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OPINION

The Quest for Dividends from Structural Change

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What we know

Pakistan has been stuck in sub-optimal growth equilibrium, while other countries in the region have moved forward and are providing higher living standards for their citizens. Given the focus of policy makers, politicians and international financial institutions (IFI's) on short-term stabilization to address inflation, the devaluation of the PKR and lack of private sector lending; it is important to pause and look at the bigger picture, the evolution of a typical Pakistani's real income (i.e. after adjusting for inflation). This exercise is important not only to identify past policy mistakes, but also to formulate a future course of action.

We show that Pakistan has been in a state of long term economic decline, which is at the source of most of its economic weaknesses- we call this the original sin. This decline can be explained by a structural focus that relies primarily on services to generate value addition and less so on agriculture and industry. As a result, the agriculture sector is slowly receding, while the industrial sector is growing far slower compared to its peers. This journey of structural change has left Pakistan with a services sector dominated by low-productivity traditional services. The sliver-lining in this unpleasant reality, is that this structural transformation has been a policy choice, which implies that it can be reversed.

To explain these findings, we first frame the problem of below average real growth in Pakistan by comparing its economic performance with Bangladesh and India. This comparison is relevant as these countries share a common colonial history, institutional development and similar natural endowments. After establishing what we call the "Pakistani Growth Rate," we explore some possible explanations for this by doing a historical and cross-country analysis of sectoral GDP[2].

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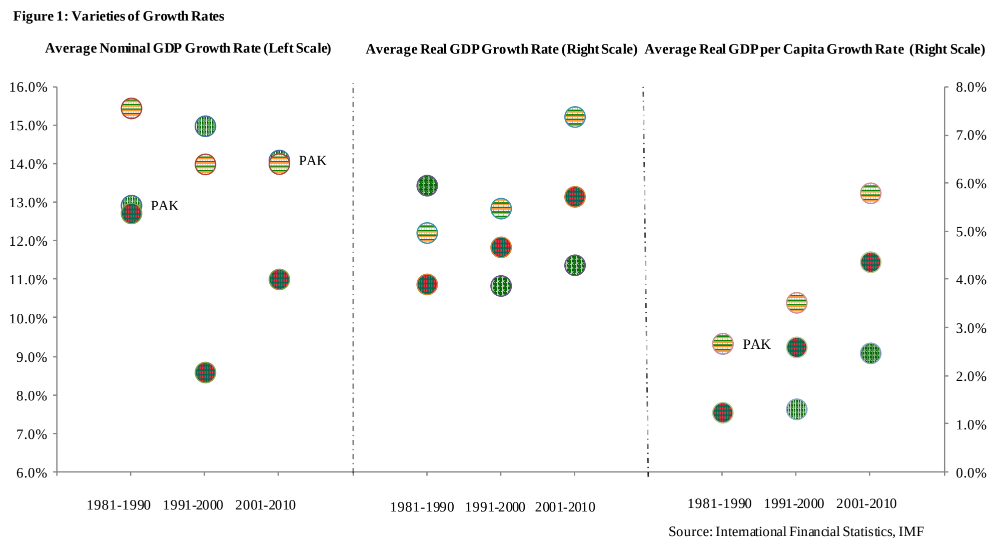
[2] Choudhary, A. and Pasha, F, (2013). "The RBC View of Pakistan: A Declaration of Stylized Facts and Essential Models," State Bank of Pakistan Working Paper Series, No. 56 (http://www.sbp.org.pk/publications/wpapers/2013/wp56.pdf).

What we should know

In Figure 1, we compare the comparative growth of South Asia for the last 30 years. The three different panels show average nominal growth, average real growth and average real per capita growth respectively, for the three countries.



It is important here to draw attention to the fact that most of the economic discussions in Pakistan tend to focus on aggregate nominal GDP growth (left panel) and on the aggregate real GDP growth (middle panel). However, the most important growth measure (real per capita GDP growth -right panel) is generally overlooked. By focusing on real per capita growth, Pakistan has become the worst performer in the last two decades compared to its neighbors. It is in fact stuck at the 30 year average of 2.3%, which we call the 'Pakistani Growth Rate[3].

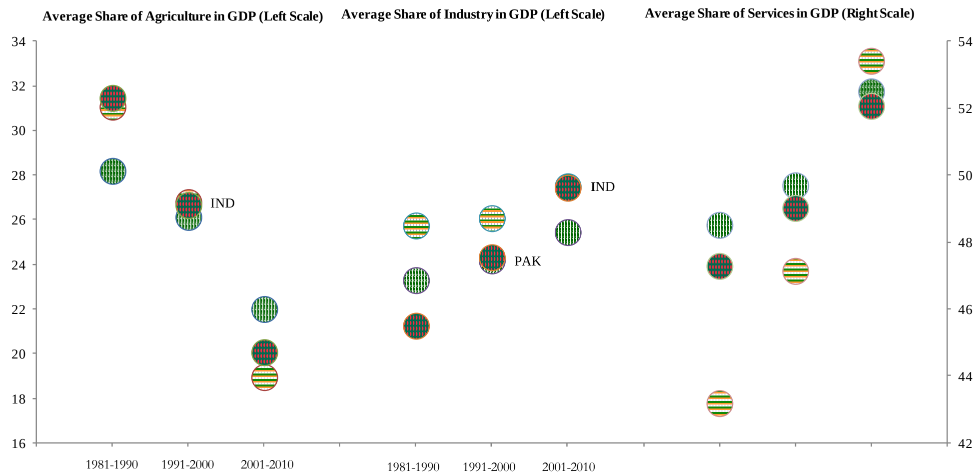
This fact is even more alarming considering that Pakistan was the best performer in the region during the 80's.Just to drive home the point, the average real growth of GDP per capita during 2001-2010 was 2.5%, 4.4% and 5.8% respectively for Pakistan, Bangladesh, and India. At this pace Pakistan, Bangladesh and India will double their real incomes in 30, 15 and 12 years respectively.

How did we structurally move to the current status quo?

First, we look into the changing nature of sectoral GDP over the last 30 years; second, we evaluate the changing nature of real growth in these sectors and third, we focus on the services by further disaggregating the sector into modern and traditional services.

[3] A term similar to the well known term of 'Hindu rate of growth', this term was coined by an Indian economist Raj Krishna which refers to the low annual growth rate of India before 1991, which stagnated around 3.5% from 1950s to 1980s, while per capita income growth averaged 1.3%.

Figure 2: Average Value Added by Sector (% of GDP)



Source: World Development Indicators, WB

Looking at the right and left panels of Figure 2, two trends emerge in all three countries; there has been a consistent decline in the contribution of agriculture and a sharp increase in the contribution of the services. However, there is a difference in the pace at which this structural re-organization is taking place: for Pakistan the pace of decline in the agriculture sector and the rise of services sector have been slower compared to India and Bangladesh.

In particular, the slow speed of de-agriculturalisation in Pakistan is note-worthy. Even though all three countries have moved away from agriculture over the last three decades, the moving away from agriculture has been slowest for Pakistan. This partially explains the lower growth of Pakistan compared to Bangladesh and India as agriculture sector has the lowest value-added growth out of all three sectors of the economy (as we will later). This situation can be due to lack of a consistent policy and sustained commitment for moving the population and labor force away from agriculture into industrial and services sector.

Turning our attention to industry (Figure 2), there is no clear trend for the three countries. Clearly, Bangladesh is industrializing at a fast pace while the industrial sector in both Pakistan and India, have been stagnant. Moreover, Pakistan has steadily become the least industrialized nation of the three South Asian economies.

The falling share of agriculture and a fast-rising services sector points towards the idea that India[4] and Pakistan have skipped industrialization phase and jumped from being predominantly agriculture-based to service oriented economies. However, the case for Bangladesh is different in the sense that the declining contribution of its

[4] This is well documented for India see for example Eichengreen, B. and Gupta, P (2011), "The Service Sector as India's Road to Economic Growth", NBER, Working Papers Series, 16757.

agriculture sector is being substituted by increased contributions from both industry and services.

It is interesting that for some time now, developing countries have been advised not to emulate the West by industrialization first, but instead directly shift to a knowledge-based economy[5] , which amounts to the expansion of specific services. This vision of skipping industrialization altogether, is considered a viable option as services (in richer countries especially) are now the driving force for economic growth in the OECD countries. In fact, India is often viewed as a shining example of services sector led economic growth.

This pronounced transformation in GDP composition of both Bangladesh and India, provide a possible explanation for their relatively better performance in terms of real per capita growth (Figure 1). However, Pakistan, unlike Bangladesh and India, has been unable to reap the gains from structural dividend.

Lack of structural dividends for Pakistan

To better understand the impact of structural changes on economic growth, and significant differences in the growth performance of the three South Asian countries, we looked into the growth of value-addition by each sector of GDP. In Figure 3, the value addition by agriculture in Pakistan has declined significantly during the last decade while it has increased for both Bangladesh and India. The growth of value-addition by the industrial sector is different across three decades. In the last decade, growth in value-addition by in industry is somewhat similar for Bangladesh, India and Pakistan, but Pakistan lacks consistency in industrial growth rate and suffers low growth in services.

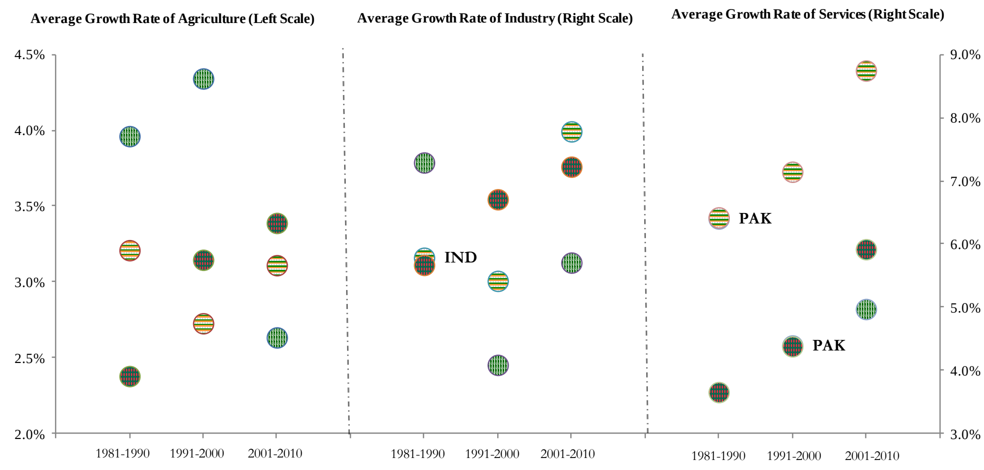
Finally, the main take away from Figure 3 is the growth of value-added in services in India is almost twice as high as Pakistan in the last decade. Furthermore, the growth of value-addition in services in India has been higher than its peers for the last three decades. Interestingly, this growth was identical for Bangladesh and Pakistan for the first two decades, but it is higher for Bangladesh in the last decade. The contrasting performances of the services sector deserve an explanation given its dominant role in GDP and its contribution to economic growth

To do so, we partition services into two groups. The first group comprises of services such as finance, insurance, real estate and business services also known as modern services[6]. The logic behind this partition is that these services are considered as

[5] The emphasis on knowledge economy as tool for growth is crystallized in sociology by 'Daniel, B (1974), The Coming of Post-Industrial Society. New York: Harper Colophon Books,' and in economics by 'Romer, P. (1990) "Endogenous Technological Change." Journal of Political Economy 98 (5).'
[6] We follow closely the definition of modern and traditional services followed by Eichengreen, B. and Gupta, P (2011), "The Service Sector as India's Road to Economic Growth", NBER, Working Papers Series, 16757.

knowledge-based services and have a higher productivity growth potential[7]. The second group comprises of traditional services such as retail and wholesale trade, hotel and restaurants, transport and communications, community, social & personal services. These services tend to offer limited productivity growth potential[8].

Figure 3: Average Growth Rate of 'Value Added' by Sector



Source: World Development Indicators, WB

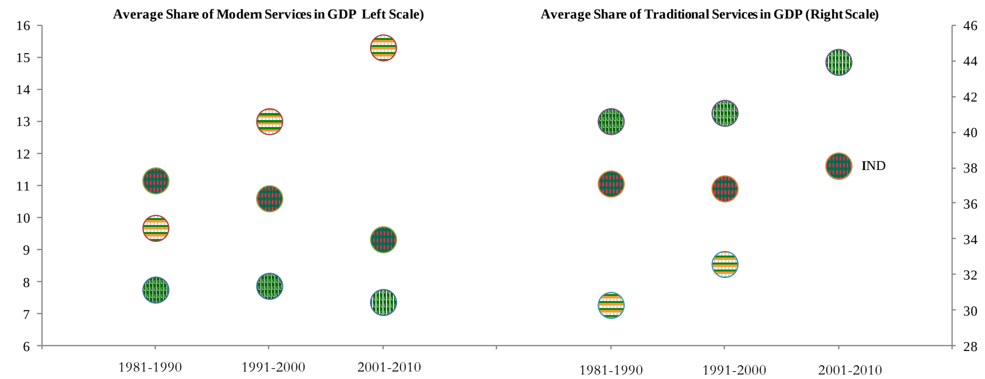
Figure 4 shows that India has excelled in developing its modern services while Bangladesh and Pakistan have fallen behind. Furthermore, Pakistan has excelled in traditional services where as India and Bangladesh are at the same level. These differing focuses of India on modern services and Pakistan on traditional services partially explain almost double growth of services in India compared to Pakistan.

This growth of modern services in India may in part be motivated by its industrial sector. To make this point, we compare the outcomes of two collaborations in the automobile sector between Japan and India as well as between Japan and Pakistan; namely the Suzuki-India and Suzuki-Pakistan partnerships. In India, the partnership was able to meet its deletion program and the car (Maruti) is now totally indigenous, while in Pakistan, to date, the deletion program remains incomplete. This highlights contrasting emphasis of industrial policies in both countries[9]. The reason we draw attention to this comparison is that business services required to complement a car

[7] Let's consider an example, an IT engineer, working in the modern services sector can allow companies to shift their mode of communications from telegrams to electronic message s speeding up the decision-making process and increased overall productivity level of companies.
[8] Let's consider an example, a waiter at your favorite restaurant, working in traditional services, can only serve so many people in a given day no matter how hard he tries.
[9] Khan, M. A. (1992), One Step Forward, Several Steps Back: The Foundry Industry in Pakistan, Unpublished Manuscript, Stanford University.

industry are different (e.g. IT specialist, engineers) from then, say, for hotels industry and their productivity impact on growth is not inconsequential in the long run.

Figure 4: Shares of Modern and Traditional Sub-Sectors in GDP



Sources: Bangladesh Bank, Reserve Bank of India, State Bank of Pakistan

The differences between the evolution of services and industry sector of the three countries provide possible explanations for higher real per capita growth in Bangladesh and India. Bangladesh may be forgiven for not developing its growth-enhancing modern services given its current industrialization drive. However, Pakistan needs to think about where it's heading given its current structural organization. Indeed, since Pakistan's services sector is more traditional it will be hard to argue for us to continue to focus on services leading us to higher economic growth. India's service-led growth formula can only work for us if we start diversifying our labor force and moving them into modern services such as banking, IT as well as focusing on our domestic market.

According to research[10] by ADBI, the main reason for the growth of services sector in India was the growth in domestic demand for services instead of exports of services. Furthermore, they also found that total factor productivity growth contributed significantly to the growth of services sector in India.

Given the history and structural transformation of Pakistani economy, it is pertinent for policy-makers to realize that it is time for us to specify a well thought out industrial policy and focus on industry and agri-industry (since Pakistan has de-agriculturalized the least) related opportunities for the Pakistani labor force to move from agriculture into other sectors of the economy.

Is skipping industrialization a concern for Pakistan?

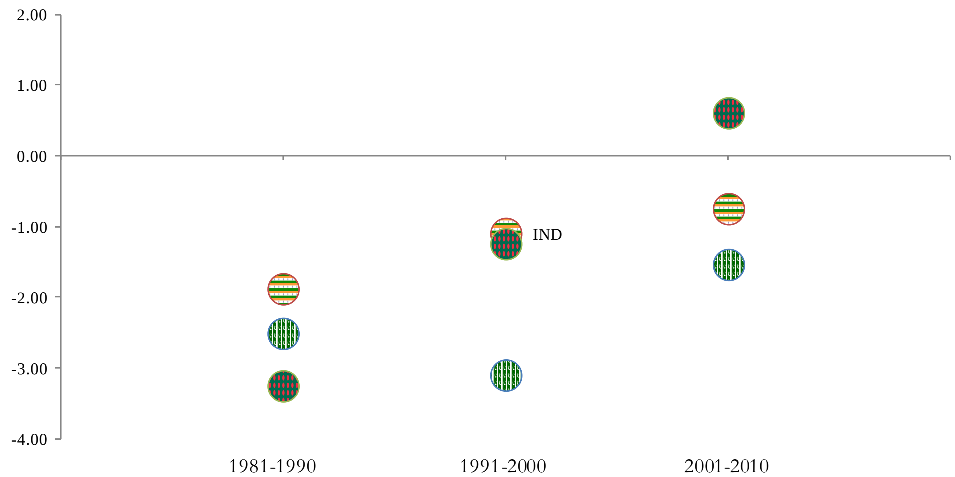
There are four reasons why skipping industrialization can be a major concern for Pakistan. First, the services sector growth in Pakistan did not follow industrialization.

[10] Das, A. Rashmi, B and Kumar, D (2011), "Global Economic Crisis: Impact and Restructuring of the Services Sector in India", ADBI, Working Papers Series, 311.

This sequencing is important because the type of services behind this structural shift offer limited productivity growth and export potential. As explained earlier, this prospect is highly likely for Pakistan than India or Bangladesh given that its services sector is largely made up of traditional services

Second, not all services a country has to offer are tradable and hence exportable. This implies that countries heavy in traditional services sector and weak on industry front may have perennial balance of payment concerns[11]. Indeed, Figure 5 below shows that until last decade all our chosen economies were in persistent state of current account deficits but in the recent decade this situation has become less inconvenient for India while Bangladesh has an export surplus.

Figure 5: Current Account Balance (% of GDP)



The lower ability to export services also implies less than adequate export earnings which in turn limit the ability of the economy to import new technologies to achieve higher productivity in other sectors. This point is especially evident from the weak growth of both agriculture and industry. Again, this hurts the long term economic growth prospects.

Three, an economy that consistently suffers from balance-of-payments issues spends much of its efforts trying to balance its books. Indeed, since 1990 Pakistan has sought an IMF program[12] every 3 years (i.e. 8 programs) compared to 7.7 and 12 years for

[11] This is easy to understand, to consume the services of your favorite restaurant at the other end of town; you probably need a ride for which you also need fuel which you perhaps need to buy from abroad for which you also need foreign currency which you probably don't have because services of your favorite restaurant cannot be sold abroad.

[12] To simplify, all IMF facilities signed at the same dates of arrangement were treated as a 'single' program.

Bangladesh and India respectively[13]. Pakistan is an example of a country dependant on external financing; setting it apart from India and Bangladesh. This is important because in such an environment, day-to-day book-keeping takes precedent and economic fire-fighting becomes a highly sought after profession. In turn decision-making for the longer term suffers without the realization that the source of the problem for Pakistan is its long-term decline.

Where to go from here?

The structural dividends have not materialized for Pakistan and are unlikely to materialize given the general nature and evolution of different sectors of the economy, and the fast moving nature of the world economy. Therefore, the long-term growth prospects of the economy remains limited and further balance-of-payments crises can be anticipated.

The three countries in our analysis have chosen three different paths for their economic transformation over the last three decades. Bangladesh chose to focus on industrialization, while simultaneously growing the services sector as well. India focused on modern services while maintaining its industrial base. Pakistan mainly emphasized on developing their traditional services, while maintaining some agriculture and industrial base. It seems that the policy makers and economic managers of the three countries used different vision and strategies to structurally transform their economies. This structural transformation has worked quite well for both Bangladesh and India but unfortunately not so much for Pakistan.

In conclusion, Pakistan is currently combating a long term declining trend of real per capita growth. One possible explanation for the decline is a structural transformation, of the economy, that started three decades ago, towards the production of goods and services with a limited capacity to raise productivity. This transformation is no random event but is by policy and by choice. The good news is that if it can be chosen, it can be changed. The future direction for a new structural change must re-focus on industry, agriculture and a fusion therein with the sole objective of enhancing productivity.

[13] This fact is in itself is a complementary explanation for disappointing growth performance of Pakistan relative to India and Bangladesh. The idea is not to frame blame but rather as a constructive self criticism. However, this topic is beyond the scope of this discussion.