Can Pakistan Pick up its Industrialization with CPEC?

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China Pakistan Economic Corridor (CPEC), a flagship program of China's Belt and Road Imitative (BRI), has been on the move for almost a decade now. Since signing of the Memorandum of Understanding (MoU) in 2013, CPEC has been one of the widely discussed subjects in print, electronic, and social media. A variety of arguments has been made over its possible implications for the domestic economy of Pakistan. The proponents consider CPEC as a game changer as it is expected to result in market access, regional connectivity, and increased trade. Specifically, the market access to Middle East, Central Asia, and Africa through CPEC is projected to produce larger trade potentials. Likewise, state of the art infrastructure in terms of energy projects, transportation networks, and Special Economic Zones (SEZs) is likely to provide the essentials for industrial development. Alternatively, CPEC is anticipated to create higher investment and employment opportunities, on one hand, and result in heightened industrial development, larger trade, and overall growth of the economy, on the other. However, on the opposing arguments, the Pakistani economy is trapped into a scenario where the country is faced with low growth prospects amid recent stagflation, persistent macroeconomic imbalances, and enlarged vulnerabilities of a sizable fraction of the populace. In particular, the persistent twin deficits have caused the debt burden to reach an unprecedented level, with current debt-to-GDP ratio standing at more than 70 percent, leaving little fiscal space for the provision of social services. To put it differently, there is much uncertainty that revolves around the possible consequences of CPEC on Pakistan's debt trap. Despite these opposing perspectives, CPEC offers both opportunities and challenges that need to be addressed in order to reap the potential benefits associated with regional connectivity, enlarged market access, enormous infrastructure, and industrial development. Here, in this article, I am making an argument on how investments under CPEC can affect Pakistan's industrial progress.

Before going to the main argument, let me describe what does CPEC offer to Pakistan and what is the current status of projects under CPEC. As is planned initially, an investment worth of $62 billion is expected to be disbursed under CPEC by 2030. The sector-wise allocation comprises $34 billion for energy projects, $14 billion for the development of Gwadar, and the remaining $14 billion are for hard infrastructure and related activities like industrial cooperation/Special Economic Zones (SEZs) and other projects of social and economic development. Accordingly, during the last decade, China has been the largest source of investment for Pakistan, with around $25.4 billion has been invested in direct projects. Around 21 energy projects (equivalent to 16,635 MW) are planned under CPEC out of which 14 projects (equivalent to 8,220 MW) are completed, 2 projects (equivalent to 1,170 MW) are under progress, and 5 projects (equivalent to 3,245 MW) are under consideration. As of now, completed power projects under CPEC contribute about one-fourth to the Pakistan's power generation, with the compound growth rate of power generation has jumped from 2.7% in pre-CPEC period to 7%

during post-CPEC period. Likewise, with regard to the transportation infrastructure, CPEC includes 24 projects (covering 6,000 KM) out of which 6 projects (covering 1,656 KM) are completed, 5 projects (covering 813 KM) are under construction, 8 projects (covering 2,989 KM) are in pipeline, and 5 projects (covering more than 500 KM) are in long-term plan. As of now approximately 40 percent of the total mileage of Pakistan's motorways is completed under CPEC which is contributing significantly to Pakistan's passenger traffic and freight movement. Specifically, the motorway network in Pakistan links different parts of the country to the main ports, i.e. Karachi Port, Port Bin Qasim, and Gwadar Port, improving Pakistan's cross-border trade efficiency. Moreover, 14 projects have been planned for the development of Gwadar out of which 4 projects (including the Development of Gwadar Port and Free zone) are completed, 6 projects (including New Gwadar International Airport) are under construction, and the remaining 4 projects are in pipeline. Finally, 27 projects of Social and Economic development are planned under CPEC out of which 17 projects are completed, and 10 projects are in pipeline. In summary, it is stated that CPEC would make a significant contribution to the Pakistan's hard and soft infrastructure which is one of the necessary conditions for industrialization.

With regard to industrialization, Pakistan's performance has been truncated over its history. Policies of export promotion and import substitutions were in place in 1960s which were based on instruments like imports rationing, credits at subsidized rates, over-value exchange rates, discriminated tariffs and other non-tariff restrictions. These policies had two effects on the industrial sector of Pakistan. First, in static sense, it resulted in higher growth rates of the manufacturing sector in the country, exhibiting an industrial growth rate of around 10% per annum and raising the share of industrial sector to GDP to 11.9% in 1965 from 6.9% in 1950. However, as a by-product, these policies resulted in the creation of an organized interest group in the form of industrial class. Subsequently, the nationalization of 34 industrial units in 1970s not only retarded the continuity of higher manufacturing growth but also resulted in inefficiency and declining incentives on part of the private sector. To put it differently, the lack of continuity in policies combined with the short-sightedness or rent-seeking of the industrial class shaped a dichotomous performance of the industrial sector in Pakistan. Consequently, Pakistan has not been able to diversify its industrial production structure as is done by comparable countries like South Korea, China or Malaysia. Likewise, amid institutional decay, the structure of private sector in Pakistan has been restricted in size and scope, with limited penetration both in local markets as well as in global markets. In domestic markets, competition has been muted which has adversely affected the dynamism of businesses, inhibiting investments in innovations and technology, thereby, restricting creative destruction. In addition to ineffective implementation of competitive practices, state has a sizable footprint in key economic sectors which has been a deterrent to entry into markets. Given these constraints, 70% of the firms in Pakistan are classified as small, with only 8% of Pakistani firms are large compared to 54% in Sri Lanka, 52% in Indonesia, and 47% in Thailand. This has also been manifested by around 30% share of Small and Medium Enterprises (SMEs) in the manufacturing sector during the last decades. Furthermore, a sizable number of businesses in Pakistan operate in the informal sector, with the size of undocumented economic activities ranges from 25% to 35%. Informality in businesses has been further creating market hurdles like unfair competition, credit constraints, and losses in revenues. For instance, according to World Enterprise Survey of the World Bank, 13% of the companies in Pakistan has been complaining about unfair competition from the informal competitors. Likewise, unregistered firms are unable to access to the formal credit market, causing them to remain small forever.

Likewise, in international markets, Pakistan's export performance has been stagnant, with its share in global trade dropped from 0.15 percent in 2005 to 0.12 percent in 2022 while China has doubled and Vietnam has tripled their shares during the same period. Specifically, Pakistan has been losing its export competitiveness, with the share of Pakistan's competitors' have been increasing substantially in the global markets. For instance, from 2005 to 2022, Bangladesh's share in world exports increased from 0.06 percent to 0.19 percent, India's from 0.61 percent to 1.65 percent, and Vietnam's from 0.14 percent to 1.17 percent. Currently, Pakistan is among the top ten countries with lowest export orientation in the World, with an export to GDP ratio averaging to 12.3% for the period 2000-2020. Second, Pakistan's exports lack diversification, including both product diversification as well as market diversification. For instance, Pakistan's exports are mainly comprising resource-based items such as cotton, rice, and hides and skins over the past many decades, dominated largely by textiles products and rice. Similarly, Pakistan's exports market is concentrated as its main trading partners are only three, the United States, Europe, and China, though it also sells much of its rice to the Middle East. The only economy for which it is a major market is Afghanistan. Third, Pakistan has never been efficient with respect to value-addition. Unlike Pakistan, most of its regional neighbors and competitors were able to transform their export base from primary commodities to high value added items. For example, over the past two decades, compared to an increase of 16 percentage point in the share of manufactured exports in Pakistan's total exports, the share of regional competitors has on average increased by 43 percentage points. Further, exporters in Pakistan are relatively small – affecting their bargaining power when negotiating with international buyers – and they operate under substantial supply constraints.

As stated earlier, CPEC entails a bunch of hard and soft infrastructure in terms of cost effective energy, motorways networks, Gwadar Port among others which all are the essential pre-requisites for successful industrialization. In addition, 9 Special Economic Zones (SEZs) are under progress under the umbrella of CPEC which offers a bunch of incentives to entrant firms. The incentives to investors fall into five categories: fiscal incentives; general incentives; facilities in export processing zones; facilities in industrial estates; and exemptions in Gwadar port. Fiscal incentives in SEZs includes one-time exemption for capital goods from all taxes and custom duties which are imported into Pakistan for the operation, maintenance and development of SEZs; a five-years exemption from all taxes on incomes which are accrued from the operation and development of SEZs; one-time exemption on capital goods to enterprises in zones from all taxes and customs duties which are imported for installation within the SEZs; and exemption of incomes of zone enterprises from all taxes for 10 years. These facilities are expected to incentivize investors to invest within the SEZs. Similar fiscal incentives are offered in Gwadar port. In terms of general incentives, all the SEZs, industrial estates and export processing zones would be offered utilities like electricity, gas, and others at the zero-point of the zones. Likewise, one window facility and dry port facility would be provided by the Board of Investment (BOI), government of Pakistan. In addition, the development of SEZs and the enterprises with in the zones would be regulated by transparent procedures and efficient regulatory mechanism. Furthermore, security arrangements, efficient dispute settlement mechanism, along with continuity of incentives would be ensured.

All these facilities imply that the stage is set for an industrial take-off in Pakistan. However, to reap the potential benefits of CPEC and SEZs we have to do some additional structural reforms in order to persuade investors to invest in Pakistan. In other words, these structural reforms constitute as threshold conditions for successful industrialization under CPEC. First, we need an organizational structure which could resolve the problems of knowledge and incentives. The decision making with regard to businesses, especially within the SEZs, must be handed over to the private sector as businesses have sufficient knowledge of the market compared to a central bureaucrat. Likewise, the incentives problem arises when the incentives of the policy makers are not aligned to the incentives of CPEC projects and successful SEZs. The incentives of all stakeholders must be aligned with the successful industrialization. Second, an efficiency or productivity based incentives mechanism should be introduced to investors in order to avoid the rent-seeking of the incumbent industrial class. Third, effective labor policy would not only generate employment; but it would also result in skill upgradation of the domestic labor. Fourth, we should prioritize our potential exports and markets for those exports in order to have beneficial effects on our overall exports and growth within SEZs. Fifth, the cost of doing business needs serious attention as exporters from Pakistan are facing tough competition from Bangladesh, India, and Vietnam. Internal security, rationalizing energy prices, performance-based incentives mechanism, and enabling regulatory environment are the key elements in this regard. Sixth, to encourage technological upgradation and enhance the size of businesses, we have to open our market to global firms, especially for joint-ventures. In other words, limited competition has halted the development of a competitive private sector in Pakistan in addition to inversely impacting the welfare of consumers. Finally, rationalizing the tariff structure from the perspective of anti-exports bias is essential as applied tariff rates are relatively high in Pakistan when compared to its peers/competitors. While higher tariff rates could be helpful in curbing unnecessary imports, tariff on imported raw materials could impact the country's export performance. With increasing importance of global value chains at different stages of production, share of exports made up of imported inputs have also increased across the globe, including Pakistan. Estimates suggest that around 20 percent to 30 percent of imported inputs have been used at different stages of production in Pakistan. So, we have to rationalize our tariff structure.

The main objective of this article is to see the prospects of industrial development in Pakistan under the umbrella of CPEC which is a flagship program of China's broader Belt and Road Imitative (BRI). We argue that CPEC entails enormous infrastructure development in Pakistan, including but not limited to energy projects, transportation network, SEZs, Gwadar port etc., which set up a stage for successful industrialization in Pakistan. However, to realize this objective, Pakistan needs structural reforms which can ensure enabling business environment to businesses by providing them with facilities and level-playing field. These reforms constitute as threshold conditions which can make CPEC as a game changer for successful industrialization in Pakistan.

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