CHAPTER 7

Regional value chains
Pakistani perspectives

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Past experience from East Asia, Europe and North America demonstrates that vibrant regional value chains (RVCs) remain a key stepping stone towards becoming an active participant in global value chains (GVCs). The most obvious channel through which this happens is the increased number of avenues for exports and imports of intermediate and finished goods and services (for details, see Slany, 2017). In this context, national and regional trade policies and agreements play a key role in bringing the countries and their enterprises closer. Most preferential or free trade agreements today are designed to promote value chains.

Apart from this, foreign direct investment (FDI) in exporting industries, which also carries a technology transfer component, helps a country's integration into transnational value chains. The determinants of FDI also impact the country's progress towards integration with RVCs. For example, while distance discourages FDI, economic size, sharing of language and norms and ease of doing business encourage investment from abroad (for details, see Noguer and Canals, 2006).

A key question that the recent literature asks is: what determines access to goods and services markets abroad as trade barriers decline over time or vice versa? The stop-go cycles in trade liberalization efforts in developing and developed worlds have complicated the answer to a question which has been empirically answered in the past. The gainers and losers in the globalization process are never easy to define through just the economic models. There is also the question of how and under what conditions being part of value chains abroad can contribute to employment generation. For example, the concept of immiserizing growth suggests that there may be instances where an economic expansion may take place even while returns to economic activity may see a decline. We have evidence from history, where increased exports in several economies were only possible by keeping wages at low levels (for details, see Kaplinsky and Readman, 2000).

An equally important concern is whether RVCs can create decent jobs. One of the targets under Goal 8, of the Sustainable Development Goals (SDGs), calls for achieving "full and productive employment and decent work for all women and men, including for young people and persons with disabilities, and equal pay for work of equal value." This concern for decent jobs is important if RVCs are going to create a dent in poverty through employment linkages (Shabbir and Ahmed, 2015). While creating decent wage employment is essential, equally needed is a focus on self-employment opportunities, for which we need to understand how small and medium-sized enterprises (SMEs) fit into the overall RVC ecosystem (for details, see Schmitz, 1998).

In the case of South Asia, recent research has revealed several barriers to the creation of dynamic RVCs. These include: limited purchasing power, concentration of manufacturing in low value-added activities, non-tariff barriers, a lack of facilitation for trade in services, uncertain logistics, skill shortages and a lack of a conducive regional investment policy (for details, see Das, 2015; Ahmed et al., 2015b).

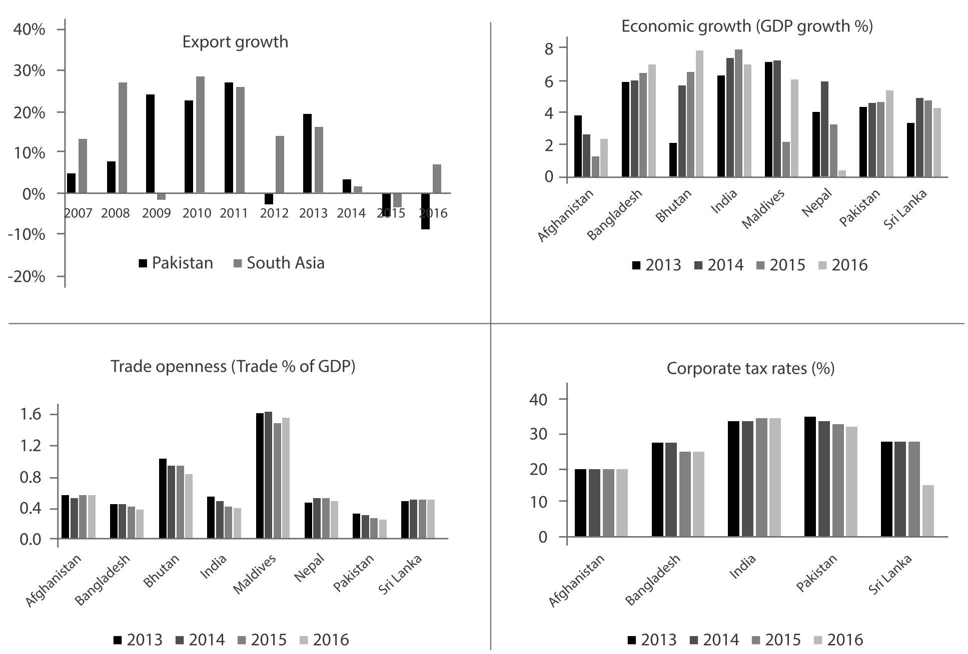
South Asia, home to one fifth of the world's population, has a less than three percent share in global trade. Intraregional trade stands at less than six percent of South Asian total trade. This is low compared to the Association of Southeast Asian Nations (ASEAN)'s intraregional trade, at 22 percent, and the European Union, at almost 60 percent. This chapter highlights the challenges to developing RVCs in South Asia, focusing on the experience of Pakistan, and suggests some steps to be taken to overcome them.

Regional situation

South Asia as a region has seen decent growth across key productive sectors. Bangladesh, Bhutan and Pakistan have seen consistent increases in their real GDP growth rates during the 2013 to 2016 period (Figure 7.1). India also saw high growth rates during the period, except for some deceleration in 2016. However, this growth has not resulted in robust export gains. In fact, overall South Asian export growth went downhill after 2010. During 2015, export growth turned negative on account of low global commodity prices, a lack of diversification in the South Asian export basket and the inability of South Asian economies to significantly bring down the cost of doing business. While some recovery was seen in

Figure 7.1

Growth, trade and taxes in South Asia



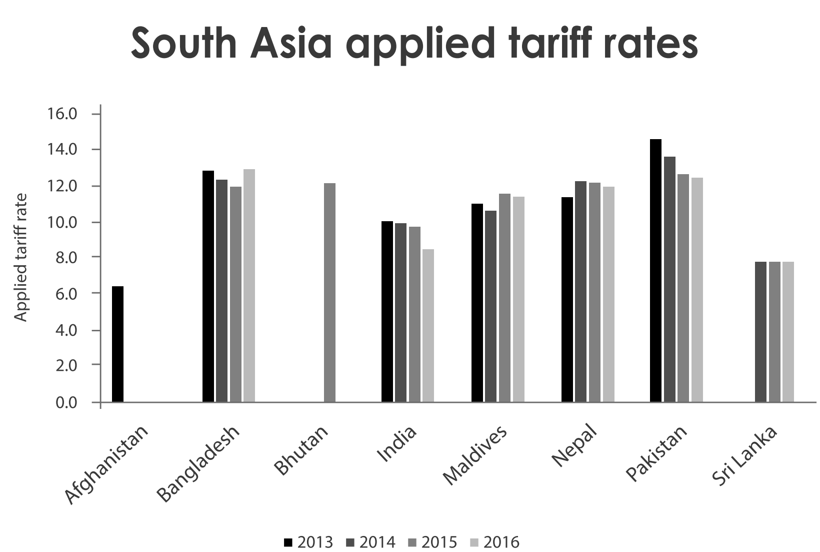
Source: World Development Indicators. The data on corporate tax rates was obtained from KPMG's country tax profiles.

export growth during 2016, the growth rate of exports in Pakistan remained negative.

This is attributed to a significant overhaul of the tax system in Pakistan and the resulting delays in rebates owed to exporting entities, which in turn resulted in temporary reductions in their working capital (for details, see Ahmed, 2018; Javed and Ahmed, 2017; Ahmed, 2017). Pakistan was the only other economy in South Asia to consistently reduce its corporate tax rates during this period (Bangladesh being the other one). Even this measure was not enough to improve the competitiveness of exporters. With changing product certification and standards-compliance requirements, particularly in key export destinations for Pakistani exporters such as the European Union, a lot more effort is required to understand the desires of foreign buyers (Samad et al., 2015).

Despite falling applied tariff rates (Figure 7.2) in major economies, South Asia as a region saw a return of the protectionist wave. This is evident in declining levels of trade openness, measured as a ratio of total trade (exports and imports of goods and services) to gross domestic product. The decline in trade openness was par-

Figure 7.2



Source: World Development Indicators.

ticularly seen in three of the largest South Asian economies—Bangladesh, India and Pakistan. The region as a whole has not been able to bring down non-tariff barriers (for details, see Shabbir and Ahmed, 2016; Ahmed and Batool, 2017a, 2017b).

While improving its rank from 122nd to 115th in the 2017-18 Global Competitiveness Index, Pakistan was far behind its peers in South Asia (Table 7.1). The key reason was a national drive to document the economy—a painful adjustment for many businesses in the country which relied on informal vendors and other undocumented backend supply chains. The increase in tax-related documentation increased the compliance costs. The introduction of laws related to anti-money laundering also made it mandatory for transactions to be channeled through the formal finance and banking institutions. Much of the energy shortage faced by industry was alleviated by new power generation capacity, made possible by the China-Pakistan Economic Corridor (CPEC). However, the per unit cost of electricity and gas faced by commercial entities remained higher than in the peer economies.

Table 7.1

Global Competitiveness Index (2016–2018)

Countries	2016-17 Rank out of 138 countries	2017-18 Rank out of 137 countries
Bangladesh	106	95
Bhutan	97	82
India	39	40
Nepal	98	88
Pakistan	122	115
Sri Lanka	71	85

Source: World Economic Forum.

Pakistan is currently integrated with the value chains mentioned in Table 7.2. Only countries from South Asia have been presented here. China too appears because its supply chain linkages exist with all South Asian economies. This assessment, however, does not fully review the potential of Pakistan's value chain integration if trade and investment cooperation is deepened (see Das, 2015). Pakistan's sector-wise potential exists in the food processing industry (with India and Sri Lanka), spinning (with India), weaving and knitting (with India and Nepal), finished cloth-

Table 7.2

Pakistan's sectoral linkages in the region

Country	Main sectors involved	Sub-sectors
Afghanistan	Manufacturing, services	Cement, energy, manufacturing, hotels and hospitality, logistics, information and communication technology, auto parts, home appliances, pharmaceuticals, construction, hardware items, health services, and banking
Bangladesh	Manufacturing, services	Textile, locomotives, banking
China	Manufacturing, services	Textile, chemicals, services, sea food, marble and gemstone, education services, banking
India	Manufacturing	Chemicals, cement, cutlery, surgical instruments, sports goods, gypsum, bauxite, marble
Sri Lanka	Manufacturing	Sea food, fruits and vegetables

Source: Authors' own assessment.

ing (with Bangladesh, Nepal and Sri Lanka), leather (with India and Nepal) and chemicals, including pharmaceuticals (with India and Nepal).

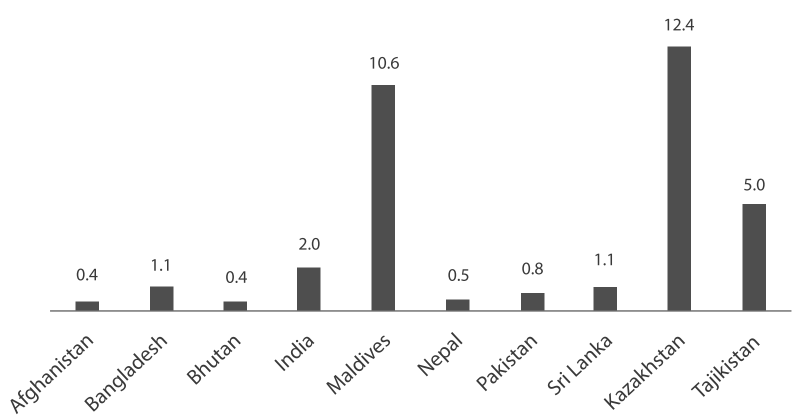
A key reason why South Asian RVCs are slow to come by is a lack of investor confidence in sourcing materials from within the region. For example, Indian or Pakistani investment in the garment sector of Bangladesh could result in higher levels of garment exports from Bangladesh to South Asia (see Kathuria and Yatawara, 2016). One needs to understand which type of FDI (e.g., vertical, horizontal, or export-oriented) can best create RVCs. This understanding is essential for South Asian economies to customize their FDI policies to lure investors from within the region (Ahmed et al., 2015a). As it stands today, a low FDI inflow as a percentage of GDP (Figure 7.3) indicates that South Asia is not a preferred destination for investors even from the rest of the world.

Methodology

This chapter follows the approach in Ahmed et al. (2015b). Starting with a two-way identification of RVCs, it first looks at the key sec-

Figure 7.3

FDI inflow, 2016 (as % of GDP)



Source: United Nations Conference on Trade and Development Statistics.

tors and activities where Central and South Asian countries stand attractive for Pakistani investors. Secondly, sectors and activities in Pakistan that may be attractive to Central and South Asian investors are identified. This process was helped by the identification provided in Table 7.2 and efforts in Das (2015) and De and Iyengar (2014).

In the next step, following the standard Delphi technique and using a brief version of the questionnaire used in Ahmed et al. (2015b), the potential and current investors in South Asia were engaged. A total of 43 investors were interviewed between January and August 2017. Most of these business persons from Pakistan are members of local Chambers of Commerce and Industry or the Pakistan Business Council. Most of the interviewees also have branch offices or investments in regions other than Central and South Asia.

A third prong of the methodology focused on engaging with actual, potential and past exporters in four provinces of Pakistan. This engagement took the form of focus group meetings held in provincial capital cities. The study team from Sustainable Development Policy Institute (SDPI) was able to host over 250 business persons in various sittings. This allowed the team to validate the responses obtained through a questionnaire-based exercise and also to document any macro-level or sector-specific barriers faced by Pakistani exporters and investors in the region.

A key source of primary information was media content analysis. Only those media discussions were selected where the correspondent had interviewed a chief executive officer of an entity which fell within the identified sectors. Mostly, sources from the print media were used.

In the last step, the interviewees and select participants from focus group discussions were approached again. They were asked to prioritize their policy recommendations and also suggest the specific institution at the federal or provincial government level in Pakistan to be entrusted with the responsibility of owning the (policy) action.

Findings: Macro-level issues preventing integration into RVCs

Uncertainty of political relations

This was termed a key barrier to more certain business with the major economies of South Asia. Most business persons believed that the decisions by Bangladesh and India not to participate in the South Asian Association for Regional Cooperation (SAARC) Summit scheduled to be held in Pakistan in 2016 derailed the overall process of engagement in the region. This happened at a time when several SAARC member countries were meeting with Pakistan at the bilateral level. Such meeting included recent visits to Islamabad by the Sri Lankan president, the foreign minister of the Maldives and the army chief of Nepal, and the Pakistani prime minister's visit to Afghanistan. They cited worried voices from within India about the likelihood of the country's future diplomatic moves in the region being seen as a "hindrance to development of the region" (see Kakar, 2018; Hanif, 2018).

Lack of business-to-consumer (B2C) channels

Due to challenges in connecting with South Asian consumers through physical or virtual means, it has been difficult for businesses to reach out to them. This is particularly so for those in the region dealing in consumer goods with high frequency consumption. This has also prevented regional growth of e-commerce initiatives. Other parts of the world have promoted five types of online B2C models: direct selling, online intermediaries, advertising based B2C, community-based marketing and fee-based arrangements.

Domestic regulatory burden not allowing SMEs to become exporting entities

There has been no national-level regulatory impact assessment recently. After the 18th Amendment, provincial governments have passed laws related to revenue, the environment, labour and municipal development—all of which impact the business environment. Several potential exporters highlighted the waste of a significant number of man hours working to comply with overlapping federal and provincial regulations. This in turn results in higher transaction costs, especially for SMEs.

Under a weak competition regime, such businesses also fear that going international and aiming to become a part of RVCs could mean further regulation, a key barrier to entry and exit. Having transparent and easy-to-follow regulations also helps other indicators under the cost-of-doing-business framework, i.e., contract enforcement, dealing with permits and licences. Some industries which face long-term price freeze (e.g., in agriculture, pharmaceuticals, vanaspati, etc.) also remain a no-go area for foreign investors.

Lack of FDI policy that incentivizes new entrants from the region

While sector-specific efforts have been carried out to address this point, there is no overarching FDI policy to attract new entrants in sectors with the largest future growth potential. A right step in the direction was the new auto policy in Pakistan, which now provides a one-off exemption to the import of plant and machinery from import duties, and concessionary import tariffs on parts for five years.

Perhaps such policies that favour new entrants and create competition are required for other manufacturing sectors in Pakistan as well. For example, for a very long time, Pakistan has been trying to convince smartphone companies to not just sell, but also produce in a country that has the sixth largest population in the world. However, this has not happened, primarily due to a lack of quality-assured supply of components in the local market.

Another example is the pharmaceutical sector, where several multinational companies (MNCs) are allowed to operate in Pakistan. They bring their intermediate ingredients not from their home country but from India. Such a process, while denying Pakistan gains from MNCs' research and development, or transfer of technology, also prevents local Indian and Pakistani firms from collaborating in horizontal or vertical value chains.

Logistics constraints

During the study team's meeting, as part of a Track II initiative, in Kathmandu during October 2017, Indian counterparts revealed that in the chemical sector, they would prefer sourcing specific items from Pakistan. However, they were apprehensive if it could increase supply (as and when demand increased) and ensure timeliness and proper storage during dwell and travel. Similar constraints were also seen in the case of another Track II meeting, attended by this team in Kabul in April 2017. Manufacturers in plastics, furniture, wood, paper and paper board all seemed to be of the opinion that Pakistan is a preferred market for sourcing inputs and intermediate items in these industries. However, they complained about the long wait time at Torkhum and, in some cases, Chaman Post as well. The unannounced closure of the Torkhum border point in the past had also prompted them to rethink the reliability of supplies from Pakistan. The other difficulties identified by Afghan manufacturers included a lack of information regarding potential suppliers, weak online connectivity with vendors, dilapidated transport networks inside Afghanistan and a lack of insurance facilities.

Information gaps regarding special economic zones (SEZs)

Exporters said that in the next phase of CPEC, nine SEZs are due to be established in several parts of Pakistan. Similarly, two corridors of Central Asia Regional Economic Cooperation (CAREC) would also pass through Pakistan. However, until now there is no mapping available as to what specific items each SEZ can supply to the neighbouring countries. At the time of writing this chapter, only brief information regarding Rashakai Economic Zone was available, suggesting that the entities that ultimately come here can supply marble, furniture, electrical products, pharmaceuticals, sugar, tobacco and beverages to Afghanistan and Central Asian economies.

Weak financial intermediation

Formal financial linkages between South Asian countries are no more a barrier to trade and investment because such linkages are possible through intermediary financial institutions, perhaps based out of a third country. However, most respondents viewed that the presence of the other country's banking sector (in the form of a branch or representative office) brings greater confidence in building investment relations with that country's traders and investors. Within the region, Pakistan, until now, has only maintained active bank branches in Afghanistan and China.

Lack of business-to-business R&D linkages

A key element in vertical RVC creation is cooperation in research and development (R&D). Until now, this has only happened at a very small scale. The example of Hamdard Laboratories in Bangladesh, India and Pakistan is a rare example. The lab is backed by the owner's family presence across South Asia (see Mitra, 2013). To take such efforts forward, the 2012 meeting of the Commerce Ministers of India and Pakistan had established the Pakistan-India Joint Business Forum, which comprised 15 business persons from each side. The forum had set up task forces to focus on areas of cooperation related to agriculture, auto, engineering, textile, pharmaceutical and energy sectors. The recommendations of this forum, however, require uptake by both governments, which seems unlikely in the present political situation.

Uncertainty of tax and tariff regime

Pakistan has seen significant changes to its tax, particularly customs, code in the past five years. There is widespread literature saying that foreign investors usually pursue a destination where their prospective cash flows can be locked for a certain time period. In the last couple of years, the country has seen the imposition of para-tariffs, beyond the standard tariffs. These have increased the cost of doing business in several sectors, some of which have moved the court. The government is considering a reduction in the number of items on which regulatory duties were imposed during 2016-17.

Findings: Sector-specific issues preventing integration into RVCs

Non-tariff barriers (NTBs) in manufacturing

Pakistan's potential value chain linkages with SAARC economies exist in sectors such as cement, energy, processed food and beverages, pharmaceuticals, construction and hardware items, locomotives, marble and gemstones, sea food and fruits and vegetables. Most of these sectors face high levels of NTBs in the region. Over time, the list of NTBs has expanded and the imposition of such measures is usually not anticipated, resulting in production losses.

NTBs in services sectors

NTBs are also seen in services sectors. Pakistan has potential value chain linkages in health services, banking, education, and information and communication services. A key hurdle to trade in these services is the barrier to the movement of persons. In health services trade, for example, the barrier makes timely travel uncertain for specialized medical professionals and also their clients, i.e., patients who may require physical travel (see Manzoor et al., 2017).

Low yields in agriculture

There are vast opportunities in agricultural RVCs if the region is able to demonstrate or ascertain better yields in major crops (e.g., wheat, rice, cotton and sugar cane), fruits and vegetables. In Pakistan, low yields have been a result of reduced soil fertility, a lack of high quality and climate-resistant seeds, lacklustre use of technology at planting and harvesting stages, and low levels of the desired nutrients in fertilizers.

High cost of electricity and gas in manufacturing

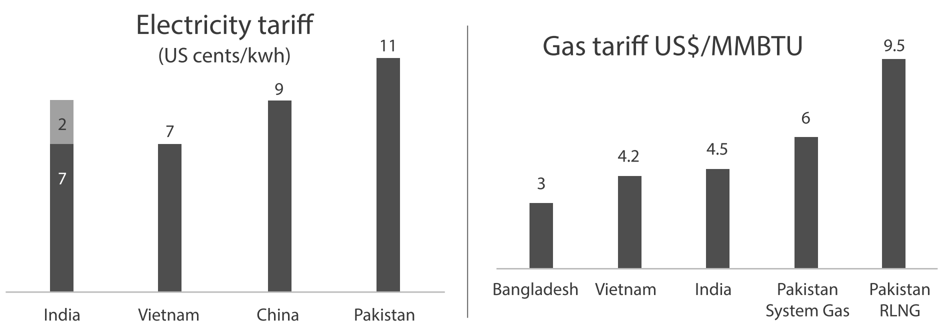
The government has reported an addition of 11,000 MW of electricity during the past four years. This has been primarily a result of investments under CPEC. However, exporting entities report that despite reduced energy stoppages, the per unit cost of electricity and gas has not come down. Figure 7.4 shows tariffs in Pakistan and a few comparator countries. This is concerning at a time when global oil prices are already being predicted to increase. As Pakistan also relies on imported energy supplies, the overall burden of rising energy costs could discourage future investment.

Existence of parallel informal trade channels

The appetite for deeper cooperation in value chains diminishes if the final product can reach the destination through informal trad-

Figure 7.4

Electricity and gas tariffs



Source: APTMA (2017).

Note: Indian state governments are giving subsidies ranging from 1 US cent to 2 US cents per unit. Electricity tariff for Xingjian province of China is further subsidized to 6 cents per unit. MMBTU is one million British Thermal Units.

ing channels. There is no need to pay the customs-related and other tax payments in such channels. Formal enterprises end up facing unfair competition. Several countries in the region have taken measures to prevent informal and illegal trade, including smuggling. Informal trade has been documented in potential RVC sectors, e.g., textile, pharmaceuticals, automobiles, cosmetics, jewellery, paper and paper items, crockery, herbal items, tobacco, fruits and vegetables (see Ahmed et al., 2015c).

Missing trade-related infrastructure

The promotion of RVCs, particularly in agriculture and livestock, requires careful handling during transportation, distribution and delivery, and adherence to set standards. Weak trade-related infrastructure, particularly at border points, has discouraged businesses in several sectors. For example, Pakistani meat and meat product exporters say that this was a priority sector in Pakistan's Strategic Trade Policy Framework (2015–2018). The vision was devised to benefit from Pakistan's proximity to leading global beef importers, including Central Asia, Russia, China and Iran.

However, lack of supportive infrastructure is holding the sector back. Cold storage facilities at airports do not comply with proper hygienic requirements. The national carrier, Pakistan International Airlines, lacks an ability to handle perishable items like meat. The quarantine fee faced by exporters in the sector is high, especially given that several countries in the region, including India, had waived the fee during 2016. This sector in Pakistan is also being hurt by smuggled meat from Afghanistan and Iran, which the government has now promised to check.

Lack of international supplier certifications

To become part of RVCs most sectors now require supplier and product certifications issued by globally accredited regulators. An inability to do so results in Pakistan being limited to exporting to developing countries with less-than-optimal certification requirements. Three issues require the public and private sector's response here. First, SMEs may not be able to afford the certification costs, particularly if they need to obtain it from an advanced country's accrediting body. Second, local regulators in Pakistan, approaching which may be more economical for SMEs, lack qualifications to become globally accredited. Third, government support to private enterprises in obtaining certifications from abroad has been limited to select sectors.

Conclusion

This chapter has drawn on enterprise-level responses from entities that are already connected with GVCs. It has discussed various impediments to the pursuit of Pakistani enterprises wishing to integrate with the region through trade and investment value chains. It has distinguished macro-level barriers that stunt the creation of RVCs from sector-specific ones.

National governments in SAARC are required to take a few immediate steps to provide greater confidence to those businesses in South Asia that may wish to integrate with the region. First, there has to be an effort to bring the SAARC process back on track. All member states should make a sincere effort to help the SAARC Secretariat to convene the stalled summit of heads of states, which has not happened since Bangladesh and India refused to participate in the 2016 meeting scheduled to be hosted by Pakistan.

Second, to ensure physical interaction among private sector representatives, it is proposed that all SAARC member countries liberalize their visa policies. This will also have a positive spillover effect on trade in services.

Third, at a national level, Pakistan needs to use its tariff policy intelligently so that industries have the incentive to import inputs from within South Asia. However, tariff policy alone may not be the answer here. A relaxation in NTBs will also be required.

Fourth, to make Pakistani businesses more competitive and attractive for conducting business with the region, it is important to review the regulatory burden on industrial sub-sectors. It is proposed that an economy-wide and sectoral regulatory impact assessment be conducted by the Ministry of Finance in Islamabad. Pakistan will also need to streamline the issue of multiplicity of taxes on the same source of income and profit at federal and provincial levels. Completing the ongoing tax reform can also bring down the cost of doing business across all sectors.

Fifth, taking a regional approach to food security in South Asia can help the case of agricultural RVCs. In this regard, the SAARC Food Bank Board may be empowered to link the bank to international institutions such as the International Fund for Agricultural Development. This will also help in securing the budget for sustainable operations of the SAARC Food Bank (see also Pant, 2012).

Sixth, Pakistan should review its bilateral preferential and free trade agreements with regional economies. Any revision of these agreements should incorporate clauses that promote investment value chains, FDI and trade in services.

Seventh, the next five-year strategic trade policy framework of Pakistan, planned to be finalized during 2018, should help SMEs in getting international supplier certifications on affordable terms. This will open new markets for Pakistani SMEs and help them integrate with RVCs.

Eighth, provincial industrial policies need to focus on how Pakistan's planned SEZs (under the CPEC programme) can be linked through trade and investment linkages with their neighboring economies, e.g., Afghanistan, China, India and Iran.

Finally, the Federal Board of Revenue will need to expedite the National One Window Programme to streamline the customs regime at trading points. Besides this, all border-related trade infrastructure development projects under the auspices of institutions such as the Ministry of Communications, the National Highway Authority and the National Logistics Cell need to be expedited as well. A critical inquiry is also needed to determine why Pakistani businesses are not making optimal use of existing dry ports in the country.

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