The Pakistan Business Council

FOSTERING ECONOMIC GROWTH

(A Company set up under Section 42 of the Companies Ordinance 1984)

Progress Review of *"Make-in-Pakistan"*

"..... despite some significant reforms, a lot remains to be done. It is still difficult to do business in Pakistan ..."

8TH JULY, 2019

SECTION 01
Executive Summary

SECTION 02
Background

SECTION 03
Progress in the "Make-in-Pakistan" Thrust

SECTION 04
About PBC

SECTION 02

Executive Summary

The Pakistan Business Council (PBC) has been advocating a "Make-in-Pakistan" thrust to promote employment, value-added exports and import substitution. The aim is to generate jobs by reversing the premature deindustrialization of the country and avoid the recurring external account crises which force repeated IMF and other bailouts. For too long, the country has been resorting to short term, expedient measures that have made it import reliant and consumption driven. PBC has also been highlighting the need to make it easier to do business and to broaden the tax base to enable much needed investment in socio-economic development. This checklist of progress over the last eighteen months in the main factors affecting business, in particular manufacturing, concludes that despite improved understanding and attention by the policy makers, it remains difficult to do business in Pakistan.

On a positive note, it is a case of glass half full rather than half empty. The present government deserves credit for starting a journey of reforms that will take several years to bear fruit. PBC has consistently advocated for a renegotiation of the free trade agreement with China. The Government has now successfully negotiated a more optimal arrangement and is working with other countries along similar lines. The Pakistan Rupee is more competitive. Energy cost for exporters is at par with the region. The government is moving with determination to broaden the tax base. Presumptive taxes are being withdrawn. Steps are in progress to stem under-invoicing. Duty on some raw materials has been reduced to encourage local production. The two major leaks in the economy - transfer of funds abroad and the leakage of money into the undocumented real estate sector are being plugged. Fiscal policy making and tax audits are to be separated from tax collection and FBR is in the process of being overhauled with infusion of talent and technology.

There is however, a need to do more as the checklist shows. The fiscal regime remains complex with 47 different types of taxes and a bureaucracy focused on extracting higher revenue from a narrow base of existing tax payers; tax rates remain higher than the region, especially GST at 17% which in a largely undocumented economy, provides incentive to evade; minimum turnover taxes for low margin sectors as also in the initial years of investment and in otherwise tax exempt projects in Special Economic Zones (SEZs) discourage investment; reduction and subsequent withdrawal of tax credit on balancing, modernization and replacement is also retrogressive for upgradation of industrial output; duty on intermediate items used in local production remain high and will negatively impact import substitution; cost and availability of land and the provision of utilities, even in SEZs, is a major constraint; development finance institutions no longer exist to provide long term credit; and bank lending to SMEs remains abysmally low. SMEs are also not properly integrated into the export value chain in which duty reclaim process is complex. Subsidy for sugarcane creates distortion and dis-incentivizes cultivation of cotton, which is required for value-addition by the textiles industry. It also does not encourage the cultivation of oil-seeds, resulting in high imports of edible oil. Foreign Direct Investment policy needs to be directed to export-led or import substitution industries and those for which local investors lack capital and risk appetite, such as oil and gas exploration.

Most government processes remain complex and paper-based with poor accountability for speed and quality of decision-making. An overstaffed bureaucracy not only slows down the economic activity, it also burdens the nation with higher expenditure. It is a pity that the core competence required to succeed currently in business in Pakistan is the ability to overcome bureaucratic hurdles. At its extreme, the degree of bureaucracy and the knowledge required to deal with it, becomes an undesirable barrier to the entry of new players. Trade, fiscal and corporate laws should be subjected to regulatory guillotine to eliminate all non-value adding, time and energy sapping requirements that make it difficult and costly to do business.

Encouragingly, a national consensus on the economy, which the PBC has been advocating for some time, is now receiving greater resonance amongst political parties. This should be seized upon to add momentum to change. If politics is the art of the possible, economic sovereignty is a prerequisite for the country's prosperity, security and global standing. Regional trade, another requisite for economic growth is stalled for want of favorable relations with our eastern and western neighbours.

Whilst the government undertakes policy reforms, business must do its bit to invest in capacity, capability, productivity and quality to be able to compete globally. Due to capacity constraints, Pakistan has not benefited from the tariff measures taken by the United States (our single largest export destination), against China, Vietnam, India or Turkey. Pakistan's exports are mainly low value-added, 100% cotton-based goods whilst global demand is shifting to man-made fibres. Reliance on protection must be time based. More businesses must adopt responsible gender and environmental practices that are good for business and good for society and also help deliver Pakistan's commitment to the United Nations Sustainable Development Goals. The responsibility to lead this is greatest on large businesses. Hence Pakistan Business Council's initiative to establish the Centre of Excellence in Responsible Business (see: https://www.pbc.org.pk/centre-of-excellence-in-responsible-business-cerb/).

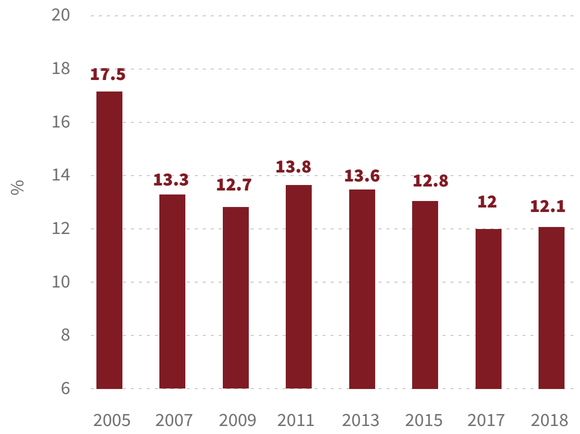
Even with progress on the factors highlighted in this report, it is unlikely that the going will get much easier for business in the near future. However, this pain is necessary for sustainable gain. All stakeholders must therefore develop the patience and fortitude to bear it. Short-term expediency must not (again) be allowed to compromise fundamental reforms. Failing this, Pakistan will keep knocking on the IMF's doors, as it has been doing in the past. Without economic autonomy, the nation will neither enjoy sovereignty, nor command the validity, legitimacy or respect in the comity of nations.

SECTION 02

Background

Pakistan is deindustrializing prematurely. The role of manufacturing in the economy has declined and its rate of growth lags far behind India, Bangladesh and Sri Lanka. As a result, over the last decade and a half, Pakistan has lost share of world exports, whilst Bangladesh's share doubled and Vietnam's grew seven-fold in the same time period. Manufactured goods represent a lower percentage of Pakistan's exports than those of Bangladesh. Disproportionate burden of taxes on industry, rampant under-invoicing, misdeclaration of imports, blatant availability of smuggled goods, a fiscal policy that relies on imports for revenue and fails to encourage capital formation and consolidation, together with knee-jerk measures to meet tax revenue shortfall have thwarted the growth of industry. A tariff policy that fails to adequately differentiate between raw materials, intermediate goods and finished products has resulted in rapid growth of imports, often negating the positive impact that trade agreements could bring through cheaper raw materials. As a result, Pakistan is not integrated well into global value chains. Poorly negotiated trade agreements have failed to secure competitive tariffs for exports. High input costs impede the competitiveness of relatively low value-added, heavily textile-reliant exports. Shortfall in availability of cotton inflates imports and impacts the potential of value-added exports. Subsidies for sugar cane and wheat create uneconomic surpluses, denying industry adequate inputs to add value to, both for exports and import substitution. Short-term oriented export policies have not encouraged the shift to man-made fibers in line with global demand. Neither has it promoted investment in adding further sophistication to products or to diversify beyond the traditional markets of USA and Europe. Energy shortfall, high cost and generally anti-manufacturing policies have also discouraged the broadening of exports beyond textiles or of import substitution.

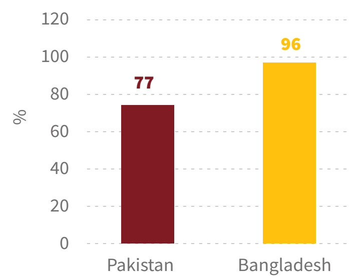
Manufacturing (% of GDP)



Source: World Bank

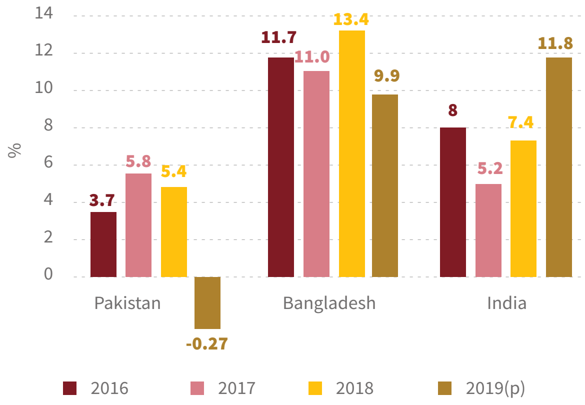
Pakistan's Share in World Exports

Manufactured Goods as % of Exports

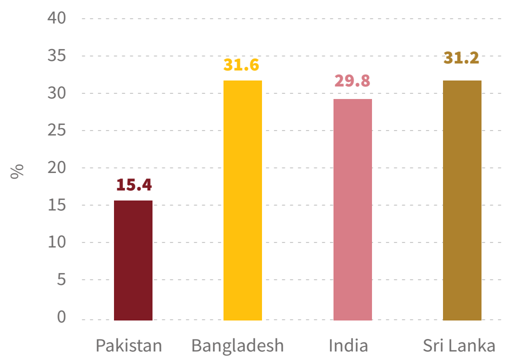


The net result of the aforementioned is a growing trade deficit and recurring cycles of external account crises; resulting in Pakistan knocking on IMF and other donor's doors for the 13th time in 28 years. There is a dire need to conduct fundamental reforms to restructure the economy and strengthen domestic industry. Besides, the country needs to generate 2 - 3 million jobs for the youth who reach the age of employment every year and for the 5 - 6 million currently unemployed.

Growth of Manufacturing



Investment to GDP Ratio (2018)



Further snapshots of an economy in need of fundamental reforms

Complex Tax System

	WB EoDB* Paying Taxes Rank (out of 190)	Number of Taxes
Pakistan	173	47
India	121	13
Hong Kong (Best in World)	1	3

*World Bank Ease of Doing Business 2019 Ranking

Disproportionate Tax on Manufacturing

Sector	FY 18	% of GDP	% of Tax Burden
Manufacturing	13.04	13.5	58
Agriculture	18.53	19.5	<1
Retail & Wholesale	18.86	18.5	1
Rest	49.57	48.5	40

Source: Pakistan Bureau of Statistics (PBS)

Higher Tax Rates

Sector	Corporate Tax	GST
Pakistan	37%*	17%
Singapore	17%	7%
Bangladesh	15%	12%
Sri Lanka	25%	15%
Vietnam	22%	10%

*Incl WWF and WPPF

Poorly Negotiated FTA's

Country	Year Signed	Trade Balance (in year signed)	Trade Balance (in 2018)
Sri Lanka	2005	$94 Mn	$250 Mn
China	2006	($3.2) Bn	($14.79) Bn
Malaysia	2008	($1.5) Bn	($1.09) Bn
Indonesia	2013	($1.1) Bn	($1.83) Bn
Mauritius	2007	$38.7 Mn	$20.42 Mn

Growth in Import Reliance - Mainly on China

Items	Import Value 2007 (US$ Mn)	Import Value 2018 (US$ Mn)	Growth Multiple	% Import from China
Footwear	34	112	3.3x	89
Pumps	47	170	3.6x	64
Glassware	13	74	5.7x	85
Tiles	50	169	3.4x	65
Blankets	17	49	2.9x	97
Fans	13	42	3.2x	87

SECTION 03

Progress in the "Make-in-Pakistan" Thrust

Factors Impacting Manufacturing and the Ease of Doing Business

01 Unfavourable trade agreements

Progress So Far

Pak-China FTA renegotiated - tariff elimination on 313 further lines

Pak- Indonesia PTA renegotiated- tariff elimination on further 20 lines (value-added)

Agreements with Turkey and Thailand put on hold pending more favourable terms

Talks with Japan commenced to achieve parity with Bangladesh and India.

U.S. has indicated that it might offer Pakistan an FTA in return for an "honourable exit" from Afghanistan

Pending

Formal discussion on a US Pakistan trade agreement has not started yet.

Talks yet to commence with Australia and Canada on preferential access

Pakistan Mercosur FTA talks have been initiated but currently on back-burner

Progress pending on a Pakistan Iran FTA and a Pakistan Afghanistan PTA

The GSP+ facility from the EU is under review. The standard by which EU evaluates compliance against HR and other conventions is becoming tougher. The Government must proactively work to preserve this valuable concession for Pakistan.

02 An overvalued currency

Progress So Far

33% adjustment in the value of the Rupee vs. the US$ in last 12 months

Pending

03 Non-cascading import tariffs hurting local manufacturing and Pakistan's integration into the global value chains

Progress So Far

Duty on 1600+ RMs proposed to be reduced in the federal budget. This is start to the policy of cascading duties to encourage local production.

Pending

Duty reduction on intermediate items not yet addressed. This is pending fiscal space

04 Rampant under-invoicing & smuggling

Progress So Far

In-principle agreement with China on EDI to curb under-invoicing

Pending

EDI with 20 large trade partners has not yet been agreed. The PBC estimates under-invoicing of over $5 Bn per annum.

Progress So Far

Tightening the outward flow of funds that finance under-invoicing

Progress So Far

Tariff Rationalization proposed in federal budget to stop misuse of transit trade

Pending

Qualitative and quantitative limits based on justifiable demand should be bilaterally negotiated for transit movement with Afghanistan. Full Pakistan duty, GST and other levies should be charged at point of entry and refunded upon satisfactory proof of export to the Afghan government. This proof should include the return of empty containers. For physical verification, independent inspection agencies and the Pakistan Army can be deployed.

Pending

No reliable figures are available on the quantum of smuggling. Estimates range between US$10 to $15 Bn. Physical controls over porous borders can be re-enforced by the Pakistan Army. Provincial authorities must take determined action to stop the blatant sale of smuggled products in markets such as Jodia Bazar, Shah Alam and Raja Bazar in Karachi, Lahore and Rawalpindi respectively.

ITP and quantitative duty on items prone to under-invoicing would provide a check to under invoiced values.

Public visibility of import values and declarations would assist Customs in verifying accuracy of declarations.

05

Uneven playing field for the formal sector

Progress So Far

Presumptive & final tax regimes are to be discontinued. Everyone in business must file a tax return

A more concerted effort proposed to trace sales of FMCG products by denying input sales tax adjustment for sales to unidentified buyers

Pending

A determined effort backed by all political parties to broaden the tax base.

06 Energy availability

Progress So Far

Power generation enhanced and load shedding reduced. Concessions in the Federal budget on import of machinery and equipment for power transmission

Pending

The national grid and transmission system requires major overhaul.

Energy is not easily available to industries wishing to expand. This is especially so in new industrial areas.

07 Uncompetitive energy cost

Progress So Far

Five key export sectors provided energy at a cost at par with regional countries

Pending

Import substitution industries continue to suffer from high energy cost

DISCOs need to enhance efforts to stem theft of power

08 Rental business models and undocumented real estate deny capital to the formal sector

Progress So Far

Imposition of Capital Gains Tax (CGT) on trading of open plots of land

Imposition of CGT on mutual funds earnings

Income Tax on rental income increased

Asset Declaration Scheme to encourage formalization of the economy

Beyond a certain limit, interest income from debt to be treated as normal taxable income

Discontinuation of Rs.40,000 bearer prize bonds

Pending

Align the federal and provincial valuations of real estate. The federal government could start with Punjab, KPK and Baluchistan where it has influence.

Pending

Replacement of the current Rs. 5,000 and Rs. 1,000 notes will promote banking and the formalization of hidden wealth. Approx. Rs 3 Trillion is estimated to be out of the banking system, reducing the capacity of banks to lend.

A simplified and centralised KYC system for opening bank accounts will make it easier for the unbanked to be banked. Likewise, digital banking.

09

Group formation to build scale and to encourage wider public participation in listed companies

Progress So Far

Partial restoration of the exemption of inter-corporate dividends from cascading taxes. This is however unlikely to encourage the formation of subsidiaries.

Pending

Full restoration of group taxation to pre FA 2016 basis is outstanding.

Longer term incentive for companies to remain listed on the PSX and comply with higher standard of governance is missing.

10

High tax rates

Progress So Far

Corporate Tax rate to be reduced by 1% a year until it reaches 25%

Pending

Reduction from 29% to 28% in corporate tax has been delayed by a year in view of the fiscal imperatives.

GST at 17%, at each stage of value-addition, in a largely undocumented economy, creates incentive to evade. A positive move is a pilot reduction of GST on restaurants from 17% to 7.5%, accompanied by incentive to customers to report usage.

Pending

Super Tax, unrelated to return on investment, continues on banks and some other sectors. A more rational basis of taxing extraordinary profits needs to evolve.

11

Disproportionate tax burden on manufacturing

Progress So Far

Steps to tax the retail and wholesale sectors announced in the budget proposal. Also to include intermediaries in the agri-supply chain

Pending

Provinces are still ambivalent to enhancing revenue from agriculture

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12

Complex tax regime

Progress So Far

Additional responsibility placed on, but no incentives provided to the formal sector to help broaden the tax base. The formal sector is to continue as unpaid tax collectors with the threat of penal action for any slip-ups.

Pending

No move to unify and consolidate taxes, even between the Federation and the Provinces under PTI's control. There are presently 47 different federal, provincial and local government taxes and levies and Pakistan ranks poorly in the Ease of Doing Business ranking. The best in the world – Hong Kong has 3 taxes and India has reduced its levies to 13.

13

Turnover taxes and alternative corporate tax (ACT) irrespective of underlying profitability

Progress So Far

Pending

Minimum tax increased to 1.5% of turnover making it unfeasible for low margin projects. Exceptions are required for such sectors as also for the initial period of projects till they become profitable.

14 Financing constraints for SMEs

Progress So Far

Reduced Rate of tax for banks from lending to/financing micro, small and medium enterprises

Increased tax on banks income from government securities. This may divert funds for private sector lending

Pending

Prudential regulations require physical collateral
for bank lending. SMEs and the IT Industry often lack this type of collateral. Hence need to review and adopt more cash-flow based risk management.

15 FDI policy not export-led

Progress So Far

Pending

Differentiated policy for attracting foreign investment in export, import substitution and capital and risk intensive sectors is yet to be announced

16 Investment incentives

Progress So Far

Greenfield projects exempt from some taxes

Pending

Reduction (and from next year the withdrawal) of tax credit for Balancing Modernisation and Replacement (BMR) is retrogressive at a time when there is a dire need for industry to upgrade capacity. Also the premature withdrawal of a facility made available till June 2021 does not augur well for building investor confidence.

Levy of turnover taxes/ACT in periods when there is no underlying profit is inequitable and raises the cost of entry into new projects.

SEZ units although exempt from Income Tax, still under the Minimum Tax Regime

17

Availability of affordable land and utilities

Progress So Far

Pending

SEZs are not yet up and running and not surprisingly, there are no signs of the much mooted investment by the Chinese, despite pressure on them to diversify their supply chains. Cost of land has become prohibitive in existing industrial areas in the absence of zoning laws barring intrusion by residential & commercial developers. Utility connections are not easily available in new industrial areas. With a few exceptions, land in industrial zones is liable to misuse by speculators.

18

Revival of sick units

Progress So Far

Corporate Rehabilitation Act 2018 promulgated

Pending

Implementation of a sustainable restructuring programme

19

Absence of development finance institutions and paucity of long term credit, especially to finance imported plant

Progress So Far

"The government intends not to borrow from the SBP. Tax on bank profit from lending to the government has been raised.

The government is working to draw in the cash outside the banking system to increase the lendable pool."

Pending

"Budgetary deficit is unlikely to limit government borrowing. Even with higher tax on lending to the government, banks will find it more attractive than to lend to the private sector, given the higher risk, resources and effort involved in the latter.

There is no proposal to establish/revive DFI's such as the erstwhile Bankers Equity, PICIC, IDBP etc., to provide investment impetus."

20

Cost of borrowing

Progress So Far

Pending

A 525 basis points increase in cost of funds with more on the anvil is an investment dampener.

21

"The corporate burden"

Progress So Far

Pending

The Companies Act 2017 places unnecessary burden on companies by duplicating the powers of the SECP and encroaching on the domain of other regulatory bodies such as the FBR, SBP etc. The definition of related parties is too wide and impractical. The disclosure requirements are repetitive. There is therefore a dire need to revise and simplify the Act. Also the Code of Corporate Governance should move to "comply or explain" basis.

An investor in a company suffers from an effective tax rate of 40% after tax on dividends is taken into account. For an investor in a holding company, the effective tax rate can be as high as 49%. Against this, an investor in an unincorporated business not only enjoys lower tax due to slab rates, she or he can withdraw profit without suffering distribution tax. Neither is there a requirement for such investors to comply with higher governance requirements of the Companies Act.

22

Multiple inspection agencies regulating businesses

Progress So Far

Pending

There is scope to simplify and reduce the disruption created by multiple agencies dealing with inspection of factories and workplaces. Food and environmental standards in provinces must be harmonised as they have been for drugs.

23

Manual systems of the government

Progress So Far

Pending

Digitization, simplification and unification of government systems and authorities would enhance the ease and reduce the cost of doing business. A regulatory guillotine must be applied, in particular to trade, fiscal and corporate laws to make it easier and cheaper to do business.

24

Complex duty reclaim process

Progress So Far

Pending

The DTRE scheme needs to be simplified to enable SMEs in particular to avoid import duty on export inputs.

25

Enabling SMEs to play a more meaningful role in the supply chain

Progress So Far

Pending

Larger export businesses may be incentivized to procure goods and services from SMEs. Transaction taxes should be removed on locally acquired inputs from SMEs for products destined for export by larger exporters. This would promote greater inclusion of SMEs into the economy and help develop skills and capability of a wider cross-section of industry.

26

Shortage of cotton

Progress So Far

Pending

Subsidy in the form of support prices for sugarcane creates distortion and dis-incentivizes cultivation of cotton which is required for value-addition by the textiles industry. It also does not encourage the oil-seeds industry, resulting in high import of edible oils.

27 Regional trade

Progress So Far

Pending

Economic growth of Pakistan will remain constrained by poor regional connectivity on both its eastern and western borders. Subject to favourable political relations and the removal of non-tariff barriers by India, higher direct trade will be beneficial to Pakistan.

28 The Africa potential

Progress So Far

Pending

The trade potential of Africa is a major whitespace for Pakistan, one which requires focussed attention and effort.

29 Single customer exposure limit

Progress So Far

Pending

The SBP is considering a change in Prudential Regulations which would significantly impact the maximum amount a bank can lend to a customer. The proposed regulation seeks to club associates and to aggregate customers and suppliers for determining the Single Customer Exposure Limit (SCEL). Thus, for example, groups co-investing in a project such as coal mining and power generation in Thar, will be deemed to be a single borrower, even for projects where they are unconnected. Industries such as fertilizers, which rely on a utility company such as SSGPL for gas which is the major part of their inputs will be clubbed with the utility company. Distributors and vendors, mostly in the SME sector, stand to be aggregated with their principals for SCEL. At a time when the economy is stressed and the need is to invest, this change in Prudential Regulations will be unhelpful.

SECTION 04

About PBC

The PBC is a private sector business policy advocacy forum composed of Pakistan's largest businesses / groups including multinationals that have a significant investment in and a long-term commitment to the growth of Pakistan. Members turnover represents every ninth Rupee of Pakistan's GDP and together the members contribute 25% of the annual tax revenues and exports. More information about the PBC, its members and its activities can be found on our website www.pbc.org.pk

The PBC's Member Companies

International Industries Ltd. Promising Reliability, For Now and Tomorrow

INDUS GROUP of companies

TOYOTA INDUS MOTOR COMPANY LTD.

JDW Group

JS BANK

Jubilee INSURANCE

KE Energy That Moves Life

K&N's

KSB

LOTTE

LUCKY CEMENT

Martin Dow

MAHMOOD GROUP

MEGA MEGA CONGLOMERATE

MILLAT TRACTORS LIMITED

National FOODS SINCE 1970

NAVEENA GROUP

Nestlé

NISHAT MILLS LTD

ORIX

PACKAGES Limited

pakarab FERTILIZERS LIMITED

PEPSICO

PSL PAKISTAN SERVICES LTD.

PSX PAKISTAN STOCK EXCHANGE LIMITED

ptcl

PAKISTAN TOBACCO COMPANY

PHILIP MORRIS INTERNATIONAL

Qarshi

rb

SAIF GROUP

Sapphire

Shan

SICPA

siddiqsons LIMITED

SIEMENS

Soneri Bank

SOORTY

HUTCHISON PORTS PAKISTAN

Standard Chartered

SPEL

TAPAL

TCS

telenor

Tetra Pak PROTECTS WHAT'S GOOD

TPL Holdings Tomorrow Delivered Today

Tufail Chemical Industries Ltd.

UBL where you come first

Unilever

The PBC Members by Sector

PBC currently has 81 members, whose businesses cover nearly all sectors of the formal economy. The sector wise representation (in alphabetical order) is detailed below:

Sector	Member Companies
Large-Scale Manufacturing	
Agro Industries	1
Cement	2
Chemicals / Fertilizer	8
Energy	2
Engineering	8
Fast Moving Consumer Goods	17
Packaging Material	2
Pharmaceuticals and Healthcare	6
Textiles	10
Total Members in Large-Scale Manufacturing	**56**
Services	
Financial service	12
Hospitality	1
Insurance	2
Logistics / Courier	2
Telecommunication	2
Utilities	1
Total Members in the Services Sector	**20**
Conglomerates	**5**

28 MNC's from 13 Countries

USA

UK

UAE

Switzerland

Japan

Netherlands

AkzoNobel

engro foods

Unilever

France

HBL

Bahrain

faysalbank

South Korea

LOTTE

Norway

telenor

Hong Kong

HUTCHISONPORTS PAKISTAN

Germany

SIEMENS

Sweden

PROTECTS WHAT'S GOOD™ Tetra Pak

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