REGULATION AND POLICY SPACE

Competitive Import Substitution: Can Industry be Protected in Pakistan

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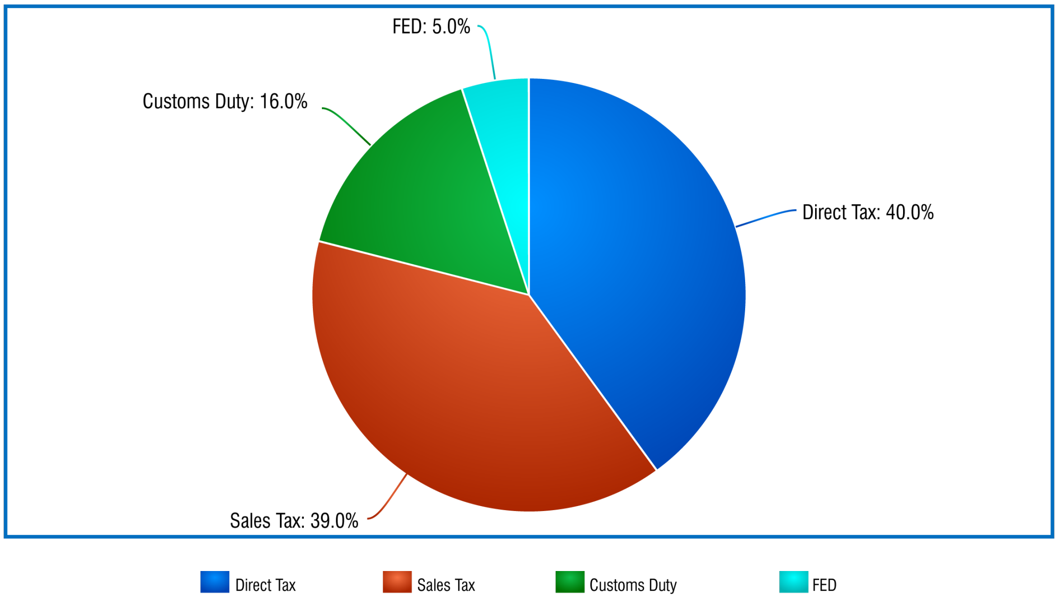
Pakistan has been designing different trade policies over the years whose goal is to maintains its balance of trade deficit, ensure the availability of necessary goods and protect the sectors that are national priorities from foreign competition. Protection to domestic industry has been achieved by restricting imports, subsidizing exports, and more recently by imposing tariffs structured in a way to discourage imports of goods produced locally. Protection has clearly been a key objective of trade policy. Protectionism can come in the form of tariffs, quotas, export subsidies, import licensing, and exchange rate controls.

Consider first the case of tariffs. A tariff is tax on the import of foreign goods in order to protect the domestic industry from foreign competition and with an additional benefit of generating revenue. Primarily, three different types of tariff are imposed; namely ad valorem tariff, specific tariff and composite tariff. Ad valorem is imposed in proportion to the estimated value of the product being imported, while a specific tariff is imposed as a fixed charge per unit of product imported. Finally, composite or compound tariff is a hybrid of ad valorem and specific rates.

Customs duty contributed 45 percent to the overall revenue in Pakistan in 1991-92. Since then, as a result of economic reforms, the percentage share of customs duty has declined to 16 percent in FY 2017-18 and presently direct taxes are the top source of revenue with 40 percent share.

Figure 1: Tax Category-wise Shares in Revenue (2017-2018)
Source: FBR Year Book 2017-2018



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The government followed a policy of import substitution initially, which entailed a highly restrictive trade regime and high tariffs. Tariff reforms were initiated in early 1990s, at the behest of international financial institutions. As a result, the number of tariff slabs was reduced over the years. In the 1980s the total number of tariff slabs was 42, which were reduced to 10 in 1993, 6 in 2015, 5 in 2016 and 4 in 2017. This indicates that the process of adopting a more uniform tariff rate structure and liberalizing of trade was taking hold in Pakistan. The process of tariff rationalization started in the 1990s and continued till 2001, as evident from the fact that the top tariff rate was 120 percent in 1985 and decreased to 25 percent in 2001, and further reduced to 20 percent in 2016 (Table 1).

Table: Pace of Tariff Reforms: 1985 - 2001

%

	Year	Top Rate (percentage)
1	1985	120
2	1990	90
3	1994	65
4	1997	45
5	1999	35
6	2000	30
7	2001	25
8	2015	25
9	2016	20

Source: FBR

Note: rate structure of statutory tariffs is by categories/ Sector

Table: Details of Reforms in Customs Tariffs in Pakistan

		1989-90	1997-98	2000-01	2001-02
1	Simple Average Rate: All Products (%)	64.8	47.1	24.8	20.4
2	Industrial Products (%)	66.0	n.a	24.3	20.2
3	Agricultural Products (%)	57.2	n.a	28.0	21.8

%

		2002-03	2003-04	2004-05	2005-06	2015-16
1	Simple Average Rate: All Products (%)	17.3	17.1	16.8	14.4	14.8
2	Industrial Products (%)	16.9	16.7	16.6	10.4	13.2
3	Agricultural Products (%)	19.6	19.5	18.1	15.6	15.4

Source: NTC

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Given this background, the question is why are we lagging behind our neighboring countries? Ideally speaking, protection should have allowed our industries the breathing space to become competitive while providing it with a captive market where products could be developed further, and brands established. So, is protection encouraging our industries to grow and compete internationally as designed, or is it making them more inefficient by encouraging rent seeking, and reducing market competition? Based on weak export performance characterized by static destination and product shares, this does not appear to have happened.

Whereas other countries such as the East Asian Tigers also adopted protectionist measures early in their development, their experience turned out to be more promising. Measures were introduced and withdrawn in a timely fashion, providing industry with the proper incentive to develop. In the case of Pakistan on the other hand, protection is harder to withdraw once given. Firms remain in their infancy stage for far longer and create a drain on the economy, not to mention the fact that they are unable to establish a foothold in the global market.

Two of the guiding principles of the recently announced National Tariff Policy 2019-24 are strategic protection and competitive import substitution. Strategic protection will be offered to industry in the infancy stage to lower the cost of doing business and is planned to be time-bound and phased out to encourage competition. However, our past performance in this regard is not promising. Industries are still receiving handouts from the government, and timelines are easily revised on some pretext or the other. Unless effectively implemented, this is going to create an additional drain on our already limited resources.

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Competitive import substitution is going to be encouraged under the NTP 2019-24, but again the policy is light on the modalities of how it will all work, not to mention the fact that it becomes hard to justify how the tariff structure is being simplified and prone to less distortions. In the past SROs have been used in addition to tariffs to achieve protectionist goals. How will this work when certain industries are receiving strategic protection while others are benefiting from competitive import substitution, and all are going to be subject to different time bounds?

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