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Crisis in Pakistan? Economic Policy Making in a Dangerous Neighborhood

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Outline

- Cyclical periods of geopolitical importance
- 2007 Crisis and 2008 Stabilization Plan
- Are we facing another crisis now?
- Consequences of a failed tax reform
- A dangerous neighborhood:
  - will the US continue to help?
  - Costs of largesse from the Chinese?
  - Self-reliance and making up with India....

Periods of geopolitical importance

- Cold war
  - Key US ally—especially in late 50s and early 60s
  - Inflow of foreign assistance
  - Interest waned after Kennedy overtures to India
  - Revival after Nixon's support during Bangladesh war
  - Bhutto: Intermediation with China,
- Bhutto abandoned after nuclear program discovered
  - Difficult early period for Zia
- Things changed after Soviet invasion of Afghanistan
  - Inflow of aid and arms to Mujahideen and Pakistan army
  - Cautious fiscal stance "borrowing only for investment" abandoned at this time (mid-1980s)
- US walked away again after defeat of Soviets
  - 1990s very difficult, more so after nuclear explosions and tightening of sanctions
  - Difficult engagements with the IMF through till 2003

Renewed importance after 9/11

- Massive inflows of assistance, military and civilian
- Resumption of growth in the post 9/11 period, curtailing of IMF program
  - Called "breaking of the begging bowl"
  - Correct strategy of improving investment climate (supported by World Bank
  - Involved shift from trade taxation to VAT, supported by modern administration ($130m World Bank tax reform project, TARP)
- But capital inflows led to a reduced emphasis on domestic resource mobilization
  - Expansion in credit to facilitate growth
  - Overvalued exchange rate led to pressure on exports, and industrial producers—protected through exemptions from the GST
- Overall addiction to foreign capital inflows and support, substitute for domestic measures
  - Not quite the breaking of the "begging bowl"
  - Capital inflows led to irresponsible decision making:
    - like giving a teenager a drink for the road along with the keys to the BMW

2007 Crisis and 2008 Stabilization Plan

Was there too much complacency?

- Sound early 2000s strategy: replace tariffs and trade distortions by VAT/modern administration
- Former achieved, not latter, despite FBR modernization project (TARP)
  - Leading to collapse of tax/GDP ratio (from high of 14% of GDP to just over 9%)
  - Export sectors taken out of tax net, domestic zero-rating, self assessment, removal of audit—hamstrung tax system, but who noticed?
  - Indirect subsidy, without coming to attention of WTO
- Pressures had begun to mount in 2007, but reserves were at record high (Oct 2007)

September 2008 GOP Stabilization Plan

- Plan by President to FODP in New York in September 2008
- Basis for IMF program—ambitious target, but with political “ownership”…worthy of $ 8 billion frontloaded with little other conditionality
- Key element: redressing domestic revenue/GDP ratio, 9.8% to 14% in a five year period
- Time needed to implement—
  - bolstering FBR, bringing back on track TARP
  - classified as unsatisfactory by World Bank in February 2008
  - Rescue strategy of FBR endorsed by WB, two Carlos Silvani reports (April 5, 2009)
- Could implement a new administration in three years, but build on old foundation

GST productivity—declining and low in comparison with competitors

	Standard rate	Revenue/GDP	Productivity
Pakistan (1990s)	15		.39
Pakistan (2005)	15	3.4	.30
Pakistan (2009)	16	3.1	.26
Sri Lanka	15	6.7	.47
Philippines	12	4.3	.45
Turkey	18	7.1	.48
Lebanon	10	5.1	.50
Jordan	16	10.1	.62
Korea	10	6.7	.67
Singapore	5	1.8	.63
New Zealand	12.5	8.9	.93

Potential

- Modest target to achieve Sri Lankan C-efficiency (around .47)
- Would more than double the current GST revenue collection (3 percent of GDP)
  - Additional 1.5 percent of GDP for provinces from divisible pool
  - Certain elements going directly to provinces
- Difficult political-economy issues with provinces

Is Pakistan facing another crisis now?

Unlike 2007, lots of countries in crisis

- Significant need for IMF support
- Greece, Ireland, Portugal….among OECD countries
- Run into difficulties with tax/GDP ratios
  - Among the lowest of OECD countries
  - But between 30 and 37 percent of GDP (versus less than 10 percent in Pakistan)
  - Steep fiscal adjustments needed, in excess of 5 to 6 percent of GDP
- But Pakistan has been unable to shift tax/GDP ratio
  - Despite raising the rate of GST in successive budgets
  - And imposing carbon tax….substituting for carbon levy

Are record reserves again leading to complacency?

- But wait, most of this is IMF monies…and from central banks
- Are record high remittances all they appear to be?
  - Conundrum: initial increase was assumed to be linked to repatriation of savings by returning workers
  - But how have they continued to rise, with not so many additional workers?
- Might some of it be related to "carry trade"/hot money?
  - Taking advantage of high interest rates, stable currency, IMF program
  - "hot monies" for personal gain, low international interest rates—whitening by bringing into Pakistan without questions
  - Fiscal indiscipline benefits some "Speculators"…tax free capital gains
  - Assess magnitudes involved/ SBP /research institutes
- Could hear sucking sound as IMF program unwinds, and pressure on reserves builds….
- Fall can be quite quick and steep….unlike in 2008….no easy access to IMF

Can level of reserves lead to complacency? Lessons from 2007?

Date	SBP/fx $m	o/w IMF $m	Rs/$
30 Jan 05	9,309	1,809	59.63
31 Jan 06	9,045	1,501	59.97
31 Jan 07	10,792	1,440	60.71
31 Oct 07	14,243	1,410	60.72
31 Jan 08	12,536	1,372	62.63
31 Oct 08	3,530	1,171	81.44
30 Jan 09	6,973	4,258	78.97
30 Oct 09	10,639	6,442	83.56
29 Jan 10	10,719	7,390	84.76
30 Jul 10	12,726	8,254	85.68
31 Jan 11	13,861	8,819	85.69
31 Mar 11	14,285	8,939	85.35

Comparisons with October 2007

- SBP reserves similar
- But $9 billion out of $14 bn borrowed from the IMF at high rates of interest
- Commodity prices worsening, oil again above $100/ barrel
- Tax reforms have failed
- Political deadlock
- No easy additional access to IMF—international credibility in tatters
- Extent of hot money? Carry trades? Empirical questions for SBP
- Probably more vulnerable than October 2007

Debt sustainability analysis

- Likely in breach of standard benchmarks
  - NPV of debt in relation to exports, revenues, GDP
  - Standard requirement by Boards of IMF, Bank and ADB
  - Not incorporated in MOF Debt Strategy Statement, or Fiscal Statement
- Debt stocks probably already too high….
  - Possible difficulties at current levels of borrowing from IFIs, especially expensive IMF monies
  - IMF augmentation not justified without the stated tax reforms and increments to revenues
  - Debt restructuring will be very painful indeed

Consequences of a failed tax reform

Unfunded Mandates for Provinces

Rent seeking—perennial curse

- Qamar-ul Islam Committee 1983: CBR is the most corrupt of institutions
- Cozy relationships with "important sectors"
- SRO culture by passes Parliamentary oversight
- Resistance to arms length administration
- Modern reforms recently reversed
  - Greater discretion to local tax officials
  - Especially for audit—non existent previously, having been abandoned in 2004

Policy implications of domestic zero-rating

- Removes taxation from clothing and carpets
- λ_i not particularly high at any level of inequality aversion
- Certainly not high priority for peoples' party with a concern for the poor, and $\varepsilon>1$
- Has to be due to "special interests", and GST in excise mode with incidence on producers
- With proper arms' length GST/VAT would not affect producers
- Tax administration would like to keep it the old way....

Table 1 Pakistan: ranks for λ_i

ε	0	0.5	1.0	2.0	5.0
1. Wheat	10	4	1	1	1
2. Rice	7	7	6	6	7
3. Pulses	8	5	3	2	2
4. Meat Fish, Eggs	13	13	13	13	13
5. Milk and Products	11	11	10	10	11
6. Vegetables, fruits and spices	12	12	11	11	9
7. Edible Oils	1	1	4	4	4
8. Sugar	3	3	5	5	5
9. Tea	5	2	2	3	3
10. Housing, fuel and light	2	6	8	9	10
11. Clothing	6	8	9	8	8
12. Other foods	9	9	7	7	6
13. Other non-foods	4	10	12	12	12

Source: Ahmad and Stern (1991)

Notes: The welfare loss for commodity *i*, λ_i, represents the effects on all households (using Household Survey data on consumption, and estimated demand responses) of an increase in the tax on the i^{th} good sufficient to raise a rupee of government revenue. The β^h are welfare weights on households, and ε is the inequality aversion parameter ranging from 0 to 5. A good ranked 1 would be such that a switch of taxation from it to any other good would increase welfare at constant revenue.

$$\lambda_i = \frac{\sum_h \beta^h x_i^h}{X_i + \sum_j t_j^e \frac{\partial X_j}{\partial t_i}}$$

Plan B on tax reforms

- Components
  - Remove zero-rating and exemptions
  - Address income tax holes
  - Consolidate arms-length administration
- Revenue implications
  - Marginal increases in GST revenues, possible decline in short-term
  - Lays the basis for the consolidation of arms-length administration
  - Could lead to faster increases in medium-term
  - Could still achieve objective with a longer time horizon: but do we have the luxury of time with impending debt crisis?
- Imposed, but then reversed within a week
  - Flip-flop is death knell of tax reforms

SRO 283—FBR's April Fool's Gift to Nation

- Very confused—mixes up final and intermediate goods
- Makes arms length administration almost impossible
- Bestows lower effective taxes for the rich
- Marginal revenue changes due to induced cascading – antithesis of GST reforms
- Reinstates the primacy of SROs for 185 items—rag bag of items #185 anything the FBR can think of in the future
- Kills arms length administration
- Destroys tax reforms for another three to four years
- Overrides tax policy primacy of parliament….!!!!

Who gains from the status quo on the GST—especially domestic zero-rating and exemptions?

- Consumers and producers of luxury carpets and textiles
  - Is it a disguised subsidy to producers who cannot compete in international markets?
  - Way to get around WTO rules?
- Certainly not the poor and middle classes!!!
- What has domestic zero-rating got to do with genuine exports which are already zero-rated?

GST reforms opposed by those who should benefit

- Never in the interests of the bureaucrats presenting and making a case to Parliament or stakeholders
- Real opposition is to income tax—would become clear with a proper GST
- Services issues—wrong assignment split base, with short-run patches (Ahmad and Bengali)
  - Could be stopped/subverted by any one province
- Vested interests point to other sectors for taxation
  - Favourite is agriculture, which is almost impossible to tax anyway, and the reality is that:
  - Input subsidy restored on April 9, when prices are at record highs
  - So that's that!!

Serious consequences of failed tax reforms

- Major debt management difficulties
- Hamstrung growth strategy—investment envelope slashed at all levels
- Key government successes in jeopardy:
  - NFC award—assumed that the VAT would be implemented
    - 1% increase in revenue/GDP ratio per annum
    - But this is stuck at 2009 levels
  - 18th Amendment—spending devolution
    - unfunded mandates
    - Could backfire

The 18th Amendment: unfunded mandates

- 18th Amendment has focused on unbundling spending responsibilities ***to provinces***
- Did not effectively address the revenue assignments—
  - apart from reinforcing the split bases for the GST, and income taxes
  - Fissures clear in the tussle over administration of the GST on services
  - Although a solution was reached, it is unstable
- Net effect will be to transfer responsibilities to provinces without requisite funding
  - Even for existing levels of provision
  - But costs will increase in transition
- Likely impact: deterioration in the level and quality of provision
  - No focus on what will happen at the district or local levels

Growth strategy to break the begging bowl?

- Define the role of the state?
  - Need for public infrastructure spending? Do we have enough roads, transport facilities, airports?
  - With inefficient public provision, will the private sector provide without state guarantees? If latter, what provisioning is to be made?
  - Effective social protection and household protection?
  - Public and national security
- Need to rely on efficient private sector
  - Where is the efficient private sector to carry out the needed investment spending?
  - Will 60-year old geriatric infants on life support subsidies be able to provide?
- Spending rationalization and prioritization within a multi-level governance structure
- But what does this imply for the public finances?

Latin American comparisons, 2008: raise domestic resources

Country	General revenues	Primary public expenditures	Primary surplus	Output growth
Argentina	33.4	30.6	2.7	6.8
Bolivia	38.9	32.6	6.3	6.1
Brazil	36.6	32.5	4.1	5.1
Chile	27.2	22.3	4.8	3.7

Note: Output growth in %; all others % of GDP
Source: IMF Regional Economic Outlook, Western Hemisphere, October 2010

Towards a global income tax?

- All income, regardless of source, to be subject to PIT
  - Capital gains on property, with standard exemption for owner-occupied property; property tax levied by localities
  - Three or four brackets, top marginal rate kept in line with lower CIT rate;
  - Adjust exemption limit with inflation—main impact on distribution—minimizes disincentive effects of high marginal rates
  - Remove "notch problem", applying relevant marginal rate to a respective bracket
  - Could income on agriculture be taxed by joint independent body on an agency basis
- Piggy backing options for provinces, with consolidated bases
- Corporate tax: consolidate to reduced single rate, 25% together with creditable minimum tax (GAT)

Alternatives to VAT/GST?

- Additional tax items
  - Income taxes—PIT; CIT/GAT; property;
  - 1- 2% of GDP
- Still need the 3% of GDP from VAT/GST in medium-term

New tax administration

- Impossible to fix FBR
- Set up new administration for "shared taxes"
- Independent agency, on private sector rules (SBP model?)
- Report to CCI? PM?
- Alternatives:
  - Peru: SUNAT (under Finance Minister): Fire staff and start again?
  - Iran: New VAT administration within administration—old administration and staff handling other taxes

Breaking the begging bowl?

BETWEEN NOW, A NEW IMF PROGRAM AND THE NFC

Multilateral: will the IMF be pressurized?

- Not likely—especially if it takes a hard line with Greece/ Portugal
- Hard to argue for more lenient treatment
- Not in interest of country to borrow more expensive IMF monies to stick in reserves
- Need to renegotiate existing multilateral debt, new program will be needed for Paris Club
- Conditionality will be quite tough this time

Will the US ride to the rescue again?

- Questions as to what is happening to the monies?
  - How is it being spent? And who does it benefit?
  - Resistance to providing additional finances, when a great deal of assistance has been so unproductive
  - Increasing trust deficit on both sides
- Considerable resistance in Congress
  - Aid likely to carry more strings, and become more unpalatable
  - MOUs cancelled by Punjab
- Grudging acceptance that both sides need each other
  - Bad marriage
  - But can the divorce get ugly? Especially as Pakistan is keen to get into the Chinese bed
  - Offering naval facilities in the port of Gwadar, mouth of the Persian Gulf—likely linked by road/rail to Xinjiang

What's in it for China?

- Can China step into the breach
  - Warm water port, access to the Gulf, like a stationary aircraft carrier—highway from Xingiang
  - Access to Gulf shipping channels—agreement to hand over Gwadar port
  - Counterweight to India
- But:
  - May require a tighter control over fundamentalists than the US (e.g., as in Xingjiang)
  - "Autonomous republic status" may not be very attractive
    - Shoot corrupt governors
    - VAT?

Concluding thoughts

- If the begging bowl is to be "broken":
- Urgent tax measures needed, plus spending rationalization
  - 5% of GDP on revenue side in 5 years, remains an achievable target
  - Must include the VAT
  - Careful about jettisoning the improvement in the investment climate from the Musharraf years
- Rent-seeking in administration and special interests remain the main constraints
- Ensure continuation of social services and social safety nets, to prevent further radicalization

Is the neighbourhood quite as dangerous as we think?

- Less disputed with India than between China and Taiwan
- Yet the trade and economic links between China and Taiwan have flourished
- Pakistan-India economic contacts virtually frozen for over 50 years
- Freer flow of trade, goods and people could diffuse tensions as between China and Taiwan, or France and Germany
- Respite may be needed in order to focus on economic development