Deregulating the Economy, Article by Dr. Ishrat Husain

As in most debates in Pakistan there are sharply polarised views on the regulation and deregulation of private-sector activities. Some advocate re-gulation by the state as an effective tool to curb the market's excesses. Others think markets should be left to themselves and the state should have few regulations.

The argument put forward by the advocates of regulation has got much traction since the 2008-09 financial crisis. The global response has been to enact legislation to enhance the regulators' powers or set up new regulatory agencies. Europe, for example, has several new institutions that have appeared on the scene in the post-2009 period. The Dodd-Frank Act has given birth to financial stability, consumer protection and oversight bodies in the US.

Financial markets have some unique features that are missing in product and factor markets. This distinction is lost sight of in this polarised debate. Shareholders' equity in bank balance sheets ranges from 8pc to 10pc. The banks are highly leveraged as they raise 90pc to 92pc of their money from depositors and borrowings from other financial institutions and markets. This high leverage effect magnifies both upside gains and downside risks, inducing the bank management, whose compensations are linked to short-term profits, to resort to excessive risk-taking.

The upside gains of the leveraged bets accrue mainly to shareholders and managers, while downside losses are so heavy that the state has to bail them out using taxpayers' money. This asymmetric treatment of the risks incurred and the accrual of rewards places a heavy responsibility on regulators to ensure that shareholders, and not taxpayers, bear the brunt of excessive risk-taking. Therefore, given the market's structure in the financial sector, state regulation is not only justifiable but desirable.

Pakistan has consistently ranked low on the World Bank's Doing Business Index.

The same logic cannot be applied to the market for goods and inputs. If a farmer's income is determined by forces outside his control he has no incentive for higher production and improved productivity. In Pakistan, the government controls wheat prices, and fertiliser prices are subsidised, largely benefiting big farmers. Irrigation water is allocated in a discriminatory manner inducing inefficiency. The food department procures wheat at official prices from those who are influential or who grease their palms. Under such stringent price and quantity regulation why should the average farmer maximise his efforts to produce more?

The differential in the yield between a progressive and an average farmer ranges between 50pc to 70pc. If there was deregulation of prices and quantity (except for a certain amount of reserves), wheat production could jump to at least 30 million tons — a conservative estimate.

Contrast this with the deregulated milk market. Except for hygiene regulations, milk supply and demand determine the prices. The fastest growth in the average farmer's cash income has taken place through money from milk. For other non-cereal products, market committees that are inefficient and operate in collusion with officials of the agriculture department have distorted prices.

The sugar market has, at different times, faced waves of regulation, fixed cane price and opaque market interventions. The government steps in when there is surplus production; it procures from local sugar mills and sells in international markets at loss.

In times of shortages, the government imports sugar, and sells at a price mostly to the mills' advantage. Efficient and inefficient mills are treated equally; there is no pressure on the latter to exit the market as they are insulated from facing the market test. Thus over-regulation, procurement by the government at non-market prices and intrusive and discriminatory practices have tilted the sugar market against the consumers. Here deregulation is badly needed.

In the manufacturing sector, as many as 40 agencies and departments of the federal, provincial and local governments are involved in giving clearances, no-objection certificates, grants of permits, licences, etc. Most factory owners have reconciled to this situation, making monthly payments to functionaries of these departments commensurate with their nuisance value. A labour inspector can arbitrarily shut down a factory, causing enormous loss to the owners, for whom the easy course is to keep the inspector contented. The same goes for the food inspector.

Pakistan has consistently ranked quite low on the World Bank's Doing Business Index for the kind of delays, red tape and obstructions imposed by various government departments and agencies when it comes to setting up and doing business. The result is the growing informalisation of the economy, with most units trapped in low-level productivity equilibrium.

Had these units been freed from the clutches of oppressive regulations and laws, thousands of small-scale units would have made the transition to medium-scale expanding output, efficiency in re-source use, employment and taxes decreasing the size of the informal economy. This sector needs freedom from oppressive laws and regulations and inspections.

Indian PM Modi recently took initiatives of some relevance to us. He asked each ministry to weed out or eliminate all overlapping, redundant, outdated rules, regulations, laws and circulars. The factory owners are now required to file electronic returns stored on a central server. There's a random selection of firms for inspection for which there are further safeguards.

It is time we started using ICT tools to enforce sensible, effective regulations and, simultaneously, got rid of thousands of pages of redundant laws and regulations that have given ammunition to low-ranking government functionaries to exploit the producers of goods and services.

The balance between promoting innovation and exercising regulatory oversight is difficult to achieve. But the tragedy in Pakistan is that on one hand, we have too much regulatory obfuscation and obstruction that stifles innovation or imitation of new technological practices. On the other, there is laxity and little regulatory enforcement where it is required — against quacks, unsafe buildings, hazardous waste, adulterated food, spurious drugs, encroachments, traffic violation, etc

Relaxing stringent product and labour market regulations and phasing out arbitrary government interventions and regulatory orders particularly those creating entry barriers for newcomers would boost innovation and efficiency. Enforcing regulations for health, safety, environment, and financial markets would protect the consumers.

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