‘HOMEGROWN’ REFORM AGENDA FOR IMF PROGRAM

By
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The government is negotiating a Program with the IMF. That the IMF would have stepped in as a lender of last resort was never in doubt, if only to secure the return of the US$6 billion that we still owe them. The objective of this article is to present a ‘homegrown’ reform package for the IMF Program.
This package includes the long overdue structural reforms under the anticipated three year program. It also suggests transitory measures to attain the goals and targets which are consistent with achieving the goal of stabilization of the economy.

1 .Reduction in the Fiscal Deficit

For a 2.5 to 3 percentage points of GDP adjustment in the fiscal deficit during the three year program period the following measures to generate additional revenues and policy actions to trim expenditures are summarized below:

Taxation Measures

The overall tax-to-GDP ratio has reached 13% of the GDP. Current estimates show that the ‘tax gap’ in Pakistan is approximately 3% of the GDP. Therefore, efforts need to be made to raise the tax-to-GDP ratio by 2020-21 to 16% of the GDP. However, in a slowly growing economy lifting the tax-to-GDP ratio will be more difficult.
The Revised Budget for 2018-19 of the Federal Government proposes a growth rate in FBR revenues of 14.5%, based primarily on improvements in tax administration and detection of tax evasion. But this will raise the tax-to-GDP ratio by only 0.2% of the GDP, which is inadequate. As such, the target for 2018-19 of FBR revenue needs to be raised from Rs. 4,398 billion to R4,643 billion. This will increase in the tax-to GDP ratio by 1% of the GDP. It will require additional taxation proposals of Rs. 245 billion.
Given below are taxation proposals which can potentially yield up to an additional Rs. 250 billion. These proposals are designed primarily to move towards a more progressive return and documentation based system with a broadened tax base, reducing reliance on indirect and withholding taxes, many of which have acquired the character of indirect taxes and are regressive in nature. There is also a particular focus on using the tax instrument to contain imports.

Income Tax

(i) The present Super Tax has an arbitrary character. There is a need to design a more objective basis for additional taxation of companies. We, therefore, propose the withdrawal of the Super tax and its substitution with an Excess Profits Tax at an additional 10% on net profit above 20% of equity plus reserves. This will make the tax system more equitable and linked to the ability to pay more.

(ii) Open-ended extension of the holding period of capital gains tax on real capital gains (and not nominal capital gains) in property and shares, with initial rate up to 5 years of 15% and thereafter 10%. The inflation index should be applied to the original cost and the difference with respect to the disposal value be taken as the capital gain.

(iii) Requirement of being a tax return filer for access to a bank credit card, membership of professional associations and access to electricity above Rs. 15000 per month as a domestic consumer and in excess of 50,000 kilowatt hours of annual consumption in the case of industrial and commercial connections.

(iv) Continued filing of return a pre-condition for continued registration of a company with SECP.

(v) Following the trebling of the personal income tax exemption limit, conversion of deductible allowances into tax credit at the rate of 10 %.

(vi) Change in the minimum income tax from 1.5% of turnover to 0.5% on value of fixed assets at cost with usual carry forward provisions.

(vii) Withdrawal of the presumptive income tax on exports of 1 percent. Accordingly, the export incentive rates may be reduced by one percentage point. This should also improve the liquidity of exporters.

With 68 different categories of withholding taxes we have one of the most elaborate withholding tax regimes in the world, with an additional complication requiring a withholding agent to distinguish between filers and non-filers, with the latter having higher rates. Almost three-fourths of total revenues from direct taxes come from this regime.

The distribution of revenue from these withholding taxes is highly skewed. The top 23 sources contribute almost 98 percent of the tax collection, while the remaining 45 sources have an extremely small share of just 2 percent, suggesting the need for rationalizing the withholding tax regime by eliminating many of the small sources. This will contribute to a less cumbersome, more transparent and progressive tax system.

We suggest that among the 45 small withholding tax sources only these which satisfy the following criteria be retained:

(i) number of withholding tax agents is small

(ii) limited scope for forward shifting

(iii) incidence is progressive

(iv) no double taxation of the tax base with provincial/local taxes.

There is need also to examine the large withholding taxes from the viewpoint of the above criteria and identify if, given their size, they are creating distortions in the economy:

The levy of a withholding tax on cash withdrawals and other banking transactions has retarded the development of the banking system and financial intermediation by leading to lower deposits and more cash transactions outside the banking system. This levy needs to be withdrawn. Instead, an advance tax may be introduced on credit card charges. The incidence of this levy will be progressive.

The fixed tax on mobile phone cards is tantamount to double taxation as the Provincial sales tax on services is also collected from the telecom sector. The combined tax rate exceeds 33 percent. Therefore, the fixed income tax rate needs to be brought down drastically to 5 percent.

The advance tax on electricity bills of industrial consumers should be reduced. This is one more factor contributing to the loss of competitiveness. The corresponding tax on commercial and large domestic consumers may be enhanced. Further, the withholding tax rate should be enhanced by 1.5 percentage points on commercial importers.

The measures proposed above should generate additional revenues of more than Rs.100 billion.

Sales Tax

(i) Move to a harmonized national value added tax on goods and services at a standard rate initially of 17%; to be brought down to 15% in next two years.

(ii) Extension of the sales tax on manufacturers of various consumer goods on the basis of the retail price, not the ex-factory price.

(iii) Fixation of the sales tax rate at the minimum of 10% on both motor spirit and HSD oil and enhancement in the petrol levy by Rs. 2 per liter.

The above proposals should be able to generate additional revenues of Rs. 75 billion.

Import Duties

(i) Withdrawal of regulatory duties and imposition of additional import duty of 5 percentage points on imports with import duty of 20% or more for the next three years.

(ii) Following evidence obtained by the National Tariff Commission there is a need to introduce a system of minimum import prices (also see below).

These proposals should enable additional revenues of Rs. 50 billion.

Excise Duty

(i) Levy of excise duty on domestic sales of cars above 1000 cc at the rate of 10% to 20%.

(ii) Levy of excise duty on polluting industries at 10%.

The measures proposed above should be able to provide revenues of Rs.25 billion.

The above taxation proposals combined have the potential to yield total additional revenues of more than Rs.250 billion.

Finally, we strongly recommend that going forward we should initiate the following policy actions:

(i) Set FBR revenue targets in gross terms to remove the incentive to hold back refunds.

(ii) For reasons of transparency and the sanctity of Parliamentary approvals all powers presently with government agencies to issue SROs should be withdrawn and all concessions granted in past SROs incorporated in next year's Finance Bill for Parliamentary endorsement. Henceforth, any new SROs should have Parliamentary approval.

2. Expenditure Measures

The principal feature of the Revised Budget for 2018-19 presented by the new Government is a major cut of Rs. 225 billion in the size of the Federal PSDP in relation to the size in the original Budget. The Punjab Government has followed suit with a cut of Rs. 158 billion. Overall, the national development program is lower by as much as 26%. This will have a significant negative impact on the GDP growth rate and the level of employment in the economy.

The approach should have been to first attempt cuts in current expenditure before undertaking a retreat on the development front. Instead, there continues to be substantial budgeted growth in current expenditures of almost 15% in the Revised Budget, even 6% more than in the original Budget.

A careful examination of the different components reveals that there is significant scope for savings in current expenditure as follows:

(i) Operating expenses are estimated at Rs. 835 billion in 2018-19. These include expenditure on utilities, fuel, acquisition of physical assets, civil works and repairs and maintenance. Specification of stronger standard operating procedures, move towards e-procurement and better expenditure monitoring could enable savings of up to Rs.80 billion.
(ii) The task force on institutional reforms should suggest ways of reducing the number of Divisions, which currently stand at 40. Also, a 'zero base' budgeting exercise may be undertaken of the over 200 attached departments and autonomous bodies at the Federal level.
(iii) The grants to the Provincial Governments should be limited to only those mandated by the Constitution, like hydroelectricity profits, or by the 7th NFC Award.
(iv) The salaries, allowances and pensions of Government employees have been increased at double-digit rates in previous years even when inflation was in single digit. Since 2007-08 the cumulative increase in real terms in emoluments has approached 60%. Senior civil servants have enjoyed a double benefit this year of a big cut in tax liabilities and also a salary increase. As such, a moratorium should be considered on increases in salary, allowances and pensions for employees in Grade 17 and above for the next two years. There should be inflation indexation only for lower level employees.
(v) The TCP should be wound up unless the Provinces are willing to pick up the costs of subsidies on fertilizer and commodity operations, since the beneficiaries are essentially farmers from whom the provincial governments collect modest amounts of tax revenues.

Overall, the runaway growth in current expenditure has to be curbed. The two big heads of cost of debt servicing and defense expenditure also need to be focused on. The capacity for public debt management has to be substantially improved and after a growth rate of 16% in defense expenditure last year, a voluntary cut may be requested for this year.

As regards rationalization of development expenditures we propose the following:
(i) Since the operational functioning of universities is now the joint responsibility of the Federation and Provinces (with the majority of these institutions chartered by the latter) it is time to move to phasing out support for them from the Federal Government, starting with a 50:50 sharing from 2019-20 between these two levels of Government, with the eventual purpose of the Provinces absorbing the entire recurring obligation by 2022-23.
(ii) Now that the functions of health and population planning have also been mandated to the Provincial Governments an understanding should be developed on the transfer/sharing of costs of the vertical programs in these sectors and all intra-provincial projects indicated above. The same strategy needs to be adopted for the allocations under BISP.
(iii) On-going projects should continue to be implemented if they are part of CPEC. If not included in CPEC the project must pass the following criteria for continuation: Either (i) 80 percent or more of the cost has already been incurred and/or (ii) it has received foreign assistance and with more funds forthcoming.

The other reform proposals are summarized below:

3. Power Sector reforms

The stock of circular debt needs to be reviewed to finalize the net debt/dues for allocation to each relevant DISCO. This net debt should then be settled, but the amount so expended should not be included in the estimate of the fiscal deficit target to be agreed with the IMF. To address the issue of the flow contributing to the increase in the circular debt arising from the tariff determination policy (referred obliquely to the impact of tariff differentials), higher distribution losses than approved by NEPRA (on account of technical losses and outright theft of electricity) and failure to collect payments against bills the following strategy is proposed.

Since the police and all associated capacity for enforcement is essentially a provincial subject we propose that the DISCOs be transferred gradually to the Provinces. To incentivize the Provinces to accept this obligation the Federal government should pick up all debts accumulated until the date of transfer and commit funding on a continuing basis but by capping its financing contribution.

This approach will also enable the Provinces to focus on the inefficient and poorly governed DISCOs, determine DISCO-wise tariffs and employ technological and other enforcement options to penalize defaulters (but with functional meters) and those pilfering electricity, thereby reducing the burden presently borne by honest consumers for the inefficiencies of, and thefts encountered in, other DISCOs. One or two DISCOs may also have to be assisted financially to enable them to invest in infrastructure to expand or upgrade capacity and manage the distribution system to ensure reliability and viability of electricity supply.

For a variety of reasons, including the lack of an adequate transmission system to transport the generated electricity and other distribution related inefficiencies, today we have a surplus of 5,000 MWs on which we end up paying heavy capacity charges to the IPPs. Furthermore, the negotiated rates will have to be paid for more than twenty years at a time that rapid technological improvements in renewable, wind (its global power tariff is now down to 2.6 cents/kwh) and solar (cost having fallen by almost 75% since 2010), are reducing energy prices sharply, adversely impacting the competitiveness of our production structures.

Therefore, as a starting point, we need to close inefficient public sector GENCOs and the IPPs using high cost and environment unfriendly furnace oil. Next we need to discontinue the sovereign and capacity commitment guarantees given by the government to IPPs that were established as far back as the first half of the 1990s. These IPPs have by now recuperated their investments several times over. In their case, the market should be allowed to operate with consumers free to buy electricity from them based on the tariff they offer.

4. Financing of fiscal deficit

The increase in financial savings following the increase in interest rates and the revocation of the withholding tax on cash withdrawals will take place only with a lag. Furthermore, if a proportion of the expenditures on some existing budgetary components mentioned above are picked up by the Provinces then they are not likely to generate significant cash surpluses. Therefore, the program should allow for SBP injections of around Rs.800 billion for a year or so, otherwise the private sector is likely to get crowded out, diluting the potential impact of policy actions in initiating a recovery in growth.

5. Privatization

Some SOEs should either be wound up or privatized. In most of these cases we may have to resort to asset stripping whereby a proportion of the assets are set aside for separate disposal (e.g. non-core functions, excess land in the case of the Steel Mills or hotels and real estate owned by PIA), to settle some of the liabilities of these entities because selling them on as-is-where-is basis will result in a heavy discounting of the sale price.

Funds mobilized from the sale of some shares of SOEs like NBP, SNGPL, SSGC, PPL, PSO and OGDC should be deployed to build up foreign exchange reserves.

6. External account

While acknowledging that the structural vulnerabilities of the external account can be dealt with comprehensively only in the medium-term (there being no quick fixes) some strong multiple actions are needed urgently on both the export and import fronts.

The pressure on the rupee and the foreign exchange reserves is not likely to subside anytime soon following the initiation of 'global currency wars'. However, merely relying on the instrument of the exchange rate to address the continuing stress on the external trade account will not be enough. With a trade deficit almost 150% of export earnings, US$ 100 worth of exports requiring imports of close to US$4 and a rupee depreciation of 10% only increasing exports by, at best, 6.5% (requiring a package to include timely tax refunds and satisfaction of customer requirements in terms of their regulatory compliance and timely deliveries) and a 3.5% reduction in imports, other policy actions will be needed in the short to medium term.

The emergency provisions of GATT permit us taking this approach. These measures will include enhancement of import duties (while quickly phasing out the regime of regulatory duties) and direct attempts to narrow the trade deficit by discouraging imports through expansion in the coverage of cash margins combined with a robust system of minimum import prices (admittedly a non-tariff barrier) to check under-invoicing.

There will also have to be an upward revision of interest rates to check speculation against the rupee (and reduce the disincentive for financial savings) as well as to manage the overall level of aggregate demand in the economy thereby restricting the volume of imports- every additional increase of Rs.100 billion in the fiscal deficit adds Rs.40-45 billion to the import bill.

7. Instruments to finance external gap

We may not be allowed to raise additional commercial loans during the currency of the IMF program. Therefore, we should consider floating Sukuks for raising funds, being asset-backed borrowing, akin to asset based borrowing for financing government's commodity operations. An instrument with these features should be acceptable to the IMF.

In our opinion it will be difficult to make an adjustment of US$ 3-4 billion in the remaining six months of the year without gravely compromising growth. Therefore, unless some commercial loans repayable later this year are rescheduled or rolled over or we can arrange supplier credits for some imports, we will need a bridging loan for roughly a year to finance our obligations for the year as they fall due.

8. Growth stimulation following Stabilization

The last year of the program following the successful implementation of the stabilization measures should be devoted to stimulation of growth by improving the competitiveness of the economy through instruments and measures aimed at lowering the cost of doing business, thereby improving investor sentiment. The factors that should contribute to such a development include a) privatization efforts; b) a less cumbersome tax regime through the withdrawal of a number of nuisance low revenue generating withholding taxes; and c) rationalization of power tariffs through efficiency gains(as explained above) and the utilization of cheaper energy sources through an improvement in the fuel mix. As argued earlier above, going forward an improvement in the growth rate will also be required for achieving a noteworthy enhancement in tax revenues.

Furthermore, the slowing down of the growth rate following the squeezing of imports can be less harsh as a consequence of CPEC related investments and a faster rate of growth of exports, assisted by timely payments of duty drawbacks and tax and GST refunds at the time of export receipts.

The inflationary impact of the measures can party be moderated by adjusting downward the support and procurement prices of sugar and wheat (or at least maintaining the current rupee prices) and by shifting from furnace oil to the cheaper fuel, LNG.

To conclude, these proposals for structural reforms should be able to address the challenges posed by the twin deficits and hence could form the major part of the IMF Program.

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