Pakistan Prosperity Forum

17th November 2021

Syed Javed Hassan

Chairman Economic Advisory Group

ROAD TO A PROSPEROUS PAKISTAN

It is an honor and humbling to speak in the presence of Dr Arthur B. Laffer- "The Father of Supply-Side Economics". Economic ideas and political philosophies that govern the course of politics evolve over long periods of time. They permeate the consciousness of society and lawmakers through the power of logic as well as how best they serve the self-interest of the people – individuals, select groups and/or entire nations. The seed of the thought may start with one person or a small cluster, but progressively spreads to determine the future course of events. Much of what I have to say today has been inspired by Dr. Laffer and some of his colleagues such as Fredrik Hayek.

Unlike economies that have managed remarkable transformation to revive growth and achieved much prosperity under the guidance of Dr. Laffer, for example the United Kingdom post the 1980s – when Britain was simply not working - his ideas have been slow to arrive in Pakistan. We hope his presence and inspiring words here do much to address the pervasive lack of understanding about the functioning and processes of free markets, as well as dispel apprehensions about the fairness of market-based economies.

Flawed notions about markets are widely believed in Pakistan, and these in turn help shape policies that are often aimed to benefit special interest groups, but presented as beneficial for society. Direct state intervention in key sectors of the economy through sclerotic regulations and state-owned enterprises (SOEs) distort prices, and has prevented optimal allocation of resources for the innovative and efficient businesses to grow, which is essential to provide jobs for a fast-growing population.

Prime Minister Imran Khan stated in 2019 that the process of growth and development seen in the 1960s in Pakistan was reversed because of a socialist government in the 1970s. The nationalization drive of that era and accompanying socialist rhetoric not only harmed the entrepreneurial spirit and willingness of the business community to take risks, but more perversely, deeply embedded a belief in the society that it is the role of the government to solve all the people's problems.

The frequent state interventions have failed to place the country on a growth trajectory that could have accelerated prosperity, and has also not helped in the much-needed alleviation in poverty levels. The fixing of support prices for certain agriculture commodities have had the perverse effect of incentivizing suboptimal usage of land holdings and sluggish improvement in yields. The state has also intervened in restricting or banning social media platforms such as TikTok as well as others, which are not only sources of social connectivity and entertainment, but increasingly important sources of income, especially for the enterprising youth. We see across the globe prosperous economies are built on countries' ability to ensure well-regulated free markets, sound money, and limiting the role of the government to only those areas where necessary, and in a manner such that it can do least harm. In contrast, the Pakistani state's intervention is pervasive through the presence of state-owned enterprises, highly-regulated industries, administrative price control, high tariff on basic imports, and as often as not, to the injury of the public.

Pakistan International Airlines' exemplifies some of the worst aspects of this phenomenon. From being "great people to fly with" to its present state of perennially posting sizable losses is emblematic of the vulnerabilities of state-owned enterprises (SOEs). The current accumulated losses of the company are over half a trillion rupees, and there appears to be little prospect of a return to profitability.

PIA's performance, like many other SOEs in the country, has steadily declined over the last few decades. Not only does it compare poorly with its competitors both in terms of operating efficiency and profitability, but also burdens the state treasury in requiring regular capital injection without which it would be bankrupt - as should any company in the private sector that consistently posts large losses.

PIA is not unique among Pakistani SOEs for being handicapped by operational inefficiencies and a chronic lack of profitability. The malaise can be attributed to having diffuse objectives with no clear operational or profitability targets, a lack of robust monitoring mechanism, and management consisting of civil servants whose incentives are not linked to performance. For instance, the state-owned Pakistan Steel Mills (PSM) has accumulated losses and liabilities of almost PKR 230bn. Despite PSM stopping production in 2015, Pakistani taxpayers spent PKR 55bn over the last five-and-half years on salaries of 9350 workers, many of whom reportedly had secured other employment in the period. Recently the government finalized on a PKR 19.656bn redundancy package for these employees.

Thankfully the PTI government is committed to reform policies and curtailing the burden of loss-making SOEs. Between June 2018 and March 2020, the total debt of SOEs increased from PKR 1,392.8bn to PKR 1,979.7bn, an increase of PKR 586.9bn in less than two years. This increasing liability limits fiscal space required to invest in high priority social sector areas such as education and health. The government therefore is looking to accelerate the process of extricating the state from loss-making corporations, especially where the private sector can do the job more efficiently and profitably.

With the global trend of increased participation by the private sector in economic activities that were previously public monopolies, the era of SOEs has ended. This has brought about not only intense competition in most industries, including the airline business, but has also stimulated innovation and improved service quality for consumers. Therefore, it is imperative that rather than applying more resources in continuing sclerotic SOEs, reforms should focus more on providing a conducive environment that ensures a level playing field, protect investor and consumer rights, mitigate against environmental externalities, and boost investments in businesses that create private sector employment.

Even in the private industrial sector, tax and trade policies that are presently often designed to shield dominant incumbent players need to be reformed to encourage competition by innovative new entrants. The acceptance of oligopolistic practices has negatively impacted productivity and exports growth. Unlike in other fast-growing developing economies, free trade and global integration are commonly portrayed in Pakistan as acting against the interests of local industry and jobs, and are therefore seen as harmful to the local economy.

In the agriculture sector, the undue influence of large landowners in legislature has resulted in state intervention through support prices, import restrictions, and direct and indirect subsidies, which have all contributed to anticompetitive practices and consumer interests being adversely affected. Resultant price distortions in food commodity markets have had the perverse effect of incentivizing large landlords toward unsustainable and suboptimal usage of their holdings, which in turn has meant sluggish improvement in productivity.

Democratically elected governments are expected by the voters to enact statutes and provide regulations that promote the public interest. It is therefore vital that the perception of free markets and free trade are clarified and disseminated widely. The public needs to understand how sometimes policies presented as vital for improving general welfare may in reality only favor a few privileged interest groups.

For instance, protective import tariffs and commodity support prices are in effect indirect taxes that transfer wealth from the many consumers to the few producers, but are commonly justified in terms of providing employment to workers and income to small farmers.

When there is no broad consensus about the adverse effects of state intervention, necessary reforms required to address inefficiencies and inequalities as a result of underdeveloped markets lack public support. It is therefore important to understand insights provided by economists such as Friedrich Hayek and our esteemed guest Arthur Laffer, who have not only elucidated the limits of even the most well-intentioned government policies, but also cogently argued the case for free markets and free trade through their examination of the role of prices and the essence of market competition.

One of their deepest insights is that economic agents (businesses, investors, workers, etc.) use the relative prices of different opportunities as signals for evaluating their individual choices on how to most effectively utilize their assets. The pattern of changing prices informs them how best to deploy their capital to increase or decrease their outputs at optimal costs.

Through the process of price signaling and actions by individual agents to maximize returns, efficiency is improved and a complex pattern of productive uses of resources is spontaneously coordinated. In effect, without the need of the government to centrally plan or the use of any form of coercion, a free price system synchronizes utilization of assets so that producers are willingly able to offer consumers the greatest range of individual choices.

However, for prices to emerge through transactions in markets, or more simply put, the buying and selling of goods and services, individuals and firms must feel confident in the security both of their own property and that of those they exchange with, as well as the sanctity of contracts. There is market failure when any of these conditions break down, and the government has a vital role to play in preventing this from occurring.

Regrettably, the Pakistani state's footprint has encroached well beyond the scope addressing market failures. It presents itself in almost all spheres of economic activity without either increasing productivity or affording consumers greater choice. There needs to be a realization among policy makers, and more broadly by the public to whom they are accountable, that the state should refrain from the fatal conceit that it can either directly control prices, or effectively coordinate the choices of millions of people to optimize their overall pattern of activities better than can be achieved by efficient free markets.

We have one of the highest tariff structures in the region. If we compare ourselves to successful stories like China or Vietnam, our tariff level is about 10-15 percent higher.

Besides customs duty, there are other duties in place such as Additional Customs Duty and Regulatory duty ranging from 3 to 7 percent to generate revenues for budgetary needs, which exponentially increase the costs of our inputs and operational cost of businesses, hinder transfer of technology and decline the productivity of our industries.

Consequently, Pakistan is one of the few large countries where there has been a decline in global integration of the economy. Less than 10 percent of the GDP is made up of exports. It is one of the lowest across the globe. One of the main drivers of this declining trend was the exceptionally high tariff structure. We must now accept that great harm is being done in terms of global integration of the economy through the use of Tariff and non-tariff barriers as revenue generation tools.

It is time we stop using such blunt and outmoded tools to compensate for the state's inability to generate revenues from direct sources. We cannot think of an export-led policy when we have such an anti-export bias. We cannot have an export industry unless we actually have free trade policies. It will also greatly assist boost exports if we become part of the regional trade groups where there is free trade. China is one of them, but we should make urgent efforts to join RCEP as well as creating a trading block with Central Asian countries with zero tariff regimes.

The lack of our ability to grow exports has meant we have a balance of payments constraint in terms of GDP growth. This constraint used to be around 6 to 5.5% in the seventies, which has now declined down to about 4% now. Any time the economy grows beyond 4%, the balance of payment goes out of whack. This is largely because our productivity growth rate has steadily been declining.

The response to this by previous governments has been to intervene even more by setting prices, imposing punitive import tariffs, and increasing government spending. It is said that the definition of madness is to repeat the same thing, and expect different results. It seems previous governments perfected this. They kept intervening, with governments providing ever larger stimuli. Yet it was magically expected to achieve different results from previous failures of doing the same.

Similarly, the budget deficit is unsustainable because the government is involved in areas where it simply should not be. Government needs to decide the few things that it can do; and do them effectively and to make a profound difference in the people's lives. A small and efficient government requires spending restraint constitutionally enshrined. One of the measures that will help in that process is having an autonomous Central Bank. This will be a major step in ensuring that we have sound money, which is undoubtedly a prerequisite toward ensuring a sustainably growing economy. The Central Bank should not in any way be driven by the Executive. It should be able to determine for itself what the interest rate should be, and interest rate setting or inflation targeting should be a major policy plank of the Central Bank.

Obviously, the above measures have an implication for revenue where the government cannot print money or raise taxes through trade tariffs. In order to address this, the country has to not only broaden the tax base, but also look to reduce the marginal tax rates. Our tax system is too cumbersome and our tax rates too high when compared to much of Asia. The tiger economies have tax rates well below 20 percent. We need to make sure the tax rate is flat, universally applied, and effectively collected. The cumbersome process of how tax is collected must be removed, and more importantly it should be direct, rather than the indirect processes that we presently have.

So, in conclusion, the road to prosperity for Pakistan requires a smaller government with spending restraints; lower taxes universally and equitably applied; lower or near zero tariff regime to bring about greater global integration. It is time for Pakistan to truly have a market-based economy and removal of the government from intervening through excessive regulations, subsidies or protection of the inefficient industries.

Not for a moment is it being suggested that there is no place for the government. Neither anarchy nor unregulated, winner takes all, type of capitalism is something that is being advocated here. There must be a role of the state in setting up quality standards and providing laws and regulations, and ensuring that these are effectively enforced. However, these should not go beyond their specific purpose at hand, and must certainly not try to replace the role of entrepreneurs. More generally state interventions should be measured, among other metrics, against the yardstick of how much they expand the freedoms of citizens in making their own choices, rather than restricting them.

Pakistani policy makers would do well to make the Latin dictum, “primum non nocere” (first, do no harm) as their guiding principle.