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STRENGTHENING STABILIZATION AND ECONOMIC GROWTH

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1. Process of stabilization

- The Government of PML (N) has been actively engaged in the process of stabilizing the economy following assumption of power. This has been aggressively pursued under the aegis of an IMF program from the Extended Fund Facility.
- The Fiscal Deficit for 2014-15 was 5.3%. The target for 2015-16 is 4.3% . If this is achieved, the borrowing for consumption will end, debt accumulation will stabilize, and debt repayment capacity will improve.
- The balance of payments position has shown substantial improvement and there has been an exponential increase in foreign exchange reserves.
- The inflation rate has shown a steep decline.
- There are clear signals that the economy has stabilized, though still not robust, due to favorable external developments and internal policy actions. Unfortunately, the cutbacks in development spending and additional taxation have had a negative impact on the growth rate. Clearly, while stabilization has been largely achieved, it has come at the cost of growth. The time has come to switch from stabilization to growth mode.

2. Federal Current Expenditure

We look here if there is scope for further reductions in Federal Current Expenditure.

The largest component is interest payments on public debt. Next in size is defense expenditure. The fast growing component is grants. The level of subsidies is variable. Finally, there are the costs of civil administration, pensions and operations of services at the federal level.

- **DEBT SERVICING**

Due to the underlying large deficit, public debt has increased. The debt stands at around Rs.19 Trillion. The component of domestic debt is around Rs.12 Trillion. Within domestic debt there is short-term debt,

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primarily in the form of Market Treasury Bills (MTBs), Pakistan Investment Bonds (PIBs), having a maturity period ranging from three to twenty years and National Savings Schemes (NSS).

- **DEFENSE EXPENDITURE**

The second largest head of expenditure is defense expenditure. Given the state of security and law and order in the country, these expenditures must have priority. The new National Security Policy calls for additional expenditures.

- **SUBSIDIES**

The major share of subsidies is pre-empted by the Tariff Differential Subsidy (TDS) to the power sector (WAPDA/PEPCO and KESC).

- **GRANTS**

Grants of various types are made to different entities with a major chunk going to Provincial Governments. Other grants are made to loss making state enterprises and utilities like the Railways, PIA, PSM and others. In addition, grants are made to the Governments of Azad Jammu and Kashmir and Gilgit-Baltistan.

- **OTHERS**

This head consists primarily of costs of civil administration, pensions, and provision of services at the Federal level. The primary factor causing escalation in the expenditure under this head is the annual increase in pay and / or allowances granted by the Federal Government.

- **PROPOSALS FOR REDUCTION IN FEDERAL CURRENT EXPENDITURE**

    - **Reducing the Size:** the Federal Government today has 38 Divisions and 27 Ministries. While the size is within constitutional limits, it seems too large following the devolution of functions envisaged in the 18th Amendment.

    Some Ministries accordingly do not have a justification for presence at the Federal level. This includes the following:

        - Ministry of Education and Training.
        - Ministry of National Health Services.
        - Ministry of National Food Security.

    In addition, many Ministries could be merged together as follows:

        - Ministry of Defense Production and Textiles with Ministry of Industries and Production.
        - Railways with the Ministry of Communications.
        - Ministry of Petroleum and Natural Resources with Ministry of Water and Power

In addition, in his previous tenure, the Prime Minister was keen to rationalize the number of embassies of Pakistan abroad.

o **Zero-Based Budgeting:** There are over one hundred autonomous organizations and attached departments in the Federal Government. In many cases, it is not clear what their contribution is. As such, a zero-based budgeting exercise needs to be undertaken to determine the case for their continued existence.

o **Rebalancing of the Debt Portfolio:** MTBs may lead to roll over problems in the future. The government in 2013 sold PIBs at 13.5% at the insistence of IMF. Currently, medium to long terms PIBs are selling at 8-9% and MTBs at 6-7%. Banks are primarily interested in the short term MTBs as the expectation is for the interest rates to rise. In order to reduce the debt servicing cost in the future, the government should try to change the PIB / MTB ratio to two-third / one - third respectively by offering PIB at a rate slightly higher than 8-9% and lock in the interest rate.

3. Public Sector Enterprise

Rebuild the public sector in the following manner prior to privatization:

- Control of administrative ministries removed and an over view management installed.
- Boards of Directors reconstituted and professionals brought in.
- Operational standards prescribed and complete autonomy given to achieve them.
- Quantifiable targets set and performance monitored.
- Right-sizing, retention of professional management and skilled staff encouraged.
- Criteria for recruitment surgical — professionalism and merit the basis of appointments.

4. Increasing the Tax-to-GDP Ratio – Provincial Taxes

- The Tax-to-GDP ratio has been increased by 1% since 2012-13.
- At the current tax rate, tax collection can be raised by four to five per cent of GDP by improving tax administration in FBR and by eradicating corruption in the public sector procurement and development expenditures.
- To enhance revenue and discourage import of luxury goods, duty should be increased or a regulatory duty levied on non-essential imports.
- Taxes on capital gains, gifts, wealth and inheritance be levied as these are rich specific.
- Fixed presumptive Export Rebates
- Norms on extent of input tax invoicing (set limits on it)
- Reduce reliance on taxes on consumption, such as sales tax and petroleum development levies, as they affect the poor more.
- Provinces should be encouraged to generate their own taxes in order to increase their current contribution to the Tax-to-GDP ratio. This ratio for the four Provincial Governments combined is 0.7%. It has risen in recent years following the transfer to provinces of the sales tax on services. Both Sindh and Punjab have created specialized tax agencies (SRB and PRA) to collect this tax. There are a dozen sources of tax revenue at the Provincial level but only five - the Provincial Sales Tax on Services (PSTS), Stamp Duty, Motor Vehicle Tax (MVT), Urban Immoveable Property Tax (UIPT)

and land revenue - account for over 90% of the tax revenues. The only major direct tax is the Agricultural Income Tax (AIT). This tax has languished due to low rates and lack of enforcement. Nationally, it yields less than Rs.1 billion. The resource mobilization strategy of the Provincial Governments ought to be to concentrate on taxes which have large tax bases and potentially progressive incidence. Three taxes satisfy these criteria, namely the agricultural income tax, urban immoveable property tax and the provincial sales tax on services.

- **Agricultural Income Tax:** In view of the low collection efficiency of the Provincial Boards' of Revenue (BOR) in this tax, the presumptive nature of this tax should be retained. The fixed tax per acre was set in 1997 when the AIT was promulgated. This should be indexed to the inflation in agricultural prices since then. Even after the escalation in fixed rates the incidence of the AIT will be only 2.5% of the estimated average net income per irrigated acre. In addition, the compliance rate is very low. This may be improved by enhancing the penalty from a maximum of Rs.1000 to 100% of the tax not paid.

- **Urban Immoveable Property Tax:** This tax yields only Rs.7 billion for the four provinces combined. The effective burden is only about 3-4% of the tax base, as compared to the statutory rate of 20%. The gap needs to be reduced by implementing the following:

  i. Extension of the rating areas to include residential and industrial development at the periphery of metropolitan cities.

  ii. Survey of properties and updating of the Gross Annual Rental Values (GARVs).

  iii. Reduction in the tax differential between owner-occupied and rental properties.

- **Provincial Sales Tax on Services:** This tax has rapidly emerged as the largest tax at the Provincial level. The combined collection by SRB and PRA, in Sindh and Punjab respectively, has reached Rs.70 billion by 2012-13. This is equivalent to 48% of the combined total tax collection in the two provinces.

  A number of proposals are put forward for further development of the Provincial sales tax on services:

  i. The law provides for the "reverse charge mechanism", according to which the tax can be levied also on the recipients of services. This implies that the tax can be charged on the import of services, including communications, construction services, financial services, IT services, royalties and license fees and other business services. A conservative estimate of the additional revenue yield is Rs 40 billion.

  ii. Remove exemptions on technical, software and engineering consultants, travel agents, cars/automobile dealers, cable TV operators.

  iii. Introduce Withholding Tax at 4% (similar to at in the ITO) on the following: technical fees, services, contracts and commissions.

  iv. Levy a presumptive tax on hard-to-tax services

  The target should be to raise the Provincial Tax-to GDP ratio by 1% in three years

- **Tax Expenditure**

  Government estimates presented in Pakistan Economic Survey (2013-14) are that the tax expenditure in the federal tax regime is Rs. 185 billion, or 0.9% of the GDP. This is the revenue foregone due to exemptions and concessions, as embodied in the tax laws and SROs. More recent and comprehensive coverage of tax expenditures by the World Bank [2013] reveals that the magnitude is substantially larger at Rs.402 billion in 2011-12, equivalent to almost 2% of the GDP. The largest share in tax expenditure is of the GST of 37%, followed by income tax and customs duty each of 31%. IPR's estimates of tax expenditure in income tax in 2013-14 are presented in the following Table. This aggregates to Rs.261 billion, equivaslent to 1% of the GDP.

Estimated Tax Expenditure in Income Tax (Tax Base of 2013-14)

No.	DESCRIPTION	Estimated Tax Expenditure (Billion Rs)
A.	**EXEMPTIONS**	**110.1**
1.	Tax Holiday(Life Time) to Independent Power Producers	60.7
2.	Under recovery of Capital Gains on Securities	32.7
3.	Exemption to Profit from Behbood Savings Certificates and Pensioner's Benefit Account	12.4
4.	Exemption of Business Income of Certain Trusts, Welfare Organizations, etc.	2.6
5.	Exemption of Profit from Euro/Sukuk Bonds	1.7
B.	**TAX DEDUCTIONS/ ALLOWANCES**	**98.3**
1.	Accelerated(Initial) Depreciation Allowance	41.0
2.	Investment Allowance to Personal Tax Payers	10.4
3.	Tax Deductions on Provisioning by Banks	27.2
4.	Tax Deduction on WWF & WPPF Payments	13.1
5.	Tax Credit on Pension Fund/Provident Fund Contributions	4.0
6.	Tax Deduction on Charitable Contributions	2.6
C.	**CONCESSIONARY TAX RATES**	**37.7**
1.	Concessionary Rate on Sales Tax	6.1
2.	Concessionary Rate on Export of Services	2.7
3.	Concessionary Rate on Export of Goods	18.1
4.	Concessionary Rate on Supplies	3.4
5.	Concessionary Rate on Teachers	1.9
6.	Concessionary Rate on Dividends	5.7
D.	**OTHERS**	**14.5**
1.	Other regional/Sector/enterprise exemptions	14.5
	TOTAL TAX EXPENDITURE	260
	Percentage of GDP	1.2

Source: Estimated at IPR

- **Taxation Proposals in Direct Taxes**
  - **Under taxation of Capital Gains on Securities:** This involves enhancement in the withholding tax on shares/securities traded in the stock exchanges, in lieu of capital gains. The proposal is to introduce a **Securities Transaction Tax,** of the type that exists already in India. The suggested rate is 0.5% of the traded value of a share.
  - **Exemption of Income of Certain Trusts, NGOs and others:** This will only become applicable if the business income exceeds 50% of the total income (including charitable contributions). The taxable business income may be taxed at the reduced rate of 20%.
  - **Tax Deduction on Pensions:** Pension contributions already enjoy tax deductibility. The present system of also exempting pension income, in effect, provides a double benefit. As such, the second benefit is proposed to be withdrawn in the case of retired corporate executives, for annual pension income in excess of Rs.750, 000.

- **Transition from Presumptive to Withholding Tax Regime**
  Currently, different forms of unearned capital income are taxed as separate blocks of income. The proposal is to make a transition from scheduler to comprehensive income taxation. As such, it is recommended to withdraw the presumptive and final tax of 12.5% on the following:-
  - Dividends
  - Interest from bank deposits
  - Profit on government securities
  - Prize bonds

  and replace by a minimum withholding tax of 12.5% which will make the tax system more progressive and raise additional revenues.

- **Taxation of Capital Gains on Property**
  Capital gains on property are more in the nature of income and should be within the fiscal powers of the Federal government. However, the focus should be on taxation of real, net nominal gains.

- **Measures to compel non-filers of returns to file returns**
  Owners of property above a minimum size are expected to file income tax returns. However, this is frequently not the case. FBR has sent notices to a large number of non-filers, but the response has been very poor. As one punitive step, property owners who are required to file returns may not be allowed to sell or transfer their property if they are unable to present the last three years income tax returns at the time of registration of the transaction.

- **Focus on Companies**
  With regard to broadening the direct tax base, there is need to focus on companies too along with individuals filing returns. Of the companies registered with SECP, only a small portion file tax returns. Therefore, a drive should be launched to induce corporate entities to file returns or face heavy penalties.

- **Taxation proposals in Indirect Taxes**
  - **Import Duties**

    The major Chapters of the Harmonized System, which enjoy the largest tax breaks due to SROs, are mostly either intermediate or capital goods, with the exception of automobiles, which fall largely in the consumer good category. The impact of SROs, consequently, is an enhancement in Effective Rates of Protection (ERPs) to domestic industry. For example, the ERP for the automotive sector is as high as 116% due largely to SROs.

    While many of the SROs represent the lobbying efforts of influential industrial groups, an indiscriminate and large-scale withdrawal could constitute a big 'negative shock' and lead to some displacement of domestic industry.

    Therefore, two basic principles need to be observed in the rationalization of import duty SROs as follows:

    Principle 1 No withdrawal of SROs on basic food items falling in Chapters 1 to 23.

    Principle 2 Cascading down the statutory rate of import duties as follows:

	Rate of Import Duty (%)
Raw Materials	5
Machinery	5
Intermediate Goods	15
Finished Goods	25

    Simultaneous withdrawal of SROs and scaling down of import tariffs will enable industry to absorb the big move, while leading to a simpler and more transparent import tariff regime.

  - **GST**

    There is currently a debate as to the type of sales tax regime, which best suits the country. The GST is levied, more or less, in the VAT mode with multiple stages of taxation along the value chain and with input tax invoicing at each stage.

    The growing disillusionment with the GST is due primarily to two reasons. First, there is a perception of over-invoicing of inputs, arising from the so-called 'flying invoices' problem. Second, industry has been complaining vociferously about delays in the payment of refunds.

    The alternative that has been suggested is the reversion to a single-stage sales tax without input tax invoicing. This is the kind of tax, which existed in Pakistan prior to the promulgation of the 1990 Sales Tax Act. As such, the GST will be levied on the value of sales/production and not on the value added. The general perception is that this will lead to a quantum reduction in the standard tax rate on the same tax bases as at present, without jeopardizing revenues. It will also imply a simpler tax system.

- **Under Invoicing of Imports**

  There are allegations by the private sector of under invoicing of imports, especially from China. There is a strong case for introducing minimum import prices of products, which are vulnerable to under invoicing. There are provisions within the WTO rules for undertaking this step.

5. Growth Strategy

- The current IMF program must continue to maturity in September 2016. Pre-mature disruption may be detrimental for our economy in the current international economic environment and may result in capital outflows in the shape of portfolio investments. However, the program should not be renewed. IMF repayments start in 2018. The governments external borrowing (Euro Bonds, Sukuks) also mature in 2018 and later. The Paris Club payments of US$ 500mi per year though start in 2016 (re-structured in early 2000's). This will give fiscal space to focus on a growth strategy.
- The exchange rate is overvalued by about 20%. The dollar has appreciated about 6% already. SBP's interference in the exchange market in the shape of selling dollars should stop. Infact SBP should buy dollars in the market to let the rupee come down further by 6-7%. There is enough cushion in the inflation rate for any upward pressure as a result. This will be a big boost for the private sector growth and will lead to higher tax revenue. Pakistan has not been able to take full advantage of the GSP + status with EU due to the overvalued exchange rate. Exports to China have declined. In particular, exports of cotton yarn have fallen. With respect to imports, the fall in price of oil has reduced the import bill no doubt. However, many industries, which are import substituting in nature, are suffering because of a big increase in cheaper imports.
- After the bankruptcy of all Development Finance Institutions in Pakistan, no project financing is available. The commercial banks offer only short term, variable rate financing. These banks should be encouraged to offer long term, fixed rate project financing. This should be done by incentivizing the banks through enhanced tax deductions on bad debts, direct tax credit for increased exposure on long term financing for private sector (LSMs, SMEs, micro finance, agriculture and housing). Long Term Financing Facility (LTFF) of SBP should be expanded after the termination of IMF program. The proposed EXIM Bank should also provide project financing for export-oriented industries.
- The combined PSDP of the Federal and Provincial Governments should be given a quantum jump from 3.8% (revised) to 5.0% of the GDP. There is need for fiscal space to make rupee resources available for implementation of projects agreed with the Chinese Government. The total outlay is $ 46 billion and it is essential that about one percent of GDP be allocated for CPEC projects in the Federal PSDP. Research has demonstrated that the short-run 'fiscal multiplier' is close to two. A rupees one billion increase in development spending leads to an increase in GDP of almost rupees two billion. Beyond this impact, larger investment in infrastructure expands the productive capacity and takes the economy to a higher growth trajectory. There is also the phenomenon that public investment 'crowds in' private investment, especially if the bottleneck of energy is removed.
- No future enhancement in tax rates should take place. FBR should focus on broadening the tax base and on improvements in tax administration.
- In the presence of a low rate of inflation, the monetary policy can also be more expansionary in character. Borrowings from SBP may be positive and up to the limits of 'seignorage' (increase in demand for money). This has been estimated at about 1% of the GDP. Further, government borrowing from commercial banks should be limited to 2.5% of the GDP, to enable a doubling of credit to the private sector. Private sector credit is growing by 30-40% so far this year.

- The SBP through Open Market Operations (OMO) is injecting large amounts in the banking system. SBP lends to the Banks at 6%, which then pick up MTBs (6-7%), PIBs (8-9%). Banks make profit without any effort. This is a backdoor method to direct borrowing by government from SBP (which tantamounts to printing money) and has the same negative impact on the economy.

6. Job Creation

- Major Job creation will come as a result of high growth policy through both private sector and PSDP.
- All infrastructure projects could entail compulsory job creation.
- Institutions like Pakistan Poverty Alleviation Fund, Micro Financing Institutions and National and Provincial Rural Support Programs should play a role in eradicating poverty and creating jobs by expanding their operations.
- Private sector should be given tax incentives to create jobs.