Policy Review

Contours of a programme with IMF
Choosing between approaching or not approaching IMF

By

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Background

After coming out of the situation of choosing between approaching or not approaching IMF for macroeconomic stabilization, the discussion now focuses on the nitty-gritty of Pakistan’s home-grown solution that it would like to negotiate with IMF for its forthcoming arrangement. However, the catch is to maintain a fine balance between the fiscal reforms that strengthen the overall fiscal responsibility at the federal and provincial levels under an IMF programme, and an indigenous agenda of structural reforms in power and public sector enterprise (PSE) management. One would have to be careful not to overcommit on performance benchmarks on power and PSE reforms without losing the pace of those reforms.

Going to fund would have some structural and some implementation conditionalities. Structural conditionalities would include some prior actions, some performance criteria and certain benchmarks. On the other hand, implementation conditionalities would include quantitative performance criteria, actions implemented on time, actions delayed, actions not implemented, and actions against which a waiver was given by IMF. For a three-year programme under a front-load arrangement (which Pakistan cannot skip), almost half of the actions are required to be taken in the first year whereas rest of them are to be taken in 2nd and 3rd year. Usually the first year is focused on achieving stability of macroeconomic fundamentals, especially the stability of foreign exchange reserves. The second year is aimed at completion of stabilization measures and enhancing the efficiency through structural reforms, whereas the third year should focus on pro-growth and pro-job policies.

It is pertinent to mention that Pakistan took following “prior actions” (by five days prior to the Board meeting where the loan was approved) before the last IMF Programme (2013-16);

- Implementation of a series of fiscal adjustment measures,
- Elimination of electricity tariff differential subsidies (totaling 0.75 per cent of GDP in annualized savings),
- Net purchases of $125 million by the SBP in foreign exchange spot market,
- An agreement at the Council of Common Interest on respecting the 2013/14 fiscal balances for the provinces under the programme,
- Issuance of 10,000 collection notices to individuals not registered to pay taxes based where indirect methods suggest large potential income tax liabilities.

Fiscal belt tightening, reduction in electricity subsidies, and appreciation of dollar against rupee was a natural outcome of those prior actions, but those were a must to convince IMF Board that Pakistan was serious to implement reforms against the structural anomalies threatening its macroeconomic sustainability.

Apart from those prior actions, the structural benchmarks that former finance minister Ishaq Dar’s team agreed for the last IMF loan included approval of a reform strategy for loss making Public Sector Enterprises (PSE), hiring a professional audit firm to conduct a technical and financial audit of energy circular debt, making Central Power Purchasing Agency (CPPA) operational by separating it from the National Transmission and Dispatch Company (NTDC), privatizing 26 percent of PIA’s shares to strategic investors, and enacting the amendments to the Pakistan Penal Code 1860 and the Code of Criminal Procedures 1898. All those benchmarks were to be achieved before December 2013.
Backed by certain one-off positive factors, including low fuel prices in international market, CPEC inflows, US$ 5 billion from Saudi Arabia, and foreign exchange generated through bonds and auction of 3G-4G broadband spectrum, IMF loan resulted in favourable growth momentum. However, failure of implementing structural reforms in letter and spirit resulted in widening of external and fiscal imbalances, and a decline in foreign exchange reserves.

One needs to keep Pakistan’s immediate past engagement with IMF in mind while negotiating the next arrangement, as IMF would pick Pakistan on its slippages in that programme. In its first post-program discussion in February 2018, IMF mentioned widening external and fiscal imbalances as a result of those slippages and emphasized on continued exchange rate flexibility, monetary tightening, stronger fiscal discipline, and decisive efforts to contain losses in public enterprises.

Taking cue from the discussion, the elements of home-grown reform agenda apart from realistic monetary policy and continued exchange rate flexibility (which is now more or less adjusted to its real effective exchange rate) may also include rationalization of government’s current expenditure (rationalization of grants and subsidies, PSE reforms, rationalization of ministries and departments); tax policy and administration reforms (broadening of direct tax base and a gradual shift away from withholding tax regime, taxing all income beyond a minimum threshold, gradual move towards modified value added tax, correcting custom duty, and giving FBR autonomy); and power and gas sector reforms (new national power policy, going towards a single transmission and many distribution companies, and control of unaccounted for gas).

Many of the above measures would have to be taken as “prior actions” and many would be benchmark indicators. This would have inflationary impact. Low global oil prices helped PML-N to address many of those inflationary impacts. However, it is expected that once the US sanctions against Iran are imposed (from 4th November), the oil prices would go up. High oil prices and depreciation in rupee value would not only increase inflation but under constrictor monetary policy would also slow down the growth.

It is important for Pakistan to see IMF programme as yet another opportunity to implement and expedite three critical structural reforms:

- Tax administration
- Public sector enterprise management
- Energy sector governance

At the same time, it is important that key reforms may be put in place that strengthen the overall fiscal responsibility at the federal and provincial levels. This will include a tightening of current expenditure and aim to bring greater focus in federal public sector development programme and provincial annual development programmes – perhaps in line with the human resource development priorities of the Prime Minister.

Recipient countries usually have a choice (depending on the bargaining power) if they would like to front-load the reforms which involve relatively painful adjustment in the early periods. We may like to adopt this path and pursue the following sequencing of the programme.

- The first year of the IMF programme will naturally focus on achieving stability of macroeconomic fundamentals, in particular the stability of foreign exchange reserves. This year may see dampening of growth due to a contractionary fiscal and monetary policies.
The second year should see the completion of measures which can induce efficiency in public sector management, expedite energy sector reform and help export-oriented industries. These reforms are mostly structural in nature.

The remaining period of the programme should focus on pro-growth and pro-jobs policies and programmes. This period should also see our reliance on the IMF tranche gradually diminishing.

The government will also be expected to exhibit willingness to reform critical areas of the economy. The following discussion acts as a start point on which there is near consensus as also indicated by parliamentarians during debate on Supplementary Finance Bill. These actions can be committed with the IMF as structural reform conditions however should be seen as Pakistan’s own priorities (as also indicated in PTI’s manifesto).

Elements of home-grown reform agenda

a. Rationalization of Government’s Current Expenditure

Subsidies and grants should only be allowed after a scientifically conducted incidence analysis of benefits. The current levels of untargeted, hidden and cross subsidies are not pro-poor and act as an additional burden on the fiscal deficit.

There is an urgent need to bring down the losses of PSEs and to restructure their liabilities. This however is not possible without the reform of management in these enterprises and legal provisions that insulate management from political pressures. The priority cases include WAPDA (PEPCO) (including Pakistan Electric Power Company (Private) Limited), Oil and Gas Development Company Limited (OGDCL), Sui Northern Gas Pipelines Limited (SNGPL) and Sui Southern Gas Company (SSGC), Pakistan International Airlines (PIA), Pakistan Steel, and Pakistan Railways.

There is room to rationalize the number of ministries and their attached departments. Several of these have seen their objective faded in recent times.

In order to keep government intervention to a minimum, it is important to reimagine the objectives and coverage of Fiscal Responsibility and Debt Limitation (FRDL) Act. A revision to FRDL Act is also important from the point of view of protecting budget allocation towards environmental protection, food security and human development priorities under Sustainable Development Goals (SDGs).

b. Tax Policy & Administration Reform

Rationalize the number and size of concessions: It is recommended that all incomes beyond a minimum threshold decided by parliament, should be treated equally for the purpose of taxation.

A broadening of the direct tax base will also allow a gradual shift away from the Withholding Taxes (WHT). The excessive reliance on presumptive taxation is distorting incentives to save and invest. The compliance of small businesses with WHT monthly reporting has increased costs.

There is a case for the simplification of the corporate tax regime in Pakistan as the current regime is a disincentive to corporatize. A four-pronged strategy to increase corporate taxes through: a) simplification of corporate tax laws, b) eliminating unfair exemptions from corporate taxes, c) broadening of the corporate tax base, and d) building capacity of the tax administration
to evaluate and audit new forms of corporate incomes, can help raise greater revenues. The appeals management and grievance redressal mechanisms will also need to be sharpened in order to build trust.

**A gradual move towards a modified value added tax (VAT):** The existing GST on goods regime is not realizing its potential due to over invoicing of inputs and the inability of FBR to process the refunds in a timely manner. At the federal level, a reform towards a modified VAT will include setting of input-output norms across major industries, and pre-fixing the export rebate across major exported commodities.

**Correcting customs duties:** The effective rate of customs duty falls as the number and value of concessions (from customs duties) increase. Such concessions need to be reconsidered. Essential imports are also hurt by multiple slabs and differentiated rates across sectors. This in turn, affects the competitiveness of exporting sectors.

**Revisiting the case for excise duty:** There is a case for phasing out excise duties. There remains a need to see on a case-by-case basis where GSTS and federal excise duties are contributing to double taxation.

**The 18th Constitutional Amendment allows the provinces, management of progressive taxes** including wealth tax, capital gain tax on immovable property, gift tax and estate duty. The provincial assemblies may introduce and strengthen the levy of these taxes.

**Revisit lessons from Tax Administration Reform Programme’s Evaluation:** The project which started in 2005 and lasted until 2009 could not render the anticipated results and failed to improve, the efficiency of the tax administration and to broaden the tax base. The less than anticipated success of TARP calls for an updated independent evaluation to help the tax authorities understand why the current organizational structure in FBR is not delivering the desired results.

**A full autonomy of FBR, similar to what was seen in the case of the State Bank of Pakistan, between 2000 and 2006 may be considered.** FBR’s own human resource should be insulated from any political influence of the government, may it be in tactical functioning or related to recruitment, promotions, accountability and reward.

**A risk-based audit along with forensic capabilities can help in the validation of tax returns.** A medium term audit reform plan can help in clearly defining the roles of tax assessment auditor and recovery managers. This will also reduce the role of discretion by tax officials. The audit will also be helped by a simplification of rules, procedures, laws and relevant forms. This will reduce the transactions cost of both revenue officials and tax payers.

**Strengthen Grievance Redressal Mechanism (GRM):** A key issue faced by the business community is lack of effective mechanism to address their complaints. None of the tax authorities in the country have a documented and publicly communicated GRM.

**Merge revenue departments at the provincial level:** The newly formed bodies to collect GSTS may be structured as independent bodies, having legal cover through appropriate provincial legislation. The board of revenue, excise departments and other tax revenue collection bodies may be gradually merged into the newly formed entities e.g., Khyber Pakhtunkhwa Revenue Authority, Punjab Revenue Authority, and Sindh Revenue Board and Balochistan Revenue Authority. This will reduce compliance cost across the country
c. Public Sector Enterprise Reform

The PSEs reform should remain a high priority involving restructuring of the boards of PSEs, attracting and retaining professional management having past commercial experience, and putting in place performance improvement plans. Some of these PSEs are incurring heavy losses for which the government may need to put in place a bail-out package comprising of both components: loans to PSEs and sovereign guarantees.

All PSEs should be encouraged to only cater for their core business and shut down all other ventures. This will encourage cost minimization with in these entities however Ministry of Finance will need to agree cost rationalization targets with the PSEs as part of the performance improvement plan. Advice from commercial sources may be required for revenue-enhancing measures. Once the entities achieve a certain level of financial fitness the government will need to consider models of ownership and operation which could include, public private partnership, disinvestment, and privatization (if necessary).

d. Power Sector Reform

The PTI government has already taken a step in the right direction to increase energy tariffs to better cover the cost of generation, transmission and distribution. Some concrete measures in this direction could be politically easier if in-built as a commitment to IMF.

The new National Power Policy should focus on strengthening efficiency, competitiveness and sustainability, as the redressal of the above three fundamental causes of energy crisis is of foremost importance. In this context, it is important to correct the structure of tariffs and subsidies in the power sector. Subsidies should only benefit the poorest of the poor.

Unaccounted-for-gas controls should be enforced and the saved gas should be diverted to the power sector. Current transmission losses of 3.6 per cent are higher than the NEPRA allowed losses. This immediately calls for introducing performance contracts (clearly mentioning targets for reduction in losses) for grid stations under National Transmission and Dispatch Company.

At the DISCOs level as well, the power policy aims for a similar mechanism of performance contracts aimed at increasing accountability of heads of DISCOs. It is further recommended that such contracts should have specific clauses on reduction in distribution losses and full collection of receivables from consumers.

e. Gas Sector Reform

In order to bring competition in the gas market, Competition Commission of Pakistan (CCP) needs to play a more proactive role. Second, the regulation should also enforce product standards in the gas sector. A large quantity of inefficient gas appliances are manufactured and supplied by small-scale producers without compliance with quality and safety standards. The low tariff for household consumers vis-à-vis registered commercial users has helped the growth of informal sector in micro and small-scale manufacturing.

Such low tariffs also encouraged inefficient usage and wastage of gas. The National Energy Conservation Centre had estimated that 20 per cent energy could be saved in the country through timely conservation measures and appropriate pricing.
Third, the judiciary dealing with gas sector cases will also deliver their part. The growth in gas theft persists as those involved know that lengthy conviction processes and legal lacunas cannot bring about certainty of punishment.

Fourth, consumer welfare in gas market is directly linked to creating competition. In the upstream, prices are set upfront without any price competition between Exploration and Production (E&P) firms. These firms will not face a substantial risk as the government, through a guarantee, will buy their gas through SNGPL or SSGC. In the downstream too, the government is the largest shareholder in both these companies. The Oil and Gas Regulatory Authority (OGRA) and Competition Commission of Pakistan (CCP) need to intervene here so that a fair competition is nurtured and consumer exploitation is curtailed.

Fifth, a related point is to unbundle the transmission and distribution which should allow perhaps a single transmission company with several distribution companies having specific and time bound key performance indicators. In the medium term, Unaccounted for Gas (UfG) losses can be curtailed through installation of smart meters network and prudent gas accounting.

Finally, several gas allocation and pricing decisions left to Economic Coordination Committee (ECC) require discussion with provinces. The provinces should have autonomy in sectoral gas allocation and management. It is, therefore, recommended that ECC decisions on gas sector allocation and pricing should be brought for approval of Council of Common Interest.

f. Ensuring export competitiveness

The Ministry of Commerce needs to focus on its core tasks as defined in Government of Pakistan’s Rules of Business 1973. This implies, for example, shedding the responsibilities of managing public sector entities such as State Life Insurance Corporation – an entirely unrelated subject. This can then allow the ministry to focus strictly on the objectives of trade policy.

The reforms towards enhancing competitiveness require a ‘whole of the government approach’, it is therefore necessary that the Prime Minister should take ownership of this agenda and convene the meetings of the Cabinet Committee on Exports and Production (CCEP) on priority. Large-scale reforms such as refunds of exporters, reducing energy costs for exports should be taken up by this committee, which should meet on a monthly basis.

Some short-term measures that can help the private sector should focus on reducing the trading costs, especially for the SMEs. The federal government can start from support towards the necessary product compliance and standard certifications required to enter and remain in a foreign market. Usually the costs and procedures towards these certifications are time consuming and expensive for SMEs and act as a barrier to their entry in the export markets.

The Ministry of Finance, using Export Development Fund (EDF), can incentivize containerization via railways for SMEs in export sectors. EDF can also be used to cover partial costs of transportation, e.g. transit levies especially in the case of trade with regional neighbours and transit trade. This could be a time bound incentive. The investments under CPEC and Central Asia Regional Economic Cooperation (CAREC) programme can also be aligned with this goal.

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1Includes costs related to manufacturing, marketing, transportation, warehousing and distribution.
The small and medium scale exporters have weak access to policy making quarters and hence suffer from a deficit of information on incentives available under Strategic Trade Policy Framework (STPF). It is, therefore, recommended to expedite outreach and implementation of other measures announced under STPF, aimed at enhancing knowledge and capacity of current and potential exporters. The Chambers of Commerce and Industries may be invited to collaborate for outreach programmes and for their participation in foreign exhibitions.

The revised regional and bilateral trade agreements should go beyond the usually negotiated market access. In order to ensure trade-led investments, these revisions can now focus on specific clauses allowing investment in goods and services, and increasing the list of services for trade. Regional agreements could also carry provisions for transit arrangements for people, goods and natural resources (e.g. gas and electricity) and one-stop border posts, which can reduce travel time for goods, and expedite the establishments of supply chains across the region.

Other immediate measures could include:

- Comprehensive package to support SMEs Cost of Doing Business
- Administrative measures for curtailing informal and illegal trade
- Reform of tariff regime faced by exporting sectors
- Facilitation to integrate with regional and global supply chains
- Insulating the export-oriented sectors from energy costs and stoppages

**Mitigating Inflationary Impacts**

The IMF programme will be accompanied with contractionary fiscal and monetary policies which, in turn, could result in low growth and employment (at least in the short-term). There may be, during the short to medium term, a rise in inflation owing to devaluation and increasing oil prices abroad. To mitigate these impacts, the government needs to strengthen social safety nets and social protection programmes. In line with PTI’s agenda of job creation, we also recommend pursing active and passive labour market policies which could include:

- Public sector employment generation schemes
- Youth paid-internship schemes
- Tax credits to employers who provide long-term contracts to employees
- Diverting PSDP to high-employment sectors
- Reforms to help startups and encourage self-employment