Pakistan as a regional manufacturing hub?

April 12, 2015
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Alongside are the excerpts from the key-note address that the writer delivered at Lahore School of Economics last month. Manufacturing's share in GDP increased from about 8 percent in 1950 to about 18 percent by 1995 and has hovered around that for the last twenty years. The composition of manufacturing sector has also remained largely unaltered with Textiles and Food and Beverages accounting for almost half of the production. Manufactured exports have been dominated by cotton textiles while the world demand pattern is shifting away to more dynamic sectors. Even within textiles Pakistan has lost market shares to regional competitors such as China, India and Bangladesh. Employment in manufacturing has not kept pace with the increase in labor supply. Investment in manufacturing sector has in fact declined from 27 percent in 2002 to 15 percent in 2010. The Philippines, which until 1985, had a lower level of manufactured exports than Pakistan was able to increase the volume of manufactured exports ten times during one decade and has been expanding rapidly since then. Bangladesh that has only $3 billion of readymade garment exports in 2003 - the same as Pakistan has crossed $25 billion while we are still struggling in the range of $2 billion. An objective assessment of the performance of this sector over last two decades shows dismal results. What have been the factors responsible for this poor performance? I would like to divide my remarks in two broad categories;

(a) External
(b) Internal

External factors

First is the China syndrome, in 1990, China produced less than 3 percent of global manufacturing output by value. In 2015, its share is nearly a quarter. Half of the world's goods are manufactured in 'Factory Asia' as the recent Economist cover story dubs it. In the decades up to 1980s and 1990s the Product Cycle hypothesis advanced by Professor Vernon of HBS reigned supreme. Leading manufacturers of products would pass on the baton to other parts of the world enabling them in their turn to manufacture their way to prosperity. For example, GE and Westinghouse ceased to be the leaders of the market for white goods consumer products and Televisions and the market for these products was captured by the Japanese manufacturers. After a while the Korean Chaebols and South East Asian countries took over this market globally. Finally, when it reached China it got stuck there for good and the baton hasn't passed to other countries unless the Chinese manufacturers, on their volition, and for their own internal reasons decide to relocate part of the production elsewhere. For example, Chinese motorcycle industry has begun to take up a hefty market share in Pakistan in the recent years. So the popular hypothesis that rising wages would push the labor intensive industries out of China is not proven as China's grip is in fact tightening. The reservoir of surplus labor in the western provinces has not yet exhausted. Factory China still dominates the world manufacturing.

It is also surprising that the Chinese are not only profitably pursuing low cost manufacturing end of the spectrum but also going up the market to exploit higher value activities. The share of global clothing exports is over 43 percent but China has also become the leader in auto mobile production too. The US consumers are deriving large consumer surpluses by buying Chinese goods and using the savings thus effected in spending on other leisure goods and services boosting the US internal economy. A kind of Pareto optimality is being achieved across the two countries.

Second, the concept of Vertically Integrated manufacturing on the same site has given rise to the global supply chain. Intermediate goods and components are manufactured elsewhere where the comparative advantage dictates lower costs and acceptable quality and these are then shipped to other places mostly China for final assembly. Asia's share of global trade in intermediate inputs has risen from 14 percent in 2000 to 50 percent in 2012. The most glaring example cited in the popular press is that of iPhone which is a Chinese final goods export but the value addition in China is only $73 million just 3.6 percent of the total $2 billion exports from China whereas the value addition in Japan is $670 million. The average journey length for Asian exports has fallen by 4.5 percent. Transportation costs have become cheaper for Asian manufacturers due to expansion in volume of trade.

Third, manufactured product today has a much lower cost of actual fabrication than in the past and cost of labor is declining per unit of output. Most of the cost is incurred on manufacture-embedded services. Design, Advertising, Marketing, Transportation, shipping and Logistics, Distribution both wholesale and retailing, ware housing and storage, financial services and insurance, Information and Technology products and services, store lay out and internal decoration make up most of the cost structure. Industries such as pharma and technology-intensive products recover their R & D investment also from the final sale price. Lean manufacturing and Just-in-time inventory have further reduced the unit cost of production depending on the nature of the industry. Therefore countries that have liberalized the trade in services, reduced tariff rates significantly, facilitated cross-border trade, allowed easy mobility of skilled and expert manpower across borders and softened custom regulations have benefited from both the global supply chain as well as manufacture embedded services exchange.

If we evaluate Pakistan against any one of these external factors, the score is almost nil. Despite our excellent political relations we haven't made much efforts in bringing Chinese manufacturers to relocate part their production in Pakistan or in penetrating the large Chinese markets although we have a Free Trade agreement. We have not glued in their supply Chain or manufacture-embedded services network. Pakistan's restrictive import regime with tariff, non-tariff and regulatory barriers and cumbersome custom clearance procedures with arbitrary powers enjoyed by low level officials amenable to rampant corruption do not allow Pakistan to enter the expanding global supply chain.

Internal factors

What are the internal factors that have impede Pakistan from regional manufacturing hub? These factors are all quite well known but let me recapitulate them for the sake of completeness.

1) Human Development Index (HDI)- Pakistan ranks 146 lower than Bangladesh and India in the HDI; Tertiary Education Rate is 7% compared to 15% in India; vocational and Technical Training enrolment ratio is 1%; the average years of schooling of labor force is 4 to 5 years. 20-25 million children in the age group of 5-15 are out of school. In such an environment where skills, education and training are in such great demand in the global market for goods and services the consistently declining share of Pakistan can largely be explained by this factor alone.

2) Low Productivity - As Pakistan's labour force is not properly trained and mostly unskilled and of low quality human capital its productivity is low relative to other regional competitors. Wide gaps between urban and rural areas, across provinces, among youth and women, implicit and explicit restrictions on labor mobility across provinces and poor nutrition and health have contributed to this outcome. For example, in Textile sector, an average Pakistani worker produces only 40 percent of what the Chinese counterpart produces per day. According to APO, Pakistan's

productivity growth rate in manufacturing sector between 2000-2010 was 2.3 percent per annum while that of China was 8 percent and 3.4 percent in India. The gap has widened since then.

3) Poor governance, weak institutions have encouraged rent seeking, nepotism and favoritism in the allocation of scarce resources. Four fifths of Pakistanis view government corruption as widespread. The National Accountability Bureau claimed that corruption costs Rs 10 billion to 12 billion a day. Pakistan ranks 139 out of 176 countries on Transparency Index Control of Corruption Indicator. Business climate can improve if property rights and contracts are enforced in a cost effective manner, the plethora of NOCs, permits and licences required by multiple authorities are streamlined and the inspection by various government agencies is made less discretionary and less arbitrary. High Tax incidence on manufacturing output particularly on the large scale organized firms has stifled the transition of medium scale firms to acquire economies of scale and reduce unit cost of production and distribution. A large segment of market demand is therefore taken away from the organized firms by the competitors in the unorganized sector who enjoy a cost advantage of at least 16 to 17 percent. They acquire considerable advantage in pushing their sales as they do not maintain any documentation and thus evade paying taxes. Withholding tax regime is another distorting factor as it allows final settlement of income tax liability of various economic agents. Credit availability to Small and Medium manufacturing units by banking sector is another constraining factor as bank credit to these units has declined from 17 percent in 2005 to less than 5 percent at present. This lack of access to credit has become a bottleneck in expanding their capacity.

4) Infrastructural bottlenecks and Energy Shortages - For the last several years, Energy Shortages have emerged as the binding constraint on Pakistan's growth performance. Generation capacity based on wrong fuel mix that has raised the cost of generation, large transmission and distribution losses, thefts and huge amounts of account receivables by the DISCO have resulted in tariff escalation, widespread outages and loadshedding. Honest customers who pay their bills are penalized by ever increasing tariffs to compensate for the non-paying customers. Privatization of Karachi Electric whereby the service has improved, reliable availability has been ensured for compliant customers, industry is free from load shedding and the company is making profits and investing in new generation capacity, grid stations and transformers is a business model that needs to be reviewed for possible application to other utility companies. Wellhead pricing for oil and gas exploration and production companies and rationalization of tariff in the gas sector can also help raise the share of indigenous fuel supply. Unexploited hydrocarbon reserves are estimated at 27 billion barrels of oil and 28 trillion cubic feet of natural gas. Unexploited hydroelectric potential is estimated at more than 100,000MW. Reforms in the energy sector which have been long pending can overcome these shortages that are incurring huge losses to the economy.

5) Normalizing trade relations with India and effective implementation of SAFTA - There is an overwhelming unambiguous evidence that the opening up to trade between India and Pakistan followed by unhindered implementation of SAFTA would be a win-win situation for the South Asia region. Regional growth Zones in the border areas between two Punjabs-Rajastan and Sindh, Torkham-Jalalabad, Chaman-Kandhar, Zahidan-Naushki, Sylhet-North Eastern States of India can become potential hubs for manufacturing and services due to economies of scale, low transport costs, clusters of services and labour. Special Economic Zones were the starting point for growth stimulus of China and there is no reason as to why this cannot be easily replicated in this region. China-Pakistan Economic Corridor (CPEC) will not only help western provinces in China to get access to the Arabian Sea and the Persian Gulf but also the backward regions of Balochistan and KPK. This corridor will become transit energy and trade corridor between Central Asia and South Asia. Investment in Trade facilitation and logistics at the border points would go a long way in promoting increased exchange of goods and services.

6) Technological backwardness Pakistan's manufactured exports are still stuck in low technology equilibrium based on the historical legacy of import substitution, protectionism, government largesse and rent seeking. The

Schumpeterian notion of Creative Destruction has not found much resonance among the policy makers and industry players alike. Artificial respiration keeps some of the sub-sectors and firms alive while they should have ceased to exist. The signaling effect of this perverse incentive structure has been "business as usual". Clamour and lobby for more concessions, get as many tax exemptions and benefits, focus on the European Union and the US markets and ask them to grant GSP plus privileges are our main preoccupations. Entry of more efficient and dynamic firms has been difficult because of the hold of these established inefficient firms. This combination of convoluted public policy and status quo minded behavior of the major industry players has not allowed Pakistan to climb on the ladder of Technological upgradation and diversify its exports to meet the demand of dynamic sectors. The share of Pakistani exports in medium and high technology products remains negligible. Research and Development both by public and private sectors remains pitiful. Supply of Science, Technology, Engineering and Mathematics (STEM) graduates is declining and their quality is highly suspect.

Way forward

In view of these external and internal factors, what should we do going forward? Besides, overcoming some of the limitations and constraints that I have outlined above we should build upon our strengths.

Pakistan's strengths

(1) A large and growing market size consisting of 60-80 million middle class consumers with purchasing power equivalent to some of the East European Countries and tastes and preferences aligned with the globalized demand pattern for goods and services offer attractive prospects for investors in manufactured goods industry. For example, fast moving consumer goods and consumer durables industries are rapidly expanding and are highly profitable because of the high demand from this class of consumers. With the middle income group expanding faster than the average size of population, the growth potential in income elastic products is quite significant.

(2) Pakistan's fertile and largely irrigated land has enabled the country to become self-sufficient in food and fibre production. This ensures basic food security on the production side and provides raw materials for industry. The composition of agriculture value added is also shifting towards dairy, meat, poultry, fruits and vegetables in line with the rising incomes. Thus, value addition through processing these products can be a source of stable expansion in the manufacturing sector. Demand for cereals would thus be subdued compared to these high value products. Higher incomes generated from the sale of these products will, in turn, raise the purchasing power of agriculture-based households reducing poverty and enhancing the size of the middle class. Rural-urban economic linkages will thus be strengthened.

(3) About 90 percent of Pakistan's GDP originates in the private sector and 70 percent of firms fall in the category of small enterprises. These enterprises are the potential sources of rapid manufacturing growth if the costs of formalization and the bureaucratic hassle are reduced. Some of the inefficiencies and waste in public enterprises can be removed if they are privatised and competitive business environment is allowed to set in. If bank financing is made available to the acquiring and new firms, services are provided to the clusters where these firms are located and technical manpower is added to their workforce the overall productivity gains would be significant.

(4) According to both informed and casual observers, the relative rate of growth of metropolitan and urban centres is much faster in Pakistan than the rural population. This shift of labor and reallocation from low productivity agriculture to high productivity manufacturing and services sector, if properly managed, can uplift the trajectory of GDP growth rate, employment and living standards. Urban and metropolitan centres should be delegated administrative and

financial powers to govern themselves. The potential of 'agglomeration economies' that characterizes the urban centres can be harnessed to generate high productivity jobs, manufactured exports and economic growth.

(5) Pakistan has achieved high degree of connectivity through its policy of liberalization, competition, smart regulation and opening up the sector to private firms. Telephone density, wireless broad band and internet penetration are on a steep upward incline. Value added services can make a substantial difference to financial inclusion through mobile banking, better health care, agriculture information availability and access to non-formal education. Strong connectivity and distribution of goods and services via e-commerce can increase the rates of return on investment.

The proponents of Industrial policy argue that Pakistan should pursue an interventionist policy to address market failures and also nurture champion industries for participating competition in the global markets. Those opposed to such policy intervention present the historical evidence of rampant government failures in Pakistan which have been responsible for rent seeking, barriers to entry, absence of level playing field, perverse incentives and selective anti-competitive regulations that favor a few at the cost of the larger segments of the economy. The dismal performance of industrial units owned and operated by the public sector can be best exemplified by the energy companies that have not only hurt production and exports but also cause a substantial leakage in public finances - almost US $5 billion a year in form of losses, theft, waste and inefficiency. Many of these companies are either without Chief Executives or the turnover of the top management is so high that consistent execution of plans, programs or projects is simply not possible.

In my view, a clear separation between policy, ownership and regulation is quite essential to maximize efficiency, protect consumers, provide competitive markets and promote investment and expansion. The capacity of regulators such as SECP, Competition Commission of Pakistan, Food and Drug Agencies, Sectoral regulators has to be strengthened while the entities-private, public or mixed - should be allowed to complete in a level playing field. A uniform tax regime should be applied to all firms and sectors of the economy on the principle of the ability to pay without any consideration of the sectoral origin of the income. Enforcement of laws and regulations has been weak and the delinquents and defaulters have no fear of penal action against them. Ideology, pre-conceived notions and binary polarization between the market and the state are not the staple for further progress. There is no 'one shoe fits all' approach to economic development but it is an interplay of political, economic, social, and cultural factors specific to the country and the dictates of globalization in which each country has to compete.