Aspects of Fiscal Policy and Resource Mobilization in Pakistan

by

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INTRODUCTION

The meaning of "domestic resource mobilization" has become centred on two major statistics: the share of saving and the share of tax revenue in G.N.P. This rather specific and narrow view of "resource mobilization" has led to a variety of results, most of them unhealthy from the point of view of designing meaningful economic policy to promote economic development. Development is identified with capital formation; capital formation is attributed to saving; and, with the government undertaking an increasing share of the leadership in promoting development, saving has become identified with government saving, which is, in turn, identified with increased taxation. In Pakistan, the identification of the tax and saving problems has been going on for some time, with emphasis on the fact that Pakistan has relatively low ratios both of gross domestic saving and of central and provincial taxes to gross national product. While the figures are open to some question, the average gross saving ratio in recent years has been between six and nine per cent[1], and the combined share of central and provincial taxes in G.N.P. has been six to eight per cent[2]. Both of these ratios are low when compared with other developing countries, and the "effort" to raise these two ratios has become a measure of the country's desire to "help itself" toward economic development.

In this paper, I have raised some questions concerning policy notions treasured by analysts and aid-givers alike which seem to ignore some of the central problems of fiscal policy as it relates to economic development.

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[1] *See*, Stephen R. Lewis, Jr. and Mohammad Irshad Khan, "Estimates of Noncorporate Private Saving in Pakistan, 1949-1962", *Pakistan Development Review*, Vol. IV, Spring 1964, especially pp. 18-23.

[2] *See* A.H.M. Nuruddin Chowdhury, "The Weight of Tax Revenue in the Pakistan Economy", *Pakistan Development Review*, Vol. III, Spring 1963, p. 104.

There are also discussions about the specific directions government policy ought to follow. However, the main emphasis here is not on the specific suggestions that are discussed, but rather on the approach that must be taken in discussing *any* fiscal measures. There is a tendency to regard sectors of the economy, and, therefore, policy measures related to various sectors, as independent of one another. I have tried to suggest in Section II a framework for analysing problems of public policy that keeps in view the interdependence of the different sectors of the economy. Section III contains a discussion of determinants of the rate of domestic saving and some considerations in framing public policy to raise the domestic rate of saving. Section IV outlines some of the major factors to be examined in designing a tax policy to encourage more rapid economic growth. The most important point in the paper is the need for a "general equilibrium" approach to policy alternatives. I hope that a somewhat reorganized way of approaching these familiar policy problems will be useful.

II: SOME OBSERVATIONS ON SECTORAL INTERDEPENDENCE

In much of the material, official and unofficial, Pakistani and foreign, written on the subject of "resource mobilization" and fiscal policy, some very simple but important interrelationships have been ignored. The remarks that follow here could hardly be called a "model", but I hope they may be of use in evaluating policy alternatives.

It is incorrect to think of domestic saving, and its second cousin, domestic taxation, as the only "resource" to be "mobilized" for economic development. Investment in plant and equipment, social overhead capital, *etc.*, are not the only sources of economic development. The matter of skilled manpower, managerial ability, business acumen are also important, if unquantifiable. But even if one limits the discussion of resource mobilization to those items that appear in the national-income accounts of a country, one must think of the *ex ante* interdependence of those items. In particular, one must look at the interrelations among investment and saving rates, tax rates, imports, and exports. In addition, the allocation of investment, not merely the rate of investment, is an aspect of the problems that tends to be forgotten until regional, sectional, or departmental interests become involved. The rate of capital formation (known by that wonderfully descriptive term "size of the plan") cannot be separated from the allocation of investment or from the availability of resources complementary to physical investment. Nor can the rate of external assistance be viewed solely as a substitute for internal saving; it must also be viewed as a substitute for exchange earnings and a complement to domestic saving and other domestic resources.

exports and imports; or a measure designed to increase exports might decrease saving or badly distort the allocation of investment. Thus, in the observations made below I have tried to point out how various measures designed to influence one variable may have important effects on other economic variables not directly under consideration.

III: THE RATE OF DOMESTIC SAVING

Despite a voluminous and growing literature to the contrary, the rate of capital formation is regarded by most economists or policymakers as the only important variable in the development process. The rate of growth of output is generally taken as directly dependent on the rate of capital formation. If capital formation is increased, the rate of growth of output will increase; if the former is decreased the latter will also decrease. This, of course, leads to the question: what can be done about the rate of capital formation? Since capital formation can be financed from abroad, it is possible to have a higher rate of capital formation than the country could finance by its own resources, at least in the short run. This pattern was followed in most of the more industrialized countries during their early stages of development. However, they also increased their rates of domestic saving over a period of time, leaving them in a position to export capital after some initial period of development. The ability of a country to finance a larger and larger share of its capital formation has been taken as an important measure of the success of development programme. All these considerations lead to the question: what determines the rate of saving, and how can one influence private and public decisions to reach a higher rate of domestic saving?

At the most elementary level, it is argued that an increasing level of per-capita income will result in an increase in the share of income devoted to saving. Thus, if we can only sustain a higher rate of capital formation for some time through external assistance, there is an automatic solution to the saving problem: saving will rise to meet the level of investment as per-capita income increases. However, due to the variety of saving rates that appear in international comparisons of saving and per-capita income, it does not appear that the rate of saving is determined only by the level of per-capita real income. And, it is naive to think that a rising rate of real income will result in a rising rate of saving regardless of how the increase in income comes about or how it is distributed.

Thus, one is led to the next step in the search for determinants of saving rate: the distribution of income. Ever since the classical economists discussed economic development and income distribution, there has been a strong emphasis on the difference between the classes of society (or the owners of factors

of production) in the way in which they dispose of their incomes. The assumptions usually made were that labour income is totally consumed and that income from profits is largely saved. Income from land has been treated separately, usually under the assumption that landlords would consume most of their unearned income by lavish living. There is a mixture of sociological and physiological elements in these assumptions. Since labourers were thought to be at the subsistence level of living in most classical analyses, there was no "potential economic surplus" from which to save. But as far as the capitalists and the landlords were concerned, there seem to have been both sociological and economic elements to the explanation for their behaviour. Capitalists' profits (in a competitive framework) come from greater efficiency, which comes from, among other things, the possession of more advanced equipment. Thus, if a capitalist is to survive, he cannot stand still but must reinvest his earnings to stay ahead of his competitors. Any lavish living will result in falling behind in the arts of production, and in the competitive framework this would spell destruction. Rent, on the other hand, comes from possession of property, and does not depend on improvements made by the landlords, who themselves have no built-in economic motivation to save and invest. Thus, we have a picture that remains throughout the economic literature of high consumption rates at all levels of labour and rental income, and high saving rates at all levels of profit income.

The observed increase in the rate of saving in countries experiencing economic growth has been attributed to the change in the income distribution in these countries from low-saving to higher-saving groups, or a redistribution of income from land and labour income to profits, accompanying the change in industrial structure away from traditional activities toward the industrial manufacturing sector, which is based on "capitalist" principles. Thus, there is an explanation for the rise in the saving rate based on some simple assumptions about the structure of income distribution and the disposal of income within broad categories of income recipients. But this raises a number of important empirical questions. Are there different saving and consumption patterns by type of income recipients? If so, what are the causes of these differences? Does the structural change in production necessarily bring about a structural change in income distribution? What changes does economic development cause in this structure? Finally, a question of more social and political importance: should development be based on increasing inequalities of income and wealth, which seems to be implied by many outlines of development "strategy"?

First, what do we know about the propensities to save from different types of income? Broadly, we know that corporate income is saved at a much higher

average rate than noncorporate incomes, and that property income is saved at higher rates than labour income. Corporate reinvestment-figures are not yet available with any great degree of accuracy in Pakistan, but scattered evidence that is available suggests an average rate of corporate saving of sixty to seventy per cent. A second category of income recipients is unincorporated enterprise, or "small-scale business". These, too, seem to have extremely high ratios of saving to income[3]. The rate of saving in the country is much lower than the rate of saving in the business sector (both corporate and noncorporate) so that the average rate of saving in the nonbusiness sector must be very low. This is certainly consistent with the findings of more detailed studies done in other countries.

Second, why is there a different proportion of income saved out of business and out of nonbusiness incomes? The most obvious answer would be that the business income is received by the rich, while nonbusiness income is received by the poor. But I think this is a very incomplete picture, since there seem to be higher rates of saving by individuals with business income than by individuals at comparable levels of nonbusiness income. It is necessary to look at the incentives for saving and the structure of saving and investment in order to understand why these groups have different saving patterns.

In the early stages of economic development, there are only rudimentary capital markets. One result of this is that the sectors or subsectors that save are also the sectors or subsectors that undertake real investment. There are limited kinds of debt instruments, and very poorly developed financial intermediaries, monetary and nonmonetary. Since, as mentioned above, there is great pressure on businesses in any competitive framework to undertake investments, and since there is insufficient demand for their own debt instruments, they undertake to finance investment from their own saving. As development progresses, individuals begin to diversify their holdings of assets and they demand different forms of debt instruments. In such a situation it becomes profitable for financial intermediaries to sell their own debt and to buy the debt of businesses that wish to invest beyond their capacity to save. These intermediaries offer a better investment in terms of risk and liquidity than individuals could achieve by loaning to businesses directly. Businesses have an increase in the resources available to them at lower rates of interest than if they had to borrow directly from individuals. Thus, the capital markets become more developed, the saving and investment functions become more specialized, and there is a greater flow of resources among sectors and subsectors.

[3] Such data as are available in systematic form are found in G. Ranis, *Industrial Efficiency and Economic Growth: A Case Study of Pakistan.* (Karachi: Pakistan Institute of Development Economics, 1961).

corporate saving might not change. But such a measure would remove the incentive now built into the tax system to use more imported goods in the production of goods for domestic use. Profit in an economic sense performs an economic function. But profit based on privileged position is not "profit" but "rent". So long as profit is based not on producing efficiently (when measured by social costs) but rather on access to import licences, then there *should* be a high tax on corporations. But the present system taxes all profits heavily, regardless of their source. The concessional rate of tax on those firms using a large percentage of local raw materials is not large enough to be effective when compared with the possible profit one could reap if one is able to become a licensed importer.

Thus, it is safe to say that the present policies lead to a rate of profit in the corporate sector which both provides incorrect incentives from the point of view of producing output at lowest social cost and inflates the general level of profits in the economy. The latter phenomenon leads to public outrage and to extremely high rates of corporate taxation, which leads to a search for means of evasion and to concession to any industry that can prove itself to be a hardship case. The result is that the incentives provided for pursuit of profit by the current tax system often encourage the use of materials that are most scarce for the economy as a whole. Since this is quite obvious economic nonsense, it seems appropriate to re-examine the notion of increasing saving by increasing the resources available to the corporate sector.

It would be a rational policy to encourage increased capital formation by increasing corporate saving *only* under certain conditions. But if the appropriate changes in the fiscal system could be made, the policy of allowing corporations to retain a larger share of their profits would be a very good one. The appropriate changes in the fiscal system would be *i*) removal of all special tax rates for special circumstances in the corporate sector, *ii*) reduction of the corporation tax rate to either a nominal payment or to zero, and *iii*) increase in the rate of duty on all items of capital goods, intermediate goods and raw materials imported into Pakistan. The effects of these changes would be to lower the pretax rate of corporate profits, but to raise the after-tax profits and raise saving in the corporate sector. In addition, the introduction of the higher rates of duties for imports (for which there should be *no* exceptions) would change the allocation of investment and would change the composition of imports as well. These latter points bear further examination and will be discussed below in a slightly different context.

Imports and Business Saving

One of the contentions that has been made regarding Pakistan's development in the recent past is that the shortage of imported goods has led to both a misallocation of investment and to a reduction in the rate of saving. The argument runs that imported goods are, in general, necessary inputs in most industrial investment-programmes, and the lack of imported goods has frustrated attempts by small and large industrialists to invest. They then either invest in residential housing, which has a small import component and apparently yields very high rates of return, or they choose not to invest at all. And, since most investors in Pakistan finance their investment out of their own saving, there is a lower rate of saving than there would be if imported goods were available.

There is, however, an important aspect of this situation that has generally been overlooked. The "shortage" of imported goods for investment purposes is in many respects an artificial shortage, and much improvement could be made in the existing situation without any increase in the total quantity of imports[4]. The major difficulty now, of course, is that imports are available at low prices to those who get licences. To those who do not receive licences, imports are virtually not available or are available at extremely high prices. If the prices of imported goods were higher, there would be a reduction in the share of imported capital goods and raw materials used in local investment and manufacturing projects.

The increase in prices of imported goods would have several beneficial results. It would promote the use of domestically produced raw materials, intermediate products, and capital goods. There has been considerable discussion of excess capacity in local capital-goods industries due to the impossibility of competing with imports which are "liberally" licensed. An improvement of the competitive position of domestic capital-goods industries would *i*) reduce the import component of investment projects, and *ii*) promote investment in the domestic capital-goods industries. This latter point is important in light of the stated desire of the Government of Pakistan and its Planning Commission to promote the development of a domestic capital-goods industry. The only way in which a domestic capital-goods industry can pay off is when the industry is able to work at or near full capacity. This will be impossible as long as imported capital goods are cheap and are licensed with some "liberality". Under the present circumstances, it is profitable to wait for an import licence rather than to use domestically produced capital goods. The distorted price structure results in

[4] One unfortunate part of the public discussions of "liberalization" is the reluctance to think about simply making the import procedure more rational.

the high import-component of domestic manufactures and a postponement of investment until or unless import licences become available. Raising the prices of imported goods would help correct this costly distortion.

Besides encouraging the development of a local capital-goods industry, it is likely that an increase in the price of imported goods would also increase the amount of investment that takes place with a given amount of imported goods available, since these goods would be allocated on a more rational basis. A further beneficial result would be a reduction in the capital intensity of production processes used in Pakistan.

It is important to remember in connection with the effects of an unequal distribution of income that under certain conditions an unequal distribution of income is self-destructive. Two necessary conditions for a "self-destructive" skew in the income distribution are: *i*) that the relatively rich invest a larger share of their income than the relatively poor; *and ii*) that the investments that do take place are of a "capital-widening" rather than a "capital-deepening" variety. The second condition is necessary in order to provide for an increasing absorption of the labour force into the sector of the economy using reproducible capital and representing higher productivity per worker. It is only when labour begins to become scarce relative to land and capital that the majority of the population which earns its living from labour income can hope to increase its level of wellbeing in absolute and in relative terms. That "capital-widening" investments have not been forthcoming in India and Pakistan has been brought out in two recent studies[5]. The serious implications of this for future income distribution were brought out by John H. Power, and the lessons of the Japanese experience were developed by Fei and Ranis. Since, therefore, the increase in the price of imported capital goods and raw materials would decrease the capital intensity of investment projects and would encourage investment of a "capital-widening" variety, the change in import-price policy is a necessary complement to any policy aimed at increasing the rate of saving, improving the allocation of investment, and reducing the inequalities in the distribution of income.

Saving in the Nonbusiness Sectors

As pointed out above, one of the most important structural changes that takes place in the course of economic development is an increasing amount of "specialization" in saving and investment decisions. As yet there is not a suffi-

5 John H. Power, "Industrialization in Pakistan: A Case of Frustrated Take-Off?", *Pakistan Development Review*, Vol. III, Summer 1963, pp. 191-207.

J.C.H. Fei and Gustav Ranis, "Capital Accumulation and Economic Development", *American Economic Review*, Vol. LIII, June 1963, pp. 283-313.

cient amount of information available about when and how the corresponding changes in debt structure took place in developed countries. Thus, there is little guidance from historical experience for the policymakers of developing countries who would like to speed up the process in an effort to encourage increases in the rate of saving. However, I suspect it is too early in Pakistan's development to expect much of "the middle class" in the accumulation of financial assets from other sectors.

The level and pattern of financial-asset accumulation by the household sector have not been encouraging over the past fifteen years. There has been some switching of financial-asset holdings, with currency holdings declining in importance and other financial assets increasing in importance. However, there has been little, if any, increase in the total annual acquisition of financial assets[6]. These facts are important to remember when diagnosing the problem of how to increase the rate of private saving. Two aspects of the problem, *i*) what constitutes saving, and *ii*) what rate of return or type of asset would encourage more saving at given income levels, are worthy of comment in light of recent discussions by official agencies.

It seems strange, at this late date, to have to point out that saving is saving regardless of the form of assets that are held, as long as the acquisition of the asset represents an excess of current income over current consumption[7]. There is a tendency in some official and banking circles to regard increases in saving deposits as saving, while increases in currency holdings or demand deposits are not regarded as saving. This is, of course, nonsense. If people choose to hold more of their saving in the form of demand and saving deposits rather than in cash hoards (as they have in the past ten to fifteen years) the task of monetary policy will certainly change. But, as noted, there was no change in the total annual amount of financial assets accumulated by the household sector over that period. Thus, there has been no increase in saving associated with the change in the form in which financial assets are held. A policy of promoting branch banking and postal saving in rural areas will not result in any increase in saving *unless* there is a higher propensity to save, or a lower propensity to consume, associated with bank-deposit accumulation than with accumulation of currency. Whether such is the case has not yet been investigated empirically, but Pakistan's experience, as cited above, would not lend support to such a hypothesis.

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Another issue here involves the effect of the rate of return on financial assets on the propensity to save. Proposals have been made to increase the deposit rate one or two percentage points, to issue a six-per-cent government bond, *etc.*, in order to encourage private saving. Again, this might encourage switching of financial assets, but whether it would encourage saving is another question. I suspect that, like so many other problems of economic development, the rate of return required to influence saving decisions would require a "structural" rather than a "marginal" departure from existing practices. Saving by small businessmen may be high because potential returns are high and there are no alternative sources of finance. The introduction of an intermediary that borrowed from the public at 10 to 12 per cent and loaned to the business community (and farmers) at 15 to 20 per cent would be more likely to have some effect on saving (and investment) rates, both by encouraging more saving and making possible more investment. But I think it very unlikely that the marginal changes that have been proposed would result in any measurable increase in the rate of saving out of nonbusiness incomes.

In sum, I think there should be a reorientation of official thinking on matter of encouraging private saving. Too much attention has been devoted to the "branch-banking" approach to saving, and not enough to the question of why saving takes place and what groups do the saving. Too much attention has been given to the bad effects of corporate profits and not enough to the question of what determines corporate profits. Too much attention has been given to the effects of relative income position on the rate of saving and not enough to the effects of relative prices. The question of saving has been isolated too much from the question of imports, import substitution and export levels. The present policies that are supposedly designed to reduce the concentration of income and wealth and promote increases in the rate of saving probably have encouraged income concentration and discouraged aggregated saving. A reversal of this trend (within the framework of a system based on private ownership of the means of production) can only be accomplished by removing the features of the fiscal system that distort the pattern of private decision-making.

VI: TAX REVENUE AND TAX STRUCTURE

When discussing the problem of increasing the rate of domestic saving, economists generally turn, sooner or later, to the solution of increasing the rate of taxation, or the share of tax revenue in G.N.P. Broadly, this is consistent with the "national accounts" view of domestic resource-mobilization, and is misleading as well. Most economists recognize that increasing government saving may decrease private saving, but some have not remembered this in practice. Others have made attempts at specifying the role of the fiscal system

in creating an incentive system to direct private resources toward ends more conducive to rapid economic growth. As yet there is no systematic treatment of the problem of using the government budget to promote economic development by influencing: *i*) the allocation of resources between saving and consumption; *ii*) the composition of final demand; and *iii*) the allocation of investment. While such a discussion is necessary, it is well beyond the scope of this article. My remarks are limited to some observations on the broad structure of the tax system and the lines along which one should move in efforts to improve the budget as a tool of resource allocation.

The broad structure of the revenue of both the provincial and central governments in Pakistan is wellknown. Direct taxes comprise 25 to 30 per cent of total tax revenue, with income and corporate profit taxes contributing 15 to 20 per cent and agricultural land taxes contributing about 10 per cent. The bulk of tax revenue, 70 to 75 per cent, is provided by indirect taxes. In recent years, customs duties have been 20 to 25 per cent of the total, excises 15 to 20 per cent, and sales taxes 15 to 20 per cent. This is broadly consistent with the pattern of revenue in other developing countries, although the share of customs duties is somewhat lower in Pakistan, a fact due partly to a lower ratio of imports and exports to G.N.P.

Much of the literature on taxation in developing countries is devoted to discussions of the pros and cons of direct and indirect taxes. It is often maintained that an increasing emphasis on direct taxes would be desirable, but that such a policy is impossible for administrative reasons. Another view that has received increasing attention in recent years is that perhaps indirect taxes are not so bad after all, and that they should be used as a device to restrain private consumption expenditure and direct resources to private or government capital formation. The latter general view seems to me to be more sensible. The question to be asked is not whether directness and generality is "better" than indirectness and specificity, but what are the effects of given taxes in given situations, what is our evaluation of these effects, and which taxes do we choose after such an evaluation. This is another of the many areas where one should ignore the text books and rely more heavily on analysis of specific situations.

A more elevant set of criteria than the "directness and generality" test would seem to be the extent to which particular taxes are consistent with, complementary to, or substitutes for other government policy measures. The first thought of administrators who are responsible for economic development-policy seems to be "what must be controlled to get this done". Controls, when direct and administrative, often tend to create disequilibrium situations in which

administered prices are different from scarcity prices. The result is either black markets, or bribery, or windfall profits, or a combination of all three.

The tax system can be used as a complement to direct administrative controls by eliminating windfall profits and actually aiding in the rationing process itself. For instance, cement is rationed in the Karachi area at a price of approximately Rs. 120 per ton. But because the available supply is less than the demand at that price, contractors will pay about Rs. 180 per ton to purchase it from those who find it unprofitable to use their own allocation. Here is an obvious opportunity to increase revenue and to improve allocation (and reduce incidence of questionable practices) by the use of the tax system. An additional tax would help create a more nearly equilibrium price, thus reducing the demands of the arbitrageurs for allocation of cement.

A somewhat different role for the tax system as a supplement to direct controls appears when the production and/or consumption of a good is to be discouraged or encouraged. The problem of encouraging import substitution is one in which the tax system has not been used satisfactorily, as has been noted by numerous individuals. I think it is probably true that the licensing system rather than the tax system has been the main vehicle for promoting import substitution in some industries and discouraging it in others. As is well known, the scarcity value of many imported goods in Pakistan exceeds, by a considerable margin, their landed costs plus import and sales taxes. Thus, it is probably true that the system of import duties has very little effect on the allocation of imports among commodity groups. The *import* duties could absorb the very high profit margins of importers without substantially affecting either the industrial composition of imported goods *or the market prices* of those goods. But, as is also wellknown, tight licensing not only inflates profits of licensees, but also creates a protected market for domestic manufacturers. If the domestic consumption of the item is meant to be curtailed, it is necessary then to impose an excise or sales tax on the good's domestic production and sale, as well as on its import. The spectacular growth of the cigarette and the cotton-textile industries in Pakistan without corresponding increases in exports are good examples of the rapid build-up that can be expected in highly protected industries in the absence of domestic tax rates that are effective[8]. Thus, it is important to remember that the structure of import and domestic commodity taxation will influence the choice of industries in which import substitution will take place. This point was raised in the last section but must be mentioned in connection with any review of the tax system.

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[8] *See*, A.R. Khan, "Import Substitution, Consumption Liberalization and Export Expansion", *Pakistan Development Review*, Vol. III, Summer 1963, pp. 208-232.

With these general observations out of the way, I would like to discuss the major types of taxes in light of the considerations pointed out in Section II above: the interrelations between saving, investment, imports, exports and taxation.

Income and Corporation Tax

My opinion of the corporation tax has already been stated in Section III. *If* there is a reform in the system of import taxation and a reduction of the special provisions of the existing tax law based on export performance or on import components of particular industries, the basic rates of corporate-profit taxes should be drastically reduced. I think there is no need to repeat the argument.

The income tax is a much more difficult tax to assess. It has an extremely high exemption level so that it potentially affects only a small percentage of the population in Pakistan. It also exempts a large proportion of the population *at* high income levels by not taxing agricultural income and by granting "earned-income relief". In addition, it has been shot through with special provisions for exemption of income used to pay life insurance premia, for education of children, and so forth. What the resulting tax-base looks like is not at all clear, and would require considerable study before any true evaluation of the existing income-tax law is possible. However, in keeping with my feeling about the inadequacy of any marginal efforts to promote higher rates of saving of the "middle class", I must confess that the existing special provisions seem to me unwarranted. If the government thinks that the statutory rates are too burden-some, it should reduce the statutory rates, not provide special provisions that only serve to make the law more difficult to administer but have little effect on the variables it is trying to influence.

Land Taxes

It is with some hesitancy that an economist raises the question of land taxation, since the subject is so highly charged politically. However, it is only in the context of a complete discussion of economic policy that the role of land tax can be properly understood or appreciated. It has often been stated, but never with any quantitative estimates, that agriculture already bears a heavy burden of "taxation" due to the effects of export duties, adverse terms of trade with the nonagricultural sector (due to protection of manufactures, the imports of PL-480 foodgrains, government procurement-policies for foodgrains, *etc.*), and the overvaluation of the rupee. There is a great deal of truth in this argument. But, once again the problem cannot be approached by examining policies separately. The existence of a variety of other policies that turn the terms of trade against agriculture does not mean that the land tax should be

reduced commensurately. The proper direction of tax policy should be to straighten out the relative price system whenever possible.

Thus, it would be beneficial, in terms of the allocation of agricultural resources, to remove the adverse effects of currency overvaluation, *etc.*, and to raise the level of land taxation across the board. Also, the level of taxation now varies with the type of crop and with the official crop-reports for a given year. The result is that the land tax is like a progressive tax on gross product. It would be more desirable to impose a higher rate of tax on all cultivated land, regardless of crop grown. Such a tax would remove the opportunities for corruption that now exist and would have additional benefits from the economic point of view by encouraging the marketing of crops by all persons in all seasons. The current pattern of indirect levies that transfer income to the manufacturing sector by adjusting the terms of trade between agricultural and manufacturing goods is harmful in its effects on the willingness of farmers to enter the market economy, and it gives an incorrect picture of the state of industrial profits as well. If the reversal of the terms of trade could take place to some extent, this should be accompanied by an increase in the rate of land taxes (and a decrease in the rate of corporate-profits taxation). In terms of the considerations mentioned in Section II, such a policy would not only encourage more saving, but would also provide increased incentive to produce cash crops for export.

In West Pakistan, the problem of water rates should be reviewed and the rate structure rationalized. While in principle the water rate should be treated as a payment for the factor of production, in practice the rates are well below the scarcity value of water and the limited water resources are rationed by nonprice means. The "water rates" are, thus, a nominal charge and are more in the nature of a tax per acre than a fee. The practice of nonprice rationing leaves a number of opportunities for questionable administrative practices, as do most of the other direct-control schemes discussed in this paper. It would seem to me that, once again, the interests of increasing the diversion of resources from the private to the public sector and the interests of a more rational price system that would promote better use of resources (*e.g.*, water) could be served by raising water rates for all crops. There is now a degree of variation in water rates charged depending on the crop grown and its average consumption of water. But since the upper limit of these rates is still considerably less than water's scarcity value for even the less water-intensive crops, the existing price differential probably has little if any effect on farmers' decisions to grow various crops. If the rates were raised one could expect a more efficient use of water as well as an

increase in revenue. Since significant changes are now being made in the entire irrigation procedure in West Pakistan, it would be appropriate to re-examine the water-rate structure as well.

The recent studies of short-run supply response of farmers in the sub-continent[9] suggest that considerable scope exists for using the price system in encouraging agricultural development and in changing cropping patterns to promote exports or provide import substitutes. By selectively improving agriculture's price position and at the same time increasing the land tax, and rationalizing the structure of water rates a substantial improvement could be made in the revenue position of the government, the balance-of-payments position and the entire relative price structure. Many developing countries do not possess an administrative structure adequate to tackle the problems of agricultural taxation properly. Pakistan is fortunate in this regard, and it is too bad that the politics of the situation are such that a sensible programme is so difficult to adopt.

Export Duties

Since the taxation of exports in Pakistan is now the taxation of cotton and jute, this issue must be considered jointly with that of land taxes in agriculture, of export promotion, of currency overvaluation, of special subsidies to industry, and of domestic consumption. Since the jute and cotton export-taxes drive a wedge between world and domestic prices of raw cotton and jute, they reduce the price to the exporter below what he would receive in the absence of export taxes. Since the domestic market price is lower, there is a subsidy to domestic users of raw jute and cotton, namely, to cotton and jute textile manufactures. This means there will also be some reduction in the local prices of cotton and jute manufacture so that in the export tax on raw cotton and jute there is an element of subsidization of the use of cotton and jute textiles. Similar distortions come about due to the overvaluation of the rupee, which is in effect a tax on exports, and which is a subject inseparable from the issue of the export tax.

To the extent that the export tax and the overvaluation of the rupee reduce export earnings, the export tax also affects the use of imports. This is true because (holding external assistance constant) the only way to buy imports is to sell exports; a reduction in exports earnings means a reduction in imports; *ceteris paribus* a reduction in the quantity of imports raises the scarcity value of imports and, in the case of imports on commercial licences, an increase

9 For a summary of findings in these studies, *see*, S. Mushtaq Hussain, "A Note on Farmer Response to Price in East Pakistan", *Pakistan Development Review*, Vol. IV, Spring 1964, pp. 100-103.

in the domestic market-price of imports will take place. Another aspect of export taxation that must not be forgotten is that an export tax is a protective device so long as imports are limited by export-earnings. Prices received by cotton and jute producers should be raised to something closer to the opportunity cost of these commodities to the economy. Since the alternative use of inputs to domestic cotton textile manufactures is as exports, and since exports earn foreign exchange which is used to purchase imports, use of domestic raw materials that could be exported should be regarded as equivalent to using imported raw materials, and should not be encouraged, as is the case under the current system of currency overvaluation and export taxes.

Since the export tax and currency overvaluation are inseparable in terms of their effects on relative prices, they must be considered together in framing a rational tax and exchange-rate policy. The considerations outlined here and those discussed in other sections on the import policy all come to the same conclusion: the disequilibrium price of foreign exchange is quite harmful to the optimal operation and sustained growth of the Pakistan economy. Some policy or set of policies should be adopted that would raise rupee price of exports to exporters and raise the rupee price of imports to importers. There are a number of alternative policies: devaluation of the rupee, removal of export duties and imposition of higher import duties, placing jute and cotton on the export bonus list and simultaneously expanding the list of imports that can be made against vouchers. Extension of the bouns list would in my judgement be the most beneficial of these alternatives, since it would involve more dependence on market criteria for the allocation of imports. However, since the demand for vouchers depends in part on the allocation of licences through the regular system, extension of the bonus list would not accomplish as much as a liberalization of all licensing policies and the imposition of a substantial import surcharge.

Such a readjustment of relative prices of imports and exports would *i*) aid in reallocating agricultural resources toward more socially profitable activities, *ii*) lead to an increase in exports of jute and cotton, which should result in higher export earnings, and *iii*) increase the price of raw jute and cotton to the domestic using-industries, thus placing their resource-use decisions on a more rational set of relative prices.

A strong objection will be raised to the idea that jute production should be encouraged. Despite the extremely unfortunate experience of other developing

countries[10] that have tried to "play the demand elasticities" by restricting output and raising, in the short run, the world price for commodities in which they had a major share of the market, Pakistan has continued implicitly or explicitly to try to restrict production to maintain world market prices. It is generally argued that since world demand for jute is relatively inelastic, it would be foolish to encourage production of jute since it could only be absorbed by a sharp fall in world market prices. But it should be emphasized that the increase in prices brought about two major efforts at substitution in other countries. *First*, industrialized countries have turned increasingly to the use of artificial materials to substitute for jute in packaging, thus reducing the rate of growth of world demand for jute. *Second*, the maintenance of high prices has made the production of jute and allied fibres extremely profitable for other countries. From the late 1940's to the early 1960's, Pakistan's share in the world production of jute and allied fibres fell from nearly 80 per cent to less than 40 per cent. The share of Pakistan's jute in world industrial consumption of raw jute fell from over 60 per cent to approximately 35 per cent[11]. The artificially high price is, among other things, a subsidy to Indian production of raw jute, which is of inferior quality and could not compete effectively if Pakistan would increase her output of high-quality jute.

It seems a much more rational course over the long run to stop placing faith in short-run restriction schemes and to pay more attention to somewhat more orthodox views of government economic-policy. Now that Pakistan is thinking in terms of 1985 as a "planning horizon" it would seem logical to look at the long-run effects of government policies relating to taxes as well.

Import Taxes

Import taxes have already been mentioned as a means of correcting distortions in the price of foreign exchange. The idea of an import-surcharge system to raise the prices of all imported goods to all importers has certainly received adequate attention in Pakistan in recent years. Most economists seem convinced of the wisdom of such a system, and I will not labour the point here. I would only reiterate that there would be substantial benefits from raising the price of imported goods either through a surcharge system, or through major changes in the tariff system, or through an increase in the scope of the export-bonus system, or through devaluation. But it should also be recalled that the

[10] Ghana's experience with cocoa, Brazil's with coffee, Argentina's with beef and food-grains, all suggest that the long-run elasticity of demand for one country's output is considerably higher than the short-run elasticity, since the maintenance of high prices in the short run encourages new entrants who *do* increase supply and drive market prices down.

[11] These figures are reported in *Report of the Jute Enquiry Commission*. (Karachi: Manager of Publications, 1960), pp. 252 and 255.

tariff structure, the structure of domestic sales and excise taxes, the licensing system for imports, and the bonus scheme should be thought of as pieces in the same puzzle. They cannot and should not be treated separately, as they seem to be at present.

Excise and Sales Taxes

These taxes contribute 30 to 40 per cent of total government revenue in Pakistan, yet are the least studied and least discussed parts of the tax system. There is a need for a detailed study of the impact of the indirect tax system, both customs, sales, and excise duties, on the structure of production in Pakistan. If there is liberal licensing and low tax-rates on imports of capital goods, their domestic production will be discouraged in favour of consumer goods. Yet, it is argued, one must maintain low prices of capital goods, otherwise the incentive to invest at all will be hampered. The latter statement is probably not true, since the demand for imported capital goods seems to exceed the supply at current prices. There is excess capacity in the domestic capital-goods industry due to the profitability of waiting for a licence to import cheaper capital goods rather than using locally produced capital goods.

The structure of sales, excise and import taxes should be redesigned to achieve a set of incentives that encourages import substitution in the capital-goods industries *at least* as much as it encourages import substitution in the consumer-goods industries. The licensing system restricts the import of consumer goods drastically, resulting in domestic prices well above the *c.i.f.* price plus import and sales taxes. There is considerable excess profit (or rent) in this situation, both for import licensees and the domestic producers. Therefore, the rates of taxation on imports and on domestic production of tightly licensed goods should be increased sharply. This could be done by increasing the sales tax on both imports and domestically produced goods, or by increasing import duties and excise duties. *Second*, the rate of *import duty* on capital goods and on raw materials should be raised to bring the rupee cost of these items more into line with their social opportunity-cost and eliminate the windfall profits of licence holders.

For any system of increased import duties or surcharges to be effective, all imports and importers should be subject to these duties. Government imports are between one-quarter and one-third of all imports into Pakistan. Government departments must be brought under the system so that they value imports at a higher price than implied by the official rate of exchange without import duties. In fact, of course, the government could institute higher "shadow prices" for foreign exchange without any reform in the private account and should do so without any further delay if it is serious about proper utilization of foreign exchange.

Within the consumer-goods sector, a system of import duties, export duties, and sales taxes should be adopted which would tax more heavily those items that are most obviously consumed by the higher-income groups and tax more lightly those consumed by low-income groups[12]. The present system of duties has tried to move in this direction to a certain extent. But particularly in the field of import duties, the rates on luxury items are not high enough to take up the difference between *c.i.f.* prices and the market price in Pakistan, resulting in large windfall gains and a fertile field for the use of influence in the licensing and sale of these items. The government will have to take a more realistic view of this situation if the set of indirect taxes is to have very much influence on the pattern of consumption, investment and production.

The indirect-tax system is not simply a fertile source of revenue and an instrument of import-substitution policy. Remitting duties on goods exported increases the *relative* profitability of producing for the export market and is a part of any export-promotion plan. The role of indirect taxes in meeting the "saving goal" is less clear. What effect high indirect-tax rates on consumer goods have on the allocation of income between consumption and saving is not known, nor can it be settled in principle. One can argue that the income effect of such taxes is stronger than the substitution effect, so that the rate of saving out of personal income would decrease if heavy indirect consumption taxes were imposed. Or, one could argue just as well that saving would increase. Both positions are *a priori* defensible, and since we have no empirical knowledge of the shape of people's preference functions, the issue cannot be settled. With regard to increased prices of capital goods, however, particularly imported capital goods, the situation is somewhat different. At present, these goods are being rationed by nonprice means, and an increase in their prices would improve the allocation of these goods among the profitable alternatives. This brings us back to the point that the parts of the system cannot be discussed separately: private profitability of investment can be taken as a guide for investment allocation *only* if the set of relative prices facing private investor reflects social preferences. Thus, the correction of the existing set of consumer-goods prices and locally produced capital-goods prices by use of the indirect tax system is an essential complement to the increase in the price of imported capital goods. Only if both are done together will the results of the revised policy be beneficial to the rate and direction of investment.

CONCLUSION

I have no illusion that the field of policies to "mobilize resources" has been adequately surveyed in this paper. The utilization of surplus labour through

12 Similar remarks are spelled out, *inter alia*, by A.H.M.N. Choudhury, *op. cit.*, p. 115.

the rural works programmes is of great potential benefit in Pakistan, and one could devote a great deal of time to a discussion of how to make this programme more effective. The availability of foreign assistance in various forms raises questions about the proper-mix of local and foreign "resources", both human and physical, in an integrated development programme. Manpower training and education are receiving increasing attention in the literature of economic development, but as usual this has had little impact on the policies of many developing countries. In the first two years of Pakistan's Second Plan, the manpower and employment sector had by far the lowest utilization rate of allocations actually made, and was the second lowest sector (behind social welfare services) in expenditure in 1960-62 as a per cent of plan targets[13]. Much has been left untouched in this article even if one takes a reasonably narrow view of "domestic resource mobilization".

What I have tried to do is to examine the two aspects of domestic mobilization, taxation and saving, which receive the bulk of the attention in official documents. I have tried to point up the interrelation of various policy goals and policy instruments facing the government of Pakistan. For the most part, the question of monetary policy has been ignored in favour of examining the fiscal system. Needless to say, monetary policy is not neutral with respect to the variables discussed here, and any serious re-evaluation of the fiscal system must include a re-evaluation of monetary policy as well. In addition, there seems to be a view prevalent that one can go on increasing the total absorption of resources into the government from the tax system and increase the inflow of foreign assistance as well without any adverse effects on the economy. Both of these forces are contractionary in their effect on final demand, and the assumption seems to be that increased government expenditure will always take up the slack, since increased government expenditure is always beneficial. This latter point has yet to be proven. The question of the structure of the fiscal system cannot be separated from that of the total share of tax revenue in G.N.P. and the level and composition of public expenditure. But I hope the comments here suggest some profitable lines along which thinking on the fiscal system in relation to development policy should be revised.

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[13] John H. Power, "Two Years of Pakistan's Second Plan", *Pakistan Development Review*, Vol. III, Spring 1963, p. 128.