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# **Pakistan: The Middle East Connection**

**An Intelligence Assessment**

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# Pakistan: The Middle East Connection

**An Intelligence Assessment**

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This paper was prepared by [redacted] and [redacted] Office of Economic Research. It has been coordinated with the Office of Political Analysis, the Office of Strategic Research, and with the National Intelligence Officer for Near East and South Asia. Comments and queries are welcome and should be directed to the [redacted]

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## **Pakistan: The Middle East Connection**

### **Overview**

In many respects Pakistan has had more extensive relations with the Middle East than with any other region.

The Middle East accounts for about 40 percent (\$1.9 billion last year) of Pakistan's total foreign exchange receipts (aid, trade, and labor remittances). Exports to the Middle East account for one-fourth of Pakistan's total, and Middle East economic aid was about 20 percent of total foreign aid. More than 3,000 Pakistani military personnel serve in Middle Eastern countries, especially in Libya and Saudi Arabia, and there are also 600,000 civilian workers throughout the region, with 200,000 to 250,000 in Saudi Arabia.

The external relationship between Pakistan and the Middle Eastern Islamic nations has strengthened and taken on new importance since the Soviet invasion of Afghanistan.

In particular, Pakistan has sought to enhance and protect its links with Saudi Arabia, its most important aid and trade partner in the Middle East.

In the past, Pakistan's search for friends among the Western nations, the USSR, and China has frequently caused its Middle East ties to loosen. General Zia will no doubt tread carefully, trying to exploit Western interest in Pakistan's security but avoiding too close an identification with any policy that might jeopardize his connections with the Middle East.

## **Pakistan: The Middle East Connection**

### **Foreign Policy Since Independence**

From its beginning as a nation in 1947, Pakistan has sought close ties with the Middle East Muslim nations. Pakistan's longstanding, stated foreign policy goal has been the building of an Islamic bloc. Its unstated aim has been to use whatever friendship and support it could obtain from the Middle East against its principal enemy, India. Pakistan quickly found, however, that the other Muslim states with histories of secular government did not view Islamic unity—and Islamabad's self-interest—as compelling a force as their own national concerns and refused to become embroiled in Indo-Pakistani disputes.

The disappointment of its failed policy of Islamic unity was a key factor in Pakistan's turning to the West for support in the 1950s. Citing the need for protection against India, Pakistan joined the Baghdad Pact of Western powers (CENTO) and later the Southeast Asia Treaty Organization (SEATO), moves which Middle East nations interpreted as a "stab in the heart of Arab and Muslim states" and which gained Pakistan the label "camp follower of Western imperialism." During the 1958 Middle East crisis, Pakistan further incensed Arab nations—and much of the Pakistani population—by backing US and UK military action in Jordan and Lebanon.

Disillusionment with its Western allies during the 1960s led Pakistan to seek support from both China and the Soviet Union, without severing its ties with the United States. Once again Indian-Pakistani relations were the crux—Pakistan was disappointed by the lack of Western support during the 1965 Indo-Pakistani war. In addition, Pakistan renewed efforts to develop better relations throughout the Middle East, which paid off with Arab support during the 1971 separation of West and East Pakistan.

It was not until the charismatic Prime Minister Bhutto gained office in 1971, however, that Pakistan successfully cemented closer ties with the Middle East. Bhutto aggressively refocused Pakistan's foreign policy on the Middle East by sending technicians throughout the

Persian Gulf states and by reaffirming support for Arab causes. The extent to which Bhutto succeeded in rebuilding Middle East relations is evident in over \$2.5 billion in aid disbursements that Pakistan has received from Middle East OPEC nations since 1971.

General Zia's relationship with the Middle East has been more tenuous. Initially, Zia moved quickly after assuming power in July 1977 to nourish these important aid connections by making personal visits throughout the area. He also reaffirmed support for the Arab position against Israel and for recognition of Palestinian independence. Pakistan was moderately critical of Egypt's peace overtures toward Israel but, since the Camp David accords, has avoided condemnation of President Sadat and maintained good relations with Cairo. On the other hand, considerable resentment remains among Middle East countries over the execution of Bhutto, especially after Zia indicated to many Arabs that the well-liked leader might be spared.

From the Middle Eastern perspective, most Arab nations feel that after 32 years Pakistan has yet to create a credible nation-state out of its collection of self-serving factions and is a part of the problem of regional instability. Nonetheless, the presence of Soviet troops on Pakistan's border has improved the prospects for extensive Middle East support, especially from Saudi Arabia.

### **The Islamic Connection**

Islam emerged from the Arabian Peninsula over 1,300 years ago; Pakistan was created as an Islamic state only 32 years ago when Muslim-dominated areas of India separated into West and East Pakistan. Despite the common bond of Islam, Pakistan's aspirations to leadership in the Muslim world have at times led to friction between it and Middle East countries. Out of its split from Hindu India, Pakistan in 1947 declared it intended to forge worldwide Muslim unity. Pakistani officials grandiosely referred to their nation as the largest Muslim country and hence the natural leader of

all Muslims. Pakistan proposed an "Islamistan" pact extending from Pakistan to Turkey, ostensibly with Pakistan at the head. [REDACTED]

Non-Arab Pakistan's pretensions of leadership did not sit well with the Arab states because of their centuries of Islamic history and tradition. Middle East countries feared that Pakistan's close ties with Britain portended a Western plot against the Islamic world. Nonetheless, the underlying Islamic connection between Pakistan and the Middle East has remained strong for three decades even though state-to-state relations may have wavered in deference to Pakistan's search for its own secure place in the world. [REDACTED]

The recent Islamic Foreign Ministers' Conference held in Islamabad demonstrates the significance Pakistan places on its Muslim ties. The 26-29 January emergency meeting attended by representatives of 35 Islamic states and several Muslim organizations was called by Pakistan [REDACTED] Syria, South Yemen, and Afghanistan—all closely allied with the Soviet Union—did not send delegates. [REDACTED]

Islamabad initially hoped to restrict the discussions to the Soviet invasion of Afghanistan. The government reportedly sought to use this international forum to strongly condemn Moscow's actions, garner additional economic assistance and moral support in the face of the Soviet threat, and gain a broad consensus on Pakistan's renewed need to improve its ties with the United States and the West. The divisive, often conflicting interests of the member states, however, resulted in an expanded agenda. [REDACTED]

The conference did condemn the Soviet military intervention, suspend Afghanistan's membership in the organization, and declare "complete solidarity with the Islamic countries neighboring Afghanistan." In addition, it encouraged member states to deny recognition of the new regime in Kabul and stop all aid to Afghanistan. Other issues were also discussed but a focus on the US role in the Middle East and Iran denied Pakistan the public mandate it sought for cooperation with the United States. [REDACTED]

[REDACTED] Individual states, [REDACTED] with which Pakistan has close bilateral relations, will probably play a supportive role and be more forthcoming in their economic assistance. [REDACTED]

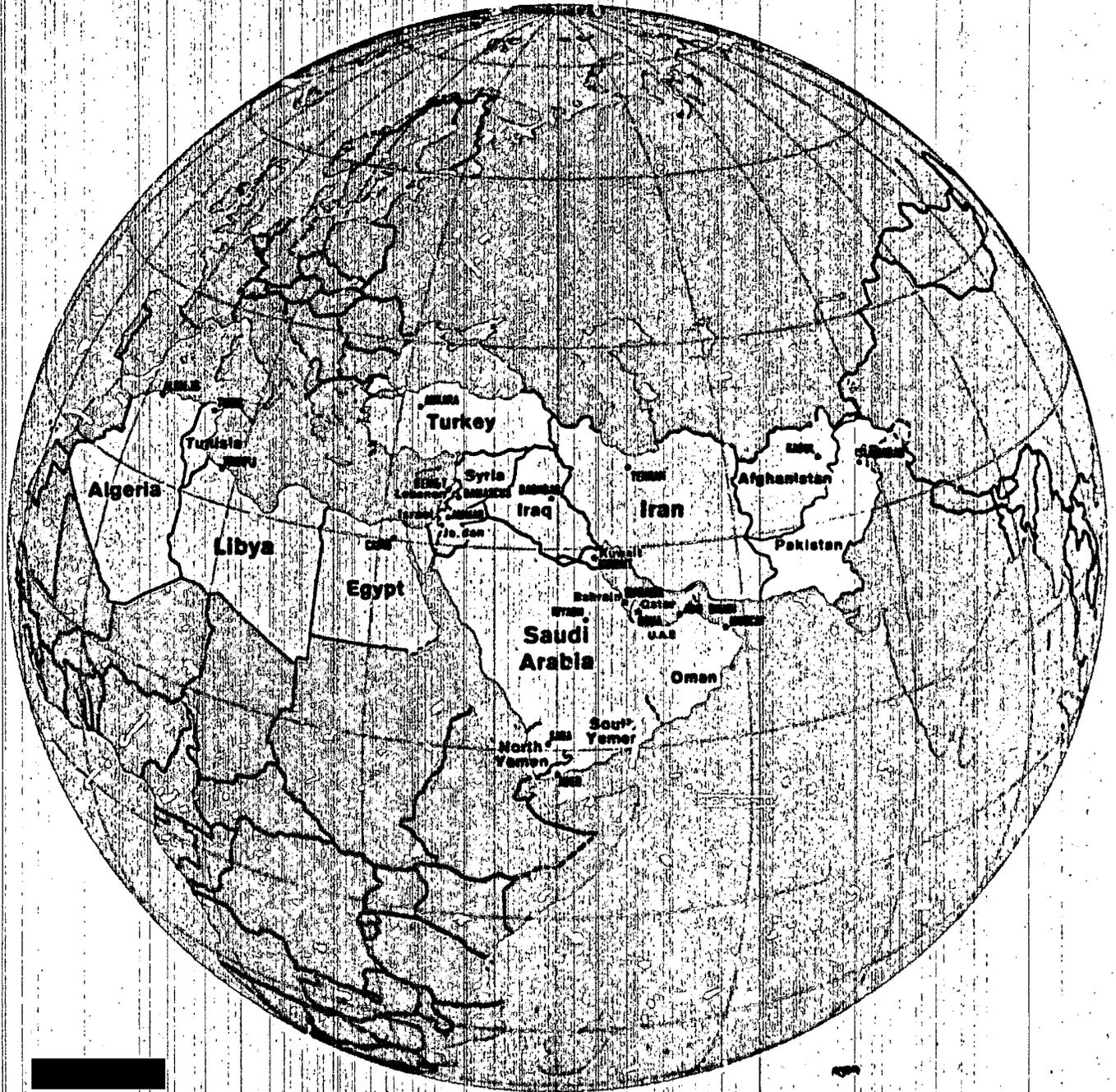
**Economic Ties: Aid**  
Pakistan became a major recipient of aid from the Middle East after the 1973/74 OPEC price increase seriously degraded its economic performance. Middle East OPEC nations have provided Pakistan with roughly \$2 billion in economic aid commitments since the beginning of 1974. In addition, Pakistan has received \$150 million from the Islamic Development Bank and the OPEC Special Fund, some of which was used for petroleum purchases. [REDACTED]

**Iran.** Iran under the Shah was Pakistan's major benefactor. The Shah viewed Pakistan as a potential market for Iranian goods and as a source of important agricultural raw materials. One of the Shah's ambitions was to link Pakistan, Afghanistan, India, and Turkey in a regional common market. To that end, he fostered the Regional Cooperation for Development (RCD) organization comprising Iran, Pakistan, and Turkey. Although little progress was made, we believe that the new government of Iran wants to maintain or expand the RCD format and improve economic relations with Pakistan. [REDACTED]

<sup>1</sup> The Islamic Development Bank was established in 1973 with funds from 22 (now 33) Muslim countries to promote economic cooperation among Muslim countries by financing development projects and foreign trade. The bank is dominated by Saudi Arabia, Libya, the United Arab Emirates, and Kuwait. The OPEC Special Fund was established in 1976 to finance development projects and foreign trade as well. Its clients include all but the richest of the less developed countries. Saudi Arabia, Iran, and Venezuela have been the major contributors. [REDACTED]

<sup>2</sup> In many ways Pakistan is closer to Iran than the Arab Middle East. For example, the Urdu and Persian alphabets are identical, and Persian is the dominant second language in Pakistan. [REDACTED]

# Pakistan and the Middle East



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**Table 1**

Million US \$

**Pakistan:  
OPEC Economic Aid, by Donor**

|              | 1974-79      |              | 1974 |   | 1975 |   | 1976 |   | 1977 |   | 1978 |   | 1979 |   |
|--------------|--------------|--------------|------|---|------|---|------|---|------|---|------|---|------|---|
|              | Committed    | Disbursed    | C    | D | C    | D | C    | D | C    | D | C    | D | C    | D |
| <b>Total</b> | <b>2,056</b> | <b>1,433</b> |      |   |      |   |      |   |      |   |      |   |      |   |

Pakistan received about one-quarter of all Iranian foreign aid commitments in the period 1974-78, including a loan [redacted] granted in 1974 for balance-of-payments support. Repayment of the loan, originally scheduled to begin in 1977, was extended until 1980 by the Shah when Pakistan failed to make the initial repayment. Since 1977 Iranian aid to Pakistan has dropped off sharply. An appeal made to Tehran last year for more than \$100 million in loans has apparently been held up by the chaotic situation there. [redacted]

**Saudi Arabia.** Saudi Arabia now ranks as the leading Arab source of economic aid and is likely to emerge as Pakistan's major source of funds during the next few years. Saudi aid goes mainly to Muslim countries, and primarily to the confrontation states. Riyadh has been especially aggressive in using aid in an effort to maintain regional stability and to forestall Communist and other radical movements in the area. One of Zia's first reactions to the Soviet troop presence in Afghanistan was to travel to Saudi Arabia for a meeting with King Khalid in late December. [redacted]

Thus far, Saudi Arabia has generally concentrated its aid to Pakistan on specific projects—fertilizer and cement plants and various projects associated with the \$1.3 billion Tarbela Dam. In addition, the Saudis have given [redacted] for an Islamic center and mosque in Islamabad. [redacted]

Conditions are ripe for massive Saudi Arabian support of Pakistan [redacted]

<sup>1</sup> See appendix.

The Saudi financial position could hardly be better. With the recent escalation of oil prices, Saudi Arabia faces unprecedented earnings and growing budget surpluses over the next few years. The surplus in 1980, for example, easily exceeds \$20 billion. Moreover, this revenue stream comes at a time when the domestic development program is headed for a slowdown and coincides with an evolving disenchantment for further accumulation of foreign assets. The Saudis are flush and have few rational options to dispose of their income [REDACTED]

Saudi Arabia supplies one-half of Pakistan's crude oil import needs (now running about 80,000 barrels per day); Iraq and the United Arab Emirates supply the bulk of the remainder. Kuwait supplies some 25,000 b/d of refined products. Despite official denials to the contrary last December, rumors persist that Pakistan is receiving a \$1- to \$2-per-barrel discount on some of its oil contracts [REDACTED]

**Libya.** Among the more radical Middle East countries, only Libya has provided significant aid to Pakistan. Despite considerable friction and reservations about dealing with Tripoli, Islamabad continues the relationship because of the economic benefits—hard currency from the services of Pakistan military personnel, civilian worker remittances, and continued Libyan aid that has amounted to [REDACTED] since the beginning of 1974. [REDACTED]

Concomitant with the growth of imports from the Middle East has been a steady increase in Pakistan's dependence on the Middle East for export markets since the first export surge in 1974. The Middle East now accounts for about one-fourth of Pakistan's export sales, compared with only 10 percent in 1971. The Middle East is the major market for about one-half of Pakistan's exports of expensive, high-quality Basmati rice\* averaging \$120 million annually since the mid-1970s. The Middle East also accounts for one-quarter of Pakistan's sales of cotton textiles and related products, which are the country's most important exports. Rice and textiles together constitute about two-thirds of Pakistan's exports to the Middle East, although the region is also a minor market for other foodstuffs, chemicals, and clothing. [REDACTED]

One of the links between Libya and Pakistan has been in the nuclear field. [REDACTED]

Since the mid-1970s, Saudi Arabia has been the most consistent market for Pakistani exports. Saudi purchases (largely rice and textiles) average \$60 million annually. Iraq also purchases about \$55 million annually of the same commodities. [REDACTED]

[REDACTED] Libyan support for Pakistan's nuclear program dates back to Prime Minister Bhutto, who sought substantial financial assistance from Libya [REDACTED]

Pakistan's export sales to its neighbor, Iran, are considerably more volatile. From an average of only \$8 million during 1970-73, Iranian purchases jumped to \$70 million in 1974 owing to large imports of rice valued at \$20 million. While rice sales to Iran fell off subsequently, the purchase of \$50 million of Pakistani textiles boosted total exports to Iran to over \$90 million in 1977. The Iranian market has since fallen off to probably less than \$25 million in 1979 because of the Revolutionary Government's policy of encouraging Iranian self-sufficiency in food and other products. [REDACTED]

**Economic Ties: Trade**

Pakistan has developed extensive trade relations with the Middle East region, and especially with the OPEC members. Between 15 and 20 percent of Pakistan's imports come from the Middle East; almost all are purchases of crude oil and refined petroleum products. Prior to the 1973/74 OPEC price hikes, less than 10 percent of Pakistan's total imports were of Middle East origin. [REDACTED]

\* Basmati rice sells for over \$700 per ton in international markets, compared with most other grades of rice priced at \$300 per ton. [REDACTED]

**Table 2**  
**Pakistan:**  
**Imports From the Middle East**

|                                      | FY 1973 | FY 1974 | FY 1975 | FY 1976 | FY 1977 | FY 1978<br>(estimated) |
|--------------------------------------|---------|---------|---------|---------|---------|------------------------|
| <b>By Country (million US \$)</b>    |         |         |         |         |         |                        |
| Total Imports                        | 989     | 1,738   | 2,158   | 2,139   | 2,325   | 2,865                  |
| Of which Middle East                 | 90      | 250     | 390     | 405     | 395     | 550                    |
| Saudi Arabia                         | 45      | 110     | 170     | 165     | 135     | 220                    |
| United Arab Emirates                 | NEGL    | 5       | 75      | 85      | 129     | 100                    |
| Kuwait                               | 25      | 100     | 90      | 105     | 120     | 210                    |
| Iran                                 | 10      | 20      | 10      | 5       | 5       | 5                      |
| Iraq                                 | NEGL    | 10      | 15      | 10      | 10      | 10                     |
| Other                                | 10      | 5       | 30      | 35      | 5       | 5                      |
| <b>By Commodity (million US \$)</b>  |         |         |         |         |         |                        |
| Total Imports                        | 989     | 1,738   | 2,158   | 2,139   | 2,325   | 2,865                  |
| Of which Middle East                 | 99      | 250     | 390     | 405     | 395     | 550                    |
| Of which Petroleum                   | 70      | 225     | 345     | 360     | 370     | 520                    |
| Crude                                | 55      | 140     | 245     | 245     | 245     | NA                     |
| Refined                              | 15      | 85      | 100     | 115     | 125     | NA                     |
| Fertilizer                           | 5       | 10      | NEGL    | 5       | 5       | NA                     |
| Middle East Share of Total (percent) | 9       | 14      | 18      | 19      | 17      | 19                     |

NA indicates Not Available.

**Labor Exports**

An estimated 600,000 Pakistani civilians are working in the Persian Gulf and remitting a large portion of their earnings to their homeland. The largest number of Pakistanis, some 200,000 to 250,000, are in Saudi Arabia. Approximately 60,000 are in the UAE and 50,000 in Bahrain; the rest are in Kuwait, Libya, Oman, Qatar and Iran.

Pakistani workers migrate without their families and range from common laborers to moderately skilled technicians. The migration to the Gulf states is temporary—one to six years on a renewal contractual basis—and sustained by economic incentives. Typi-

cally an unskilled worker in the Gulf earns about \$150 to \$200 per month, compared to \$20 to \$30 in most Pakistani cities and considerably less in rural areas. Annual remittances from workers have grown from \$145 million in 1973 to the current level of \$1.6 billion. At this level, remittances are equal to 80 percent of Pakistan's merchandise export earnings. Given the sizable and worsening foreign trade deficit, the remittances have been crucial in alleviating the pressure on Pakistan's external account.

**Table 3**

**Pakistan:  
Exports to the Middle East**

|                                      | FY 1973 | FY 1974 | FY 1975 | FY 1976 | FY 1977 | FY 1978<br>(estimated) |
|--------------------------------------|---------|---------|---------|---------|---------|------------------------|
| <b>By Country (million US \$)</b>    |         |         |         |         |         |                        |
| Total Exports                        | 810     | 1,020   | 1,052   | 1,163   | 1,170   | 1,342                  |
| Of which Middle East                 | 110     | 260     | 250     | 315     | 340     | 400                    |
| Saudi Arabia                         | 20      | 60      | 65      | 65      | 60      | 45                     |
| United Arab Emirates                 | 20      | 45      | 40      | 50      | 45      | NA                     |
| Kuwait                               | 15      | 10      | 30      | 35      | 30      | 30                     |
| Iran                                 | 15      | 70      | 20      | 35      | 90      | 55                     |
| Iraq                                 | 15      | 30      | 40      | 60      | 50      | 65                     |
| Other                                | 25      | 45      | 55      | 70      | 65      | NA                     |
| <b>By Commodity (million US \$)</b>  |         |         |         |         |         |                        |
| Total Exports                        | 810     | 1,020   | 1,052   | 1,163   | 1,170   | 1,342                  |
| Of which Middle East                 | 110     | 260     | 250     | 315     | 340     | 400                    |
| Of which:                            |         |         |         |         |         |                        |
| Rice                                 | 30      | 135     | 90      | 140     | 110     | NA                     |
| Textiles                             | 15      | 35      | 60      | 55      | 110     | NA                     |
| Other Foods                          | NEGL    | NEGL    | 5       | 10      | 15      | NA                     |
| Chemicals                            | NEGL    | 5       | 5       | 5       | 5       | NA                     |
| Middle East Share of Total (percent) | 14      | 25      | 24      | 27      | 29      | 30                     |

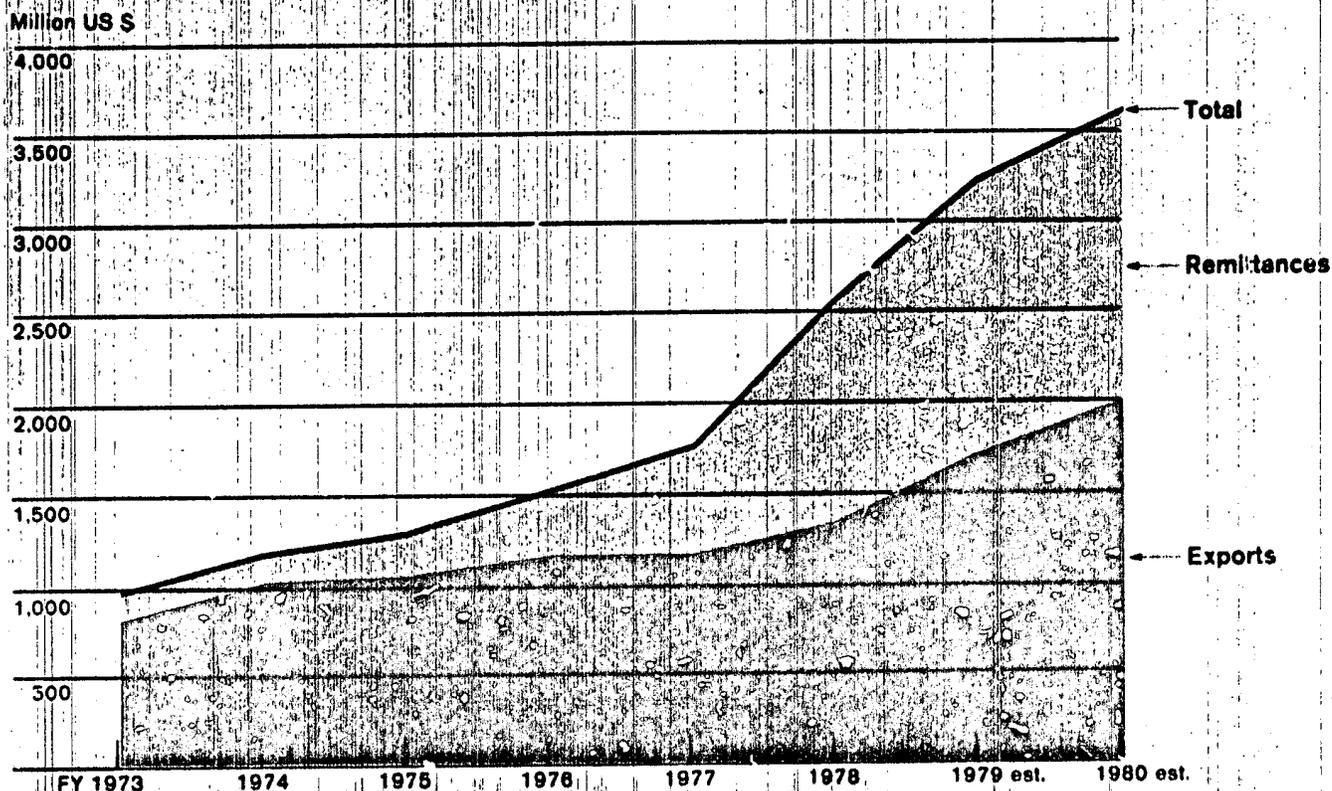
NA indicates Not Available.

At present, the growth of remittances is slowing sharply and over the next several years the number of Pakistani workers employed abroad could turn down. For both political and economic reasons, many Middle East states have scaled down their development plans and cut back the number or size of projects using foreign labor. Iran, since the fall of the Shah, has gone to the extreme and expelled most foreign workers. Pakistani laborers in the Middle East are also meeting increased competition from Indian, South Korean, and Philippine firms, which tend to use their own nationals as workers. Moreover, as the Middle Eastern states place more emphasis on sophisticated and highly skilled jobs the share of employment going to the less skilled Pakistanis and other foreign nationals will decline. ■

Because of the importance of the remittances to the economy, Islamabad has taken steps to guide earnings into productive channels. Pakistanis and their families generally use the higher incomes earned abroad to purchase luxuries such as lavish wedding and other social ceremonies, and to buy real estate and consumer goods. Last year Islamabad eliminated many of the legal and administrative obstacles to domestic investment by expatriates. Workers abroad now have the option through Pakistani banks of allocating part of their foreign earnings toward shares in investment schemes when the earnings are repatriated. Special incentives are offered for investment in small- and medium-scale industries in underdeveloped areas of Baluchistan and the North West Frontier Province. ■

### Pakistan: Workers Remittances and Exports

Figure 2



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Table 4

### Pakistan: Foreign Exchange Receipts, 1978-79

|                   | Total         | Middle East Share |         |
|-------------------|---------------|-------------------|---------|
|                   | Million US \$ | Million US \$     | Percent |
| <b>1978</b>       |               |                   |         |
| Total             | 3,858         |                   |         |
| Exports           | 1,342         |                   |         |
| Labor Remittances | 1,226         |                   |         |
| Aid               | 1,290         |                   |         |
| <b>1979</b>       |               |                   |         |
| Total             | 4,629         |                   |         |
| Exports           | 1,725         |                   |         |
| Labor Remittances | 1,504         |                   |         |
| Aid               | 1,400         |                   |         |

**Table 5**

Million US \$

**Pakistan: OPEC Military Financial Assistance, by Donor**

|              | 1974-79      |              | 1974 |   | 1975 |   | 1976 |   | 1977 |   | 1978 |   | 1979 |   |
|--------------|--------------|--------------|------|---|------|---|------|---|------|---|------|---|------|---|
|              | Committed    | Disbursed    | C    | D | C    | D | C    | D | C    | D | C    | D | C    | D |
| <b>Total</b> | <b>1,085</b> | <b>1,065</b> |      |   |      |   |      |   |      |   |      |   |      |   |

NA indicates Not Available.

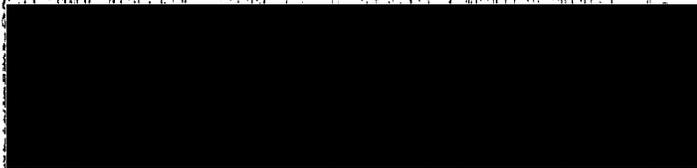
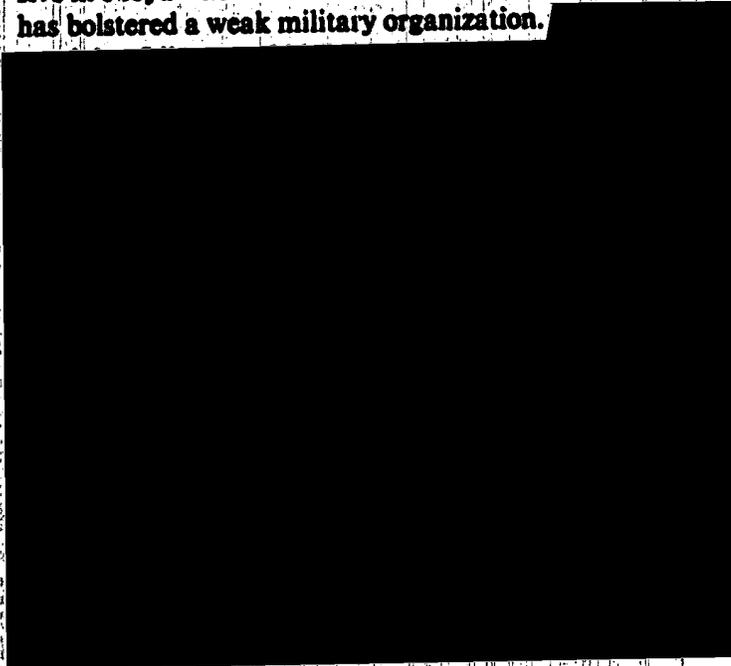
**Military Ties**

*Aid.* Pakistan has received roughly \$1 billion in military assistance from the Middle East in 1974-79.

Since the beginning of 1974 Pakistan has purchased \$1.6 billion of foreign military equipment from more than a dozen suppliers. Better than 80 percent of the orders were placed in France, the United States, and West Germany, with most of the remainder going to China.

*Advisers.* The Middle East states draw heavily on Pakistan's highly trained—by Asian standards—military establishment. India's British colonial heritage left Pakistan with an appreciation for formal military training. Pakistan has an extensive system of military service schools, and has sent officers for training to the United States, the United Kingdom, Australia, the USSR, and China. More than 3,000 Pakistani military advisers are scattered throughout the Middle East. The bulk of these Pakistanis are providing military instruction and technical services such as aircraft maintenance.

Pakistan's foreign military cooperation is most extensive in Libya where the infusion of foreign personnel has bolstered a weak military organization.



## Appendix

### Pakistan's Call for an Islamic Economy

*Nizam-I-Islam* (life according to the teachings of the Prophet Muhammad) has been the byword of Pakistani politicians since independence more than 30 years ago. *Nizam-I-Islam* lay dormant as a policy issue after the death of Pakistan's founder, Muhammad Ali Jinnah, in 1948. Postindependence problems of economic development that faced Western-educated Pakistani leaders overshadowed the religious and social needs of Pakistan's Muslim community, which constitutes 97 percent of the 77 million population.

The idea of an Islamic state resurfaced in the 1970 election campaign of President Zulfikar Ali Bhutto. Although *Nizam-I-Islam* at first was used against Bhutto by opposition religious leaders and devout Muslims, Bhutto expediently committed his government to "Islamic socialism" and won a sweeping election victory. Popular doubts about the seriousness with which Bhutto practiced Islam nonetheless remained, and his failure to move the promise of an Islamic state beyond political symbolism partly explains his overthrow by General Zia in 1977.

#### Zia and Islamic Economics

Zia, a devout orthodox Muslim, has used his martial law powers to try to move the Pakistani economy closer to the Islamic pattern.<sup>1</sup> In February 1979, Zia announced, with much fanfare, the imposition of two basic Islamic fiscal measures slated to go into effect at the start of FY 1980 (1 July 1979)—*zakat* (a tax on wealth) and *ushr* (a tax on agricultural production). Both taxes are traditional Islamic tools for the redistribution of wealth and for the discouragement of hoarding.

*Zakat*, as one of the "five pillars of Islam," is an indispensable requirement for an Islamic state.<sup>2</sup> As

<sup>1</sup> The other four pillars are fasting during the Ramadan, praying five times a day, making a pilgrimage to Mecca during one's lifetime, and professing the faith verbally.

specified in the Koran, *zakat* is a voluntary annual levy on personal wealth. According to Islamic law, it can be used only for the benefit of the poor and the promotion of Islam. *Zakat* clearly fits in with Islamic concepts of state and individual social responsibility for the basic human needs of disadvantaged Muslims. Zia, however, has proposed a *zakat* that is more than voluntary. Besides a 2.5-percent self-assessed tax on personal property, the government will levy a 2.5-percent tax collected at the source on bank deposits, stock holdings, insurance policies, and retirement funds.

*Ushr* is of less symbolic importance than *zakat*. Nonetheless, it has a long history as a source of revenue for Islamic treasuries. Traditionally, *ushr* was collected from Muslim farmers at harvest time on crop output in excess of production costs. The levy was based on the kind of crop, productivity of the land, and cost of production.

Zia's versions of *ushr* is a 5-percent mandatory tax on all farmers. The tax will apply to each crop a farmer grows; for example, if a farmer grows wheat, beans, and millet, each crop will be separately taxed to the extent its output exceeds 948 kilograms of wheat or its equivalent. Landowners, tenants, and sharecroppers are all subject to the tax. Farmers of rain-fed land will be required to pay an additional 5-percent land tax since they are now exempt from paying water taxes.

#### Wrestling With Interest

Zia so far has been unable to formulate the most difficult and contentious reform proposed for a fully Islamic economy—the abolition of all interest charges and associated reform of the banking system. Thus far, Zia has only implemented interest-free housing loans for lower grade civil servants and interest-free loans for bicycle purchases. Although both programs are touted as interest free, in practice they are not. As is common inside Saudi Arabia, the prohibition against interest is

circumvented by the borrower making a supplementary "gift" when paying back the loan. [REDACTED]

Serious conceptual problems will complicate the achievement of Zia's goal of an interest-free economy by 1982. Islamic scholars are divided on the interpretation of the Prophet Muhammad's proscription against interest payments. Some interpret the Prophet's commentaries on the financial abuses of his age as prohibiting all charges that even remotely resemble interest; others interpret the doctrine more loosely, as the prohibition on usurious charges only. [REDACTED]

Even if agreement can be reached on a standard interpretation of Islamic law, officials would then face the problem of restructuring the banking system without seriously disrupting production and trade. Under the Islamic model of an interest-free banking system, depositors would purchase equity shares in their bank; the bank would both invest in productive enterprises and offer short-term, interest-free credit repayable on demand. Depositors would share in the profits—and losses—in proportion to their equity. Pakistani economists have yet to work out the mechanics of adopting such a system in an economy already operating with a Western-style commercial banking system. Even if they succeed in doing so, Pakistan faces difficulties in integrating an interest-free system with the conventional international financial community, on which the country depends for much of its development financing. [REDACTED]

#### Impact of the Taxes

Islamabad had expected that the new taxes would generate about \$300 million in FY 1980.<sup>3</sup> Land and wealth taxes now yield about \$25 million annually. The current low yield reflects extensive exemptions and widespread tax evasion. Under Zia's Islamic tax system, Pakistani Muslims will be expected to voluntarily meet their religious requirements of *zakat* and *ushr*. [REDACTED]

<sup>3</sup> Total central government tax revenues are now approximately \$2 billion annually, an amount equivalent to 13 percent of GNP. [REDACTED]

Nonetheless, Zia has set up a committee with powers to enforce collection. For example, government inspectors will have authority to order bank accounts opened for examination. The new tax revenues, in conjunction with an initial contribution of \$225 million from Saudi Arabia and the United Arab Emirates earmarked for the *zakat* fund, would be used to improve education and health care for the most destitute of Pakistan's poor. Even if *zakat* revenues reach the level anticipated by Islamabad, they will be stretched thin. At present, the poorest 40 percent of the population amounts to roughly 30 million people. The \$525 million *zakat* fund—if efficiently and equitably distributed—would translate into per capita outlays of less than \$20 for the poor. [REDACTED]

Neither the *zakat* program nor *ushr* taxes have gotten off the ground. The business community has criticized Zia harshly on the *zakat* issue because of the compulsory nature of what should be a voluntary program. Shortly after the *zakat* was seriously proposed, many businessmen withdrew their potentially taxable funds from the banking system. On the other hand, the poor have been highly critical of Zia for failing to implement a workable welfare program. Local religious leaders complained of the centralized *zakat* fund's high administrative costs which left little for distribution to the needy, and of the government's use of the Saudi contribution to the fund for balance-of-payments support. [REDACTED]

*Ushr* will have an adverse but as yet unmeasurable impact on farm output. The agricultural sector is now only lightly taxed, yet little margin exists to absorb taxes among most of the Pakistani farmers. We thus expect the new taxes to reduce incentives, morale, and purchases of needed inputs to agriculture. [REDACTED]

#### Long-Term Issues

Zia's Islamic measures will do little to solve Pakistan's underlying economic problems, which stem from a combination of capricious government policies and longstanding institutional barriers to efficient mobilization of capital and labor. Among the basic economic problems are the sizable foreign debt and burgeoning debt payments, the low productivity in agriculture (relative to available resources), and a commitment to a number of costly capital-intensive investment projects, such as a \$2 billion steel complex. [REDACTED]

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