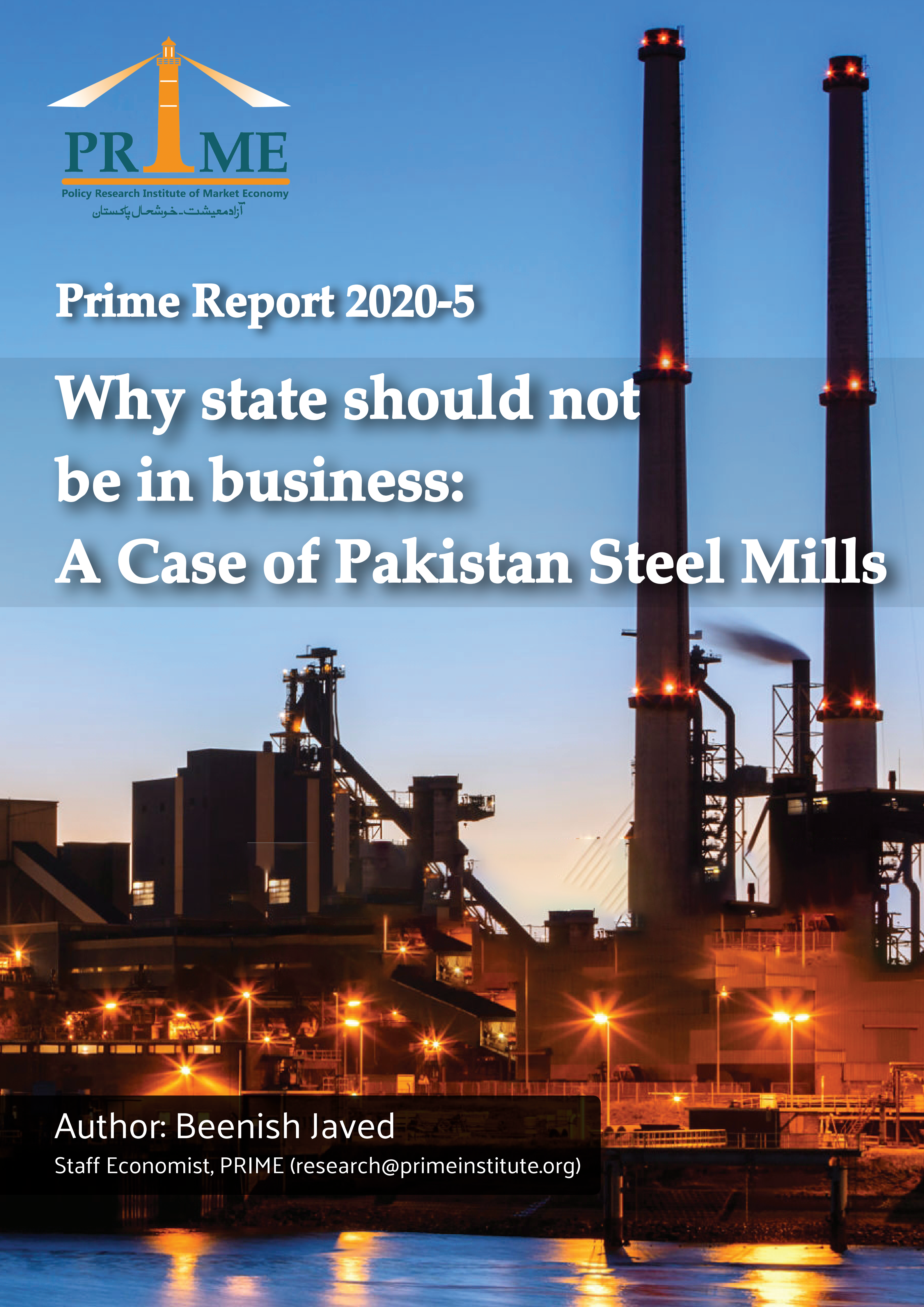

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Why state should not be in business: A Case of Pakistan Steel Mills

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Key Messages

01 Pakistan has 204 State-Owned Enterprises; in 2017, 77 SOEs reported loss of Rs. 453 billion whereas 99 SOEs reported profit of Rs. 262 billion.

02 SOEs employ half a million people and cost Rs. 400 billion to national exchequer every year.

03 The accumulated total cost of Pakistan Steel Mills since its unsuccessful privatization in 2006 has reached to Rs. 334 billion, including losses, bailouts and salaries.

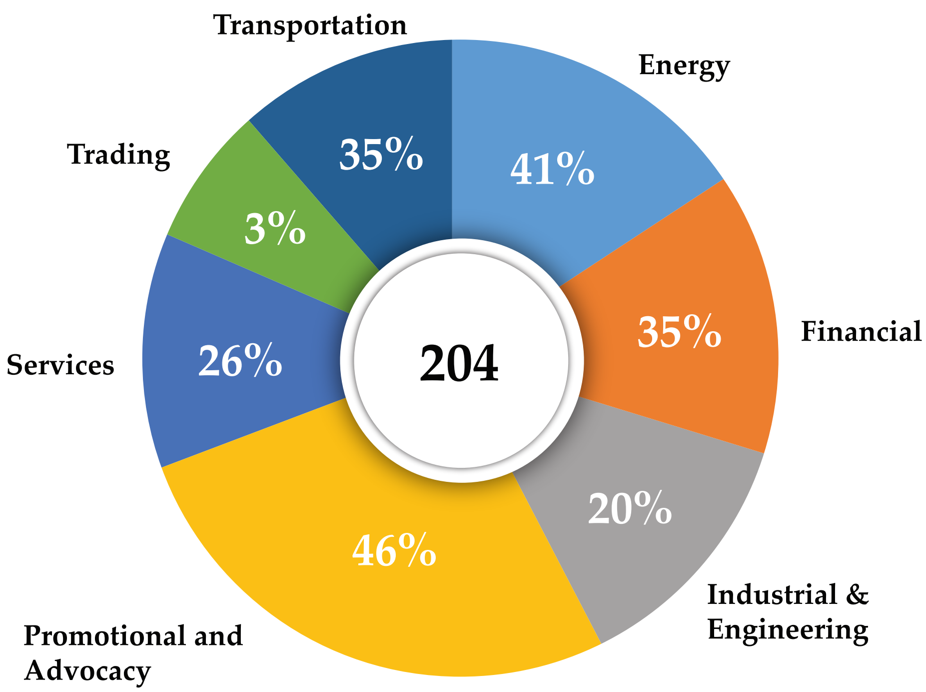
04 Pakistan has developed sufficient capacity of private steel mills in last two decades and privatization of Pakistan Steel Mills is unlikely to have any harmful effect for local industry.

05 The employees of Pakistan Steel Mills should be provided with adequate bonuses, re-training opportunities and other incentives.

Overview

State-Owned Enterprises (SOEs) are used globally by governments for venturing into commercial activities. In Pakistan, there are 204 SOEs categorized into Public Sector Companies (186), Development Finance Institutions (8) and Federal Authorities (10). The Public Sector Companies are further classified as commercial (138) and non-commercial (48)[1]. A significant number of SOEs fall in the promotional and advocacy sector followed by energy, transportation and financial sector (see Figure 1).

Figure 1: Sectoral Decomposition of SOEs

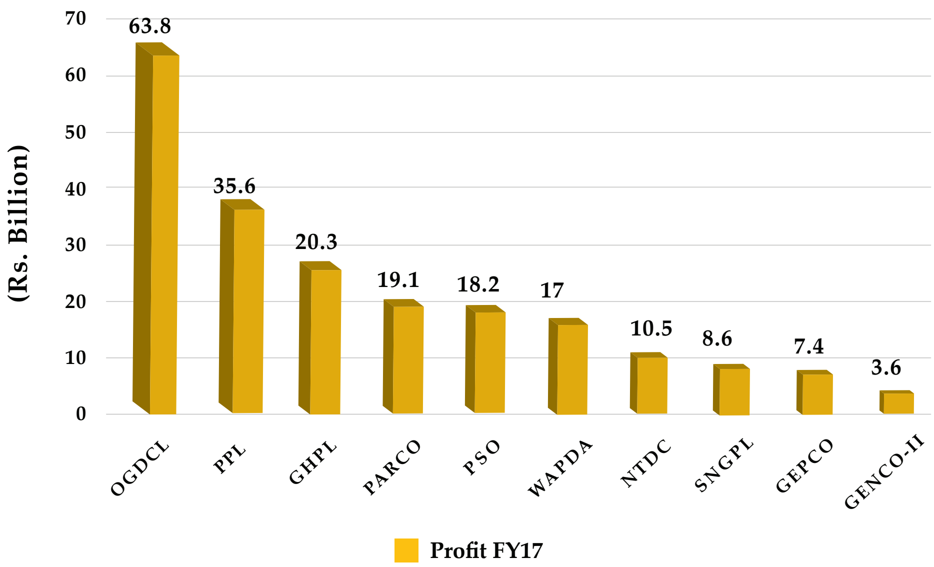


Source: SOE Annual Report FY17, Ministry of Finance.

[1] SOE Annual Report FY17, Ministry of Finance.

Out of the 204 SOEs, 177 have been incorporated under Companies Ordinance 1984, 20 by enactment and 7 by incorporating foreign entities. Under the nationalisation programme of 1972-77, 30 firms[2] were nationalised in the category of iron and steel, basic metals, heavy engineering, heavy electrical equipment, motor vehicles, tractors, petrochemical industries, electricity, gas and oil refinery and cement. In addition, vegetable oil, insurance and banking companies were also included under public ownership. Despite continuous support from the government, many SOEs continue to operate losses. During FY17, the cumulative loss of all the SOEs exceeded the cumulative profit. Precisely, 77 SOEs were making a total loss of Rs. 453 bn while 99 SOEs were making profit worth Rs. 262 bn[3]. Oil and Gas Development Company (OGDCL) and National Highway Authority (NHA) were the top profit- and loss-making entities respectively. Other major loss-making public enterprises during FY17 included the Pakistan Railways, Pakistan International Airlines and Pakistan Steel Mills, the latter despite being non-operational since 2015 accrued Rs. 14.8 bn worth of loss (see Figure 2 & 3).

Figure 2: Top 10 Profit-Making SOEs in FY17



Source: SOE Annual Report FY17, Ministry of Finance.

At a cost of providing employment to approximately half a million people, these SOEs add on average a burden of Rs. 400 bn[4] on the national exchequer each year causing a rise in fiscal deficit. Moreover, the excessive commercial lending guaranteed by the government to the SOEs crowds out private investment. As noted by Naveed Iftikhar in his study[5], the SOEs are plagued by multiple accountability checks, poor governance and management all of which enhance operational inefficiencies and create confusion about public sector company's strategies and policies.

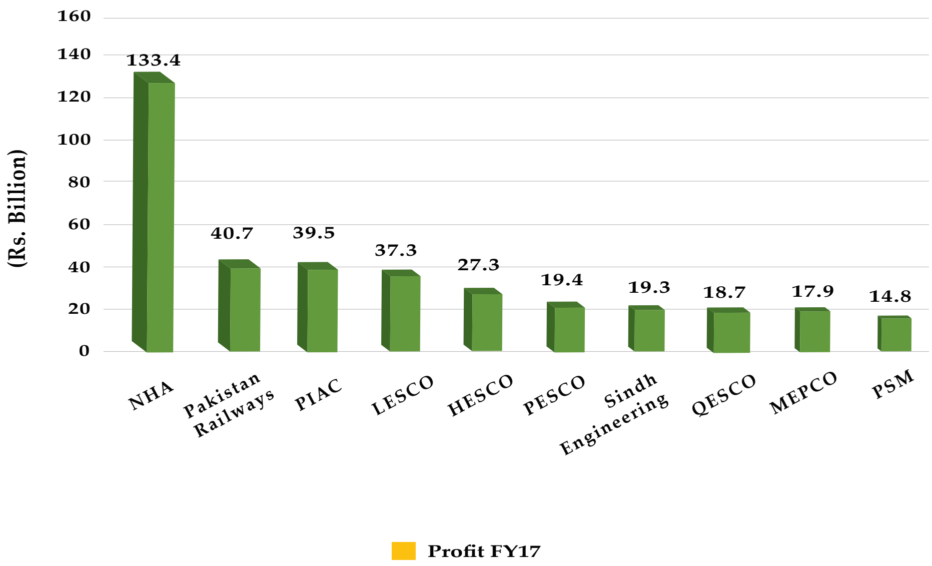
[2] Special Report: The Triumph of Populism 1971 1973 *Dawn.* Retrieved: https://www.dawn.com/news/1360571

[3] Ibid. This figure is for FY17 when few SOEs were pending audit and few were inactive or not operational.

[4] State-owned Enterprises. *Dawn.* Retrieved: https://www.dawn.com/news/1489112

[5] Muhammad Naveed Iftikhar (2015), State-owned Enterprises in Pakistan: The Need for Corporate Governance and Private Investment, Islamabad: PRIME Institute.

Figure 3: Top 10 Loss-Making SOEs in FY17



Source: SOE Annual Report FY17, Ministry of Finance.

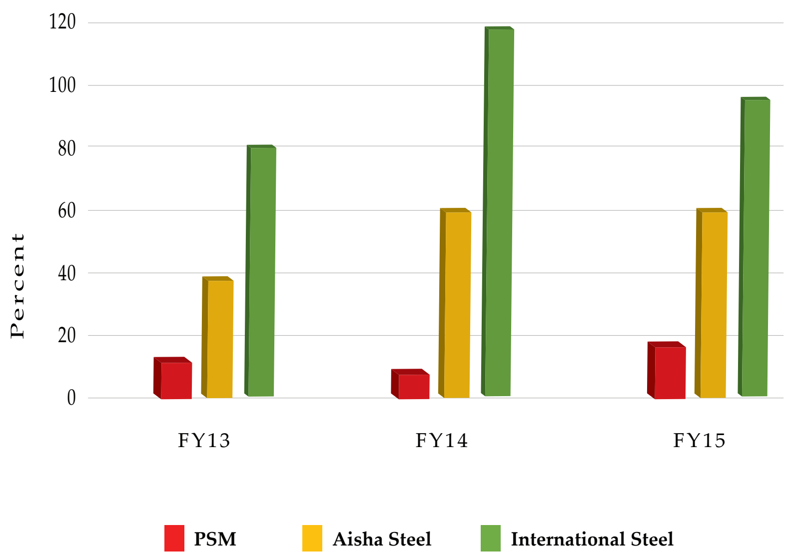
It is pertinent to note that SOEs which are operating in sectors without natural monopoly or the sectors where private sector has a strong presence have a dismal performance. There are various sectors where there is little to no rationale for state's intervention such as aviation, energy distribution and steel. Pakistan Steel Mills (PSM) is a good example of why it is not the business of the state to be in the business.

The Case of Pakistan Steel Mills

PSM was incorporated in 1973 at a total cost of Rs. 24.7 billion. The mill started commercial operations in 1984 and has a production capacity of 1.1 million tons per year. Its net assets include land measuring about 19000 acres out of which the plant and machinery is located on 4457 acres of land (core land) besides the land of downstream industrial estates.[6]

Pakistan's steel industry consists of various private firms in addition to Pakistan Steel Mills (PSM) which is the sole public enterprise in the industry. There are 6 major private players[7] in the steel industry including Aisha Steel Mills and International Steel. These 6 players cumulatively cater to 50 and 60 percent of the total domestic demand for galvanized and Cold Rolled Coils (CRC) in the country.[8] For comparison purposes, this section focuses on PSM's production and utilization capacity vis-a-vis two large private steel firms namely Aisha Steel and International Steel.

Figure 4: Capacity Utilization of PSM vs. Private Steel Firms



Source: SOE Annual Report FY17, Ministry of Finance.

[6] Year Book 2018-19. Ministry of Industries and Production. Government of Pakistan.
[7] Others include Amreli Steel, Crescent Steel, Ittefaq Iron Industries and Mughal Iron & Steel.
[8] Annual Report 2017-18. The State of Pakistan's Economy. State Bank of Pakistan.

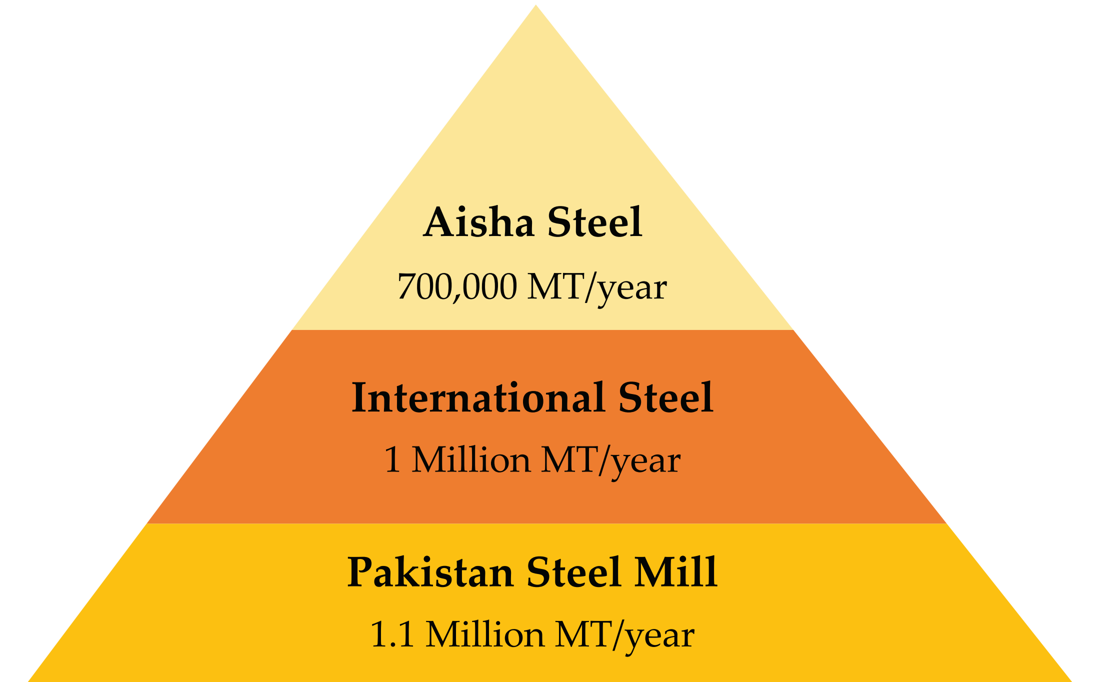
Production & Utilization Capacity

Main private players in the steel industry such as Aisha Steel Mill (2009) and International Steel (2010) started their commercial operations long after PSM however, by 2013 their capacity utilization far exceeded that of PSM (see Figure 4). By FY18, the two large private steel firms were operating at a capacity of 95 percent and 72 percent respectively.[9]

During 2003-04, PSM's utilization capacity was its highest at 93.6 percent.[10] Since 2007-08, its production capacity plunged from 82 percent[11] to 14 percent in 2014-15. Despite being a steel firm with largest production capacity (see Figure 5), PSM has failed to efficiently utilize it, let alone expand it. On the other hand, its private counterparts are already investing in expanding their existing production capacities. Since 2015, PSM's production has come to a halt owing to non-payment of gas arrears. Since then it has posed an excessive burden on the national exchequer.

Despite being non-operational, the public enterprise essentially with the assistance of the government, is still paying wages and salaries to its overstaffed and retired employees amounting to Rs. 55 bn since 2015 till date.[12] Technically, this is taxpayers' money being spent on a corporation that has zero output in addition to staggering losses and liabilities.

Figure 5: Production Capacity of PSM vs. Private Steel Firms

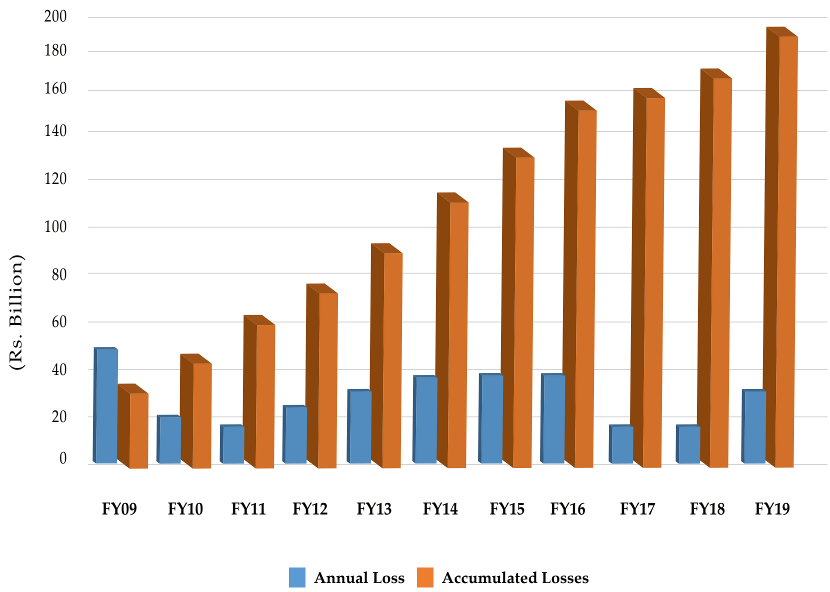


Source: Annual Reports of Respective Firms

[9] Topical Report on Steel Sector FY16, State Bank of Pakistan.
[10] PS capacity utilization enhanced. *Dawn.* Retrieved: https://www.dawn.com/news/384449/ps-capacity-utilization-enhanced
[11] Pakistan Steel Mills in a tailspin. *Dawn.* Retrieved: https://www.dawn.com/news/1029129
[12] Privatizing Pakistan Steel. *The News.* Retrieved: https://www.thenews.com.pk/print/756391-privatizing-pakistan-steel

Losses & Liabilities

Figure 6: Annual Losses of PSM



Source: Financial Statements June 2019, Pakistan Steel Mills

Although PSM did experience a brief period of profitability (2000-2008), it has been incurring losses ever since owing to a plethora of factors notably overstaffing, mismanagement, corruption, lack of capital investment and less than ideal tariff policy, just to mention a few. As evident from Figure 6, its accumulated losses have reached a staggering Rs. 189 bn as of FY19. Presently, these have crossed Rs. 212 bn mark.[13] As at June 2019, PSM's current liabilities exceeds its current assets by Rs. 159.3 bn.[14] Moreover, the enterprise has an outstanding debt of Rs. 230 bn.[15] Since 2008-09, the Economic Coordination Committee of the Cabinet (ECC) has given Rs. 90 bn[16] in bailout packages to PSM. With the addition of recently announced retrenchment package of Rs. 20 bn[17] and paid dues of retired staff amounting to Rs. 23 bn[18], the amount inflates to over Rs. 130 bn.

Efforts to privatize PSM

Given the dismal state of PSM, the PTI-led government has decided to privatize the mills. This plan began with retrenchment of over 4,500 employees in order to curb financial burden on the mill. As mentioned previously, Rs. 20 bn has been allocated by ECC for that purpose. However, this is not the first time that PSM has been considered for privatization; in fact, this is the third time. It was first considered for privatization in 1997 by the Council of Common Interests (CCI). However, this initiative was not materialized due to multiple reasons.

In 2000, the government brought forward a restructuring plan for the mills to make it financially viable. This plan focused on human and financial restructuring as well as repair and maintenance of the mills. The restructuring plan paid off as PSM started its profit earning journey which lasted till 2008. In 2004-05, the mills had a profit of Rs. 6 bn.[19] Notwithstanding, the Ministry of Privatization and Investment through the approval of Privatization Board placed the mills for privatization.

[13] Court questions maintainability of PSM's plea seeking permission to sack over 50pc workers. *Dawn.* Retrieved: https://www.dawn.com/news/1595225/court-questions-maintainability-of-psms-plea-seeking-permission-to-sack-over-50pc-workers

[14] Financial Statements June 2019, Pakistan Steel Mills.

[15] Privatizing Pakistan Steel. *The News*. Retrieved: https://www.thenews.com.pk/print/756391-privatizing-pakistan-steel

[16] Losses of state-owned enterprises surpassed annual defence budget. *The Nation.* Retrieved: https://nation.com.pk/06-Jun-2020/losses-of-state-owned-enterprises-surpassed-annual-defence-budget

[17] Rs19.7 billion set aside for PSM staff retrenchment. *Dawn.* Retrieved: https://www.dawn.com/news/1591551/rs197-billion-set-aside-for-psm-staff-retrenchment

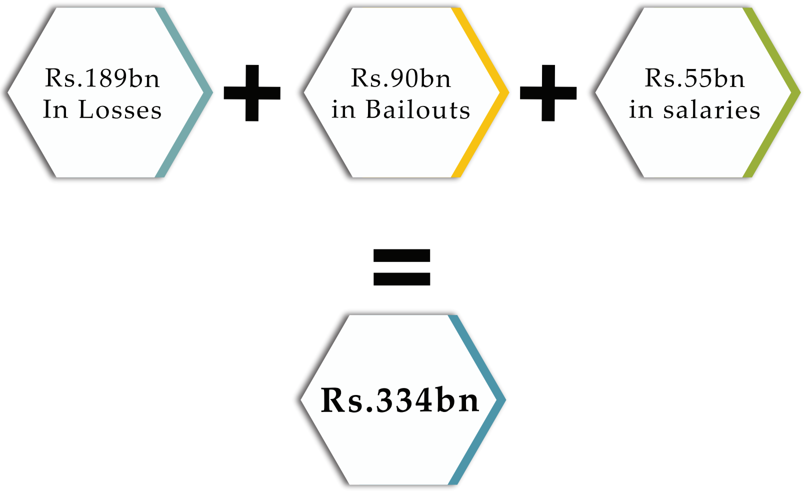
[18] SHC orders utilising Rs23.1bn from Centre to pay up dues of PSM's retired employees. *The News.* Retrieved: https://www.thenews.com.pk/print/757866-shc-orders-utilising-rs23-1bn-from-centre-to-pay-up-dues-of-psm-s-retired-employees

This would have been an appropriate time for PSM's privatization had it not been for Supreme Court of Pakistan's interruption. Supreme Court halted the initiative on the grounds of "acts of omission and commission".

What went wrong?

Following the reversal of the 2006 privatization initiative, PSM's fate changed for the worse. Over the years, its performance plunged owing to a plethora of factors including overstaffing, mismanagement, nepotism, lack of capital investment, corruption and flawed governance structure etc. All these factors have their fair share in bringing the industrial giant to where it stands now. The opportunity cost of PSM to the economy amounts to Rs.334 bn (see Figure 7). This is the sum that could have been utilized for more productive purposes in the economy.

Figure 7: PSM's Opportunity Cost to the Economy



Conclusion

Various SOEs in Pakistan are operating losses despite government's multiple bailout and restructuring initiatives to sustain them. Pakistan Steel Mills is one such enterprise where numerous bailout packages could not prevent it from collapsing. PTI-led government has finally realized that it is futile to spent taxpayers' money on an industrial giant which has been shut down since last 5 years. As of late, government has approved a retrenchment package of Rs. 20 bn to lay off over 4,500 PSM employees with the hopes to ease the financial burden and make the enterprise viable for privatization. The goal is to terminate 9,350 employees in two phases. However, Federal government's decision has been met with resistance and criticism from all quarters. Many consider the timing of this decision to be off. With the ongoing pandemic, economy and job markets are already in recession and these layoffs would just add to the misery of these workers and their families. The Rs. 2.3 million (on average) compensation provided to each employee is also not adequate to sustain them for long, as critics argue.

[19] A playground for perversity. *The Nation.* Date accessed: December 16, 2020. Retrieved: https://nation.com.pk/14-Dec-2020/a-playground-for-perversity

[20] PSM privatisation to help govt save Rs700m per month: minister. *Profit.* Retrieved: https://profit.pakistantoday.com.pk/2020/06/04/psm-privatisation-to-help-govt-save-rs700m-per-month-minister/

Though these arguments are valid, it should also be considered that PSM has many inherent flaws that cannot be rectified through retaining these employees. Those issues are far-fetched and could only be resolved through major restructuring and privatization of the mills. Rationally, it does not make any sense to water a dead plant using taxpayers' money. By privatizing PSM, government would be saving Rs. 700 mn[20] each month. That money can alternatively be utilized for more productive purposes such as health, education, job creation and investment in water and energy sector that can yield long-term benefits for the people and the economy. This is high time to accept inherent flaws in the placement, establishment and operations of various SOEs including Pakistan Steel Mills. It's about time the government retreats and encourages private investment in areas where private sector is actively playing a part including the steel sector.

For the government to successfully materialize PSM's privatization, there are a few policy options that may be considered to facilitate the process:

- **Transparency:**
  The incumbent government should learn from the past mistakes particularly from the 2006 privatization attempt and ensure that the entire process takes place with transparency.
- **National Endowment Fund:**
  The government can sell some land from the 19,000 acres under PSM to set up a National Endowment Fund (similar to Benazir Income Support Programme) through which a monthly stipend can be provided to the sacked employees until they find an employment opportunity.
- **Vocational Training Programme:**
  The National Endowment Fund should be accompanied by a technical and vocational training programme. It is pertinent that the retrenched employees be provided with technical and vocational training in order to upgrade their skill set and equip them for other employment opportunities. This combination may provide a sense of relief and empowerment to the sacked staff.