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Awake the Sleeper Within: Releasing the Energy of Stifled Domestic Commerce

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ISLAMABAD

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ABSTRACT

Policy in Pakistan has been fairly path-dependant, placing a higher weight on export promotion and domestic industrialisation development than on domestic commerce. Yet domestic commerce is growing rapidly, and quite possibly is the largest sector in the economy. This paper argues that a more holistic policy, with no favourites, that allows for all sectors to grow leads to better long-term economic results. A vibrant domestic commerce sector is the core of the economy facilitating intermediation between supply and demand, entrepreneurial development, risk-taking, innovation, and competitive markets. Such an economy moves beyond commodity exports to brand name, process, and capital exports, all of which command a higher rate of return. Pakistan could therefore achieve a higher and a more sustainable growth rate by adopting a more balanced growth strategy.

Many developing countries may still be the “slaves of defunct economists.”¹ They lack public policy research capacity—lack think tanks and universities—places where serious research can be conducted and policy debate can take place. The result is that economic thinking and debate is seriously discounted often being left to non-professionals.² In keeping with Keynes’s famous statement, Pakistani policymakers may be “distilling the wisdom of some academic scribbler of a few years back.” Haque (2006) has already argued that Pakistan and perhaps many developing countries are continuing to follow the planning strategies of the past which emphasised production, mercantilism and government led, planned growth. Pursuance of this strategy may be costly in terms of forgone growth. This paper now makes the case that the continued pursuit of a growth strategy based on production for mercantilist goals has stifled domestic commerce and the development of a consumer economy in Pakistan. Unleashing the potential of domestic commerce may be the path to high sustainable growth in the country.

STATIC GROWTH PARADIGM

For many years, Pakistan’s growth strategy that has been followed in many poor countries such as Pakistan is a derivative of the early ‘big push’ models which emphasised purposive expansion of output. In Pakistan, the Harvard Advisory Group thinking, which Dr Mahbub ul Haq so eloquently presented in his book ‘strategy for economic planning developed a growth strategy based on three pillars: chasing industrial production, a mercantilist approach (protecting favourite and inefficient sectors while subsidising and promoting exports) for developing foreign exchange surpluses, a large and dominating role of the government with a suspicion of the market and the private sector [see Haq (1963)].

In keeping with this thinking, Pakistan has continued to promote production, especially industrial production, often with concessions. In past Pakistan has given this sector substantial subsidies-cheap interest rates, land below market rates, energy subsidies etc. Even while subsidies are eliminated under IFI pressure, policy gives production and exports some cover through

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¹John Maynard Keynes (1883–1946) ‘The General Theory of Employment’. Interest and Money, ch. 24 (1936).

²See Haque and Khan (1998).

interest rate subsidies, export rebates, and public sector development of industrial estates. Despite WTO, policy continues to protect items such as cars and engineering goods while the entire government machinery is geared to promoting exports. Many presidential and prime ministerial state visits are directed toward export promotion.

Following the thinking of the sixties most developing countries continue to believe in the 2-gap model, the two gaps being a domestic saving shortage and a foreign exchange shortage. Planning calculates a domestic investment need based on desired growth on industry. This investment need is always larger than domestic savings and hence sends the government continuously to the donors to look for financing.

Since the emphasis is on industrial development, state planning also needs to find the foreign exchange that will be required for importing the capital that is necessary for this goal. For this reason strategies to conserve foreign exchange have pervaded developing country history. For much of history, government has maintained stringent capital controls, used every conceivable subsidy for export promotion and maintained high tariff walls for consumer goods. The result of this policy has been that the domestic consumer in these countries lives with substandard consumer goods while the exporter exports basic commodities and simple manufacturing goods such as the very basic textile and clothing items. An emphasis on export promotion and import substitution industry is known in history is known as 'mercantilism'. Evidence has shown that this policy that should be pursued for any length of time.

Dr Mahbub ul Haq's (1963) classic on economic planning discussed all these principles very well discussed.³ He also pointed out how and why the government needed to lead the economic development process. It was believed then that the government always knows best and must direct the economy. Few however, remember that Dr Haq also mentioned the weaknesses in the bureaucracy that might make it difficult to implement the plans that were being devised. Instead all stakeholders continue to let the government dominate the economy and the market, while letting the bureaucracy remain in charge in its non-technical and unreformed state.

Chart 1 illustrates the current strategy, which emphasises production and mercantilism. In this scheme, policy emphasises production for both export and imports substitution. Exports are based on basic products like knitwear and garments and some agriculture while imports are heavily taxed allowing for low quality import substitution. The result is that new product development and entrepreneurship are seriously impeded. Consumer markets remain underdeveloped because policy discourages them and the lack of markets further

³Papanek (1967) presents another exposition of Pakistan's strategy. Ranis (2004) presents a historical note on the evolution of development thinking. See Lal (1997) for a critique of the development policy that countries like Pakistan have followed.

Chart 1

reinforces the stunted development of entrepreneurship and new product development.

Much has been learnt about the growth process in the world and this knowledge needs to be applied in Pakistan and perhaps to many developing countries. Haque (2006) reviews the medium term development strategy of Pakistan to show that the paradigm has not shifted. The government continues to push production along mercantilist lines while taxing domestic consumer and commerce.

WHY NOT A 'CONSUMER' FOCUS?

The earlier approach based on government-centered planning, reliance on foreign resources, and mercantilism, has not worked because the structure of incentives that resulted from this approach led to the neglect of governance, development of rent seeking, and a society that did not nurture talent. There is an urgent need to shift the growth paradigm in Pakistan. Let us see how!⁴

An economy is an integrated whole which works best when all participants in it share the benefits of trade and growth. A long time ago, Adam Smith, the father of economics, pointed out that all economic agents could maximise their welfare if they were freely allowed to trade with each other and the rest of the world. Much economic literature exists to show that the mercantilist approach of incentivising export promotion and import substitution is not an optimal strategy. Export promotion and import substitution can be (and in Pakistan that is the case) followed at the cost of domestic markets and consumers. For example, exports are subsidised to provide the foreign consumer a Pakistani subsidy while imports are heavily taxed for import substitution to make Pakistani consumer goods very expensive. This leads to inadequate trading at home and welfare loss to domestic consumers. It also means that inadequate investments are made in domestic market development since the products are expensive and consumers poor. In this situation the only driver of change is the external sector and external demand.

Nobel Laureate Hayek had pointed out that markets where consumer demand was clearly articulated are the nervous system of an economy.⁵ Well functioning markets clear demand and supply through price adjustments, which convey relevant market information to all producers and consumers. Consumer markets are therefore the 'front end' of the economy where the demand and supply of many products, brand names, new products and new services are all equilibrated through the price system. In such markets innovations and entrepreneurship thrives through risk taking and understanding of tastes and markets.

⁴See Pakistan (2003, 2005) for a discussion of the country's current growth strategy and see Haque (2006) for a discussion of that strategy.

⁵See Hayek (1945).

Stifling domestic markets while trying to push the external sector, as has been done in Pakistan, results in lopsided development. The economy is a system that needs to work as a whole, with domestic and external trade supporting each other. It is in domestic markets that all manner of innovation and entrepreneurship can take place which later will move out and lead to higher exports and foreign exchange earnings. Entrepreneurs and innovators need neighborhood markets to perfect their products, brands and recipes, which they will then export. Multinationals like Coke, McDonald's, and Ford all started as domestic industries. Their testing ground was domestic consumer market.

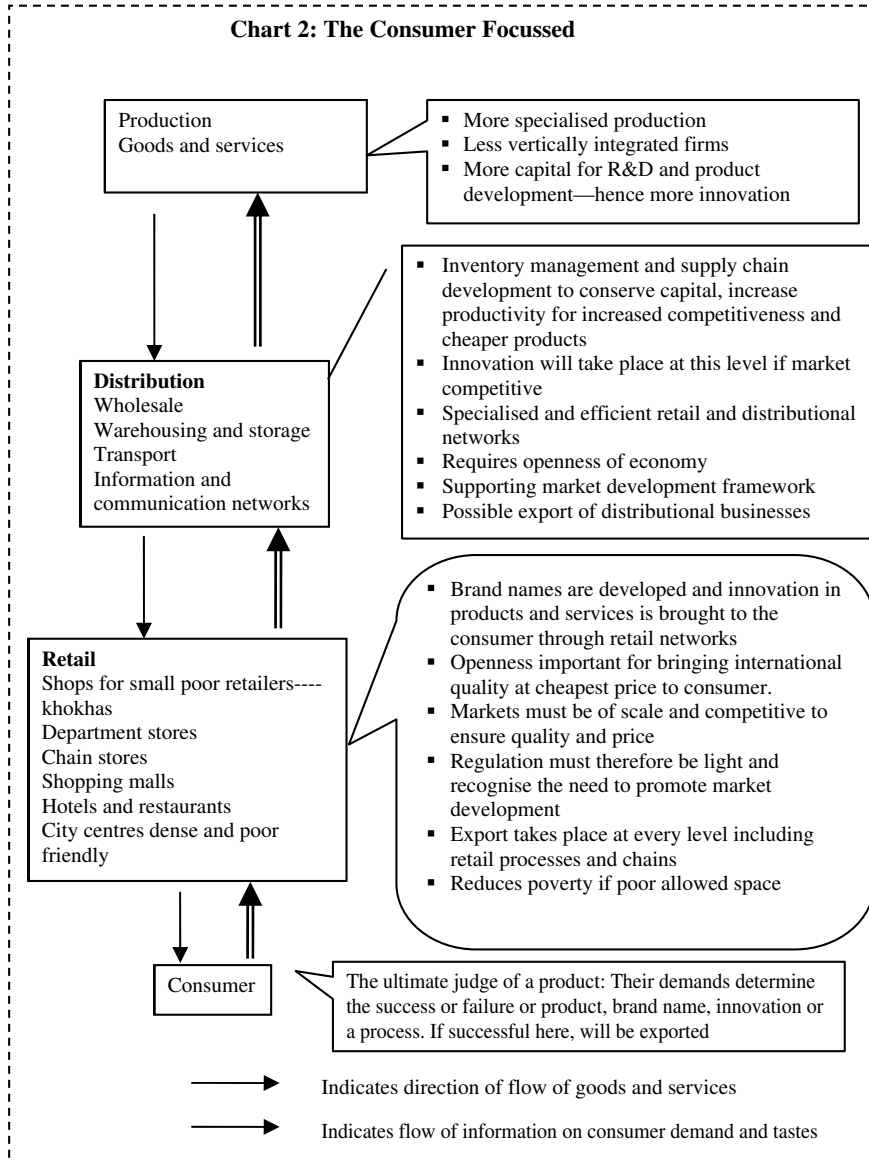
In the current paradigm of industrial mercantilism, Pakistan has not moved beyond the export of the most basic goods—simple textiles and basic commodities. All manner of committees argue for “more value-added exports” or “move up the value chain!” Yet this is not happening. Perhaps the missing link is domestic commerce?

Chart 2 shows a schematic illustrating the consumer-focussed growth paradigm that will develop if the proposed domestic commerce strategy is adopted. In this strategy, domestic consumer markets are allowed freedom resulting in the development of entrepreneurship and new product development. Many new activities and businesses are developed. These new goods and brand names that are developed are the key to develop new export markets. More importantly in this model not only goods are exported but there is a greater likelihood of businesses being exported leading to the birth of the Pakistani multinational. Examples of this process include ‘Guess’, ‘Samsung’ and ‘Sony.’ Even today, Sony releases many new products in Japan first before exporting them. This is how international experience develops value-added exports that committees and planners are asking for—through the development of domestic commerce.

In ‘production/mercantilism’ paradigm, we are able to achieve high rates of growth periodically. In the sixties we were able to attain 6 percent, in the eighties we were able to get 7 percent per annum and now in the 2005 we have been able to get to 8 percent. In the past this growth was not sustainable. For the future, we have to wait and see. But in each growth spurt, poverty was not eradicated or reduced significantly. If the growth paradigm were to shift and policy were friendlier to commerce and markets allowing cities that were commerce friendly then I would propose 2 hypotheses

1. Growth on broader foundations of deep domestic markets and commerce friendly cities would be higher and more sustainable.
2. Poverty would decrease more dramatically since the poor are mostly engaged in domestic commerce activities since they have no capital or assets.⁶

⁶See Husain (2003) for a very informative analysis of poverty in Pakistan.



THE STATE OF DOMESTIC COMMERCE

In the current paradigm, domestic commerce is a forgotten sector. It receives no attention from the policy-maker. No information on it is collected. No attempt has ever been made to develop a coherent policy framework for it. Indeed this is surprising given that we do know that this sector is the largest employer, providing for all segments of society especially the poorest (see

Tables 1 and 2). This sector touches all. Yet it remains under-researched! Surprisingly, no government department collects any information on this sector or reviews the various policies and regulations that affect this sector.

Table 1

Employed Labour Force by Sectors (No. in Million)

| Industry/Sector | 2001-02 | | | 2003-04 | | |
|-------------------------------|---------|-------|--------|---------|-------|--------|
| | Total | Male | Female | Total | Male | Female |
| Agriculture | 16.37 | 12.69 | 3.68 | 17.97 | 13.22 | 4.75 |
| Manufacturing and Mining | 5.38 | 4.52 | 0.86 | 5.73 | 4.7 | 1.03 |
| Construction | 2.35 | 2.33 | 0.02 | 2.43 | 2.41 | 0.02 |
| Wholesale and Retail Trade | 5.77 | 5.67 | 0.1 | 6.18 | 6.06 | 0.12 |
| Transport | 2.29 | 2.27 | 0.02 | 2.4 | 2.39 | 0.01 |
| Financing and Insurance | 0.35 | 0.34 | 0.01 | 0.44 | 0.43 | 0.01 |
| Community and Social Services | 6.03 | 5.04 | 0.99 | 6.27 | 5.15 | 1.12 |

Source: Labour Force Survey, 2003-04.

Table 2

*Share of Services Sector in Gross Domestic Product
(At Constant Factor Cost-Percent)*

| Industry/Sector | 1969-70 | 2000-01 | 2001-02 | 2002-03 | 2003-04 | 2004-05 |
|--------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Services Sector | 38.4 | 51.8 | 52.7 | 52.9 | 52.6 | 52.4 |
| Transport, Storage and Communication | 6.3 | 11.7 | 11.5 | 11.5 | 11.4 | 11.1 |
| Wholesale and Retail Trade | 13.8 | 18.1 | 18 | 18.2 | 18.5 | 19.1 |
| Finance and Insurance | 1.8 | 3.1 | 3.6 | 3.3 | 3.3 | 3.7 |
| Ownership of Dwellings | 3.4 | 3.2 | 3.2 | 3.2 | 3.1 | 2.9 |
| Public Administration and Defense | 6.4 | 6.3 | 6.5 | 6.7 | 6.5 | 6 |
| Other Services | 6.7 | 9.4 | 9.9 | 10 | 9.9 | 9.6 |
| GDP (Constant Factor Cost) | 100 | 100 | 100 | 100 | 100 | 100 |

Source: Economic Adviser's Wing, Finance Division.

A recent consultation with all stakeholders revealed how severely constrained is this sector.⁷

- Urban zoning remains uninformed of modern city and commercialisation needs. It is managed by the generalist officials of the elite public service who occupy positions of city managers and planners on transfer for a short period to move on to other activities. They have neither the expertise nor the time to develop an interest to understand this complex subject. The unfriendly zoning laws are perhaps the biggest constraint to serious domestic commercial development.
- ◆ It continues to regard all forms of domestic commerce as undesirable demanding large commercialisation fees and leaving it only with residual space. Zoners are strongly biased towards large single-family homes on the style of large American suburbia. Unlike America, which they are copying, zoners remain unfriendly to large commercial development. They leave no space for large shopping malls, office, and warehouse or hotel development. They particularly dislike mixed use where the poor and the middle classes can live. In fact, there are no city centres in any Pakistani city as mixed use, where commerce and the middle classes commingle, is not allowed.⁸
- ◆ Urban zoning is in particular very unfriendly to the poor retailer who lacks the capital to get into structured expensive retailing that in any case is in short supply. Unlike Bangkok, Hong Kong and Singapore, urban zoning allows no space for street vending through kiosks in city centres. This change alone could have a huge impact on poverty.
- ◆ The declaration of commercial space is arbitrary and cumbersome [see Haque, *et al.* (2006)]. Clustering of commercial activities or consolidation of lots for large commercial development can be extremely difficult. Even if the government zones an area as commercial, each lot has to be converted separately through a cumbersome procedure and payment of large fees. For example, the area around all hotels in Lahore, Rawalpindi and Islamabad remains basically undeveloped because zoning does not allow lots around these to be converted to commercial space. In other countries such space is used for clustering commerce.
- ◆ Because of this urban management policy, there remains a huge excess demand for offices, warehouses, flats, retail, and other forms of commercial space. Businesses make do by converting the existing

⁷For a complete report on the conference that took place on the subject, 'Domestic Commerce—The Missing Link', see Haque and Waqar (2006).

⁸Unfortunately urban economics has not been a subject of serious research in Pakistan. Some interesting observations may be found in Haque (2004).

housing stock illegally to these required functions. This imposes costs on businesses through increased rentseeking and the provision of non-standard and non-purposive space.

- Government continues to own large tracts of land in city centres for official residences, offices, training institutes and other non-commercial official purposes. This blocks productive city centre development.
- In keeping with the prevailing growth paradigm, taxation seems to visit this sector more than the policy-favoured sectors—industry and export. Resistance by the sector to unfavourable tax zoning and regulatory policy leads to these businesses being termed ‘informal’ or ‘smugglers’.
- The cost of doing business because of affect all business.⁹ However, industry because it is favoured by the policymaker and agriculture because it has political clout can obtain some relief in the form of subsidies or tax concessions. Domestic commerce because of the additional constraints mentioned here has never been able to achieve the scale to attain a seat at the policy table.
- Banking laws as well as prudential supervision remain unfriendly to domestic commerce and its expansion needs. Financing of domestic commerce inventories and cash flows is not possible in the current framework.
- Unlike export based industry, domestic commerce expansion requires complex contracting mechanisms as well as delegated management structures. The current state of law and order and especially contract enforcement regime would need to be seriously strengthened to enable the contracting requirements of say a retail network or a large franchise operation.
- While the state is engaged in developing subsidised industrial parks, consideration to a possible commercial park, with office, retail and warehousing has never been given. Instead as noted above, the unintended consequence of most state policy is the inhibiting of such development.

The upshot is that Pakistan has a very poor domestic commercial sector that can hardly serve the consumer. There are no department stores, shopping malls, supermarkets, chain stores, branch networks, leisure industry, brand names, city centres, warehousing, storage, or community and public spaces of any significance. Shops continue to be little boxes in dusty streets or corridors with no access. They have no inventory, carry no quality goods and warranties and consumer protection is unknown. There are hardly any businesses based on

⁹These would include frequent changes in government policies, the threat of ‘fundamentalism’, lack of copyright protection, inadequate property rights, poor quality of education, and inadequate physical infrastructure, cumbersome regulatory procedures, etc.

domestic commerce listed on the stock exchange. Their access to financial markets has always been limited in our history.

The history of retail is shown in Table 3 below. As argued above, retail is the front end of the market and a developing retail market will allow many

Table 3

Historical Development of Markets

| Stage | Type | Characteristics | Upstream Infrastructure and Legal Needs |
|--------|---|--|---|
| First | Small shops along well traveled routes | Limited convenience, high margin, low turnover, limited inventory and high search costs, no consumer protection | Small manufacturers |
| Second | Supermarkets and shopping clusters especially markets of a similar good e.g. Diamond market, the clothing market etc. | Improvements in convenience, margin, turnover, inventory and search costs over first phase as more competition develops but still market participants lack financial strength to truly benefit consumers | Craft and small manufacture |
| Third | Department stores | Offering convenient one stop shopping, brand names that invest in quality and consumer protection. Low search costs as department store maintains large inventories. | Distribution, wholesale and warehouse activity. Professional management |
| Fourth | Chains of stores | Bringing the department store reliability and consumer benefits close to all consumers. Large turnovers with margins dropping | Growth in distribution, wholesale and warehouse activity. An open economy supplies this network. Supporting legal framework for long distance management and contracting |
| Fifth | Convenience stores and discount stores | Big companies with deep pockets using their buying power and marketing ability to do a high volume, high turnover, low margin business. Consumer welfare enhanced | Supporting financial markets and open economy that allows a global reach. Warehouse and distribution companies are large partners |
| Sixth | Shopping malls to house above activities | Increased convenience making shopping a pleasant experience | Development of institutional investors who invest in large physical investments such as shopping malls and financial and legal system that supports this form of specialised multi contracting business |

upstream industries to be developed. But for that to happen, openness of the economy must be increased and maintained while also developing the legal and financial markets to be a handmaiden to domestic commerce. Pakistan remains at the first or second stage of development. To move it along to the following stages, a change in the current policy mindset is seriously needed.

The State of Market Development!

The domestic commerce agenda is that of market development. In the current approach, markets development is seriously impeded. The current policy stance has not really fostered competitive markets. Government response has been to develop competition legislation and set up regulation for market development.

The policymaker needs to understand the complexity of development. The strategy of favourite sectors leads to lopsided and static development. This is evidenced in Pakistan's protection of various industries for long periods of time without making them sustainable over the long term in an open environment.

Developing markets and giving all businesses room to compete and grow will establish entrepreneurship and develop dynamic comparative advantage.^{10,11} This is the approach that has been followed in the more successful economies such as Dubai, UAE, Chile and Thailand.

Focusing on markets and consumers instead of production and mercantilism will allow many synergies of development to be exploited. Complex linkages between the various activities of domestic commerce will reinforce growth. For example, large, branch-networked retail needs to be supported by extensive development of distribution and warehouse networks, office space and transport networks. All this in turn could enable tourism and hotel development. All this reinforces Pakistan's integration into the global market place. And greater global integration will strengthen modernisation and retard the spread of fundamentalism.¹²

Moving the Paradigm

As argued above, the growth paradigm remains producer and export focussed and is based on government domination of the market. If the consumer was to be served and the domestic commerce sector were to develop that would

¹⁰It is extremely important to establish entrepreneurship as the vehicle of growth in the country. See Haque (2006a) for a discussion of the state of our entrepreneurship and Drucker (1970) for a conceptual discussion of the role entrepreneurship plays in enterprise and in the economy.

¹¹Haque (2006a) argues that the current growth strategy is not developing entrepreneurship. Instead, it is facilitating rent-seeking.

¹²See Bhagwati (2004) for a review of globalisation and its benefits.

necessarily mean the development of the market place and a retreat of government and the power of the bureaucracy.

The entire government machinery seems to be focussed on exports and production offering these sectors all manner of budgetary and official support. In countries like Pakistan, no information is collected on domestic commerce. Hence the impact of policy and regulations on this sector is not even known or understood.

If this new paradigm is accepted, policy would be based on the following.

- Cities in Pakistan should be independent and large commercial centers where mixed-use activity abounds with plenty of office, retail, warehouse, leisure, hotel, and other commercial space. For this we will require:
 - ◆ Professional urban management that is sensitive to mixed use city center and commercial development.
 - ◆ Change of mindset that favours single family homes for the rich over commercial development and middle class housing.
 - ◆ Commercialisation fees that penalise commercial development should be removed.
 - ◆ City center government land must be privatised and those large tracts be made available for mega commercial projects that will include hotels, shopping malls, office space and flats.
- In addition the legal framework must be made supportive of the complex needs of diverse domestic commerce development. This would include the provision of Secure and transparent property rights including intellectual property such as brand name protection. In addition, legal and judicial system for speedy contract enforcement would facilitate a dynamic domestic commerce sector.
- Roll back fundamentalism and limit their ability to influence commerce.
- Policy which till now has been focussing mainly on export promotion will now be concerning itself with “*promoting successful business through encouraging trade, entrepreneurship and innovation and providing fair and efficient markets for the welfare of all Pakistan*”. Specifically, Ministry of Commerce will accept this mandate and will become the **guardian of openness and competition in Pakistan**—a mandate that seems natural for the ministry of commerce. Trade policy will no longer be only for promoting exports but for promoting all trade both at home and abroad. The Ministry of Commerce will have to lead the deregulation effort in the country to unleash the power of the market. If this Ministry truly is able to accomplish this agenda, it will help develop sound economic governance in Pakistan.

CONCLUSION

It is the contention of this paper that if unleashing the growth potential of the domestic commerce sector will not only significantly increase Pakistan's growth but also develop a more egalitarian and just society.

Why this has not happened as yet is because little effort is put into understanding fundamental questions as 'the country's growth paradigm.' The rush to make policy without research has led to a situation where a key sector is ignored and suffering the consequences of overregulation through neglect.¹³

Nevertheless, even casual empiricism and stakeholder consultation does suggest that the policy conclusions that will emerge will involve a substantial degree of deregulation. In particular outmoded and anti-commercial zoning policies that pervade our city management need to be urgently modernised. As will the government's attitude to continued ownership of vast tracts of city centre land which could be better used for commercial development.

To sum up, this new approach must unshackle domestic commerce while also continuing to open out the economy. Let markets develop, push back regulation including outmoded urban zoning and develop technical expertise to meet with the challenges of the open market economy. It must develop a greater consumer focus and maintain a level playing field for all forms of economic activity. It must seek to increasingly integrate Pakistan into the global economy. It must have faith in producers to compete without special privileges and concessions.

However, for this to happen, the government must step back and allow markets to develop!

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¹³The lack of serious economics profession has led to a serious decline in standards, leaving policy to consultants and generalists. [See Haque and Khan (1999)].

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