EXPORT SUBSIDIES AND IMPORT SUBSTITUTION: STEERING MERCANTILISM IN THE MODERN TIME

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Mercantilism, rather than being a well-organized body of thought, is better understood as a set of ideas and policies aimed at controlling and interfering with international trade. This economic philosophy remained prominent in Europe from the 16th to the 18th century, where nations sought to accumulate wealth and power by managing trade flows and maximizing their stock of precious metals & valuables (Haque, 2006).
One of the core principles behind mercantilism is the Montaigne fallacy—the belief that in trade, the gain of one person or country comes only at the loss of another. According to this fallacy, wealth is viewed as a zero-sum game: "No profit can be made but at the expense of another." (Qadir, 2022)

This assumption, driving many mercantilist policies, leads to the idea that a nation's wealth is determined by its stock of precious metals (gold and silver), making the accumulation of these resources a key economic goal. Countries while adopting policies, would impose tariffs and export subsidies, protect domestic industries, and hoard precious metals to enhance power in the homeland. It has been noted that Pakistan's economic policies have historically aligned with mercantilist doctrines by focusing on export promotion[2], import substitution[3], and policies that are often linked to currency management (Raja,2003)[4]. Currently, they are considered outdated but the fragments of mercantilist thought still exist in modern policies where nations emphasize export promotion and import substitution, often at the expense of global cooperation and long-term economic efficiency (PIDE webinar, 2022). Despite the efforts for export substitution Pakistan managed to export only 65% of its products to traditional export partners and has not made remarkable progress in terms of destination diversification (RASTA-PIDE,2023).

With this backdrop, this paper aims to test the hypothesis that "Is Pakistan a mercantilist state seeking to subsidize exports and substitute imports with high tariffs to maintain an appreciated exchange rate?". Additionally, it will be argued how these policies are impacting the economy. A thorough review has been done. To meet the objective of this paper, secondary sources, policy documents and PIDE research all are explored well.

PAKISTAN'S POLICY CHOICES AND OUTCOMES

In the contemporary global economy, where nations strive for integration, liberalization, and the unified flow of goods and services, Pakistan stands as a country still following a mercantilist approach. This economic philosophy of 16th to 18th-century European powers is characterized by a strong emphasis on export subsidies and import substitution through high tariffs. This policy aims to maintain an appreciated exchange rate, and raise national wealth and economic self-sufficiency. However, in a world of complex interdependencies, this strategy seems questionable and impacts the long-term economic growth of Pakistan.

Pakistan's trade-related policies aim to enhance exports and protect its domestic economy. The Strategic Trade Policy Framework (STPF) focuses on export growth, while the National Tariff Policy (2019-2024) is designed to safeguard the domestic market. The Trade-Related Investment Policy seeks to attract investments in export-oriented manufacturing. Special Economic Zones (SEZs) are being developed as industrial hubs to draw foreign direct investment (FDI). Additionally, Pakistan participates in multiple trade agreements, including bilateral deals, free trade agreements, and is a member of the World Trade Organization, South Asian Free Trade Area, and China-Pakistan Free Trade Agreement.

Pakistan's economy is politically captured, with businesses getting export subsidies and forming cartels to gain market power and exploit opportunities. This environment stifles business growth, as firms avoid equity markets and focus on maintaining control. The informal economy thrives outside formal structures due to lawlessness, low trust, and regulatory lobbying (PIDE Knowledge Brief, 2020). Investment is hampered by political instability and security concerns, deterring foreign investors and limiting local economic growth. Pakistan's ranking in global ease of doing business is 108th (WB group, 2020) and 107th in GCI in 2018 (PIDE webinar brief, 2022) raises serious concern.

[2] Export promotion (EP) strategy- implemented in early 1990s
[3] Import substitution (IS) strategy-adopted in early years, & in current period
[4] https://pide.org.pk/research/misplaced-mercantilism-and-the-case-for-domestic-markets/

PAKISTAN TRADE POLICY OR MERCANTILIST APPROACH

Pakistan's trade policies reflect a mercantilist approach—focused on export subsidies, high tariffs to block imports, and potential exchange rate interventions to manage external trade relations. As noted by (Haque,2007 ; and Siddique, 2003[5]) mostly the country is focusing on Exports over Domestic trade; Import substitution policy: Lopsided policy focus; Appreciated exchange rate.

1. **Focus on Exports Over Domestic Trade:** In Pakistan, trade discussions are focused on increasing exports while neglecting domestic commerce. This mirrors mercantilist policies, which prioritize boosting exports as a way to accumulate wealth. The bias against domestic trade supports the idea that the state's policies are designed to promote exports over internal economic development.

   Policymakers focus on export-led growth without addressing the domestic retail market. It implies that this preference for exports over domestic economic development aligns with the mercantilist mindset, where exports are prioritized to accumulate foreign currency, even at the expense of fostering strong domestic commerce (Raja, 2003).

2. **Import Substitution Policy:** Mercantilism often involves high tariffs or import barriers to protect domestic industries, which aligns with the statement being tested in this paper using high tariffs to substitute imports. The view of (Raja,2003) is that Pakistan has long pursued policies favouring producers over consumers, reflecting these import-substitution strategies. While (Haque,2007: and Siddique, 2003) also mentioned the Haq/HAG model from the 1960s, which emphasizes import substitution—a classic mercantilist strategy where high tariffs or trade barriers are imposed to reduce imports and protect domestic industries. This aligns with the concept of shielding domestic markets from foreign competition, as a mercantilist state would, to reduce reliance on imports. It has also been discussed that import substitution policies create anti-export bias (Mahmood, 2023)[6]

3. **Lopsided Policy Focus:** The "lopsided" focus on exports and import substitution has been at the expense of broader market development, reinforcing the claim that the state seeks to artificially boost exports through subsidies while implementing protectionist measures (such as high tariffs) to minimize imports (Siddique, 2003).

4. **Appreciated Exchange Rate:** Although the article does not explicitly mention the exchange rate, maintaining an appreciated exchange rate is often associated with controlling inflation and subsidizing export competitiveness. This can be inferred as part of the broader economic strategy to manage trade balances, particularly if the exchange rate is manipulated to favor exports.

[5] https://pide.org.pk/research/can-domestic-trade-be-the-engine-of-pakistans-growth/
[6] https://pide.org.pk/research/exchange-rate-and-trade-regime/

Some writings implicitly focus on an appreciated exchange rate, as it can be seen from the policies of subsidizing exports and protecting domestic industries from imports through tariffs. Such policies are often employed by countries aiming to protect the value of their currency by limiting imports (which would require foreign exchange) and boosting exports to earn foreign reserves, maintaining a stronger currency.

5. **Subsidies to Export-Oriented Industries:** The article criticizes the persistent policy of giving subsidies to "export-oriented" industries. This reflects a mercantilist approach, where the government prioritizes exports by offering financial incentives to industries that focus on external markets. You can use this to argue that the state is heavily focused on boosting exports, a hallmark of Mercantilism (Raja, 2003).

THE LEGACY OF THE HAQ/HAG MODEL OR IRREPARABLE DAMAGE?

In Pakistan, domestic trade has long been unnoticed as a potential part of economic growth. The country's past policy framework has been shaped by the Haq/HAG model of the 1960s, which emphasized the two goals of boosting exports and reducing imports through an import substitution strategy[7]. While this approach aimed to secure foreign exchange and build industrial self-sufficiency, it unintentionally put aside the development of domestic commerce and inhouse market dynamics.

The Haq/HAG model's focus on import substitution led to a disproportionate policy agenda that prioritized protecting domestic industries from foreign competition and incentivizing exports. This policy environment was not suitable and muffled the growth of domestic markets, restricting competition and innovation within the country. As a result, the country could not develop strong infrastructure, and logistics, and market access remained limited for small and medium-sized enterprises (SMEs), which only flourish in the supportive domestic trade environment.

The bias against domestic commerce has had far-reaching implications for Pakistan's economy. By concentrating policy efforts on international trade, the potential of local markets, which could have driven employment, productivity, and innovation, was mainly ignored. In addition, domestic trade could have served as a shield against global economic volatility, providing stability in times of external shocks.

To unlock the potential of domestic commerce, Pakistan must revisit its economic strategy. Implementing policies that encourage market development, improve logistical challenges, and encourage competition internally (Ahmad et al., 2022)[8]. By creating a balance between external trade and internal market expansion, Pakistan can promote a resilient economy that strengthens both export-driven growth and domestic well-being.

[7]Emphasizes industrial production, creating foreign exchange surplus through export promotion, and a large government footprint.
[8]https://pide.org.pk/research/business-and-investment-issues-in-pakistan/

IS SUBSIDIZING EXPORTS A GOOD OPTION OR A DOUBLE-EDGED SWORD?

Pakistan's approach to subsidizing exports is rooted in the desire to enhance the competitiveness of its goods in international markets. The government often provides financial assistance to key export-oriented industries such as textiles, agriculture, and sports goods. These subsidies aim to lower production costs, enabling Pakistani goods to compete more effectively on the global stage.

However, while this strategy may yield short-term gains, it also risks fostering inefficiencies within the economy. Industries that rely heavily on subsidies may lack the incentive to innovate or improve productivity, leading to a dependency that could hinder long-term growth. Moreover, such subsidies can strain public finances, diverting resources from critical areas like infrastructure, health, and education.

WILL IMPORT SUBSTITUTION AND HIGH TARIFFS BE ABLE TO SHIELDING DOMESTIC INDUSTRY?

Pakistan has also adopted a policy of import substitution, imposing high tariffs on foreign goods imports (PIDE Policy & Research, 2020; PIDE Blog. 2020; PIDE Costonomics, 2024). This protectionist measure is mainly designed to encourage domestic production, protect domestic industry and reduce reliance on imports, thereby preserving foreign exchange reserves.

On one side, import substitution can stimulate local industries and create jobs, but on the other side high tariffs lead to higher prices for consumers, reduce their purchasing power and potentially fuel inflation. Likewise, by limiting competition, protectionism can suppress innovation and efficiency within domestic industries, making them less competitive over time. In an interconnected global economy, where supply chains are increasingly complex, separating a country from imports can also disrupt access to essential inputs, hindering industrial growth. Pakistan has made limited progress in upgrading its export product value chain. The country's bottom 10 high-value-added exports have shown little change since 2003. The modest diversification achieved since 2005 has not significantly boosted income, with 26 new products contributing only USD 4 per capita in 2020 (RASTA-PIDE,2023).

Despite decades of import substitution policies, Pakistan has seen little progress in industrialization, with a growing reliance on imported raw materials. From 2000 to 2020, the share of imported intermediate inputs rose. High tariffs and cascading rates have led to the highest effective protection rate (ERP) in the manufacturing sector, making raw materials more expensive. In contrast, ERP is very low in agriculture and negative in services. Within manufacturing, the automobile and cooking oil industries are the most protected, contributing to higher consumer prices for cooking oil (RASTA-PIDE,2023).

IS THERE ANY SOLUTION OF THE EXCHANGE RATE ENIGMA?

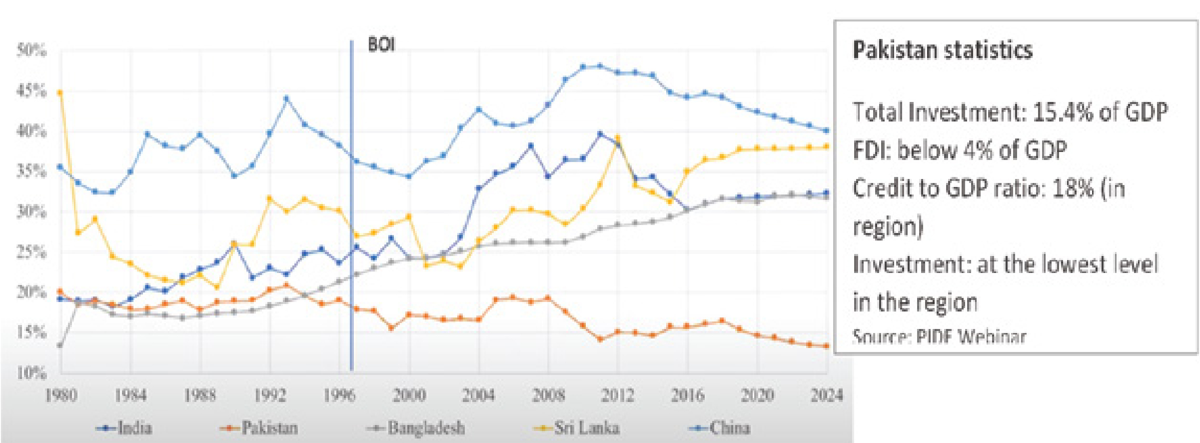
An appreciated exchange rate is usually maintained through interventionist policies and is an evidence of Pakistan's mercantilist approach. A strong currency makes imports cheaper, helping to control inflation and reduce the cost of imported inputs for domestic industries. Conversely, it also makes exports more expensive in the global market, potentially discouraging the competitiveness that the country seeks to achieve through subsidies.

Additionally, maintaining an appreciated exchange rate can lead to imbalances in the balance of payments, as the cost of imports outweighs the revenue from exports. This scenario can exert pressure on foreign exchange reserves and necessitate borrowing, further complicating economic stability.

INVESTMENT ENVIRONMENT IN PAKISTAN VS THE REGIONAL COMPETITORS

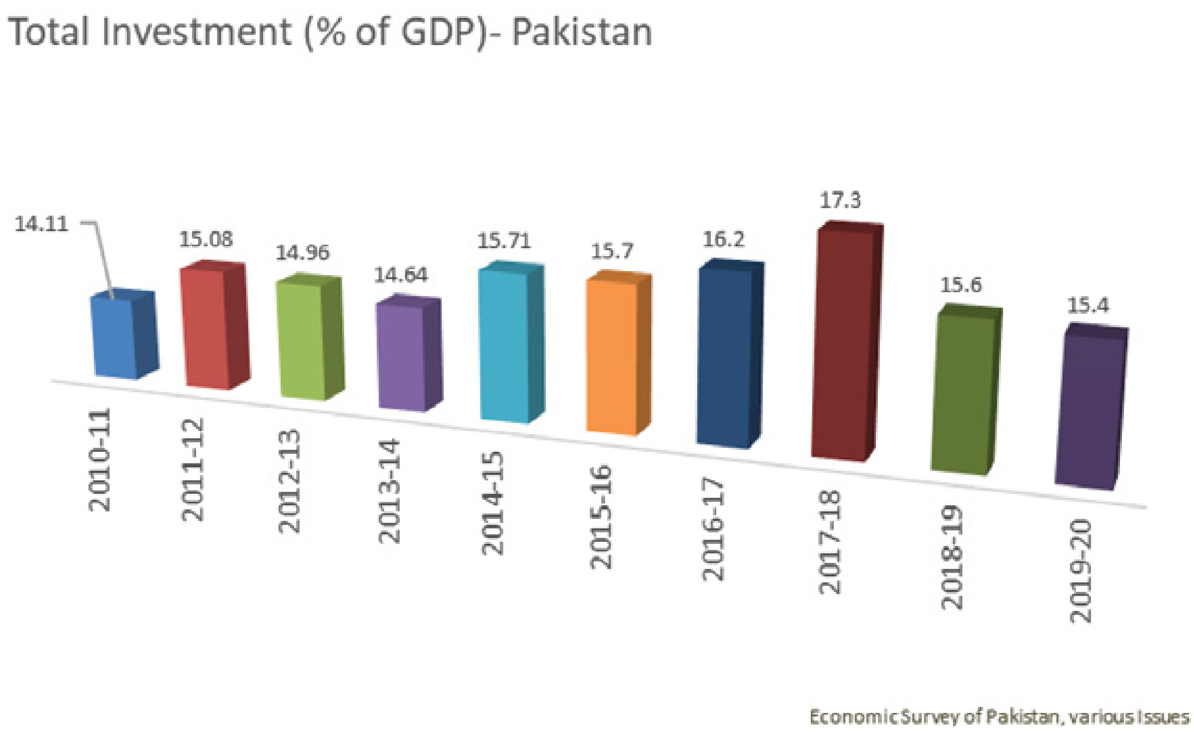
Pakistan's economic history faced a weak industrial base encountered with a closed economy, agricultural dominance, and political instability. Policies in the past were meant to strengthen the industrial base. Pakistan adopted a restricted trade regime and protected its domestic industries. In past, the government nationalized various industries in the country. The privatization program of Pakistan was started mainly as a reaction to the large-scale nationalization in 1972-77. The purpose of the privatization program was to encourage private ownership and to attract foreign investment. Gradually government tried to adopt measures of trade liberalization to encourage exports in each regime. Key measures were the devaluation of the Pakistani rupee, the elimination of the export bonus scheme, and the discontinuation of the restrictive licensing scheme. Like in India's dismantling of license raj in the 1990s. Steps were taken to stimulate exports of manufactured products. Businesses face multiple challenges in both the short-run and long run. The government also focused on enhancing the role of the private sector and tried to enhance competitiveness in the economy.

Fig 1: Total Investment (% of GDP) of Pakistan and regional countries



Total investment in Pakistan is at 15.4% of GDP which is just the replacement investment. In the region, Pakistan has always ranked the lowest (see figure 1). It is indeed worrisome that India and Sri Lanka have an investment GDP ratio of over 30 % and China over 40%. Surely this should be a matter of policy concern (PIDE webinar brief, 2022).

Vietnam and India have performed well in exporting capital goods as compared to Pakistan which continues to export consumer goods and industrial supplies with a very small share of the export of capital goods (RASTA-PIDE, 2023).



Comparing businesses in South Asian region it is noted that India has more investments in businesses while Pakistani companies grow, but at a slower rate, partly due to low investment levels. While a few leading businesses have expanded their consolidated sales by 2-3 times, many others are still striving for growth (Webinar brief, 2022). The economies of Bangladesh, India, China, and Vietnam have witnessed an increase in the concentration of export products due to the rising levels of specialization in these economies (RASTA-PIDE,2023).

Is growth the only fundamental problem for Pakistan? Nationalization in past damaged the business attitude. Directions come from the top public levels and are more about power and control. Business sentiment is at the lower end and the country will never grow until it becomes a core value from top to bottom. Policies do not grow in Pakistan as it has become a victim of the manifestation of the system and non-conducive work culture. Businesses are running in an environment where the business community is forced to take action for their existence in the market not for growth. Unthoughtful policies and an environment of distrust exist. The current situation of the economy differs as Pakistan now fall lowest in investment and maintains the lowest credit to GDP ratio (Pakistan 18%, Bangladesh 47%, and India 50%) (PIDE webinar, 2022).

Comparing the FDI inflow in Asia; India has the leading role while Pakistan and Bangladesh stand lower. For Pakistan, most of the FDI inflow comes from Hong Kong and China and the power, finance and oil sector have almost 70% share of the total FDI in the country. Pakistan has a grim vacuum of policies as no conclusive growth policy, industrial policy, or export policy exists. Pakistan unfortunately failed to demonstrate big investment transactions in the last several years like RECODEC, KARKEY, Bahawalpur solar project. There are structural flaws and disconnections between institutions at the federal and provincial levels. The ultimate solution is to rely on the private sector to run some economic zones. SEZs and the Provision of utility services are also important to attract foreign investors (PIDE webinar, 2022).

CONCLUSION AND THE WAY FORWARD

Pakistan's incessant devotion to mercantilist policies has taken the country to the brim of complex challenges. While the desire to build self-sufficiency and protect domestic industries is understandable, the long-term efficiency of such strategies in a globalized world doesn't seem possible and remained a part of economic debates. Pakistan must critically assess the sustainability and long-term impact of these policies. The country can try to build a more resilient economy capable of dealing with the complexities of modern times. Reducing the government footprint and moving away from interventional policies is recommendable. In today's world, an economy is a set of transactions. More transactions and more interconnections mean higher economic growth. The recommended approach is the gradual reduction of subsidies and tariffs while encouraging a competitive business environment. Engaging in trade agreements, and investment treaties that provide access to new markets, adopting new technology and modernising infrastructure, can help Pakistan's industries compete globally without the need for excessive protectionism.

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