

Reindustrializing Pakistan through CPEC-SEZs

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Abstract

Signs of de-industrialization are quite visible in Pakistan, this is evident from the declining share of manufacturing industries in the GDP. Incidentally, the large-scale manufacturing industries recorded a decline in its growth rate over the past ten years. Concomitantly, the share of manufactured exports in total exports also declined. Pakistan is now exporting much less than its imports, mainly due to lack of competitive strength that has caused exceptionally high current account deficit. Prevailing situation has precluded investment in manufacturing industries, which in turn has adversely affected their growth.

This precarious situation is the outcome of deep-rooted structural weaknesses, which stems from yesteryears' neglect of the issues affecting manufacturing industries. The country now direly needs a paradigm shift in its industrial strategies and policies to overcome structural weaknesses and bringing back manufacturing industries' heavy weightage in the GDP. To make such shift a reality, Pakistan holds some vital natural endowments and advantages as well as the unrealized growth potential that can be harnessed by adopting a new strategy for reindustrialization.

At this juncture, the strategic partnership initiated with China Pakistan Economic Corridor (CPEC) has laid down a solid foundation for reindustrialization through the establishment of Special Economic Zones (SEZs). Establishment of SEZs will be a once-in-a-lifetime opportunity for Pakistani firms to work jointly with Chinese firms for the development of export-oriented industries. The SEZs will adapt the 'collaborative business model' practiced by the Chinese companies to generate strong complementarity links with domestic industrial clusters and existing SEZs

to realize resource efficiency. They are expected to contribute to competitiveness, productive and durable jobs through high-tech industrialization, transfer of technology and knowhow, development of entrepreneurship, etc. The SEZs are thus expected to stimulate the growth of industrial and allied activities and development of a robust structure of industries. CPEC has created a new eco-system wherein governmental policy actions introducing a competitive incentive system and favorable business environment, in lockstep with SEZs, would reindustrialize Pakistan.

To capitalize on the opportunities for reindustrialization emanating from CPEC-SEZs, Pakistan is likely to face a number of policy challenges given the constraints and weaknesses currently faced by its industries. In this regard, this paper provides a set of robust strategic policy directions to manage the challenges and harness opportunities as a way forward to reindustrialize Pakistan.

Key Words: *Deindustrialization, Reindustrialization, CPEC-SEZs, China, Pakistan.*

1. Introduction

After several decades of relatively rapid industrial growth, the signs of de-industrialization are quite visible now in Pakistan. This is evident from the declining share of manufacturing industries in the GDP (i.e., from 19.1% in 2007 to 13.0% in 2019). Incidentally, over the same period the large scale manufacturing industries recorded a decline in their growth rate from 8.7% to -0.3%. Whereas, the share of manufactured exports in total exports has declined from 77% to 70%. Overall, Pakistan is now exporting much less than its imports mainly due to lack of competitiveness, lack of exportable surplus and rise in the cost-of-doing business that has caused exceptionally high current account deficit as a percentage of GDP, which rose from 1.7% in 2016 to 6.3% in 2018¹ resulting into fast depletion of foreign reserve assets, thus culminating into currency crisis. Prevailing situation has precluded investment in manufacturing industries, which in turn has adversely affected the manufacturing growth. This downturn in the manufacturing industries' performance is not merely the trough of a business cycle, but rather a slow-growth trap that can only be broken through a major strategic policy shift.

This precarious situation is the outcome of deep-rooted structural weaknesses², which stems from yesteryears' neglect of the

¹ All the data used above are obtained from GoP (various issues).

² Evidently, at present, it is also an outcome of onerous government regulations causing high cost-of-doing business, high interest rate (due to the tight monetary policy being adopted by the State Bank), and market sentiments created by the structural reforms measures introduced by the incumbent government such as

issues undermining manufacturing industries. Fortunately, Pakistan holds some vital natural endowments and advantages as well as growth potential that needs to be harnessed through reindustrialization. For instance, Pakistan's promising demographic profiles, with a large-sized pool of bright educated youth (68% of the total population), have the capability to drive the industries towards a higher growth path. Likewise, growing urbanization and sizeable (80 million) middle-class consumers market with international tastes are the new sources of attraction for foreign direct investment (FDI). Moreover, Pakistani diasporas living abroad can play a decisive role in providing much needed expertise, knowhow and investment resources for reindustrialization.

At this juncture, Pakistan is committed towards a paradigm shift, by leap-frogging, to bring back manufacturing industries' lost weightage in the GDP and exports. Luckily, the strategic partnership initiated with China Pakistan Economic Corridor (CPEC) projects in 2013 has laid down a solid foundation and created positive externalities for reindustrializing Pakistan through the establishment of Special Economic Zones (SEZs). Establishment of CPEC-SEZs (henceforth the SEZs, unless otherwise specified)³ will be a once-in-a-lifetime opportunity for Pakistani firms to work conjointly with

documentation of the economy, widening of the tax base, sharp adjustment in the exchange rate, etc.

³ Here, I differentiate CPEC-SEZ (the SEZs) from domestic zone SEZs (DZ-SEZs) and domestic industrial clusters already established in Pakistan. CPEC-SEZs will be developed by adapting the Chinese SEZ experience and removing obstructions and distortions present in the DZ-SEZs.

Chinese firms and adapt their ‘collaborative-business model’ to generate strong complementarity links with domestic existing SEZs and industrial clusters to create resource efficiency. Reindustrialization through the SEZs is expected to contribute to industrial efficiency and competitiveness as well as productive-durable jobs through high-tech industrialization, transfer of technology, knowhow and management practices, development of entrepreneurship, etc. The SEZs are, thus, expected to stimulate the growth of industrial and allied/ancillary activities in the domestic zone (DZ, the non-CPEC-SEZ part of the country) by raising total factor productivity (TFP). The SEZs in turn would benefit from complementary linkages (via activities including sub-contracting/out-sourcing, specialization in components, etc.) that they would create in coordination with competitive and dynamic DZ-SEZs and industrial cluster firms. In this manner, the SEZs will enable DZ firms to shift to higher industrial growth trajectory and connect them with the global supply and value chains. This would enable both the SEZ and DZ firms to penetrate in both Chinese and other global markets. For Pakistan CPEC has thus created foundations for a new eco-system wherein governmental policy actions introducing a competitive incentive system and favorable business environment, in lockstep with the SEZs, would reindustrialize Pakistan.

Nonetheless, reindustrialization through the SEZs will not be an easy one. Because Pakistan is likely to face a number of policy challenges to alleviate constraints and weaknesses being faced by DZ-

SEZs and industrial cluster firms. More specifically, the institutions responsible for the development of skills and technology have become very weak and cannot cater the needs of a modern industrial sector.

Within the above perspectives, this study develops a reindustrialization strategy to reap the opportunity now available to Pakistan through the SEZs that is likely to create backward and forward linkages and complementarities with DZ and existing domestic clusters.

Rest of this study is divided into five sections: Section 2 provides a historical overview of industrialization and deindustrialization in Pakistan. Section 3 examines SEZ's opportunities and challenges for reindustrialization. Section 4 assesses the state of economic partnership between China and Pakistan. Section 5 provides a strategy to reindustrialize Pakistan through the SEZs. Finally, Section 6 concludes the paper.

2. From Industrialization to Deindustrialization: A Historical Overview

At the time of independence in 1947, both East Pakistan (now Bangladesh) and West Pakistan together had 34 factories employing 26,400 workers. Soon after, Pakistan embarked on the program of industrialization. Using the import-substitution industrialization strategy, it successfully established manufacturing industries by protecting them from foreign competition and quickly became a success case for other developing countries to emulate. The large-

scale manufacturing (LSM) industries grew at an annual average rate of 15.75% in the 1950s (Table 1). The industrial policy then mainly focused on processing the indigenously available agro-based raw materials and manufacturing import-competing consumer goods. Imports, investments, and prices were subject to strict direct controls by government. These controls created rigidities in the system and deterred the industrial efficiency. Moreover, the exchange rate purposely was maintained overvalued and no compensatory export subsidies were available to offset the impact of import restrictions on raw materials and appreciation of the domestic currency.

Table 1: The Growth Rates of Manufacturing Industries (%)

Period	Small-scale	Large-scale	Total Manufacturing
1950-60	2.30	15.75	7.73
1960-70	2.91	13.39	9.91
1970-80	7.63	4.84	5.50
1980-90	8.40	8.16	8.21
1990-00	5.06	3.54	3.88
2007-17	8.34	2.44	3.13

Source: GoP (various issues).

The LSM industries maintained their growth thrust in the 1960s when they grew at an average annual rate of 13.39%. It was achieved particularly through 4.3% growth in TFP (Table 2). During this time period, price controls were removed on most of the products, forex market was liberalized, exports were subsidized, and tax holidays and enhanced depreciation allowances were granted on capital. Although, these policy measures created sharp industrial

growth, but they could not create any significant export product or market diversification. This success was mainly nurtured through protection, which paradoxically created inefficiencies, as protection was accorded for too long. Consequently, by the end of the 1960s, structural problems emerged in the manufacturing sector, which discouraged private investment.

Table 2: Trends in Total Factor Productivity in Manufacturing Industries

Period	Growth Rate (%)			
	Value Added	Capital	Labor	TFP
1964-65 to 1969-70	8.99	2.96	1.78	4.25
1970-71 to 1979-80	5.48	2.04	1.43	2.01
1980-81 to 1989-90	8.09	2.10	0.61	5.38
1990-91 to 2000-01	3.99	2.09	0.25	1.65
1964-65 to 2000-01	6.39	2.23	0.94	3.22
2000-01 to 2006-07	7.09	0.92	0.67	6.84
2007-08 to 2018	4.01	0.03	0.15	3.83

Source: From 1964-65 to 2001 estimates are from Kemal (2006). From 2000 to 2014, estimates are from Tufail (2015). For the latest years Tufail assisted me in updating the estimates, for which I am thankful to him.

The growth rate of LSM industries fell to 4.84% in the 1970s, mainly due to the policy of nationalization of heavy industries and oil price shocks. Other policy measures introduced included: price controls to contain profiteering and hoarding, anti-monopoly measures, withdrawal of fiscal incentives and export subsidies, and some reduction in import duties on finished goods. Concomitantly, devaluation of the rupee eliminated the multiplicity of exchange rates introduced by the Export Bonus Scheme of the late 1960s, which

neutralized the exchange rate policy for large- and small-scale industries. The unification of the exchange rate made small-scale manufacturing (SSM) industries internationally competitive. Furthermore, SSM industries were given equal access to the imported inputs. These favorable policy changes created sharp growth of 7.63% in SSM industries (Table 1).

In the 1980s, the growth rate of LSM industries increased by 8.1% per annum. It was achieved mainly with improvements in TFP (Table 2), which got uplift through the policies of denationalization, privatization, deregulation and trade liberalization. During this time period, direct controls were eliminated, tariff structure was rationalized, export duties were removed on raw cotton and cotton yarn, and exporters were given some facilities including export refinancing facility. Fixed exchange rate regime was replaced with managed floating exchange rate regime, investment was deregulated, and some of the state enterprises were divested. During this decade, Pakistan proactively encouraged FDI to attract transfer of technology through a program of indigenization (so-called the 'deletion program').

Once again, in the 1990s, the growth rate of LSM industries fell when they realized an average annual growth rate of 3.54% (Table 1). During this time period, tariff structure was further rationalized and import licenses were generally abolished; however, some imports were controlled through negative and restricted lists that were gradually reduced. Some new export promotion measures were also

introduced. But random liberalization policies, political instability, uncertainty created by the law and order situation, and lack of continuity in economic policies created a depressing situation.

In the 2000s, the industrial sector grew by 6.1% per annum. The main impetus to growth came from the promotion of automobile and consumer electronics industries. In this decade and afterwards, tariff rates were cut substantially. Starting from 2003, the maximum tariff was reduced to 25% from 45% in the 1990s. But with an increase in the trade deficit in 2008, the maximum tariff was raised to 35%. Then in 2013, the maximum tariff was again reduced to 30%, with reduction in tariff slabs from 8 to 7. In 2017, the maximum tariff was further reduced to 20%, with tariff slabs reduced to 6 to further simplify tariff structure.

Since 2007, deindustrialization has been taking place especially in the LSM industries. Between 2007 and 2017, LSM industries experienced an annual average growth rate of 2.44%, the lowest from the time of independence of the country. This was the outcome of inadequate policy change to meet the challenges posed by the changing global environment, created by the dismantling of multi-fiber arrangement (MFA) in 2008, great recession, and energy crisis in the country. Textile and garment industries have been in the state of inertia that was created for them by the MFA through guaranteed market access. They kept on producing low-end traditional textile products.

The SSM industries grew at meagre average annual rates of 2.3% and 2.9%, respectively, in the 1950s and the 1960s, because of policy bias in favor of LSM industries. During the 1970s, the annual growth rate of the SSM industries increased to 7.6%, which further rose to 8.4% in the 1980s, but fell to 5.1% in the 1990s. The increase in the growth rate of SSM industries was due to their exemptions from sales taxes and excise duties. During the period (2007-2017) when LSM industries experienced all time low growth rate, the SSM industries managed to achieve a high growth rate of 8.34%. With exception of 1980s, SSM industries always performed much better than LSM industries, however later could not face the burden of policy change.

The importance of the manufacturing industries in the economy can also be noted from their share in the GDP. Their share continuously rose until the mid-2000s, when the share was all-time high at 17.7%, with 13.4% for LSM industries and 4.3% for SSM industries. But afterwards, it started declining and by 2017, their combined share fell to as low as 12.65%, with LSM industries falling to 10.76% and SSM industries to 1.89% (Table 3). This evidently is indicative of deindustrialization across the board. In addition, there is evidence, as reported earlier, of a decline in the share of manufactured exports as well.

Table 3: The Share of Manufacturing Industries in the GDP (%)

Period	Small-scale	Large-scale	Total Manufacturing
1949-5	4.56	1.83	6.39
1960s	4.35	9.86	14.21
1970s	3.89	11.83	15.62
1980s	4.28	11.86	16.14
1990s	4.77	11.87	16.64
2000s	4.80	12.04	16.84
2006-07	4.30	13.40	17.70
2016-17	1.89	10.76	12.65

Source: GoP (various issues).

So, what do we learn from Pakistan's industrial experience? Why is deindustrialization the outcome? Overall, Pakistan's industrial structure changed very slowly. In fact, over the past three decades, there has been very little evidence of a significant change in the composition of industrial output. Industries did not adapt to the fast changing global industrial patterns and consumer demands as well as the changing global trading environment. What then explains such a dismal industrial performance for a country that was once widely cited as an example of rapid industrialization in the developing world? The answer is inadequate industrial investment as one of the main factors, which can be attributed to non-availability of sufficient investment funds, insufficient demand faced by heavily protected and inefficient industries producing low quality good, low profit margins amidst uncertainty induced by capital flight to safe havens abroad, lack of competitive business environment, and shyness of private investors, an outcome of the nationalization policies of the 1970s and

voluntary export restraints imposed by the developed countries in the garb of MFA since 1974. Besides, there remained heavy reliance on protectionist policies, which created incentives for ‘directly-unproductive profit-seeking activities’ *al a* Jagdish Bhagwati (rent-seeking and tariff-seeking) using precious industry resources. With the focus on import-competing industrialization, increasing exports through value-addition and quality products was virtually ignored, an outcome of the lack of modern technology and management practices.

Historically, trade regime remained complicated in the presence of the system of statutory regulatory orders (SROs) that provided discretionary exemptions. This, in turn, eroded fair competition in the market since SROs treated different firms differently.

Ace industry of Pakistan, textiles and clothing, failed to prevent a sharp decline in its growth soon after it faced the open market access in the aftermath of dismantling of MFA in 2008. Industries that were acclimated with heavy protection and windfall gains of secured market access under MFA could not face fierce competition from countries like Bangladesh and Vietnam that got special market access in the developed countries’ markets. This resulted in closure of a large number of inefficient firms as their profit margins became very low both nationally and internationally. This was the time when the country, otherwise, was using reform programs. What was needed from the planners was the introduction of an efficient system for the promotion of export-oriented industries;

it was naïve to expect that mere reduction of heavy protection was sufficient to realize efficient and rapid industrial growth. Ironically, the planners, trying to promote efficiency, could not foresee this reasoning. It was therefore not surprising that implementation of the reform program resulted in industrial stagnation. Had the planners simultaneously introduced reforms to reduce the cost-of- doing business, eased the conduct of doing business, connected domestic industries with the web of global supply and value chains, the industrial performance would have been drastically different from what Pakistan has today!

3. Reindustrialization through SEZs

Pakistan now direly needs to rapidly reindustrialize its economy. This is because reindustrialization would restore the lost role of manufacturing industries in growth, job creation and development of the country. Not only this, it would act as a strategic priority to enhance the competitiveness by creating conditions for restructuring and upgrading of industries, through updating of the technological base via innovations and transfer of technology. Reindustrialization would thus create new competitive advantages for domestic industries to expand exports.

Establishment of the SEZs is expected to catalyze reindustrialization by introducing the much needed structural transformation. This is because they would create new environment conducive for industries by removing critical ‘binding constraints’

perpetually faced by the manufacturing industries. The SEZs' special policies would create incentives for firms that might not be available in the DZ-SEZs.

Global experience suggests that competitive SEZ firms are not attracted by financial incentives alone.⁴ As opposed to competitive firms, it is weaker firms that only care about financial incentives. Success factors for competitive firms would include; efficient and cost-effective infrastructures, ease of doing business, efficient trade facilitation system and good governance that will distinguish them from DZ firms. Success of the SEZs would encourage government to introduce such measures in the DZ for reindustrializing the entire country.

If planned prudently, then success of the SEZs is likely to spur: (i) complementarity between the SEZs and DZ-SEZs; (ii) diversification of the industrial base to produce new and high value-added products; (iii) creation of proficiency in local workers with positive spillovers for DZ-SEZs and clusters firms; (iv) transfer of modern technology and management system and dissemination of knowledge; (v) promotion of ancillary and allied industrial activities; (vi) development of local entrepreneurship; (vii) development of basic and intermediate manufacturing industries; (viii) creation of modern export platform enabling diversification of export markets through the SEZs' established global marketing networks; and (ix)

⁴ As opposed to competitive firms, weaker firms only care about financial incentives.

forging of backward and forward linkages with DZ ‘competitive’ firms and ancillary suppliers.

Besides, creation of a favorable business environment in the SEZs would provide an opportunity to some of the Pakistani diasporas to return home and participate in the nation building activities.⁵ The SEZs, if carefully planned, will certainly come to the aspiration of the diasporas. Chinese potential investors view them as a big social capital available to Pakistan due to their accumulated advanced skills and experience obtained abroad.

Private investors from China are accustomed to special economic policies and flexible governmental measures, which ensures an economic management system that is more appealing for firms to do business. In Chinese SEZs, investment is conducted without any authorization of the central government. Tax and other incentives are offered to attract foreign investment and technology in SEZs. So the challenge for Pakistani policy makers would be to provide comparable, if not better, incentives, infrastructure and business environment to Chinese investors that they are used to with at home and in other competing countries. In this context, long-term government commitment and consistency for harmonized policies would be crucial for the success of the SEZ.

Before devising special policies for the SEZs, the policymakers need to keep in front the following obstructions being

⁵ At present, the size of diasporas residing abroad is about 9.1 million – almost 5% of Pakistan’s total population (see, Amjad (2017)).

faced by the domestic manufacturing industries (especially those based in DZ-SEZs) that are some of the main reasons for deindustrialization: (a) unsuitable location at remote places, because SEZs were detached from existing industrial clusters consequently they were excluded from the benefits of ‘external economies’ enjoyed by the cluster firms; (b) absence of connectivity with global value and supply chains, due to their remoteness from conventional supply routes, primarily highways and ports, which raised trade costs and time uncertainty for them; (c) high cost-of-doing business; (d) absence of quality infrastructure; (e) lack of modern technology and management practices; (f) lack of proficiency in workers to run modern machines or basic amenities for workers; (g) lack of efficient trade facilitation system; (h) anti-export bias in policies; (i) foreign firms were not attracted; and (j) lack of coordination between different state institutions due to bureaucratic snags in the provision of utilities, infrastructures and other facilities.

Pakistan has got a new opportunity to transform its manufacturing industries on modern footings for reindustrialization. It should capitalize on it by taking necessary steps on fast-track basis before Chinese companies lose their interest and fly somewhere else.

4. State of Economic Partnership between Pakistan and China

China-Pakistan relations began in 1950 when Pakistan became one of the first countries to recognize the People’s Republic of China. The first trade agreement between the two countries was

signed in January 1963. China-Pakistan Joint Committee on Economy, Trade and Technology was set up in October 1982. In April of 2005, both countries signed the “Treaty of Friendship, Cooperation and Good Neighborly Relations”, which marked a closer and strategic partnership between them. The early Harvest Program between China and Pakistan was made operational on 1st January 2006 and then on 24th November 2006 it was merged into a bilateral free trade agreement (BFTA). Both countries started implementation of the BFTA in 2007. In July 2013, they signed the landmark agreement to construct the Economic Corridor, which has now laid down the foundations for Pakistan to reindustrialize by establishing the SEZs.

China-Pakistan Trade and Investment:

Formal trade between China and Pakistan started in 1960. At that time, the size of total bilateral trade was \$19 million and the balance of trade was in favor of Pakistan. This pattern and trend in trade continued until 1980. Afterwards, the size of trade started growing sharply and remained always in favor of China. In 2018, total trade volume between the two countries was \$17.5 billion with imports from China were \$15.8 billion and exports to China were \$1.7 billion (Table 4).

China is now Pakistan’s leading source country of imports, accounting for 27% of its imports and is the third largest destination of its exports, accounting for 8-9% of total exports. The upsurge in imports from China is largely attributed to: (a) the rise in machinery

and equipment owing to growing development activities in Pakistan; b) “trade creation” and “trade diversion” towards China from other trading partners (Khan and Mahmood, 2017); (c) the intensified demand for imported intermediate goods with the development of indigenous assembly lines and outsourcing activities in Pakistan; (d) strong demand for relatively cheaper goods; and (e) diversion of trade channels from informal to formal after the signing of BFTA.

Pakistan’s exports to China did not garner much from tariff reductions exchanged in the BFTA. Despite the apparent substantial growth, the volume of exports remained small⁶. The key reasons are as follows: (a) Pakistan’s potential export items remained limited due to lack of competitiveness and lack of exportable surplus for higher-end products especially textiles and garments; (b) Pakistan didn’t include many of its competitive products, especially intermediate goods⁷, in the BFTA; (c) Pakistan lacked the initiative of diversification of export goods base and exploration of opportunities for non-traditional products demanded in the Chinese market; (d) Pakistan’s preference margin eroded due to China’s FTA with ASEAN members and in some products with vast export potential like rice tariff preference is not given to Pakistan whereas Vietnam enjoys

⁶ Paradoxically, official trade figures reported by Pakistan were under-invoiced by \$5 billion in 2018.

⁷ It needs to be underscore here that countries become part of outsourcing schemes more effectively and efficiently provided they accord duty free status to their intermediate goods.

free entry to Chinese markets; and (e) economic slowdown in China has diminished demand for raw material and intermediate goods.

Table 4: Trends in Pakistan's Trade with China (Million Dollars)

Year	Export	Import	Year	Export	Import
1960	15	4	2008	690	4711
1970	39	34	2009	699	4072
1980	221	180	2010	1154	4418
1990	67	357	2011	1633	5783
2000	337	485	2012	2196	6718
2002	229	575	2013	2611	6641
2003	245	838	2014	2421	7709
2004	288	1154	2015	2171	10396
2005	354	1843	2016	1670	12106
2006	464	2706	2017	1469	15132
2007	576	3534	2018	1691	15766

Source: Data between 1960 and 2000 are obtained from IMF (various issues), while rest of the data are taken from GoP (various issues).

Table 5 shows tariff reduction modalities of China within five years after entry into force of the BFTA. Accordingly, 'tariff elimination' is offered on 35.5% of tariff lines, whereas on 34.5% of tariff lines, there would be a tariff reduction of 0-5%. In the remaining 30% tariff lines; there would be no concession at all to 15% and reduction of marginal concession to the remaining 15% of tariff lines. So, in total, Pakistan received concessions on 6,418 tariff lines from China through BFTA.

Reciprocally, Pakistan offered to China concessions on 6,803 tariff lines for the initial five years (Table 6). While, zero tariff rates were offered on machinery, electric and electronic products,

chemicals and numerous raw materials; all critical to the industrial sector of Pakistan. Nevertheless, no concession was given on woven fabrics, synthetic fibers, machinery products, paper & paperboard, and footwear. Pakistan omitted a list of 92 tariff lines, which include drugs, alcohol, arms and ammunitions.

Table 5: Tariff Reduction Modality of China

	No. of Tariff Lines	% of Tariff Lines at 8-digit
Elimination of tariff (three years)	2681	35.5
0-5% tariff reduction (five years)	2604	34.5
Tariff reduction on Margin of Preference from 50% (five years)	604	8
Tariff reduction on Margin of Preference from 20% (five years)	529	7
No Concession	1132	15
Total	7550	100

Source: MOC (2019).

Table 6: Tariff Reduction Modality of Pakistan

	No. of Tariff Lines	% of Tariff Lines at 8-digit
Elimination of tariff (three years)	2423	35.6
0-5% tariff reduction (five years)	1338	19.9
Tariff reduction on Margin of Preference from 50% (five years)	157	2
Tariff reduction on Margin of Preference from 20% (five years)	1768	26.1
No Concession	1025	15
Exclusion	92	1.4
Total	6803	100

Source: MOC (2019).

From 1998 to 2006, net accumulated Chinese FDI into Pakistan was \$74.4 million. Then it took a leap to \$712.1 million in 2007, with investment in-flowing into telecom sector. Afterwards, between 2008 and 2013, a sum of \$172.8 million net inflow was recorded. However, since 2014, a period that coincides with CPEC project, accumulative net inflow between 2014 and 2018 is recorded as \$5,103 million (Table 7). Chinese investment is coming in the sectors including chemical & pharmaceutical, iron & steel, engineering goods, light manufacturing & home appliances, auto parts, spare parts, agro-based products, textiles, construction materials, and use efficient, petrochemicals, energy-saving and environmental friendly processes and equipment. Reportedly 138 Chinese companies are currently working in Pakistan (Table 8).

Table 7: Net FDI from China to Pakistan (Million Dollars)

Fiscal Year	FDI (Net)	Fiscal Year	FDI (Net)
1998	24.3	2009	-101.4
1999	19.8	2010	-3.6
2000	10.5	2011	47.4
2001	0.1	2012	126.1
2002	0.3	2013	90.6
2003	3.0	2014	696.0
2004	14.3	2015	319.1
2005	0.4	2016	1063.6
2006	1.7	2017	1211.7
2007	712.1	2018	1812.6
2008	13.7		

Source: SBP (2019).

Table 8: List of Chinese Companies in Pakistan

Sector	Number of Firms
Electronics and Engineering	52
Textiles	8
Automobile	7
Medical & Pharmaceutical	8
Furniture & Woodwork	8
Trading/ Logistics, Imports and Exports	55
Total	138

Source: PCBF (2019).

About 1200 Chinese manufacturing companies are ready to relocate to Pakistan as soon as later is prepared to invite them in the SEZs. It is worth noting that about 100 Chinese firms are already working in Pakistan mostly in the manufacturing sector. Out of these 34 companies reportedly are based in Gwadar with the investment of \$479 million. So far 854 delegations from China have visited Pakistan to explore business and market opportunities. One of the main concerns shown by the Chinese potential investors is lack of linkage with the private sector, perhaps due to the petty politics. Pakistan needs to take swift measures in this regard.

Chinese Interest in Pakistani SEZs:

Chinese SEZ experience provides a rich array of lessons for Pakistan to learn from for its reindustrialization drive. China has shown a keen interest in investing in the SEZs that Pakistan has committed to establish for Chinese companies. History of joint China-Pakistan industrial parks goes back to 2001, when a successful joint-venture between a Pakistani company and a Chinese company, was

established in an industrial park near Lahore, producing and assembling electrical and electronics products.

Some experts argue that, given the new stage of development, China does not want to provide policy support anymore to its domestic industries that have lost comparative advantage due to rising labor cost; consequently, they intend to relocate such industries abroad. Another viewpoint is that, with huge surplus, Chinese companies intend to invest closer to their own markets, provided they get desired skills, infrastructures, and favorable business environment.

More importantly, Chinese investors are keeping in front, the growing urbanization, large middle class consumer population, large educated youth looking for productive job opportunities and the Pakistani diasporas, some of whom are aiming to return to the country with their vast skills and financial resources. On its part, Pakistan is preparing to welcome Chinese investors and expects that the establishment of SEZs will help in achieving much desired structural transformation via positive technology spillovers, knowledge diffusion, skill development and attracting Pakistani diasporas back home along with their tacit knowledge, thus creating new productive capabilities, and realizing a paradigm shift for reindustrialization.

5. A Strategy for Reindustrialization

China's upgrading to higher industries has left a huge space for Pakistan to enter into those industries where Chinese companies

are exiting. For this to realize, Pakistan must fast prepare itself to capitalize from this opportunity that would transfer better technology than that is currently possessed by its domestic firms.

Pakistan, therefore, needs to develop a reindustrialization strategy where Chinese investment will be its core. It would be naïve to imagine that this opportunity would be sufficient on its own to guarantee dynamic, resilient manufacturing industries. Investment would be only one of the components required for reindustrialization. To reap dynamic benefits, the SEZ investment policy needs to be accompanied by development of infrastructures, support services, skills renewal, etc. More specifically, the following strategic policy directions need to be adopted to provide enabling environment to the SEZs for reindustrializing Pakistan:

1. **Location Decisiveness:** Chinese private investors would be attracted to those SEZs that would have complete necessary cost-effective infrastructures, supply of proficient workers, and easy access to domestic markets for raw materials and other inputs along with deep connectivity with domestic and global supply chains. Besides, a maximum of 2 to 3 vertically integrated products in each SEZ should be planned adjacent to the region or existing DZ-SEZs/ industrial cluster that are also specializing in these products. In this way, foreign investors will have complete clarity about where they are going and what specialized skills and other natural resources and

ancillary private and public services they are likely to have near their doorsteps. Initially locate the SEZs in proximity with established industrial clusters. Adopt a ‘gradualist approach’ so that location decisions do not fall captive to vested interest groups.

2. **Effective Planning of the SEZs:** The SEZs should be designed to match and support national competitive advantages. An ingenious first stage would be fundamental to the SEZ success; which should encompass all key development phases in the short run. But, if the initial stage consumes too much time, as it appears to be taking presently, it will create distrust among potential investors. Therefore, from the very beginning, plan closely with the Chinese government and private investors to keep them on board for effective implementation of the whole reindustrialization plan.
3. **Cost Effective Provision of Infrastructures, Services and Utilities:** To draw Chinese investment especially in export-oriented industries, it is imperative that the raw materials, intermediate inputs and utilities are available to SEZs at internationally competitive prices/rates. Thus, ensuring readiness of all the infrastructures, services and utilities required for modern production processes at rates that are internationally competitive. In this regard, engage private

companies to develop international standard infrastructures for their provision to the SEZs.

4. **Creating Complementarity/Synergy:** Create complementarity between the SEZ and DZ-SEZ/ cluster firms by forging backward and forward linkages. For this, Pakistan needs to systematically plan from the outset. Pakistan will not benefit much from the existence of SEZs, if they are established to work in seclusion from DZ-SEZ/ cluster firms. This will enable all the participants to draw benefit for an extended period. For instance, encourage Chinese firms to produce intermediate goods to be exported internationally and DZ-SEZ/ cluster firms.
5. **Investment Decisiveness:** It needs to be underscored that privileges like special fees for land or facility use, fast customs clearance, repatriation of invested capital and investment income, enforcement of intellectual property rights, quality of infrastructures, efficient administration, and political *will* and *determination*, generally influence the investment decision of competitive firms. All of these are necessary conditions if not sufficient conditions for the success of SEZs. Therefore, policy focus should not be merely on fiscal incentives, they should solely be offered to offset higher risks to foreign investment in the new environment. Fiscal incentives should not be the only motivation for investment decision; as investors will contemplate to exit from SEZ as soon as fiscal

incentives are removed. Thus, creation of good business environment should be the main reason for investment decisions.

6. **Access to Finance for SMIs:** Dynamic domestic small and medium industries (SMIs) are expected to play an important role in creating links with the SEZ firms and learning from them about various aspects of industrial production and processes. Ensure access to finance for SMIs through banking channels which normally prefer large scale firms. In this context, establish a credit rating agency for SMIs that can assist banks about the wellbeing of the SMI firms. The State Bank of Pakistan (SBP) offers export refinancing facility (ERF) and long term financing facility (LTFF) to large firms. The SBP needs to devise a mechanism to extend these facilities to SMI firms.
7. **Develop Skill Proficiency:** Initially, Chinese firms will demand semi-skilled domestic labor for their assembly-lines and processing, while Pakistan would be interested in the transfer of modern technology and knowledge. Thus, readiness of workers will be a decisive prerequisite for technology transfer. In this context, provision of customized and specialized education and training should be prioritized in order to generate, upgrade and expand knowledge and skills base in the country. Chinese firms should be offered incentives to encourage on-the-job training to local workers.

8. **Engage Diasporas in the SEZs.** Engage Pakistani diasporas from the outset with the Chinese firms in the SEZs. Encourage them by assuring that their investments will be safe and the contribution of their skills and knowledge will be highly prized by the nation. Facilitate diasporas to invest either directly in the SEZs or jointly with Chinese companies in the SEZs. Allow the SEZ firms to issue investment bonds exclusively for the diasporas, who would become shareholders or partners in the SEZ enterprises.
9. **Create Strategic Global Connectivity:** Connectivity is a key to achieve competitiveness. Therefore, to catalyze reindustrialization, it is essential for the SEZs to be connected with vital infrastructures and logistic services. Link the SEZ firms with global supply and value chains using Chinese experience and networks.
10. **Ensure Reliable Input Supplies:** Presumably, Chinese producers in the SEZs will be reluctant to source intermediate inputs from local supplier firms owing to the low quality or time uncertainty. Therefore, it is imperative to incentivize domestic producers to improve quality of their production, and make their supply more reliable through better management practices. Besides, improve the logistic infrastructures to timely ship the required intermediate goods and other materials to and from DZ firms.

11. **Strictly Enforce International Standards.** Effectively enforce technical standards, property rights, *Sanitary and Phyto Sanitary* measures, etc., that would be demanded by Chinese investors and traders.
12. **Create B2B Linkages.** Improve business-to-business links to understand each other as strategic partners of development and not as competitors.
13. **Create Industrial Linkages:** The SEZs' sustained success would be entwined with their backward and forward linkages with DZ-SEZ/clusters. Firms need to be encouraged by the government and the SEZ management, to link with competitive DZ firms via domestic supply and value chains and outsourcing relations to create positive technology and productivity spillover effects. Develop competitive local vendor industries so that transfer of technology takes place, else Chinese companies would rely on imported intermediate inputs and components.
14. **Negotiate Special BFTA.** Success of SEZs would hinge on their duty free market access to Chinese markets. Therefore, Pakistan should negotiate with China to secure a special duty free status for all exports originating from SEZs. This duty free access agreement will be in addition to the present BFTA.

6. Conclusion

Reindustrialization of the economy is certainly the most desirable option for Pakistan to absorb the growing youth workforce and achieve high industrial and economic growth targets. It is, therefore, essential to make reindustrialization through the SEZs the top priority in the new industrial growth strategy. Treat the SEZs as platforms for improving competitiveness, industrial growth, export expansion and productive durable jobs creation through skill development, transfer of technology and knowhow, development of entrepreneurship, improved business environment, regional and global connectivity, etc. The government's role should be limited to providing the enabling business environment and develop foundations to effectively implement a dynamic industrial growth strategy.

The SEZs would be a once-in-a-life-time opportunity to reindustrialize Pakistan by exploiting synergies and complementarities of different specialization of the SEZs and DZ firms. To capitalize from the opportunity would need serious and careful planning and concrete but swift policy actions, as suggested earlier.

A long-term industrial strategy is needed as reindustrialization through the SEZs may take longer time. In this context, it is imperative for policymaking to carry out shared activities amongst different stakeholders.

The SEZs require strategic locations with cost-effective and efficient infrastructures, effective institutional support, commercial viability, one window services, and a strong legal framework. The SEZ and DZ firms and diasporas should all play significant roles for the successful realization of reindustrialization. Ease-of-doing business and efficient infrastructures coupled with fiscal incentives would provide the best incentive package for investment in the SEZs that will put Pakistan on a new path of reindustrialization.

Finally, for the success of reindustrialization strategy, it needs to be underscored that: (a) the contribution by domestic firms and workers in the SEZs would be crucial in ensuring technology and productivity spillovers; thus, encourage the SEZs firms to employ and facilitate local work force to avail job openings in the SEZs; (b) selection of industry for the SEZs needs to be finalized in consultation with Chinese and domestic sponsors, it is important for the arrangement of domestic resources and activities required by foreign investors and for their consequential technology spillover for the absorption by domestic firms; (c) prepare local firms ready to absorb technology by adopting the best management practices; (d) eliminate any regulatory and administrative constraints to industrial and support firms' linkages; (e) with the assistance from Chinese vocational institutions set up training facilities, and establish science & technology industrial parks to satisfy the technology needs of the DZ and the SEZs firms; (f) ensure the SEZ firms earn most of their sales revenues from overseas export markets, this would alleviate pressure

on foreign exchange reserves once outbound investment income would start; (g) simplify and make tax laws more transparent and uphold consistency in policies; and (h) improve coordination between provincial and federal ministries and departments to ensure ease-of-doing business.

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