



Pakistan Policy Note 2

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Reinvigorating the Agenda for Open Trade

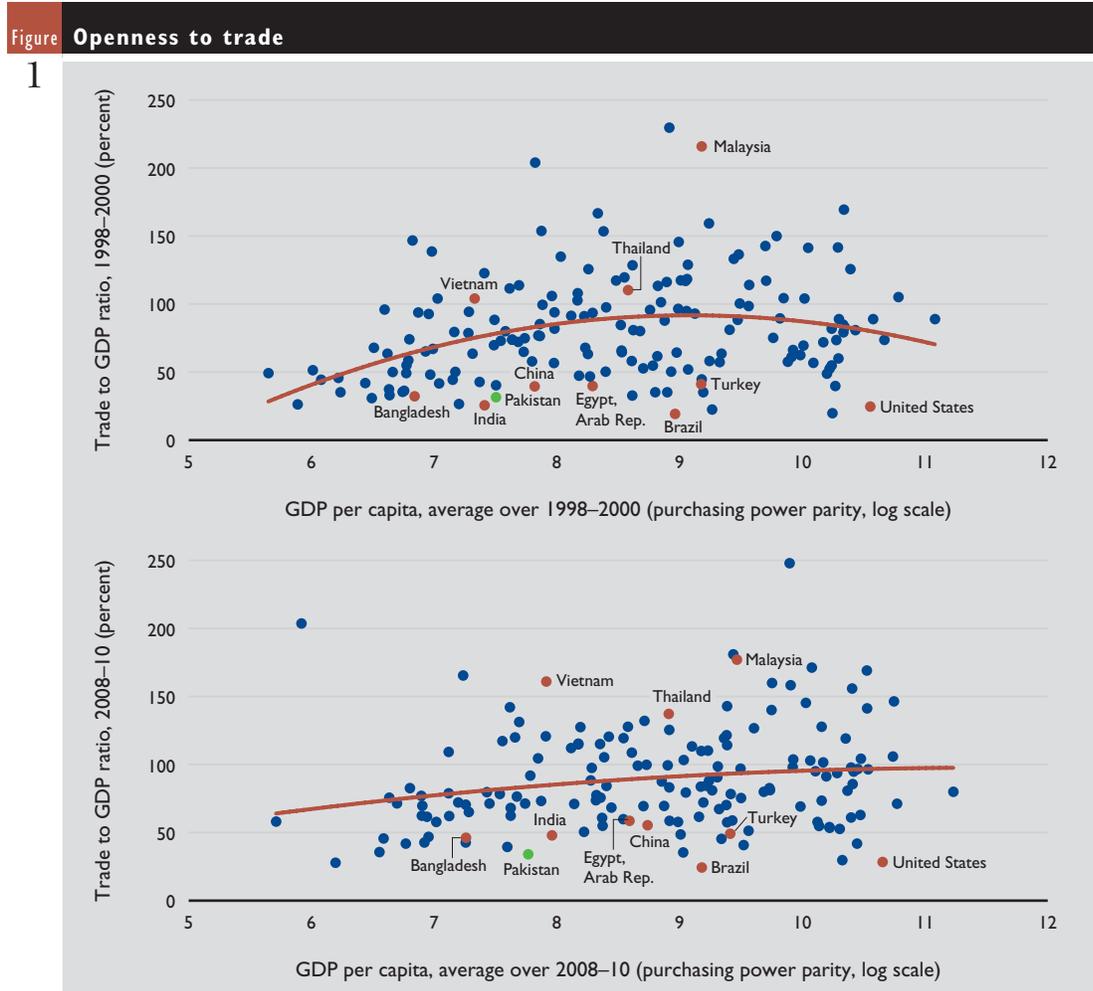
Pakistan's trade performance is disappointing. Despite being in a very dynamic region, the country's position in world trade has barely changed over the past three decades. The trade to GDP ratio showed only a very small increase in the last decade. Exports generally lack sophistication, and dynamism (as marked by entry and exit in foreign markets and new exports) has declined in recent years, coinciding with the reversal of trade policy to a less open stance since the mid-2000s. Open trade is central to any growth strategy—worldwide, no successful growth story has exclusively featured inward-looking growth. Restoring the country's place in international markets is thus critical for resuming growth, raising productivity, and creating jobs. To improve its trade competitiveness, Pakistan needs to simplify tariffs and trade regulations in order to reduce the anti-export bias; accelerate deep preferential trade agreements to encourage trade creation; fully normalize trade relations with India to benefit from growth there; and address logistical weaknesses to reduce trade costs.

Trade is an integral part of Pakistan's growth agenda. The country has failed to benefit from the trade bonanza in both South Asia and the world, and its position in global trade has changed little over the past three decades. While its world market share has declined over the last 20 years (despite a moderate recovery after the global crisis), those of Malaysia, Mexico, and Thailand have doubled, and China's tripled. Aided by large reductions in trade barriers and technological advancements, developing countries—led by China and other emerging markets—have

become major drivers of global trade. There is now little dispute that, in the long run, economies more open to trade show stronger economic growth and overall development performance, including export growth (Dollar and Kraay 2002, 2004; Michaely, Papageorgiou, and Choksi 1991; Winters, McCulloch, and McKay 2004).

Pressure is growing on developing economies to improve productivity and restructure industry. World trade has undergone a dramatic transformation over the past decade and is increasingly characterized by global fragmentation of production leading to greater trade and a wider variety of traded goods and services—a trend that has largely eluded Pakistan. The evolving trade landscape, dominated by emerging economies like China and India, is likely to exact more pressure on firms in other developing economies, such as Pakistan, to improve productivity and restructure the industrial sector to enhance their competitiveness so that they can benefit from international market opportunities. Steps to enhance domestic competitiveness are becoming more important—as is how they measure up to competitors' actions.

Pakistan's recent trade performance is one of stagnation, as indicated by a very small increase in its trade to GDP ratio over the last decade.¹ Peer countries have leapfrogged with high growth. Pakistan's position below the predicted line indicates that it "undertrades" relative to countries at comparable GDP per capita incomes (Figure 1).² What



Source: Authors' calculations based on United Nations Statistics Division (n.d.).

is striking, however, is that Pakistan's average trade-to-GDP ratio for 2008–10 (bottom panel) was only 2.6 percentage points higher than a decade earlier (top panel), in contrast to the shares of its peers. In 1998–2000, Pakistan's trade to GDP ratio was barely lower than China's and much higher than India's. Ten years on, both China's and India's shares nearly doubled while Pakistan's remained largely stagnant, increasing only 2.6 percentage points, from 31.5 percent to 34.1 percent. Both other countries also showed higher rates of economic growth.

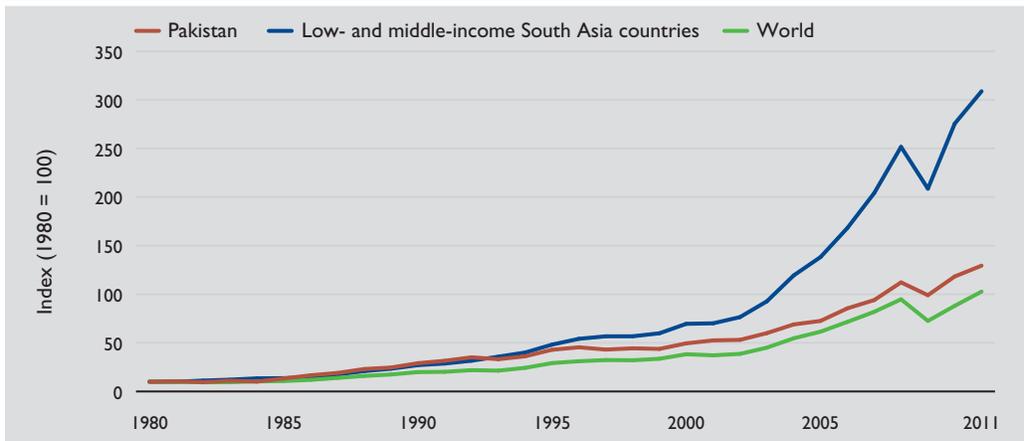
Over 1980–2011, Pakistan's exports grew faster than the world's but far more slowly than those of its South Asian peers. Indeed, Pakistan's exports grew 13-fold, much less than the 30-fold in the rest of South Asia. During this period, the most intense growth of Pakistan's exports was at the end of the 1980s, the start of the 1990s, and the

mid-2000s. The end of the 2000s, however, saw a strong deceleration of export growth, following the drop in demand associated with the industrialized countries' debt and economic crises, as well as slower growth in South Asia (Figure 2).

Firm-level data show declining dynamism in export markets. Export entry and exit rates are slower than in peer countries, and new entrants barely offset the loss in exports by exiting firms. Each year, some 16–37 percent of firms exit and another 19–37 percent enter. At first glance, there seems to be significant destruction and creation of exporters in the data, but entry and exit rates are lower than in other lower middle-income countries (Figure 3). As a result, the effect on the number of exporters seems marginal, suggesting that the number of exporters is not expanding much and that Pakistan's trade openness is stagnating.

Figure 2 Export growth, 1980–2011

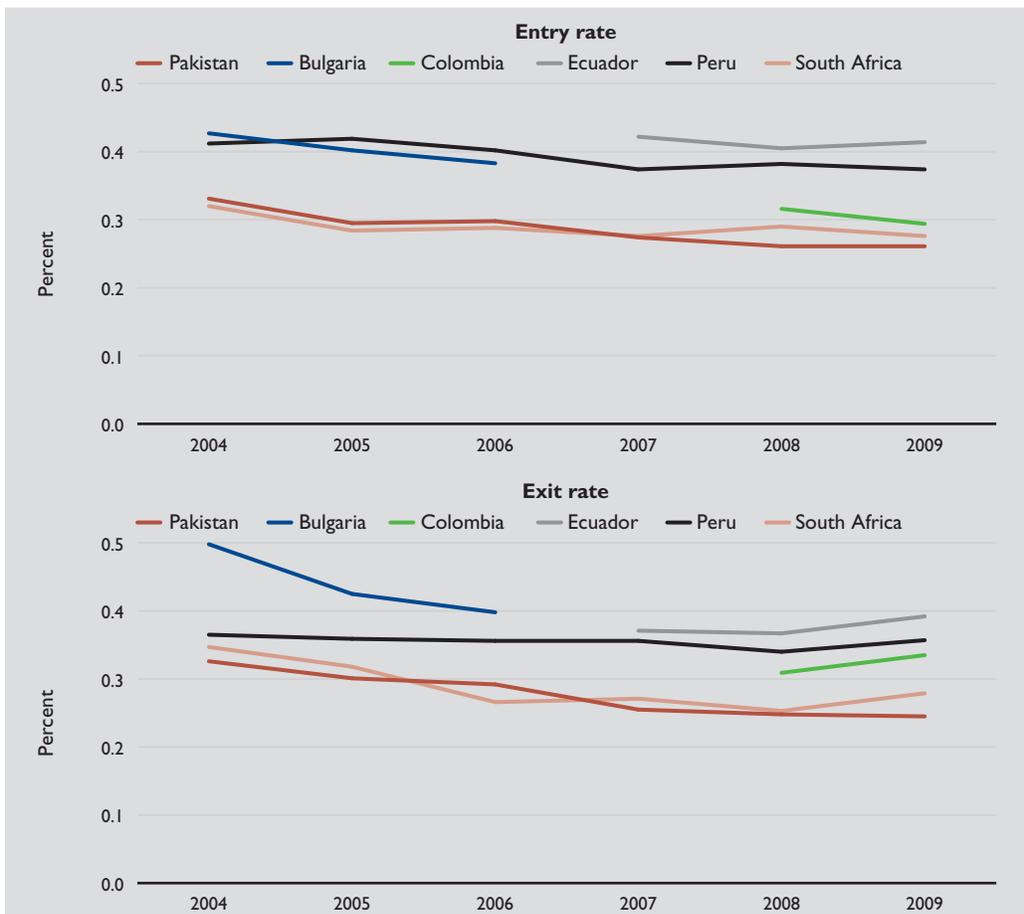
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Source: Authors' calculations based on United Nations Statistics Division (n.d.).

Figure 3 Exporter entry and exit rates in Pakistan and peer countries, 2004–09

3



Note: The above middle-income and medium-size countries were selected from the list of countries available in the firm-level database, which is much more limited than the ones for aggregate data.

Source: Authors' calculations based on World Bank (n.d. a).

Dynamism decelerated sharply after 2004, as evidenced by the decomposition analysis of export growth in firm, country, sector, and product extensive and intensive margins presented in Figure 4.³ On average, fewer firms entered and exited the export market after 2004. Incumbent exporters gradually became more conservative in export markets, as well as sector and product experimentation. In short, entries and exits by new firms, as well as existing firms in new countries, sectors, and products, all fell in the second half of the 2000s.

Many important changes, such as the security situation and trade policy, have taken place in Pakistan over the past decade, which may explain these trends in firms' export growth. The fact that export growth decomposed by entries and exits at the firm, sector, and product levels have all declined suggests a decrease in the dynamism of Pakistan's exports—and possibly a lack of incentives for the exporters to innovate. Could changes in trade policy have affected this performance?

Main Issues

The following impediments stand in the way of Pakistan improving its trade competitiveness.

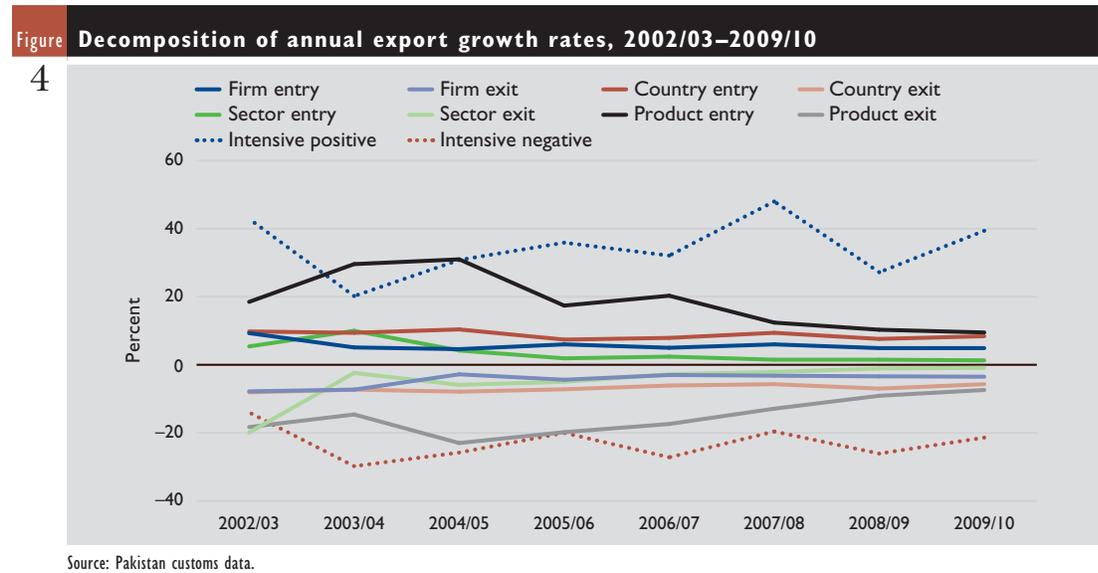
Reversion to protectionism

Pakistan's trade policy is reverting to protectionism. Over the last 15 years, it has seen a pendulum-like trajectory. Starting in the mid-1990s, the

country embarked on a major trade liberalization program, which included reducing trade tariffs, simplifying the overall tariff structure, and abolishing nearly all remaining quantitative restrictions. Trade policy initially favored multilateral and unilateral trade liberalization and aimed at reducing government intervention, in a period when a relatively favorable macroeconomic environment supported trade policy reform and export expansion.

In the mid-2000s, the pendulum started swinging back. New import substitution policies came in, with the pace picking up after the start of the global crisis in 2008 (Planning Commission 2011). Current trade policies have become more oriented toward providing extra protection to the processing margins of selected local products and producers. The Planning Commission (2011) reports that of the 906 manufactured products granted tariff exemptions, 91 percent benefited a single local monopoly producer, and 5 percent two producers, while smaller producers in particular were excluded from the exemptions' benefits.

This recent reversal has made Pakistan the world's seventh most protected economy, thus risking further undermining its already poor openness. The Overall Trade Restrictiveness Index (OTRI) suggests that the country's overall restrictiveness has increased. On the OTRI—which ranges from 0 in Singapore and Hong Kong SAR, China, to



16 in the Islamic Republic of Iran—Pakistan reached 9.9 in 2010, up from 9.0 in 2004. (Box 1 gives further details on the index.) While Pakistan's OTRI is not South Asia's highest, with a score of 9.9, it places Pakistan in the 88th percentile, among countries with the most restrictive trade policies (Figure 5). Overall trade restrictiveness developments in Pakistan are possibly associated with the increasing complexity of national trade policy and with the reversal of some of the early progress toward reforms.

Trade policy complexity

The high degree of tariff escalation and complexity in the tariff structure are reflected in the effective rate of protection (ERP). By taking into account protection on both outputs and inputs, ERPs better represent tariff-generated transfers to producers than do nominal rates of protection, which are based on protection of outputs only. Protection on services industries is mostly negative, imports of most basic raw materials are relatively free of import restrictions, and products at an intermediate stage of production have moderate ERPs. By contrast, import-substituting industries, such as beverages, tobacco, motor vehicles and accessories, and vegetable oils and fats, yield very high ERPs. These results reinforce the earlier assertion about the escalatory tariff structure in Pakistan and provide evidence for the instrumental role of exemptions and high duties to achieve indigenization objectives in several manufacturing activities, and the automotive sector in particular.

Pakistan's pattern of protection discourages the production of high value-added products. ERPs (taking into account protection on outputs and inputs) are typically exaggerated with low value-added activities, such that even low tariffs on final goods can lead to increased returns (Figure 6). Sectors with high ERPs tend to have low value added, or conversely there is a higher incentive to produce low value-added goods. That sectors with higher ERPs tend to be domestically oriented demonstrates the inherent bias against export-competing sectors.

The first-generation reforms in the early 2000s cut heavily into the use of quantitative restrictions as protective devices, though Pakistan still applies some nontariff measures. The most prominent is the Indigenization Program, with its discretionary control over new entrants to specific industries, because all potential entrants must negotiate with the Engineering Development Board (a separate agency set up in 1995 to manage the large number of industrial "local content" programs originally sponsored by the Ministry of Industry) and agree on an individual indigenization program and how it would be phased in over time. The administration of this—often competing—dual regime discriminates against the import of domestically available materials, amounting to a de facto local content requirement. According to Global Trade Alert, other nontariff measures include bailouts and state aid, export subsidies, export taxes and restrictions, import bans, sanitary and phytosanitary measures,

Box Overall Trade Restrictiveness Index

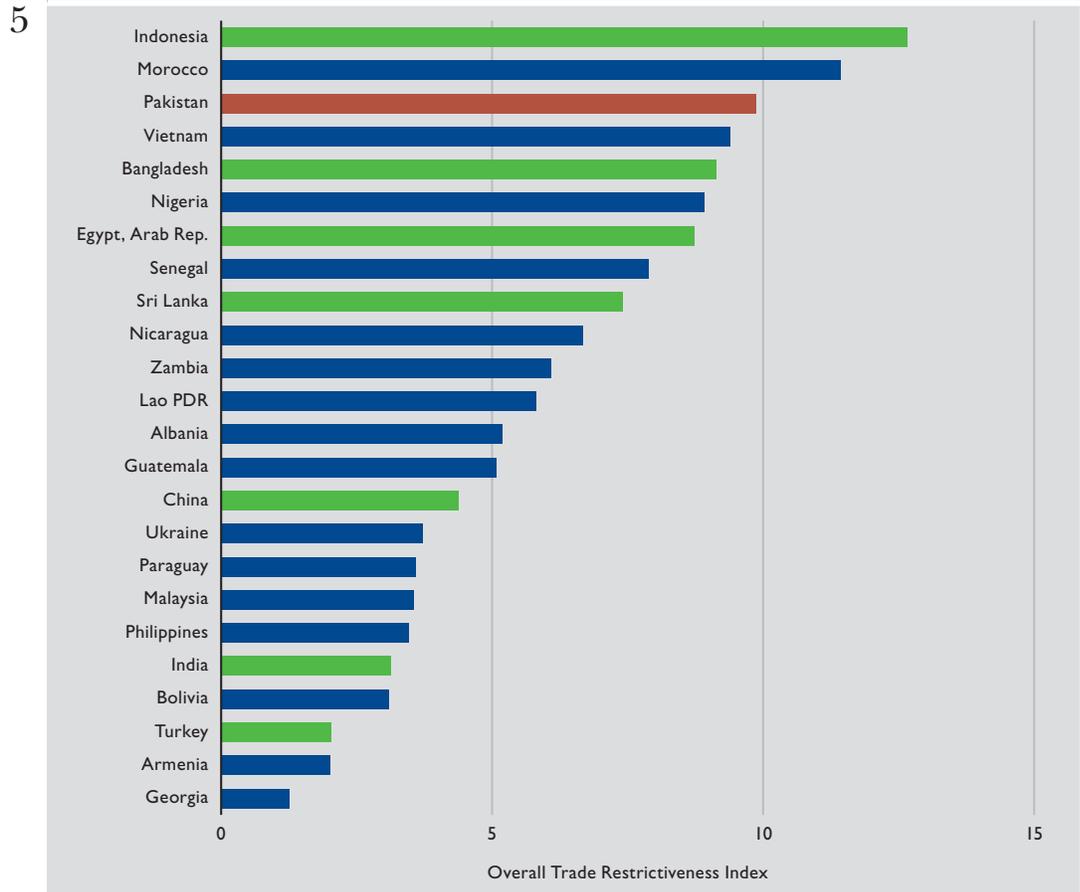
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Measuring the restrictiveness of trade policy is often a complex task, especially given countries' multifarious tariff and trade regimes. Standard indicators of restrictiveness do not capture widespread exemptions affecting imports and other policy barriers and are not well grounded in theory (Kee, Nicita, and Olarreaga 2008).

The Overall Trade Restrictiveness Index (OTRI) quantifies the uniform tariff that, if imposed on home imports instead of the existing heterogeneous structure of protection, would leave aggregate imports at their current level. It is a rigorous way to calculate and compare countries' weighted average tariffs, with weights reflecting the importance of each good in total imports and the responsiveness of the import of each good with respect to the relative tariff.

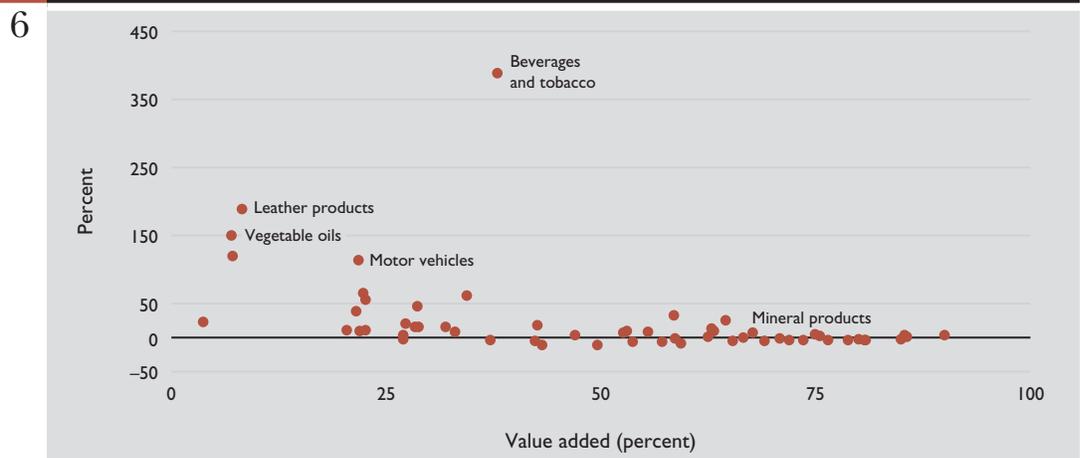
Its theoretical foundation, developed by Anderson and Neary (1996, 2003), was first applied empirically by Kee, Nicita, and Olarreaga (2008, 2009). Following Kee, Nicita, and Olarreaga (2008), the authors estimate the OTRI for Pakistan and other countries using the latest Center for Global Trade Analysis Project (GTAP) Data Base (version 8, base year 2007) and the current GTAP model (Hertel 1997), using applied tariffs and nontariff barriers. The GTAP Data Base provides a more comprehensive estimate of nontariff barriers than the measures in the United Nations Conference on Trade and Development's Trade Analysis and Information System database, the latter of which are used in the calculation of OTRI published in World Bank (n.d. b).

Figure 5 Estimated Overall Trade Restrictiveness Index, selected countries



Note: Green highlights some of Pakistan's main competitors. Base year is 2007, except for Pakistan, which is 2002. Source: Authors' calculations based on Center for Global Trade Analysis (n.d.).

Figure 6 Effective rates of protection



Source: Authors' calculations.

and trade-defense measures, such as anti-dumping measures, countervailing duties, and safeguard measures. Although not all these measures are barriers or protectionist, many do have a negative impact on export competitiveness, as recognized in the recently announced Strategic Trade Policy Framework for 2012–15 (Box 2).

Poor trade facilitation and logistics

A sound trade facilitation and logistical system can play a decisive role in attaining export-led growth—by reducing trade costs, upgrading service quality, improving connectivity between domestic and foreign markets, and moving up the supply chain. Yet Pakistan's logistics are worse than India's and the South Asian and global averages, according to the 2012 Logistics Performance Index (Figure 7). South Asia lags behind all regions except Sub-Saharan Africa, faring in line with its per capita income, and performs marginally better than the low-income country group (Figure 8).

Despite its low rating, Pakistan's Logistics Performance Index improved over 2007–12 (Figure 9). It picked up sharply in customs and infrastructure but declined in logistics competence. In customs and infrastructure, the public sector played a larger role than in logistics competence, which depends more on the private sector.

Improving the performance of Pakistan's seaports and that of the core national trade corridor will benefit the rest of the economy. More than 90 percent of Pakistan's international trade is transported by sea and passes mostly through Karachi. Pakistan has two other ports, Qasim and the recently developed Gwadar Port, which is near the border with the Islamic Republic of Iran. The three are largely feeder ports connected to hubs in the Middle East (Salalah) and Asia (Colombo and Singapore). Authorities have expressed interest in developing Karachi in particular as a hub and Gwadar as a specialized bulk and transit port. But Pakistan's ports lie close to a major international shipping lane

Box 2 The Strategic Trade Policy Framework for 2012–15

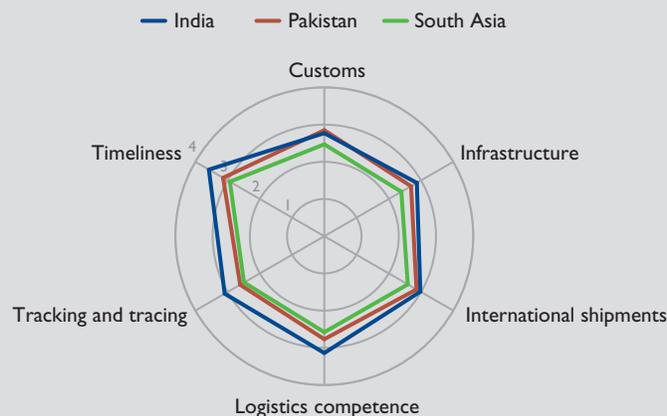
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The new Strategic Trade Policy Framework unveiled by the Ministry of Commerce of Pakistan for 2012–15 recognizes the impact of high tariff protection on export competitiveness and adopts a series of guiding principles to create a more competitive environment (Ministry of Commerce 2012).

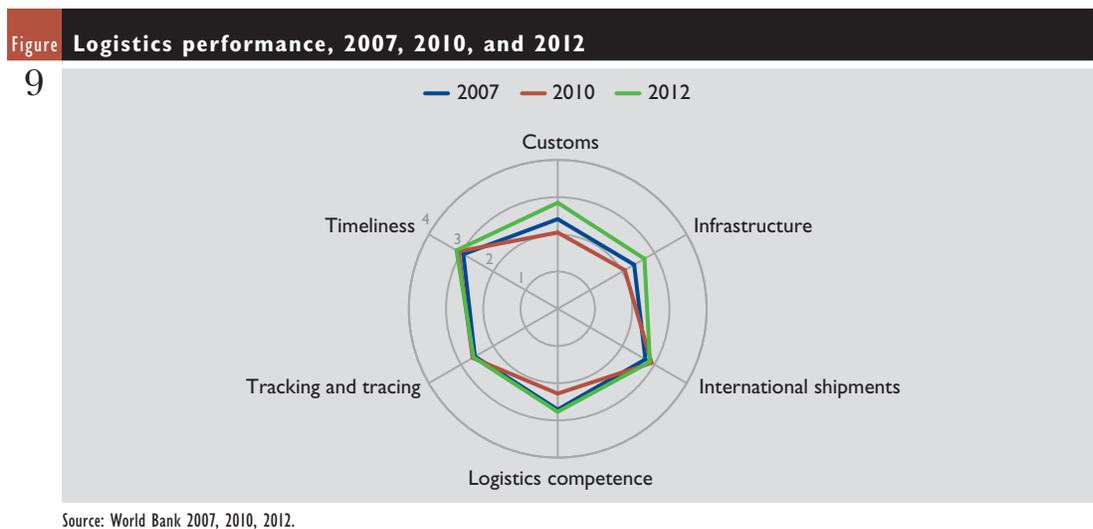
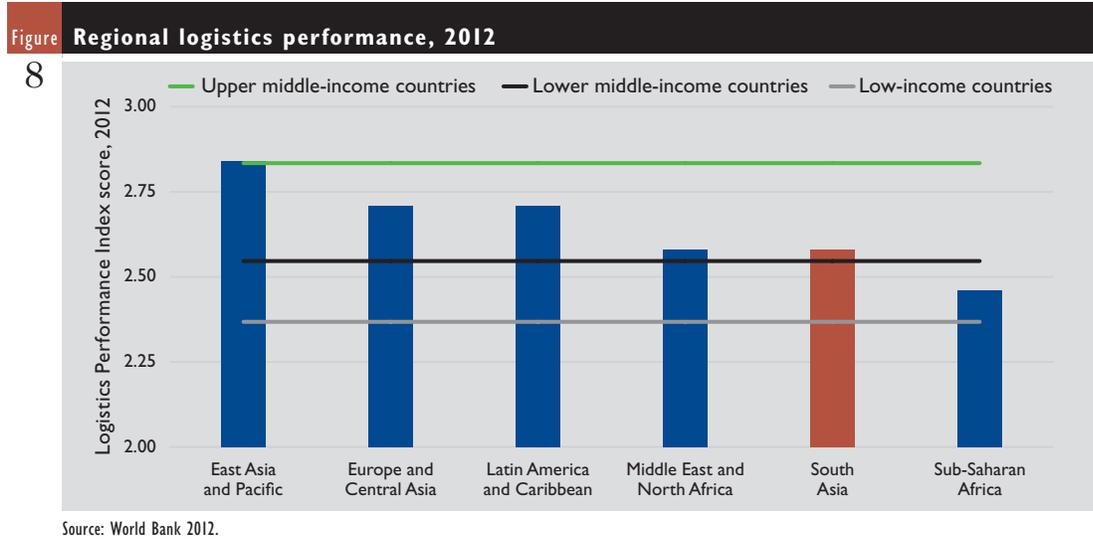
The framework lays out as guiding principles promoting competitive markets, catering to the changing needs of the economy, and giving consideration to consumer welfare. The measures include short-term tariff reductions for imports of capital goods, as well as medium-term measures such as establishing a Services Trade Development Council (to tap the country's potential of export services) and an Export-Import Bank. Perhaps still missing is a clearer medium-term strategy to move toward reducing complexity of the current tariff structure.

Figure 7 Logistics performance in India, Pakistan, and South Asia

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Source: World Bank 2012.



and in a region with competition. For instance, based on traffic volumes, Karachi ranks 75th globally, exceeded in size by eight other nearby ports. Developing the ports as hubs depends on drastically improving port operational efficiency or focusing on niche markets for specific products. In this regard, authorities propose developing Gwadar as a specialized port for containers but more importantly to handle bulk commodities and transit cargo for the Central Asian republics.

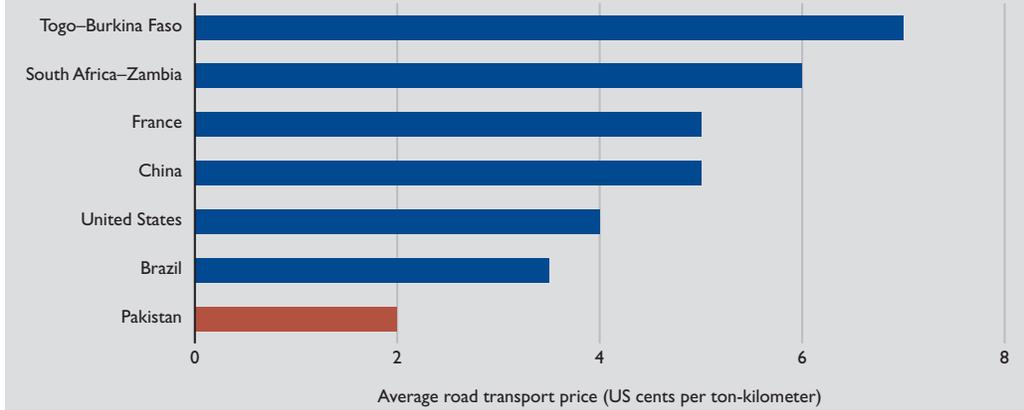
Overland movement of cargo in Pakistan depends largely on road transport but faces challenges in quality of service and in border management (which has an interface between public and private sector agencies involved in goods clearance). These topics are now discussed in more detail.

Road transport is the dominant mode of land transport, accounting for more than 80 percent of cargo volumes. Despite poor conditions of parts of the road network, Pakistan has some of the lowest road freight transport rates in the world (Figure 10), partly due to the industry’s structure. The majority of trucks are operated informally as small fleets. In 2007, Pakistan had as many as 209,000 registered trucks, more than two-thirds of them rigid trucks. Most vehicles are old and highly fuel inefficient. Truckers keep rates low by maintaining old fleets and by overloading their vehicles. Competition and high operating costs cut heavily into their margins and hamper efforts to modernize their fleets.

The Pakistan trucking market continues to evolve with an increasing number of formal companies

Figure Selected transport prices, 2007

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Source: Authors' calculations based on Teravaninthorn and Raballand (2009).

running large fleets of trucks (more than 50 vehicles). The largest fleet operator is the state-controlled National Logistics Cell (NLC), which owns more than 1,500 trucks. The NLC, owned by the military, previously had a monopoly on Afghanistan transit traffic by road. The NLC suffered from a lack of capacity, and the market was opened up in 2011. Other large fleet operators are petroleum companies, such as Shell, and dry-port operators, notably Sialkot (more than 70 trucks) and Faisalabad. These larger operators all provide modern services, including vehicle and shipment tracking.

The independent truckers have also changed how they are organized. Previously they were contracted for individual shipments with rates negotiated directly with the shippers or their brokers, and they secured backhauls from the many brokers in the major cities. Over the past few years,

some of the larger road haulage companies have begun contracting service to independent truck operators to supplement their own fleet. The government is currently implementing a trucking policy that seeks to modernize the trucking sector, albeit slowly (Box 3).

While some of these initiatives may raise trucking prices, they also raise quality, especially reliability, which is especially critical for sophisticated supply chains. Some market segmentation should therefore be expected, with the more sophisticated chains paying more.

Customs has been modernizing border management for the past several years, though several challenges remain. Reforms introduced include the use of the Harmonized Code, creation of a Single Administrative Document (Goods Declaration), and electronic submission and processing

Box New policy on trucking industry

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In 2007, the government drafted a trucking policy, which is now under implementation. The policy is designed to serve as the basis for modernizing the trucking sector. It has several progressive provisions that, if realized, would raise the trucking sector's service quality. Key provisions of the policy include:

- *Enhancing access to finance.* The policy seeks to make it possible for trucking concerns to access financing from financial institutions. This is being pursued by designating the sector as an "industry," which under Pakistani law then enables trucking concerns to borrow from banks at less than commercial rates. Limited access to finance has long been an impediment to modernizing and replacing the current fleet of predominantly old trucks. The policy provides incentives for this to happen.
- *Motor vehicle registration.* The provinces handle motor vehicle registration in Pakistan. It is thus usually difficult to obtain current information on the vehicle fleet. The policy proposes to establish a central depository for motor vehicles for nationwide maintenance of data.
- *Vehicle worthiness testing and certification.* The policy provides regular tests of fitness of vehicles and their road worthiness certification. This will be accompanied by training and capacity building of staff involved in the tests.

of declarations at seaports and major land borders. These improvements have cut clearance times and increased the collection of duties and taxes. Until recently, there were two IT systems for submitting the Goods Declaration—the Pakistan Customs Computerized System (PACCS) and the web-based One Customs. In 2012, One Customs was adopted as the sole system and is now being rolled out across the country. This has helped address the problems of duplication of systems development posed by the previous situation.

Inspection decisions are often accompanied by informal payments. The rate of physical inspection has been reduced but remains higher than it would be under an effective risk management system. The typical clearance time for cargoes with proper documentation is two days for imports and one day for exports, while that for other cargo is longer (USAID 2010). Customs has a risk management unit that developed some risk profiles and in theory selects the level of inspection applied for individual shipments. However, both the PACCS and One Customs systems perform limited functions, and neither has a risk management module. (PACCS randomly selects containers, but this can be overridden by an officer, creating opportunities for informal payments.)

Although the procedures for handling transit cargoes have been simplified, the time required for issuing transit permits is long, and the procedures for inspecting transit cargo are neither transparent nor efficient. Nor does Pakistan have a formal system of Authorized Economic Operators, although informal recognition is given to preferred traders who receive expedited clearance. Modern X-ray scanning has been introduced but only at the Qasim International Container Terminal and only for exports to the United States as part of the Customs-Trade Partnership Against Terrorism.

Policy Recommendations

The following policy actions aim to stimulate export diversification and expansion.

Simplify tariff and trade regulations

The priority is to abolish the distorted and highly complex tariff structure. Domestic market protection

through tariff protection generates an anti-export bias. Because Pakistan cannot influence world market prices, exporting firms gain no benefit from domestic tariff policies. By contrast, producers for the domestic market enjoy a price advantage over foreign competitors. This leads to market distortions that incentivize producers to focus on the domestic market. Simplifying the complex import tariff and tax regime would also foster certainty, increase transparency, and promote firm dynamism.

The remaining regulatory duties also need to be eliminated—and the import tax regime liberalized. While many regulatory duties were removed in 2011, selective protection and concessions on inputs remain a source of economic inefficiency because valuable resources are being diverted—to less productive sectors that are protected from otherwise low international prices and away from the industries that have comparative advantage. Concessions that work as a de facto import licensing regime entail transaction costs to the firms that hope to benefit, to the government bodies that administer it, and to the Engineering Development Board. Because the information and transaction costs will tend to be lower relative to their output, the system probably benefits larger established firms and discriminates against small and medium-size enterprises. This “customized” domestic protection entails important costs and risks, including the risk that protected firms have a disincentive to become efficient, often relying on continued protection to remain in business, rendering a loss to consumers, and reducing economic efficiency. High duty rates and a regulatory duty imposed only on imports is an extremely inefficient way of cutting imports of “luxury” products and is a counterproductive method for generating government revenue. The very existence of schemes granting protection to selected sectors and products increases the scope for smuggling and under-invoicing.

In the short term, a road map should be outlined for gradually simplifying the tariff regime. It might include an immediate reduction of the top rate to 25 percent and a move to a transparent, three-band structure (25 percent, 10 percent, and 0 percent).

In the medium term (three to five years), the government should consider phasing out regulatory duties and eliminating exemptions outside trade agreements and free zones. These steps would have important positive effects in the long run, with transitory adjustment effects on output and employment limited to some sectors and a relatively small impact on tariff revenues.⁴ Higher value-added export-oriented sectors, such as chemicals and chemical products and machinery and equipment, are likely to benefit even in the short run. Many lower value-added, import-competing sectors, such as processed foods, rubber and plastic goods, and other manufacturing, would adjust production downward in the short run, as would many services sectors that temporarily lose out as consumption adjusts to take advantage of lower prices, particularly in traded goods.

The medium term should also see a move toward an eventual uniform 10 percent tariff. Estimates calculated for this note found that eliminating all exemptions and moving toward a uniform 10 percent tariff would raise tariff revenues 79 percent and total import tax revenue 36 percent while increasing import prices 1.4 percent. The full effects of reform would start to emerge over the medium term, as economic agents respond to the new incentive environment, shifting resources from less productive to more productive economic activities.

Accelerate deep preferential trade agreements

Accelerating implementation of deep preferential trade agreements and signing other agreements in that vein are key initiatives in expanding market access. Pakistan has to scale up efforts to benefit from the geographic advantage of being in a high growth region of the world. Significant trade-creation effects are likely to originate from the relatively recent trade agreements with China and Malaysia, due to the deep nature of these agreements and their coverage beyond market access issues. By contrast, regional preferential trade agreements limited to market access are unlikely to bring benefits because of Asia's deep, fast-paced integration agreements.

Fully normalize trade relations with India

Fully normalizing trade relations with India, including opening the border, will facilitate deep forms of trade integration. The measures are necessary to benefit from India's fast growth and to promote complementarities, including value-chain activities and investment potential. Our calculations using a gravity equation suggest that exports to India are 40 percent below their predicted potential. Similarly, Pakistan is the key missing market for India, underlining that both countries would gain greatly by normalizing their trade relations. These moves should aim at deep forms of trade integration and not be limited to market access. Given that trade is only now starting to be normalized, the focus should be on expediting measures to facilitate trade, building on the recently signed agreements on mutual recognition and visas, and improving infrastructure, institutions, services, policies, procedures, and market-oriented regulatory systems.

Specific measures for further assessment, potentially on a joint basis with India, include:

- *Removing impediments at the border, especially Wagah–Attari, and along trade routes.* A one-stop border post at Wagah–Attari would have a large demonstration effect, as would inland container depots on either side of the border. There is also potential for transit agreements to link Pakistan to Bangladesh and to Nepal, and India to Afghanistan (similar to the one negotiated between Pakistan and Afghanistan); for associated infrastructure supporting new trade routes; and for online payment systems.
- *Further integrating border communities.* Populations along the border regions are among the poorest in both Pakistan and India, and so integrating their communities presents particular challenges. More localized initiatives to target them, including border bazaars and other measures to encourage cross-border trade, are yet to be fully explored. Some initiatives along these lines are already in place between Bangladesh and India.

Address logistical weaknesses

It is critical to improve the regulation of trucking and of the clearing and forwarding industries. A

wide gap in the legal framework is a liability for goods as they move along the chain—truck operators, for instance, carry only third-party liability. (A draft law on logistical service providers, currently in Parliament, should help improve the quality of other logistical services.) Given the presence of numerous small players in this market, a solid legal framework for responsibilities and liabilities, including those of truckers, is paramount. Freight forwarders, most of whom are also clearing agents, are the most important intermediaries in trade logistics in any country, and in Pakistan they urgently require capacity building.

Improving customs and border management is crucial for lowering logistical costs, particularly port operations and customs procedures. It is important to reduce the current high dwell time for cargo, especially in ports. A unified and comprehensive customs system would benefit trade logistics, allowing the private sector to develop and invest in appropriate interfaces. Also critical is the introduction of an effective risk management system, a formal Authorized Economic Operators regime, and an expedited regime for transit shipments. These measures will allow more cargo to be cleared inland, reducing bottlenecks at seaports and land borders, making clearance procedures more effective, and allowing for greater cooperation between shippers and customs officials. As Pakistan is developing trade links to the Central Asian republics in the north, these systems would be strategic.

Notes

1. The trade to GDP ratio is one of the most basic indicators of openness to foreign trade and economic integration. It weighs the combined importance of exports and imports of goods and services in an economy. The ratio gives an indication of the dependence of domestic producers on foreign demand and of domestic consumers and producers on foreign supply. There is a concave relationship between trade openness and per capita income: countries tend to trade more as incomes rise, but at a decreasing rate.
2. An ordinary least squares regression (using cross-country data from the World Development Indicators database) of trade/GDP on the log of per capita income (purchasing power parity dollars), its squared value, the cost of exporting (using a sub-indicator from Doing Business 2008 to 2010), and population predicts a trade share of 65 percent. The actual trade share of less than 32 percent is therefore extremely low.
3. Export growth is said to take place at the intensive margin when it occurs by selling more of the same products to the same markets, while growth at the extensive margin includes new product discovery, existing products sold to new markets, and new firms entering export markets.
4. An exercise conducted for this note shows that a reform that puts a ceiling for tariffs at 25 percent but retains all other features of the current tariff regime, including exemptions, would reduce tariff revenues 3.7 percent but import tax revenues only 1.8 percent, and import prices only 0.6 percent.

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