Investment collapse and government

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Some things are very clear about the state of the Pakistani economy. We are not doing too well and have not for quite a few years. A lot of the explanation for this comes from industrial performance having been rather poor over these years. Both largescale and smallscale industry have slowed down significantly over the last decade, and continue to be slow despite government efforts at revival for years.

The million-dollar issue has to do with understanding what is keeping industrial activity slow and hampering revival. The usual answers have to do with the high risks of investing in Pakistan, and the political and other uncertainties associated with setting up a business here. These have some explanatory power. A lot of investors do feel that Pakistan provides a high risk environment, especially for longer gestation projects.

This also explains some of our difficulty with attracting foreign investments. Foreign investment can come in as portfolio investment since it is easy to move out, but foreign direct investments are harder to attract, as that usually implies the investor has to sink capital into a market, and it can take months to move money out of a particular investment, if one is able to. A high risk environment has to provide appropriate guarantees to potential investors before they will even think of putting money in.

This is exactly what we did with the IPPs. We guaranteed them high returns over a long time horizon, and received sizable investment under those conditions. But we have not been able to honour some contracts. The temptation to renegotiate was too hard to resist. The problem is that renegotiation, though successful with existing investors, tends to make other investors shy. We are hoping investors will enter other areas, especially oil and gas, but we have to guarantee generous returns here too, and ensure that the urge to renegotiate is somehow resisted.

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offering legal protection as well as by trying to persuade investors that the political risks of appropriation, lack of protection and the possibilities of renegotiation are very low, but few have been convinced by the rhetoric. One cannot really blame them. The international and local political situation is such, and recent events in a multinational in Islamabad have also shown this, that no investor in his right mind can seriously contemplate coming in on the promises of the government or by taking on a local partner.

But what is stopping local investors? Most local investors have better information, have better connections and can make money through manipulation of the rules of the game, so what is making them shy away from investing? The political situation should not be so large a deterrent for them.

There is some research that shows the regulatory framework imposes significant transaction costs on investors in Pakistan. Setting up a factory or a commercial unit, and running it, brings an investor in contact with so many departments, and so often at such high cost, that it makes a lot of activities too hard, or not profitable enough, to pursue. Research has also the above might be true to an extent.

What makes the story even more interesting is that though interest rates on borrowing for industrial investment have come down significantly in the last few years, this has not spurred the demand for investment funds. In fact, banks seem to be loaded with cash. They have been forced to enter consumer lending in a big way, and have come up with all sorts of packages for consumers, but industrial demand for funds has not budged by much.

There might be other explanations for the lack of industrial growth. Some might have to do with our inability to move to higher quality products, the lack of a trained and educated workforce to deal with more sophisticated quality, and Just-In-Time delivery. Others might have to do with vicious cycles of low quality or low output or lock-ins that might have happened due to sunk investments made at one point, but these are unlikely to explain the slowdown across all industries and of the extent we see.

We might not have a complete list of reasons, but we have enough clues (given above) that we can make a coherent start at addressing some problems. Every so often one hears of a new task force or committee to look into 'impediments to investment.' But in typical government fashion they end up recommending things that almost never get done. The example of the CBR is probably the best documented. All surveys that have tried to document 'impediments to investment' have identified the CBR as one of the major obstacles to doing business in Pakistan (tax related issues of cost of compliance, rates of taxes and unpredictability of policy changes being the main culprits). GoP has been aware of this for years, and has had commissions upon commissions and task forces galore work on the issues, and have gathered a plethora of suggestions. They have even had committees reconcile reports of previous committees, yet to date the progress, in terms of reforming the CBR and addressing people's concerns, has been almost nil. The same is true of other areas.

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One can see the effect of perceptions of risk on investor willingness to come to Pakistan through revealed interest of investors in assets that the government wants to privatise. UBL went after much wheeling and dealing, in which many a reputation was tarnished. There is little or no interest in KESC, and most American firms are not interested in retail related outfits: PSO is an example. Even PTCL, once expected to fetch $7-8 billion, is now only expected to bring $1 billion odd. And even here, only a few second-string companies, none of the telecommunications leaders, have shown much interest. WAPDA, Railways and other state assets show similar lack of investor interest. In some of these cases it is not the inherent lack of profit-making opportunities causing lack of interest. Some are going to be monopolies or oligopolies at worst. They are likely to make a lot of money, if managed well. It is more the political risk that is making investors shy away.

GoP has tried to address this by assuring investors, investors have better information, have better connections and can make money through manipulation of the rules of the game, so what is making them shy away from investing? The political situation should not be so large a deterrent for them.

There is some research that shows the regulatory framework imposes significant transaction costs on investors in Pakistan. Setting up a factory or a commercial unit, and running it, brings an investor in contact with so many departments, and so often at such high cost, that it makes a lot of activities too hard, or not profitable enough, to pursue. Research has also shown that the quality and cost of infrastructure available in Pakistan also impose very high costs. Electricity and transport costs, the uncertainty involved in having access to infrastructure (reliability of service), seaport and airport facilities, sewerage and water access and access to gas, all impose significant costs on investors, and to an extent it can be shown that these costs in Pakistan are larger than in other countries in the region. Thus net returns to investment are lower, which will surely have a dampening effect on the quantum of investment.

But this is not the full story. Though infrastructure costs have increased significantly with the deregulation of the last decade, the increase is not large enough to really explain the slowdown in industrial growth. Some researchers have speculated that in addition, the crackdown on banks and the way credit was being disbursed up to now has also slowed down industrial expansion. Initiatives like NAB have also been said to have had some effect on reducing investment. All of

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GoP has promised foreign investors they will be treated fairly. Some of the IPPs will not think the promise worth much. Even in the case of private partnerships, companies like Westinghouse and Mobilink might have interesting things to tell. Even the privatisation process, the most high profile government attempt to be 'fair and transparent' has been found wanting. So how can we have revival of investment?

Policies need implementation, promises need enforcement and commitment, and consistency and transparency, in the face of opportunistic opportunities (_ la Williamson and the transaction cost literature) are necessary prerequisites for establishing a credible environment. The work GoP has done so far, on any of these fronts, does not even come close to addressing the core issues. It is not thus surprising that despite sharp cuts in interest rates, investment response has been fairly muted.

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