Towards Industrial Policy 2.0 (Part-2)

Ishrat Husain | September 2023
PI-28-23

Whether Pakistan should pursue an industrial policy or not is a question that has not yet been debated seriously. There are clear ideological divisions among those who believe that the state should have a better control over generation and allocation of resources and others who are of the view that the state should set the direction and incentives structure and let the households, private firms, businesses, and farmers make the choices.

The important questions that need to be addressed are (a) what is the end goal of such a policy? (b) What would be the nature of policy interventions by the state? And (c) what would be the main ingredients of the policy which should be used to achieve the end goal?

The end purpose of an Industrial policy for Pakistan should be to achieve competitiveness through higher productivity which brings greater profits for entrepreneurs, higher wages and better working conditions for the workers, more tax revenues for the Government, stable prices for consumers and saving in foreign exchange as exports become competitive and production of import substitutes efficient. The following quotation by a former Prime minister of India, VP Singh very aptly captures this end goal.

"What we need is growth that falls like rain on the mountain and flows down in stream to the valleys and plains below, not growth that is like snow, which sticks to the mountain tops".

Empirical research has provided evidence that most of the factors hindering GDP growth in Pakistan particularly in commodity producing sectors (agriculture and industry) are institutional or policy based requiring reform rather than additional financial injections. Focusing more specifically on Industry, it was found that the failure to take off or stunted industrialization was due to dysfunctional markets and excessive participation of government in productive activities. A recent PIDE study concluded that the Government had a footprint of 67 percent of GDP. The declining growth in value added has been accompanied by falling productivity.

A) The prerequisites for a workable Industrial policy are political stability, sound macroeconomic policies and economic governance. Fiscal dominance which is crowding out private sector credit for fixed investment and working capital has to come to an end. The growing informalization of the economy in production and trade is a manifestation of the weakness of the state capacity to enforce the laws and rules and exercise its coercive power. Therefore, a strong state apparatus is necessary under Industrial Policy 2.0 to play an entirely different role i.e., to correct market failures, remove constraints from the way of a competitive market structure and improve allocative efficiency, eliminate policy induced distortions and perverse incentives rather than pick winners through an elaborate system of protection and subsidies. Highly protected domestic markets not only reduce the incentive to export but also penalize the economy by allowing inefficient producers to extract policy induced rents from domestic consumers. Enforcement of contracts and protection of private property rights necessitate a well-functioning judicial system that adjudicates and resolves the disputes expeditiously and at affordable costs for small and medium businesses.

The nature of government interventions under the Industrial Policy 2.0 would, therefore, be to unshackle the entrepreneurial energies of the private sector (by providing a level playing field), and to shift from resource based to technology intensive products whose demand is growing at a rapid pace in domestic and international markets. The basic thrust of the policy would be for the state to eliminate unnecessary and costly regulations and extortive taxation system, promote research and development in productive sectors, provide skilled and trained manpower and infrastructure, and avoid distorting markets through administrated prices of inputs and output. Market structures characterized by oligopoly, monopoly, collusive practices, cartelization, and other defective practices have to be cleaned up. Entry barriers for newcomers as well as for scaling up the size of the operations have to be dismantled. Industries that can export or save foreign exchange, attract Foreign Direct Investment, generate employment, have strong backward and forward linkages are most likely to emerge under such a policy. A lot of risks are too big to insure against privately. The state should step up in such cases through public-private partnerships where the rewards to society at large are enormous.

B) The main ingredients of a forward-looking Industrial policy for Pakistan ought to be:

I- Innovation: Rapid technical change is at the heart of the new competitive scene and innovation and productivity growth are interrelated. R&D Expenditure in Pakistan was already paltry, but it has declined from 0.32 percent of GDP to 0.28 percent in the last decade. Support for Scientific Research and Development in both private and public sector to alter the production structure and processes in response to changing demand patterns, preferences and technology has to be given the highest attention and resources. Institutional specialization, complementarity between University and industry, patents acquisition, and stakeholder involvement would generate beneficial results. Transition to Green Technology and Clean energy, adaptation and mitigation of climate change risks and emerging technologies such as AI, Robotics, Data analytics etc. have to be the major components of an R&D program. Financial incentives should be given to the firms for in-house R&D activities that enhance their technological capabilities and enable them to implement new innovative techniques and processes. An Innovation Development Challenge Fund can be a useful instrument for this purpose.

ii- Institutions: Strengthen Institutions of economic governance by devolving powers, delegating decision making and decentralizing fiscal resources, giving them autonomy while holding them accountable for results. The State should withdraw from running businesses and allow the private sector to compete on a level playing field. The role of the state should be that of a facilitator, enabler, and promoter but also that of delivering basic public goods and services in a cost effective and efficient manner. Technology Parks, Incubation

Centers, Special Economic zones can create clusters for exchange of knowledge, skills and provision of common services resulting in agglomeration economies. Narrower forms of specialization in fragmented production that now dominate global value chains have changed the dynamics of industrial and export activity. Pakistan has to find niche products in the chain where it can compete. These clusters would also house quality testing labs, standards metrics compliance and extension services to SME suppliers and vendors. These clusters along with joint ventures between Pakistani and foreign firms can further reinforce the process of upgrading technologies, building new capabilities, and finding new markets and market niches.

iii- Deregulation and Taxation: Formal industrial sector is overregulated and heavily taxed. About two thirds of taxes are collected from the Manufacturing sector which accounts for only 13 percent of GDP. The plethora of laws, rules, regulations, and No objection certificates required for compliance by the federal, Provincial, and local governments–some overlapping–have stifled the entry of newcomers by increasing the cost of doing business and thus retarded the forces of competition. For example, minimum tax based on turnover acts as a barrier to new entrants. As a result, Pakistan has gone through Deindustrialization and the share of Manufacturing in GDP has remained stagnant. Easing the regulatory burden and lowering the tax incidence on manufacturing industries (by bringing in other sectors and firms into tax net) would allow the existing firms to expand their scale of operations and new companies to invest in activities that would become profitable. Large scale firms tend to be more productive reflecting economies of scale. Export subsidy schemes have to be rationalized to incentivize new products, sub sectors and for penetration in new markets. One way to promote consolidation, capital formation, scaling up and expansion of manufacturing sector is to remove tax on inter corporate dividends.

iv- Human Capital formation and Skilled Labour Force: Despite loud claims that Pakistan has a large pool of talent the fact is that we rank below our peers in Human Capital Index. One third of the children are out of the school, alarming learning poverty, rising number of unemployed graduates, Low Female Labour Force Participation Rates, Malnutrition and Stunting and acute shortage of skilled workers demanded by the industries pose serious constraint to productivity growth. Science and Mathematics should be introduced early in the school curriculum and made mandatory for all middle and secondary school students. Technical and Vocational training institutes should be expanded and operated by the private sector. Universities should produce more STEM graduates of employable skills. Manufacturing 's growing parts in value addition are research, design, engineering, marketing, and networking. Digital Economy would require a large workforce of ICT professionals.

v- Infrastructure: Pakistan's unending energy crisis and high-end user costs have done an enormous damage to industrial growth and diversification, particularly the export sector. The present model of Single Buyer-Single seller is the root cause of this recurring problem. Unless private sector firms, selected through a transparent competitive process, are brought in at the retail stage of distribution of electricity and natural gas and the monopolies of DISCOs are dismantled the situation will remain precarious. There are very few countries which subsidize piped gas for households and penalize industrial units. Circular Debt would keep piling up while the rising costs to the industrial units particularly those in international trade would drive them out of business.

vi- Labour Laws: Pakistan has a youth employment problem. More than 70 labor laws on its books which, according to its own reckoning "are complex, overlapping, anomalous and at times render the subject matter difficult to understand, besides creating confusion for those who deal with them. "Despite the passage of a dozen years the mission of consolidating and simplifying these laws into five core laws has been deflected by the power tussle between the Federal and the Provincial Governments. Despite such an abundance of laws and regulations, contract, casual, temporary, and daily wage modes of employment have become the accepted norms in the manufacturing industries. Formal and wage employment in the manufacturing sector has remained stagnant. These laws also encourage firms to remain small and not scale up their size of operations. Consequently, the skill level and the average schooling are low, on the job training is missing, females are not found for dexterous jobs for which they are well suited, wages fall below a decent living benchmark, and overall labor productivity lags behind that of the peer countries. Only 7 percent of firms in Pakistan offer formal training to their workers compared to 85 percent in China and 50 percent in Viet Nam. The firms which provide formal training are found to have much higher productivity. It must be realized that a single rupee of investment in skills and improved efficiency of the labor force would have on average at least 30 to 40 percent additional returns that can be distributed in the ratio of 75:25 between the owners and the workers. Labor productivity is thus a viable avenue for profit maximization, capital formation for expansion and investment, new job creation, awarding decent living wages and increasing global competitiveness.

To sum up, Resurgence of Industrialization is needed for increasing exports, stimulating GDP growth, adopting technology, creating jobs, and developing skilled work force. Industrial Policy has to be ensconced in the overall growth strategy of the country with adequate social safety nets for those likely to lose out from the pursuit of this policy. Pakistan's journey towards Industrialization which has been off the track for past few decades can be put back on the rails by not relying on the contours of Industrial Policy 1.0 which has been discredited but by a new policy in which "technological competence, skills, work discipline and trainability, competitive supplier clusters , strong support institutions, good infrastructure and well-honed administrative capabilities "are developed, nurtured and promoted and the rent seeking subsidies and protection to specific firms and industry or sector are shunned. Industrial Policy 1.0 was supposed to benefit consumers, producers, and others in the economic chain. The concessions and subsidies in the name of "infant Industry" have continued unabated as there were no benchmarks set to evaluate performance and whether the intended goal has been achieved or not. The policy had not been built in sunset clause and some of the industries are enjoying the benefits even after a lapse of several decades. As distortions were introduced through administered input and output prices, firm, subsector, industry specific differential concessions, the resultant manipulation, collusion, speculation, gaming cumulating to excessive rent seeking have failed to produce the desired results. A wedge is created between 'observed prices and their fundamental determinants. Investors shy away from productive activities and shift to unproductive activities where quick, short-term gains can be achieved in an environment of market distortions and imperfections. Private profits keep accumulating at the cost of benefits to society. Overall, low economic growth coexists with excessive returns earned by selected market players. Industrial Policy 1.0 was therefore bound to fail sooner or later. Governments were accused of indulging in crony capitalism through concessions, exemptions, bank loans, preferential allocation of land at below market prices, and import licenses to selected few. The beneficiaries of these favors were political supporters, friends, and family members or in blatant exchange of pecuniary benefits to those administering the Policy.

Governments are also not very good at identifying the sectors which should be promoted. It is only the businesses themselves with a sharp eye on markets, relative returns to investment and taking account of the dynamic comparative advantage who can undertake that task. A growing source of capital flows for investment is the Sovereign Wealth and Private Equity Funds. Between 2018-2022 the Emirati funds and firms invested $34 billion in India. Instead of asking for deposits for boosting the Central Bank reserves and other forms of aid, which is indeed demeaning for a country like ours, the private sector under the Industrial Policy 2.0 should be able to tap into these funds as the recent results indicate that the relative returns to corporates in Pakistan are still quite attractive despite the difficult macroeconomic situation. Saudi Arabia has also committed a substantial amount for investment in Egypt.

Had Pakistan maintained its Exports to GDP ratio at the level of 16 percent as in 1999 the total merchandise exports would have reached $ 56 billion in 2022 i.e., 75 percent higher than $ 32 billion actually realized and the current account deficit with even higher level of imports would have been manageable. Import duties on intermediates and final consumer goods have to be brought at par with other competing nations as they act as a tax on exports and increase the profitability of selling in the domestic markets. Pakistani publicly listed exporting firms are found to be on average 20 percent more productive than the domestic oriented firms (World Bank). According to a 2018 report by Pakistan Business Council the manufacturing sectors they recommend for potential value addition and export Diversification are Automobile, Electronics, Engineering and Food Processing. For Import substitution the sectors chosen are Steel and iron and Petrochemicals. Some other business groups would like to have upgradation and the establishment of new oil refineries which can also lead towards the Petrochemicals chain. On the face of it, these appear quite reasonable but detailed feasibility studies have to be carried out by the potential investors themselves. Government can act as a facilitator, enabler, provider of level playing field and problem solver but not a direct intervener in investment choices. Besides maintaining political stability, pursuing sound macroeconomic policies, improving delivery of public goods and services through devolution, the Government has to curtail its claims and pave the way for access to bank credit and capital markets by the private sector for increased investment in productive sectors such as Agriculture and Manufacturing. Broadening of Tax net as well as expenditure rationalization would not only reduce the budgetary deficit requirements but also help the private sector by lowering tax incidence while providing complementary public investment. Old habits die hard but unless we have a mindset change, a serious political commitment and earnestly implement the required changes, we would end up facing one crisis to another every few years and keep knocking at the doors of the IMF and our friends. Industrial Policy 2.0 may also meet the same fate as its predecessor.

CDPR's series "Insights for Change" contains think pieces that take an analytical approach to devising action oriented policy solutions. They are authored by economists and practitioners who are experts in their field. All views expressed are the author's own.

Dr. Ishrat Husain

About the Author

Dr. Ishrat Husain, is a Pakistani economist who has previously served as the dean of the Institute of Business Administration (IBA). He is also a former governor of the State Bank of Pakistan and former advisor to the Government of Pakistan.

cdpr Consortium for Development Policy Research

IGC

This Activity is Supported by the International Growth Centre