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Economic impact of prior fiscal actions in the IMF program

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Pakistan Economy

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The National Assembly on Thursday (13th Jan'22) passed two bills, the Finance (Supplementary) Bill, 2021 and the State Bank of Pakistan (Amendment Bill), 2021 (reportedly with some amendments in the original bills). This is part of the process of implementation of prior actions for successful completion of the sixth review of the IMF program with Pakistan. Completion of these actions is expected to lead to the approval by the IMF Executive Board of the release of $1 billion to Pakistan until the end of this month. This special article is organized as follows. The first section identifies the tax reforms committed to by the Government of Pakistan in the Letter of Intent to the IMF on the 9th of April 2021, which remained unimplemented up till the commencement of the sixth review in October 2021. The second section of the article describes the key features of the tax expenditures in the Federal general sales tax (GST) and the reforms proposed in the Finance (Supplementary) Bill, 2021. Results of the analysis of the impact on prices, growth and on different segments of the population are presented in this section. The third section focuses on the key features of the State Bank (Amendment) Bill, 2021. Analysis is undertaken of the impact of greater autonomy of the Central Bank. Finally, a summary is presented in Section 4.

Key Data	
KSE100 Index	45,763
KSE-All Share Value (PKRmn)	6,481
KSE-All Share Value (USDmn)	36.7
KSE-All Share Volume (Shmn)	327.6
Market Capitalization (PKRtn)	7.8
Market Capitalization (USDbn)	44.4
1Year High	48,726
1 Year Low	42,780

Source: PSX, Next Research

1. AGENDA OF TAX REFORMS

The reforms agreed to in the letter of intent issued by the Government to the IMF on the 9th of April 2021 are as follows:

(i) Sales Tax reforms: This will include, first, elimination of all zero-rated goods in the Fifth Schedule of the Sales Tax Act, 1990, except on export and machinery, and levy of standard sales tax rate. Second, removal of all reduced rates in the Eighth Schedule and bring them all to the standard rate. Third, elimination of exemptions in the Sixth Schedule excluding a small subset of goods (i.e., basic food, medicines, live animals for human consumption, education, and health-related goods) and bring all others to the standard rate. Fourth, removal of the Ninth Schedule to replace a specific tax rate for cell phones with the standard rate., These reforms are expected to yield 0.7 percent of the GDP on an annualized basis.

(ii) Increase Progressivity of the Personal Income Tax: This will include, first, reduction in the number of rates and brackets from eleven to five and decreasing the size of the income slabs. Second, reduction in tax credits and allowances by 50 percent (except for Zakat and those provided for disabled and senior citizens).

2. FEATURES OF THE FINANCE (SUPPLEMENTARY) BILL

This bill has the primary focus on the sales tax reforms, while some changes are also proposed in other taxes. The quantum of revenue loss currently in the sales tax system has been estimated by FBR for 2020-21 and is presented in Table 1.

Table 1: Estimated Revenue Loss due to the Different Sales Tax Schedules, 2020-21 ***(Rs in Billion)***

Schedule	Description	Revenue Loss*
5th	Zero-rating	12.9
6th	Exemption on Imports	173.8
6th	Exemption on Local Supplies	156.1
8th	Reduced Rates	208.5
9th	Mobile Phones	27.1
	TOTAL	**578.4**

***Source:** FBR, Tax Expenditure Report, 2021.

The revenue loss estimated by FBR is equivalent to 29 percent of the revenues collected from the sales tax in 2020-21. The Finance (Supplementary) Bill proposes the following changes in the Schedules.

Fifth Schedule: The following omissions:

Schedule	Description	Revenue Loss*
5th	Zero-rating	12.9
6th	Exemption on Imports	173.8
6th	Exemption on Local Supplies	156.1
8th	Reduced Rates	208.5
9th	Mobile Phones	27.1

The additional revenue is marginal.

Sixth Schedule

Many exemptions are proposed to be withdrawn including the items in the following serial numbers of the Tables of the Schedule:

Serial numbers: 1, 2, 3, 11, 12, 16, 20, 21, 23, 46, 49, 50, 51, 52, 52A, 53, 54, 55, 57, 58, 60, 61, 63, 71, 72, 81, 84, 92, 99, 102, 104, 105, 107, 109, 110, 113, 114, 116, 117, 126, 127, 129, 130, 131, 132, 134, 135, 136, 138, 139, 140, 141, 142, 146, 149, 150, 155 and 158 and entries relating thereto in columns (2) and (3) shall be omitted; and

From Table 2 of the Schedule:

Serial numbers: 1, 2, 4, 9, 15, 16, 22, 23, 33, and 38 and entries relating thereto in columns (2) and (3) shall be omitted.

From Table 3, in the Annexure,

2, 2A, 3, 4, 5, 6, 7, 8, 9, 11, 13, 14, 14A, 15, 15A, 15B, 17 and 21 shall be omitted.

Within this long list, the major import items on which exemptions have been withdrawn are as follows:

Serial No.	Description	Revenue (Rs bn)
20	Seeds and spores used for sowing	2
110 & 14A	Items for renewable source of energy	6.8
131 & 132	Laptop Computers and Personal Computers	4.8
141	Preparations for making Animal Feed	1.8
	TOTAL	**15.4**

These withdrawals of tax exemptions will have negative impact on the agricultural sector (especially livestock), investment in renewable energy and the development of the IT sector of Pakistan, especially exports.

The Eighth Schedule

The Eighth Schedule has implied the largest revenue foregone of over Rs 200 billion, as shown in Table 1. The FBR had initially prepared a very long list of items to be shifted to the standard rate. However, this list was subsequently truncated by the Ministry of Finance. The key items retained in the Eighth Schedule are shown in Table 2. Fortunately, this retention has reduced the potential negative impact on agriculture, use of LNG/LPG and the chemicals industry.

However, the consequence is that there is a substantial overstatement of the total revenue impact of almost Rs 350 billion. It could be less by over Rs 150 billion. The question is, will the IMF be able to identify this gap and ask for more reforms in the sale tax regime or elsewhere?

The major items which will be subject to the standard rate following the passage of the Bill are shown in Table 3.

The long list of items in Table 3 on which the standard rate will be applied following passage of the bill will have a negative impact on crop agriculture, livestock, fishing, steel industry, automobile industry (above 850cc) sales, nutrition for infants, medicines, personal computers, etc. Private investment, especially in agriculture and renewable energy will also be discouraged. The sales tax on retail outlets will go up from 10 percent to 12 percent. The negative impact would have been much larger if items in Table 2 had also been excluded from the Eighth Schedule.

Table 2: Major Items Retained in the 8th Schedule *(Items Excluded from the Original List Submitted by FBR to the MOF)*

Section	Rate	Description	Revenue (Rs bn)
5	5	Raw and Ginned Cotton	1.8
22	8.5	Soya bean Seed on Import	11.0
23	5	Second hand clothing	3.4
25	5	Agricultural Tractors	2.1
43	5	Natural Gas supplied to Fertilizer plants	4.4
44	5	Phosphoric Acid	6.5
51	12	LNG/LPG	19.7
52	2	Fertilizer	87.0
57	10	Rock Phosphate	0.3
58	10	LPG	3.4
60	10	Fat-filled Milk	3.7
65	10	Ginned Cotton	12.8
67	5	LNG	2.3
		TOTAL	**159.4**

Table 3: Major Items to be excluded from the 8th Schedule and to be Subject to the Standard Rate			
4	Oil Seeds meant for sowing	72	Uncooked Poultry Meat
6	Plant & Machinery	81	Cotton Seed
Jul-14	'Exotic' Food Items	84	Preparations for Infants
15	Ingredients of Poultry, Cattle Feed	92	Sewing Machines
16	Machinery	99	Compost
17	Temporary Export	102	Machinery, materials in EPZs
20	Machinery	104	Substances as Drugs
26	Agricultural Machinery	105	Raw Materials and ingredients for Pharmaceuticals
27	Agricultural Machinery	107	Iodized Salt
28	Irrigation Equipment	109	PIA
29	Agricultural Machinery	110	Renewable Energy Machinery
30	Agricultural Machinery	113	Irrigation Equipment
34	IT, Media	114	Green House Farming
45	Poultry Machinery	116	Plant & Machinery for FATA
46	Phosphoric Acid	117	Ostomy Equipment
54	Battery	126	Aviation
55	Fish Seedlings	127	Aviation
59	Milling Industry (excluding wheat)	129	Plant & machine and equipment for mobile phone manufacture
61	Silver	130	Vitamins
62	Gold	131	Laptop Computers, Notebooks
63	Jewellery	132	Personal Computers
64	Prepared Food, Sweetmeats supplied by Rest, bakeries & goat meat shops	134	Gifts
66A	Supplies made by Retail Outlets	135	Sunflower and Canola Seed
66B	Import of Remelt-able Scrap	136	Combined Harvesters
68	Frozen Meat	138	Fish feed
69	Meat	139	Fans for Dairy Farms
66	Retail Outlets	140	Bovine Semen
70	Cars up to 850cc	141	Inputs for Animal Feed
		146	Miscellaneous Items

The other tax measures relate to amendments in the Islamabad Capital Territory (Tax on Services), Ordinance, 2001, income tax enhancement on cars and a new tax on foreign TV Plays and Ads, and higher excise duty on tobacco.

Further, a cut of Rs 200 billion is being imposed on the Federal PSDP and the Petroleum Levy is to be increased by Rs 4 per liter monthly on petroleum products.

3. THE STATE BANK OF PAKISTAN (AMENDMENT) BILL, 2021

Further, a cut of Rs 200 billion is being imposed on the Federal PSDP and the Petroleum Levy is to be increased by Rs 4 per liter monthly on petroleum products.

The SBP (Amendment) Bill submitted to the Parliament represents one of the most fundamental attempts at institutional reform in the history of Pakistan. Comments on the different sections of the proposed Bill are given below.

2. Preamble: The primary objective of the SBP according to the Bill will be to achieve domestic price stability by way of regulating the monetary and credit system of Pakistan. The basic question is how much control does the SBP, in fact, have on inflation caused by rise in international prices of commodities imported by the country or due to cost-push factors like escalation in energy tariffs?

Contemporary developments highlight this problem. Up to November, the SBP was focusing on an inflation target for 2021-22 of 7 to 9 percent. In the December meeting of the Monetary Policy Committee this was raised to 9 to 11 percent. The actual rate of inflation was 12.3 percent in December. Will the SBP again revise upwards its inflation projection?

Also, for a developing country there is need for a balanced combination of the growth and inflation targets. As per the Constitution, the Annual Plan with these projections/targets is approved by the National Economic Council chaired by the Prime Minister. The SBP Governor should ex-officio be a member of the NEC and contribute to the finalization of the Annual Plan. The SBP should also then work towards achievement of these targets.

4B. Objectives: This clause of the proposed legislation states that the 'Bank will contribute to the stability of the financial system.' Instead, the Bank should be made 'responsible' for the stability of the financial system.

4C. Functions of the Bank:

Item (c) This should state that the SBP will undertake research to identify in quantitative terms the broader social and economic impacts of the use of different instruments of monetary and credit policies.

9C. Prohibition of Government Borrowing: This clause clearly states that the SBP shall not extend any credit to the Government. There are two comments on this proposed legal limitation.

First, there is need for an emergency provision in the event of natural disasters or territorial security concerns. Second, the drafters of the Bill are probably not aware of the phenomenon of 'seignorage'. This is the normal non-inflationary increase in the demand for money in a developing country, which is estimated at 1 percent of the GDP in Pakistan. This much direct borrowing should be allowed, equivalent to Rs 500 billion.

9G. Governor and Minister of Finance to establish liaison: Informal mechanisms generally do not work. The existing Act has a provision for the Fiscal and Monetary Policies Coordination Board. This has been an effective mechanism for development of mutually supportive fiscal, monetary, trade and other policies. This Board should be retained.

39. Accountability: The proposed Bill states that the Governor shall submit an annual report to the Parliament regarding the achievement of the Banks' objectives. Ideally, this should be twice a year. The Governor should present the report himself to the Finance Committees of the National Assembly and the Senate. Further, quarterly reports should be released by the SBP on the State of the Economy.

42. Distributable Earnings: There is need for a careful analysis of the proposed formula for quantification of distributable earnings, especially that to be remitted to the Government of Pakistan. Access to SBP profits has been one of the largest sources of non-tax revenues to the Federal Government.
The focus of the above comments is on policy issues and not on operational autonomy of the SBP. We look forward to a high-quality discussion and debate in the Parliament on the proposed SBP (Amendment) Bill.

4. SUMMARY

(i) A large number of items will be withdrawn from the 5th, 6th. and 8th Schedules of the Sales Tax Act, 1990. The expectation is that this will lead to annual revenues of almost Rs 350 billion. However, many of the sensitive items like fertilizer, pesticides, tractors, natural gas, LNG, LPG, etc., have fortunately been retained in the Schedules. Consequently, the impact on the price level will be much less. However, the maximum revenue that will be generated is likely to be less than Rs 220 billion. The IMF may ask for inclusion of more items if it is able to ascertain the quantum of revenue from the Finance (supplementary) Bill in its present form.

(ii) Several sectors will be negatively impacted by the rise in sales tax rates on outputs, inputs or machinery. This includes crop agriculture, livestock, fishing, electricity generation, telecommunication, information technology, retail trade, etc.
The impact on households includes the rise in the sales tax on some food items, electronic goods, medicines, jewellery, sewing machines, personal computers, mobile phones (above $200 price), automobiles (above 850cc), contraceptives, etc. The incidence is likely to be higher on upper income households.

(iii) The State Bank of Pakistan (Amendment) bill envisages extreme autonomy for the Central Bank. There are serious issues related to the preamble, level of responsibility for regulation of the banking system, setting of the inflation target, prohibition of direct Government borrowing, dissolution of the Fiscal and Monetary Policies Coordination Board, nature of Accountability to the Parliament and Formula for Distribution of Profits to the single shareholder (the Government).

The likely time to be taken in the passage of the two Bills by the Parliament will imply that the Sixth Review completion by the IMF Executive Board will be delayed and lead to some market uncertainty. Also, it remains to be seen how the IMF will react to any proposed amendments to the bills if they are not passed in their present form.

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R = Expected Dividend Yield + Expected Capital Gain
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