SPDC

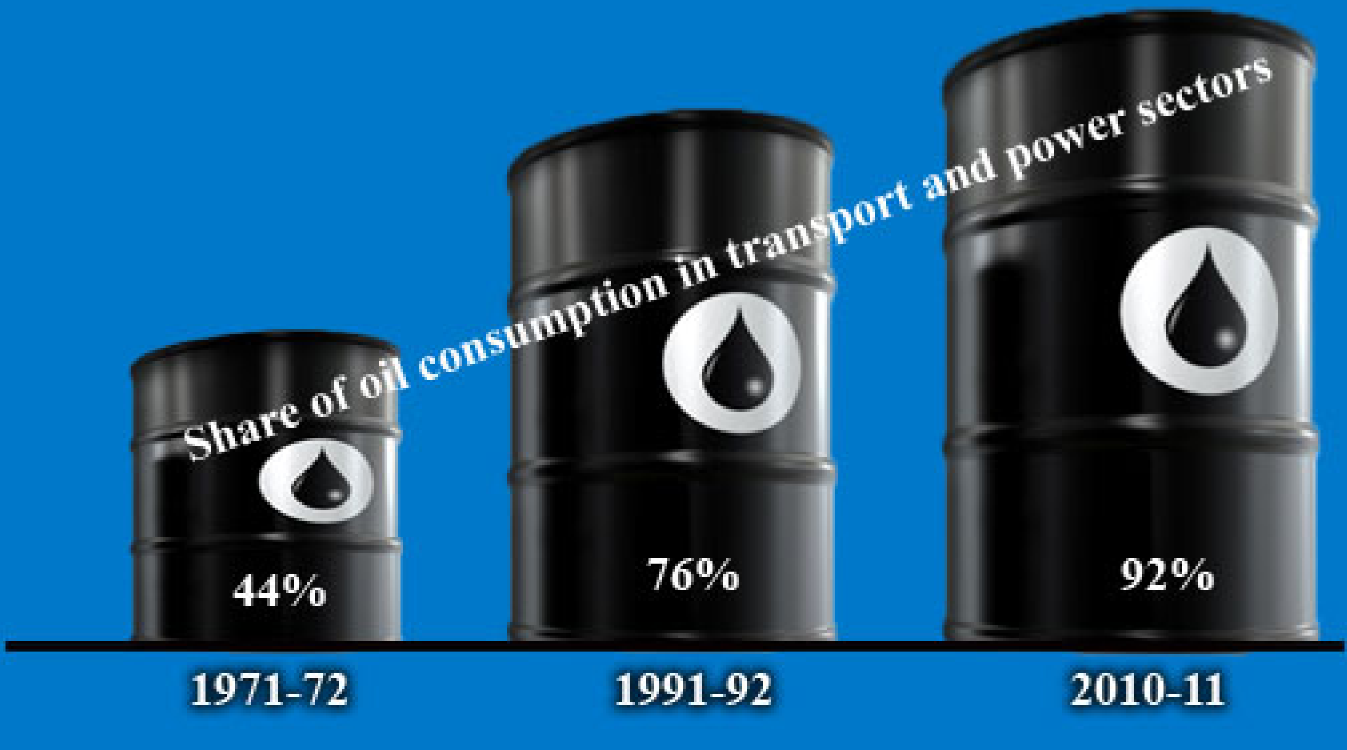
Working Paper No.7

Draft for
Public Discussion

Proposed

Agenda for Sustained Economic Revival

Dr. Kaiser Bengali



SOCIAL POLICY AND DEVELOPMENT CENTRE

Graphics and Designing

Muhammad Rizwanullah Khan

Printed in Karachi by The Times Press (Pvt.) Ltd.

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Agenda for Sustained Economic Revival

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September 2013

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FOREWORD

Economic policy management covers a large area encompassing several sectors and sub-section. An important area of macroeconomic management is monetary policy and the issue of discount rates and banking spread (i.e., the difference between the banks deposit and lending rates) that impacts on the cost of production. Another critical area is that of economic governance and law and order. There are a host of procedural issues that industrialists and industrial managers face on a day to day basis and which impacts on manufacturing development. This Working Paper, however, is restricted to some aspects of macroeconomic policy, considered more critical for economic revival, and argues for priority attention to these aspects

Pakistan has gone through a number of reform programmes in the last two decades. Most of them have been lender driven, but have failed to provide any long-term solutions. The paper proposes reforms in the fiscal and import structures of the economy, with the aim of resolving the underlying severity of budget and current account deficits. The paper considers plugging the rupee and dollar gaps as crucial for sustained economic recovery and, in this respect, pleads for stopping hemorrhaging of foreign exchange and for expansion of the industrial base and creating a sustained basis for employment growth.

No claim is made about the finality of the proposals; rather, they are presented to initiate public discourse on the subject.

Prof. Dr. Khalida Ghaus
Managing Director

Agenda for Sustained Economic Revival

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Summary of Proposals

Pakistan's economic crisis can be seen analytically as a product of two gaps: the rupee gap and the dollar gap.

Bridging the *rupee gap* requires:

a. raising revenues from direct taxes and taxes from agriculture, trade and services;
b. reducing the non-debt component of non-development expenditure by keeping these expenditures constant in nominal terms for three-five years. Consequently, the reduced need for government borrowing will tend to reduce the debt burden in the medium- to long-term; and
c. switching resources thus saved to finance development projects.

Bridging the *dollar gap* requires:

a. Curbing import of furnace oil and diesel by
   i) switching thermal electricity generation from furnace oil to locally extracted coal;
   ii) raising natural gas prices by three-four times and using the surplus to subsidize power supply to manufacturing units located in designated industrial estates; and
   iii) shifting long distance movement of goods transport from road to rail, and to this end
      - creating a holding company comprising Pakistan Railways and National Logistics Cell (NLC); and
      - creating an integrated goods transport network: moving goods long distance by container trains and short distance by container trucks.

b. Raising exports by expanding the supply base, i.e., industry, by
   i) reducing the tax burden on manufacturing, i.e., lowering the GST rate to five percent, with no adjustments and no refunds; and
   ii) reducing profitability in alternative 'soft' sectors by
      - demutualizing of the stock exchange and proper enforcement of capital gains tax,
      - introducing the 'right of first purchase' in land/property transactions and
      - introducing the 'right of first purchase' in imports.

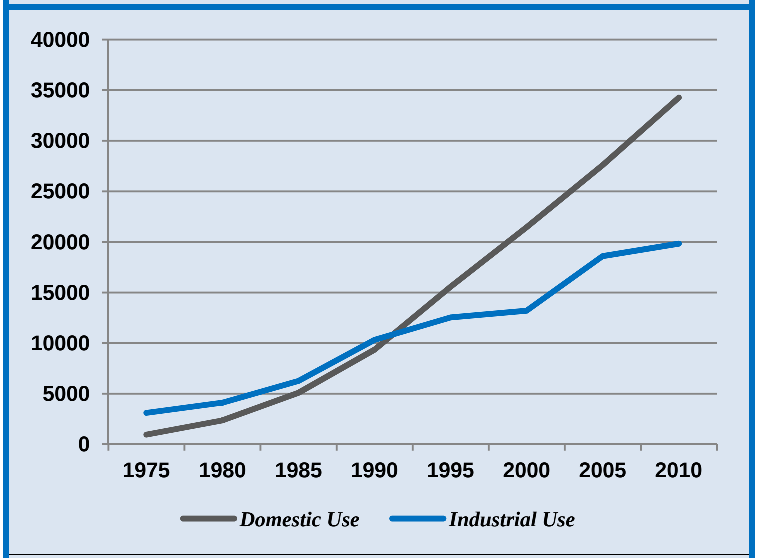
c. Reviving the PIDC model of industrialization, with private sector participation.

Agenda for Sustained Economic Revival

That Pakistan is in the throes of a serious economic crisis is common knowledge. This crisis is structural and cannot be resolved by ad hoc, short-term measures. However, governments over the last 25 years have had the tendency to firefight crises, rather than address their root causes. The responsibility for this state of affairs cannot be placed on one government or another. What we are facing is a crisis at the state level and has been brewing for over three decades. Needless to say, concerted collective efforts are required to lift the economy from stagnation.

If the Charter of Democracy, signed by Mohtarma Benazir Bhutto Shaheed and Mian Nawaz Sharif, has succeeded in restoring the supremacy of the constitution and democracy, a similar charter is needed for managing the economy. National consensus on an economic policy framework will need all major political parties, and the military, bureaucratic, agricultural and business leadership to be on board.

Chart 1
Electricity consumption by sector (in GWh)
1975-2010



Source: Ministry of Petroleum & Natural Resource, Energy Yearbook (various isues)

The fundamental problem is that Pakistan has become a consumption society, without a corresponding production base to support the desired level of consumption. Today, nearly 85 percent of the national GDP is generated by consumption and the changing inter-sectoral pattern of electricity consumption is indicative of this fact (see Chart 1). Till around 1990, industrial power consumption exceeded domestic power consumption; thenceforth, the situation has reversed[1]. For the last two and a half decades, domestic power consumption has been rising faster than industrial power consumption. However, ***we cannot consume what we do not produce.*** Borrowing has its

[1] It can be argued that many large industries now self-generate power during load-shedding hours. However, the large and growing gap cannot be explained by this factor.

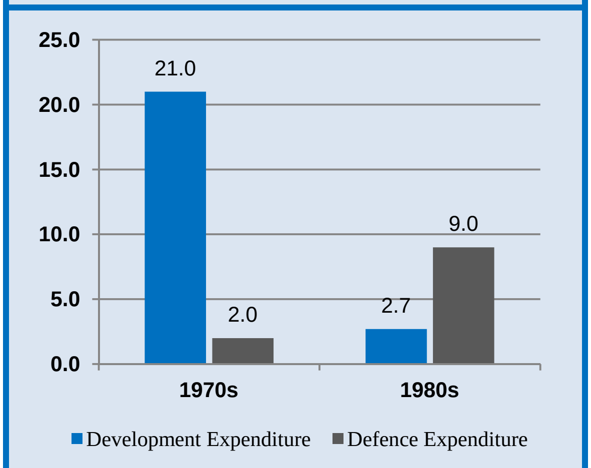
limits and we have reached those limits, and are paying the high economic and political costs that borrowing entails.

HOW DID WE REACH HERE?

This economic crisis has emanated from structural distortions that have developed over the last three and a half decades. Over the first three decades of the country's life, 1947-1977, Pakistan was a 'development state'; whence, economic development was the agenda of the state and pursued by every government -- civilian or military, capitalist or socialist. In 1977, the 'development state' gave way to the 'security state', and economic development has not been on the primary agenda of the state since then despite brief attempts to revive it in the 1990s.

Statistical indication of the demise of the 'development state' and the birth of the 'security state' can be discerned from Chart 2. During the 1970s, the real rate of growth of development expenditure was 21 percent per annum and the rate of growth of defence expenditure was two percent. During the 1980s, the rate of growth of development expenditure crashed sevenfold to three percent and the rate of growth of defence expenditure escalated almost fivefold to nine percent.

Chart 2
Comparative development and defence expenditure: average growth rates



Source: Ministry of Finance, Economic Survey (various issues)

The approach to economic management during the two periods differed radically. The 'development state' period was marked by large-scale asset creation including the construction of a series of dams, irrigation systems, highways, power plants, industrial complexes, factories, etc. that changed the economic geography of the country. Industrialization was led by the state-supported private sector in the 1960s and by the state itself in the 1970s. Irrespective of the modalities, though, large-scale and rapid industrialization did take place.

By contrast, the 'security state' period has been marked by a process of asset depletion. Along with the failure to invest in additional capital formation, economic assets created earlier have not received the necessary replacement investment. Moreover, the state has washed its hands off industrialization and the private sector has failed to take charge.

It is, thus, not surprising that the Rann Pathani railway bridge near Hyderabad collapsed in 2005, resulting in the suspension of rail traffic from Karachi – the country's only port city – to the rest of the country for about 20 days. The following year, four berths of Karachi Port collapsed into the sea. That strategic infrastructure is actually collapsing is an indication of the fact that funds for essential repair and maintenance have not been forthcoming and the facilities have been rusting to the point of falling apart.

Analyzing the crises

Conceptually, the economic crisis can be seen in terms of two gaps – rupee and dollar.

The rupee gap is the difference between government revenues and expenditures and creates the (domestic) budget deficit. The dollar gap is the difference between export receipts and import payments and creates the (foreign) trade deficit. The deficit in services also contributes to the dollar gap. Together, the two gaps have created domestic and external indebtedness, crowded out resources for development, and trapped the economy in a low-level growth bracket. For the people, the result is a stagnating job market, a growing gap between employment supply and demand, falling real incomes and poverty.

The rupee gap

The 'rupee gap' can be seen in Table 1 and its impact can be understood as follows.

Table 1
The rupee gap

2007-08	Revised: in trillion Rs.
Tax Revenues *(Direct and Indirect)*	1.00
Current Expenditures *(Debt Servicing, Defence & Civil Administration)*	1.16
Balance	-0.16

Source: Ministry of Finance, Federal Budget 2008-09

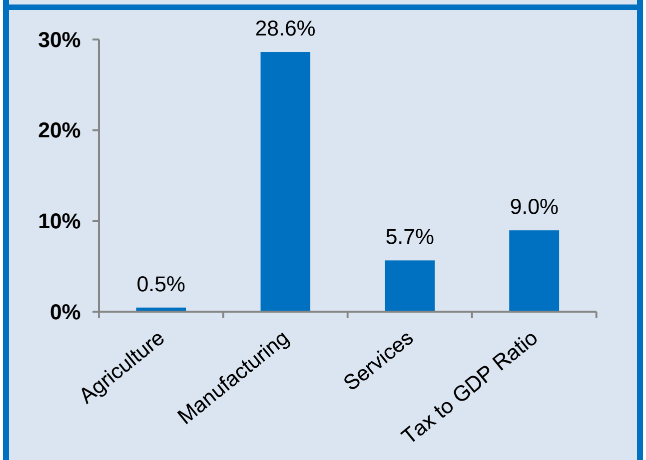
The year 2007-08 was distinctive in the sense that total tax revenues equaled Rs1,000 billion. The same year, current (non-development) expenditures on three heads – debt servicing, defence and civil administration – were Rs1,160 billion. In other words, the government spent Rs160 billion more on itself than it collected in direct and indirect taxes. Clearly, no tax rupees are available for economic infrastructure or social services.

This is akin to a factory that spends more than its total sales revenue on its head office and security guards and there is no money left for raw materials and spare parts. Clearly, such a factory is destined to shut down. Pakistan's economy is at such a point.

All attention with regard to reducing the budget deficit has centered on resource mobilization and the abysmally low tax-GDP ratio is regularly cited. It needs to be noted, however, that the tax burden is highly unbalanced inter-personally as well as inter-sectorally[2]. Inter-personally, the tax regime is regressive. Over 80 percent of tax revenues are generated from indirect taxes, with the richest 10 percent of the population paying 5.9 percent of their income in indirect taxes and the poorest 10 percent paying 9.3 percent. Inter-sectorally, the tax regime is highly unbalanced (see Chart 3). While the overall tax-GDP ratio hovers around nine percent, the direct tax-to-GDP ratio is even lower at about three percent and the manufacturing taxes-to-manufacturing GDP ratio is as high as almost 30 percent[3]. Manufacturing contributes over one-fifth of the GDP, but bears over two-thirds of the indirect tax burden. Clearly, the fiscal effort needs to be concentrated on enhancing receipts from direct taxes and non-manufacturing sectors and on reducing non-development expenditure.

The expenditure side has not received sufficient consideration. All attention with respect to expenditure has to date been focused on public enterprise subsidies as the source of the problem. Fiscal history, however, indicates a more nuanced situation. The government resorted to wholesale privatization of public enterprises in the early 1990s, citing their losses as *the* source of budget deficits. Nevertheless, budget deficits have continued to bedevil the country's public finances.

Chart 3
Sectoral Tax receipts as percent of sectoral GDP



Source: CBR Quarterly Review, Vol.6 No.2, 2006

[2] Social Policy & Development Centre, Social Development in Pakistan, Annual Review, *Combating Poverty: Is Growth sufficient?*, 2004
[3] Government of Pakistan, CBR Quarterly Review, Vol. 6 No. 2, October 2006; p. 43.

A comparative overview of fiscal trends during pre- and post-privatization years is instructive, as highlighted in Table 2. Admittedly, the fiscal deficit as a percentage of GDP declined from an average of 7.8 percent over the immediate pre-privatization years, 1985-92, to 6.6 percent over the immediate post-privatization years, 1993-99.

Table 2
Comparative pre- and post-privatization fiscal profile

	1985-92	1993-99
Budget Deficit/GDP	7.8	6.6
Annual average growth rates		
Current Expenditure on Subsidies	19.5	10.8
Current Expenditure	15.4	13.8
Development Expenditure	16.6	1.9

Source: Ministry of Finance, Economic Survey (various issues)

Prima facie, this decline can be attributed to the halving of the average rate of growth of federal subsidies from 19.5 percent over 1985-92 to 10.8 percent over 1993-99. And the average rate of growth of current (non-development) expenditure declined somewhat from 15.4 percent during 1985-92 to 13.7 percent during 1985-92.

A closer look, however, reveals that the principal reason for the decline in the budget deficit was the sharp drop in the average rate of growth of development expenditure from 16.6 percent during 1985-92 to 1.9 percent during 1993-99. The collapse of development expenditure can also be gauged from the following. During 1985-1992, Rs52 out of every Rs100 collected in taxes was spent on development whereas from 1993 to 1999 only Rs32 out of every Rs100 collected in taxes was spent on development.

Clearly, public enterprises losses have been used as a bogeyman to advance the neo-liberal political agenda and to keep attention from being focused on the internal structural factors. In reality, deficits are endogenously generated from within the structures of government and attention needs to be focused on the configuration of debt servicing, defence and civil administration. The fact is that we have no choice but to reduce our current (non-development) expenditure and switch freed resources switched to meaningful public investment in economic infrastructure.

With efforts to reduce subsidies via privatization failing to dent budget deficits, the axe keeps falling on development expenditure. The latter has been consistently falling as a percentage of GDP from nine percent in the 1970s to 7.3 percent in the 1980s to 4.7 percent in the 1990s and to 3.5 percent in the 2000s.

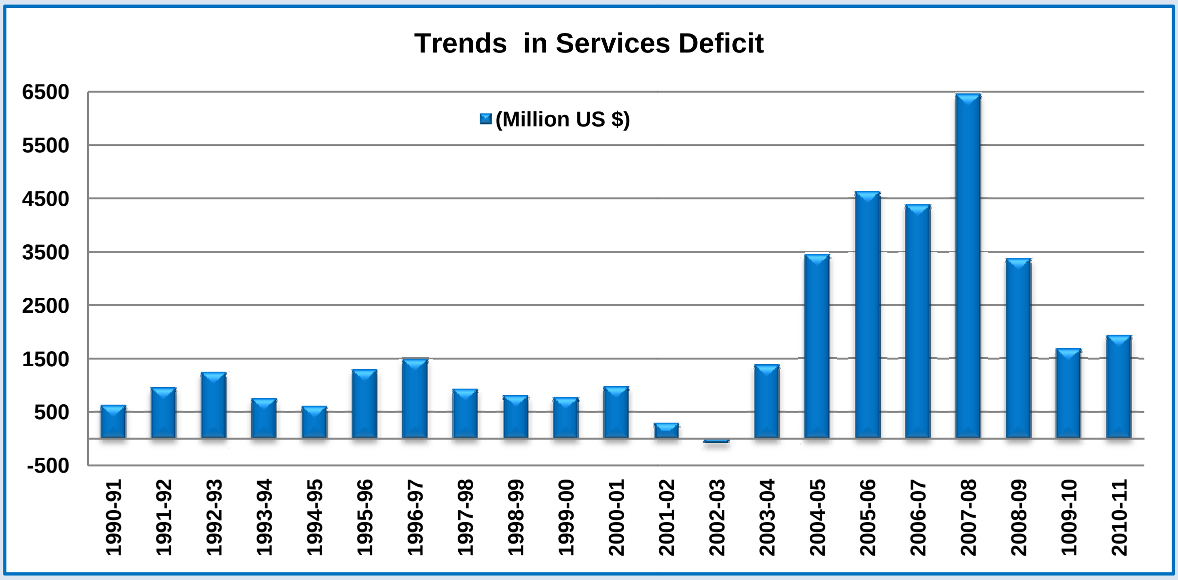
Box 1
Options for privatization

Pakistan has never had a coherent privatization policy. The first rational attempt at arriving at a policy was in 1988-90, with a government-commissioned study by an international consultant and small moves to off-load government-held equity through the stock market as a pilot measure. Thereafter, there was wholesale sell-out of public enterprises first in the 1990s and then again during 2002-07.

The case for privatization in the 1990s was made on the grounds that public enterprise losses were a major contributor to the budget deficit. Ironically, however, the government began with privatizing profit making units, for example, Millat Tractors and Zeal Pak Cement, among a host of others. Many of the industrial units were sold at less than the value of the land the enterprise held. It is, therefore, not surprising that many of the units were shut down within months and converted to housing. The profitable Zeal Pak Cement is one such case.

With respect to the second round of privatization during 2002-07, the case for privatization was made on ideological grounds: *the state has no business to be in business*. However, the largest state enterprise to be privatized was Pakistan Telecommunications (PTCL) which was sold to Etiselat – a UAE-based state enterprise. Effectively, thus, the ideological motto was rendered amended to: *the (Pakistani) state has no business to be in business(in Pakistan, but a foreign state can be in business in the country).*

While the first round of privatization led to de-industrialization, the second round of privatization has led to balance-of-payments problems. Initially, of course, the flow of foreign direct investment[4] (FDI) improves the balance of payments for the year. Thereafter, the outflow of foreign exchange in terms of profit repatriation to the host country impacts negatively on the balance of payments. As highlighted in the chart below, the services deficit ranged below US$ 1,500 up to 2004 and began to rise from 2005, reaching a peak of US$ 6,500 in 2008.



Source: Ministry of Finance, Economic Survey (various issues)

Privatization for the purpose of managing the budget deficit or the current account deficit amounts to selling the family silver to cover up for poor economic management. It amounts to consuming income from future generations. Privatization for the purpose of efficient management of public assets can be a worthwhile objective and must be approached as such.

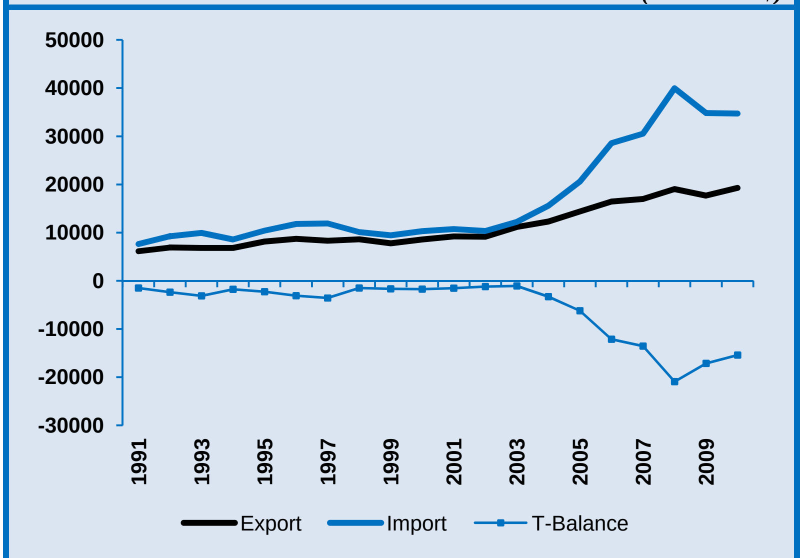
Consideration may, therefore, be accorded to a policy of privatization of management, rather than the asset itself. This can be carried out by awarding management contracts for operation of state enterprises (e.g., PIA, Steel Mill, etc.) for specified periods and under well-defined performance terms.

4.The use of the term 'investment' in this case is a misnomer. Investment is defined as creation of new assets. The sale of an existing enterprise to a private party is a mere change of ownership and no new asset is created. As such, the component of FDI on account of privatization does not qualify as investment.

However, cutting development expenditure rather than current (non-development) expenditure to cut budget deficits is akin to an industrialist dealing with his cash flow problems by laying off the (wealth-producing) factory labour and retaining the (wealth-consuming) array of domestic servants in the household (khansamas, ayahs, malis, chowkidars, drivers, etc.).

The dollar gap

Chart 4
Trends in imports, exports & trade deficit
(US million $)



Source: Ministry of Finance, Economic Survey (various issues)

The ‘dollar gap’ emerges from the excess of goods and services imports over exports and the insufficiency of other inflows – remittances, FDI, etc. – to fill the gap. The key role in enlarging the gap has been played by the trade deficit, with the deficit as a percentage of GDP having doubled from an average of 3.6 percent over 1992-2002 to 7.6 percent over 2003-2010. This has occurred on account of the growing import-intensity of the economy -- as can be seen from the fact that imports were, on average, 27 percent higher than exports during 1992-2002 and 65 percent higher during 2003-2010. Chart 4 illustrates this.

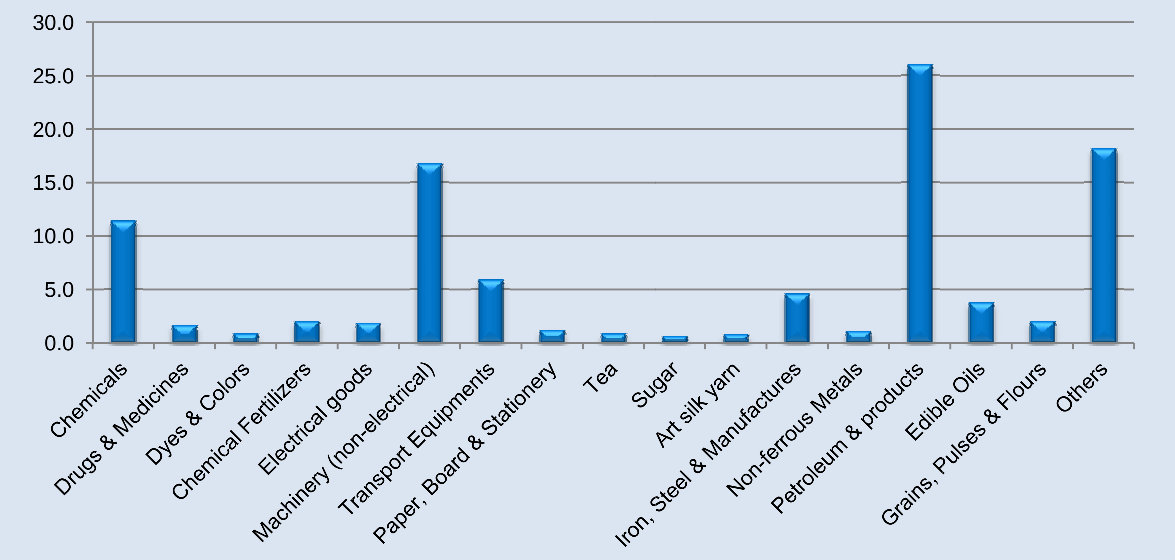
Since 2006, the rise in international oil prices has raised imports to 88 percent more than exports. In other words, we now import US$ 1.88 worth of goods for every US$ 1.00 worth of goods exported. For an economy, like Pakistan’s, large and rising trade deficits signify structural weakness, which needs to be addressed. The argument that trade deficits can be financed through remittances and other capital inflows is not tenable. Capital inflows have been speculative and unable to cushion the trade deficit. The run on foreign exchange in 2008 (and on several occasions earlier) is a case in point. The imbalance in the foreign trade account is on account of structural factors and attention needs to be focused on the transport and power sectors, in particular.

STRUCTURAL FACTORS IN TRADE DEFICIT

Curbing imports

Economic data lists 17 categories of imports, of which POL (petroleum, oils & lubricants) is the single largest item and accounts for over one-quarter of the import bill (see Chart 5). Efforts to contain the trade deficit must, therefore, begin with reducing oil consumption, or reducing the rate of growth of oil consumption.

Chart 5
Average Composition of Imports – 2000-2010
(percent)



Source: Ministry of Finance, Economic Survey (various issues)

POL consumption is high primarily on account of two sectors: transport and power. POL comprises seven different product categories – high speed diesel (HSD), low speed oil (LSO), petrol, furnace oil, aviation fuel, etc. Of these, HSD (used primarily by trucks) and furnace oil (now used largely by thermal power plants) stand out in terms of volume and growth. This is also indicated by the growth in the share of oil consumption by the transport and power sectors from 44 percent in 1971-72 to 76 percent in 1991-92 and to 92 percent in 2010-11. POL imports are hemorrhaging foreign exchange and plugging this drain is one key element in achieving economic stability.

Transport sector

Of the seven categories of oil products consumed, HSD alone accounts for about 55 percent. Why is HSD consumption so high? Because over 90 percent of long distance goods transportation is carried out by road. However, rail transport is said to consume two-thirds of fuel per unit of goods transported per kilometer. Thus, theoretically speaking, if all long distance goods transport is shifted from road to rail, HSD consumption can be reduced by one-third and overall POL imports can be reduced by up to 15 percent. However, even a five percent reduction will be meaningful. In fact even a reduction in the rate of growth of HSD consumption will serve to reduce the pressure on the demand for foreign exchange and on balance of payments and, consequently, on the need to seek regular bailouts from the IMF and supplicate 'friends' for assistance.

The argument is made that railways cannot be a viable alternative, as it is inefficient and riddled with corruption. The last charge deserves no comment, since there is hardly any department that is not afflicted with some degree of corruption. It can be said, however, that the primary reason for the decline of railways is not corruption, rather, corruption has festered as a result of institutional and policy neglect.

With respect to inefficiency, Pakistan Railways is actually a victim. All transport entities in the world – shipping, air, road or rail – generate their profits from moving cargo. Passenger services alone cannot generate the revenues to support the transportation services efficiently and profitably.

There was a time when Pakistan Railways generated a modicum of profits and provided reasonably efficient service. In the mid-1970s, the road sector was deregulated which was followed by the establishment of the National Logistics Cell. Thereafter, the road transport sector began to draw goods traffic away from railways – laying the grounds for the latter's decline.

Today, Pakistan Railways has not only lost much of the goods business to the road sector, it also faces an uneven playing field. While Pakistan Railways has to incur the cost of building and maintaining its own rail tracks, trucks and trucking companies – including NLC – have to incur no cost on building or maintaining roads. While the state builds and maintains roads out of the public budget, Pakistan Railways has to maintain its tracks out of its own budget.

A strong case exists for rehabilitation of railways, with the first step being to restore its goods market. Other secondary steps, identified by a World Bank study, can then follow. History, however, cannot be reversed; thus, one option could be to create a holding company encompassing NLC and Pakistan Railways and create an ***integrated goods transportation system***. Long distance goods transport from and to Karachi and Bin Qasim ports can be via container trains and short haul transportation via container trucks. Once the institutional changes and the necessary investment are made to rehabilitate the rail system, the holding company is likely to be in a position to self-finance its operations without any resort to the government or foreign assistance.

The railway plays an important defence role as well. War entails rapid movement of men and materials on a large scale which can only be effected by railways. As such, rehabilitation of railways is imperative not only from the perspective of relieving the balance-of-payments pressure, but also for national defence. NLC's profit considerations cannot and should not be allowed to override the strategic defence needs of the country.

Power sector: Oil

Currently, gas and electricity are two components of Pakistan's energy supply. Electricity is generated largely from hydel and thermal sources. Hydel power supply faces a shortage of water during about four (winter) months a year; whence, reliance has *per force* to be placed on thermal sources. In 1971-72, the power sector accounted for four percent of total oil consumption; in 2010-11, it accounted for 46 percent – a twelvefold increase. This change has come about by the fact that thermal power accounted for half the total power generated in the early 1990s and now accounts for nearly two-thirds.

Currently, the shortfall in electricity generation is about 5,000-6000 megawatts. The installed capacity to generate the required electricity exists, which can reduce load-shedding to zero[4]. If there are power outages, it is due to financial and distributional problems. However, every additional megawatt of electricity produced will drain more foreign exchange; given that it would be generated from imported furnace oil or coal. The move would further strain the country's balance of payments.

We are faced with a potential trap. Reliance on thermal power is likely to increase in the years to come, thermal power is generated largely using imported furnace oil, (or imported coal) and

[4] Current moves by the government to resolve the power crisis are understandable, but are likely to create additional indebtedness and balance of payments problems in the future.

furnace oil costs foreign exchange. However, plugging the hemorrhaging of foreign exchange on account of POL imports is a key element in achieving economic stability.

Power sector: Natural gas

Natural gas is in short supply and the shortage is certain to increase over time. As such, there is an urgent need to consume gas more efficiently, something that the country has not done for half a century. Inefficiency in gas consumption can be attributed directly to one factor: abysmally low prices. It is, therefore, imperative to raise gas prices to its economic (scarcity) value. That will require gas prices to be increased three to four fold from its current level. Essentially, an integrated energy pricing policy is needed; whereby, all energy sources are priced at a uniform rate per BTU[5]. Such an increase will increase the cost of producing electricity from gas-based plants and impose a shock on domestic[6] and industrial consumers as well.

However, that shock will have a strong positive medium- and long-term impact on the economy. While electricity producers will be forced to move towards alternative economically efficient raw material sources, shocks for domestic and industrial consumers can be moderated somewhat. The impact on low-income domestic consumers can be mitigated by a progressive rate structure, with the first 100 units charged nominally.

The fertilizer industry is a major industrial consumer of natural gas, and fertilizer is an important input in agriculture. The impact on the fertilizer industry can be mitigated by reducing general sales tax rate on fertilizer to one percent[7]. For other industries, the surplus generated from higher natural gas prices can be used to cross subsidize the cost of electricity for industry located in designated industrial estates.

Considerations of importing gas from Iran or Central Asia or electricity and coal from India are misplaced on economic grounds. Current moves to set up power plants based on imported

[5] British Thermal Unit

[6] The poor, living in informal dwellings in villages and urban slums, do not have access to gas and are unlikely to be affected by the increase in gas tariffs.

[7] The one percent tax rate is proposed in order to ensure documentation and for the purpose of ensuring that all sectors remain in the tax net. There are a finite number of fertilizer plants and production and accounting systems are fully automated; as such, tax payment/collection costs will be low for the industry as well as for the tax authorities.

coal are misdirected. The imports will have to be paid for in foreign exchange and foreign exchange is scarce. The fetish to import energy is incomprehensible, given the presence of huge coal deposits within the country -- exploiting which can provide the entire country with electricity round the clock and all year round.

The technical and economic feasibility of Thar Coal has been established and several local and foreign companies have lined up to set up power plants on site. Once the basic infrastructure is in place, coal-generated electricity can begin to flow into the national grid within three-four years. Thar coal based electricity can be generated 24 hours/365 days a year, and can cater to the needs of the entire country with foreign exchange earning potential from electricity export to India. Generation of electricity from locally available coal will reduce reliance on foreign exchange-based inputs, save valuable foreign exchange and contribute to balance-of-payments stability.

Accelerating exports: Imperative of industrialization

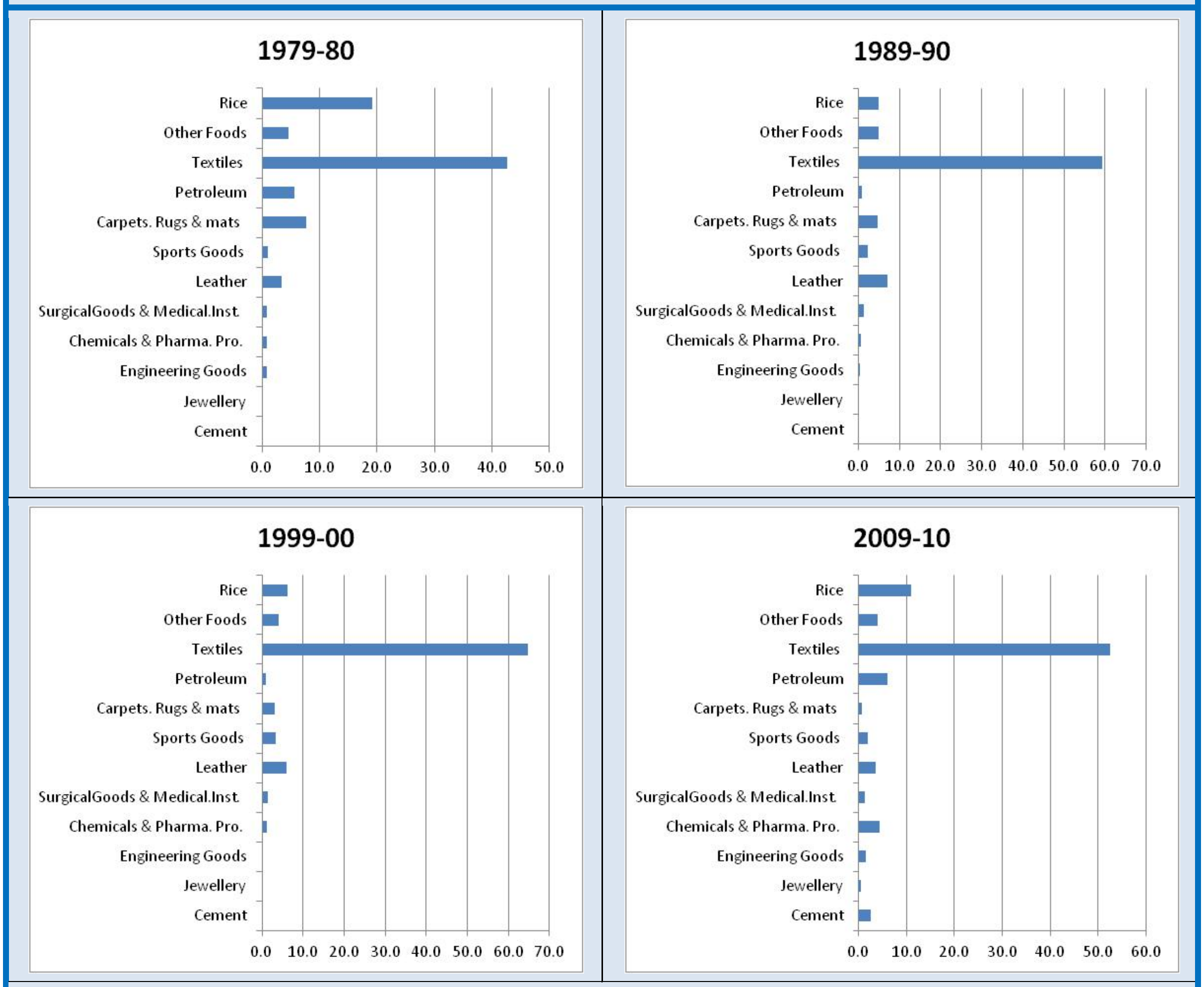
Pakistan's exports have been stagnating on two fronts: growth and composition. One, the rate of growth of exports as a percentage of GDP has remained locked in the range of 12 percent for over three decades. In fact, despite the advantages that Pakistan faced as a result of the change in the international textile trade regime in 2005, our exports-to-GDP ratio fell one percentage point to 11 percent. And two, the country's exports are largely composed of three 'che'[8], *chawal* (rice), *chamra* (leather) and *chaddar* (textiles), which together comprise two-thirds of exports (see Chart 6). The constraints faced by non-traditional exports are ascribed more to domestic supply limitations, rather than to foreign demand for Pakistani products. Sluggish expansion in the export base can be attributed to the constraints facing the manufacturing sectors.

The rupee and dollar gaps have also stagnated the economy and created an employment gap. The crisis, herewith, is a product of jobless growth and misplaced efforts, especially in the last decade and a half, to create an import-dependent and services-dominated economy. However, Pakistan neither has a large and secure source of foreign exchange inflows, (e.g., oil) to pay for imports, nor the education and skill level, to be a services exporter and an active part of the world post-industrial economy. Rather, except for three or four cities, the

[8] 'Che' is the 7th alphabet in Urdu language.

rest of the country is still in the pre-industrial age and most of Balochistan and parts of Khyber Pakhtunkhwa are still in the pastoral age. The fetishes of Washington, New York, London and Manila based consultants – foreign and Pakistani – cannot and should not be allowed to lead the country into a blind alley.

Chart 6
Composition of Exports (%)



Source: State Bank of Pakistan, Annual Report (various issues)
Note: Changes in shares of textile exports are on account of changes in shares of rice export.

Agriculture and manufacturing are two commodity producing sectors on which the economy stands. A strong services sector imposed on weak commodity producing sectors is akin to someone with a bloated body trying to stand on weak legs. Such an economy can neither be strong nor stable. Investment in agricultural infrastructure, particularly water management and soil conservation, is essential to enhance farm productivity. Manufacturing is the engine of growth and the source for exports and jobs and will remain so for the next two-three decades.

However, the macroeconomic policy framework that has been followed over the last two decades has created an anti-industry bias, which has *reduced* absolute and relative profitability in manufacturing and *raised* absolute and relative profitability in alternative non-commodity producing sectors. An environment has been created where few potential investors are likely to choose manufacturing as the first choice for investment, given that opportunities exist for large and easy profits from speculative trading in the land, commodity, and stock markets -- most of which is undocumented and, as such, effectively tax free. The result is stagnation in new investment in manufacturing, and, indeed, a situation of de-industrialization.

This situation has been created on account of the fact that industry has been under assault on three fronts:

1. distorted trade policy;
2. unfair competition from imports; and
3. competing non-commodity producing sectors.

Distorted trade policy

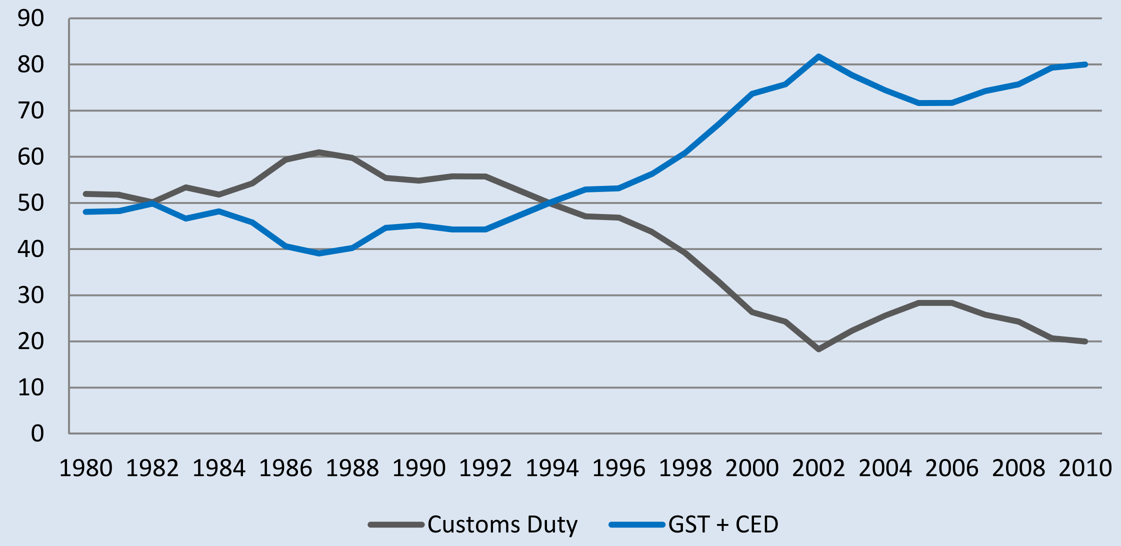
An example of the distorted trade policy can be discerned with respect to the discriminatory tax regime facing the paper and printing industry. Import of paper faces an import duty, while books are imported duty free. The result is that even Urdu books are printed in other countries, e.g., Indonesia and Malaysia, and imported into the country. This policy benefits the handful of (capital intensive) paper mills, but restricts the growth of the 10,000-15,000-strong domestic (labour-intensive) printing industry -- the latter accounting for several thousand jobs.

While book imports should continue to be accorded import duty-free status, it is imperative that paper imports are also rendered import duty free. The resulting import duty revenue loss will be minimal and is more than likely to be made up by enhanced domestic sales tax receipts from the printing industry. The outflow of foreign exchange is likely to be reduced and the employment impact is likely to be significant.

Unfair competition from imports

The onslaught of imports began with the formal adoption of the neo-liberal policy framework in 1988 and consequential trade liberalization in the early 1990s. The results have been devastating. A comparison of revenue receipts from customs duty and domestic indirect taxes – sales tax and central excise duty – shows that, from 1980 to 1993, the ratio of customs duty receipts and domestic indirect taxes receipts was 55:45. It was 50:50 in 1994 and declined to 20:80 by 2010 (see Chart 7). If the charge, earlier, was that imported goods did not enjoy a level playing field, now it is the domestic manufacturing sector that does not face a level playing field.

Chart 7
Trends in ratio of customs duty to domestic indirect taxes (% Share)



Source: CBR Yearbook (various issues)

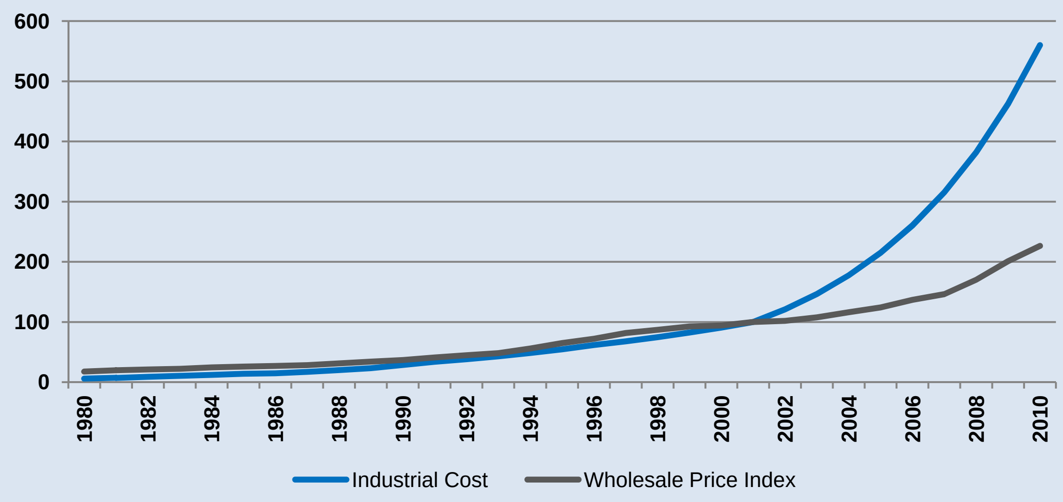
The escalation of the domestic tax burden has been accompanied by increases in other production costs, particularly energy, partly, due to the need to self-generate power at a significantly higher unit cost. The recent 75 percent increase in electricity tariffs for industry is akin to a death blow for the manufacturing sector. Any business will be profitable as long as revenues exceed costs. An industrial unit will be profitable till the output price of its products exceeds its input (production) cost. However, with input costs rising faster than output prices, industry has been rendered uncompetitive with respect to imports and with respect to competing non-manufacturing sectors. Chart 8 illustrates this.

A comparison of industrial cost and output prices, represented by wholesale price indices,[9] from 1980 shows that, for the period 1980 to 2000, the wholesale price index is higher – although slightly – than industrial cost index. From 2001, industrial cost has risen sharply

[9] Wholesale price index is used as a proxy for output prices

compared to wholesale prices. Given this situation, it cannot be a matter of surprise that investors have tended to abandon the manufacturing sector for more lucrative alternative opportunities.

Chart 8
Trends in industrial competitiveness
(2001 = 100)



Source: Ministry of Finance, Economic Survey (various issues) and Federal Bureau of Statistics, Census of Manufacturing Industries (various issues); estimates for missing years derived by interpolation/extrapolation.

Measures are needed on a number of fronts to reduce the absolute and relative costs facing the manufacturing sector, in order to render it competitive vis-à-vis other sectors competing for investment funds. Two areas stand out: one is land cost and the other is taxation. The land cost issue is dealt with in the following section. The tax burden arises in monetary terms and in terms of additional transaction costs; the latter on account of the VAT mode of collection of GST. The 17 percent GST rate is prohibitively high and needs to be reduced, perhaps, to as low as five percent[10]. This step will reduce absolute monetary costs to industry and raise its absolute and relative profitability.

Manufacturing needs to be accorded preferential treatment for a period of at least 20 years. Essentially, the objective of collecting GST from manufacturing should be to document the economy and not to raise revenues to finance the non-development expenditures of the state. Manufacturing is the goose that is laying the golden eggs – in terms of exports and jobs – and cannot be sacrificed at the altar of the state's (and society's) obsession with consumption.

[10] The rate can be reduced progressively over a period of five years. The rate for GST Services, collected by provinces, can remain in the 15 percent range and that of telecommunications and financial services in the 20 percent range.

Admittedly, the reduction in the GST rate will reduce revenues; however, improved compliance can be expected to ensure that net reduction will be lower. The reduction in revenues from GST should be made up by

- fiscal reforms, i.e., reduction in non-development expenditures and enhanced tax collection from direct taxes and taxes from non-manufacturing sectors (see Box 2) and
- raising absolute and relative costs to competing non-commodity producing sectors.

Competing non-commodity producing sectors

The land market: Land is a finite commodity and investment in land does not increase the supply of land. When property ownership changes, it is a personal investment for the buyer; however, it is not an investment as far as the economy is concerned, as no new asset has been created. As such, an increase in land/property prices cannot be equated to an increase in national wealth. Land prices can rise if there is a shortage of land, as in Mumbai or Hong Kong. In this case, land prices reflect scarcity values. This is not the case in Pakistan, where land price escalation is due to cornering of plots and speculation and which is facilitated by flawed institutional factors that facilitate under-valuation. Speculation has driven land prices to levels where urban land cost is now the single largest item in fixed capital cost of businesses and industries.

The modus operandi is as follows. Property dealers purchase properties (plots/houses/flats) and hold them; thereby, cornering the market. Next, they collude to purchase properties from each other – on paper – and raise prices. A similar method is applied by builders launching new schemes. They book several properties themselves – on paper – to create a market impression that there is great demand for properties in order to induce potential buyers on the fence to actually make a booking, sometimes at a premium.

This malpractice is rendered possible as there are no controls on land/property trading and the trading regime allows pervasive under-valuation of land/property at the time of registration of a sale. For example, a plot sold for, say, five million rupees is registered for, say, half a million rupees. A series of impacts follow. One, black money to the tune of Rs4.5 million is created. Two, the government loses revenue (transfer taxes, stamp duty, etc.), given that the property is registered at a fraction of its actual sale price. And three, the sellers accrue windfall untaxed profits. The artificially escalated land/property price has rendered industry relatively uncompetitive and made housing unaffordable for the middle class. The fundamental right to housing stands seriously compromised.

Box 2
Fiscal reforms

Reduction in non-development expenditures
That more than 100 percent of tax revenue is consumed by non-development expenditures is untenable and unacceptable. Resultantly, government borrowing has reached levels where productive investment is crowded out -- with implications for employment growth. It is, therefore, imperative that non-development expenditure be reduced. Admittedly, debt servicing obligations have to be met. As such, the burden of expenditure reduction will have to fall on civil administration and defence.

The abolition of the Concurrent List by virtue of the 18th Amendment should lead to absolute reduction in civil expenditure of the federal government. With respect to defence expenditure, an accounting needs to be made of non-combat expenditure and a phased reduction planned for. A 20 percent reduction can and needs to be aimed at and can be achieved by holding both expenditures constant in nominal terms for a period of, say, three-five years. This exercise is likely to lead to a reduction in the need to acquire debt and, in turn, lead to a reduction in future debt servicing expenditures. Greater resource availability for development expenditure is likely to lead to sustained economic growth and in employment and incomes.

Enhanced tax collection from direct taxes and from non-manufacturing sectors
The share of direct taxes in total tax revenues is abysmally low[1], rendering the tax regime regressive. In other words, the burden of maintaining the state – and the consumption standards of the rich – lies on the poor. There is, thus, an urgent need to raise the share of the tax burden on the rich and reduce the same – absolutely and relatively – on the poor.

In this respect, the withdrawal of the wealth tax – a tax on the rich – was uncalled for and needs to be remedied. The question of the wealth tax has been the subject of some debate and deserves a few comments. The argument *against* the wealth tax is made on the following grounds: wealth is accumulated income and since incomes are taxed, a tax on wealth amounts to taxing the same base twice. This argument is not tenable on the following grounds: income is a flow, while wealth is a stock, and as such, the two tax bases are not the same. There are many instances of similar so-called double taxation over which there are no objections. One is property taxation on properties – a stock – and income tax on rental income from properties – a flow. Another similar case is levy of customs duty and sales tax on the same imported goods. And so on.

Of course, revenues from the wealth tax have been low. However, that has been the case on account of the fact that filing wealth tax returns has been based on voluntary declaration of a limited range of assets. Rendering wealth tax effective will need the tax to be based on assets that visibly indicate wealth: land, house, motor vehicles, etc.

The discussion on expanding the tax base generally tends to move in the direction of taxation of agricultural taxation. Contrary to popular perceptions, however, receipts from tax on agricultural income are not likely to be large[2]. Nevertheless, justice and equity considerations render it imperative that all incomes be taxed. As such, the constitutional exemption to federal taxation of agricultural taxation[3] is uncalled for and needs to be removed, and collection of income tax from agricultural incomes should be made the domain of federal tax authorities. The potential for tax revenues is significantly larger on services and needs to be exploited.

1. There is now an increasing share of 'withholding taxes' that forms part of direct tax statistics. However, analysis of tax data shows that about two-thirds of withholding taxes is passed on to the consumer and should be actually classified as part of indirect taxes.
2. This is on account of the fact that (a) over 85 percent of rural landowners are small farmers and likely to fall below the income tax exemption limit and (b) large farmers account for less than five percent of farms. As such, even if Rs10 billion is collected in income tax from agriculture, it will amount to just two percent of total direct tax collection.
3. Constitution of Pakistan 1973, Fourth Schedule, Item 47 reads: Taxes on income other than agricultural income. The words "other than agricultural income" need to be deleted.

Speculative trading in land means that neither sellers nor buyers are interested in the property *per se* and it is 'files' that are traded. Profits from land/property speculation have reached a point where industries are shutting down to make way for upper income housing schemes; despite there being thousands of vacant upper income residential plots and flats. Two cement plants, one in Hyderabad and the other in Karachi, are pertinent examples despite the fact that the cement industry is booming.

Land (like air, water and sunshine) is a gift of Allah Almighty for all human beings and one set of individuals cannot claim exclusive ownership and deny access to others. Housing is a basic need for the people and cannot be left to the mercy of the market, particularly unscrupulous land sharks. Other countries have taken measures to ensure efficient and equitable use of land and three measures are recommended in this regard.

1. introduce the right of first purchase[11];
2. impose capital gains tax on property sales; and
3. subject all purchasers of land valued at, say, five million rupees to a detailed tax audit.

The 'right of first purchase' can operate as follows. When a property deal is registered, the case must be placed on a designated website for a period of, say, 10-15 working days, stipulating the details of the property and the price at which the sale has been negotiated and being registered. During this period, any other private party should have the right to bid for the property at, say, 10-15 percent above the declared value and should have the first right to purchase the property. This provision will reduce, if not eliminate, under-valuation of landed property. Resultantly, government revenues will rise.

The imposition of capital gains tax on property if sold within, say, three years of purchase will also reduce speculative buying and selling of land/property. The resulting price stability in land/property is likely to ensure that land cost does not escalate out of range for business and industry and for households. Improved competitiveness for industry will create jobs and stable property prices will render housing affordable for the middle class[12]. The three measures combined are likely to choke off the channeling of 'black money' into the real estate sector.

[11] The existing government determined Valuation Table must be abolished.
[12] Provision of housing for the poor requires a different set of measures.

The import market: In addition to the drastic reduction in import duties and increase in domestic taxes, an aspect of imports that affects industry adversely is pervasive under-invoicing. The modus operandi is as follows: A product priced at, say, US$ 100, is invoiced at, say, US$ 80. The importer saves 20 percent on customs duty and GST – which is the revenue loss to the government. The more damaging loss is borne by domestic industry, which has to face competition from artificially 'cheap' imports.

Here too, the introduction of the 'right of first purchase' can reduce the impact of under-invoicing. The 'right of first purchase' can operate as follows. The first step in the import of a product is the opening of a 'letter of credit', which creates an arrangement between two banks – one in the importing party's country and the other in the exporting party's country. Once the goods arrive in the port of the importing country, the banks representing the importing party execute payment to the exporting party.

A system needs to be instituted, which requires the 'letter of credit'(in particular, description of goods and its price) to be placed on a designated website and allowing any third party to bid for the product at a price, say, 20-25 percent, higher than the invoiced cost. The third party should have the first right to take delivery of the goods after paying the cost to the importing party. This provision will reduce, if not eliminate, under-invoicing of imports, accrue higher revenue to the government, and protect domestic industry from unfair competition.

The stock market: The stock market is an instrument for mobilizing resources for investment. As such, the values of stock market indices reflect the state of the economy at any given time. This is not the case in Pakistan. Empirical evidence suggests that trading in the stock markets have failed, over the last two-three decades, to act as platforms for resource mobilization for new investment and trading takes place for the same set of shares. Stock markets have, thus, become centers for speculative trading and profiteering, and do not contribute to creation of national wealth.

This situation has arisen largely on two counts. One, capital gains from speculative trading profits have generally not been subject to capital gains taxation and, two, the nature of stock market incorporation has made it a preserve of a handful of its directors. Two measures are, thus, necessary. One is the imposition of the capital gains tax – a move that has tentatively been made. And two, demutualization of the stock exchanges, so as to broad-base and democratize its ownership and control.

Box 3 **Reviving Pakistan Industrial Development Corporation**
Given the importance of industrialization in strengthening the economic base for sustained development and employment generation, the state's withdrawal from the industrial development arena needs to be reversed. This is particularly necessary in view of the failure of the private sector to invest in ventures where large capital outlays and higher levels of technical and managerial skills are required and where the payback period is longer and risks higher – relative to short-term investments in speculative trading. Consideration may, therefore, be given to reviving the Pakistan Industrial Development Corporation (PIDC), with a changed mandate. Earlier, PIDC invested public funds in establishing industrial units and managing them till they reached commercial viability and then privatized them. An amended mandate may be as follows: PIDC invests in industrial ventures *in partnership* with the private sector, with majority equity provided by the government and debt responsibility resting with the private party. Subsequent to achieving commercial viability, the private party can have to option to buy out the government share or the entity can be sold to another private party.

The Social Policy and Development Centre (SPDC)

Established in 1995, SPDC is a civil society sector research organisation that serves as a focal point for policy-relevant research on social sector development. Using a multidisciplinary approach, SPDC assists both public and private sector institutions including non-governmental organisations (NGOs) to plan, design, finance, execute and manage social sector programmes in a cost-effective manner. The results of its research are made available to policy makers, interested groups and general public to promote informed discussion and action on vital social sector issues.

SPDC being an independent and non-partisan organisation cooperates and collaborates with organisations/institutions working on issues of common concerns (both) within Pakistan and abroad. Being an autonomous and independent organisation, the centre identifies its own research agenda and parameters remaining within the mandate and objectives identified. The main areas identified for research by SPDC are: poverty, inequality, governance, provincial finances, social sector policies, gender issues and macroeconomic policy issues. Having established its credibility, SPDC is considered as one of the outstanding research policy institutions of Pakistan focusing on public policy analyses and social sector development.

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