

## 9

**Industry and Trade****NAVED HAMID**

Industrial growth in Pakistan has been closely determined by internal and external economic policies. This chapter reviews some of the basic trends of the last two decades, after the break-away of Bangladesh in 1971.

**BHUTTO'S NATIONALIZATIONS**

In December 1971, Zulfikar Ali Bhutto came to power. Bhutto's Pakistan People's Party (PPP) was a product of the anti-Ayub Khan movement, and was committed to eliminate the privileges enjoyed by industrialists during the previous two decades. According to the PPP election manifesto, the concentration of ownership in both agriculture and industry was to be ended through nationalizations and land reforms, and the condition of the masses was to be improved through public supply of consumption goods, price controls, increase in wages and other benefits.

The objective of the proposed industrialization strategy was the

attainment of self-sufficiency in intermediate and capital goods. It was to be a continuation of the earlier import-substitution strategy, except that the emphasis was now to be on capital and investment-related industries, i.e., to move on to the next stage of import-substitution. These industries were to be set up in the public sector because it was believed that the state should control the 'commanding heights' of the economy. Therefore, the PPP government proceeded to restructure the industrial and other related sectors.

In 1972, the management of 31 manufacturing firms in 10 basic industries was taken over. The managing agency system, a remnant of the British period, was abolished, and life insurance was nationalized. In 1973, the vegetable ghee (edible oil) industry and export trade in raw cotton were nationalized, and the government acquired ownership of manufacturing firms whose management it had taken over in 1972. In 1974, banks, petroleum distribution and shipping were also nationalized and export trade in rice was made a state monopoly. In 1976, cotton gins, and flour and rice mills, which numbered several thousand, were nationalized.

Although the industries taken over by the government accounted for a relatively small proportion of the value-added in the large and medium-scale industry (LMSI) sector, the piecemeal process of nationalizations and the anti-capitalistic rhetoric which accompanied it, was a traumatic experience for the industrialist class which had been thoroughly pampered during the previous two decades. The response of many of the large business houses was to liquidate whatever industrial assets they could, transfer capital abroad, and concentrate more on trade and commerce.

The Bonus Voucher Scheme was abolished and in May 1972 the rupee was devalued from Rs. 4.76 to Rs. 11.00 against the US dollar. (The rupee/dollar rate was subsequently adjusted to Rs. 9.90 in February 1973.) A fundamental change was also made in the system of import controls. Prior to the change, only public sector imports and most capital goods and some raw materials could be imported at the official exchange rate. All other items, whose import was not banned, were imported against bonus vouchers. The system not only created distortions because of different exchange rates for different categories of imports, but it was also fairly restrictive with the import of many items being subject to quantitative restrictions or an outright ban. This was replaced with a system of Free and Tied Lists, wherein the import

of items not appearing on either list was automatically banned. The Free List was divided into three parts. If an item was on Part A of the Free List, any importer, in theory, could get a licence and import it, but if foreign exchange was scarce, licences were difficult to obtain. Items in Part B of the Free List were reserved for industrial importers only, and those in Part C could only be imported from a particular country, usually under barter. This represented a significant import liberalization compared to the earlier period. Under the first post-devaluation import policy, there were about 300 commodity categories at the four-digit level on the Free List, but new items were added to the list each year; and by 1977, the number of categories had increased to 407.

Initially, import duties were reduced to compensate for the impact of devaluation; subsequently, duties were adjusted upward each year according to revenue needs. It is difficult to gauge the overall impact of these changes as no work has been done on effective rates of protection in Pakistan during this period. However, according to Naqvi and Kemal, the overall level of effective protection was significantly lower in 1981 compared to the 1960s.<sup>1</sup> Since hardly any trade liberalization occurred between 1977 and 1981, this decline in effective protection must have taken place between 1972 and 1977.

On the export side, devaluation combined with the world commodity boom resulted in windfall gains to exporters. Consequently, the government levied export duties on most exports. As world prices rose, export duties were also increased; and by October 1973 they reached a peak of 45 per cent on raw cotton, 40 per cent on cotton yarn, 25 per cent on grey cloth, and 15 per cent on other finished cotton and leather products. As the boom collapsed, export duties were also reduced in stages until all export taxes on manufactures were abolished in August 1974. There was some lag in reducing export duties and this had a negative impact on exports, which was aggravated by worldwide recession, disarray in domestic industry, and establishment of government monopolies in the export of cotton and rice. To overcome the resulting stagnation in exports, certain incentives such as compensatory rebates, a 50 per cent reduction in the tax on income from exports, and expansion in the concessionary finance scheme to all manufactured exports were introduced in 1976. However, the full impact of these measures was only felt in the next period.

An additional impact of the devaluation was to eliminate the

implicit subsidy on capital goods. At the same time, the tax holiday scheme was also abolished. The result was a considerable reduction in the distortions in the factor-price ratio.<sup>2</sup> However, the impact of this on the choice of technique in LMSI was limited because there was hardly any new investment in the private sector (Table 9.1), and the public sector was not too concerned with profitability in the choice of project/technique.<sup>3</sup> However, it made small-scale industry (SSI) much more competitive by reducing the bias in favour of LMSI and thus providing an impetus to its growth.

As already mentioned, another important policy change during this period was the increased emphasis on public sector industry. During the first two decades, the public industrial sector was managed by the Pakistan Industrial Development Corporation (PIDC), an autonomous body which was created for the purpose of accelerating the rate of industrial development in Pakistan. PIDC was to invest in fields in which private investment was weak due either to technological complexity or the lack of immediate profit potential. It was subsequently assigned the additional task of promoting regional balance by setting up industries in backward areas.

By June 1972, PIDC had completed 58 industrial and mining projects of which 40 remained under its management. In addition to the completed projects, a number of projects were under implementation in 1972, such as the Pakistan Machine Tool Factory, the Heavy Mechanical Complex, and the Heavy Foundry and Forge Project. Thus, even before the establishment of the PPP government, the public sector had begun to move into capital goods industries.

On 1 January 1972, the new government issued the Economic Reforms Order under which the government assumed total responsibility for the development of 10 basic industries.<sup>4</sup> The state took over the 31 locally-owned units in these industries and the private sector was totally excluded from further development of these industries.

The Ministry of Production was created to coordinate and administer the activities of the public manufacturing enterprises (PMEs) and the Board of Industrial Management (BIM) was established to control these enterprises, with the Minister of Production as its chairman.<sup>5</sup> The PMEs were grouped into 12 sector corporations under the BIM.

TABLE 9.1  
Trends in LMSI Investment, 1964-88 (Rs. million, 1959/60 prices)

Year	Investment: LMSI			Total (It)	Value-added in LMSI (VA)	Total GFCF <sup>a</sup>	Investment rates (percentage)		
	Private (Ipr)	Public (Ipb)	Public (Ipb)				Ipr/VA	Iu/VA	Iu/GFCF
1963/64	865	30	895	2,233	4,311	96.7	38.7	40.1	20.7
1964/65	967	109	1,076	2,523	5,108	89.9	38.3	42.6	21.1
1965/66	867	110	977	2,796	4,638	88.7	31.0	34.9	21.1
1966/67	714	90	804	2,982	4,280	88.8	24.0	27.0	18.8
1967/68	731	97	828	3,209	4,108	88.2	22.8	25.8	20.2
1968/69	646	59	705	3,548	3,723	91.6	18.2	19.9	19.0
1969/70	827	121	948	4,043	4,681	87.2	20.5	23.5	20.3
1970/71	780	44	824	4,293	4,486	94.7	18.2	19.2	18.4
1971/72	631	60	691	4,273	4,229	91.3	14.8	16.2	16.3
1972/73	427	62	489	4,665	4,278	87.4	9.2	10.5	11.4
1973/74	307	165	472	4,948	4,680	65.0	6.2	9.6	10.1
1974/75	287	307	594	4,871	4,704	48.4	5.9	12.2	12.6
1975/76	354	855	1,209	4,843	6,512	29.3	7.3	25.0	18.6
1976/77	381	1,121	1,502	4,834	6,957	25.4	7.9	31.1	21.6
1977/78	338	1,394	1,732	5,362	6,932	19.5	6.3	32.3	25.0
1978/79	358	1,352	1,710	5,783	6,747	20.9	6.2	29.6	25.3
1979/80	433	1,098	1,531	6,417	6,906	28.3	6.7	23.9	22.2
1980/81	515	754	1,269	7,153	6,729	40.6	7.2	17.7	18.9
1981/82	509	728	1,237	8,276	7,698	41.2	6.2	14.9	16.1
1982/83	629	791	1,420	8,820	8,766	44.3	7.1	16.1	16.2
1983/84	820	824	1,644	9,499	9,199	49.9	8.6	17.3	17.9
1984/85	1,023	523	1,546	10,258	9,835	66.2	10.0	15.1	15.7
1985/86	1,266	590	1,856	11,002	10,460	68.2	11.5	16.9	17.7
1986/87	1,449	400	1,849	11,796	11,877	78.4	12.3	15.7	15.6
1987/88	1,402	350	1,752	12,654	11,687	80.0	11.1	13.8	15.0

Source: Pakistan Economic Survey 1988-89.

Note: a. Gross fixed capital formation.

The substantial profits enjoyed by the private sector during the 1960s gave rise to unrealistic expectations when these industries were nationalized. The PME's were consequently burdened with multiple and at times conflicting tasks and objectives, particularly with regard to increases in government revenues and employment generation. For example, between 1973 and 1977 PME's employment grew from 40,000 to 65,000, the index of production increased by 23 per cent, pretax profits declined from Rs. 174 million to Rs. 59 million, and taxes and duties paid by PME's increased from Rs. 667 million to Rs. 1,408 million.<sup>6</sup>

A massive public sector industrial investment programme was also launched by the PPP government though it was only during its last two years that the investment expenditure was large in both absolute terms and as a proportion of total public investment. Most public manufacturing investment was in steel and fertilizers, though there were also a number of major projects in chemicals, cement, textiles and engineering. Most of the funding for this programme came from federal government budget allocations or from financial institutions; self-financing by BIM was only about 3 per cent of the total.

## INDUSTRIAL PERFORMANCE

### Large and Medium-Scale Industry (LMSI)

The growth of LMSI deteriorated sharply during the period. The LMSI sector grew by 9 and 5 per cent in 1973 and 1974 respectively; and then for the next three years it experienced, on the average, a negative growth rate of about 1 per cent per annum. The short-lived recovery of 1973 was the result of a rebound in domestic demand, after the disruptions of the previous two years and the worldwide commodity boom. The latter facilitated reorientation to the world market of goods formerly sold to East Pakistan, thus largely mitigating the initial economic impact of its separation. However, the second and subsequent rounds of nationalizations in 1973 and 1974 and the worldwide recession dealt a severe blow to the growth of LMSI in the private sector. High inflation and economic stagnation, which characterized the years 1975 to 1977,

also adversely affected the public sector industries, and production of the PMEs stagnated during the last two years. Consequently, it would not be incorrect to say that the LMSI sector was in the grip of serious crisis by the end of the period.

The story on the export side is somewhat similar. At first, manufactured exports (in current dollars) grew fairly rapidly because of devaluation, buoyant world demand for cotton textiles and diversion of interwing trade to international markets (Table 9.2). However, from 1974 onwards exports of the LMSI stagnated, with exports of cotton yarn and cloth being 14 per cent lower in 1977 compared to 1974. On the other hand, exports of manufactured goods produced by SSI, such as carpets, garments, leather and textile made-ups, continued to increase rapidly. This coincided with the explosive growth that occurred in SSI during this period, which is discussed in the next section.

The crisis in LMSI was reflected in the behaviour of private sector investment which in 1975 fell, in real terms, to about one-third of the 1970 level (Table 9.1). At that point, the public sector began to assume a much larger role as a massive investment programme was launched in 1974. Public sector investment increased rapidly, growing from Rs. 62 million in 1973 to Rs. 1,121 million in 1977 (both in 1960 prices). As a result, the share of public sector in total LMSI investment increased from about 10 per cent prior to the PPP government to about 75 per cent in 1977. However, given the minimum gestation period, the public sector investment had a limited effect on industrial output before the fall of the Bhutto government in 1977.

The changing fortunes of the private sector and the large public sector investment programme had a substantial impact on the structure of LMSI during the 1970s. The decline in the share of textiles accelerated, so that the share of consumer goods in LMSI fell to 53 per cent in 1980 from 62 per cent in 1970 (Table 9.3). The primary gainers during this period were fertilizers, iron and steel, and transport equipment industries. Most of these industries were in the public sector, and import substitution provided the basis for their growth.

### **Small-scale Industry (SSI)**

The export performance of SSI and the growth in agriculture-related engineering industry, particularly tubewells, led many to

TABLE 9.2  
*Growth and Composition of Manufactured Exports, 1970-88*

	1969-70	1973-74	1976-77	1979-80	1984-85	1987-88
Share of manufactured exports to total (%)	67	61	59	58	71	72
Value of manufactured exports (US \$m)	226	626	673	1,372	1,769	3,208
Rate of growth* (%)	—	29.0	2.4	26.8	5.2	21.9
Composition of manufactured exports (% share)						
Cotton cloth	24.0	23.0	24.0	17.8	17.2	15.2
Cotton yarn	23.6	29.4	17.6	15.0	14.7	16.9
Carpets and rugs	5.1	7.4	13.7	16.2	7.5	7.9
Tanned leather	10.1	6.8	9.7	9.3	8.6	9.0
Textile made-ups	—	—	8.1	7.0	10.9	11.3
Synthetic textiles	1.6	1.1	0.5	0.4	2.4	6.2
Garments	1.8	2.7	7.6	7.1	9.9	15.1
POL products	4.5	2.9	4.0	13.0	1.9	0.9
Sporting goods	2.8	3.1	3.0	1.8	2.5	2.0
Surgical instruments	1.4	1.4	2.1	1.9	2.9	1.8
Others	—	—	9.7	10.5	21.5	13.7
Total	100.0	100.0	100.0	100.0	100.0	100.0

Sources: *Pakistan Economic Survey 1988-89*; Government of Pakistan, Federal Bureau of Statistics, Statistics Division, *Pakistan Statistical Yearbook 1989*.

Note: a. Average annual rate of growth for the period, i.e., between 1969-70 and 1973-74, 1973-74 and 1976-77, and so on.

believe that SSI growth during the 1960s was much faster than indicated by official statistics. Also, there is no doubt that growth in the SSI sector accelerated greatly during the 1970s.

Possibly the single most important factor responsible for the increase in SSI growth rate during the 1970s was the devaluation of 1972 and the abolition of the Export Bonus Scheme. Since LMSI could import capital goods and raw materials (until the late 1960s) at the official exchange rate, while SSI had to pay the free market price for these items, it was difficult for SSI to compete with LMSI. Devaluation and unification of the exchange rate changed this. On a more general level, an important constraint faced by SSI during most of the 1960s was a shortage of imported raw materials. There was considerable improvement in availability of raw materials in the post-devaluation period and this also provided a boost to the SSI. Further, the increase in the effective exchange rate for

TABLE 9.3  
*Structural Change in LMSI: Share of Value-added by Industry, 1960-85*  
 (percentage)

<i>Industries</i>	<i>1959/60</i>	<i>1969/70</i>	<i>1979/80</i>	<i>1984/85</i>
Food, beverages and tobacco	14.3	18.4	16.5	16.0
Sugar	(2.8)	(7.4)	(7.3)	(6.9)
Textiles, garments, and footwear	42.8	34.2	27.1	20.9
Cotton yarn and cloth	(32.6)	(26.9)	(16.7)	(11.9)
Printing and publishing	2.3	1.8	1.4	1.4
Drugs and pharmaceuticals	2.3	3.6	5.6	4.8
Other consumer goods	6.2	4.3	2.8	4.4
<i>Total Consumer Goods</i>	68.0	62.3	53.4	47.5
Cotton ginning	3.7	3.8	2.4	1.8
Industrial chemicals	2.3	4.5	8.8	10.5
Fertilizers	(-)	(2.8)	(6.0)	(7.2)
Petroleum refining	1.2	8.8	8.0	5.6
Other intermediate goods	5.6	7.9	7.4	6.8
<i>Total Intermediate Goods</i>	12.9	25.0	26.6	24.6
Non-metallic mineral products	5.9	3.2	2.9	4.9
Cement	(4.0)	(2.7)	(2.2)	(4.1)
Iron and steel basic industries	3.1	2.8	5.6	13.0
Other investment-related intermediate goods	3.9	2.3	3.3	1.9
<i>Total Investment-related Intermediate Goods</i>	12.9	8.3	11.8	19.8
Machinery (including electrical)	2.5	3.7	3.8	4.6
Transport equipment	3.3	1.7	4.0	3.1
Other capital goods	0.3	0.0	0.5	0.5
<i>Total Capital Goods</i>	6.2	5.4	8.2	8.2
<i>All Industries</i>	100.0	100.0	100.0	100.0

*Sources: Pakistan Census of Manufacturing Industries, various issues.*

machinery and equipment (previously importable at the official rate) was greater than that for raw materials (previously importable on cash-cum-bonus). Thus, the competitiveness of the engineering industry, an important sub-sector of SSI, vis-à-vis imports was also improved. Finally, since SSI tended to be export-oriented—exports of carpets, garments, surgical instruments and sporting goods, all produced in the small-scale sector, grew at over 25 per cent per annum during this period compared to the 8 per cent growth rate for all exports—it benefited more from the devaluation than did LMSI, which was primarily producing for an already highly protected domestic market.

Besides devaluation, several other factors contributed to the acceleration in growth of the SSI sector. First, nationalizations probably diverted resources from LMSI to SSI. An extreme example of this was the textile industry where many looms were physically uprooted from large mills and set up as small, independent production units by the mill-owners. Second, because of nationalizations, many experienced entrepreneurs turned from industry to trade, and they were successful in finding export markets for new products such as carpets and garments produced by SSI. Third, labour legislation introduced in 1972, and the growth of the trade union movement during the period, prompted a move toward smaller production units where labour laws did not apply. Finally, workers' remittances contributed to the emergence of a 'new middle class' and expansion of the domestic market for consumer goods. Since this 'new middle class', unlike the old one, had not been exposed to Western education and tastes, it was more willing to consume the less 'sophisticated' products of local manufacture. Also, the outflow of workers to the Middle East resulted in labour shortages in agriculture, which in turn led to more rapid mechanization of agriculture and thus induced growth in the agricultural machinery industry.

Because of these factors, the growth in the SSI sector accelerated substantially in the 1970s. According to official statistics, the growth rate of SSI increased to 7.3 per cent per annum, compared to 2.9 per cent in the 1960s, while other estimates put the growth rate from 1970 to 1977 at an even higher level (Table 9.4).

The growth rate of value-added in textiles in SSI was 22 per cent per annum during the period 1970 to 1977. This was in sharp contrast to the textile sub-sector in LMSI, which was stagnant (cotton cloth production in LMSI declined by more than 30 per cent). Though textiles in SSI grew partly at the expense of LMSI, this was not the only source of its growth. The carpet industry experienced rapid export-led growth during this period.

The engineering sub-sector in SSI also experienced a high rate of growth (over 26 per cent per annum) primarily because of two factors. First, the 1972 devaluation, as discussed earlier, gave its products a competitive edge over imported machinery. As a result, the local industry was able to capture a large part of the domestic market for power looms, presses, lathes, and other machine tools as well as agricultural machinery. Second, since most of the

TABLE 9.4  
Structure and Growth in SSI by Industry, 1970-84

Industries	% share in value-added		Growth rate			
	1976/77	1983/84	Value-added		Employment	
			1969/70-1976/77	1976/77-1983/84	1969/70-1976/77	1976/77-1983/84
Food	9.6	16.6 <sup>a</sup>	4.6	17.2 <sup>a</sup>	9.7	16.3
Textiles	29.9	21.3	21.9	3.3	17.0	1.5
Garments	0.8	0.8	33.7	8.2	20.5	10.7
Leather products (except footwear)	1.4	1.1	9.7	5.3	7.9	8.8
Footwear	5.4	6.7	16.9	11.9	13.3	14.0
Wood products	3.6	6.3	19.3	17.5	13.9	16.9
Furniture	4.6	4.9	16.3	9.5	16.6	12.0
Printing	1.7	1.2	17.8	3.2	8.4	6.1
Plastic products	1.7	0.8	50.1	-2.2	41.0	-6.4
Pottery, china, and earthenware	0.5	0.4	6.0	5.0	12.9	-2.4
Iron and steel	1.0	0.5	8.8	-3.0	12.9	-6.7
Fabricated metal products	8.8	8.6	13.6	8.0	8.6	10.0
Machinery (except electrical)	1.8	1.3	-2.1	4.0	1.4	5.5
Electrical machinery and apparatus	1.8	1.3	-2.1	4.0	1.4	5.5
Sports and athletic goods	1.1	0.5	-1.2	-2.8	-0.2	-6.5
Others	22.5	24.0	—	9.4	—	0.0
All industries	100.0	100.0	14.1	8.4	14.0	6.1

Sources: Government of Pakistan, Federal Bureau of Statistics, Statistics Division, *Survey of Small and Household Manufacturing Industries 1983-84*; Hamid N., 'Growth of Small Scale Industry in Pakistan', *Pakistan Economic and Social Review*, 1983.

Note: a. There seems to be an error in the value-added data for the rice-milling sub-sector in Sind; therefore, it was adjusted using the VA/L ratio for other industries in Sind.

machinery used in SSI, unlike LMSI, tended to be locally produced, the rapid growth of SSI itself provided additional demand for the engineering industry.

A number of other important industries (footwear, furniture and wood products) had growth rates of between 16 and 20 per cent per annum, and two relatively new industries—garments and plastic

products—did even better with 34 and 50 per cent per annum growth rates respectively. The former was primarily export-based, while the latter benefited from rapidly expanding domestic demand for its products.

The structure of SSI in 1977 was in some ways similar to that of LMSI with textiles and the food groups dominating, but the two sectors produced widely differing products (Tables 9.3 and 9.4). For example, sugar and vegetable ghee dominated the LMSI food group and spinning was the most important activity in its textile industry, but these industries hardly existed in SSI. Other examples of activities found almost exclusively in LMSI were the manufacture of industrial chemicals, cement, fertilizers, paper, beverages, cigarettes and petroleum refining. There were, however, industries that were common to both, such as weaving and engineering. In brief, the product-mix of SSI differed from that of LMSI in that in the former there was a concentration of labour-intensive products—such as textiles (weaving), footwear, furniture and engineering—while in the latter capital-intensive industries—such as textiles (spinning), sugar, cement, fertilizers and petroleum refining—and industries in which scale economies in advertising and marketing were important, such as cigarettes, beverages and tea, dominated.

By 1977 LMSI was in a severe crisis. The inefficiencies inherited from the 1960s remained and were compounded by excess capacity, run down and obsolete machinery and demoralization of the entrepreneurial class. In addition, there was the problem of a relatively inefficient public sector and a huge ongoing investment programme of public sector industries which were capital-intensive, had long gestation periods, and because of the 'minimum economic scale' factor had little chance of being internationally competitive. However, on the plus side, because of nationalizations, devaluation, and the accompanying reduction in direct controls, the stranglehold of a few business houses on the industrial sector had been broken, paving the way for the emergence of a new entrepreneurial class. Small-scale industry was growing rapidly and competing successfully in the world markets. Remittances from workers in the Middle East were increasing rapidly and were already large enough to have a significant impact on the size of the domestic market. It was in these circumstances that the Zia ul-Haq government took power in July 1977.

### **POLICIES 1977-90**

The Zia ul-Haq government decided fairly early that the private sector should play the leading role in industry. However, in implementing this it was faced with a number of obstacles. First, even if it had wanted to, there were practical problems in returning nationalized industries to original owners who were unwilling to take over the losses accumulated after nationalization, or the large number of highly paid workers currently employed in these units.<sup>7</sup> In any case, the public sector industries provided lucrative jobs for bureaucrats and retired military personnel, so the bureaucracy was not too keen to hand these back to the private sector. Second, the massive public sector industrial investment programme which was underway was difficult to curtail in the short run because a large proportion of the funds had been either spent or committed in the form of international contracts. Third, the private sector, after the experience of the previous five years, was extremely cautious about undertaking any substantial new investments. Finally, the overall economy was also in bad shape. Agricultural and industrial production was stagnant, inflation was at double-digit levels, and foreign exchange reserves were at an all-time low.

Consequently, the new government adopted a gradual approach. To restore the confidence of the private sector, the agro-processing industries (cotton ginning, flour milling and rice husking) nationalized in 1976 were returned to their former owners. Fiscal incentives such as tax holidays and exemption of duty on imported machinery for certain areas, accelerated depreciation allowances, and tax credits for investment were reintroduced. Private investment in sub-sectors previously restricted to the public sector was permitted, and the process for obtaining investment sanctions was simplified.

The continuing process of deregulation of industrial investment improved the general investment climate by reducing the complexity, delays and cost of the investment sanctioning system. Under the new policy, official sanction was only required for investment in specified sub-sectors,<sup>8</sup> projects above a certain size or having foreign equity, and industries based primarily on imported raw materials and producing goods whose import was either banned or

subject to high tariffs. However, restrictions on commercial imports of machinery and mill work meant that for most industrial investment, some form of government sanction was still needed. Moreover, electric power shortages and infrastructure bottlenecks, particularly electricity and gas, continued to cause delays in the execution of new projects or expansion of existing ones.

Besides reducing barriers to entry through liberalization of sanctioning policies, other steps were also undertaken in the 1980s to promote domestic competition. The most important in this regard was the move away from price controls and cost-plus pricing arrangements. In this connection, between 1983 and 1986, prices in sugar, cement, fertilizer and vegetable ghee industries were deregulated.

A policy of import liberalization, particularly for raw materials, was also followed after 1980 by adding new items to the Free List, raising or eliminating value and volume limits where applicable, and streamlining procedures for grant of import licenses. As a result, the proportion of domestic industrial value-added protected by bans or restrictions was reduced from 64 per cent in 1980 to 34 per cent in July 1983. In 1983, a significant change in the system of import controls was introduced by moving to a negative list. Whereas previously import of all items not specifically permitted was banned, under the new system all items not specifically banned or restricted were freely importable. By moving to the negative list system, about 150 commodity categories previously banned or restricted were made freely importable. As a result in 1984, the first year of its operation, there were about 450 commodity categories (out of about a thousand at the four-digit level) on the negative list. However, further progress towards import liberalization was limited and by 1988 only about 50 additional categories were deleted from the negative list. Also, it is important to note that the import liberalization measures adopted during the 1980s were primarily designed to improve availability of raw materials and capital goods to the industrial sector rather than to expose domestic industry to greater foreign competition.

In addition to industrial and import liberalization, government policy was also directed towards improving incentives for manufactured exports. These included improvement in the procedures for obtaining duty drawbacks against taxes paid on imported raw

materials used in exports, introduction of compensatory export rebates, extension of the export refinance scheme, a further reduction in the effective rate of income/corporate tax on profits from exports, and a move towards a more realistic exchange rate regime.

Possibly the most important policy reform affecting industry and trade during this period was the introduction of a 'managed-float' of the rupee in January 1982. Until then, the rupee-dollar exchange rate was fixed at the level set in 1973. The higher inflation rate in Pakistan in the 1970s compared to its trading partners had eroded its industry's competitiveness in the world market. This was further aggravated by the appreciation of the dollar against major currencies in 1981. Therefore, in 1982 the government decided to delink the rupee from the dollar and set the exchange rate on the basis of a basket of currencies. As the dollar continued to appreciate, the government barely managed to keep the real value of the rupee stable against a trade-weighted basket of currencies until 1984. However, when the dollar fell against the major currencies between 1985 and 1987, by sliding down with the dollar, the rupee was devalued in real terms by about 30 per cent. This not only provided a boost to manufactured exports, but also allowed the government to pursue its policy of import liberalization without it generating excessive pressure on the balance of payments.

As far as public sector industries were concerned, the Zia ul-Haq government decided fairly early that privatization was not a practical option. However, it also realized that to prevent PMEs from becoming a permanent drain on government resources, it was necessary to improve their efficiency. To achieve this, it decided to decentralize the management structure and give greater autonomy to the individual units. Consequently, the Board of Industrial Management was abolished, some of the sector corporations were merged, boards of directors were established at the company and the corporation levels, and an Experts Advisory Cell was created in the Ministry of Production to develop and operate a management information system, and to monitor and evaluate the performance of the PMEs.

It was also decided to restrict public sector industrial investment from the government budget to projects already underway. New investment and expansion was to be permitted only if it was financed by the PMEs themselves. This policy led to a fairly high level of investment in the first few years, and then to its gradual

tapering off (Table 9.1). It was successful in ensuring the completion of ongoing projects with a minimum delay, thus yielding a high pay-off in terms of increased output.

### INDUSTRIAL PERFORMANCE

Growth in the LMSI sector increased dramatically, averaging over 9 per cent per annum between 1977 and 1988. However, there was a significant difference between the performance in the first and the second half of the period. From 1977 to 1982, LMSI grew at over 11 per cent per annum. The growth during this sub-period was led by the public sector as new projects in fertilizers, chemicals and engineering, started during the PPP period, came on stream. The growth rate of value-added in the public sector industries during these five years was close to 15 per cent per annum. The private sector also recovered sharply from the depressed levels of the previous three years. Growth of value-added in the private sector, largely as a result of improved capacity utilization, averaged just under 10 per cent per annum between 1977 and 1982. The recovery was aided by strong growth in the domestic market as a result of good agricultural performance and large increases in workers' remittances.

As public sector projects were completed, growth in LMSI had to come increasingly from the private sector, and once excess capacity in the latter had been used up, further increases in output could only come from expansion in capacity. But private sector investment was slow in recovering because of political uncertainty and the experience of the 1970s and, as public sector investment slowed, total investment in LMSI declined in real terms until 1982 and then increased only slowly (Table 9.1). As a result, a slow-down in the LMSI growth rate was inevitable. The situation was made worse by infrastructural bottlenecks, particularly energy shortages, declining workers' remittances and extremely erratic performance of the agricultural sector. Consequently, during the period 1983 to 1988, despite the coming on stream of the Pakistan Steel Mill and the good performance in key industries such as cement and textiles, growth in LMSI only averaged just over 7 per cent per annum.

Structural change in LMSI during the first half of the 1980s reflected the effects of the public sector investment programme started in the Bhutto period. The most significant change was the large increase in the share of the iron and steel industry, following the completion of the Pakistan Steel Mill complex (Table 9.3). Also, the coming into production of the large public sector fertilizer and cement projects raised the shares of these two industries, and the lack of investment in petroleum refining—a public sector preserve—decreased its share. Another factor in the changing structure of LMSI was the continuing decline in the share of textiles, and hence that of the consumer goods sector as a whole. However, the recent revival in the cotton textile industry and the rising share of private sector investment with its consumer goods bias may well have reversed this trend in the latter half of the decade.

As far as SSI is concerned, national accounts data show a further acceleration in its growth rate after 1977 to 8.4 per cent from 7.3 per cent. However, if it is true that the growth rate for the earlier period was underestimated, then there is a possibility that there was actually some slow-down during this period (Table 9.4). A comparison of the sub-sector growth rates for the two periods, based on the survey data, shows that only in the food group was the growth rate significantly higher in the post-1977 period, and a marked slow-down occurred in the textiles, garments, plastics and engineering industries. This moderation in growth may have, in part, been due to the shifting of resources, and in part due to a return to a more sustainable growth rate in the small-scale sector.

The performance of manufactured exports from 1977 to 1988 was characterized by rapid growth at the beginning and the end of the period with stagnation in the middle years. Between 1977 and 1980, in response to the change in economic policies and greater export incentives, manufactured exports increased on the average by over 25 per cent per annum (Table 9.2). This also contributed to the high growth in industrial output observed during this period. Appreciation of the rupee in 1981, the disastrous cotton crop of 1984, and the worldwide recession during the early 1980s adversely affected manufactured exports which grew at only 5 per cent per annum between 1981 and 1985. As a result of the sharp devaluation of the rupee in 1985 and 1986 and the revival of growth in the industrialized countries and in world trade, manufactured exports once again expanded at over 20 per cent per annum between 1985

and 1988. However, the expansion this time was fairly narrowly based and the impact was generally limited to the textile sub-sector, which experienced a strong revival after over a decade of stagnation.

To sum up, the performance of the industrial sector in terms of growth, investment and exports showed considerable improvement in the period 1977 to 1988 compared to the previous period. However, because of certain structural weaknesses and the inability of the government to go beyond a certain point in deregulating industry and reforming the trade regime, the initial momentum of industrial growth could not be sustained.

## **PROBLEM AREAS IN INDUSTRY TODAY**

### ***Employment Generation***

The greatest failure of industrial development in Pakistan during the last 40 years was its inability to generate employment. Industrial policy had favoured LMSI throughout this period, and during the last 25 years about 18 per cent of the total investment in the economy had gone into LMSI (Table 9.1). However, in 1985 the total employment in LMSI was only 522,000 out of a total employed labour force of 27 million (Table 9.5). Between 1970 and 1985, employment in the mining and manufacturing sectors increased by about a million, but LMSI's contribution to this was only 50,000.

The trends in employment, productivity and real wages between 1970 and 1985 are also quite instructive. From 1970 to 1976, despite slow industrial growth, employment and real wages in LMSI increased significantly, while over the next nine years productivity and real wages increased at 10.7 per cent and 6.4 per cent per annum respectively, and employment declined. The increase in employment during the first period was the result of the rapid expansion in labour absorption by PME's and the inability of the private sector to lay off surplus workers in the face of strong government support for organized labour and upsurge in militant trade unionism. All this changed under the martial law regime, and firms took advantage of the situation to trim their labour force

TABLE 9.5  
*Employment, Productivity, and Wages in LMSI, 1970-85*

Year	Employment ('000)			Productivity <sup>b,c</sup> (Rs. '000)	Real wages <sup>c,d</sup> (Rs.)
	Total	LMSI <sup>a</sup>	Mining and manufacturing		
1969-70	17,750	472	2,760	23	5,268
1975/76	21,080	605	2,950	22	5,645
1979/80	24,150	445	3,470	39	7,809
1984/85	26,960	522	3,730	54	9,856

Sources: *Pakistan Census of Manufacturing Industries*, various issues; *Pakistan Economic Survey 1988-89*.

Notes:

- To account for non-response, CMI employment figures have been adjusted by multiplying them with a factor equal to the national accounts value-added divided by CMI value-added.
- Productivity is defined as real value-added per worker.
- 1975/76 prices.
- Includes cash and other benefits.

to a bare minimum. Also, the expansion of employment in PMEs was stopped. This led to a sharp drop in LMSI employment in the latter part of the 1970s and a slow increase in it thereafter. As for the rapid growth in real wages and productivity after 1976, the former probably resulted from shortages of skilled labour arising from the emigration of workers on a large scale to the Middle East, and the latter from improved capacity utilization and increasing capital intensity in LMSI.

The highly capital-intensive nature of LMSI is the result of the substantial import substitution bias in industrial policy and continuing distortions in factor prices. Because of the former, most of the growth of LMSI in the 1980s took place in the intermediate goods industries, such as steel, cement, fertilizer and other industrial chemicals, which are by nature very capital-intensive. Moreover, government policies have tended to reduce the cost of capital and increase the cost of labour<sup>9</sup> relative to their scarcity determined prices. This has encouraged the use of capital-intensive technology even in industries which were traditionally labour-intensive. For example, most of the textile mills set up recently have opted for highly automated technology that minimizes the use of labour.

As a legacy of the nationalizations in the first half of the 1970s and the large public sector investment programme between 1975 and 1985, Pakistan today has a substantial state-owned industrial sector. The PMEs dominate key areas in industry. For example, in 1988 their share in the national cement output was 81 per cent; in fertilizers, 58 per cent; in light commercial vehicles and cars, 100 per cent; in buses and trucks, 71 per cent; in tractors, 85 per cent; in milled steel and engineering products, 42 per cent; and in steel products, almost 100 per cent.<sup>10</sup> Thus, PMEs not only compete with the private sector for scarce resources such as credit and foreign exchange, but also provide a number of strategic inputs for the rest of the industrial sector. Consequently, the efficiency of the public industrial sector has a considerable impact on the growth of the industrial sector as a whole.

The steps taken by the Zia ul-Haq government to improve the efficiency of the PMEs were partially successful. For example, comparing the last three years of the Bhutto period with the years 1986 to 1988, it is seen that on the average in the latter period for PMEs (excluding the Pakistan Steel Mill), while employment was unchanged, production, taxes and duties, and pre-tax profits (all adjusted for inflation) were 259, 170 and 362 per cent respectively of the 1975 to 1977 levels. In 1988, PMEs (including Pakistan Steel Mill) accounted for 14 per cent of the value-added in LMSI and had fixed assets of Rs. 153 billion, i.e., about 50 per cent more than the total fixed assets of the over 270 private sector (non-financial) firms listed on the Karachi Stock Exchange.<sup>11</sup> However, the PMEs' sales and pre-tax profits were only about one-third that of these private sector firms, indicating to some extent the potential that exists for further efficiency gains in the public sector.<sup>12</sup>

The consequences of public sector inefficiency are significant for the economy since it is the dominant producer of key industrial inputs. The steel industry provides a good example of this. The Pakistan Steel Mill,<sup>13</sup> because of a size less than the 'minimum efficient scale', outdated technology, and inefficient management, is a high-cost producer of steel. The government had the option of subsidizing it or protecting it by imposing high duties on imported competing steel products. It chose the latter option, and the resulting high price of steel products in the domestic market has had an extremely negative impact on the local engineering and construction industry. In turn, the users of domestically produced machinery

and equipment, specifically SSI and the agricultural sector, have been adversely affected by the higher prices they have had to pay. The ripple effect continues as the higher costs of production in these sectors affects their export competitiveness and the price of food and raw materials in the economy. A similar series of effects can be traced for high-cost public sector producers in industries such as fertilizers, industrial chemicals and cement.

The most commonly used measure of efficiency is the effective protection rate (EPR), which shows the proportion of value-added in an industry due to protection. Several studies in the 1960s found very high EPRs for most industries in Pakistan; and in a number of cases, even negative value-added at world prices. Important changes in the industrial structure and policy framework have taken place during the last two decades; however, the only available comprehensive study on EPRs is for the year 1980–81.<sup>14</sup> According to it, the average implicit EPR was around 60 per cent for the manufacturing sector as a whole, a significant drop from an implicit EPR of 217 per cent in 1963–64.<sup>15</sup> There are always problems of comparability between different studies on effective protection, but with such a large change, one can say with confidence that a significant liberalization of the import regime and improvement in efficiency of the industrial sector took place over the period.<sup>16</sup>

Although information on changes in EPRs since 1980–81 is not available, it is likely that, because of the continuing import liberalization during the 1980s, a further decline in the EPRs took place during the period. Some indications of this can be discerned if one looks at the changes in the Nominal Protection Rates (NPRs). The NPR (including sales tax and import surcharge) was extremely high in the early 1980s with an average of 107 per cent for the manufacturing sector as a whole,<sup>17</sup> and by 1987 the average NPR (including sales tax and import surcharge) had declined to 97 per cent. The effective average duty rate on actual imports (excluding duty free imports) also declined to 42 per cent in 1987 from 47 per cent in 1982. However, in Pakistan quantitative restrictions have always been more important than tariffs in protecting domestic industry. As discussed earlier, there was some reduction in these, particularly with the changeover to the negative list system in 1984. However, even in 1987, out of the total 1,011 four-digit commodity categories, 395 were on the negative list, and the import of another 112 categories and 780 individual items was restricted.

As a result, the extent of import competition in key industrial products, particularly consumer goods, remained low. For example, the import share in food, beverages and tobacco, and the textiles, garments and footwear industry groups is less than 10 per cent.<sup>18</sup> Also, because of unpredictable shifts in industrial policy, arbitrariness of government regulatory decisions and the granting of ad hoc temporary exemptions (through Standing Regulatory Orders or SROs) firms perceive that there are high returns to lobbying for modifications in policies or obtaining exemptions. Thus, more time is spent by entrepreneurs on rent-seeking activities than on improving productive efficiency. Consequently, despite the improvement since the 1960s, the level of efficiency in the industrial sector is still low.

### **POLICY ISSUES AND PROSPECTS**

Forty years of a relatively high rate of industrial growth has resulted in a fairly substantial industrial sector in Pakistan (over 20 per cent of GDP). Moreover, because of differential sub-sector growth rates in the three periods, the industrial structure has become more balanced over time. Also, the concentration of ownership has declined, and the distribution of industrial assets is more broad-based compared to the 1960s. However, as discussed in the previous section, certain important weaknesses remain which, in turn, point to the key policy issues for the 1990s. These issues are examined briefly as they are likely to be the primary determinants of the prospects for industrial development in Pakistan in this decade.

### **Trade Liberalization**

The import substitution bias persists even today. An idea of the extent of this bias can be had from the fact that the implicit effective exchange rate for imports is about 50 per cent higher than that for exports. In addition, over time the tariff structure has become fairly distorted because of the ad hoc, revenue-oriented policies of the Ministry of Finance. These distortions include reverse cascading of tariffs, different tariff rates, and exemptions for different categories of importers and extremely high import duties on

industrial raw materials. As a result, not only is there misallocation of resources and production inefficiencies arising from rent-seeking activities of the industrialists, but exports are discouraged and, because of the high tariffs on industrial raw materials and intermediate goods, manufactured exports have been restricted to items based on local raw materials, such as cotton textiles, leather goods and woolen carpets.<sup>19</sup>

The heavy taxation of imported industrial raw materials was the outcome of government's need for revenue in the face of a virtual ban on the import of inessential consumer goods. However, it is ironical that, despite forgoing the opportunity of generating revenue from import duties on consumer goods, the protection currently provided by the government to the domestic producers of a large number of consumer goods is relatively limited. Because, as a result of smuggling and personal baggage imports, domestic industry, while paying heavy import duties on raw materials and sales and excise taxes on production, is generally faced with prices of banned consumer goods in domestic markets substantially below what would be their duty-paid value if their import was allowed.<sup>20</sup>

Trade liberalization efforts so far have largely been directed at improving the availability of capital goods and industrial raw materials, and a comprehensive reform of the trade regime is long overdue. The reform should be such as to substantially reduce tariffs on raw materials and intermediate goods, increase competition for domestic industry, and provide free trade status to exporters. It seems unlikely that industrial growth can be accelerated without undertaking such a reform.

### **Deregulation**

Industrial policy has focused primarily on regulating entry and exit of firms and prices of industrial products. These policies were introduced to serve a variety of purposes. Investment sanctioning has been used to restrict demand for foreign exchange (by retaining control over the level of machinery and raw material imports), and prevent the emergence of excess capacity and discourage concentration of ownership and market power (by restricting the size of the project). Location restrictions and incentives are used to ration scarce infrastructure such as electricity, gas and water and to

promote dispersal of new investment. Restrictions on firm closure and measures to provide financial assistance to sick industries have the objective of avoiding labour unrest and preventing capacity from sitting idle. Finally, cost-plus pricing has served the objectives of encouraging new investment by guaranteeing a minimum rate of return, ensuring the survival of incumbent firms and restraining the exercise of monopoly powers.

These policies have, on the one hand, generally failed to fulfil their objectives and, on the other, have promoted inefficient industrialization. Investment sanctioning has prevented firms from attaining the most cost-effective scale of production (e.g., cement, chemicals, sugar and vegetable ghee), encouraged excessive entry behind high trade barriers into a small domestic market (e.g., automobiles, tractors, air conditioners and televisions), and led to excessive vertical integration (e.g., polyester fibre). However, as discussed earlier, it has failed to prevent excess capacity and concentration of ownership. Locational incentives, instead of promoting dispersal of industry, have led to satellite-type developments around major cities (e.g., Hub Chowki and Nooribad near Karachi and Kasure near Lahore). Also, by reducing the cost of capital, locational incentives, have tended to increase the capital-intensity of investment.

Efforts to restructure or close firms are hampered by bank regulations and practices, and labour legislation. Consequently, physical assets which are still valuable cannot be sold to be used again but sit idle. In some cases, loss-making firms continue to be supported by bank credit, which limits the finance available to new or growing investments while arrears accumulate in declining firms. This obviously has a negative impact on the allocative efficiency and dynamism of the industrial sector in a changing environment.

In the 1980s, as discussed earlier, some progress was made in the deregulation of industry. However, there is a need to generally move away from the control-oriented approach of the bureaucracy, and allow market forces to play the dominant role in determining investment decisions. This would require, besides trade liberalization, the abolition of sanctioning requirements for almost all industrial investment, greater autonomy for, and eventual privatization of, banks and development finance institutions, elimination of remaining price controls, and simplification of exit regulations.

### Privatization

Although public sector industry contributes less than 15 per cent of the value-added in LMSI, it is concentrated in such key areas as steel, chemicals, cement and engineering. The inefficient public sector industries are heavily protected, resulting in high prices for these critical items. Consequently, private industries, such as engineering, which are users of the output of public sector industries, are also rendered uncompetitive.

In addition to industry, public sector monopolies in energy, telecommunications, banking and finance have become major obstacles to the continued rapid development of the industrial sector. The infrastructural bottlenecks not only cause delays in and raise the cost of industrial projects, but also increase the unit cost of production. The cost imposed by electricity shutdowns (planned and unplanned), which have become a regular feature during the last five years, is obvious; but the cost to industry of a poor telecommunication system in the present-day world is probably no less.

Similarly, an inefficient and technologically backward banking system, which does not provide the quality and range of services available in other countries, puts the industry at a considerable disadvantage in the world market. Also, since the banks and development finance institutions are government-owned, there is lack of accountability. In many cases, loans are made on other than economic considerations and loan recovery in such cases is extremely difficult. These borrowers are generally under no pressure to use the funds efficiently, while many viable ventures are denied access to institutional credit. Therefore, the average efficiency of investment in the sector as a whole remains low. Furthermore, since the effective cost of debt capital is very low for most borrowers, the same problems that existed in the 1960s still apply, i.e., lobbying for loan sanctions, over-invoicing of imported plant and equipment, and the use of highly capital-intensive technology.

There are no easy solutions to the problem of public sector inefficiency. The government's attempts at improving efficiency through decentralization and introduction of management information systems have been only partially successful. Privatization is the long-term solution. Since 1985 there has been a proposal in the budget to privatize some public sector industries. The programme

of privatization has been given greater emphasis recently. However, bureaucratic delays and political considerations have limited the effect of measures being undertaken in this regard. Privatization of the banking sector, although being considered, is even more difficult for the government, since it is a low-cost source of funds for financing the budgetary deficit and a most useful means of dispensing political patronage. As far as public utilities such as electricity and telecommunications are concerned, some proposals for the involvement of the private sector are under consideration, but progress in this area is likely to be even slower than that in the industrial and financial sectors. However, the speed and success of privatization is likely to be a key determinant of the pace of industrial development in Pakistan during the 1990s.