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Mhammad Hanif Akhtar

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Editorial Staff: Tele. No: 5874385

Telefax: 0092 - 42 - 5714936

E-mail: 1es@brain.net.pk

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The Determinants of Foreign Direct Investment in Pakistan: An Econometric Analysis

Mohammad Hanif Akhtar*

Abstract

This study contributes to an understanding of locational determinants of FDI in Pakistan. Although there exists a great deal of literature in this area, there is hardly any evidence of such a study in the case of Pakistan. Economy level analyses are carried out to explore the determinants of FDI through multivariate regression analysis. The results of the multivariate regression analyses reveal that market size, relative interest rates and exchange rates are the major determinants of FDI in Pakistan. The variables such as market growth and political instability were consistently insignificant in the analyses. However, mixed findings were revealed by the variables such as consumer goods imports and the political regime in Pakistan.

1. Introduction

Returns on foreign direct investment (FDI), taking the form of profits, expansion of business, market development and innovations, are linked to social, economic, political, financial and cultural factors in the host economy in addition to those internal to transnational corporations (TNCs). The association of returns with these factors makes the latter significant determinants of FDI, with a varying degree of risk attached to them. For this very reason, studies on the determinants of FDI have tended to concentrate on the role of these factors in the overall decision of TNCs to invest overseas. The significance of econometric analysis, as an *ex post* estimation of approaching the issue of what determines the inflows of FDI in an economy, is widely held in the literature. Studies on the determinants of FDI have been invaluable in detecting the factors underlying these inflows.

It is relevant to mention the fact that motives for FDI vary across different types of FDI. The main motives are grouped under market-seeking, resource-seeking and efficiency-seeking reasons. The behaviour of the locational variables or factors determining the inflows of FDI in the host economy will vary according to these motives. For instance, relatively lower wages might be attractive for efficiency-seeking FDI in the host economy. For market-seeking ventures, a high wage rate would be more influential as

* Lecturer in Economics and International Business, Deptt: of Commerce, B.Z. University, Multan, Pakistan.

it reflects a greater spending potential in the economy. Data constraints in Pakistan do not allow the disaggregation of FDI across these motives. Therefore, the behaviour of the location factors or variables determining FDI in Pakistan reflects the joint effect of these motives for FDI. In such a situation, estimated signs of the variables might be counter to those expected while the significance level might also be affected, depending upon the motive which is dominant in overall FDI in the economy.

Increased and continuing support by the government of Pakistan in recent years has resulted in a surge in FDI mainly taking the form of acquisitions through privatisation. An attempt has been made to explore the determinants of FDI in Pakistan using the time-series data for 1972 to 1996. The selection of the time period was largely affected by factors such as general consistency, availability and reliability of the relevant data. The economy level determinants of FDI are explored by using the stock and flow data on FDI in Pakistan.

The rest of the discussion is organised as follows. Section 2 introduces the data set and the estimation method employed in the analysis. Section 3 takes up the definition and explanation of the variables used. Section 4 puts forward the main findings from the empirical analysis while section 5 presents a summary of results with some policy implications. The final part offers the main conclusions.

2. Data and Estimation Method.

An attempt was made to visualise the distributional properties of the data by plotting actual values of the variables against time. In addition to that, each of the explanatory variables was also plotted against the dependent variable and the residuals were also examined by running an initial regression analysis. Such an exploratory data analysis revealed the existence of non-linearity among the variables. Hence, natural scale variables were converted into natural logarithms (indicated by ln) to ensure symmetry and linearity in the data set. This also facilitates the interpretation of coefficients as elasticities.

All the explanatory variables are measured simultaneously with the dependent variables. Lag structures were also tested to find out the lagged response of the dependent variables against the explanatory ones but in every instance these resulted in inferior results¹. Data sources are listed in Table-1 below.

¹ Lags were tried only for those variables that appeared as insignificant or with an unexpected sign.

Table-1: Data Sources

Variable	Sources
FDI _{st}	United Nations, <i>World Investment Report</i> , Various Issues.
FDI _{inf}	(1)- IMF, <i>Balance of Payments Yearbook</i> , Various Issues. (2)- IMF, <i>International Financial Statistics Yearbook</i> , 1997. (3)- SBP, <i>Annual Report</i> , Various Issues.
GDP	IMF, <i>International Financial Statistics Yearbook</i> , 1997.
GR	GoP, <i>Economic Survey</i> , Various Issues.
Imp _{con}	GoP, <i>Economic Survey</i> , Various Issues.
Exch.	IMF, <i>International Financial Statistics Yearbook</i> , 1997.
I _p /I _H	IMF, <i>International Financial Statistics Yearbook</i> , Various Issues.
DPI	1- <i>Political Handbook of the World 1997</i> . 2- <i>The Europa World Yearbook 1997</i> .
DMR	1- <i>Political Handbook of the World 1997</i> . 2- <i>The Europa World Yearbook 1997</i> .

3. Definition and explanation of the variables

3.1. Dependent variables

The dependent variables are constructed mainly from the gross inflows of FDI in Pakistan. Real stock of FDI (FDI_{st}), for the period 1972-96, is composed of the FDI inflows in each year added to or subtracted from the stock of FDI in 1980. Real inflows of FDI (FDI_{inf}) are the annual inflows of FDI for the period 1972-96. Real values of the dependent variables are obtained by deflating the nominal values with constant prices of 1990. In this regard, due to non-availability of the appropriate capital goods price deflator, the GDP deflator is used instead, as rendered by Clegg (1995) and Clegg and Scott-Green (1998) in their in-depth analyses of American and Japanese FDI in the European Community.

3.2. Explanatory variables

Only locational determinants of FDI are explored in the analyses of determinants of FDI in Pakistan. The choice of the explanatory variables was largely affected by the existing literature on FDI determinants taking into account the trends and policies towards economic development and FDI in Pakistan over time. Table-2 below gives the information concerning

definition of the variables and their hypothesised sign. Construction of the variables used in the analyses is explained in the following section.

Table-2: Definition and Hypothesised Relationship of the Variables

Variable	Definitions and proxies	Sign
Ln-FDI-st.	Stock of FDI in Pakistan in million US dollars.	..
ln-FDI-Inf.	Inflows of FDI in Pakistan in million US dollars.	..
ln-GDP	GDP in Pakistan in million US dollars.	+
ln-GR	GDP growth rate of Pakistan economy.	+
ln-Imp _{con}	Imports of consumer goods in Pakistan as a per cent of total imports.	+
ln-Exch.	Exchange rate in Pakistan, rupees per US dollars.	+
ln-I _p /I _H	Interest rate in Pakistan relative to that of the average in home countries.	+
DPI	Dummy for political instability in Pakistan.	-
DMR	Dummy for military rule in Pakistan.	-
μ_t	Random and normally distributed error term with zero mean and constant variance.	..

Note: All monetary variables are in real values.

3.2.1. Real GDP and growth of GDP

As received theory suggests, the absolute size of the foreign market is believed to be positively related to the level of FDI (Buckley and Casson, 1981) because of economies in transaction costs and the benefits of a foreign production location. A large market size enables TNCs to produce and diversify their products according to local tastes and demands. The significance of market size has been generally acknowledged (Scaperlanda and Mauer, 1969; Caves, 1982; Torrissi, 1985; Culem, 1988; Artisien et al., 1991; Moore, 1993; Clegg, 1995; and Clegg and Scott-Green, 1998). Pakistan fits well into the large market argument in terms of its GDP and population size and for many products this market can be served better through local production than by exports from the source country. Real GDP is used as a proxy to estimate the impact of existing market size in Pakistan on FDI as it reflects the demand potential in the economy. The

data for this variable, being in millions of rupees at constant prices of 1990, was converted into dollars using each year's average exchange rate of rupee per US dollar.

A high level of economic growth is a strong indication of market opportunities. The growth of the host market is deemed to be significant for expansionary direct investment (Clegg and Scott-Green, 1998). Market size exhibits existing demand in an economy while growth represents the future potential. Growth is also important because higher rates of economic growth are usually associated with an increase in the profitability of corporations (Gold, 1989, p. 213). There exists relatively little support in the existing literature for this determinant of FDI as compared to the market size variable (Goldberg, 1972; Scaperlanda and Balough, 1983; Culem, 1988 and Clegg 1995²). Growing at an average rate of 5.5 per cent during the period 1972-96, Pakistan's potential future market cannot be overlooked. Taking into account the growth record of Pakistan and existing theoretical strands, it seems plausible to test the growth rate hypothesis in these analyses. Real growth rate of GDP is used to test the proposition that a growing Pakistani market attracts FDI.

3.2.2. Real exchange rate

The exchange rate variable has been widely debated in the literature on FDI determinants with some heterogeneous evidence with regard to its impact e.g. Cushman (1988), Froot and Stein (1991), O'Sullivan (1993), Dewenter (1995) and Clegg (1995). An economy (being served through exports from the home country) with a depreciating currency attracts more FDI as exporting from abroad to it becomes expensive, while it becomes cheaper to produce locally. Hence, exports by the home country are replaced through local production in the host country. Devaluation in the host economy also makes it cheaper to export from this base, adding to the competitiveness of TNCs. Such a situation is attractive for the firms looking for an export base, reducing their production costs and earning higher profits. It also increases the local value of assets (financial and real) of TNCs held in foreign currency.

However, there are certain costs associated with such a scenario of devaluation. Firstly, a devaluing currency lowers the potential for profit repatriation by shrinking the real volume of profits in terms of home currency. Secondly, depreciation of the host currency makes imports expensive, bidding up the prices of necessary inputs imported by affiliates of the TNCs. Thirdly, devaluation also reduces the book value of real

² Clegg's findings for this variable are mixed.

assets considered in terms of the home currency, lowering the assets side of the balance sheet of TNCs. This suggests that the impact of the exchange rate varies across the motives, nature and origins of FDI. In addition, currency fluctuations impel TNCs to guard against losses arising from such swings.

The use of the real exchange rate variable in the analyses, as compared to the nominal exchange rates, is justified on methodological grounds as the latter is affected by inflationary impacts. In this case, the inclusion of a nominal exchange rate variable would result in spurious correlations among some of the explanatory variables, which entail inflationary impacts, leading to the problem of multicollinearity. The use of real exchange rates is also expected to control for the problematic trending in the time-series data. Exchange rate fluctuations are expected to play a greater role in determining or deterring the flows of FDI in future. For instance, significant increases or decreases in FDI might take place in anticipation of an advantageous or disadvantageous exchange rate respectively.

FDI in Pakistan primarily appears to be market-seeking through local presence and a positive sign is therefore, hypothesised. Real exchange rate is the nominal exchange rate (rupees per US dollar) adjusted for relative changes in consumer price index (CPI) based on 1990 prices. The variable is used to test for the effect of changes in the value of the rupee against that of the US dollar. Average exchange rate for each year is used in the analyses.

3.2.3. Relative interest rates

The use of the interest rate variable as the determinant of FDI has not been quite common in the analyses. However, attention of researchers is gradually increasing to use this variable as a financial determinant of FDI, regardless of the absence of strong theoretical reasons within the OLI framework. TNCs can raise funds both at home and abroad to finance their activities, depending upon the relative rates of interest. Local borrowings in the host country might increase when interest rates are lower as compared to those in the home country or elsewhere. So, actual involvement of TNCs would be more than that measured in monetary terms through balance of payments statistics. If FDI is perceived as the total financial involvement of foreign investors in the host country, the recorded FDI might underestimate the true financial foreign investment (Culem, 1988). This may lead to an underestimation of the operations of TNCs. Such a discrepancy in measurement of the true involvement of TNCs' activities can be overcome by using the volume of output produced by their affiliates in the host country. However, the availability of such data is very restricted, leaving us

to the use of the monetary measure of FDI. To overcome this issue of measuring the true financial involvement of TNCs, the relative interest rate variable is used by researchers as a proxy to account for the financial nature of FDI in contrast to the ideal, but unattainable, data on operations of TNCs.

Financing FDI activities in the host countries by the affiliates of TNCs helps them to hedge against the risk of devaluation of the host country's currency. Such a financing mode is advantageous, in terms of costs, if interest rates in the host country are lower than those in the home country or elsewhere. Higher borrowing costs in the host economy, relative to those in the home country, would make the TNCs more competitive in the former, leading to higher inflows of FDI (Grosse and Trevino, 1996). Stated differently, the lower the interest rates in Pakistan relative to those in the home country, the more is the chance of raising funds locally in order to finance new and existing investments of affiliates, thus decreasing the inflows of FDI from abroad.

Nominal interest rates in Pakistan relative to that of the home countries' (USA and the UK) are used to assess the impact of borrowing costs of financing FDI in Pakistan. Long-term government bond rates are used in the analyses, indicating long-term opportunities to TNCs in home country markets and the opportunity cost of financing FDI in the host market. Interest rates in Pakistan reflect the opportunity cost of financing FDI in the economy while for the USA and UK such rates indicate the long-term opportunities for the TNCs in their home country. The variable is constructed by dividing the nominal interest rates in Pakistan by the average of those in the USA and the UK, the largest foreign direct investors in Pakistan. Due to non-availability of disaggregated data on the stocks of direct investment in Pakistan across sources, the rates employed are unweighted, following Culem (1988) and Grosse and Trevino (1996).

3.2.4. Imports in Pakistan

Countries with imports from abroad will attract FDI (Mundell, 1957). Imports in the host economy serve as an indicator of the existing market for the exports of the home country firms. Higher imports in the host economy (source country exports) encourage the TNCs to produce locally for market-seeking ventures (Culem, 1988). Such ventures become more desirable when there are high trade barriers (both tariff and non-tariff) on imports. Thus, TNCs find it attractive to produce locally in order to satisfy domestic demand. It would, however, be relevant to mention that the

TNCs might follow the various routes³ of servicing the host market before moving to FDI as the end result (Buckley *et al.*, 1988, p. 45). This variable⁴ has also been tested by Wang and Swain (1995) and Grosse and Trevino (1996).

In these analyses, consumer goods imports in Pakistan are used as an explanatory variable instead of total imports for two reasons. Firstly, because of market imperfections, such as tariffs, import controls and quotas, resulting from the policy of import-substitution industrialisation (ISI) in consumer goods, foreign firms might find it attractive to produce these goods locally to satisfy domestic demand. This means attracting more FDI in the consumer goods industry in Pakistan. Secondly, total imports include the capital goods imports, the major part of which is initiated by the TNCs leading to the fact that capital goods imports might be a part of FDI. To evaluate this, consumer goods imports, as a per cent of total imports, are included in the analyses of FDI determinants in Pakistan.

3.2.9. Dummy for political instability in Pakistan

Political instability is a qualitative phenomenon (Jun and Singh, 1996), exact measurement of which is a complex issue in terms of what investors perceive as politically risky and a constraint to their investment. For instance, there might be factors that affect or can potentially affect the TNCs' decision to invest abroad. These factors might be perceived as risky in the beginning but may not turn up as such in the end. Hence, exact measurement of this phenomenon is of paramount significance. As a part of their risk diversification strategy, TNCs will invest according to their current portfolios, balancing risks across the world. This leads to the determination of the fact that political risk needs to be seen largely as a global portfolio balancing issue, rather than a single country issue. In a time series analysis such as this, it is not possible to fully account for the effects of such cross sectional issues.

The effects of political instability have been explored through proxies in the form of dummies, (Lucas, 1993 and Wang and Swain, 1995), statistical measures⁵ (Wheeler and Mody 1992) and through commercially available data (Grosse and Trevino, 1996 and Jun and Singh, 1996). However, evidence in the literature, concerning the effects of this variable, is inconclusive (Robinson, 1961; Basi, 1963; Bennet and Green, 1972; Root

³ These include exporting, servicing through agents or the sales subsidiary before starting direct operations.

⁴ Total imports are used as an explanatory variable in these studies.

⁵ Principal components analysis.

and Ahmad, 1979; Schneider and Frey, 1985; Wheeler and Mody, 1992; Wang and Swain, 1995; Jun and Singh, 1996). There are various factors that account for conflicting results with respect to the impact of this variable. Firstly, there seems to be a difference of perception among researchers as to what constitutes political instability and which variable measures it in a most appropriate way. Secondly, there remains inconsistency regarding the variables used and the methodology employed to test the impact of these variables. Thirdly, the degree of risk resulting from such phenomenon might vary across TNCs from different origins, their extent of involvement, portfolio diversification and the nature of industries. Fourthly, the effect of the home countries' guarantees on FDI against risk resulting from political instability in the host countries needs to be taken into account (Agarwal, 1980, p. 761). Such considerations have usually not been taken into account while determining the full effects of the political instability variable in the analysis of FDI determinants.

Political instability in Pakistan has been a frequent phenomenon. It was, therefore, intended to estimate the effect of this conventional factor on FDI flows to a developing country such as Pakistan. An attempt was made to use the commercially available data in the form of political risk ratings for Pakistan. However, such risk ratings were not available for the whole period of analysis i.e. 1972 to 1996. Hence, reliance has to be made on the use of an episodic dummy, acknowledging the fact that it stands as a crude measure of such risk in terms of its construction and does not take into account some of the above-mentioned considerations, mainly due to data and resource constraints. Factors such as civic unrest, political riots and demonstrations, ethnic violence, dismissal of the government (constitutional and non-constitutional) and military coups are taken into account in construction of the dummy. This assumes a value of 1 in the years when the aforementioned factors are present and zero otherwise.

3.2.10. Dummy for military rule in Pakistan

There is hardly any evidence in the literature with regard to the impact of military rule on FDI ventures. Martial law has been a dominant feature in the political history of Pakistan. During the period 1972-96, the country has been under a military regime for nine years. Such a regime is perceived as less open to foreign investors vis-à-vis democracy. Hence, it is intended to test for the overall influence of this kind of regime on the inward FDI in Pakistan. It takes the unit value in case of military rule and zero otherwise.

4. Empirical results

The strength of econometric analysis largely depends upon the measurement of variables, model specification, data consistency, statistical and economic significance of variables in the analysis, number of observations and the fact that all the important variables are included in the analysis. A deficiency on any of these fronts is expected to jeopardise the reliability of estimates.

While regressing the explanatory variables against the dependent variable, an attempt has been made to take into account the number of degrees of freedom. Caution has been taken to avoid any inferior results by not overloading the equations with too many explanatory variables. Statistical findings from the regression analyses under varying specifications, presented in Tables 4 & 5 below, give the estimated equations and conventional tests of significance.

An assessment of the tests of significance and the regression equations indicates that the results of the parameters in the equations are in line with conventional economic theory and are statistically significant. The coefficient of determination (R^2), adjusted for the degrees of freedom, denotes the predictive power of the equations. The magnitude of the adjusted R^2 indicates the fact that the equations have performed reasonably well. The value of the F-statistics, significant at 1 per cent in all the equations, allows us to reject the null hypothesis that all the estimated coefficients are not significantly different from zero. In most cases, the Durbin-Watson statistic is in the acceptable range and there is no serious concern for the presence of positive or negative serial correlation⁶. This indicates that there are no specification errors in the equations.

As many of the macroeconomic variables tend to move together and are interdependent in most cases, it would be difficult to avoid any collinearity among the explanatory variables. Some of the variables have to be included because of strong theoretical reasons (Clegg, 1995). Therefore, it seems to be an unavoidable convention to use such correlated explanatory variables simultaneously in the literature on FDI determinants. There seems to be no evidence of multicollinearity⁷, seriously affecting the quality of

⁶ An explanation is provided where there is some evidence of the lower degree serial correlation.

⁷ This is supported by the fact that variance inflation factor (VIF), a measure of the multicollinearity, remained around 1.0 for most of the variates and closer to 5.0 for a few

results, in the equations. However, if there appeared to be a little evidence of some degree of multicollinearity, remedial measures have been taken to redress the problem. Simple correlation (Table-3) among some of the explanatory variables is not found to be distorting the test statistics or the significance levels at all, as most of the coefficients are significantly different from zero at the 5 per cent level or better.

Table-3: Correlation Matrix: Economy Level Variables

Variable	FDI_st	FDI_inf.	GDP	GR	Imp _{con}	Exch.	I _p /I _H	DPI	DMR
FDI_st	1.00								
FDI_inf.	.89	1.00							
GDP	-.32	-.20	1.00						
GR	-.09	-.02	.51	1.00					
Imp _{con}	-.24	-.19	.33	.45	1.00				
Exch.	.90	.74	-.38	-.17	-.39	1.00			
I _p /I _H	.86	.73	-.39	-.20	-.42	.70	1.00		
DPI	.24	.36	-.26	-.46	-.47	.26	.26	1.00	
DMR	-.43	-.33	.69	.37	.45	-.58	-.31	-.23	1.00

of them. A VIF value being larger than 10.0 (a usual threshold) indicates high degree of multicollinearity (Hair *et al.* 1995, p. 152).

Table-4: Economy Level Determinants of FDI in Pakistan 1972-96: FDI Stock as Dependent Variable

Dependent Variable	Constant	Ln_GDP	Ln_GR	Ln_Exch.	Ln_L/L	Ln_Imp	DMR	DPI	R ²	Standard Error	F Statistic	DW Statistic
Ln_FDI_st. (Result 1)	-1.938 (-0.778)	0.399 (2.251)	6.989E-05 (0.002)	0.584 (6.556)	0.413 (6.715)	1.090 (3.579)	-0.095 (-1.828)	0.050 (1.318)	0.94	0.06694	52.235	1.760
Ln_FDI_st. (Result 2)	-1.941 (-0.985)	0.399 (2.524)	—	0.584 (6.746)	0.413 (7.225)	1.090 (4.681)	-0.095 (-1.922)	0.050 (1.417)	0.94	0.06506	64.525	1.760

Notes: 1. Figures in parentheses are t statistics.

2. Significance levels are denoted by: a(1%), b(5%) and c(10%).

Table-5: Economy Level Determinants of FDI in Pakistan 1972-96: FDI Inflows as Dependent Variable

Dependent Variable	Constant	Ln_GDP	Ln_GR	Ln_Exch.	Ln_L/L	Ln_Imp	DMR	DPI	R ²	Standard Error	F Statistic	DW Statistic
Ln_FDI_inf. (Result 1)	-46.146 (-1.946)	3.436 (2.011)	-0.180 (-0.573)	1.675 (2.247)	1.162 (2.141)	2.538 (0.966)	-0.304 (-0.689)	0.249 (0.785)	0.57	0.55910	5.347	2.388
Ln_FDI_inf. (Result 2)	-29.476 (-2.024)	2.775 (1.953)	—	1.782 (2.506)	0.904 (1.984)	—	-0.118 (-0.307)	0.198 (0.725)	0.60	0.54237	7.755	2.133

Notes: 1. Figures in parentheses are t statistics.

2. Significance levels are denoted by: a(1%), b(5%) and c(10%).

4.1. FDI stock as the dependent variable

The equation for the determinants of FDI stock in Pakistan took the following form:

$$\ln_FDI_st. = \alpha + \beta_1 \ln_GDP + \beta_2 \ln_GR + \beta_3 \ln_Exch. + \beta_4 \ln_I_p/I_H + \beta_5 \ln_Imp_{con} + \beta_6 DMR + \beta_7 DPI + \mu_t$$

Results on the stock of FDI ($\ln_FDI_st.$) as the dependent variable are presented in Table-4. The significance of the market size variable is reaffirmed because the traditional proxy on market size is significant at the 5 per cent level. This supports the earlier empirical work by Scaperlanda and Mauer (1969, 1972), Caves (1982), Torrissi (1985), Culem (1988)*, Wang and Swain (1995), Clegg (1995)* and Clegg and Scott-Green (1998)* and also confirms findings of the survey results of the authors' current research. This result is partially strengthened by the significance of \ln_Imp_{con} variable, an indicator of the size of the existing market for the exports of foreign investors.

The insignificance of the growth rate variable in the analyses might be due to uneven growth of the Pakistan economy. The variable was also tested using lags of up to three years but this resulted in inferior results. The growth rate variable appears to have no impact on the stock of FDI and has no contribution to the explanatory power of the equation. This is confirmed by the fact that exclusion of this variable leaves the explanatory power and DW statistic unaffected (Result 2). It would be pertinent to mention that no evidence was found that the effect of this variable is eroded by the other explanatory variables like GDP because of significant moderate correlation (0.51) between the two. Such correlation does not distort the signs and significance of the other variables. Both \ln_GDP and \ln_GR were tried interchangeably, but exclusion of the former did not lead to significance of the latter. Findings on the insignificant growth rate are in line with those presented by Scaperlanda and Mauer (1969), Torrissi (1985), Clegg (1995) and Clegg and Scott-Green (1998).

A high degree of statistical significance is possessed by the relative interest rate variable which has a positive effect on existing stocks of FDI. An increase in the interest rate in Pakistan relative to that in the home countries leads to lower fund raising within the economy as the opportunity cost of raising funds goes up. More funds are raised outside the economy resulting in higher inflows of FDI. The results are in line with the partially

* These findings partially support the hypothesis as the variable appeared significant with the expected sign in some of the specifications.

supported findings by Culem (1988), Clegg (1995), and Clegg and Scott-Green (1998) but contradict those presented by Grosse and Trevino (1996).

The same pattern of significance level is sustained by the other finance-related determinant of FDI: the exchange rate (ln_Exch.). The variable is constructed in a way that an increase in exchange rate translates a devaluation of the Pakistani rupee against the dollar. The positive sign found for the exchange rate supports the hypothesis that a devaluation of the host country's currency attracts FDI (Cushman, 1988; Froot and Stein, 1991; O'Sullivan, 1993; Grosse and Trevino, 1996 and Clegg and Scott-Green, 1998⁸).

Imports of consumer goods (ln_Imp_{Con}) in Pakistan emerge with the highest coefficient value, demonstrating the most significant influence on existing levels of FDI. It also supports the idea that ln_Imp_{Con} attract FDI, strengthening the market-seeking argument. This result supports the earlier analyses by Grosse and Trevino (1996).

The dummy for military rule (DMR) obtains a significant, negative coefficient, which supports the hypothesis that military rule is considered as less welcoming by foreign investors. The dummy for political instability (DPI) appears not only as insignificant but is wrongly signed. This gives the impression that political instability is not found to be influencing the existing investors in Pakistan. This might also be due to the fact that political risk in Pakistan is viewed by investors in the perspective of their global portfolio balancing strategy (as mentioned earlier) rather than as a one country phenomenon. This finding supports the camp (Bennett and Green, 1972; Levis, 1979 and Mody, 1992) which found that political instability does not hinder FDI inflows and is contrary to those who found its reverse impact on FDI (Schneider and Frey, 1985; Lucas, 1993; Wang and Swain, 1995; and Jun and Singh, 1996).

4.2. FDI inflows as the dependent variable

The following equation is tested on the economy-wise determinants of FDI inflows in Pakistan:

$$\text{Ln_FDI_inf.} = \alpha + \beta_1 \text{ln_GDP} + \beta_2 \text{ln_GR} + \beta_3 \text{ln_Exch.} + \beta_4 \text{ln_I}_p/\text{I}_H + \beta_5 \text{ln_Imp}_{\text{con}} + \beta_6 \text{DMR} + \beta_7 \text{DPI} + \mu_t$$

Table-4 presents findings on the determinants of FDI inflows in Pakistan. The same combination of explanatory variables is used in the case

⁸ The variable is significant with hypothesised sign only in the second model EC(9) specification.

of $\ln_FDI_inf.$, as the dependent variable. Variables like \ln_GR , and \ln_Imp_{con} are found to be insignificant while the contrary sign is attached to the \ln_GR variable. The insignificance of the consumer goods imports in Pakistan, uncovers the fact that the local production effect is becoming stronger for inflows of FDI as compared to imports. This might also be due to the fact that the effect of import substitution in consumer goods has become weaker leading to insignificance of \ln_Imp_{con} for flows as compared to stock of FDI in Pakistan.

Variables such as \ln_GDP , $\ln_Exch.$ and \ln_I_p/I_H appear with the correct hypothesised sign and are significant as well. The large value of the coefficient on \ln_GDP suggests that market size is the prime determinant of FDI inflows in Pakistan. It is followed by the financial variables i.e. $\ln_Exch.$ and \ln_I_p/I_H in terms of strength of their effects on FDI inflows. Taking into account the elasticity values of $\ln_Exch.$ for the stock vis-à-vis inflows of FDI, it emerges that the latter is more responsive to exchange rate fluctuations as its coefficient value is higher. The lower response from the existing investors might reflect their cautious approach towards FDI as a result of the exchange risk linked with profit repatriation, import prices and value of the existing assets held in local currency.

Both the dummies DMR and DPI appear to be insignificant with only DMR being signed correctly. This produces no evidence that these factors contribute towards the inflows of FDI in Pakistan.

A smaller degree of negative serial correlation is found to be present in the first case (Result 1) as indicated by the value of Durbin-Watson statistics. This is because of the negatively signed insignificant growth rate variable and the insignificant \ln_Imp_{con} . Hence, inclusion of these variables does not seem to be necessary for the proper specification of equation 2. Estimates of FDI inflows obtained without \ln_GR and \ln_Imp_{con} variables result in a higher adjusted R^2 (0.60) and a more appropriate DW Statistic (2.133), eliminating the problem of negative serial correlation as well (Result 2). This suggests that the growth rate and consumer goods imports in Pakistan are not seen as playing any role in FDI decisions of the TNCs.

5. Summary and Policy implications

5.1. Summary of the results

An attempt has been made to examine the empirical relevance of the various hypotheses proposed in the literature and discussed in section 3. The findings of this study suggest that economic variables are more significant and consistent determinants of FDI in Pakistan than political

ones. The study conforms to the earlier findings in the literature on the market size, relative interest rates and exchange rates as the determinants of FDI.

FDI in Pakistan largely seems to be driven by the market-seeking behaviour of TNCs. Substantial differences do emerge among the FDI inflows and stocks in terms of elasticities for \ln_GDP . The same stands true for the financial variables such as $\ln_Exch.$ and \ln_I_p/I_H . This reflects the fact that the FDI inflows seem to be more sensitive to these location-related factors vis-à-vis \ln_FDI_st .

Market growth is not found to be as attractive to TNCs in Pakistan. It is an unexpected result which manifests the fact that scope for the future market development in Pakistan is slim. Inconsistent policies and an unstable macroeconomic environment might be reasons for this, leading to fluctuations in Pakistan's growth rate.

A consistent and overwhelming pattern of significance is exhibited by the exchange rate and interest rate variables which focuses attention on the role of monetary policy in Pakistan as FDI inflows are quite sensitive to financial variables. This demonstrates that financial considerations do possess greater weighting in the investment decisions of TNCs in Pakistan.

The significance of \ln_Imp_{Con} in the stock data analysis and its insignificance in the inflow data represents the fact that the former is driven by the exports from the home country while the latter concentrates on local production. This might be showing the significance of scale economies in local production by TNCs in Pakistan.

Mixed results are obtained from the findings on the nature of the political regime dummy (DMR). It leads to the partial conclusion that TNCs prefer civil rule rather than military rule in Pakistan.

Evidence on the issue of political instability (DPI) is consistently insignificant which might be accounted for for two reasons. Firstly, it might be possible that the full effects of political instability, being a rather complex phenomenon, are not being captured by the dummy (as the portfolio balance effect cannot be captured by the time series methods). A comprehensive treatment, in terms of using the most appropriate measure of political risk in Pakistan might lead to an answer for this paradoxical result. Commercially available data on the political risk in Pakistan might help in this regard, but its non-availability for the whole period of analyses is another limitation. Secondly, it might be possible that such a factor is disregarded by TNCs while making investment in Pakistan. This is a likely possibility in a situation where the

degree of such risk is low or its effect is undermined by the strong locational or other advantages. However, the latter argument does not seem to be convincing in the case of Pakistan with substantially lower inflows of FDI.

5.2. Policy implications

Some of the policy implications emerging from the above analyses are mentioned below.

- Consistently insignificant performance by the growth rate variable unveils the fact that there is a great need to improve and stabilise the growth rates of the economy. Policy consistency and a stable macroeconomic environment are expected to ensure a persistently growing market. This, in turn, can enhance and reflect the true potential of Pakistan in attracting larger inflows of FDI.
- A stable exchange rate policy has to be ensured in order to avoid the exchange rate risk attached to the assets, import prices and profit considerations of direct investors in Pakistan.
- A military regime is deemed to be unattractive for the TNCs and civil rule is considered to be more appropriate in terms of its openness.
- Given the insignificant dummy for political instability and the lower levels of FDI in Pakistan, it can be deduced that locational advantages in Pakistan are not strong enough to attract larger inflows of FDI. Hence, there is a need to improve the locational strength of Pakistan. Factors like incentives, policy consistency and a more open and less regulatory investment regime can be of immense value in this regard.

6. Conclusion

Results of the study indicate there is a great need for improving the locational factors in Pakistan to attract the market-seeking FDI. High and stable growth, exchange rate stability accompanied by political stability, are the main areas of concern in providing an attractive investment environment to TNCs in Pakistan.

The study of the location factors in Pakistan, as the determinants of FDI, was the main objective of these analyses. There remains great room for further research to explore how geography influences the use of ownership and internalisation (OI) advantages in a national context or how the use of OI factors helps to exploit an existing locality. A comprehensive and extensive treatment of such factors is expected to lead to a better and deeper understanding of the determinants of FDI in Pakistan.

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Significance of the Small and Medium Enterprises (SMEs) Sector in Pakistan and Assessment of its Employment Potential

Shahid Amjad Chaudhry*

Definitions and Sources

Definitions: In this paper it is proposed to use the definition of self-employed, small scale (2-9 employees), medium scale (10-99 employees) and large scale (100 employees and above) to discuss the issues relating to the Small and Medium Enterprise (SME) sector in Pakistan. The national pension (regulated through the Employees Old Age Benefit Institution Legislation) and health insurance (The Provincial Social Security Institutions Legislation) is applicable to institutions with 10 or more employees and provides a natural cut off point between the small scale and medium and large scale sectors. The cut off between the medium and large scale at 100 workers is also appropriate.

Sources: Major sources of data were the: (i) The Census of Establishment 1988; (ii) The Labour Force Survey 91-92; (iii) The Report of the National Manpower Commission 1991; (iv) The Employment and Management Situation in Pakistan (ILO) 1997 and (v) The Economic Survey 1997-98. A large number of other sources were also used as required and these are indicated wherever possible.

Significance of the SME Sector

The large scale sector in Pakistan has ceased to be a major engine of employment growth over the last several years and this situation is likely to continue for the foreseeable future. The large scale sector in Pakistan is and will continue to be important. It currently accounts for about 9 per cent of total employment and as much as 30 per cent of GNP. It is the dominant organisational form in the energy, telecommunications and finance sectors as well as in the provision of public (government) provided goods and services. Bank lending to the large scale sector comprise almost 60 per cent of the total bank advances. Cutting edge technology and managerial progress are intimately linked to this sector. Government denationalisation of major assets WAPDA, PTC, PIA, Nationalised Banks etc. will focus both the interest of multilateral agencies and multi-national firms further here. While all this is to be encouraged the sector is still unlikely to provide the output and

* The author is currently the Rector, Lahore School of Economics, Lahore.

employment growth that is needed by the Pakistani economy today. This output and employment growth momentum over the next decade is most likely to come from the SME Sector if its potential is appropriately tapped.

The SME Sector currently provides about 54 per cent of employment and about 50 percent of value added in Pakistan today. As mentioned above, employment in large scale enterprises is about 9 per cent of total employment and this sector contributes about 30 per cent to value added, while the self-employed sector constitutes 37 per cent of employment and has a share of about 20 per cent in value added.

**Table-I.1: Pakistan Aggregate Structure of Employment 1997-98
(Estimates)**

	Million				
	Total Mn	Self Employment Mn (%)	Small Scale Mn (%)	Medium Scale Mn (%)	Large Scale Mn (%)
Total	36.2	13.2 (37%)	16.6 (46%)	3.0 (8%)	3.4 (9%)
Urban	13.4	3.5 (26%)	4.9 (37%)	2.2 (21%)	2.9 (21%)
Rural	22.8	9.7 (42%)	11.7 (51%)	0.8 (4%)	0.5 (3 %)

Source: Estimated from *Economic Survey 1997-98, Census of Establishments 1988* and *Census of Agriculture 1990*.

Pakistan's urban areas are inhabited by about one-third of its population and provide thirty-seven percent of total employment in the country. A little more than a quarter (26 per cent) of this employed labour force is self-employed, a little more than half (53 per cent) works in the SME sector while about one-fifth (21 per cent) work for the large scale sector. Most people are engaged in trade (mostly shops) and community and social services (schools, hospitals, urban services). This is followed by employment in manufacturing, construction, transport and finance services (in decreasing order). Small scale establishments pre-dominate – providing about 37 percent of urban employment.

The rural areas, wherein the remaining two thirds of the Pakistani population live, provides employment to about 63 per cent of its employed labour force. Here the bulk (42 per cent) are self-employed, mostly in small scale agriculture and livestock production but also in trade and construction activities. The SME sector is again the largest employer (55 per cent) – but here in the rural areas almost all who work in this sector work in small establishments. The medium and large scale sector have relatively little importance in the rural areas and employ 4 and 3 per cent of the employed

labour force respectively. Table I.2 presents further detailed estimates by sector of the structure of employment for both rural and urban areas.

**Table-I.2: Pakistan: Structure of Employment by Sector 1997-98
(Estimates)**

			Million				
			Total	Self Employed 1 Person	Small Scale 2-10	Med. Scale 10-100	Large Scale above 100
1	Agr. (Crop) Farming	- Rural	13.7	5.10	8.60	-	-
2	Agr. Livestock	- Rural	3.20	1.60	1.60	-	-
3	Trade	- Total	5.24	2.30	2.70	0.16	0.04
		- Urban	3.64	1.20	2.30	0.10	0.04
		- Rural	1.60	1.10	0.40	0.06	-
4	Community and Social Services	- Total	4.80	0.80	1.60	1.30	1.10
		- Urban	3.60	0.40	1.00	1.00	1.10
		- Rural	1.20	0.40	0.60	0.30	-
5	Mining and Manufacturing	- Total	3.80	0.20	1.30	1.00	1.30
		- Urban	2.30	0.10	0.90	0.60	0.80
		- Rural	1.50	0.10	0.40	0.40	0.50
6	Construction	- Total	2.60	2.40	0.20	-	-
		- Urban	1.60	1.40	0.20	-	-
		- Rural	1.00	1.00	-	-	-
7	Transport	- Total	1.84	0.15	0.40	0.37	0.90
		- Urban	1.61	0.09	0.30	0.32	0.88
		- Rural	0.23	0.06	-	0.05	0.02
8	Finance Services	- Total	0.42	-	0.18	0.16	0.06
		- Urban	0.39	-	0.15	0.16	0.06
		- Rural	0.03	-	0.03	-	-
9	Other	- Total	0.06	0.60	-	-	-
		- Urban	0.30	0.30	-	-	-
		- Rural	0.30	0.30	-	-	-
Total			36.20	13.20	16.60	3.00	3.40

Source: Estimated from *Economic Survey 1997-98, Census of Establishments 1988 and Census of Agriculture 1990.*

The significance of the SME sector for Pakistan must therefore not only be recognised but also be made the centre piece of any employment and growth strategy. In the urban areas SMEs already provide the bulk of urban employment and are focussed in the trade, services and construction sectors where employment elasticities are quite high. In the rural areas SMEs dominate formal agriculture (with its 150 acre land reform ceiling), agricultural services (machinery repair, input and output distribution), livestock and milk production and provision of construction and community services. In both urban and rural areas SMEs are increasingly providing employment to women and encouraging their entry into the labour force. Finally, in terms of human development, SMEs in education and health are increasingly emerging as the prime agents of change.

Assessment of Employment Potential of the SME Sector

A further analysis of Pakistan's historical experience over the last years (1980-96) which examines historical sectoral growth rates and employment elasticities, clearly indicates that the agriculture crop sector and large scale manufacturing as presently constituted have lost their potential for being the engine of both output and employment growth. Output and growth potential in the agricultural and manufacturing sector is now increasingly with livestock (largely milk and poultry) production in family household units and with small scale manufacturing which, with their cumulative high growth rates of the last decade and a half, now contribute almost 45 percent of agriculture value added and one third of industrial value added. The construction sector is almost entirely self employed or small scale and despite being denied its true potential has contributed substantially to employment growth because of its labour intensity. Finally, the transport and trade sectors have shown vigorous output and employment growth and are characterised again largely by their being mainly in the SME sector. The community/social services sector (including education and health) is still largely dominated by the state sector. This historical experience is summarised in Table I.3 below.

Table-I.3: Pakistan Historical Sectoral Growth Rates and Employment Elasticities, 1980-96

	Average output Growth Rate % p.a.	Employment Elasticity	Employment Growth Rate % p.a.
1 Agriculture and Livestock - 100 % SE and SME	4.1	0.34	1.40
(Agriculture -100 % SE and SME)	(3.2)	(-0.19)	(-0.6)
(Livestock - 100 % SE and SME)	(5.3)	(0.51)	(2.7)
2 Manufacturing	6.9	0.18	1.24
(Large Scale)	(5.3)	(0.02)	(0.11)
(Small Scale)	(8.4)	(0.85)	(7.14)
3 Construction - (100 % SE and SME)	4.3	1.15	4.93
4 Transport- (50% SME)	5.7	0.48	2.76
5 Trade - (96% SE and SME)	6.2	0.61	3.79
6 Education and Social Services - (80% State owned)	6.3	0.63	4.00
Total (average)	5.7	0.39	2.2

Source: (i) For Aggregate Sectoral Elasticities, "The Employment and Manpower Situation in Pakistan," ILO 1997.

(ii) For Agriculture, Livestock, Large Scale and Small Scale Industry Employment Elasticities estimates from ILO's "Review of the Sixth Five Year Plan," 1988.

Crop Agriculture: The entire crop agricultural sector consists either of self employed or small and medium enterprises according to our definition. About 13.7 million people (38 percent of the total employed labour force) work in 5.1 million farms in the crop agricultural sector which contributes about 14 percent to GDP. Pakistan's agricultural holdings are relatively small - 60 percent of total farm acreage or 66 percent of total cultivated area and 93 percent of farm holdings are below 25 acres. Even the larger farms are not that large. Farms 25-50 acres of which there are 240,000 average 31 acres in size (and comprise 16 percent of total farm area and 5 per cent of all farms), farms 50 to

150 acres of which there are 92,000 average 70 acres in size (comprising 12 percent of total farm area and 2 percent of all farms); while 15,300 farms above 150 acres average 311 acres in size of which on average 168 acres are cultivated and comprise 10 percent of total farm area. Given this size distribution of farms the agricultural revolution in major crop production – rice, wheat and cotton – has now run its course. Farming is almost entirely mechanised for major crops for both planting and harvesting (except for rice planting by hand because of unlevelled fields). The “glass ceiling” in agricultural major crop production has been reached. There will have to be a major shift towards high value vegetable and fruit production for which farm size and land and climatic conditions are highly suitable. This requires new technologies and institutional (including credit arrangements). Successful transition could substantially accelerate the growth rate in this sector and also reverse its current shedding of labour.

Livestock/Milk: This entire sector which contributes about 7 per cent of GDP falls in the self-employed and small scale enterprise category. The predictions of doom through social unrest, because of unemployment and low incomes in the rural areas as a result of the labour displacing effects of mechanisation which were made over the last two decades, have been averted through the remarkable growth of the livestock and particularly milk production sectors. This sector, which has been growing at almost twice the rate of the crop sector and now constitutes about 45 per cent of value added of the entire agriculture sector, has been the response of the average Pakistani villager to the labour displacing effects of mechanisation. Pakistan today has 13.6 million milking buffaloes and 4.5 million milking cows being kept in 8.5 million rural households with an average herd size of 2 buffalo/cows. Pakistan produces 20 million metric tonnes of milk - making it the 7th largest milk producer in the world (ahead of the UK which is at number 9 with 15 million metric tonnes). However Pakistan’s milk yields (annually 1150 liters per animal/year) are half those of India’s and are one-fifth of Europe’s. This unexploited potential has immensely positive implications for income and employment growth – particularly for women who form the majority of workers in this sector. While milk production is predominant in terms of value added and employment, the poultry and meat producing sectors (particularly sheep and cattle) have also tremendous potential for output and productivity increases.

Table-I.4: Potential Agriculture Sector Output and Employment Growth Rates 2000-2010

	Actual Average Annual Output Growth Rate % p.a.	Est. Actual Employment Elasticity 1980-1986	Potential Average Annual Output Growth Rate % p.a.	Projected Employment Elasticity 2000-2010	Potential Average Annual Employment Growth Rate % p.a.
1. Crop Agriculture (Major Crop)	3.2	-0.19	4.2	0.21	0.9
(Minor Crops Including Fruits & Veg)	(2.8)	(-0.25)	2.8	(-0.25)	-0.7
	(4.4)	(0.25)	(6.5)	(0.25)	(1.6)
2. Livestock	5.3	0.51	6.5	(0.51)	3.3
Total	4.1	0.34	5.0	0.40	2.0

Potential of Crop Agriculture and Livestock Sectors: The agriculture sector (almost entirely crop agriculture and livestock) contributed about 22 per cent to GDP in 1996-77 and produced almost all outputs at internationally competitive levels of efficiency. Table I.4 above summarises the potential which the agriculture sector (comprising entirely self employed and small and medium scale enterprises) has for output and employment increases over the next decade. With a significant shift both towards our present day 'minor crop' including oilseeds, fruits and vegetables and also towards dairy production, the agricultural economy of Pakistan is capable of increasing its output growth rate from 4 to 5 per cent and its employment growth rate from 1.4 to 2 per cent. This will substantially stabilise the economy and also to a large extent reduce the rural to urban population drift.

Manufacturing: The manufacturing sector contributed about 15 per cent to GDP in 1996-97. The large scale manufacturing sector (100 employees and above) contributed 68 per cent of value added and 18 per cent of employment within the sector, while small enterprises contributed overwhelmingly to the remainder (self employment in the sector being virtually negligible and medium scale industry being relatively minor in terms of output and employment). Presently the large scale sector is in deep recession with almost one third of industrial capacity closed down and the firms in deep arrears to the financial system. This is not entirely surprising since a large proportion of this capacity was built behind walls of domestic protection and as these are being gradually dismantled for sensible international efficiency reasons (and under pressure from external donor agencies) they are increasingly not able to

compete. An “Industrial Efficiency Study” undertaken by the Governments’ Planning and Development Division (completed in 1998) showed DRCs in the engineering sector of 0.90 for small, 0.70 for medium and 1.24 for large, for the textile sub-sector of 0.94 for small, 0.99 for medium and 0.71 for large, and for the chemical sub-sector of 1.16 for small, 0.94 for medium and 1.12 for large. The large scale sector in Pakistan is only efficient in agro-based products including textiles, heavy transport natural resources based products (cement) and the captive monopolistic energy sectors (energy and gas production and possibly oil refining). These large scale efficient sectors are likely to grow while the remaining large scale units will contract and continue to shed labour. ILO’s Mid Term Review of the Sixth Five Year Plan in 1988 stated that the decline (to almost zero) of employment elasticity could be irreversible ‘at least’ over the Sixth Plan period. This state of affairs is likely to persist -perhaps as long as until 2010 - as the last of the inefficient large scale units close down. Accordingly, while large scale manufacturing may well continue to grow till 2010 at its growth rate of 5.3 per cent of the 1980-95 period, it is unlikely to provide any significant new employment over the 2000-2010 period.

An interesting feature of the Pakistan manufacturing sector is that almost the entire small scale sector is unregulated. The Pakistan Census of Manufacturing Industries (1991) which covers manufacturing establishments registered under the Factories Act 1934 reported in 1991 a total of 4792 establishments employing 0.62 million people with a value added of Rs. 111 billion. Establishments of more than 100 employees had 0.52 million employees and contributed 87 per cent to total value added as reported in the Census. These were also 3031 establishments employing 10-99 workers employing 95 thousand workers with value added of Rs.14 billion (or 13 per cent of the total). These registered establishments are reported as large scale manufacturing in the national accounts. The unregistered ‘small scale’ manufacturing in the national accounts – reported separately – is estimated therein to contribute 32 per cent of the value added of the sector and now provides about 80 per cent of the total estimated employment in the sector.

While the ‘un-regulated’ manufacturing enterprises have grown rapidly, these are still in the nature of ‘repair shops’ producing spare parts for the stock of largely imported machinery vehicles and equipment in Pakistan. This sector will also continue to grow at its own pace and have the highly favourable employment elasticities (approaching 0.85) documented in the GOP’s Report of the National Manpower Commission of 1991. The real potential of the manufacturing sector in Pakistan is in the medium scale sector which has the highly favourable DRCs in the agro-industry, consumer goods, textiles and engineering sub-sector (reported earlier) and which has the potential to be competitive internationally. This sector has been largely

ignored in Pakistan, subject to intense regulation by a multiplicity of agencies and has also been subject to the predatory take-over of the large firms- particularly the multinationals. A recent classic example is that of Lever Brothers buying out its competitor Brooke Bond in tea and closing down its establishment with golden handshakes to workers. If the regulatory and institutional environment of this sector can be remedied and it provided appropriate credit it has the potential to grow rapidly and change the industrial structure of Pakistan.

The output and employment potential of the entire manufacturing sector is summarised in Table I.5 below for the 2000-2010 period.

Table-I.5: Potential Manufacturing Sector Output and Employment Growth Rates 2000-2010

	Actual Average Annual Output Growth Rate % p.a.	Est. Actual Employment Elasticity	Potential Average Annual Output Growth Rate % p.a.	Projected Employment Elasticity	Potential Average Annual Employment Growth Rate % p.a.
	1980-1996	1980-1986	2000-2010	2000-2010	2000-2010
Large Scale	5.3	0.02	5.3	0.02	.01
Medium Scale			8.4	0.18	1.5
Small Scale	8.4	0.85	8.4	0.85	7.1
Total	6.9	0.18	6.7	0.38	2.5

Note: Medium Scale Industries are included in Large Scale for the 1980-96 Period

Wholesale and Retail Trade Sector: The Trade Sector (including hotels and eating establishments) had a value added of Rs. 402 billion in 1997-98 (7 per cent of GDP) and employed about 5.2 million people (14.4 per cent of total employment). Within the sector 3.64 million people were employed in urban areas of which 1.2 million were self-employed, 2.3 million worked in small scale establishments (2.9 workers), 0.1 million worked in medium scale establishments (10—99 workers) and only 0.04 million worked in large scale (over 100 worker) establishments. Within the rural areas there were an estimated 1.6 million workers, of which 1.1 million were self-employed, 0.4 million worked in small scale establishments, 0.06 million worked in medium scale establishments and virtually none in large scale establishments. The sector has been growing at about 6.2 per cent per annum between 1990-96 and had an employment elasticity of 0.61. This sector has provided the bulk of employment growth in the last several decades and this sector is expected to continue its vibrant growth in the future.

At the superficial level, the sector appears to be flourishing. Both in the urban and rural areas this is the favoured sector for self employment and for small scale enterprises. There are about 2.3. million 'one-person stores' in the country equally divided between the urban and rural areas. In addition there are about 300-400 thousand small-scale establishments employing 2-9 persons mostly in the urban areas. The number of medium scale establishments are only a few thousand and large scale establishments non-existent. This rather interesting breakdown in fact shows the weaknesses presently inherent in the sector. The problem in Pakistan is the lack of medium scale establishments which have to provide the essential link between the producer and the buyer-particularly in the agricultural sector.

The Report of the National Commission on Agriculture 1998 highlighted the weaknesses in the agricultural marketing system. Defective preparation of produce, absence of organised and regulated marketing practices, and the lack of physical storage marketing facilities leads to excessive losses. This is income lost both to the producer and the trader of agricultural commodities. Substantial efficiency gains in domestic trade of agricultural products are therefore required. Finally the food preparation and hotel sector needs major improvements.

Table-I.6: Potential Trading Sector Output and Employment Growth Rates 2000-2010

	Actual Average Annual Output Growth Rate % p.a.	Est. Actual Employment Elasticity	Potential Average Annual Output Growth Rate % p.a.	Projected Employment Elasticity	Potential Average Annual Employment Growth Rate % p.a.
	1980-1996	1980-1986	2000-2010	2000-2010	2000-2010
Trade Total	<u>6.2</u>	<u>0.61</u>	<u>8.5</u>	<u>0.60</u>	<u>5.1</u>
Self Employed			6.5	0.61	4.0
Small Scale			6.5	0.61	4.0
Medium Scale			12.0	0.50	6.0

In order to get both productivity and employment gains, it is necessary to modernise the sector by focussing on both the small and medium scale establishments. This will require working capital, improved infrastructure and a modern regulatory environment. The potential gains in national well being (through healthy and safe products) as well as in output and employment growth are substantial and are summarised in Table I.6 above.

Education, Health and Community Services: In 1997-98 this sector employed about 4.8 million people (3.6 million in the urban areas) placing it third after agriculture and trade with regard to employment. While all major sectors of the economy are important, the key to Pakistan's growth and development in the 21st century lies in the human development sectors and particularly in education. Historically, Pakistan's record in education (and health) has been poor. The nationalisation by Mr. Bhutto in 1973 of all private sector educational (and health) institutions is now acknowledged to have destroyed the sector. As public sector educational (and health) institutions deteriorated, private sector SMEs in the form of private schools and colleges and private hospitals have emerged to fill the gap. These SMEs are harassed through over-regulation and seldom encouraged. Their true potential has therefore not been realised.

Education: Pakistan with its literacy rate of 46 per cent (1998 census) has very poor educational indicators for a country of 130 million people. By the last count (1996-97) Pakistan had only about 175,000 schools (150,000 primary), a thousand colleges and 25 universities in the education sector employing about 700,000 teachers (215,000 female). There are only about 22 million students in schools (9 million girls) and about 1.1 million in colleges and universities (0.4 million girls). About 90 per cent of educational establishments are in the public sector. However, private sector educational institutions are rapidly being established. A recent (1997) survey by the Punjab Government indicated that 60 per cent of children in primary schools in Lahore go to private schools and 80 per cent of these pay less than Rs.100 per month.

While the Government and the international agencies (particularly the World Bank and ADP) are pushing public sector education through the vehicle of the SAP (the Social Action Programme) aiming to increase public sector expenditure from 2 to 3 per cent of GDP it is increasingly clear that education in the urban areas cannot be provided of the required magnitude and quality solely by the public sector. The enrolment ratio needs to be increased by 50 per cent for primary education, doubled for secondary education and quadrupled in the colleges and universities over the next decade. This will require another 780,000 teachers (half of them female) and implies a growth rate of about 7 per cent per annum. About

three quarters of this growth should be in the urban areas and should be provided by private sector SMEs (Schools, Colleges and Universities). However, this will require a sea-change in thinking by the public sector oriented educational, administrative and political establishment where the current attitude towards private educational institutions is to “fine them, control their fees and drive them from the cities” through draconian (and often arbitrary) regulations.

Health: Pakistan’s health sector is miniscule, with (in 1996) about 900 hospitals with 73,000 beds, 5000 dispensaries and rural health centres with 3000 beds, and 74,000 doctors, 3000 dentists, 21,000 mid-wives and 23,000 nurses. Ninety five percent of health establishments are in the public sector. Pakistan’s health sector indicators (like its education indicators) are poor and the country needs at a minimum to double its health establishment over the next decade (which implies a growth rate of 7 per cent per annum) almost entirely from the private sector. The health establishment is more permissive to the growth of the private sector in health- perhaps because the entire health sector establishment including the leading doctors work in public sector hospitals during the mornings and also have their private hospitals and clinics which they operate in the afternoon and evenings. Overall, however, the private sector in health needs to be further encouraged. The growing private sector health institutions will be almost entirely SMEs.

Community Services: This sector employs about 3 million people and provides community services. The majority are government employees engaged in public administration. There are about two million public sector employees in public administration. Another half a million work in the provision of public community services including education (but excluding teaching staff), health (excluding doctors and nurses) and recreation. The remaining half a million are in private service and provide personal services divided almost equally between repair services and personal services (including as domestics). Growth in municipal / city employment in both the public and private sectors is likely to maintain historical community urban sector employment growth rates at about 6 per cent per annum. However, within this government, employment will decline while increasingly private sector SME establishments will be used for contracting out tasks. Employment in health and education related community services has the potential to grow at about 7 per annum as noted earlier.

Table-I.7: Potential Education, Health and Community Services Output and Employment Growth Rates 2000-2010

	Actual Average Annual Output Growth Rate % p.a.	Est. Actual Employment Elasticity	Potential Average Annual Output Growth Rate % p.a.	Projected Employment Elasticity	Potential Average Annual Employment Growth Rate % p.a.
	1980-1996	1980-1986	2000-2010	2000-2010	2000-2010
Total	6.3	0.63	11.00	0.63	6.93
Community Services					
Public Education			6.00	0.63	3.78
Private Education (SME)			12.00	0.63	7.56
Public Health			6.00	0.63	3.78
Private Health (SME)			8.00	0.63	5.04
Other Community Services					
Public			6.00	0.63	3.78
Private (SME)			1.50	0.63	6.61

Table I.7 sums up the output and employment potential of the education, health and community services sector. This sector has the unique potential of doubling its present employment in ten years i.e. from 4.8 million in 1997-98 to 10 million in 2010. The demand is there, the potential to provide these services from the private SME sector is there. The only feature lacking is supporting government policy.

The Construction Sector: In 1996-97 the construction sector contributed about Rs.83 billion to value added (4 per cent of GDP) and employed 2.6 million people (1.6 million in the urban areas). Almost all construction workers are definitionally self employed – hiring out their labour on a one-to-one basis or through contractors (which is the norm in the urban areas and turns the labour force technically into an SME). The sector is highly labour intensive – its employment elasticity was estimated at 1.15 in the 1980-95 period.

The sector has substantial potential – given the shortage of housing in Pakistan. However this potential has been poorly realised –as shown by its average 4.3 per cent growth rate in the 1980-96 period. The sector is constrained by poor housing policies including the absence of public built housing and/or financing for private housing. In addition, the recent privatisation of the cement industry has created an industrial cartel which has doubled prices over the last year and restricted output to 50 per cent of capacity. If these constraints can be removed the sector has the potential to grow at least at the projected rate of the National Economy (about 6 per cent per annum) and with its employment elasticity of 1.15 double its employment levels over the next decade (from 2.6 million in 1996-97 to 6 million in 2010).

The Transport and Communication Sector: This sector contributes about Rs.221 billion to value added (10 per cent of GDP) and employs about 1.8 million people. This sector has an employment elasticity of 0.48 largely due to the road transport sector which is relatively labour intensive compared to the air and (almost negligible) sea transport sectors. The telecommunication sector which contributes almost one-third to value added of the sector also provides very little aggregate employment. The road transport sector is almost entirely SMEs (about half of total employment). The air, sea, telecommunication, radio and TV sectors are entirely large scale and are almost all government monopolies – these provide the other half of the employment of the sector.

While all these sub-sectors have substantial output potential, only the road transport sector seems to have major employment potential. The government monopolies are inefficient and are in the process of being privatised. They will therefore be likely to shed labour or at least not have substantial employment growth over the next decade. Substantial employment potential exists in the road transport sector and with current major road building and automobile assembly programmes under way, the sector will likely grow at seven or eight percent per annum over the next decade. Overall output for the sector has the potential to double and employment to grow by 70 percent over current levels.

Conclusions: The SME sector in Pakistan has the potential to grow very rapidly and with its favourable employment elasticities can also provide substantial additional employment for Pakistanis. While all sectors have this potential (except air services, telecommunications and finance) – the analysis undertaken above indicates that the education sector offers perhaps the single largest potential for employment generation. A comparison of employment possibilities in 2010 (Table I.8 below) indicates that a strategy drawn by using the potential of private SMEs in all sectors and particularly education could create 7.3 million additional jobs compared to the

continuation of present policies. Even with the continuation of present policies the bulk of new employment generation will be by SMEs.

Table-I.8: Summary Potential Sector Employment 1997-2010 alternative Scenarios.

	Millions		
	Employment	Employment	Employment
	1997-98	Scenario # 1 2010	Scenario # 2 2010
Agriculture	16.9	20.0	21.4
Manufacturing	3.8	4.4	5.1
Trade	5.2	8.1	9.4
Education & Social Services	4.8	7.7	10.7
Construction	2.6	4.6	5.2
Transport	1.8	2.5	2.7
Others (in Finance)	1.0	1.6	1.7
Total	36.1	48.9	56.2

Note: Employment Scenario #1 uses historical 1980-95 average output growth rates and employment elasticities. Employment Scenario # 2 uses potential average output growth rates and employment elasticities developed in this chapter.

II. Assessment of Existing SME Related Policies Programmes in Pakistan

SMEs provide the bulk of economic activity and employment all over the world including in the developed countries. Italy with a per capita income higher than that of the United Kingdom is particularly known for an extremely large (more than 60 per cent of the economy) and dynamic SME sector which dominates the world in production of quality products including machinery, textiles and clothing. The lessons from the world experience are fairly well established. A healthy and prosperous SME sector depends upon: (i) A stable macro economic environment under a free trade regime; (ii) A workable legal and judicial system; (iii) Fair regulatory policies which encourage competition and protect SMEs from the predatory policies of both private monopolies and state power; (iv) A well functioning and competitive financial sector to provide Banking Services and Finance to SMEs; (v) A Business Development Services Infrastructure to provide both advocacy and policy formulation so that SMEs have increasing access to information, technology, finance, markets and training; and (vi) Sector-specific SME policies. Pakistan's Policy Frame-work towards SMEs needs to be reviewed in this analytical frame-work.

Stable Macro-Economic Policies and a Freer Trade Regime

Pakistan's macro-economic management over the last few decades has been poor and the country was able to sustain a sufficiently high level of economic activity over the last decade mainly through heavy domestic borrowing, large external aid inflows, private foreign investment particularly in the energy sector and huge and increasing foreign exchange balances held in Pakistan largely by Pakistanis resident overseas. The Pakistan economy was in an inherently unstable situation throughout the 1990-97 period and it was only a matter of time before the bubble would burst. This was triggered by the Atomic Tests undertaken by Pakistan on May 28,1998 as a response to the Indian Atomic Tests on May 11,1998. The western countries and IFIs suspended their assistance and private foreign investment, and Pakistan "froze" the non-existent foreign currency deposits (FCAs) which had long since been used up, as shown by the fact that its reserves were less than \$1 billion on May 28,1998 compared to the FCAs of \$ 11.5 billion. Subsequently, by wise economic management domestically and by support from a reluctant western world which did not want to see an economically collapsed Pakistan with atomic weapons which may proliferate, the country revived in 1999 an IMF Extended Fund Facility which led to debt relief by the western creditors for the two year period 1999-2000. The Government of Pakistan IMF/World Bank Programmes extended through June 2000

with programmes targets been set to June 2002. Since the next four years macro-economic management of the Pakistan economy will be in an “IMF/World Bank Agreed Mode” it is useful to consider the Pakistan/IMF programme as the Medium Term Macro-economic Programme of the Government of Pakistan.

The Pakistan – IMF Macro-economic Programme 1999-2002: The GOP Policy Frame-Work Paper (PFP) agreed with the IMF in 1999 had the following four major objectives: (i) Recovery of real annual GDP to 5-6 percent (up from 3.5 per cent 1998-99); (ii) Reduction in inflation to about 6 per cent (down from about 18 per cent in 1997-98 and about 9 per cent in 1998-99); (iii) Reduction in the current account deficit (excluding official transfers) to less than 5 per cent GDP; and (iv) Stabilisation of the public sector Debt to GDP Ratio. In order to achieve these objectives the following major policy actions have been agreed upon: (i) Reduction in the fiscal deficit from 5.4 per cent of GDP in FY 99 to 3.3 per cent in FY 2000; (ii) Retirement of domestic debt up to the rescheduled amount originally due to official creditors (about \$ 5 billion due in 1999-2000); (iii) Unification of the exchange rate by July 1,1999 to a market determined rate (currently there is a “ composite rate” which is 95 per cent market determined and 5 per cent official), (iv) Removal of all quantitative restrictions on exports and imports by July 1,1999; (v) Reducing the dispersion of Tariff Rates to 0-35 per cent by March 31,1999 (already done); (vi) Accelerating the privatisation process in all sectors including the sale of all major nationalised banks in 1999; and (vii) Restoring foreign investor confidence by reaching an agreement with foreign Independent Power Projects (on a per unit 6.2 cents electricity charge or an alternate 3 cents capacity charge). The fiscal deficit target was to be met through: (i) Increase of the General Sales Tax on goods (except agricultural inputs) to 15 per cent (already done by Jan 1,1999) and its extension to services, petroleum products, electricity and agricultural inputs by FY 99-00; (ii) Increasing coverage of the General Sales Tax to small retailers by FY 99-00; (iii) Revenues from Tax on Agriculture to be increased to 0.3 per cent of GDP in the medium –term with assistance from the World Bank starting by March 1999; (iv) Increasing power tariffs to meet revenue requirements of WAPDA and removing cross subsidies particularly to agriculture (an average increase of 9.5 per cent in the overall power tariff implemented in April 1999 including a 70 per cent increase of tariff of agricultural tube-wells – further increases as required); (v) Adjusting petroleum prices to retain the present rate of petroleum development surcharge on petroleum products at Rs. 15.65 per litre for motor spirits; Rs.4.37 for high speed diesel and Rs.1.5 per litre for fuel oil to give revenues equal to about Rs.80 billion or 3 per cent of GDP; and (vii) Cutting back public expenditure as required throughout the Programme Period to meet the deficit targets (the Public Sector Development Programme of the Federal Government has been slashed in 1998-99 to less

than 3 per cent of GDP to meet this target). Other major PFP agreements state that: (i) The existing hiring freeze at the Federal level will be maintained; (ii) Administrative reforms will be undertaken; (iii) New public sector projects will be carefully scrutinised; (iv) In social policies emphasis will be on primary education, basic health care, population welfare (planning), water supply and sanitation; and (v) In the transport sector public sector allocation for rehabilitation and selective improvement of highest priority road network will be enhanced.

Suggestions to Strengthen Pakistan's Macro-Economic and Public Policy

Management: The 1999-2000 Pakistan-IMF Programme formed an excellent starting point to provide macro-economic stability and a freer trade regime for the economy over the next several years. This is of vital importance to the growth of the SME sector which needs a stable macro-economic environment, continuity of macro-economic policies and free trade to prosper. However, there are several areas where the macro-economic and public policy framework needs to be additionally strengthened to meet the free competition requirements of the SME sector. First, with regard to privatisation policies no natural monopolies should be privatised (for example railway ground infrastructure should not be privatised while railway goods and passenger traffic wagon and trains infrastructure can be privatised). Second, with regard to private investment irreplaceable land sites should not be eligible for permanent private ownership (BOT rather BOO) for roads, airports, harbours and electric power dams. Third, the Government should maintain a permanent minority share (a minimum of 20 per cent) in all major privatised companies as a major source of future revenue. Fourth, enhance the quality of high level manpower in Government by aggressively recruiting qualified people for government service and retraining presently underqualified public servants. Fifth, encourage the rapid growth of education at all levels (not just the primary level) particularly by upgrading and more intensively using existing public education facilities and by relying increasingly on private education through supportive public policies.

Workable Legal and Judicial System.

Pakistan is very fortunate in having a very honourable and extensive judicial system with a long historical tradition. However, the major elements of civil laws and procedures still continue from the pre-independence period. This, coupled with inadequate funding for the judicial system and antiquated court and case management procedures has meant that civil courts are choked with litigation and recourse to civil action (particularly against two civilian adverseries) rarely reaches judicial closure. As a result financial institutions are reluctant to lend only against the limited liability of the companies and instead insist (when they lend at all) on having the borrower mortgage other

assets (including personal assets) to secure lending. As a result, all banking/finance civil suits have been reduced to mortgage suits. The recent Banking Act of 1997 created Banking Courts with accelerated procedures. However, these courts also function effectively only as mortgage courts. The overall result of all the above is that the legal and judicial system needs to be further strengthened in order to allow SMEs to function effectively.

Present Government and Judicial Initiatives to Strengthen the Legal System: The Government and the Judiciary has now been increasingly sensitised to making the system work more effectively. The push towards judicial reform is presently largely aimed at the criminal justice side due to recent terrorist and other related threats. However, the Government and the Judiciary has also been working with the Asian Development Bank (ADB) to put into place a medium term programme to strengthen court and case management systems throughout Pakistan and to increase the efficiency of civil litigation including through review of the Civil Procedural Law. This GOP/ADB Judicial Sector Programme is expected to be in place by the end of 2000.

Suggested Additional Policies to Strengthen the Legal System: The SME related requirements for the judicial system should also be integrated into all future proposals for judicial and legal reform. In addition to accelerating civil litigation dispute resolution between civilian parties, a particular requirement is to protect the small and medium enterprises from the often predatory and arbitrary regulatory actions by the state. The United States "Small Business Regulatory Enforcement Fairness Act of 1996" made the following amendment to the United States Code: "If, in a civil action brought by the United States....the demand by the United States is substantially in excess of the judgement obtained by the United States The court shall award to the party the fees and other expenses related to defending against the unreasonable demand". A similar proviso is recommended under the appropriate Civil Laws in Pakistan.

Regulatory Policies

Regulatory Policies affecting SMEs fall under two broad categories: (i) Regulatory Policies which encourage Free Competition and Free Trade; and (ii) Regulatory Policies which regulate the functioning of SMEs by State authorities (including Local Bodies) and which need to be fair and not anti-SME.

Present Government Policies Concerning Free Trade and Competition: With regard to the first, the Pakistan-IMF agreement on lifting all quantitative restrictions on exports and imports by July 1999 will help achieve the freer trade objective. Arbitrary increases in tariffs and export duties through "SROs" issued by the Central Board of Revenue were intended to be abolished under

the 1999-2000 IMF agreement. However, the quick Government decision to impose a 20 per cent regulatory duty on sugar by the Economic Committee of the Cabinet rather than the National Tariff Commission after maximum import duties on all commodities were lowered to 35 per cent (on March 31,1999) shows that the SRO abolishment agreement may not be entirely effective. Serious additional issues relate to monopoly control and competition. Here both the Monopoly Control Authority (created in the 1970's) and the National Electric Power Regulatory Authority (created last year) seem completely ineffective. The Monopoly Control Authority gave a judgement in December 1998 on cement prices which was completely ignored by the Cement Manufacturers (and contradicted by an arbitrary decision at a meeting chaired by the Minister of Finance). The National Electric Power Authority after going through weeks of hearings on a WAPDA petition to revise tariffs found itself with a revised petition on March 30,1999 drafted by the World Bank (and WAPDA) and was forced to announce acceptance of the revised petition the same night. Both these incidents show that monopoly control in Pakistan is completely ineffective.

Another major barrier to domestic trade and competition were the import and export taxes varying from 1.5 to 6.5 percent imposed by the local urban bodies and local rural bodies respectively throughout Pakistan. These were payable through all the jurisdictions which goods pass through and while subject to refund at intermediate (passing through) jurisdictions, in fact are de-facto not refundable since all their taxes are auctioned to contractors. These domestic trade taxes constituted a huge barrier to the development of SMEs in Pakistan. The 1999-2000 IMF agreement stipulated that these taxes be abolished once the General Sales Tax is extended to services with the proceeds passed on to the Provinces and this has been done with effect from July 1, 1999.

Suggested Additional Policies to Improve Free Trade and Competition: In order to remove arbitrary government discretion on trade policy and tariff changes, these should be implemented through Finance Acts passed by the National Assembly. Similarly, to reduce the influence of monopolists, the Government Agencies and the International Finance Institutions such as the World Bank and ADB or the Regulatory Agencies should be placed under the Supreme Court.

Present Government Regulatory Policies Affecting SMEs Directly: There are a large range of outmoded regulations imposed by the State, Provincial Governments, Local Bodies and Public Sector Utilities which affect the day to day functioning of the SMEs. These range from out-dated Local Body and State zoning regulations (which particularly adversely affect private schools) to a multiplicity of utility agency (water supply, electricity etc) regulations.

Most of these regulations are obscure and arbitrary. They exist largely because of the fact that most legislation in Pakistan has an enabling clause which allow “regulations to be made by the Government/Authority to give effect to the purposes of this Act”. These subsequent regulations are never scrutinised at high levels and largely reflect the whims of administrative secretaries and politicians and in the absence of a “sun-set clause”, survive for generations buried away in cup-boards to be used to harass SMEs at unexpected intervals. While there is no deliberate policy to harass SMEs but only to “protect the public interest”, the adverse effects of these policies on SMEs are often not anticipated correctly.

Suggested Additional Policies to Improve the Regulatory Environment Affecting SMEs: Several countries have faced and overcome the problem of an existing regulatory environment which is detrimental to the fair and efficient functioning of SMEs. A land-mark Act in this regard is the U.S. Small Business Regulatory Enforcement Act of 1996 referred to earlier. This Act has the following objectives: (i) Create a more co-operative regulatory environment among Government Agencies and Small Businesses that is less punitive and more solution-oriented; (ii) Make Federal regulators more accountable for their enforcement actions by providing small entities with a meaningful opportunity for the redress of excessive enforcement activities; (iii) Provide for judicial review of regulatory actions; and (iv) Encourage effective participation of small business in the Federal Regulatory Process. The Act provides for Oversight of Federal Regulatory Enforcement by establishing in each state a Regional Small Business Regulatory Fairness Board comprising five members who are owners or officers of small businesses. These Boards report substantiated incidents of excessive regulatory action against small businesses to a Regional Small Business Ombudsman who works with agencies to remove genuine problems and reports his findings to the Congress and the Federal Government.

It is recommended that similar legislation be enacted in Pakistan to improve the regulatory environment affecting SMEs.

Banking Services and Finance Policies

A well functioning and competitive financial sector is a pre-requisite for SME development and growth. Pakistan is again fortunate in having a relatively modern and efficient Banking and Financial Services sector (including Leasing Companies and Islamic Financial Institutions). However, inappropriate and politically influenced lending by public sector banks and the depressed economic conditions over the last few years (including in the critical textiles sector) has meant that the “non-performing loans” portfolio of public sector banks is currently about 30 per cent of their assets and of private banks

(mainly foreign banks) about 17 per cent of their assets. This coupled with the legal problems of debt collection and financial restructuring referred to earlier has meant that banks need to add a 5-7 per cent mark-up on normal interest rates to maintain operations and provision for losses. As a result interest rates for SME borrowers currently range between 17-20 per cent while for big borrowers they are about 14-16 per cent. However even at these high interest rates banks are extremely reluctant to lend to small and medium scale enterprises. As Table II.1 indicates, loans to Small Businesses comprise only about 10 per cent of total private sector credit by the scheduled banks while the Government Self Employment Scheme received only 2 per cent of total credit. The remaining 88 per cent of all credit in the economy went to larger businesses (of which 60 per cent went to 8,589 large companies each borrowing in excess of Rs.10 million).

Table-II.1: Private Sector Credit by Scheduled Banks, 1998

	Rs. Billions					
	Stock				Flow	
	November 1998		June 1998		July- November 1998	
	Total	Percent	Total	Percent	Total	Percent
Total	598.7	100%	573.1	100%	25.7	100%
1. Export Financing	77.7	13 %	70.8	12 %	6.9	27 %
2. Government Self Employment Scheme	10.1	2 %	10.9	2 %	-0.8	-3 %
(Unemployed Persons)	(2.1)	(0.4 %)	(1.5)	(0.3 %)	(0.6)	(2 %)
(Public Transport)	(8.0)	(1.6 %)	(9.4)	(2 %)	(-1.4)	(-5%)
3. Small Loans	60.8	10 %	57.6	10 %	3.2	12 %
(Agriculture)	(29.2)	(5 %)	(25.2)	(4 %)	(4.0)	(16 %)
(Business)	(11.1)	(2 %)	(10.3)	(2 %)	(0.8)	(3 %)
(Industry)	(20.6)	(3 %)	(22.1)	(4 %)	(-1.5)	(-7 %)
4. Agriculture (Large Scale)	59.7	10 %	59.1	10 %	0.6	2 %
5. Manufacturing (Large Scale)	230.2	38 %	221.2	39 %	9.0	35 %
6. Trade (Large Scale)	27.4	5 %	27.2	5 %	0.2	1 %
7. Import Financing	11.6	2 %	13.2	2 %	-1.6	(-6 %)
8. Investment (Long Term)	23.6	4 %	17.0	3 %	6.6	26 %
9. Others	97.6	16 %	96.0	17 %	1.6	6 %

Source: State Bank of Pakistan

Present Government and Banking and Finance Service Policies for SMEs: Government policies have been focussing on: (i) Bringing down interest rates; (ii) Increasing small loans to the agricultural sector; (iii) Increasing disbursements under the self employment scheme (being personally promoted by the former Prime Minister by receiving half an hour of public phone calls every week; and (iv) Creation of the Small and Medium Enterprise Development Authority (SMEDA) to act as an “Advocacy Mechanism” to enhance commercial bank lending to SMEs. A major step to reduce interest rates has been taken by the Government retiring Rs.43 billion of domestic debt in the period July’98/March’99 (these being the savings on the external debt rescheduling) and by the consequent ability of the State Bank to cut its short-term liquidity requirement related interest rates to Banks including the three day REPO rate from 15.5 per cent to 14 per cent in April 1999. This is expected to lead to a similar cut in bank lending rates (to about 19 per cent for SMEs) immediately and this downward trend should be maintainable if the fiscal deficit continues to be curtailed and further debt rescheduling relief is applied to the reduction of Government debt. The increased small loans to the agriculture sector comprise essentially increased tractor loans as a result of a Rs. 1 lakh (or 30 per cent of cost) subsidy on tractors provided to manufacturers of agricultural tractors during 1998-99. The disbursements under the self-employment scheme have been slow but increasing largely because of pressures exerted by the former Prime-Minister himself. Finally, SMEDA has been established in Autumn 1998 (discussed in the next section) with a view to providing an “advocacy mechanism” for SME’s including to obtain bank financing. SMEDA’s original effort in this regard has been resisted by the commercial banks as inefficient directed credit. The commercial banks have so far been successful in resisting directed credit as was confirmed by the former Prime-Minister himself in March 1999 when he officially announced that SMEDA will act as facilitator and not extend/sanction loans for any project. However, it is expected that SMEDA’s efforts will have a positive effect on commercial bank lending for SMEs.

Suggested Finance Sector Policies for SMEs: One major policy instrument for freeing bank credit for SMEs and also to enhance the working of credit markets is to encourage large scale enterprises (with sales above Rs. 1 billion per annum) to go to the market with their own ‘term-finance certificates’ and rely a little less on bank credit. This could be accomplished by allowing them only a 95 per cent tax credit offset on interest payments to Banks as against a 100 per cent tax credit on interest payments on their own term-finance certificates to be placed in the open market. The interest rate credit for commercial bank borrowing applicable to these large companies

could be reduced further every year depending on the success of the initial reduction and the ability of these largest companies – both public and private – to raise a small proportion of their credit requirements in the open market. A second policy instrument would be to allow banks to take up equity in SMEs and other enterprises (a legal option which is available to all banks operating in Europe). Finally, a third policy instrument (already available) is to encourage the growth of Leasing Companies to lease to SMEs which will compensate for the reluctance of Banks to extend credit to SMEs because of the faulty legal environment concerning collection and administration of bad debts (discussed earlier). Venture capital is still unknown in Pakistan but has proved to be an important source of capital in developed countries and emerging markets.

Business Development Services

SMEs need Business Development Services in order to function in any economy. Agencies (or an agency) is needed for SME advocacy purposes in Government and political fora, to increase access to information and counseling of SMEs, and to obtain access to technology, to markets, to finance and training for SMEs. They (or it) also serves as a coordinating and strengthening point for SME Business Associations.

Present Government Policies Concerning Business Development Services for SMEs: As mentioned earlier, the previous Government created the Small and Medium Enterprise Development Authority (SMEDA) in the fall of 1998 to focus as the Key Government Agency for promoting SMEs. SMEDA is still in the process of defining its turf (as was mentioned in the earlier discussion on the battle for ‘directed credit’ for SMEs which SMEDA lost). However, it is headed by a dynamic chairman and has highly qualified staff which has done detailed analysis of various sectors. Its analysis of the Fisheries Export Sector presented to the Government and the Commercial Bank Sector and the consequent restructuring of the Sea-Food industry currently under way (including through loans for fisherman and by legislation to correct the policy environment) is a good example of what SMEDA is capable of doing. Major new sectoral initiatives include jewelry, surgical instruments, agricultural products, electronic goods assembly, light machinery and the transport sector.

Suggestions Concerning Business Development Services for SMEs: SMEDA’s role as an ‘advocacy agency’ including detailed study of industries and products relating to finance, markets, training, information and counseling is well under way. What now needs to be developed further is its policy formulation abilities particularly with regard to balancing the regulatory requirements of the state against the de-regulation requirements

of the SMEs. This will require adding to its staff a core group of economists and will result in a substantially strengthened SMEDA.

Sector Specific SME Policies

The Government needs to develop sector specific SME policies, in part through SMEDA and in part through the Business Associations in the respective SME Sectors. The only sector specific SME policy that has been developed so far is for Housing and this was formulated by a Committee of Developers appointed by the former Prime Minister Mr. Nawaz Sharif. Its findings were made public in March 1998 and approved by the former Prime Minister. A summary of the proposals in Mr. Nawaz Sharif's Housing Policy is quoted below as an example of the excellent work which is possible to do to promote the SME sector in Pakistan and which must be done as a matter of priority for all SME sectors in the coming months.

Government of Pakistan Proposed Housing Policy 1999: Former Prime Minister Nawaz Sharif approved in March 1999 a number of measures for the construction of 500,000 housing units all over the country under his programme for economic revival (housing sector). These proposed measures (many of which have been abandoned/postponed after the fall of the Nawaz Sharif government) had the following major elements: (i) Enhance the loan portfolio of the House Building Finance Corporation from the present Rs 2 billion to Rs 7 billion. Also the mark-up on loans up to Rs 300,000 be considered for reduction to 10 per cent for low income group; (ii) All commercial banks to advance loans for houses and housing projects by earmarking a substantial percentage of their loan portfolio, like other industrial and commercial projects; (iii) Banks be allowed to give mortgage loans and float long term bonds at market rates; (iv) Re-finance window be opened at the State Bank of Pakistan (SBP) for long-term funds from multilateral agencies; (v) Institutions maintaining insurance funds, provident funds etc., be allowed to invest a substantial part of their portfolio in the housing sector; (vi) The foreclosure laws would be examined to see if there was a need for modification to ensure the effective recovery of advances from the defaulters within 90 days. As a result, banks would have legal powers to repossess a house, if the borrower defaults;(vii) Development of unified, transparent and market value oriented land acquisition laws and procedures for the entire country; (viii) The Federal Government including Evacuee Trust Property Board, Ministry of Railways, and other autonomous bodies and corporations would identify land with them to the PM's committee on economic revival; (ix) Presently, duties/registration fees are exceptionally high and are in the range of 15 per cent to 21 per cent. Aggregate total charge be considered to be around 5 per cent; (x) Housing loan installments to individuals were to be treated as expenses in tax return;

(xi) Collection of levies such as EOBI, education cess, social security, professional tax etc. would be through “one window” operation; (xii) Property Tax should be substantially reduced; (xiii) Wealth Tax not be charged on housing; (xiv) Developers/investors, local and international, would be treated at par; (xv) Development of master/structural plans, including base maps on GIS, were to be made a mandatory requirement for all urban and rural areas, at all levels of the Government. Updating of master/structural plans on a regular basis (every 5 years) may also have been made a mandatory requirement; (xvi) Development of unified building and zoning regulations of all the urban centres were to be made mandatory; (xvii) Development of computerised land information system would be made a mandatory requirement, for all urban and rural areas, to ensure correct and updated information on all land in urban and rural areas; (xviii) It should be made mandatory for the utility agencies to provide trunk infrastructure for approved housing schemes, satellite towns, and other suburban development; (xix) Charge of non-utilisation fee would be made only after notified handing over of the scheme by the development authority to the municipality; (xx) Housing be given the status of industry and be made entitled to privileges given to other recognised industries. The housing industry would be entitled to all fiscal incentives/special treatment and other benefits, as envisaged in the investment policy announced by the government.

III. Education, Labour Laws and Social Security – Reinforcing the SME Agenda through Focus on Vulnerable Groups: Children, Women, Unorganised Labour and the Elderly

The SME Agenda for Pakistan has a vital social and economic dimension which needs to be examined through another perspective by focus on vulnerable groups – children, women, unorganised labour and the elderly. Poor school enrollment ratios, child labour, employment discrimination against women, the exploitation of unorganised labour and the lack of care for the elderly are issues of vital national concern. What is not being adequately recognised is that these issues are an integral part of the SME agenda – being both part of the initial problem and the ultimate solution.

Poor School Enrollment Ratios, Child Labour and Employment Discrimination Against Women

School Enrollment Ratios: In Pakistan school enrollment ratios are low compared to any country in South Asia (e.g. the Gross Enrollment Ratio GER- for primary schooling age 5-9 is 76 per cent for Pakistan compared to 98 per cent for India for 1997-98). Gender discrimination (against females) is pronounced and becomes progressively worse at each higher stage in the school system. GERs are particularly poor for the age group 10-14 years (the middle and secondary school levels) with only 5.5 million children out of 17 million enrolled – a GER of 32 per cent for all children in this age group (the GER for females is about 23 per cent)

Table-III.1: Pakistan School Age Population and Enrolment Rates 1998

Class	Age Group	Total Number (Mn)	Enrollmen t (Mn)	Out of School (Mn)	Gross Enrollmen t Ratio	G.Female Enrollmen t Ratio
Primary	5-9 Years	20.5	15.5	5.0	76 %	64 %
Middle	10-12 Years	9.5	3.8	5.7	40 %	30 %
Secondary	13-14 Years	7.5	1.7	5.8	23 %	16 %
	Total	37.5	21.0	16.5	56 %	46 %

Source: For Age structure of Population from Akhtar Husan Khan “1998 Census: The Results and Implications”. For School Enrollment “G.O.P Fifty Years of Pakistan in Statistics”.

Child Labour: There are varying estimates for working children in the 10-14 year age group but it is conservatively estimated that at least 20 per cent of these children (about 3.4 million in 1998) work as child labour. This constitutes about 9 per cent of the country's labour force. Most of these children are employed in small scale enterprises not regulated under the Factories Act and in the informal sector. As has been clearly documented in several studies their working conditions are poor, their wages pitiful, and they are subjected to severe health hazards and sexual abuse and violence (Akmal Husain, *Lahore Journal of Economics*, 1997). In agriculture, children are involved in pesticide and fertilizer applications, rice transplantation, fodder cutting, weeding and harvesting. In urban and semi-urban areas they are engaged in the services, small scale manufacturing and construction related sectors where they often work 54-72 hours per week at an average wage of about Rs.320 (US \$ 6) per month which is about one -sixth of the average minimum wage.

Current Government Policies in the School Education Sector: In the school education sector the entire public education programme is driven by the Social Action Programme of the World Bank (co-financed by other donor agencies). A stringent set of conditionalities are in place to try to gradually increase public sector expenditure on school education (from 2 to 3 per cent of GDP) in order to expand coverage and to improve the functioning and curriculum of government schools. However, the extremely constrained financial situation has meant that expansion of the system's coverage is painfully slow, and efforts being made to upgrade teaching staff and curricula are being foiled by a variety of political pressures and legal actions by the public sector teachers (the latest being a "stay order" being obtained by Punjab's 20,000 English Language School Teachers from being asked to take a proficiency test in English).

Proposed Policies for the School Education Sector: While public sector schooling should be supported through the SAP, donor pre-occupation with the SAP Programme and the vested interests of the public education bureaucracy has resulted in neglect (and in fact persecution) of the private educational sector. The former Sindh Governor publicly pointed out on April 20, 1999 that 80 per cent of Sindh's students appearing for the Matriculation Examination come from private schools. This is true for all Pakistan. Beyond the primary level, the bulk of education and particularly quality education is now being provided by the private sector through SME sized schools. Surveys indicate that private schools provide comparable education at half the cost of the public schools with better qualified staff. Yet these schools are treated as "profit making institutions" and subjected to excessive regulation and taxes. Serious problems are created by Pakistan's archaic zoning regulations as a result of which every one of all the tens of thousands of private schools of Pakistan

are “illegal” – not having “commercialised” their premises. This “commercialisation” involves a very large cost – as if they were setting up a commercial shopping centre - which these Schools cannot afford to do. Similarly all utilities are supplied to them at “commercial rates” which are twice the industrial (and domestic) rates. Perhaps most damaging is the apathy and down-right hostility to the private school system shown by the politicians and the bureaucrats which does not allow a rationalisation of the system.

Primary education (through class V or age 10) has been compulsory in the Punjab and NWFP since 1993. It is now proposed that compulsory middle school education should be legislated from September 1999 and through high school (class X or age 14) from September 2005 recognising the lags inherent in implementation. In order to meet these school education and higher education sector student enrollment and related teacher training and employment targets for the period 2000-2010 through expansion of the private educational system as proposed in the first part of this report, it is suggested that: (i) The Private Education Sector be treated as an “industry” for the purposes of all government policies including tax and credit policies and for the pricing of all public utilities; (ii) the Private Education sector be completely de-regulated and there be no control (pre-approval) of fees, other charges etc; and (iii) That Zoning Laws all over Pakistan be changed by a uniform Federal Law which will set reasonable zoning standards to encourage private schools in all localities and all areas.

Current Government Policies For Regulating and Eliminating Child Labour: The prime instrument of Government regulatory policy for curbing child labour is the Employment of Children Act 1991 which governs child labour below 14 years. It prohibits employment in transport, cement, carpets, clothes, dying and weaving, building and construction and hazardous industries. It also prohibits work between 7 pm and 8 am , sets the maximum daily working hours at seven, with a break of one hour after every three hours of continuous work, does not allow overtime and stipulates one-weekly holiday. Violations for breach of the Act is imprisonment for upto one year and a fine of Rs.20,000. In addition the Government took a number of welfare initiatives to encourage children to come back to school. The private sector and particularly trade export bodies are also discouraging child labour (e.g. the ‘Child Labour Free Rugmark’. Despite all these initiatives child labour remains a major fact of life in Pakistan.

Proposed Policies For Eliminating Child Labour: The Employment of Children’s Act 1991 was important because it showed that the sector responds to Government Penalties as is shown by the virtual absence of child labour in the prohibited sectors. A progressive approach to eliminating child labour is possible by combining the school education proposals made above with

prohibitive legislation as follows: (i) Starting Year 2000 Middle School Education (upto age 12 or Class VIII) be made mandatory for boys and girls and the Employment of Children Act 1991 amended to prohibit employment below 12 years; (ii) Starting Year 2005 High School Education (upto Age 14 or Class X) be made mandatory for boys and girls and the Employment of Children 1991 Act be amended also to state that after 2005 employment of youth below 14 years is prohibited. It is also proposed that the movement from child labour to school enrollment be encouraged through publicly financed School Feeding Programmes for both private and public schools.

Employment Discrimination Against Women

The gender gap for females in school enrollment has been noted earlier. While there are pockets of traditional resistance against female education in some areas of Balochistan and the Frontier, this has largely been overcome over the last few decades throughout Pakistan. The substantially increased enrollment rates for primary education for both males and females are testimony to this and it has been the premise on which the previous recommendations on mandatory education for children through middle school immediately and through high school from 2005 were based. Pakistan's younger generation is quickly becoming better educated and in fact the younger generations of workers are almost all literate with some years of schooling. However, a more difficult task which now has to be faced is ending employment discrimination against women.

There has been improvement in female labour force participation rates over the past two decades but it has not been enough. For urban areas female labour force participation rates have increased from 3.6 per cent in 1974-75 to 8.4 per cent in 1996-97 while for rural areas they have increased from 7.6 per cent in 1974-75 to 16.3 per cent in 1996-97. Overall the increase in female labour force participation rates has been from 6.4 per cent in 1974-75 to 13.6 per cent in 1996-97.

Table-III.2: Pakistan Labour Force Participation Rates 1974/75-1996/97

	All Areas		Urban		Rural	
	Female	Male	Female	Male	Female	Male
1974-75	6.4	76.7	3.6	68.8	7.6	79.8
1984-85	8.7	77.1	4.0	72.6	10.7	80.0
1994-95	11.4	69.1	7.0	64.3	13.3	71.3
1996-97	13.6	70.0	8.4	66.5	16.3	71.8

Source: N. Mahmood and D. Nayab, "Gender Dimensions of Demographic Change in Pakistan" PIDE, 1999.

Government Policies Regarding Work for Women: Successive Governments in Pakistan (including two headed by a woman Prime-Minister) have only paid lip service to ending employment discrimination against women. The slight improvement in female labour force participation rates are only due to the push of economic factors. In the rural areas women are now almost exclusively actively involved in milk production and this has been a growing sector as discussed earlier. Similarly, women already constitute a little more than 30 per cent of the total teachers in the entire education sector in both urban and rural areas. This is primarily where the increased employment gains have come over the last two decades. Minor gains have come from increased employment in carpet making (replacing child labour), garments (particularly embroidery) and the services sector including public administration and the public and private financial sector- the last being largely confined to upper class, highly educated professional women.

Proposed Policies: Employment discrimination against women has been a historical fact in all societies and even till the end of the 1930's women in the USA (which even in 1930 was much more liberal than the Pakistan of 1999) largely faced an employment profile similar to that of Pakistan. For the USA gender discrimination came to an end with World War II with women having to "man" the offices and the factories. For Pakistan gender discrimination will only end with education. Therefore the proposed education strategy based on public and increasingly private sector schools (in Pakistan all the private schools are owned by women and largely employ only women) and on compulsory schooling for both boys and girls has profound implications for female employment. Making schooling compulsory for girls (and boys) will increase the demand by more than 100 per cent for female teachers. This, together with the more educated girls and boys who will enter the labour force in the period 2005-2010, will ensure the virtual end of gender discrimination in all sectors of the economy by 2010.

Unorganised Labour and The Elderly –Labour Laws, Pension and Social Security System Reform.

The SME system will only work if the labour force working in them (largely unorganised) are entitled to the coverage of humane labour laws and if pension and health benefits accrue to them and their dependants during their working lives and after their retirement. While this is applicable to all workers in all sectors of the economy, in Pakistan only medium and large scale establishments (covered by the Factory Act and employing 10 or more workers) currently are legally covered by EOBI (Pension) and Social Security (Health) Schemes. In practice, only employees of large scale enterprises benefit

from these programmes. Accordingly the entire SME sector comprises largely unorganised labour which does not benefit from labour legislation.

As has been discussed earlier the emerging labour market and employment situation for the next decade shows that the overwhelming majority of the labour force will get employment in the small scale, labour intensive sector. The SME sector is not by definition 'backward' (as has been shown by world-wide and particularly the Italian experience). Increasingly in most cases they will become quite modern (shops, boutiques, catering houses, leather, machinery fabrication etc.). The large scale sector organised along factory lines will continue to expand, but its relative importance in the economy with regard to future employment generation will continue to diminish.

The structural change in employment towards SMEs which is under way and which is proposed to become the norm for employment in Pakistan has substantial implications for the expansion and reform of the labour relations and industrial relations frame-work. The push by organised labour, Government Labour Ministries, the ILO etc. – has been focussed both to defend the benefits and legal safeguards that labour has achieved over the last few decades through tremendous sacrifices and also to expand benefits and the scope of existing labour laws to smaller and smaller organised units. This strategy now needs to be further developed. The aim should be to make labour laws sufficiently flexible, while retaining safeguards and benefits, so that the entire labour force can be brought into its ambit, whether it is the large scale or small and medium scale sector. A proposed strategy for reform of the labour relations and industrial relations frame-work is discussed below.

Preventive Laws – Regarding Workers Health and Safety: Preventive provisions regarding workers health and safety are given in the following laws: The Factories Act 1934, The Mines Act 1923, The West Pakistan Shops and Establishments Ordinance, 1969. These include standards on cleanliness, ventilation and temperature, humidity, overcrowding, lighting, precaution in case of fire, fencing and guarding of machinery, precautions against hazardous occupations, etc.

The Factories Act applies to establishments with 10 or more workers; while the West Pakistan Shops and Establishments Ordinance covers all other establishments (with a few exceptions for non profit institutions, hospitals etc). It excludes households and agricultural labour. The Factories Act is fairly comprehensive on 'prevention' with 20 sections in the law covering the subject and a system of formal inspection with 'inspectors' of Factories. The Shops and Establishment Ordinance has only one section on prevention (viz. "in every industrial establishment, all mechanically or electrically propelled machinery

shall be guarded in the prescribed manner”). The Act also lays down a formal system of inspection with inspectors of ‘shops’.

It is recommended that the preventive provisions of the West Pakistan Shops and Establishments Act be strengthened (but not by the stringent standards of the Factories Act) and that all exceptions to the Act with regard to coverage be removed immediately with suitable amendments to cover households’ employees and farm labour. This will safeguard the interest of the workers without diminishing flexibility in the system. The security of workers health and safety is an area which should be of prime importance in any reform of labour laws.

Preventive Laws – Concerning Working Hours: Maximum working hours per week (48) and hours per day (9) with limited provisions for overtime (15 hours/year) together with a weekly holiday are mandated both by the Factories Act and the Shops and Establishments Ordinance. There are some exceptions for technical staff. Overall these provisions are adequate for protecting labour and do not need major changes. However, the law needs to be expanded so that the same protection with regard to working hours is extended to household employees and farm labour.

Beneficial Laws – Minimum Wages: Minimum wages are regulated by the West Pakistan Minimum Wages for Unskilled Workers Ordinance 1969 and the Minimum Wages Ordinance 1961. The major 1969 Laws fixes minimum rates of wages for unskilled workers employed in industrial and commercial establishments of 50 or more persons (excluding essential services, Government and defense). The 1969 Law was amended by the Unskilled Workers (Amendment) Act 1993 to fix the minimum wage at Rs.1500 per month (with maximum deductions of upto Rs.25 p.m. for housing and Rs.10 p.m. for transport). The 1961 Law laid down minimum wages for certain industrial undertakings with regard to time work, piece work and work on weekly day of rest which are subject to renewal by the Tripartite Minimum Wage Boards set up by the Provincial Government.

It is recommended that the Minimum Wage Ordinance be extended to all paid workers including households and agricultural labour and all industrial, commercial and noncommercial establishments, regardless of the size of the workforce.

Beneficial Laws – Holidays With Pay: Workers right to holidays with pay is laid down by the Factories Act 1934, the Mines Act 1923, The Road Transport Workers Ordinance 1961 and the West Pakistan Shops and Establishment Ordinance 1969. The Shops and Establishments Ordinance allows 14 days of annual leave, 10 days of casual leave, 8 days of sick leave

and 10 days of festival holidays (total of 42 days a year). However, as a result there is a conflict between the legal hours of work in the Government (with about 38 hrs/week) the organised private sector (42 hrs/week) and the unorganised private sector (which is not protected by any labour laws).

It is recommended that the standards of the West Pakistan Shops and Establishment Ordinance be made applicable to all employment in Pakistan.

Beneficial Laws – Financial and Welfare Benefits: Pakistan is fortunate in having on its books an extensive body of legislation which grants workers (in establishments employing more than 10 workers, and some cases more than 50 workers in the industrial and commercial sectors) an extensive system of financial and welfare benefits. Principal laws which govern this are: (i) The Employees Old Age Benefit Act 1976 (for pensions); (ii) The Provincial Employees Social Security Ordinance 1965 (for health benefits); (iii) Workers Welfare Ordinance 1971 (for housing); (iv) The Companies Profits Worker's Participation Act 1968 (for sharing profits); and (v) The Worker's Compensation Act 1923 (for death and accident benefits). All these laws need to be extended to the entire work force but with substantial modification in the case of the first four in order to make them more flexible, given the reality of the current and projected employment situation.

The Pension Scheme: (EOBI, 1976) currently applies to establishments with more than 10 workers and to workers earning up to Rs.3000 per month. It is financed through employers contributions of 5 percent and matching contributing from the Federal Government. The present scheme is a defined benefits scheme based on open group valuation and is basically unsustainable (that is, it promises benefits which will have to be changed downwards constantly over time as the scheme matures and early generations get collection and benefits administration). Its present coverage of 900,000 (including 95,000 pensioners) cannot possibly be extended to the entire employed labour force in the future given the structural nature of the projected employment.

It is proposed that the old-age pension scheme coverage be extended in a phased manner from the present level of less than 1 million to about 8 million SME employed urban and rural non-agricultural workers by the year 2000 and to cover agricultural workers (10 million) by the year 2005. The nature of the pension scheme will have to be flexible with workers allowed to choose between the existing EOBI scheme and an Individual Pension Scheme which will have the following features: (i) Fully funded defined contribution scheme; (ii) Individual pension accounts for all

including seasonal, contract and piece rate labour maintained by individual workers themselves in pension 'books' held at designated banks (with the total pension fund being held and invested centrally); and (ii) Equal employer/employee contribution of seven percent of wage each (introduced gradually for employees and the government phased out).

Health Insurance: (SSO, 1965) Financed through employers contribution of 7 per cent of wages is offered to establishments of more than 10 workers through Social Security Institutions in the Provinces which maintain Social Security Hospitals. The promised benefits again are not sustainable (and would cost at least Rs.3000 per month if offered privately rather than the maximum subscription of Rs.210 per month collected today). It is proposed that the health coverage be expanded at the same rate as the pension coverage, that the 7 per cent of pay which is employers contribution be matched by a 7 per cent employees contribution (introduced gradually over time) and that the workers be allowed to choose between joining the existing Social Security Organisations with their own hospitals or be allowed to join Health Maintenance Organisations (HMOs) to be established by the newly autonomous public hospitals and the private sector.

Worker's Housing: (WWO, 1971) is financed through a 2 per cent levy on assessable company income in excess of Rs.1 lakh which goes into a Workers Welfare Fund (WWF) which also receives 'excess' of workers entitlement to profits under the Workers Profit Participation Act. The WWF has generally not been used well with only a limited number of housing units constructed and the general use of these funds has been to provide free bicycles, sewing machines, grants for *Jabez* etc. The WWF has built up substantial liquid balances.

It is proposed that the WWO be extended to all workers (in line with the expansion of the pension and health schemes) and that an alternative minimum contribution of Rs.25 p.m. be required (since many companies declare no profits). The money should be put into a Workers' Housing Bank which should provide financing for workers housing using the funds generated as an interest rate subsidy.

Workers Participation in Profits: (CPWA, 1968) is based on 5 per cent of company profits exceeding 1 lakh to be distributed to workers subject to limits of 100 per cent of monthly wage not to exceed Rs.3000. The excess is to be deposited into the Workers Welfare Fund.

This law should also be extended to cover all categories of establishments including farming establishments (in line with the expansion of the pension and health schemes) although for obvious reasons it cannot

be extended to household and not-for-profit organisations. Some changes need to be made in the law to prevent misuse of liquid funds (held for substantial periods of time) by the Workers-Employers Committees.

Laws on Industrial Relations: Trade Unions, Management – Labour relations, collective bargaining and dispute resolution machinery are regulated by the Industrial Relations Ordinance 1969 which derives its main force from the ILO Conventions 87 and 98 as ratified by Pakistan. Trade Union activities are permitted with 10 per cent representation of the office bearers from outside the organisation. There is no restriction on the number of unions within an organisation except that they have to be registered. The registered trade unions have the privilege of contesting elections for the determination of Collective Bargaining Agent (CAB) – the representative body having the authority to negotiate with the employer. This law should be amended in line with developments in the developed countries to cover SMEs.

Laws on Hiring and Firing: Employers' right to hire and fire in establishments with 50 or more workers is nominally subject to one months wage in lieu of notice (West Pakistan Industrial and Commercial Employment Ordinance 1968). Reason has to be given in writing and workers may appeal under S.25 of the Industrial Relations Ordinance 1969 to the employer directly or the Collective Bargaining Agent and if dissatisfied with the decision, take it to an Industrial Labour Court. The Procedure restricts the right of employees to hire and fire. It is proposed that the above laws be amended to cover SMEs but recognising the special conditions of SMEs, employers be given the unrestricted right to hire and fire with two months wage for each year of service as compensation.

Conclusion

Pakistan is historically uniquely placed in that it can further protect its vulnerable groups – children, women, unorganised labour and the elderly by its SME agenda to focus on universal school education and the strengthening of its labour and social security laws. The proposals in this section are intended to achieve this objective.

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Uruguay Round Agreement: The Interface Between Anti-Dumping and Competition

Kishwar Khan and Sarwat Aftab¹

All the provisions of the Uruguay Round Agreements have a bearing upon competition policy, since the international framework governing trade determines the extent of competition in the national markets. Apart from the fundamental provisions of GATT Articles I (MFN treatment), III (National Treatment) and X (Transparency), there are numerous specific WTO provisions which are relevant in varying degrees to competition²

- GATT Article VI and the WTO Agreement on Antidumping which involves concept of injury, treatment of price discrimination, public interest, etc;
- GATT Article XVI and the WTO Agreement on Subsidies and Countervailing Measures such as concept of injury;
- Agreement on TRIMs; requiring the elimination of deletion programme and local content requirements;
- Agreement on TRIPs involving anti-competitive practices in contractual licenses, etc.

On the one hand, the consecutive multilateral trade talks at the WTO have reduced tariffs and trade barriers between member countries. But with the fall in the traditional trade policy tools, a rise in the new forms of protection has emerged. One important distinction between the traditional protection and the new forms of trade protection is that the latter are generally felt to be more selective and less transparent. Especially the use of antidumping measures, atleast in part, have replaced the tariffs and VERs.

The preparations for the Seattle Ministerial Conference indicated that many countries including Japan, Korea, Hong Kong, etc. were to argue for opening up WTO Anti-dumping (AD) Agreement with respect to

¹ The authors work in the Monopoly Control Authority as Economist and Assistant Director respectively. The views expressed in the paper are of the authors and in no way relate to those of the Monopoly Control Authority.

² Indepth discussions regarding consistency between trade and competition rules; and also on the possibility of international rules is worked out by OECD, see (8) and (9) for details.

competition-consistency³. The AD Agreement was discussed at the Seattle Conference held on December 1-3, 1999. Japan's view point on the AD Agreement was that its abusive use should be regarded as a disguised form of protectionism that nullifies tariff reductions. The improvement of the AD Agreement was considered as a lynchpin of the new round and this view was supported by many developing countries⁴. However, there was no concrete outcome of the Conference since the talks were suspended inconclusively. This does not necessarily mean that the issues raised in the Conference have now lost their significance, since this was not the first time that the Ministerial talks were suspended⁵.

This paper examines the AD Agreement with respect to implications for competition, combining both theoretical as well as practical issues. The first section gives an overview of the AD Agreement. The second section covers the relationship between AD Policy and Competition Policy (CP). Central concepts are also explored e.g., price discrimination, predation, injury, causality and minimum cause, etc. The third section gives a comparison of Competition and Anti-dumping legislation. The status of Pakistan's AD legislation is covered in the fourth section. The last section gives some specific suggestions and conclusions of the paper.

I. An overview of the Article VI of GATT

The Anti-Dumping Agreement elaborates the rules for applying the provisions of Article VI of the General Agreement and the Tokyo Round Code. It provides greater uniformity in the implementation of anti-dumping rules, protecting the interests of exporting countries, including developing countries. Anti-dumping measures and unilateral remedies which may be applied by a Member after an investigation and determination by that Member, in accordance with the provisions of the AD Agreement, that an imported product is "dumped" and that the dumped imports are causing material injury to a domestic industry producing the like product. The additional disciplines in the Agreement include:⁶

- more detailed methodology for calculating the dumping margin and, in general, stricter discipline on the data to be used for such a calculation;

³ WTO website, Preparations for the Seattle Conference, various country contributions.

⁴ WTO Briefing note on Ministerial Conference, WTO website, December 7, 1999.

⁵ Other instances of talks suspension include the UR Mid-Term Review, Montreal December, 1988; Brussels Ministerial Meeting December 1990. Statement by WTO Director-General, Mike Moore. WTO website, Press Release, December 7, 1999.

⁶ This section is based on the information contained in the Legal Texts (1) and from the WTO website.

- more detailed requirements for the determination of injury, in particular, treat of injury;
- a definition of producers related to exporters or importers;
- a specification of a *de minimis* dumping margin and volume for terminating proceedings. Anti-dumping cases are to be terminated if the margin of dumping or the share of the volume of imports from particular countries in the importing market are below the specified threshold levels;
- stricter disciplines on the initiation and subsequent investigation, imposition of provisional measures and prices undertaking entered into by exporters;
- time limits on the duration of an investigation, the period within which refunds are to be provided and the duration of anti-dumping measures;
- increased transparency in the procedures to be followed by the investigating authorities and in the public notice;
- disciplines on the imposition of anti-dumping duties on exporters or producers who have not been investigated individually;
- an accelerated review for producers who did not export the product in question during the period of investigation;
- a review of anti-dumping measures by the authorities of the importing country; and
- a provision for domestic judicial review.

Under the AD Agreement, the investigating authorities must take due account of any difficulties experienced by interested parties, in particular small companies, in supplying the information requested.

II. Relationship Between Anti-dumping (AD) Policy and Competition Policy (CP)

AD policy aims at reducing the impact of an anti-competitive practice i.e., selling abroad for less than in the domestic market. Thus AD policy is, in a rather special sense, a part of the competition policy. CP is directed at actions taken in regard to the domestic market, and generally by the domestic firms. But the countries which have properly articulated CPs do address actions taken abroad by foreign-controlled and foreign-based companies, which have anti-competitive effects in the domestic market(11).

The question arises whether the CP and the law of a country could also cover the AD system, alongwith other measures against anti-competitive practices by foreign companies. More specifically, the issue is why one particular type of anti-competitive practice – price discrimination – should be dealt with under different rules, standards and tests when it is practised by exporters in other countries then if it is practiced by domestic firms.

In case, the AD system penalises price discrimination in import trade more severely than similar price discrimination in domestic commerce (under competition law), the AD system would therefore be more protectionist in nature. Due to this reason, its application would appear to be in breach of the National Treatment obligation of GATT Article III.

It is obvious that governments have to take some remedial action when there is a sharp increase in the volume of imports at unusually low prices, displacing domestic production. A government has, then, to determined whether the intolerable surge in imports is due to an essentially anti-competitive action by a foreign firm(s), or whether it reflects changes in the structure of production. In the first case, measures designed to offset the anti-competitive action may be appropriate; in the latter case, the government should focus on other adjustment measures to protect the labour force from displacement.

Price discrimination, predation and injury

AD laws are directed at international price discrimination. In this sense, there appears to be some resemblance between injury under AD laws and “primary line” injury under competition laws concerning price discrimination. In some countries, for example the US, the competition law makes a distinction between “primary line”, “secondary line” and “tertiary line” injury. “Primary line” injury concerns injury to competitors of the firm while “secondary line” injury concerns injury to downstream firms. “Tertiary line” injury concerns injury to the customers (4).

For price discrimination claims in a domestic competition policy context, it must be shown to harm competition, not merely to harm particular competitors. Furthermore, in some jurisdictions the complaint of price discrimination is subject to defenses such as “meeting the competition”, that is a competitor lowers his price in one area in order to compete with the lower prevailing price. There is no similar defense available in dumping cases.

Predatory pricing is designed to exclude an equally or more efficient competitor from the market and thus is anti-competitive in nature. The AD

provisions (i.e., the Agreement and national legislation) are not directed at predatory dumping, but at any dumping which causes injury or threatens injury to a domestic industry.

Under the WTO rules, the determination of injury is a separate inquiry from the determination of dumping margins. When injury cannot be proven, the analysis ends regardless of whether the existence of a dumping margin has been proven. The WTO rules also provide that there “shall be immediate termination in cases where the authorities determine that the margin of dumping is *de minimis* (less than 2 per cent of the export price), or that the volume of the dumped imports (generally less than 3 per cent for any one country), actual or potential, or the injury, is negligible”.

The GATT/WTO framework requires that authorities examine any known factors other than the dumped imports which at the same time are injuring the domestic industry, and injuries caused by these factors must not be attributed to dumped imports. Many countries believe that the concept of injury is separable – i.e., an industry can be suffering from various injuries, from various causes. It is worth noting that both the EU and Canada have legislative provisions to apply the “community interest rule” in an Ad case. This rule takes into account the interests of both the producers and the consumers.

The standing requirements for initiating a dumping investigation under the GATT – WTO framework are more demanding for a complainant than is the case in competition proceedings. For a dumping case to proceed, there must be evidence that the complaint is made by domestic producers constituting more than 50 per cent of the domestic production of the like product. This requirements under competition laws are not so stringent. However, the parties need to demonstrate that they are potentially harmed by the alleged anti-competitive practices.

The AD investigations are subject to strict negotiated time schedules codified in WTO Agreements, whereas there is no such multilateral agreement and few domestic law requirements that limit the decision-making time in competition cases.

Causality or minimum cause

Causality means that the dumped imports must be shown to be the cause of a material injury to the domestic industry. The demonstration of a causal relationship between the dumped imports and the injury to the domestic industry is based on an examination of all relevant evidence before the authorities. Factors which may be relevant in this respect include the

volume and prices of imports not sold at the dumping prices, contraction in demand or changes in the pattern of consumption, trade restrictive practices of and competition between the foreign domestic producers, developments in technology and the export performance and productivity of the domestic industry.

Competition Consideration in AD Agreement

The wording of AD Agreement appears to make it mandatory that domestic authorities, when investigating the impact of dumping, consider “trade restrictive practices of and competition between the foreign and domestic producers”. This phrase is from Article 3.5. However, not all countries have taken all Agreement provisions into their domestic legislation. Accordingly, in domestic law in those countries there may be no requirement that the requirements of Article 3.5 be considered by the administrative authority. Clearly, there is one step that could be taken to bring CP considerations into Ad policy without changing international rules: all that appears to be required is that the existing Agreement provisions be properly implemented.

The Working Group on “Interaction Between Trade and Competition Policy” is discussing the possibilities of international competition regimes, but one thing should be clear: the creation of an international competition policy would not eliminate the need for AD laws because competition laws are designed to attack a different set of problems than AD laws. Antitrust laws can never be a substitute for Ad law because these two disciplines have different objectives and seek to remedy different practices.

It should be considered at this stage that the competition law is neither always fully developed nor is there international agreement on policy. This reflects the fact that within many countries there are sharp, and often highly politicised differences of views about the economic and legal rationale of CP. CP varies widely from one WTO member to another. Therefore, the possibilities of multilateral actions in either area should be worked out carefully.

III. Antidumping and Competition Laws

Competition laws focus primarily on consumer welfare and attempt to remedy price discrimination, predatory pricing or other anti-competitive practices by the private actors. AD laws focus on the interest of producers and their workers.

Although competition and Ad legislations have different objectives there is a direct link between the two: when a foreign government fails to enact or enforce competition legislation (CL) in its home market, thereby giving its producers an artificial competitive advantage, those producers may engage in injurious dumping in other markets. Protection by the government may also take the form of tariffs and non-tariff barriers (NTBs). NTBs include state-sponsorship of domestic distribution regimes, government pricing policies etc. A government may protect a domestic industry by simultaneously placing limits on domestic competition and creating barriers against foreign competition. It may directly subsidise a domestic industry via provisions of grants or by imposing price control, or indirectly by arranging with a domestic producer to sell its goods to a state trading company at an artificially high level, with the trading company then selling the goods abroad at artificially low prices. Such measures give these companies advantages in the market place that do not arise from greater efficiency, thereby leading to serious mis-allocations of resources⁷.

The AD laws are based on the assumption that there is inherent value in protecting workers and their companies from injury by other companies that are not manufacturing products more efficiently. In the short-term dumping improves the well-being of domestic consumers in the form of lower prices. The long term picture is not so positive as the injury caused to domestic producers may cause workers to lose their jobs, and even the most efficient factories to close, causing distortionary ripples in the economy. Faced with less competition those companies that remain will raise prices. The pace of innovation slackens, and ultimately, consumers pay the price with inferior, higher-priced products (10).

Several governments have begun to employ anti-dumping legislations since the UR entered into force. Singapore repealed outmoded AD laws in 1996. China enacted its first AD legislation in 1997. Of course, China's application of its Ad law will not be subject to review by the DSU unless and until that nation enters the WTO.

AD legislation vary from country to country. The EU AD legislation deviates from the US in a number of respects: first, the level of Ad protection in the EU is limited to the injury margin provided it is smaller than the dumping margins. In the US, the duty is always based on the dumping margin which results in higher duty levels. Second, the EU besides duties often imposes price undertakings which can be compared to 'voluntary price restraints'. Third, duties in the EU are levied prospectively,

⁷ Frederic Jenney (12) provides an informative discussion on the international dimension of competition policy.

this means only after positive dumping and injury findings. The US has a retrospective duty system, where a bond has to be deposited before the outcome of an investigation is known but which is paid back in case the alleged dumper is not found guilty. A refund of duty revenue in the EU is possible in principle but in practice very difficult to obtain. Refunds have only occurred in very few cases and may take upto ten years after the period of protection. Interest over this period is never refunded⁸. Finally, the EU 'Sunset clause' stipulates that AD measures automatically lapse after five years, in contrast to the US, where measures only lapse if the foreign importer shows that dumping has stopped (6).

In the past few years, developing countries have increasingly been using antidumping laws. Developing countries have initiated dumping cases against both developed and developing countries⁹. Interestingly, atleast five developing countries (India, Egypt, Indonesia, Malaysia and Pakistan) have criticised the developing country provision of the WTO AD Agreement. This provision states that special regard must be given by developed countries to the special situation of developing countries when considering the application of AD measures. The provision further provides that "possibilities of constructive remedies provided for by this Agreement shall be explored before applying AD duties where they would affect the essential interests of developing country members". These countries complained that this provision needs to be turned into concrete steps that can be implemented. Interestingly, India has become a significant user of its AD law, including against developing countries. In 1997, 240 AD investigations were initiated world wide. Some countries that had been strong critics of the Ad laws are now applying them with frequency.

IV. Status of AD Law in Pakistan

Presently, the draft AD legislation is in the Senate for approval. The law provides for all the relevant important definitions. The procedure would be such that the application for dumped imports will be received and processed by the National Tariff Commission for preliminary investigations¹⁰. The Commission then, will pass on its recommendations to the Government for investigation. An appeal could be filed with the Customs Tribunal against the government's decision. The matter if disputed, would then be referred to the DSU at the WTO. Industries which have alleged dumping of imports in Pakistan include chemicals, tin plates, toys, polyester staple fiber,

⁸ Vanden Bussche, Linda Springael and Jozef Konings in 'Import diversion under European Antidumping Policy', National Bureau of Economic Research, September 1999.

⁹ For details on WTO dispute cases, see (3).

¹⁰ Source is National Tariff Commission.

etc. however, no case could have been initiated by Pakistan due to non-existence of a legislation.

V. Conclusions and Suggestions

A number of WTO members, including developing country members, share the concerns about the adequacy and the fair implementation of rules governing trade remedies such as AD measures. AD measures have been invoked with increased frequency and by an increasing number of measures. Easy access to and increased dependence on such trade remedies will nullify the benefits of tariff reductions. Developing countries, like Pakistan are worried not just about the frivolous complaints but also the repeated AD charges against the same products. It is noteworthy that new investigations are initiated against the same products almost immediately after the conclusion of an earlier investigation. Moreover, when it is proved that AD duties have been imposed without sufficient justification and evidence, the country which has acted unjustly to blunt competition is not penalised and made to reimburse the affected exporters the duties collected from the AD moves. The WTO is silent on the issue, though it needs to be addressed urgently.

While an AD measure is one of legitimate trade remedies permitted under current WTO regimes, due attention should be paid to avoid its abuse for protectionist purposes. Serious problems exist even if final duties are not imposed, such as the AD investigations entail huge burdens on respondents, and that restrictive effects on the trade of the countries in question are significant. The reasons of the above mentioned problems are, *inter alia*; (i) lack of appropriate implementation of the AD Agreement due to its ambiguous provisions; and (ii) insufficient disciplines in the relevant provisions of the AD Agreement to avoid inappropriate AD measures. As a pre-requisite of appropriate implementation, it is essential to eliminate ambiguities in relevant Articles in the Agreement, thus clarifying standards for judgement entrusted to the investigating authorities. This can prevent arbitrary usage and has the advantage of facilitating implementation when measures are truly necessary. Clarification of procedures and standards can contribute to preventing unjustified petitions or investigations as well.

Some specific recommendations for Pakistan are as follows:

- There is an urgent need to have domestic AD legislation at the earliest.
- The AD Agreement does not adequately address the potential for the abuse of AD proceedings to harass exporters. There is a need to

eliminate ambiguities in the relevant articles of the AD Agreement. These issues should be raised in the post-Seattle Ministerial Conference discussions.

- The Pakistan Government and private industry need to join hands to counter the charges of dumping being levied against different sub-sectors of the textiles industry because the cost of participating in AD investigations is expensive and cumbersome.
- There is a need to develop expertise within the country, by tapping the handful of Pakistani professionals with the requisite experience to counter the growing menace of AD claims being prepared against Pakistan by the industrialised economies.
- The Agreement on AD unfairly restricts the role of Dispute Settlement (DS) Panel. According to the Article 17.6 of the Agreement which says “in its assessment of the facts of the matter, the Panel shall determine whether the authorities’ establishment of the facts was proper and whether their evaluation of those facts was unbiased and objective. If the establishment of the facts was proper and the evaluation was unbiased and objective, even though the Panel might have reached a different conclusion, the evaluation shall not be overturned”. This means that if there are two or more interpretations of any provision, the interpretation of the country imposing the penalties will prevail, even if the Panel disagrees with this interpretation. The DS Panel for Ad is only empowered to assess whether the evaluation of the facts by the party imposing dumping duties was carried out in an unbiased and objective manner. Such a provision contrasts sharply with the powers enjoyed by the Panels under other articles of the agreements. These selective methods and the discretion they provide to those initiating the Ad cases need to be reformed. Without these reforms, the WTO will fail to function independently as a neutral body in determining the veracity of AD claims. The issues needs to be raised jointly by the developing countries.

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On the validity of the Capital Asset Pricing Model

Hassan Naqvi*

Abstract

One of the most important developments of modern finance is the Capital Asset Pricing Model (CAPM) of Sharpe, Lintner and Mossin. Although the model has been the subject of several academic papers, it is still exposed to theoretical and empirical criticisms.

The CAPM is based on Markowitz's (1959) mean variance analysis. Markowitz demonstrated that rational investors would hold assets, which offer the highest possible return for a given level of risk, or conversely assets with the minimum level of risk for a specific level of return.

Building on Markowitz's work, Sharpe and Lintner after making a number of assumptions, developed an equilibrium model of exchange showing the return of each asset as a function of the return on the market portfolio. This model and its underlying assumptions are reviewed in section 1. This model known as the Capital Asset Pricing Model has since been the focus of a number of empirical tests, and as shown in sections 3 and 5 the majority of these tests deny the validity of the model. However, as discussed in sections 4 and 6 these tests have not been free of criticism. Section 2 briefly presents a framework under which the empirical tests of the CAPM can be carried out. Section 7 provides a conclusion.

1. The CAPM and its assumptions

Sharpe and Lintner assumed that there are no transaction costs and no income taxes. Further, they assumed that assets are infinitely divisible and there are no restrictions to short selling and that investors can lend and borrow unlimited amounts at the risk free rate of interest. More importantly they assumed the homogeneity of expectations and that individuals hold mean variance efficient portfolios. Another implicit assumption of the CAPM is that all assets including human capital are marketable. Moreover the CAPM is essentially a single period model.

It is clear that these assumptions do not hold in the real world and thus, not surprisingly, the model's validity has been suspect from the outset.

* The author has an M.Sc. in Finance and Economics from the London School of Economics. He is currently a Lecturer in Economics at the University College, Lahore.

However, on closer examination the assumptions underlying the CAPM are not as stringent as they first appear to be.

Exactly the same results would obtain if short sales were disallowed. Since in equilibrium no investor sells any security short, prohibiting short selling will not change the equilibrium. More formally the derivative of the Lagrangian with respect to each security will have a Kuhn-Tucker multiplier added to it, but since each security is contained in the market portfolio, the value of the multiplier will be zero and hence the solution will remain unaffected.

Further, Fama (1970) and Elton and Gruber (1974 and 1975) give a set of conditions under which the multi-period problem reduces to a single period CAPM, where all individuals maximise a single period utility function. The conditions are that firstly consumers act as if the one-period returns are not state dependent, i.e. the distribution of one-period returns on all the assets are known at the beginning of the period. Secondly, the consumption opportunities are not state dependent and lastly consumers' tastes are independent of future events. Fama further shows that given these conditions the derived one period utility is equivalent to a multi-period utility function given nonsatiation and risk aversion. However, it is argued by many that the above conditions are rather restrictive.

Merton (1973) has shown that a necessary and sufficient condition for individuals to behave as if they were single-period maximisers and for the equilibrium return relationship of CAPM to hold is that the investment opportunity set is constant. Furthermore, the main results of the model hold if income tax and capital gains taxes are of equal sizes.

If the assumption of riskless lending or borrowing is violated, then Black (1972) has shown that we still obtain a linear relationship between an asset's returns and its risk as measured by the covariance of the assets returns with the market. This model as distinct from the standard CAPM is known as the zero beta CAPM.

Thus, even though the assumptions underlying the Capital Asset Pricing Model are demanding and have been the basis for much of the criticism against the model, nevertheless these assumptions are not altogether inflexible. More importantly, the final test of the model is not how reasonable the assumptions underlying it seem to be, but rather how well the model conforms with reality. Indeed, many proponents of the CAPM argue that due to technological advances, capital markets operate as if these assumptions are satisfied.

Sharpe and Lintner, thus making a number of assumptions, extended Markowitz's mean variance framework to develop a relationship for expected returns, which more precisely is

$$E [R_i] = R_f + \beta_{im}(E[R_m] - R_f)$$

$$\beta_{im} = \frac{\text{Cov}[R_i, R_m]}{\text{Var}[R_m]}$$

where R_i = return on asset i

R_m = return on the market portfolio

R_f = return on the riskless asset

Thus the return on an asset depends linearly on β_{im} (hereafter simply beta) which is a measure of the covariance of the asset's return with that of the market. Intuitively, in a rational and competitive market investors diversify all systematic risk away and thus price assets according to their systematic or non-diversifiable risk. Thus the model invalidates the traditional role of standard deviation as a measure of risk. This is a natural result of the rational expectations hypothesis (applied to asset markets) because if, on the contrary, investors also took into account diversifiable risks, then over time competition will force them out of the market. If, on the contrary, the CAPM does not hold, then the rationality of the asset's markets will have to be reconsidered.

Black has derived a more general version of the CAPM, which holds in the absence of a riskless asset. For this *zero beta CAPM*, we have

$$E [R_i] = E [R_{om}] + \beta_{im}(E[R_m] - E[R_{om}])$$

$$\beta_{im} = \frac{\text{Cov}[R_i, R_m]}{\text{Var}[R_m]}$$

where R_{om} = return on the zero beta portfolio, i.e. the portfolio (lying on the portfolio frontier) which has a zero correlation with the market portfolio.

2. Framework for testing the validity of CAPM

The standard CAPM can also be written in terms of excess returns

$$E [Z_i] = \beta_{im}E[Z_m]$$

$$\beta_{im} = \frac{\text{Cov}[R_i, R_m]}{\text{Var}[R_m]}$$

where $Z_i = R_i - R_f$

$$Z_m = R_m - R_f$$

Empirical tests of the standard CAPM have focused on three testable implications, namely the intercept is zero, beta completely captures the cross sectional expected returns and that the market excess return is positive. In this section the focus will be on the first testable implication, i.e. the intercept is zero.

The excess return market model is:

$$Z_t = \alpha + \beta Z_{mt} + \varepsilon_t$$

$$E[\varepsilon_t] = 0, \quad E[\varepsilon_t \varepsilon_t'] = \Sigma$$

$$E[Z_{mt}] = \mu_m, \quad E[(Z_{mt} - \mu_m)^2] = \sigma_m^2$$

$$\text{Cov}[Z_{mt}, \varepsilon_t] = 0$$

where Z_t = (Nx1) vector of excess returns for N assets

β = (Nx1) vector of betas

Z_{mt} = time period t market portfolio of excess return

α = (Nx1) vector of intercepts

ε_t = (Nx1) vector of disturbances

The implication of the standard CAPM is that the vector of intercepts is zero. If this is true then the market portfolio will be the 'tangency' portfolio.

Assuming that the returns are IID and are normally distributed, the maximum likelihood estimation technique can be used to estimate the parameters α and β . The probability density function (pdf) of excess returns conditional on the market excess return is given by

$$f(Z_t | Z_{mt}) = (2\pi)^{-N/2} |\Sigma|^{-1/2} \exp[-(1/2)(Z_t - \alpha - \beta Z_{mt})' \Sigma^{-1} (Z_t - \alpha - \beta Z_{mt})]$$

and given that the returns are IID the joint pdf is

$$f(Z_1, \dots, Z_T | Z_{m1}, \dots, Z_{mT}) = \prod f(Z_t | Z_{mt})$$

Thus the log-likelihood function is

$$\Lambda(\alpha, \beta, \Sigma) = -(NT/2)\log(2\pi) - (T/2)\log|\Sigma| - (1/2)\sum_t (Z_t - \alpha - \beta Z_{mt})' \Sigma^{-1} (Z_t - \alpha - \beta Z_{mt})$$

The first order conditions are:

$$\partial\Lambda/\partial\alpha = \Sigma^{-1}[\sum_t(Z_t - \alpha - \beta Z_{mt})] = 0$$

$$\partial\Lambda/\partial\beta = \Sigma^{-1}[\sum_t(Z_t - \alpha - \beta Z_{mt})Z_{mt}] = 0$$

$$\partial\Lambda/\partial\Sigma = -(T/2)\Sigma^{-1} + (1/2)\Sigma^{-1}[\sum_t(Z_t - \alpha - \beta Z_{mt})(Z_t - \alpha - \beta Z_{mt})']\Sigma^{-1} = 0$$

Solving the above FOCs we get estimates for α , β and Σ , and it should be noted that these estimates are the same as the ones obtained using OLS. However, compared to the OLS they have better large sample properties.

The Wald test can then be used to check whether the intercept is zero. The Wald test statistic is given by

$$W = \Lambda [\text{Var}(\Lambda)]^{-1}\Lambda$$

which has a chi-square distribution with N degrees of freedom.¹

3. Empirical Tests of the CAPM

Most of the early tests of the CAPM employed the methodology of first estimating betas using time series regression and then running a cross sectional regression using the estimated betas as explanatory variables to test the hypothesis implied by the CAPM.

Using this approach one of the first tests of the CAPM was conducted by Lintner, which is reproduced in Douglas (1968). Using data from 1954-1963, Lintner ran the following regression

$$R_t = \alpha + bR_{mt} + e_t$$

where R_t = (Nx1) vector of asset returns

R_{mt} = return on the market portfolio

b = (Nx1) vector of estimated betas

Lintner then ran the following second pass regression:

$$\bar{R} = a_1 + a_2b + a_3S_e^2 + \eta$$

where S_e^2 = (NxN) matrix of residual variance (i.e. the variance of e in the first pass regression).

¹ Since the material in this section is quite standard I will not venture further into this but I have included a detailed discussion of the statistical framework to test the CAPM in the appendix.

The testable implications of the CAPM are that $\alpha_1 = R_f$; $\alpha_2 = (E[R_m] - R_f)$ and $\alpha_3 = 0$.

However, Lintner found that the actual values did not confirm with the theoretical values. α_1 was found to be much larger than R_f or even R_{om} , α_2 was found to be statistically significant but had a lower value than expected and α_3 was found to be statistically significant as well. Thus Lintner's results seem to be in contradiction to the Capital Asset Pricing Model.

Fama and MacBeth (1973) performed one classic test of the CAPM. They combined the time series and cross-sectional steps to investigate whether the risk premia of the factors in the second pass regression were non-zero.

Forming 20 portfolios of securities, they estimated betas from a time-series regression similar to Lintner's methodology. However, they then performed a cross-sectional regression for each month over the period 1935-1968. Their second pass regression was of the following form:

$$R_t = \gamma_{0t} + \gamma_{1t}\beta - \gamma_{2t}\beta^2 + \gamma_{3t}S_e + \eta_t$$

If the standard CAPM was true then we should have the following:

- $E[\gamma_{0t}] = R_f$
- $E[\gamma_{1t}] > 0$ as the market risk premium should be positive
- $E[\gamma_{2t}] = 0$ as the securities market line (SML) should be linear, i.e. the relationship between return and the relevant risk should be linear.
- $E[\gamma_{3t}] = 0$ as the residual risk should not affect asset returns.

All of the above should be true if the standard CAPM is to hold.

Fama and MacBeth found that γ_3 was statistically insignificant and its value remains very small over several subperiods. Thus, in contrast to Lintner, they find that residual risk has no effect on security returns. Miller and Scholes (1972) showed that residual risk would act as a proxy for risk if beta had a large sampling error. This fact might reconcile Lintner's and Fama and MacBeth's results, as the latter's estimate for beta had much less sampling error due to their use of asset portfolios.

Fama and MacBeth further found that γ_2 is not statistically different from zero. Moreover, they found that the estimated mean of γ_1 is positive as predicted by the model. They also find that γ_0 is statistically different from

zero. However, their intercept is much greater than the risk free rate and thus this would indicate that the standard CAPM might not hold.

Black, Jensen and Scholes (1972) performed another classic test of the Capital Asset Pricing Model employing time-series regression. They ran the following familiar time series regression:

$$Z_t = \alpha + \beta Z_{mt} + \varepsilon_t$$

As observed before, the intercept should be zero according to the CAPM. Black *et al.* used the return on portfolios of assets rather than individual securities. Time series regression using returns on individual assets may give biased estimates, as it is likely that the covariance between residuals may not equal zero. This is not generally true with portfolios as they utilise more data.

The results from the BJS time series regressions show that the intercept term is different from zero and in fact is time varying. They find that when $\beta < 1$ the intercept is positive and that it is negative when $\beta > 1$. Thus, the findings of Black *et al.* violate the CAPM.

Stambaugh (1982) employs a slightly different methodology. From the market model we have

$$R_t = \alpha + \beta(R_{mt}) + \varepsilon_t$$

If the CAPM was true then the intercept in the above equation should be constrained and should in fact be

$$\alpha = \kappa(1 - \beta)$$

where $\kappa = R_f$ (under the Sharpe-Lintner CAPM)

or $\kappa = R_{om}$ (under the Black's version of CAPM)

Stambaugh then estimates the market model and using the Lagrange multiplier test finds evidence in support of Black's version of CAPM but finds no support for the standard CAPM.

Gibbons (1982) uses a similar method as the one used by Stambaugh but instead of the LM test uses a likelihood ratio test. He uses the fact that if the CAPM is true then the constrained market model should have the same explanatory power as the unconstrained model, but if the CAPM is invalid then the unconstrained model should have significantly more

explanatory power than the constrained model. Using this test, Gibbons rejects both the standard and the zero beta CAPM.

4. Possible Biases in tests of Asset Pricing Theory

Miller and Scholes (1972) in their paper “Rates of return in relation to risk” discuss the statistical problems inherent in all the empirical studies of the CAPM. They point out that the CAPM in time series form is

$$\bar{R}_t = R_{ft} + \beta (\bar{R}_{mt} - R_{ft})$$

or

$$\bar{R}_t = (1 - \beta)R_{ft} + \beta\bar{R}_{mt}$$

and thus if the riskless rate is non-stochastic then the CAPM can easily be tested by finding whether the intercept is significantly different from $(1 - \beta)R_{ft}$. However, if R_{ft} varies with time and moreover is correlated with R_{mt} , then we inevitably encounter the problem of omitted variable bias and thus the estimated betas will be biased.

Miller and Scholes, then using historical data find that R_{ft} and R_{mt} are negatively correlated. Intuitively, a rise in the interest rates is conducive to stock market declines. They then prove that if R_{ft} and R_{mt} are negatively correlated then this will lead to an upward bias in the intercept and further the slope will be biased downwards. This is in fact what many empirical studies find and thus the fact that many studies reject the CAPM does not imply that it does not hold.

Another factor that may bias the intercept upward and the slope downwards is the presence of heteroskedasticity. However, Miller and Scholes find no evidence of heteroskedasticity.

Miller and Scholes then go on to show the biases that one may encounter in the two stage regressions used by Lintner and Douglas and by Fama and MacBeth. The problem in this methodology is that estimated betas instead of the true betas are used in the second pass regressions and thus any error in the first stage is carried to the second stage. Miller and Scholes show that this ‘errors-in-variables problem’ will bias the intercept upward and the slope downwards.

However, this problem can be encountered by grouping assets into portfolios, by using instrumental variables or by the direct bias adjustment of Shanken *et al.*

Another possible problem in many tests of the CAPM arises due to it being a single-period model. Most tests of the CAPM use time series regression, which is only appropriate, if the risk premia and betas are stationary, which is unlikely to be true.

In his influential paper "A critique of asset pricing theory's tests", Roll (1977) shows that there has been no single unambiguous test of the CAPM. He points out that tests performed by using any portfolio other than the true market portfolio are not tests of the CAPM but are tests of whether the proxy portfolio is efficient or not. Intuitively, the true market portfolio includes all the risky assets including human capital while the proxy just contains a subset of all assets.

If we choose a portfolio, say m from the sample efficient frontier as a proxy for the market, then from efficient set mathematics we know that the mean return on any asset or portfolio j , will be a weighted average of the return on m and the return on the portfolio which has a zero correlation with m , i.e.

$$R_j \equiv (1 - \beta_j)R_{om} + \beta_j R_m$$

where

$$\beta_j = \frac{\text{Cov}(R_j, R_m)}{\text{Var}(R_m)}$$

More generally, if A and B are any two sample efficient portfolios, then the mean return on asset j is given by

$$R_j \equiv (1 - \beta_j)R_A + \beta_j R_B \quad \forall j$$

Conversely, if R is the mean vector of returns and β is the $(N \times 1)$ vector of slope coefficients obtained by regressing asset returns on the returns of some portfolio m , then we have

$$R = R_{om}\mathbf{1} + (R_m - R_{om})\beta$$

where $\mathbf{1}$ = vector of ones

The above relationship will hold iff R_m is ex-post efficient. Thus if m is not efficient then mean returns will not be linearly related to betas. Using this result from efficient set mathematics, Roll asserted that the only testable implication of the CAPM is that the market portfolio is mean-variance efficient. All other implications of the model, including the linearity of expected returns and beta follow from the efficiency of the market portfolio and thus are not independently testable.

Furthermore, for a given sample of mean returns, there always exist an infinite number of ex-post mean-variance portfolios. For these portfolios there will be an exact linear relationship between sample returns and sample betas. This linearity will hold whether or not the true market portfolio is efficient. Thus, the two-parameter asset pricing theory is not testable unless all assets are included in the sample.

In contradiction to the above argument, Fama and MacBeth in their paper incorrectly state that there are three testable implications, namely that the relationship between expected returns and beta is linear; that beta is a complete measure of risk; and that given risk averseness, higher return should be associated with higher risk, i.e. $E[R_m] - E[R_{om}] > 0$. Roll points out that if m is efficient then all the above implications are not independently testable and further asserts that the last inequality follows from the mathematical implication of the assumption about m rather than risk averseness per se.

Thus the only testable hypothesis concerning the zero beta CAPM is that the individuals prefer portfolios which are mean-variance efficient and that the market portfolio is ex-ante efficient.

On the contrary, the famous paper of Black, Jensen and Scholes does not even mention the possible efficiency of the market portfolio and concludes that the relationship between expected returns and beta is not linear. This conclusion is enough to prove that the proxy used by BJS does not lie on the sample efficient frontier. If on the other hand, the proxy had been on the efficient part of the frontier than BJS would have found a linear relationship between mean returns and beta. This is all in accordance with efficient set mathematics.

The relevant testable implications of the Sharpe-Lintner CAPM can be illustrated by means of figure 1. In the figure, m^* is the tangent portfolio. If m is used as the proxy, then the return on the asset is given by

$$R_j = R_z + (R_m - R_z)\beta_j \quad (a)$$

On the other hand, if m^* is used as the proxy, then the return on the asset is given by

$$R_j = R_f + (R_{m^*} - R_f)\beta_j^* \quad (b)$$

It should be noted that since efficient orthogonal portfolios are unique, β_z^* should be non-zero.

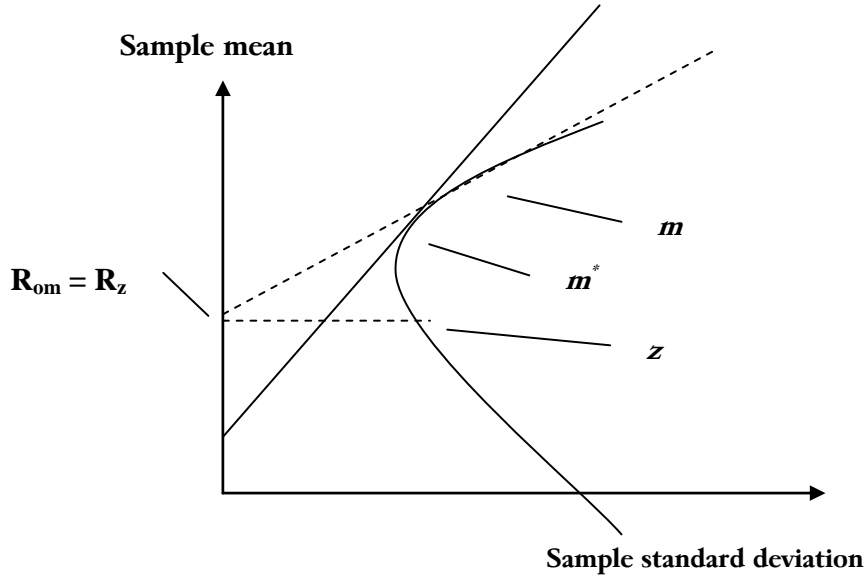


Figure 1

Since each individual will invest partly in the riskless asset and partly in the tangent portfolio m^* , thus the principle testable hypothesis of the Sharpe-Lintner CAPM is that the ex-ante efficient tangent portfolio is the market portfolio.

On the other hand, as already mentioned, BJS by using a market proxy estimated the following regression:

$$R_j - R_f = \alpha + \gamma\beta_j + \varepsilon_j \quad (c)$$

They found that α was not only greater than zero but was also highly variable. Moreover, they found that γ was less than $R_m - R_f$. On the basis of these results, they rejected the standard CAPM.

However, Roll showed that unless BJS were successful in choosing the tangent portfolio m^* as their proxy, their results are actually in accord with the standard CAPM. Suppose, BJS chose m as their proxy, then substituting $j = z$ in (b), we have

$$R_z = R_f + (R_m^* - R_f)\beta_z^*$$

Substituting the above equation in (a) we get

$$R_j - R_f = \beta_z^*(R_m^* - R_f) + [R_m - R_f - \beta_z^*(R_m^* - R_f)]\beta_j \quad (d)$$

Comparing (c) with (d) we see that if the Sharpe-Lintner CAPM is true than α should be equal to $\beta_z^*(R_m^* - R_f)$. Thus, since β_z^* is not equal to

0, α should in fact be not equal to zero and further since the return on the tangent portfolio m^* is a random variable, hence α should also be variable. Thus, it can be seen that the results of BJS are fully compatible with the standard CAPM!

Roll in his paper also shows that the proxy used by BJS was not even close to the tangent portfolio. However, even if BJS had found that the intercept was equal to zero, their result would not have invalidated the CAPM, simply because of the fact that they were not using the true market portfolio.

Fama and MacBeth in their study use the Fisher's Arithmetic index (an equally weighted portfolio of all the stocks in the NYSE) as their proxy. This portfolio is not even close to the value-weighted portfolio and thus should not have been used as a market proxy. Thus the conclusions of Fama and MacBeth are also not immune to suspicion.

It is clear that there will always exist a portfolio in the tangency position but it is not clear at all whether this portfolio is the value-weighted average of all assets, i.e. the market portfolio.

Furthermore, as shown by Roll, the situation is aggravated by the fact that both the Sharpe-Lintner CAPM and the Black's version of CAPM are liable to a type II error, i.e. likely to be rejected when they are true. This is true even if the proxy is highly correlated with the true market portfolio. Thus the efficiency or the inefficiency of the proxy does not imply anything about the efficiency of the true market portfolio.

It is not surprising therefore that Fama (1976) concluded that there has been no single unambiguous test of the CAPM.

5. Variables other than the market factor affecting stock returns

According to the CAPM, only market risk is priced, i.e. only beta affects returns and all other variables are irrelevant. However, there have been a number of empirical studies, which find that non-market factors have a significant affect on average returns.

Basu (1983) provides evidence that shares with high earnings yield (low price to earnings ratio) experience on average higher subsequent returns than shares with low earnings yield. Banz (1981) was the first to provide evidence of the 'size effect'; i.e. low market capitalisation firms have higher average returns compared to larger firms. Rosenberg, Reid and Lanstein (1985) show that firms with lower price-to-book ratios have higher mean returns.

A number of empirical studies also find support for the traditional use of the dividend-price ratio as a measure of expected stock returns. Sorenson and Williamson (1983) provide evidence that an increase in dividend yields raises average returns. Rozeff (1984), Flood, Hodrick and Kaplan (1987), Fama and French (1988) and Campbell and Shiller (1988) find similar results.

Merton (1973) has constructed a generalised intertemporal capital asset pricing model in which factors other than market uncertainty are priced. He models individuals as solving lifetime consumption decisions in a multi-period setting. After making a number of assumptions, Merton shows that the return on assets depend not only on the covariance of the asset with the market but also on its covariance with changes in the investment opportunity set. Hence, changes in interest rates, future income and relative prices will all influence returns. Intuitively, individuals will form portfolios to hedge themselves away from these risks. These actions of investor's will affect returns. According to this 'multi-beta CAPM', the return on securities will be affected by a number of indices apart from the market factor. Hence excess returns will be of the following form

$$E[R_i] - R_f = \beta_{im}(E[R_m] - R_f) + \beta_{i1}(E[R_1] - R_f) + \beta_{i2}(E[R_2] - R_f) + \dots$$

This can also be interpreted as another form of the Arbitrage Pricing Theory (APT).

Elton and Gruber (1988), (1989) find that a five - factor APT model better explains expected returns compared to the classic CAPM model in the Japanese market. They find that in Japan, smaller stocks are associated with smaller betas and thus according to the CAPM they should give smaller mean returns. Yet, smaller stocks have higher expected returns than their larger counterparts. They also find that a multi-factor model is more useful in constructing hedge portfolios for futures and option trading.

Fama and French (1992) in an influential paper entitled, "The cross-section of expected stock returns", show that two easily measured variables, size and book-to-market equity combine to capture the cross-sectional variation in average stock returns associated with market beta, size, leverage, book-to-market, and earnings-to-price ratios.

Fama and French using data for non-financial firms conduct its asset-pricing tests using the Fama and MacBeth regression approach. Their results from applying the FM regressions show that market beta clearly does not explain the average stock returns. The average slope from the regression of returns on beta alone is 0.15 per cent per month and it is only 0.46 standard errors from zero.

Furthermore, Fama and French point out that variables such as size, earning yield, leverage, and book-to-market are all scaled versions of a firm's stock price and thus some of them are redundant to explain returns. They show that of these variables only size and book-to-market equity explain cross-sectional average returns. Moreover, they find that when allowing for variations in beta that are unrelated to size, the relationship between beta and average return is flat. Hence, they naturally argue that the CAPM is dead.

6. Can the CAPM be saved?

The results of the previous section suggest that the CAPM is wrong and new alternatives have to be devised. However, as suggested earlier we cannot just discard the CAPM, until we can observe the true market portfolio.

One possible interpretation of the above findings is that the factors found to be significant in the above studies may actually be correlated with the true market portfolio.

Furthermore, Lo and MacKinlay (1990b) argue that biases relating to data-snooping may explain the observed deviations from the model. With hundreds of researchers examining the same data, some relationship between non-market factors and returns is bound to be significant. Lo and MacKinlay show that such biases, which are largely inevitable, may be immense especially in tests of the Sharpe-Lintner version of the CAPM.

Moreover, sample selection biases also exist in such studies as COMPUSTAT data exclude some stocks from the analysis. Kothari, Shanken, and Sloan (1995) argue that firms that have not been performing well are excluded. And since the failing stocks have a lower return and a high book-to-market ratio, thus the average returns of the included high book-to-market firms will be biased upwards. Kothari, et al. argue that this bias may explain the result found by Fama and French.

It is also claimed that measurement problems in estimating the CAPM may explain the observed 'size' effect. It is argued that the estimated betas for small firms are too low. If this is true then the CAPM will give a smaller expected return for small stocks and thus the difference between actual and expected returns will be large (and positive), even though it may actually be zero if there were no measurement errors associated with betas.

Christie and Hertz (1981) point out that those firms, which become small also, become riskier but since beta is measured using historical returns, it does not capture this increased risk.

Further, Reinganum (1981) and Roll (1981) show that the beta estimated for small firms will be biased downward as they trade less frequently than do the larger firms.

Goetzmann and Jorion (1993) in their paper "Testing the predictive power of dividend yields" re-examine the ability of dividends to predict long-horizon stock returns. Using the bootstrap methodology as well as simulations to examine the distribution of test statistics under the null hypothesis of no forecasting ability, they find that the empirically observed statistics are well within the 95 per cent bounds of their simulated distributions. Overall, they find no statistical evidence to indicate that dividend yields affect stock returns.

They further argue that previous studies found a significant effect of dividend yields on returns as movements in prices dominate dividend yields. Thus the regressions suffer from biases as the right hand side variables are correlated with lagged dependent variables. Goetzmann and Jorion by using the bootstrap methodology explicitly incorporate the lagged price relation between returns and dividend yields and hence find no evidence of the significance of dividend yields.

Goetzmann and Jorion further claim that another reason for the results of the preceding studies is that both returns and dividend follow random walks and hence, following the result of Granger and Newbold (1974), the combination of the two series in a regression could result in spurious conclusions regarding explanatory power.

Roll and Ross (1994) in their recent paper point out again that a positive and exact cross-sectional relation between returns and betas must hold if the market index used is mean-variance efficient. If such a relationship were not found then this would suggest that the proxy used is ex ante inefficient. They further iterate that given that direct tests have rejected the mean-variance efficiency for many market proxies (e.g. Shanken (1985) and Zhou (1991)) it is not surprising that empirical studies find that the role of other variables in explaining cross-sectional returns is significant. However, what is surprising is the fact that some studies (e.g. Fama and French (1992)) find that the mean-beta relationship is virtually zero.

Roll and Ross then analyse where an index would have to be located to yield a specific relationship (including no or zero covariance) between a set of true betas and true expected returns. More specifically, they accomplish this by solving the following programme:

Minimise portfolio variance subject to the constraints:

- (a) the portfolio's expected return is a given value;
- (b) the portfolio weights sum to unity;
- (c) and the cross-sectional regression of expected returns on betas has a particular slope.

Solving the above programme and defining k = the cross-sectional covariance of R and β , i.e. the numerator of the OLS slope from regressing individual expected returns on betas, they show that in the special case of $k = 0$, the market proxy (which gives a zero cross-sectional relationship between returns and beta) lies within a parabola which is inside the efficient frontier except for a tangency at the global minimum variance point. This is shown in figure 2 below.

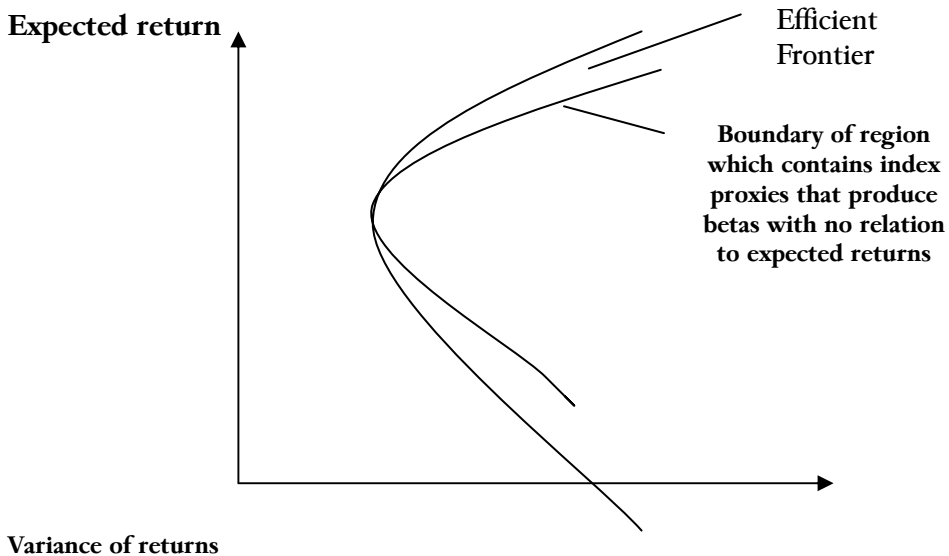


Figure 2

Roll and Ross then showed that assuming reasonable parameter values, a proxy which is just 22 basic points below the efficient frontier can give a cross-sectional mean-beta relationship that is actually zero. Hence, even small deviations of the market proxy index from the true market portfolio can give the wrong answer! Thus, a market proxy can be substantially inefficient and yet produce a strong cross-sectional relationship between expected returns and betas. Conversely, an index proxy can be quite close to the efficient frontier and still give a zero cross-sectional relation.

The situation is further aggravated by the presence of sampling error. With sampling error the power of cross-sectional tests is further reduced and therefore the probability of not rejecting a zero cross-sectional relation when the slope actually is not flat, may be quite high.

Thus a slope equal to or near zero tells us nothing about the validity of the SLB model.

The results of Roll and Ross are similar to those of Kandel and Stambaugh (1987), (1989). Kandel and Stambaugh after deriving the correlation between an arbitrary portfolio and the efficient portfolio, derive tests for the efficiency of an unknown index proxy with a given correlation with the true index. They thus argue that an unambiguous test of the CAPM can still be conducted *conditional* on the assumed correlation of the proxy with the true index.

Roll and Ross in their paper also show that depending on the econometric technique used, one can get a range of differing results with the same data. In particular they propound that the use of GLS instead of OLS always produces a positive cross-sectional relationship between expected returns and betas. This is true regardless of the efficiency of the proxy as long as the return on the proxy is greater than the return on the global minimum variance portfolio.

It is not surprising therefore that Amihud, Christensen, and Mendelson (1992) by using the superior technique of GLS, and by replicating Fama and French tests find that in contrast to the results of Fama and French, beta significantly affects expected returns.

Kandel and Stambaugh (1995) advocate the use of GLS as they show that by using GLS, R^2 increases as the proxy lies closer to the efficient frontier and vice versa. Thus the use of GLS can mitigate the extreme sensitivity of the cross-sectional results to deviations of the proxy from the true market portfolio. However, the problem with GLS is that the true parameters are unknown and hence the true covariance matrix of returns is also unknown. Furthermore, since the use of GLS results in almost every proxy producing a positive cross-sectional relation between mean returns and beta, hence unless other tests of efficiency are carried out, the results are by themselves of little significance.

7. Conclusion

Considering the arguments above, there is no doubt that it is not easy to give an unambiguous conclusion. On the one hand, there is strong

empirical evidence invalidating the CAPM and on the other hand it is clear that the empirical findings themselves are not sufficient to discard the CAPM.

Indeed, as noted by many authors including Fama and French in their recent article, "The CAPM is wanted, dead or alive", the empirical tests have been undermined by the inability to observe the true market portfolio. In effect, even though the 'synthetic' CAPM based on the proxy market index can be rejected, nevertheless it is virtually impossible to reject the original CAPM.

Nonetheless, since the true market portfolio cannot be observed it is fair to say that the CAPM is of little use for practical purposes. It cannot be used for estimating the cost of capital, to evaluate the performance of fund managers or as an aid in event-study analysis. This does not imply, however, that its substitute, the synthetic CAPM be used instead because as already seen there is a host of evidence against this form of the CAPM.

Given that we will have to work with the proxy index in the foreseeable future, thus for practical purposes, Merton's intertemporal CAPM or some form of the APT would have to be resorted to for the purpose of explaining expected stock returns.

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The Day of the Week Effect in the Pakistani Equity Market: An Investigation

Fazal Husain*

This paper investigates the day of the week effect in the Pakistani equity market. Using daily data on eight sector indices as well as the general market index from January 1989 to December 1993, the analysis did not find, in general, significant differences in stock returns across trading days in the market. An overtime analysis indicates the presence of this anomaly in the period before the market was opened to international investors which disappeared in the later periods.

Abstract

An active area of investigation in finance literature is to explore the existence of a pattern in stock returns. A predictable pattern is evidence against market efficiency. Even if the pattern does not seem to affect the stock returns directly, it can provide useful clues to investors concerning their investment decision.

One of the significant patterns identified is the day of the week effect which implies that stock returns are not distributed identically across the days. For example, in the U.S. capital market, rates of return on Mondays tend to be negative while those on Fridays tend to be high. Cross (1973), French (1980), Gibbons and Hess (1981), Keim and Stambagh (1984) and others consistently observed lowest returns on Mondays, termed as the 'Monday effect'.

Similar kinds of effects have been found in other capital markets. For example, Jaffe and Westerfield (1985 a,b) observed the Tuesday effect in the Japanese and the Australian capital markets, whereas Broca (1992) found the Wednesday effect in the Indian capital market. On the other hand, Malaikah (1990) and Aybar (1992) did not find any evidence of the day of the week pattern in the capital markets of Saudi Arabia, Kuwait, and Turkey. At present, there is no satisfactory explanation for this anomaly. Perhaps evidence from other capital markets will provide some clues to explain the phenomenon.

* The author is Senior Research Economist at the Pakistan Institute of Development Economics, Islamabad.

This paper investigates the day of the week effect in the Pakistani equity market using daily sector indices from the Karachi Stock Exchange (KSE), the main equity market in Pakistan¹. The market has been the subject of significant changes in the 1990's. Like other developing economies, Pakistan has also taken significant steps towards the development of its capital markets. Various measures have been taken for privatisation, economic liberalisation, relaxation of foreign exchange controls, and the easing of regulations on the repatriation of profits, investment and operation of financial institutions. The most significant step was the opening of the equity market to international investors in February 1991.

The paper is organised as follows. The first section describes the data and the sample. Section II discusses the methodology, whereas results are presented in section III. The final section is the summary and conclusions.

Data and Sample

The data consist of eight sector indices besides the general market index, covering the period from January 1, 1989 to December 30, 1993. The data were obtained from the files of the State Bank of Pakistan, the central bank, that prepares and maintains these indices. The general index, called the State Bank General Prices Index, covers all the stocks listed on the exchange.

The analysis was done for the full sample period as well as for three sub-samples to examine the effects of liberalisation measures, particularly the opening of the market to international investors, announced on February 7, 1991. The first sub-sample consists of the period before the market was opened.

The market became bullish after its opening and unprecedented trends were observed. It appears, however, that the market overreacted in that period because it was followed by a correction phase, (IFC 1993). This first year of the opening of the market, characterised by overreaction and/or the correction phase, constitutes the second sub-sample period. Finally, the third sub-sample consists of the period from one year after the opening of the market to the end of the sample period.

¹ Interested readers can see Mirza (1993) and Khan (1993) for comprehensive information concerning the evolution, regulations, and operations of the Pakistani equity market, particularly the KSE.

Methodology

In Pakistan, the trading days are different from the usual days of Monday to Friday². Further there was a change in the trading days during the sample period. Earlier the trading days were Saturday to Wednesday which was changed to Sunday to Thursday in June, 1992.

The change in trading days during the sample period caused some problems in examining the day of the week effect for the full sample. In order to overcome this difficulty it was decided to treat the trading days as the sequence of the days, i.e., first trading day, second trading day etc., instead of the labels of the days i.e., Sunday, Monday etc. With this adjustment, the day of the week effect was examined by the following regression.

$$R_t = \lambda_1 + \lambda_2 D_{2t} + \lambda_3 D_{3t} + \lambda_4 D_{4t} + \lambda_5 D_{5t}$$

Where R_t is the return at time t , calculated as the first log difference i.e., $\ln P_t - \ln P_{t-1}$, and

$D_2 = 1$ for second trading day (Sunday for earlier period and Monday for later period),

$D_3 = 1$ for third trading day (Monday for earlier period and Tuesday for later period),

$D_4 = 1$ for fourth trading day (Tuesday for earlier period and Wednesday for later period),

$D_5 = 1$ for fifth trading day (Wednesday for earlier period and Thursday for later period).

λ_1 represents the mean return on the first trading day whereas λ_2 to λ_5 indicate the shifts in mean return across days. Significant values of λ 's imply significant shifts in mean return, thus confirming the existence of the day of the week effect.

To examine the effects of the opening of the market, the analysis was also done for the three sub-samples. However, it was confined to the indices only to make the comparison simple. Further, in these analyses the labels of the days were used. The use of labels reduced the third sample to June, 1992 to December, 1993.

² The trading days changed to Mondays to Fridays in 1997.

Empirical Results

The results show some evidence of significant differences in mean return across days. However these cases are very few relative to the whole sample. Hence it can be generally inferred that the market does not have any day of the week effect.

One reason of not finding any conclusive result may be the change of the days during the sample period. In other words, it may be possible that investors give more preference to the labeling of the days. Some people may consider some days lucky for them and they do not care whether it is a first trading day or any other trading day. In order to capture this behaviour as well as to examine the effects of the opening of the market, the analysis was done for the three sub-samples using labeling of the days instead of sequence.

For the first two periods the trading days were Saturday to Wednesday. Hence the constant represents the mean return on Saturday whereas the label dummies represent the differences in mean, relative to Saturday's mean. It can be seen that in the first period, the period before the market was opened, there is evidence of negative returns on Saturday, the first trading day. Although, these returns are not significant, these to some extent match with the negative Monday effect, observed in the USA, where Monday is the first trading day. In contrast, in the second period, the period immediately after the market was opened, there is conclusive evidence of significant positive returns on Saturday.

In the third period the trading days were different, that is, from Sunday to Thursday. Hence the constant term representing the mean return on Thursday, the last trading day. Here too there is some evidence, although not significant, that the average returns are lower on Sunday and Monday, the first two trading days. A comparison of the results of three periods suggests that there is some evidence of significant differences in mean return across days in the period before the opening of the market, but these differences tend to disappear in the periods after the market was opened. Hence, there is no conclusive evidence of any day of the week effect in the market.

Summary and Conclusion

The objective of the paper was to investigate the existence of the day of the week effect in the Pakistani equity market. Using daily data on eight sector indices as well as the general market index from January 1989 to December 1993, the issue was examined by regressing stock returns on

dummies for trading days. To overcome the problem of change in trading days during the sample period the trading days were identified as the sequence of the days i.e., the first trading day, the second trading day, etc.

The results did not indicate, in general, any significant differences in stock returns across days in the Pakistani equity market. An analysis of this anomaly overtime indicates its presence in the market earlier in the form of lowest returns on Saturdays, the first trading day. However, the behaviour tends to disappear after the opening of the market to international investors. Though the paper indicates identical distribution of stock returns across days in the Pakistani equity market, a thorough analysis will be useful to understand the anomaly in the context of Pakistan.

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Postmodernism/Poststructuralism: A Theoretical Perspective

Saeeda Shah*

Theoretical underpinnings of research are highly significant for the academic value of that study. Qualitative studies are increasingly using poststructural constructs as theoretical frames. This paper will briefly discuss postmodernism and poststructuralism, together with the aspects where poststructuralism has a relevance with Islamic philosophy, highlighting the points of convergence.

Introduction

In a world of multiple causes and effects, looking for black and white is turning a blind eye to limitless shades and colours created at diverse intersections. Any particular phenomenon is shaped by historical and cultural specifications interacting in a complex way. Putting these into neat categories across sharp divisions hampers the possibilities of knowledge that can be formulated at limitless points and interstices. Traditional Western philosophical thought was constructed around dualities and dichotomies that imposed “homogeneity and identity upon the heterogeneity of material” (BenHabib: 1992: 208). Post-structural epistemology involves attention to diversity, plurality and relations of power. It offers possibilities by opening spaces for voice/s, and provides a framework to position the ‘subjects’. According to Gaby Weiner, two aims of post-structuralism are:

“It seeks to deconstruct, to analyse the operations of difference and the way in which meanings are made to work. [Second,] It also offers the possibility for the production of a counter discourse (or reverse discourse) which challenges meaning and power” (Weiner: 1994:101).

Poststructuralism is generally defined as a variant of postmodernism or as “a subset of a broader range of theoretical, cultural, and social tendencies which constitute postmodern discourse” (Best and Kellner: 1991:25). This requires a brief discussion of postmodernism along with poststructuralism. The two terms are often used loosely and interchangeably (Sarup: 1988: 118), which adds to the confusion and ambiguity surrounding the terms, but it also signifies their essence. Generally, postmodernism is associated with art, architecture and culture, and post-structuralism with literary theory, philosophy and history – but the shared standpoint is a rejection of metanarratives linked with specific notions of self, subject, and knowledge.

* The author is Dean, University College of Home Economics, Mirpur, Azad Kashmir.

Postmodernism

In any discussion of postmodernism, the argument inevitably focuses on modernism. Understanding and reading of any 'post-' concept or situation requires an investigation of the pre-post phenomenon. The post- of the modern equally has been problematic. According to Habermas the term modern expresses a 'transition from the old to the new' (1985:3). By pre-fixing it with post- it becomes a self contradiction (Bordo:1992). This problematises post-modernism with relation to modernism¹.

Postmodernism is explained and theorised in multiple ways which has a conceptual relevance to its rejection of absolutes, and a critique of the "tendency of definitions to conceal as much as they reveal and to maim and obfuscate while pretending to clarify and straighten up" (Bauman: 1997: 165). It is explained as a falling apart of 'unified world-views of religion and metaphysics' (Habermas: 1985: 9), a break with modern politics (Said: 1978) and nation-states (Ahmed: 1992), and a continuation/extension of modernism (Baudlard: 1985). On the other hand, it is critiqued as non-historical and located in an eternal now (Eagleton: 1991), irrational, relativist, nihilistic (Gellner: 1992), and many more. The differences are within and across postmodernisms and the critiques; and they emphasise ambiguity, fragmentation and hybridity emphasising that the term is "itself a *site* of continuing controversy and reflection" (Slater: 1994:87).

The half-hearted efforts to categorise post-modernism probably reflect the discomfort of operating outside categories. One critique of postmodernism is directed at the **notion of 'other'**. From a postmodern perspective, 'other' implies recognition of plurality and fragmentation, perceived as 'political saturation' by Rosie Braidotti (1992). She argues that the postmodern subject is "a subject in process, organised by a will to know and a desire to speak" (1992: 183). This is an acknowledgement of the authenticity of other voices, but is seen by critics as depriving them from "access to more universal sources of power by ghettoising them within an opaque otherness" (Harvey: 1990: 117), leading to 'loss of voice'. However, seeing post-modernism as merely relativistic is fixing it in a frame which would be contrary to a post-modern perspective. I prefer to see it with Ali Rattansi as decentering, de-essentialising and shifting, offering possibilities for restructuring and redefining the frame itself to suit the research aims; a post-modern frame which attempts to highlight and destabilise the overlapping and cross-cutting binaries "always potentially unstable and held in place by networks of power and knowledge, discursive structures and

¹ For an interesting discussion of this debate see chapter one in Stronach, Ian and MacLure Maggie: 1997: *Educational research undone: the postmodern embrace*. Buckingham: Open University Press.

strategies” (1994: 47). According to Ali Rattansi (1994), the strength of postmodernism is that boundaries cannot be drawn, as the argument informing this frame is “exposing the relative arbitrariness of boundary formation in social and intellectual configurations, and an interrogation of the policing of these borders by the disciplinary apparatus of power/ knowledge” (1994: 22). It draws into focus new forms of division, hybridisation, fusion, fracturing and recomposition, and a redrawing of boundaries.

This stance announces the **end of metanarratives**. Discussing postmodern distrust of metanarratives, Sarup sees it as signaling “a crisis in a narrative’s legitimising function, its ability to compel consensus’ (1988: 132). Grand narratives are critiqued for association with a political programme and for being oppressive in intentions. The situatedness of narratives and an **emphasis on culture as a social force** has significance for analysing education and its socio-economic dimensions. A postmodern perspective gives ‘importance to cultural analysis in social theory’ (Blake: 1996: 62) and “forces us to recognise the significance of cultural representations for understanding influences and responses to education” (Skeggs: 1991: 261).

A post-modern perspective is an ontological and epistemological shift from the rational ‘I’ to a **constructed and situated ‘I’**. There occurs a “noticeable shift in sensibility, practices, and discourse formations which distinguishes a post-modern set of assumptions, experiences, and propositions from that of a preceding period” (Huysen: 1998: 181). The epistemological break is marked with the death of ‘the subject’, posing challenges to ‘the classical episteme of representation’ (BenHabib: 1992: 205). It critiques the tradition of thought that imposed homogeneity and identity upon the heterogeneity of matter, and challenges ‘transcendental guarantees of truth’:

“It is precisely at the legislative frontier between what can be presented and what cannot that the postmodernism operation is being staged – not in order to transcend representation, but in order to expose that system of power that authorises certain representations while blocking, prohibiting or invalidating others” (Owens: 1985).

A presumed ‘epistemological ambivalence’ of postmodernism (Boyne and Rattansi: 1990: 36) at times makes some thinkers – feminists, educationists and others – cautious of its relevance for a cause or programme (Braidotti: 1991; Lovibond: 1990; Skeggs: 1991). The same makes it a target for relativism: a relativism which “entails moral ... [and] cognitive nihilism” (Gellner: 1992: 71). The post-modern point is to

highlight that definitions and analyses are always partial (Lather: 1991: 59), and meaning needs to be constructed situationally. Bauman sees “a genuine emancipatory chance in postmodernity, the chance of laying down arms, suspending border skirmishes waged to keep the stranger away, taking apart the daily erected mini-Berlin Walls meant to maintain distance and to separate” (1997: 33). The smaller localised ‘visions’ acknowledge plurality and hybridity, and deconstruct ‘larger vision/s’; as Braidotti clearly makes the point:

“The only way to find a larger vision is to be somewhere in particular” (1991: 272).

A significant premise of postmodernism is this challenge to the notion of knowing subject and the issue of voicing. It un-fixes the knowing self and recognises it as shifting and multiple constructed, interwoven in a play of power/knowledge:

“A self does not amount to much but no self is an island; each exists in a fabric of relations that is now more complex and mobile than ever before. Young or old, man or woman, rich or poor, a person is always located at ‘nodal points’ of specific communication circuits, however tiny these may be. Or better: one is always located at a post through which various kinds of messages pass. No one, not even the least privileged among us, is ever entirely powerless over the messages that traverse and position him at the post of sender, addressee, or referent” (Lyotard: 1984: 15).

Post-structuralism

Post-structuralism derives from the philosophical tradition of structuralism, but with suggestions of ‘continuity’ as well as ‘contradictions’ between the two (Sarup: 1988: 4). Both offer a critique of human subject and progressive history, doubt the possibility of general laws, emphasise impossibility of being objective, and critique the structure of binary oppositions (Sarup: 1988: 43). Human reality is defined as “a construction, as a product of signifying activities which are both culturally specific and generally unconscious” (Bid: 2). But the differences are there.

While “sharing with the structuralism a dismissal of the concept of the autonomous subject, poststructuralism stressed the dimensions of history, politics, and everyday life in the contemporary world and attacked the scientific pretensions of structuralism which attempted to create a scientific basis for the study of culture” (Best and Kellner: 1991: 20). The argument furthered is that ““meaning is produced not in a stable,

referential relation between subject and object, but within the infinite, intertextual interplay of signifiers” a production of signification that resists structural constraints (Best and Kellner: 1991: 21; Sarup: 1988: 3). It is here that poststructuralism moves away from structuralism, and overlaps with postmodernism can be identified. One fundamental premise shared by poststructural/post-modern analyses is that “subjects are constituted in and through discourses, which provide ‘speaking’ positions, subject-positions, identities and identifications; and that ... discourses clearly have institutional locations” (Rattansi: 1994: 37).

This notion of constructing/re-constructing subjectivity offers promises of un-fixing boundaries and shifting positions, affecting the margins and the centres (Hooks: 1991). It encourages us to “take the risk of reconstructing subjectivities’ to transform cultures and cultural practices (Bordo: 1992: 164). Bordo argues that:

“poststructuralism has encouraged recognition of the fact that prevailing configurations of power, no matter how dominant, are never seamless but are always spawning new forms of subjectivity, new contexts for resistance to and transformation of existing relations. [and] to recognise ‘ body’ as “not only materially acculturated (e.g., as it conforms to social norms and habitual practices of “femininity” and “masculinity”), but it is also mediated by language: by metaphors, and semantical grids (e.g., binary oppositions such as male/female, inner/outer) that organise and animate our perception and experience” (Bid: 167).

Qualitative paradigms and interpretivism “rely on the interactional, adaptive and judgmental abilities of the human inquirer” (Greene: 1994: 538). The argument offered for the relevance of ‘**human as instrument**’, particularly for researching social phenomenon, maintains that to guard against social biases, objectivity implying neutrality and detachment, is not possible (Guba and Lincoln: 1985). It holds that by making explicit all the subjectivities, contextual conditions, and constraints, the research for situated truths and lived realities can be facilitated.

Poststructuralism provides a methodological tool not only to locate the subject in the discourse but to analyse the discourse formative practices as well. A post-structural framework emphasises discourses and texts, that produce and are produced by social institutions. Language gains an importance as constitutive of reality and subjectivity even while the meaning shifts and reformulates in a situated interplay of discourses and subjectivities. Foucault developed discourse as an analytical tool to illuminate how struggle over meaning is saturated with **power and**

knowledge. He re-conceptualised power as a network of strategic relationships, and knowledge became a metaphorical domain:

“once knowledge can be analysed in terms of region, domain, implantation, displacement, transposition, one is able to capture the process by which knowledge functions as a form of power and disseminates the effects of power” (Foucault: 1977).

Meaning shifts with the ‘form’ and ‘effects’ of power as diverse social, cultural, political, institutional and other factors interact. This interplay problematises the notions of ‘self’ and ‘truth’. This view of meaning rejects universal totality, whole truths and complete answers. The emphasis is on the particular and the situated, with an acknowledgement of complexity, diversity, plurality and fragmentation. Post-structuralism argued against the fixed oppositions which restrict understanding of a complex, multifaceted world with diverse cultures and historical specifications. It is relevant as a methodological tool, with sufficient sensitivity and flexibility, to analyse the complexities and inter-relationships of a situation and its power dimensions.

An analysis guided by poststructuralism implies recognition of diversity and plurality, producing spaces for inter-discursivity. It acknowledges a need for critical exploration of similarities and differences, providing spaces for a multiplicity of voices which can enhance perception and understanding, and subsequently enrich theorising. However, there are multiple issues interfering with this opening up of spaces for silenced voices. The questions are, as Said sees them:

“Who writes? For whom is the writing being done? In what circumstances? These, it seems to me, are the questions whose answers provide us with the ingredients making for a politics of interpretation” (1985: 135).

One requirement of the interpretive paradigm and post-structural approach is to make explicit the discursive positioning of those involved in knowledge-construction and interpretation. A post-structural approach aims at developing a voice among those who have been historically silenced and/or marginalised, providing opportunities to speak, to question, and to explore:

“Voice as a form of protest is directed both outward at the social construction of meaning making and the structures that reinforce those meanings, and inward at the way the individual takes part in the production of certain constrained beliefs, roles and practices” (Giltin and Russell: 1994: 186).

And there is also the demand that:

“You have to pass through certain rules of accreditation, you must learn the rules, you must speak the language, you must master the idiom and you must accept the authorities of the field To which you want to contribute” (Said: 1985: 141).

How far is it possible to achieve this end of allowing voices to be heard, is a complex issue where reporting, analysis, interpretation and many other factors are involved. Another dimension to the issue in a Muslim context is Islamic philosophical thought, as post-structuralism is essentially a Western theoretical construct; and this is discussed in the next section.

Islam and post-modern/post-structural perspective

From a post-modern/post-structural perspective, the subject and the social are constantly under construction and transformation, with invariably shifting boundaries. Does this decentring and de-essentialising frame fit an Islamic perspective? Or is postmodernism a Western/non-Islamic project? Considering a similar question regarding modernism –“Is it a Western project?”, Anthony Giddens’ answer was a cryptical ‘Yes’ (Giddens: 1990: 175); and this brings the debate back to historically prescribed East/West dichotomy.

Modernism had different implications across this eco-politically charged divide and involved myriad factors, which are beyond the scope of the present discussion. A relevant aspect here is that in the East, particularly among Muslims, modernism was regarded with a wariness. It was welcome because politico-historically it coincided with the end of colonialism, and the establishment of Muslim states². Economically, it offered possibilities of progress and development. But, ideologically its secularism implied a move away from religion and challenged the socio-cultural fabric, and that was perceived as a threat by Muslims. There have been influential modernist figures among Muslims like Sir Syed Ahmed Khan (Malik: 1980), Syed Jamal-ud-Din Afghani (Keddie: 1972) and Mohd Abduh (Badawi: 1978; Kedourie: 1966), but, in general, it was a love-hate relationship: identifying with some aspects of modernity and disavowing others (Ahmed: 1992: 29-31). With postmodernism again the ‘predicament’ is:

² For further details Esposito, John L and Voll, John O: 1996: Islam and democracy. New York: Oxford University Press; Ruthven, Malise: 1991: Islam in the world. Harmondsworth: Penguin Books; and Schimmel, Annemarie: 1992: Islam: an introduction. Albany: State University of New York Press.

“How can the Muslims retain their central Islamic features in the face of the contrary philosophy of the post-modern age”, and

“How does a religious civilisation like Islam, which relies on a defined code of behaviour, and traditions based on a holy book, cope in an age which self-consciously puts aside the past and exults in diversity” (Ahmed: 1992: 5).

Discussing the question, Ahmed makes the argument that in spite of the postmodern spirit of pluralism and a heightened scepticism of traditional orthodoxy, religious revivalism can be understood as “both cause and effect of postmodernism” (1992: 13³). Modernism was understood in the Muslim world as distancing and alienating people from religion. The Islamic revival in the 1970s which challenged the modern nation-states, historically coincided with postmodernism. In spite of philosophical differences, there exist points of convergence.

Accommodating the notion of revealed knowledge and a coherent system of values in Islam with the post-modern rejection of metanarratives is problematic. But I agree with Akbar Ahmed that “postmodernism also promises hope, understanding and toleration – and this is where it connects with Islam” (Ahmed: 1992: x). The spirit of inquiry, drive for self-knowledge, celebration of diversity, and emphasis on tolerance and understanding, are essential caveats of Islam, which connect with post-modern ‘toleration’. In Islam, this tolerance and understanding extends even to religions:

“There shall be no compulsion in religion” (the Quran: 2: 256); and

“Your religion for you and mine for me” (the Quran: 109: 6)

There is another dimension of relevance. Early Hadith methodology required to ‘record faithfully’ and establish *isnad* (authenticity) through a chain of reliable transmitters and making these sources of ‘transmission’ explicit (Mernissi: 1991: 35). This required to clarify the positioning of the ‘narrator’ and transmitter/s of *hadith/s* and of the researcher/collector, and emphasised making explicit as to who transmitted and who verified it, to confirm the validity and reliability of investigations (Azami: 1977: 58-67). Traditionally, the authenticity of a *hadith* was established through an analysis of the positioning and the subjectivities of the participants, the collectors and the transmitters, as well as the process of research and collection. Theoretically, it was a qualitative approach, which put value on

³ See also Bauman, Zygmunt: 1997: Postmodernity and its discontents. Cambridge: Polity.

the participants, their subjectivities and positioning, ignoring the mere numbers of the transmitters or verifications.

This has a pertinence for post-structuralist epistemology which negates 'episteme of representation' and emphasises that the subject is created in the conflux of multiple influences and contextual forces. Islam encourages *ijtihad*⁴ (innovative judgement) *shura* (consultation), and *ijma* (consensus), and thus acknowledges the value of opinions and perspectives. Ahmed quotes a dialogue between the Prophets and Muadh ibn Jabal, a judge on his way to Yemen. The designated judge was advised to decide a problem according to the Quran, but if guidance was not there, then according to the *Sunnah*, and if not there either, then to use his own judgement (Ahmed: 1992: 120). This acknowledgement of a plurality of perspectives provides a space within an Islamic context where a poststructural frame gains relevance.

At one level, distances between the dominant Islamic philosophy of knowledge and truth and corresponding poststructuralist notions seem tremendous. But if we move from the 'revealed' to the 'acquired' and 'constructed' knowledge, recognising epistemological difference between the two, and understand post-structuralism as problematizing (not rejecting as such) universals and truths (Weiner: 1994: 99), some theoretical contradictions can be resolved.

With the increasing use of qualitative methodology in research, and because of a general concern with the issues of 'self' and 'identity' these theoretical debates are drawing more and more attention. No explanation is final but each adds to the development of theory, pointing to further possibilities and venues.

⁴ Maududi (Maududi, Sayyid Abula'la: 1980: The Islamic law and constitution; translated and edited by Khurshid Ahmad. Lahore: Islamic Publications. Pakistan. Pp. 72-92) explains the notion of *ijtihad* in Islam. Although he considers it from the perspective of Islamic law and constitution with reference to Pakistan, but the discussion is also useful for an understanding of this concept in general.

⁵ Here I am referring to that content of revealed knowledge where compliance is demanded and which pertains mostly to faith.

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Developed Countries' (DC) Buyers Apply Higher Levels of Power over the Exporters from A Country such as Pakistan: A Perceptual Study

Muhammad Ehsan Malik*

Abstract

The power aspect in conceptualising importer-exporter interaction is very critical, but few studies are available concerning this issue in the context of export distribution channels. This article explores the power-related dimension of importer-exporter interaction.

An effort has been made to discern the pattern of perceptual differences between a number of importer-exporter pairs. It has been found that broadly speaking, the importer exercises higher levels of power over the exporter rather than vice-versa. But the perceptual differences between the importer and exporter do not follow a systematic pattern. Research efforts have significant implications for the exporters' community, generally in developed and particularly in developing countries such as Pakistan.

Introduction

Power, a much broader concept than authority, is the ability of individuals or groups to induce or influence the beliefs or actions of other persons or groups (Koontz and Weihrich, 1993). Research with regard to export marketing has mainly focussed on such broad areas as: export strategies (Baker and Abou-Zeid, 1982, Crick, 1995); export initiations (Czinkota, 1994); the impediments and parameters related with export success (Czinkota and Ricks, 1983, B. Ramaseshan and Geoffery N. Soutar, 1996); export development models (Bilkey and Tesar, 1977, Cavusgil, 1980, Cavusgil & Yeo, P.L., 1994).

On the other hand, behavioural aspects related to export marketing channels have been largely ignored in Pakistan. Relatively little attention has been given in the marketing literature to export from less developed countries (LDCs) such as Pakistan, despite the fact that export development of manufactured products constitutes a vital input to enhancing their industrialisation and in turn, improving their economic outlook. The issue of power has been focused on the understanding of distribution channels as

* The author is an Assistant Professor at the Hailey College of Commerce, University of the Punjab, Lahore.

behavioural systems in this article. Effort has also been made to analyse importer-exporter interaction and to identify the underlying pattern of perceptual differences between the two parties.

Power

The general concept of power stipulates the ability to make someone acquiesce to doing something that he or she would not have done. In the marketing channels' paradigm, power is defined as a member's "ability to control the decision variables in the marketing strategy of another member in a given channel at a different level of distribution". In this paradigm it implies an importer's ability to influence the behaviour of an exporter as "the mechanism by which the channel is organised and orderly behaviour preserved" (French, Jr. and Raven, 1978).

Some marketing analysts view the above behavioural paradigm as synonymous with power. However, most scholars discriminate between these concepts, where power is considered "the ability to alter..." whereas influence or control refer to "the actual changing... resulting from the application of power" (Butaney and Wortzel 1988).

In this study, it is the exercised/unexercised power framework that is adopted. The exercised power is the control or actual alteration of another's behaviour, whereas unexercised power is associated with the ability to control or alter another's behaviour (Gaski 1984). It is clear that in channel relationships there is an imperative for each party to exercise mutual power in the interaction with its channel partners, as channel members must take each other's efforts into consideration when they attempt to achieve their own objectives (Frazier 1983).

Review of Literature

By analysing the association between channel control and success, Ahmed has (1977) revealed:

- *That the exporter did not practise tight control over the importer*
- *And that there was very weak interaction between the extent of the exporter's degree of control and the importer's market penetration.*

Nevertheless, it should be noted that Ahmed's attempt can be regarded as simplistic in both theoretical and methodological terms. In an empirical study, Leonidu (1989 & 1995) attempted to conceptualise the pattern of behaviour by indigenous manufacturers of consumer products

based in *developing countries*, in the context of their working relationship with importers in *developed countries*.

It was established that the importer exercised higher levels of power in areas concerning the marketing side of the business association, while the exporter confined its exercised power to the production side. The importance of this research lies in the fact that it provides considerable guidance in the development of effective models for further research in the field.

Hypotheses development

It has been argued that indigenous manufacturers in LDCs possess low marketing skills, since marketing is viewed as a marginal function by the management of the firms (Kaynak and Hudana 1987). Such manufacturing firms are unlikely to successfully market their products abroad, particularly in developed countries. They rely mainly on their own policies and capabilities that result in the following factors:

- *Short-term marketing plans;*
- *Cost-based pricing;*
- *Limited promotional activities;*
- *Ineffective marketing research (Kinsey 1988);*
- *And, 'bad habits' developed by operating in a domestic market which is characterised by 'sellers' conditions' in many sectors (Malhotra and Leonidou 1988, Frazier et al. 1989).*

On the other hand, there is evidence that the developed country-based importer plays a crucial role in the decision making process with regard to the strategic marketing issues associated with imported products from the LDC's framework. The importer, for instance, dominates on such issues as:

- *Product design and Packaging,*
- *Quality control by inspecting the finished goods (such as ISO 9000),*
- *Inventory levels,*
- *Final selling price,*
- *Promotional activities and so on.*

Based on the above premises, the following hypothesis can be developed:

In the interaction between Pak Exporters and Developed Countries' (DC) Buyers, the importers apply higher levels of power over the exporters, in their mutual relationship.

Checkland (1981) demonstrated very rightly that people observe the same reality from the perspective of their individual world view depending on their past experience. Similarly, one would expect the exporter and importer to have a differential in their perception with respect to the exercised power in the association. This can be ascribed to in the different:

- *Ethnic origins and backgrounds,*
- *Norms and values,*
- *And importer-exporter interaction.*

It has also been speculated that in a channel interaction one member's perception of power, conflict, satisfaction, etc., will be inversely related to the perception reported by the other party (Gaski, 1984). Thus,

In the interaction between Pakistani Exporters and Developed Countries' (DC) Buyers, there are perceptual differences between the importers and exporters, with regard to exercised power. The one party's perception of the level of exercised power is diametrically different to that reported by the other party.

Methodology

A model can now be constructed comprising a developing country such as Pakistan and a DC. Any DC country is a typical developed country significantly involved in import activities from many countries, and is also considered a major market for a country such as Pakistan. On the contrary, Pakistan is a very small and less developed country highly dependent on its trading activities, especially with the developed countries.

Since only exercised power affects another's behaviour, a number of variables were employed to assess the aspect of exercised power. The final list of items was developed with the help of five export managers and two academicians familiar with research on channel behaviour. Exercised power was operationalised as a member's degree of participation in decision making on a number of important issues of his/her partner. The questionnaire of two forms was pre-tested in personal interviews with seven sales managers in

Pakistan and three DC importers (e.g. from UK, Germany and Holland were interviewed through friends) in an attempt to ensure that the instrument was as reliable as possible.

The sampling frame of Pakistani exporters was identified from the Karachi and Lahore Chambers of Commerce and Industries and Export Promotion Bureau (EPB) of Pakistan, while that of the DC importers were identified from the Trade Information Directory published by ITC/UNCTAD/GATT with regard to import Promotion Offices (IPOs) in EU countries. All firms in each sampling frame were requested to take part in the study. The overall usable sample included 34 Pakistani exporters and 13 DC importers responded. The product samples involved in the study were:

- *Textile manufactured products,*
- *Leather garments,*
- *Sports goods,*
- *Surgical instruments*

Data collection

In collecting the data, the key informant technique was employed. However, it has been argued that this technique has certain limitations associated with the complexity of the social judgements involved, positional bias, and ignorance of facts, which in turn can introduce considerable measurement error. In view of these deficiencies, a series of measures were taken to minimise the potential for systematic and random sources of errors as follows:

- *Information collected about a specific interaction in each case,*
- *Interviewers were requested to check the facts with other company personnel,*
- *Interviewers had to determine relevant marketing policy decisions and contact with appropriate individuals, identified by the importers and exporters.*

The fieldwork was conducted in two stages. The exporters' data were collected in Pakistan during 1996, while DC importers' data were collected during October 1995-February 1996.

Hypothesis 1

Power variables (e.g. packaging, products covered, final selling price, promotional activities, transportation methods, inventory levels, unit ordered mix, sales force organisation, territorial and customer restrictions, and marketing research). Based on the perception of Pakistani exporters, it was revealed that in present business interactions DC importers exercise higher levels of power in those decision making areas which are related to the power variables. On the contrary, Pakistani exporters were found to prevail over the DC importers in the decision making process associated with the following four areas:

- *Product quality,*
- *Quality control (ISO 9000),*
- *Manufacturing process,*
- *Payment terms.*

Joint basis decisions between the exporters-importers in the other marketing areas, in accordance with the results, were shown as under:

- *Product design and style,*
- *Brand name,*
- *Selling/purchasing price,*
- *Minimum order size,*
- *Delivery schedules,*
- *Trading with other DC importers.*

The DC importers were found dominant in the interaction with the Pakistani exporters in the following areas:

- *Large size of the importer's firms,*
- *Strong financial positions,*
- *Proximity to the market,*
- *Access to a large number of alternative exporters from LDCs,*
- *Entailing low degrees of dependence on the Pakistani exporters' habits,*

- *Superior marketing capabilities developed by operating in an “export market framework”.*

Hypothesis 2

The existence of perceptual differences between the importer-exporter in the pairs studied adds to empirical evidence by research, that, by carrying out inter-group comparisons, a “conflict gap” was identified between the perceptions of UK manufacturers and those of their German intermediaries. In this research study, the perceptual gaps can be explained by differences in the task that each member had to perform in the interaction activity, by the fact that the exporters and importers appeared to have different backgrounds in terms of:

- *Values and Norms,*
- *Political and Economic,*
- *Socio-Cultural and Technological Factors.*

The above factors, in turn, have affected the perceptual as well as behavioural outcomes accordingly.

This study described that in general, the interaction was governed by imbalance of power exercised by DC importers over the Pakistani exporters. The sound market knowledge and superior marketing skills of the DC importers were found to be complimentary to the production capabilities of the Pakistani exporters.

As a result, full acceptance of Gaski’s speculative hypothesis that exercised power will decrease satisfaction and increase channel conflict may substantially be questioned, as a result of the exercise of expert power in the interaction activity.

Conclusions

The aim of this article was to study the working interaction of Pakistani exporters with DC importers, and to shed light on the magnitude and pattern of potential perceptual gaps between that two parties, in the context of exercised power.

The study has described that DC importers, overall, exercise higher levels of power over Pakistani exporters. It was also revealed that in the majority of cases the examined parties were characterised by mutual perceptual gaps but such identified gaps had no discernable pattern.

Pakistani exporters need to recognise that the structural characteristics of foreign markets are different to those prevailing in the domestic markets, hence implying that they should accordingly be treated differently. Pakistani exporters may find advantages in adopting an active export orientation with a planned, organised and systematic approach in carrying out export activities.

Opportunistic and unsystematic involvement may result in under-exploitation of the overseas market potential and may become a major obstacle to such exporting firms. Pakistani exporters appear to be unwilling or, sometimes, unable to contribute to a joint marketing programme with overseas customers which would include:

- *Marketing research projects,*
- *Selling policies and sales force training,*
- *Packaging characteristics and,*
- *Promotional activities.*

Pakistani exporters should direct their efforts towards establishing more joint decision-making on marketing programmes and possibly take the initiative in some other aspects such as:

- *A new product development process,*
- *Product design and style,*
- *Quality standards (ISO 9000),*
- *Packaging features and,*
- *Brand recognition.*

It may sometimes be difficult to draw general conclusions about individual phenomena when the subjects studied belong to a variety of industrial sectors, with its own experiences and configurations, as well as with particular strengths, weaknesses, opportunities, and threats (*SWOT analysis*) in a specific market framework. Finally, the reality of this article is concerned with both sides of the international trading equation, e.g., the *exporters* and the *importers*.

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Economic Policies Continuation: A Critical View of the Eighth Plan 1993-98

Pervez Tahir*

Why Policy Continuity?

Traditionally, five year plans suggest an indicative set of policies to achieve medium-term targets. Operationalisation of these policies, however, takes place through annual plans and budgets, formulation of trade and monetary policies and fiscal measures deemed necessary and announced during the course of a year, the so-called mini-budgets. In recent years, while five year plans have increasingly been seen as analytical frameworks for consistency rather than tight blueprints for discipline, there have been demands, especially from the private sector, that economic policies should be announced for a medium term. Underlying this shift of emphasis are the profound changes that have occurred in economic organisation and management in the country as well as the broad sweep of the forces of rapid globalisation. Of the total fixed investment in Pakistan today, over 60 per cent originates in the private sector. Only a decade ago, the private sector share was well below 50 per cent. Similarly, foreign investment used to be an insignificant component of foreign inflows. It stood at over a billion dollars for three years in a row in the nineties. The degree of openness of the economy has also increased significantly. Exports and imports alone constitute one-third of the GDP. The impact of liberalised financial flows is in addition.

With an expanding role of the private sector, domestic and foreign, and an increasingly open economy, the issue of policy continuity assumes greater significance. (Policy continuity is also important for the public sector, but governments take time in realising the true costs of their mistakes.) Shifting the balance of investment in favour of the private sector is motivated by the need to push up the rate of investment in the economy. Investment acceleration is sought to generate a higher GDP growth, the assumption being that private investment is relatively more productive than public investment. In the Eighth Plan (1993-98), private fixed investment was protected at 56 per cent of the total Plan investment so as to consolidate and build on the Seventh Plan (1988-93) achievement of reversing the balance in favour of the private sector. The Seventh Plan had taken the private investment share to 52 per cent compared to 48 per cent

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in the Sixth Plan (1983-88). It was also expected that 8.8 per cent of the total private investment projected for the Eighth Plan would be foreign investment. As a proportion of GDP, private investment was projected to rise from 9.7 per cent in 1992-93 to 11.8 per cent in 1997-98.

Investment is thus the linchpin. Private sector needs policy continuity because investment has costs; uncertainty kills the drive to incur these costs. Most investments take more than a year to install any capacity to produce and much longer to provide a returns flow to fully pay back. Quick changes of policy stance signal disasters of two types. First, by altering the costs-returns calculus, the investment activities already started would fall sick. Second, new investors are scared away. The economy as a whole pays in terms of lost economic growth and diminished employment opportunities. It can take years to regain the lost momentum, even if the offending policy reversals are corrected quickly. In a globalised world investors have wider choices: foreign investors simply relocate; domestic investors vote with their feet and indulge in capital flights.

Policies of the Eighth Plan

The Eighth Plan had started in the wake of commitments to structural adjustment, deregulation, liberalisation, privatisation and a more open economy for domestic as well as foreign investment. In this general environment, supportive policies in the fiscal, monetary, foreign exchange and trade regimes were to be designed. The private sector was also to be facilitated through adequacy of services and physical infrastructure, education and training, better health coverage and the strengthening of capital markets.

Direct private sector participation was to be encouraged in the energy sector. Private sector entry into power generation had been allowed since 198~, but the Eighth Plan laid down an unequivocal emphasis not only on reserving new thermal power generation for the private sector, but also on privatising the existing thermal power plants in the public sector. In addition, policies were to be laid down to attract private investment in the exploration, development and distribution of oil and gas. In the transport and communications sector, the Plan took note of the transport policy implemented towards the end of the Seventh Plan. Besides road transport, the private sector was to be induced to enter the sub-sectors of communications, aviation, airways, ports and shipping.

Effective policy requires better governance. The Eighth Plan was the first plan to recognise this critical aspect of implementation. The Plan emphasised transparency, accountability, merit, mitigation of the heritage of collusion and promised decisive action against defaulters of taxes, bank loans and utility bills. Public-private partnership was to be promoted in all

activities, with possible cost-sharing, segmentation of activities and BOT arrangements. The need for a satisfactory state of law and order was highlighted. Stability of policy direction, avoidance of volatility and frequency of changes were emphasised. According to the Plan, “the most critical task is the stability of the development environment.”

Clearly the foregoing were broad statements of policy. To look at what was promised in the Plan with some analytical clarity, it is possible to u three broad areas of policy/manufacturing, transport and communication energy. As Table-1 indicates, these were also the areas of priority, in that in tern's of the investment expectations of the Eighth Plan.

In terms of sectoral distribution, the projected private investment broke new grounds. As can be seen from Table-1, quantum jumps were expected in non-traditional areas of private interest such as physical infrastructure. The share of energy would have jumped from negligible in the Seventh Plan to over 14 per cent, while the share of transport and communications was expected to more than double. As a result, a decline had to be projected in the share of manufacturing, the traditional abode of the private sector, and also in agriculture.

Table-1: Sectoral Distribution of Private Investment (%)

	Seventh Plan	Eighth Plan	
	1988-93	1993-98	
	Actual	Target	Actual
Agriculture	15.4	9.5	10.5
Manufacturing	41.1	38.5	32.0
Energy	0.6	14.1	10.5
Transport and Communications	8.9	19.5	7.9
Ownership of Dwellings	21.7	11.7	20.0
Services/Others	12.3	6.7	19.1

Manufacturing and Macroeconomic Policies

The ebbs and flows of the manufacturing sector are most directly affected by the continuity and change in macro-economic policies. The Plan promised the private sector economic stability by bringing down the fiscal deficit from 7.9 per cent in 1992-93 to 4 per cent and thus avoid crowding it out for investment finance, current account deficit from 7 per cent to 2.4 per cent and the annual rate of inflation from 9.3 per cent to 6 per cent. It also envisaged monetary expansion below nominal GDP growth, maintenance of external debt at 36 per cent of GDP, acceleration of privatisation and

retirement of high cost debt by utilising privatisation proceeds, and the rise of national savings rate from 13.6 per cent in 1992-93 to 18.2 per cent per annum. At the micro-economic level, the Plan aimed at competitive markets by lowering the tax rates and broadening the base along with improved documentation and tax compliance, curtailment of special concessions and rent-seeking activities, lowering of tariff structure and integration with the world economy. Anti-export bias was to be eliminated and investment in export-oriented industry was to be encouraged. Disciplined management was expected to pay more attention to productivity and efficiency. Initiatives were to be undertaken to improve the linkages between the small scale and the large scale sector, for shifts towards value-added products, and to establish common facilities and service centres for small and medium enterprises. Promotion of productivity was also stated as an objective.

All these were the so-called good policies, placed firmly within the accepted market-friendly role of the state. The outcome at the end of the Eighth Plan was, however, more instability and less growth. During the period of the Eighth Plan, the share of manufacturing in total private investment was significantly less than the target (Table-1). In constant prices, there were sharp, absolute declines in three out of the five years and, except for the first year, the size was less than the benchmark year (Table-2). The Plan target was missed by a hefty 39.4 per cent for large-scale manufacturing. A low output growth of 2.8 per cent against the target of 10.5 per cent corroborated with the depressed state of investment in the large-scale manufacturing sector.

Table-2: Private Investment in Manufacturing
(Constant 1992-93 Billion Rs)

	Total	Large Scale	Small Scale
1992-93 (Benchmark)	60.1	53.4	6.7
1993-94	62.0	54.7	7.3
1994-95	40.5	32.6	7.9
1995-96	45.7	37.2	8.5
1996-97	44.5	35.2	9.3
1997-98	41.3	31.3	10.0
1993-98 (Eighth Plan total)	234.1	191.0	43.0
Eighth Plan Target	365.2	315.2	50.0
% Achievement of Target	64.1	60.6	86.0

Fiscal deficit in the last year of the Plan was 5.6 per cent rather than the targeted 4 per cent. Though significantly lower than the benchmark figure of 7.9 per cent, the reduction was achieved, rupee for rupee, at the expense of development expenditure, which fell from 5.57 per cent of GDP to 3.2 per cent. It meant the failure of tax reform on the one hand and under provision for social and physical infrastructure on the other. The maximum tariff came down from 92 per cent to 45 per cent, but the reform proceeded by fits and starts, such that it stretched the competitive ability of the import-competing industry more than reducing the anti-export bias. The lack of a productivity policy to prepare industry for efficiency and competition made matters worse. At the end of the Plan period, the current account deficit was 3 per cent of GDP against the target of 2.4 per cent. Comparing the end year with the base year, the export/GDP ratio increased marginally and the import/GDP ratio declined by over 3 percentage points. This sharp reduction in imports adversely affected investment and revenues.

Money and prices behaved as adversely as the other indicators. Persistent fiscal deficits led to annual M₁ growth of 15.7 per cent against the target of 12 per cent. The rate of inflation was as high as 10.9 per cent. The national savings rate fell from 13.6 per cent in 1992-93 to 12.5 per cent in 1997-98. Compared to the target of 18.2 per cent, the average annual rate of national savings was estimated at 12.6 per cent. Medium and long term external debt was maintained at 36 per cent of GDP but the reliance on the more volatile short term debt increased significantly. With the addition of short term liabilities, the external debt rose from 41.5 per cent of GDP in 1992-93 to 45.8 per cent in 1997-98, besides partial divestiture of PTCL shares. Some retirement of the expensive domestic debt took place, as the outstanding amount declined from 45.9 per cent of GDP in the base year to 41.8 per cent of GDP in the terminal year of the Plan. The use of proceeds of privatisation for debt retirement was only to the extent of Rs. 3 billion. Defaulted loans continued to expand, tax compliance was lax and the number of utility bills delinquents was on the rise.

Good Policies, Bad Outcomes

Why have these prescriptions of good policies in the Eighth Plan led to not-so-good outcomes? An important explanation is the gap between the role assumed by the government and its capability. This capability is a function of social and governance capital. Institutions are a critical ingredient. If these institutions are functioning, they are in the nature of rules of the game, the observance of which is gainful and violation costly. Formal rules, together with informal codes and conventions promote predictability of outcomes, reduce uncertainty and promote investment. Rules involve players-

politicians, bureaucrats, business persons and citizens. Weak institutions create incentive compatibility problems, i.e. decision situations like “what is in it for me”. Policy instability is the inevitable result.

The Eighth Plan was formulated in the background of weakening institutions, a process which continued during the Plan period, its intentions to the contrary notwithstanding. The benchmark of ‘1992-93 was a very unusual year. Economic growth was less than population growth. While the economic market wore a gloomy look, the political market was humming with activity. The work on the Plan had been started by the first Nawaz Sharif government in 1991. Before this government could put in place a “home-grown” set of policies as opposed to the elusive IMF package, a severe external accounts crisis led to differing perceptions of governance between the president and the government. The government was dismissed and the Mazari caretaker regime was installed. However, the Supreme Court restored the government, which only had time to get through the National Assembly the budget for 1993-94, i.e. the chronological first year of the Eighth Plan.

It was replaced by the caretaker Moin Qureshi regime on July 19, 1993 which had no taste for five-year planning. The major policy initiatives of the first Nawaz Sharif government were stopped immediately. These included the Lahore-Islamabad Motorway, the Yellow Cab Scheme and the Taameer-e-Watan Programme. Measures were introduced to tax agricultural income and wealth and recovery of tax arrears from the politicians. A list of loan defaulters was published, the State Bank was granted autonomy to check political interference in the banking system and a Debt Retirement Fund was established to utilise sale proceeds of privatisation. The IMF returned with a Stand-by arrangement.

The second Benazir government took over from the Moin Qureshi regime on October 19, 1993. It continued with the stabilisation stance of the caretaker regime until December so as to meet the IMF Stand-by targets. By February 1994, a three-year EFF/ESAF arrangement was agreed with the IMF. After its first year had already passed, the Eighth Plan was approved and published in June, 1994. The “good” policies of the Plan came from the IMF programme. However, continuing with the political policy cycle, the government limited the autonomy of the State Bank, cold-storaged agricultural income taxation and let the Debt Retirement Fund die. Taameer-e-Watan Programme was re-started under the name of Peoples Programme. A down-graded version of the Lahore-Islamabad Motorway project was revived, but all other motorway plans were shelved. The government announced a Petroleum Policy in 1994 with significant tax and duty concessions, but withdrew these concessions in June, 1996. While the resolve of the government to stabilise the macro economy had been weakened by the

businessmen's strike against the 1994-95 budget, the pretense of reform was also given up in the 1995-96 budget by introducing major deviations from the IMF programme. The IMF responded by suspending the programme. In November 1996 the second Benazir government was also dismissed by the president amidst a serious judicial and external accounts crisis. The caretaker government of Malik Meraj Khalid was propped up by an IMF Stand-by and massive short-term commercial borrowing. Its only contribution of note was the installation of an accountability machine.

The second Nawaz Sharif government came to power in February, 1997. It was thus responsible for the last 16 months of the Eighth Plan. With renewed vigour it announced a continuation of the "home grown" economic policies of 1990-93, the period of its last tenure falling in the Seventh Plan, and a Programme of Economic Revival encompassing tax and tariff reductions and export incentives. An Agricultural Incentives Package and National Debt Retirement Programme were also made public. In October 1997, the Petroleum Policy was recast to bring back the concessions withdrawn in 1996 and the important elements of the 1991 policy. In the following month, a new Investment Policy was launched with the aim of raising the annual inflow of foreign investment to 2 billion dollars. However, as Table-3 indicates, the East Asian meltdown and the re-opening of the contracts of Independent Power Projects (IPPs) had begun to adversely affect the flow of foreign investment before the nuclear explosion of May 28, 1998. While the IPP controversy signaled inability of the government to ensure policy continuity, the post-explosion economic sanctions imposed by the G-7 countries deterred foreign investors directly. The simultaneous move to freeze the foreign currency accounts scared away the overseas Pakistanis. It was a major policy reversal, serving a serious blow to policy credibility.

Policies are shaped by institutions. "Good" policies yielded bad outcomes because they were perceived to be externally imposed, including the "home-grown" variety. They were mostly in the nature of a last-minute reprieve in the wake of foreign exchange crises. Institutional poverty was reflected in policies related to the political allocation of development funds, yellow cabs and green tractors, and too ready acceptance of fiscal, monetary and balance of payments targets. More dangerously, it was also reflected in the inability to collect, process and present information in a credible manner. The Benazir government was accused of fudging the fiscal deficit of 1995-96 by half a percentage of GDP.

Table-3: Foreign Investment Flows

(Million Dollars)

	Direct	Portfolio	Total
1992-93	306.4	136.8	443.2
1993-94	354.1	288.6	642.7
1994-95	442.4	1089.9*	1532.3
1995-96	1101.7	205.2	1306.7
1996-97	682.1	267.4	949.8
1997-98	601.3	221.3	822.6
1998-99	376.0	27.3	403.3

* Includes PTC vouchers valued at 862.2 million dollars.

Sectoral Policies

In the overall framework of macro-economic policies, a special set of policy measures were included in the Eighth Plan for the leading sectors of transport, communications and energy.

A. Transport and Communications

In the transport sub-sector, privatisation of railway operations in selected areas was to be explored. Commercial exploitation of railway lands and properties would be initiated. During the Eighth Plan period, property disposal was started, but the intent of privatisation stalled investment in locomotives, coaches and oil tankers. The failure to clarify the role of the state and the private sector vis-a-vis railways only led to further deterioration of the assets and services. Freight traffic fell at the rate of 6 per cent per annum and passenger traffic at the rate of 1.7 per cent per annum.

The Plan committed to complete the Lahore-Islamabad Motorway project during the Plan period, albeit with critical modifications. An allocation of Rs. 9.5 billion was made for it. The move could be seen as an example of policy continuity because work was started in 1991-92 by the first Nawaz Sharif government when an expenditure of Rs. 3.9 billion was incurred on land acquisition and earthwork. The project was first brought up before the Planning Commission in 1990, which deferred it until responses were received to satisfy the standard appraisal concerns. It was taken off the CDWP/ECNEC clearance process by constituting an independent National Highway Council in 1991. In 1992-93, the Nawaz Sharif government allocated Rs. 2.8 billion for the construction of a 60 Km section of the Lahore-Islamabad Motorway and

Rs. 454 million to initiate work on the Islamabad-Peshawar Motorway. The caretaker government of Moin Qureshi stopped work on the Lahore-Islamabad Motorway. The second Benazir government included it in the Eighth Plan with reduced scope and cost, but cancelled the contract for the Islamabad-Peshawar Motorway. Progress, however, was slow and investigations were instituted to unearth possible corruption. Work was speeded up by the second Nawaz Sharif government towards the end of the Eighth Plan period and the 371 Km long Motorway was completed at a total cost of Rs. 40 billion. Its original cost, with a larger scope, was estimated at Rs. 28 billion and the plan was to involve the private sector on BOOT basis. In practice, the entire cost was borne by the public exchequer, with average income per day from tolls significantly below the average maintenance cost per day. Obviously no lessons were learned from this mega project, as the Islamabad-Peshawar Motorway was also revived. Estimated to cost Rs. 36 billion in its 6 lane version, the burden of this huge project was also thrown on to the public sector, despite the estimations of a negative rate of return. An allocation of Rs. 2 billion for the Mekran Coastal Road never materialised.

Incentives were to be devised for the participation of the private sector in shipping and ports in the Eighth Plan. Only six ships were registered against 200 licenses. PNSC could not be privatised. Private sector built container terminals at 3 berths on West Wharf at Karachi port. It also constructed a container terminal as well as a permanent oil terminal at Port Qasim. A major project delineated for the private sector was the deep sea port at Gwader to cater to ships of upto 100,000 DWT. The interest expressed by a Gulf State became the subject of intense controversy. Cargo handling was also to be shared with the private sector. This included construction of a Fully Integrated Container Terminal, reconstruction of Berths 5-8 at the East Wharf, acquisition of VSP tugs and pilot boats and construction of container, grain and fertiliser terminals and development of maritime industrial area at Port Qasim. To improve the legal framework Merchant Shipping Act, 1923 and KPT Act, 1986 were to be revised and enacted. Private sector participation was also to be encouraged in airlines and in the construction of new air terminals at Islamabad, Lahore and Peshawar on BOT basis. Only the new Islamabad airport was tendered. Five private airlines started operations, but three survived due mainly to a confused aviation policy.

In telecommunications, the private sector had been successful in installing half a million telephone lines in the Seventh Plan on Build, Lease and Transfer (BLT) basis. It was planned to accelerate this participation by allowing parallel systems and operating companies and by encouraging the production of telecommunication equipment in the private sector. Most important, Pakistan Telecommunication Corporation itself was to be

privatised. After a successful initial sale of PTC's vouchers, opportunities were missed by the delays in its privatisation. Investors' confidence was shattered by the failure of the PTC to maintain the integrity of financial data. Out of 18 licenses issued to private companies for data transmission services, only 5 became operational. Policy lethargy in the telecommunications sub-sector slowed down the economy's entry into the information technology revolution.

Table-1 indicated transport and communications as the second largest sector of private investment. This priority was based on the portfolio of projects prepared by the first Nawaz Sharif government on BOT basis, which originally included motorways. The transfer of Lahore- Islamabad Motorway to the budget and lower priority attached to the sector by other governments reduced its share in the total private investment realised during the Eighth Plan period to be the lowest.

B. Energy

In terms of actual investment, the energy sector did far better than transport and communications mainly because of private power policy, which enjoyed a sufficiently long period of political ownership during the Eighth Plan period (Table-1). While the Nawaz Sharif government took the highways out of the purview of the CDWP/ECNEC process, the Benazir government did the same in the case of the energy sector by setting up a separate cabinet committee on energy.

Five year plans do not normally contain fully worked out policy details. But the Thermal Power Generation Policy and the Petroleum Policy had been announced in 1994, i.e. before the Plan was published. The overall objective was to decentralise and deregulate the energy sector agencies and to promote the induction of the private sector. Large public utilities such as WAPDA, KF.SC, SNGPL and SSGCL were to be restructured and privatised. In view of the long gestation of energy projects, energy sector policies were laid out in a long-term perspective. It was made clear that in the short run of 2-3 years, supply side development had to be limited to existing proven resources. In the case of thermal power projects identified by WAPDA, the Eighth Plan proposed that they be offered for competitive bidding in the private sector. Other important policies in the power sub-sector included Hydel Power Policy 1995, Transmission Lines Policy 1995.

The privatisation efforts were initiated according to a model under which a number of BOOT and BOO type projects were considered. The salient features of the 1994 private power policy were as follows:

- Purchase of electricity at 60 per cent plant factor would be guaranteed.

- Projects on BOO or BOOT concepts based on competitive bidding or unsolicited proposals would be accepted.
- The Government established the Private Sector Energy Development fund (PSEDF) with the assistance of various donors. Approved private sector projects would be eligible for loans of upto 30 per cent of the project cost from this Fund. This arrangement would greatly help the private sector in providing long term financing and cushion their risks.
- An instrument of Extended Co-financing (ECO) had also been put in place alongwith the World Bank to safeguard the risk of availability of foreign exchange with the Government.
- Standardised Implementation, Fuel Supply and Power Purchase Agreements.
- Introduction of bulk tariff of 6.5 cents per KWH for 10 years, with premium of 0.25 c/Kwh for projects above 100 MW commissioned by end 1997.
- Allowing private investors the option of making their own arrangements for the import and transportation of fuel/oil for their power plants.
- Permission to power generation companies to issue corporate bonds, both bearer and registered.
- Permission to issue shares at discounted prices to enable venture capitalists to be provided higher rates of return proportional to the risk, without the current stipulated 10 per cent discount limit.
- Exemption from Iqra Surcharge, Flood Relief Surcharge, and Import License Fees which would be treated as a part of custom duty for power projects. This applied to all projects (including those under construction).
- Permission to foreign banks to underwrite the issue of shares and bonds by the private power projects.
- Change in Companies Ordinance to permit registration anywhere in Pakistan to allow them to avail reduction in Stamp Duty and Registration Fees for registration of debt documents allowed by the Federal Government.
- Same tax facilities for private sector instruments as those

available to NBFIs as financial institutions.

- Recommendation by GOP to the State Bank for modification of Prudential Regulations to allow 80:20 debt equity ratio.
- Removal/reform of Section 13 of 1947 Foreign Exchange Regulation Act to enable non-residents to purchase securities issued by Pakistanis without State Bank permission.
- Abolition of 5 per cent limit on investment of equity in associated undertakings.
- Government approval for an independent rating agency so that individual investors could make informed decisions.
- For local engineering and manufacturing companies, the present SRO 555(1)190 was made applicable to private power plants.
- Orders received by local engineering and manufacturing companies from private sector projects to be treated as export for refinance under the State Bank Finance Scheme for Exports.
- One Window Operation through the establishment of Private Power Board.
- Incentives for co-generation by providing adequate buy back tariff based on the principle of avoided cost.
- Issuance of a separate SRO consolidating all existing and new exemptions and incentives for private sector power plants.
- Setting up of National Electricity Regulatory Authority and corporatisation/privatisation of WAPDA/KESC assets to be expedited.

The response of the foreign private investors was tremendous. Against the Eighth Plan expectation of 2.5 billion dollars, the actual total investment was 4.4 billion dollars. The total number of applications was 127 to generate 26,000 MW, Of these 81 were given Letters of Intent. Letters of Support were issued to 34 projects, while 19 projects of 3,454 MW reached financial close. During the Eighth Plan period six of these projects were commissioned. Their combined installed capacity was 1,236 MW. The 1,292 MW HUBCO project was also commissioned in 1997. The Kot Addu thermal power plant of WAPDA was privatised.

Towards the end of the second Benazir government in 1996, an internal debate had started on the balance of payments implications of

private power. The second Nawaz Sharif government viewed the tariff allowed under the Thermal Power Generation Policy 1994 as burdensome for the budget as well as balance of payments. With power demand lower than the projections, over capacity would be an additional burden on the economy. Consequently, the agreements were reopened and some IPPs were also investigated for wrong-doing. Foreign investment is extremely sensitive to the sanctity of contracts. While the contracting parties have every right to negotiate to their best advantage before the contracts are signed, any deviation after is invariably destabilising. Small wonder, the IPP issue had dragged down overall foreign investment. Its adverse influence can also be seen on the process of privatisation of power utilities.

There was a stark contrast between the incentives-based Thermal Power Generation Policy and other policies. The Hydel Power Policy 1995 and the Transmission Lines Policy were non-starters. As noted above, a number of concessions given in the Petroleum Policy 1994 were withdrawn in 1996. These were restored in the Petroleum Policy 1997, which was an improvement over the Petroleum Policy 1994 in its emphasis on off-shore exploration. Some elements of the Petroleum Policy 1991 were also brought back. Thus it was hardly a case of continuation of economic policies in the Eighth Plan.

Summing up

Seven governments, elected as well as unelected, were variously involved in the formulation and implementation of the Eighth Five Year Plan. This works out as an average of 0.7 years per government. The approval of the Plan itself was late by a year. This was the time when the state was restricting its role to public interest regulation and the creation of incentives for the private sector. Private sector investment requires policy continuity—stable, predictable and transparent decisions. The combination of political and economic policy discontinuities frustrated not only the private sector plans, the resulting slowdown of growth gave no leeway to satisfy even the political constituents. At 4.6 per cent per annum, the GDP growth of the Eighth Plan exceeded only that of the First Five Year Plan.

An important test of the confidence generated by policy continuity is the integrity of official data. Twice during the Eighth Plan period the data of the state and a major state enterprise was cast in doubt. Bureaucracies used to work in an environment shrouded in secrecy are as much of an anachronism as the strictly policed five-year plans since the fall of the Soviet Union.

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Economic Theory and the Explanation of Poverty

Sikander Rahim*

This article is an attempt to explain why poverty has persisted to a great extent in Pakistan, despite sustained growth of national income, and to review two publications dealing with poverty and social development, "Social Development in Pakistan: Annual Review 1999, Social Development in Economic Crisis", published by the Social Policy and Development Centre, (SDP) and "Human Development in South Asia, 1999: The Crisis of Governance", published by the Mahbub ul Haq Human Development Centre (HD).

I: Neo-Classical Theory's Problem: Markets or Policies?

Two ways of writing on poverty

Alleviating poverty in developing countries has, over recent years, been receiving more and more emphasis from donors of foreign assistance, especially the World Bank and the IMF. On the face of it, the reason is the disappointment with the consequences of policies that laid too much stress on economic growth and not enough on how its fruits were shared. Supposedly the premise of these policies was that the higher income from economic growth would accrue to the poor, as well as to the rich, and this did not happen, or, at least, it happened so little that the numbers of poor have scarcely fallen in most developing countries and have increased in several faster than the population.

The failure of growth to reduce poverty more than it has done has provoked a large amount of writing on how poverty can be alleviated or removed. This writing can be divided into two types. One is concerned with the mechanisms and institutions that enable the poor to increase their incomes and improve their living conditions. It is primarily microeconomic and institutional, much of the institutional aspect being related to the communities to which the poor belong, and their functions include a wide range of activities, such as repayment of micro-credits, starting and running schools and improving sanitation and water supply. It does not necessarily claim to explain why poverty persists despite economic growth, but incompetent state. Not much need be said in the present article about this type of writing; it stands on its own merits and would be needed even if government policies had had better results.

* The author is Professor of Economics at the Lahore School of Economics.

The second type of writing is more general in nature and more concerned with general government policies. When it proposes apparently specific measures, such as decentralisation, community based organisations and self-help schemes, it does not enter into the details of how such measures can or should be made to work, in contrast to the first type of writing on poverty, for which the success of the measures depends on how they are implemented. One would have expected the second type of writing to examine and explain the persistence of poverty, but surprisingly little of it makes any attempt to do so. Mostly it advocates policies without giving any reason to believe that these policies are related to the causes that perpetuate poverty or that they will remove or counteract them. Instead of analysis it provides an abundance of description, illustrations and journalistic devices. When financed by foreign agencies, this results in glossy publications with photographs, coloured charts, boxes, personal anecdotes and the various visual devices used in magazines and advertising to hold the casual reader's attention and to influence him, yet not oblige him to follow a coherent discussion with a critical mind.

Not surprisingly, these publications resemble the World Bank's "*World Development Reports*" and other publications of international organisations intended for a wide public that includes government officials and politicians. The world Bank has, with time and with the help of outside professionals, learnt how to make its publications highly persuasive to the casual reader. Government officials and politicians are not usually experts, they have neither the training nor the time to examine the facts and reasoning presented in these publications critically, let alone to formulate alternative views. They must take on trust much of what the experts tell them and, if those they believe to be experts seem convincing because they have acquired the skills of the advertising business, officials and politicians are likely to be influenced. And even if they are not persuaded on specific points, in the long run their broad outlook and their way of interpreting economic developments are determined by the unceasing flow of publications of the World Bank and kindred institutions, which are, therefore, most effective in determining economic policy in developing countries.

Political and economic agendas

Such an elaborate effort to persuade only has a point if the institution behind it has an agenda. That the World Bank and the IMF are acting at the behest of the developed countries, particularly the US, to liberalise trade, privatise public enterprises, reduce state leadership of and direct support for industrialisation and to allow capital to flow freely across frontiers is well known. Less obvious is that much of the type of writing on poverty under review here has a similar agenda, the only difference of

substance being that those who write on poverty can not at the same time advocate relaxing controls on the outflow of capital. It is this conformity to the agenda of the bilateral and multilateral sources of assistance that accounts for the network of internationally prominent people on the boards and panels of the institutions behind these writings and the foreign financing for their expensive publications.

Poverty as a Problem for Neo-Classical theory

The reason for the superficiality of the second type of writing is the inability of orthodox neo-classical economic theory – and the World Bank and the IMF, in particular, are thoroughly orthodox – to come to grips with the subject of poverty. Neo-classical theory maintains that when markets function freely, the earnings of labour and other factors of production are determined by their marginal products, i.e. by the technical features of production, about which nothing can be done, and that this is efficient in the Pareto sense that nobody can be made better off without somebody else being made worse off. If poverty occurs when markets function freely, it is part of an efficient outcome.

For the economist who adheres to neo-classical theory and wishes to make an issue of poverty, the extent to which the theory determines outcomes by the technical features of production raises the question of how much can be done to remove or alleviate poverty. In other words, if the economy left to itself is deterministic and efficient, what can and should economic policy do? In particular, what should it do in Pakistan?

To this the orthodox economist has two answers. One is to assert that markets work and that the outcome is Pareto efficient, but that a more even distribution of income is, all the same, desirable. In this case poverty is not the result of bad policies, but suitable taxes and transfers of income can yield a better outcome. The alternative answer is to assert that markets fail to work as they should in some parts of the economy and that this is what causes poverty. In this case, not only may the policies pursued by the government have caused the market failures and, therefore, poverty, but adoption of suitable policies will be the cure. Policy can then be both cause and remedy.

Nevertheless, the importance of policy is limited; the most that can be expected of it is to correct for market failure and to redistribute income by fiscal means. If this is all that policy does or can do, the only advice economists can give is, allow markets to function freely, except in the few cases where there is market failure, and, otherwise, use progressive taxation to subsidise some of the consumption and investment of the poor.

The question is, does this suffice? Will it prevent the incidence of poverty from rising and help the poor increase their incomes? Although some orthodox economists may believe it will, there seems to be no coherent analysis to justify the belief. To be cogent such an analysis should show how market failure, whether the result of policy or not, does not prevent the economy from growing faster than the population, but does prevent income from “trickling down”. It would have to specify the form of each market failure, explain how it affects income and growth, as compared to what they would have been in its absence, and show how it can be remedied. Then, if the economist wished to redistribute income as well, he would have to show that the taxes and income transfers, coupled with the steps to remedy the market failure, will not affect the growth and distribution of income so as to offset the gains. There is no lack of writings in which explanations of poverty are couched in terms of generalities, but the present author is not aware of any that satisfy the conditions for cogency just given. In other words, although the possibility exists that neo-classical theory can provide a satisfactory explanation of poverty, there is no such explanation at present, at least for Pakistan, and, consequently, no reason to believe that remedies derived from neo-classical theory will be effective.

Since neo-classical theory has not yet provided a cogent explanation of poverty, at least for Pakistan, the question arises, can it provide one? In other words, can market failure really explain poverty? Or must some other explanation be sought? An idea of how market failure might result in poverty can be obtained by examining what is probably its most prominent case, namely education.

According to neo-classical theory, education is a form of capital invested in people, human capital. An educated worker, therefore, earns, in addition to the wage given by the marginal product of labour, a return on his human capital. Since the marginal product of labour is low in Pakistan, it is the income from human capital that allows a worker to rise out of poverty. But the poor do not have the money to pay for education and market failure prevents banks and enterprises that would benefit from a better educated labour force from financing them. So, unless the state ensures that education is provided to the poor, poverty will persist. And when the state finances education for the poor, it both corrects for a market failure and redistributes income by taxing the less poor to obtain the financing.

The defect of this explanation is that it assumes what needs to be explained. It assumes that the marginal product of labour is so low that uneducated workers must necessarily be poor. The cause of poverty is, therefore, the low marginal product of labour, which is taken as given. The ability of education to reduce poverty in the neo-classical theory is simply a

result of the treatment of education as a form of capital and the usual relation whereby more capital yields more income. However plausible it may be that the marginal product of labour is so low in Pakistan as to keep an uneducated worker in poverty, it is still an assumption. Then, the desirability of investing in education is also an assumption, for education is simply a form of capital formation whose economic rate of return must be compared to that of other forms of capital. One must bear in mind that economic growth has been high enough to raise income per head and, if, after comparing the rates of return, the economist decides that physical capital is preferable to human capital, the market failure is irrelevant.

If market failure can not convincingly explain why poverty has been so persistent, despite continuous economic growth, i.e. why the increase in income has not “trickled down”, two conclusions follow. One is that neo-classical theory can not explain poverty and, therefore, that policies to alleviate it that follow from the theory have no justification. The second conclusion is that the causes of poverty must have been the policies pursued by the government. This means that, knowingly or not, governments have chosen policies that kept the incomes of the lower income groups down, when they could have chosen other policies that would have allowed these incomes to rise.

What follows is an attempt to show briefly how government policies have affected income distribution in Pakistan and, therefore, the incidence of poverty, and why the proposals in the writings under review are often irrelevant or even harmful.

II. Policy and Poverty in Pakistan

The Period of Ayub Khan

In Pakistan the government only began to affect the distribution of income actively after the boom in commodity prices caused by the Korean war ended in 1953. While the boom lasted Pakistan enjoyed a degree of prosperity it has never had again; export earnings were higher, in dollar terms, than at any time until the 1970s and imports were abundant. When the boom ended, the fall in commodity prices reduced export earnings so far that the government felt obliged to impose restrictions on imports. This was the first positive step the government took to alter income distribution; demand for consumption goods exceeded supply, prices rose in spite of price controls and the distribution of income shifted, with profits taking a larger share.

The shift was accentuated by the government policy of the next few years of giving priority to industrialisation, notably cotton and jute textiles. Domestic production received almost total protection. For instance, imports of cotton cloth were almost entirely stopped and, since local industry hardly existed at all at that time, those who were able to set up textile mills made such big profits that they could usually recoup their investment within a year.

The balance of payments, nevertheless, continued to deteriorate until, on the advice of German experts, the bonus voucher scheme was introduced to forestall a crisis. The bonus voucher was an entitlement to purchase foreign exchange at the official exchange rate of Rs. 4.5 to the US dollar, and the scheme allotted these vouchers to exports of most kinds of manufactures in proportion to the value of the exports. The vouchers could be sold on the market and, since all foreign exchange had to be surrendered to the State Bank of Pakistan and since foreign exchange to import most non-essential goods had to be bought using the vouchers, they fetched a price termed the premium. For example, cotton textile exports might be allotted bonus vouchers equivalent to 30 per cent of their export value. So, for an export of cotton textiles equal to Rs. 100, calculated at the official exchange rate, the exporter would get bonus vouchers for Rs. 30, in addition to the Rs. 100 obtained when he surrendered his foreign exchange to the State Bank. Usually the premium ranged between 130 and 180 per cent, which meant that the exporter received an additional Rs. 39 to 54 from selling the vouchers. Since exports of raw materials were not allotted bonus vouchers, their domestic prices remained determined by the official exchange rate. The exporter benefited from a dual exchange rate. The importer, however, had to pay Rs. 230 – 280 to import goods worth Rs. 100 at the official exchange rate and this cost was passed on to the consumer.

The effect of the scheme was to subsidise exports at the expense of consumers. Since the consumers of non-essential imports were mostly the middle classes, the scheme caused an income transfer from middle class salaries to industrial profits. Goods that are not necessarily luxuries for the middle class, such as cars, motorcycles, watches and air conditioners, were not classified as essential and had to be bought with bonus vouchers.

The effect of bonus vouchers on profits was addictive. The German experts had warned that the scheme was just an emergency measure to stimulate exports of manufactures and should be ended as soon as possible. It was not an auction mechanism for balancing the demand for foreign exchange against the supply, because the premium stayed in the private sector and the demand was merely transferred from one person to another. A balance would have required that the premium accrue to the state and not be spent. As it was, excess demand for foreign exchange continued,

sometimes pushing the bonus voucher premium to 200 per cent but never letting it fall to 100 per cent. The increase of profits caused by this transfer was so great that it was possible to export profitably even when the foreign exchange value of the exports was less than the foreign exchange cost of the inputs used to make them, what was termed negative value added at international prices. Then exports cost more foreign exchange than they earned. By the early 1960s some economists calculated that a number of Pakistan's exports, including cotton and jute textiles, were earning less foreign exchange than they cost. Nevertheless, neither the industrialists nor the Ayub Khan regime, which had close links to them, saw that as a reason to give up a scheme that yielded such generous profits.

Whether or not the government and its planners understood that the bonus voucher scheme was not much other than a means for transferring income from middle class consumers to industrialists, it fitted well into the economic strategy of the Ayub Khan regime, of which the most important element of the strategy was rapid industrialisation stimulated by high profits. Several methods were used, apart from the bonus voucher scheme, to keep profits high, including almost total protection against competition from imports, large amounts of financing at low interest rates, tax privileges. Trade unions were suppressed or rendered ineffectual in order to prevent higher wages and better working conditions from affecting quick profits.

Apart from the obvious purpose of being an incentive to investment, the favouring of industrial profits had the purpose of increasing saving. The theory was that people with higher incomes saved more than people with lower incomes, so concentrating national income with a small set of people would raise the national saving rate. This was evident in the Second Five Year Plan (1960-65). The Plan practically ensured that the consumption per head of most of the population would not rise. It aimed at an increase of consumption per head of all the population of slightly more than one percent per annum and proposed to 'keep the increase in consumption in check'¹ by higher indirect taxes 'of a kind which reach ordinary incomes'². Since the rise in the saving rate was largely in the private sector, it could only be achieved by increasing income inequalities, which meant that the increase in consumption per head would mostly be confined to the better off.

Such policies did not shock economists at the time. The Planning Commission was being advised by the Harvard Advisory Group and the

¹ Second Five Year Plan (1960-65) p.57

² Second Five Year Plan (1960-65) p.27

theory behind the Second Plan was expounded by Mahbub ul Haw in his book "The Strategy of Economic Planning"³. In this book he contrasted the choice between less hardship at the start, but less saving and slower growth, with more hardship at the start and faster growth. The former he called the Rostow model and the latter the "Russian" model. Haq shared the widely held opinion that the accumulation of capital in the industrial countries in the 19th century was achieved by keeping the income of most of the population low, though he does not explain why the same hardship should be necessary now, when the techniques of production are much more advanced. His advocacy of the "Russian" model led him to assert that 'social services should be given less emphasis' because 'it would be unfortunate' if a change 'in growth philosophy of economies still at this stage of "take-off" were to occur.'⁴ The object of the hardship was a marginal saving rate 'generally between 30 to 40 per cent. These rates are quite high and have not yet been achieved outside communist countries for a sustained period of time.'⁵ Such an achievement could not be seriously presented without believing that there was a means of bringing it about, especially since the saving rate had dropped during the period of the First Plan. Haq refers to a study that showed that "Pakistani industrialists ploughed back 75 to 80 per cent of their retained income into investment if they could get complementary inputs like foreign exchange."⁶ The only way of getting near the desired saving rate was redistribution of income in their favour.

III. Freer Markets and More Poverty

The New Policies and the Critics

Economic policies changed little while the Ayub Khan government lasted, except for an increase in the emphasis on agriculture, though western economists and sources of foreign aid at the time were growing concerned that the developing countries were not becoming less dependent on aid and that the living conditions of the poor were not improving. For this they blamed the inefficiency of the industries protected by high trade barriers and the lack of interest of the governments, the owners of the industries and the wealthy land owners in social development. The development policies of the World Bank shifted progressively to improving the conditions of the poor and allocating resources better by freeing markets, and other donors followed it.

³ Mahbub ul Haq. *The Strategy of Economic Planning*. Oxford. 1963.

⁴ Mahbub ul Haq Op.cit. pp.3 & 35

⁵ Mahbub ul Haq Op.cit. pp.65

⁶ Mahbub ul Haq Op.cit. pp.23

With variations, these are the policies that have dominated development assistance and government policies in most developing countries, very much so in Pakistan, for the last three decades. They have brought attention to the persistence of poverty but have had no more success than the earlier policies in reducing it in Pakistan or anywhere else. On the contrary, the failure has been so great that there is now a widespread tendency in the developed and developing countries to blame poverty on the World Bank, which has for so long made it its prime concern, and on the IMF, which influences macroeconomic policies more, although it, too, has begun to profess concern.

The critics of these institutions are too diverse to have a line of reasoning in common. Some are uninterested in economic theory but react to what they understand to be the effects of the application of the advice of the World Bank and the IMF, unemployment, reduced wages and less provision by the state of social services and subsidies directed to the poor. Such criticism has two limitations one is a limitation that the World Bank and IMF emphasise, namely that the effects blamed on them by the critics are usually the consequences of the governments' imprudent macroeconomic policies and that worse would have followed if the institution had not come to the rescue.

The second limitation is that the critics argue from appearances, but have no coherent economic theory and policy of their own. The World Bank and IMF have the advantage of having a standard set of development policies to recommend, namely liberalising trade and domestic markets, privatisation and prudent macroeconomic balances. To this the critics can reasonably reply that the countries that implemented the reforms recommended by the two institutions seem rarely to reduce poverty and avoid more crises of the type that obliged them to seek these institutions' help at the start; too often these institutions praise countries for their following their policies only to criticise them later, when they fall into difficulties again, as with Mexico and Ghana⁷ in the early 1990s. Nevertheless, not having something to propose against the World Bank and the IMF, the critics are at a disadvantage.

The orthodox economist who wishes to criticise the World Bank or the IMF can not attack their theories or policies since these institutions follow the same text-books as he does. He must attack the way the institutions work, namely their objectives, quality of analysis and implementation, costs, organisation, procedures, secrecy and so on, none of which need be discussed here. As to whether or not the World Bank and IMF, or any other multilateral institution, alleviates or worsens

⁷ For a description of how the World Bank changes its views on Ghana, see Mkandawire and Soludo, p. 84.

poverty by the policies they propagate, the orthodox economist's views can differ little from theirs, so he must advocate the same policies regarding markets and macroeconomic stability as they do and maintain either that these policies do not hurt the poor in the long run, or that they actually benefit them.

Exchange rate Movements and their Effects

In doing so, the World Bank, the IMF and the orthodox economist, deliberately or not, ignore the effects of the exchange rate policies they advocate. In 1973 the developed countries were forced by the growth of international capital flows to abandon the system of fixed exchange rates with which they had enjoyed higher sustained rates of growth and less unemployment than before or since. Floating rates became orthodox and, though several European countries tried to maintain fixed exchange rates among themselves, in time the developing countries were made to believe that the correct thing to do was either to let their exchange rates float or to adjust them frequently, always by devaluation.

The theory is that devaluation lowers the domestic cost of production relative to the prices of imports and exports. But the operation of the market causes domestic prices of traded goods to adjust to the prices of imports and exports, and the prices of untradable goods must also adjust as the prices of their direct and indirect traded inputs rise. No such market mechanism causes the nominal price of labour to rise, so the real wage declines, unless workers can persuade employers to raise them. And if they succeed in raising their nominal wages to offset the price rise, the effect of devaluation on the cost of production is cancelled at the cost of a rise in prices. Hence, a successful devaluation is one which results in a fall in real wages, at least in the tradable goods sectors. Then, if a decline in production does not follow, GDP stays constant in real terms and the share going to profits increases.

The purpose of devaluing a currency is to lower the real wage, though the official argument is that devaluation offsets domestic inflation, which would, otherwise, make Pakistan uncompetitive in world markets. To state the official argument more precisely, Pakistan's exports and importers have little influence over the prices they get or pay for their goods, so, if production costs rise too far, the profit margins of domestic producers of tradable goods fall to zero. (One can ignore the possible intermediate stage when exporters try to sell in the domestic market and lower the profit margins there.)

The argument may be valid, but actual practice does not conform to it. The argument implies that independent experts study the domestic costs of production and compare them with costs and prices in other countries, and that the decision to devalue is based on their conclusions. This is, of course, not what happens, nor does anybody imagine that it does. Rather, officials make broad comparisons of domestic inflation with some measure of international inflation, or inflation in other suitably chosen countries, and assume that there is a case for devaluation if the former is the higher.

Such comparisons of inflation are just comparisons of the movements of price indices and can not substitute for direct comparisons of costs and prices. Inflation means a general rise in prices and the indices used to measure it are broad based, whereas devaluation acts specifically to lower real wages and salaries. Following devaluation the domestic prices of tradable goods can be expected to adjust to their earlier relation to import and export prices, provided trade barriers do not change. The prices of untradables that have tradable direct or indirect inputs must also rise; for instance electric power may require imported oil and transport uses fuel and spare parts. This is the familiar inflationary effect of devaluation. By reacting to inflation, instead of studying the costs of production, the authorities are led to devalue again, even if the nominal wages has not risen.

The decision to devalue should, therefore, depend on the answers to two questions: how are nominal wages and salaries expected to react and how much does inflation have causes other than devaluation? If nominal wages do not rise as much as prices, at least in the tradable goods sectors, devaluation is considered to be successful. In this case the production costs of tradable goods have fallen relative to prices in export and import markets because the cost of labour has fallen relatively, i.e. the real wage is lower. But, if because trades unions are strong or for other reasons, nominal wages in the tradable goods sectors catch up with prices, the costs of production will be lower only for the time before wages have caught up. In this case the gain to profits in the tradable goods sectors is transient and the real incomes of those who can not raise their wages or salaries to match decline.

The answer to the second question, how much inflation may be due to causes other than devaluation, is theoretically straightforward. The common argument, that government deficits and money creation must cause prices to rise, though true for the closed economy, fails to hold for the open economy to the extent that the domestic prices of tradable goods are determined by export and import prices. If the economy is open, the increase in monetary demand relative to the supply of goods is met by an increase of imports or reduction of exports, whose prices are determined outside the domestic economy. Hence, with a constant exchange rate,

domestic price movements in the open economy only occur within the limits allowed by obstacles to trade or are the results of price movements outside, and increases or decreases in demand relative to supply are accommodated by the balance of trade.

Nevertheless, orthodox economists and institutions like the IMF and the State Bank of Pakistan try to prevent prices of goods and nominal wages from rising after devaluation. The reasoning is not clear, since they also believe that, for economic efficiency's sake, domestic prices of tradable goods should be determined by world prices. To keep prices and nominal wages from rising, they take the usual deflationary measures, raising interest rates and restraining the growth of bank credit and supply of money. These measures may alter the pace at which domestic prices adjust to export and import prices, but they can not prevent the adjustment. When prices rise faster than the volume of credit or supply of money, unless there is a change in the way firms finance their activities and a rise in the velocity of circulation of money, both of which can normally be ruled out, the outcome is a decline in economic activity, a recession. Almost always the effect of deflationary measures is to reduce investment, which results in an improvement in the balance of trade if saving does not fall by the same amount. Since a recession leads to higher unemployment, workers are less able to raise their nominal wages and the real wage declines. This is the familiar outcome associated with IMF programmes.

What orthodox economists, the IMF and the World Bank hope from a recession is that reduced domestic demand will lead to more exports and fewer imports, part of which is commonly achieved by the fall in investment. But the cost in terms of lost growth and unemployment is so high that officials and politicians often allow common sense to prevail over economic doctrine by letting the supply of money expand to accommodate, at least partly, the rise in prices. Devaluation thus leads to an increase in the money supply.

Devaluation, inflation and the supply of money

The official view of the SBP is that inflation is caused by the growth of supply of money, a view it believes to be substantiated by a study by Dr. Anjum Nasim, "Determinants of Inflation in Pakistan". The study states that 'money supply would appear to be a key determinant in an economy',⁸ that 'the empirical results suggest that that monetary expansion is one of the main explanations in Pakistan'⁹ and that 'this study provides strong empirical

⁸ Nasim. Op.cit. p.1.

⁹ Nasim. Op.cit. p.2.

evidence that to lower rates of inflation, monetary expansion has to be curtailed and output growth encouraged'.¹⁰

Although the study appears to put money supply as the main explanation of inflation, its data lead rather to the conclusion that the main explanation of inflation is the movement of import and export prices as determined by the exchange rate and inflation outside Pakistan. Already, the first few pages lead to that conclusion. In a chronology from 1970 to 1995 (pages 2-6) high inflation in Pakistan is always associated with devaluation or high international inflation and low inflation with a stable exchange rate and low international inflation. The association with money supply is not as close; in certain periods (1977-79, 1982-83, 1992-93) inflation and money supply did not move together. Visual inspection of the study's diagram (Fin.1.b) plotting the consumer price index and the rupee prices of tradable goods (a proxy for international prices) over time shows that the CPI follows the tradable prices with a short lag. No such relation is apparent in the diagram giving the CPI and the money supply (Fig.1.d), rather it is the contrary movements that stand out.

How do the econometric exercises yield results at variance with logic and appearance? Like the senior officials of the SBP, the present author studied econometrics before the co-integration relations, Dickey-Fuller and Phillip-Perron tests and Engle-Granger two step procedures used in the study had been invented. So a detailed evaluation of the econometrics is not given here.

The numerical results need not be questioned, but they do not lead to the apparent conclusion that the growth of money supply is the main explanation of inflation, or any explanation at all. The two significant determinants of inflation given by the econometric estimates, money supply and international prices in rupees, an indirect cause of inflation, or it can be caused by inflation. The study recognises the possibility; it points out that an expansion of money supply can lead to a worsening of the trade balance, to which the authorities react by devaluing, which causes inflation.¹¹ From this arises the possibility of 'simultaneity bias', for which the study can give no definite answer.¹² To assert that this connection makes money supply a determinant of inflation, as the study seems to do, is wrong, for an alternative to devaluation is to act on the cause given for the trade deficit and reduce it by reducing domestic demand. It is the better course, since devaluation, by itself, does not reduce the excess demand that caused the

¹⁰ Nasim. Op.cit. p.20.

¹¹ Nasim. Op.cit. p.34.

¹² Nasim. Op.cit. p.35.

deficit, but merely transfers income from wages and salaries to profits. Not distinguishing between direct and indirect causes is a specification error. In this cases the increase in the supply of money need not result in inflation. If, like some of the East Asian or major industrial economies, Pakistan had foreign exchange reserves equivalent to a few years' imports, the expansion in money supply need not prompt the authorities to devalue, and the lack of reserves becomes as good an explanation of inflation as the money supply.

The study does not refer to the other possible connection between money supply and devaluation, mentioned earlier, that devaluation causes prices to rise and that the authorities prefer accommodating the higher prices by expanding the supply of money to causing a recession. The study appears to exclude this possibility on the grounds that prices adjust to money supply. It does not explain how this view can be reconciled with the view it also expresses, that the domestic prices of tradable goods are determined by international prices, but follows the argument of Friedman that, if the price of one good rises, it leaves less to be spent on other goods, whose prices must, therefore, fall.¹³ The possibility that, not the prices, but the volume of sales goods falls is ignored. By this reasoning a recession can never be caused by restraining the supply of money or bank credit, a conclusion that Friedman wanted to reach but not one that accords with experience or that is accepted by most economists and central bankers.

The foregoing discussion of the effects of devaluation can be summarised simply. The prices of tradable goods are determined by the prices of exports and imports and the prices of untradable goods by the prices of their tradable inputs, the rate of return on capital and the nominal cost of labour. If the nominal cost of labour does not rise as much as the prices of tradable goods, the rate of return on capital rises. Hence, the only way devaluation can reduce the costs of production of tradable goods relative to their export and import prices is by lowering the cost of labour relative to the prices of tradable goods. Devaluation may be advisable if the domestic costs of production of tradable goods are too high to yield a profit, but it is inflationary and, since the decision to devalue is taken on the basis of inflation, rather than on the study of production costs, one devaluation leads to the next and the real income of labour falls each time. An expansion of the money supply can be associated with devaluation in two ways. One is that money supply is increased to accommodate the higher prices, rather than force a recession. The other is that an increase in money supply increases the demand for goods relative to the domestic supply and worsens the trade balance – not raises prices of tradable goods, since they are determined by export and import prices – to which the authorities react with

¹³ Nasim. Op.cit. p.10.

devaluation. Hence a spurious correlation of money supply with inflation, which is interpreted by the authorities as the explanation of inflation.

Devaluation has other effects that harm the economy. Once the expectation of repeated devaluation has been established, as in Pakistan, holders of monetary wealth have an incentive to convert their money into sounder currencies, which usually means transferring it out of the country. The result is a continual outflow of capital. Devaluation also raises the replacement cost of capital goods relative to historic cost, which, since depreciation is calculated on the basis of historic cost, means that the depreciation funds of manufacturing firms do not suffice for replacement. These firms must, therefore, borrow to replace their capital stock and increase their debt:equity ratios. Inflation also reduces the real value of savings, which hurts the poor most of all, since they are the least able to obtain rates of return on their financial assets that compensate for inflation.

Ultimately, the motive behind devaluation is psychological. Devaluation is the sign of being underdeveloped, a symbol of status. Respectability in the eyes of the officials of developed countries and international institutions comes from conforming to one's standing in the hierarchy of economic power, and a country that does not devalue from time to time brands itself as presuming to ape the developed countries. The proof is given by the reaction of officials in developed and developing countries when international inflation causes domestic inflation. According to the same theory as determines that countries should devalue to offset domestic inflation, they should revalue to offset international inflation. But, however much officials lament over domestic inflation that is no fault of the country, they scorn any suggestion that the country should revalue – that would be impudence.

The depreciation of the international exchange value of the Pakistani rupee is not, of course, the sole cause of the persistence of poverty. An example of how poverty can be generated with the exchange rate fixed was given by the Ayub Khan government's policies in the 1960s. Moreover, the lack of attention to education and the social sectors that was virtually institutionalised by that government can be said to be a contributory cause in the sense that, had the attention been greater, poverty now could have been expected to be less. But poverty could also have been expected to be less despite the neglect of education and the social sectors; more income could have been expected to "trickle down". What the effects of depreciation of the rupee do is help answer the question, why did poverty persist so much, despite economic growth, after governments had stopped deliberately trying to make income distribution more unequal?

IV. “Social Development in Pakistan” and “Human Development in South Asia”

SDP and HD illustrate the limitations of treating poverty with neo-classical economic theory. Although both make many proposals regarding specific problems faced by the poor and regarding the general running of government, neither has a convincing plan for altering the distribution of income. Neither explains how income growth can be made to “trickle down”. As a rule the proposals of the first, specific type are likely to better the conditions of the people they are meant to help, if well implemented, and, applied together on a large scale, could make life better for much of the population. But they do not remove poverty, they only help make it more bearable. Of the second type of proposal, some are vague or general suggestions whose practicability is doubtful and some have no obvious relation to the problems of poverty or social development, but are part of the economic and political agendas of the publications. Rather than give a lengthy exposition, just a few examples are provided of the two types of proposals.

Among the ‘institutional reforms in social service delivery’ in SDP’s chapter on the Social Action Program, the proposals for elementary education include non-formal basic education, basic community schools and home schools.¹⁴ These schemes can not be objected to, given the present state of education. But they are desperate measures for a desperate situation, not an education policy for the long run. Similarly, strengthening Zakat and the Bait-ul-Maal is merely to make charity a government obligation, not a measure to reduce the need for it. The same is true for the proposals for a rural works programme and directed food subsidies.¹⁵ Schemes such as these will be needed for a long time, even if economic growth accelerates and incomes “trickle down” more, but they are palliatives, not cures.

Without having tried to explain the persistence of poverty using economic theory, SDP and HD advocate free market policies among their proposals of the second, general, type. What is a political choice is presented as the will of the people; according to HD, “There is a broad consensus in South Asia that a liberal economic framework in which critical prices reflect their scarcity values and in which the private sector is afforded maximum opportunities to operate freely, is in the best interest of long-term development, provided markets can be regulated in the best interests of the less privileged.”¹⁶ No evidence is given and many would be surprised if it were true. But, even if it were true, few economists, least of all the World Bank and the IMF, would accept that economic policy should be

¹⁴ Social Development in Pakistan. P.74.

¹⁵ Social Development in Pakistan. P.113-4.

¹⁶ Human Development in South Asia, 1999. P.34.

determined by consensus. One could also retort that, if put to a vote, the caste system would have a majority in favour. In any case, whatever meaning the statement might have is removed by the proviso: if such regulation is not possible, as is likely, would the authors advocate another system?

Both SDP and HD advocate trade liberalisation and refer to profits of protected industries as “economic rent”. Yet, apart from Britain and Hong-Kong, no economy has industrialised without protection. Britain, being the first to industrialise, had the most advanced industry until the late nineteenth century and so it believed in free trade. The other countries that have industrialised protected their industries from British competition, because they knew that they would otherwise never industrialise. Hong-Kong’s circumstances were unique and not relevant to other countries. The World Bank, IMF and many economists point out that in most developing countries the industries that flourished under protection never became efficient, let alone internationally competitive, and draw the conclusion that protection is necessarily bad. A better conclusion is that the problem, one which each country must solve for itself, is how to ensure that the protected industries eventually become reasonably efficient, a problem the East Asian economies understood but neo-classical theory does not.

A relation exists between liberalisation of trade and poverty in developing countries: the former causes the latter. Almost all liberalisation programmes imposed by the World Bank and the IMF have been followed by permanent falls in the level of investment. What the devaluations that accompanied the reforms did not do to increase poverty, unemployment did. In Latin America, where the reforms have gone furthest, economic growth has been slow and unsteady, capital has been flowing out and poverty has been spreading. HD asserts, with no mention of a source, that trade liberalisation would add nearly 5 per cent to GNP. Well known neo-classical economists have tried to estimate the gains to be expected from liberalisation and have found them to be minimal.¹⁷

Another proposal of the second type advocated by HD is the proposal ‘for empowering the poor through the provision of micro-credit’.¹⁸ It argues that ‘the experience of the Grameen Bank in Bangladesh has demonstrated that the poor are good savers and investors, and they are eminently creditworthy’, that ‘access to credit should be treated as a fundamental human right’ and that bankers ‘should take a chance on the future potential of the people’. All this may be oversimplifying. Even if the Grameen bank and similar institutions in other countries have worked out how micro-credit schemes can be made to work under the right conditions,

¹⁷ Among several studies are those by Dornbusch and by Rodrik.

¹⁸ Human Development in South Asia, 199. P.146.

they are specialised and their scope is limited. HD does not explain how private banks would be induced to extend micro-credit, so presumably the banks that 'should take a chance' are in the public sector. In any case, HD proposes that 'the credit needs of the poor could be met by recovering defaulted loans from powerful businessmen and influential politicians' and those loans were made by public sector banks.

The general proposals also include some that are openly political and far-reaching. Among them is decentralisation, which HD describes as the second most crucial step', after representative democracy, 'in empowering people'¹⁹. Both SDP and HD assume that government administration is responsive to ordinary people, especially the poor, only if under locally elected politicians. Plausible as it sounds, it is belied by experience all around the world. Decentralisation is popular in the developed countries these days, but in the history of Europe and Japan it was the emergence of strong central governments that broke the local power of the feudal lords. In the US it is the federal government that reduces income disparities and protects the rights of minorities; state governments tend to aggravate inequalities and weaken minorities, and counties are still worse. That is why the struggle over state rights is so bitter. HD recognises that local governments may 'further empower elites rather than ordinary people', but can only offer vague suggestions, such as 'positive discrimination' to counter the danger. That the successful East Asian countries all have strong central governments, HD omits to mention.

Both publications go further to advocate devolving government responsibilities to NGOs.²⁰ It seems to be a rule that NGOs acquire more importance in countries whose economic and social development have been disappointing, unless they are suppressed by an authoritarian state. Pakistan, like many developing countries, has become dependent on them and it is tempting to imagine that they could take over some of the responsibilities that the present administrative system seems incapable of carrying out satisfactorily.

These two proposals are representative of many people who believe that the decay of the state has gone so far that improvement can only come from by-passing it. They place their hopes in local government and the self-help stimulated by and charity provided by NGOs. In effect they advocate a weak government. A less optimistic view of the outcome is that it could end in anarchy and civil war. Many NGOs have political and religious affiliations that do not fit into the benign tolerance SDP and HD seem to assume. Both

¹⁹ Human Development in South Asia, 1999. p.51. Social Development in Pakistan. p.78-9.

²⁰ Human Development in South Asia, 1999. Ch.7. Social Development in Pakistan. p.68-89.

in Egypt and Turkey the religious parties have gained their popularity because they genuinely cared for and looked after the poor, but their political aims are not those of the institutions behind these two publications. What the combination of weak government, strong NGOs and the unending parochialism in many parts of the country could lead to is not easy to predict, but it could be disastrous.

Nevertheless, the publications bring out what may be the most important question of all, which is, the choice between strong, efficient government and decentralisation managed by local politicians and NGOs. Strong government is not necessarily unrepresentative of or unresponsive to the people, as SDP and HD seem to imply, but it presupposes a wide range of reforms, especially of the civil service, business procedures, judiciary, police and so on. If this seems too much to ask for, the alternative is what the publications under review propose.

Substitutes for Good Theory

Both SDP and HD try to compensate for the lack of sound theory, the former by its economic model and the latter by the invention of the concept of humane governance.

"The Integrated Social Policy and Macroeconomic Manning Model"

To some economists and many non-economists the SDP's economic model might appear to replace the need for coherent analysis. Models give the impression of showing how things actually work, though all they do is reproduce the opinions and preferences of their authors. People who do not have much experience of economic models believe that those who use them obtain their results by putting in objective data for the past and present and making suitable assumptions about the future, e.g. regarding the prices of exports or the inflow of foreign financing, and then letting the model reveal the consequences. In practice, as anybody who has worked extensively with economic models knows, merely feeding them data and reasonable assumptions almost always gives absurd results. The economist must run the model many times, modifying the assumptions, altering its equations and, as a last resort, manipulating the data before sensible results emerge. The more complicated the model (rich specifications in the parlance of SDP) the more effort goes into getting the results right. Just like its equations, the model's results merely reflect the opinions and preferences of the user.

The lack of any clear economic theory is evident from the equations of the model. An illustration is the discussion of the effect of devaluation. SDP asserts that it 'increases the relative price of capital goods (which are imported) and thereby discourages private investment'. Relative to what the

price increases is not clear, but having just stated that depreciation raises domestic prices, it seems that it means relative to the price of labour. Normally, in neo-classical economics, this relative price movement is assumed only to alter the factor intensities or choices of techniques, not the amount of investment. Moreover, the rise of prices of goods relative to the nominal wage causes a more than proportional rise in the profit margin and, hence, in the return on capital. Devaluation gives more incentive to invest by reducing the real wage.

Not enough information is given to judge the other relations assumed, but, the behaviour equations, like the relation between investment and the exchange rate, are estimated from single equation regressions. According to econometric theory, when the same variables occur in several equations, i.e. when there are simultaneous equations, the correct procedure is to use simultaneous equation estimation. This is usually difficult, often impossible. But the difficulty or impossibility of using the correct method does not mean that the wrong method gives the right results; single equation estimates can not be used and the estimates they give are meaningless. Economists who use them incorrectly in this way usually plead that they have heuristic value or are approximately correct, though there is no reason to believe either to be true. Single equations regressions would be illegitimate even if the results appeared to be statistically significant, though SDP says nothing about the results of significance tests. One advantage of using simultaneous equation estimation is that it sometimes exposes illogical or inconsistent assumptions; the attraction of single equation estimation is that it does not.

Humane governance

HD presents the problems of social development in South Asia and, more particularly, in Pakistan as problems of governance; the subtitle is "The Crisis of Governance". Governance has been a preoccupation of the World Bank for some years now, because interest has grown in understanding how institutions determine the formulation and implementation of policies, as well as the routine conduct of business. It is mainly concerned with institutions and organisations, and much of it derives from the ideas of principal:agent transactions. But, as happens to many words that become fashionable, its meaning has been stretched. By the time it is defined as 'the sum of the many ways individuals and institution, public and private, manage their common affairs',²¹ not much meaning is left.

As a notion for the analysis of how societies or economies function

²¹ Part of the definition by the Commission on Global Governance, quoted by Human Development in South Asia, 1999. p.29.

and how policies are formulated and implemented, governance in the narrow sense involves no judgement as to whether a particular outcome is desirable or not; it tries to explain outcomes by the way institutions work. When the degree of desirability of outcomes is specified, governance can be good or bad, but governance as the operation of institutions and the degree of desirability of the outcomes remain distinct. In HD's notion of humane governance the distinction is lost; it is a political and economic agenda of the authors. Much of it would not be disputed in the western liberal scheme of values: human rights, impartial judiciary, equal rights, corporate social responsibility, etc. These are moral imperatives. But, when humane governance includes removal of rent seeking, HD is presenting free market economics as though it were on the same moral plane as human rights. Similarly for decentralisation. Moralising has taken over.

V. Summary

Poverty has remained more widespread in most developing countries than would have been expected from their economic growth, and this demands an explanation. Neo-classical economic theory helps little, since it attributes income distribution to the technical features of production, unless there are market failures. Its two remedies, therefore, are income transfers through taxes and correcting the market failures. The first risks inefficiency, while market failure is not a convincing explanation of widespread poverty. The alternative to neo-classical theory is that policies have been the cause of poverty. It was obvious in the time of the Ayub Khan government, which was virtually explicit that its policy was to concentrate income. Since then policies have changed, yet poverty persists. The change all over the world has been to freer markets and flexible exchange rates. Devaluation, or gradual depreciation of a currency, is intended to improve the trade balance, but it works through lowering the nominal cost of labour in terms of foreign exchange, and hence the real wage. It also causes inflation, since domestic prices of tradable goods rise along with import and export prices. Since the authorities react to inflation with more devaluation, regardless of what has happened to real or nominal wages, the country is caught in a cycle of repeated devaluation and inflation. Orthodox economists and institutions, like the World Bank and the IMF, are unable to offer effective remedies for poverty because neo-classical theory does not provide any, so they can only talk about palliatives and market reforms that actually make things worse.

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Book Review

Shahrukh Rafi Khan, *Government, Communities and Non-Governmental Organizations in Social Sector Delivery; Collective action in rural drinking water supply*, Ashgate Publishing Ltd., Hants, England and Ashgate Publishing Company, Vermont, USA, 1999. 144 pp., price not mentioned.

The author, a senior member of the Sustainable Development Policy Institute, Islamabad and well known figure in the sphere of participatory development and community effort, has compiled this work consisting of first, a brief overview followed by two detailed chapters based on field research reports.

The primary objective of the first report was to ascertain to what extent the transfer of rural water supply schemes to communities was sustainable and the conditions under which such transfers ended up as failures. The second report, initiated by the World Bank was on testing the hypothesis that the fundamental variable in the sustainability of rural water supply schemes was demand. The hypothesis was extended to include whether 'more sustainable water supply schemes result from the social mobilisation that NGOs engage in to induce collective action'.

From a layperson's point of view, perhaps the most interesting part of the book is the first introductory chapter in that it gives a succinct and comprehensive account of the concept of participatory development. The author likens the support NGOs use of social organisers to the use by Marxist parties of cadres to spread radical ideas of revolution and politically 'indoctrinate' and motivate the masses. 'The difference is that the goal of social mobilisation is community social and economic betterment via their participation and self help'.

The author then talks about past attempts at implementing participatory development in Pakistan, how this particular concept diverges from the conventional development approach, the crucial role of NGOs in bringing it about and lastly, a comparison with socialist and capitalist approaches to throw light on its salient features.

In passing, the author points out that some amongst us might see the role of NGOs as a substitute for the state and that it logically follows that if the state encourages NGOs, it is in fact simply being escapist and abdicating its responsibility. He then suggests various possible scenarios of the respective roles of NGOs and the state, among them being a sort of mutual supporting role of both. As to the market, Dr. Khan dismisses it

outright as a way to bring about participatory development, stating very cogent and convincing reasons in doing so. A little further he says that participatory development is market friendly, not opposing private property and hence inequalities. The difference lies in participatory development being concerned with collective goods in the main, in the interests and for the well being of the poor.

Chapter 2 revolves around the sustainability of the policy by the government to transfer rural water supply schemes back to the community. The transfers were thought of in the first place because it was rightly felt that the federal and provincial governments were over extended especially in terms of fiscal responsibilities and staff commitments. The study group found that all was not well and only 14 of the 50 sample schemes were sustainable. Further, even the sustainable schemes confronted the problems of default and mal-practice. The real problem for that matter apparently lies in tackling the nitty gritty of 'free riding', default, raiding, breakage and uneven distribution. An unusual and innovative scheme to deal with the problem was that of announcing the names of defaulters after the Friday sermon. Also to assist in enforcement problems were the field staff of the survey.

Throughout the survey the distinction between general variables that explain sustainability or its lack and policy variables which affect change was kept in view, with the focus of the survey being on the latter. One variable accounting for the lack of sustainability was absence of need for instance, a phenomenon which led to inoperability or a vestige of operability as in the case of the sample taken from Murree. Other problems in this area were the existence of households built singly or in clusters and hence a scattered population that would naturally lead to reduced contact amongst the villagers.

One insight gained from non-sustainable schemes was the chronic lack of basic hygiene with villagers rarely, if ever, cleaning water tanks and disinfecting the water. Women unfortunately were not overly enthusiastic to being involved, merely wanting an abundance of water of adequate quality. Somewhat stating the obvious, but worth reiterating no doubt is why bother about water supply in the first instance, the author explaining the health hazards of poor water supply in the process.

The author also adds a note of warning in that with the existing age of the schemes and population pressure to boot, the need for major rehabilitation, repair and extension would be extremely high in the not too distant future. The state, the author correctly feels, ought to assume responsibility for this in its entirety.

Again to make the projects feasible in the future, Dr. Khan sensibly points out that it is not simply the engineering criteria that matter, but the sociology of communities which is of critical importance. Attention should in fact be given to the latter, at least more than has been thus far.

Having elaborated on the various stages of the study, the outcome in the main was that, despite the fact that so few of the total sample schemes transferred to communities were sustainable, they found that raw potential existed virtually in abundance for collective action in village communities. The nuts and bolts of the study are spelt out amply in the appendices to the chapter and these could prove to be most useful to other researchers in the field and have an intrinsic value in themselves.

Chapter 3 is a comparative institutional analysis of the sustainability of rural water supply schemes. At the outset the author presents a conceptual framework of ideas such as 'participation' and 'motivation' which is again useful even if it somewhat belabours the point. The hypothesis tested in this survey was whether demand responsive project rules and social mobilisation are positively correlated with scheme sustainability. In determining the role of demand, the author conceptualises 'latent demand', this being revealed by community solicitation of the scheme. And, what seems like a foregone conclusion, latent demand did indeed play a vital role.

Logically, with a strong association between community demand and scheme sustainability, the author feels that public policy should at best be modified. Policy should be altered in terms of reducing expenditure on the military, enhancing agricultural income tax and a curtailment of urban bias in order that rural sectors do not encounter the scarcity of drinking water which presently persists.

The entire work, packed concisely, is highly readable and comprehensive even to the layperson. Its simplicity in style and clarity of ideas has an appeal in and of itself. Perhaps the only flaw I, for one, found was that the reader is bombarded by a maze of acronyms such as RWSS (Rural Water Supply System) and since these are hard to keep track of, can be problematic. But then, perhaps it simply could not be avoided.

The impression which one gets having been through the pages, is that neither does the author seem to romanticise poverty, nor does he at any point sound patronising and condescending either. A state of mind which most of us living in a society where dire poverty exists, should attempt to adopt. His views are balanced, he is the epitome of pragmatism with the necessary sprinkling of idealism, and he is down to earth. Despite

the relative dryness of such a subject, the very title of which the average reader would balk at, the author sustains the reader's interest almost throughout its length. In sum, a job well done and those concerned with rural water supply, not just specifically in Pakistan but throughout the developing world, ought really to pay heed.

Lahore School of Economics
Lahore

Nina Gera

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