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Tax relief for manufacturing and services sectors aid economic recovery from Covid-19 in Pakistan

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Key messages

- Tax reductions for the manufacturing sector produced the highest growth in real GDP.
- Consumer prices were reduced the most under this policy option.
- The provision of tax relief to key economic sectors, such as manufacturing and services, can boost exports and improve consumer welfare.

Improved tax policies are necessary to address the Covid-19 emergency

In response to the Covid-19 crisis, national and sub-national governments enacted tax relief measures for individuals and businesses. As a result, the federal government is eager to learn how tax policy and administration can aid pandemic recovery efforts.

Weak economic growth and low tax revenues made it difficult for the government to maintain social protection measures during the Covid-19 pandemic. While micro, small, and medium-sized enterprises (MSMEs) received some tax relief in FY20, continued assistance is vital amid the ongoing

global health emergency, which would likely increase government borrowing requirements. Furthermore, the government sought to improve tax relief to ensure that only the most vulnerable receive exemptions and subsidies.

With Pakistan subject to an International Monetary Fund programme, implementing any tax relief is challenging. Thus, tax relief options must ease the financial shocks experienced by individual taxpayers, small and medium-sized businesses, and trading companies while minimizing the government's revenue loss.

The study

In 2020-2021, a team of local economists and policy analysts conducted a study to assess the impact of implemented policy options. The team used macro policy (CGE) modeling techniques to simulate the effects of different scenarios on the national economy. The results are summarized in this brief.



Policy Options

From discussions with key policymakers and other stakeholders, and in light of real data, four main tax relief and subsidy policy options implemented by the government during the pandemic are worth considering and are assessed here:

1. A 3.5% reduction in GST for large-scale manufacturing sectors.
2. A 2% reduction in tariffs on priority agriculture and food items.
3. A 3% decrease in general sales tax on selected services sub-sectors.
4. A production subsidy allowed to cotton sector, estimated as a 2.5% negative GST rate on cotton sector output.



Photo: UN Women/Fahad Abdullah Kaizer Hoel/World Bank

Key findings

Compared with all other government measures adopted during the pandemic, tax reductions for the manufacturing sector (option 1 above) have produced the highest growth in real GDP.

The impact of manufacturing sector tax reductions on fixed investment is also relatively high and will continue to increase. This scenario generated the highest price reduction, almost twice as much as any other simulation.

Tax reductions for the manufacturing sector can also help trade firms achieve export gains and boost household consumption.

While government interventions have led to positive outcomes, not everyone benefits equally. For example, reducing indirect manufacturing taxes may help all households, but wealthier households in rural and urban areas will benefit more than poor households. The concentration of affluent households in manufacturing activities may be a factor.

Tax relief for services sector firms (option 3 above) is also an effective policy option. Since services account for a large share of GDP, fixed investment gains are highest when these sectors receive a tax rate reduction.

While all fiscal responses led to increases in

Table 1: Synopsis on the effectiveness of policy options in contributing to economic recovery (Percentage change over baseline).

Indicators	Fiscal policy change options			
	Reduction in GST for manufacturing sectors	Reduction in tariffs on priority agriculture and food items	General sales tax on select services sub-sectors reduced	Production subsidy allowed to cotton sector
Real GDP Growth	0.153	0.052	0.043	0.028
Investment	0.410	0.263	0.476	0.187
Prices (CPI)	-1.624	-0.543	-0.615	-0.412
Exports of manufacturing sector	0.354	0.246	0.396	0.152
Consumption of poorest households	1.80	0.40	1.50	0.20

exports, the impact on net exports or terms of trade can differ. For example, while the reduction in indirect taxes led to increased manufactured exports, import demand in this sector surged during the same period.

Finally, the Covid-19 pandemic may have exacerbated overall food consumption inequalities. While the policy options discussed saw increased consumption levels among all households, the gains are relatively smaller for poorer households.

Further, the policy options contributed to increases in wages, but earnings growth was higher for skilled workers than unskilled workers.

All policy options were evaluated based on their effectiveness, efficiency, and fairness. The results of these evaluations can be found in Tables 1 (above) and 2, with each table providing a breakdown of the options' performance for each criteria.

Table 2: Efficiency level of policy options

(Ratio of the change in a performance indicator over the state revenue loss).

Performance indicators		Fiscal policy change options			
		Reduction in GST for manufacturing sectors	Reduction in tariffs on priority agriculture and food items	General sales tax on select services sub-sectors reduced	Production subsidy allowed to cotton sector
Real GDP Growth		2.25	0.03	0.08	0.10
Investment		0.38	0.21	0.31	0.30
Exports of manufacturing sector		0.24	0.11	0.21	0.34
Consumption of poorest households		0.45	0.19	0.38	0.22

Conclusions and policy implications

The findings discussed above offer conclusions that can improve tax policy responses during economic emergencies, such as the one presented by the Covid-19 crisis. Indeed, out of all fiscal policy changes, those designed for the manufacturing sector offer the highest gains in real GDP and a reduction in consumer prices. The tax relief provided to the manufacturing sector also meets almost all the evaluation criteria.

Furthermore, the conclusions in this report indicate that tax and subsidy changes alone are not enough to mitigate the Covid-19 crisis's adverse impacts on poverty and inequality and sustained social protection and social safety nets are necessary.



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To find out more about the scientific research methods and findings, read the full [PEP working paper 2022-13](#).

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