

Pakistan, the United States and the IMF: Great game or a curious case of Dutch Disease without the oil?

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ASIA RESEARCH CENTRE WORKING PAPER 57

I. Introduction: the issues

A history of Pakistan's relations with the IMF (and the Bretton Woods Institutions in general)² cannot be told without reference to the complex and changing role played by the United States, especially since the mid-1980s when the Reagan administration stepped up responses to the Soviet Union in Afghanistan. We argue that the influx of US assistance over the past quarter of a century has distorted incentive structures in Pakistan, and weakened the desire for self-reliance. It has created a Dutch Disease-like effect,³ except that the country lacks oil, and trades on its geographical importance. As this importance fluctuates over time, it leaves the country increasingly vulnerable.

The stormy roller-coaster affair between Pakistan and the United States is highlighted in a recent Woodrow Wilson (2011) study,⁴ which describes it more diplomatically as “stop-go” that has heightened suspicions and distrust on both sides. More importantly, large inflows from the US have coincided with the war in Afghanistan with the Soviets in the 1980s, fought with proxies supported through Pakistan, and then again after 9/11, with an intensification of the war in Afghanistan by the Obama administration in 2009. This has led to changes in behavior and expectations on the side of successive Pakistani administrations, leading to a consolidation of what could be termed “limited access society” (see North, 1990, and North, Wallis and Weingast, 2009). This has been manifested through a rentier-class dependent on “external handouts”, supporting 65-year old ‘infant’ industries that are unable to compete given a level playing field with efficient producers in East Asia, or even Bangladesh. The congruence of interests between the landed aristocracy and industrial elites, politicians and rent-seeking bureaucrats endangers growth, as well as effective service delivery and maintenance of personal and household security. The internal dynamics of this process are not sustainable.

The periodic waning of direct US interest in the region, e.g., in the late 1970s, and after the withdrawal of the Soviets from Afghanistan in the late 1980s and the

² The full assessment of the IMF programs, and also some of the related World Bank interventions, will be examined in a short monograph on this subject to follow—Ehtisham Ahmad, Khurram Husain, Azizali Mohamed and Christine Wallich, *Pakistan, the US and the BWIs*, forthcoming.

³ This is associated with the sharp inflow of foreign currency, typically associated with the discovery of oil, which makes traditional exports less competitive, often resulting in deindustrialization. In the current context, the sharp increases in foreign currency were due to foreign assistance linked geographical importance, albeit of a cyclical nature, but which did considerable damage to the productive potential of the country.

⁴ Woodrow Wilson Center, 2011, *Aiding without abetting: making US Civilian Assistance to Pakistan work for both sides*, Washington DC.

subsequent collapse of the USSR, permitted US-concerns about nuclear issues to predominate, and imposition of sanctions on a key ally, leading to a sense, on the part of the Pakistani establishment, of being treated unfairly.. However, Pakistan was not completely cut off and IMF programs were instituted, with US support.

Exceptionally favorable conditionality and flexibility in giving waivers, on not meeting even soft conditionality standards, has led successive Pakistani governments to treat lightly the fundamental issue of domestic resource mobilization measures that underpinned each program. This is not surprising, as weak civilian governments vying for popularity, and military governments without political support seeking legitimacy, depended on the selected beneficiaries of the “limited access society” for both financial and political support. Subsequently, virtually every government in the past 25 years resisted raising domestic resources by failing to expand the tax base, modernizing tax administration and closing preferences and loopholes, among other essential reforms required to run a modern state. Thus, 11 out of 12 IMF programs since 1988 were abandoned in the middle or scrapped altogether—and the country has become known as a “start-stop adjuster” Governments have tried to “game” the IMF, and achieved partial success each time.

A similar pattern is seen with World Bank assistance—particularly with the failure of successive Social Action Programs (SAPs) that should have been seen as providing direct support for enlightened government policies. Even more telling was the failure of the \$135 m program on the Tax Administration Reform Program (TARP); and the program on strengthening budgets and transparency, PIFRA of similar magnitude. Both of these should have been in the interest of the Pakistan government from a longer-term perspective. However, short-term priorities prevailed. Neither the World Bank, nor the IMF (for that matter), raised alarms in a timely manner especially in the period around 2005/6, as the tax reforms were gutted by a favorite government allied to the War on Terror.

Despite the promise of an abundant land, with water, irrigation and natural resources, a large and hard-working population, and an ancient civilization, and significant inflows of foreign capital over the past 65 years—development outcomes have been disappointing.

Successive governments since the 1980s had become reliant on external funding, and this has led to periodic spurts of growth, including the huge inflow of US assistance following the Soviet invasion of Afghanistan and after 9/11. However, when these inflows declined, the economy quickly headed towards fiscal and balance of payments crises. Long-standing under-investment has resulted in practical hindrances for business, most notably in the necessity of ‘load-shedding’—pre-planned power cuts, which affect the industrial and export sectors in particular. The economy has also proved vulnerable to the impact of global price rises, in particular for petroleum products and foodstuffs, as well as to natural disasters.

In the post-2008 period, a weak and beleaguered government, dependent on minority parties and special interests for its survival, has been singularly unable to take tough decisions on the economy, or to remove special deals and preferences from the tax code. Thus, the economy continues to flounder, but muddles along with the help of high levels of home remittances, and the IMF's foreign exchange cushion (albeit one which has to be repaid within the next two years), and in anticipation of renewal of the US lifeline, but with little reasonable prospect of serious reforms in an increasingly uncertain global environment. Thus the country's growth potential remains dismally underutilized.

We examine the incentive structures underlying each of the three players in this new "Great Game"—the US, the IMF (including staff and the Board), and the elites in Pakistan. Finally, we warn that any short-term gains may come at the cost of long-term stability and development. This could be disastrous in an increasingly polarized country with a growing population and a youthful labor force facing limited employment prospects and possessing a large stockpile of nuclear weapons.

II. The Elephant in the Room: The Pakistan-US relationship

The foundation of the relationship with the US is based on Pakistan's strategic location at the mouth of the Persian Gulf. Initially, Pakistan was a key partner against Soviet interests, given India's close links with Moscow in the Cold War days. But the motivation has changed over the years as the US cultivated a more comfortable relationship with India. The repeated waxing and waning of the US relationship with Pakistan has led to a perception of the country being used in a "Great Game", the nature of which continues to evolve but remains anchored in the strategic location of the country, its growing nuclear capacity, and its vulnerability to terrorism.

In the early years, particularly till the mid-1960s, both US and multilateral assistance was used effectively. While there was a military component to the former, the World Bank played a critical role in the Indus Basin treaty and the construction of the mega dams to compensate for the loss of water from three rivers in the Indus region

The India-Pakistan war in 1965 led to a suspension of US assistance, and this came as a shock to the establishment in Pakistan. The dismemberment of the country following the Bangladesh war, and the lack of support from close allies, led Pakistan under the Bhutto administration to pursue nuclear weapons, as conventional parity with India was clearly not feasible. This severely complicated the relationship with the US, and led to the imposition of sanctions given US emphasis on preventing nuclear proliferation. While relations between the Bhutto administration and the US cannot be described as cordial, sanctions were imposed after the Zia coup d'état in the late 1970s, as the new military government continued with the nuclear policy.

One of the first serious efforts at tax reform was initiated during this period, with the appointment of a respected administrator, Qamar-ul Islam at the head of a distinguished Commission. The commission's report, in the mid-1980s,⁵ correctly identified corruption and "cheating" as very significant problems that needed to be tackled in order to move the tax/GDP ratio from a high of 14% towards 20%, for a sustained increase in investment and growth. But the report was shelved as the inflows from the US peaked at about the time it was completed.

The variability of foreign, especially US, assistance during the 1980s, illustrates the harmful effects on Pakistan's efforts at domestic resource mobilization. Large-scale economic and military assistance was directly linked to Pakistan's support for "Charlie Wilson's" covert war against the Soviets. However, the assistance effectively led to abandoning plans for tax reform, and more insidiously, the government for the first time abandoned the principle of "the golden rule" and began to borrow for current spending.

A decline of US assistance at the end of the 1980s followed the Soviet withdrawal from Afghanistan, with the consequent reduced strategic importance of Pakistan. There was a tightening of US sanctions under the Pressler Amendment, aimed at dissuading Pakistan from pursuing the development of nuclear weapons.⁶ However, the US actively supported the IMF programs and World Bank Structural Adjustment Loans that followed. In Pakistani eyes, the modalities of assistance had changed, and not the principal sources. Hence, IMF conditionality, was treated as largely superfluous in a classic example of the "moral hazard" problem. Despite the restraining influence of the more conservative members of the IMF Board, successive programs through the 1990s largely failed to achieve their twin objectives of fiscal consolidation and establishing the autonomy of the Central Bank.

The nuclear explosion in May 1998, led to a cut-off of bilateral assistance and tightening of US sanctions. The Fund program in operation also abruptly came to an end because the expected foreign inflows assumed in the program dried up with the sanctions. At this stage, Pakistan made it clear that it would default on IMF payments if the program were not revived, but that it would continue to pay the Fund if the program was to be renegotiated.⁷ This episode could be taken as illustrative of the "defensive lending" incentives on the side of the Fund to continue its support. However, given that a Pakistan default would not have materially affected the IMF's balance sheet, the question arises whether another reason why the Fund continued to engage with Pakistan, rather than to allow it to sink to the

⁵ See Government of Pakistan, *National Taxation Reforms Commission*, 1996.

⁶ Screws were tightened on Pakistan in the late 1970s, after Prime Minister Zulfikar Ali Bhutto started work on the nuclear program, and probably contributed to his overthrow. However, the new military administration of General Zia continued the policy, and the pressure was maintained until Pakistan was coopted in the covert war against the Soviets.

⁷ Communication from Governor Yaqub.

status of Sudan, was to maintain a policy dialogue with a nuclear-armed state in a sensitive part of the globe.

Incidentally, the sanctions at the end of the 1990s led to the second serious attempt at tax reform, with the Shahid Husain Commission⁸ (with the support of the World Bank) following up on the main recommendation of the Qamar-ul Islam Commission in the mid-1980s. This Commission recommended an arms-length integrated Revenue Authority, organized on functional grounds. It was issued a few months before 9/11, and the significant inflow of US assistance. The World Bank entered the fray in the tax arena, providing a \$130m loan for the Tax Administration Reform Project (TARP). However, the implementation more or less ignored the Bank-sponsored Shahid Husain report, as well as the previous work on tax policy and administration by the IMF (10 red-cover reports in the 1990s), as well as the earlier Bank-supported research by Ahmad and Stern (1991). This may be linked to the incentives facing Bank staff to generate fresh “technical assistance” with each large loan, an issue that we will explore in more detail in the monograph to follow (Ahmad, Husain, Mohammed and Wallich, forthcoming).

Chart 1 describes the “stop-go” pattern of US assistance as highlighted in the 2011 Woodrow Wilson report. It is interesting that the Shahid Husain and Qamar-ul Islam Commissions were set up in the depths of the downturn, although by the time both reports were submitted, the mood had changed and receptivity to tax reforms had weakened.

As the US Assistance floodgates opened again following 9/11, the TARP degenerated into a program to build new offices and purchase staff cars, and there was no effort to create an integrated administration. Indeed, with the overvaluation of the exchange rate, the key export sectors were removed from the General Sales Taxes (), and audit programs were abandoned in a reversal of the tax administration reforms. Neither the Bank nor the IMF protested. While description of the economy in the 2005 IMF Article IV report pointed to some of the problems (see below), the staff assessment surprisingly endorsed the measures. However, the World Bank declared the TARP non-performing in February 2008.

The juxtaposition of IMF programs and the “stop-go” US aid cycle is illustrated in Chart II. In each of the downturns (early 1970s and a decade later in the late 1980s) there was recourse to IMF funding, with support from the US.

⁸ This Commission was established by General Musharraf in June 2000. See Government of Pakistan, 2001.

Chart 1 History of US Programs

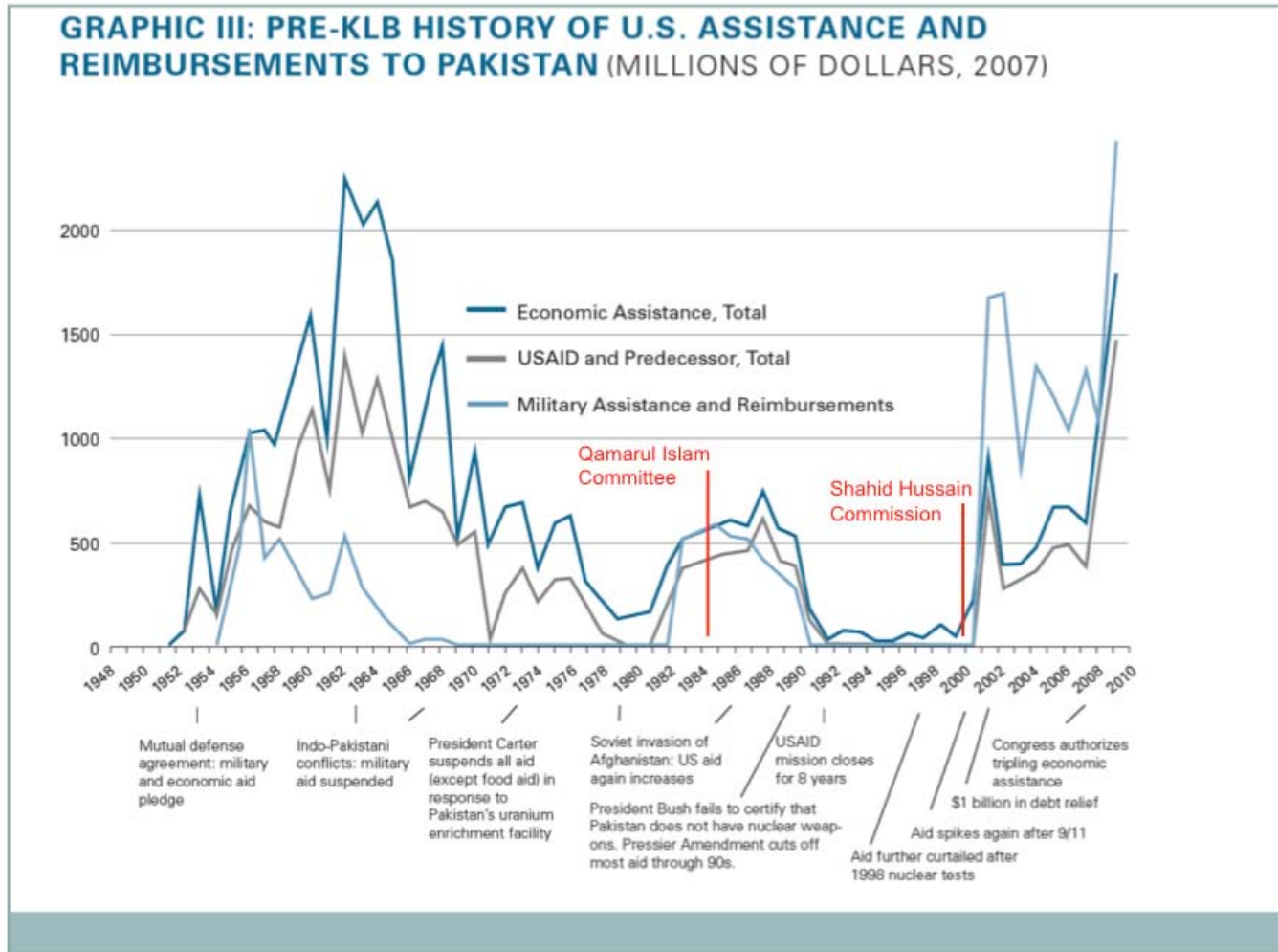
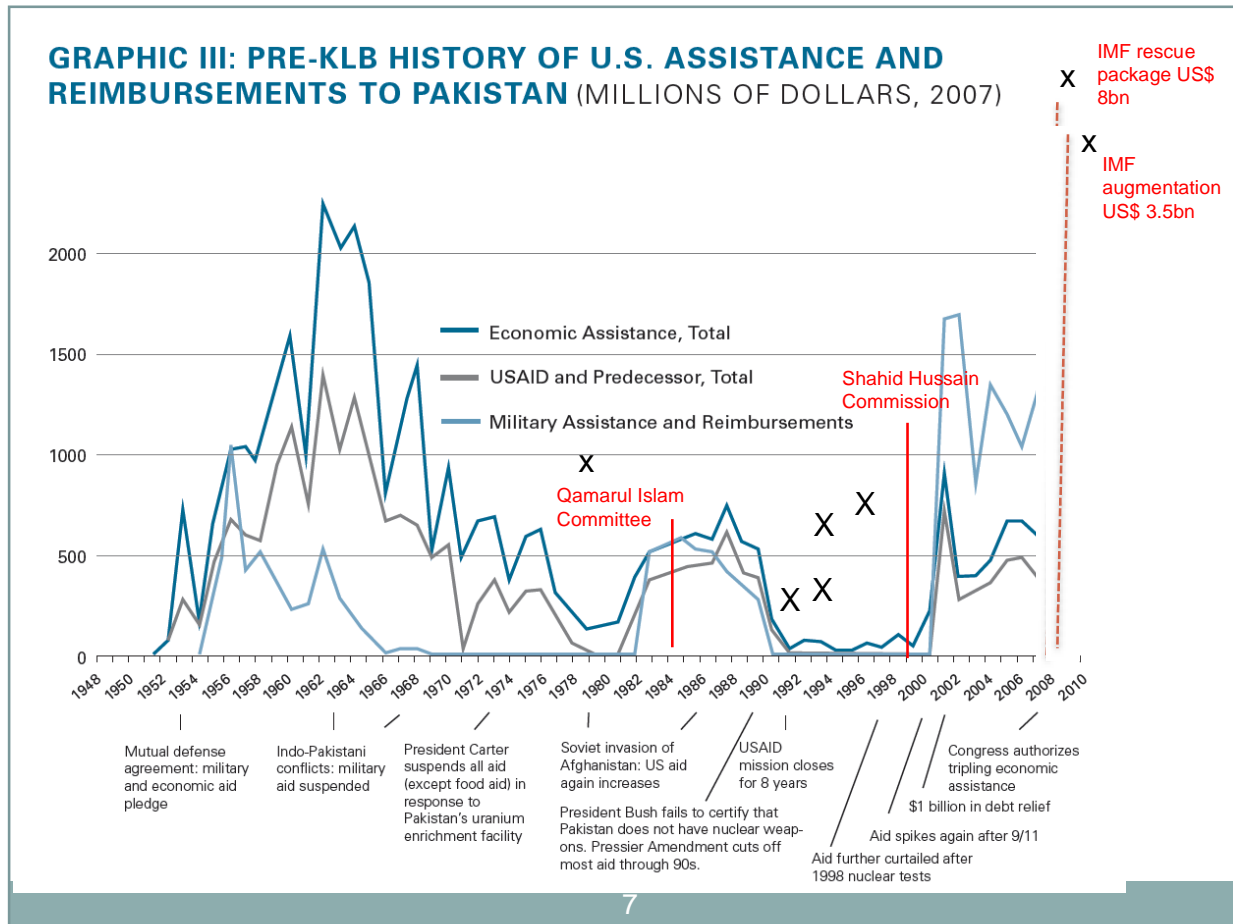


Chart 2. Juxtaposition of US Assistance and IMF programs



Note: The X's reflect IMF programs that were concentrated in periods of low US direct assistance, except in 2008.

Chart II suggests that the “stop-go” pattern of US assistance was moderated by periodic IMF safety nets. There was a negative net effect on incentives facing successive governments, particularly the weak political regimes of the 1990s, but also the Musharraf administration. The clearest lesson was that domestic resource mobilization might detract from the ability to extract “location rents” from the US, or the international agencies.. Associated with this was the desire to “protect” special deals with sectors that provided financial support to the benefit of the party in power, and also to selectively punish “enemies”. Thus, arms-length tax administrations and level playing fields were far from the top of the list of priorities for a “limited access society.”

The stop-go, combined with the likelihood of periodic failures in IMF programs meant that a pliant Central Bank was essential as a “safety valve” to provide credit in times of need. Although there were intermittent efforts to strengthen Central Bank independence, the institution operated in a genuinely autonomous manner only in the 1993-99 period. Thereafter the State Bank reverted more or less willingly, depending on the stature of the Governor,⁹ to being an effective appendage of the administration with the prime objective to accommodate fiscal policy slippages. Thus, the incentives to meet the other main condition underlying IMF programs were effectively non-existent .

The difficulty is that through this entire period of 25 years and more, the tax/GDP ratio has continued to decline, rent-seeking has become endemic, and the gap between resources and spending needs continues to widen. The result has been a ratcheting effect of the stop-go game, but at the cost of the quality of infrastructure, public services and living standards. Thus, the curse of the geographic rents has been largely negative, despite the periodic success in extracting external resources—in a process reminiscent of “Dutch disease”, but without the oil resources.

⁹ The short three-year term of the Governor leaves room for moral suasion for reappointment. Since 2008, the appointment of one Governor was not renewed for a second-term, and the two subsequent Governors appointed were forced out of office before the completion of their first term. Governors can choose to be independent at their own risk. The “independent” monetary policy committee was also dispensed with.

III. Succession of failed IMF programs—habitual broken promises

The IMF is the lender of last resort, par excellence, to be used sparingly to overcome short-term balance of payments difficulties. Pakistan since 1988 has been an aberration, with 12 programs over 20 years, all but one linked to the cessation of US bilateral assistance or sanctions. And all programs, barring one, failed in meeting the macroeconomic targets and were aborted. Only one was “concluded” satisfactorily, and that too because of the influx of US assistance, reinstated after 9/11.

The last failed program approved in 2008 permitted loans of \$8 billion, or more than twice as much as was purchased in the entire 20-year period since 1988. This mega program only had two conditions—fix the VAT to reverse the slide in domestic resource mobilization and ensure the independence of the central bank. These conditions dated back to the start of the habitual involvement in 1989, and were proposed by the government itself to the Friends of Democratic Pakistan in September 2008 (before the formal approach to the IMF), as part of the “ownership of the program”¹⁰ by the newly elected democratic government. The failure of these conditions does not say much for the true “ownership of the program”. It also does not say much for the continued involvement of the IMF (together with the World Bank) in ensuring structural reforms, or reducing the vulnerability of the country to external shocks or domestic “meltdowns.”

The successive programs did not address the fundamental incentive issues facing weak, incompetent and often corrupt administrations. After a lengthy period of military led rule (the Zia decade), the political parties were focused on generating resources for re-election, or reaping the benefits of incumbency that involved making friends and influencing people. This tended to involve exemptions and preferences of all kinds (both in relation to tariffs and domestic taxes). Fund staff was more interested in maintaining favorable relations with the government of the day, and with the most important shareholder(s) in the BWIs. This led to programs that failed time and again, to technical assistance that was given and implemented on a pro-forma basis without lasting results, and to weak surveillance. The most egregious example of the latter was the sanguine assessment for 2007 that may have contributed to a lack of policy measures that precipitated a crisis when the external environment deteriorated.

¹⁰ Government of Pakistan, Ministry of Finance, *Economic Program of Pakistan: reinvigorating hope and ameliorating peoples’ livelihood*, September 20, 2008, Islamabad.

In keeping with the analysis of North's "limited access" society: the question that we pose is whether the IMF inadvertently played into the hands of vested interests that led to the continuing deterioration in service delivery, infrastructure and institutions. And was this due to attempts to appease the principal shareholder, in the "Great Game" that continues to this day? An alternative explanation may be that the Fund was engaged in "defensive" lending.

We examine the incentive structures that have faced various players in the triangular relationship—the US, Pakistan and IMF Staff, Management and the Executive Board.

1. Pakistan-IMF Relations: political expediency or defensive lending?

The record of IMF relations with Pakistan through the decade of the 1990s', was reviewed by the Independent Evaluation Office (IEO) of the IMF in 2002 which sought to answer the question: what accounted for the country's prolonged use of IMF resources? Pakistan was one of six countries selected by the Fund's Independent Evaluation Office (IEO) as "prolonged users" and its study tried to answer the question: what accounted for Pakistan's prolonged use? It noted that programs in the 1989-99 period ¹¹ suffered from substantial policy slippages and soon went off-track.....a large share of the committed financing was not disbursed". Even what was disbursed required "relative generosity" in the granting of waivers, with five of the seven program reviews completed in the 1990s' involving the granting of "at least one and generally several waivers" and all the waivers on quantitative performance criteria being "requested for reasons other than minor technical deviations or exogenous shocks". Moreover, the IEO study notes that "in spite of the many interruptions suffered by IMF supported programs, the intervals between two disbursements of IMF resources were generally short -- never exceeding twelve months over 1991-99".

The IEO study finds that the prime explanation for this prolonged engagement is the role played by non-economic considerations. It notes that "until 1998, the prevailing perception within IMF staff was that the principal IMF shareholders, no matter how demanding they claimed to be on the substance of programs, were not willing to take the risk of major turmoil in Pakistan that an interruption of IMF support might have caused". It quotes "some IMF staff members" that program design weaknesses "such as unrealistic macroeconomic projections, the pretense of toughness.....were symptomatic of attempts to find a face-saving way to justify continued lending to Pakistan". In our view, this perspective is essentially correct, as the appeasement continued during the period when there was no program in effect, but with the Musharraf/Shaukat Aziz government seeking to extract a seal of good housekeeping—we come back to this issue further.

¹¹ IMF, IEO, September 2002.

The IEO study finds four dimensions of the IMF mandate that “might account for some of the design problems” in the Pakistan case. The first is the difficulty of reconciling the Fund’s role as a provider of temporary balance of payments support with the imperative of the time required to undertake complex institutional reforms for achieving longer-term sustainability”.

A second explanation is the lack of close collaboration with the World Bank as a result of which “key areas, such as governance and institutional reforms in tax administration, civil service, and public enterprises, ended up being handled inadequately by both IFIs.” This has been particularly damaging in the areas of tax reform and budget systems. In the former, work done by the IMF during the 1990s (including 10 red cover reports on tax policy and administration) was ignored and the World Bank was brought in to help with the tax administration reforms (TARP—described above). Staff incentives dictated that previous work by the World Bank was also ignored, and fresh contracts were issued for both tax policy and administration.¹² On the budget side, the \$130 m PIFRA meant to track spending left out the IMF’s GFS2001 budget classification as well as the UN’s COFOG—making it hard to track or evaluate public spending of general government in Pakistan—nicely illustrating the IEO’s observations about the split responsibilities between the Fund and the Bank in important areas.

A third factor is the IMF’s role “as gatekeeper for many other sources of financing”. While this might be expected to have given the IMF greater leverage, it “also meant that the consequences of a prolonged interruption of programs would be very severe”. The IEO study states that the IMF “proved extremely reluctant to risk the costs of such major disruption, which meant that there was an in-built tendency not to insist too hard on the core issues.” This factor has become less relevant, especially since the mid-2000s, as the importance of conditionality in the implementation of Bank projects (such as PIFRA) has declined. This has converted many multilateral project loans into approximations of budget support, and the trend has increased sharply since the failure of the 2008 SBA in 2011.

A fourth factor in the IEO view is the obligation to support member countries making the necessary effort to address their economic difficulties. Given the political instability in the 1988-99 “democratic” period that brought a succession of governments into engagement with the Fund and given the fact that “each new (lending) arrangement practically coincided with a new government...it would have been extremely difficult not to give such a government the initial benefit of the doubt on its declared policy intentions.”

¹² As noted above, the World Bank supported a significant research program on tax policy reforms in Pakistan in the 1980s (see Ehtisham Ahmad and Nicholas Stern, 1991); and also supported the Shahid Husain Committee 1999 that recommended a revamping of the Central Board of Revenue on functional grounds.

While the IEO naturally has looked at the prolonged use of resources from the perspective of an external agency, it is important to look at the same experience from the point of view of Pakistani policy-makers and their representatives on the Fund's Executive Board. We discuss this issue at greater length below.

The interaction of economic and political factors in decisions to resort to IMF assistance is not easily disentangled. While the IEO evidently subscribes to the notion that political or non-economic factors accounted for at least two out of the four elements in the IMF mandate that contributed to prolonged use, it can be argued that one factor on the "supply" side that was not given the weight it deserves was the implicit risk of debt servicing arrears to the IMF emerging in the absence of a Fund program and hence a powerful incentive for "defensive lending"—a possibility that the IEO study discards as not a "significant factor" except on three occasions when "Pakistan came closest to the brink of foreign exchange crisis: (i) in late 1996, just before the revival and augmentation of the SBA; (ii) in the months preceding the completion, in January 1999, of the second review of the 1997 EFF/ESAF following its de facto interruption in May 1998 and (iii) in mid/late 2000 prior to the approval of the SBA" However, Pakistan received non-conditional or low-conditionality disbursements from the IMF at critical points of time during this period which were not mentioned in the IEO Report, presumably because they were not part of "conditional lending", and could well be treated as "defensive lending".

The size and sequencing of the 2008 program cannot be ascribed to defensive lending. However, now that the IMF has lent such large sums, it is clear that defensive lending might be a factor in any new arrangement, in addition to the political economy considerations that we believe have been the case over the years.

2. Interests of the authorities

Pakistan has an immature political structure, with political parties struggling to replenish coffers after lengthy periods in the wilderness—especially given long periods of military-led rule. The interests of the politicians, seeking funds for reelection, and perhaps personal gain, and an increasingly rent-seeking bureaucracy coincided. Holes in the tax system and preferences in the tariff regime, facilitated by SROs that often override legislation, are a useful way to "make friends and influence people." While paying lip service to IMF conditions to remove such loopholes, including under the ESAF negotiated by technocratic PM Moeen Qureshi in 1993, the second Benazir Bhutto administration actually increased the magnitude of such exemptions in its budget of June 1994, although going through the motions of eliminating some minor provisions.

It is interesting that Musharraf's selection of a private banker as Finance Minister, Shaukat Aziz, who was presumably immune to "rent-seeking" influences, attempted to cut the Gordian knot by removing entire sectors from the GST (textiles, sports goods, carpets and leather goods among others—virtually all the productive

exporting sectors that have exports zero-rated anyway). His bureaucrats apparently misled him and this created a bonanza for the rent seekers, and the tax-breaks have since become entrenched!!

Given the inflow of US assistance and capital inflows after 9/11, Mr. Shaukat Aziz made a show of “breaking the begging bowl”. As a prelude, he wrote directly to the Managing Director,¹³ admitting to “misreporting” by the previous political government, something that had eluded IMF staff surveillance, and would probably not have been discovered had it not been “volunteered” by the authorities. He also leaned on the IMF staff¹⁴ to present a “favorable” report on the Pakistan economy in 2007, as the run-up to the elections approached, even though the underlying staff analysis had showed signs of overheating and an overvalued exchange rate.

Since the resumption of “democratic rule” in 2008, the interests of the parties remain stubbornly parochial, and buttressed by the ability to bestow favors and punish enemies. Although a transparent tax system and a VAT without holes was promised to the IMF as a means to reverse the decline in the tax/GDP ratio that had then fallen below 10% (from a high of 14% in the mid-1980s), there was no genuine “political” ownership, despite protestations to the contrary. Another technocratic Finance Minister, Shaukat Tarin, in 2008/9 actually tried to reform the tax system and go after special interests (including in relation to the independent power producers (IPPs) and the sugar barons) but was let go after one year in office—albeit after obtaining the IMF loan and augmentation. His technocratic replacement, Dr. Shaikh, also tried, but was unable to circumvent the powerful interests within the ruling coalition, or the machinations of the bureaucrats.

It is very convenient for the politicians to maintain an honest and genuinely sincere technocrat as a Finance Minister. This presents a kinder, gentler and more credible face to the international community—while it is business as usual in the Forum.

3. Interests of staff

A factor on the “supply” side that requires consideration is the interest of the Middle East Department¹⁵, which includes Pakistan, in protecting a lending relationship with one of the very few member countries under its jurisdiction that had a need for

¹³ This bypassed the Executive Director representing Pakistan, Dr. Mirakhor, who was also Dean of the Board, and who took a balanced view of the interests both of Pakistan as well as the IMF—having witnessed the ebb and flows of so many governments of different persuasions during his tenure.

¹⁴ This again bypassed the Executive Director, Mirakhor—it was evident to the authorities that it was not so easy to lean on the Dean of the Executive Board.

¹⁵ The brief of the Department was extended in 200x to include a number of Central Asian Republics and the Horn of Africa countries. But for the longest stretch of time Pakistan was one of the most active countries in the Department and has so remained until the present.

IMF funds.¹⁶ The presence of a large country with a continuing program relationship would have seemed essential to the Department in order to attract and retain “high-flier” staff and to provide them with experience in lending operations that would prepare them for higher responsibilities elsewhere, either within or outside the Fund. Indeed, Pakistan has been a “proving” ground for many successful careers for distinguished mission chiefs in the Fund, and subsequently outside.¹⁷

Not rocking the boat may have played a role in softening conditionality in the early 1990s (excluding arrears and borrowing of public sector enterprises from the debt criteria); or overlooking non-performance. A perennial problem has been the cascading resort to tax exemptions. The 1993 ESAF negotiated by an interim government had the removal of exemptions from the GST as a performance criterion for the June 1994 review. Although the 1994 June budget removed a few exemptions, it introduced major new loopholes and exemptions for the main industrial sectors, such as textiles that have been impossible to remove since then. Yet the August 1994 Staff report reported that the performance criterion had been met.¹⁸ The same report also confirmed that legislation for the autonomy of the State Bank had been passed—and appeared to have worked in the next few years under a strong Governor, the subsequent loss of authority is confirmed by the 2011 Staff Report noting that the legislation before Parliament did not ensure operational independence of the State Bank.”¹⁹

The Staff in both the Bank and the IMF enjoy a large degree of autonomy in their operations. This derives from the high caliber of the personnel assembled by both institutions, including many from the developing world, and the detailed knowledge of member country institutions and their policy makers that they have accumulated over the years. In the case of the Fund, its surveillance role involves periodic (mostly annual) consultations with the financial authorities of each member and a more intensive collaboration ensues when lending transactions are under negotiation or monitoring during the period when Fund resources are disbursing or are outstanding as significant percentage of the borrowing member’s quota.

In 2004/5, the Musharraf administration removed major sectors from the GST. While the 2005 Staff Report raised the concern that “exemptions from the sales tax value added chain undermine the self-enforcing nature of the system,” (p. 23); the

¹⁶ Most of the other countries in the Department had no such need (many of them being prosperous oil exporters) or had forfeited such a relationship because of the accumulation of unrepayable arrears (Sudan), or had lost interest in meeting Fund conditionalities (Egypt at that time, although the situation has changed since the Arab Spring).

¹⁷ Among them were Andrew Crocket and Malcolm Knight who went on to serve as Presidents of the Bank for International Settlements (BIS) at Basle and Mohammed El-Erian who left the Fund to serve as President of the Harvard University Endowment and currently is Co-Director of the PIMCO Investment Fund.. All three are among other distinguished Fund economists who have served as Mission Chiefs during critical periods in the Fund relationship with Pakistan.

¹⁸ See IMF, EBS/94/159, August 16, 1994, Table 10, p.30.

¹⁹ See IMF 2012, CR 12/35, p.20.

staff assessment condones the government strategy as “appropriate in generating revenues” (p.25).²⁰ This reversal effectively led to a questioning of the preceding 15 years of IMF engagement and conditionalities. It also encouraged the authorities to “lean on the Fund”, as became painfully clear just over two years later. This was the precursor to the overruling by the management of the Department of staff analysis in 2007.

The 2007 Staff report is of particular interest, especially since there was no program. However, it came at a low ebb in the fortunes of the IMF, as many wondered at the time whether the institution was needed. The Management of the Fund, and in the MCD, was interested in seeking favor with influential countries, and their even more powerful “protectors.”²¹ Despite growing evidence since 2005 that the rapid credit expansion had led to an overheating problem ²² leading to an overvalued exchange rate, the assessment of the Staff Report basically endorsed the stance of the government of the time that the “real effective exchange rate is broadly in line with fundamentals.”²³

Although there was growing unease with the growing imbalances due to the food and energy shocks, the IMF assessment probably persuaded Musharraf to hold the line on administered prices, given the large accumulation of reserves, in the run-up to the elections in early 2008. By the time the elections were held in January 2008, the crisis was in full swing, and the reserves were disappearing at a rapid clip. The unfortunate 2007 Staff report was published in January 2008, and the same staff team was quickly engaged in negotiating an emergency program based on a sharp depreciation of the rupee, domestic resource mobilization and fixing the VAT, In terms of institutional dynamics, it is interesting to note that there were more changes in highly experienced missions chiefs on Pakistan in the 2006-8 period, than there have been changes in Central Bank Governors in Pakistan, during 2008-10. We shall revert to the implications of this dynamic in the monograph that follows.

The removal of exemptions through an arms- length VAT law was a critical element in the 2008 program, as was the effective independence of the State Bank, and was proposed by the authorities themselves (in a proposal made by the newly elected President to the Friends of Pakistan meeting in New York in September 2008, before the formal approach to the IMF).²⁴ The criterion included in the SBA was submission of the new “arms-length” VAT law to Parliament by end 2009. This relatively weak criterion was reported by the authorities to have been met, but was in fact not achieved until spring 2010. The staff continued to display flexibility, as the authorities argued that they did not have the political strength in Parliament to

²⁰ See IMF 2005, CR05/409.

²¹ In the World Bank, a similar view prevailed.

²² See SPDC, 2005 Annual Report—An overheating economy?

²³ See IMF 2008, CR08/21, p. 19.

²⁴ See Government of Pakistan, Ministry of Finance, 2008; and Letter of Intent, November 20, 2008.

pass the legislation. The Staff proposed a Plan B in March 2011, which involved removal of exemptions by the FBR without reference to Parliament (these were in fact instituted by the FBR unilaterally). However, on April 1, 2011, the FBR issued SRO 273, which included 184 new exemptions and special provisions and rates. Item 185 stated “Any other goods as may be specified by the Federal Board of Revenue.”²⁵ This “deliberate snub” effectively doomed the 2008 SBA.

The fact that the IMF walked away from the 2008 program came as a shock to many in Government. However, it would have been difficult for staff to justify to the Board the failure to implement minimal conditionality, proposed by the country itself, and that had been in programs for the previous 20 years. The cynical rationalization in Islamabad was that this was also the period when the relations between Pakistan and the US reached yet another nadir, and Management was preoccupied with the crisis in Europe.

The staff of the IMF tries to be objective but the final decision to present a program for Board approval is in all cases made by the Management on the basis of its own assessment of the likelihood of its gaining sufficient Board support. It is at this stage that the Executive Director representing the country on the Board seeks to take the pulse of the Board and to counter initial opposition by mobilizing the national authorities of the country and its allies to focus their persuasive efforts with Management. How to exercise pressure effectively to override negative technical assessments or the objections of dissident members of the Board is a skill that countries like Pakistan seek to deploy with varying degrees of success. .

4. Interests of the Board

An issue of some interest is how the political interests of one major shareholder, the United States (US) on the creditor side and a minor shareholder, Pakistan on the debtor side, are accommodated and reconciled within the framework of an inter-governmental organization empowered with a large area of discretion and autonomy for its executive and managerial organs. Unlike most other agencies in the UN system, which operate on the principle of “one country-one vote”, the BWIs operate with weighted voting power, as reflected in the shares allocated to each member in their respective capital resources, on the basis of one vote per \$100,000 share of capital allocated to each member (plus 250 “basic” votes regardless of capital share). While successive enhancements of the total capital of the BWI and in the periodic re-allocation of individual member shares (called “Quotas”) in the Fund have reduced the US share to around 16% at present, the US share has not been allowed to fall below 15 percent of total voting power.

While most operational decisions in the BWI require the normal 51% of total votes cast, certain strategic decisions require an 85 percent super-majority vote. This

²⁵ Government of Pakistan, Federal Board of Revenue, 2011.

means that as long as its voting share is not reduced below 15%, the United States remains the only shareholder with an effective veto in respect of such decisions.. Among these decisions are those involving amending the Fund's Articles of Agreement (also known as its "Charter") or raising temporarily the size of the Fund's Executive Board of Directors beyond the 20 seats stipulated in the last amendment of the Fund's Charter (as against the 24 seats allowed at present). The existence of US veto power poses a non-trivial element of vulnerability, but also an opportunity, for a country like Pakistan which "belongs" to one of the "marginal" constituencies, the one headed by Iran.

The degree of influence exercised by an Executive Director on behalf of one of its constituency members is a matter of some complexity, depending upon a number of variables, such as that constituency's share in total voting power, the seniority of the particular individual serving as a member of the Board and his/her relationships with other members of the Board, with Management and Staff etc. There are no formal rules for constituency formation but the composition is the result of informal political understandings reached among member countries. Pakistan with a tiny voting share of the Fund's total voting power has maintained a second or third ranking within its constituency and that has never enabled it to chair the constituency in the Fund, while it has been able to alternate with Algeria in chairing the parallel constituency at the World Bank.

Pakistan has been quite well-served by the Executive Directors, starting with Zaki Saad, who represented the Middle East constituency in which Pakistan resided from the outset of its membership until it decided in 1993 to move to another Middle East constituency headed by Iran.²⁶ This move brought to Pakistan's service an Executive Director, Abbas Mirakhor, who enjoyed great respect among both his colleagues and staff. Not only was he an effective representative of the country, he also kept the interests of the IMF at heart. Instead of acting as a one-way conduit for the views and responses of the Pakistani authorities, he increased the credibility of the Pakistan position by keeping an even handed approach,. Mirakhor's influence with his Board colleagues was reflected in their decision to elect him in the late 1990s as the Dean of the Board, a position he continued to hold until his retirement in 2008.

The extent to which Pakistan could draw strength from its Executive Board representative inevitably weakened after Mr. Mirakhor's departure in early 2008. However, the Government was able to bypass their representative on the Board and deal directly with the US authorities, who interceded on their behalf at critical junctures in the 2008 SBA, and its augmentation. The 2008 SBA is of particular interest, as at the start of the program, key Board members were opposed to giving Pakistan such a large access with such limited conditionality, and with generous

²⁶ . The original Middle East Department was responsible for roughly the same list of countries as those electing Zaki Saad as their Executive Director and this happy coincidence enabled him to influence the workings of the Department in a way not available to most other Executive Directors.

front loading—given the pattern of repeated promises and failure to meet the same conditions. However, the argument by Minister Tarin and that the program was “owned by the authorities”, and that the newly elected President was totally committed to the tax reforms and the independence of the State Bank swung the argument in the Board. The augmentation in August 2009 was much more contentious, and the stringent opposition within the Board was only overcome by assiduous campaigning by the US on behalf of Pakistan.

Thus, it could be reasonably said that Pakistan’s interests as a shareholder have been represented well beyond what it was entitled to by its trivial voting share in the Fund and goes some distance to explaining its relative success in attracting Fund resources despite a desultory record of performance.

IV. Conclusion and prognosis

Pakistan faces a perfect storm due to the confluence of short-term interests that meet immediate goals for each party involving the US, the ruling elites in Pakistan and the IMF. Unfortunately, this could have grave longer-term consequences for the people of Pakistan as living conditions and security in the country continue to slide into a vortex.

The US, seeking an exit from Afghanistan will require Pakistani cooperation and assured land-links over Pakistani territory. It has resumed its payments under the Coalition Support Fund, even if Congressional approval for the Kerry-Lugar provisions is not guaranteed.

The IMF is likely to come under strong pressures from its most important shareholder to step into the breach. It remains to be seen if the staff interest to conduct an objective assessment of the country, supported by the more conservative members of the Board, might prevail. This tendency could again be offset by political pressures on Fund Management by countries engaged in the new Great Game, and by the defensive lending imperative, given the very large repayments due to the Fund in 2013 and 2014.

Neither the current government nor the main opposition parties appear to be willing to take on the difficult issues, and fear antagonizing their key financiers and domestic supporters, especially if foreign assistance continues to be available. There is a chance that the political process, overseen by an independent judiciary and election commission will ensure that the 70 percent of members of Parliament who do not file tax returns are barred from standing for elections. However, if the electoral process offers little more than a repeat of the 1990s—absent pressure from the bilateral friends of Pakistan and multilateral agencies—the issue of fair taxation and inclusive service delivery remain a distant dream, and it is hard to see how increasing polarization of the society and deepening militancy can be avoided.

Iqbal's vision of a shared common goal appears to be singularly absent in today's Pakistan (Ahmad, 2010).

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