it is important to decipher if governance failures are merely a result of flaws in the design of policies or the public administration system or if they are more deeply embedded in the political and social dynamics of a country

[9] In this system, land was allotted to households on the basis of household size.
[10] See Bardhan (2001), Khan (2000), Bates (1995) and McDonald (2005).

contended in the literature. Khan (2000 and 2005) suggests that the institutions of well-defined and well-protected property rights may not even hold up the transition from a pre-industrial to a capitalist society. According to Khan (2002), creating a capitalist economy requires substantial restructuring of property rights and incentives for emerging capitalists to rapidly acquire new technologies. During this transition, Khan (op.cit) suggests that the condition of stable property rights is an odd one, particularly since the existing structure of rights and production systems is by definition of low productivity.

The case of Pakistan illustrates this point well where entrenched property rights of large landlords in the agricultural sector has not only impeded the investible surplus to be invested in relatively high productivity sectors but has also resulted in exceptionally slow social change from a 'feudal' dominated agrarian economy to a 'modern' industrial one . The demand for land reforms in Pakistan has been continuously thwarted by a powerful landed lobby on the pretext of a historical right on property, which in large part was given to these landlords for non-economic reasons.[11]

It is not only in the realm of 'meta' social transformation from an agrarian to an industrial economic structure, but within the modern industrial structure also that attenuation of property rights is necessary if the structure of industry and commerce is to be made dynamic enough to capture new income streams that come about through changing demand profiles and technical change. This attenuation could either be through transfer-based rents such as direct subsidies or through altering relative prices.[12] Examples from East Asia support this hypothesis. [13] Admittedly, many other developing countries, including Pakistan, have intervened in this manner without notable success.[14] Nevertheless, history bears upon the fact that *known* cases of transformation have always been steered actively by the state rather than a *laissez faire* market.

This is not to suggest that well defined property rights are not required or that their protection is not an important prerequisite for investment and growth to take place. The issue is the *degree* to which such rights are entrenched that makes it difficult to attenuate them if required by the imperatives of capturing new technologies or income streams.

Conclusion

After having laid out the salient features of the IC framework, this section attempted to demonstrate that it does not stand up to empirical and conceptual scrutiny. This, however, does not mean that the individual components that make up the ingredients of the IC cocktail are not irrelevant. They can indicate some areas where

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[11] For a detailed discussion on the failure to create effective land reforms in Pakistan, see Naqvi, et.al (1987).

[12] These can take the form of provision of subsidized infrastructure and credit to targeted sectors. See Chang (1994).

[13] See Amsden, (1989), Wade (1990) and Chang (1994) in this regard.

[14] See Sayeed (2002) for illustrations on the manner in which through state-allocated credit and the process of investment and import licensing, the state attempted to create new property rights structures but were not able to sanction the capitalists from merely wasting the rent created in their direction

improvements are needed but they do not constitute a sufficient basis for analysing and promoting investment. Cross-country analysis underlines their limitations. Having gone through this analysis, we invoke a more historically grounded political economy approach in understanding the investment conundrum in Pakistan.

2. Growth Spurts and Regional Diversity: State-Business Relations and Investment Behaviour in Pakistan

The starting point for understanding and promoting investment in Pakistan is the particular pattern of investment: major differences over time and between regions. In order to explain these inter-temporal and inter-regional differences, this section goes beyond the IC framework.

We start with Rodrik's (2004) observation that Pakistan is one of those developing countries that have gone through spurts of growth without having been able to sustain it. In section 2.1. we look into the pattern of growth and investment spurts and busts in the context of the policy environment that prevailed during these periods. We observe that rather than the policy environment *per se*, growth spurts appear to be highly correlated with the pattern of foreign resource inflows as well as political instability in the country.

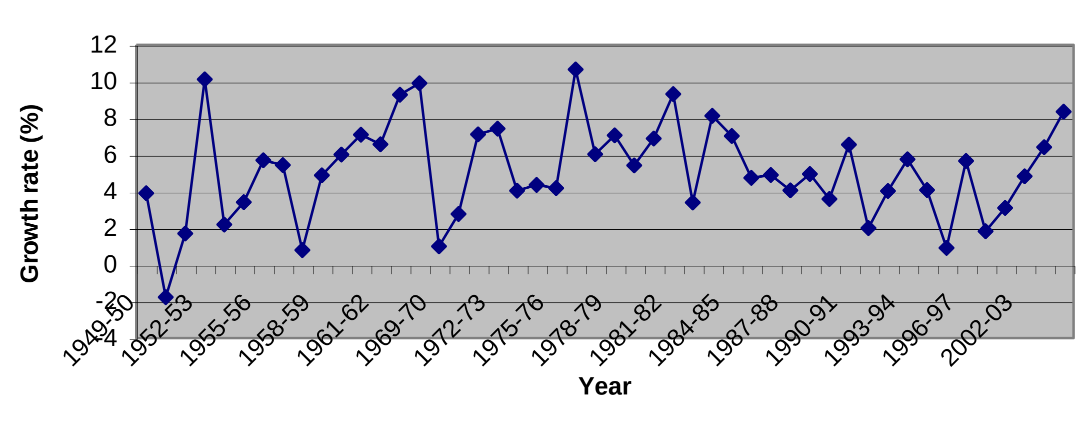
Section 2.2 analyses the shifts in intra-country investment. The centre of gravity in terms of industrial investment appears to shift from the southern port city of Karachi to the eastern province of the Punjab in the last two decades or so. While there are no statistics available for this phenomenon,[15] there is evidence to suggest that this phenomenon has been on the rise, at least for the last two decades. According to the World Bank (2006a, p 10), Sindh's share in national GDP has fallen in almost all sectors "with the largest declines recorded in large-scale manufacturing." This trend of investment concentration appears to be linked to the changing business-state relations within the country. Understanding these relations in turn requires taking into account ethnicity. . The link between ethnic relationships and development has been the focus of several political economy models (Easterly and Levine 1997, Bates 1999 and Posner 2000**).** Moreover, there is empirical evidence from other countries that within countries investment patterns can differ markedly across regions and industries (see Haber, et.al 2003; Kohli 2005). Taking these phenomena into consideration, we explore the literature that looks at network formation primarily along ethnic and kin lines in order to access the state for property rights protection and rent-seeking as a marker for investment behaviour.

2.1. Growth Spurts: In Search of an Explanation

Figure 8 below demonstrates the pattern of growth spurts that Pakistan's economy has experienced. As can be observed in the Figure 8, periods of high growth have followed periods of stagnation and indeed regression. Elsewhere we have shown that spurts of growth in Pakistan have generally been led by the manufacturing sector (see Sayeed, 2002).

[15] The Census of Manufacturing Industries, the main source of data on industrial investment has not been published in its entirety since 1995-96. Moreover, the published data is not at a sufficiently disaggregated level to discern regional trends.

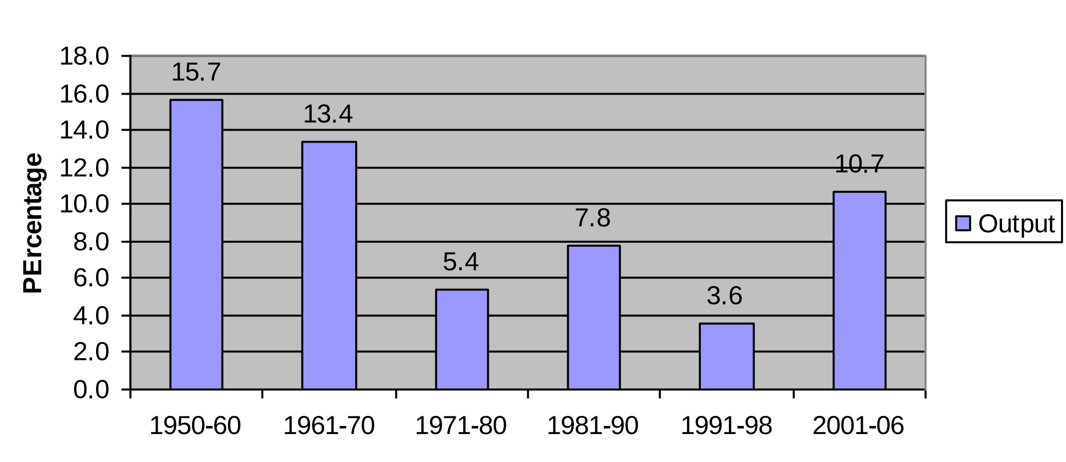
Figure 8. Pakistan's Growth Performance



Source: GOP (1997) and *Pakistan Economic Survey*, various issues

Once we focus on the manufacturing sector, we see in Figure 9 that there are three growth spurts that we can identify. The first one lasted the longest, roughly from the beginning of the 1950s to 1970. The second growth spurt, though not as long took place through most of the 1980s. Pakistan is once in the midst of another growth spurt that started after the cataclysmic events of September 11, 2001.

Figure 9. Output growth in large scale manufacturing



Source: GOP (1997) and *Pakistan Economic Survey*, various issues

Most observers of the Pakistani economy agree that high growth rates in the 1950s were essentially a function of the low base from which economic activity initiated. This is especially true for manufacturing as areas constituting Pakistan had virtually no industrial base.[16] Apart from the low base, manufacturing activity was also spurred

[16] See Papanek (1967), Lewis (1969) and Ahmad and Amjad (1984).

by the Korean War in the early 1950s.[17] Traders who had migrated from India initially set up basic processing units to export cotton and jute, the two most abundantly available raw materials in Pakistan at the time. An overvalued exchange rate buttressed the already high levels of profits. At the end of the boom, in 1952, the imposition of export controls prevented further export of jute and cotton, which were instead provided to local manufacturing units being set up. With declining opportunities of commerce and increasing prospect for profits in the industrial sector, many of the families that made their fortune during the Korean boom shifted into manufacturing.[18]

The 1960s were characterized by a much more conscious policy on the part of the state to spur private-sector led industrialization. The hallmark of the policy was a system of multiple exchange rates through a bonus voucher scheme, which allowed the voucher holders to import machinery at an overvalued exchanged rate[19]. This simultaneously made capital imports cheap and provided incentives for exports. At the same time, tariff barriers kept the manufacturers protected from foreign competition. This scheme created significant rents for the industrial sector and created the surplus profits that could, and arguably were, reinvested in manufacturing (Ahmed,1980 and Sayeed, 1995). Such was the exuberance in the early 1960s that an international media report suggested that, "Pakistan may be on its way toward an economic milestone that so far has been reached by only one other populous country, the United States" (quoted in Zaidi 2005, pg 90). Nevertheless, in the late 1960s, the growth regime collapsed. How could such high rates of industrial investment and growth sustained over nearly a decade collapse in the matter of a few years?

The neo-classical literature on rent seeking provides one perspective. Arguments relating to excessive intervention in the form of high tariff rates and distortions in the exchange rate formed the basis of the critique of the industrial policy at the time (See Little.et.al 1970 and Lewis and Guisinger 1968). In effect, this critique of the industrial policy of the time was geared around the deleterious effects of rents that state intervention created. But Sayeed (1995) and Ahmed (1980) show that not only were rents being re-invested but total factor productivity rates were also higher than other similarly placed developing countries(Sayeed 1995, p 56). This goes to demonstrate that although the state created rents as an incentive device for investment to take place, it was able to contain the negative effects of rent-seeking by selectively choosing rent beneficiaries and using sufficient influence on them to re-invest profits sought through rents (see Sayeed, op.cit).

Explanations for the demise of the growth regime instead have been sought essentially in the wider politics that this growth generated rather than the economic policy of the

[17] When war broke out in Korea in the 1950s, countries started stocking up on raw material particularly jute and cotton, which were the primary export products from Pakistan at the time. See Lewis (1969) for details.
[18] See Papanek (1967) for more detail on this attempt by the state to transform commercial capital into industrial capital.
[19] Exporters were provided with vouchers with a face of value corresponding to their foreign exchange earnings. Exporters could either import machinery through the vouchers or sell them at a premium, at times almost 50 percent of the face value, to other importers. For a detailed discussion, see Zaidi (2005), pg 99.

time. Monopolistic ownership pattern of the industrial structure[20] as well as the horizontal and vertical inequities[21] that this growth generated created a political backlash that the military regime of the time could not withstand. Perhaps an equally important reason for this growth spurt not sustaining was the drying up of US aid to Pakistan in the second half of the 1960s for geopolitical reasons. Since the country's industrial policy was based on the import substitution model, this foreign exchange resource constraint was a factor – albeit not the most important one – in the unravelling of the growth regime.

The next growth spurt took place in the 1980s. It followed on the heels of economic populism and nationalization initiated by the populist regime of the Pakistan People's Party in the 1970s. Growth in that period plummeted because of adverse external conditions – the oil crisis of 1973 – as well as the policy of nationalization of industry and the financial sector led to a virtual investment strike by the private sector.[22] The new military regime (1977-88) was able to create a growth spurt on the basis of some simple policy reversals as well as a favourable tide on the external front.

The public-private policy mix whereby the public sector allocated resources to the private sector at a time when the resource constraint was relieved by external inflows created large rents for private sector entrepreneurs doled out by the state. As the loans were provided on subsidized rates, there was a rent associated with access to the financial sector. If this was a one-off rent, it would not have any efficiency implications as such. However, what transpired was that loans were continuously re-scheduled and an incentive to 'take the money and run' was created (Sayeed, 2002, p 238). Part of the loan recipients were pro-regime politicians, to whom these loans were provided as pay-offs for political support to a regime bereft of political legitimacy. That the process of resource allocation was inefficient is best gauged from the fact that Total Factor Productivity growth during the period was negative (Sayeed, 1995). Consequently, once external inflows dried up at the end of the 1980s, the growth regime also collapsed.

In line with the emerging trend in the global economy, Pakistan's economy went through a thorough dose of liberalisation in the 1990s. The manufacturing sector was at the centre of these policy shifts. A number of rent-seeking opportunities were ostensibly closed as trade and foreign exchange regimes were liberalized, subsidized credit was virtually abolished, barriers to entry were removed through reduction in red tape and privatization of state enterprises was initiated.[23] However, as we see in Figures 8 and 9, aggregate GDP as well as manufacturing growth plummeted.

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[20] According to Amjad (1982), 44 monopoly houses controlled roughly 80 per cent of the total domestic assets of the large scale manufacturing sector.

[21] Horizontal inequity was across the Eastern (now Banglasesh) and western parts of the country (see Sayeed, 1980, chapt 4 for details). Vertical inequity was fostered by the growth regime being profit share led rather than profit rate led (Ahmed, 1980).

[22] Although the government of the time did succeed in maintaining the overall investment rate through public sector investments, because these investments were in intermediate and heavy industries and as such were long gestation in nature, growth rates in the short and medium run plummeted.

[23] See Sayeed and Nadvi (2004) and Zaidi (2005) for details.

While there is a lively debate in Pakistan if this deceleration in growth was *because* of or *in spite* of liberalization measures undertaken earlier in the decade,[24] the binding constraint again seemed to be foreign resource inflows. Sayeed and Rasheed (2003) show that external debt during the decade reached unsustainable proportions. One reason, amongst many for this occurrence was foreign aid to Pakistan being suspended once more on geo-political grounds.[25] This explanation is supported by subsequent developments. The post 9/11 period has witnessed another spurt of growth in the economy. The post 9/11 geo-politics has once again enabled Pakistan to reap a bounty of foreign resource inflows.[26]

This discussion on the policy environment bears out that rather than *economic* policy variables, *political* variables - such as foreign exchange resource inflows for geo-political considerations[27] and political instability- have correlated closely with booms and busts in the economy. This is borne out by the fact that growth spurts have occurred when the state created and managed rents from the private sector (1960s and 1980s) and also when state created rents have been minimized because of liberalization (the 2001-2006) period. Similarly busts have occurred at times when rent-seeking policies had been drastically reduced (as in the 1990s).

Rodrik (2004, p4) argues that sustained economic growth requires "sound institutional underpinning to maintain productive dynamism." One direction in which the inability of the Pakistani state to provide such 'sound institutional underpinnings' is in the realm of creating optimal state-business relations that can be growth enhancing.

2.2. *Intra-Country Differences and State Business Relations in Pakistan*

Section 2 of this paper seeks to explain the investment pattern in Pakistan. The first feature was the unevenness over time, discussed in section 2.1. Section 2.2 is concerned with the unevenness between regions. The central proposition is that this unevenness lies in the way business people have related to the state. Ethnicity helps to explain these regional differences. Ethnicity based networks appear to matter, because, as will be discussed, they imply differences in the ability to secure property rights and seek rents by entrepreneurs.

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2.1.1. Industrial Ownership and Ethnicity

[24] See Hasan (1998) and Husain (1999) who defend the liberalization of the economy. For a critical perspective on the nature and sequence of liberalization, see Sayeed (2002) and Zaidi (2005).

[25] In 1990, Pakistan was put under sanctions under the Pressler Amendments for conducting a covert nuclear programme. Subsequently in 1998, when Pakistan conducted the nuclear test, these sanctions were further intensified.

[26] Because of its role in the war on terror, Pakistan has received a significant re-profiling of its bi-lateral foreign debt. Also, given a perceived uncertainty amongst Pakistanis living in the US and Europe about the security of their savings there, they have shifted resources back to their home country. See Sayeed and Rasheed (2003) for details.

[27] An ex finance minister of Pakistan in an article endorses this view: "…there is a direct relationship between Pakistan's economic performance and its foreign policy." He goes on to say that "history will repeat itself…[as Pakistan] has made little effort to provide a domestic base for the growth of its economy." (http://dawn.com/2007/02/27/op.htm).

The importance of ethnicity in the economic organization of Pakistan is well documented.[28] These studies suggest the instrumentality of ethnicity as a marker of identity that creates the basis for, and perpetuates, exclusive networks in social economic and political domains. Nadvi (1997), for example, shows how networks built around ethnic identity can be called upon to guarantee contractual obligations in the Pakistani city of Sialkot.

In terms of ethnic dominance over the Pakistani economy, there have been two important historical markers: 1947 and 1971. Prior to the creation of Pakistan in 1947, business in those parts of India that now constitute Pakistan primarily constituted of commerce rather than industry and was dominated by Hindu communities. The only notable Muslim trading community were the Chinioti Shaikhs of the Punjab and even they were generally operating out of areas that constituted India after the Partition in 1947.

After the Partition of British India, Muslim traders and merchants migrated in large numbers to Pakistan. As we see in Figure 10, the largest business groups in the country were primarily Punjabi Shaikhs and Gujarati sects of Muslims[29] who migrated to Pakistan from locations as diverse as Bombay and Calcutta in India to Rangoon in Burma and East Africa. It is important to note that the business elite of the country did not have a commercial/industrial presence in Pakistan prior to 1947.

It has been already discussed that the Korean boom of 1950-52 enabled traders and merchants to reap enormous profits. Kochanek (1994) suggests that, being major trading communities, it was the Gujaratis and Shaikhs who benefited from the boom. After the boom, when the government of Pakistan embarked on its industrialization strategy, it was these communities again who managed to benefit from state created rents and set up large industries. Since Karachi was declared the capital city of the country and it was the only port city in the Western wing of the country, this is where basic infrastructure for industry was developed by the state and consequently became the industrial hub of the country.

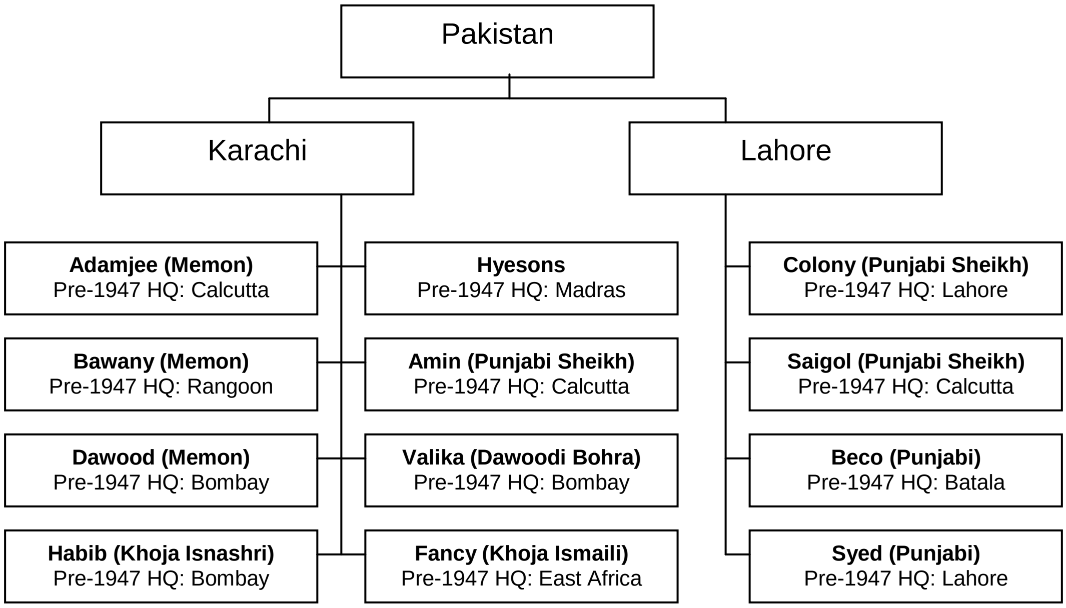
Kochanek (1983) suggests that it was economic muscle as well as their location in Karachi, the center of power at that time, which assisted the Gujaratis and the Shaikhs to lobby the government for rents. By the 1960s, families from both these communities owned a large proportion of the industrial assets in Pakistan.

This initial gain by certain ethnic communities was not linked to the nature of state power in Pakistan. Instead it was the carry over from the occupational caste system historically prevalent in pre-partition India. It was economic power that provided access to the state, even though the major beneficiaries tended to be certain ethnic communities.[30]

[28] Papanek (1967), Papanek (1972) Sayeed (1980) and Kochanek (1983 and 1994).
[29] The Gujarati community included the sub-communities of Memons, Bohras and Khoja Ismailis.

[30] See Papanek (1972) and Ali (2001) for a detailed description of the history of these groups and their importance in commercial activities within the context of India's social structure.

Figure 10: Ethnic Origins and Pre-1947 Headquarters of Prominent Industrial Families in Pakistan



Source: Kochanek, (1983, p 93)

2.2.2 Ethnic Networks and Business Associations

Opportunities of direct access to the state were limited to the larger industrialist groups. The relatively smaller groups used collective action to lobby the state through the Chambers of Commerce fora.[31] After independence in 1947, the Karachi Chambers of Commerce and Industry (KCCI) emerged as the largest and most powerful organization of trading interests in the country. Though the Gujaratis controlled the Karachi and the Federal chambers until 1971, nonetheless, Kochanek (1994) notes that ethnic tensions were kept at a minimum.

The ethnic balance, as well as the role of the Chambers, changed in the 1970s and 1980s. Having lost substantially to the East Pakistan debacle and Bhutto's nationalization policies in the 1970s, the Gujaratis lost their might. The Punjabi *Chiniotis*[32] were, however, more proactive in the 1970s and gained footing in the economic sphere. Their power was further consolidated by the Zia regime (1977-1988) when, it is alleged, they were looked upon favourably.

> "The Gujaratis charged that Punjabi business, and especially Chiniotis were being given easy access to credit from public sector banks and credit institutions, enjoyed preferential access to the Punjabi dominated bureaucracy and were the only group to benefit from the limited denationalization policies of the Zia government" (Kochanek, 1994, pg 8)

[31] The Chambers of Commerce are organized at the city level which then become members of the apex Federation of Pakistan Chambers of Commerce and Industry (FPCCI).
[32] Also referred to earlier as Punjabi *Shaikhs*

Moreover, General Zia politicized the office of the president of the federal chamber by directly recruiting chamber presidents as his personal advisers for commerce and industry. It is speculated that Zia wanted to involve civilians, preferably Punjabi, in order to create a constituency for himself and give some legitimacy to his government (Kochanek, 1994). This step increased competition for the post and aggravated regional tensions. Elections for the post also became subject to the control of the commerce ministry.[33] The loss of the Karachi based Gujarati community in terms of state patronage also marked a shift of industrial investment from Karachi to the cities of Lahore and Faisalabad in the Punjab.

Beyond the Chambers of Commerce route to accessing the state, collective action amongst businessmen has also developed along the lines of industry specific associations.[34] The most prominent of such chambers that has emerged is the All Pakistan Textile Mills Association (APTMA). Dominated by the large-scale, capital intensive spinning sector, this organization also reflects the occupational specialization of particular communities, particularly the Punjabi Shaikhs based in the Punjab.[35]

While ethnicity may not be the only reason that investment shifted from Karachi to the Punjab, the literature reviewed above does demonstrate that collective action along ethnic lines is an important element in the way in which state-business relations operate in Pakistan.

2.2.3.*Political Networking and Representation*

Yet another avenue for businesses to seek rents and protect their property rights is to access the state through political representation. Even though the military has ruled Pakistan for 32 of its 60 years since independence, political representation at the local levels has existed for most years of military rule also.

Khwaja and Mian (2005) show that those firms that are politically well connected are able to obtain loans from the state owned financial sector and their rate of default is also higher than firms without political connections. These results are based on a loan-level dataset of 90,000 corporate borrowings in Pakistan. They define politically connected firms as those where one or more directors "participate in an election." (op.cit, p1). They go on to show that the probability of those firms whose directors have won an election and belong to the ruling party tend to access loans and default more than others do. Moreover, they allude to the existence of political networks whereby politicians that have not won elections also carry a higher probability of acquiring and defaulting on loans than those who do not have a political history.

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[33] In 1981 for example, the commerce minister of the time issued an order to the chamber to elect a pro government businessman as chamber president. When his order was defied, he refused to recognize the elected president and paralyzed the functions of the chamber for a year (Kochanek 1994, pg 14). The chamber had little choice but to acquiesce.

[34] In principle, individual industry associations are members of the Chambers. Here we refer to them accessing the state autonomously of the Chambers.

[35] Although the Punjabi Shaikh community had invested in Karachi earlier, with the ethnic balance of power vis a vis the state shifting in their direction, they started investing in the Punjab also.

…a politician who is out of the government may still wield substantial influence both because he has links with those currently in power and because he is likely to return to power soon. In terms of rent-seeking, entry into the 'political network' has equal importance as the politician's relative position within the network. (op.cit p21).

Whether the political network that is referred to is actually underpinned by an ethnic or clan network, which is politically powerful in its own right, requires further investigation.[36] Since regional change in investment accentuates in this period, it appears that political networks did have an ethnic flavour to them. However, this issue will require further empirical corroboration.

2.2.4. Access to the State Bureaucracy Through Ethnic Networks

Changes in the state structure is the other side of the state-business relations equation. In section 2.2.1, we saw that the state itself was encouraging the shift in the balance of power from the Karachi based Gujarati and Urdu speaking community to Punjab based ethnic groups. It was around this time that we see evidence of the ethnic composition of the state bureaucracy also altering. This is all the more important in the Pakistani context where the civil and military bureaucracies have been important political players in that their role has not been confined to bureaucratic arms of the state but they have also held the levers of executive power. As such Jalal (1995) and Alavi (1972) have termed the Pakistani state as one where the non-elected arms of the state or the military-bureaucratic oligarchy have held sway over political decision making also.

In terms of ethnic composition, the Punjab has always dominated the bureaucracy, both, in numbers and in holding particularly powerful positions. Nevertheless, until the 1970s, Urdu speaking bureaucrats also held key positions, though their numbers were much smaller (Sayeed, 1980, pp 72). Since the 1970s, however, the Urdu speaking community's presence has been declining steadily in the bureaucracy. Furthermore, Kennedy (1987) reports that the presence of the Urdu speaking community in the bureaucracy decreased from approximately 30.1 percent in 1973 to 17.4 percent in 1983. Similarly, their presence in Gazetted positions also decreased from 33.5 percent in 1973 to 20.2 percent in 1983. The numbers of Punjabi speaking officers, on the other hand, went up from 53.5 percent to 55.8 percent among gazetted officers, and 49.2 percent to 54.9 percent in the bureaucracy as a whole.[37]

While the bureaucracy as an institution has declined in importance, the military has steadily increased its political role. Ethnic and kin networks that include military personnel, it will stand to reason, will be critically important in accessing the state. Historically, the military in British India was largely provided by the Punjab and this

[36] Apart from using the political space for accessing debt instruments, there is also evidence that political networks have been used for industrial licenses and import permits in the past as well as funding political campaigns. Evidence for the latter is provided by Kochanek (1983).

[37] Kennedy (1987) provides information on the basis of provincial rather than ethnic identity. Since the Urdu speaking population is concentrated in urban Sindh, we have taken figures of urban Sindh to represent the Urdu-speaking people. In reality, their percentage would be lower, though probably not by a large margin, as other ethnic communities would also be included in urban Sindh.

trend appears to have continued to date.[38] Although there has been diversification in recruitment patterns, with larger numbers of recruitments from the North West Frontier taking place, but according to Rizvi (2000), roughly 70% of the officer corps is still recruited from the Punjab.

Whether the ethnic profile of the state bureaucracy (both civil and military) creates ethnicity based access to the state for investors is an empirical matter which needs further investigation.

Conclusion

In the words of Dani Rodrik (2004, p43), "we talk so much about growth [because] we understand so little about it." The foregoing discussion has also alluded to the complexity in understanding investment behaviour in Pakistan. While the emerging focus on investment in the mainstream literature is a welcome development, as we argued in Section 1, the conceptual and empirical tools put together to form the investment climate checklist fall short of providing a robust explanation of investment patterns, at least in Pakistan.

Pakistan's growth trajectory, as we saw in section 2.1.correlates more with its foreign resource inflow patterns than the policy environment. That foreign resource inflows are in turn dependent greatly on geo-political developments is an important pointer towards the importance of non-economic variables in understanding growth and investment patterns in the country.

Section 2.2.attempts to show the pattern of state-business relations that provide some evidence – albeit indirect – for the shift in inter-regional investment pattern in the country. Based on the literature reviewed, we do know that ethnicity and kin based collective action amongst entrepreneurs is prevalent in Pakistan. We also know that the military occupies a dominant position within the state structure and that it is largely Punjabi in its ethnic makeup. *Prima facie*, therefore, changes in state-business relations as an explanation for shift in investment from Karachi to the Punjab appears a reasonable proposition.

The further corroboration of this proposition, however, requires going beyond existing literature. We do not know, for instance, whether ethnicity indeed provides an advantage to one group of entrepreneurs (those based in the Punjab) compared to their Gujarati and Urdu speaking counterparts based in Karachi. This basic question will require investigating – through structured surveys – different forms of networks, such as direct relationships between individuals and state personnel, domination of industry associations, mediation through the political process or other societal networks (school ties, membership of clubs, etc.). Unravelling these processes can potentially help us provide a more robust explanation for the investment conundrum in Pakistan than has been offered hitherto.

[38] See Rizvi (2000) for details on the historical as well as contemporary patterns of recruitment in the army.

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