POLICY BRIEF

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Trade Liberalization and Fiscal Management of Pakistan: A Brief Overview

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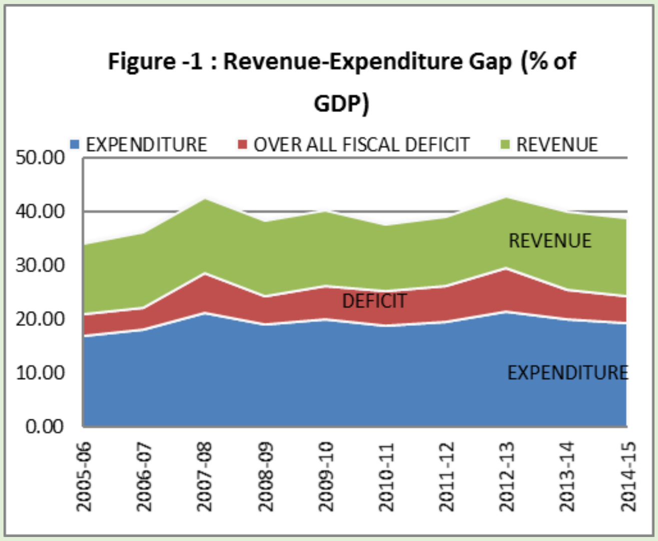
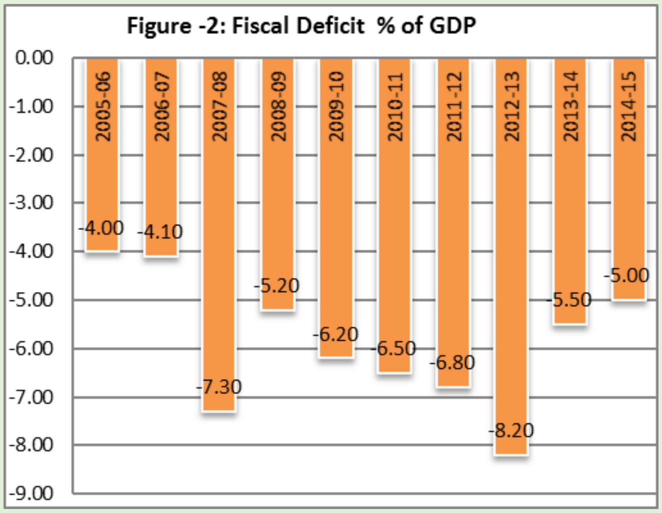
The world is rapidly transforming into a global village and trade liberalization has gained exceptional attention from various developed as well as developing economies. In this era of globalization, developing economies are facing new fiscal revenues challenges and they are forced to change their traditional revenue collection methods under the headship of World Trade Organization (WTO), International Monetary Fund (IMF) and the World Bank. Following the developed countries, the developing countries are also decreasing their tariff rates from last three decades under the instructions of WTO, IMF and World Bank. However, developing countries are still confused how to compensate rising government expenditures with low domestic and tariff taxes. Throughout its economic history, trade policies were continuously modified in Pakistan. Trade policies lead the reduction in slabs of tariff to 4 % in 2016 which were 17 % in 1995. The main focus of government is to enhance the productivity of private sector which further increases the efficiency and competitiveness of domestic industry in the process of exports promotions in Pakistan. In this concern, government has provided tariff cuts on machinery imports, tax holidays and other fiscal incentives to domestic exporters. Reduction of trade tax due to trade liberalization created the problem of revenue loss in Pakistan and the share of customs duty has reduced from 43% to 7 % during the last three decades due to worldwide liberalization policies (Figure-3, Figure-4). Developing countries use number of policy options to incorporate the fiscal revenue losses due to trade liberalization. With regards to this, Pakistan has adopted a number of tax reforms, administrative measures to improve domestic revenue collections.

Fiscal policy is an important part of economic framework, it can play an important role in influencing the economic direction of the country as it can bolster economic growth and human development through efficient utilization of resources and prudent expenditure management. After global financial crisis of 2008, the sound fiscal policies with prudent expenditure management has become an important part of the policy debate among policy makers. The prudent expenditure management not only accommodates shortfall in revenues, creates buffers but also helps in easing pressures on public finances. Managing fiscal deficit in Pakistan has always remained an overwhelming task together with unexpected high government expenditures. Due to unfavorable climatic behavior along with security situation posed, serious threats to fiscal sustainability efforts. Pakistan has been facing continuous fiscal deficit on an average 5.2 % of GDP and 9.2 % of tax-to-GDP ratio from early 2000's (Figure-2), which is 30% higher than that of developed economies. The existing fiscal imbalance in Pakistan causes lower domestic saving and investment, lower tax to GDP ratio, impeding growth performance. Because of these fiscal imbalances, Pakistan's government is unable meet the demands for public utilities and other social welfare activities.

When the present government came into power in June 2013, it particularly focused to balance the external account, contract the fiscal imbalance (Figure-1, Figure-2), contain the inflationary pressure, revive the economy through short term policy measures by resolving all structural issues. Government's efforts started to reap the benefits as evidenced from initial gains in macroeconomic recovery. Over the years, Pakistan has faced formidable challenges on fiscal front due to inefficient utilization of resources and ineffective expenditure management strategy in the wake of less efficient tax system and unplanned expenditures.



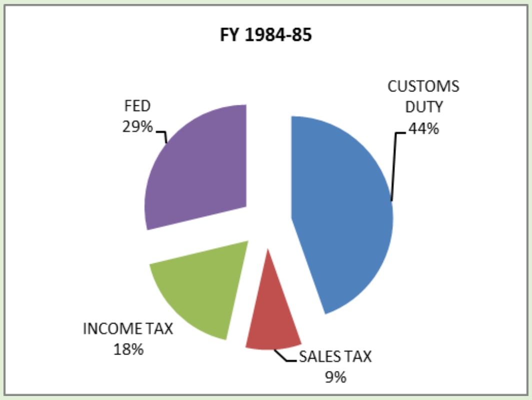
Source: Economic Survey of Pakistan, 2014-15



Source: Economic Survey of Pakistan, 2014-15

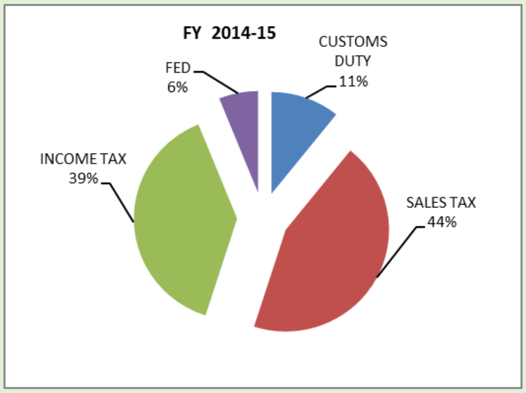
Taxes are the most important source of public revenues and fundamental to strengthen the successful functioning of the government. In this regard, strengthening resource mobilization is imperative for designing an efficient tax system which can promote inclusive growth, encourages good governance, ensures the delivery of public services and promotes social justice. Inefficient tax system in developing countries has long been a major concern. Pakistan has also witnessed numerous tax policy challenges to establish efficient tax system. Resultantly, narrow tax base lead not only lower tax to GDP ratio but also posed serious threats to fiscal sustainability. Despite the increase in tax revenues in absolute term, FBR tax to GDP ratio varied between 8.5 to 9.7% during the last 10 years. However, to achieve the fiscal sustainability, the present government is stringently focusing on wide-ranging resource mobilization strategy with an aim to increase the tax to GDP ratio to 15 % in next few years (Figure-3 and Figure-4). Pakistan is facing fiscal issues due to its heavy trade taxes, just like other developing nations, so it must cope with important fiscal issues in domestic taxation system. Although trade liberalization is attached with some fiscal revenue costs, but these costs can be recovered with the help of proper and strong fiscal policy.

Figure 3: Share of Federal Taxes



Source: Economic Survey of Pakistan, 1987-88

Figure 4: Share of Federal Taxes



Source: Economic Survey of Pakistan, 2014-15

Table-1 Tariff Structure, Custom Duties, Effective Rates and Trade Openness

Year	Max-Tariff-Rate (%)	Net-Customs-Duties-(Rs.Millions)	Share-of-CD –in-FBR-Revenue-(%)	Effective-Rates(%)		Trade-Openness %
				Dutiable-Imports	Total Import	
1987-88	150	38,001	50.1	53.6	33.8	28.3
1988-89	125	42,362	47.0	48.0	31.2	29.4
1990-91	125	50,528	45.7	53.7	29.5	30.3
1991-92	90	61,821	44.2	46.4	26.9	33.2
1993-94	80	64,240	37.2	38.3	24.9	29.7
1994-95	65	77,653	34.3	35.7	24.2	30.7
1997-98	45	74,496	25.4	22.0	17.1	30.2
1998-99	35	65,292	21.2	18.4	14.0	29.1
1999-00	35	61,659	17.8	17.8	11.6	25.5
2000-01	30	65,047	16.6	16.8	10.4	27.7
2002-03	25	68,836	14.9	15.8	9.6	28.0
2003-04	25	91,045	17.5	14.5	10.1	28.5
2004-05	25	115,374	19.5	13.3	9.4	32.0
2005-06	25	138,384	19.4	13.1	8.1	32.8
2006-07	25	132,299	15.6	13.1	7.1	31.2
2007-08	35	150,663	14.9	11.7	6.0	34.9
2008-09	35	148,403	12.8	11.1	5.4	31.1
2009-10	35	160,273	12.1	12.5	5.7	30.5
2010-11	35	184,853	11.9	12.7	5.6	30.5
2011-12	35	216,906	11.5	14.1	5.6	30.5
2012-13	30	239,459	12.3	15.1	5.7	29.9
2013-14	30	242,810	10.8	14	5.4	28.5
2014-15	25	279,765	11.8	10.8	6.0	29.0

Source: i) Pakistan Economic Surveys (various issues)
ii) Year Book (2010-2015), Federal Board of Revenue.

Table-2 Exports Imports at Current Prices in Millions

Year	(Rs Millions) Current Prices	
	Exports	Imports
2000-01	539,070	627,000
2001-02	560,947	634,630
2002-03	652,294	714,372
2003-04	709,036	897,825
2004-05	854,088	1,223,079
2005-06	984,841	1,711,158
2006-07	1,029,312	1,851,806
2007-08	1,196,638	2,512,072
2008-09	1,383,718	2,723,570
2009-10	1,617,458	2,910,975
2010-11	2,120,847	3,455,286
2011-12	2,110,605	4,009,093
2012-13	2,366,478	4,349,879
2013-14	2,583,463	4,630,521

Pakistan Economic Surveys (various issues)

Key Findings

Like other developing nations, Pakistan has experienced significant difficulties in recovering revenue losses of trade taxes with domestically collected taxes. Developing nations are using number of other policy options to recover the losses of revenue due to trade liberalization. Therefore, the tax collectors should focus on administrative measures to enhance the tax collection performance in Pakistan. Following the given empirics, it may be concluded that: The experience of trade liberalization in Pakistan has increased the overall welfare and quantum of trade and consumer surplus as well (Table-1). Trade diversion in the economy has improved the trade balances at international level. Trade liberalization policies along with improved macroeconomic policies may contribute positively in tax reform policies of the economy. There is tax friendly atmosphere and sufficient tax capacity in Pakistan which can help fiscal and monetary policies to recover the loss of revenue due to trade liberalization within span of 2 years.

Pakistan has involved in customs tariff reforms and experienced significant difficulties in recovering revenue losses from tariff tax with the help of domestic taxes. The most important factors in this regard are: (i) agricultural sector economic activities are exempted from all domestic taxes in Pakistan; (ii) mostly there is unskilled labor force with low wage rate that is exempted from income tax in Pakistan; (iii) weak administration, poor accounting standards and low educational attainment / high illiteracy rates in Pakistan. So, there a is need to adopt long-term strategy to hit real goal of the tax policy such as simplicity, reduced economic distortions in the allocation of resources, or distributional considerations.

Policy Suggestions

- Under the existing macroeconomic environment, trade liberalization increases the trade volume and enhances consumer surplus (Table-2). Therefore, it is very crucial for federal government to implement liberalization policies in the presence of other macroeconomic issues such as budget deficit and fluctuating exchange rate. Trade liberalization in the form of tariff reforms in Pakistan has increased the overall trade and welfare of consumer which has 1 to 4 % share of GDP.

- Pakistan has sufficient potential to absorb the reduction of tariff shocks. So, it is suggested that trade liberalization is helpful for improving the domestic tax collection through changes in political atmosphere, tax friendly environment, better control over terrorism and improvement in Law & Order situations.

- Pakistan has less efficient tax collection system and inappropriate fiscal policy measures. There is need of hour that more efficient tax administrations and result oriented fiscal policies may decrease Pakistan's dependency upon trade tax revenue which further boost trade liberalization.

- Economists and policy makers support gradual trade liberalization instead of one-time trade liberalization. The gradual liberalization of trade has some political as well as economic reasons. If the existing trade reforms are not providing reasonable adjustment, then it is unlikely that sufficient trade liberalization would take place in Pakistan. Trade liberalization with immediate response has some gradual adjustment steps. If the partners of international trade agreements want to increase the credibility of trade liberalization, they must announce different trade reforms with the passage of time.

- Federal Board of Revenue brings frequent changes in domestic tax structure of Pakistan; so that simplicity and certainty can be brought in the existing tax structure. If complications are introduced in tax system which may create difficulty for practitioners and taxpayers and less amount of tax revenue would be collected.

- The main issue with the tax policy formulation process in Pakistan is that in reality it is not working well at all; current practices do not match with international standards. In every year, most stress is given to potential revenue enhancing measures at time of new budget by FBR and the Ministry of Finance, while paying little attention on deeper admired comprehensive reforms of domestic tax system. There are several reasons for this state of affairs, but the most important single reason is the lack of government interest on the importance of tax policy within the portfolio of federal government policies.

- At present, the roles of FBR and the Ministry of Finance regarding tax policy formulation is not well defined. Policy stands are often reactive rather than proactive: It would appear that many of the changes made to the tax legislation during last few years are due to external pressures of IMF, WTO and the World Bank rather than FBR and the Ministry of Finance. The changes made to the tax laws would appear to be considered and pushed forward by different departments at the FBR. There has been a lack of an explicitly designed vision or strategy for tax policy reforms.

- There are some internal pressure groups which create disturbance while implementing the domestic tax laws in Pakistan. So, the government should control these groups for national interest and economic development.

Disclaimer:

The views in the Policy Brief are solely those of the author(s)' own understanding and should not be reported as representing the views of the Department of Economics, University of the Punjab.

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