

## COMMENTS ON CPEC RELOCATION POLICY

The document follows up on an agreement at the JCC that a set of incentives will be offered to setup/relocate Chinese businesses to Pakistan. It mentions priority SEZs, which “would be specific to CPEC”. While the wish list from the Chinese is awaited, this document sets out a set of proposals from Pakistan.

### **General comments:**

1. The investment incentives should be offered after a detailed review of international best practice, including evaluations of the experiences of other countries. The document includes a comparison of policies offered in other countries, but there is no analysis of how effective these policies have been. Analyses of the effectiveness of investment policies have already been undertaken by the OECD, IMF, World Bank, IGC, UNCTAD and by several academics, and this research should inform Pakistan’s policy design.

2. It is against Pakistan’s interests that incentives be given only to Chinese investors and that the SEZs be restricted to Chinese investors. These incentives should be given to all foreign investors and joint ventures to ensure competition and to ensure that the highest valued investment takes place. The Chinese already have a natural advantage due to their physical proximity and the fact that the CPEC links them to Pakistan. There is no economic basis for further tilting the playing field in their favour. Hence, the investments for establishing the zones and for investments within the zones should be open to all investors local and foreigners.

3. A time limit should be specified for the incentives, especially those relating to taxes and duty free import.

4. For clarity purpose the policy package for zone developers and zone enterprises must be clearly stated. Cost of land subsidy has to be clearly different for zone developer and zone enterprises. Moreover, as the policy allows a 100% foreign owned entity to be zone developer this leaves government with little room to control. The international comparison provided does not state what the ownership structure of these zone authorities have been in sample countries. This may be looked into before taking a decision.

## Specific comments

Specific incentives are proposed, which are part of SEZ Act 2016.

1. Provision of public goods, basic infrastructure and reduced regulatory burden are welcome. These include
  - a. Provision of utilities and permission for captive power generation
  - b. One window operation for government compliances
  - c. Bulk supply of electricity, gas and utilities
  - d. Provision of plots on installments
  
2. Provision of incentives to encourage technology acquisition and capital investment are welcome. These include
  - a. 50% freight subsidy on imported equipment
  - b. Duty free import of machinery

These can be supplemented or replaced with

- a. *Investment tax credits* that deduct a fixed percentage of an investment from tax liability. Specifying a minimum holding period would mitigate any bias toward short term assets and prevent asset resale after the credit is claimed. It is also useful to use incremental tax credits, which are earned as a fixed percentage of qualifying investment expenditures in a year in excess of some base that is typically a moving-average base. This helps target tax relief to the incremental expenditures that would not have occurred in the absence of the credit
- b. *Investment allowance* that deducts a fixed percentage of an investment from taxable profit (in addition to depreciation). The value of the allowance is the product of the allowance and the tax rate. So, unlike a tax credit, its value will vary across firms unless there is a single tax rate. Moreover, the value is affected by changes to the tax rate, with a tax cut reducing it.
- c. *Accelerated depreciation* that allows depreciation at a faster schedule than is available for the rest of the economy. This can be done in many ways, including through higher first-year depreciation allowances or increased depreciation rates. In nominal terms tax payments are unaffected, but their net present value falls and the liquidity of firms increases.

The recommended incentives have the advantage of being back-loaded in the sense that they are applied after an investment has already taken place i.e. the benefits

have already been realized. Incentives such as credit and land are front-loaded and the costs to the Government occurs before the benefits are realized, carrying a risk that the benefits do not actually materialize.

3. Income tax holidays are **not** recommended. Several studies have now shown that income tax holidays do not have significant impacts on increasing FDI and come at a disproportionate loss to the exchequer. Other documented disadvantages include:
  - a. Income tax holidays are not tied to specific priorities such as value addition, export promotion, technology acquisition or reinvestment of earnings
  - b. Tax holidays are unrelated to the amount the capital invested or its growth
  - c. They do not enable governments to share the benefits of profitable investments and tend to be attractive to high-profit investments. These are likely to have been even without the incentive, or if not, it likely to relocate once the incentive is withdrawn.
  - d. They can produce greater opportunities for transfer pricing
  - e. They can result in a transfer of tax revenue from Pakistan to the investor's home country

Based on this if it is seen necessary to offer some tax incentive sit must be tied to performance. The performance measure should be on degree of technology transfer, localization, value addition and export sophistication of the product. If the companies are able to export high end products to high value markets then tax incentives may be provided.

4. Other incentives that seem fine:
  - a. Renting out sheds for industrial use
  - b. Road shows
  - c. The criteria for specialised clusters seems OK too: value addition and export orientation, local employment generation, environmentally friendly, avoidance of obsolete technology, HR and skills development, low dependence on imports, 100% foreign owned or JV

5. Incentives that require clarification:

- d. "Any type of industry except four restricted sector can be set up". It is not clear what these four are and what the basis for restriction is. Moreover, any type is too general and may result in low value or dirty industry being shifted across to Pakistan. It is important that the recommendation on industry must be specific and must be linked to certain environmental and quality standards. One generic way of doing that is to initially allow industry that are able to export in EU and US markets – specifically, one could ask for industries that can help the country realize the potential under the GSP-Plus provisions.
- e. "Markup support" is not clear. What kind of mark up on loans is being referred to? Moreover, these incentives may be linked to penalties if the companies do not perform.
- f. Additional provincial incentives for specialized industrial clusters – this depends on the specific provincial incentives being offered
- g. On land the incentive is fine, however, if during the phased payment period or an agreed period the companies do not become operational then a penalty may be imposed.