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Leaning on the IMF will cost govt dearly

Pakistan has to commit to a further fiscal adjustment of around 2.5 per cent of GDP along with 'deep-rooted' and wide-ranging structural reforms to secure a bailout from the International Monetary Fund (IMF) despite top-level political interventions, according to sources.

This adjustment will have to be supported by a further increase in electricity and gas rates as well as reining in the bleeding in public-sector entities to address the quasi-fiscal deficit in the system. The combined adjustment over the next two years can go beyond 3.5pc of GDP (over Rs1.4 trillion).

The circular debt capping plan promised by the power division for finalisation in the first week of December 2018 is still pending. The circular debt has since gone up to about Rs1.64tr from about Rs1.3tr at the end of September that year.

Faced with rising inflation amid higher energy prices, the government's major concern is the political and economic costs of the painful IMF programme

The government's drive for the recovery of arrears and reduction in system losses in both electricity and gas sectors has yet to show tangible results. Transmission losses in the power sector increased to 4.3pc in January from 2.6pc a few months ago while gas losses remained stagnant above 12pc. Gas and electricity rates were raised a couple of months ago by up to 30pc and 15pc, respectively, and are estimated to go further up by 30pc by June.

The government believed the major challenge pertained to the fresh flow of the circular debt, which should come to an end over two years, starting with about 20-25pc tariff adjustment in the first phase. The old stock of Rs800bn or so can then be addressed over the medium term.

The IMF wants the next year's tax revenues to expand significantly to close to Rs5tr from the target of about Rs4.4tr this year. Strengthening the central bank's autonomy in line with the international best practices, a market-based flexible exchange rate and reduction in the debt ratio are some of the key areas of the framework that the two sides have to work out by April this year in order to make it a part of the next year's budget.

The two sides have to reach a staff-level agreement on the pace and sequencing of policy actions on both fiscal and structural fronts that the IMF mission can defend before its executive board in tough circumstances. Both sides have generally agreed upon the broad policy direction of about $5-6bn package, except that the IMF wants actions frontloaded in the first year and the government desires that the implementation be phased equally over three years.

Already facing criticism over rising inflation amid higher energy prices, the government's major concern was the political and economic costs of the painful programme. It can hardly afford to have public protests like those in some European countries. Therefore, it wanted to delay any further increase in electricity, gas and petroleum rates to ensure reasonable gaps.

Also, the fund and the authorities have been negotiating an unusually difficult programme as evident from the protracted engagements since September-October last year for many reasons, including a not-so-friendly geo-political situation despite a recent relative ease in tension between Islamabad and Washington over the dialogue with the Taliban. The IMF management has a limited role as the decision has to be made through majority vote.

Unlike the previous practice of GST rate adjustments, an effort has already been set in motion to increase the petroleum levy on petroleum products to partially offset slippages on the revenue targets. The levy on petrol and high-speed diesel increased massively for this month to up to Rs18 (from Rs10) and Rs25 (from Rs8) per litre, respectively. This is despite the fact that the PTI government had reversed a target of Rs300bn set by the PML-N government for this year to Rs180bn.

This stems from the fact that the GST is a divisible tax that mostly goes to the provinces at the political cost of the federal government while the petroleum levy stays in the federal kitty.

Going forward, the key requirement of the fund programme is for the government to generate sufficient resources to fully finance government expenditures, including social and public service delivery and the development programme, except for interest payments ie the primary budget surplus.

That is where the role of the provinces comes into play in terms of provincial cash surpluses or devolution of responsibilities commensurate with the transfer of resources under the NFC award and shared financing needs of Azad Kashmir, Gilgit-Baltistan and tribal districts — the so-called proposal for setting aside 7pc of the gross divisible pool resources.

Therefore, Finance Minister Asad Umar-led team will have to manoeuvre policy dialogue on two intertwined objectives and directions with the IMF on one hand and the provinces on the other. No decision can be imposed on the provinces as the NFC award has to be reached with consensus. The provinces have agreed to be part of the dialogue with the IMF at least in the matters of fiscal adjustments.

While the government has already started shifting a huge stock of borrowing from the State Bank of Pakistan (SBP) to commercial banks through successive increases in policy rates to an extent of about 450 basis points, this may need further support beyond 11pc. More significantly, the rupee has to get close to its real effective exchange rate to come to terms with the IMF.

There are also indications about the revival of discussions for the introduction of a universal value-added tax (VAT) to replace the GST for an integrated coverage of goods and services across the country for which the provinces will have to show consent. All past efforts failed to reach a consensus on VAT or even the reformed-GST.

The federal ministries of planning and development and finance have already been advocating cost-sharing with the provinces on health and education programmes, such as polio, income support and higher education, as these subjects fall basically in the provincial jurisdiction.

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