# *A Call for Structural Reforms*

***PBC advocates "fixing" the fundamentals instead of merely "managing" the crises***

The Pakistan Business Council (PBC), in its ***100-Day Economic Agenda for the Incoming Government***, issued prior to the general elections, advocated a well-structured IMF programme for Pakistan to fix the fundamental issues confronting the economy. Now that a decision has been taken to approach the IMF, PBC hopes that the programme will take a holistic view of the factors leading to the present crises instead of merely managing them. This paper revisits the rationale and concludes that a ***"Make-in-Pakistan"*** approach, in a well-structured programme is the only way to revive industry, generate jobs, boost exports, encourage import substitution, leading to macro-economic stability. An essential enabler of this is the broadening of the tax base, closure of avenues of tax and wealth leakages and the simplification of processes to make it easier and cheaper to do business. This is an opportunity to break out of the recurring crises that has seen Pakistan go to the IMF on twelve occasions in the past 28 years. Otherwise, the country will suffer pain, without sustainable gain.

***Pakistan's economy is not immune to the global downturn***

Notwithstanding Pakistan's low is less integration into the world economy, it is not immune to the global downturn. Normalization of the US monetary policy with rising interest rates is resulting in outflow of investment from the emerging markets. The US$ is strengthening and emerging market currencies are declining, including Turkey, Argentina and India. Crude oil costs are rising from an average of $62/barrel in the FY 18 to around $80 currently, an increase of 30%. With sanctions against Iran tightening and OPEC pursuing yield, oil costs could rise even higher, offsetting any increase in Pakistan's exports. Trade tensions between USA and China and the US administration's determination to protect domestic jobs will surely cause disruptions, before translating into opportunity for countries like Pakistan. Continuing uncertainty over Brexit is a vulnerability, given the high reliance of our exports on UK and the EU. The global outlook on growth is a lot bleaker than July when we first recommended an IMF programme.

***Growing deficits on the external and fiscal accounts and a shrinking import cover all signal rising risks***

| **MACRO-ECONOMIC INDICATORS** | **FY 17** | FY 18 | Jul-18 | Aug-18 | Sep-18 |
|---|---|---|---|---|---|
| **EXTERNAL ACCOUNT % GDP** | | | | | |
| Exports | 9.03 | 9.57 | 9.43 | 9.85 | 9.62 |
| Imports | 18.53 | 21.19 | 24.99 | 20.10 | 22.50 |
| Trade Balance | -10.16 | -11.62 | -15.56 | -10.25 | -12.87 |
| Remittances | 6.34 | 6.27 | 7.54 | 7.90 | 7.71 |
| Current Account Balance | -4.13 | -5.79 | -8.29 | -2.33 | -5.29 |
| **SBP FOREX RESERVES ($ Mn)** | 16,145 | 9,789 | 10,211 | 9,885 | 8,408 |
| **IMPORT COVER (weeks)** | 14.8 | 7.7 | 6.9 | 8.3 | 6.3 |
| **FISCAL DEFICIT % GDP** | -5.8 | -6.6 | -7.1 | -7.1 | -7.1 |

Whilst exports have begun to respond to the adjustment in the exchange rate, imports are likely to grow on the back of higher oil costs. The trade deficit for the first quarter of FY 19 amounted to US$ 8.8 Bn, suggesting a full year aggregate of $30-35 Bn. Remittances are so far holding but remain vulnerable to uncertainty in the ME. SBP forex reserves, despite injection of $2 Bn from China in July, are depleting with the import cover now at a precarious 6 weeks.

Concurrent with the challenge on the external account, the country faces a growing fiscal deficit. In FY 18, revenue grew by 5.9% whilst expenditure rose by 10.1%, leading to a deficit of 6.6% of GDP. This is likely to grow in FY 19 unless programme actions kick in. Public debt at 72.5% of GDP is well above the 60% mandated by the Fiscal Responsibility and Debt Limitation Act. Alarmingly, debt maturing in FY 19 represents over 80% of the net liquid forex reserves as of June 2018. By September '18 this crossed 90%, sharply up on the 27.7% just a year ago, further indicating a danger of default. Maturing debt includes commercial loans and SAFE deposits from China. Another vulnerability is the weighted average time to re-fix the cost of public debt. In an environment of rising borrowing costs, mark-up on over half the debt is re-adjustable within a year. The state of the economy has worsened since July.

***Circular debt and PSE losses are acerbating the pressure***

Circular debt on account of under-recovery of electricity costs amounted to Rs. 1.14 Trillion, whilst PSE losses stood at Rs. 1.0 Trillion as of June 2018. Whilst the revision of power tariffs will help, transmission and distribution losses and PSE deficit will continue to pose a burden on public finances.

***GDP is consumption driven, which in turn is import reliant, whilst investment takes a back seat***

Private consumption represents over 85% of GDP and accounted for 93% of the GDP growth in FY2018. Investment on the other hand was merely 16% of GDP and represented only 17% of the GDP growth in 2018. Consumption exceeds the average in South Asia and the rate of investment is half that of our neighbours. To make matters worse, in the absence of a strong domestic manufacturing sector and until recently an artificially strong Rupee, imports fed consumption. The government has taken steps through regulatory duties to stem import demand. This will be augmented by the correction in the exchange rate. Both will take time to positively impact the trade balance.

***Pakistan is de-industrializing prematurely. We have become a nation of traders***

The role of manufacturing in the economy has declined since 2007-8. Its rate of growth at under 6% is half that of Bangladesh and Vietnam and significantly below India's. Manufacturing at 13.5% of GDP and industry at 20% is burdened with 58% of the tax burden. Pakistan has become a nation of traders and our fiscal policy is designed to collect revenue from imports. High duties and hitherto presumptive taxes incentivize under-invoicing and mis-declaration. The extent of under-invoicing is estimated at US$ 5 Billion a year. Not only does this deny tax revenue, it undermines local manufacturing. Poorly negotiated trade agreements and non-cascading tariffs have resulted in export impediments and influx of many items of daily use, displacing those hitherto manufactured in the country. Smuggled products are widely available.

***Tax base is narrow, tax regime is complex, tax rates are high and businesses are not encouraged to consolidate and float on the stock market***

With just 700,00 filing tax returns and an even smaller number paying taxes, the government relies on withholding taxes and import duties for revenue. Tax rates, especially GST, are high for an undocumented economy. This creates incentive to evade. Just two players each in the tobacco and footwear industries account for over 80% of taxes. Combination of tax policy making and tax collection under the FBR, results in knee-jerk measures to meet revenue shortfalls. Unrealistic revenue targets and demand for payment of taxes in advance result in harassment. Fiscal policy does not encourage capital formation, accumulation and consolidation. Cascading taxes on inter-corporate dividends and the reversal in 2016 of group taxation rules enacted in the Finance Act 2007 have negatively impacted the formation of holding companies and the floatation of subsidiaries. This impacts the capital market.

**The IMF programme should be structured to address the fundamental flaws impacting the economy. These are the actions recommended to revive the industry in a Make-in-Pakistan thrust.**

1. **Alignment of government policies:** The ECC should establish a task force, which with the Council of Business Leaders, should identify conflicts in existing government policies which create complexity, raise cost and make doing business difficult. The focus of this exercise should be to promote employment, ideally through value added exports and by encouraging import substitution. It should also identify ways to create a level playing field by broadening the tax base. The Prime Minister must be seen to be leading the thrust to revive industry and exports.

2. **Fiscal Policy:** Fiscal policy making should be separated from tax collection. Fiscal policy should address the medium to long term objectives of creating and sustaining the scale and competitiveness of industry as well as of country's tax revenues. Tax collection by the FBR should be made effective by a radical change in leadership, induction of fresh talent and the use of technology, as well as through simplification of returns and the reengineering of processes and targets to reduce the risk of harassing tax payers. The primary KPI should be taxes collected from new tax payers. Cases for audit should be selected on a transparent basis and conducted by experts, independent of the FBR, as should appeals.

   Fiscal policy should promote capital formation, accumulation, consolidation and investment. Formation of groups leads to scale. Group structures should be promoted by restoring the provisions enacted in the Finance Act 2007. Public listing should be incentivized.

   All presumptive taxes should be phased out. Taxes collected in advance may be adjusted against assessed profits based on the tax returns filed - everyone engaged in a taxable activity should file. Tax evasion should be made a criminal offence.

The tariff policy should promote industrial growth and not be used merely as a revenue tool. Cascading import tariffs should ensure that raw materials and intermediate items, not available in Pakistan, are taxed at a significantly lower rate than finished products to encourage local manufacturing. Anomalies in Regulatory Duties on inputs for the manufacturing industry should be removed promptly. FTA concessions on finished products, other than machinery not produced locally, should be curtailed.

The Federal Government should engage with the Provincial Governments to address the growing complexity and conflicts resulting from the devolution of power. The aim should be one National Tax Authority, reducing the number of taxes and simplifying the payment and filing of returns.

The Government should standby the commitment made by its predecessor to bring the corporate tax rate down by 1% each year until it reaches 25%. The sales tax rate should be revised downwards.

To discourage tax evasion, the withholding rates for non-filers should be increased to three times the rate applicable to tax filers. FBR's primary performance target should henceforth be tax collected from new tax payers. When assessing performance against targets, tax refunds outstanding should be excluded. Tax in advance of due date should not be sought. The effectiveness of tax collectors should be judged by the number of cases won in the courts.

3. **Trade Policy:** All trade agreements should be renegotiated and future arrangements should ensure the maximization of Pakistan's value-added exports, promotion of jobs in the country and the optimization of tax revenues. Pakistan must achieve tariff parity with ASEAN, Australia and New Zealand in the FTA with China. Even Bangladesh enjoys more favourable access than Pakistan.

   The coordination between the Ministry of Commerce and Pakistan Customs should be improved to stem the rampant mis-declaration of imports, under-invoicing and smuggling. The Federal Government should work with Provincial Governments to aggressively deal with the blatant sale of smuggled products. Imported food items should carry Urdu labels and ingredient information. Pakistan should enter into electronic exchange of trade data with all leading trade partners to stamp out under-invoicing. The National Tariff Commission should be made more responsive to the interest of domestic industry.

4. **Exports and Import Substitution:** Cost of energy to industry should be brought down to create jobs and be globally competitive. Whilst export industries should be prioritized, those producing import substitutes should not be ignored. From a trade balance perspective, a $ saved in imports is equal to a $ generated from exports. However, the former contributes more in taxes.

   Exports should be zero-rated for all taxes to avoid the need for refunds. Tax refunds outstanding should be settled promptly. Export rebates should be credited by banks upon the realization of foreign exchange proceeds. Pakistan should continuously maintain a competitive exchange rate. The Government should fast forward schemes to provide pre and post export refinance and export credit guarantees. It is essential for Pakistan to broad base its exports, both in product profile and destination markets. Textiles, which represent 6% of world trade cannot continue to compose 60% of our exports. TDAP should move into a PPP model and be empowered to help achieve a quantum jump in exports as opposed to simply participating in exhibitions.

Global demand in textiles has shifted from 100% cotton to made-made fibers, whilst Pakistan continues to focus on the former. A comprehensive review of the factors thwarting Pakistan's adaptation to demand should be undertaken.

There is opportunity for Pakistan to benefit from the tariff surcharge imposed by the US on goods from China. In the immediate time horizon, this would be from utilizing spare capacity and existing capabilities. In the medium term, textile industry in particular should team up with Chinese companies to relocate plants to this country. The Chinese can also help upgrade skills, transform product quality and help Pakistan diversify its market focus.

Provinces should review the policies that inhibit industry in general and exports in particular. As land in big cities is expensive, vertical factories for apparel and light industry and "plug and play" industrial estates with adequate utilities, infrastructure and transportation facilities should be developed. Cluster focus will additionally bring scale and synergy. Bangladesh and Vietnam have successfully deployed these models.

With rising cost and import of oil and gas, Pakistan needs to redouble effort on exploration, in particular of gas for which the current well-head prices are far lower than what we pay for imports.

5. **FDI:** The policy should focus on exports, on technology oriented sectors and on those for which the private sector lacks capital and risk appetite, such as infrastructure and oil and gas exploration. Concessions should be tailored to promote JVs and public listing. The BOI should develop sector knowledge and sharpen focus on investors (foreign and local) that meet this criterion.

6. **Agriculture:** The distortion created by incentivizing the growth of sugar-cane and wheat, at the expense of cotton (required by the textile industry), and oil-seeds (deficiency of which forces imports exceeding US$ 3.5 Bn annually) should be reviewed, especially in the context of scarce water resources. An Agri-Emergency should be declared to increase the per acre yield and to promote employment and exports. Likewise, dairy and meat yield and quality need to be improved. China could help grow long-staple cotton in arid conditions, improve yield and variety of rice and address factors in cold chain and logistics that impede horticulture.

7. **National Standards:** The Governments should ensure a national standard in conformance with global best practice for products, services and the environment. Provinces should ensure compliance. This will reduce complexity, provide scale and help improve competitiveness.

8. **SMEs:** SMEs have the highest potential to add jobs. Provision of bank credit through credit guarantee schemes should be facilitated, especially to SMEs in the agri-sector and those engaged

in exports, whether directly or through larger exporters. Private sector businesses and State Owned Enterprises should be incentivized to incorporate more SMEs into their value chains. Regulatory constraints that limit the growth of private equity should be removed.

9. **The ICT Sector:** The world is moving to a knowledge economy. This is where Pakistan needs to focus for future jobs and exports. Computer programming should be made part of school curriculum. The federal and provincial tax burden on broadband should be reduced and every nook and corner of the country should be internet enabled. Software exports, Business Process Outsourcing and Call Centers need to be encouraged through comprehensive alignment of federal and provincial polices. Pakistan has amongst the highest number of freelance software developers but fragmentation results in sub-optimal earnings and remittances. Obstacles, such as the absence of a payment platform that thwart Pakistani businesses in e-Commerce, especially in exports, should be removed.

10. **Skill Development:** There is significant room to improve the skill base to enable industry to be globally competitive. The government should encourage public-private partnerships and the deployment of WPPF towards upskilling and vocational training. A special focus on promoting women's employment should include support for day-care centres.

11. **CPEC SEZs:** To make CPEC truly a game changer, investment in SEZ's should be promoted along a "plug and play" model for all, not just the Chinese investors, provided it (i) results in net incremental jobs; (ii) positively impacts the external account and (iii) does not undermine existing industry. Tax holiday is one such concession that needs to be reconsidered. A 50% export condition should apply.

12. **The Environment:** Pakistan is a water-stressed country. It is also vulnerable to the havocs of climate change. In pursuit of its commitment to the United Nations Sustainable Development Goals, the Government should work with the private sector to promote greater responsibility towards the environment. In particular, it should support initiatives for water and energy conservation such as by right-pricing this scarce resource and by promoting investment in reduction, recovery and recycling of materials to address garbage and solid waste-management.