

EXPERIMENTS WITH INDUSTRIAL POLICY:

THE CASE OF PAKISTAN

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Abstract³

There is an urgent need for policy makers to adopt a cautious perspective when dealing with the recent revival of protectionism. The changing policy context of global competition requires that emphasis be placed on facilitating broad-based innovation. This is in sharp contrast to the current and past industrial policies that were based on import substitution and sector-picking. This paper briefly outlines Pakistan's experience with industrial policy over the past 6 decades, and shows how protectionist industrial and trade policy regimes are ineffective with respect to equipping Pakistan to compete globally. The paper also outlines global best practices with reference to designing an enabling industrial policy and suggests policy reforms that are appropriate in the political and global context of Pakistan. There also exist contrary views about the scope and composition of industrial policy even within the government functionaries. There is a dire need for a shared vision and deeper consensus building. Thus this paper aims to highlight the radical contrast in perspectives that exists between the current policy of the ministry of industries and a policy conducive to a prosperous Pakistan.

³ This paper draws from our work titled *Framework for Economic Growth* at Planning Commission of Pakistan. Five working papers were produced under this project and presented in International Conference on Inclusive Growth held in Islamabad during July 2011. We are grateful for the helpful comments which have improved our output. The usual disclaimer applies.

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Introduction

In today's post-industrial era high performing economies have information technology and high value added services as their drivers of growth and for Pakistan to catch up, the long suppressed industrial and manufacturing sectors first need to be unleashed in order to provide the unemployed masses with jobs and promote innovation. The imperative need for industrialization is the view of the ministry of industries and production (MOIP) in Pakistan as well as that of the new growth strategy initiated by the Planning Commission and the authors of this paper. However, the point of controversy is the way this may be achieved. The MOIP believes Pakistan's industries need to be protected for the same reason this paper advocates that a level playing field should be created; i.e. to develop a vibrant industry. It is this disharmony and conflicting opinions of Pakistan's policymaking institutions that this paper aims to highlight.

This paper reveals that only by removing impediments to innovation including; the government's participation in most markets i.e. lack of competition, the unfriendly business environment, the biased industrial policies favouring particular sectors not based on economic rationale restricting new entrants and reinforcing inefficient incumbents, and untargeted subsidies, will Pakistan's industry flourish and move upwards on the value chain and productivity ladder. Pakistan's government needs to take a less intrusive and a more facilitative approach to industrial policy.

This paper begins with a brief background about Pakistan's past and present industrial policy by linking it to the motives of each political regime. The next section illustrates trends in industry, trade and growth in Pakistan whilst comparing it with regional economies. The third section calls for a shared vision and the need for consensus in industrial outlook among Pakistan's ministries. Section four outlines global best practices in industrial policy and provides a literature review that corroborates the way forward for Pakistan which is outlined in section five. This section describes the obstructive institutional setting of doing business in Pakistan and offers recommendations regarding different areas of the economy that need attention with respect to providing a business environment conducive to a vibrant industry including regulatory burden, investment climate, competition policy, sick industries and insolvency laws, and trade policy. The final section provides concluding remarks.

Brief History of Industrial Policy in Pakistan

Pakistan's industrial policies were either formulated in response to a crisis, or as part of the medium-term development plans – most of which never saw their actualization. Pakistan has experienced 5 waves of significant industrial policy changes. The first was based on a decision by India to impose a trade embargo on Pakistan in 1948 shortly after independence. India blocked the transfer of funds that they owed to Pakistan under the 1947 partition agreement. This trade war adversely affected Pakistan since it was highly dependent upon import of basic goods from India. Pakistan at the very beginning encouraged investment in consumption goods and provided protection from external competition. This approach resulted in an increase in industrial output for domestic consumption.

The next wave was part of the Second and Third (1960-65 and 1965-70 respectively) five-year development plans during President Ayub Khan's regime. This was a continuation of the first wave with two distinctions. Firstly, it employed industrial licensing to increase the diffusion of the ownership of industries. Secondly, it drew on development finance companies like the Pakistan Industrial and Commercial Investment Corporation (PICIC) and the Industrial Development Bank of Pakistan (IDBP) to facilitate industrialization. The World Bank funded these organizations and at the time publicly owned development finance organizations were perceived as the most appropriate to speed up the process of industrialization. The aim of this policy was to establish small scale units (e.g. textile spinning and weaving) in and around the industrial centres of Karachi. Dozens of spinning mills were set up but they were operating significantly below optimal capacity. This was the beginning of the distortive protection provided to the textile industry that we continue to witness today.

Brecher and Abbas (1972) take a deeper look into the economic planning and the resulting performance during the period 1950-1968. They find that the highest level of economic growth was recorded during the first half of the 1960s when political instability was relatively kept at bay. Annual growth in real GNP over the period 1950-68 was an average of 3.9%; 2.7% for 1950-1955 (pre-plan), 2.4% for 1955-1960 (first five year plan) and 5.5% for 1960-1968 (second five year plan). The manufacturing sector expanded at a rate of 9.2%, 5.7%, and 8.8% per annum during the three above mentioned periods respectively and at 8.1% per annum for the whole period. On the other hand, the agricultural sector expanded at an average annual rate of 2.4%

with rates of 1.6%, 1.4% and 3.5% respectively for 1950-55, 1955-60 and 1960-68. In 1950, the share of agriculture was 60% of GNP whereas that of manufacturing was 6% and the rise in the GNP growth rate during the last period was mainly due to rising prices in the agricultural sector.

The authors draw the following conclusions:

- (i) The rate of growth in the manufacturing sector is high. The 1950-55 periods shows rapid expansion and then a slowdown during the period after that. Nevertheless, the industrial growth during the entire period of the study was relatively high due to the initial level of excess unutilized capacity
- (ii) The increase in agricultural growth during the final period reflects favorable weather conditions and insubstantial productivity growth.

Other indicators of change for the period studied by Brecher and Abbas (1972) include capital formation. Investment was 7.5% of GNP in 1950-55 after which there was a remarkable expansion to 9.8% in 1955-60 and 13.9% in 1960-65. Productivity on the other hand was less encouraging. The index for productivity per head in the manufacturing sector declined from 115 in 1953 to 103 in 1959/60. On the other hand, agriculture showed an improvement of 1.6% per year in productivity but the authors attribute this to the unreliable employment estimates. Thus it is important not to conclude that import substitution strategies caused the high industrial growth during this period; it was due to the poor initial conditions after independence and the decline or stagnancy of productivity.

The first five year plan (1955-1960) involved outlays to the public sector of Rs. 7.5 billion and Rs. 3.3 billion to the private sector. The plan maintained that 'while the government cannot determine precisely the magnitude or the kind of private investment that will actually be made, it can, by suitable policies and its import licensing powers, greatly influence the magnitude of private investment'.⁴ The government selected sugar, cement, cotton textiles, cigarettes and jute goods for protection. The policies, as mentioned above, were guided by short-term demands and as a result the economy remained consumption oriented⁵. Although a few of the reasons for the failure of this plan include adverse weather conditions and a fall in trade, the authors suggest the

⁴ Brecher and Abbas (1972)

⁵ See Power (1963), Winston (1967) and Islam (1973).

main causes were the lack of effort to cut non-developmental expenditure, excessive budget deficit to fulfill current expenditures and inadequate measures to expand exports.

The second plan was almost twice the size of the first plan; however, the sectoral allocations differed slightly with agriculture receiving a greater share in the development budget. The overall political situation in the country was more stable. The industries targeted by the government were sugar, vegetable ghee, jute, super-phosphates, soda ash and caustic soda. Actual growth surpassed the planned growth rate. It should be noted however that this period was also characterized by massive inflows of aid⁶, which led to the growth spurt, and a more able government in office.

The third five year plan (1965-70) had aimed to achieve similar success of the Second Plan; however, this period involved drastic deterioration of Pakistan's economy due to the Indo-Pak war in 1965.⁷ Resources were diverted to defense expenditure and aid inflows were interrupted which weakened productive capacity. The industrial sector output declined due to the under-utilization of capacity, raw material shortages and reduced investment in capital equipment. The rollback of import liberalization was reversed in 1966/67 and by 1968 over 90% of all imported raw materials was free of controls. The reduction in aid inflows led the government to cut down the size of the development budget. Islam (1973) explained that by the end of the third plan productivity was declining due to large and inefficient public sector enterprises (particularly in East Pakistan- now Bangladesh). Furthermore, there existed multiple exchange rates for exports and imports and there was a dearth of financial intermediation.

The third wave of industrial policy involved the nationalization of large scale manufacturing under President Zulfikar Ali Bhutto's administration (1971-1973). Public sector corporations were set up to finance the industrial sector which was the beginning of today's deep rooted public management distortions. Ahmed and Amjad (1984) explain that the Board of Industrial Management (BIM) controlled 32 major manufacturing (nationalized) enterprises covering 10 sub-sectors. BIM and Pakistan Industrial Development Corporation (PIDC) together made the industrial sector more inefficient as new projects were chosen on political and not meritorious grounds. In 1977, with the return of military government under President Zia-ul-Haq, a State Enterprises Review Commission and later Implementation Committee on Reorganization of

⁶ The first half of the sixties saw a growth of aid inflow from 8.4% of GDP in 1961 to 12% in 1965 after which it continued to drop till it reached 2.8% in 2008 (Javed and Qayyum 2011).

⁷ See Brecher and Abbas (1972) for more details.

State Industrial Enterprises recommended the abolition of the Ministry of Production, BIM, and sector-specific corporations involved in commodity operations.

The return of democracy in 1989 started the fourth wave of industrial policy for the decade of the 1990s. It had 3 main components, namely; deletion policy, deregulation measures and privatization (Saeed 2005). The deletion policy focused on achieving self reliance in the engineering sector and the promotion of technology transfer. The democratic administrations began privatizing large banks and enterprises. However, since there was no effort directed at putting in place pro-competition laws, the privatization efforts did not improve industrial activity (particularly with reference to value addition). The most important development of this era was the Small and Medium Enterprise Development Authority (SMEDA) which was established for improving products, adopting new technologies and management practices, and facilitating with cost benefit analysis at the firm and market level.⁸

The fifth wave (1999-2008) resulted in the private sector gaining a very prominent role (Brecher and Abbas 1972). Deregulation and adjustments to the tariff regime led to major developments in the automobile and consumer electronics industries. In 2002-03 macroeconomic stabilization was carried out through prudent fiscal and monetary policies followed by structural reforms; as a result, the GDP growth rate increased to 5.1% in 2002-03, 6.4% in 2003-04, and 9.1% in 2004-05. While agriculture and manufacturing both displayed an increasing trajectory the overall growth rate still remained below other comparable Asian countries. Pakistan's ranking in the human development indicators and technological development continued to be low (Planning Commission 2005).

Moreover, the 2008 fiscal crisis and the lack of domestic support for innovation did not give entrepreneurs the confidence they needed. The trade liberalization was successful but not sufficient to sustain Pakistan's growth. Burki (2008) states that the lasting negative impact of industrial policies at the time of entrepreneurship is clearly illustrated by the inability of the textile industry to benefit from the end of the Multi-fiber Arrangement (MFA) in 2005. Although the Musharraf government attempted to encourage the private sector, it did not provide the necessary regulation to protect consumers, encourage competition across the board and

⁸ See Brecher and Abbas (1972) for more details

enhance corporate efficiency. A few regulatory bodies were set up; however, they did not have much autonomy to work effectively. This brief history shows that industrial policy has been specific to how each government viewed different productive sectors and has lacked a long-term consensus-driven vision.

This section has thus outlined different phases of industrial policy in Pakistan and highlighted the fact that Pakistan's industrial policies were either formulated in response to a crisis, or as part of the medium-term development plans, i.e. a comprehensive strategy to promote overall growth was never at the top of the agenda. Projects were chosen on political and not economic grounds, public sector enterprises were established and certain industries like textiles were provided discriminate protection- all of which continues to happen today-, and even privatization and liberalization attempts weren't sufficient or comprehensive enough to drive growth.

Industry, Trade and Growth in Pakistan

Past development planning strategies in Pakistan have had the following similarities⁹:

- They focused on the arbitrarily set growth and investment rates.
- They provided relatively thorough projections for public sector investment with only general indications of private sector investment.
- They relied on the government playing a lead role through sector picking and market controls.

These efforts essentially suffered from 3 major weaknesses:

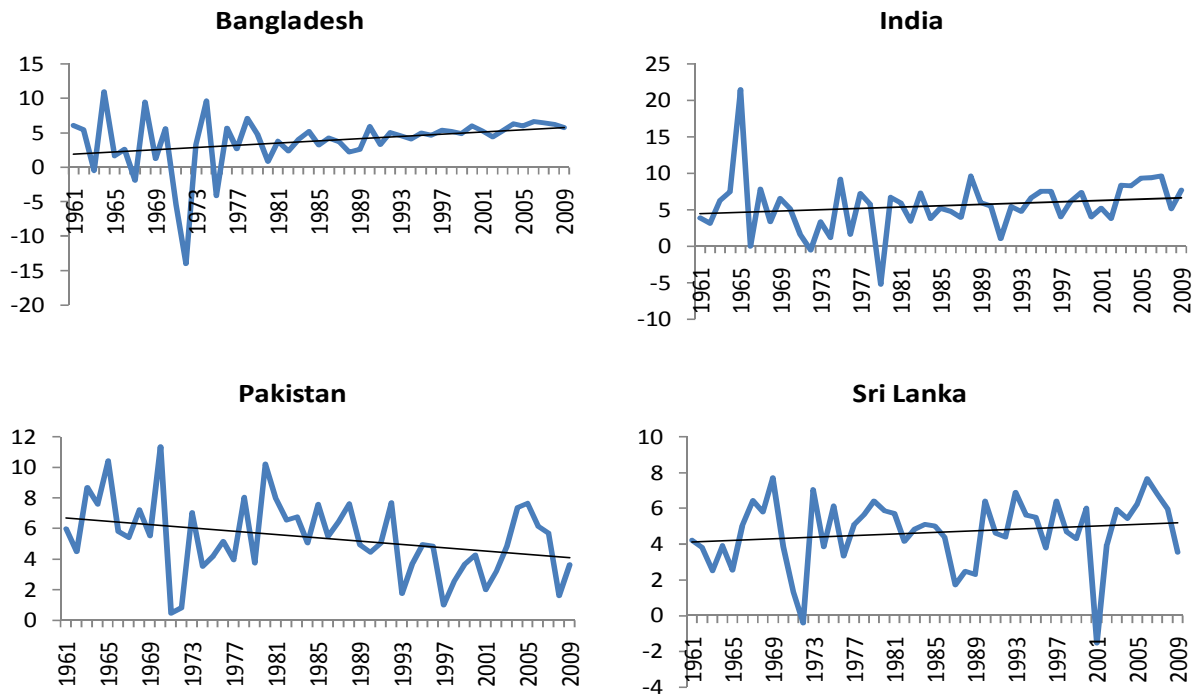
- They relied on a lead role by the government even when privatization and trade openness were required.
- Inadequate attention was paid to raising productivity which was important to obtain higher output at each investment level.
- The governing institutions were not keeping pace with markets that were struggling to develop with increasing liberalization. Meanwhile, corruption and maladministration increased.

In short, the plans and the macroeconomic goals were not anchored in appropriate microeconomic understanding and analysis (Haq 1973).¹⁰ Later Ghani and Musleh-ud-Din (2006) found no significant relationship between public investment and long-run economic growth in Pakistan; however, public investment did attract some private investment (Naqvi 2000). Phases of stagnating investment rates have also occurred with frequently changing political regimes and economic policies, and volatility in balance of payments (Naseem 2008). Pakistan has experienced phases of import substitution, export orientation and the resurgence of protectionism. Thus trade and industrial policy in Pakistan was never supported by broad-based growth model. Hausmann and Klinger (2008) indicate that most of the factors hindering GDP growth (particularly in commodity producing sectors) are institutional or policy-based requiring reform rather than additional financial injections.

⁹ Planning Commission (2010)

¹⁰ Also see Mahbub Ul Haq (1963) for a case study of Pakistan's economic planning.

Figure 1 Real GDP Growth across South Asia (%)



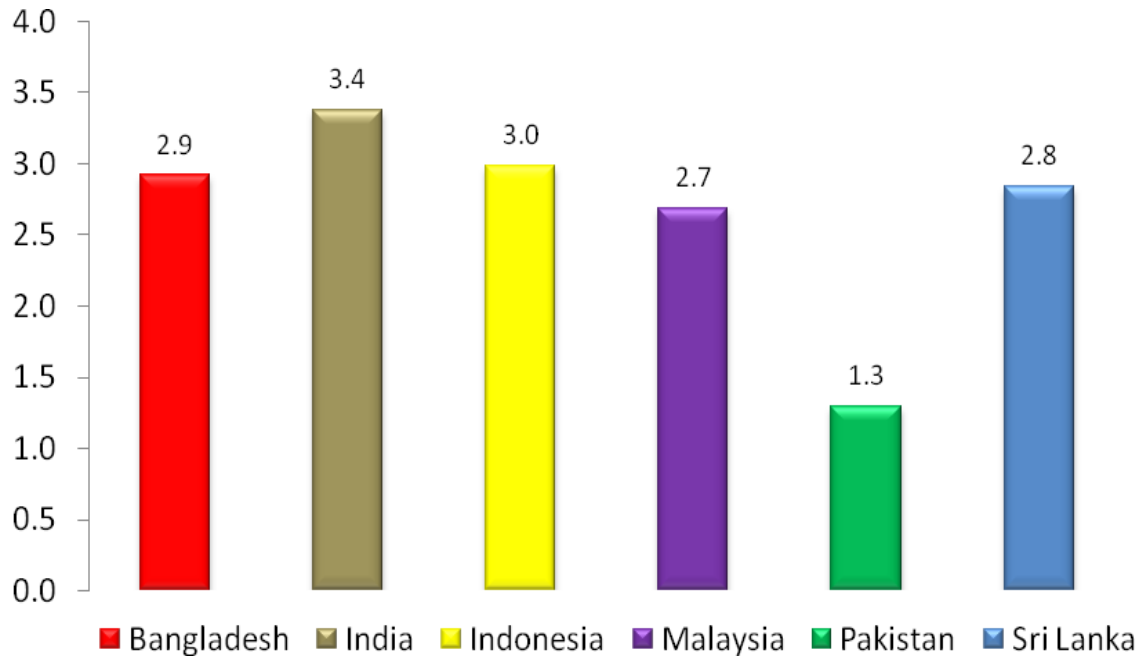
Source: World Development Indicators

Figure 11 clearly exhibits the falling real growth rates for Pakistan vis-à-vis other South Asian neighbors. The failed pursuit of industrialization is partially responsible for this overall declining growth trend in the long run. The coefficient of variation, or volatility relative to the average, is also higher than that in regional economies such as Bangladesh and India. Most growth diagnostics also indicate that the failure of industry to take-off was due to dysfunctional markets and excessive participation of government in productive activities.¹¹ Even today the government competes with private sector in most commodity producing and service delivery sectors. The declining growth in value added has also been accompanied by falling productivity.

Figure 22 indicates that Pakistan had the lowest average total factor productivity growth between 1995 and 2006 in a sample of Asian economies.

¹¹ As indicated by extensive analysis and consultations by Planning Commission, see Chapter 2 in the 'Framework for Economic Growth', Planning Commission (2011).

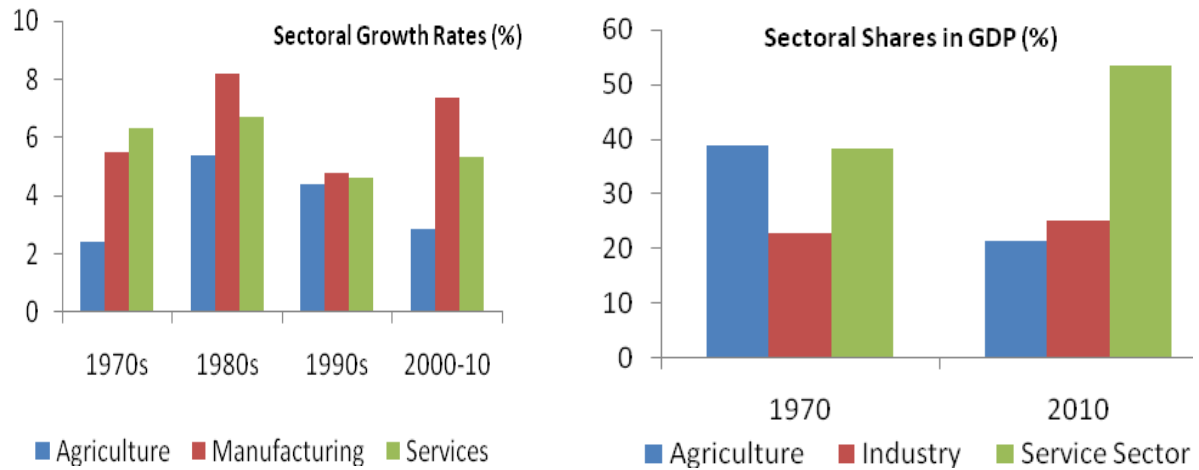
Figure 2 Asian Productivity Growth % (1990 – 2006)



Source: Asian Productivity Organization 2007

Figure 33 indicates that the industrial sector has been the fastest growing sector since the 1980s. However, this progress has not translated into a rising share of industry in the overall GDP. The sectoral share has in fact remained more or less same for the period 1970-2010. Furthermore, the declining growth rate of the agricultural sector since the 1980s is certainly not good news for Pakistan. This is because even in the industrial sector there is a heavy contribution of sub-sectors such as food processing, cotton-based textile, leather etc. which in turn are dependent on the growth rate in crop and livestock sectors.

Figure 3: Structural Transformation 1970-2010

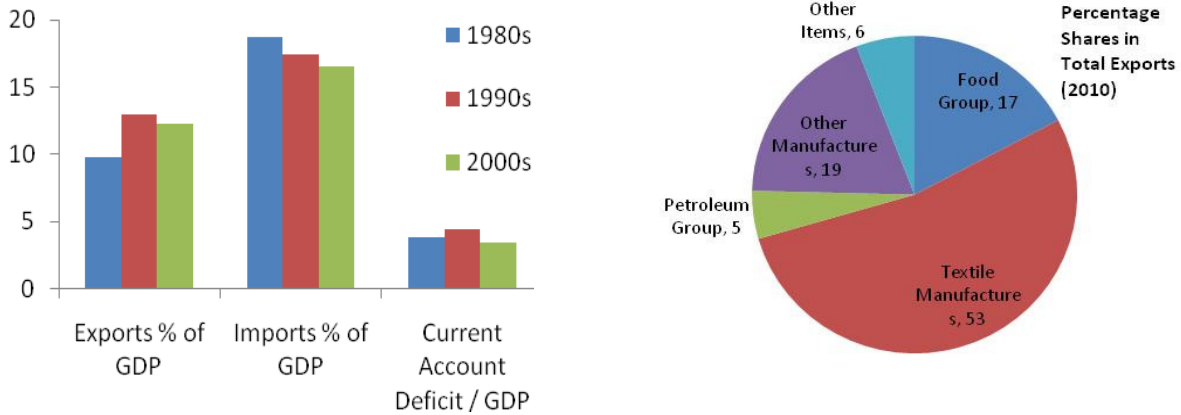


Source: *Economic Survey of Pakistan* (various issues)

The stagnant share of industry in overall GDP is further explained by the near constant structure of Pakistan’s exports (Figure 44). The trade sector has remained stagnant over the past three decades; the export to GDP ratio has declined from the average levels seen in the 1990s. Since the textile protection in the 1960s, the industrial sector has not diversified its exports away from textile products—which are low-value-added. Pakistani exports are also geographically concentrated in limited areas which makes them vulnerable to economic crises in the United States and the EU. Finally, policy in Pakistan aimed at boosting exports through domestic market controls including curbs on domestic consumption, resource allocation and sporadic market development efforts.¹² Pakistan’s key exporting countries have not witnessed rising imports during the 2000s.

¹² See Haque (2006) for more detailed evidence

Figure 4: Exports, Imports and Current Account 1980s–2000s

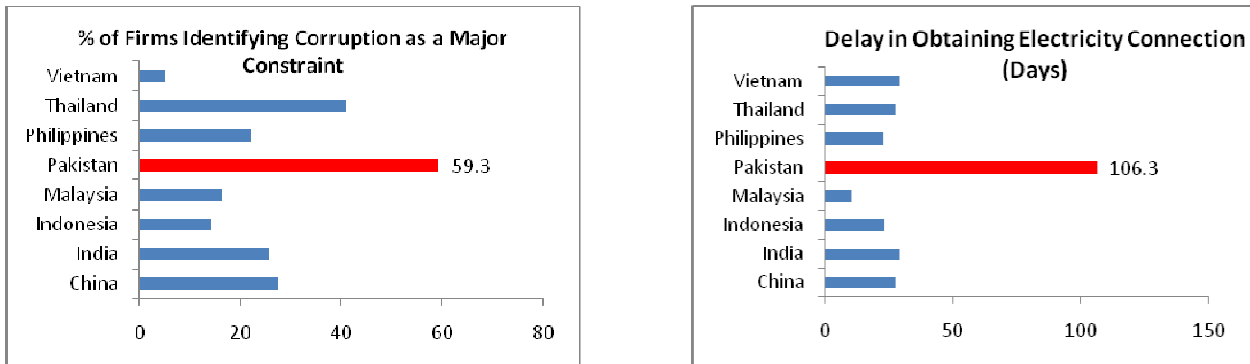


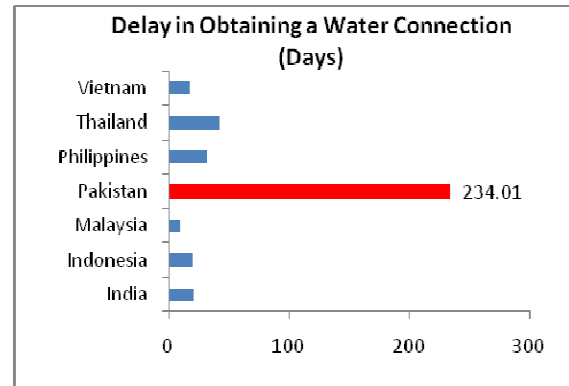
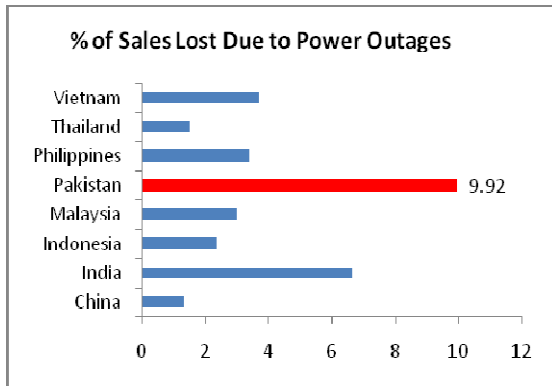
Source: *Economic Survey of Pakistan* (various issues)

Economic governance still remains an area requiring immediate attention and without which the dream for sustainable growth in the industrial sector may not be realized. The government must reform itself first if it is to provide the enabling environment at the grass root level—which currently depicts a dismal picture if compared regionally (

Figure 55). Energy and water will remain important inputs for industry and agriculture respectively. Similarly the role of civil service, tax administration and regulatory bodies must be reoriented to be that of a facilitator rather than an inspector with distortive incentives.

Figure 5 How Governance impacts Productivity?

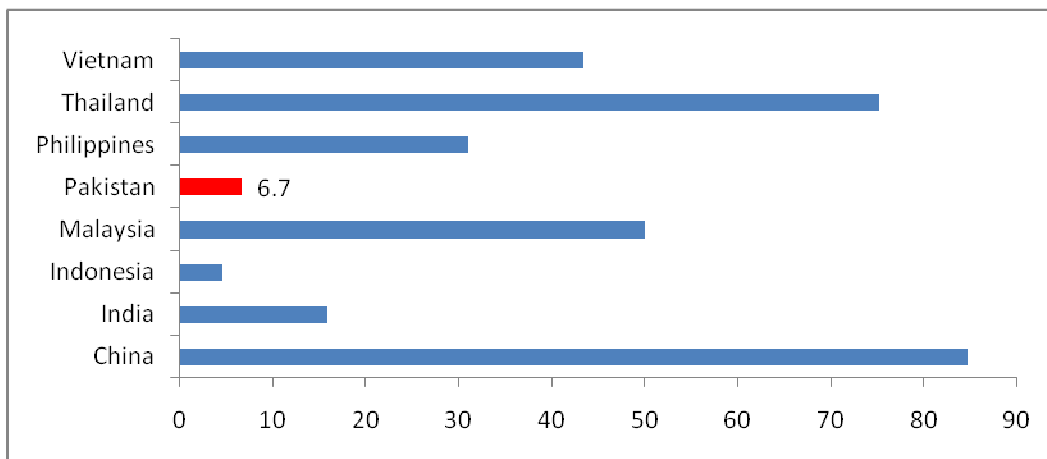




Source: Enterprise Survey 2007

At the firm level there hasn't been much drive towards human capital accumulation. In fact it seems that the need to train and retain talent has yet to be recognized in Pakistan (Figure 66). One of the reasons may be the underlying disincentives for the firms to become part of the formal economy. The estimates of the informal economy are now more than 100 percent of the formal economy. These disincentives mainly include the cumbersome labour, property and taxation laws.

Figure 6 Percentage of Firms Offering Formal Trainings (%)



Source: Enterprise Survey 2007

The Need for Consensus

The recent National Industrial Policy draft (NIP) published by the Ministry of Industries and Production (MOIP) is proposing a strategy that also follows the distortive approach of the past. The policy favours the protection of specific industrial sectors namely; steel, fertilizer and chemicals and sub-sectors which the ministry feels are worthy of supporting. The NIP is based on the premise that free-market and free-trade policies in Pakistan and neighboring economies have been unsuccessful, thus protecting certain sectors is necessary to place Pakistan on the path of 'indigenous, broad-based industrialization'.¹³ There is no economic rationale for supporting these specific industries; however, the draft justified this by quoting examples of countries including Pakistan where it is claimed that liberal trade policies have caused economic instability and the weakening of the manufacturing sector. Thus according to MOIP, the way forward is to assign a central role to the state in incentivizing local manufacturing and discouraging the import of finished goods and/or export of raw materials through the placement of non-tariff trade barriers.¹⁴

Between 1997 and 2003, the Government implemented radical trade liberalization reforms. Pakistan tariffs have been reduced significantly leading the applied rates to be mostly below the bound rates as required by the WTO. The simple average applied tariff of approximately 20% in 2002 indicates a sharp fall when compared to the average of 56% in 1995 and nearly 80% in 1985 (Lall and Weiss 2003). Import quotas, import surcharges and regulatory duties were removed. Pakistan's openness ratio increased from 25 percent in 1999-00 to almost 30 percent in 2004-05. Despite these policy changes exports remain predominated by textiles (which are currently two-thirds of total exports) with drastic losses in other product categories of world market share (Lall and Weiss 2003). Pakistan's export growth rates were still low by international standards; there was a 110 percent increase in its exports (in nominal US dollars) during the 2007/08 period (compared with 2001/02) which was lower than India's export growth by a factor of three.

In response to high twin deficits during the second half of the 2000s and after the global financial crisis of 2007-08 Pakistan's industrial and trade policies have seen a drive towards protectionist import substitution policies and a reversal of the above mentioned trade liberalization policies. Tariff cuts were reversed, tariff dispersion and escalating tariffs were increased, liberalizing reforms in agriculture (wheat, sugar and fertilizer policies) were reversed, the Engineering

¹³ Draft National Industrial Policy 2011

¹⁴ The MOIP's implementation framework assigns the role of non-tariff barriers (NTB) placement to the Industrial Development Board (IDB) which is the restructured EDB proposed by the ministry.

Development Board (EDB) exercised discretionary import controls; WTO compatible regulations were used to restrict imports—including quasi-import licensing mechanism—primarily for the protection of local industries, and restrictions on imports of second hand consumer products were in place (e.g. passenger cars, motor-cycles, air conditioners, industrial machinery); rapid expansion of anti-dumping practices, and the continuation of the long standing ban on imports from India.¹⁵

Statutory tariffs have become less relevant as a measure of the true level of protectionism as they are now modified through large scale and uncontrolled use of Statutory Regulation Order (SRO) exemptions bringing extra protection to selected industries. Thus, if a final product is (nominally) protected by a statutory tariff of 25%, its effective protection could further increase by a reduced tariff on its raw material inputs. These distortions across import substitution activities have increased the general anti-export bias in the system.

Current trade policies essentially provide extra protection to the processing margins (effective protection) of selected local producers. The Strategic Trade Policy Framework 2009-12 acknowledges important “implementation issues” related to poor quality of governance as well as the structure of management, which are a clear example of government (coordination) failures in trade (and industrial) policy. The failures of institutional structure of the major bodies in charge of implementing trade policy (Engineering Development Board and the National Tariff Commission) are described in the final section.

Lall and Weiss (2003) assert that supporting selected industries will not improve global competitiveness due to the changing policy context of global competition. In a global economy consisting of players restricting infant industry protection, performance requirements like local content, FDI restrictions, and reverse engineering etc, it is impossible for Pakistan to compete with selective protectionist policies. The determinants of competitiveness have also changed where low labour costs are not enough, and skills, technological competence, work trainability, efficient supplier clusters and support institutions, effective infrastructure and well-rounded administrative capabilities are the new instruments of comparative advantage. UNIDO (2002) calls this the ‘triple-L’ strategy i.e. linking, learning and leveraging.

In the case of Pakistan where the textile and clothing industry has always been favoured, export growth rates are limited. Within such products, it is not easy for developing countries to upgrade into the more advanced end of the value chain due to the more complicated skill, design and

¹⁵ Pursell et al. (2011)

branding requirements. Sophisticated fashion exports as well as differentiated food products, for example, remain the areas of expertise for rich countries (Lall and Weiss 2003).

In 2011 the Planning Commission of Pakistan came forward with a new Framework for economic growth-strongly grounded in the endogenous growth theory. This framework opposes the views in draft Industrial policy formulated by the Ministry of Industries and proposes an across the board enabling environment, strict refrain from sector-picking, further reduction in tariffs and abolishing of regulatory duties and enforcement of the national competition act.

Like any other democratic process, there are differences as to what form Pakistan's future industrial policy should adopt. While Ministry of Industries wants a revival of protectionist regime, Planning Commission of Pakistan wants to further pursue privatization, deregulation and liberalization of trade and investment regimes. There is a need to establish consensus and look also towards the regional competitors and their strategies.

Global Best Practices in Industrial Policy

Rodrik (2007) tells us that ‘development is fundamentally about structural change’ and the key driver of structural change is productivity growth. The process of structural change towards enhancing productivity is called ‘industrialization’, which is at the core of ‘high development economics’ (Krugman 1995). A structural transformation from agriculture and light manufacturing to modern industry and from low to high productivity processes is needed to cope with global competitiveness. Structural change is essential not only for the promotion of higher growth in productivity and incomes, but also to produce greater diversity within the structure of the economy, to reduce vulnerability to negative external shocks (Naudé, Santos-Paulino and McGillivray 2009).¹⁶ Table 1 illustrates that all high-income economies are distinguished by significant contributions to GDP from the service and manufacturing sectors.

Table 1 Sectoral contribution to GDP (%) in 2000

	Agriculture	Manufacturing	Services	GDP per capita in 2000 (constant USD)
United States	1.23	16.96	74.61	39,111
Euro Area	2.5	19.89	69.68	20,047
Latin America and Caribbean	5.87	18.23	64.59	8,134
Middle East and North Africa	12.56	12.56	44.13	5,410
East Asia and Pacific	14.64	30.66	41	2,723
South Asia	23.88	15.45	50.32	1,644
Sub-Saharan Africa	16.51	14.82	54.17	1,551

Source: Naude (2010)

The most important feature of the industrialization process is the role of the government in speeding up the transformation process, which is evident from its industrial policy. Naude (2010) defines industrial policy as a guide to government interventions in the economy and asserts that many define it as a guide to intervention by the government to promote selected manufacturing sectors (analogous to ‘picking winners’) with the aim to ‘disregard’ a country’s comparative advantage and to develop its ‘latent’ comparative advantage (e.g., Lin and Chang 2009). On the other hand there is the view that industrial policy should not be ‘selective’ but should preferably be of a ‘functional’ or broad-based nature, which promotes the

¹⁶ Naude (2010)

‘competitiveness’ of the manufacturing sector as a whole (Lall 2004). Naude (2010) states that such functional policies have also been described as ‘soft’ industrial policies (e.g., Devarajan and Uy 2009) since they are not restricted to manufacturing but include the entire economy’s supply side, including the service sector and sub-sectors such as tourism.

However, there are ongoing debates about the justification of industrial policy. Various opinions have opposed the concept of state intervention and industrial policy in the recent past and policymakers in the US, for example, consider the term as a taboo and politically incorrect, describing it as tainted of planned economy socialism. In spite of this however, industrial policy is alive and well in the US particularly at the state level and across the globe in the form of support for a few selected industries (Pemberton 2008).

The debate about industrial policy has currently shifted (Table 22) from the ‘why’ to ‘how’ to create an appropriate policy contingent upon global circumstances and the ability of a country to cope with them. This is most important for Industrially Lagging Countries (ILCs) who need to consider the binding implications of the shifting patterns of globalization, the crises in fuel, finance and food, the climate change challenge, and the evolving nature of the entrepreneurial economy (Naude 2010). Rodrik (2007) believes that industrial policy should be a process of ‘dialogue between the policymakers and the private sector to reduce informational difficulties by uncovering the binding constraints and suggesting solutions to them (See Figure 1). Naude (2010) states that for the poorest economies, industrial policy should be concerned with the manufacturing sector. However, for ILCs, and developed countries who also struggle with climate change, industrial policy should be ‘the process whereby governments aim to deliberately affect the structural characteristics of their economies’¹⁷. In other words, governments should intervene to enhance the structure of production as a whole.

¹⁷ Naude (2010, pg 4)

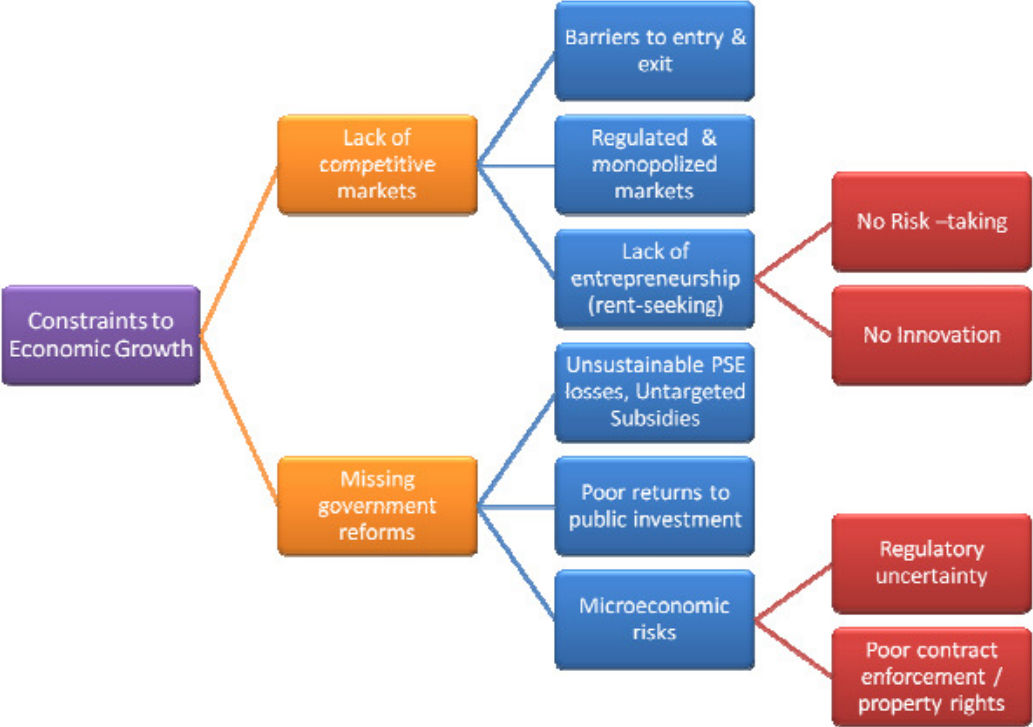
Table 2 Evolution of theory and practice of industrial policy¹⁸

Phase	Key ideas	Representative contributors
1940s to late 1960s	<ul style="list-style-type: none"> -Industrialization is necessary for development. -Market failures would prevent this from happening automatically. -Market failures are pervasive in developing countries. -IP is needed, particularly infant industry protection, state ownership and state coordination. 	Rosenstein-Rodan (1943) Hirschman (1958) Prebisch (1959) Myrdal (1957)
1970s to 1990s	<ul style="list-style-type: none"> -Practical obstacles to IP are considered significant. -Government failure is worse than market failure. IP is invitation to waste and rent-seeking. -Focus on trade liberalization (exports), privatization and attracting FDI together with macroeconomic stability and minimum government interference are the basic requirements for growth and industrialization. -The era of the Washington consensus, especially after the debt crisis of the early 1980s and the ubiquity of structural adjustment programmes (SAPs). 	Baldwin (1969) Krueger (1974;1990) Pack (1993; 2000)
2000s to present day	<ul style="list-style-type: none"> -Market and government failures are present. -The ‘how’ rather than the ‘why’ of industrial policy is important. -Institutional setting matters but design difficult. Need to understand political context. -Flexibility in the practice of IP is important. -Differences exist with respect to the extent to which comparative advantage needs to be defied, not the principle. -Innovation and technological upgrading should be a central objective of industrial policy. -Promoting national innovation systems 	Amsden (1989) Dosi (2009) Rodrik (2004; 2007) Chang (2002; 2003; 2009) Lall (2004) Lin (2009) Nelson (1993) Robinson (2009).

¹⁸ Taken from Naude (2010)

	should be an important objective of IP.	
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Figure 7 Constraints to Economic Growth and Reforms



Source: Planning Commission (2011)

There is no blueprint for the ideal industrial policy, it is contextual. Several developing economies that had opened up their trade and investment regimes and brought about a level playing field are now once again considering and reviewing their industrial policies since economic growth has been slowing down in the wake of the recent food, fuel and financial crises. In today’s global economy, the suppliers of labour-intensive products in developing nations, need not only overcome the traditional trade barriers but also must become part of

market access agreements to become visible internationally. International trade is now driven by supply chains where foreign buyers tend to enforce the prices they desire to pay to producers in developing countries and then there is also no assurance that the arrangement would be long-lasting due to the constant emergence of more attractive sources of supplies. Thus, even the incomplex labour intensive manufacturing has become intensely competitive. With regards to domestic competition, developing countries need a durable competition policy to complement the industrial policy (Haque 2007) in order to overcome the inefficient monopolies which have been created and sustained through vested interests and political pressures.

Many developing countries lack the necessary expertise for coordinating their in-house economic policies. This is particularly in the case of industrial, competition and trade policies. An ‘island approach’ (Valila 2008) is often adopted since industrial policy is mostly considered as political rather than economic in nature. Not only is there a lack of debate/consensus between government bodies that leads to the forming of conflicting policies, but it is the differing goals of each type of policy that cause mismatching too. Contemporary trade policy recommendations involving liberalization aim for more open economies. On the other hand, the goals of industrial policy are mainly protectionist. Innovation support enhances a country’s competitiveness and therefore is in line with liberalizing trade policies. Protecting declining or infant industries, on the other hand, may be in conflict with free trade.

Contradictory policies may also be attributed to the choice of instruments for implementation. Since industrial policy does not have instruments specific to it, in practice industrial policy is implemented either through *fiscal* (production, investment and export subsidies; subsidised loans; loan guarantees; tax breaks and the sponsored construction of economic infrastructure) or *structural* policy instruments (tariff and non-tariff barriers and preferential financing arrangements). This dependence of industrial policy on trade and fiscal policies illustrates the need for a coordinated and synchronized effort of both industrial and trade policymakers in setting coherent growth plans.

In the past government intervention was viewed necessary in the presence of ‘market failures’ which has been the traditional motivation for industrial policy. This approach became known as ‘import substitution industrialization’ (ISI) originally coming from Raul Prebisch (1950) and Hans Singer (1950). It was based on two essential premises: (1) in a continuous widening of the gap between rich and poor countries there would be a deterioration in the international price of commodities and raw materials with the lack of industrialization in the LDCs; and (2) to

industrialize, smaller countries required that their then newly emerging manufacturing industry be protected. This logic was linked to the infant industry argument for industrialization.

Although this protectionist paradigm dominated the 1950's and 1960's, researchers were also looking into more open models for the economy since they believed that government failures were as bad as or even worse than the market failures. ISI policies led to bigger and inefficient governments. The 1982 debt crisis added impetus to the spread of outward-oriented policies. The 1980's was the era of the 'Washington Consensus' principles which stipulated the importance of liberalization, privatization and deregulation for the growth of an economy. This called for Export-Oriented Industrialization (EOI) or the export promotion strategy which involves government support for exporting activities by providing subsidies, tax exemptions and special lines of credit. Krugman (1984) argued that ISI strategies are a form of export promotion; however, both strategies are often seen as alternative approaches. Research by Anne O. Krueger and Jagdish Bhagwati suggest that EOI was more appropriate for achieving sustainable increases in GDP than ISI¹⁹.

The proponents of outward orientation suggested that EOI was the reason behind the success of the East Asian countries which adopted market-friendly policies as a result (World Bank 1993). When the failing Latin American countries, who employed ISI strategies religiously, were compared with prospering East Asian countries who were liberalizing at the time, more economists and international organizations like the World Bank and IMF encouraged outward-oriented policies and imposed them using conditional assistance in the form of structural adjustment programmes (SAPs).

On the other hand, economists like Ajit Singh (1995) stated that the East Asian economies were not completely globalized despite their strong export orientation and ISI strategies still prevailed. Amsden (2001) argued that heavy state intervention led to East Asia's success; protection was conditional on export promotion which permitted import-substituting infant industries to become globally competitive industries with an export-orientation.

In contrast, present day debates regarding industrialization strategies emphasize the 'how' part and not whether there should be government intervention. The rollback of liberalization that took

¹⁹ Bhagwati (1978), 'Anatomy and Consequences of Exchange Control Regimes'
Krueger (1978), 'Liberalization Attempts and Consequences'

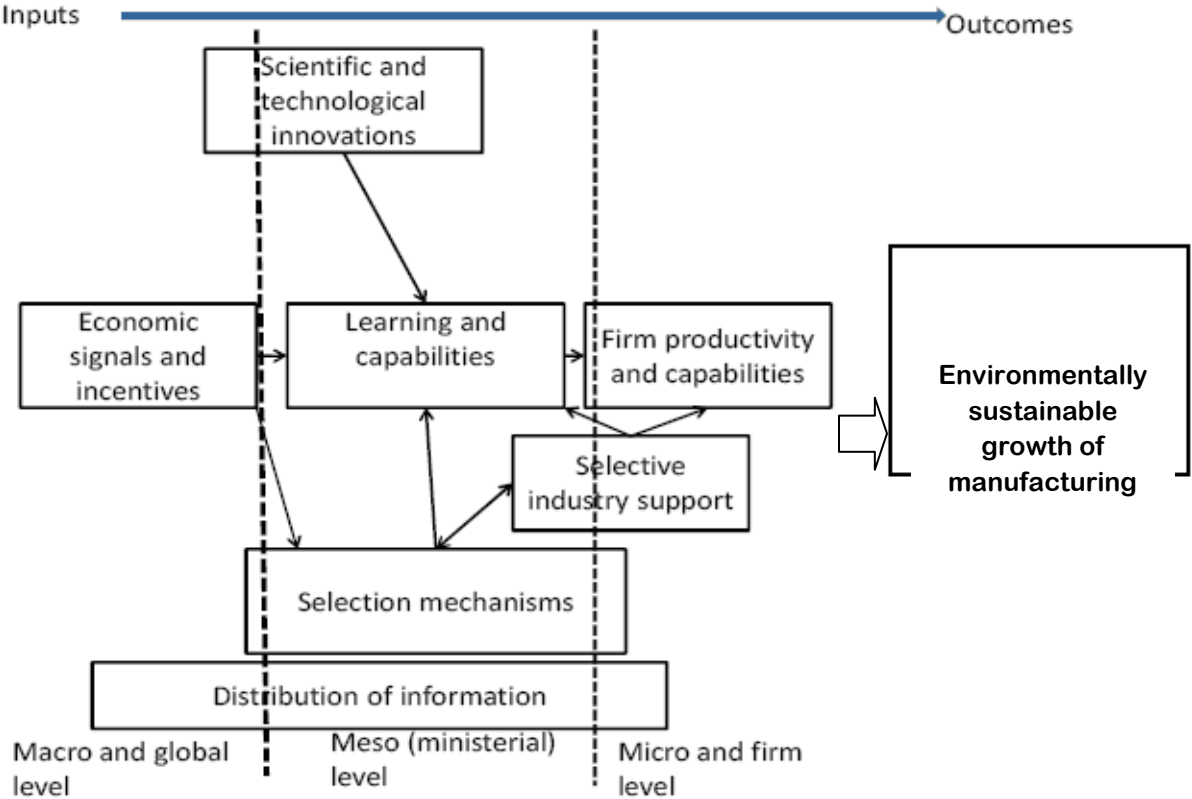
place after the 2007-08 global financial crises has led developing countries to return to selective industrial policy. However, interestingly, it is argued by authors like Ely (2009), Leonard (2009) and Stiglitz (2009) that the selective nature of American industrial policy to promote the financial sector contributed to the market crash.

The solution is not to abandon industrial policy altogether but to realize that the design of the interventions is more important and innovation along with technological upgrade across the board should be industrial policy's goal (Naude 2010). Thus it is safe to assume industrial policy is contextual in nature and the past tendencies of standard recommendations for all countries around the world are no longer feasible. Blecker (1999) pointed out that EOI cannot be adopted by every country simultaneously since export promotion requires the presence of a market at the other end that would absorb the extra exports. In addition, China's integration into the world economy has increased the difficulties faced by countries with even slightly higher labour costs to adopt export oriented strategies. Blecker asserts that global imbalances may result from simultaneous export promotion efforts. Krueger (1997) also opposes the acceptance of stylized facts as policy prescriptions, which was the premise of early development theory. Uncontested policy inferences were applied as policy recommendations for all developing countries.

Naude (2010) shows that the disparity between the industrial successes of China, Finland, Japan, and the Newly Industrialized Economies (NIES) and the industrial failures in Sub Saharan Africa (SSA) and areas of Latin America illustrates the significance of the content of industrial policy. These diverging outcomes, as argued by Dosi (2009), were caused by the differences in the efficiency of their national systems of innovation (NSI). For example, Latin America extensively followed ISI policies prior to the pervasive trade liberalization of the 1980s, however with inadequate monitoring of failing firms. Political interference in SSA perpetuated low productivity activities sustaining large welfare losses (Killick 1978; Robinson 2009). Imbalances in macroeconomic indicators (overvalued exchange rates and inflation) further impeded performance. In contrast, infant industry protection in East Asia was performance-based with rigid conditionality for attaining specific export targets, promotion of domestic competition, strong political will for the cessation of assistance to failing firms (Hodler 2009; Pack 2000; Robinson 2009) and policymaking flexibility. These aspects enabled the rapid innovation accumulation in East Asia.

Given the established importance of the content of industrial policy, Figure 8 illustrates the relationship between the inputs, outcomes and levels of coordination across different spheres of industrial policy. Thus, maintaining appropriate incentives is mainly the national government’s responsibility in cooperation with international role players. Such instruments are more functional or ‘horizontal’ and tend to be less discriminatory towards the firms i.e., they are more market-based or soft. Moving from the left to the right of the columns, industrial policy instruments become less market-based (or soft), and more promotional (or hard). Industrial catch-up and policy formation is by nature a learning process which impels communication and feedback between outcomes and inputs and across levels.

Figure 8: The Relationship between the inputs, outcomes and levels of coordination across the various domains of industrial policy



Source: Naude (2010)

Rodrik (2004) proposes an intermediate stand in terms of the role of the private and public sectors where private entrepreneurship drives growth with the support of governmental coordination and economic restructuring. Rodrik develops a framework that requires the government to engage in strategic collaboration with the private sector to expose the barriers to entry and exit in the market. This requires establishing accountability controls to avoid rent-seeking and corruption. In other words, it is the policy process that needs to be focused on and not the policy outcomes. Thus industrial policy needs to be a 'discovery process' instead of a decision making process which often leads to the favoring of specific industries which may or may not be lucrative enough to contribute to the country's growth.

The Ideal role of Industrial Policy

Industrial policy should focus on the demand rather than the supply of innovation and entrepreneurship. Low-income countries with little employment opportunities, for example, see no use of obtaining higher education so they choose illiteracy and thus the solution is not to construct more schools, rather it is to enhance the business environment.²⁰

Rodrik (2004) illustrates the importance of self-discovery by stating that similar income economies with similar skills and resources often produce and export different products, for example Pakistan exports soccer balls whereas Bangladesh has no soccer ball industry. Conversely, Bangladesh produces hats whereas Pakistan does not. Rodrik attributes this to random self-discovery and then imitation. In order to encourage entrepreneurship Rodrik recommends a carrot-and-stick approach, i.e. providing subsidies in the form of venture capital for example but to ensure success, these must only be given to initial investors and not to imitators. This is impossible in practice, so a second-best policy response for such an incentive program requires either performance requirements or close monitoring of the funds given. Klinger and Lederman (2004) identified a positive correlation between innovation and entry barriers; low entry barriers attract imitation and not self-discovery since entrepreneurship rents are reduced. Thus the role of the state is to make sure failing businesses are phased out to avoid wastage of resources, and instead of picking and favoring specific sectors, governments should be able to pick out the losers.

²⁰ See Pritchett (2004) for the study that yielded this result.

In some instances the role of the state may be important in promoting a new industry to make up for a failing one rather than continuously supporting it in vain. For instance, when Taiwan's traditional sugar industry slumped due to low international prices, the government responded by investing in a world class orchid industry²¹. This is an extreme example; however, in this case it proved successful due to the high incentives and expected profits. In Pakistan, for example, the textile, automobile and fertilizer sectors are still seeking budgetary subsidies and remain uncompetitive globally even after over 40 years of fiscal support. It is imperative that subsidies have a deadline. Rodrik proposes that governments provide ex-ante subsidies like investment guarantees to avoid burdening the budget.

Most development projects require large-scale investments that need to be made simultaneously. In other words, since the production of one good or service comprises a set of different activities, coordination in supporting the whole process is what industrial policy should aim to achieve. To avoid this coordination failure, Rodrik suggests that instead of promoting certain sectors, policy intervention should aim to support new technologies and new activities which are cross cutting in nature and benefit the entire spectrum of production processes.

Institutional design

Political leadership and support at the top is essential to facilitate any policy intervention. It was also mentioned above that both public and private sectors need to collaborate in setting industrial policy, i.e. coordination and deliberation councils²² need to be established where both sides may communicate their needs. However, it is important that the institutional setting, within which bureaucrats and the private sector interact, does not provide too much autonomy to the bureaucrats and less embeddedness of private stakeholders to minimize corruption. For an optimally balanced setting there must be some form of accountability. There should be complete and transparent accounting of public resources spent in the promotion of activities' the operation of the deliberation/coordination councils must be published and the decisions reached must be publically disseminated.

Rodrik (2004) while emphasizing embeddedness, carrots-and-sticks, and accountability, specifies the key features of an optimally designed industrial policy:

²¹ *New York Times*, August 24, 2004, p. A1.

²² These are public-private bodies which should not only include the typical 'peak' (well organized) organizations but involve firms of all sizes. The councils would seek to gather information on investment ideas, coordinate with relevant state agencies, demand changes in legislation to reduce transaction costs and generate subsidies with appropriate conditionality.

Design principles²³

1. Incentives should only be given to “new” activities.
2. Clear benchmarks/criteria for success and failure need to be in place.
3. A built-in sunset clause is vital.
4. Public support should be targeting activities, and not sectors
5. Subsidized activities must have the potential for generating spillovers and demonstration effects.
6. Agencies with demonstrated competence need to be in charge of carrying out industrial policies.
7. The implementing agencies need to be monitored by someone with a direct stake in the outcomes who also has high political authority.
8. Promotion agencies must maintain channels of communication with the private sector.
9. Establish safeguards against “picking losers”.
10. The cycle of discovery must be continuous, thus promotion activities need to have the capacity to be renewed.

Institutional Reform: the need for public and private collaboration

Rodrik (2008) explains two different perspectives of institutional reform. International organizations, like the IMF, push for standard institutional restructuring (best-practice) involving the reform of procedures which permit cross-country comparisons for instance, the number of days required to register a firm or to settle a dispute in court. This approach however, ignores the fact that interactions with other spheres of policy are more important if economy-wide growth is the objective. He suggests that a ‘second-best mindset’ is required which acknowledges the impact of the public institutions’ links with the environment of doing business. In other words if governments only focus on formal reform it is more than likely that other paths of reform are neglected.

To illustrate the above rationale the author compares contract enforcement and judicial reform in Africa and Vietnam. Both countries have a weak judiciary and in practice firms engage in relational contracting which rarely requires them to resort to courts. It may be tempting to

²³ Rodrik (2004)

conclude that judicial reforms are needed to strengthen the economic activity in Africa. However, considering the booming economy of Vietnam it becomes necessary to take a deeper look at what each country really needs to reform. Strengthening courts in Africa may not be effective since small firms may find it difficult to switch from their familiar ways of relational contracting that is enrooted in their society. A more effective way may be to improve relational contracting, for example by helping disseminate information about the reputation of firms, or even enforce judicial reform that targets new firms which do not possess the necessary social capital required to engage in relational contracting. An example of one such successful Alternative Dispute Resolution (ADR) system is the Karachi Centre for Dispute Resolution (KCDR) in Pakistan, that had received over 924 cases (till end 2009) and as a result, \$27 million had been released in out-of-court mediations.²⁴

In continuance of Rodrik's argument above regarding the ineffectiveness of standardized best practice indicators in guiding sound policy reform, Hausmann et al. (2005) test correlations between the timing of growth (sustained for a period of 8 years) and reform, and conclude that since countries have experienced very frequent growth accelerations in the past, achieving growth now is not out of reach. However, policymakers need to understand that these growth spurts were not determined by shifts in economic policies, institutional and political reform or external conditions but were predominantly produced by small idiosyncratic changes. This reinforces Rodrik's suggestion for the need to look beyond the standard best practice and adopt a second-best viewpoint in order to uncover the binding constraints that need to be targeted. On the other hand, when testing sustained accelerations for more than 8 years, the author found that fundamental economic reform and positive political changes increased the likelihood of longer term growth. Thus, no single strategy will ever be appropriate for all countries at all times, and this dynamic nature of industrial policy further emphasizes the need for industrial policy making to be a process of learning between public and private entities.

Sick Industries

Ideally in a market economy, survival of the fittest mechanisms allow non-productive firms to exit and successful ones to remain. However, this process of self-selection needs to be facilitated by government legislation in terms of bankruptcy laws. In his book²⁵, David Moss describes how the government needs to be the ultimate risk manager in 'reducing or reallocating' risk. The government needs to facilitate a business environment which guarantees the option to exit a certain business if it does not succeed. The lack of proper exit procedures and bankruptcy laws causes sick industries to remain unliquidated, restricting the business owner from investing

²⁴ <http://www.kcdr.org>

²⁵ Moss, D.A., (2004). 'When All Else Fails: Government as the Ultimate Risk Manager', Harvard University Press.

elsewhere. This lack of dynamism discourages innovation and sick industries become yet another driver of sluggish growth (see Pavcnik 2002).

Trade liberalization exposes firms to foreign technology and higher quality standards at an increased cost. This leads to a reallocation of resources and only productive firms are able to survive this self-selection process (Melitz 2003). The Melitz model suggests that openness increases productivity through this process where non productive firms are pushed out of the market. Thus the government needs to have effective bankruptcy laws in place to facilitate the move of firms out of one industry and into another, e.g. Chile exposed its markets to international trade in the 1980's where the least productive firms exited; productivity rose in both import and export oriented sectors to about 32% and 25% respectively.²⁶

Industrial Policy Challenges

Naudé (2010b) adds to Rodrik's arguments by stressing the significance of taking certain aspects of the global economy into consideration when designing industrial policy: (i) the challenge of rapid globalization of the world economy, in particular the rise of global sharing of production, (ii) the recent food, fuel and financial markets crises, (iii) the challenge of climate change, (iv) the growth of China and India, and (v) the rise of the 'entrepreneurial economy'.

Altenburg (2009) recommends that industrial policies be adapted to local circumstances. He lists five aspects important for a better understanding of the needs of industrial policy in developing countries, namely (i) sophistication of the economy, (ii) endowment of natural resources, (iii) location of the country, (iv) its history and patterns of industry, and (v) the development orientation of political actors.

²⁶ For Pakistan's case see Azam *et al.* (2009).

The Way Forward for Pakistan

Contemporary literature on economic growth asserts that the key determinants of growth today are economic governance and human capital and the traditional growth accounting variables such as investment and savings should be considered endogenous to the system. In other words, we are in search of factors that allow space and freedom to invest productively. Assets need to be accumulated through competitive markets, the use of existing and new technology, and productivity-inducing knowledge and business models. The main concern for policymakers is now how to achieve sustained productivity growth and sophistication in production. In order for industrial policy to be pro-growth the following predicaments need a strong resolve:

Revisiting Institutional Coordination

Policies tend to fail if institutions are not working in a coordinated and synchronized manner. For instance, legal reforms are futile if laws are not enforced or there are severe delays in the settlement of cases. The privatization efforts cannot succeed unless there are institutions that ensure competition and low transaction costs. The 8th Five-Year Plan recognized the importance of “good governance” and the strengthening of regulatory institutions. The 9th Five-Year Plan focused more heavily on governance reforms and advocated decentralization, corporate governance, legal institutions, participation, social capital, enhancing voice of the civil society, governance of data and statistics and public sector management issues. Many of the initiatives proposed in the 9th Five-year plan were undertaken but Pakistan continues to perform relatively poorly with respect to governance indicators. Public Sector Enterprises (PSE) are exhausting the government’s resources despite the lack of rationale for the government’s presence in these sectors. There are vague, untargeted subsidies and a multiplicity of taxes across sectors and regions. One of the important reasons implementation of institutional reforms remains poor is because each time the reforms agenda is expected to be implemented by the very system that needs change – civil services. There is an urgent need to expedite results-based management across the public sector.

Regulatory burden

According to Planning Commission (2011) the footprint of the government is expected to be over 50 percent of the national income. The formal market development is being impeded for several reasons:

- High degree of government involvement in most markets ranging from agriculture to manufacturing, from retail to transport and from trading to construction.
- Government is a player/competitor in many of these markets making it difficult to define a transparent competitive market.
- Government regulation is not organized or informed by research, leading to contradictory and cumbersome regulation.
- Lack of clarity in government policy – importing commodity one year, buying from the local market next year, allowing imports then disallowing— creates opportunities for rent seeking at the expense of the consumer.
- Better configuration is required between law and economics – particularly in the case of property rights and sanctity of contracts.
- Ultimate incidence of public policy should be judged on welfare grounds with focus on increasing consumer welfare.²⁷

Physical space

Pakistan’s current state of cities is appalling. The rapid urbanization and poor management of cities has led to a lack of availability of affordable land and space. The most hindering aspect is the outdated zoning and building regulations and high commercialization fees. Leading developers contend that zoning is the biggest constraint to industrial development. These regulations prevent cities from becoming clusters of dense mixed use and business hubs. The existence of overlapping agencies has worsened the situation. For example, various institutions that have their own building regulations for commercial development are: Cantonment Boards (6 of them); Karachi Building Control Authority (KBCA); Defense Housing Authority (DHA) and Private/Cooperative Housing Societies. Also there are several agencies which keep records of property rights including Land Registrar, Revenue and Excise Departments, local Development Authority, Municipal Corporations, Cantonment Boards and others (World Bank, 2005). There remains a long standing demand for one window operations in order to reduce transaction costs. The management of urban areas comprises of local governments and development authorities operating independently of each other without any proper coordination and integration.²⁸

Connectivity

Pakistan, like many other developing countries, is characterized by the lack of physical and social connectivity. Connectivity supports trade, commerce and interactivity (exchange of

²⁷ Ministry of Finance, *Economic Survey of Pakistan*, Islamabad, 2010

²⁸ For detailed recommendations see Ahmed (2011)

information, ideas, methods and processes, goods and services, and transfer of funds), enhances productivity and economic growth and ultimately promotes prosperity. Connectivity may be viewed as a network of simple (direct) connections which could either be physical or social in nature. Physical connectivity facilitates movement of people, flow of information, goods and services and in many cases provides a platform for social connectivity. Social connectivity occurs when people interact individually or as a group for some common goal.

The results of poor connectivity include disintegrated domestic markets, lethargic cities, and surplus of youth with unemployable skills. The combination of unfriendly zoning systems and poor public transport reduces interactivity. The use of Information Communication Technology (ICT) and e-governance must be encouraged across the board. For example, in order to reduce transaction costs all custom ports should be automated and interconnected. After a decade long procrastination towards energizing the National Trade Corridor, it is unfortunate that member ministries could not resolve their inter-ministerial regulatory issues.

Sector picking hinders diversification

Pakistan's various governments in the past, and as currently proposed by the MOIP, have always favoured certain sectors when it comes to protection. Sadly this protection was never time bound and private sector never graduated from the subsidy-led regime. It is an established fact that domestic protection reduces export incentives and allows inefficient domestic firms to remain in business by accruing policy-induced rents at the expense of the consumer in terms of product quality, price and variety. Lall and Weiss (2003) state that while the infant industry argument could make a case for industries with strong learning externalities, public policy should provide support which is time-bound and linked to performance. Sectoral protection has caused businesses to move away from technology based industries and into less technology intensive industries like textiles and clothing which has provided minimal value-addition. The textiles and garments industry forms 57% of total exports as of 2007-8 ²⁹ which is why Pakistan needs an industrial policy that encourages other industries with a global dynamic demand in order to achieve diversification in international trade. In addition, the textile industry is not a dynamic one and does not provide any learning or technological spillovers (Lall and Wiess 2003) making it an inadequate and ineffective way of achieving sustained growth.

Investment climate

Pakistan has a heavily regulated business environment with long delays in customs clearance. The degree of regulation can be measured by the time and cost required to start up a new business calculated as a proportion of GDP per capita. Pakistan fares poorly when related to

²⁹ Planning Commission (2011)

other Asian economies. During the late 1990s, there were, on average, 8 steps in starting a business, taking 50 days, at a cost of 55% of national income per capita. The 2010 Doing Business report estimates that firms in Pakistan spend on average 560 hours preparing, filing, and paying taxes, which is twice the South Asian average of 284.5 hours. Pakistan's performance in global competitiveness index also points towards increasing cost of doing business with respect to security, business cost of violence and institutional performance. Pakistan is continuously ranked poorly in some sub-indicators involving public institutions, such as property rights (107 out of 139 countries), efficiency of the legal framework in dispute settlement (103), and transparency of government policy (115). The worsening security environment is reflected by significantly low ranking related to the business costs of terrorism (138), business costs of crime and violence (126), organized crime (127), and reliability of police services (119).³⁰

Competition policy

The Competition Commission of Pakistan aims to provide a legal framework for the business environment based on healthy competition; however, it fails to do so efficiently due to the government's industrial licensing and financial sector policies which lead to the prevalence of monopolistic market structures. The government in Pakistan is a major market participant/competitor which in turn promotes monopolies. Significant sectors such as railways, gas marketing, ports, civil aviation, postal service, electricity transmission and supply of potable water are still controlled by the public sector. The lack of public transport in most cities indicates the presence of restrictive regulatory regimes.

Not having prudent energy sector governance has led to the worst inter-corporate debt between energy companies. The power sector was previously fully state-owned; however, currently it has been partially privatized and Independent Power Projects (IPPs) have been set up to address the production gap. However, this has given rise to anti-competitive practices. The current setting requires electricity generating companies to sell to just one state owned entity and the distribution of power to customers is selective and carried out at high prices.

The same goes for the pharmaceutical industry in which the government sets fixed prices with the intention of keeping them low. However, this discourages new entrants. The MOIP's proposal to provide tax incentives, duty-free imports and subsidies for WHO and FDA GMP certification³¹ are positive steps but not enough to bolster the sector's performance in a monopolistic market structure.

³⁰ The ranking is from Global Competitiveness Report 2011 (out of 139 countries)

³¹ The Food and Drug Administration (FDA) and World Health Organization (WHO) administer a quality assurance certification schemes and ensure compliance by providing certificates of Good Manufacturing Practice (cGMP).

MOIP proposes to incentivize the fertilizer industry by encouraging fertilizer plants to invest in alternate modes of energy whereas the key issue is that the government exercises significant regulatory authority over the distribution of natural gas and setting up a fertilizer plant requires prior allocations from a gas quota which fortifies the existing firms and discourages competition. In spite of privatization efforts the fertilizer sector did not yield broad-based efficiency gains due to high costs of production and the heavy reliance on subsidies provided by the government. Thus the energy crisis in Pakistan is a management and not a capacity issue. The energy sector is marred by a lack of institutional strength necessary to carry out integrated planning, policy development and effective implementation.

Similarly, for the aviation sector Bilateral Air Service Agreements (BASAs) with other countries grant Pakistan International Airlines (PIA) exclusive rights to direct flights to those countries and the Competition Commission has recommended the BASAs to be amended to include multiple airlines.

In the banking sector, the minimum paid-up capital requirement for banking and insurance firms is fixed to induce financial sector stability. However, this negatively impacts the competition environment. These requirements encourage mergers/acquisitions and pose a market entry barrier limiting the scope of competition in the long run.

The difficulties in the enactment of the Competition Act 2010 are due to the following pending issues:

- **Financial constraints:** The Competition Commission of Pakistan (CCP) Fund was established to include federal government grants, charges levied by the commission, and a percentage of the fees of regulatory agencies in Pakistan. However, due to the shortage of government funds and the failure of regulatory agencies to comply with the statutory provisions, the fund did not materialize. The regulatory agencies including SECP, OGRA, PTA, PEMRA and NEPRA continue to delay the payment of their dues to the CCP.
- **Competition Advocacy:** Creating awareness of competition by holding consultations on competition issues, merger guidelines and capital issues, and reviewing policy frameworks for promoting competition are all important factors for the actualization of the Act but they have not been carried out due to lack of funds.
- **Capacity:** the current workforce at the CCP constitutes 40 non-administrative staff which is insufficient for the proper enforcement of the Act. Due to the shortage of funds the CCP is not able to hire competent professional staff.

- **Judicial process:** CCP currently has 170 pending cases with the courts out of which 89 are appeals filed against the decisions of the Commission to regulate cartels and deceptive marketing practices.³²
- **Competition Appellate Tribunal** has not been established yet.

Role of the Provinces

The department of industries at the provincial level must also change their stance which favours domestic production over trade. The new National Finance Commission (NFC) award and the 18th Amendment to the Constitution of Pakistan will impact the nature of interaction between the federation and provinces. The extent of change can be measured in terms of provincial autonomy, abolishing the concurrent list, strengthening the Council of Common Interests, and devolving more subjects to the provinces. Consequently, the provinces will face increased responsibility in improving public service delivery. Provincial departments of industries will have to frame a new role for themselves where they are in line with the national goals of economic growth and inclusive development.

Untargeted Subsidies

Water and Power Development Authority (WAPDA), Karachi Electric Supply Company, Trading Corporation of Pakistan, Utility Stores Corporation and PASSCO are all receiving untargeted subsidies from the government. The government also provides support to oil refining, wheat and sugar retail, spinning sector mark-up, and R&D for the textile and the motorcycle industries. These untargeted subsidies exist in the budget due to political pressures and are not grounded in poverty-related arguments. It has been pointed out in the past that sustaining such subsidies is crowding out the private sector in key productive sectors.

Institutional setting³³: Engineering Development Board (EDB) and National Tariff Commission (NTC)

The EDB has gained significant power over particular firms and industries through its discretionary control over:

³² As of May 2011.

³³ This section draws from the study by Garry Pursell (2011).

1. the imports of components used in a particular industry., If a component is deleted from the list of permissible imports it has to be produced domestically. This acts as a non-tariff barrier to imports and is effectively a continuation of the old system of import licensing,
2. permitting local content levels of particular firms,
3. new entrants to an industry, since all potential entrants are required to negotiate an individual indigenization programme with the EDB and how it would be phased in over time.

Selectivity in granting import concessions is more harmful than beneficial to the economy. In the cases of most SROs only manufacturers get input importing concessions whereas commercial importers have to import the same products at the full statutory tariff rate. As a result, the final products of the manufacturers are protected against import competition by normal tariffs. The negative impacts are as follows:

1. Importing is a knowledge-intensive activity and manufacturers may not have the importing know-how which results in their focus shifting away from manufacturing. In addition, the individual manufacturer will have minimal input requirements compared to a commercial importer who would import in bulk at lower freight costs.
2. Commercial importers are important for the functioning of new entrants and SME's because these firms are not significant enough to negotiate tariff concessions as compared to larger incumbents. This practice fortifies the existence of monopolies and undermines competition.
3. The costs of participating in the negotiation process with EDB are very high which provides only larger firms with the opportunity to gain from the concessions.
4. Any discretionary regulatory system invites the possibility of rent-seeking and corruption.
5. The discretionary powers of the EDB have led current policies to shield specific firms from import competition through highly effective protection rates and erecting barriers to new entrants. EDB works closely with industry level committees which consist of the major firms. These committees are unlikely to welcome increased competition.

Pursell et al. (2011) call for the complete abolition of the system of import licensing, which at present, is being administered by EDB and by different line ministries, and introduce tariff uniformity so that tariffs on individual products are the same for all importers, including trader-importers.

Another institution that requires mention here is the National Tariff Commission (NTC). Its main functions involve processing anti-dumping, countervailing duty and safeguard cases and reporting tariff protection and/or subsidies affecting individual industries. According to the 1973 *Rules of Business*, any changes to the tariff schedule after the annual budget has been published must be part of a report and recommendations by the NTC. Nevertheless, in reality many tariff

adjustments have been implemented without recourse to the NTC. Tariff adjustments, whether processed by NTC or in the manner mentioned above, are all announced in SROs issued by FBR. However, the information about the reason for the changes or whether they have been subject to the NTC is not available to outside stakeholders.

Institutional reform should aim to call for more transparency in publishing such tariff adjustments and the role of the NTC should be to provide sound economic rationale for any tariff and other protection issues since currently the NTC is unclear about the criteria of its recommendations on tariff structures. The NTC works on the principles that ‘tariffs should provide adequate protection for the survival and healthy growth of the affected industries and they should conform to the *cascading principle*³⁴ i.e. that tariffs should systematically rise with the degree of processing’³⁵. For a national trade policy, that is not biased towards protecting certain sectors, the government must publish a general set of guiding trade policy principles which the NTC must follow.

Sick industries and Insolvency laws

According to a study by the Directorate of Industries, Commerce & Labour, Peshawar (2009), there are 163 sick enterprises in Punjab, 702 in Khyber Pakhtoonkhwa, 345 in Sindh and 122 in Balochistan. The SECP proposed a Corporate Rehabilitation Act (CRA) in 2009 to deal with sick industries. The formation and enactment of laws is not the problem; their implementation is, and this needs to be complemented by strong political will. The lack of support from political leaders and the volatile political situation has led to inconsistent laws in all spheres of the economy. In the past, laws have been shifting between the revival of sick industries and the recovery of bankrupt firms.

In spite of the enactment of a series of successive creditor-friendly laws- e.g., the Recovery Act 1997, NAB Ordinance 1999, CIRC Act 2000 and the Recovery Act 2001- non-performing loans (NPLs) remained high. There is a dire need for a corporate rehabilitation law in Pakistan since corporate debt has been growing (at 10 - 12% p.a.) and liquidation values have been plummeting at a constant rate over the past several years.³⁶ CIRSU (Committee for the Rehabilitation of Sick Industrial Units) was created through a notification by the Ministry of Finance in 2000. It has been elected to operate as an “arbitration window” but has not acquired the capacity needed for

³⁴ The cascading tariff structure imposes a higher tariff on the final good than on intermediate goods and raw materials which implicitly subsidizes the import competing sector leading to an anti-export bias. Ideally, a uniform tariff structure should be implemented to avoid the distortion of incentives.

³⁵ Pursell et al. 2011, pg 22)

³⁶ <http://www.secp.gov.pk/CS/ChairmanInterviews/CRA.ppt>

operational restructuring. Typically a debt is re-scheduled (often cosmetically) and *revival* is declared. Thus the SECP suggests its closure.

Salient features of the proposed CRA include:

- Entering into rehabilitation proceedings is a right. However, this step must be considered carefully by debtors due to the provision in place for an automatic conversion into liquidation if no rehabilitation plan is approved. Various quantitative tests for entry were considered, but were discarded owing to the widespread use of *cooked* financial statements.
- The process is stakeholder driven; both debtors and creditors can file plans.
- The process has been shortened with the introduction of finite time-frames. For example, the debtor is given one month to file a plan after beginning rehabilitation proceedings.
- Taxes, levies and government dues in Pakistan benefit from substantial legal protection. Income tax, sales tax, and customs officers can *re-open* cases even after several years. Unfortunately, bankers have often designed rehabilitation plans through a change in management or the initiation of a new entrepreneur only to be impeded by extortionist claims for past taxes. All such taxes and levies are classified as unsecured debts in the CRA in order to move part of the cost of inevitable losses away from the banking system.
- Treatment of stakeholder rights and priorities. The current system of giving priority to unsecured creditors (e.g. state dues, taxes, wages, provincial levies, utility bills, etc.) is archaic and not sustainable and will have to be removed (IBRD/ UNICTRAL Insolvency Principle 16).
- In the United States, the purpose of the cram-down feature is to force consensus on a rehabilitation plan. The authors of the CRA act expect rather active use of this provision in the case of Pakistan– at least in the beginning before prior to the emergence of case law and before whole system develops maturity.

Interface with Trade Policy

In addition to the enactment of the Competition Act 2010 the following modifications to the trade policy will go a long way in increasing efficiency of industrial policies. Many of these have been highlighted in some recent studies including Pursell *et al.* (2011).

- Non-tariff measures, like import licensing, should not be used to control import and exports, i.e. abolition of import licensing currently being administered by EDB and by several line ministries

- As a basic principle, if tariff concessions are given, they should be available to everyone including trader/importers
- Introduce uniformity in import tariffs so that tariffs on single products are the same for all importers including trader- importers.
- Explicit abandonment of the current “cost plus” and “cascading” approaches to tariffs
- The economic justification for above normal protection given to industries needs to be reviewed
- A review of the economic justification for the present export subsidies and taxes
- Public availability of the tariff evaluations made in SROs whether with or without reference to the NTC.
- Maintain a neutral real exchange rate policy.
- Accelerate the re-establishment of normal trade relations with India, including border opening
- Accelerate the maximum potential possible under already signed free trade agreements, for example with China and Malaysia.
- Publication and easy access to information on appeals against anti-dumping decisions.
- All economic ministries must frame their policy and regulatory stance based on the intentions defined in this growth strategy.

Conclusion

The case for employing industrial policy is clear. Pakistan needs to take a less intrusive and a more facilitative approach to industrial policy. The role of industrial policy must be such that enables an environment in which broad-based innovation is encouraged in all sectors rather than favouring certain sectors based on political, and not economic, rationales. As Rodrik (2004) states, 'industrial policy needs to be viewed as a component of an economy's growth strategy rather than as giveaways to already privileged sections of the economy'.

Pakistan's growth strategy followed sector-picking in the name of import-substitution and later export promotion. Both have led to distortive incentives in the private and public sector. While the former faces dysfunctional markets and high barriers to entry, the latter competes with the private sector in almost every market and sector of the economy. While there is an urgent need for further deregulation, the private sector will also have to realize that 6 decades of subsidies and tax incentives must go if true entrepreneurship and innovation is to be promoted.

This paper sheds light upon the lack of coordination and contrary views about the scope and composition of industrial policy even within the various government functionaries. The main recommendation of this paper is the need for a shared vision and deeper consensus-building to devise an industrial policy that is broad-based and fosters innovation and productivity. The public sector enterprises directly competing in the industrial (and agriculture) markets in Pakistan should be considered for privatization. All the major public sector enterprises are facing operational losses, which in turn is draining 3% of GDP. Institutions responsible for bringing about competitive markets should be given autonomy; these include the Competition Commission of Pakistan, Securities and Exchange Commission of Pakistan and the central bank. In order to promote across the board openness in trade and investment, the non-tariff barriers including import controls imposed by entities such as the Engineering Development Board and Federal Board of Revenue must be revisited.

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