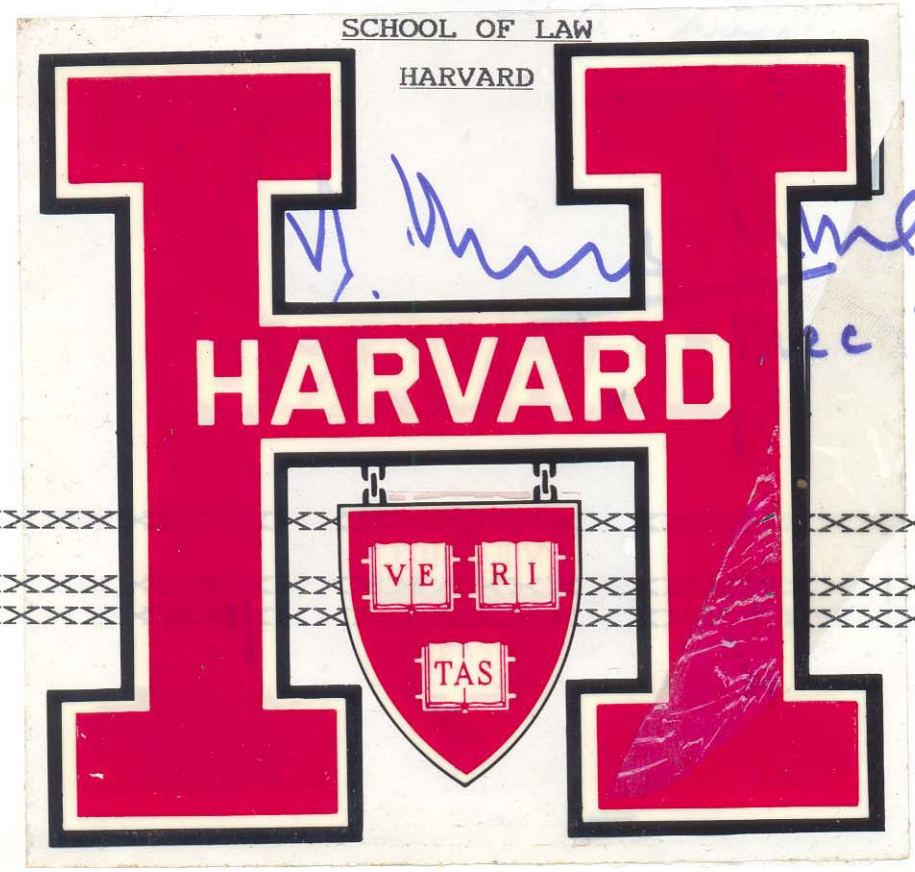
A critical appraisal of the scheme of fiscal incentives incorporated in the Pakistan Income Tax Code

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1 9 8 5 - 8 6

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Mohamad Sabih,

This is an excellently organized, elegantly written paper. Except for a few small notes, I have little to offer but praise.

After glancing through it, would you return it to me so that I may make copies of it?

P.S. – It looks as if you spent too much time on this. Perhaps you would care to expand on this a little & call it your 3rd paper assignment.

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A critical appraisal of the scheme of fiscal incentives incorporated in the Pakistan Income Tax Code.

Muhammad Munir Qureshi

1:00-PAKISTANS TAX PROFILE. *1

Income Tax in Pakistan is a Federal Tax.The Law governing the charge of Income Tax and Corporation Tax is codified in the Income Tax Ordinance of 1979 which supersedes the (Indian)Income Tax Act of 1922 as adapted in Pakistan through Act XI of 1947.

Resource mobilization remains a primary objective in the levy of Income Tax.Of increasing significance however, is the provision of incentives through deliberate manipulation of the Income Tax Law as it ~~impacts on~~ effects selected categories of taxpayers.

The scope of fiscal measures expressed through the direct taxation of Income is limited however, by the extremely narrow tax base.This is apparent from the fact that direct taxes contributed only 13% of aggregate govt. revenues in fiscal 1984-85- down from 25% in 1949-50 and 17% in 1979-80.What aggravates the 'narrow base enigma' is the continueing exemption for income derived from agriculture.Thus, while the agri. sector contributed 25% to the GNP in 1983-84 the federal exchequer received nothing by way of income tax.

That the Income Tax base is indeed narrow is further highlighted by the fact that there were ~~less~~ fewer than 1 million taxpayers nationwide in 1985-when the total population (65% of which is still in the rural-largely agricultural-areas) approached 100 million.

The basic system of corporate income tax in Pakistan has been fairly stable over the years with an income tax of 30% and a super tax of 30% on profits.(Reduced to 55% overall in 1983).

The maximum rate of personal income tax has been reduced from 97% in 1958 to 75% from '61 thru '64, to 70% from '65 thru '75 and 60% in '83 The 'zero bracket' exemption limit was Rs 2,500 in 1948, Rs 6,000 in 1957, Rs 12000 in '74, 18000 in '83 and 25000 in '85. *2 (How much in US $?)

Income tax evasion remains widespread and it has been estimated that the actual yearly collection is about 50% of the potential amount.

In relation to tax base income taxes in Pakistan have been estimated to have had an 'elasticity co-efficient' of 1.52 over the period 1952/53 to 1963/64 and 0.83 over '72/73 to '79/80. *3

*2 - This would be equal to (Approx) $(U.S.) 1,563 = (in 1985).

Sources:

*1 Govt., of Pakistan Taxation Structure of Pakistan 1980-81 P 20-1
Govt., of Pakistan Pakistan Economic Survey 1984-85
*3 Viqar & Amjad The management of Pakistans economy 1947-82-OUP 1984

1.01

INTEGRATION OF FISCAL INCENTIVES WITH THE ECONOMIC DEVELOPMENT STRATEGY. AN OVERVIEW

Since 1947 the economic development program of Pakistan can be seen to have passed through various 'phases' with a specific 'bias' evident in each such phase.Broadly speaking, the 'package' of fiscal incentives #2 put to use in a particular period reflects an endeavour to help facilitate achievement of the specific objectives that have priority in the growth strategy for that time frame.

The first phase in Pakistans growth strategy can be seen to extend from 1947 to 1958.The outstanding feature of govt. policy in this period was a pre-occupation with building up industrial infrastructure As part of the effort to promote industrialization, a variety of fiscal incentives were put into play.These included accelerated depreciation allowances, tax concessions on industrial profits and exemption for capital goods from customs duties.

Gross monetary investment in the private sector increased from Rs 515 Million in 1949-50 to Rs 1030 Million in 1954-55.The largest increases were recorded in Industry, Urban development and Traders stocks.As against this,public sector investment lagged behind remaining at about half the private sector level.

Phase-2 would be over the period 1960-65.This is also the period of the **second five year plan** and the underlying theme of the growth effort in this phase is illustrated through adherence to the doctrine of **'functional inequality'**, ie a belief that in order to build up savings and create entrepreneurial dynamism, a significant inequality in incomes is a necessary evil in the initial stages of western style (capitalist) economic development.As Pakistan openely 'aped' the western model class inequality was tacitly accepted as 'unavoidable'. **The pro-industrial bias'** in policy continued and the fiscal concessions made avaiable in phase 1 were extended to phase-2 with the significant **addition of a 'tax holiday' scheme** providing an across the board exemption from income tax for specified industries set up in the less developed areas of the country.The accent thus

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#2 The Management of Pakistans Economy 1947-82
Viqar Ahmad & Rashid Amjad Oxford Univ Press 1984 Pp 65-104

was not only on industrialization per se but rather on the geographical dispersal of industry consistent with the pursuit of "balanced economic growth."

The Tax Holiday concession devised in 1959 continued till 1972, when it was abandoned. Although it became a controversial measure it offered nevertheless a significant fiscal concession and showed the seriousness of the government's resolve to aid "new industry."

Private Sector investment in this period amounted to Rs 3662 Million in 1963-64 and Rs 4198 Million in 1964-65 yielding a percentage increase of 14.64. The largest increases were recorded in Manufact-uring, transportation, housing and agriculture - in that order.

A major change in development strategy took place in 1965 with the implementation of the third five year plan. This change was evident in the emphasis now placed on the development of intermediate and capital goods industries as against consumers goods industries and, what was much more important, a heightened awareness of the need to bolster the agriculture sector. The latter came to pass not in the natural course of events but through the compulsions of repeated disastrous crop failures.

The fiscal concessions package contrived for the third plan in the context of Income Taxes, showed no radical departure in content from what was already being implemented on the launching of the third plan except that the concessions were now targeted to the selective expansion of industries geared to agriculture and exports. Accelerated depreciation allowances and tax holiday continued to be the principal features of the fiscal package.

Gross fixed capital formation in this period was indicated at Rs 3231 Million in 1964-65 and which increased to Rs 3493 Million in 1969-70. As against this public sector investment amounted to Rs 2831 Million in 1964-65 and increased to Rs 3342 Million in 1969-70. In the private sector investment the largest increases were recorded in manufacturing, transportation and housing.

The first radical change in policy since 1947 came in the early '70's when a new govt., that did not espouse a capitalist or quasi capitalist economic development philisophy, came to power. It

made its intentions clear by firstly, devalueing the rupee in may 1972.This measure had the effect of cancelling the 'subsidy'the industrialists had hitherto received as a result of the overvalued exchange rate.Secondly, the abrupt increase in the procurement prices of agricultural goods was clear manifestation of the determination to change the pro-industry anti-agriculture bias of the growth strategy adopted in the past.The private investor was no longer viewed as the principal vehicle for promoting industrial development. The State now came to play a direct role in the establishment of 'basic industry.'A wide array of industrial units were nationalized and fiscal measures came to focus more on 'resource mobilization' and less on'tax relief'.

For the first time in 1972-73 Gross Fixed Capital Formation in the Public Sector overtook the Private Sector Capital Investment setting a trend that increased sharply in magnitude in the following years.The significance of this reorientation of policy is evident from the fact that whereas in 1972-73 capital formation in the public sector amounted to Rs 3920 Million against Rs 3726 Million in the private sector, by 1976-77 public sector investment stood at Rs 18642 as against Rs 9215 Million only in the private sector.Thus public sector capital formation had recorded an unheard of increase of 471% over the period 1971-72 to 1976-77 whereas private sector capital formation in the comparative period had increased only by 157%.Also in this new 'era' the much touted tax holiday scheme was withdrawn (in 1972) the experiment, begun in 1959, having clearly failed to yield the desired results.*1

The current phase, begun in 1977 with the dramatic collapse of the Peoples Party Govt brought in its wake, once again, a reversal of policy.The private sector came back in favor and a fairly attractive package of fiscal and non-fiscal incentives was gradually assembled in order to promote private investment in industry.The income tax component of this 'package' will be looked into in depth in the next section.

*1 : See Section 1.03 for details in this context.

1.02 #3

The scheme of fiscal incentives in the Income Tax Ord., 1979.

The Income Tax Ordinance of 1979 supersedes the Indian Income Tax Act of 1922 as adapted in 1947 in Pakistan by Act XI of that year. The Ordinance of 1979 is essentially an attempt at rationalization of the body of Income Tax Law codified in the Old Act as it was widely recognized that repeated 'amendments' incorporated therein had made it cumbersome and difficult to comprehend.The new Ordinance was however, a departure from the past in that it incorporated some of the fiscal incentives introduced by the new Govt., that had come to power in 1977, designed to revive private industry.
In this section we examine, in some depth, the variety of fiscal incentives as these find mention in the Ordinance."Amendments" incorporated in the Ordinance through 1983 are also examined.

a) **Depreciation:**
Since 1947,a key element in the fiscal package has been the allowance for depreciation.Such an allowance has traditionally been allowed for the use in business of **wasting assets**.However, it is the acceleration of the ordinary depreciation allowance that makes it a significant fiscal incentive for it enables a qualifying business to minimise tax liability or even avoid it altogether not only for the current year but for succeeding year(s) as well -depending on the type and magnitude of the investment made.
The legal sancion for the depreciation allowance under the Ordinance is available in Clause (V) of sub-section (1) of Section 23.Such allowance is available for **buildings, machinery, plant, furniture or fittings**.The amount of the allowance itself is to be calculated in accordance with the stipulations made in **The Third Schedule** to the Ordinance.Normal (Ordinary) depreciation is allowable under clause-2 of the Third Schedule.The rate of such Ordinary depreciation ranges between 5 and 30 percent for different classes of assets.
A noteworthy feature here is the 100 percent depreciation allowed as Ordinary for **below ground installations in mineral oil concerns.**
Clause-3 allows multiple shift depreciation. However, the really

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#3 (Repealed) Income Tax Act 1922 (ACT XI of 1947 -amended-
Pakistan Income Tax Ordinance 1979 (XXXI)of 1979 Finance Ordinance 1980 thru '83
Income Tax Law S A SALAM 1984-85

important part of the depreciation provisions in the context of acceleration are contained in **Clause**-5 that incorporates a special incentive ~~incentive~~ in the form of **initial depreciation** allowed in addition to the normal 'ordinary ' depreciation.Such initial depreciation is admissable at the rate of 25 per cent for residential buildings forindustrial labor as against 10 % for other buildings. On **machinery** (other than ships or motor vehicles not plying for hire) the rate of initial depreciation is also 25%.An added incentive here is that where a 'new' industrial undertaking commences commercial production after 1st July 1981, initial depreciation is admissable at 40%.In such cases the total depreciation allowance can add up up to 60%- assuming multiple shift operation.

As a result of an amendment made to the Ordinance through the Finance Ordinance of 1982 **Clause (cc)** was added to the Third Schedule which permits scheduled banks and financial institutions to claim initial depreciation at a rate of 40% of the written down value on machinery and plant leased out by them.This is a somewhat novel arrangement whereby the bank or financial institution instead of loaning funds on interest leases out machinery and plant equipment bought by it and earns lease money thereon.Ultimately the lessee will buy out the assets.Till such time the lessor only claims depreciation as the owner of the equipment.Lease money received is assessable separately in terms of section 30 (2)(d).

It is important to point out here that under the law presently in in vogue the sale price realized on the disposition of any depreciable asset is directly deductible from the last written down value on record and any losses resulting from the sale are ignored (ie not recognized) till such time as the entire class of assets to which the said asset belonged have actually been sold and there is an overall loss on the sale.On the other hand any gains made on disposition are immediately recognized.As a result it is possible that an asset having been rapidly depreciated as a consequence of acceleration may, before the time it is sold, end up with a written down value of zero or with a WDV that is lower than the amount realized on the sale of that asset.Sich a situation is quite conceivable given inflationary conditions and the manner in which

the accelerated depreciation provision operates.Thus it is possible that the incentive of accelerated depreciation be actually defeated-unless ofcourse an organization keeps on adding new plant and machinery.As against this, under the provisions of the repealed Income Tax Act of 1922 (Act XI of 1947) if the sale of an asset resulted in a realization that was less than the Written Down Value then an additional 'terminal allowance' was allowed to the taxpayer in terms of section 10(2)(vii) of the repealed Act.If the disposition resulted in a realization higher than the WDV then the 'extra' depreciation that had caused the WDV to fall so sharply was brought to tax-but only to the extent of the depreciation that had been allowed originally.There was thus a 're-capture' of the 'extra' (accelerated) depreciation allowed.Where no depreciation had been claimed on an asset the excess amount realized over the original cost was not subject to tax.

Under the present law therefore, the taxpayer may end up worse off both if has suffered a loss on disposition and also if he realizes a gain as in the first case the loss may not be immediately recognized (till the entire 'class' of assets to which the asset sold belongs has been disposed off) and in the second, the gain is brought to tax immediately as Ordinary Income and not as a Capital Gain (which infact it is).

Ostensibly the objective of the whole arrangement is to block possible 'speculative' sales of depreciable assets but, as has been pointed out above, an anamolous situation can concievably arise for the taxpayer with consequences that would effectively negate the 'incentive' aspect of the accelerated depreciation provision.

(b) Hundred percent 'expensing' of all expenditure(including capital expenditure) in the first year of operation, in specifically designated activities-

This is a significant fiscal concession and the aim is to promote business related scientific research (clause (xii) of Section 23(1) the setting up of any educational institution or hospital in Pakistan for the benefit of the employees or their dependants (Cl (xiii) and the setting up of any institue for the training of industrial

workers provided the said institute is recognized by the Federal Government or any local Authority.The object here is to promote the building up of infra structure in education and medical facilities.Normally investment in these areas is expected from the Government.Where a comercial establishment or industrial undertaking takes an initiative in this context the Govt., through the provisions referred to above, would in effect be providing a subsidy by foregoing the tax on income equal to such expenses. This incentive can also be spoken of as a **'tax expenditure'**.

(c) INCENTIVES TO PROMOTE SAVINGS & INVESTMENT

In order to promote savings a whole range of incentives are provided. These are contained in sections 39 through 46 of the Ordinance. Collectively,they form the 'Investment Allowance.'
First,there is (in section 39) the **allowance for life Insurance Premium paid.**The rationale behind the allowance is not only to encourage a middle class earner to provide for the future of his family but more significantly to encourage capital formation.This is made possible by the fact that the bulk of the insurance premium is colected by the State Life Insurance Corporation.This Corp. is a major investor in the country, investing in the share capital of various companies approved by the Controller of Insurance.However the allowance here is subject to certain conditions.Thus if the annual premium paid exceeds 10% of the sum assured no relief is admissable on the excess.The object here is to defeat possible manipulation of the provision by say taking out a policy payable after 12 months and claiming relief on the entire sum assured.Another requirement prevents recognition of assurance where te policy is surrendered or paid up within 36 months.Also, if the premium or proceeds are payable outside Pakistan, the allowance cannot be claimed- even by a person 'ordinarily resident' in Pakistan.
Section 40 of the Ord. provides for an alowance for moneys contributed to a provident fund (whether the fund has been set up for public or private employees) Prescribed rules require that the fund so mobilized be invested in Government Securities.This is obviously to thwart any speculative use of the fund.

Section 41 of the Ordinance provides for an allowance on account of investment made by **non-company taxpayers** in specified areas including the share capital of approved Pakistani investment Companies and (approved) Pakistani Industrial Public Companies **provided** the allotment of shares is made directly by these companies.A minimum holding period of three years is prescribed for all such investments **except** Invest., Corp., of Pakistan Mutual Fund Certificates and shares of approved companies.The allowance facilitates mobilization of capital by the Invest., Corp of Pakistan and the approved companies referred to above.Also the hlding period requirement prevents early encashment of 'open ended'certificates.

Incentives to encourage retention of the shares of public companies and certifcates of Mutual Funds by the investor include exemption of dividend income upto Rs 15000= from income tax.Furthermore, capital gains realized on share transactions stand exempted under the Second Schedule to the Ordinance.Also, the realized value of Defence Savings Certificates is exempt from income tax.

A blanket exemption from income tax to the profit made from investment in various savings schemes introduced by the Govt., encourages channel~~ization of~~ funds to these schemes by the small investor. However no rebate from tax is allowed on the original investment in these schemes.Only the profit stands exempted.

Section 42 of the Ord., treats the cost of 'books' (relevant to a profession or business) as part of the Investment Allowance. This allowance is applicable to companies also.

Section 43 provides an allowance to non-company taxpayers investing in Pakistani Industrial Public Companies owned atleast partially and managed ad controlled, directly or indirectly by the Federal Government.

Section-44 provides for tax relief on ~~any sum~~ paid by an individual who is not entitled to any pension benefits, to secure a contract of annuity with the State Life Insurance Corp of Pakistan or the Pakistan Post Office Life Insurance Deptt.**Section 44A** has been specifically provided to enable professionals not having the benefit of a providend fund or a pension scheme to secure an annuity.

Note:

* **Section 45 limits** the total investment allowance (section 39 through 44) to a maximum of 1/3rd of the Total Income or Rs 50,000- whichever is higher.

With a view to encourage liberal donations for education and char -itable institutions the govt has made it possible for a taxpayer to donate even his entire income and yet enjoy an exemption from tax on the entire amount.This is possible through the machinery of section 47 of the Ord.However the law requires that the recipients of such 'largesse' be approved institutions.One such approved recipient is the QuaideAzam Memorial Fund.

The major incentive for exports from the income tax side is the 55% rebate on income tax and super tax payable.Almost all categories of exports qualify for the rebate except raw cotton and a few other specified items.Exports also receive generous concessions on the indirect taxes side (customs duty & sales tax) so that the aggregate fiscal incentives package plays a vital role in consolidating their competitive position internationally.That the encouragement provided has paid of rich dividends is evident from the fact that Pakistans exports have increased from Rs 1700 mill in 1969-70 to Rs 10,286 mill in 1974-75 and to Rs 37,339 in 1983-84.Thus Pakistani exporters have not only got over the 'shock' of the loss of the East Pakistan market but have been able to make significant inroads in larger and much more competitive markets.

The "export" of manpower has, since the mid seventy's, been an increasingly important source of hard currency.The remittances from Pakistanis employed abroad, especialy the middle east, now is in the region of 5 BILLION DOLLARS (U.S.) annually ie both from official and unofficial channels.Remittances are now the single most important category of foreign exchange earnings for the country and have partially compensated the loss of foreign markets for traditional Pakistani exports due to stiff competition from South Korea, Taiwan and India.However this area has not recieved the attention that it deserved.Much of the Rupee equivalent of the remittances has been dissipated in conspicuous consumption and in real estate creating significant inflationary pressures.There is a pressing need for structuring of effective incentive measures to ensure the channelization of these funds into meaningful investment. The problem assumes heightened significance from the fact that avenues for employment in the middle eastern region are becoming more limited by the day caused partly by declining oil revenues due to a fall in the price of crude and increasing military budgetary requirements resulting in much reduced outlays for the developmental projects of the type on which most of the Pakistani manpower has been engaged

(d)

SPECIFIC INCENTIVES FOR THE CORPORATE SECTOR:

(I) Partial exemption for Industral profits.

Specified industrial undertakings viz those engaged in manufacturing, processing, shipbuilding or the generation and supply of energy are allowed an exemption from tax equal to 10% of the capital employed provided the undertaking is new and does not employ plant or machinery previously used in Pakistan for business purposes.Also , the undertaking must not have been formed by the splitting up or the reconstruction or reconstitution of business already in existence.

The requirement that 'all' the machinery employed in such an undertaking be used for the first time in that unit in Pakistan is clearly unreasonable as it would disqualify an undertaking employing even nominally any machinery previously used in Pakistan.It is hardly realistic to debar an undertaking in so drastic a maner.As for determining the amount of capital employed for purposes of calculating the allowance some discretion is available to the assessing officer which conceivaly could create complications in some situations.

The exemption from tax is available in the first five years of commercial production.If the profits are not adequate to cover the

exemption no deficit can be carried forward.This can defeat the intent of the legislation as after availing the benefit of accelerated depreciation allowance very few undertakings would be disclosing significant profits in the first two or three years of operation. The benefit of the legislation would thus be lost for this period as against the five years contemplated by the statute. Section 48 of the Ordinance controls this exemption.

(II)A TAX CREDIT FOR BALANCING, MODERNIZATION AND REPLACEMENT OF MACHINERY—and also for extension of plant capacity.

Section 107 allows a tax credit at 15% of the cost of machiery and plant installed for balancing, modernization and replacement of the equipment in use in an existing industrial facility.The credit is allowable in the year of installation of the machinery and not in year in which commercial production commences.Any unabsorbed tax credit can be carried forward to two subsequent years only. Although no separate approval of the C B R is required here, the requirements of rule-42 have to be satisfied.These require a certification from the Director of Industries as to the category of machinery intended to be installed.Bureaucratic red tape can create problems here especially as the said official has no direct liaison with the tax deptt, and moreover is under no legal obligation to issue such a certificate.Valuable time can thus be lost simply in persuading the Director that the machinery is intended for a use covered by the exemption statute.In actual fact every conceivable practical situation is already covered by the exemption and it is dificult to visualize any other reason for use of such machinery. It may be pointed out here that no such certificate is required for preferring a depreciation claim for the machinery.

(III)

A Tax Credit for companies investing in the share capital of other Pakistani Companies.

Under section 106 of the Ord., a tax credit is available to companies investing in the shares of other Pakistani companies. Ofcourse the investment has to be made in approved companies. The tax credit is available at 30% for the so called underdeveloped areas viz Baluchistan, the Tribal Areas, the Northern Areas, Azad Kashmir and at 15% for the rest of the country except Karachi, Lahore and Faisalabad for which areas no credit is available.The minimum holding period for such shares is five years otherwise the relief is liable to be withdrawn.In case the undertaking does not disclose positive income the credit can be carried forward for any number of years.

There seems to be no compelling reason for providing for the holding period of five years.Once a 'share'is purchased its subsequent sale on the stock market does not amount to 'dis-investment'. The holding period requirement thus does not appear to be rational. Another anomoly here is that the credit is only available from the date of comencement of comercial production.The relevant rules require that the undertaking issuing the shares give a firm date in this context.If for any reason it is subsequently not able to adhere to the schedule announced any credit already allowed to an investing company is liable to be withdrawn.This appears to be patently unfair insofar as the investing company has no means to foresee any delay in commencement of production and can only rely on the schedule and projections given in the feasability study. Withdrawal of the credit under these circumstances would clearly appear to be an unwarranted penalty on the investor.

(IV)

Tax Rebates.

Under the first schedule rebates in 'super tax' (also called Corporation tax) are allowed to certain companies.Thus there is a rebate of 5% merely for getting a company listed on the stock exchange.This is to encourage the liqidity of stocks and thus

provide an incentive for investors to hold shares and consider them convertible into cash at short notice.Additional rebates of of 5% are allowable to such companies the paid up capital plus free reserves of which do not exceed Rs 500,000.If these exceed half a million rupees but do not exceed one million, a rebate of 5% will be admissable only if it also owns an industrial undertaking.

If the original cost of the fixed asets, excluding land, owned by even a private Pakistani company, does not exceed Rs 5000,000 it will still be entitled to a rebate of 5%.

A rebate of 10% is allowable to a Pakistani company on profits and and gains derived from processing, freezing, preserving and canning of food, vegetables, fruit, grain, meat, fish and poultry.

A rebate of 15% is allowable on the income, profits and gains earned abroad and remitted into Pakistan.

(V)

Item 80(c) Second Schedule: This sub-clause exempts totally dividends of new public companies distributed out of the profits of new industrial undertakings. The exemption is available for the first five years starting from the year of commercial production.

(VI)

Items (7) & (8)-the second schedule:

Pakistani companies have frequently to employ foreign technical personnel in the first few years of a new industrial undertaking equipped with sophisticated modern technology.However approval from the State Bank and the Commissioner of Income Tax has to be obtained.The remuneration received by the foreign person so employed will then stand exempt from tax for three years.In case the period of employment exceeds three years another concession is is available in that tax paid by the employer on his salary will not be treated as a perquisite.Industrialists may thus be able to to negotiate favorable salaries for the foreign personnel employed by them.This will obviously impact favorably on their cost of production.

(VII)

Other incentives for the corporate sector include an exemption for all capital gains arising from the disposal of movable assets. The exemption holds good for the assessment years 1975-76 through 1988-89.A tax credit of 50% is available on the amount invested by Pakistani companies in the shares and debentures of of the Equity Participation Fund.The entire income of an investment company registered under the Investment Companies and Investment Advisers Rules 1971 stands exempted from Income Tax.Also, the income of a registered company equal to the face value of bonus shares issued by it stands exempt from 1977-78 through 1987-88. This is another concession aimed at enlarging the capital base of companies.Furthermore, Dividend income declared and paid by public companies registered between 1st July 1978 and 30th June 1982 out of its profit for any income year ending on or before 30th June 1982 is exempt and the Dividend Income received from Public Companies engaged in an industrial undertaking and registered between 1st July 1978 and 30th June 1983 is exempt for a period of five years beginning from the year in which commercial production commences.For Tax Holiday companies falling in this category the concession has been extended for a further five years through the 1983-84 budget.Finally, inter-corporate dividends are taxed at a reduced rate of 5% in the case of Public Companies and at 15% for foreign cmpanies.For private companies the rate is 20%.

(e)

INCENTIVES TO ATTRACT FOREIGN CAPITAL.

(I)

The Tax Holiday Scheme.

The first 'experiment' in giving a tax 'holiday', begun in 1959 ended in 1972.In 1977 the 'holiday'was revived though ofcourse in a modified form.As per the new scheme, a blanket tax holiday is allowed to all new industry starting comercial production uptil the 30th June 1988 for a period of 5 years, located in Baluchistan, certain areas of the frontier province and Azad Kashmir.
A tax holiday has also been allowed to certain specific industries

irrespective of their geographical location.In this context priority has been given to agro-based industry especially that engaged in the manufacture of agricultural implements, poultry farming and dairy farming.Industry with an export potential such as that engaged in garments manufacture has also been included here.Such 'holiday' is also available to the data processing industry.
Besides the above, a tax holiday has also been granted to an industrial undertaking located in an 'industrial estate' approved by the C B R located in the so called 'less developed ' areas of the country.Also, the holiday applies to companies set up between 1st July 1981 and 30th June 1985 and engaged in the exploration and extraction of specified minerals.

(II)

THE EXPORT PROCESSING ZONE, KARACHI.

Industry set up in this zone will enjoy a blanket exemption from income tax for five years.This includes an exemption for the income of any foreign personnel employed in the industry.The exemption is further extendable by govt.,depending on the initial performance. Also, any capital gains realized on sales of assets and shares also qualify for the exemption.

(III)

Other incentives for foreign capital include an exemption from income tax to interest paid (a) to a non-resident on a private loan ~~utilized~~ on a govt approved project in Pakistan;(b)by an industrial undertaking in Pakistan under an approved agreement with a financial institution in a foreign country;(c)on money borrowed abroad (with the prior aproval of the govt) for purchase abroad of plant and machinery; (d) to an agency of a foreign govt or an approved foreign national for loans made to the Federal Govt, or to other persons in Pakistan under an approved arrangement; and (e)by the authorized banks in Pakistan on their foreign accounts .

1:03 CRITICAL EVALUATION.

An important objective of fiscal policy in Pakistan has been to increase the savings rate so as to be able to channelize funds into invest -ment on a magnitude that would ~~impact~~ effect decisively on the overall growth rate of the economy. It thus remains to be seen now how far the fiscal concessions offered so far as discussed in 1:02, have been successful. In the context of economic development strategy, capitalist philophy has traditionally relied on high concentrations of income in society chara -acterized by marked inequality of income distribution, to release entrepreneurial leadership and finance for investment in the early stages. Pakistan, relying on the western 'model', sought to duplicate the western economic experience by tolerating concentration of income #4 in a few hands and even encouraging it so as to build up the level of investment in the initial period of development. From 1947 through 1969 the private sector was looked up to as the 'engine of growth' in Pakistan. Liberal credit and a variety of fiscal incentives fueled the 'engine' while savings (surpluses) generated were recycled back into investment (atleast a part thereof) and the 'arrangement' sustained the sector and even gave it a degree of dynamism. Gross domestic saving that amounted to 4.6% of the GNP in 1949-50 rose to 6.8% in 1954-55, 12.2% in 1964-65 and a high of 12.5 in 1969-70. Gross fixed investment in this period amounted to 4.6% of the GNP in 1949-50, 7.9% in 1954-55 21.1% in 1964-65 and 15.6% in 1969-70. Of the aggregate gross fixed inv -estment private sector investment amounted to 72% in 1949-50, 72% again in 1954-55, 54% in 1964-65 and 52% in 1969-70. The significant role of the private sector is further made evident by the data for Domestic Fixed Capital Formation which goes to show that the private sector contributed 39%, 54% and 52% in 1959-60, 1964-65 and 1969-70 respectively, of the total gross domestic fixed capital formation which rose from Rs 2014 Mill in 1959-60 to Rs 6746 Mill by 1970.

*See note-3 Page 20-

In the post 1970 period when a reversal of national policy took place and the private sector lost its pre-eminent position, private sector investment declined to 5.6% of the GDP in 1972-73 and to 5.2% in 1976-77. Gross domestic savings also fell in this period from a high of 12.5% of the GNP in 1969-70 to a low of 5.6% of the GDP in 1974-75. Of the aggregate gross fixed investment the private sector contri -buted 49% in 1972-73, 32% in 1974-75, 29% in 1976-77 and 34% in 1981-82.

#4 Rashid Amjad Industrial Concentration and Economic Power in Pakistan Univ., of the Punjab Lahore 1974
L White Industrial Concentration & Econ Power in Pakistan Princeton 1974

The 'revival' of he private sector in 1981-82 paralleled a reversal in national policy in 1977 when the left leaning Pakistan Peoples Party was replaced by a rightist Military Govt., that scorned the socialist leanings of the govt., it replaced.

From the data given above it is apparent that the private sector did infact respond positively to the incentives it received over the period 1949-50 to 1969-70.How much of this 'response' can be correlated statistically to the package of incentives bearing on income tax and Corp., tax is a question whose answer can only be inferred and that too in very general terms given the constraint of data limitations.

A study made in the 70's concludes that the tax 'holiday' scheme #5 which was an important fiscal concession over the period 1959 -1972 cost the exchequer upto Rs 1293 Mill.At the same time the 'holiday' itself resulted in a high degree of concentration of economic power and encouraged the formation of uneconomic units.The highest benefits accrued to those industries which were already earning very high profit margins and in terms of a greater regional balance the effort was minimal.The tax holiday per se was seen to have motivated investment in only 20% of the cases and most of the investment took place in the relatively more developed regions of the country -where ofcourse the holiday was for a shorter period.

The tax holiday scheme was revived in 1977.In its operation over the period 1977-83 it has been seen that the investment actually made in tax holiday areas constituted 14% of the total investment in this period, 71% of the investment so made has been made in areas that are not the most underdeveloped in the country.Further, the 'approved' investment in tax holiday units constituted 26.1% of the total approved investment.Also it has been observed that the actual realization of investment in tax holiday industries has been 22.8% as against 41.6% in non tax holiday areas.

It is probably too early to comment on the effectiveness of the 'revived' holiday.However tentatively, it appears that the response so far, is at best, lethargic.

Probably the single most important factor in the fiscal incentives package discussed in section 1:02 has been the accelerated deprec-

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#5 B A Azhar-Tax Holiday for Indus. Develop -An evaluation Pakistan Economic Journal 1973-74 Pp 72-85

Viqar & Amjad-The Management Of Pakistans Economy 1947-82 O U P 1984 Pp 272-3

iation allowance.It is almost impossible , because of data constraints to quantify precisely the actual impact but the significance of this concession is evident from the fact that given multiple shift operation a new industrial undertaking can expect to recoup its entire capital investment in the first 3 to 5 years. Together with the additional concession of partial exemption of income that would be available in most cases, the impact of the allowance is further enhanced.However it needs to be pointed out here that the nature of the operation of the depreciation allowance has created an inducement to invest in industries that are relatively ' capital intensive.'This has not only aggravated the unemployment problem but has contributed significantly in turning the terms of trade against the agriculture sector in the country thus adding to the stagnation in that crucial area of the economy.At the same time it has to be recognized that there is really no truly 'appropriate' technology for a developing country.The best technology that is available has got to be imported and that happens to be capital intensive.It enables eficiency in production enabling a developing country like Pakistan to maintain a competitive posture #6 internationally and to convert the technical efficiency of the imported machinery into significant investible surpluses thus making possible a 'second round' of investment.The solution to the enigma here is therefore, not easy.

In the post 1977 period two of the most significant fiscal incentives appear to be the B M R Credit (for Balancing, modernization replacement and extension of existing plant capacity) and the partial exemption of income.During 1977-78 to 1981-82 a total investment of Rs 12.8 Mill was approved for the areas entitled to partial exemption of income.This constituted 33.5% of the total Invest.Out of this, investment amounting to Rs 3.90 Mill, constituting 28.9% of the approved investment actually materialized.

As for the B M R Tax Credit, available statistics reveal that the total number of industrial units availing the credit increased from 130 in 1979-80 to 167 in 1981-82 with credit amount indicated at Rs 103.77 (Mill) in 1979-80 and Rs 135.16 (Mill) in 1981-82.

While the B M R Tax credit appears to be an extremely important fiscal incentive it has been observed that in practice more and more

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#6 N Kaldor Strategic Factors in Econ Dev Ithaca 1967

units are making increasing use of the credit for the extension of existing capacity.The problems created by the existing high concentration of industry in many industrial towns have thus been aggravated. Taking cognizance of his trend the credit was withdrawn for existing industrial units located in the developed regions of Karachi, Hyderabad, Lahore and Faisalabad in 1983-84.

Foreign capital has not so far shown much inclination for investing unilaterally in large scale industrial ventures.In the early years lack of necessary infrastructure inhibited such movement. Later, an adverse political climate (1970-71 to 1976-77) in which the threat of nationalization loomed large, prevented foreign venture capital from moving in.A more favorable climate for the foreign investor now obtains and especially with the negotiation of several Double Taxation Avoidance Treaties and various fiscal concesions an improved response can be expected.

1:04

CONCLUSION.

Fiscal incentives, especially accelerated depreciation allowances and, in the post 1977 phase, the B M R Tax Credit do appear to have had an impact on both the quantum and type of investment.In general, these have encouraged investment in relatively large scale capital intensive projects.While such incentives are not the 'only' determinants of investment, however, insofar as they impact on the overall profitability of an enterprize they do enter into investment decision making.It is necessary though, that the govt., monitor on a continuous basis the operation of these incentives so that any attempt at 'exploitation' of an incentive (as happened in the use of the tax holiday incentive in the period 1959-1972) be checked and defeated in time.It is also imperative that a concerted effort be made to enlarge the tax base significantly.The present narrow base would appear to deter structuring of effective incentive measures as such incentives impact unfavorably on resource mobilization.

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NOTES:

1.Because of deficiencies in the data base, especially for the 1950's, the statistics compiled by govt agencies have to be interpreted cautiously.For the 1950's the data as collated by the Central Statistical Office(the CSO) with regard to gross fixed investment for all sectors was based mainly on a 'commodity flow method' and that was an important reason for deficiencies creeping in.Some sector estimates even today, as for te non-monetized investment in agriculture, may still be considered as 'rough approximaton.'

2.The macroeconomic identities of key variables cited in relation to savings and investment (Section 1.03 p-16) are clarified as under:

GrossFixed Invest=Gross domestic savings plus external resource balance(i)

External resourc e balance =Imports of goods and non-factor services minus exports of goods & non factor services.(ii)

Gross domestic savings(as %ofGDP)= Gross Fixed Invest minus external resource balance. (iii)

Gross national savings(as%ofGNP)=Gross domestic savings plus net factor income from abroad (iv)

Gross fixed investment=Gross national savings plus external resource balance minus net factor income from abroad.(v)

3.The observation that the private sector responded 'positively' to the incentives received by it does not ofcourse mean that the response was 'adequate'.Infact, the overall savings rate in Pakistan has never been consistent with the requirements for "take-off."(See W Rostow "Stages of economic growth for details of "stages" in econ develop) but rather has been deficient by atleast 10% at the best of times.

4. .The declining elasticity coefficient refered to in section 1.01 means that the income tax structure is, over time, losing its ability to 'mop up' significantly the incremental additions to revenue that ought to result from expansion of the tax base as a sequel to normal economic growth.

5.The fact that private industry has received preferential treatment in Pakistan should not be taken to mean that agriculture has been completely ignored.Infact the continueing 100% exemption from income tax on all income arising from agriculture is in itself an indication of the 'sacrifice' that the federal exchequer has been forced to make in terms of revenue foregone.Furthermore, direct subsidies for key agri inputs and support prices for agri produce have been an almost permanent feature in Pakistan.Also land reforms by rationalizing the size of land holdings and improving therby the lot of the peasantry have all resulted in improved agri productivity.At the same time however it is true that all that has been done has not been enough. Perhaps a crucial"mistake" made has been the dissociation of the

agricultural sector from the industrialization experience of the rest of the country.Agro-based industries have never received the attention they deserved and thus the self re-inforcing"feedback" (from agriculture to industry and vice versa) necessary for the "**symbiotic growth**" of these two sectors has been lacking leading inevitably to the isolation and stagnation of the agri sector.

6.The ability of (West)Pakistans industry to find alternate markets abroad after the secession of the eastern half of the country in 1971 is an achievement whose significance is often ignored.That together with the 'fortiutous' (considering the time period) employment of thousands of Pakistanis in the Middle East in the mid-seventies and continueing till the present day surely saved what remained of Pakistan from imminent economic collapse.Although the government played a significant role in facilitating developments, it goes to the credit of the private sector that it was able to rise to the occasion and seize opportunity as it arose often in a highly competitive, and even at times, hostile, environment.

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