INSTITUTE FOR POLICY REFORMS

IPR

REPORT

LIVING ON BORROWED TIME: HOW THE FEDERAL GOVERNMENT COLLECTS AND SPENDS OUR TAXES IS WHY WE ARE ECONOMICALLY WEAK

July 2024

Living on borrowed time: How the federal government collects and spends our taxes is why we are economically weak

Each time an IMF review is on the cards, and it seems that one always is, there is news of a hike in power tariff and petrol prices. Similarly, there are new pledges by GoP to increase tax rates and expand the tax base.

Yet no number of increases in taxes have bridged GoP's budget deficit. Nor have frequent bouts of belt tightening changed anything. There is a change in approach now, but still too early to know how it goes.

Citizens must pay for the mistakes by decision makers that have got us in to the debt trap. And once again, since the state has not taxed the privileged, we fear that 'indirect taxes will continue leading FBR's charge'. That charge will be on those who "had nothing to do with this financial mess"[1].

The power supply chain's cost recovery has not improved, despite repeated hikes in tariff. Circular debt has grown unchecked. In fact, tariff growth may have caused increase in circular debt[2].

The government does not explain to citizens why previous price and tax increases have not helped. Nor do we know why despite many IMF programmes, the economy is in a worse shape than it was. Both IMF and GoP call the programmes 'structural reforms.

For decades our approach to economic and public financial management is a patch work of quick fixes. Those stopgap steps have done little to pull us out of the economic morass and may well have made matters worse. In addition, they have slowed the economy and burdened the common citizen.

Behind GoP's languid approach is the lack of an organizing principle and political purpose about public financial management. Every act of GoP affecting revenue, prices and spending must have the goal of spurring growth by raising firm productivity or citizen welfare. What we see though are indicators pointing to the opposite direction. Expediency has become strategy.

We also see repeat of the same tried and failed solutions that take away entrepreneurship and deny basic services to the people. The last two may be the real causes of our economic troubles.

This paper shows the disorder in which public financial management finds itself. It then recommends how we could gradually release ourselves from economic chaos.

The country's economic troubles are of our own making. They are the outcome of political choice and a lack of organization.

[1] Business Recorder, The AJK curtain-raiser, May 16, 2024
[2] PIDE, Immediate Reform Agenda: IMF and Beyond, Nadeem Ul Haque, Ahmed Waqar Qasim, April 2024, page 64.

Part One

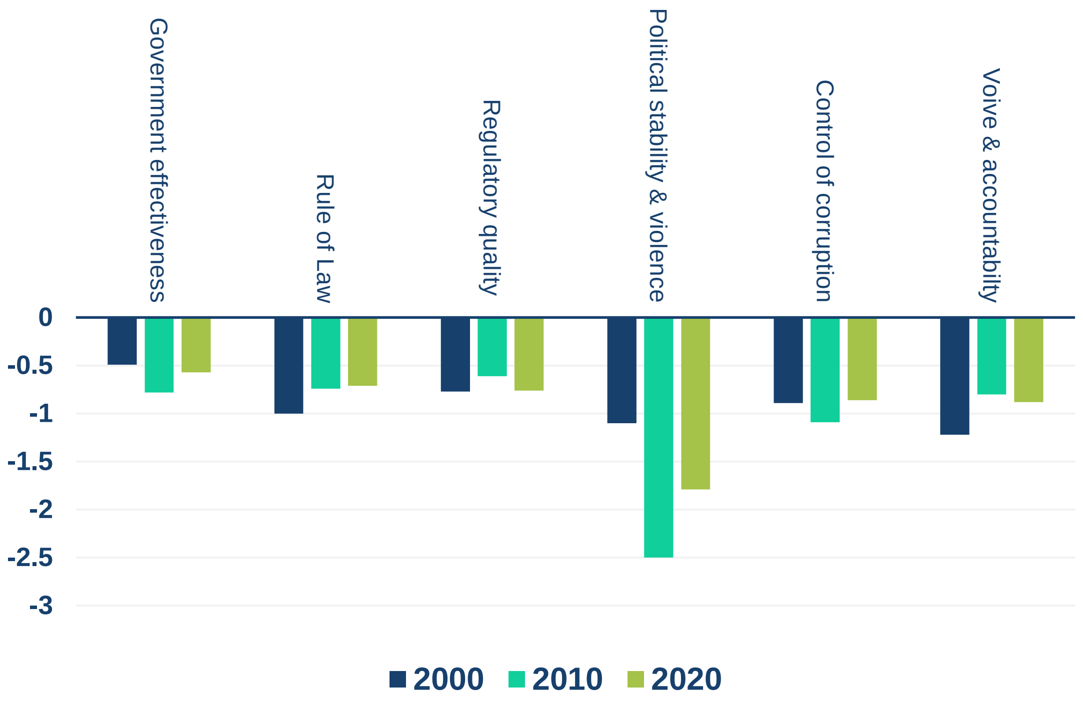
Where we stand is not a happy place

- Near default. External account will be fragile for a few years. External debt servicing unsustainable.
- Increased inequality and poverty
- Low growth and low job creation, decent jobs scarce
- Falling human resource measures and competitiveness
- Declining savings, investment, productivity and exports
- High public debt. Over 50% of federal spending is on interest.
- Poor governance
- Weak infrastructure support
- Dysfunctional cities
- Globalization taking new shapes, while domestic markets not efficient

The economy is besieged by a wide set of problems. These are:

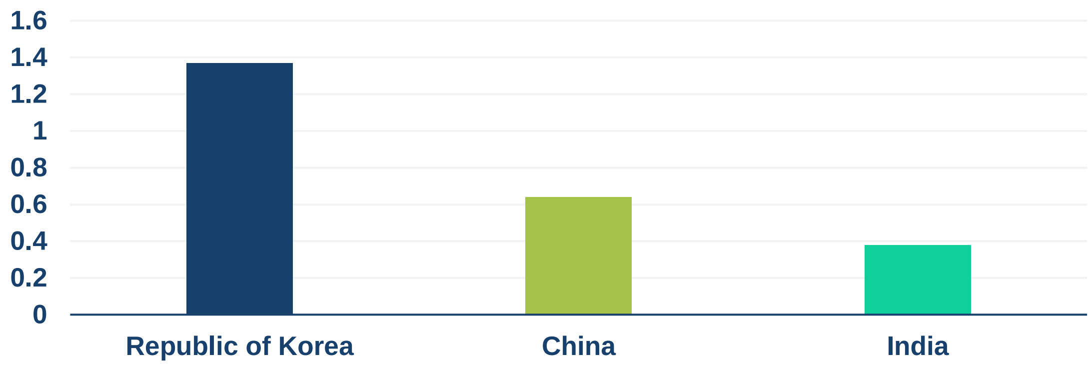
1. Flawed governance at all levels:
    - Poor services at the local and city level with firms encumbered by rules.
    - No long term strategy for economic revival at the federal level.
    - Political uncertainty.

Figure 1: Pakistan Governance indicators, 2000-2020



Above, Pakistan's score is in the negative in all of the six criteria along which the World Bank measures governance. WB scores each country within the range of -2.5 to 2.5. And though the scores have improved of late, they have stayed in minus throughout. Other economies do better as seen in the example of just one criterion.

Figure 2: Government effectiveness, 2020



2. Poorly functioning cities. Because of low investment in talent and infrastructure, they do not act as centres of growth and innovation.
3. Vast gaps in needed infrastructure: Logistics, cost and uncertain supply of energy. Internet services are often down and slow. Inadequate water supply for crops and its inefficient use.

Figure 3: Infrastructure, ranking by World Economic Forum, 2019

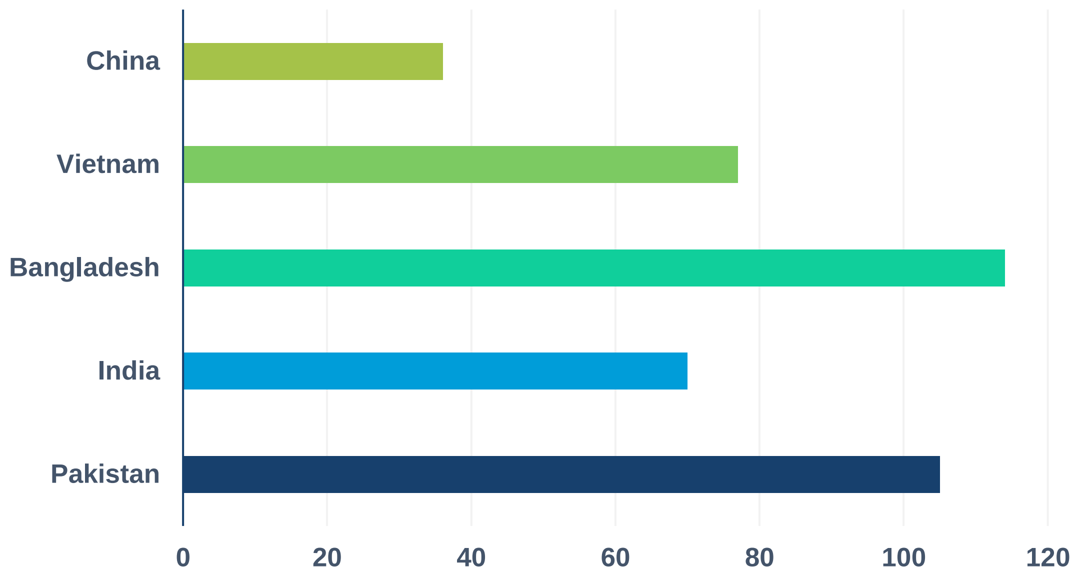
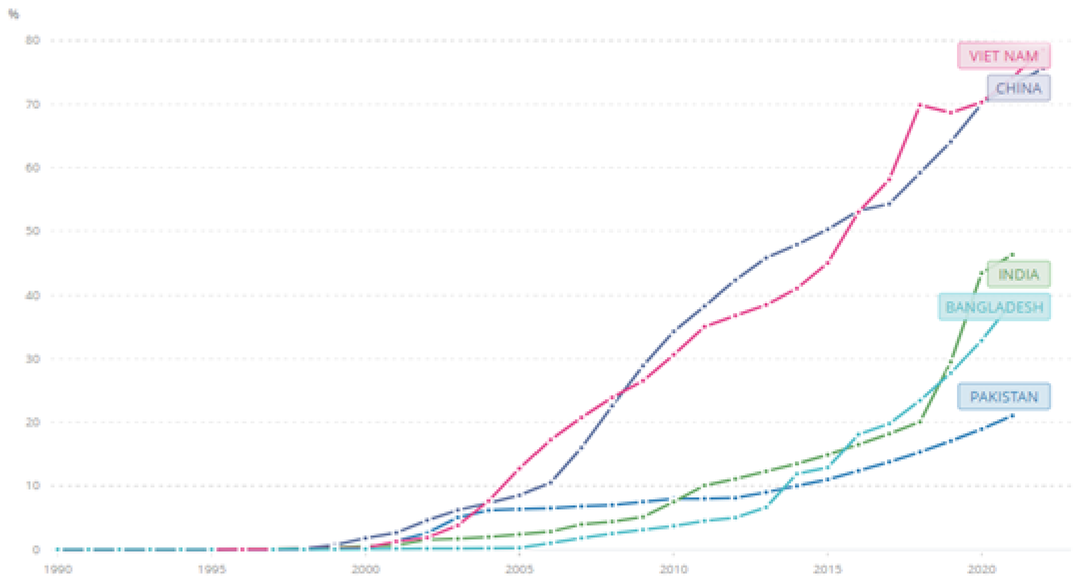


Figure 4: Individuals using the Internet (% of population) – Pakistan, India, China, Viet Nam, Bangladesh



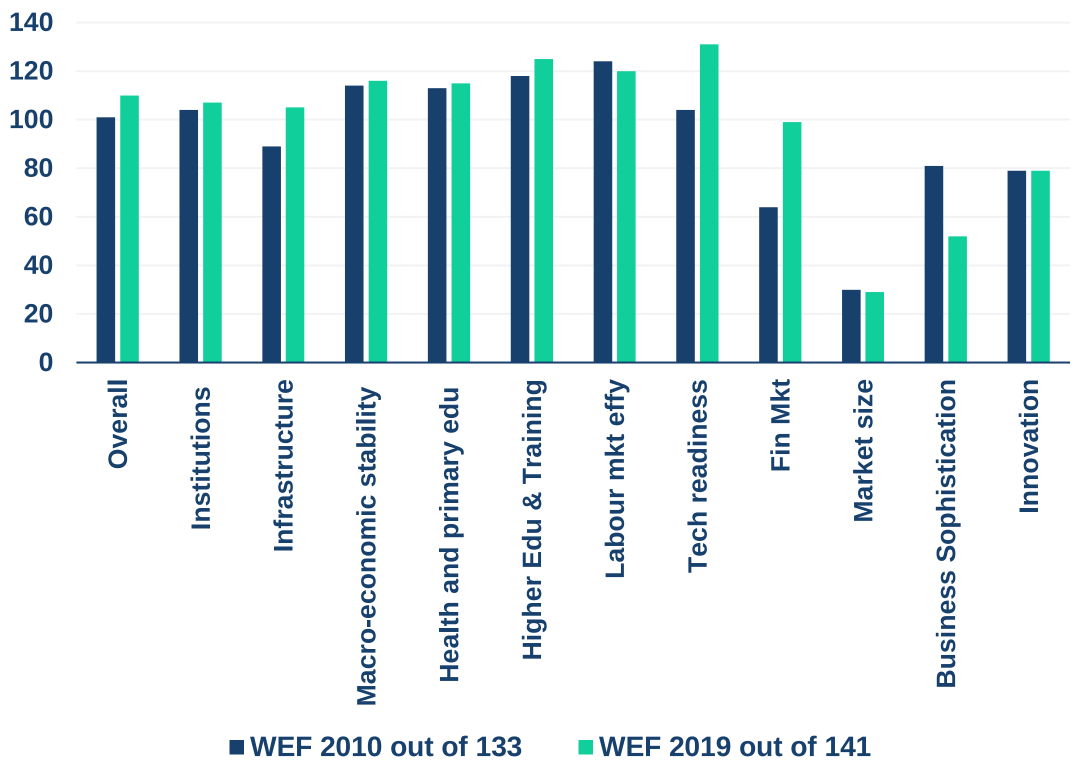
Source: International Telecommunication Union (ITU) World Telecommunication Indicators Database

Table 1 % of population using internet,	%
Pakistan	21
Bangladesh	39
India	46
China	76
Vietnam	79

Source: World Bank data

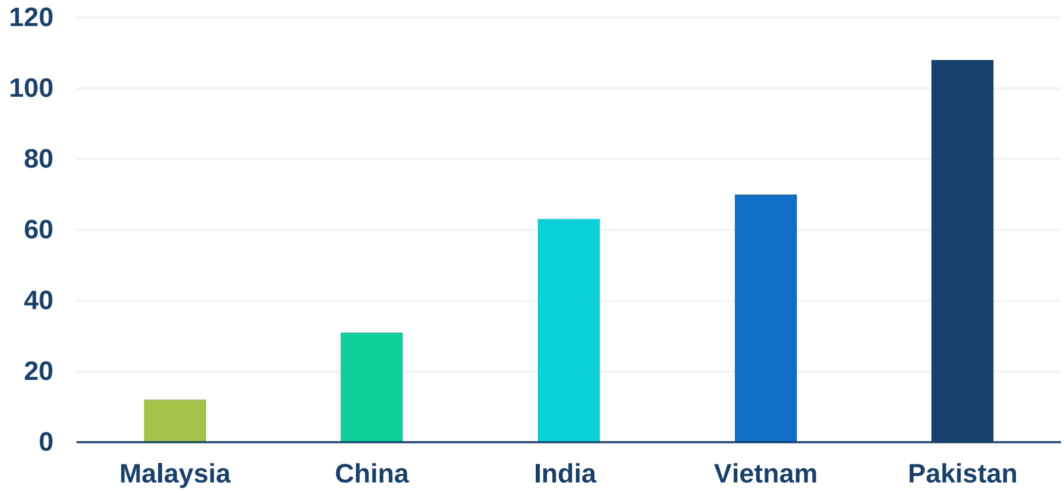
Pakistan's rank has fallen in the World Economic Forum's competitiveness index. In almost all categories, the country has a lower rank in 2019 than in 2010.

Figure 5: World Economic Forum Competitiveness Index



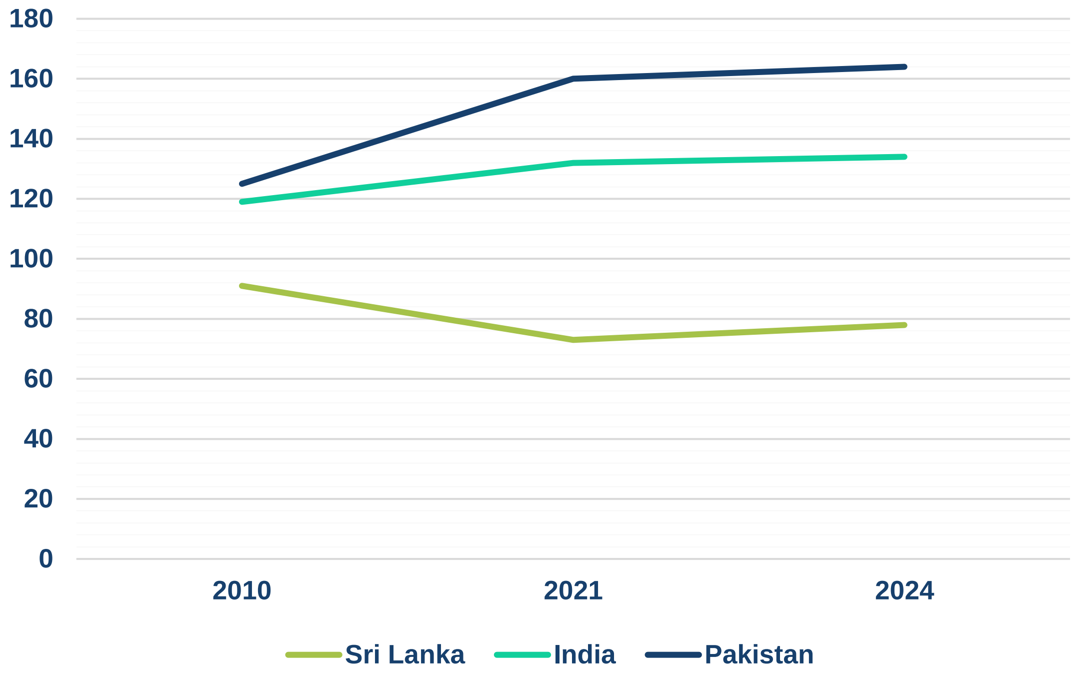
The same holds true for WB's Ease of Doing Business. Pakistan shows especial challenge in Paying Taxes, enforcing contracts, registering property, getting credit, electric connection and construction permits:

Figure 6: World Bank's Ease of Doing Business Rankings 2020



4. Low investment in human resources: Skill gaps have left the economy woefully short of needed HR. We may be wasting our demographic dividend. Pakistan's HDI rank has fallen from 129 in 2010 to 164 of 193 countries in 2024.

Figure 7: Pakistan's HDI rank is low and has worsened



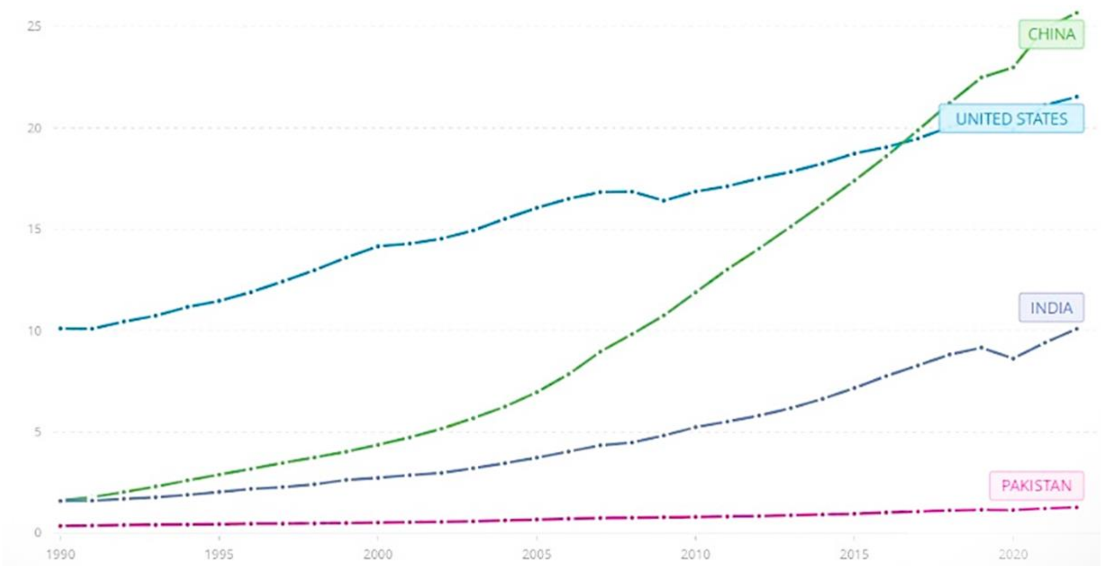
5. Weak labour market. Not enough jobs for new entrants to the labour pool "about 20 percent of urban workers and less than 10 percent of rural workers had formal wage jobs in 2017"[3]. PIDE estimates that annually new entrants for jobs number 4 million[4].

6. Our capital market has been captured by a few players. Firms, especially small firms, do not view it as a reliable source of funds. Banks prefer to buy government security while private investment suffers.

7. A fragmented domestic market. The country needs a unified home market connected by logistics, contract enforcement, common laws and tax rules among provinces to ease domestic trade. At a time of reversal of globalization, markets at home are all important.

   Thus there is low GDP growth, low investment, low productivity and falling exports. Most macro indicators are weak. In constant 2017 $ terms, our PPP GDP has hardly improved since the 1990s[5].

Figure 8: GDP, PPP (constant 2017 international $) – United States, China, India, Pakistan



Source: International Comparison Program, World Bank | Eurostat-OECD PPP Program

[3] WB, Overview of Pakistan Jobs Diagnostic: Promoting Access to Quality Jobs for All, https://documents1.worldbank.org/curated/fr/894711570187147368/pdf/Overview-of-Pakistan-Jobs-Diagnostic-Promoting-Access-to-Quality-Jobs-for-All.pdf

[4] PIDE, Immediate Reform Agenda: IMF and Beyond, Nadeem Ul Haque, Ahmed Waqar Qasim, April 2024, page 15

[5] World Bank Data

And high volatility. In essence, GDP grows because of just one driver, foreign capital inflow. The rest drivers are in decline.

Figure 9: GDP % growth 1960s to 2022[6]

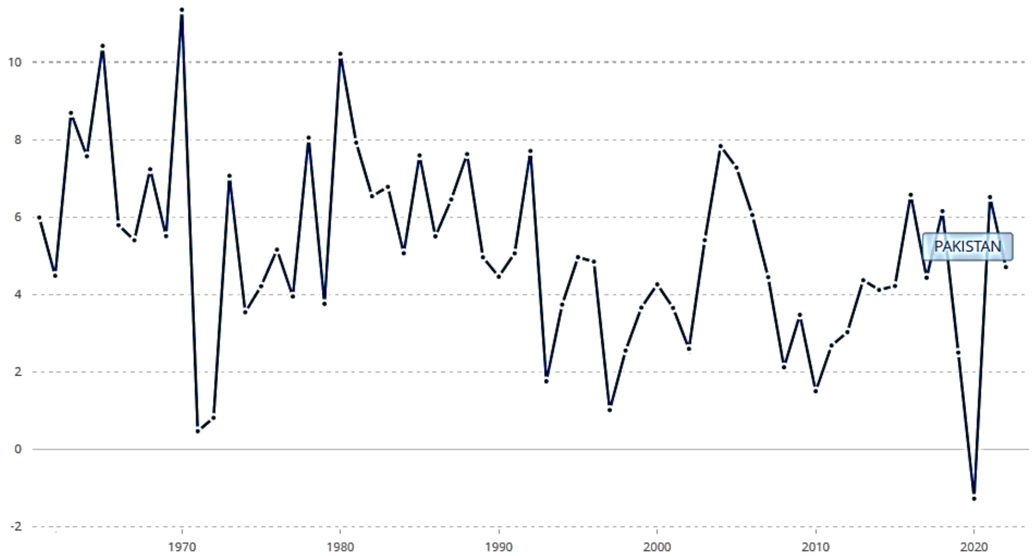
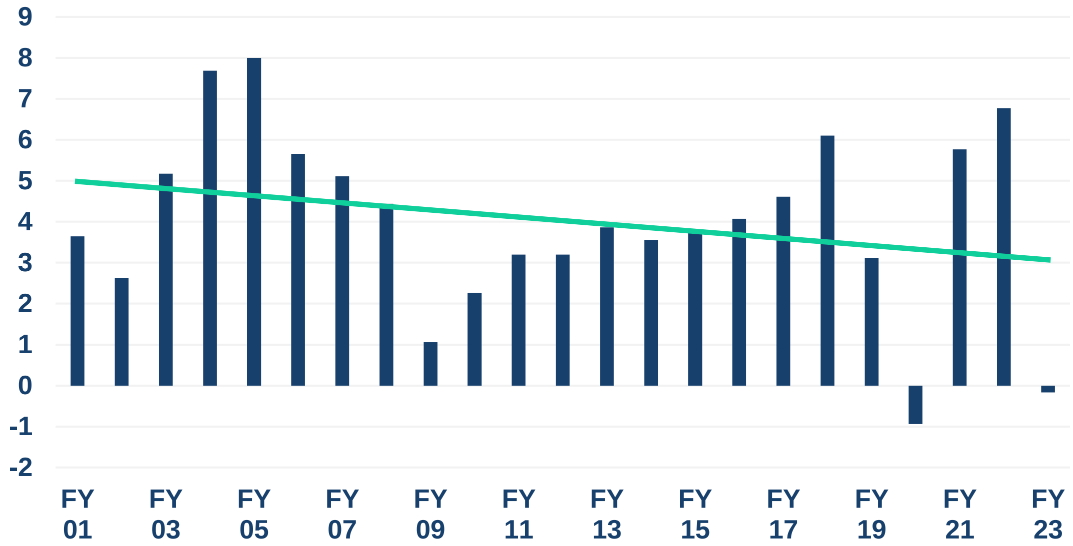


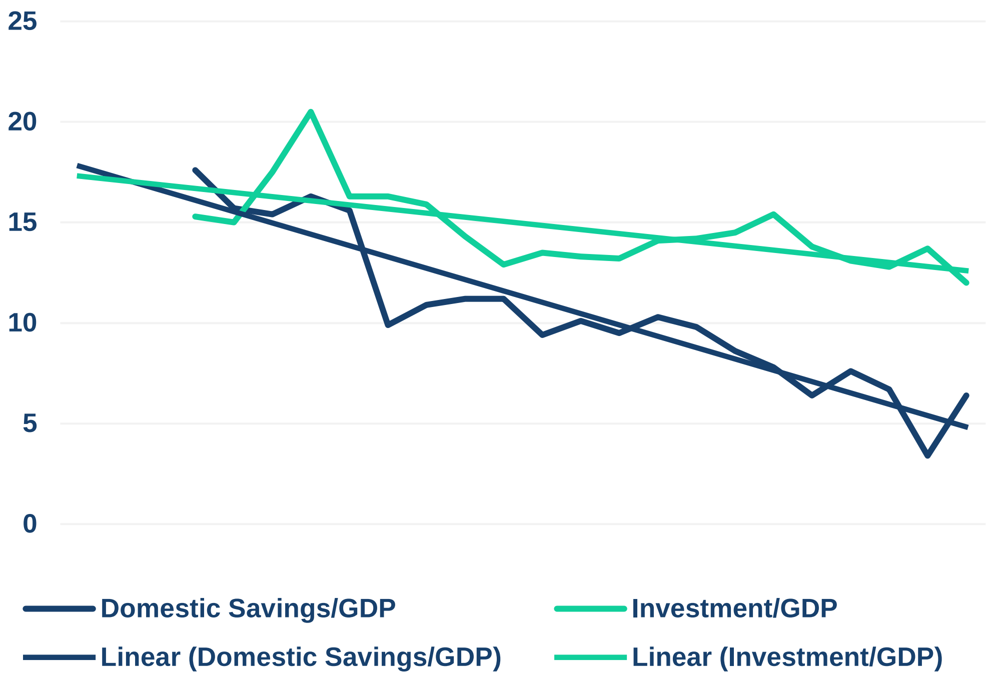
Figure 10: GDP growth rate %, FY 01-23



[6] Graph and data from World Bank, Figure 10 based on PBS data

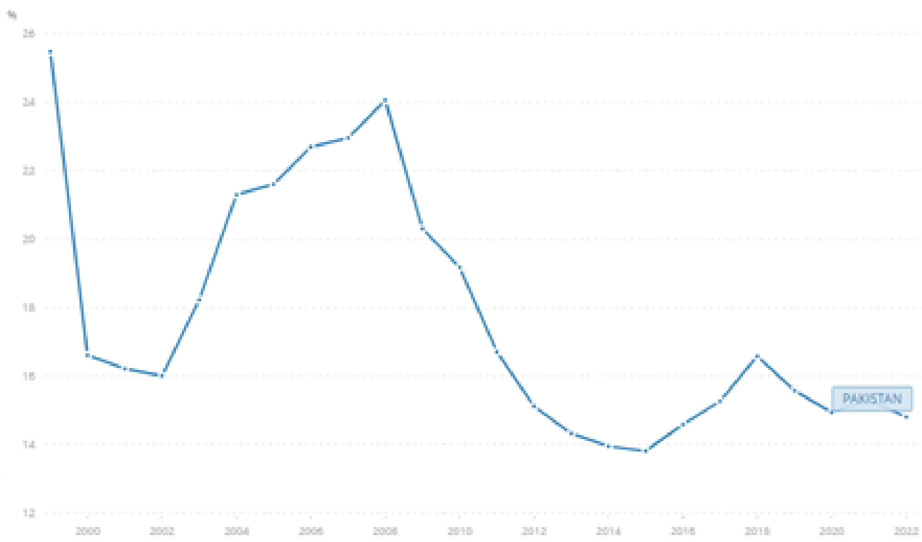
Key drivers of the economy's growth are in decline. Savings have fallen, as GoP preempts available liquidity. So have investment, productivity and exports:

Figure 11: Falling Savings and Investment as % of GDP, with increasing gap filled with debt 2003-2023



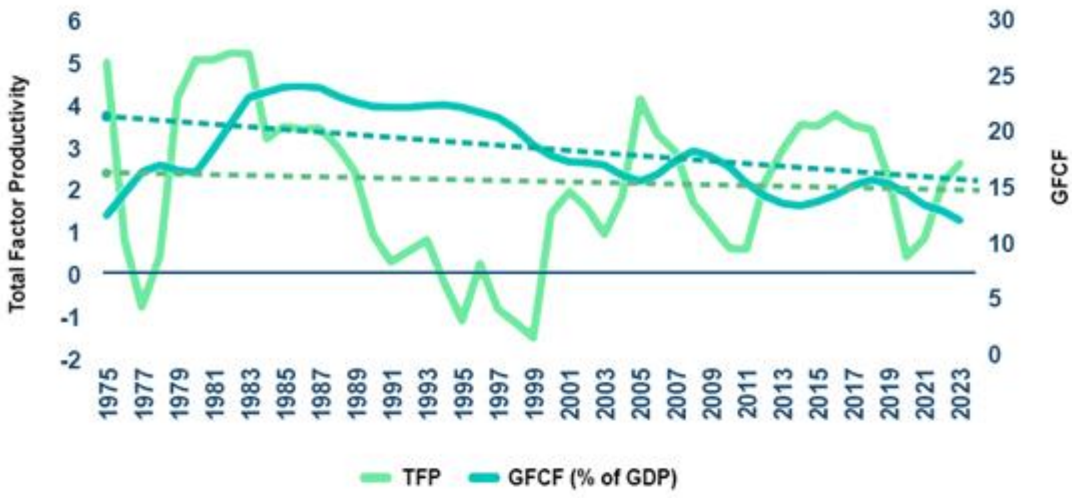
Source: IPR research based on MoF Fiscal Operations data

Figure 12: Falling credit to private sector, % of GDP[7]



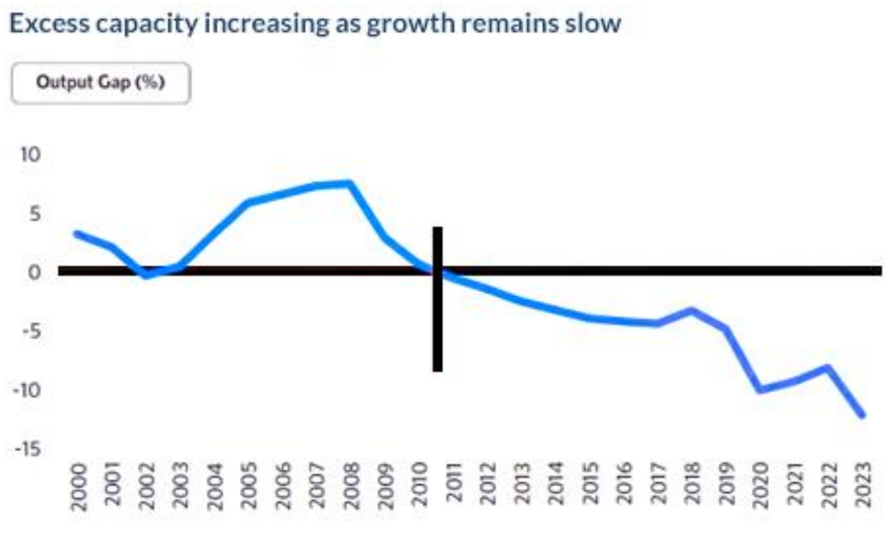
[7] World Bank data and graph

Figure 13: Investment, Productivity & Exports[8] are in long-term decline[9]



Source: PIDE's calculations

Figure 14: Consequently, the economy has been operating below its potential[10]



Source: IMF Report, 2024

"The output gap is an economic measure of the difference between the actual output of an economy and its potential output[11]".

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[8] Investment is measured by GFCF or Gross Fixed Capital Formation

[9] PIDE, Immediate Reform Agenda: IMF and Beyond, Nadeem Ul Haque, Ahmed Waqar Qasim, April 2024, page 13

[10] PIDE, April 2024, Page 5

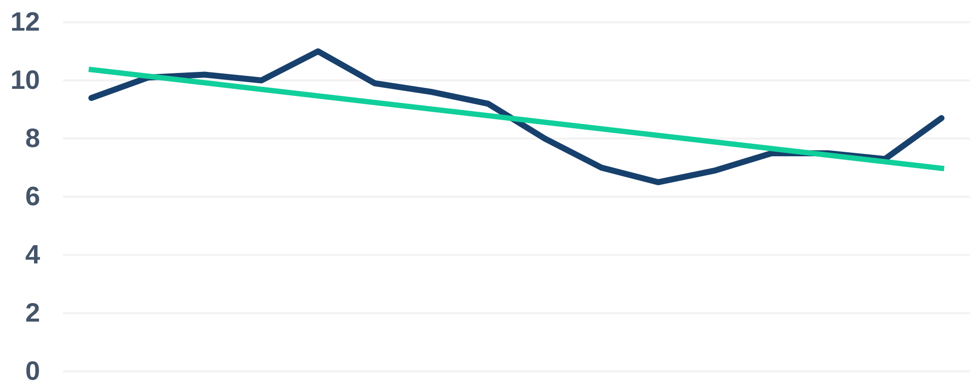
[11] IMF What Is the Output Gap? FINANCE & DEVELOPMENT, September 2013, Vol. 50, No. 3, Sarwat Jahan and Ahmed Saber Mahmud

PIDE has based its estimate on an IMF report. While such estimates involve considerable assumptions, the estimate is significant:

- It is likely caused by GoP expenditure and revenue policies
- It confirms that the economy is in no position to create the millions of jobs needed each year
- That current inflation is not because of excess demand, but excess money supply caused by government borrowings.

No surprise that exports as % of GDP have declined:

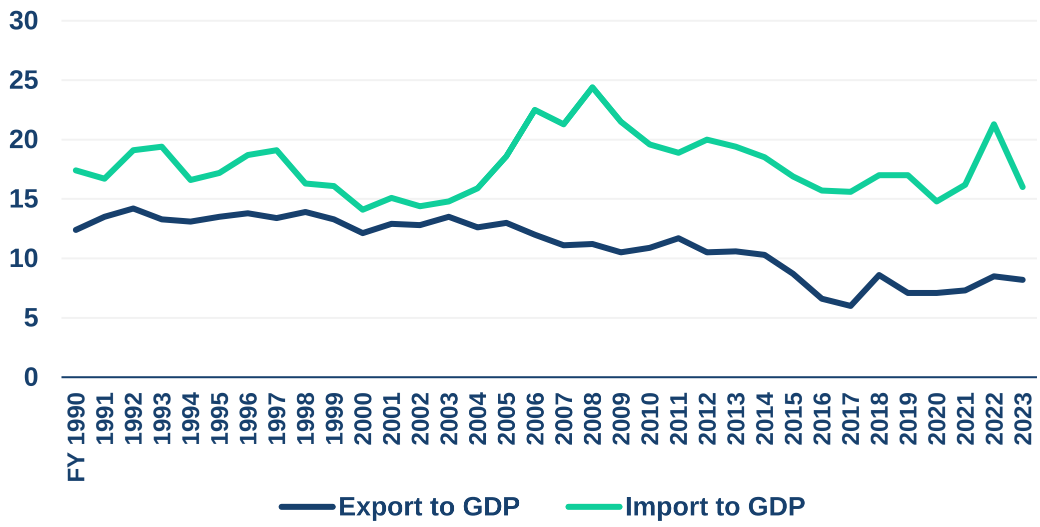
Figure 15: Export as a % GDP, 1990s-2023



Source: SBP and PBS data

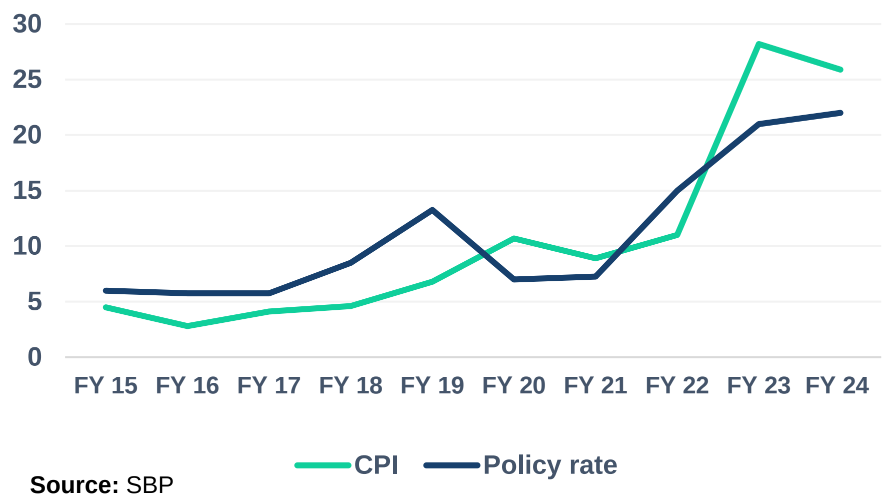
With widening gap between exports and imports:

Figure 16: Trade Deficit % of GDP, FYs 1990-2023



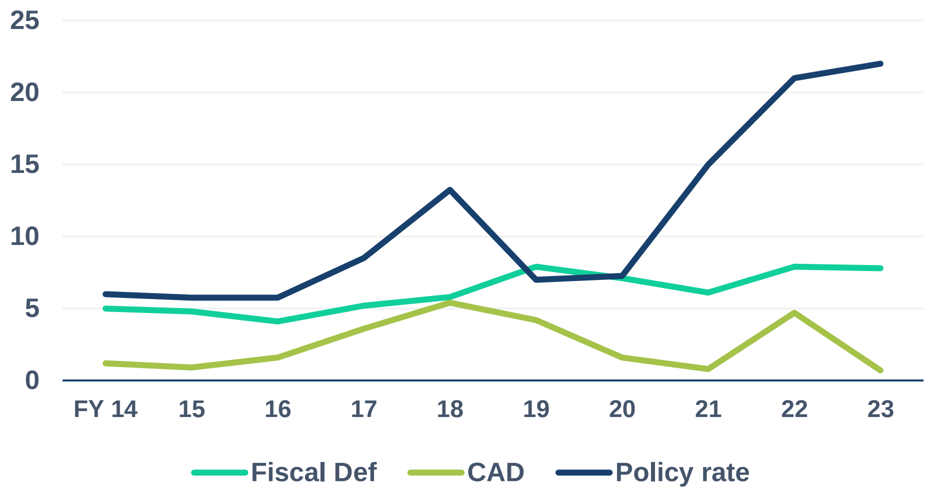
Source: Pakistan Economic Survey

Figure 17: Inflation and Policy Rate correlate



Source: SBP

Figure 18: Relation between policy rate, fiscal and current account deficit, % and % of GDP



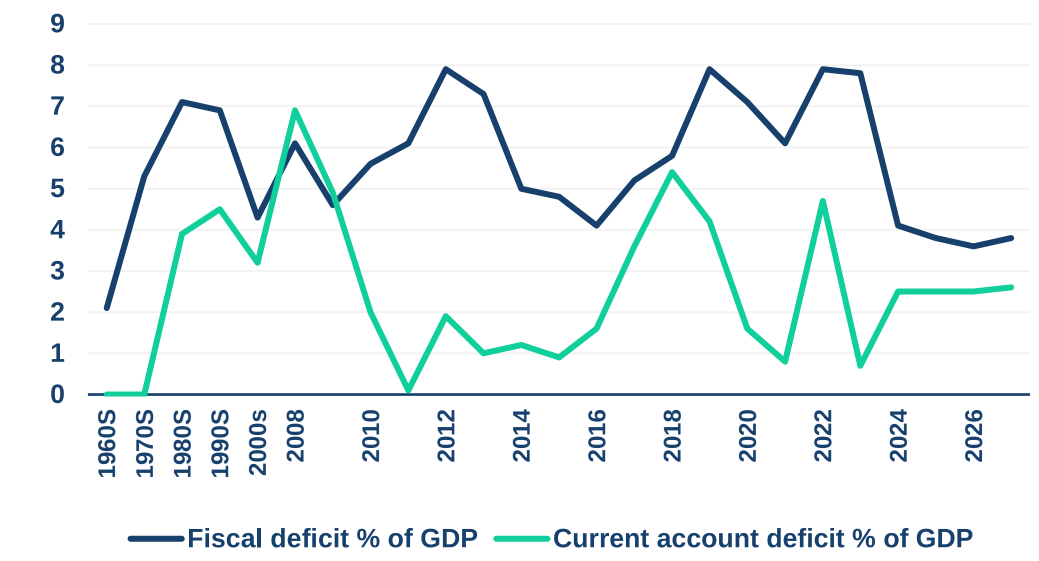
Source: SBP and MoF data

High interest rates have kept the current account deficit in check, while also slowing the economy. Its effect on inflation is uncertain, and perhaps with a longer lag, because high interest rate increases government borrowing to service debt, and thus the money supply. The budget/fiscal deficit has not gone out of control because GoP is cutting all other expenses, including defence and PSDP.

Thus the economy is vulnerable and dependent. Both fiscal and current accounts have been constant.

Gains in these indicators, post 2023 are IMF estimates:

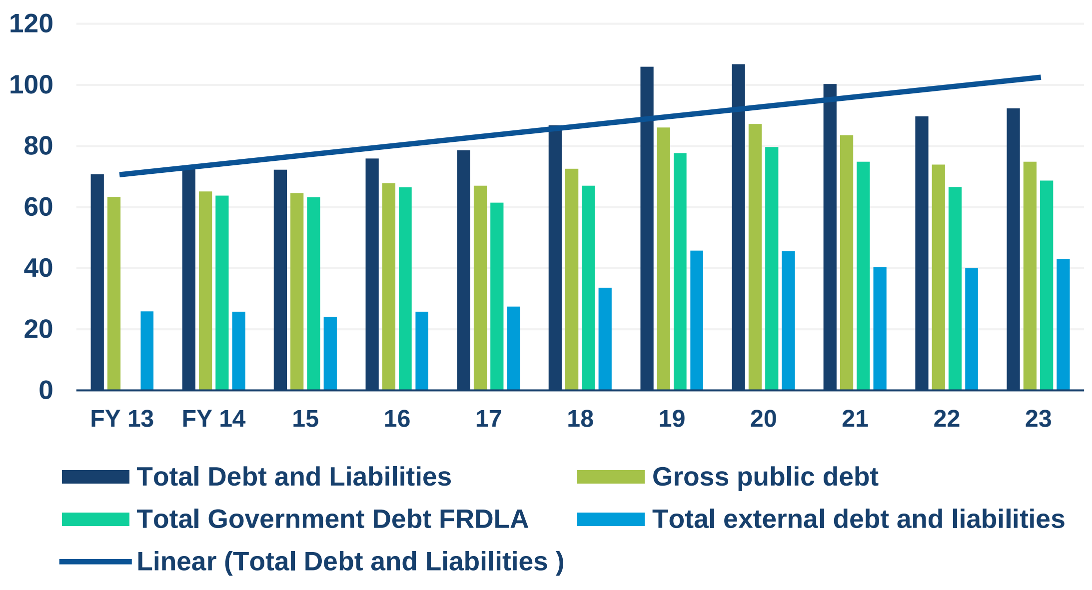
Figure 19: High twin deficits, % of GDP 1960s to 2023



Source: SBP and MoF

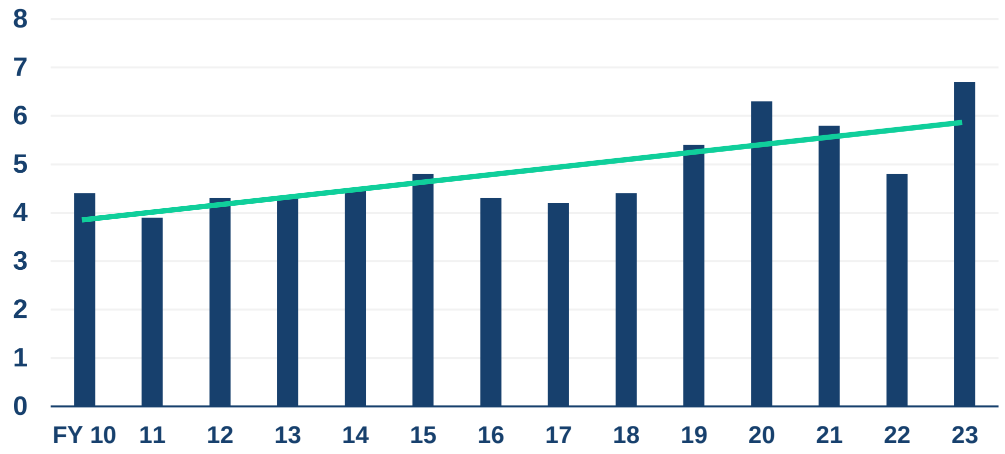
The economy's indebtedness and debt servicing have grown:

Figure 20: Debt as % of GDP



Source: SBP data

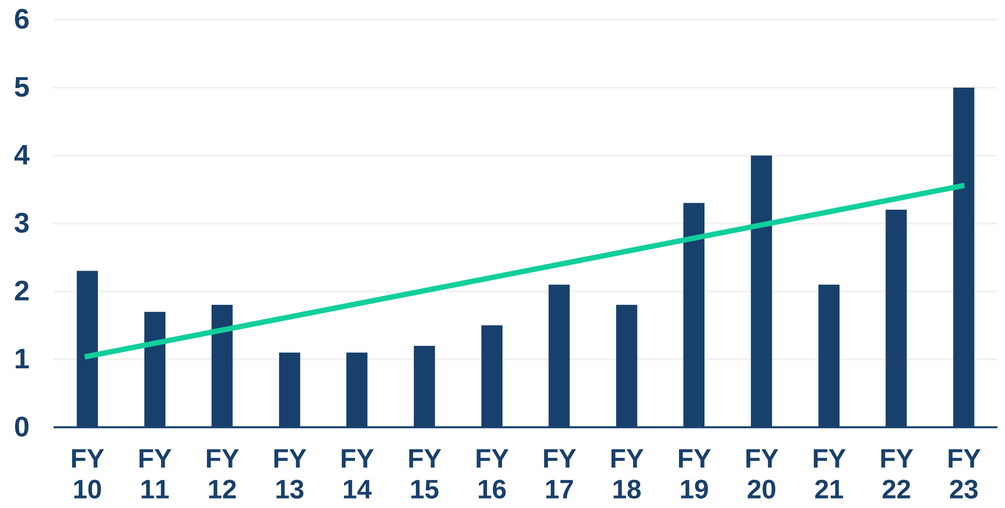
Figure 21: Interest on debt % of GDP FY 2010-23



Source: SBP and MoF data

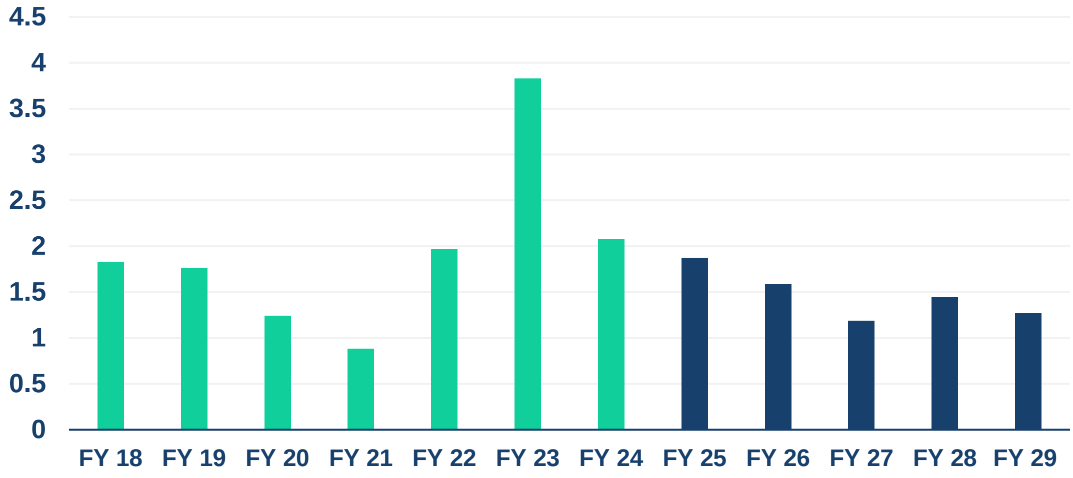
External vulnerability has increased and poses high risk:

Figure 22: External debt servicing, interest + principal as % of GDP FY 2020-23



Source: SBP

Figure 23: Ratio of Gross external financing needs/gross official reserves, FY 2018-29



Source: IMF second review tables

Gross financial needs as % of foreign reserves was acute in FY 23. Subsequent years are IMF estimates in blue.

Table 2
Share in total external debt and liabilities by lending source

%

	FY 10	FY 15	FY 21	FY 23
Paris Club	25.1	17.9	8.8	6.2
Multilateral	42.7	37.3	27.6	29.6
Other bilateral	3.3	7.5	16	13.9
Bonds/Sukuk	2.7	6.9	6.4	6.2
Commercial	0	0.4	8.4	4.4
Forex liabilities	2	5.7	7.2	8.6
IMF	14.5	6.3	6	5.6

Source: SBP data

Expensive debt is replacing low cost multilateral and Paris Club debt

Macro-economic weakness has undermined economic outcomes as well as all drivers of the economy, such as human resource quality and stock of physical infrastructure.

Table 3

Average of FY 2009-2019, unless otherwise stated

Country	Ext debt/GNI % 2020	Gov debt/GDP	Current A/c/GDP	Budget Balance/ GDP	Debt Ser/GDP	CPI	10 yrs GDP %	Mfr Value added /GDP	Invt/GDP	Exp/GDP	Skills WEF Rank 2019	Infra WEF Rank 2019	Institutions WEF Rank 2019
	Macro-stability						Outcomes				Enablers		
Pakistan	40	73	-2.25	-6.4	5.4	8.1	3.9	13	15.7	11.2	67	105	107
India	19.8	49.7	-2.2	-4.9	2.2	7.1	6.7	15.5	34.5	21.5	64	70	59
Bangladesh	11.8	30.6	0.6	-3.5	0.99	6.7	6.6	17.8	29	16.5	117	114	109
Vietnam	38.4	41.75	0.75	-1.1	3.2	6.1	6.4	14.4	28.7	87	103	77	89
China	14.5	42.4	2.1	-2.7	1.2	2.3	7.8	30	45	22.8	37	36	58

Source: World Bank Databank, Statista, Trading Economics, and CEIC, Census and Economic Information Center, WEF
Note: Best indicator blue, most vulnerable indicator highlighted in yellow.

Table 3 above, reiterates the close link between macro stability and economic outcomes. See the three broad divisions at the top of the Table. Our macro indicators are the worst, of the five economies selected for comparison, yellow highlights. So are our economy's outcome. We are better than Bangladesh in terms of enablers of the economy, but marginally so. It is not enough to boost outcomes.

Figure 24: In 13 years between 2010-23, debt indicators greatly worsened weakening all other indicators

Indicators	Multiples of FY 10 in FY 23
Gross public debt	6.8 X
	from Rs. 9.2 to Rs. 62.9 T
as % of GDP	1.2 X
	from 62 to 74.8 %
External debt	1.4 X
	from Rs. 4.9 to 36.1 T
as % of GDP	1.3 X
	from 33 to 43%
Total debt servicing as % of GDP	1.8 X
Share of interest as % of fed exp	1.79 X
Domestic debt servicing as % of GDP	1.5 X
External debt servicing, % of GDP	2.1 X
GDP in current Rs. B	4.2 X
GDP in current USD	1.46 X
Export of goods and services	1.4 X
Foreign exchange earning	*from 24.8 B, 35.4 B*
	1.43 X
	from 33.7 B to 62.8 B
Export of goods and services, ratio/GDP	-17% of GDP
	from 12.5 to 10.4%
Import of goods and services	1.61 X
	from 37.9 B, 61,3B
Domestic savings % of GDP	*from 11.2 to 6.4*
	-43%
Fixed investment % of GDP	*from 14.3 to 13.7*
	- 4%

Source: SBP and MoF Data

The focus on managing the macro economy through debt has achieved the opposite of GoP's intention. Most macro indicators are weak while the drivers of growth and competitiveness have suffered.

Part Two

We now move on to a discussion of where the federal government spends the money. This paper breaks down the major heads of expenditure and how much of the money goes to stimulate the economy. How GoP spends funds shows us its priorities and the political choices being made for us. We see that management of public finance has been an epic failure.

State's reliance on foreign advice at the expense of our businesses and citizens has been especially damaging.

Where does the federal government spend taxpayers' money?

In this section we find:

- Great inefficiencies in GoP spending borne out of:
  - Debt servicing: 57 % of FY 24 total federal expenditure (July-March). Proclivity for runaway debt.
  - High tariff differential subsidy paid for line losses because of flawed energy policy
  - Deficit of loss making PSEs
- Together they take up about 65% of total federal expenditure[12].

GoP's expenditure choices stifle GDP growth and economic activity

In the next section on Revenue we see:

- Falling revenue: Long term and uncorrected revenue losses and influence of lobbies on tax policy and enforcement
- Repeated cycles of increase in tax and prices have created more deficits
- Grant of exemptions from tax, 2.6 % of GDP
- Inelasticity of tax: It does not respond smoothly to economic activity
- Tax paying citizens and firms are often burdened with more taxes when it is GoP's responsibility to check tax evasion.

[12] Access to details of actual expenditure on grants and subsidy is not easy.

Data suggests that GoP's spending and revenue choices may be causing economic instability

Table 4
Overall Public Finance, federal and provincial % of GDP

	FY 00	FY 08	FY 13	FY 18	FY 23
Total Expenditure	20.7	21.7	21	21.7	19.1
Total Revenue	15.9	14.3	13	15.2	11.4
Tax % of GDP	11.3	10	9.6	13	9.2
Federal expenditure	15.9	16.4	15	13.6	13.4
Interest payment	6.8	4.7	4.3	4.3	6.7
Grants	1.1	0.8	1	1.1	2.5
Defence	3.8	2.7	2.4	3	1.9
PSDP	3.8	4	5	4.7	2.3
Overall deficit	5.2	7.4	5	6.6	7.7

Source: MoF Fiscal Operations,
Note: *1. Total exp or rev includes federal and provinces. All ratios to GDP are understated in FY 22, because of rebasing. FY 21 GDP of Rs. 47,709 B is before rebasing. This figure appears in MoF's fiscal operations data.*

- Overall government expenditure has been in decline. It fell 2.6 pp (percentage points) between 2018 and 2023. Federal expenditure has also fallen by 3 pp to 13.4% from its peak of 16.4% of GDP in 2008.
- Tax and total revenue are also in decline. In FY 23, total revenue was 3.8 percentage points lower than in 2018. Tax revenue also fell by 3.8 pp. Austerity, high cost of capital and free float of the Rupee have brought a slack in the economy
- For many years, budget deficit has been high. Low expenses in FY 23 did not help.
- Within the reduced spending envelope, non-productive expenditure has grown at the expense of security and development.

Table 5
Essential indicators, federal and provincial % of GDP

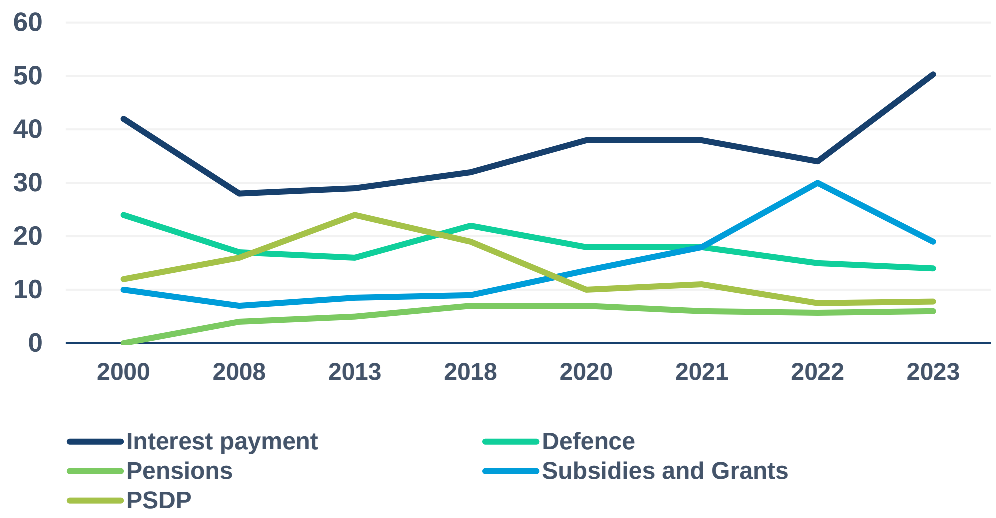
	FY 00	FY 08	FY 13	FY 18	FY 23
GDP growth rate, %	3.91	4.44	3.86	6.1	-0.17
Overall deficit, % of GDP	-5.2	-7.4	-8	-6.6	-7.7
Current account, % of GDP	-1.6	-7.06	-1.1	-5.4	-1.1
Inflation, %	3.6	12	7.4	3.9	29.2

Source: MoF Fiscal Operations, SBP and PBS data

Though global factors have played a role, our macro indicators have mainly suffered from policies at home.

- Austerity and suboptimal spending choices have caused growth rates to fall.
- Despite cuts in spending, overall deficit is still high.
- Inflation has been at unheard of rates for two years, though correcting.
- Preference to spend on non-productive heads, which has grown at the expense of economic and basic services.
- No evidence of structural reforms.

Fig 25: Trend of major heads of federal expenditure % of total federal expenditure



1. Federal government's spending does little for growth:

   a. Interest payment was 57 % of total in FY 24, July-March. It was 28% in FY 2008. Pakistan has been hasty about procuring debt.

   - Not much left for defence, development, services, transfers to the poor and incentives for businesses. They have been mostly in decline.
   - Since 2018, debt servicing, in Rupees, has grown more than four times.
   - Foreign debt servicing (repayment and interest) has more than doubled. It was 1.9% of GDP in FY 18 rising to 4.6% of GDP in FY 23.
   - Beneficiaries of the enormous amount spent on interest are creditors, foreign and at home. Indirect beneficiaries are individuals who place their savings in banks and certificates. Payment is by tax payers, majority through indirect tax.

Table 6
Interest expenses multiplying

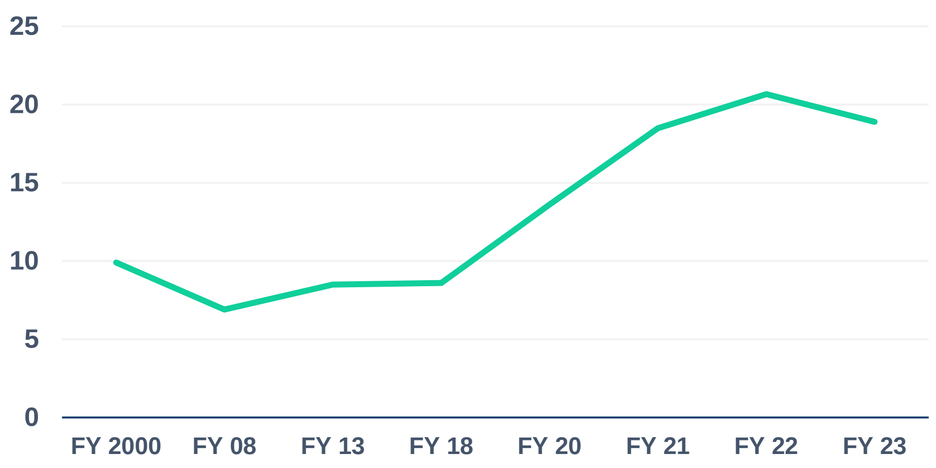
	2018	2023	% +/-
Interest on domestic debt, Rs B*	1,323	4,936	273%
Foreign debt servicing, interest and repayment, Rs. B	821	5,152	530%
Total debt servicing, Rs. B	2,144	10,088	370%
Foreign debt servicing $ M**	7,480	20,815	180%
Conversion at SBP rates	@RS.109.8/$	@248/$	

*__Source__: MoF, **SBP external debt servicing, Conversion rates also SBP

b. Subsidies and grants have the second highest share in GoP's total spending: Since 2000, amount spent on them ranged between 8 and 10% of total federal spending. That started to change in 2018 and took off from FY 21. In FY 20, it rose to 13.6% of total federal spending and in FY 22, it was 30% correcting in FY 23, see Figure 26.

   A lot of the subsidy and grants prop up bad policy and poor management. Much of the subsidy, though not all, goes to IPPs as tariff differential subsidy. Grants also partly meet deficits of PSEs. Despite their high expense, both heads have built up large payables. According to Dawn, total power payables are Rs. 2.6 trillion[13]. Among PSEs, PIA alone owes Rs. 825 billion in debt payable[14]. This spending acts as a drain on the economy and does little for growth.

Fig 26: % Share of subsidies and grants in total federal expenditure, %



Source: IPR calculations based on MoF data

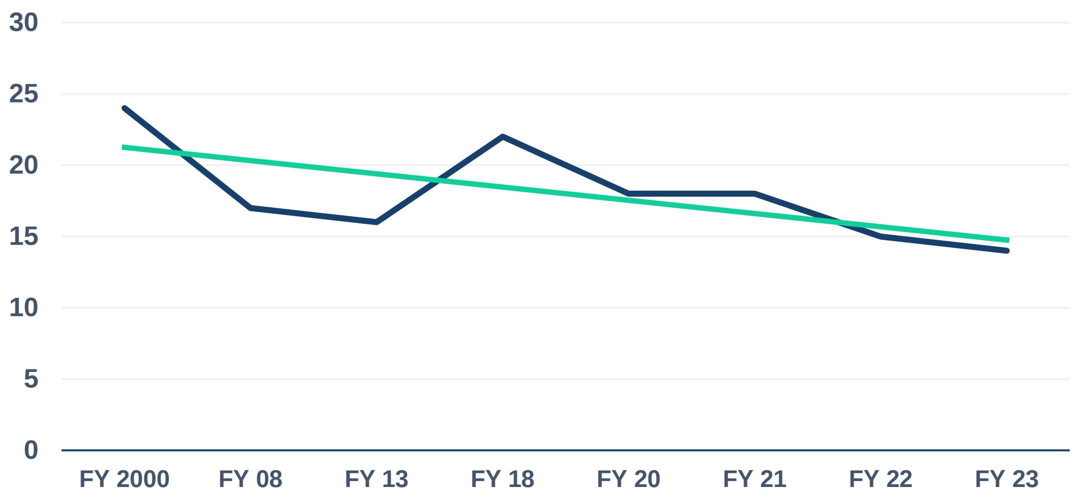
In FY 24, interest and grants/subsidies will together take up about 70% of federal government's total expenditure.

c. On the other hand, some crucial expenses have taken a hit:

   - Expense on defence has gone down from 3.8 % of GDP in FY 20 to 1.9% in FY 23. Its share in total federal spending has fallen from 24% in FY 2000 to 14% in FY 23. This is a disturbing trend as defence is a vital expense.

[13] Circular debt over Rs2.6tr, surpassing govt commitments, Khaleeq Kiani, May 20, 2024
[14] Express Tribune, PIA debt burden shifted to taxpayers Govt backtracks, Shahbaz Rana, February 02, 2024

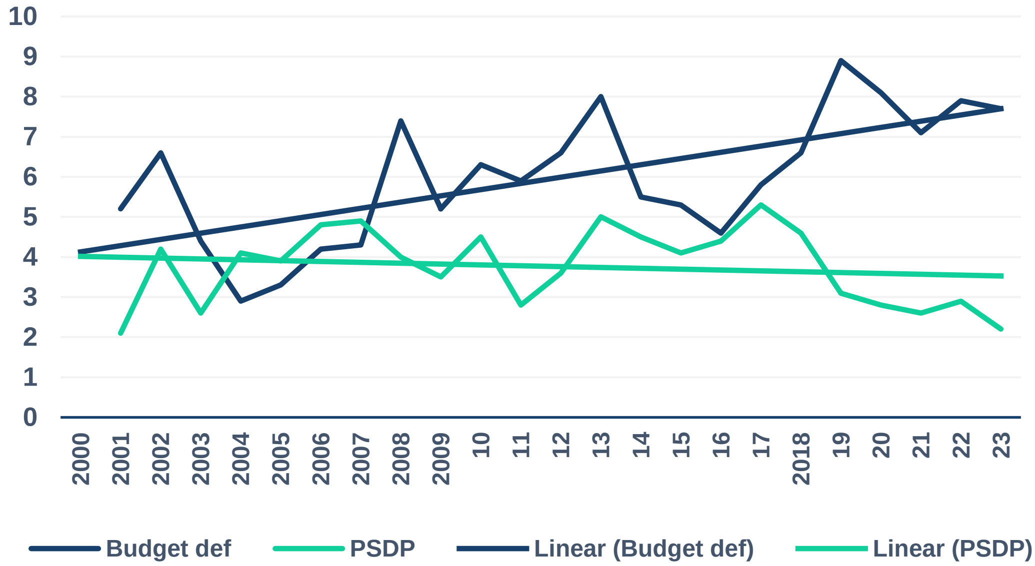
Fig 27: Share of defence in total federal expenditure, %



Source: IPR calculations based on MoF data

d. PSDP: While interest and grants do not spur growth, PSDP does. PSDP needs reforms, but its role in GDP growth and potential for raising productivity is beyond doubt. From 4% of GDP in 2008, total PSDP fell to 2.3% of GDP in FY 23. Federal PSDP has fallen from 2.6% of GDP in 2008 to 1% in FY 23.

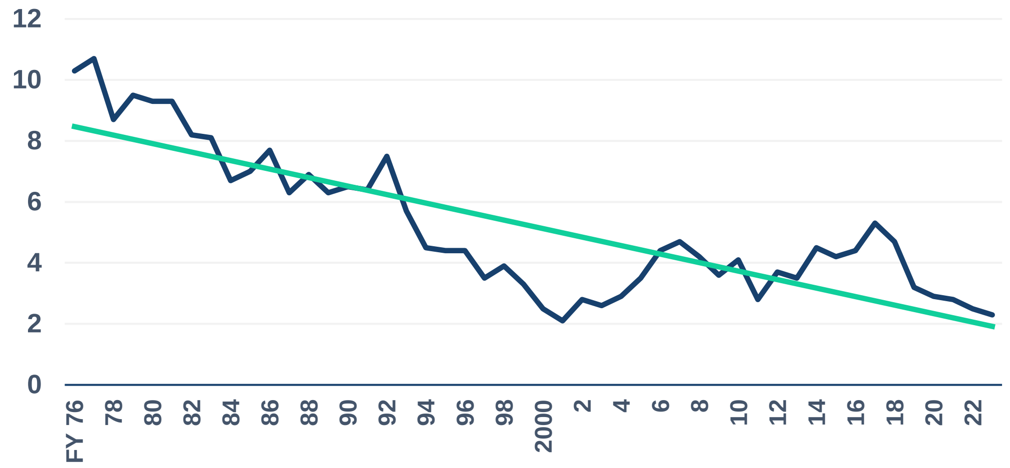
Figure 28: While budget deficit has grown, PSDP spending has fallen, % of GDP



Source: IPR research based on MoF data

It is a long term trend, suggesting political consensus on short changing growth:

Figure 29: PSDP % of GDP, 1976-2023



Source: MoF

e. As transfer to provinces have fallen to pre NFC award levels, expenditure on basic services have also fallen. Most basic services are now offered by provincial governments. So, fall in transfer to provinces causes in fall in basic services. Taken together, spending on education and health fell from 3.6% in GDP in FY 18 to 3% of GDP in 2022[15]:

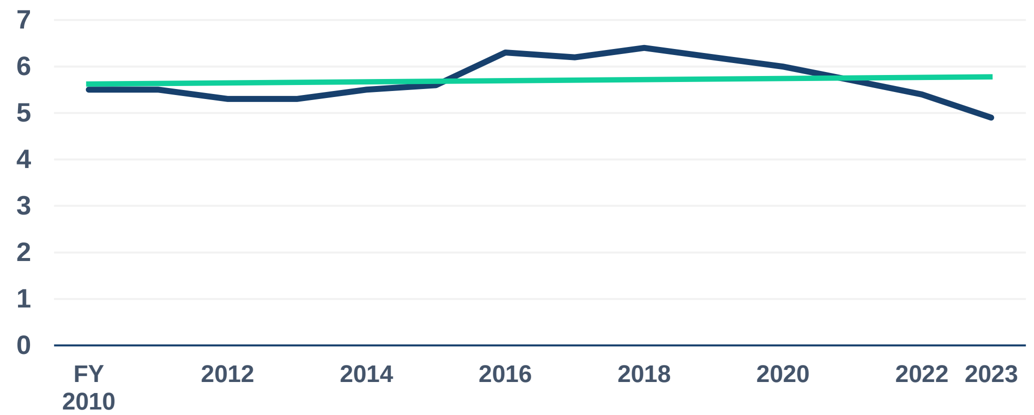
i. In FY 2018, education expenditure was 2.4% of GDP. In 2022, it fell to 1.6% of GDP.

ii. Expenditure on health improved slightly. It was 1.4% of GDP in 2022, compared to 1.2 % in 2018.

iii. Expenditure on roads and irrigation services fell significantly.

iv. Transfer to provinces was 5.5% of GDP in FY 10, rose to 6.4% in FY 18. In FY 23, provinces received 4.9% of GDP.

Figure 30: Transfer to provinces % of GDP



Source: MoF

[15] MoF PRSP Budgetary Expenditures. Latest statement is for FY 22.

Expenditure on basic services have moved along with transfer to provinces, Figure 30. Combined expenditure by the country on four basic and economic services are less than interest on debt, except in 2018, when transfers had peaked, Table 7.

Table 7
Low expenditure on basic and economic services, % of GDP

	FY 2008	FY 2013	FY 2018	FY 2022
Roads	0.8	0.5	1.3	0.7
Education	1.7	2.1	2.4	1.6
Health	0.6	0.7	1.2	1.4
Agriculture & Irrigation	0.8	0.6	0.8	0.6
BISP + Baitulmal	0	0.2	0.3	0.3
Interest payment	4.7	4.3	3.0	4.8

Source: MoF

How GoP spends its funds is an outcome of political choice. It is the cumulative effect of decades of lax decision making which has led to a shift in focus from growth to short term measures for fiscal management.

Low HR investment in favour of non-productive expense is also a choice that diminishes our competitiveness and increases dependence. It also increases poverty[16].

[16] Basic and economic services include education, health, sanitation, irrigation, roads, social security + BISP, population, calamity control plus others.

Figure 31: Expenditure on basic services are well below expenditure on interest and grants, % of total federal and provincial

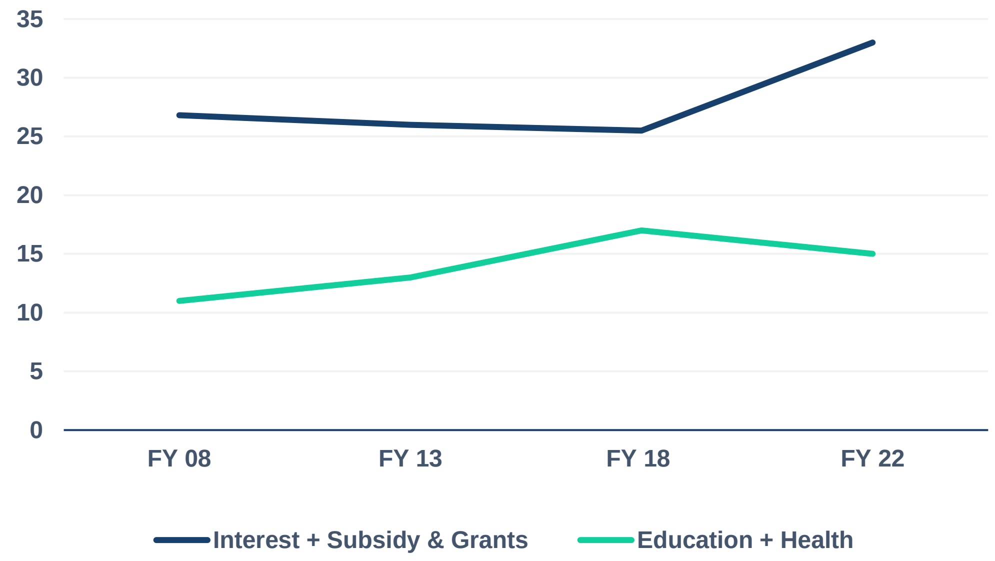
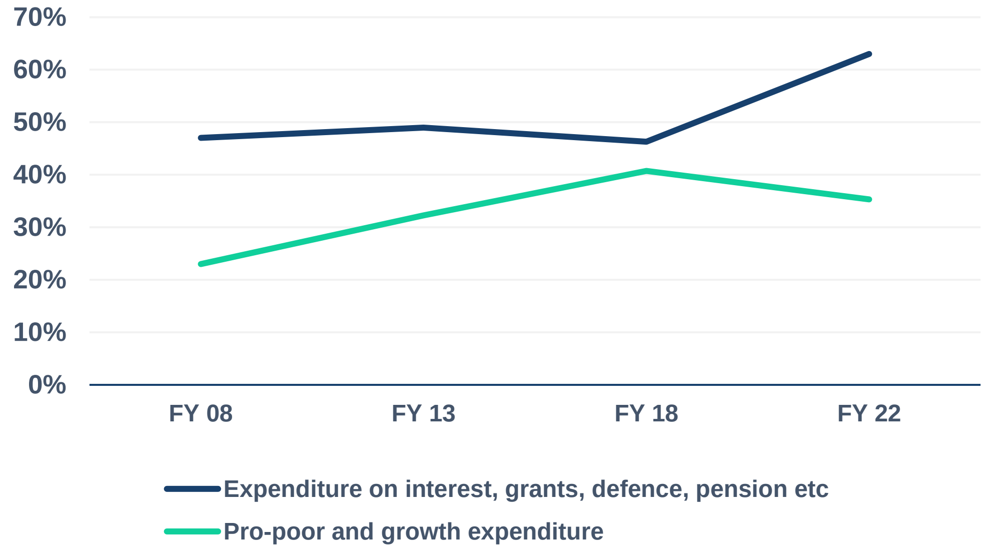


Figure 32: General expenditure that need to be rationalized Vs expenditure on basic and economic services, % of total federal & provincial



Discussion in the public space widely refers to high government spending as a drain on the economy. In fact, Pakistan has one of the lowest ratios of public expenditure to GDP. The economically conservative Heritage Foundation says that "public spending could contribute to productive investment and economic growth"[17]. This is despite Heritage Foundation's economic philosophy, which calls for less government. They, however, rightly warn against runaway debt.

In Pakistan, government indebtedness is a major problem.

Table 8
Government spending as % of GDP

Pakistan	20
India	29
Korea, Republic of	29
China, PR	33
USA	36
Japan	44

Source: IMF, Government expenditure, percent of GDP, % of GDP, 2022

Apart from Pakistan's low public spending, our spending also lacks effectiveness. A large part of the spending is non-productive and preempted by special interests. Part 2 of this report gives data. Even within the small envelope, expenditure on economic and basic services are very low and declining, see Figure 32. In essence, government spending in Pakistan does not generate growth.

Another myth is a bloated bureaucracy. Pakistan has a about 2.7 federal employees per capita. Just 0.1 employees/per capita have decision making authority[18]. Pakistan's share of public workers as % of total workers is 7.3%. The number for China is 28%. For Japan, it is 8%, 14% in USA and 10% in Korea. Malaysia, Vietnam, Thailand all have figures that are higher than of Pakistan[19]. India has a lower share.

We may not anymore reduce government workers. Though they must be trained and motivated/supervised to perform better. Reducing service providers affects provision of services to the people[20].

[17] Index of Economic Freedom, 30th Edition, Heritage Foundation
[18] Establishment Division, Government of Pakistan, Annual Statistical Bulletin Of Federal Government Employees for 2018-19
[19] Source: International Labour Organization and OECD data.
[20] Also see IPR Report Strategy not Tactics, Page 24

Part Three

Revenue:

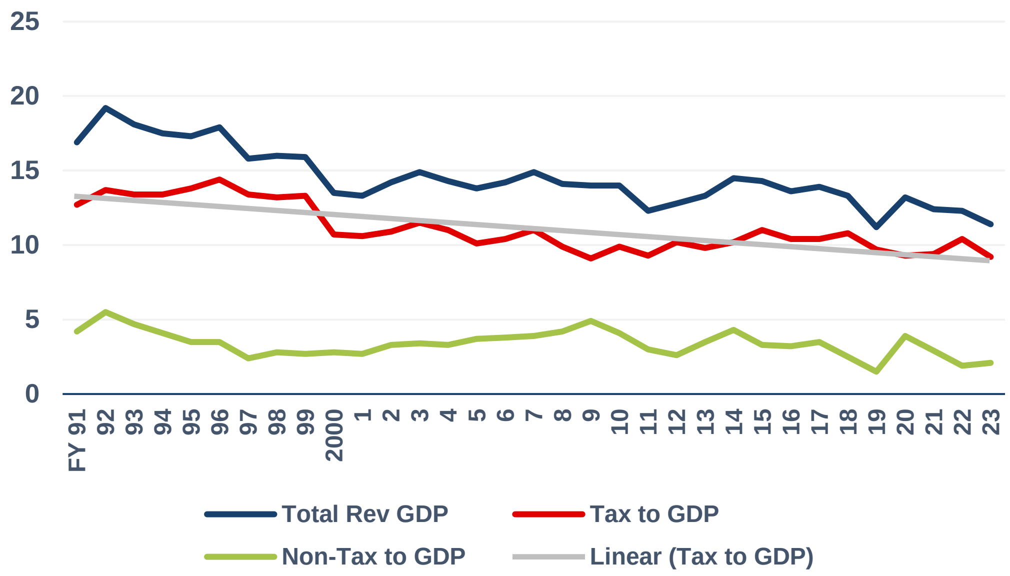
Trend of GoP’s revenue collection. We find:

- Low and declining tax to GDP ratio. High dependence on indirect taxes.
- The tax system is not elastic. Does not respond to GDP growth.
- High amounts of tax exemption.
- FBR plays a minor role in income tax collection.
- There are distortions in tax policy. Not all income receive equal treatment
- Some consumption goods attract multiple indirect taxes. More sales tax on imports than from domestic consumption.
- Citizens perceive tax system as unfair. Those already paying are taxed more.
- Low collection of tax by provinces.

Low and declining tax collection:

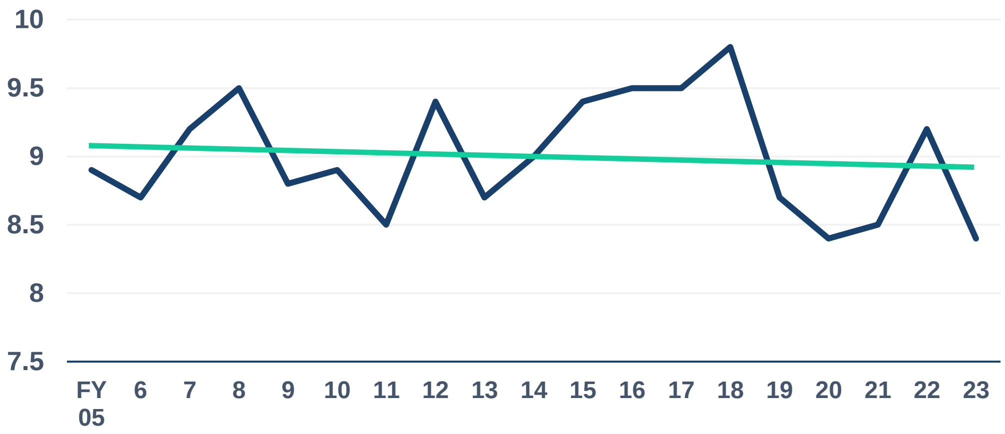
Tax collection has been in decline. With FBR controlling about 90% of all taxes, their performance is critical. Figure 33 below shows total tax to GDP ratio from 1991-2023 (red line) [21].

Figure 33: Total Federal and Provincial Revenues, FY 1991 to 2023, % of GDP



Each decade has been worse than before. Average tax to GDP ratio in the 1990s was 12.1. For the first decade of 2000s, it fell to 10.5. And for the years 2010 to 2023, the average is 10% of GDP.

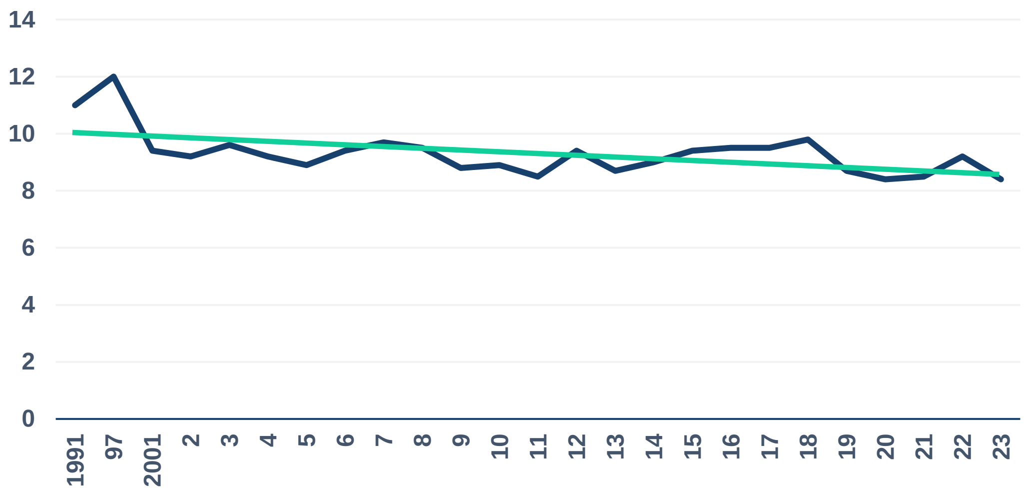
Figure 34: Ratio of FBR Tax to GDP, 2005-23, %



[21] MoF, Pakistan Economic Survey, relevant years

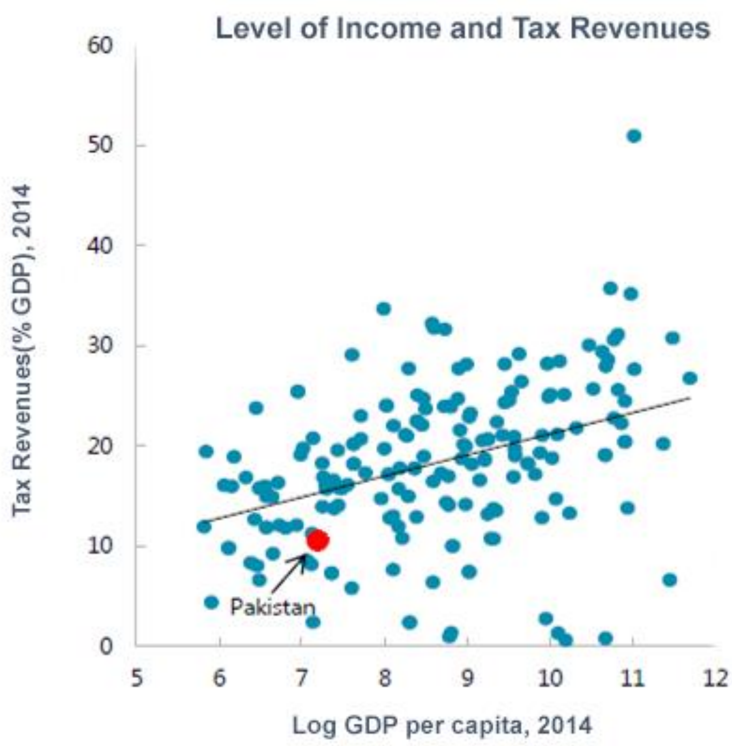
Pakistan's tax/GDP ratio crossed 13% often during the 1990s, peaking at 14.4%.

Figure 35: FBR Tax/GDP Ratio, 1991-2023



IMF says that Pakistan could double its tax ratio and raise it to 22% of GDP[22].

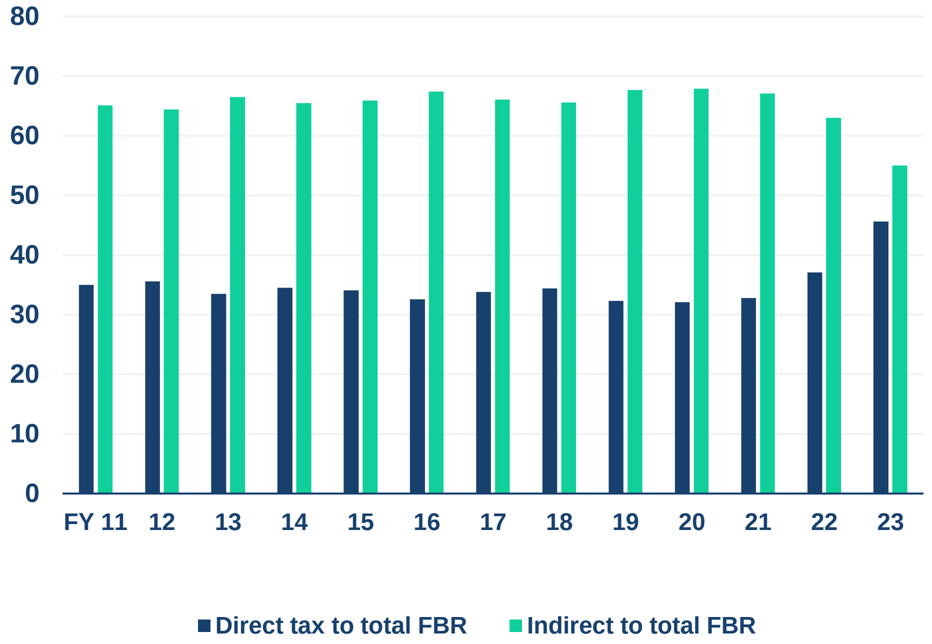
Figure 36: Pakistan's ratio is low compared to many economies with similar or lower income[23].



[22] IMF Working Paper, Unlocking Pakistan's Revenue Potential, Serhan Cavik, 2016, Page 3
[23] IMF Working Paper, Unlocking Pakistan's Revenue Potential, Serhan Cavik, 2016, Page 3, Figure 1

- **High dependence on indirect tax**
  Between FYs 2001-23 its average share in total taxes was 66.7%. Even this high share is understated, as FBR incorrectly counts all withholding tax as income tax. Many items though are tax on consumption. IPR calculates, that the real share of income tax in total tax is 28%[24]. Other estimates are 25%[25] and 19%[26], about equal to share of direct tax before withholding tax was introduced.

Figure 37: Share of direct and indirect taxes in FBR's total tax collection



A Business Recorder column states that in FY 21 high indirect taxes on consumption could have pushed “millions of Pakistanis below the poverty line”[27].

When first introduced in the late 1980s, withholding tax was greeted as a major development [28]. Its share has now grown, taking the form of tax on consumption in many cases. In 1989, share of ‘deductions at source’ was 46% of direct taxes and ‘collection on demand’ was 26%[29]. In 2021, withholding tax share grew to 72% and ‘collection on demand’ fell to under 4.6 %[30].

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24 Source: IPR calculations based on details of withholding taxes in FBR/Revenue Division Yearbook.
25 Business Recorder ‘Pathetic direct tax collection,’ Huzaima Bukhari | Dr Ikramul Haq 10 Sep 2021
26 UNDP NHDR 2020
27 Business Recorder ‘Pathetic direct tax collection,’ Huzaima Bukhari | Dr Ikramul Haq 10 Sep 2021, https://www.brecorder.com/news/40119282
28 Hafiz A. Pasha, Political Economy of Tax Reforms: The Pakistan Experience, Pakistan Journal of Applied Economics, 1995
29 Ibid Table 2
30 FBR Yearbook 2020-2, Tables 6 and 8

Even after including all withholding tax as direct, GST as a % of GDP is more than direct tax, exacting a high cost on lower income groups. See Table below:

Table 9
Distribution of Tax, % of GDP

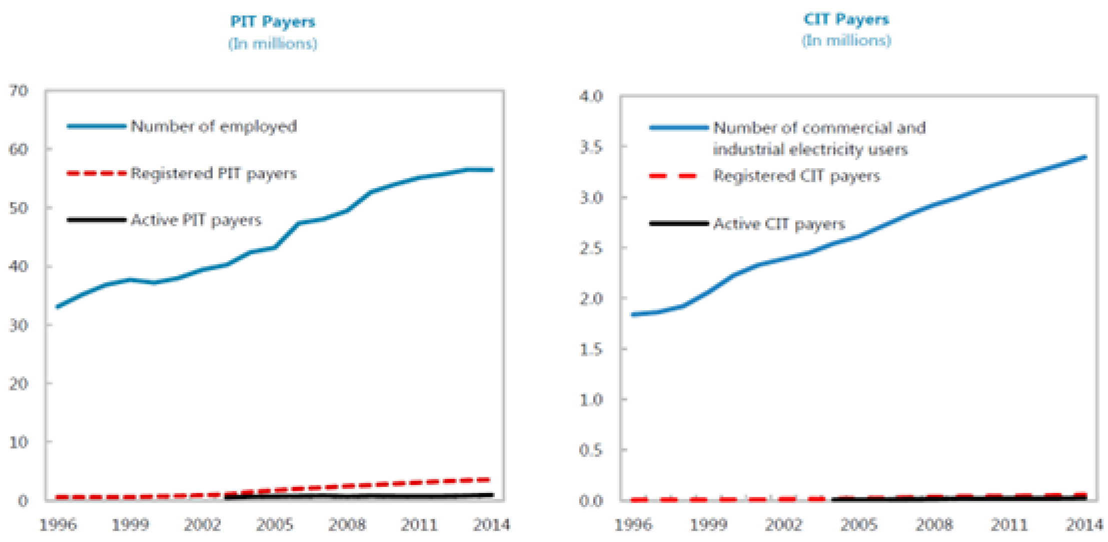
	2002	2005	2010	2015	2020	2022
Direct tax	3.7	2.7	3.6	3.8	3.7	3.4
Indirect tax	9.7	7.4	6.4	7.2	7.8	6.7
Of which GST/GDP %	4.8	3.6	3.5	4	3.8	3.8
Total tax	13.7	10	10	11	11.4	10.1

Source: MoF Fiscal Operations

Informal economy means low number of people and companies registered as taxpayers.

In Figure 38 below, the total number of firms and employed people have risen multiple times. Yet, number of active tax payers, gray line, has stayed flat[31].

Figure 38



Sources: Federal Board of Revenue; State Bank of Pakistan; NEPRA; author's calculations.

WB reports that registered taxpayers touched nearly 10 million in 2023. Only 4.4 million of them filed annual tax returns and a mere one-fourth of the registered paid any tax at all[32]. Share of population filing tax returns is less than 2%. The number is 5.8% in India.

[31] IMF Working Paper, Unlocking Pakistan's Revenue Potential, Serhan Cavik, 2016, Page 6

[32] Express Tribune, Tax base widens to record 10m. However, only 4.4 million file tax returns and one-fourth pay any tax, Shahbaz Rana, October 15, 2023

- Not all income are treated equally: Many exemptions exist for specific sectors. Also, there are different rates for some areas:
  - Salary earners with a marginal tax rate of 35% are not allowed deductible expense. They virtually pay tax on their gross pay.
  - Farms are taxed by the acre
  - Selected sectors get preferential treatment on capital gains or on dividends. Dividend paid by IPPs has a tax rate of 7.5%[33]. Mutual funds have a tax rate of 15%.
  - Taxpayers that have organized as a group, the agriculture lobby and city traders, wield political influence.
    - In 2022, traders were asked to pay a small fixed tax, much smaller than the tax rate due on them. Even that had to be reversed.
    - In FY 22, agriculture had a 23.5% share in GDP, or Rs. 15.7 trillion. Yet that year, "all provincial governments cumulatively collected Rs. 2.4 billion as agricultural income tax, though its potential could be up to Rs. 800 billion"[34].
- Low elasticity cannot fully take advantage of economic growth[35]:
  - IMF Working Paper analyzed tax elasticity for the period 1960-2015 and found that "elasticities of tax revenue are slightly above 1 over the period 1960-2015, indicating a relatively small response to economic growth".
  - While corporate income tax and GST had elasticity coefficients well above 1, the response of personal income tax was much lower.
  - The paper also finds that the elasticity coefficient in Pakistan is about 40% less than a group of selected developing countries.
  - The paper recommends reinforcing tax administration. It also suggests "Fighting tax evasion should initially focus on a comprehensive list of high-wealth individuals and corporate entities".
- FBR's reduced role in tax collection: In FY 21, 'Collection on Demand'[36] and 'Payment with Returns' together had a share of 7.7%. The former had a share of 26% in 1989. Rest amount is almost all collected by third parties, at the point of transaction. Withholding tax had a share of 72% in total collection and advance tax was about 23%.

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[33] FBR Tax Rates: Dividends, Profit on Debt, Fee for Technical Services or Royalty and Offshore Digital Services, https://www.fbr.gov.pk/income-tax-tax-treaties/132245/132253
[34] PIDE Discourse 2023, Agriculture Income Tax, Dr. Ikramul Haq
[35] IMF Working Paper, Page 18
[36] COD: Collection on Demand. Reliance in WT has reduced the urgency to issue demands.

Table 10 Trend of Income Tax Revenue by Type, %[37]				
	1988-89	**2004-05**	**2010-11**	**2020-21**
Total Income Tax Rs B	13.4	183.1	602.4	1,726.0
Share %				
Collection on Demand	26.0	9.5	11.9	4.6
Payment with Returns	28.8	40	32.5	27.0
With Returns	-	-	*1.9*	*3.1*
Advance Tax	-	-	*30.6*	*23.8*
Deducted at Source/Withholding	46.0	60.2	59.4	72
Less Refunds	-11.0	-15.8	-7.7	-5.3

Source: FBR Yearbooks relevant years. For 1988-89, Pakistan Journal of Applied Economics, Political Economy of Tax Reforms, Dr. Hafiz Pasha, 1995,

- More sales tax is collected from imports than from domestic consumption: FBR Yearbook 2020-21, shows that of the total GST of Rs. 1.9 trillion collected in FY 21, 56.4% or 1.1 trillion was sales tax on imports[38]. The national accounts show that consumption is 94% of GDP.

  The split between imports and domestic consumption is 23:77. It is likely easier to collect tax at import rather than from the many businesses that operate all over the country. Thus the abnormally high share of GST from imports than from domestic consumption.

- Some consumption goods attract multiple indirect taxes:
  - Mobile phones: A consumer of mobile phone services pays import duty and GST built in the price of the product and FED, GST, and advance tax on its purchase. Import duty and GST combined is between 50 and 70% of telephone cost. Taxes on mobile telephone service is an extra 28 to 37% of usage cost[39]. The advance tax is shown as direct tax by FBR, even if it is charged on buyers who do not qualify to file returns.
  - POL: POL is an especial case. It attracts import duty, GST, federal excise, withholding tax on import. Then there is a petroleum levy. These taxes and levies see frequent increases. No surprise that just import duty and GST receipts on POL was up 72% YoY for July-January FY 22.

[37] FBR Yearbooks relevant years
[38] FBR Yearbook 2020-21, Table 9, Page 16
[39] Dawn Editorial, Tax on cellular services, 29 January 2022, 2. Pakistan Today, 1 January 2022, Mini-budget: How much tax mobile phone consumers will pay?

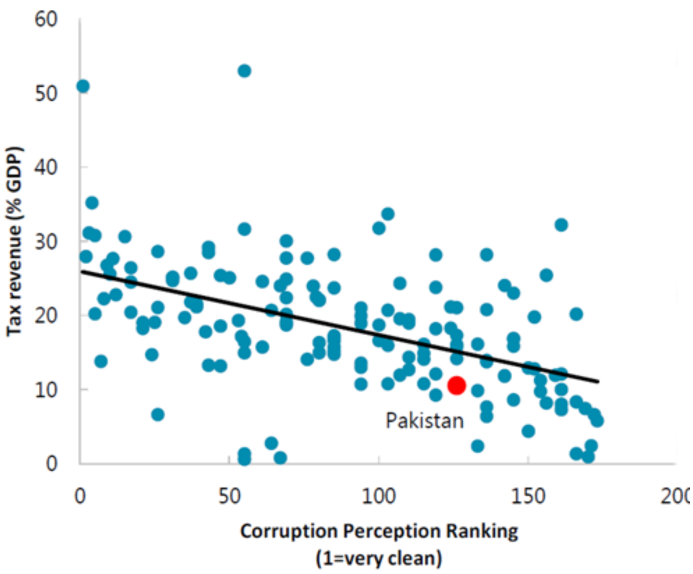
This practice of multiple taxes on some items that are widely used by all income groups, including low income people is an unfair burden on low income citizens while collection on income tax stays low.

- Low contribution by provinces: In FY 23, provincial taxes was 8.5 % of total revenue collected by federal and provincial governments[40]. They are virtually all indirect. Provincial share has improved marginally with collection of sales tax on services. Provinces have done very little to tap into agriculture income. IMF surmises that this is partly because they have the comfort of transfers from federal government. It is also because of the power of the agriculture lobby. According to NHDR 2020, “more farm area has been accumulated in fewer hands”[41].

- Fairness is an absolute requirement for the tax system to work: The point that escapes decision makers is that many of the issues listed here instill a perception of unfairness about the tax system. This perception deters all potential taxpayers from complying with tax laws. Fairness is an absolute requirement for the tax system to work. Else, everyone justifiably wants to skirt around it. And GoP is forever increasing tax rates on the salaried class as they perforce must pay.

- Strong link between tax collection and corruption: IMF’s finding is summarized in the Figure below. It shows a relationship between the level of corruption in an economy and the tax to GDP ratio. Pakistan well below the regression line, red dot.

Figure 39
Corruption and Tax Revenue



Pakistan’s revenue losses are caused both by poor enforcement and flawed policy. Here decisions on tax breaks for key lobbies and more indirect tax take place. Thus, ‘ability to pay’, a fundamental tax principle is set aside with serious economic consequences.

[40] MoF, Fiscal Operations FY 23 Tables 1, 2 and 5
[41] UNDP NHDR 2020, Page 23

Part Four

Analyses:

The long journey above details government's capacity and its policy preferences with respect to expenditure and revenue. It suggests that Pakistan's:

- Public financial management is designed to promote low growth, high indebtedness, loss of opportunity and inequity. It has a large role to play in our present economic despair.

  Thus:

  - Pakistan has had many years of low and volatile growth and not enough job creation.
  - Both the fiscal and external account are in constant deficit.

- Also it has:
  - Double digit inflation.
  - Precarious forex reserves, based on borrowed money.
  - Sharp fall in Rupee. Its present stability is fragile.
  - High domestic and foreign debt. Gross public debt is 75% of GDP. Foreign debt and liabilities are 43% of GDP. Debt servicing consumes almost 60% of federal spending. Total debt servicing is almost 11 % of GDP, of which foreign debt servicing is 4.6% of GDP.
  - Low savings and investments
  - Falling credit to private sector at high interest rates.

In sum, what we have done so far has not worked, though apparently, we plan to do the same

Figure 40: Important indicators weakening

	1980s	1990s	2000s	2010-23
Low and fluctuating GDP growth rate, avg, %	6.5	4.3	4.3	3.47
	Growth		**Share**	
GDP by sectors, 3-year avg growth and sector share, %				
Agriculture	*3.1*		*22.8*	
Industry	*4.0*		*18.9*	
of which Manufacturing	*5.3*		*12.1*	
Services	*4.0*		*58.3*	
GDP Components, %				
Consumption, of which			*94*	
Household			*84.2*	
Government			*9.7*	
Investment			*13.6*	
Net export/import			*-7.6*	
Low growth of per capita GDP, constant $, Avg of 10 years FYs 14-23, %			2.4%	
High inflation			29.18	
CPI FY 23- and 5-year avg, %			13.73	
Fiscal position, 5-year avg, % of GDP				
High fiscal deficit			7.6	
Expenditure				
Total federal & prov			*21*	
Federal			*14.5*	
Prov			*6.5*	
Revenue				
Total			*13.3*	
Tax			*10.6*	
Federal tax			*9.4*	
of which direct			*3.6*	
Provincial			*1.2*	
Non-tax			*2.5*	

Non-productive expenditure high		
Interest		*5.5*
Defence		*2.6*
Subsidies & grant		*3*
Total non-productive expense, FY 22, %/GDP		12.9
Pro-poor and pro-growth expense, FY 22, %/GDP		7
Public debt	62,881.0	67,330.1
Gross Public Debt, Jun, Dec 23, Rs. B		
% of GDP	74.8	80.0
Total Debt of the Government, Jun, Dec 23, Rs. B	57,779.2	60,531.2
% of GDP	68.7	72.0
Total external debt & liabilities, Rs. B	36,125.7	36,976.9
Total external debt & liabilities, $ B	126.1	131.1
% of GDP	43.0	44.0
Debt servicing: % of total fed exp	50.3	63.0
% of GDP, June 2023	10.6	
Domestic debt interest	*6*	
Foreign interest	*0.9*	
Amortization of foreign debt	*4.8*	

	2019	2020	2021	2022
Declining Rs. Value, YoY June, %	-38.5	-6	+5.5	-31

High interest rate, %	‘19	‘20	‘21	‘22	‘23
6month KIBOR	13	7.5	7.5	15.75	22

	2008	2013	2018	2022
Declining credit to private sector, % of GDP	24.1	14.3	16.6	14.8

	2000	2010	2020	2023
Export, % of GDP	13	11	7	8
Import, % of GDP	15	19	15	16

	2000	2010	2020	2023
Current account deficit, % of GDP	0.7	2.2	1.5	0.7

	‘17	**‘18**	**‘20**	**23**
Declining manufactured production, index	104.2	111.5	102.6	114.8

Rapidly falling savings and investment, % of GDP	**‘00**	**‘08**	**‘13**	**‘18**
Domestic savings	14.5	10	10	8
Fixed Investment	16	16	13	15
Savings and Investment Gap	-1.5	-6	-3	-7

Part Five

What Pakistan must do

What Pakistan needs are

Rapid and continued growth[42]. Also, gradually build exports. They will happen only with reforms that are wide and deep, otherwise we will stay a dependent and survival economy.

Things to do:

1. GoP must set a vision for the future with consensus and commitment by all players. All levels of the government, political parties, private sector, academia and media must have a role in planning and execution.
   a. Reforms for sustained growth need thoughtful and long term plans with commitment.
   b. Repeating IMF talking points or sound bites will not do.
2. The above plan should be announced as a major national development programme on the lines of past successful initiatives of China and Malaysia in 1980s, and US in 2021 and 2022[43].
   a. It would also boost the country's morale.
3. Rapid GDP growth is a must to create jobs, increase exports and to reduce debt:
   a. Estimates show that we need higher than 8% growth p.a., requiring about 30% of GDP as investment. Up from 15% in FY 23[44].
   b. This needs savings to go up similarly from the present 8% of GDP.
4. The will to make difficult decisions: Show resolve to take on lobbies. Build capacity to design policies that bring economic return not *just* return for some domestic and foreign investors.
5. Recognize the changed shape of globalization: Low labour cost and low tech exports is no longer enough. Profits come from talent, our fit in the value chain, R&D, product design, branding and how production is organised. There is low competition in these areas. Factory automation and near shoring have also reduced low labour cost advantage[45].

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[42] Economist, Going green could bring huge benefits for India's economy, Special Report, April 22, 2024

[43] In Malaysia, the National Economic Policy of 1971 was followed in 1981 by Mr. Mahathir's thirty year vision with successive National Development Policy, National Vision Policy and New Economic Model. In China, Mr. Deng Xiao Ping's three step development strategy was key which China overachieved in each phase. Its key components were the 'four modernizations' (of agriculture, scientific and technological development, and national defense). Currently, Secretary General Xi Jinping's modernization of industry, technological upgradation and self-reliance have become that country's key priority in a fast changing world. During President Biden years, USA has announced three major industrial policies in the shape of the Infrastructure Investment and Jobs Act with an investment target of $ 1 trillion, the CHIPS and Science Act to boost American research, development and production of semiconductors, and the euphemistically named Inflation Reduction Act, 'which will invest $391 billion in energy security and climate change' (White House). Excerpted from IPR document Dealing with Permanent Crisis

[44] PIDE, page 17

[45] Breaking the Mould, Reimagining India's Economic Future, Raghuram G Rajan and Rohit Lamba, Princeton University Press (May 14, 2024), "Apple is sixty times as valuable (as iPhone manufacturer Foxconn, even though it manufactures nothing! That is because it provides the R&D and product design services at the beginning of
the global supply chain for iPhones, as well as the branding, marketing and content (think iTunes and the App Store) at the end".

6. US- China rivalry is a big threat and something to keep an eye on[46].

Contrary to common belief, government's strategy and intervention is not grant of incentives here or to amend a regulation there. That policy serves special interests, of which we have plenty, but no economic prosperity.

It is important to view the strategy as a stimulus for structural change and not to promote a specific industry or firm.

Constraints:

- Without another IMF programme or foreign debt restructuring, Pakistan faces default. Even under a programme, it would take several years of rigour to restore order in the external account.
- Low tax-to-GDP ratio and preference for non-productive expenditure leaves nothing for investing in infrastructure and human capabilities or for incentives to boost exports.
    - ➢ Special interests in many areas burden economic efficiency
- IMF estimates that forex reserves are expected to stay at bare levels until FY 29, less than 3 months imports[47]. So, economic activities must not cause imports to rise by too much.
- Continued double digit inflation will challenge citizens and firms.
- Our investment level is low and well below the need of a growing economy. Even for FY 29, IMF estimates gross capital formation to be just 13.7% of GDP[48]. Better governance could lead to revival, without too much additional investment.
- Low HR capital causes low income. Thus domestic demand suffers. Nor is there enough talent in the economy to spur growth:
    - ➢ As economy's competitiveness is low, increase in domestic demand is as important as exports. A deeper single market in the country will boost domestic demand, see Box below.

[46] Project Syndicate, The Global Economy's Real Enemy is Geopolitics, Not Protectionism, Sep 6, 2023, Dani Rodrik
[47] IMF 2nd review Table 3a: Pakistan: Balance of Payments, 2018/19–2028/29
[48] IMF 2nd review Table 2: Table 2. Pakistan: Medium-Term Macroeconomic Framework, 2019/20–2028/29

Pakistan is behind on many fronts and there is lots to do. The strategy must have the following components:

1. Reforming governance and improving capacity of officials:
    a. This is a top concern. No reform will work if officials cannot deliver.
    b. Major governance reforms must:
        i. Boost entrepreneurship in the country. More economic activity is a top priority.
        ii. For the present, get rid of notions of documenting the economy. GoP goes after the voiceless, while nurturing powerful lobbies. Let the efficient private sector grow. There should be more and more transactions in the economy[49].
2. Industrial policy[50]. The country is stuck in a cycle of low investment, low technology, falling productivity and low exports
3. Software and services growth strategy[51]. This is the future for every economy. If left behind for too long, we will never catch up. "AI is a "A critical source of business value—when done right". It can "multiply value for" businesses[52].
4. Technology policy[53]linked to exports.
5. A 'rural uplift programme', a self-help initiative of local activities supported by minimal financial and organizational from local/provincial government[54] (examples of China, South Korea, Japan and 19th C Europe)
    a. It will reduce poverty, promote entrepreneurship and supply workers for industry
6. An 'education and skills programme' that feeds into above. It limits economic activity and growth. UN's HDI shows how far behind we are.
7. Social transformation
    a. Development would lead to population shifts in an ethnically diverse country
    b. Modernize society[55]

[49] For governance reforms, see recommendations in IPR document: Strategy not Tactics: Better Governance for Social Stability in Pakistan, http://ipr.org.pk/wp-content/uploads/2014/09/Strategy-not-Tactics-Final.pdf
[50] See recommendations in IPR document: Dealing with Permanent Crisis: Industrialization, export and a case for a robust industrial policy, https://ipr.org.pk/wp-content/uploads/2023/07/dealing-with-permanent-crisis.pdf
[51] IPR recommendations in "Information Technology: An Essential Prerequisite for a Knowledge Based Economy in Pakistan", Hassan Nabi Dar, https://ipr.org.pk/wp-content/uploads/2019/07/IPR-Brief-Information-Technology-an-Essential-Prerequisite-for-a-Knowledge-Based-Economy-in-Pakistan-FINAL.pdf
[52] Accenture, New Global Research, The art of AI maturity: Advancing from practice to performance
[53] Broad recommendations in IPR paper 'General Recommendations to Promote Science, Technology, and Innovation in Pakistan', Dr. Attaur Rahman, https://ipr.org.pk/wp-content/uploads/2018/05/Recommendations-to-Promote-ScienceTechnology-and-Innovation-in-Pakistan.pdf
[54] IPR document: The key role of small enterprises in industrialization and poverty reduction, refers
[55] The News, Charter of national revival, Yousuf Nazar, March 20, 2024

> With AI, the world is on the brink of a tech revolution that "could jumpstart productivity, boost global growth and raise incomes around the world. Yet it could also replace jobs and deepen inequality". Kristalina Georgieva, IMF MD

We recommend a complete rework of economic policy and priorities:

GoP's sole focus on managing the macro economy, largely through debt, must not come at the expense of business activity. Its present preference for borrowing is not sustainable and has brought about instability and slow growth. It must also focus on business revival and jobs. Present spending choices and economic policy suggest otherwise.

We must:

- Reform an economy hijacked by special interests with high cost on the taxpayers and its growth retarding effect[56]
    - Especially, reform tax policy and enforcement.
    - Reform energy sector
    - Review protection to many manufacturing and trading sectors
    - Reform or privatize PSEs.
- Liberalize regulated areas so that all parties receive equal treatment. Real estate especially stands out here.
- Also set rules for a host of regulated areas to do away with permission which exacts a high price in cost and time: seed certification, registration of new drugs, food products quality and their labelling.
- New incentives if any must focus on activities that are new to the economy. Intervention should:
    - Reduce hurdles to promote private activity
    - Expand the range of capabilities of the economy[57].
- Improve governance

[56] Throughout this paper there are examples: tax policy and enforcement are lax against those with influence, some entities and goods are exempt from tax, agriculture and retail sectors use influence to evade taxes, PSEs have run on deficit for decades, the energy policy, auto assemblers have an estimated 60% cost advantage but they sell at international prices,

[57] Refer Marriana Mazzucato podcast. In her view, limiting government role to market failure is very limiting. If it were so, none of the key US research would have been made on which today's high tech products, such as iPhones, pharma etc. are based. "How the Consulting Industry Warped the Economy, Infantilized Government, and Weakened Business" with Mariana Mazzucato based on her book The Big Con: How the Consulting Industry Weakens Our Businesses, Infantilizes Our Governments, and Warps Our Economies Hardcover – March 7, 2023

To pursue the above, a holistic refocus would involve:

a. Deregulation:

   i. To allow private activity to grow with minimal regulation. Consult with private sector for a priority list of hurdles. GoP should ensure no compromise on safety, security, environment or fiduciary concerns.

   ii. To allow competition and plug the losses from uneven enforcement

   This calls for bold and astute revamping of present policies hurting the economy.

b. Pakistan needs new infrastructure. GoP must ascertain which service would most boost businesses productivity. For private sector to benefit, infrastructure plans must include focus on service and outcomes. For example, physical improvement at ports must result in fast clearance of goods, quick vessel turnaround and low user costs.

   i. Given fiscal limits, some large projects must wait or GoP must find innovative financing[58].

   ii. The economy faces large gaps in logistic solutions, use and supply of energy and water, cities that work for businesses and reliable and fast internet connection.

c. Improved human capital and living conditions: The economy will revive only by involving a large number of talented people. A small percent of capable Pakistanis cannot deliver on their own:

   i. The grim reality of our cities, governance quality, health and education are major factors for the economy's weakness.

   ii. We need a stronger state that delivers basic services[59]. See our government effectiveness data in Figure 1. They must go up.

d. GoP's R&D support has not helped firms to make new goods for export. GoP doesn't have the people or the funds to support development of new products. Partly, cost may be shared by user firms. Partly, GoP may use foreign grants. Also, hire talent from abroad, with proven record of success, to jump start R&D. Many new industries need support from publicly funded R&D, well integrated with private sector activities and needs. Government must also help with general technical training.

e. From our image as producer of low cost low end goods, we must produce goods that meet global standards. Pakistan Standards and Quality Control Authority must become effective.

[58] Though without forgetting the mistakes of IPP policy.
[59] Yi Wen, The Making of an Economic Superpower

Recommendations:

- Pakistan must have its own national growth strategy to supplement the IMF programme, within the macro framework agreed with IMF:
    - Without growth and exports, the economy will stay vulnerable. IMF forecasts current account deficit of a high 2.6% of GDP in FY 27[60]. Experts consider even this high estimate as optimistic.
- A new IMF programme will stabilize the economy, but at low growth rates. Unless GoP can have a part of loans earmarked for essential growth activities or schemes[61]. For two decades we have availed programme lending. That means borrowing to spend. And thus our inability to pay back. In FY 22, 79% of foreign debt disbursed was for balance of payment[62].
    - Borrowing for growth will bring in forex for BOP and would also enable us to repay if projects are selected with care, especially such that do not increase imports.
    - Selected projects must enhance growth, improve private productivity and possibly exports. One of IMF goals is to act as "catalyst for private-sector investments"[63]. Some selected project must also raise human capital. Major infrastructure projects are needed, but must wait[64].
    - In order to make a new start, a new programme should result in real reforms. With respect to public interventions, GoP must focus more on policy and organization issues rather than physical inputs.
- Possible ideas for foreign assistance that takes us beyond stabilization to reforms and growth:
    - a. Upgrade internet connectivity, b. large scale training in IT and associated skills, language skills programme, software development and maintenance, back office support and (later) IT based R&D, product design and digital marketing. (Apart from internet connectivity, other projects will not cause major increase in import).
    - c. Modernize agriculture for export, d. fish farming, e. upgrade health care to build future health tourism, f. vocational training on mass scale with certification, to exit poverty and avail foreign jobs, g. online training assistance on MOOCs or customized platforms, h. technical personnel for our industry, as needed by PBC and trade organisations, i. establish link between universities, R&D institutes for product development, with publishers of text and knowledge books for translation into Pakistani language/s.

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[60] PIDE, page 7
[61] Rescuing Economic Growth in Highly Indebted Developing Countries, Jan 11, 2023, Dani Rodrik et al. Just the concept, not the measures recommended in the article, is taken from here.
[62] Pakistan Economic Survey, Statistical Supplement, Table 9.2
[63] IMF, Effectiveness of IMF Lending Programs, May 2019
[64] East Asian and now Indian rapid growth rode on the back of major infrastructure investment. Pakistan does not have the space at present, except through innovative financing. We must keep in mind the fiasco that is IPPs.

The last few activities may not involve debt, as most such help is offered under technical assistance, but these activities must be part of the IMF programme.

- J. If there is a line of credit for the private sector from an IFI, GoP may pass through the credit on same terms as the one it receives. The idea is to stimulate private activity. This will insulate selected industries from the tight monetary policy. GoP may add a risk coefficient or service fee.

GoP's growth strategy must move ahead in other areas:

I. To build IT competitiveness, the economy must raise its human and physical capacity in the sector.

- GoP must also offer incentives for growth of IT firms.

II. With foreign help, we must build a cluster of export industries, including in the areas of food, other consumer industry and possibly defence (though the last is import dependent).

The above does not suggest that we do away with traditional manufacturing altogether

III. We need to continually upgrade labour-intensive sectors and yet move to new areas and IT.

IV. It is important also to blend IT and financial services with manufacturing. Examples include online ordering of goods, linking with logistics and finance[65].

More innovation will continually push the export frontier.

Also, financial sector must improve. For years, it has profited from GoP borrowing. There is not enough private project finance. Domestic credit to the private sector has fallen consistently, Figure 12.

V. Need for financial inclusion with a big push to facilitate low income people to open bank accounts. In the last ten years, India has opened 520 million such accounts holding $28bn in deposits[66].

VI. The capital market is concentrated in a few hands. Most private firms do not consider it a viable source of financing. PSX market capitalization is 8% of GDP Vs 94% for Malaysia and over 100% for India and Thailand. For China the figure is 64%. Incentivize separation between shareholders and managers[67].

VII. Review and reform Pakistan's foreign portfolio investment rules. At present, it may be causing speculation and unpredictability exacting cost on GoP and investors alike.

VIII. Revive DFIs.

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[65] It is happening already on a small scale. Refer examples given in Breaking the Mould, under the heading 'Manufacturing Embedded in Services and Vice Versa

[66] Economist, Special report | The India express: For its next phase of growth, India needs a new reform agenda, Apr 22nd 2024

[67] PIDE, page 82-87

IX. Incentives for export of new product lines so that firms find their niche in the global value chain.

X. Offer R&D support

XI. Give boost to small and medium firms. Stop trying to document them for ten years and start helping them with credit, skills, compliance and R&D support. Begin creating a domestic mass market, see Box.

Governance improvement:

The root cause of poverty is not a lack of capital, but a lack of organization and false political choice.

GoP must make a serious effort to improve governance. Pakistan's rank in WEF's Competitiveness Index has fallen. The same is true also for WB's Ease of Doing Business index. Refer Figures 5 and 6. Rather than help, our government has become a hurdle for the private sector. Governance induces poverty.

XII. Improve business environment: It doesn't need hard capital investment. It needs leadership and reorienting mindset of officials.

XIII. Each department may make a check list of rules and regulations that bind private activity. They may do away with some and alter others with the purpose of promoting economic activity.

XIV. Firms waste too much time and money in getting permissions. The country must have rules, not a system of seeking permissions at each stage[68] . Each department must introduce digitization, so that permissions, if any, are online and there is uniform application of rules.

XV. Simplify tax policy and create distance between tax officer and taxpayers. Make the tax system fair and broad based. It boosts compliance and returns.

This is SIFC's mandate, though for foreign investment. SIFC may direct departments to remove obstacles in doing business at the federal and provincial levels in a systematic way. This is especially a need for Pakistani firms. Doing so piecemeal is insufficient and could likely help only firms with influence, also see below section titled 'How to plan and execute the national strategy'.

One reason large firms survive and become influential is because of difficulty in doing business and access to capital. SMEs cannot manage these challenges.

XVI. Incentivize exports: make it a national priority, rationalize tariff, tax incentives for brand export, help with technical and R&D support, priority access to credit and the broader support of logistics and trade facilitation.

[68] PIDE, Page 21

Energy market: The policy is a travesty in which we have high prices, huge losses and unreliable supply:

- Our power policy ensures surplus profits for some at the expense of many.
- Each year, tariff differential subsidy, paid by taxpayers, is given out in hundreds of billions.
- In addition government raises tariffs regularly, yet the circular debt keeps going up. It is an object lesson in governance failure. "Important circularity: tariff increases circular debt, in turn, circular debt leads to tariff increase"[69].
- Line losses have not improved and DISCO receivables are high.
- Rather than treat it as an irresoluble issue, GoP must tackle it innovatively by also looking at market based options.

The government must be pro-active in making governance work for business. It has to rid the economy of inefficiencies from special interests. It must make administrative changes that emphasizes business creation as a core goal. Officials must be tasked to keep that front and centre of their activities.

If possible, the new IMF programme must have a title that highlights the urgency for growth, along with stability.

IMF's definition of structural adjustment usually refers to:

I. Market exchange rate
II. Privatization
III. Trade liberalization, (at a time when EU and US are becoming protectionist).
IV. Reduction of primary budget deficit, that reduces services and public investment to focus on interest payment.
V. Remove subsidies (except perhaps tariff differential subsidy).
VI. Anti-corruption drive.

GoP may follow the above, and also have some projects for growth

[69] PIDE, page 64

How to plan and execute the national strategy[70]:

It needs a rigorous institutional set up that:

Prepare an action oriented economic growth strategy with several components to be rolled out gradually, based on IMF agreed macro-economic constraints.

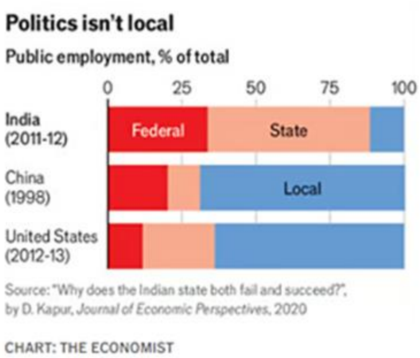
This national development programme needs top leadership involvement. That would gradually build 'learning by doing' political capacity:

- Fevered and goal targeted engagement of the leadership, without compromise.

Designate an organization to plan and implement the policy. Perhaps led by the SIFC:

- It would need major human resource inputs to improve capacity of officers planning and executing the strategy. GoP may avail TAs from Japan, China or South Korea.
- For success, the plan must involve provinces and city/local governments and ensure their total commitment.
- Establish a process with businesses and internally in government to determine the areas where policy action by GOP is most needed.
- Remove obstacles: SIFC may guide departments to remove obstacles to doing business at the federal and provincial levels in a systematic way. Doing so piecemeal is insufficient and could likely help only firms with influence:
- Update regulatory framework, based on experience.
    - ➢ Incentivize exports: make it a national priority, rationalize tariff, tax incentives for brand export, help with technical and R&D support, priority access to credit and the broader support of logistics and trade facilitation.
    - ➢ Simplify tax policy and create distance between tax officer and taxpayers. Make the tax system fair and broad based. It boost compliance and returns
    - ➢ Firms waste too much time and money in getting permissions. The country must have rules, not a system of seeking permissions at each stage. Each department must introduce digitization, so that permissions, if any, are online and there is uniform application of rules.
    - ➢ Delegate and decentralize: In essence, quality of governance "is proportional to the scale on which it is exercised". While the data for Pakistan is not clearly known, the share of local level officials, managed by local governments, would be nowhere close to the US and China, or even of India[71].

Figure 41



[70] Most of this section adapted from IPR Report, Dealing with Permanent Crisis
[71] The Economist, Special report | The India express, For its next phase of growth, India needs a new reform agenda, With the right changes, it can become an engine of global growth, say Arjun Ramani and Thomas Easton, April 22, 2024

Important principles:

- Any incentives on offer must have specific benchmarks/criteria for success and failure. Without these, firms could game the system.
- There must be performance criteria and built-in sunset clause. In the past, GoP has committed resources endlessly.
- Government support must go to activities with spillovers crowd in investment. They must not be for specific sectors. A focus on activities or process is a 'corrective to specific market failures instead of generic support for this or that sector'[72].
- Rather than offer investment incentives, say, for tourism or call centers, programs may support training for language. Similarly, for other areas such as IT, agriculture or manufacturing. Cross-cutting programs benefit more than one area.
- GoP must have constant communication with the private sector to identify needs. Though it must optimize between useful information to target incentives, while avoiding collusion.
- Industry specific consultation is needed to identify specific business needs.
- Our goal should be to try to minimize the chances that mistakes will occur and to correct if they do happen.
- Government must revive DFIs for priority sectors that meet its economic goals, especially new activities with spillovers.
- There must be a nuanced understanding about the pros and cons of state intervention. State intervention often helps but also hurts. Some points cannot be stressed enough:
- Selecting priorities on the basis of cogent logic and via an exhaustive process would minimize risks.

  The effort must be for state intervention leading to a self-sustaining process of economic progress and for an efficient economy.

[72] Industrial Policy for the Twenty-First Century, Dani Rodrik, Harvard University and UNIDO

Stay alert to state capture:

Having the right institutional design would reduce flops and increase successes. For example, incentives given to the construction sector in recent years. And textile exporters' frequent demands for taxpayers' support are examples of the political economy going out of control. Similarly, a clear case of an incentive going too far is concessions for localization for mobile phones[73]. It shows a complete lack of understanding of the match between an economy's capabilities and the stated goal.

Despite the distortions, the answer is not to stop government support for all industries, but to offer help with performance conditions and sunset.

Sustained growth needs rigour and discipline in execution.

Intervene to improve agriculture productivity so that fewer farm hands can produce food in equal or greater quantity as before.

Economic progress is an abstract idea. It is a process of social transformation and modernization, which requires people to adjust to a new way of life. Government must understand it. Or visit the travails of Dickensian England, which is how most people in Pakistani cities presently live without a Dickens to show us the mirror.

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[73] Express Tribune, Still importing to 'Make in Pakistan' Phone assemblers using imported material despite tax benefits of Rs46b, Shahbaz Rana, March 18, 2023

Box 1

What does it take to create a mass market. How can the government help?

A few factors are essential in creating a mass market:

- **Credit intermediation**: In the absence of government support and access to the formal credit market, for small scale low tech industry, merchants are the most likely source of providing credit. This allows the small firms to scale up operations.

- **Contract enforcement:** a national market is possible if small firms have the certainty that they will receive payments for service and goods delivered, or if there is a way to enforce them meeting their credit and other obligations. This builds social trust that enables more market transactions.

- **Means of transportation** and delivery for firms to receive supply of input and to reach their customers.

- **Efficient communication** and accurate information

Also, markets need rules and regulations – product standards; controls on anticompetitive business conduct; consumer, labour, and environmental safeguards; lender-of-last-resort and financial-stability functions – which are typically promulgated and enforced by governments . These must promote efficient transaction. (From Project Syndicate, The Global Economy's Real Enemy is Geopolitics, Not Protectionism, Dani Rodrik).

The essential characteristic of a firm is in division of labour. Large market size enables more division of labour, which in turn stimulates growth of firms. Large markets promote large businesses.

Box 2
Building SMEs

One way for industry to grow and also absorb the growing labour force is to have a dedicated focus on SMEs as one of the major drivers of growth in Pakistan.

We must have a plan to:

- Register SMEs giving them the comfort that they will not be taxed. The registration should be backed by law, which would recognize them as legal entities to enable them
  - To apply for civic services
  - Resist extortion by state functionaries
  - Avail credit from the formal sector. Though GoP and SBP have made noticeable efforts to extend credit to them, much of it doesn't get used because of compliance requirements. They must change methods by using NADRA and other technology solution to prevent bad debt.

Unwittingly, government has forced SMEs to stay in the informal sector.

GoP must support SMEs with:

- Contract enforcement: a national market is possible if small firms have the certainty that they will receive payments for services and goods delivered
- Means of transportation and delivery for firms to receive supply of input and to reach their customers.
- Efficient communication and accurate information

Not promoting SMEs is a missed opportunity. SMEs account for nearly 90 percent of all the businesses in Pakistan They contribute 40% to GDP and 25% to exports. Unsurprisingly, 97% of them are in the informal sector. (Pakistan Economic Survey).

Few of these micro and small enterprises ever reach medium size. SMEs suffer from a lack of knowledge. SMEs also raise income level of the poor, which increases domestic demand. A major hurdle for them is they do not know government or business processes. They must be governed by different rules.

The above has been excerpted from IPR Report, Dealing with Permanent Crisis.

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