The Pakistan Business Council
FOSTERING ECONOMIC GROWTH
(A Company set up under Section 42 of the Companies Ordinance 1984)

Ehsan A. Malik
Chief Executive
8th Floor, Dawood Centre,
M. T. Khan Road,
Karachi-Pakistan.
PABX : 35630528-29
Fax : 3563 0530
e-mail: ehsan.malik@pbc.org.pk

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Mr. Muhammed Aurangzeb
Federal Minister for Finance and Revenue
Islamabad

Dear Minister,

As you leave for the IMF/World Bank spring meetings and explore the construct of the 24th IMF Program for Pakistan, we would like to submit the following contours to ensure that this time, the program achieves fundamental and sustainable reforms. You have often stated that it is a Pakistan reform program that we wish to implement with IMF's help. We agree and suggest the following framework.

1. REFORM-CENTRIC QUALITATIVE TARGETS

IMF's previous programs for Pakistan have suffered from short-term, front-loaded, mainly quantitative targets to manage the twin deficits without sufficient regard to their long-term qualitative impact on the reform agenda. This, aside from weak political will, is a major reason why we continue to have recurring deficits and IMF programs. Two glaring examples of short-term quantitative (but not backed by qualitative) targets are tax revenue and the tariff-based measures to control the energy circular debt. A smarter way would be to set targets that result in sustainable progress on the reform agenda instead of relying by default on the easy options of extracting more from those who are already contributing more than their fair share. Unfortunately, the government's decision making has moved to one of fire-fighting. The short-term IMF bailout programs with front-loaded targets have perpetuated this practice. It is time we restore the sanctity of long-term plans and deal with fragmentation and silo-working of various ministries as well as the center and provinces.

a) Tax Targets

Front loaded tax revenue targets in the absence of FBR's capacity and capability to broaden the tax base have, not surprisingly, led to higher taxes on those that are already contributing a disproportionate percentage of taxes relative to their representation in the economy. At the same time, wholesale, retail, services, transportation, parts of construction and the undocumented real estate sectors have been left outside the tax net. The formal sector has suffered from the twin effects of higher taxes on business and brain drain of quality talent due to elevated tax on its salaried employees. A smarter way to measure sustainable progress on taxation would be revenue from new tax payers coupled with relief provided to the over taxed sectors to encourage investment, scale and retention of quality talent in the country. The net impact over time would be sustainable increase in the tax to GDP ratio.

Restructuring the FBR, infusing it with technology and appropriate talent, redesigning the fiscal policy to promote investment and formalization of the economy will not result in immediate impact on tax revenue. Targets should be phased in line with capacity to tax in a fair and broad manner. Short-term tax collection targets have not served Pakistan well.

In the discussion on taxation, we find ample talk (and now some walk) on broadening the tax base. However, there is little mention of equitable taxation by reducing the disproportionate burden of taxes on the few. Unless the government (and the IMF) recognizes the value of fair and competitive wealth creation, benefits of formal sector scale, wider shareholding through listing, regionally competitive tax rates, fair taxation of salaried employees and simplification of the tax processes, Pakistan's formal sector will remain small and fragmented and the informal sector will continue to grow. Some of the measures to support equitable taxation, such as removal of double taxation of inter-corporate dividends is often misconstrued as contrary to IMF's wishes. This is strange as most countries in the world don't penalize group formation, scale and competitiveness by levying multiple taxation of inter-group dividends. Neither do they penalize success through super tax. Our fiscal policy needs to be aligned with our industrial, trade and investment policies and should support growth of the formal corporate sector, not penalize success. Also, when levying new taxes such as Capital Value Tax and Super Tax, due consideration should be given to the likelihood of driving local investors abroad. When local investors move abroad and some surrender their Pakistan nationality, foreign investors are hardly likely to be attracted to invest in Pakistan. Lastly, the solution to the Rs. 1.7 Trillion of taxes claimed to be pending court decisions is not to deny independent appeal processes. Instead, the FBR should be held accountable for exaggerated tax notices and the harassment, delays and legal costs of its actions.

b) Energy Circular Debt Targets

A tariff-led approach to arresting (or slowing) the growth of the energy circular debt is not a sustainable solution to the deep flaws within the energy sector. Across the board higher tariffs sweep with a wide broom by failing to differentiate between productive and other consumers. Industry, which generates employment and exports, helps replace imports and contributes taxes is thwarted in these objectives when it is burdened with cross subsidies and the inefficiencies, theft and under recovery of the transmission and distribution system. Fundamental reforms would need to address these factors as well as find ways to generate higher demand to reduce payments for unutilized generation capacity. Lower tariffs, especially in winter would also incentivize domestic users to switch heating and cooking from gas to electricity. Addressing gaps in transmission to evacuate cheaper renewable energy, converting plants using imported to local coal, phasing out expensive RFO will all take time. Wes should therefore move from addressing symptoms through tariff increases to removing the fundamental flaws in a phased and realistic manner. The short-term tariff led approach has rendered our productive sector uncompetitive in exports, resulting in negative consequences on the external account. That surely is not IMF's objective. Therefore, it is important for the government to engage the IMF to move away from the short term, tariff-based approach.

2. FISCAL & MONETARY POLICY

Aside from inequitable taxes and high energy costs, the country's formal productive sector is suffering from high inflation and cost of borrowing. The last two are a result of fiscal indiscipline. High government spending leads to higher levels of borrowing, crowding out the private sector and resulting in high borrowing cost for both business and government.

a) Policy Rate

IMF supports SBP in targeting a positive policy rate with reference to headline inflation which includes food and energy. IMF imposed energy tariff targets drive headline inflation, which then keeps the policy rate high, forcing the government to borrow more, leading to further impact on inflation. Additionally, a high policy rate only impacts less than half the real economy which is in the formal sector, further undermining its ability to compete and generate taxable revenues. This is a vicious cycle that needs to be reversed. The policy rate should be set with reference to core inflation, which excludes food and energy.

The demand compression objectives of monetary policy are successfully achieved from a combination of targeted controls on lending to auto and consumer sectors and through higher cash reserve requirements on banks. Besides, the devaluation of the PKR, repeated increases in energy tariffs and growing unemployment have sapped spending power. Also, through Open Market Operations, SBP is complicit in driving inflation, and then it seeks to control it by setting a high policy rate. This phenomenon is costing the country dearly and needs to be tackled.

Policy rate has limited effect on the exchange rate in Pakistan due to high cash in circulation, large unbanked and informal economy, high current account balances, interest-free Islamic banking deposits and significantly lower deposit rates available on foreign currency accounts. Recent experience has shown that speculative conversion of PKR to US$ and gold is motivated by factors other than the policy rate.

b) Equitable Distribution of Resources and Responsibilities

With current distribution of resources and responsibilities between the center and provinces, it is inconceivable that the fiscal deficit can be managed without excessive borrowing, leading to high inflation. A Pakistan reform program must achieve equitable distribution of resources and responsibilities, besides motivating provinces to collect agriculture and property taxes.

c) Rationalization of Government Expenditure and Regulatory Burden

Whilst governments are quick to shift burden of fiscal management to tax payers and consumers of goods and services produced by inefficient state-owned enterprises, it has been slow in cutting the size of the government, deregulating, simplifying and digitalizing its processes and reducing its expenditure. A reform centric program with or without the IMF should give reducing state control and its associated costs a high priority.

d) Pensions

Pension reforms are urgently required to limit the government's exposure to growing liability. The center and provinces should emulate KP by moving from defined benefit to defined contribution scheme.

3. PRIVATIZATION

Privatization and public/private partnerships such as outsourcing airports and DISCOs are part of government's policy. In pursuing FDI, we urge the government to carefully evaluate the trade-offs between one-time foreign investment inflows and subsequent outflows, given Pakistan's risk profile and relatively short-term payback expectations of foreign investors. Exceptions should only apply to export and foreign exchange oriented FDI or those that bring knowhow and technology, otherwise not available to local investors. Moreover, privatization proceeds should be utilized to paydown debt, not to sustain high government expenditure.

We look forward to progress on the talks with the IMF and wish you success in negotiating a reform-centric, sustainable program.

Yours faithfully,

Ehsan Malik

cc:

Mian Shehbaz Sharif, Prime Minister of Pakistan

Syed Awais Ahmad Khan Laghari, Federal Minister for Energy (Power Division)

Mr. Musadik Masood Malik, Federal Minister of Energy (Petroleum Division)

Mr. Jam Kamal, Federal Minister of Commerce

Mr. Ahsan Iqbal Federal Minister for Planning and Special Initiatives & Inter-provincial Coordination

Rana Tanveer Hussain, Federal Minister for Industries and Production

Mr. Abdul Aleem Khan, Federal Minister for Privatization and Investment

Secretary, Special Investment Facilitation Council