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Pakistan: pathways to change – II

Over the medium-term, macroeconomic sustainability calls for urgent action on a few fronts. To shore up the fiscal side the most critical items are:

i. Domestic resource mobilization from all sources: taxes, market pricing for services rendered and capital markets. Federal taxes and GDP remained around 11.2% - almost half of country's tax potential. Large segment of economy, including agriculture, real estate, retailers and the large informal sector are outside tax net in addition to pervasive tax evasion. Despite collections from Amnesty Scheme, overruns in the fiscal deficit are equivalent to slippages in revenues. The Tax Reform Implementation Programme, with the support of the World Bank, has yielded suboptimal results and the number of taxpayers remain embarrassingly low.

ii. Adopting a rule-based fiscal policy, keeping in perspective the need for an effective debt management strategy, modernization of public financial management practices and inducing investment efficiencies. Fiscal preemption overburdens monetary and exchange rate management and creates tax distortions that hurt industry and trade competitiveness and costs.

iii. Given the need for pursuing fiscal consolidation over the medium-term, Pakistan will need to deploy public funds and guarantees judiciously to promote public-private partnership for infrastructure development. There is need to strategize in this area. Pakistan relocated the Pakistan Infrastructure Financing Facility from the Ministry of Finance (MoF) and established the Public-Private Infrastructure Advisory Board under the chairpersonship of Minister of Planning and Development Reform. Provinces have their PPP centres which are operating under different authorities and policy regimes. At the same time, IFC is setting up a specialized private sector-driven PPP Infrastructure Financial Institution. Besides offering policy, legal and regulatory clarity to these alternate bodies, there is need for upgrading technical competence in these institutions to manage the potential load of the PPP projects, strong governance in bidding and procurement and managing effective social and environmental safeguards.

Given its federated structure, Pakistan has managed to devolve political, economic and social powers to provinces. Devolution was a welcome step provided it promotes right revenue-expenditure balance to promote fiscal sustainability and effective development outcomes. In recent years, consolidated provincial PSDP is higher than the federal PSDP. Indeed, the federal PSDP has had cumulative cuts of close to Rs 635 billion over FY18-19 because of the revenue squeeze and transfers at the federal level. With the breach in its Fiscal Responsibility Debt Limitation (FRDL), securing more debt will be challenging. Specifically, the FRDL amendments impose a limit on the federal government budget deficit (excluding foreign grants) of 4 percent of GDP for FY18-20, and 3.5 percent of GDP thereafter. It also limits government debt to 60% of GDP until FY18 (its currently 73.5% of GDP). The mandated limits, effective FY18 apply on a net basis, rather than gross debt. Unless law is revised, Pakistan legally needs to adopt a 15-year transition path to move the sustainable debt/GDP ratio.

To deal with external vulnerabilities, the balance of payments must be strengthened to safeguard and cushion the economy with at least 4-5 months of reserves. This calls for:

i. Pakistan to expand and diversify its exports beyond primary and resource driven products. Low tech textile-based exports now account for 60% of the total exports. These exports are low value and exporters do not have sufficient flexibility to respond to take advantage of market changes. In addition to being low value with limited capacity and older technology, these exports are stuck at low end of technology ladder. Medium and high-tech products constitute barely 6% of the total exports despite Pakistan's talent in this area (witness all the IT-related shops in all the big cities around the world run by Pakistanis!). Now is an opportune time for Pakistan to become a larger player in the global supply chains in tech-related manufactures. This diversification should be in line with the revealed comparative advantage in agriculture, mining and animals, etc. The dynamics of competitiveness can change as innovation, creativity, technology and FDI flows evolve efficient linkages with global and regional value chains. Exports should be zero rated rather than anchored on tax refunding mechanism. Flexible exchange rate management is critical but will work better if structural impediments facing exports are addressed. Underpinning all of this is an investment in human capacity.

ii. Managing tradeoffs carefully. On one hand ensuring that a growing economy and exports have unencumbered duty-free access to raw material, intermediate and other inputs; while at the same time managing the current account balance requires skill. Possible import substitution should also not be off the cards. Among other changes, more options need to be on the table for a sustainable energy mix that would also reduce Pakistan's dependence on imported oil, which accounts for almost one quarter of the import bill (and the price is increasing).

These shifts call for a more rational and conducive industrial and trade policy that promotes well a diversified, efficient and competitive industrial sector that generates new opportunities for accelerating exports, while meeting the growing domestic demand locally. Moving away from tax refund and subsidy culture, government should design a tax policy which incentivizes industrial and export diversification. The current policy is skewed towards dependence on a textile industry that eventually needs to cater for higher value addition and quality. Effort is warranted to support agriculture or possible new industries to exploit opportunities for import substitution. Promoting software and business process outsourcing and call centres or IT services would among others serve to be key enablers of productivity enhancements. Appropriate financing vehicles, startups and the venture capital industry are critical for supporting more innovative industries.

Among other priorities, the country needs to continue to simplify, streamline and remove tax anomalies, regulatory duties and the cascading structure of import tariffs on raw materials, intermediate goods and final products. The rate structure of the corporate sector needs to be globally competitive. Realistic expansion of the tax net will only occur if penalties are imposed on non-filers and tax exemptions are removed to bring in all sectors currently outside the tax net. Adoption of an electronic trade platform and exchanging data and information across borders will help reduce red tape and transaction costs and improve tax collection efficiency.

Given the current disruptions in global supply chains resulting from trade wars, FTAs need to be reviewed and renegotiated. Pakistan industry must take advantage of potential opportunities and ensure reciprocity, especially in the Pak-China FTA. Pakistan must be upgraded to allow most favourable access to Chinese markets at par with ASEAN and others. There is potential for Pakistan to tap these export opportunities if producers illustrate flexibility and current constraints are lifted to provide a more supportive trade environment for exporters. More effort to reach out and grab foreign direct investment need to be initiated. Pakistan's regional and global linkages need to be harnessed to directly link industry to supply chains. Stable and predictable exchange rate management is an integral part of industrial and trade policy and needs to be continued.

To make this industrial push successful, there needs to be consistency of objectives and policies across the ministries of industry, textiles, commerce and finance, as well as better federal and provincial coordination. Among other areas, managing a common sales tax regime, harnessing SMEs linkages with larger industry and finally reaching the global supply chains will be beneficial. The CPEC offers an opportunity to develop industrial economic zones and industrial clusters whose development now needs to be fast tracked. This approach has been shown to be successful in many other countries and could be successful in Pakistan as well.

The state-owned entities and energy sector continue to act as a drag on growth. Dealing with off budget liabilities, which have now hit over Rs 2.2 trillion, and improving operations will help alleviate fiscal pressures while improving competitiveness and the business environment. The top priority must be resolution of power sector losses that aggravates inter-enterprise arrears and cost of industry. Adjustments in power and gas pricing, however, blunt efforts to increase global competitiveness. Reducing technical and financial leakages can effectively and immediately improve sector efficiency and power access across the country. However, given the current challenges facing this sector and the large capital investment required, planning needs to be long-term and implemented consistently over time with emphasis now on improving affordability, reliability and long-term sustainability. With the support of CPEC, Pakistan has managed to add significantly to its generation capacity and more will be added as CPEC projects under implementation are completed. Following this, next phase should focus on restructuring distribution system to enhance cost recovery and improving reach and efficiency of the transmission infrastructure. On the petroleum side, aside from LNG importation, domestic production of oil and gas will be key to mitigate the high dependence on imports. Long-term stewardship, accountability and governance of power sector will be critical to ease macroeconomic stress.

Final message: Fixing macroeconomic management calls for strong political ownership, stable and predictable policy environment, and homegrown long-term solutions

To conclude, Pakistan's macroeconomic outlook and resilience has been at risk. As domestic demand retreats in FY19 in response to old and new measures, MDBs and SBP forecast growth continuing to slide. Future growth dynamics will depend on how swiftly macroeconomic stability can be restored. This must include a combination of stronger demand management, while offering growth-stimulus by fixing the business environment. Reinforcing basic pro-growth policies such as promoting a conducive, sustainable, business environment; being inclusive and supporting access for all to education and cost effective and efficient management of SOEs will help turn things around in Pakistan.

The demand management adjustment prior to the current FY will undoubtedly have some impact dampening the surge in imports. SBP reserves which grew to $10.2 billion by 18 August have come under renewed pressure and declined to $8.4 billion in October 2018. Bilateral negotiations with few countries is expected to help build up reserves offering relief to the Government and calming the exchange markets. Depending on the size of bilateral deposits and stabilization scenario adopted, financing requirements including the roll-over of deposits and debt repayments may still require recourse to IMF - a prerequisite for opening the door to new long term official assistance from the World Bank, ADB and other international players.

(Concluded)

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