ON THE 23RD IMF PROGRAM FOR PAKISTAN
SEVENTH AND EIGHTH REVIEWS UNDER THE EXTENDED ARRANGEMENT UNDER THE EXTENDED FUND FACILITY, REQUESTS FOR WAIVERS OF NON OBSERVANCE OF PERFORMANCE CRITERIA, AND EXTENSION, AUGMENTATION, AND REPHASING OF ACCESS

PIDE COMMENTARY

SEPTEMBER, 2022

PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS
International Monetary Fund (IMF) issued a staff report on the seventh and eighth reviews of the extended arrangement under the Extended Fund Facility (EFF) on September 1, 2022. As per the review report, the authorities of Pakistan are allowed to draw USD 1.1 billion, keeping in view the measures taken by authorities to address fiscal and external challenges. The IMF board has also approved the extension of the EFF till June 2023 along with extra Special Drawing Rights (SDR) of 720 million, bringing the total access under the EFF to about USD 6.5 billion.

The review report has also identified some priority measures to be considered by the Pakistani authorities, such as the implementation of an approved budget, market-determined exchange rate policy, proactive and prudent monetary policy, the expansion of the social safety net, and structural reforms related to the performance of state-owned enterprises (SOEs) and governance. The set of measures that have been identified contains both short-term and medium-term measures to promote long-term growth. In this regard, the Pakistan Institute of Development Economics (PIDE) has also been working extensively to identify the measures that are necessary to remove the bottlenecks in the economy to improve productivity and increase growth.

Therefore, the objective of this document is twofold, i.e., a commentary on the measures suggested by the review report and what other measures should be part of the program.
The PIDE reform agenda (RAPID) notes that Pakistan needs a sustainable growth rate of around 8 percent over a long period, given the population pressure. However, the review report shows that the economy of Pakistan starts overheating at a growth rate of around 6 percent. PIDE notes that this is primarily due to the low investment rate in the economy accompanied by a worsening long-term trend of investment as a percentage of GDP. Additionally, there are substantial regulatory and productivity constraints in the economy that the program should be addressing (See PIDE Reform Agenda (RAPID) and PIDE Sludge Audit. I).

Source: IMF Pakistan Country Report (2022)
The review report suggests that the State Bank of Pakistan (SBP) will continue a tight monetary policy, as per the standard prescription, to restrain higher inflation expectations. According to the review, the SBP and the IMF staff agreed to a tight monetary policy to achieve positive real interest rate. However, the real rate remains negative! And the real rate is likely to remain negative through the program period. This implies that the nominal interest rate should be 20 percent or even more. However, it would be challenging for the SBP to curtail inflation through monetary tightening due to the following facts:

Source: IMF Pakistan Country Report (2022)
The SBP began to tighten monetary policy in November 2021 but failed to achieve positive real rate and control inflation.

The review report projects that the broad money growth will be around 12 percent during the FY-2023. Therefore, PIDE argues that the demand-side pressure will not be a major driver of inflation in the near future. The current wave of inflation may be more supply-side shock driven.

PIDE estimates suggest that supply-side pressures will contribute to inflation by more than 80 percent during FY-2023. Hence, further tightening of the monetary policy may not be desirable. Interestingly, the Risk Assessment Matrix of the review report also points out that several supply shocks, including the disruption of supply chains, higher energy prices, and higher commodity prices are more important for inflation. Nevertheless, further tightening of the monetary policy may reduce the exchange rate pressures. The current external sector pressure is due to surging import demand. A tight monetary policy may reduce external sector pressure through effective import demand management. The review report, however, did not take a clear stance on this issue.

We also agreed with IMF that all concessionary interest rates should be eliminated to ensure that the policy rate has teeth. Unfortunately, we do not see the program recommending a time path to achieve this goal. There should be a sunset clause.

\[1\] From November 2021 to July 2022 the SBP has raised the policy rate by 800 basis points — from 7 % to 15 %.

\[2\] In-house calculations, see PIDE Analytics 01 for the methodology.
3. **WHY DEVELOPMENT FINANCIAL INSTITUTIONS (DFIs)?**

We also note that DFIs have not worked in Pakistan’s crony environment. Instead of boosting industrialization, they created an environment of subsidies and rent-seeking. Several of these DFI’s had to be closed down, with huge losses that the government took over.

4. **FISCAL POLICY AND PUBLIC DEBT**

4.1 **Taxation**

The review report has not addressed the structural issues of taxation in Pakistan. Instead, *the proposed measures in the report would make taxation more complex*. The measures proposed are either focused on new taxes or increased rates for existing taxes without highlighting the coverage issues. The review report has not included key taxation issues in Pakistan, such as differential treatment, withholdingisation, complex tax codes, and minibudgets. Many important reforms are more buoyant and less distortionary, but the review report has overlooked them altogether.

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**Budget Position (Billion Rupees)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Tax revenue</th>
<th>Direct taxes</th>
<th>Federal excise duty</th>
<th>Sales tax/VAT</th>
<th>Customs duties</th>
<th>Petroleum surcharge</th>
<th>Gas surcharge and other</th>
<th>GIDC</th>
<th>Provincial</th>
<th>Nontax revenue</th>
<th>Expenditure</th>
<th>Current expenditure</th>
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Source: IMF Pakistan Country Report (2022)
PIDE suggests the following measures related to taxation:³

Rationalization of the withholding tax (WHT) regime to simplify the tax structure.

Eliminate the revenue-non-spinner WHTs. For instance, 45 WHTs contribute less than 1% (merely Rs. 11 billion) to total tax collection. Elimination of these 45 revenue-non-spinner WHTs will simplify the tax structure⁴.

Increase general sales tax (GST) coverage and focus on the point of sale (POS) integration, which is still incomplete.

Tax on agricultural income is still missing. PIDE recommends income tax should be universal.

Pakistan still maintains distortive taxes, such as having a filer and non-filer distinction:

- There is no significant change in the numbers of tax filers – 2.29 million filers in FY-2021, from 2.28 million in FY-2020.
- Introduction of clauses such as deemed income for property taxation.
- Refunds to the poor who pay income tax on purchases, including the Benazir Income Support Program (BISP) recipients, are not a priority.

4.2 Program unbalanced and tax heavy

The review report retained the significance of revenue generation through taxation, but it does not stress expenditure reforms, which is a low-hanging fruit in the case of fiscal adjustment.

³See PIDE policy viewpoint No. 17
⁴See Saood and Khalid (2022)
After the 18th amendment, the primary functions were devolved to provinces, but overlapping roles by the Federal Government are still in place. The government’s footprint is expanding instead of decreasing, with new government entities being created without reviewing the existing organs of the state.

Additionally, the medium-term budgetary framework (MTBF) has not been optimally used for budget development in Pakistan. There are no indications on how the fiscal cost would be reduced and savings can be generated.

PIDE suggests the following steps:5

1. Close down inefficient public sector agencies.

2. Zero-based budgeting and a good expenditure review.

3. Performance-based budgeting should be invigorated.

4. Limit on ministries and divisions as recommended in the 18th amendment.

5See PIDE One Year Growth Strategy (2022)
Limit on setting up new agencies, and any new agency to be set up only after proper costing and open parliamentary approval.

Unlock the huge dead capital that exists in the form of public assets.

Pension reforms are essential. Financial liabilities are growing without any substantial reform in sight. Moving to a contributory system and pay-off developed based on a comprehensive actuarial analysis is required.

Cleaning up of the public sector development program (PSDP).  

### 4.3 Nobody knows the extent of contingent liabilities

Contingent liabilities are a huge empty hole in the fiscal management system. Guarantees are provided based on the assumption that the contingent liabilities would not go beyond a certain threshold. However, the limits are breached. Often these liabilities are funded from the budget to clear the balance, thus, putting unwanted pressure on the fiscal resource. The debt management office must develop an elaborate framework and strict compliance with the required thresholds.

The Treasury Single Account (TSA) issue is mired in the capacity of the Ministry of Finance (MoF). TSA-1 has not been fully implemented due to many bottlenecks and resistance. The review report suggested the implementation of TSA-2 without considering the situation on the ground.

PIDE suggests:

Without civil service reform, capacity issues will not allow far-reaching changes. The same is true in the case of tax administration and other aspects of SOE reforms.

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7 See Sattar (2022)
No amount of Technical Assistance (TA) will solve the problem created by obsolete colonial systems and poor incentives.

4.4 Debt profile and management

The expectation that the debt-GDP ratio would decline in the face of a stagnant economy and a current account deficit of 3 percent of GDP is untenable. The debt-GDP trajectory is showing an upward trend. Given the fact that fiscal retrenchment is not possible and without comprehensive fiscal reforms, the sustainability of debt is only a distant dream.

External liabilities are gradually shifting from multilateral to bilateral and commercial sides, which has increased the debt servicing cost over time. While domestic debt, specifically the front debt mix, has been converted into long-term debt with high-interest costs. Therefore, debt servicing would require more external resources and substantial improvement in external inflows. The review report has also projected an increase in external flows. PIDE notes that attracting external flows, without adopting structural reforms seems daunting.

Moreover, the secondary market yields on government bonds have also been significantly increased. All these concerns indicate that Pakistan may need another Fund program shortly.

PIDE recommends:

Establish an independent debt management office (DMO) by consolidating the national savings, the MoF debt management, and SBP’s debt management functions. The proposed DMO could be able to bring the savings into formal channels by introducing new instruments to the market. Such instruments will create additional resources for the rapid completion of projects without creating new debts.
Once again, SOE reforms have been highlighted in the review report. Various methods or management approaches to improve SOEs performance have been debated, and some of those are also mentioned in the review report.

PIDE notes that:
While the SOE Act is not available in the public domain, it is important to note that the **SOEs need autonomy with accountability**, which cannot happen if the practice of taking all decisions by the ministries at the central level without transparency remains intact. The autonomy of the SOEs can only be achieved by empowering the boards and the managers instead of the secretaries and ministries.

The Asian Development Bank *(ADB)* is again advising **on regulatory reforms at the cost of local expertise**.

A large part of the problem lies in the lack of institutional reforms, which has eroded the capacity of the state institutions.
6. IGNORING AN OVER-REGULATED ECONOMY

PIDE has substantial work on tariffs and regulations, which should be included in future programs, the real estate sector that goes far beyond the program document. Rather than trying to curb activity in the sector and treating it as a pariah, the need is to create a real estate market.

The Public Procurement Regulation Authority (PPRA) system reform has been suggested but without any assessment. Officials feel it causes huge time delays and increased costs in the public procurement processes. A discussion between the Auditor General and PIDE has also confirmed the inefficiencies of the PPRA system. Once again, the World Bank (WB) is supposed to provide technical assistance (TA) in this regard. It is a noteworthy point that it was the WB that developed the PPRA system for Pakistan. PIDE notes that a Pakistani agency must be asked to provide TA instead of relying upon foreign technical assistance.

7. OVER-EMPHASIS ON CORRUPTION

Pakistan has suffered for 75 years from a violent campaign against corruption, which is hard to disentangle from the ongoing power struggle. The National Accountability Bureau (NAB) and other investigative agencies have hurt more innocent people than caught criminals. Unfortunately, most of our anti-corruption campaigns have been political in nature. Such campaigns have also led to very intrusive officialdom and documentation. All of this has eroded our social capital and scared away investment. Due to this campaign, decision-making is paralyzed, and risk-taking has ceased.
PIDE notes:

The inefficient incentive system fosters poor governance and facilitates corruption.

PIDE Sludge report\(^9\) notes that huge rents are available.

The protection policy also fosters poor results.

**NO FINANCIAL SECTOR REFORMS! WHY?**

While the attention to financial sector health is welcome, financial sector reform finds little mention in the review report. PIDE notes that small banks would either close down or merge with larger banks, so competitiveness of the banking system needs to be considered.

- The banking spreads are larger than in the nationalized days.
- Banks draw deposits from rural areas and small cities and invest in larger cities.
- Entry into the banking system is virtually prohibitive.
- Non-banking financial institutions have also been severely limited.
- Opening a bank account is extremely difficult.

\(^9\) See PIDE Sludge Audit Vol. I
While we appreciate the reaffirmation of the commitment to an open economy, it should be noted that in the last three programs we have increased tariffs, regulatory duties, and surcharges to increase distortive bands, which in turn have led to inefficiencies in the economy.

Recently, we have also seen massive controls on current account transactions. Investment and market transactions are increasingly being based on speculation about these policies as well as the exchange rate. The program should think of developing clear rules and guidelines to set a time path to open the economy with few tariff lines.

The review report projects a 47 percent reduction in the current account deficit in FY-2023, with the deficit shrinking from USD 17.3 billion in FY-2022 to USD 9.3 billion in FY-2023. These projections are based on the assumed increase in the export bills by USD 3.2 billion and a USD 3.3 billion decrease in the import bills. Furthermore, the projections also assumed adherence to the ‘market-based’ exchange rate. Now the question arises, what will be the real effective exchange rate (REER) given that we have imposed bans, regulatory duties, surcharges, and extreme foreign exchange controls along with the heavy foreign exchange interventions? Although PIDE agrees and advocates the market-based undervaluation of the exchange rate, there are two important considerations to keep in mind:

The SBP must restrain from market interventions and learn from past experiences. Currency crises in Pakistan have always emerged due to heavy interventions in the foreign exchange market through exchange controls.

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10See Jalil (2021, and 2022)
11See Hina and Haque (2020)
The SBP must **focus on foreign exchange reserves building** instead of the exchange parity.
ON IMPORTS AND IMPORT BANS

Considering the depleting reserves situation and worsening balance of trade, the government has started looking towards import restrictions. PIDE notes that contrary to popular belief, Pakistan’s per capita import of goods is relatively static and much lower compared to similar developing economies. Instead, Pakistan has an export problem that contributes to its balance of trade worsening, with no significant increase is witnessed in exports during one last decade.

The government recently imposed an import ban on over 800 commodities terming them luxury and/or non-essential items. The ban though did not prove effective and was wholly eradicated in two phases within three months. A large part of the import ban’s ineffectiveness came from the fact that the goods termed luxury and non-essential constituted a tiny part of the country’s annual imports, hence, not having any significant impact on the overall trade position.

Furthermore, the ban also did not manage to curtail the currency depreciation as the rupee depreciated by around Rs. 25 against the US dollar during the three months the ban was imposed.

For details: see PIDE Policy Viewpoint No. 39:2022
The IMF thinks that the only solution is to increase prices for the consumer that reduces Pakistan’s competitiveness.

10.1 Circular Debt

Circular debt first broke out in 2006. Since then, this is the third IMF program focussing on a deteriorating circular debt with little impact. We always emphasize increasing prices and passing on the burden to consumers without worrying about structural losses. PIDE notes that \textit{tariff increases without structural changes can increase inefficiencies and sector losses}. Consumer-end tariffs are highly sensitive to the losses in the transmission and distribution systems and bill recoveries. Per unit increase in price by Rs. 1 adds to an additional loss of more than Rs. 10 billion.\textsuperscript{12}

Only increasing tariffs has not resolved circular debt or power sector inefficiencies. \textit{The power sector needs serious decentralization of decision-making and management overhaul}. Technical issues, such as line losses and bill collection, need to be resolved locally by the local management.

\textsuperscript{12}See Malik (2020)
State-owned distribution companies (DISCOs) are corporatized but only on paper; it is unclear under which law the DISCOs are governed. Over the years, instead of decentralization of power, the government's footprint on the sector (power division) has become more significant.

PIDE further notes that a tariff structure in which costs are not recovered from all consumer categories is discriminating in nature. Besides, creating financial difficulties for the government, such a structure also generates inefficiencies in the system and misleads investment decisions in the supply system. In Pakistan, more than 60 percent of electricity is produced by thermal sources providing costly electricity. Furthermore, the tariff mechanism adopted provides electricity charges, that are different across categories, creating inefficiencies and making electricity expensive for the economy's productive sectors (industry and businesses).
Pakistan’s **power sector needs a fair pricing regime**, where consumers pay according to their consumption on a progressive trend. The best way is to move from increasing block tariff to a flat linear tariff without slabs and consumer differentiation.

There will be no competition when accounts of inefficient and efficient DISCOs are treated as one, and a uniform tariff is charged. PIDE notes that moving from a uniform tariff to a different flat rate across DISCOs will also significantly minimize inefficiencies. Tariffs should be based on the actual cost of services in all geographical markets.

The fat (linear) tariffs, however, may not be a win-win situation for all (e.g., poor households). PIDE notes that **direct cash transfers**, compared to electricity subsidies, have proved to be a better welfare alternative for low-end consumers. Since we already have a social protection system, there is no reason to subsidize electricity. The same goes for agriculture, which consumes about 9 percent of the electricity.

Besides, **the energy subsidy plan itself is very unrealistic**. The domestic consumption of electricity is more than 50 percent. On average, 75 percent of domestic consumers use 300 or fewer units of electricity. There is ample evidence that the households opt for options to remain in lower slabs; for instance, they install two to three meters in residential premises to divide load. They also temper with meters, steal electricity or pay a fixed amount to the lower staff of a company.

In Pakistan, the idea of energy conservation and demand management has not remained popular because of the government’s neglect and a lack of public awareness of its overall benefits. PIDE notes that we can reduce 20 to 25 percent of energy demand through its productive use in various sectors.13

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13See Malik (2020) and Malik & Urooj (2022)
Energy planning has to be done holistically and not through whimsical projects. Pakistan's power sector needs coordinated planning to realize an optimal power generation mix from imported fuels and indigenous resources.

To overcome the governance and financial problems, the government, under pressure from international financial institutions (e.g., the World Bank and the ADB), started the reform process in the sector. After over three decades, no progress has been achieved; rather the sector is worse off, facing even more challenges.

Once again, the WB and the ADB are providing technical assistance to the power sector. Perhaps it is time to let the local people do the necessary reform. PIDE suggests a moratorium on IPPs in the future, including the proposed solar project. All new investments should be based on competition and the financial dynamics of the sector.

PIDE recommends audits and reaffirming the contracts for the private projects already in the system.

Developing a competitive electricity market is only viable solution to all problems in the power sector. We discussed creating a market for the last 20 years, and now is the time to give it the impetus it needs. Establishing a power exchange market like the competitive trading bilateral contract market (CTBCM) in Pakistan in the current scenario seems impracticable.
The market should start with **bilateral contracts and wheeling power**, keeping transmission constraints and participants' capacities in mind. Distributed generation is a norm in electricity markets globally. However, DISCOs and its managerial authority, the Power Division, are creating hurdles in allowing 'wheeling' and 'net-metering' regimes, which are supposed to bring competition to the sector. NEPRA should facilitate these by discouraging the hurdle-creating entities.

On the privatization of state-owned energy companies, it is worth noting that we do not have **the capacity for efficient and transparent contracting** and ensuring its implementation. The lesson drawn from the privatization experience in the last three decades is (not only in electricity utility but in other sectors) that privatizing for the sake of it, without a due thought process, ends up as a wrong decision\(^\text{14}\).

Social protection has become a political instrument. The expenditures on social protection observe an increasing trend and stand at around Rs. 316 billion in the review report. While well-meaning, the program is seeking further expansion along with indexation.

PIDE estimates of poverty suggest the poverty rate in Pakistan is around 21.5 percent. We note that BISP already covers people far more than the ultra-poor. Still, social protection is an expanding agenda in Pakistan, and the provinces also have social protection policies. Social protection is being done through utility stores, the provision of health cards, the National Rural Support Program (NRSP), the Pakistan Poverty Alleviation Fund (PPAF), micro-finance networks, fuel subsidies, public sector education provision, and a state-owned pension scheme. PIDE notes that:

\(\text{\textsuperscript{14}}\text{See Malik (2020)}\)
It is not clear what is the objective of social protection.

Is it the precursor to universal basic income?

Do we have the fiscal resources to do this?

Perhaps there is a need to undertake a critical review of this whole system and seek consolidation and productivity gains. In addition, these schemes have no concept of graduation or mobility. Conceivably this is indicative of the economic pessimism in the country. PIDE notes that the overlapping expenditures for social protection under different public schemes are not considered.

PIDE has prepared a Reform Agenda for Growth and the One Year Growth Strategy. The latter is our minimum structural adjustment program that could form the basis of a Fund program.
REFERENCES

The suggestions proposed in the document are based on the following work done at PIDE:


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