ESSAYS IN DEVELOPMENT ECONOMICS
No. 1

Egalitarianism Versus Growthmanship

Syed Nawab Haider Naqvi

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
Old Sind Assembly Building,
M. A. Jinnah Road, Karachi-1 (Pakistan)

ESSAYS IN DEVELOPMENT ECONOMICS

This is the first number in the series *Essays in Development Economics* which will be published from time to time by the Pakistan Institute of Development Economics.

The author is Officer-in-Charge of the Karachi Office of the Pakistan Institute of Development Economics and has published extensively on International Trade Problems in both national as well as international journals. His most recent article is "Optimizing Gains from Pakistan's Export Bonus Scheme" which has been published in the January-February 1971 issue of the *Journal of Political Economy.*

This series is intended to be restricted to meritorious studies in the general field of Development Economics.

While the Institute intends to provide all the freedom of expression to the contributors to the series, the authors are fully responsible for the views expressed therein. The Institute does not assume any responsibility for the views expressed by the authors.

Pakistan Institute of
Development Economics

SYED NAWAB HAIDER NAQVI
Officer-in-Charge

ESSAYS IN DEVELOPMENT ECONOMICS

No. 1

Egalitarianism Versus Growthmanship

Syed Nawab Haider Naqvi

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
Old Sind Assembly Building,
M. A. Jinnah Road, Karachi-1 (Pakistan)

Syed Nawab Haider Naqvi
Essays in Development Economics, No. 1.
Egalitarianism Versus Growthmanship

Price

Inland: Rs. 2.00
Foreign: US $ 1.00

Published by
The Pakistan Institute of Development Economics, Karachi

Printed at
Din Muhammadi Press, I. I. Chundrigar Road, Karachi
JUNE 1971

Egalitarianism Versus Growthmanship

I: INTRODUCTION

The years 1968-69 have proved to be a watershed in Pakistan's history. They witnessed the first-ever successful national upheaval against an unrepresentative though well-entrenched regime. At first sight the events of 1968-69 appear to have been touched off by a rising sentiment for the rule of law and the establishment in the country of a parliamentary democracy based on adult franchise. However, the political turmoil in Pakistan was sustained by the gross social injustices to which the people had been subjected.

The main lesson that policy-makers and economists should learn from the social turbulence in 1968-69 in Pakistan is that a relentless drive for economic growth without due regard for social justice can spur a social revolution of the first order. It, therefore, follows that while economic growth might well be the basic objective of economic policy, government should also adopt specific measures to protect the majority of the people against the tyranny of a privileged minority. It may be unavoidable in a free-enterprise economy for a few investors to be the first recipients of a major part of the national wealth, but the State should ensure that they are not also the last recipients. The aim of government policy should be not only to secure from each according to his ability but it must also provide to each according to his needs.

The purpose of this article is to discover the true causes of the national upheaval in 1968-69 and to learn the right lessons from it. It shows in the second and third sections that policy-makers in Pakistan continue to distil their economic wisdom from the theories of some defunct economists of the distant past. Not only has the government tolerated the emergence of an unjust society; it in fact helped to perpetuate it by allowing wealth to concentrate in a few hands on the presumption that saving and investment in the economy would rise and the rate of economic growth be accelerated thereby. We attempt to show that such a policy has not only been unnecessary but utterly wasteful. Moreover, it has helped the growth of powerful vested interests in the society which will obstruct any changes in the *status quo.*

II. THE END OF EUPHORIA

II.1

The muted response of the general public in Pakistan up to 1968 to a policy of unbridled growthmanship had driven both politicians and the economists into making the false presumption that any economic solution to the problems of under-development could be imposed on the public with impunity. It was maintained, as is still done, that we should first grow and then redistribute, that we should try to enlarge the national cake before we could ever begin to have it distributed. Hence, a major portion of national savings should be ploughed into the build-up of physical capital. The development of human capital was seldom given the place it deserved.

The theoretical underpinnings of such a policy derive from the assumption usually made in economics that the saving propensities of profit-earners and wage-earners are such that while the former tend to save the major part of their earnings, the latter tend to dissipate their earnings in consumption. Thus, it is contended that, if the maximisation of saving and investment is the primary goal of government policy, income should be allowed to concentrate in the pockets of profit-earners rather than go to wage-earners. This belief lies at the roots of the Anglo-Saxon tradition of political economy, which has maintained since the days of Adam Smith that any attempt at redistributing income in favour of wage-earners should simply provide them with the wherewithal to procreate rather than invest.

This basic tenet of classical political economy is known as the Iron Law of Wages. It is so deep-rooted in traditional economic thought that economists have always tended to blame unemployment on a high level of wages. It has been maintained that if unemployment is to be reduced, all that can be done is to reduce the wages. It was this disdain for the social consequences of economic policy that prompted social philosophers like Carlyle to term economics the dismal science. This view was challenged by Keynes in the late thirties and since then economics has experienced a "change of heart" by incorporating welfare economics into the main corpus of economic theory.

However, the men in authority in Pakistan still seem to distil their economic wisdom from the theories of some defunct economists, with the result that actual policy-making lags far behind developments in economic theory. The Iron Law of Wages, which inspired and guided the Industrial Revolution in 1776 in Britain, still rules the roost. The guiding principle of economic policy is still the same: the share of profit earners must be made as large as possible while wages are kept to be a minimum; the goal of rapid industrial growth should be pursued relentlessly and ruthlessly, and the libertine spirit of the industrial sector remain unfettered.

This policy has paid off in that, with the exception of Japan, Pakistan has recorded the highest rate of growth achieved by any country in the post-war world. The large-scale manufacturing sector, which was nothing at the time of the partition of the sub-continent, has grown sharply at an average rate of 15 per cent or more since 1960, three times faster than the growth in GNP. As a result, the contribution of the large-scale manufacturing sector to Gross National Product had risen from 1 per cent in 1948-49 to about 10 per cent in 1969-70. However, while industrial growth has been remarkable, the incomes gap between social classes has widened. It has been estimated that at present 29 industrial units control most of the industrial assets. There has also been a tendency towards cartelization and monopolization in industry; industrialists not only own industrial assets but also control the major sources of finance — e.g., they have their own insurance companies and their own banks.

Furthermore, as discussed below, while wages have not been permitted to increase, no effort has ever been made to regulate the profit margins of the industrial investors. As a result, a privileged class of industrial elite has emerged who owns palatial houses and big cars while nothing has been done to ameliorate the fast-deteriorating living standards of the working class. Such glaring disparities in the living standards of the rich and the poor have created an explosive social situation in Pakistan. The national disturbances of 1968-69 dramatically demonstrated the untenability of such a policy of unbridled growthmanship. Now, as never before, the popular demand is for a drastic social change. And it appears that without far-reaching reform in social and economic policies the very fabric of the Pakistani society may be torn asunder.

II.2

The root cause of the social maladies that have afflicted Pakistani society is that the government has let the private sector do the job of extracting the required investible surplus from the economy. The policy of the government has been to transfer real resources to the industrial investors from the rest of the economy. This policy objective has been magnificently accomplished through a complex economic manoeuvre. Firstly, as pointed out in the second section, while the investors have been given every incentive to save and invest on a large scale, a virtual freeze has been imposed on any wage increases. It has been estimated that for over 12 years from 1963 onwards, money wages have remained virtually static while real wages fell as the general price level rose. As a result, profits multiplied without limit. Secondly, this process of profit multiplication was further strengthened by stringent import restrictions which raised tremendously the marginal profitability of new investment. With no effective system of price controls in force, industrialists in Pakistan have grown in wealth without fear of foreign competition. While the industrialists have not been checked in the selfish pursuit of profit maximization, the common man has been forced to buy inferior quality and high-priced goods as a matter of patriotic duty.

Thirdly, in order to enable the private sector to save on such a large scale, the existing tax structure has been heavily biased in favour of the industrial investor. The government policy has been to drug the industrialists with extrastrong fiscal and monetary incentives. Nowhere else in the world except, perhaps, in Germany, have the industrial "robber barons" been fed such large chunks of "meat" at the expense of the public exchequer. Some of these fiscal incentives have been: differential tax in favour of paying dividends — 10 per cent off the corporate of 45 per cent; a rebate of personal income tax for investment in securities, so that a man with Rs. 30,000 of income can get 40 per cent on such investment up to Rs. 12,000; dividend income is exempted from tax up to new industrial ventures get Rs. 5,000, a six-year tax holiday, and so on.

Are all of these incentives really necessary to keep the wheels of industry turning at an ever-increasing pace? My contention is that, whatever may have been the justification for pursuing such a policy in the past, a continuation or, even a worse, a reinforcement of it in the future, is both unnecessary and wasteful. Such a multiplicity of tax exemption and concessions have seriously eroded the tax base and have eased considerably the strain on human ingenuity to evade tax payment. Furthermore, such losses to the public exchequer may not have been offset by additional tax revenues from increased production in the manufacturing sector. After all, we already have cases of excess industrial capacity and over-capitalisation in certain lines of production, in other words of a misallocation of resources. Besides, tax incentives are only one of the several determinants of investment. Most important of them all is the availability of foreign exchange which sets an upper limit to the extent to which additional investment can be undertaken. If tax incentives are given without regard to the availability of foreign exchange, they merely lead to more money going into the pockets of the investors rather than into more investment, and into conspicuous consumption. There are strong reasons to suspect that this is what has been happening in Pakistan.

The main point that I want to make is that the strategy of unbridled (or not adequately bridled) *laisser faire* is bound to bias income distribution heavily in favour of a small group of investors. Government policy is then reduced to coaxing, cajoling and not infrequently to begging this small group of investors to use this additional money for productive investment. The belief that it is possible to redistribute after the growth process has gone far enough is at best naive, and at least downright pernicious. For in the process of economic growth powerful vested interests also grow, and they tend to resist any change in the *status quo*. The latest example of such resistance by pressure groups in Pakistan is their reluctance to really enforce the minimum wage law in both letter and spirit. The frequency of strikes by industrial workers who can hardly "afford" to do so unless they are really pushed to the wall, is another example of the dangers of letting the "dog" sleep undisturbed for too long. The basic point is that inequality of income is NOT a pre-requisite for additional saving and investment.

II.3

The recent developments in economic theory do not support the hypothesis that income inequality, such as has been consciously promoted by the government in Pakistan, is a pre-requisite of economic growth. Several arguments can-be advanced against such a hypothesis. Firstly, the hypothesis that inequalities of income have to be tolerated as a *necessary evil* in order to make it possible for the capitalist to do the job of extracting the required investible surplus from the economy is ill-founded in theory and makes the economic process appear unnecessarily forbidding and devoid of any sympathetic concern for social suffering. The hypothesis is ill-founded in theory because it *assumes that there is only one way of extracting the required investible surplus from the economy.* However, the government can also do this job, and there is a presumption that it can do this job at a much lower cost to the society. Hence, in order to establish the superiority of the private sector, one must compare the costs of collecting and redistributing economic resources among various classes by the government with the cost of relying mainly on the private sector. It can easily be shown that whereas the policy of relying on the private sector to generate the investible surplus imposes both production and consumption costs on the economy, no such costs are involved if the government acts as a redistributive agent.

Secondly, the belief that investors today would reinvest whatever they earn above a reasonable standard and would lead an ascetic life ignores the force of the demonstration effect on consumption levels — the Duesenbury hypothesis — which operates both at a national and at an international level. The appeals of government to the conscience of profit-motivated investors did find a favourable echo with the investors of the 18th century Britain and the early settlers of America, mainly because they were not yet exposed to the corrupting influence of conspicuous consumption. A touch of puritanism may also have induced these pioneering investors to reinvest dutifully rather than indulge in the baser occupations of luxurious living. But the contemporary investor, unlike his (spiritual) ancestors, has to resist the more compelling temptation of owning consumer durables and big houses, while at the same time puritanism has spent its force, if it ever was much of a force. The ownership of excessive wealth provides strong incentive to indulge in conspicuous consumption.

Thirdly, even if investors do reinvest more than they squander, "self financing" by the investors leads to a misallocation of resources via over-capitalization and excess industrial capacity, which in turn adversely affect long-term growth rates. Fourthly, the above hypothesis ignores the fact that gains in productivity are linked not only with investment in physical capital but also with investment in human capital — healthy labour is as much a force for economic growth as increments in physical capital.

It follows that if the government persists with the policy of unbridled growthmanship then the society must accept a large-scale deflection of the resources put at the disposal of a small class of the society into wasteful expenditure on big cars and palatial houses as a necessary price of economic growth. This is of course a very high price particularly because the social gains in the form of additional investment fall far short of the cost to the society in allocative inefficiency and social unrest which, if suppressed for too long, leads to upheavals like the one the country experienced in 1968-69. Furthermoie, not noly that there is no necessary link between inequalities of income and economic growth, but that such inequalities may in fact generate forces which may ultimately hinder the process of economic growth itself by encouraging conspicuous consumption and by promoting a misallocation of resources.

As a matter of fact, a strong case can be made for the proposition that a just and socially acceptable distribution of income may release much stronger forces for economic growth than an equitable system would, for it would induce the public to cooperate with the government more effectively. Such mutual confidence between public and government is the basic requirement for making a democratic system of government, such as we are trying to establish in Pakistan, work for the good of the people. If people coud *see* that they get tangible collective benefits greater than their individual tax contributions, the payment of taxes would no longer be considered as unwanted burden to be thrown off at the slightest pretext but as a citizen's obligation to society and to himself.

Furthermore, a greater mutual confidence would enable the government to make more effective use of its fiscal powers. This is because when wealth is more evenly distributed the *monetary incentive* to evade taxes is considerably weakened. The smaller individual tax liability would not justify the time, money and effort now spent on devising successful schemes of tax evasion. While taxation experts will lose clients and money, society's chances of betterment will improve. With a more equal distribution of income, government would also be able to reduce considerably the top marginal tax *rates* because of a broadening of the tax *base*. As a result, while incentives to save and invest will become greater because of a lower marginal tax rate on the top income brackets, government will also acquire greater financial iesources for spending on social welfare.

III. WHERE THE RAINBOW ENDS

III.1

It directly follows from our analysis that in order to undo social injustices and to provide a just dispensation to society, the government must take over from the private sector the job of extracting the required investible surplus from the economy and adopt policies to rein in the private sector. As a first step, the government must withdraw all the wasteful fiscal incentives that it at present grants to the private sector. Every effort should be made to broaden the tax base and to destroy at the very source the incentive to evade taxes. Fiscal policy should be used more effectively as a mobilizer of private resources to the public sector. These additional resources will then be available for achieving the egalitarian objectives of social policy. In sum, taxation policy must be restored to the service of public welfare. It should not be allowed to remain a symbol of the exploitation of the poor by the rich, with the government being an accessory to the crime.

Furthermore, the government must take specific steps to compensate the losers in the society. This means that the government will have to play a bigger and a more effective role in leading the economy towards a more just social order. For, the basic aim of government policy must then be to maximise social welfare. This would require that government adopt two distinct set of policies, first, to make private investment flow into socially desirable channels of production; and second, to regulate relative consumption levels among social classes. While the first set of policies will be needed to correct a socially suboptimal pattern of production, the second set of policies will be required to satisfy requirements of equity in relative consumption standards. In other words, any democratic government worth its salt must not only secure "from every one according to his ability", but also provide "to every one according to his needs". Many economists in this country, though not all, may be alarmed at these suggestions, and dub them communist and what not. However, it can be easily shown that under fairly broad assumptions these general principles follow directly from the two basic rules of welfare economics — *i.e.*, firstly, production should be extended in various branches of production in such a way as to equalise marginal social productivities among them and, secondly, the distribution of income among consumers must be such as to equalise the marginal utilities of consumer goods among all consumers. The satisfaction of these rules will ensure the maximisation of social welfare. It is important to note that these rules are perfectly neutral and one need not assume socialism, capitalism or any other "ism" for their realization. However, whatever the political framework, basic social institutions must be created to ensure the fulfilment of each of these principles. There is no denying the fact that it would take a lot of human ingenuity to create and operate such institutions, but then what would the acquisition of knowledge do if it were not spent in devising ways and means of alleviating human sufferings.

Pure economic theroy tells us that in the event of a divergence between social and private benefits or costs, the market will fail to perform its allocative function optimally. In such a case, the State must intervene in order to maximise social welfare. The optimal form — *i.e.*, in a special sense, the "best" form — of state intervention under such circumstances is a subsidy to those industries where the gain to society from additional investments exceeds the gain to the private investor. The government must also impose a tax on socially undesirable investment, the basic principle being that the government must aim at equalising marginal productivities in different lines of production. If this is done the gain to society from productive activity will be optimized.

However, it is important to note that an appropriate tax-*cum*-subsidy scheme designed to regulate productive activity in the country only is not sufficient to satisfy the requirements of social justice — *i.e.*, it cannot by itself achieve a social optimum. For the system of *laisser faire* fails in a more fundamental way as to achieve distributive justice: the market mechanism makes no provision for the institution which could equalise marginal utilities among consumers. In order to correct this failing, a redistribution of income in favour of the losers is required. It has been suggested that such a redistribution of income can be affected, among other things, by making the tax structure more progressive — that is, by raising the proportion of direct to indirect taxes. But a tax on income affects work incentives and hence is only a second-best solution. On the other hand, taxes on wealth and on capital gains do not affect incentives and constitute an optimal solution. Of course, the optimal solution may be impossible to achieve, and one would have to settle with the second-best. But whatever it is, an ambitious social security programme remains the main policy instrument for achieving distributive justice; for every citizen of the country, whether employed or unemployed, whether able-bodied or old and sick, should be provided with a minimum income.

III.2

The reader may have wondered whether we are advocating the complete socialization of society in Pakistan. This is not the case. It can be shown that the government can ensure social justice without complete ownership of all the means of production. The important thing is that the government should regulate the private sector adequately and properly. The model for Pakistan is not a completely regimented economy where the State acts as a supreme overload and is invested with arbitrary powers to coerce the individuals into following a pre-established course of action; nor is it a completely free-enterprise economy where a few enterprizing individuals run the economy for the government. Such systems may be perfectly suitable for the countries in which they originated and flowered; but the ideal for Pakistan should be to move towards a welfare state in which, while the citizens enjoy all the civil liberties guaranteed by a democratic government, there exist enough safeguards against the tyranny of powerful vested interests, whose growth in a democratic society is almost natural.

Pakistan can draw inspiration from the experience of Scandinavian countries like Norway and Sweden. For decades now the policy-makers in these countries, unlike our own, have not felt impelled to make a choice between equity and growth. The impulse to alleviate social suffering has been so strong that economic policies have been framed to achieve high growth rates while also satisfying the "equity constraint". As a result, these countries, by making judicious use of government's vast coercive powers, have succeeded in establishing a just society, while growth rates of 5 per cent or so have been maintained — all without curtailing individual civil liberties. The experience of these countries should make us pause and think. It is no argument to say that the government in Pakistan, as in other under-developed countries, is, of its very nature, corrupt and inefficient. Even if such, in fact, is the case, it is no argument for surrendering government authority to the "invisible hand" of the market but underscores the urgency of improving the efficiency of government. For, without a strong and efficient government democracy could become the tool of a few exploiters.

IV. CONCLUSION

The upshot of our analysis is that the conflict between growth and distributive justice is nothing like a law of nature. It is a conflict in appearance only which arises mainly from our unquestioning belief that the monopolistic profit-maximiser must be given his pound of flesh in order to attain high rates of economic growth. We have shown that such a belief is at best naive, if not downright pernicious. It is based on out-of-date economic deoctrines and is a hangover from the Industrial Revolution of the 18th century. It is clearly anachronistic today when sentiment generally favours a welfare state.

The ultimate test of economic policy is the contribution it makes to the alleviation of social suffering. Granted economic growth will lead to higher welfare in the future and that the present generation must suffer. But why should a few enterprising individuals be allowed to acquire and keep excessive wealth and bathe in the warm glow of luxurious living while the major part of the population remains stuck in a quagmire of shameful poverty? It is only fair that the economically strong be made to pay for the economically weak. For Government must not only secure "from each according to his ability", but also provide "to each according to his needs". A democratic government, such as we are trying to establish in Pakistan, must satisfy both these social principles simultaneously in order to justify its existence.

Futhermore, even if it is true that the present generation must suffer for posterity's sake, care should be taken in apportioning the burdens of economic growth between the present and the future generation. For, it is the lure of tangible benfits in the present generation rather than the promise of an El Dorado for posterity that acts as a centripetal force in human affairs. You can temper this egoism a little, but any effort to alter it too much would certainly evoke a hostile social response. Society, and the individuals composing it, cannot be expected to indulge in acts of self-sacrifice entirely for the benefit of posterity, and certainly not for the benefit of the privileged few. No propaganda machine could ever enlist the whole-hearted cooperation of the public in the cause of economic growth if all it did was to promise a glittering future.

We must never forget that the centre of all our economic activity is Man himself. We need to understand that economic processes do not take place in a vacuum but involve living humanbeings who cannot be used as guinea pigs for economic experimentation. The State must provide for national welfare before it can hope to start off a vigorous and self-sustaining process of economic growth.