INSTITUTE FOR POLICY REFORMS

IPR REPORT

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Proposals for Budget 2017-18

About IPR

Institute for Policy Reforms is an independent and non-partisan think tank established under Section 42 of the Companies Ordinance. IPR places premium on practical solutions. Its mission is to work for stability and prosperity of Pakistan and for global peace and security. IPR operations are supported by guarantees from the corporate sector.

On the surface, the annual budget does no more than present estimates for the coming year's revenue and expenses. Yet it attracts a lot of well-deserved attention. For one, changes in rates of tax and tariffs are of interest to businesses. Also, the budget shows us where the money will come from and where it will go. The amount and the source and application of funds depend on economic policy and political choice. In that respect, the budget is an outcome of political decisions.

There are concerns with the way government makes the budget. Both its stated goals and estimates often turn out to be misplaced. In most years, the budget sets out to realize the aims of growth and poverty alleviation. However, few measures in the budget support these goals. For example, the budget usually does not prioritize investment in human resources, which directly supports both goals. The obvious sign of inaccurate estimates, is a lower than justified target for the fiscal deficit. This too happens most years. The budget usually gives higher revenue and lower expense amounts than circumstances merit. It also uses a high estimate for provincial surplus to bridge the gap. Why must we resort to artifice? Because successive governments have made no fundamental shift in policy.

To earn more revenue, GoP must make hard choices that affect the political economy of tax avoidance and evasion. To make spending more effective, it must revisit subsidies for PSEs and power supply. It must also think through development priorities and debt management. These are top level decisions. Government has done well at fiscal consolidation recently. In fact, 2015-16 was the first time in years that FBR achieved its target. Yet, for many reasons we are far from having a stable macroeconomy that can underpin growth.

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It is unclear if this year too GoP will claim a growth budget with low fiscal deficit. Either way, growth will come only with deep reforms that are implemented consistently over time. So far, there is not even a discussion in this regard. This is the last budget before next elections. We expect inclusion of some popular projects, though how they affect expenditure would depend on how much gets done on the ground. Most likely, the new budget will again tweak at the edges because it will lack a strategy or plan.

Temporary changes aside, there are enduring concerns about the economy that only a sustained strategy can counter. Below are some of the challenges:

- Twin deficits: enduring fiscal and current account deficits. The latter is growing, with further pressure on the balance of payment. Already, GoP is relying on Chinese largesse (repayable) about whose terms and conditions we do not know. This is not sustainable.
- Inadequate public revenue with not enough money for provision of services, investment in human resources, or development of infrastructure.
- Ineffective public spending: need for review of priorities, reduce transparency concerns, reform PSEs, and review power policies. After early success, reliance on existing flawed power policy will have the same consequences as before.
- For now, prices are under control, but there are signs that energy price may increase again. This will put further pressure on the balance of payment and SBP's monetary policy.
- Low savings rate and low investment
- Modest growth in manufacturing, fluctuating agriculture production, and stagnant exports
- A large part of the work force, 44%, is in low productivity farm work. Need to enhance farm productivity and to shift the labour to jobs in other areas.
- Lack of competitiveness of the economy and low knowledge input in production. Therefore, exports are stagnant.
- Weak governance increases cost of doing business. It adds to uncertainty in firm level decision making. A major part of the economy is undocumented.
- The economy is open to external shocks

The budget is a support document. It aids in meeting the above challenges only if GoP is committed to tackling them. Its preparation must follow a strategic plan. We do not know how well the annual budget links with GoP's Vision 2025, the five year or the annual plans. From the look of it, it seems very little. In any case, budget reflects policy where we see no change.

The budget must also keep an eye on the country's need for stability. The data is instructive. Pakistan has a young population with about 60% people below the age of 25 years. This means there are about 120 million young people in the country. While overall unemployment in the country is below 6%, 11% of the young are without jobs. Two million young people enter the job market each year. GoP estimates that 22.6 million children are out of school. About a third of the young suffer from malnutrition that could affect their cognitive skills forever. These numbers are important. It shows how Pakistan has lost the potential that a young population offers. Such disadvantage are also drivers of instability as they cause alienation. All over the world, populist ideologies have captured the imagination of young minds. In Pakistan, this has happened for many years.

To be realistic, this paper recommends an incremental approach. It is important though that Budget 2017-18 should move the economy in the right direction even if it is in small steps. For it to have meaning, the budget should support the goals below:

A. Strengthen macro framework for higher growth

B. Rationalize and, where possible, increase public investment in infrastructure and human development

C. Build Competitiveness

D. Give economic opportunity to the young and those outside economic mainstream

The Table below lists the goals that the budget must pursue with activities that would support them. Many of the activities are not part of the budget. Some of these must be done outside and before the budget. The budget must give them operational ability through provision of resources.

Table of Recommendations

Economic Goals	Budget Measures	Policy instruments and Activities
A. Strengthen macro framework for higher growth	1. Increase government revenue to reduce fiscal deficit	1. Broaden tax base, reduce exemptions, strengthen compliance 2. Structural tax reforms: simplify procedures, rationalize systems, remove distortions,
	2. Rationalize expenditure	1. Increase % share of development spending 2. Reduce subsidy 3. Debt management 4. Clean up PSDP, target it to growth 5. PSEs privatization or reforms to do away with subsidy 6. Governance reforms and review of power policy to reduce tariff differential subsidy
	3. Increase Savings and investment	1. Incentivize domestic savings, allow positive rate of return on savings 2. Increase public revenue (specific proposals will follow) 3. Increase PSDP, do away with the policy of managing fiscal deficit at the cost of investment 4. Introduce new long-term savings vehicle
	4. Reduce twin deficits	1. Increase revenue and rationalize expenditure to reduce deficit 2. Reduce reliance on external debt to run government operation 3. Build competitiveness to increase exports: invest in human development, skills training, improve governance 4. Long-term financial product to attract more funds from overseas Pakistanis 5. Debt management

B. Rationalize and increase public investment in infrastructure and human development	Increase share of expenditure on development	
C. Build Competitiveness	1. Public investment in education, skills, human development, and infrastructure	1. Rationalize PSDPs to target competitiveness 2. Improve government performance in support of services to business 3. Invest in reliable power supply and improve logistics 4. Build efficient industrial parks 5. Strengthen books, e.g. resolve outstanding circular debt
	2. Attract FDI	1. Review incentives and security for FDIs (e.g. SEZs)
	3. Upgrade industrial structure	1. Target next generation industry for incentives 2. Use any mix of the following: Tax breaks, subsidy, tariffs, cheap credit, dedicated training, dedicated infrastructure, SEZs, GoP supported R&D 3. Reduce incentives from low value added industry
	4. Review tariffs	1. Rationalize tariffs to serve development and export interests. 2. Shift from viewing tariffs as GoP revenue
	5. Improve productivity	1. Coordinate SEZs, industrial park, tariff policy with skills training and R&D 2. Actively support gradual shift of farm labour to manufacturing

D. Give economic opportunity to the young and those outside economic mainstream	1. Stimulate private sector investment	1. Enhance access to credit, especially to priority industry 2. Review regulation to reduce barriers to investment 3. Improve governance and reduce corruption 4. Public investment in education, skills, and research
	2. Actively promote inclusive growth and massive investment in training	1. Partner with international service providers of Mass Open Online Courses to create mass training courses in Pakistan (Udemy, Udacity, Code.org). Plan on training millions of young Pakistanis each year.
	3. Consider linkage with an existing social security system e.g. BISP	1. Enhance BISP for protection of unemployed youth through skills development or credit
	4. Promote movement of workforce to other countries	1. Skills training with international certification 2. Share information about markets and jobs

In past reports, IPR has given detailed recommendations on the above goals. A summarized version of these is given below. This is an exhaustive list and not everything is possible in one budget.

A. Strengthen macro framework for higher growth

Increase government revenue to reduce fiscal deficit: At present, GoP's total revenue is 15% of GDP. Tax earning is 12% of GDP. It may target a revenue to GDP ratio of 20% in five years, by increasing tax/GDP ratio from 12% to over 15%. IPR recommends anchoring this on growth of direct taxes. This is a complex issue, because it affects interest groups. No government has addressed it, so far. On the other hand, the burden of indirect tax is high on businesses and citizens. Coupled with other high costs for doing business, further indirect tax increase may dampen economic activity. Let's look at the issues and what can be done.

Issues

A very narrow direct tax base: In 2015, a mere 980,000 Pakistanis filed tax returns. This is out of seven million that should be doing so. (IMF estimates this number to be 5.7 Million).

Not all directly taxable income is treated equally: Agriculture contributes Rs. 6.3 trillion to the GDP. A mere 1% of that amount is Rs. 63 billion. Currently, agriculture income contributes Rs. 1 Billion in taxes.

Often, GoP meets growth target by increasing the burden on those already in compliance: Corporate tax rate is high in South Asia in general. Pakistan especially has high rates of corporate tax. The manufacturing sector contributes about 70% of total direct taxes. Only a small number of SECP registered companies file returns. Often, the filers are asked to pay more.

Productivity of income tax and GST is low: Each one percentage point increase in tax rate yields 0.1% of GDP. Our productivity is half the average for low income countries

High tax expenditure: In 2015-16, the federal government lost Rs. 395 Billion in tax revenue. This is about 13% of total tax collected by FBR

Recommendations

Government has already improved collection. As a ratio of GDP, FBR revenue has increased from 8.8% in 2008-09 to 9.5% in 2014-15 and 10.5% in 2015-16. Much more needs to be done to meet the target of tax to GDP ratio of 15%.

Improvement in tax performance by provincial governments is critical. At present, the four provinces contribute 0.7% of GDP. They could increase collection by1% of GDP in three years.

Tax reforms must have the objectives of:

- Increasing total revenue
- Increasing efficiency and equity of the tax system

This will be achieved through:

- Broadening the tax base
- Strengthening compliance
- Structural reforms: simplifying procedures, rationalizing tax systems, and removing distortionary practices

Proposed Action

- Broadening of Tax Base and Strengthening Compliance:
  - Increase penalty for tax evasion, especially for not filing returns, and highlight some major examples of delinquency. This calls for political will as it has never happened in the past and is unlikely in an election year.
  - Continue incentivizing tax officials to bring non-filers into tax net.
  - Rigorous follow up on notices to non-filers. So far, response to these notices has been limited.
  - Require NTN in all immovable property transactions and major financial transactions.
  - Those parties to whom notices have been sent by FBR and property owners above the threshold for filing returns must not be allowed to buy or sell property, if they are unable to present income tax returns. (This calls for coordination with provincial governments)
  - Integrate databases between FBR, SECP, property title registrar, bank accounts, car registration, and stock transactions to find non-filers. (This is a medium-term reform).
  - Only a small number of companies registered with SECP file tax returns. FBR may focus on non-filing companies to enforce filing returns. They may impose penalties for default.
  - Analyze extent and major sectors where under invoicing of imports take place. Introduce minimum import price in the most affected sectors. Government has begun with Chinese Customs an online mechanism for exchange of information.
  - Enforce ‘Benami’ accounts restriction on Banks

- Structural reforms: simplify procedures, rationalize systems, remove distortions, and measures to enhance revenue:
  - Make non-filing a criminal offence.
  - Rely on a system of non-compliance risk to tax payer entities for audit.
  - Begin research on tax policy to assess economic effect of tax policy changes and to support policymaking. Research would also guide if fiscal incentives (that result in revenue foregone) meet desired goals. PIDE could be a useful resource.
  - Tax capital gains on securities held below a certain period and implement a unified tax rate for capital gains on all financial assets. Include real estate transactions (owned for less than a defined period).

- ➢ Gradually withdraw exemptions from import tariff, except in declared prioritized sectors. Also, rationalize import tariff rates to remove distortions and stimulate economic activity. Go back to the simplified four-tiered import tariff structure cascading down from finished goods to raw materials.
- ➢ Gradually withdraw GST exemptions for specific industries.
- ➢ Simplify corporate tax system and consider rate reduction to encourage participation and competitiveness
- ➢ Simplify corporate tax system and consider rate reduction to encourage participation and competitiveness
- ➢ Gradually withdraw exemptions from income tax, except in declared priority sectors. Specifically, income tax exemptions for IPPs set up over ten years ago, must be reviewed. Most of them have recovered their investment.
- ➢ The federal government must impress on provincial governments to mobilize revenue, especial in the agriculture sector.

- Agriculture: the present tax collection on agriculture is a travesty. It generates Rs. 1 Billion nationally. It is a land-based tax enforced on a per acre basis. The rate per acre was assessed last in 1997. At a minimum, it is necessary to index and reassess this rate to current agriculture prices. In addition, increase in penalty for non-compliance may correct large-scale evasion. Penalty now is a farcical Rs. 1,000. It must increase to twice the unpaid tax amount

B. Rationalize and increase public investment in infrastructure and human development

Citizens and firms in Pakistan suffer because of poor services. Infrastructure, especially power supply, is deficient. Human resource and social deficit indicators are low. In quality of infrastructure services and HDI, Pakistan lags many low-income countries. GOP's federal PSDP 2016-17 of Rs. 800 Billion is 2.7% of GDP and 16% of the budget.

Issues

Several shortcomings affect effective use of PSDP, even within its small allocation:

- Weak link between strategy and resource allocation
- Politically motivated prestige projects
- Disconnect between stated priorities and resource allocation, some key sectors are under resourced
- Bias for new projects over maintenance of existing projects
- Several layers of procedures

Recommendations:

Incrementally increase share of development expenditure taking the aggregate federal and provincial PSDPs to over 7% in five years.

- The PSDP must flow from Vision 2025, the Five-Year and Annual Plans. The link between the PSDP and these plans are tenuous at best. We recommend that Planning Commission prepare the Annual Plan several months before the PSDP. Wide consultation must take place on the Annual Plan for it to serve as a meaningful road map. It must go through parliamentary committees, chambers and trade associations, users' representatives, and the Cabinet. This will reduce top down decision-making and create a better connection between strategy and budget.
- Based on strategy agreed in the Annual Plan, prioritize three or four sectors for funding so that projects do not have a throw forward of more than three years (unless there are operational reasons). GoP must prioritize transmission and distribution of power, water storage and efficiency, higher technical education and skills development, and logistics. Within the latter, it must favour rail over road.
- Consult ministries and provinces to reduce the number of projects in the PSDP for prioritized funding within available envelope. Until a quantum increase in funding takes place, the PSDP may not have more than 250 projects. Clear criteria, approved by NEC, must guide cleaning up of PSDP.
- A lot of rigour and care must go into new project approvals. Each new project has repair and maintenance estimates. Approval must be contingent on MoF's assurance that funds for maintenance will be available.
- Strengthen project monitoring, especially of priority projects, through top-level reviews. Transparency in procurement must be a priority.

C. Build Competitiveness

Many activities below are not part of the budget, but listed for government to have a coherent strategy:

- Build effectiveness in public investment and rationalize PSDP portfolio (discussed above).
- Focus on urban infrastructure so that cities support economic growth and serve as service clusters. The best way to do so is through devolution. As the political appetite for devolution is limited, federal and provincial governments should do this. Cities need physical infrastructure such as power, gas, and water supply. They need efficient mass transit and sanitation. They need high class Wi-Fi service and value added telecommunication as well as efficiently managed air and sea/dry ports.

- Set up quality skills development and R&D centres specializing in technologies that support prioritized industries and services sectors. Urban development needs a focus hitherto denied. This has affected growth of productive sectors.
- Build SEZs and industrial parks and provide infrastructure and services and single window support to them
- Build an effective logistics chain that connects SEZs with domestic and international markets and promote trade
- Skills training for specific prioritized industries to shift labour from low productivity jobs to manufactures and value added services
- Review the power sector policy framework.
- Increase agriculture research and extension services as well as credit, input, and marketing support
- Use industrial policy to upgrade economic structure and strengthen exports through fiscal incentives, tariff policy, preferred access to capital and foreign exchange, regulation, and soft and hard infrastructure support.
- To select sectors for GoP support, focus on next technology, having export potential, with high socio-economic returns.
- Identify industries that can become part of the global supply chain. Government must provide them soft and hard infrastructure support
- Incentives, both macro-and micro: Macro incentives across all businesses, micro incentives that are targeted to support prioritized industries. They include tax incentives, access to credit, low cost credit, R&D support, dedicated infrastructure, and training of personnel
- Government may play a pump priming role in industrial development. To reduce risk in greenfield private projects GoP may aid financial close by taking limited equity position and offering credit guarantees. It may consider setting up an equity participation fund for this purpose.
- Use trade policy and foreign exchange policy to boost export and stabilize trade balance
- Enhance regional and world connectivity:
    - Through logistics corridors including CPEC infrastructure, transit arrangements, and improved trade facilitation
    - Rationalize tariff structure in support of development needs and export led growth
- Attract FDIs in value added export oriented sectors

- Initiate FTAs with ASEAN bloc or individual member ASEAN countries. In addition to trade in goods, FTAs must include trade in services, trade facilitation measures, and investment agreements
- Resume FTA negotiations with Iran
- Gradually normalize trade relations with India and reinvigorate SAARC
- Build regional integration and take full advantage of China's Belt Road Initiative to strengthen relations with economies of the region. In addition to infrastructure, we must make especial effort to improve facilitation, reduce number of clearance documents, and the time taken for clearance of goods.
- Stop reliance on import duty as public revenue and move to a nuanced approach where tariff supports industrial policy.

D. Give economic opportunity to the young and those outside economic mainstream

- Stimulate private sector investment
  - ➢ Enhance access to credit, especially to priority industry
  - ➢ Review regulation to reduce barriers to investment
  - ➢ Improve governance and reduce corruption
  - ➢ Public investment in education, skills, and research
- Actively promote inclusive growth and massive investment in training
  - ➢ Partner with international service providers of Mass Open Online Courses (MOOCs) to create mass training courses in Pakistan (Udemy, Udacity, Code.org). Plan on training millions of young Pakistanis each year.
- Develop linkage with an existing social security system e.g. BISP
  - ➢ Enhance BISP for protection of unemployed youth
- Promote movement of workforce to other countries
  - ➢ Skills training with international certification
  - ➢ Share information about markets and jobs