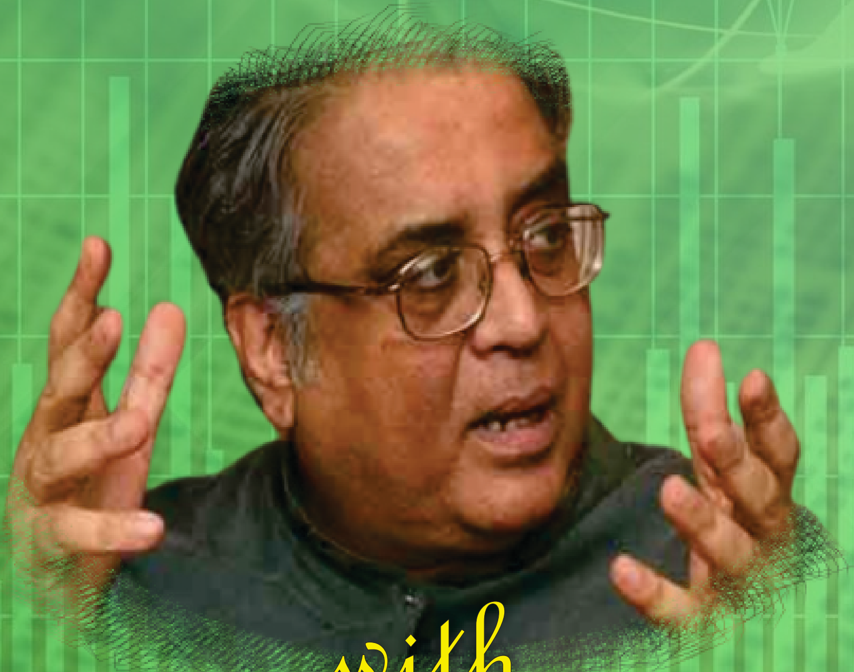
Pakistan Institute of Development Economics

A VISION FOR FORGOTTEN ECONOMY



with

Dr. Hafiz A. Pasha

Webinar Brief 98:2022

Pakistan Institute of Development Economics invited Dr. Hafiz Pasha, a renowned economist, for PIDE series conversation on the economy of Pakistan “A Vision for Forgotten Economy”. The aim of this series is to invite eminent scholar to comment on the state of the economy and identify priority areas to work on for next government. Hafiz Pasha has served in United Nations as Senior Undersecretary. He served as Finance Minister and also as deputy chairman in planning commission. He is an academician at heart. He recently wrote extensively on economic landscape of Pakistan in form of books and reports. These include books namely Agenda for Economic Reforms in Pakistan, Charter of the Economy, and Human Development Report for UNDP. He talks extensively on the future of Pakistan and the reforms in Pakistan.

Key Points: Dr. Hafiz Ahmed Pasha

The vision for forgotten economy is an appropriate title for today's webinar. There's hardly any discussion on this subject.

It is truly amazing that we are in the second half of the May 2022, but we are not discussing about the preparation of the Federal and Provincial Budget. The discussion is not at all seen on the media about the prospects of the next financial year.

We are only concerned about the political settlements. The debate currently is overly focused on the petroleum prices. Therefore, the presentation of the budget which is the most important financial event for any year is not discussed at all. This is truly a tragedy.
The year of 2022, might be considered the year which will go down in history as the worst financial year of Pakistan's history.

I don't agree with the methodology currently used to calculate fiscal deficit by comparing it to the GDP of base year 2015-16 but if we relate it to the GDP with base year of 2005-2006, Pakistan will probably close this year with consolidated fiscal deficit of about Rs. 5,000 billion.

The target deficit was about Rs. 3,440 billion. However, the deficit is over the target by almost Rs. 1,600 billion. The original target set was 6.3% of GDP but the deficit is now around 9% of GDP. This is the largest percentage deficit in the history of Pakistan which justifies the magnitude of the problem.

When we consider the depreciation of rupee, it will add almost Rs. 3,000 billion in the public deficit. The government debt will be increased to Rs. 8000 billion due to this reason, which is about 16% increase in debt. We are on the verge of financial insolvency. A lot of focus is on the external side as dollars are involved and we are short of dollars.

Now what is the root cause here?

The root cause here lies is the very large budget deficit which adds to aggregate demand causing increased imports. If we have to solve the structural problem, we have to start with the bigger problem which is the budget deficit.

The reason of our bust in budget is the increase of oil prices from early 2022. The revenue from the petrol levy which was targeted as Rs.610 billion but we got only Rs.140 billion. So, there is a shortage of Rs.470 billion.

The FBR revenue are progressing very well, as 30% growth rate is witnessed. This growth rate has come down because the sales tax revenue from the petrol prices has come to end due to increase in prices, as we are subsidizing oil prices.

On the revenue side, we have two major shortfalls primarily linked to petroleum. The rapid growth of imports is compensated by the FBR revenues more or less. Optimistically speaking, FBR may get to the revenue of Rs. 6,100 billion or may get short by just only Rs.100 billion.

Major spillover of the Expenditure Side

On the current expenditure side, the spillover is close to Rs.one trillion. This is not very good public finance management by the previous or the present government. Why is this shortfall present here? First, when the optimistic budget was presented for this year, the interest rate was at extremely low rate of 7%. Now it has reached to about 12.25%. This amount includes the cost of debt servicing also.

The subsidies are about Rs.100 billion, which are being given on the petroleum products monthly. The root cause here is the growth in the subsidies that we are giving to the power sector. There was a time about five years ago, when the subsidy was about Rs.100-125 billion for the power sector, which was mostly in the nature of tariffs differential subsidy.

Today, the subsidy is about Rs.600-700 billion, mainly due to the issue of liquidity constraints imposed by the mammoth increase of the circular debt. There is a need to solve this issue by the supplementary grants and injections into the power sector. This is the reason why the current level of expenditure goes up.

The other problem is the grants that are beginning to explode. The reason for it is the mushroom growth in contingent liabilities.

Contingent liabilities are the guaranteed debt by the government taken by the state-owned enterprises either in local rupees or in the foreign currency. This is again growing and approaching two and a half trillion rupees. And every year, they guaranteed the debt servicing in terms of interest payments particularly repayments which are adding up to about Rs.500 billion or so.

So, the end result would be that the current expenditure spillover will be almost a trillion rupees. And as mentioned earlier, the budget deficit would be about Rs. 1,500 billion above the targeted figure.

Sacrifice Development Expenditure

Unfortunately, there is always one area that we sacrifice is the development. Development budget will be cut by Rs.300 billion. Otherwise, the deficit would have been Rs. 1,800 billion.

That's why, instead of being at a target deficit of 6.3% of GDP, which we had agreed with the IMF following the sixth review, we stand at 9% of GDP, which is the highest ever in the history.

Has the government prepared itself for the stability in the public finance process? The point is that there is too much focus on immediate policy for the next day or next week. This has been magnified by the growing perception in the financial difficulties that we are facing as a country.

Budget Strategy Paper

There is not any deep thinking on the budgetary process. In fact, the public financial management act, which was passed a few years ago, the government was expected to present before the parliament a budget strategy paper which shows the perspective for the next three years. This was a very good and sensible decision because it compelled the government to think strategically. But as always, it has degenerated into an exercise into a wishful thinking only. The last budget strategy paper shows that by 2024-2025, Pakistan's fiscal deficit would be 4% of GDP and this year we are closing at 9%.

There is not a single meeting held by the ministry of finance on the budget. The IMF discussion are going to start in the coming days to fund our government. Do the government possess vision for the discussion?

So, what will happen next year?

It is single most important policy question in my mind. This will fundamentally affect the nature of our discussion with IMF.

What has the government agreed with IMF following the sixth review in terms of next year fiscal and budgetary targets? The staff report after the sixth review contains the projection for the next year. It is expected to close the year 2022-2023 with a budget deficit consolidated to about 4.5% of the GDP.

Cutting the Budget Deficit

It means that we have to cut the budget deficit by half in just one year. This is to say the least mathematically impossible and I find it very strange that the government is negotiating in the second half of the year. This must have been agreed at the start of the year, as now we are bound to this target during this discussion of IMF which are going to take place in Doha.

Having spent so much time on the research on public finances, my own assessment is that given the deficit of 9% of GDP, we will virtually perform the miracle if we can bring down the deficit to 6% of GDP next year. Bringing the deficit down to 4.5% is out of question mathematically and theoretically. I don't know, how we will able to convince the IMF but it stretches the credibility to its absolute limits.

Key policy measures to achieve 6%

Firstly, we will have to raise the federal revenue by Rs. 1,100 billion. In real terms, this will be an increase of about Rs. 1,500 billion because from the last year the collection of sales tax and petroleum levy on petroleum products was zero.

The base is artificially inflated and it has to be cut down. The base figure has to be adjusted accordingly if this situation persists. The minimum increase in revenue required is about Rs. 1,500 billion.

Secondly, the Pakistan Bureau of Statistics is doing very poor job as they are showing that our industry witnessed 26% of growth. If this is so, then why are we going to the IMF? There is a need to investigate the figures produced by the PBS.

What needs to be done of current expenditure front, as the debt servicing burden is higher due to the interest rate that stands at 12.25%? In the coming days, the monetary policy committee will further enhance the policy rate.
Thirdly, IMF says that Pakistan has no scope of increasing its development expenditure. We will have to sacrifice this expenditure to achieve the 6% deficit of the GDP. Just one percent increase in spending of GDP on development will transfer through the multiplier effect to 1.7%. We must stop any kind of injections from the budget in this expenditure.

How can we generate additional revenues?

In the tax base, we do not have any petroleum products for sales tax and petroleum levy. This is a huge handicap situation for Pakistan. Now we do not have any other option but to raise the prices of petroleum products. If we don't solve this issue of petroleum prices then are we going for a target of extra Rs. 1,200 billion in subsidies. It will take the country to bankruptcy. The subsidies on the petroleum products must be withdrawn and also there must be no taxes on these products. We are imposing 13-14% of indirect taxes on petroleum products which must be sacrificed also.

Imports Substitution

We have tried to control the imports through various instruments particularly exchange rate and to some extent through interest rate. We also tried regulatory duties and also import margin restrictions. However, these instruments did not work very well. The imports are still continuing to grow, not just in price terms but also in volume terms.

The only option available now is forced import substitution through high import tariff wall. On agriculture products, Pakistan has by far the lowest import tariffs in South Asia. It is shocking to see that; we have zero import duty on cotton. India imposed 60% of import duty on the agriculture products.

Currently our tariff structure has four slabs; 5%, 11%, 16%, and 20%. We need to go back to the structure which was present seven to eight years ago having a six-slab structure. We should also impose tariffs on exotic luxury items. There must be an exception to this policy. Exception is for the basic food items, medicines and the fuel.

Progressive Income Tax

Pakistan now has to start moving towards a more progressive income tax structure. Comparing the income tax structure of Pakistan with India and Bangladesh, the surprise is the income level at which the maximum marginal income tax rate applies. In India, it is applied at a level which is 10 times the per capita income level in the country. In Bangladesh, it is at 8 times while in Pakistan, it is 300 times of the per capita income level. Making the tax structure progressive is the only solution. Raise the exemption limit, reduce rates at middle class level, and then sharply raise it for the upper class and maximum to about Rs.20 million instead of Rs.75 million. IMF is pushing for these reforms in Pakistan and these are perfectly justified.

Issue of Division of Taxes

Another problem is the partition of taxes. We have divided the taxes on different types of income and get away with it without evaluating tax on overall total income.

Now the capital gains tax which shows a new concept of the holding period. This holding means that you can hold an asset for four or six years, and after that you can cash it or sell it through which there will be zero capital gains tax. Zero taxation is totally out of question here.

Value Added Taxes

India took many years to take the step of imposing national value added tax. The sales tax on services which is a provincial subject while the sales tax on products is federal one. These are blended into one to make the national value added tax. Unfortunately, due to partition, we have huge problems of cascading and pending repayments and duties. The worst thing to mention here is that the provinces are reducing down their tax rates so that the tax base can be increased. This step is totally counterproductive for the economy.

We have to solve all these issues to set the economy on track as all these above-mentioned issues are interlinked.

Question and Answer Session

Dr. Nadeem-ul-Haq

We have been in a death dance with IMF having 23 programs over the last 75 years. The issues you mentioned are all the growing issues. Why are we unable to address these growing issues? Why did IMF also unable to address? How would you feel that IMF may not be the right agency to go to? What do you suggest to the government about the immediate structural reforms so that we can get out of the IMF death dance?

Dr. Hafiz Ahmed Pasha

The politicized nature of the IMF program is the major issue. The program of 2013-16 was the good program in which the agenda was in line with the government. Now they are exceptionally tough and the last meeting was brutal with the government of Pakistan. However, they are willing to talk to Pakistan despite the issue of petroleum subsidies. The politicized nature can be solved through consensus among the political parties which the current prime minister mentioned in 2018, when he was an opposition leader. The charter of the economy book was given to all the party leaders but no action was taken till now about consensus which focuses on growth and removing the issues in the country.

Dr. Nadeem-ul-Haq

Why do we have so complicated tax structure? Do we have to simplify our tax policy? Why the documentation policy is so complicated?

Dr. Hafiz Ahmed Pasha

The complexity is intentionally introduced by the tax collectors. There is an import duty, regulatory duty and withholding tax, which are not justified at all. There should be one universal tariff. The transparency must be ensured for this universal tariff. There must be only one tax and the government must ensure to penetrate it into the informal sector also. Currently, we have about 73 types of withholding taxes. This is totally absurd and unacceptable. The income tax law must be simplified totally. Simplification, transparency and removal of vested interests are the key solutions.

Dr. Nadeem-ul-Haq

According to FBR, tax expenditures are Rs.1.3 trillion. Tax to GDP ratio must be minimal according to the experts. We have the regulatory burden as high as 39%. We calculated the government footprint on the economy which came out to be 70-80% of GDP. Is our investment really sustainable, which is about 15-16%?

Dr. Hafiz Ahmed Pasha

There is a huge investment constraint in our country. Pakistan Bureau of Statistics data must be checked very carefully as I have serious doubts about their figures. The two areas of ease of doing business, where we performed extremely poor are tax levies and the regulatory interventions.

Key Takeaways

- Remove the subsidies from the petroleum products.
- Increase the import tariffs to decrease imports.
- Increase the revenues through reforming the tax structure.
- Remove the abundant and unnecessary taxes.
- Make the tax system transparent, simplified and remove the vested interests.
- A right kind of growth strategy can finance itself.

Prepared by

Prepared by: Syed Talha Ali
MPhil Economics
PIDE

Edited by
Saima Bashir

Design by
Afzal Balti