INDUSTRIAL POLICY REFORM

Ishrat Husain

Pakistan, which has gone through deindustrialisation in the last few decades, has to examine carefully whether it can benefit from evolving an industrial policy of a kind different from earlier periods. What is the rationale and purpose of this new industrial policy?

Had Pakistan maintained its export-to-GDP ratio at the level of 16 percent as in 1999, the total merchandise exports would have reached USD 56 billion in 2022, i.e. 75 percent higher than USD 32 billion actually realised and the current account deficit – with even higher level of imports – would have been manageable. The previous industrial policy thus failed to make the country competitive internationally. How to recapture this lost market share and become more competitive is the challenge. This goal is attainable because empirical evidence shows that Pakistan's publicly listed exporting firms are found to be on average 20 percent more productive than domestically oriented firms (World Bank). The present incentive structure is biased against manufactured exports and favors production and imports for the domestic market.

Resurgence of industrialisation is therefore needed for not only increasing exports, but also for stimulating GDP growth, adopting technology, creating jobs and developing a skilled work force. Industrial policy has therefore 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. The point of departure for the new policy is that it requires "technological competence, skills, work discipline and trainability, competitive supplier clusters, strong support institutions, good infrastructure and well-honed administrative capabilities" be developed, nurtured and promoted and the rent seeking subsidies and protection to specific firms and industry or sectors be shunned.

Under the old industrial policy, concessions and subsidies in the name of 'infant industry' have continued unabated as there were no benchmarks set to evaluate performance and assess whether intended goals were achieved. The policy had no 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, as well as firm, subsector, and industry specific differential concessions, the resultant manipulation, collusion, and speculation led to excessive rent seeking. A wedge was created between 'observed prices' and their fundamental determinants. Investors tend to 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 the society. Overall, low economic growth coexists with excessive returns earned by selected market players. Bureaucrats and politicians are accused of indulging in crony capitalism through concessions, exemptions, bank loans, preferential allocation of land at below market prices, and import permits to a select few. The beneficiaries of these favours are political supporters, friends and family members or blatant pecuniary benefits to those administering the policy.

Governments are also not particularly good at identifying the sectors which should be promoted. It is only the businesses themselves – with a sharp eye on markets – that can evaluate relative returns to investment by taking account of the dynamic comparative advantage to conduct this task. Government can act as a facilitator, enabler, provider of level playing field through regulation, promoter of competition and problem solver but not a direct intervener in investment choices. Besides maintaining political stability, pursuing sound macroeconomic policies, investing in human capital and physical infrastructure, and 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 the tax net and rationalising expenditures would not only reduce the budgetary deficit requirements but also help the private sector by lowering tax incidence while providing complementary public investment.

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 0.6 percent of GDP in the early 2000s to 0.28 percent currently. 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 resource allocations. Institutional specialisation, complementarity between academia and industry, patent 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 a comprehensive R&D initiative. 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 decentralising fiscal resources, giving local bodies autonomy while holding them accountable for results. State should withdraw from running businesses and allow the private sector to compete on a level playing field. The state should focus on delivering basic public goods and services in a cost effective and efficient manner. Technology parks, incubation centres, and special economic zones can create clusters for exchange of knowledge, skills and provision of common services resulting in agglomeration economies. Narrower forms of specialisation 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. The 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 of which are overlapping) have stifled the entry of newcomers by increasing the cost of doing business, thus retarding the forces of competition. For example, minimum tax based on turnover and advance tax act as a barrier to new entrants. As a result, 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 the tax net) would allow 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 rationalised to incentivise new products and sub sectors so as to facilitate penetration in new markets. One way to promote consolidation, capital formation, upscaling, and expansion in the manufacturing sector is to remove tax on inter corporate dividends. 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 domestic markets.

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 on the Human Capital Index. One third of children are out of school, learning poverty is sky high, a rising number of university graduates are unemployed, female labour force participation pates are abysmally low, and malnutrition and stunting continue to grow. The acute shortage of skilled workers demanded by the industries pose a 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 components 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 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 recurrent 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, with monopolies of DISCOs being dismantled, the situation would remain precarious. There are very few countries which subsidise piped gas for households and penalise industrial units. Under current circumstances, the circular debt would keep piling up while the rising costs to the industrial units, particularly in international trade, would drive them out of business.

vi. **Labour laws.** Pakistan has a youth employment problem. More than 70 labour 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 federal and provincial governments. Despite such abundance of laws and regulations, contract, casual, temporary and daily wage modes of employment have become the accepted norms in manufacturing industries. Formal and wage employment in 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 labour productivity lags behind that of 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 realised 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 workers. Labour productivity is thus a viable avenue for profit maximisation, capital formation for expansion and investment, new job creation, awarding decent living wages and increasing global competitiveness.

Old habits die hard but unless we have a mindset change and a serious political commitment to earnestly implement the required changes, we would end up facing one crisis after another every few years and keep knocking at the doors of the IMF and our friends.

The author is a former Advisor to the Prime Minister on Institutional Reforms and Austerity with the status of Federal Minister. In this capacity he also served as the member of National Economic Council, ECNEC, Economic coordination Commit¬ee of the Cabinet and several other Cabinet Committees.