Amnesty vs. Accountability

Mushtaq Khan[1], April 29, 2019

The series of events that led to Asad Umar's (AU) removal from the post of Finance Minister, has surprised the market and polarized business sentiments. The market is confused as it expected AU's return from DC to pave the way for the forthcoming IMF program, while some businessmen are celebrating AU's departure as they blamed him (and his management) for the poor economic performance. Others fear that the new team is more beholden to powerful financial interests, and will lack the appetite for real reforms.

Timeline

The events that led-up to AU's removal as Finance Minister are important to understand, as they reveal the possible cause. This timeline was developed on the basis of the coverage of the *Express Tribune*:

- 5 April: AU states that a new amnesty scheme will be announced when he returns from the Spring Meetings in Washington DC;
- 11 April: Hafeez Shaikh meets the PM in Islamabad, while Asad Umar is in DC;
- 16 April: In a surprise move, senior PTI cabinet members express reservations about Asad Umar's amnesty scheme, which he has been developing with FBR. As a result, the FM postpones his press conference (scheduled for later that day) in which he was expected to launch the scheme;
- 18 April: Asad Umar tweets that he has left the cabinet, and with the PM's consent, he has declined the energy portfolio. He nevertheless expresses his full confidence in the PM, and says he will continue to fight for *Naya Pakistan*;
- 19 April: KSE rallies by over 900 points, and manages to retain a one-day gain of 480 points. Two stock market titans (Akeel Karim Dhedhi & Arif Habib) tell the press that this was not due to the departure of Asad Umar, but SBP's clarification that had assured the market that the single treasury account (STA) would not be implemented;
- 21 April: Hafeez Shaikh rejects Asad Umar's amnesty scheme, and directs FBR to simplify the scheme and keep it open-ended. He also informs the meeting that there is no urgency on this matter and FBR should focus instead on the forthcoming federal budget;
- 24 April: A 5-page Asset Declaration Ordinance 2019, begins to make the rounds on social media. This is a legal document that reads like a Presidential Ordinance, with an end-June 2019 deadline for declarants who seek to avail the scheme. Despite his earlier statement, it seems the amnesty scheme is a policy priority for Hafeez Shaikh; &
- 29 April: Negotiations between the IMF and GoP begin in Islamabad.

Looking at this sequence of events, AU's departure appears to be linked to the amnesty scheme. The manner in which this scheme has been changed by the new finance team reveals a policy mindset that may not be suitable for final negotiations with the IMF.

In this paper, we will look at the various versions of the amnesty scheme that have been announced, and discuss whether the latest version will be formally launched, or is currently being debated with the IMF. We argue that AU's removal suggests that powerful financial interests have taken charge of

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policymaking, which could complicate negotiations with the IMF. We also look at differing perspectives of what the amnesty scheme should seek to achieve. We then try to understand how these vested interests view Pakistan's current predicament, and whether they realize that their attempt to protect their wealth could stall the stabilization program within the first year. To illustrate this potential outcome, we build a step-by-step scenario whereby Pakistan's economy slips into crisis.

Amnesty scheme

It is insightful to compare AU's version of the amnesty scheme to the PML-N version, which it was supposed to supersede[2]:

- Compared to the PML-N version, Asad Umar's amnesty scheme increased the scope of assets covered to include Benami assets; undeclared sales (which carries a mandatory sales tax); and undisclosed expenditures;
- AU's version required 5-year banking details of all bank accounts (own and Benami) of the declarant; the PML-N version just required end-of-period balances;
- AU's version included cash and gold balances kept in kind, which did not exist in the PML-N version;
- AU's version required declarants to file their tax returns for FY18 (not required with PML-N);
- In terms of valuations, the Asad Umar version increased the tax rate on super structures (buildings, houses); tightened scrutiny of motor vehicles that are declared; and insisted on an objective valuation system for foreign asset holdings (instead of self-declared valuations as in the PML-N version); and
- As Shahbaz Rana wrote on April 22, AU proposed a range of tax rates on the following asset classes, which was to be decided by the cabinet:
    1. On repatriated off-shore assets (fixed or liquid), a penal tax range of 5% to 15%;
    2. On declared domestic assets, a penal tax range of 10% to 20%; &
    3. For legalization of Benami assets, a penal tax range of 15% to 25%.

In his April 22 coverage, Shahbaz Rana claimed that Hafeez Shaikh's initial view was that AU's amnesty scheme was too complicated, and asked FBR officials to simplify the scheme into two assets classes (i.e. merge Benami assets and undeclared domestic assets into one). The story goes that Hafeez Shaikh disagreed with the idea that the scheme should be closed-ended, offering instead the suggestion that future amnesty schemes could be designed, if the need arose. Finally, he told the FBR meeting that the amnesty scheme was not a policy priority, and suggested that FBR focus its attention on the forthcoming federal budget.

Table 1: Asset Declaration Ordinance 2019

Class of assets/income	Declaration is filed on or before		
	end-June 2019	end-Sept 2019	end-Dec 2019
Undeclared assets/undisclosed income	5%	10%	20%
Domestic Real Estate	1%	2%	4%

However, it appears that the Finance Adviser's team has been working diligently to formulate an alternative amnesty scheme that retains the end-June 2019 deadline. In the form of a Presidential Ordinance, the *Asset Declaration Ordinance 2019*, is a simplified and lenient scheme that has been making the rounds since 24 April (see **Table 1**) – it has not been implemented. In our view, if the feedback on this amnesty scheme is positive, this 5-page legal ordinance will be signed by the President of Pakistan, by the powers given to him by clause (1) of Article 89 of the Constitution.

[2] We assume that AU shared the details of the amnesty scheme with the IMF while he was attending the Spring Meetings. Only with the IMF's tacit approval would he have brought it to the cabinet for final approval and launch.

The following points capture the thrust of the new amnesty scheme:

- It overrides all other amnesty schemes that have been offered;
- Public office holders are not eligible, and the list of people this encompasses is included as part of the ordinance. However, blood relatives of office holders may avail the scheme if they can prove they were not *financially dependent* on the office holder during his/her term in office;
- Asset/income declaration can only be done electronically, via a federal government website;
- In our view, the higher tax rates on declarations after end-June 2019, are irrelevant as the June rates are so attractive;
- Only liquid foreign assets have to be declared and repatriated back to Pakistan. Assets in the form of foreign real estate holdings (which are far more substantial than liquid assets) do not have to be declared;
- Liquid foreign assets have to be valued at the date of declaration (also an incentive to declare early);
- Domestic real estate holdings (Benami) – which are the bulk of hidden wealth – can be regularized by paying just 1% of the FBR valuation;
- Undeclared sale receipts can be regularized by paying just 3% tax, which is a significant discount as the GST rate is 13%;
- Hoarded cash that is declared, would have to be deposited in a bank account;
- Bearer financial instruments cannot be declared;
- Leaking information about the people who have availed the amnesty scheme, is deemed to be a punishable offence;
- This information cannot be used as evidence in any future legal case against the declarant, which means once declared, the declarant is scot-free (after paying the nominal tax);
- If there are any legal complications created by provincial governments, the federal government can overrule them. In effect, the 18th Amendment is held in abeyance; &
- Declarants will have 3 months after coming forward, to file their income and wealth tax forms for FY18.

This amnesty scheme will certainly be celebrated by holders of undeclared wealth, just as surely as it will anger those who pay their taxes as required by law (whether the 25-30% income tax, or the 13% GST). Compared to AU's version and PTI campaign promises, this scheme is much too lenient, and effectively disallows any sort of investigation (accountability) of those who are not currently being investigated.

Other than the anger this amnesty should spark with tax-abiding citizens, the latter may decide not to pay their taxes, and wait for the next amnesty scheme. This leniency will also not be appreciated by the IMF. In a clarification from the IMF Resident Representative in Islamabad on 22 April, Ms Teresa Daban said the IMF has always opposed tax amnesty schemes because they generate very little revenues, but more importantly, they create an acute moral hazard problem and undermine the tax-paying culture.

The IMF may also be annoyed by the Shahbaz Rana story wherein the new amnesty scheme was designed in collaboration with members of the elite and their lobbyists (22 April). As the IFIs have been flagging the *elite capture* of policymaking in Pakistan, the manner in which this amnesty scheme has been reworked, will surely be a source of frustration for the IFIs. With Pakistan looking desperately at the IMF to avoid an economic crisis, the proposed amnesty scheme is a policy blunder, even if it is not yet a policy. Equally important, it is indicative of the resistance that fundamental reforms face in Pakistan as the status quo reasserts itself when a crisis looms.

Revenues vs. Documentation

There is no denying the direct trade-off between accountability and amnesty. If the policy focus is accountability, then amnesty can only come in at the last-stages to reduce the level of punishment: if the focus is on amnesty and to get as many people to declare their wealth, then these people cannot be held accountable.

In Pakistan, there are differing sentiments about an amnesty scheme: many say the authorities must focus on getting hidden wealth into the tax net by incentivizing people to declare the true quantum of their assets; others claim that a lenient amnesty scheme will penalize tax-abiding citizens, and undermine the already weak tax-paying culture. From a political perspective, many will claim that lenient amnesty goes against PTI's manifesto and will anger its support base.

More specifically, many argue that GoP's primary goal should be documentation (i.e. get the maximum number of people to declare all their assets), and not revenue generation. If we look at this issue from a carrot-stick perspective, and give 10 points to the most lenient amnesty, and a score of 1 to the most penal version, we could categorize the amnesty schemes discussed earlier as:

- The PML-N amnesty scheme could be a 6-7 score (somewhat penal);
- AU's version would score a 3-4 (penal, if the higher tax rates are imposed); and
- The Hafeez Shaikh version would get a score of 9-10 (very lenient).

As discussed later, FATF and the IMF may have reservations about any scheme that scores above 5, not just to signal intent about stamping out money laundering and terrorist financing, but also to generate revenues and instill a tax-paying culture. Pakistan's vested interest would clearly prefer a higher scoring amnesty scheme.

In our view, while the Hafeez Shaikh version is focused only on carrots, a proper amnesty scheme will only work if the stick plays a bigger role in ensuring full compliance. More simply, people are likely to declare all their assets if they know that after the deadline, the authorities could easily identify non-moveable assets (the bulk of undeclared wealth), and will prosecute non-declarants with an iron-fist. This threat must be credible if the amnesty scheme is to be effective.

The issue is not to sweeten the deal to incentivize people to comply, but to threaten those who don't avail the scheme that if they are subsequently caught, they will pay a heavy price. With a heavy stick, policymakers can get more revenues *and* greater documentation. The perceived trade-off between revenues and documentation only manifests itself when the stick is non-existent. In our view, this is what the lobbyists for Pakistan's vested interests have been telling the government, which could explain the Hafeez Shaikh version.

The mindset of the vested interests

For the past decade, I have wondered why business interests are so hesitant about change, even when they know that without the change, the entire economy could crash. In simple terms, perhaps they haven't realized that *they* are now the system, and they cannot act as individual investors. We would suggest the following possibilities that may explain why powerful personalities will persist in protecting their financial interests, even when they know this could drive the economy into the ground:

1. They don't truly understand the nature of how bad things are, and they suffer from a stubborn confidence that Pakistan has seen problems before, and will weather this one as well (i.e. *clueless*);

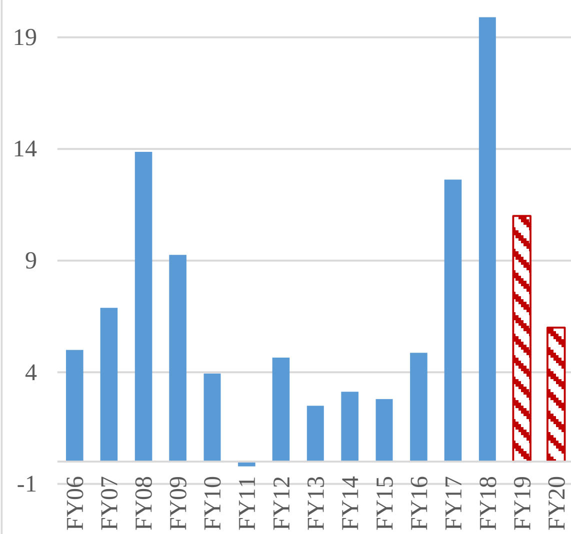
2. They understand the problem, but since the proposed changes are so painful to their private interests, they cannot bring themselves to change their stripes (i.e. *fixed mindsets*);
3. They accept measures to fix the BoP problem (since the country cannot print Dollars), but resist any fiscal reforms (e.g. documenting their activities, and paying a fair tax to sustain the country). They refuse to accept the fact that remedial steps on both fronts are required (i.e. *lack big-picture thinking*);
4. They hope for a miraculous positive shock that will make the crisis go away (i.e. *Allah will protect Pakistan*);
5. They have policy power, and want to show everyone that they will use their "elite capture" if required (i.e. *I have the power*);
6. From their perspective, short-term certainty (game the system till it breaks) is better than medium-to-long-term prosperity, which is uncertain. They may also question whether they will retain their privileged position in the new order. In some cases, the more unscrupulous individuals may see a economic crisis as an opportunity to increase their share of a shrinking pie (i.e. *collapse creates opportunity*); &
7. With their wealth stashed abroad, they think that they can escape and wait till things return to normal, and then return for Round 2 (*Dubai challo*).

Vested interests with policy power may suffer from a combination of these characteristics. Even if they collude and enter into a group think about what to do, they may still look to protect their interests, and leave it to the others to pick up the pieces. For individuals who are used to making quick money, manipulating markets, keeping bureaucrats on their pay-roll, and using sweeteners to have policies tweaked in their favor, taking a measured or mature approach to adapt their business interests to economic realities, is a near impossibility.

Unlike bureaucrats and policymakers who may shy away from hard steps during their limited term in power, the vested interests are "vested" in the country, and should know better. Perhaps they do not realize how a country like Pakistan could easily slip into an economic crisis.

Deconstructing an economic crisis

Fig 1: CA Deficit ($ bln)



Let's start with Pakistan's Achilles heel – the external sector. SBP data shows that for the 12 month period from March 2019 to February 2020, Pakistan must repay $ 22-23 bln, of which $ 14.7 bln are debt repayments. Let's assume that GoP is able to narrow the current account deficit to $ 11 bln in FY19 (compared to a deficit of $ 20 bln in FY18), and continues to show restraint in FY20, and keeps the external deficit to *only* $ 6 bln in FY20 (see **Figure 1**). Let's also assume that SBP needs to build its FX reserves by $ 4 bln in this 12 month period, from its end-February 2019 level of $ 8 bln.

Assuming that all FX swaps are rolled over, this means that Pakistan needs $ 24.9 bln in the period between March 2019 and February 2020.[3] Realize that this number is based on ambitious limits on the current

[3] This hard number is computed as follows: If we assume a CA deficit of $ 11 bln in FY19, then the current account deficit that must be funded in the last 4 months of the year is $ 2.16 bln. If we assume that the CA gap in FY20 is just $ 6 bln, then for the period Jul-Feb 2020, this boils down to $ 4 bln, which means a CA gap of $6.16 bln for the 12 month period. We know that debt

account deficit this year and next (see **Figure 1**), which reveals just how exposed & vulnerable Pakistan's economy is. One must appreciate that in Pakistan (as in most developing countries) an economic crisis always begins because of a shortage of foreign exchange.

Furthermore, a fractured political system will facilitate an economic crisis. Having said this, political posturing will not have much of a role once an economic crisis is in play – more simply, political messages to influence the behavior of citizens, will have little impact once the bare essentials are out of reach for the average person. In our view, politics becomes a luxury and people cannot be distracted when they are not able to secure day-to-day essentials.

So let us now paint a scenario about how Pakistan could slip into an economic crisis.

1. Political backdrop

There is growing disillusionment amongst PTI supporters over their party's capture by elite interests – the Hafeez Shaikh amnesty scheme could be used as a case in point. There is a sense of betrayal for those who voted for *Naya Pakistan*. Furthermore, PPP and PML-N remain in disarray because of tainted top leadership, and the growing perception that the next generation of *dynastic* leaders are weak, pampered and self-serving. Finally, regional political parties are adopting an ethnic posture, which is gaining domestic and international legitimacy.

As things stand, Pakistan's economy faces two challenges: one, to ensure it is not placed on the FATF blacklist (decision is expected in October 2019); and two, enter the IMF program and stay on track till the macro economy has stabilized.

2. FATF:

Many people will view this as a geo-political game with India playing a detrimental role. While this is true to an extent, the real issue is whether Pakistan will be able to convince the OECD that its financial checks are sufficiently robust to stop terrorism financing and discourage money laundering. Some would also argue that Pakistan's military ties with China are of particular interests to some countries, which could use FATF to secure this information.[4]

A more problematic issue is how FATF would respond if the Hafeez Shaikh amnesty scheme were to be announced. The leniency we have described earlier, could be viewed as an escape for those who have either generated money via corruption, or are channels for terrorist financing. While GoP could argue that post amnesty, it will tighten its documentation of financial flows, the nature of this amnesty scheme will create the perception that Pakistan is too easy on people who are involved in dubious financial transactions. If FATF shifts Pakistan to its blacklist, it will join countries like North Korea and Iran. This means that most trade flows will be halted, which will place the country on a path towards an economic crisis (see **stage 4** below).

3. IMF:

1. After prolonged & bitter negotiations with the IMF, the program begins. The IMF insists on strict quarterly limits to narrow the twin deficits in FY20. GoP agrees to these program targets, as it is now desperate for Dollars;
2. Pressure from debt servicing, defence spending and below-target revenues, pushes the fiscal deficit beyond the IMF ceiling in the 2nd quarter of the program (i.e. six months into the program);
3. Unlike the past program, the IMF does not grant the country a waiver, and the program stalls;

servicing in this 12 month period is $ 14.7 bln. This means FX payments of 20.9 bln. If the IMF insists that SBP must increase its NIR by $ 4 bln in this 12 month period, the grand total becomes $ 24.9 bln.

[4] More specifically, the US & India would want details about how a resource-constrained country like Pakistan, is able to collaborate in an ambitious plan to develop fighter jets and high-tech missiles.

4. Pakistan's sovereign credit ratings are downgraded & GoP begins to selectively default on its FX repayments;
5. An economic emergency is declared[5], and SBP's FX reserves are earmarked for urgently required imports (essential foods and fuels). All non-essential imports are temporarily banned;
6. The federal cabinet takes charge of all economic policies (18th Amendment is put into abeyance);
7. For an oil dependent country like Pakistan, retail fuel is rationed. This creates shortages at petrol stations, which creates panic and unleashes public anger against the government;
8. Scrambling for a response, the government accuses unscrupulous actors for undermining the country's economy, which results in a clampdown on bank lockers and suspected persons;
9. Those found with disproportionately large cash balances (PKR and $) are named and shamed by the media. The government promises legal proceedings and strict accountability. Pakistan's vested interests are firmly in the public eye;
10. The stock market collapses, and commercial banks experience panic withdrawals – the central bank shuts down the banking system and begins printing currency notes to meet demand;
11. People begin hoarding essential food items and medicines, creating a panic. There is a clampdown on godowns (storage facilities) and their financiers;
12. Power utilities stop operating because of fuel shortages, while people shift Rupee assets into FX or gold. Smuggling begins to take place openly;
13. By now, most of the country's elite have left the country, fearing for their safety;
14. Normal economic activities stop completely and hyperinflation takes hold; &
15. Lawlessness becomes pervasive, especially in urban centers. Rangers move in to secure law and order, and parliament is dissolved.

The point of this scenario is to dispel the view that Pakistan cannot experience an economic crisis. We would argue that things have come to the stage where unless very dramatic steps are taken to address the economic fundamentals, Pakistan could easily slip into an economic crisis. For the vested interests who feel that Pakistan has weathered economic problems before and will do so again, this should be a reality check.

The preferred path forward

To brighten the mood a bit, we would suggest the following as the better path forward:

- GoP should disown the amnesty scheme that is circulating on social media;
- GoP should revisit the Asad Umar version, and discuss this with both the IMF and FATF;
- After gaining the endorsement of these institutions, GoP should launch the AU amnesty scheme with a deadline of end-December 2019;
- Get NADRA and FBR to create a fiscal cadaster (a digital record of all assets owned in Pakistan), and use this database to urge specific people to avail the amnesty scheme. This nudge from the government will increase the credibility of the stick that could be used after the deadline. To get the message across, put some of the more glaring examples (people with lots of assets but no NTN) into the public domain; &
- After the deadline has passed, go after those people who have not availed the amnesty scheme to show the country that the government is serious.

[5] Some political commentators have already suggested that if an economic emergency is declared, this creates a sufficient pretext to dissolve the elected parliaments and make a case to the Supreme Court that elections be postponed till the country's economy has been stabilized.

Conclusion – a hard slog ahead

The next 15 months (April 2019 to June 2020) will be tough as the external deficit has to be narrowed and tax revenues have to be increased – this will hurt economic growth, spark inflation and stoke public anger. SBP will find it very challenging to manage a floating Rupee (using interest rates and domestic liquidity) that is necessary to narrow the external deficit, while keeping some control of the price of essential items.

If the Hafeez Shaikh amnesty scheme is an indication of the government's policy resolve, the chances of staying the course in the 3-year IMF program are not very high. In our view, the policy resolve that is currently needed, is what GoP *had* when it started the 10-month stabilization program back in November 2000. At that point, the Musharraf government made the IMF program its only policy priority, as the alternative would have been to default on its external obligations.

As discussed in the paper, there is a ubiquitous sense that some external intervention will save Pakistan from an economic crisis. For a country with a growing tactical nuclear arsenal, prolonged economic stress will create a level of uncertainty, which the global powers may not tolerate. Hence, the *Pakistan-is-too-important-to-fail* argument would kick in, and its progress in the IMF program would be assured, the pain would not be too high, and the country would certainly not be allowed to spiral into an economic crisis.

While this narrative may be popular in Pakistan, the global perception could be quite different as geo-political thinking has changed significantly in the past two decades. The new world order may view Pakistan's chronic economic problems as symptomatic of elite capture, which simply refuses to give up its privileged status. More importantly, if Pakistan remains on the fringes of the global community (e.g. FATF concerns about undocumented financial flows, extremist groups based in the country, violent attacks on minorities, etc.), a defiant Pakistan could instead become isolated, and its status as a nuclear power may again become a global concern. As we have seen in the past, Pakistan has experienced economic sanctions because of its nuclear program.

While the country has faced frequent bouts of stress because of a shortage of foreign exchange, Pakistan now faces a more severe BoP problem because the numbers are so much larger, and the prospects of a positive shock (like 9/11) are non-existent. Also, while Pakistan has seen a record number of IMF programs in the past three decades, and many that have ended prematurely, a premature end to the next program would have very serious economic consequences.

If GoP does not fortify its policy resolve, change its economic narrative to champion the 3-year stabilization program, and distance itself from perennial elite interests, it should get used to living under the sword of Damocles.