No. 415-FM/2015

 CR 5682-PK

Senator Mohammad Ishaq Dar
Minister for Finance, Revenue, Economic Affairs, Statistics and Privatization

ISLAMABAD
1st May 2015

SUBJECT: LETTER OF DEVELOPMENT POLICY

Dear President Kim,

The Government of the Islamic Republic of Pakistan (Government) is pursuing a comprehensive program of economic and social reforms. These reforms are essential to reinvigorate the economy, address vulnerabilities and spur inclusive growth.

On behalf of our Government, I am writing to request approval of a Second Pakistan's Fiscally Sustainable and Inclusive Growth (FSIG-II) reform credit for US$500 million. The credit will provide needed external financing and signal our determination to implement sound reforms. This Letter of Development Policy sets out the Government's key economic policy actions to be supported by the second operation in the series (FSIG-II) over 2014/15, which will consolidate reforms supported by the first operation (FSIG-I).

The main objectives of the FSIG series are to steer Pakistan back on the path of sustained and broad-based economic growth, create jobs and protect the poor. This requires macroeconomic stability, fiscal discipline and business-friendly policies that foster private investment and economic growth. The main program development objective is to support reforms which are most critical for increasing investment and improving inclusive growth. We have prepared this operation in close collaboration with the World Bank Group.

Our Vision

Let me reiterate the basic tenets of our vision for Pakistan during the present administration. First, we want to build an economy that is not dependent on others except through trade and investment, based on competitive advantage and market considerations. This can only be obtained with rapid and sustained growth. Second, the private sector has to be the lynchpin of economic activities, which explains the strong accent we give to it in the Bank supported operation. Third, the only areas where government's presence in economic affairs can be justified are where investments are too large for private sector to undertake and/or markets are unlikely to function. Fourth, all segments of population must share the burden of revenue mobilization and enjoy the benefits of reforms. The distortive and inequitable culture of concessionary exemptions and concessions must end, and provinces should also be encouraged to participate in this effort. Fifth, government must limit itself within the broader limits imposed by available resources, i.e. respect fiscal discipline, and aim for their efficient use. And sixth, we have to protect the poor and vulnerable segments of our population with an accessible and reliable social safety net, which explains the priority given in this operation to the Benazir Income Support Program. The requested operation - FSIG-II - fits squarely with all components of our vision.

Economic Context

The Government inherited severe macroeconomic imbalances and vulnerabilities. In the previous five years, economic growth had averaged at 3 percent, well below potential and about half its average in past decades, and inflation had averaged around 11.8 percent. By end-June 2013, State Bank of Pakistan's (SBP) international reserves had dropped to around 1.5 months of imports; more than Rs 500 billion of accumulated circular debt was crippling the power sector; Investment-to-GDP ratio was declining continuously and had reached 12.6percent; tax-to-GDP ratio had declined to 8.5percent while the fiscal deficit was 8.8 percent of GDP; and public debt was well above the 60 percent of GDP advised by Pakistani legislation, with some international predictions even suggesting that Pakistan would default.

However, there are visible signs of marked improvement in economic conditions. As a result of our reform efforts and initiatives, we have been able to make considerable progress on the economic front. During the first half of the present fiscal year, growth appears to keep picking up and might even reach around 5 percent for FY 2014-15; favored by low international oil prices, inflation is now on a downward trajectory at around 5 percent; the fiscal outturn is being gradually contained; public debt is on a declining path, and the external current account deficit remains modest. Moreover, the position of international reserves has made a turn-around since end-December 2013, and has reached a comfortable cushion level of 2.6 months of imports and is expected to reach 3.5 months of imports by June 2015. These encouraging signs balance significant external and domestic risks and further efforts are needed to consolidate those gains and get the economy back to its potential.

The outcome of such efforts is quite encouraging. Some key results are:

- Pakistan has by now successfully completed six reviews under the US$ 6.64 billion Extended Fund Facility (EFF) program of the International Monetary Fund (IMF). This has enabled Pakistan to access international capital markets as well as funding from multilateral donors.
- Pakistan has successfully re-entered international capital markets after seven years by issuing Euro Bonds worth US$ 2 billion. Our initial offer was oversubscribed by 14 times.
- Pakistan, after nine years, issued Islamic paper, Sukuk, for US$ 1 billion. This offer was also oversubscribed by more than 5 times.
- Successful revival and resumption of the privatization program, whereby we have already divested the shares of United Bank Limited (about US$ 400 million), Pakistan Petroleum Limited (subscription Rs. 30 billion, which is the highest ever in our stock market history), and Habib Bank Limited raising over a billion dollars (largest ever equity offering in Asian frontier market).
- Successful auction of 3G-4G spectrum licenses. As against the target of Rs. 50 - 79 billion during the last 5 years, we set an ambitious target of Rs. 120 billion in our government's first financial year ended on 30th June 2014. And our target was achieved.
- Moody's raised the outlook on Pakistan's dollar bond from stable to positive.

Despite these early gains, longstanding constraints still prevent Pakistan from reaching its growth potential. We are committed to tackling problems of the energy sector, which we estimate have lowered output by up to 2 percentage points per year; reform and/or privatize public sector enterprises; carry on key initiatives to improve investment climate; increase access to finance, simplify and liberalize international trade regime, and create fiscal space for productive investments and expanded protection to the most vulnerable. The Government recognizes that Pakistan's investment climate has considerable room for improvement. Investment climate has been further eroded by an adverse security situation and energy shortages. To tackle these constraints, the Government has already committed to a program supported by a 36-month extended arrangement under the Extended Fund Facility (EFF) with the IMF and two reform policy series with the Bank.

Our Government is fully confident that Pakistan can attain a higher growth path if there are improvements across the board in all these dimensions. The country must ensure a stable and fiscally sustainable macroeconomic environment. Our target is to increase private sector investment to about 20 percent of GDP by 2017/18 supported by a comprehensive agenda that includes actions described below. Main actions in both directions, timely supported by the FSIG series, are described in the following paras:

Fostering Private and Financial Sector Development

The Government is keen on reviving and revitalizing Pakistan's privatization program that had been more or less stalled for the past eight years. We are committed towards reforming State-Owned Enterprises (SOEs) by focusing on minimizing poor performance at service delivery, improving public sector resource allocation, and attracting private sector participation. The Cabinet Committee on Privatization (CCOP), in its meeting held in October 2013, approved a list of 31 priority SOE-projects to be implemented in a phased manner; and subsequently added another 7 to the list. These projects were selected from the list of 65 SOEs approved by the Council of Common Interests (CCI) for privatization. The Government initiated the implementation of the privatization program in December, 2013 by appointing a full-time professional (from the private corporate sector) as Chairman of the Privatization Commission and constituting a new Privatization Commission (PC) Board, consisting of leading private sector professionals.

The Privatization Commission (PC) has already launched the privatization process by completing on average at least one transaction per quarter since June-2014. It has done so by successfully selling minority stakes in United Bank Limited (UBL), Pakistan Petroleum Limited (PPL), Allied Bank Limited (ABL), and Habib Bank Limited (HBL) so far in the current fiscal year; and by completing the first SOE strategic sale of Heavy Electrical Complex (*prior action*). Other equity operations and strategic sales are also under consideration for the rest of 2015. And to foster efficiency and transparency, the Ministry of Finance (MoF) now publishes an annual report on SOEs investment tracking and performance that includes their financial liabilities and operational targets for 2014/15.

Expanded access to finance and to credit information and strengthened creditors' rights are critical for investment recovery. Financial inclusion is all about providing access to financial services to as many people as possible and respecting their rights. In Pakistan there are gaps and restrictions in place which preclude the effective use of credit information to enhance access to finance, or to ensure consumers have adequate protections, redress, and access to information, which ultimately reduces coverage of potential borrowers. Among these gaps, borrowers and third parties do not have access to their own credit information; positive information is not included in public bureau credit reports; and credit histories do not include information from non-financial institutions. To rectify this, the Government had submitted to Parliament a credit information bureau law, so-called "Credit Bureaus Act" designed to put in place a number of features and address a number of gaps which will increase the depth of available credit information while providing consumers with effective protection over their personal data. The Act was approved by the National Assembly in March 2015 (*prior action*). We will also continue to strengthen our regime for creditors' rights through a submission of a new law on secured transactions. In addition, to support the digitalization of payments and give depth to financial services among the broad segments of population, we have become member of the Better than Cash Alliance global initiative (*prior action*). All these actions are now covered by a comprehensive National Financial Inclusion Strategy led by the State Bank of Pakistan (SBP) which focuses on reaching the poor and underserved clients and has a strong emphasis on bringing women into the financial sector.

Ease of business entry is one of the most important aspects of entrepreneurship in competitive markets and of doing business. In the previous two years, the Securities and Exchange Commission of Pakistan (SECP) had developed and rolled out an electronic platform for the company registration system, which had led to a significant reduction in time taken to register a business in corporate form. The Government has launched a virtual One-Stop-Shop for business registration in December 2014 (*prior action*), creating a shared platform for registration between the SECP, the FBR, and the EOBI, to reduce the time for registration of businesses. These three key agencies have launched the new OSS through the finalization of the functional specifications and architectural design of the integrated business registration software. We also launched a physical OSS last March in liaison with the Lahore Chamber of Commerce (*prior action*), and have set up a commensurate goal of establishing a physical OSS in each province. SECP has also finalized a concept paper and submitted it for public consultations before drafting a bill on Limited Liability Partnerships (LLPs). LLPs are being aimed to foster growth in the services sector and support an enhanced business registration in the country. Professional accounting bodies and service providers have supported the development of this framework, which combines the advantages of both a partnership firm and a company, while mitigating their drawbacks. Overall, we expect to reduce the number of days to register a business by at least 3, which will facilitate doing business in the country and will likely increase Pakistan's ranking on the Business Registration Doing Business Indicator.

Foreign investment can also be spurred by the creation of Special Economic Zones (SEZs). This is why the creation of Special Economic Zones (SEZ) in Pakistan has been advanced through the SEZ Act of 2012. The framework for SEZs will help catalyze creation of industrial clusters, increasing productivity and competitiveness. The Government has now embarked on a path towards implementation of the law. After clarifying to private investors the fiscal benefits allowed to developers, it reviewed and approved three provincial SEZ applications among those received to date. Going forward, the Government is committed to accelerate implementation and approve at least one SEZ application in Lahore, while providing additional guidelines and criteria for attracting further applications.

Trade policy reforms would stimulate growth and competition and increase consumer welfare. The Government is committed to achieving a simple statutory (Most Favored Nation--MFN) rates regime of 4 slabs by end 2016/17; thus ending discriminatory statutory regulatory orders (SROs) that establish special concessionary Customs tariff rates; and improving trade relations with our commercial partners and deliver a level playing field and a much needed boost on trade-related growth and investment. As an initial step in tariff simplification, the Government already reduced the number of tariff slabs from 8 to 6 within a range of 0 to 25percent for all tariff lines, with very few exceptions and tariff peaks allowed just to address sensitive goods or special sectors, effective with the budget 2014/15 approved by the Parliament. This step was followed by the approval of a Tariff Rationalization Plan for achieving 4 slabs in 3-years in March 2015, to be effective as part of the budget 2015/16 (*prior action*) when the number of tariff slabs shall be reduced to 5. Pakistan is also reinvigorating trade relations with our commercial partners which involves taking full advantage of trade preferences available from the EU where we have autonomous trade preferences in 75 items - EU has extended GSP plus benefits (zero percent duty) from January 1, 2014 on Pakistan's exports - and consolidating our trade opening with India, Afghanistan, China and other regional countries, especially under various regional trade arrangements.

Mobilizing Revenue and Protecting Priority Social Expenditure

Sustainable high economic growth for Pakistan requires fiscal consolidation. Fiscal consolidation is the only possible way to open future fiscal space, reduce borrowing needs from the banking sector and, by the same token, increase credit to the private sector. Our target is to bring the fiscal deficit to on or below 4 percent of GDP by 2016/17. And as consolidation takes place, created fiscal space should be allocated to priority public investments and targeted social spending to protect the poorest and the most vulnerable.

Mobilizing revenue is a crucial objective. There is full realization within our Government that weak revenue mobilization is one of the main factors constraining Pakistan's economic development as it reduces Government's stabilization options to expenditure compression. Pakistan's tax collection, slightly above 10 percent of GDP, is highly inadequate to raise public savings and investment to levels which are consistent with our desired higher growth trajectory. Infrastructure gaps, especially massive power load-shedding and low level of human development in Pakistan, indicate low level of public resources. Expanding the resource envelope, therefore, is the key element of Government's stabilization and economic recovery program.

The Government is committed to reach a respectable tax to GDP ratio of 15 percent by 2017/18 through domestic resource mobilization. Growth in the Federal Board of Revenue (FBR) tax collection during the first eight months of FY15 has been positive despite legal challenges and the negative impact on tax revenue associated to the low oil prices and low inflation. The bulk of the growth in revenue shall come from FBR revenues and, to a lesser extent, provincial taxes. We keep working on several pillars: broadening the tax base; rationalizing concessionary regime and eliminating privileges; reducing the tax gap; and improving tax collection management and taxpayer' behavioral change as part of comprehensive tax administration reforms. We are encouraged by tax policy measures initially adopted in the budget 2013/14 that are providing above than expected results; complemented by tax contingency measures adopted in February 2015 to fill the gap in relation to the annual target. FBR tax collection appears slightly below its revised FY15 target which gives us confidence that the tax ratio will have a successive positive increase of at least half a point of GDP for the first time in many years.

In addition, supported by FSIG-II, several key measures were adopted: the Government obtained Parliamentary approval of a budget 2014/15 including a tax expenditure annex; a set of tax exemptions and SROs were eliminated; and tax measures for a total revenue impact equivalent to no less than 0.7percent of GDP (*prior action*). As the Government is committed to approving legislation to permanently prohibit discriminatory special SROs that establish tax exemptions (including Customs tariffs) and concessions, it has issued a Presidential Ordinance containing all amendments of the corresponding tax laws to permanently eliminate the discretion of FBR to issue special tax exemptions, making any proposed tax exemption subject to parliamentary approval as part of the annual budget law and/or the corresponding tax legislation; and it will submit to the Parliament such amendments as part of the Finance Bill 2015/16 (*prior action*). Furthermore, FBR issued no less than 171,000 notices by February 2015 to identified potential tax evaders to register and file tax payment, and took administrative and/or legal actions on at least 25percent of the potential taxpayers who received notices by December 31, 2014, but failed to respond to them (*prior action*). FBR also selected at least 7.5 percent of large taxpayers (filed for tax year 2013) through ballot or risk-based audits, and initiated audits for at least one-quarter of those selected cases (*prior actions*).

And to improve financial planning and fiscal transparency, we approved three notifications: one by Ministry of Finance requiring each relevant department or ministerial officers to provide commitments to the Accountant General within 10 days of the monthly closure (the quarterly budget releases to all department and ministries will be contingent on full compliance with this provision); another by MoF approving timely disclosure on the MoF website of monthly in-year revenue and expenditure reports of the federal budget execution; and another by the Controller General of Accounts committing to disclose on its website the Government's annual audited financial statements for the last 5 years, and committing to disclose future financial statements within 15 days of the date they are laid before the Parliament (*prior action*). The Federal Government also encouraged provinces' initiative to increase revenue either by expanding the scope of services taxed by the General Sales Tax (GST) or modifying other provincial taxes so as to increase by over 26 percent their budget 2014/15 allocations to non-salary education and health spending (*prior action*).

Effective allocation to protect key social protection is a priority of the Government. The Government is committed to expand the safety net supported either by unconditional or conditional cash transfers. The rigorous fiscal adjustment requires very tight management of discretionary spending by the Federal Government, and yet the Government recognizes the importance of protecting programs with demonstrated effectiveness in benefiting the poor while curtailing less productive expenditures. For example, the planned reduction of the untargeted power subsidies could disproportionately affect the extreme poor. Furthermore, jointly in collaboration with provincial authorities, BISP also introduced Co-responsibility Cash Transfers (CCT) linked to primary education in 27 districts so as to address one of the sources of intergenerational transmission of poverty.

The Government is prioritizing three sets of actions to expand the safety net. These are: the 2014/15 budget increased BISP allocation to Rs.97.5 billion; increased the benefit amount to Rs.1,500 per beneficiary per month, well above inflation; expanded CCTs for primary education in 27 districts with a benefit of Rs.250 per month per child attending school; and BISP reached implementation agreements with each provincial/regional government on a cost-sharing arrangement for CCTs. (*prior actions*). Last but not the least, to solve managerial bottlenecks that were preventing an efficient execution, BISP's recently reconstituted Board issued internal regulations compliant with BISP Act 2010, better delineating the powers and functions of the Management and the Board (*prior action*).

Concluding Remarks

The Government is firmly convinced that the comprehensive growth-enhancing reform agenda outlined above while ambitious, is what Pakistan requires to improve its social, economic and financial conditions. The Government has shown resilience in its determination to fight attempts to roll back policy measures or attempts to delay the implementation of further stages of the program. The Government will continue to promote an ample national dialogue on reforms, and forge political consensus required to deepen, consolidate and execute the program timely and successfully. The Government expects to mitigate the possible adverse impact of its policy actions with increased and better targeted social spending, and increased effectiveness in basic public service delivery.

Mr. President, our country has made extraordinary efforts to overcome a tough economic period. The good news is that these efforts are showing positive results. We are committed to consolidate reforms and would like the continued support of the World Bank Group in assisting us in this process through the much needed knowledge sharing and financial support.

Kind regards,

Yours Sincerely,

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