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No. 44

Memorandum on the Foreign Exchange Surcharge System

By

Professor Emile Despres



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I fully agree with the view put forward in Clair Wilcox's note of 15 November, entitled "Overplanning?". Moreover, the tendency pointed out in this note to become too detailed and specific in drawing up a private investment plan seems to me one aspect of a more deepseated difficulty. There appears to be an assumption that Government must plan and regulate all aspects of economic life in detail even though the regulations are applied without coordination or clear objectives and without adequate data or efficient administrative apparatus. Many factors are responsible for this, including a rather paternalistic view of the role of government.

There are many portions of the private sector, such as agriculture and cottage industry, in which positive governmental stimulation is essential. There are others, such as luxury construction, in which more restrictive governmental controls would be highly desirable. But there is a broad area which could best be left to semi-automatic, decentralized regulation through the mechanism of the market. In this area the apparatus of direct controls, including import licenses, licensing of new firms, capital issues authorizations and many others, is a major impediment to economic efficiency and growth.

I have used the term "semi-automatic" in the previous paragraph because the government's role in spheres which are left to the working of the market mechanism should be by no means completely passive. In the first place government should continuously investigate the prices of major commodities to detect promptly cases in which they are being held substantially above competitive levels, through collusive practices or otherwise. Cotton cloth and vegetable ghee seem, for example, to be good candidates for investigation. If existing laws do not enable the government to take

EDITOR'S PREFACE

This widely read note of Professor Despres's was written nearly a decade ago (May 12, 1956), in response to a request by the Chairman of the Planning Commission "for a working paper on the foreign exchange surcharge system and the foreign exchange auction system as methods of avoiding the shortcomings of the existing licensing system".

The memorandum was not regarded by Professor Despres as anything but a presentation of thoughts "in somewhat loosely organized fashion". Hence, it should not be read as a piece of completed research, but rather as an excellent example of the kind of contribution which a seasoned observer can produce in a bit of jotting. This memorandum has proved seminal for at least a half dozen research projects within the Pakistan Institute of Development Economics, has had a distinct influence on Pakistan's foreign exchange control policies, and has been repeatedly used most fruitfully in the Training Course at PIDE.

For these reasons even though the memorandum has been duplicated for circulation at least twice previously, it is being re-issued in the PIDE Research Report series. This expedient is being followed as a means of making the memorandum available to a larger number of readers than heretofore--despite the fact that it was written two years before Professor Despres began his long association with PIDE, as its Director.

Bruce Glassburner
Senior Research Adviser, PIDE

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corrective action, these laws should be strengthened.

In the second place, there are many cases which do not require direct controls but in which the impact of market forces can usefully be modified through the use of taxes and subsidies. Taxes and subsidies are frequently preferable to direct controls as an instrument to influence the uses to which existing resources are put, the structure of production and the dimension of new investment. To some extent these devices are already used for this purpose as in the case of protective tariffs. Many of the present tax devices, however, are not well calculated to improve the use of resources. The tax concessions on new investment, even if originally justified, have become unnecessary and wasteful since new capital is already grossly underpriced and existing demands for capital equipment for repair and replacement, as well as for modernization and expansion, cannot be fully satisfied. The present sweeping concessions, instead of providing a needed stimulation to investment, merely augment this excess demand and provide an unnecessary windfall to the taxpayer.

On the other side, the whole policy of taxation of exports should be carefully re-examined, both in general and for specific export products, in order to determine whether these taxes are not seriously interfering with the most productive use of the country's resources. The need for revenues is not a sufficient justification of continuation of these taxes if their larger economic effects are found to be adverse, since the revenue lost could be more than recovered by a new levy on imports, as is proposed later in this memorandum. In considering the economic effects of export taxes, the main questions are the following:

1. To what extent would the physical volume of exports be increased by removal of the tax?
2. Would increased export volume be fully translated into foreign exchange earnings, or would much of the benefit

be wiped out by the depressing effect on world prices? (This question, which relates to the elasticity of world demand, arises chiefly in the case of jute.)

3. Taking into account both the increased export volume and the possible adverse effect on world jute prices, would the net gain in foreign exchange earnings be sufficient to compensate for the internal costs involved in additional production of goods for exports? In the case of cotton and jute, the chief element of internal costs would be the loss of other agricultural production through diversion of acreage. Would the additional export earnings be more than sufficient to make good this loss of other agricultural output?
4. Should the cotton textile and jute textile industries continue to be subsidized, or should they now be required to stand on their own feet without subsidy? If a continued subsidy is deemed necessary, are export taxes which depress the internal prices of raw cotton and raw jute be the best means of subsidizing their manufactures?

It is easier to raise these questions than to answer them, and even when further research has been carried out, difficult questions of judgement will still remain. The main point, however, is that a decision regarding these taxes should be based on full assessment of their economic effects rather than upon direct revenue considerations. If the economic effect of a removal of some or all of these taxes would be to increase the overall productivity, it should be possible to make good elsewhere the loss of revenue directly involved.

Once this point is clearly recognized there are many opportunities to use taxes instead of direct controls as a positive regulatory device. For example, market demand for cigarettes appears to be high and growing. If the government feels that scarce capital, instead of being used to expand the capacity of this industry, should flow into other fields of greater social value, the tax on cigarettes could be increased to a point where demands for cigarettes is held within the limits of existing capacity. If, instead, new investment is merely curbed through denying import licenses for the machinery while demand for cigarettes continues to grow, the price of cigarettes will rise and manufacturers and distributors

will gain an unjustified windfall. This price increment might better be captured as taxes than be permitted to accrue as private profits. A price ceiling at the manufacturer's level cannot meet the problem, since it would merely transfer the distributors. If placed at the retail level, the ceiling would be widely evaded. Nor is rationing a workable solution for articles like cigarettes. Rationing, when administratively feasible, is probably the best course where essential consumer staples are in short supply, but should be limited to such goods. In other cases, the tax device proposed above is greatly preferable.

With respect to direct controls, import controls are the worst offenders of all. They are said to be justified on the ground that foreign exchange is short. But if foreign exchange ever reaches a condition of abundant supply, it will be a sign, among other things, that the development effort is grossly inadequate and that the country is not making full use of a key resource. Foreign exchange should be short. The fact of shortage, by itself, does not justify continuation of the present system, which misuses resources and provides easy, monopoly profits to established, favoured firms and established industries. It favours proximity to Karachi. It greatly hampers small and medium sized firms and cottage industry. On the whole, it favours capital-intensive projects. It creates needless bottlenecks and waste of resources, owing to shortages of repair parts or key materials. It impedes the entry of new firms, thereby stifling entrepreneurship restricting competition and retarding industrial diversification. It provides easy profits to a favoured group. It deprives the government of such revenue which it could easily and properly obtain. Although gradual strengthening of administration and the slow development of more detailed statistical data might somewhat mitigate these shortcomings they are largely inherent in the system itself.

The present dependence of direct controls of all sorts prevents prices from fulfilling the regulatory role which they can perform. There is a widespread attitude in official quarters, that things should be kept cheap even when they are scarce. This attitude, which is justified in the case of basic necessities which can be rationed, causes needless difficulties in other areas. Since there is not enough to go around at the controlled cheap price, the favoured firms or individuals, who are able to buy at the controlled price are able to enjoy a quite unjustified wind-fall gain. In the case of scarce productive resources, the advantage of allowing their prices to rise to a level which reflects their scarcity is that users generally will be induced to economize in their use, and generally speaking, only those who can make the most profitable use of the scarce resources will buy them. Although the most profitable uses are not invariably the most productive uses, the criterion of profitability should be accepted in most fields. Under the present systems of low prices, those who are fortunate enough to receive the necessary permits often use the resources extravagantly, while others whose needs are, in many cases, of higher economic and social urgency are denied access to the supplies. The result can scarcely be called a system of private enterprise; it tends, rather, towards a restrictive type of state capitalism.

There are many examples of this unwillingness to let prices perform their appropriate function. I am told, for example, that coal prices are equalized among the main consuming centers, so that prices in Lahore and Karachi, for example, are the same although Lahore is closer to the source of supply. There is simply no reason for this. Rail haulage of coal is costly: it is capital-intensive; railroad capacity is strained. A higher price for coal at Karachi, which would encourage the use of other fuels here and encourage industries using such coal to locate closer to the

supplies, seems appropriate. It is also said that the price of Sui Gas instead of being placed well below coal, has been fixed "competitively" with coal which has retarded substitution of the cheaper for the dearer fuel. I have not checked the accuracy of the foregoing statements on fuel prices, but I believe this sort of thing is widespread.

The Planning Board has given much attention to the problem of over-centralization in public administration. The problem discussed above is a closely allied one. Under the system of direct controls, the function of decision-making in the private sector of the economy has been to a considerable extent transferred to government. Although decentralization of initiative, with coordination through market processes is perhaps the major advantage of a system of private enterprise, this advantage is now largely lost through the pervasiveness of official controls. The result is that the decision-making process for both the public and private sectors is characterized by government over-centralization. Moreover, the application of the separate controls is largely uncoordinated, with resulting large impairment of productivity through disturbances of economic balance.

The Draft Plan stressed the general principle that national income could be raised not only by expanding total resources through new investment but, even more important, by using existing resources of higher levels of productivity. The Plan mentions several ways in which the use of existing resources can be improved. In addition to the methods cited there, one should add an increased degree of reliance on the market mechanism, with reduced dependence on an uncoordinated use of centralized controls.

In this connection the most important single step would be a substantial modification of the present system of import controls (while retaining present exchange regulations to prevent flight of

capital, restrain vacation travel abroad and provide an additional check on luxury imports.) The change would consist of the imposition of an import licence purchase roughly sufficient to eliminate the present excess demand for imports. This level need not be accurately estimated in advance, since it can be found by successive totals. A single rate of surcharge would apply to most imported goods. A few goods, such as foodgrains and pharmaceuticals and necessary remittances to Pakistanis studying abroad might be exempted from surcharge, partly for social reasons; a few, such as private passenger cars and other imported luxuries, might be subject to a special penalty rate. With these exceptions, a uniform rate would apply. Generally speaking, differentials, in the levies on particular imports should continue to be confined to other rates of custom duties.

An effort would be made to fix the surcharges at a level high enough to permit all remaining demand for import permits to be met except, perhaps, for luxury imports. There would be no need, however, for a precise balancing from day to day. The surcharges might be fixed at annual or semi-annual intervals, and the foreign exchange reserves of the State Bank might serve, as at present, as a buffer stock to absorb surpluses or meet deficits. The surcharges should be paid not only by private importers but by government departments. It is understood that the I.M.F. while opposing the auction system, does not look with disfavour on a system of the type proposed above and considers it in many respects preferable to the present type of licensing system which relies on official rationing rather than surcharges as a means of allocating scarce foreign exchange.

This system possesses two basic advantages. In the first place, scarce foreign exchange would be put to more productive use than at present. Access to import permits would be greatly broadened.

Apart from importers of luxury goods, who might be denied licences even if willing to pay the penalty surcharge, all those who were willing to pay the custom duties, sales tax and general surcharge would be granted licences to import. The decisions of buyers based upon their willingness or unwillingness to pay the surcharge would be substituted for the decisions of government officials in determining the allocation of scarce foreign exchange among competing claimants. Although it cannot be held that those who are willing to pay the highest price will invariably be those who would put imported goods to their most productive uses, it is strongly probable that a much better result would be obtained than if the matter is left to government allotment. As an example, the benefits to cottage industry are readily apparent. Many such industries must have imported equipment in small amounts. Since the price of the equipment, even if high, is not a major element of cost, the price is usually of quite secondary importance to the prospective buyer. Many cottage industries today are fettered by their inability to get needed imports at any price. The same line of reasoning applies wholly or in part to many small-scale and medium-scale enterprises, to new firms and to business lacking representation in Karachi. The proposed liberalization of the import licensing system would go far to remove this obstacle. It would by no means obviate the need for Cottage Industries Centres and other positive measures of stimulation, but it would make the task of stimulation much easier. Cottage industries, as well as small-scale or medium-scale industries which are now unable to obtain licenses would benefit greatly. Since these industries are generally labour-intensive, the small amounts of capital equipment which they need would be very highly productive.

At the other end of the scale, large established firms, under the system now operating, are sometimes allotted much more foreign exchange than they would choose to acquire under the sur-

charge system. The result has been that exchange has sometimes been used to purchase unnecessarily elaborate equipment and to set up industrial plants using "advanced" technologies which are needlessly capital-intensive and therefore unsuitable here. Along the same lines, imported steel and other metals have been extravagantly used in much construction work. Firms with large uninvested profits, when granted licenses, have purchased imports well beyond their requirements since they would rather hold imports than idle rupee balance. Although it might not be effective in all cases, the imposition of a high import license surcharge would tend to curb many of these low-priority uses of foreign exchange, thus freeing exchange for more productive purposes. It would also help to eliminate many crippling bottlenecks which now arise due to shortages of spare parts or key materials.

The second major advantage of the system here proposed is that it would provide large government revenues which could be used for economic development. The producer of export crops receives a price in rupees which depends upon the official rates of exchange of which the foreign exchange proceeds of the exports are surrendered to the State Bank. If the producer of exports were allowed to sell the foreign exchange proceeds in a free market, instead of at the official rate, his income would be greatly increased. In effect, therefore, the requirement that the exporter surrender exchange at the official rate imposes a large, hidden levy on the producer of export goods. Although a part of this levy is captured by the government through customs duties and sales taxes on imports, and through income and profits taxes, the major portion accrues as profits to private firms and individuals who sell industrial goods, imported or domestic, at the prevailing scarcity prices. Just as a levy is imposed upon the exporter who is required to sell foreign exchange at the official rates, a gift is bestowed upon the importer who receives a license and is

allowed to acquire foreign exchange at these rates. For example, the manufacturer possessing an import license is permitted to buy his capital equipment and raw materials with foreign currencies purchased at low official rates and to sell the resulting product at prices which fully reflect internal scarcities. Much of his profit emerges from the spread between world prices and internal prices. His gain is not essentially different from that of the importing merchant who merely resells at high internal prices the same goods he has been licensed to purchase abroad at much lower world market prices.

Favoured access to cheap foreign exchange is one of the major sources of the large industrial and commercial profits of recent years. While continuation of the hidden levy on exports represented by present exchange rates appears desirable unless a situation is reached where devaluation would substantially increase foreign exchange savings, the proceeds should be collected and used by government for economic development. The levy becomes difficult to justify if it is chiefly transferred to private profits in the industrial and commercial sector.

The internal price structure for industrial goods contrasts markedly with that for agricultural products. The effect of the official exchange rates and of export taxes on agricultural exports have been mentioned. In addition, governmental procurement of foodgrains and other official measures have been used to hold down the prices paid to producers of domestically-consumed agricultural products. Consequently, the domestic terms of trade between the rural, agricultural sector and the commercial and industrial, urban sector are markedly unfavourable to agriculture and highly favourable to industry and commerce, in comparison with corresponding price ratios in the world market. Although this is to some extent characteristic of underdeveloped, agricul-

tural economies which export agricultural products and import manufactures, it is markedly accentuated in this country by government policies.

These policies, although they bear ^{most} heavily on the poorer, backward sector for the benefit of the wealthier, developing sector should now be drastically reversed. In a predominantly agricultural country striving for economic development, a substantial share of the internal resources needed for development uses must come, directly or indirectly, from agriculture. The question, therefore, is one of degree. It is not whether agriculture should bear such levies, both direct and disguised, but how large these levies should be.

My answer would be that the direct levies, chiefly land revenue and water rates, are now too low, that the hidden levies probably are somewhat too high and that too large a share of the hidden levies is emerging as private industrial and commercial profits rather than as public revenue. Such ^{private} profits, if predominantly reinvested in high-priority fields, can contribute decisively to economic development. This contribution was of first-rate importance in stimulating and financing urgently needed industrial expansion in the initial phase of Pakistan's development. At present, however, these profits are not being so usefully employed. Top priority should today be given to agriculture rather than industry, and most of the high-priority investment needed at the present stage is public investment. A somewhat higher level of agricultural prices as a whole in relation to industrial prices would probably reinforce the effectiveness of the schemes for raising agricultural productivity although this cannot be stated with certainty. In any event, the growth of urban buying power may make it gradually more difficult to maintain present price relationships, even if crop yields recover to normal levels. What-

ever view may be taken on this question, it is clearly necessary that commercial profits be more heavily taxed in order that these funds may be funneled through the public sector into agricultural schemes and public investment projects which today deserve top priority. An import surcharge appears to be the most effective, single measure for this purpose.

Another serious case of underpricing of an acutely scarce resource is that of capital. Underpricing in this case results from a combination of direct and indirect causes. The direct causes are (1) the import licensing system, under which the price in rupees of imported equipment paid by firms granted licenses is held down; (2) low interest rates to these restricted classes of borrowers who can obtain funds through security floatations, bank credit, loans from insurance companies and similar sources and (3) substantial tax concessions on new investment. Thus, the businessman who obtains an authorization to build or expand his plant, or import permit, and bank credit or permission to issue securities gains command over a scarce and highly profitable resource at extremely favourable terms. At these favourable terms, there exists today a sizeable, unsatisfied demand for import permits, for credit facilities and for other official authorizations.

The general disadvantages of this system of under-pricing and official rationing have already been pointed out. Official restraints on certain types of profitable but undesirable investment, wherever possible through taxation or if this^{is} not possible by more direct means, should be continued and, in some fields, strengthened government should encourage and promote private investment in other fields which, although potentially of high productivity, are held back by lack of entrepreneurship or special obstacles. But the present attempt at private regulation of the whole field of new investment results in wasteful and distorted use of resources.

Although the market mechanism does not yield ideal results, the results, apart from special cases, are likely to be much better than under the present system of pervasive regulation.

Revision of the present import licensing system has been proposed above. The draft Plan contains proposals for controlling present tax concessions on new investment. There remains the problem of broadening credit facilities and the closely related problem of interest rates. The rates paid on government loans and loans to first class private borrowers are at a level with or below those now prevailing in most advanced countries. The volume of funds which can be made available for lending without producing dangerous inflation is narrowly limited, however. Under present conditions, financial facilities are inadequate and loanable funds are available to only a few, restricted classes of borrowers, so that most of the productive demand for funds from credit-worthy borrowers remains unsatisfied. Thus, low interest rates go hand in hand with a restrictive rationing of financing facilities, partly through government action and partly through the narrowly restrictive lending practices of the banks.

The draft Plan contains recommendations for a comprehensive broadening of credit facilities to both industry and agriculture. As this is achieved the total demand for loans would greatly exceed the amounts which could be made available without leading to serious inflation. An obvious solution would be to permit interest rates to rise in order to discourage marginal borrowers and limit demand to those productive borrowers whose uses for funds promised sufficiently high returns to enable them to meet the higher interest costs. High interest rates, besides channeling funds into uses promising the highest returns, might also be conducive to increased thrift.

Since high interest rates are generally deemed objectionable on religious and moral grounds, this method of meeting the problem probably must be rejected. An alternative approach, which, although providing no inducement to increased thrift, would be as effective as higher interest rates in making it possible to broaden the availability of credit to borrowers who at present cannot obtain funds at any price would be to impose an annual tax on a borrower's average outstanding indebtedness above a stated minimum figure. The annual carrying charge on a loan would then consist of the interest paid to the lender plus the tax paid to the government. The exemption limit should be placed high enough (1) to exempt the borrowing of small and medium sized cultivators; and individuals borrowing small amounts to meet temporary personal needs and (2) to keep down the costs of collection by excluding a large number of small assessments. Enforcement of the tax would be aided by utilizing the loan records of banks, insurance companies and other major lending agencies. In explaining the tax to the public, it would be justified both as a measure for capturing the windfall profits which some businesses get through low interest rates and as a measure which must go hand in hand with the broadening of credit facilities in order to avoid the dangers which a marked broadening of credit facilities would otherwise involve. The tax might perhaps be waived on a highly selective basis, for a few new industries deserving of high-priority and needing special inducements to expand.

An increased measure of reliance on the price mechanism is the unifying trend linking the proposals in this memorandum. They run counter to much accepted practice in the sub-continent and will doubtless be resisted for this reason among others. I suspect, however, that in actual practice, India has moved a considerable distance in recent years towards freeing private industry from a network of official controls, while controls here

have increased. Although the ideology of Pakistan is rather friendly, and that of India rather unfriendly, to private business, the actual scope for private initiative may well be broader in India than in Pakistan.

The proposals in this memorandum may be objected to on the ground that by reducing profits, they will restrict private business. While it is true that private enterprise responds to the incentive of profit, it by no means follows that greater profit always invokes greater enterprise. When easy profits for a few are the result of government policies which exclude other potential bidders for resources, they are a deterrent to enterprise.

The present situation in Pakistan appears somewhat analogous to that which prevailed in Western Europe in the late mercantile period. In the preceding stage of European development the grant of subsidies and monopoly privileges to selected commercial interest appears to have provided a powerful stimulus to commercial expansion. By the 18th century, however, these traditional devices obstructed development by favouring a few, long-established and strongly entrenched interests and handicapping new enterprises and new activities. Although in Pakistan there are many, specific fields which still require government assistance, the economy has reached a stage where the present pervasive system of controls exerts a similar restraining effect.

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