

Working Paper # **146**

**Energy and Tax Reforms: Firm-level
Analysis from Pakistan**

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List of Acronyms

APTMA	All Pakistan Textile Mills Association
ECC	Economic Coordination Committee
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
GENCOs	Generation Companies
GoP	Government of Pakistan
GSP	Generalised Scheme of Preferences
GST	General Sales Tax
IMF	International Monetary Fund
IPPs	Independent Power Producers
LCCI	Lahore Chamber of Commerce and Industry
MDGs	Millennium Development Goals
PKR	Pakistani Rupee
PSE	Public Sector Enterprise
SDPI	Sustainable Development Policy Institute
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprise
VAT	Value Added Tax
WB	World Bank

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Abstract

This paper captures the business community's perceptions about key economic reforms particularly in the context of taxation and energy sectors. The main objective of the survey exercise is to gauge the firm-level business appetite for reforms and the type of reform effort they would be willing to support. The survey reached out to 300 firms. These include both formal and informal sector entities across the country. The timing of this survey is important as it was carried out immediately after the 2013 elections. This exercise, therefore, provides a good benchmark against which the people's expectations from the government can be traced as the tenure proceeds. The key findings suggest that trust deficit continues to be a primary reason as to why people evade taxes. The government at the highest level needs to demonstrate fiscal responsibility and accountability which, in turn, will persuade the taxpayers to register and fulfill their liabilities. On energy reforms, the business community was in favour of revising power tariffs to cover full economic cost of generation, transmission and distribution. However, in return, they demanded load-shedding to be gradually eliminated (particularly daytime outages) and load-shedding to be scheduled and announced in time.

1. Background

Pakistan's economic growth in the short run remains under stress due to the ongoing energy crisis and a weak balance of payments. The long run growth potential is also constrained by falling productivity of both labour and fixed capital. The reduced capacity of the state to collect taxes is not allowing public sector development expenditures to support goals towards poverty reduction and MDGs.

The falling value of domestic currency has escalated the cost of imports and debt servicing. Contrary to economic theory, weak domestic currency is hurting the exporting sectors as these remain heavily dependent on imported raw material, machinery and related intermediate inputs.

The loss making public sector enterprises (PSEs) are adding to the challenges of the government. The IMF programme bounds the exchequer to restructure the debts of these entities, improve organizational management and make them worthy assets, which at a later stage may attract private capital through modes such as public private partnerships or a gradual privatization.

Given the recurrent circular debt in the energy sector, the government seems mindful of low levels of resource mobilization, which make it difficult to finance such liabilities. Earlier this year, there had been a debate in the Economic Coordination Committee (ECC) regarding the possible privatization of power distribution companies and transferring their regulatory role to the provincial governments.

A key victim of the low growth equilibrium is the private sector of Pakistan. On almost all indicators exhibited below it remains one of the worst performers across the globe (Table 1). The lack of competitiveness has implied reduced levels of exports. The business community in Pakistan believes that the state has not provided them with essential inputs such as energy for scaling up output and realizing productivity gains. Furthermore, there seems to be a perception that the lack of savings and investible funds may be due to corruption, burden of taxes and lack of property rights protection (PC 2011).

Table 1 Pakistan: State of Private Sector

Indicators	2012-13 ¹	2013-14
Global Competitiveness Index	124/144	133/144
Private sector productivity	91	92
Technological Readiness	118	118
Business Sophistication	78	85
Exports % of GDP (rank)	136	144
Irregular payments & bribes	119	123
Property rights protection	116	123
Quality of power supply	126	135
Paying Taxes ²	166/189	166/189

Source: Global Competitiveness Reports, Cost of Doing Business Survey (WB)

¹ Ranking out of total 144 countries

² The cost of doing business database provides data on 189 countries.

Despite all these challenges, the private sector's hopes from the PML-N government are high. They are upbeat about the possibility of foreign direct investment and remittances from abroad – materializing into essential injections that can kick start the economy. The award of GSP plus status by European Union has also motivated some to move to higher levels of economies of scale particularly in the textile sector. There is an ongoing debate on the privatization of public sector enterprises, trading opportunities with neighboring countries (particularly China and India) and energy cooperation with Afghanistan, Central Asia, and Iran.

The two game changers will be the deadlock in domestic security situation and post-2014 milieu in Afghanistan. Both the factors will continue to impact businesses and their productive capacities in Pakistan. In this milieu we expect that the two key reform efforts that can produce a win-win situation for the government and private sector are energy and taxation-related corrective measures. From the viewpoint of the latter, energy reforms may bring firm-level output back to the pre-energy crisis levels seen before 2007. For the government, a revival of firm-level growth and output can imply that it can push for progressive tax reforms and thereby finance its expenditures better.

2. Objectives and Methodology

This paper captures business community's perceptions about key economic reforms particularly in the context of taxation and energy sectors. Our aim is to gauge the firm-level business appetite for reforms and the type of reform effort they would be willing to support. We provide a disaggregated analysis by firm-type in order to identify pockets of reform opportunities.

The timing of this survey is important as it was carried out immediately after the 2013 elections. This exercise, therefore, provides a good benchmark against which the business community's expectations from the government can be traced as tenure proceeds. There is a newly-signed and more stringent programme with the IMF under which the government is bound to increase the tax to GDP ratio as well as power and gas tariffs.

Both the moves now seem inevitable given the pressures on fiscal deficit, domestic borrowing and exchange rate. However, a critical question we answer in this paper is whether and by how much people are willing to embrace the painful adjustments in both reform areas. There are specific questions in this survey exercise which probe firms' willingness to pay taxes and electricity tariffs, which reflect full economic cost.

The survey was conducted in seven districts drawn from four provinces. These districts include Faisalabad, Hyderabad, Karachi, Multan, Peshawar, Quetta, and Rawalpindi. We were able to collect a data on 200 firms having a mix of both female and male entrepreneurs doing business in both rural and urban areas of the above-mentioned districts. We also collected data on 100 informal sector firms. However, for the ease of understanding our results, the analysis on informal sector firms has been documented in a separate section below. Table 2 provides district-wise split of sample size.

The sample size for each province has been derived from firms (formal sector) registration database disaggregated by province, available with the Securities and Exchange Commission of Pakistan. Once the control weights from provincial disaggregation are available, the sample is further split into seven sub-stratums (districts). In each sub-stratum, ratio of urban and rural respondents follows

sample division as observed in Pakistan Social and Living Standards Measurement Survey. In line with the percentage observed in the national income accounts, allocation was ensured for both commodity producing sectors (agriculture and industry) and services sectors. In both sectors, firm selection was randomized in a manner that responses from both small and medium enterprises (SMEs) and large-scale entities could be collected. The ratio of SMEs versus large-scale entities, however, varied depending upon the district being surveyed. We used employed labour as a criterion for determining the firm-size.

The informal firms were interviewed on the same region and area coordinates as identified for the formal firms, however we have a reduced overall sample size for this sector. Our primary reason is the underlying assumption that there are tractable links between the formal and informal sector (Chen 2007, ILO 2013). The limitation here is that in reality and particularly in the case of countries facing internal migration, such as Pakistan, assuming the same proportion of provincial and district-level firms in the formal and informal sectors may not be entirely correct. However, in the absence of a recent survey of informal enterprises in Pakistan we have resorted to the same proportion for both sectors. Interviewing mode in this exercise was face to face on-site interviews.

Table 2 Composition of Sample Size

Provinces	Districts	(Formal Sector)	(Informal Sector)
Punjab	Faisalabad	30	15
	Rawalpindi	30	15
	Multan	30	15
	Total sample size of Punjab	90	45
Sindh	Karachi	30	15
	Hyderabad	30	15
	Total sample size of Sindh	60	30
Khyber Pakhtunkhwa	Peshawar	30	15
	Total sample size of KPK	30	15
Balochistan	Quetta	20	10
	Total sample size of Balochistan	20	10
Total Sample Size		200	100

The next section highlights the business community's major expectations from the newly-elected government followed by sections on the importance that our respondents attach with tax and energy reform in the country. A separate section provides analysis on responses from informal sector firms. We try to conclude by giving an understanding of how business community's perceptions about reforms should be corrected and they may be better explained about stakes in the economic reform process. Such an understanding should help in preparing them for the adjustment, which is required at the macroeconomic level to address the ballooning fiscal deficit, rising government debt and pressures on domestic prices and exchange rate.

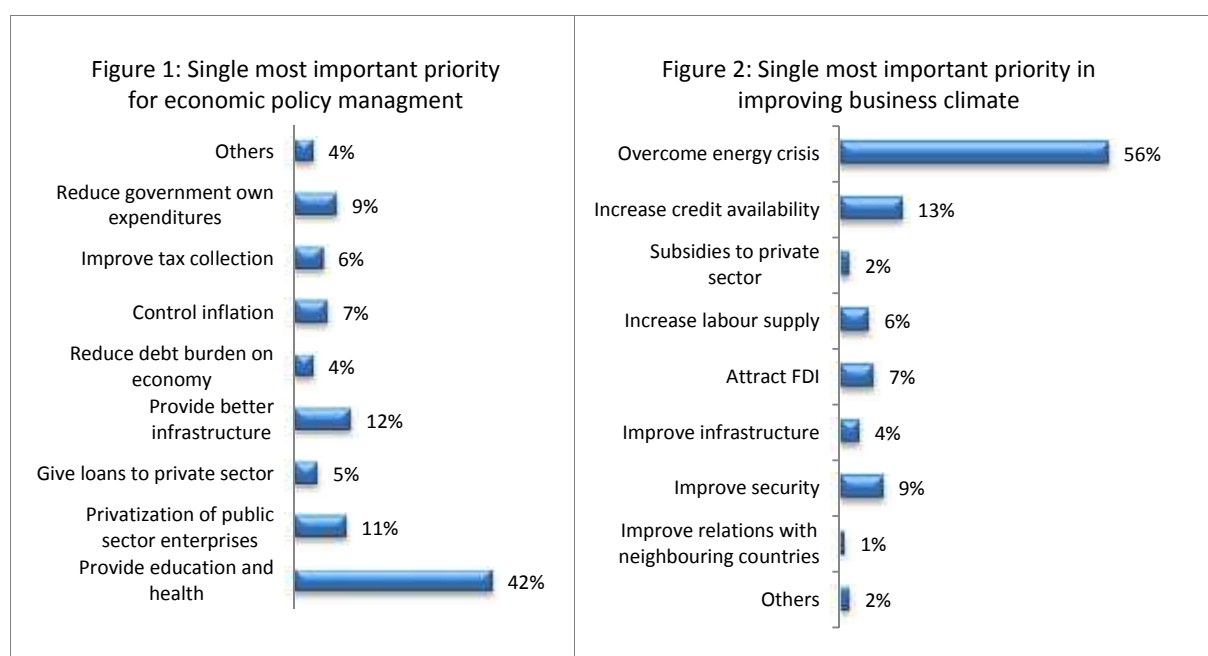
3. Expectations from the New Government

In many respects, the elections in 2013 marked a turning point in the history of democracy in Pakistan. It was the first time since 1947 that a civilian government completed its tenure and power was transferred through elections to another civilian government. This is despite high pre-electoral violence and local conflicts. In the four weeks leading up to the election day, there were 130 attacks, which claimed 150 lives.³ The voter turnout was 55% compared to 44% in 2008 elections.⁴ A significant factor in the increased turnout was unprecedented youth participation.

With a majority youth population the key challenge of providing skills and jobs remains unaccomplished. The growth rate of labour force continues to outpace the growth rate of GDP in Pakistan. The business community in our survey has attached highest priority (42% of respondents) to the provision of education and health services with the hope that the future labour force should be competitive and in tune with global demands (Figure 1).

Around 12% respondents felt that the provision of better infrastructure (including energy) will go a long way in kick starting and sustaining growth in the longer run. There were about 11% who understood the consequences of loss making public sector entities and favoured their speedy privatization.

Regarding determinants of investment and overall business climate, 56% felt that robust solution to the energy crisis is required so that investment can be lured (Figure 2). There were 13% respondents who felt that availability of credit for working capital should be a priority in improving business climate. Minority responses also included improving security situation and increased efforts for increasing foreign direct investment.



Source: SDPI Survey Unit 2013

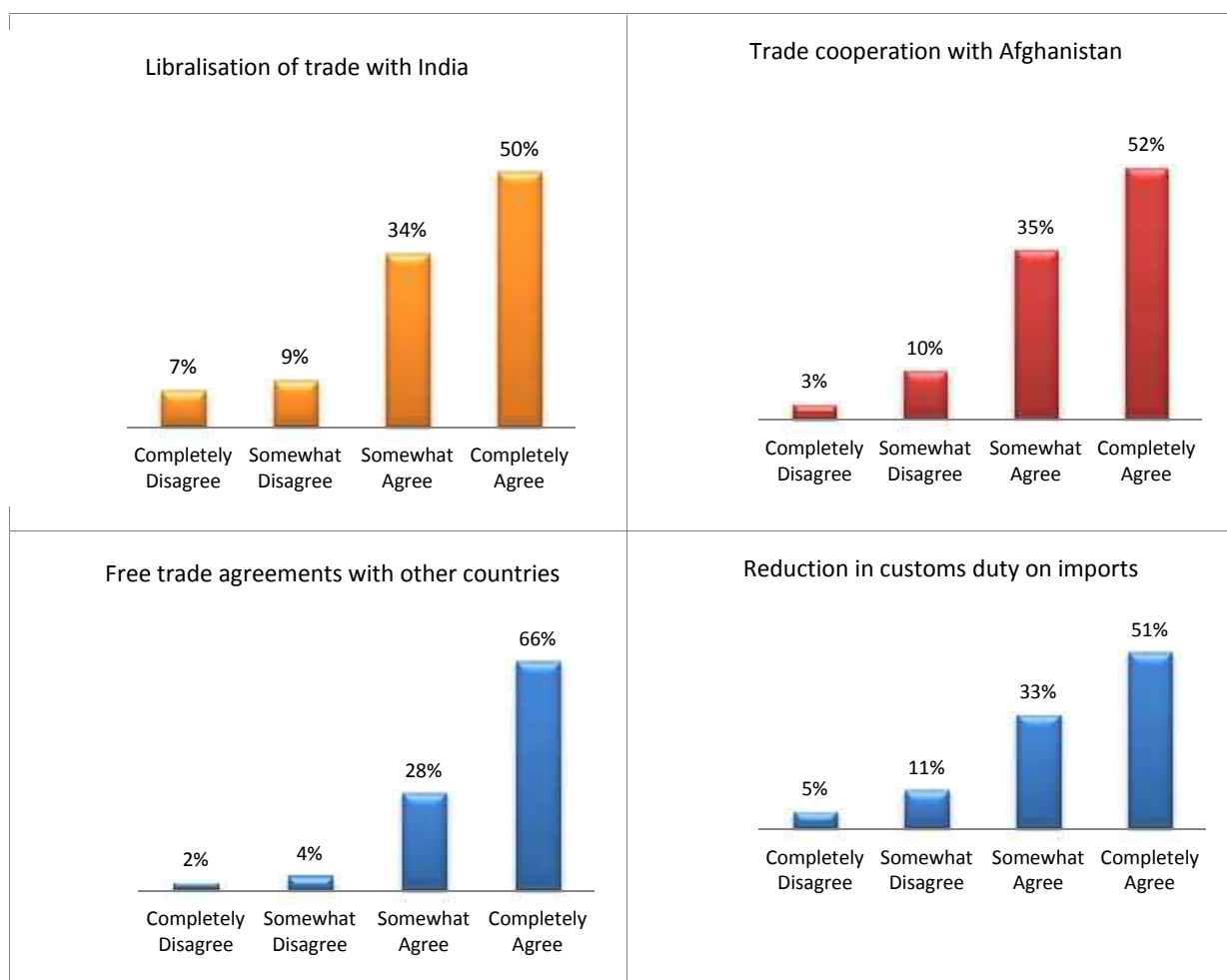
³ 'Progress in Pakistan: Report from 2013 Elections', National Endowment for Democracy.

⁴ Election Commission of Pakistan 2013

The business community is upbeat regarding trade liberalization with neighboring countries, and they are in favour of further liberalization of trade with India and trade cooperation with Afghanistan (Box 1). Over 80% of our respondents desire increased trading opportunities with Afghanistan and India.

The majority of our respondents also agree on fostering trade diplomacy through regional agreements and reduction in customs duty. Both measures in their opinion can imply gains in both producer and consumer surpluses. Furthermore, a liberal importing regime will be pro-growth as Pakistan’s exports have a substantially large imported content.

Box 1: Pakistan and Regional Trade



Source: SDPI Survey Unit 2013

4. Are Taxes Important?

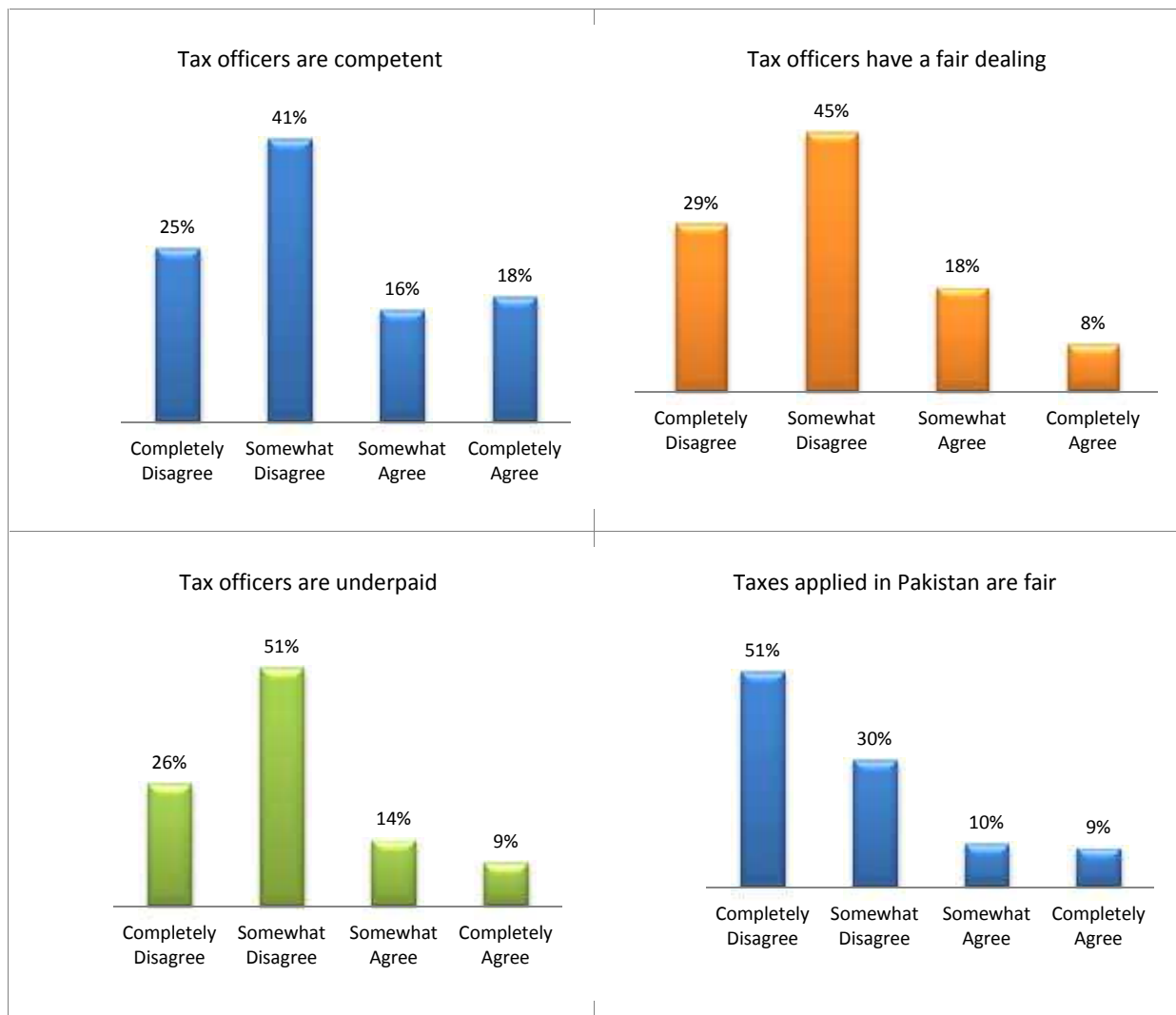
Pakistan has the lowest levels of tax collection with respect to income levels in the world, even compared to countries with similar levels of per-capita income such as Bangladesh and India. In our sample of formal sector firms we found 96% firms were registered with Federal or Provincial Board

of Revenues and only 4% were not registered.⁵ The informal sector entities however, did not see much benefit in such registration and feared intrusion if they were formally the part of revenue authority's record.

4.1 Trust Deficit

Around 51% of the respondents completely disagreed that taxes applied in Pakistan are fair (Box 2). The business community feels that the burden of taxes is not justified and skewed towards selected sectors. To a question on tax officers being competent, majority of the respondents disagreed. There was a feeling that the tax machinery is heavily driven by rent-seeking motives of officials. Businesses in Pakistan remain reluctant to expand in the formal sector due to the fear of harassment by tax administration. The start-ups continue to remain informal for a substantial time period owing to similar reasons.

Box 2: Tax Administration in Pakistan

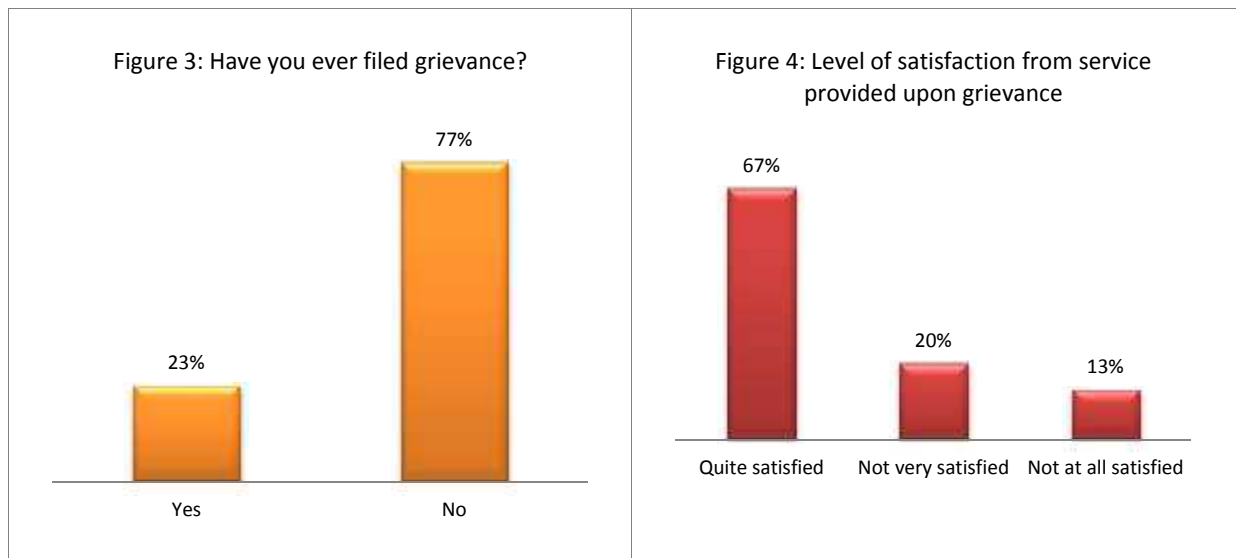


Source: SDPI Survey Unit 2013

⁵ We did not seek any documentary evidence. The survey team entirely relied on the verbal response provided by the senior management in the firms.

To another question regarding filing of any grievance with Federal or Provincial Boards of Revenue, 77% of the respondents said that they have not registered any grievance to the tax department whereas 23% respondents did so (Figure 3). Those who have filed their grievance with a tax department were then asked to rate their experience of level of satisfaction with the redressal of their grievance. 13% respondents indicated dissatisfaction however, 67% respondents were satisfied (Figure 4). Many of them acknowledged that initiatives such as one-window and tax payers' facilitation unit are helpful and should be further expanded.

Access to grievance redressal mechanisms is easier if there is a certain level of trust between both parties. During the survey there were responses, which revealed a sense of fear if FBR was approached for guidance and documentation was exposed to them.



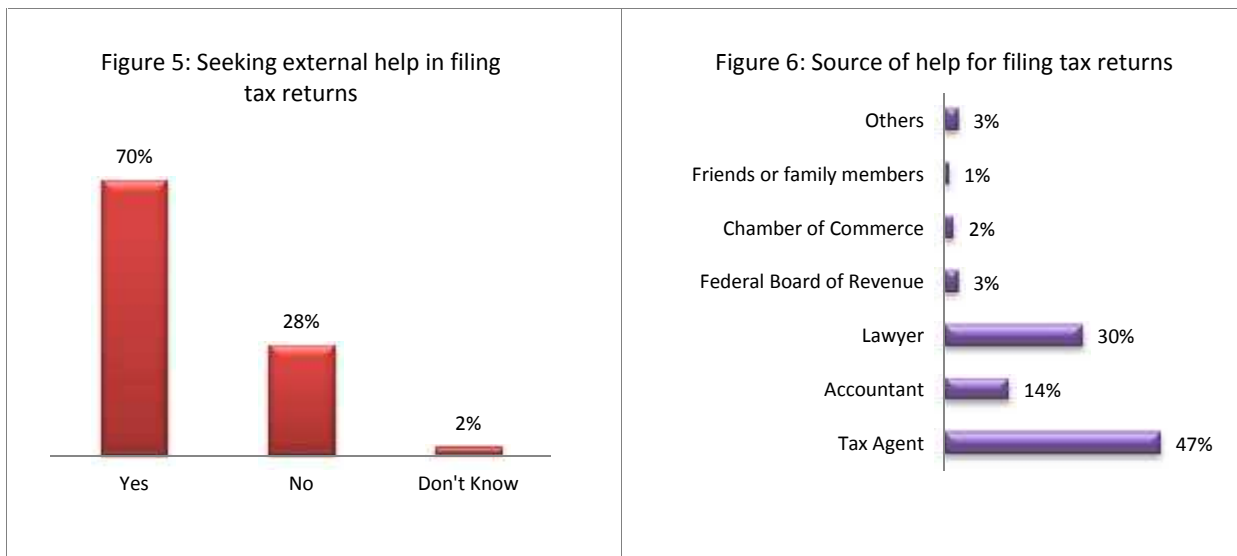
Source: SDPI Survey Unit 2013

4.2 Filing Tax Returns

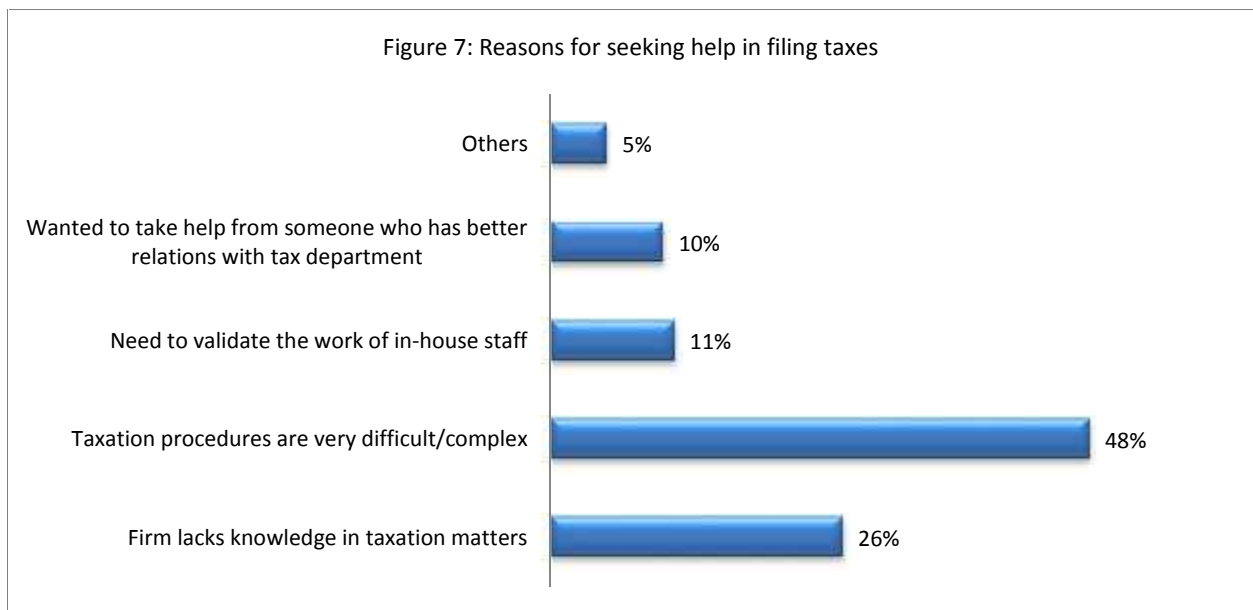
In our results, 70% of the respondents said that they seek external help in filing their tax returns while 28% of the respondents were not seeking any such support (Figure 5). Out of those seeking help 47% resort to tax agents, 30% seek help from tax lawyers, and 14% had accountants to file tax returns. Only 3% seek help from FBR for filing their tax returns (Figure 6). This indicates the need for FBR to increase its outreach whereby transactions cost of compliance can be reduced. FBR should ideally be the only guiding source for the taxpayers. The taxpayer facilitation units need to be capacitated for catering to the larger number of people wishing to access tax filing support.

The respondents were then asked to explain why it is necessary to see help. Around 48% respondents were of the view that they are unable to understand the complex documents in particular the tax-related jargons (Figure 7). 26% of the respondents said that their firms lacked in-house capacity to file taxes, therefore, this task had to be outsourced. Similarly, 11% considered it important to validate the work of in-house staff through external help. Around 10% of the respondents explicitly said that they wanted to seek help from someone having better

relations with tax department so that no harassment from tax authorities may take place at a later stage.



Source: SDPI Survey Unit 2013



Source: SDPI Survey Unit 2013

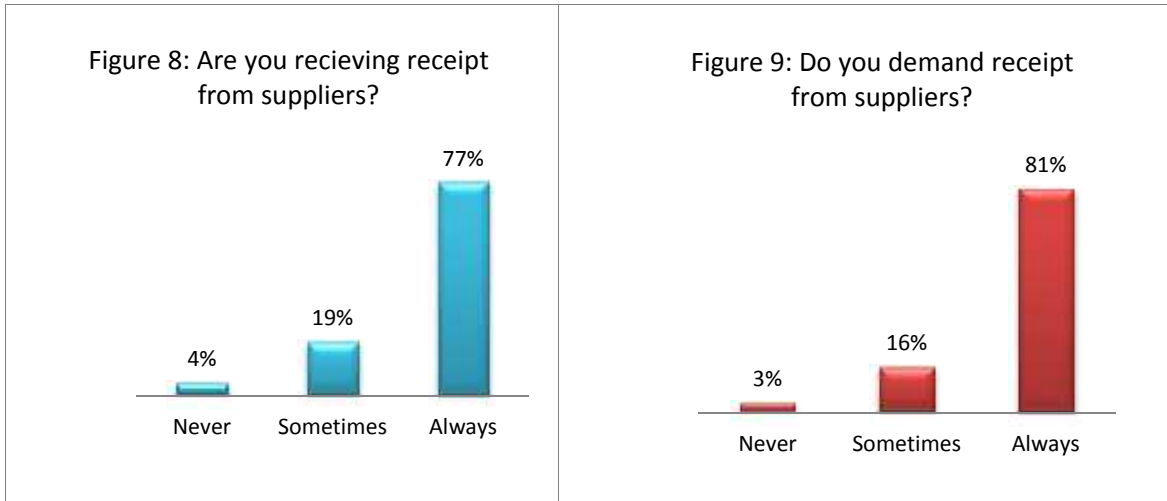
4.3 Documentation of Taxable Economy

The rising informal sector is a matter of concern for both the government and formal enterprise. These segments largely go untaxed causing loss to the exchequer. In the rural areas (and peri-urban area) there is no established norm of providing documentation (in the form of computer generated or manual receipts) upon transactions.

In our responses, 77% were of the view that they always get the receipt from their suppliers, while 19% of the respondents may receive on some occasions and 4% of the respondents never

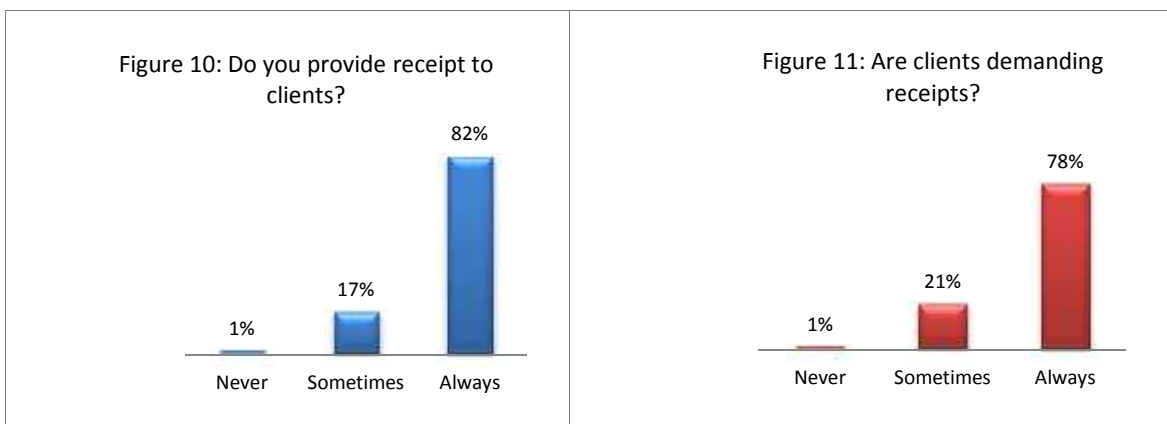
get receipt from their suppliers (Figure 8). Interestingly, those who get occasional or no receipts are handling substantially large values of transactions on a daily basis. Many such businesses were also seen supplying to entities, which are the part of global value chains.

On a similar question, 81% of the respondents were of the view that they always demand receipt from their suppliers, while 18% of the respondents do so sometimes, and there are 3% who never demanded receipt from their suppliers (Figure 9).



Source: SDPI Survey Unit 2013

It is also noteworthy here that among our formal sector firms only 17 % provide receipts to their clients occasionally (Figure 10). This is a practice that allows evasion of general sales tax in addition to keeping the transaction undocumented. It was claimed by our respondents that 21% of their clients only rarely demand such receipts (Figure 11). The weak practice towards maintaining transactions record in fact promotes expansion of an informal economy, which keeps the tax collections low and distorts incentives of formal businesses.



Source: SDPI Survey Unit 2013

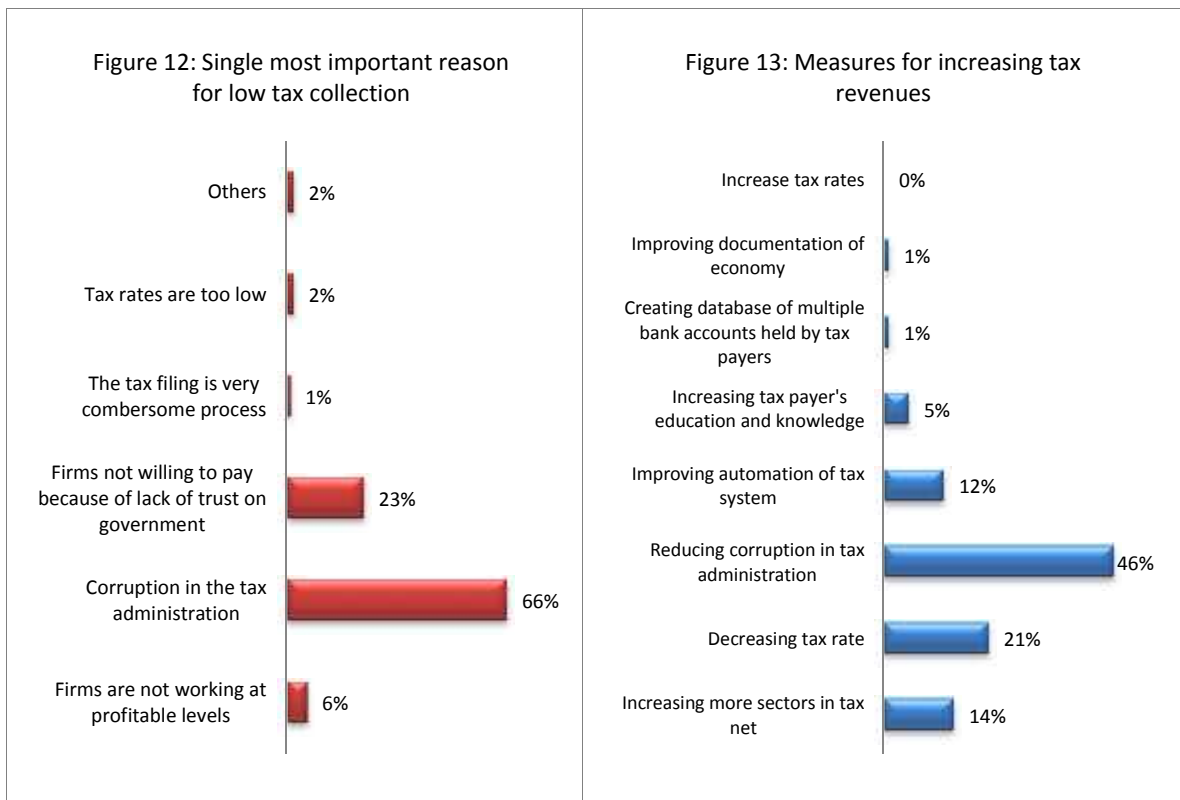
4.4 Tax Administration

More than 95% of the total government revenue is collected by FBR. The provinces have yet to fully implement comprehensive resource mobilization strategies. The frequent changes in tax legislation and discretionary powers to the FBR have reduced transparency in the overall tax

regime. There are weak controls in terms of taxpayer registration system and penalties for non-compliance are inadequate and expensive to put in practice. The tax collection costs hover around 1% of overall revenue collected, however, the efficiency of this spending on tax administration and value for money is still not optimal (Qureshi 2008).

To a question regarding the single most important reason of low tax collection in respondents' sector of business, 66% of the respondents were of the view that the key reason was corruption in the tax administration, while 23% were of the view that firms are not willing to pay taxes because they have lack of trust on state machinery (Figure 12). However, 6% of the respondents viewed low growth of the economy and business operations, a reason due to which tax collections have been low.

The above-mentioned view, which links low tax collections with low economic growth, has little backing from the empirical literature. Mukarram (2001) and Azeem (2013) write that increase in revenue overtime has been achieved in Pakistan through enhanced tax rates. The role of economic growth *per se* has been limited. There is a need to adopt those policy measures which increase the buoyancy of the tax system (Azeem et al. 2013). Despite low economic growth, there remains a substantial tax gap.



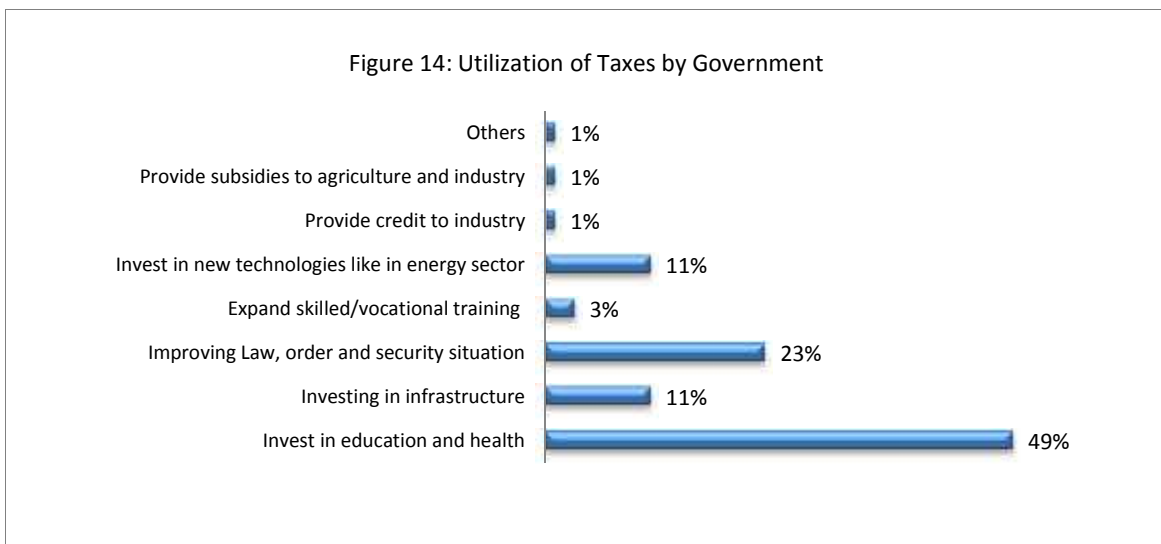
Source: SDPI Survey Unit 2013

To a question that how can the government increase the tax revenues in Pakistan, 46% were of the view that tax revenues can be increased by controlling corruption of tax administration whereas 21% of the respondents said that through decrease in tax rates, the overall revenues can be increased (Figure 13). Around 14% suggested inclusion of more sectors in tax net and 12% were of the view that the revenues can be increased if the government improves automation

system and data warehousing at FBR. Improvement in data mining capacities at the FBR would enable the organization to link multiple bank accounts and cash flow sources of those whose taxable incomes are above the minimum exemption ceiling allowed.

Kemal (2007) provides some endorsement of the view that decreased rates may lend greater revenues. His econometric estimation reveals that an increase in tax rates for sectors already in the tax net implies a rise in tax evasion. This also implies an expansion in the undocumented economy, which in turn distorts incentives of the formal sector (Kemal 2007).

The respondents were asked another question regarding the government’s spending of taxes collected from the private sector. 49% respondents favoured investing greater revenues for the provision of better education and health facilities, while 23% of the respondents suggested that these taxes should be spent on improving law and order, and security situation of the country. Around 11% each were of the view that these taxes should be spent on investment in infrastructure and investment in new technologies like energy sector.



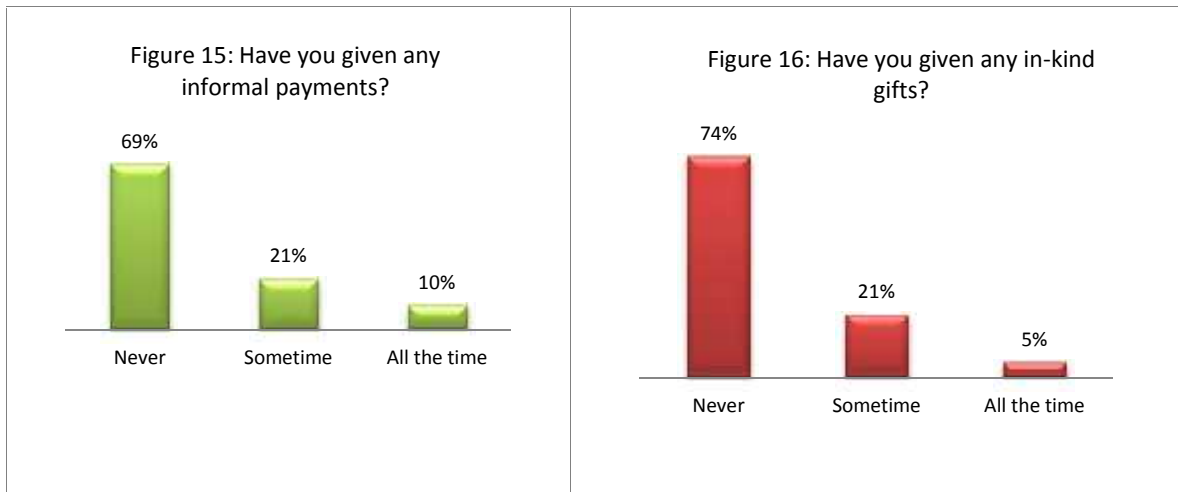
Source: SDPI Survey Unit 2013

The respondents were asked if during the past 12 months they were expected to give any informal payments or gifts to the tax department officials. 21% respondents said they occasionally offer such payments. However, 10% respondents have paid during all of their engagements with the tax officials (Figure 15). Similar results are seen in case of in-kind gifts to tax officials (Figure 16).

Such open acceptance of bribing the tax machinery came with a cynical view regarding the overall reform efforts. Those who are willingly giving these informal payments or gifts believe that the taxation machinery cannot be reformed easily and it is easier for them to safeguard from any future harassment by providing such bounties to the tax officials. Several of these respondents felt that the only solution to the problem was further reduction in human interaction during the entire process of tax compliance.

There is some evidence to suggest that a reduction in human interaction via increased technology adoption leads to reduced corruption. However, this in no way warrants a permanent change in the behaviour of officials (Bailard 2009 & Marie 2012). Similarly, Garcia-Murillo Martha (2013)

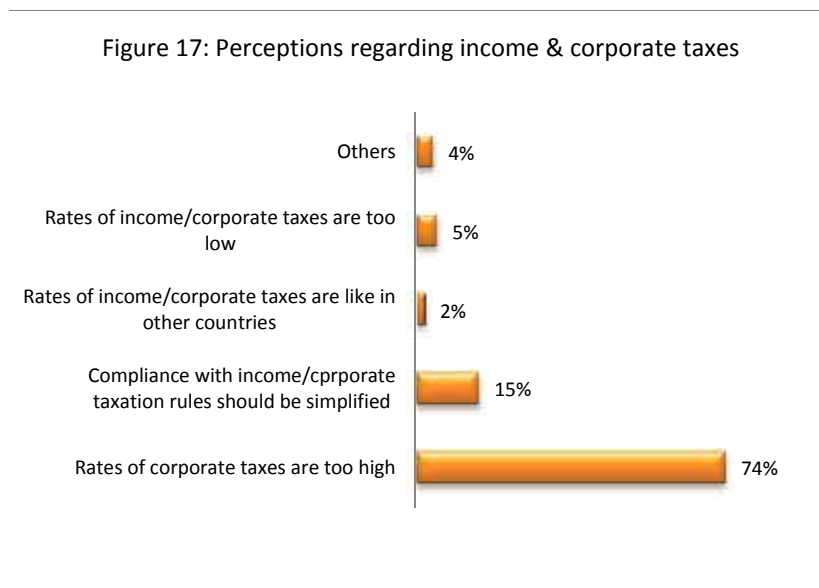
exhibits as to how the government’s presence on the web-enabled grievance redressal mechanisms reduces perceptions of corruption (Fung et al. 2010).



Source: SDPI Survey Unit 2013

4.5 Perception on Direct Taxation

Around 74% respondents were of the view that rates of corporate tax faced by firms in Pakistan are too high, 15% of the respondents were of the view that compliance with income and corporate taxation rules should be simplified (Figure 17). There was a feeling among the industrial cohort that it may end up bearing the brunt of taxes whereas agriculture and services sector go untaxed.



Source: SDPI Survey Unit 2013

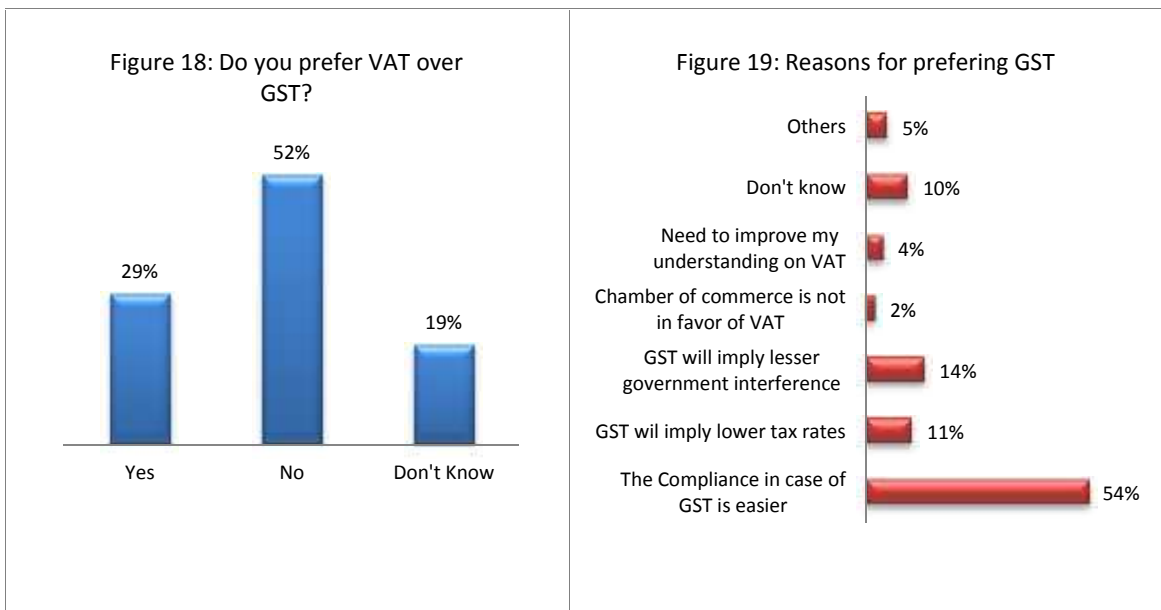
To a question about the respondents’ own estimate of the percentage of businesses who file regular taxes, the average response was around 36%. The data from FBR in 2011-12 showed that there were 51,000 companies registered with the Securities and Exchange Commission of

Pakistan (SECP). However, only 21,300 of these companies actually filed tax returns. Only 11,600 reported a positive tax liability. This implies a compliance rate of 42%.

4.6 Value Added Tax (VAT) versus General Sales Tax (GST)?

A question was asked about the preference of VAT over GST. Around 52% of the respondents were of the view that they do not prefer VAT over GST while 29% of the respondents favoured VAT in the interest of greater formalization of businesses. However, 19% respondents remained indifferent (Figure 18).

Among the respondents favouring GST, 54% were of the view that the compliance in case of GST is easier (Figure 19). There were 14% who view lesser government interference under GST regime. 11% said that GST implies lower tax burden. There were 10% who had no specific reason but to side with the majority perception of declining VAT reforms. In more general terms it was felt that the knowledge of Pakistani firms regarding the objectives of the VAT regime is weak. It is also not realized that the current GST is also in VAT mode. Here again FBR has a potential entry point whereby greater outreach efforts may result in improving understanding and trust.



Source: SDPI Survey Unit 2013

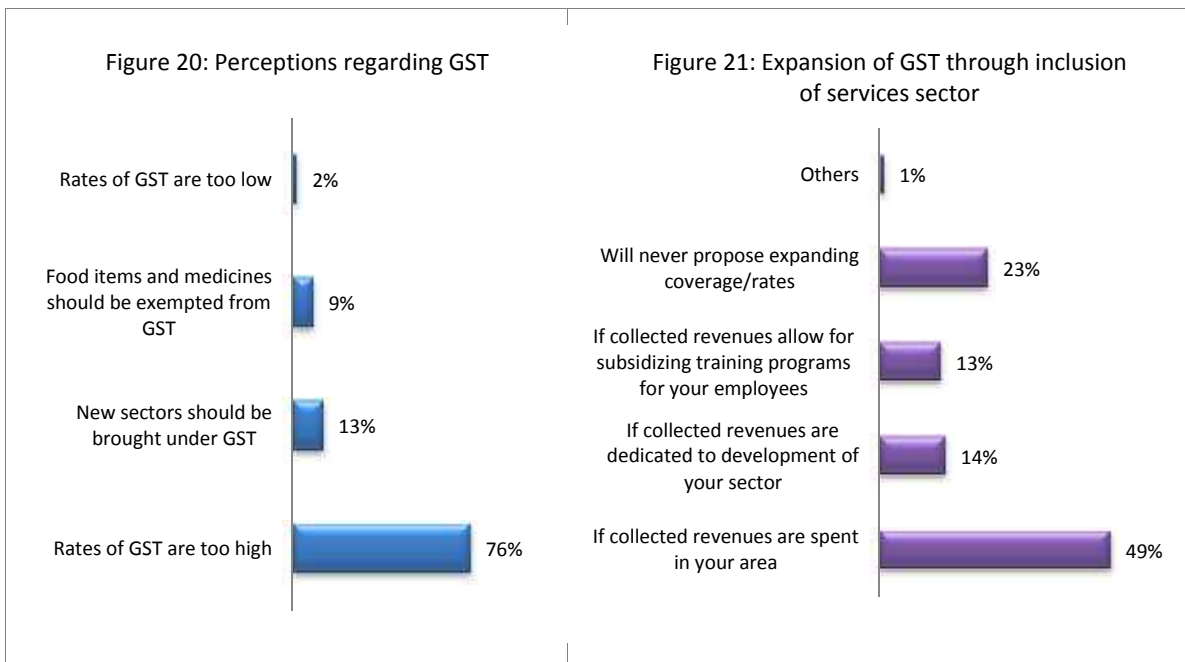
We asked the business community regarding their possible reaction in the event of government going ahead with the introduction of VAT. 44% did not know how their peers in the private sector will respond, while 40% of the respondents were of the view that in such a case, the percentage of businesses filing taxes will increase. 14% of the respondents were of the view that the percentage of businesses that are currently filing GST will reduce.

We asked about the perceptions regarding prevalent GST processes.⁶ Around 76% of the respondents viewed the rates of GST in Pakistan too high, 13% felt that new sectors should be

⁶ The survey was conducted in early days of June 2013 when GST rate was 16%.

brought under GST whereas 9% of the respondents were of the view that food and medicine items should be exempted (Figure 20). There was a perception that subsequent governments continued an increase in GST rate (due to its ease of implementation). However, this resulted in cost-push inflation. This view of the private sector has also been documented earlier in Baloch et al. (2013).

Currently, sub-sections of the services sector in Pakistan are vastly exempted from GST and this sector accounts for over half of Pakistan's GDP. We asked our respondents regarding the circumstances under which they will be willing to propose expanding GST coverage and rates for the services sectors. Around 49% are in favour of expanding GST across the services sectors, 14% of the respondents were of the view that if the collected revenues are spent for the development and promotion of their own sector then they may favour this move, 13% of the respondents were in favour if collected revenues allow for subsidizing training programmes for their employees in services sector. 23% of the respondents were not in favor of expanding GST in the services sector (Figure 21).



Source: SDPI Survey Unit 2013

Summary of Tax Reform Measures

- Open Budget Initiatives such as the one practiced in several Commonwealth countries can strengthen fiscal transparency and overtime enhance taxpayers' confidence.
- FBR and provincial revenue authorities need to design innovative outreach programmes in order to lessen the trust deficit.
- Outreach programmes for taxpayers can demonstrate proper utilization of tax resource at micro level. These outreach programmes if carefully designed can help the public understand as how the paying taxes can improve public service delivery in social and infrastructure sectors.
- The number of firms registered with SECP has grown overtime. The taxpayers' facilitation units require expansion in order to cater for the demands of an expanding taxpaying segment.
- The documentation on corporate taxes needs further simplification. User friendly and web-enabled documentation should be promoted.
- For the long-term, a strategy for transitioning towards VAT should be put in place.
- Tax administration measures that put in place smart ICT tools can help minimize human interference and corruption. Equally important is to correct the perceptions regarding corruption. For this leadership at the revenue authorities should keep a closer contact with business associations.
- Prompt grievance redressal mechanisms will help in bridging the high levels of trust deficit between the state and the taxpayers.

5. Energy Sector Challenges

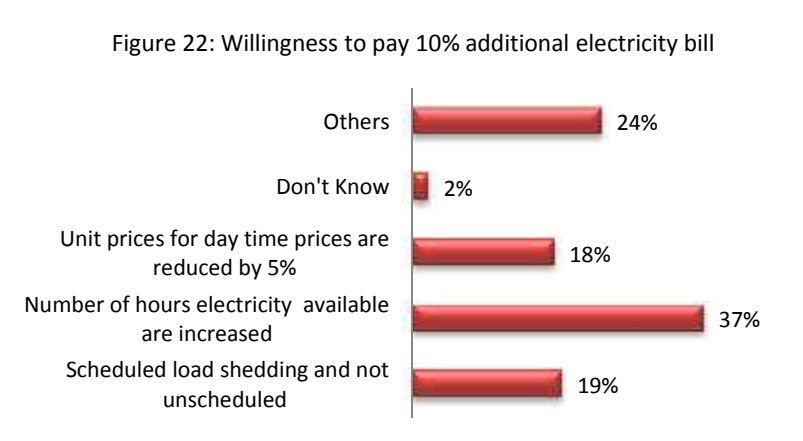
According to the Economic Survey of Pakistan 2012-13, USD 4.8 billion or 2% of the Gross Domestic Product (GDP) was lost due to power sector outages during 2011-12. This is a major factor behind Pakistan's disappointing economic performance over the past 5 years with GDP growth averaging under 3%.

The key challenges confronting this sector can be categorized into demand-supply gap, inefficiency and pilferage, and affordability. In 2012, the average demand-supply gap was observed at around 5000MW (31.8% of peak demand). Around 44% of power was generated through expensive thermal means. The transmission and distribution (T&D) losses stood at 25% and theft was valued at PKR 140 billion.

5.1 Willingness to Pay

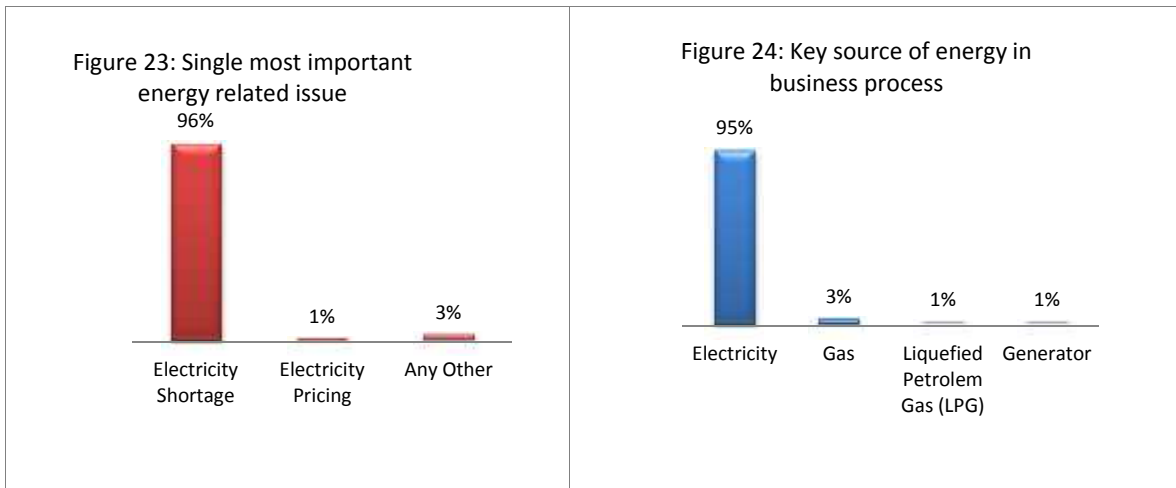
Under the IMF programme, the government is committed to gradually increase energy tariffs to a level that covers full economic cost of generation, transmission and distribution. We, therefore, inquired about the willingness of the business community to pay higher energy prices in lieu of improved supply.

Our survey results indicate that 37% respondents are willing to pay 10% extra electricity bill if the number of hours electricity is available are increased. There are 19% respondents who were willing to pay 10% extra bill if the load-shedding is scheduled. Around 18% of the respondents will pay extra if the unit prices for the daytime electricity are reduced by 5% (Figure 22).



Source: SDPI Survey Unit 2013

A wide majority of the respondents felt that electricity pricing had nothing to do with the current energy crisis (Figure 23). In fact many were readily willing to pay additional charges. Their key concern was certainty of supply. For most of our formal sector firms, it was electricity that acts as a major input in their production process (Figure 24). On average, a firm is spending PKR 124, 274 per month on using electricity through meter.



Source: SDPI Survey Unit 2013

Regarding the spending on generator (petrol/diesel), the results indicate that on average a firm is spending PKR 62,258 per month on these alternatives. This excludes the capital cost of acquiring such alternatives. Some of the firms using gas through meter, were asked to share their monthly spending, the results show that on average a firm is spending an amount of PKR 35,558 per month on this source of fuel. The large-scale firms were able to adjust to some extent to the rising prices or energy shortages, however, the respondents from medium-sized firms revealed that it is not easy for them to switch between fuels whenever shortage of a single source occurs. In case of smaller firms, a large number of these from manufacturing sector have not been able

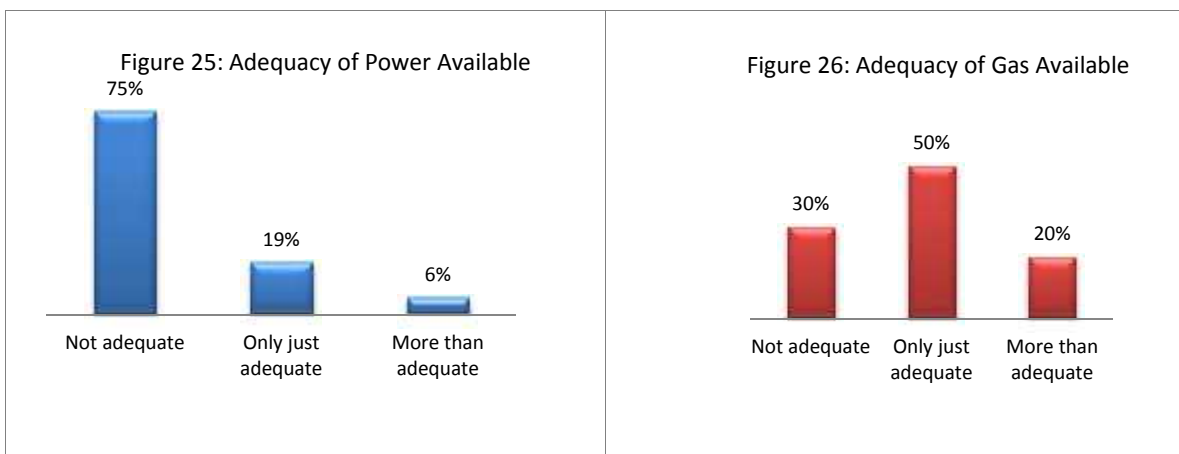
to afford alternatives and have gone out of business (due to their inability to cover variable costs) since 2007-08.

According to the Lahore Chamber of Commerce and Industry (LCCI), 40% of industry in the Punjab province has come to a closure during the past 5 years (Lashari, Suhail 2014). Another estimate by All Pakistan Textile Mills Association (APTMA) indicates that 30 of textile industry remains shut due to its inability to operate under energy deficits. The industry has not been able to meet export orders. This could also undermine Pakistan's enhanced access to European Union under the GSP+ initiative (APTMA 2014).

5.2 Adequacy of Key Sources of Energy

Regarding the adequacy of the incoming energy supply, 75% of the respondents were of the view that the quantity of electricity available for production and servicing purposes is not adequate (Figure 25). Around 19% stated that it is just adequate, however, 6% respondents had considered it more than adequate. Those who felt that the supply was adequate were from the services sector or other businesses, which are not energy intensive. During a visit to one of the steel manufacturing units (December 2013) in I-9 industrial area of Islamabad, it was witnessed that there was a straight 6 hours of power stoppage in the daytime shift.

Regarding the quantity of gas available for production, 30% respondents were of the view that it is not adequate for their production units (Figure 26). However, 50% considered it only just adequate to maintain the current levels of output. Only 20% viewed that it is more than adequate and their business was not heavily dependent on gas as an input.

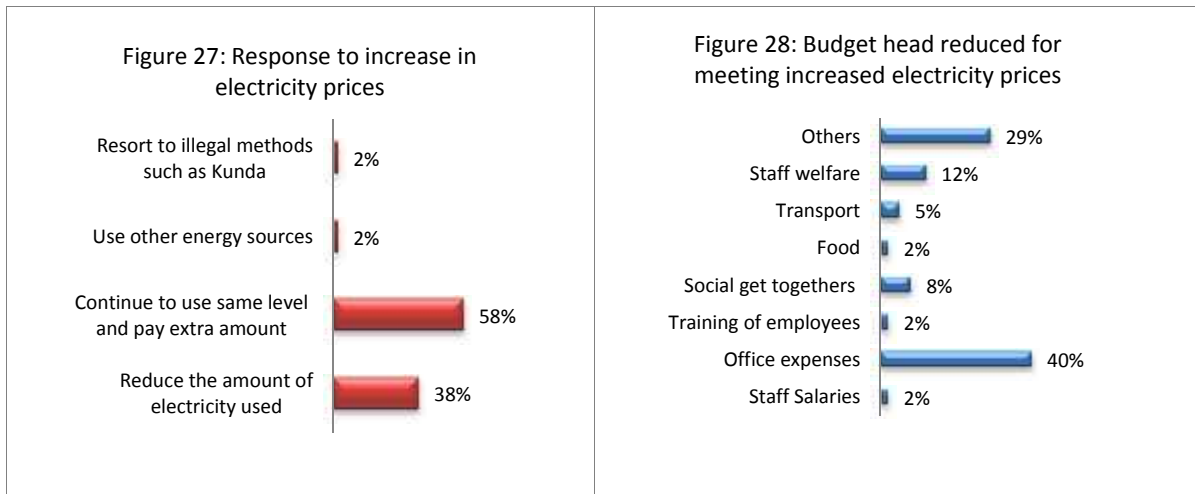


Source: SDPI Survey Unit 2013

It is evident from the published literature in Pakistan that private sector's demand for energy rises with an increase in fixed capital stock. This can be attributed to Pakistan's energy-intensive growth pattern. As production expands, there is an increase in the energy units consumed and this only slightly decreases as output expands. (Zeshan and Ahmed 2013). In the light of this result, business community's own response (as mentioned above), where 75% feel power deficiency, can imply a negative impact on their future investment decisions.

5.3 Coping Strategies to Absorb Increase in Electricity Prices

The survey results exhibit that 58% of the respondents, as part of their coping strategy, continue to use the same level of electricity but pay the extra amount for retaining same consumption level (Figure 27). Around 38% respondents had reduced the electricity consumed by their businesses, in turn implying a reduction in output expansion. Those who have reduced electricity consumption largely fall under small and medium sized industrial units. There were 2% respondents, who confessed resorting to illegal means for maintaining their power consumption.

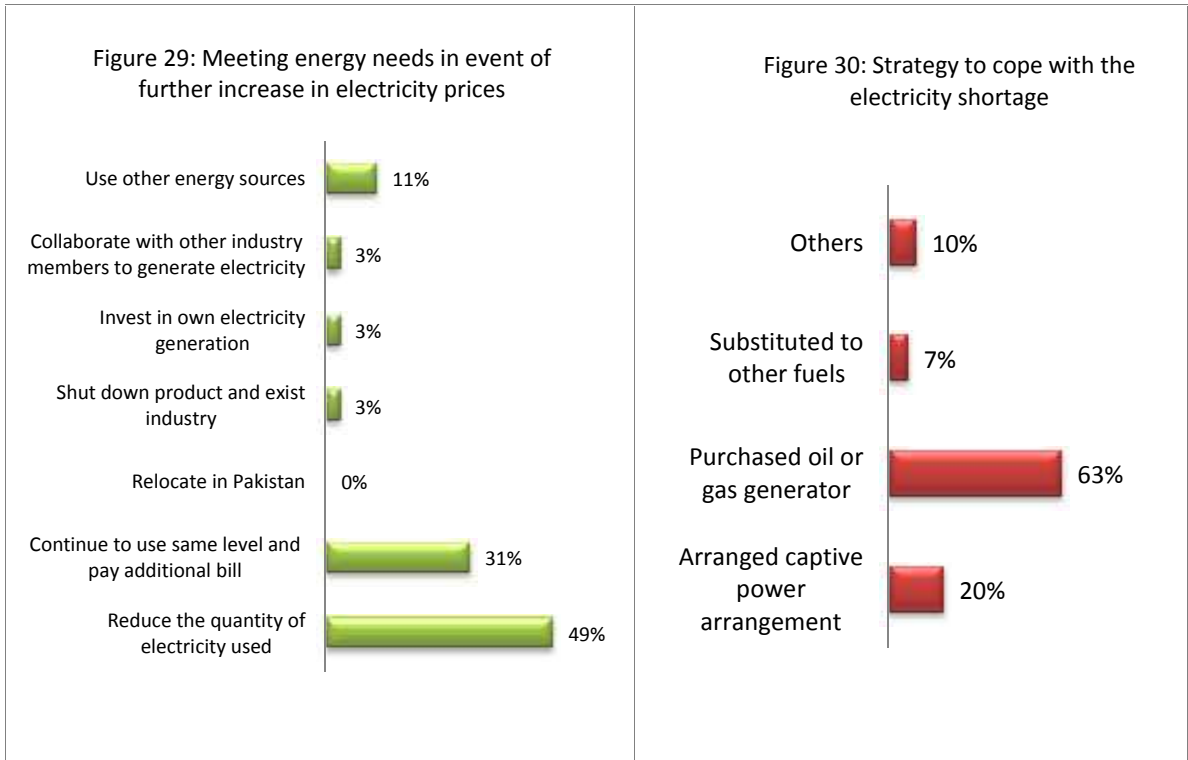


Source: SDPI Survey Unit 2013

Those respondents, who selected the option of continuing to use same level of electricity and pay extra amount for it, were asked regarding the budget-head reduced in order to cope with additional power spending. Among them 40% reported reduction in office expenses in order to absorb increase in electricity prices (Figure 28). Another 12% had decreased spending on staff welfare.

Such internal budgetary adjustments at the firm-level have been discussed in the current literature. Malik (2009) discusses some ways in which the government can reduce the burden of rising energy costs for the businesses. One of the ways, she explains, is to rationalize the taxes and levies on electricity and gas. The government may be selective in imposing these levies. The selection criteria should not be based on sectors contributing most to the government revenues, but to impose levies in a manner that ensures minimum loss of firm-level output and GDP.

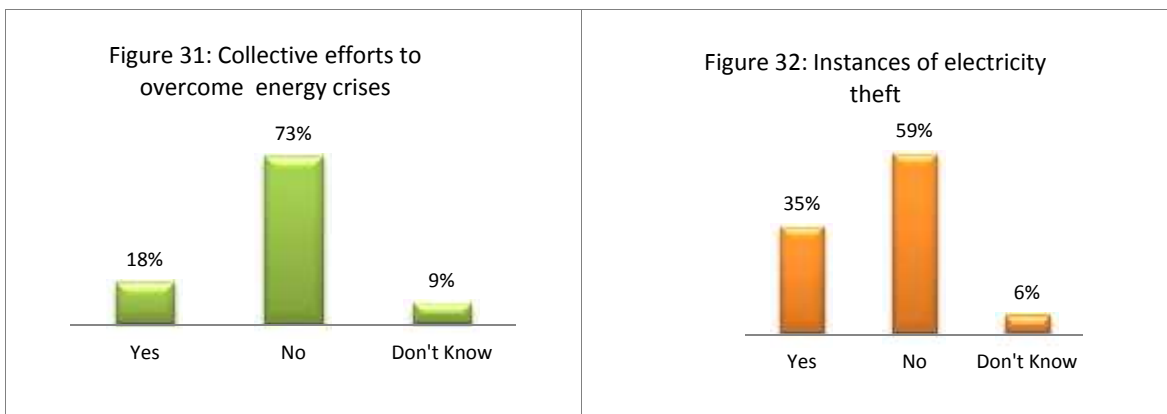
On business sector response to further increase in the electricity prices, an overwhelming 49% responded that they will reduce the usage of electricity, which would also reduce their production level (Figure 29). Around 31% respondents were of the view that they will use the same level of electricity and will pay the additional bills.



Source: SDPI Survey Unit 2013

Around 63% of the respondents had purchased gas and petrol-based generators to meet their existing demand while 20% of the respondents had arranged captive power arrangement (Figure 30). A captive power plant is an electricity generation unit, which produces electricity for the owner’s own use. Most of these arrangements in Pakistan require imported fuel in turn having an adverse impact on the balance of payments.

We also infer that majority of the business community has not invested in collective efforts to overcome energy crisis. 73% of the respondents were of the view that they have not made any collective effort to overcome energy crisis (Figure 31). However, 18% respondents did provide some examples of efforts on their own. A respondent particularly cited the case of ceramics industry, which is facing business shut downs because the alternatives are expensive. In the production process, most ceramic items require a heat level, which is reached after several hours. Any energy stoppage implies shut down of the entire plant.

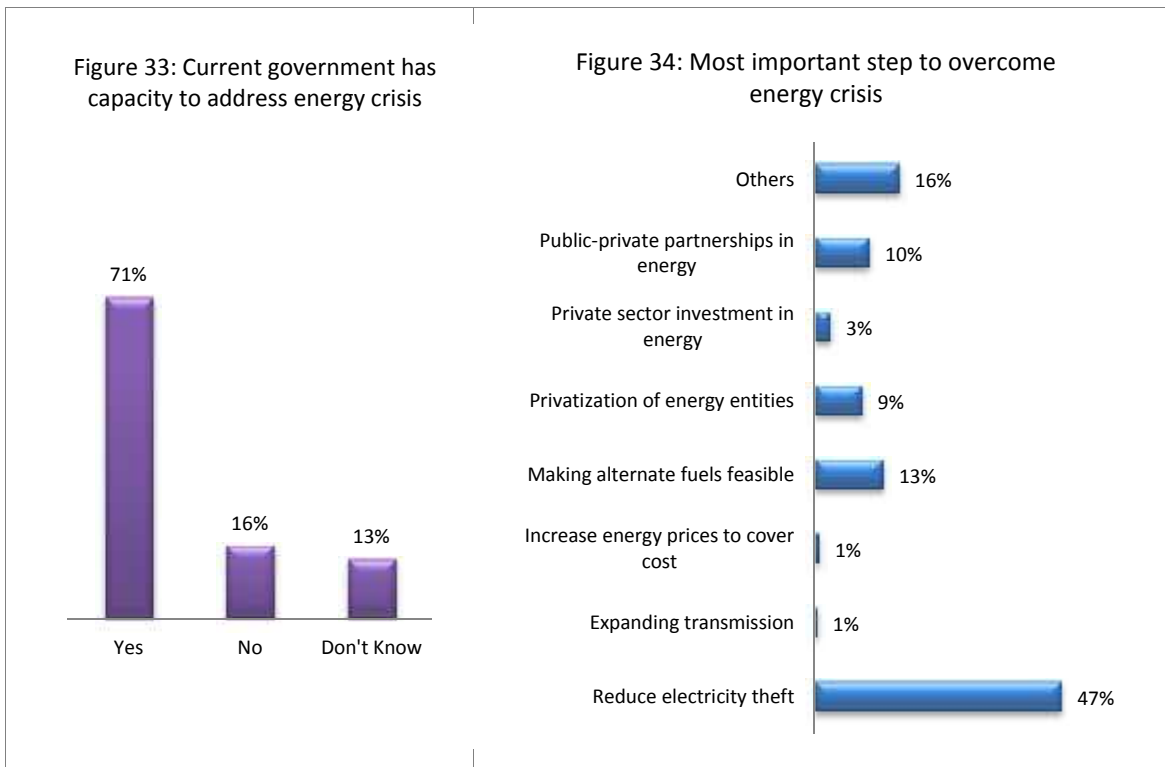


Source: SDPI Survey Unit 2013

Around 35% respondents claimed to have information on instances of electricity theft in their area (e.g. *kunda* method). 6% were indifferent to this situation (Figure 32). Addressing theft requires prudent governance and is certainly a low hanging fruit if the government is serious about resolving the energy crisis. In August 2013, the Secretary of Water and Power Ministry informed the Senate Standing Committee that Pakistan loses PKR 150 billion (USD 1.7 billion) annually in line losses and power theft. Till August 23, as many as 770 cases of theft were registered and under trial, but only three cases were punished. Moreover, the fine imposed was less than PKR 5,000 in each case. The ironic aspect of this issue is that the power sector managers get away with the theft issue by showing a substantial portion of this crime under line losses.

5.4 Future Outlook of Energy Sector

The business community is hopeful that the newly-elected government should be able to resolve the problem of energy shortage in the country. The results indicate that 71% respondents were certain about the current government’s capacity to handle energy crisis (Figure 33). The private sector is aware of and has confidence in PML (N) policy on energy in the election manifesto.

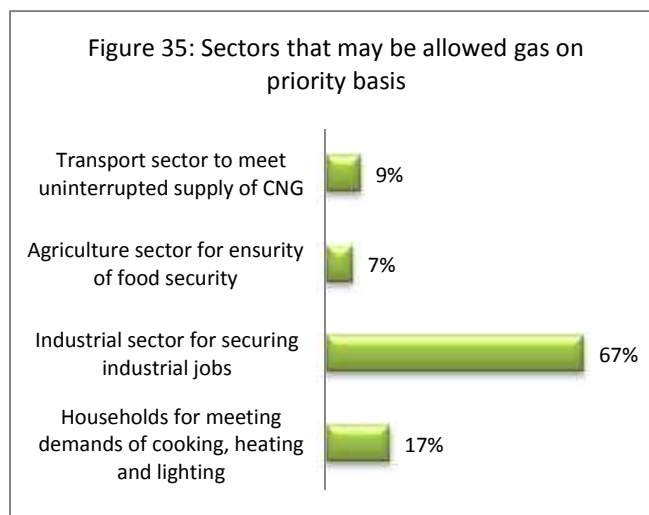


Source: SDPI Survey Unit 2013

The respondents were asked for their opinion on the most significant challenge in overcoming energy crisis. About 47% respondents were of the view that the government’s prime focus should be on reducing electricity theft in the country (Figure 34). 10% recommended public private partnership in energy generation and 9% favoured outright privatization. The understanding that one of the key reasons behind power crisis is the lower than economic cost prices and existence of untargeted, hidden and cross subsidies, is still weak. Only 1% favoured increasing power prices to cover costs.

The large number of private sector entities now favouring privatization of public sector energy concerns can be an important entry point for the current government. There is a recognition at the political level as well that the government's own management structure is not capable of restructuring the liabilities of these entities and turning around the loss making operations.

On the allocation of gas to various sectors on priority basis, 67% of the respondents were of the view that priority should be given to the industrial sector so that jobs can be secured and production can be revived (Figure 35). Besides, 17% respondents recommended priority gas allocation to the households for cooking and heating purposes. It is noteworthy that at a conceptual level, job creation is perceived to be a phenomenon limited to the industrial sector. The understanding that several agricultural activities and services sub-sectors are more labour intensive than industry is still weak. Similar understanding was observed during the household-level survey where 44% of respondents attached priority to the industrial sector.

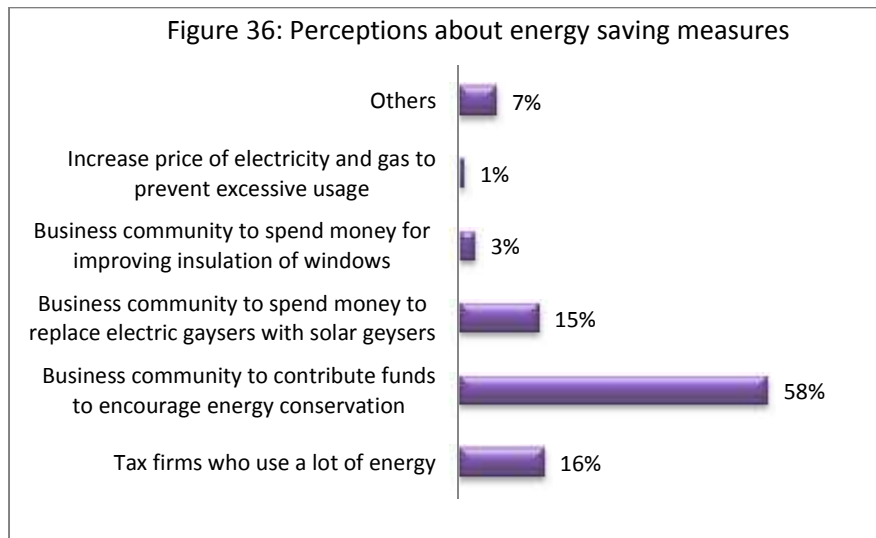


Source: SDPI Survey Unit 2013

On energy saving measures in the respondents' locality, 58% were in favour of business community contributing funds for advocacy campaigns to encourage energy conservation (Figure 36).⁷ Around 16% respondents were in favour of high tariffs or indirect taxation on firms with above average energy consumption in order to conserve energy. The private sector lacks knowledge on energy conservation models that are being promoted by the government and non-government organizations. The initiatives of ENERCON, Alternate Energy Development Board and Atomic Energy Commission of Pakistan were not well known to the business community.

An outreach programme can be developed in this regard by the provincial environmental protection departments in Pakistan. However, private sector's perception of the environment departments and agencies needs to be corrected. Most of these entities are viewed with suspicion due to the rent-seeking behavior of the officials.

⁷ This could be done through business associations, e.g. Chambers of Commerce and Industry.



Source: SDPI Survey Unit 2013

Summary of Energy Reform Measures

- Legal amendments may be undertaken to ensure effective punishment in case of energy theft. Majority of business community is ready to work with the government in curtailing such leakages.
- The government should correct the perceptions at the community level that power sector defaulters are above the law.
- The business associations, e.g. Chambers of Commerce and Industry may be encouraged to collaborate with ENERCON and non-governmental organizations to advocate energy conservation.
- A comprehensive conservation policy can be helped by a properly designed outreach campaign, smarter tariffs that are progressively levied (in line with usage), and liberalization of imports of greener technologies in energy sector (e.g. solar power).
- While tariff increase in both power and gas may be inevitable, however the government can reduce burden on SMEs through selective imposition of energy related taxes and levies (instead of across the board imposition).
- A substantial number of respondents were willing to pay non-subsidized tariffs if there was certainty of energy supply. A nation-wide identification of these consumers and willingness to pay analysis may be institutionalized at the national (Ministry of Water and Power) and sub-national levels (DISCOs).
- Deeper research will be required to see a) if it is justified to have a large tariff variation between various sources of energy (power and gas) reaching the same household, and b) how energy poverty is forcing people to trade off their budgetary requirements towards food intake, education, and health.
- Privatization of DISCOs may be expedited followed by GENCOs. Until this is done GENCOs and IPPs should compete for fuel based on their efficiency levels.

6. Findings from Informal Sector

6.1 Perceptions on Taxation Reforms

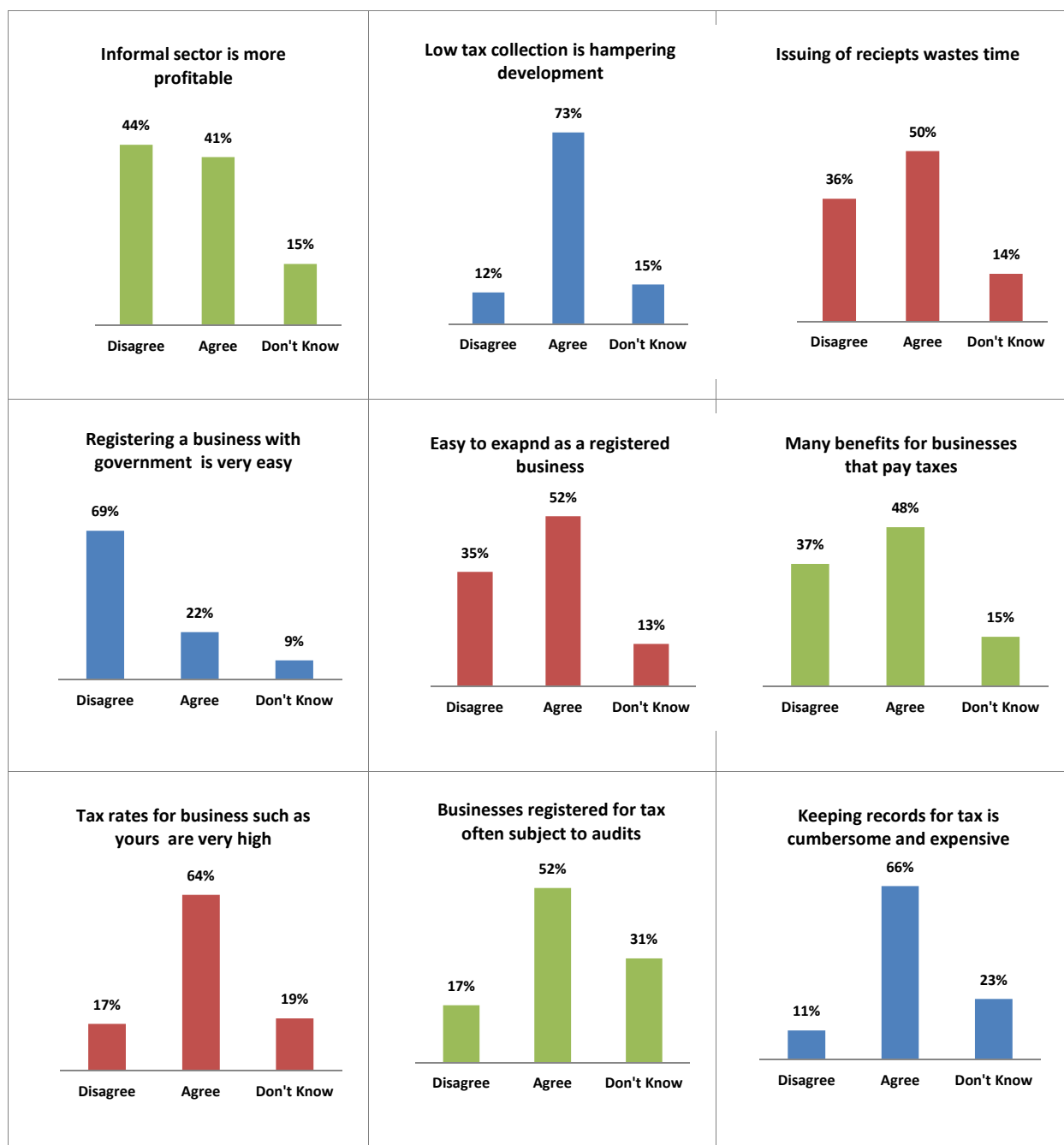
A substantial number of our respondents (41%) view the informal sector to be profitable. Despite a sound understanding that the lack of documentation of the economy and low tax revenues of the government impede development, they are not willing to formalize the transactions with their clients (e.g. in the form of issuance of receipts). Around 50% said that providing receipts to their buyers wastes time and increases their transactions cost.

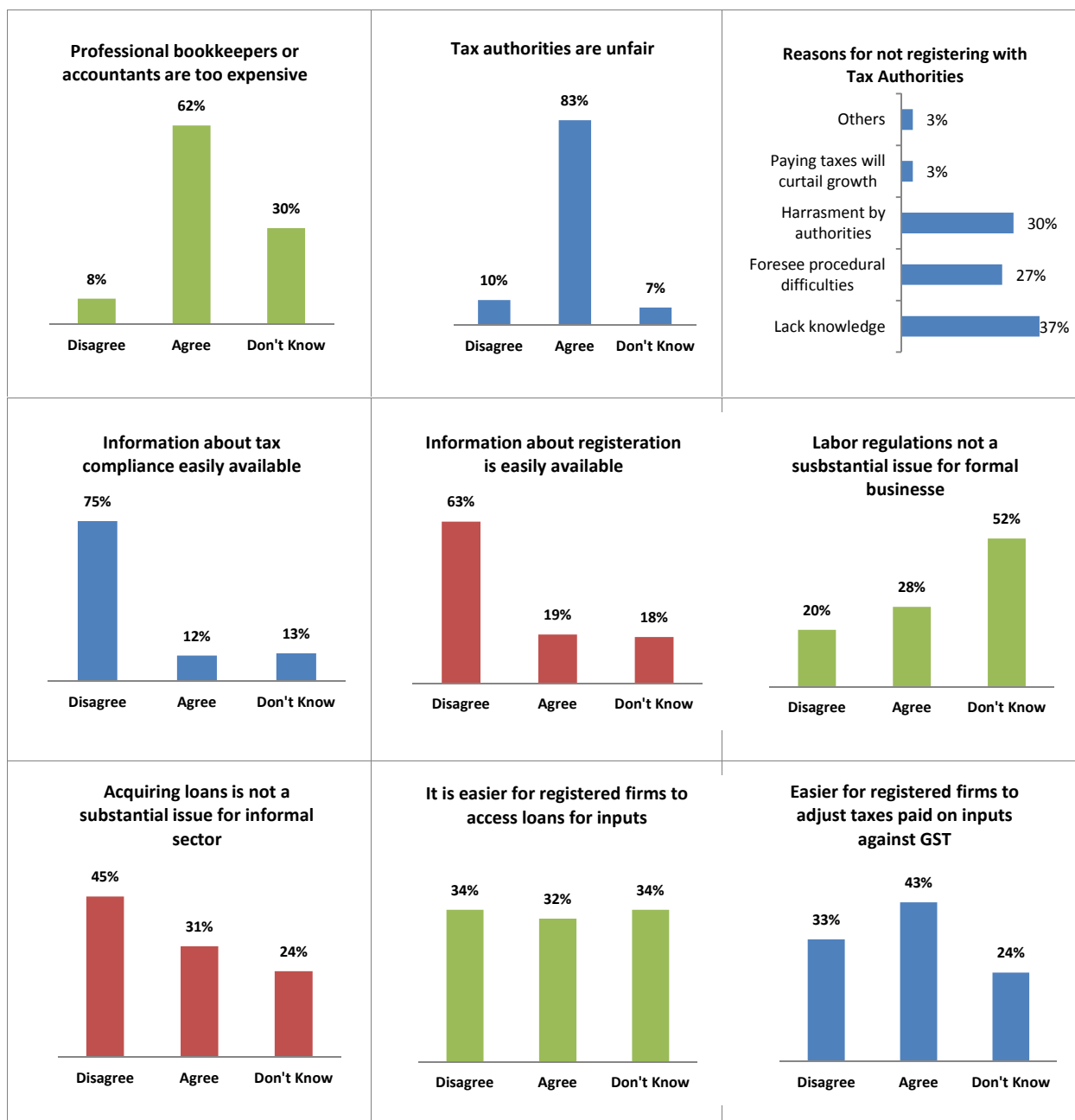
Despite the efforts by Securities and Exchange Commission of Pakistan and FBR to reduce the time and cost involved in registering a business, the informal sector firms still consider business registration a difficult process. The majority views about the taxation system and tax administration are provided below:

- Tax rates for sectors in which informal businesses operate are high (64% respondents)
- Businesses registered with tax authorities are subject to frequent audits (52%)
- Maintaining transaction records for taxation purposes is cumbersome, time consuming and expensive (66%)
- Engaging accountants to help file taxes is expensive (62%)
- Tax authorities are not helpful and their dealing with registered businesses is unfair (83%)
- Information on tax compliance is not easily available (75%)

These results clearly indicate that the FBR needs to step up its communication efforts in reaching out to the informal sector about the potential benefits of registering with the tax authorities. Formalization of businesses should be branded and incentivized. Furthermore, awareness programmes are needed at local level informing about initiatives such as the taxpayers' facilitations unit and how to access these forums.

Box 3: Informal Sector Perceptions on Tax Reforms

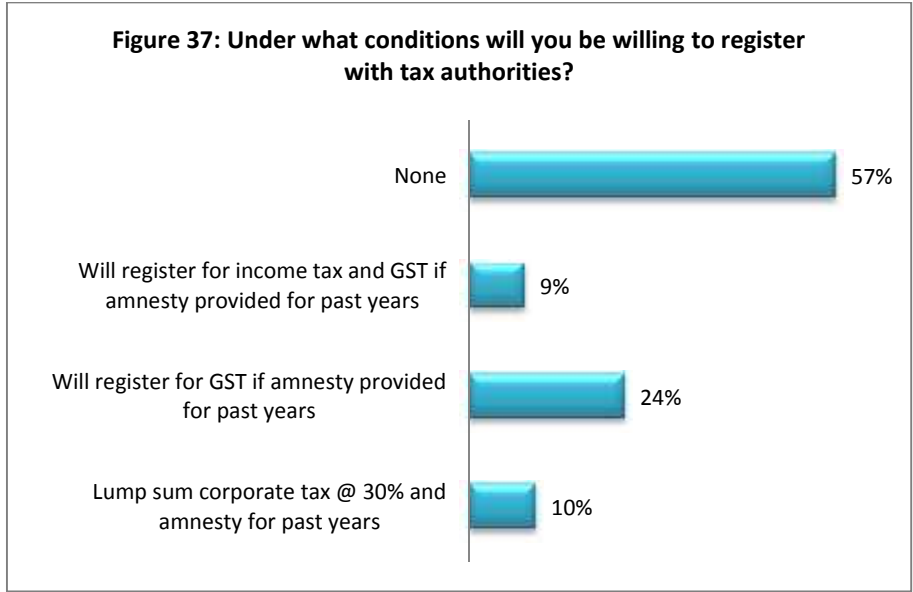




Source: SDPI Survey Unit 2013

The response to incentivise registration with the tax authorities has interesting policy implications. 57% of the respondents stated that no incentive scheme is going to compel them to register with the tax authorities. This clearly shows the acute trust deficit (Figure 37).

However, 24% stated that they may register for GST if amnesty is provided for past years. There are 9% who will register for both income tax and GST if similar amnesty is provided. Finally, 10% recommended tax rationalization in the form of a single lump sum corporate tax. They will be willing to pay this lump sum corporate tax at a maximum ceiling of 30% if amnesty is allowed for past dues.



6.2 Perceptions on Energy Reforms

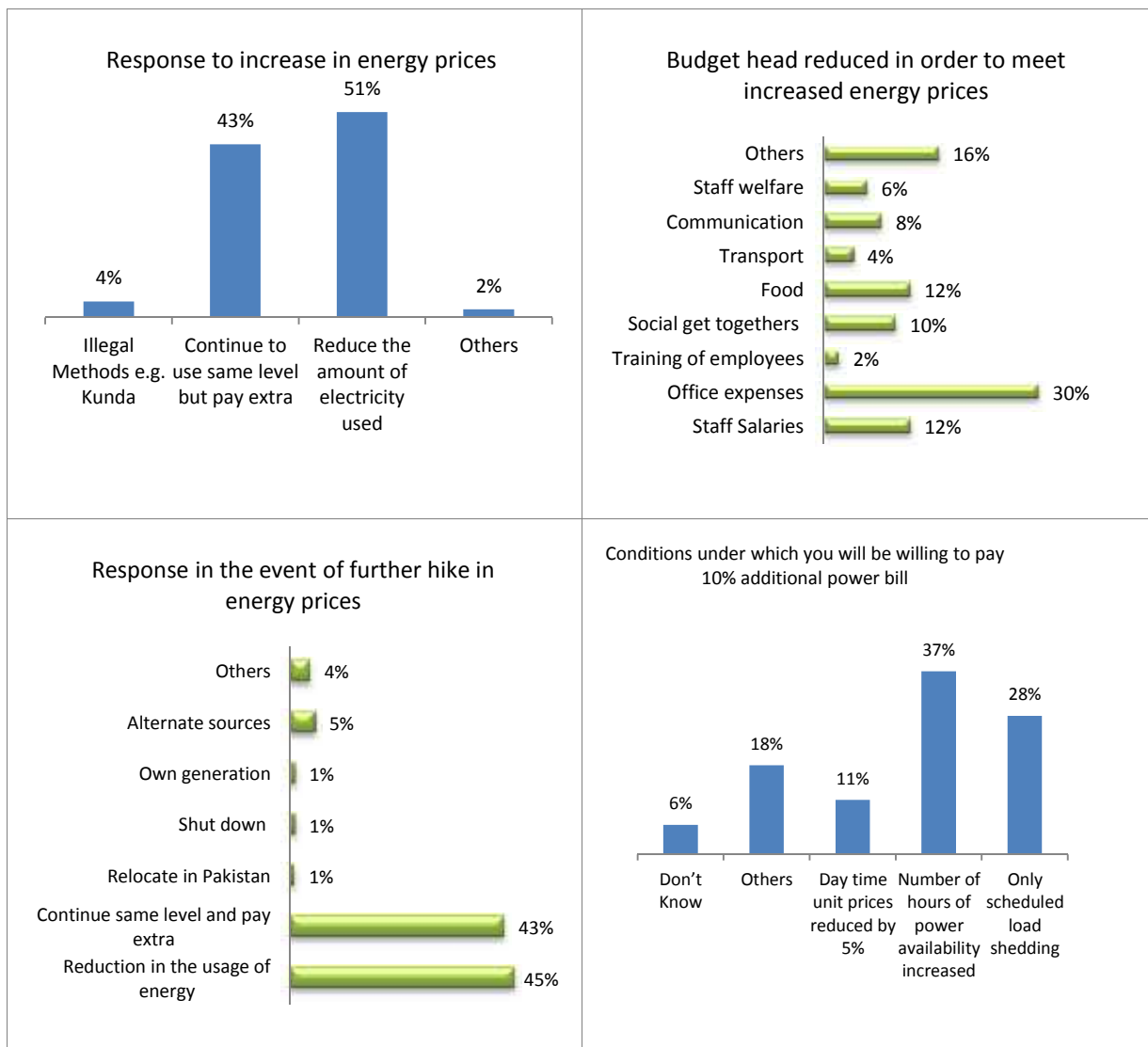
The survey also covered the response of the informal businesses to the increase in energy prices. Over half of the respondents have reduced power consumption to cope with higher prices. There are 43% who continue to use the same level of power but pay a higher bill (Box 4). These firms have managed to pay the additional amount by cutting down expenditures on official expenses (30% respondents) and staff salaries (12%) among other budget heads shown at the next page. This has implications for livelihood of the poor, as in most circumstances it is the poorest among the labour segment that ends up working for the informal sector. A cut in their salary implies addition to persons below the poverty line.

On further increase in energy tariffs, 45% responded that they will have no option but to further reduce their level of power or gas consumption. Around 5% said that they will have to switch to alternate sources (which involve incurring a capital expenditure). Around 1% indicated relocation to destinations in Pakistan where their energy costs can be curtailed or will shut down.

43%, who have already paid extra to remain at the same level of energy consumption, were still ready to pay more. This provides an interesting entry point for those wishing to improve the reform design. The energy tariffs have been well below the economic cost of generation and transmission. This tariff structure must be revised to cover the full economic cost of producing energy. Our survey of informal firms indicates that there are 43%, who have the ability and willingness to pay more in lieu of certainty of power and gas supply.

In order to supplement this information, the respondents were also questioned on conditions that would motivate them to pay 10% higher energy bills to improve the government's cost recovery. 37% respondents were willing to pay extra if day time power availability was increased. Another 28% (particularly from the Punjab province) can pay extra if the power stoppages are announced in time so that production decisions can be better planned. 11% respondents were willing to pay extra if unit price of daytime power tariff is reduced by 5%.

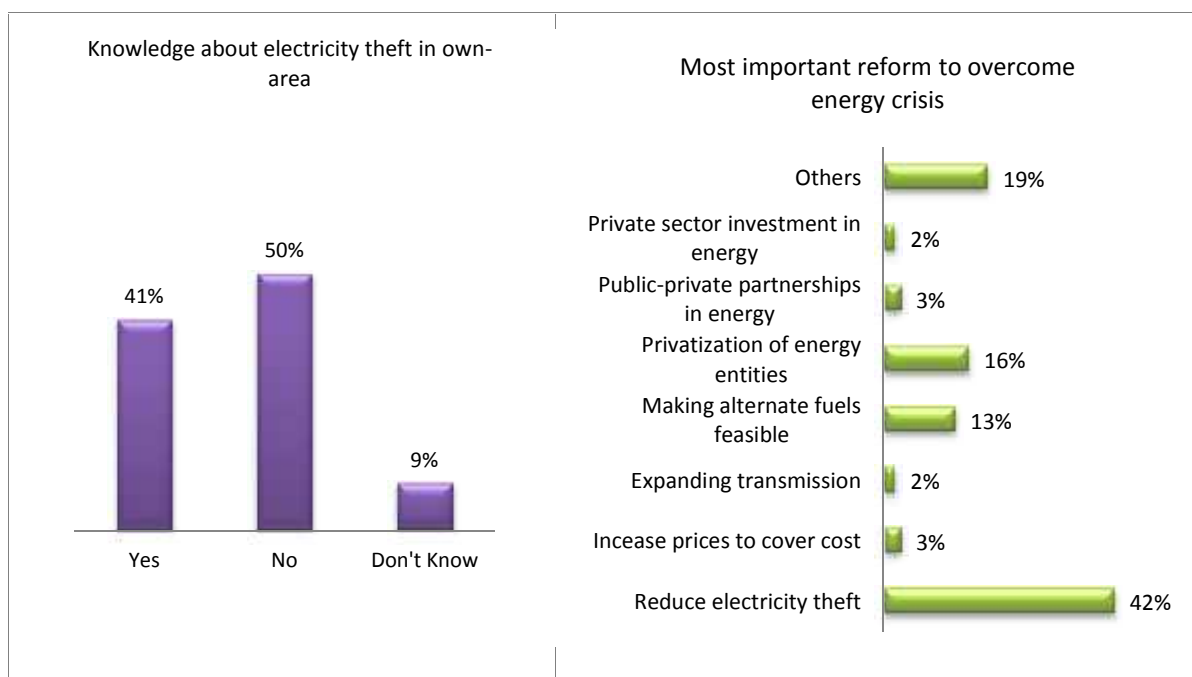
Box 4: Informal Sector Perceptions on Energy Reforms



Source: SDPI Survey Unit 2013

On energy theft, 41% of informal sector respondents reported having knowledge of theft in their own-area. Such responses were particularly large for peri-urban and rural localities in the Punjab and Sindh (Box 5). The respondents were also aware of the damage such practices were causing in aggravating the ongoing energy crisis - 42% responded that reduction in energy theft could be one of the most important reform measures that could provide a short-term respite. Another 16% favoured speedy privatization of energy entities, and believed that an injection of private sector investment and prudent management could bring efficiency and drive competition in this sector.

Box 5: Reforms for Energy Crisis



7. Conclusion

This firm-level survey was conducted to gauge the business community's perceptions on tax and energy reforms in Pakistan. With the implementation of the IMF programme, it seems that the private sector will have to face tougher adjustment in the medium term as the government tries to sustain macroeconomic stability and kick start economic growth.

The key findings from our survey suggest that trust deficit continues to be a primary reason why people evade taxes. The government at the highest level needs to demonstrate fiscal responsibility and accountability, which in turn will persuade the taxpayers to register and fulfil their liabilities. The perceptions regarding corruption in the tax machinery also need to be corrected. The survey respondents were not willing to seek guidance or file grievances with the tax authorities owing to fears of intrusion if documentation is exposed. Such intrusion, according to them, later translates into harassment by tax officials.

A stronger outreach programme should be structured by the federal and provincial tax authorities, which should highlight the improved tax administration measures put in place. For example, the knowledge of respondents on the taxpayers' facilitation unit or other one-window operations by FBR was found weak.

On energy reforms, the business community was in favour of revising power tariffs to cover full economic cost of generation, transmission and distribution. However, in return they demanded load-shedding to be gradually eliminated (particularly daytime outages), scheduled and announced in time.

There was fair knowledge among the respondents on energy thefts in their localities and its role in aggravating energy crisis. In order to improve this situation they favoured greater accountability of

the ground level staff as well as privatization of power distribution companies. The respondents also anticipated that private management will be better able to clamp down theft as well as other transmission and distribution losses.

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