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### **An Approaching Reality**

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**The Fiscal Deficit for the economy stands at 4.2% of the total GDP for FY 06 as against the deficit of 3.3% of GDP for the preceding year. With the future infrastructure investment plans of the government, this deficit is expected to grow to higher levels. This signals a need for disciplining fiscal management while especially correcting for the structural weaknesses in the current tax system and broadening the narrow tax base. The budget for FY 07 has already taken this into consideration as it subjects certain financial services to the sales tax and federal excise duty while also marginally increasing the capital value tax. Additionally the budget assumes an abolishment of tax exemption on capital gains after June 2007.**

**Considering the possibility of the execution of a capital gains tax in Pakistan pretty soon, this issue analyzes the benefits and risks associated with capital gains tax on the concerned investors and the economy as a whole.**

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## **Gazing into the Crystal Ball**

The economy of Pakistan continues to receive deserved rations of appreciation for preserving a firm pace of economic growth for the past four years during which the economy grew at an average rate of almost 7.0% per annum. The appreciable expansion is stimulated largely by dynamism in industrial and services sector while the emergence of a new investment cycle presents a fundamental driving force.


This new investment cycle owes most of its development to the maintenance of liberal pro investment reforms that have been in place for over a decade. Actively seeking foreign and domestic investment, the current elected government of Prime Minister Shaukat Aziz offers broad arrays of incentives to attract new capital inflows. Among many others, these incentives include exemption of taxes on realized capital gains. These pro investment policies have resulted in steady upsurge of the investment upturn that is expected to be sustainable in the near future. The total nominal investment for FY 06 stands at 20% of the total GDP as against the 18.1% investment-GDP-ratio for the preceding year.

However it is important to stress that the economy is not growing without facing certain risks in terms of a growing fiscal deficit that rose to 4.2% of GDP for FY 06 as against the deficit of 3.3% of GDP for the preceding fiscal year. Additionally, with the future infrastructure investment plans of the government, this deficit is expected to grow to higher levels. This signals a need for disciplining of fiscal management while especially correcting for the structural weaknesses in the current tax system and broadening the narrow tax base. Though the tax revenue witnessed a growth of 19.1% during FY 06, it failed to counter a 25.5% rise in expenditure. Considering this, the federal budget of FY 07 has taken various measures to improve the tax to GDP ratio and broaden the tax base. These include subjecting certain financial services to the sales tax and federal excise duty and marginally increasing the capital value tax. Moreover the budget assumes that the tax exemption on capital gains that has been in practice for over a decade will be abolished from June 2007. This has created considerable disturbance among the investor community that is already demanding a relaxation for a longer period. However it is difficult to predict the response of the government to these demands at this point and thus a capital gains tax may not be too far from reality.

## **Penalizing Gains**

A capital gain tax is defined as a tax levied on a capital gain. A capital gain is simply the difference between the price at which an asset is sold and the price at which it was initially purchased:

$$\text{Capital Gain} = \text{Selling Price} - \text{Purchase Price}$$



There is controversy over whether capital gains are income or not. However, the comprehensive concept of income incorporates capital gains because they increase a person's assets allowing him to consume more. Since there is no reason to tax some forms of income and not others, many consider that it is sensible to charge a tax on this gain as well. Though the structure of capital gains tax differs in economies, the amount of capital gains tax paid is largely determined by the length of time an investment is held; that is if the investment is long term or short term. However it must be noted that the time period for short term and long term are defined differently in different economies for different assets. For e.g. in India long term is defined as 3 years for some assets like gold and real estate and one year for others like mutual funds and stocks.


It is important to stress that this gain is not realized until the asset that has appreciated in value is sold. For example, an individual purchases a stock that appreciates by 15% in value by the end of the year. Although the investment has increased in value since the day it was bought, the individual will not realize any gains until he sells the stock. Hence no taxes need to be paid until a capital gain is realized. This property makes a capital gains tax quite different from almost all other forms of federal taxation in that it is a voluntary tax. Since the tax is paid only when an asset is sold, taxpayers can legally avoid payment by holding on to their assets. This phenomenon has been termed as the lock-in effect.

Whether an individual invests in stocks, bonds, mutual funds, real estate, or any other financial instrument, it is imperative to understand the impact of the capital gains tax on his/her returns. Additionally capital gains tax can have widespread consequences on the economy as a whole. All over the world perhaps no single economic issue has been embroiled in more controversy than that of the capital gains tax. Considering the fact that this tax may soon be executed in Pakistan, it is important to analyze the arguments that exist in economic literature for and against the implementation of this tax.

### **Say YES to CGT!**

The proponents of capital gains tax argue that CGT is fair and broadens the tax base. Arguing in favor of capital gains tax, tax analysts often maintain that CGT promotes equity as it improves the progressivism of the tax system. This is because the returns on capital accrue primarily to the owners of the capital and that those owners tend to be wealthier than the average worker or family in the economy. Hence a capital gains tax shall improve income distribution within the economy by means of decreasing the income of the affluent individuals.

Besides this, the main justification presented for implementation of CGT is that it will reduce the incentive for taxpayers to avoid tax using transactions that represent revenue as capital gains. This shall raise normal income tax collection because of lower avoidance.



Lastly, it is argued that CGT will undoubtedly broaden the tax base, which will facilitate income tax rate reductions at all income levels. Moreover the broader tax base shall reduce the budget deficit. Hence if a capital gains tax increases revenues and decreases the federal budget deficit, then savings and investment in the economy might actually rise after the tax cut.

### **Say NO to CGT!**

*The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced by new ventures in obtaining capital and thereby the strength and potential for growth in the economy.*


President John F. Kennedy, 1963

The opponents of capital gains tax argue that the tax is economically inefficient due to its penalizing effect on entrepreneurship and investment and hence must not be implemented in the first place. Additionally it is widely believed that the structure of capital gains tax around the globe is unfairly embedded.

A capital gains tax will diminish investment, output, and real wages. This is primarily because a tax imposed on the return from capital investments will reduce these investments. This is because the rate of growth of the nation's capital stock is inversely sensitive to the rate of taxes on the return from capital. Using conventional economic models it is not easy to calculate the magnitude of the capital response but the direction of change is clear. Consequently a capital gains tax shall shrink investment capital especially for small and growing businesses as these high-risk small business start-ups receive their seed money primarily from informal investors and venture capital which are subject to the capital gains tax. This resulting decreased investment has undesirable risks associated with it as all economists agree that these investments stimulate productivity, real capital formation, national output, and eventually higher living standards.

In the long term the real impact on workers of imposition of a capital gains tax is reflected in wages: As a capital gains tax lowers the expected after-tax return for the owner of capital it leads businesses to reduce their purchases of capital, equipment, computers and new technologies. Hence in the very short term firms may use less capital and more labor to produce goods and services. As workers have less capital to work with, the average worker's productivity that is the amount of goods and services he/she can produce in an hour falls. This will cause the wage rate to fall as wages are a function of productivity.

Moreover, a tax would lock-up capital and hence reduce possibilities of new investment. For those planning to sell their investments to generate further investments, a capital gains tax might create a locking effect as individuals would decide not to sell their assets that have accumulated in value and not shift their portfolio holdings to assets with higher long-run earning potential. Additionally the locking effect may cause price distortions as



hoarding capital reduces the supply of capital within the economy and misrepresent the price.

The most common argument presented by economists favoring capital gains tax is that it broadens tax base. However opponents of CGT believe that the tax on capital gains will actually reduce tax collections. This is because capital gains tax acts as a disincentive for investment reducing economic growth. This contraction shall generate less tax revenue for the government.


Moreover there is unfairness imbedded in the tax treatment of capital gains if not indexed for inflation. The seller pays tax not only on the real gain in purchasing power but also on the illusory gain attributable to inflation.

There is one other large inequity of the capital gains tax in that it signifies a form of double taxation on capital formation. As mentioned earlier capital gains represent the appreciation in the value of an existing asset. However any appreciation reflects an increase in the after-tax rate of return on the asset as the price of the asset already reflects the taxes implicit in the asset's after-tax earnings. Thus any additional tax is strictly double taxation. Take, for instance, the capital gains tax paid on a stock. The value of that stock is based on the discounted present value of all of the future proceeds of the company. If the company is expected to earn \$ 200,000 a year for the next 10 years, the sales price of the stock will reflect these returns. The gain that the seller realizes from the sale of the stock will reflect those future returns and thus the seller will pay capital gains tax on the future stream of income. But the company's future \$200,000 annual returns will also be taxed when they are earned. So the \$200,000 in profits is taxed twice that is when the owners sell their shares of stock and when the company earns the income.

Considering the benefits and risks associated with CGT on not just the investment but the whole economy, it is highly imperative for the government of Pakistan to run a complete cost benefit analysis before deciding on the reenactment of CGT. This is because if the risks on the economy of CGT are large, the efforts of the government to extract its intended benefits may be futile.

### **Heed before you leap!**

Due to the inability of the economy to tax individuals adequately and equitably, the tax to GDP ratio remains at low levels. In 2005-06 the ratio is estimated at only 10.4%. Consequently most tax analysts suggest enhancement of the tax to GDP ratio, addressing the need for widespread reform of the present taxation system by abolishing almost all exemptions and bringing into the tax nets all incomes irrespective of their source. The budget for FY 07 has already taken this into consideration as it subjects certain financial services to the sales tax and federal excise duty while also marginally increasing the capital value tax. Additionally the budget assumes a reenactment of the capital gains tax from July 2007. Nonetheless in view of the widespread implications of the capital gains



tax, it is highly imperative for the government to reconsider its intention of reenacting the CGT.


First and foremost the initial observance of CGT will be expensive, time consuming and difficult. This is because the tax structure already in place needs to be revamped. It will be necessary to formulate new methodologies for the implementation of the tax that will have to be clearly communicated to the tax payers and the administration to ensure the exact compliance of the capital gains tax. Hence administration and compliance present serious difficulties, but it must be stressed that these mainly relate to the setting up of the tax, and should not be a major difficulty every year. Moving forward then it is important to unveil the bigger hindrances that will prevent the economy from extracting the intended benefits of the CGT, once imposed.

Currently a significant risk facing the Pakistani economy is the unacceptably low savings rate relative to the other growing Asian economies. Despite a growth of 6.4% in FY06 the national savings to GDP ratio reached its lowest level since 2001 at 16.4%. A CGT will just act to worsen this ratio by reducing investor's appetite to save.

Another risk facing the growing economy is the economy's large undocumented sector and significant portions of capital. This poses a serious concern for the government's decision of reenacting the CGT as it is extremely difficult to formulate the true valuations of these undocumented ventures and capital and hence the collections of CGT are diluted. Take for instance the case of the real estate sector. There is no centralized structure present especially in the underdeveloped regions of the economy to keep a record of the transactions taking place in the sector. Even where there is some adequate record keeping method present, the valuations are almost always understated. This inadequate documentation shall undoubtedly reduce the collections of CGT from the real estate sector.

This implies then that the burden of CGT falls on the documented sectors of the economy like the equity markets that are adequately documented. In this way a CGT represents a penalty on the equity markets for being documented. Hence it would not be surprising to witness a diversion of national productive resources to undocumented sectors of the economy like the real estate in an attempt to evade taxes in the near future.

In the total tax receipts of Rs. 712.5 billion for FY 06, a significant part was contributed by the corporate sector. All listed companies are taxed at a uniform tax rate of 35% and the shareholders of these respected companies are taxed twice as they are additionally taxed on the dividends. The dividends for the public listed companies are taxed at 10%. Moreover a capital value tax was charged at 0.01% on purchase of shares with a withholding tax of 0.005% on sale value of shares. Hence it must be noted that the CGT will just further add to the net taxes paid by these ventures and their shareholders. As a result of these heavy taxes, it is reasonable to expect the currently bullish financial markets of Pakistan to view a gradual downfall in terms of reduced investments.



This presents a substantial risk for the currently growing economy as in recent months the corporate sector has witnessed a significant upsurge stimulating and sustaining the average 7% growth rate of the economy. The appreciable achievements of the yet emerging sector are reflected in the recent issuance of MCB's and OGDC's GDR that has revitalized foreign interest. Hence it is important to question if the enactment of a CGT is worthy of disrupting the momentum of the fast pace developing equity sector. Take the case of India, where in order to promote investments into the equity markets, the Indian Finance Act of 2004 amended the tax rates that apply to capital gains realized from the transfer of equity shares and units of equity oriented funds on a recognized stock exchange in India by eliminating the tax on long term capital gains and reducing the tax on short term gains from 30% to 10%.


Perhaps the most pertinent question that arises is that even if the CGT is imposed, what will be its contribution to the total tax receipts of the Pakistan economy. In case of most developed countries for instance CGT fails to contribute significantly to the total tax revenue. This is despite of credible documentation present for all sectors of these economies. For example Britain has over the years witnessed an insignificant contribution of CGT in the total tax revenue collected as shown in Table 1. Even in the United States, tax receipts from realizing capital gains have historically contributed around 2% to 3% to the total receipts. Hence if the well documented economies fail to collect significant tax receipts from CGT, it is unlikely that CGT will contribute any noteworthy portion to the tax revenue in Pakistan that has a large undocumented sector.

**Table 1**  
**Net Receipts of Capital Gains Tax, UK**

Year	Amount (£ m)	Share of Government Receipts (%)
1998-99	2002	0.6
1999-00	2122	0.6
2000-01	3236	0.9
2001-02	3034	0.8
2002-03	1596	0.4
2003-04	2225	0.5
2004-05	2000	0.4

*Source: Inland Revenue & HM Treasury*

This insignificant contribution of capital gains tax all over the world has opened numerous debates with regards to the issue. It is interesting to note that all around the world many economies are considering shifting their tax structures away from capital gains tax by either reducing the tax or abolishing it all together. A pertinent question then arises that why are we intending to move in the opposite direction to these economies?



In the face of the above arguments it is extremely critical to question the plan of the government to reenact the capital gains tax in 2007. Though it is important to discipline the fiscal management by means of broadening the tax base, what is more vital is to broaden the tax base by increasing the number of taxpayers paying the current taxes rather than increasing the tax burden of the already taxed individuals and ventures. Hence considering the current boom of the equity markets in Pakistan, and the undesirable consequences associated with the implementation of the capital gains tax in terms of low investments, low savings and consequently low output as well as price distortions resulting from the lock in effect on capital we would advocate for protracting the capital gains tax exemption beyond June 2007.

*You're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country, because that's when the work will come back. People say capital gains are for the rich, but I've never been hired by a poor man.*

Painting Contractor, New Jersey



## Economic Snapshot

Fiscal year 06														
Units	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	
<u>Inflation</u>														
Headline Inflation	%	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11
Core inflation	%	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70
Food inflation	%	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54
Non-food inflation	%	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64
6 month	%	8.14	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81
12 month	%	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00
<u>External Sector</u>														
Export	Mln US\$	1,317	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	1290
Import	Mln US\$	2,021	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	2191
Trade balance	Mln US\$	(704)	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	(901)
Remittances	Mln US\$	373	309	336	391	339	444	401	507	464	376	435	422	410
Forex reserves	Mln US\$	11,715	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503
n.a = Not Available														



**Research Desk  
Treasury and FX Group  
MCB BANK LIMITED  
20<sup>th</sup> Floor  
MCB Tower  
I.I Chundrigar Road  
Karachi**

**Contact**

**Sana Qureshi  
Research Analyst  
Telephone: 92-21-2270025  
0300-3915027  
Email: [sanaqureshi@mcb.com.pk](mailto:sanaqureshi@mcb.com.pk)**

**Usman Siddique, CFA  
Head of Research and Structured Products  
Telephone: 92-21-2270024  
0333-2153438  
Email: [usman.siddique@mcb.com.pk](mailto:usman.siddique@mcb.com.pk)**

**Fax: 92-21-2270094  
92-21-2270109**

