The distinction between pro-business & pro-market

Mushtaq Khan & Salim Raza,[1] December 14, 2019

Instead of our on-going narrative about Pakistan's economy, we thought we would step back and discuss how a global debate on economic ideology could impact policymaking in Pakistan. In the Anglo-Saxon world, politicians like Bernie Sanders and Jeremy Corbyn are arguing that both the US and the UK needs to adopt socialist policies, which have been disparaged by free-market advocates for over a century. In a world that looks at the *command-and-control* economies of the Soviet Union and pre-reform China, as failed models of the 20th century, this debate is uncomfortable for businesses.

Not many people in Pakistan are thinking about free-market capitalism versus China's model of economic development. Many have been critical of our strong support for an overarching industrial policy based on CPEC, claiming that this creates a false hope anchored to a failed model. Critics point to the failed socialist policies of the 1970s (which they associate with the nationalization phase), and are ideologically opposed to government intervention. Many of them think that Pakistan's government should be selective about China's influence, as they view China's development model as being centrally planned and public-sector led. These people claim that the PPP's socialist policies of the 1970s halted Pakistan's industrialization, and has incentivized short-term investment and capital flight. They view *socialism* and *planning* as somewhat synonymous, which we think is a gross misunderstanding.[2]

This paper will focus on the need for planning, within the context of the policy choices that Pakistan is facing. It starts with a discussion that government intervention is not inherently counter-productive, but actually necessary – and not just for welfare concerns. We argue that government intervention is necessary for the private sector to be more efficient, and more importantly, sustainable. So it is not a *government vs. no-government* debate, but what sort of government intervention Pakistan needs. To make this point, we will flush out the distinction between *pro-business* and *pro-market* policies, to suggest that structural reforms are not possible without an active role for the government.

Our goal is to add a new dimension to our narrative on Pakistan's economy. This dimension will focus on how vested interests operate in the country, and suggest an alternative way of thinking for Pakistan's business interests. The paper is not about prescriptive policy recommendations, but more a way of thinking about how economic policies should be made.

Government intervention

We would first like to dispel the impression that these words signify evil intent, or that government intervention is only about promoting a public-sector agenda. Government intervention is necessary to counter erratic weather conditions (e.g. managing the impact of rainfall and droughts, protecting farmers

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[2] The socialist agenda is most clearly stated in the Second Welfare theorem, where the government enforces a more equitable redistribution of scare resources, and then leaves it to the free choice of individuals (the free market) to decide what to consume, how much to produce, and how many hours to work. The elegant Edgeworth Box from Econ 101 should be sufficient to jog the memory. Socialism is associated with high taxes and generous social services (i.e. shifting resources from the rich to improve the wellbeing of the poor), but this is only a small sub-set of government policies. In our view, the Madina model is not the issue in Pakistan (which conceptually entails a strong social/redistributive agenda), but it is the scope and nature of government intervention that is being debated. Free market advocates are ideological slaves to a simple (and deceptive) motto: *less government is good government*. But deep down, these same people want the government to play a role in the economy – it's just that they want the government to play a role that protects and promotes their specific business interests.

from wild fluctuations in commodity prices, safeguarding coastal cities from seasonal tides, etc.) and to protect public goods the private sector will never care about (e.g. air pollution, global warming, overfishing, sewage disposal, how to deal with used PET bottles and plastic bags, etc.). Government intervention is about creating a more sustainable environment, and also looking out for the welfare of the poor.[3]

Characterizing Pakistan's economy

In making the distinction between pro-business and pro-market, we will frame the issue in stark terms to better flush out the difference – we will also use Pakistan's current situation to sharpen the argument.

We start with the following set of assumptions:

- Stabilization policies have succeeded, and there is a growing sense of optimism about Pakistan's economic outlook;
- CPEC does not have the prominence it had four or five year ago. Perhaps this was inevitable as the initial package was so large, that most Pakistanis simply assumed a transformational change would follow. We would also argue that Pakistan's private sector has not embraced CPEC as we had anticipated, which could explain why the Pakistan Army is now leading the charge (via the new CPEC Authority);
- The Washington Consensus (dominated by the thinking of the US government) is against CPEC, as it views OBOR as China's ambitious plan to dominate the economies in Asia, Eastern Europe, Central Asia and Africa;
- In the past four decades, Pakistan economy and policymaking have been influenced by free-market thinking (the Washington Consensus). This means that Pakistan's business groups are inclined towards the West, not just because of a sense of familiarity, but also by having a personal stake (being educated in the West, having assets there, travelling there for vacations, business/financial links, etc.);
- Prominent business interests have developed strong links in the government machinery, and have operated profitably despite changing governments and senior bureaucrats (it's a symbiotic relationship that has been nurtured over decades);
- Prominent businessmen have served as advisers and federal ministers, in all governments since the late 1980s;
- With the exception of automobiles, Pakistan has witnessed significant de-industrialization in the past three decades;
- The textile sector – as the mainstay of Pakistan's exports – is strongly supported by government policies that protect their profit margins. However, these policies have failed to push their product offerings up the value chain;
- Pakistan's economy has become increasingly import-dependent, and can only grow when the country's FX position is comfortable. A growth phase longer than three or four years, often leads to a balance of payment (BoP) crisis that eventually forces the country back to the IMF. This also means that a growing share of domestic production is designed for the local market;
- The concentration of economic power is rising as specific family groups have become conglomerates. This increases the policy power these groups have to support their diverse business interests;
- The bureaucracy had become politicized, with business/political agendas determining the people who head key ministries, regulators and price-setting agencies. As seen in the past decade, these

[3] Government collaboration is at the core of public-private partnerships (PPP). Here, the government can formulate policy, ensure its consistency, provide land, build basic infrastructure, offer tax incentives and provide long-term management contracts to the private sector to run projects. In our view, the role of the state in the development of the private sector is critical, not optional.

institutions could not resist short-term policymaking. While the PTI government has taken some steps to strengthen these institutions, more is needed;
- Despite being an agri-based economy, Pakistan's agricultural yields are the lowest in the region (and perhaps the lowest amongst large crop producing countries);
- Over the past three decades, Pakistan's social indicators have fallen far behind its peers in South Asia;
- While business groups regret the weakened state of the country's economy/institutions, trading-based families still view business success from the perspective of short-term profitability; &
- The endemic corruption in the country (both in the government and private sector), creates a transactional relationship between the government and businesses. This discourages long-term thinking, which explains why the planning process (the Planning Commission) has become dysfunctional. With little (or no) planning, Pakistan has fallen back on the policies recommended by the international financial institutions (IFIs).

Pro-business vs. pro-market

Against this backdrop, we would make a distinction between policies that are *pro-business* (as often touted by the government) and policies that are *pro-market*. The key distinction is that policies that are pro-market, seek to use market forces (more specifically, the opportunity to make profits) to encourage new players to operate in the economy; pro-business policies, on the other hand, also focus on higher profits, but this is limited to *existing* business groups. To make a finer point, pro-business could be seen as *protective* policies, while pro-market could be viewed as *disruptive* policies. For the status quo, pro-market policies that encourage new players to enter the market, will be viewed with alarm.

To get a better handle on the differences, see **Table 1**.

Table 1: Policies that encourage the private sector

Pro-business	Pro-market
Focus on existing business interests. Protective policies;	Encourage new investors to enter the market (foreign & domestic). Disruptive policies;
Will deliver quick results, as incentives to existing businesses will bear fruit in a much shorter period of time;	Results will take more time, as new companies need time to establish themselves before they can show results;
Limited upside (more of the same);	Upside could be significant if new projects spawn other business opportunities;
Have strong ties with the government machinery (bureaucracy);	May have strong support from the political leadership, but is unknown to the bureaucracy;
Short-term fiscal incentives (reduced rates, duty-free imports, export rebates) can deliver results;	Tax holidays must be legislated, and stay in force for a significant period of time to be effective;
Policymakers can tweak existing rules, and do not need much planning or deliberation (passive policymaking);	Needs planning and coordination across several ministries and/or regulatory bodies (active, hands-on policymaking);
Implicitly against CPEC, as this could threaten their business interests.	Could be part of CPEC, or would likely be reinforced if CPEC thrives.

From **Table 1**, governments would prefer pro-business policies (over pro-market policies) for a host of reasons: (1) it's easier to do (no planning or new policies are required, just call in the business leaders and support their efforts); (2) it appeals to people who are familiar with how to work the government machinery; (3) the government can claim quick results; (4) time-bound tax exemptions are easier than legislating in parliament; and (5) the bureaucracy is always keen to maintain the status quo.

China's experience with economic reforms

As we have discussed in an earlier paper (*One Belt, One Road: Building Asia on China's Strengths*, 21 August 2016), China's development model can best be described as heuristic (which means *learning by doing*). There was no top-down policy agenda imposed by the government machinery. The former Chinese premier, Deng Xiaoping – known for his humility and practicality, and now remembered for his wise sayings – is widely acknowledged as the architect of China's miraculous economic transformation.[4]

More specifically, Deng's "household responsibility system", transformed China's rural sector when it was first introduced in 1979. This allowed peasant farmers to sell any surplus produce beyond the government's quantitative targets. This sharply increased agricultural productivity by incentivizing the use of better seeds, more efficient harvesting and transportation, and created rural markets where price signals determined sowing and consumption patterns. This system was then replicated in light industrial units and eventually rolled-out across the entire country.

The simplicity of this "reform" belies how powerful the impact was: (1) at the grass-root level, there was a significant increase in production; (2) the change did not disrupt the then existing production system, but gradually surpassed it; (3) the profits motivated an increase in labor supply and private investment; and (4) since these profits enhanced the welfare of the poor, there was widespread public support for such reforms.

Unlike Pakistan's experience with reforms, China's reform strategy was shaped by three assumptions:[5]

1. Economic reforms cannot be implemented according to a well-defined blueprint. The point is that reforms can never be minutely planned, as implementation challenges are often unpredictable and cannot be factored into a master-plan;
2. Reforms are primarily driven by specific problems encountered during the transition. In effect, the future reform agenda is formulated while implementing current reforms; and
3. Reforms should by design be gradual and incremental to minimize social disruption. Hard timelines are unnecessary and go against the spirit of reforms.

This is quite a departure from what Pakistan has been doing in the past three decades. The sequence of IFI-sponsored economic reforms are time-bound with quarterly targets that focus on Pakistan's economic weaknesses – inadequate tax revenues; stagnant exports; loss-making SOEs; and growing import-dependency. While we acknowledge that these cyclical reforms are driven by IMF stabilization programs (which are different from structural reforms), even the structural changes are managed within the framework of a three year plan with quarterly targets. Little is learnt from past failures, and one is left with a sense of *deja vu*.

Can the bureaucracy be an agent of change?

This may be an odd question to ask, since the government machinery is the only avenue to implement economic reforms. However, with three decades of stop-start reforms that have delivered little (positive steps are often back-tracked), we would argue that the bureaucracy is not suited to be an agent of change. Certain characteristics of any bureaucracy – especially Pakistan's – could be summarized as follows: (1) as an institution, the bureaucracy prefers to operate with a schedule and quantifiable targets; (2) given its

[4] One of his more celebrated quotes: "No matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat", reveals Deng Xiaoping's preference for results over ideology. His approach to economics is often referred to as *Market Socialism*, where socialist goals to reduce poverty and increase labor productivity, were anchored to market forces.
[5] Page 5, *One Belt, One Road: Building Asia on China's Strengths*, 21 August 2016, Mushtaq Khan & Danish Hyder.

strong inclination to follow rules and procedures, the bureaucracy is least likely to be adaptive; and (3) the bureaucracy is primarily geared towards solving problems (often in firefighting mode), and is unlikely to identify *new* issues that need to be resolved. In effect, for the Chinese model of economic reforms, Pakistan's bureaucracy is ill-suited.

One could argue that Pakistan faces very different obstacles compared to China, when the latter adopted pro-market policies in the 1980s and 1990s. In China's case, we would argue: (1) pro-market policies were not resisted by the state-owned enterprises (SOEs) as the Chinese government *itself* had decided to change its economic model; (2) the government had full executive power, with no pushback from the legislature and/or the judiciary; and (3) there were no business/financial interests that could challenge the executive. In effect, the Chinese government could experiment with pro-market policies, tweak the reforms (learning by doing), gauge their impact, and then roll-out the reforms across the country with few objections and little resistance.

As it currently operates, Pakistan's bureaucracy is not well suited to drive reforms. However, we would argue that if a suitably empowered planning body is created, it should be able to identify the right people within the government machinery that could drive the reform momentum. Pakistan's bureaucracy is often criticized for being anti-business, but it has a deep information base that has been developed over decades of trying to solve Pakistan's chronic economic problems (see the next section). In other words, if these sector specialists are given a fresh mandate, and carry the full support of the executive, they should be able to come up with new ways to tackle chronic structural weaknesses. For its part, the executive will have to ensure that the entrenched interests do not derail the reform process.[6]

To summarize this section, China's success with economic reforms gives us some key takeaways:

1. Economic reforms are by definition disruptive and need a clear vision of what is to be achieved. This vision is necessary to generate the political will needed to take on the vested interests, which will always oppose change;
2. China's economic transformation was not ideologically driven, but implemented in a practical, bottom-up manner. China firmly adopted pro-market policies;
3. China's spectacular economic growth was led by the private sector, which created the world's largest middle class. This did more to pull people out of poverty than specific policies to enhance China's social development;
4. The Anglo-Saxon model for economic reforms is more ideological than the Chinese model. The neoclassical, free-market paradigm of the Washington Consensus is deeply seeped in ideology compared to China's heuristic approach; and
5. Reforms need a visionary and cannot be championed (or implemented) by the bureaucracy. People need to believe in the end-goal, to generate the resilience to handle the uncertainty and disruption that economic reforms entail.

Priorities for Pakistan

While the EFF entails a comprehensive reform agenda, we would argue that it is primarily focused on stabilization and not structural reforms. As discussed in a previous blog (*Will economic stability usher in a growth phase?* 4 December 2019), the EFF seeks to ensure that Pakistan has the money to finance its twin deficits, but does not directly cap how large the twin deficits can be. This means the country is

[6] In the case of agricultural reforms, resistance will come from the Arthis (the middlemen), seed providers, community leaders, landowners, and many of their friends who are elected members of the provincial and federal legislature. In comparison with China, this resistance will be much greater in Pakistan, but the upside for the farmer (and his political support for change) should be just as significant as was the case in China.

either burdened by higher external debts, or becomes vulnerable to hot money flows. The latter may help improve market sentiments by creating comfort for investors (especially foreign investors), but it doesn't create a solid base to generate economic growth.

To focus on sustainable growth, we would propose the following sectors by priority:

1. Agriculture. Pakistan's agri yields are the lowest in the region. For an agri-based economy, this is the lowest hanging fruit. Rationalizing major crop patterns; corporate farming; improving the quality of seeds; increasing the use of mechanization; more efficient water management; reducing the quantum of waste in harvesting and transportation… are quick fixes that need specialized policies;
2. Non-traditional (and new) exports. While the government is busy securing funding to finance its *structural* trade deficit, polices are needed to narrow this gap. Instead of just focusing on textiles, policymakers need to understand why Pakistan's non-traditional exports have been stagnant for over two decades, and what can be done to revive them;
3. Upgrade Pakistan's textile sector. Bangladesh and Vietnam (which do not grow cotton) have become dominant players in the global textile/garment market because they have adapted and upgraded their product offerings. With the growing popularity of polyester-blended garments, Pakistan's textile sector must gear up. It should also consider partnering with Chinese companies to enter China's global supply-chain in textiles and garments;
4. To narrow the trade deficit, policymakers must adopt import substitution as an explicit strategy. While this may be unpopular with the Washington Consensus, policymakers must be clear about what Pakistan needs, and use this vision to sell the idea to the IFIs; and
5. Formulate an industrial policy to create jobs, train labor and build industrial cities that will reduce the pressure on Pakistan's cities, and absorb the vast number of people entering the labor force.

Conclusion

As discussed in an earlier paper (*In Pakistan, hot money could be a very slippery slope*, 19 November 2019), Pakistan is at an inflection point where the stabilization phase is over, and a new source of foreign exchange could trigger a premature growth phase. Most people will agree that this will only trigger another boom-bust cycle.

Instead of this short-term fix, policymakers and analysts should consider the distinction between a pro-business approach to economic growth, and a more transformative pro-market strategy. In this paper, we have argued that it is easier to go with pro-business, but this generates limited upside and no meaningful change in how this economy operates. Pro-business policies are also introverted and will not solve the structural problems in Pakistan's tradable sector.

Since they are disruptive, pro-market policies will not be supported by Pakistan's business interests. However, as is patently obvious, economic reforms are not painless, and trying to find an easy way to "reform" the economy, is tantamount to failure. This failure suits the status quo, but if the country persists with its old ways, it will continue to fall behind the rest of the world. We have argued that China provides a sobering, and ultimately successful example of how to reform. Having said this, we also sense that Pakistan is split about how it views CPEC – pro-business advocates see CPEC as a threat, while pro-market reformers are keen to use CPEC to change the country's economic model.

With a new Cold War unfolding between the US and China, there may be echoes of this rivalry within Pakistan (and its institutions). Instead of taking sides (which will have adverse consequences for the country), policymakers in Pakistan must formulate their own economic strategy that is best suited to the country, and defend this vision to both superpowers. If this means pushing back against the vested business interests, the latter should view this as *tough love*. In our view, Pakistan cannot sustain 6-7% growth rates within the current framework of its economy. Pakistan needs its prominent businessmen and their vision and experience, but it also needs to ensure that elite businesses are outward-looking and dynamic. This group must become part of the needed change, and put aside its focus of preserving short-term profitability in a stagnating economy.

