Tax Reforms in Pakistan

Brief Prepared for Policy Symposium on Tax Reforms in Pakistan

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Sustainable Development Policy Institute

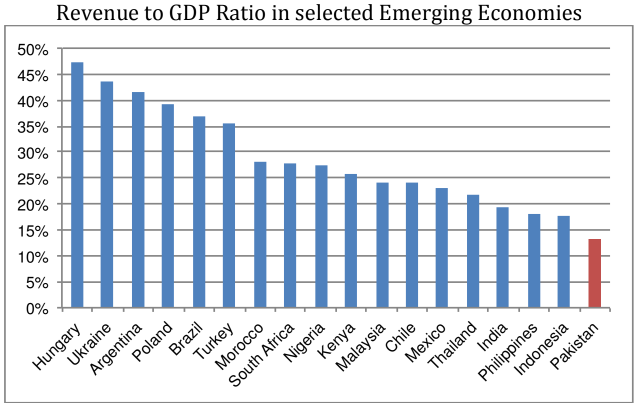
Taxes matter. Taxes affect citizens, economy of the country, businesses, and delivery of public services. If a government is unable to collect adequate taxes and use them effectively then the result is economic instability and poor service delivery to the public.

Pakistan's taxation system has been receiving increased attention due to its inability to collect enough revenues required for improving lives of Pakistanis.

Pakistani government spends around 0.7 percent of GDP on health. This is less than half of what other governments in lower middle-income countries spend on health. On elementary education, Pakistan spends less than 2 percent of GDP. This is also low when compared with other regional countries.

One of the main reasons for low investment in social services is low revenue collection. Total revenue collected by the Pakistani Government, using tax and other measures, is around 13 percent[1] of GDP, which is the lowest among all emerging economies. No country can afford basic government services with such low levels of revenue.

Revenue to GDP Ratio in selected Emerging Economies



Source: World Development Indicators 2013

The revenue collected is not nearly sufficient to meet public expenditure, which has averaged 20 percent of GDP over the past five years. The result is high government borrowing that has led the country into a 'debt-trap' (in 2012-13 the Federal Government paid over 60% of its revenue as interest on loans). Expenditure beyond revenue has also created economic imbalances, forcing Pakistan to repeatedly seek assistance from the IMF. In its latest programme, the IMF has advised the Pakistani government to reduce its budget deficit. Without radical increases in revenue, this must mean spending cuts and further deterioration in public service delivery.

The Government collects more than 80 percent of total revenue by imposing taxes. This is around 10 percent of GDP, of which 9 percent of GDP is collected through Federal Board of Revenue (FBR).[2] This is amongst the lowest rates of tax collection by Federal Government in the World – excluding oil-producing countries. The tax to GDP ratio has decreased from around 14 percent in the mid-eighties to 10 percent. By contrast, China has increased its tax to GDP ratio from 10 percent to over 20 percent since the early nineties.

The Constitution of Pakistan specifies the type of taxes that the Federal and Provincial Governments can collect. For example, taxes on individual incomes and on company

[1] World Development Indicators

[2] Average of past 5 years. For 2012-13 the FBR collected tax equivalent to 8.3% of GDP

profits are Federal taxes, while taxes on property and agriculture are provincial taxes. At the provincial level taxes are collected by provincial Excise and Taxation departments (that collect taxes from urban areas), Boards of Revenue (that largely collect taxes from rural areas), and Revenue Authorities / Boards in Sindh and Punjab (that were recently established to collect sales tax on services).

Provinces have struggled to increase their own tax revenue in recent years. On average 0.4 percent of GDP is collected through provincial taxes. The three main reasons for low revenue generation are: 1) politicians find it difficult to justify increase in taxes to their constituencies, primarily because of poor public services, and hence there is lack of political will; 2) provincial tax collection machinery – especially in rural areas - lacks administrative skills; and 3) the 7th NFC Award[3] increased the provinces' share of FBR's taxes from 47 to 57.5 percent, with the rather mild condition that provinces should work with Federal government to enhance national taxes. This condition was never taken seriously and the agreement with the provinces under the Award to increase taxes to 15 percent of GDP by June 2015 is highly unlikely to be met.

The new government has announced its intention to increase the tax to GDP ratio to 15 percent by 2018. This is a big challenge and will require considerable effort by both federal and provincial governments. To achieve this target, fundamental shifts in tax policy and tax administration will be required. We highlight three key issues:

1. Exemptions, Concessions and Preferential Treatment

For many years, different governments have allowed extensive tax exemptions, concessions and preferential treatments. Exemptions are provided in the tax laws, and through a legal instrument called 'Statutory Regulatory Order' (SRO) issued by the Federal Board of Revenue. To date FBR has issued 1,920 SROs. Independent studies estimate revenue leakage at 3-4 percent of GDP due to: 1) the amount of tax liability faced by taxpayers that is not paid on time; and 2) revenue loss resulting from preferential treatment. Losses in 2012 are estimated at between Rs.600 and Rs.800 billion. If tax evasion - also estimated at 3-4 percent of GDP - is added to this, the total loss in the present taxation system is roughly equal to total government borrowing each year.

As per Article 77 of the Constitution, Federal taxes will be levied by an Act of Parliament. However, the tax laws grant the government power to give exemptions, concessions and preferential treatment **without Parliamentary approval**. This is almost unheard of in other parliamentary systems, meaning parliament can be over-ruled by bureaucrats and Ministers. There is not even a requirement in the law to report the total value of these exemptions to Parliament.

What is needed is a phasing out of these exemptions and concessions. A number of exemptions were removed in the Budget 2013-14 and the government has agreed to review and remove all exemptions through SROs within three years.

We recommend an exemption phase-out plan to be designed by the Government, including necessary amendments in taxation laws. We also recommend that any proposed future exemptions and concessions should be subject to Parliamentary approval so that public representatives have a say in matters that affect tax revenue. The value of exemptions and concessions should be calculated using internationally

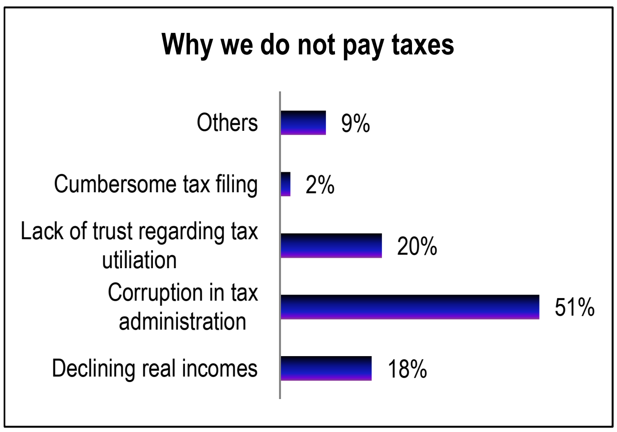
[3] The mechanism through which tax revenues collected by FBR are distributed between Federal and Provincial governments, applicable from July 2010

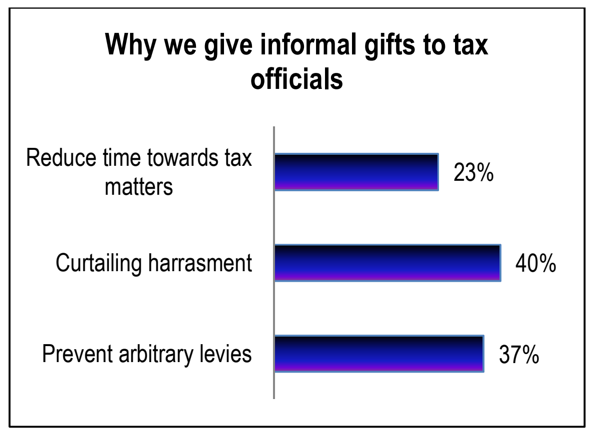
recognised methods and reported in the budget each year so that Parliament and the public are aware of the resulting revenue losses.

2. Weak and Inefficient Tax Administration

Tax collection in Pakistan remains non-transparent with substantial instances of rent-seeking. A 2004 World Bank study found that the FBR suffered from deep institutional and management weaknesses. The 2005 'Tax Administration Reform Project' had largely failed to achieve its objectives by 2012. Tax administration organisations (both federal and provincial) have suffered from inefficient and fragmented management, weak human resources, lack of supporting systems, and excessive scope for discretion and rent seeking behaviour. Weak tax administration results in high tax avoidance and opens avenues for corruption as indicated in the figure below.

SDPI's Household Survey conducted in May 2013 reveals taxpayers' lack of trust and perceived corruption in tax administration as major reasons for not paying taxes.





We recommend that; 1) consideration should be given to full autonomy of FBR along the lines of State Bank of Pakistan – having its own human resource structure and management to create a professional workforce – independent from the direct influence of the Government, 2) FBR should be restructured to create functional expertise, 3) FBR should upload its medium-term strategic plans on its website and monitor and report key performance indicators on a regular basis, and 4) at the provincial level, newly formed provincial revenue authorities should take over the functions of existing revenue departments and focus on enhancing collection of agriculture, property and services taxes.

3. Narrow Tax Base

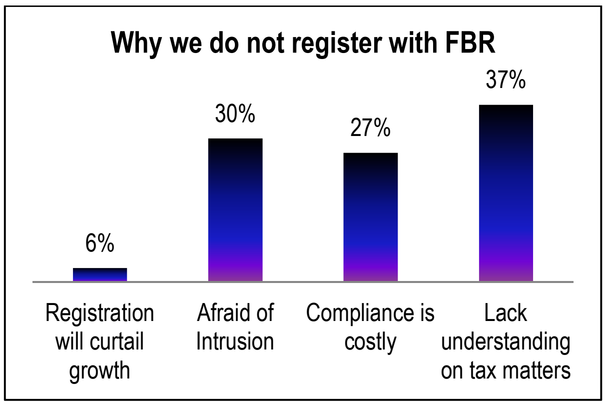
Very few Pakistanis pay income taxes. Out of a total workforce of 58 million less than 2 million are registered taxpayers, and last year only 0.7 million people actually paid income tax. This is roughly 2 people in 100 employed. Of all the lawmakers in the National and Provincial Assemblies 61 percent did not pay taxes in the year they contested the elections. 51 percent of Senators did not pay tax. 62 percent of Cabinet Ministers did not file tax returns.[4]

Of the total income tax collected, more than 60 percent is collected through 'withholding

[4] This was reported in the international media and strongly criticised in the UK Parliament.

tax'[5]. Withholding tax is not a good international practice. Pakistan's exceptionally high dependence on the tax signifies an unusually high proportion of 'hard-to-tax' individuals. Only 28 percent of income tax is collected through deduction at source, or through voluntary payments by taxpayers. The remaining 12 percent is collected through tax inquiries by the tax officials.

Pakistan ranks 162nd in the global 'paying taxes' index compiled by the World Bank. There are many reasons why people do not pay income taxes. As per the survey, it takes an average of 560 hours (highest in South-Asia) to comply with tax. Another reason is rent-seeking behaviour of tax officials. SDPI's survey of informal sector businesses in 2013 found that almost 22 percent do not intend to register with the tax authorities, with a large proportion afraid of intrusion by tax officials.



Another reason is weak enforcement. Hardly anyone gets convicted for tax crimes. In 2011 the FBR announced that it had access to a list of around 3 million people who do not pay taxes yet enjoy a lavish lifestyle including frequent foreign visits, more than one bank account, and number of vehicles and property registrations. The lack of convictions, discretion for tax officials and lack of documentation together make it easy for people to evade taxes. Independent studies point to losses due to tax evasion of between 3-4 percent of GDP each year.

It is essential that Pakistan's tax system should be seen as fair, adequate, simple, transparent, and administratively easy to comply with. People's perceptions regarding revenue collecting authorities and the Government that provides them with services are also important. Tax avoidance must be made costly and compliance cheap. If tax leakages (as identified above) are removed, an extra 6 – 8 percent of GDP of revenue can be realised. But Pakistan has a long way to go to improve its tax system and until this is accomplished one cannot expect much improvement in poverty and welfare at grassroots level.

[5] A system in which advance tax is collected at the time of a transaction – e.g. when paying a mobile phone bill – and it is assumed that the person paying has an income of more than Rs.400,000 per annum – the minimum amount above which income tax is applicable