Towards a Fair and Just Fiscal Policy in Pakistan

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‘The impact of economic growth on the lives of people is partly a matter of income distribution, but it also depends greatly on the use that is made of the public revenue generated by economic expansion’.

Drèze and Sen (2013)

The current tax system in Pakistan is characterized as unfair and inequitable. Two-thirds of tax revenue is mobilized through indirect taxation, which is regressive in nature and unfairly burdens the poor and middle classes. The government does not mobilize sufficient tax revenue required to finance essential public services, including health care and education, on which the poor rely the most. Consequently, these services remain inadequate, hampering efforts to reduce poverty and address extreme inequalities.

Background

There is an emerging concern that rising income and wealth inequalities in Pakistan are incurring social and economic costs, including violence, political instability and social fragmentation. There has also been a realization overtime by experts, that fiscal policy in Pakistan has not been redistributive. In 2014, total revenue generation by the public sector was around 9.8 per cent of GDP, which is among the lowest in emerging economies.

The low level of domestic resource mobilization has three visible implications. First, essential public services, including basic education, health and clean drinking water – services which the poorest sections of society depend on the most – are under financed. Second, public debt is increasing, caused by the government’s need to borrow both from internal and external sources to meet essential expenditure. This has a knock-on effect in terms of the higher future tax burden. Thirdly, the government has had to resort to borrowing from the banking sector which leaves little for the private sector to borrow.

A large wealth portfolio, including real estate, remains untaxed, while the goal of a progressive taxation structure is undermined by current tax exemptions, high compliance costs and related tax evasion, and an overall tax framework that allows several agricultural and services sectors to slip through the tax net. According to the Federal Board of Revenue’s (FBR) own survey estimates, the tax gap, representing those transactions not being taxed, stands at 79 per cent. Provincial governments have also struggled to increase their tax revenues. They currently only contribute 6.5 per cent to the consolidated tax revenues in the country.

Fair & Just Tax Regime;

Issue based solutions/Recommendations

Against the highlighted backdrop, this paper explains the four basic elements necessary for a fair and just tax regime, which, if implemented, would strengthen the domestic revenue base, increase equity and improve overall development outcomes, as the public sector will have more resources at its disposal.

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disposal to spend on human and social well-being.

1. Broadening the (direct) tax base

The difficulties in expanding the direct tax base partially come from the exemptions granted to commodity producing sectors and from an increased reliance on withholding taxes (WHT), which are particularly burdensome for small enterprises. The WHT results in higher prices of goods and services, which are passed on to the end consumers. The increased cost of compliance also keeps a significant proportion of small enterprises from entering the formal, documented economy. There are varying estimates as to the size of the shadow or undocumented economy in Pakistan; however, there is a consensus among experts that this segment of the economy is on the rise.

Pakistan currently has less than a million voluntary tax return filers. Sustainable Development Policy Institute’s (SDPI) household survey conducted in 2013 revealed that 71 per cent of eligible taxpayers did not pay because of a lack of faith that tax revenue will be utilized correctly and weak administration. The respondents also revealed giving informal gifts to tax officials for: curtailing intrusion and harassment (40 per cent), reducing time towards tax compliance (29 per cent), and preventing arbitrary evaluations and levies (37 per cent).

The absence of robust tax audits, the multiplicity of taxes, the difficulties in calculating tax liability, a lack of adequate incentives to file taxes and the poor relationship between taxpayer and payee are key reasons why levels of tax evasion are so high in Pakistan. This also reflects an erosion of the social contract between citizens and the state. The latter has not been able to show that tax money is being spent on people’s welfare.

The corporate sector uses aggressive tax avoidance strategies; in the overall tax gap identified by Ahmed and Rider (2013) almost 25 per cent can be attributed to the corporate sector. Kemal (2010) notes how corporate entities show a large part of their incomes coming from agriculture and other exempted or zero-rated sectors. The loopholes in tax policy allow businesses to claim tax exemptions against activities which are falsely classified as corporate social responsibility.

In the future, the use of ICT tools, biometric information and a data warehouse that links banking information with the NADRA’s database could help the tax authorities to earn revenue from untapped sources. Provincial governments also have an opportunity to improve the valuation of real estate, capital gains, the rental value of property and assets, and to bring them into an effective tax regime.

Following the enactment of the 18th Constitutional Amendment, public service delivery in social sectors is the responsibility of the provincial governments. Therefore, as their revenue authorities begin to demand statutory taxes, it is important that citizens are informed regarding the efficiency with which government resources are spent. This may be one of the ways to restore taxpayers’ confidence.

2. Reduction in indirect taxes

A recent study carried out by the Lahore University of Management Sciences and Oxfam on inequality in Pakistan indicates that around 60 per cent of FBR revenues come from indirect taxes, which are regressive in nature. The current tax regime effectively increases the disposable income of the rich, while simultaneously pushing the disposable incomes of the poor downwards.

The report also explains that inequalities could be mitigated through: a) phasing out federal excise duty; b) simplifying and gradually reducing the rates of general sales tax (GST); and c) further lowering customs duties and reducing the tariff slabs. Tax
incidence studies from Pakistan also suggest that reducing indirect taxation has a pro-welfare impact.\textsuperscript{19} For immediate relief to poor and lower-middle-income groups, food and fuel items widely used by poor groups should be exempted from sales tax, including cooking oil, bread, milk, vegetables, fruits, tea and sugar.

An ongoing concern is that there are three provincial governments\textsuperscript{20} which have enacted the GST on Services Act. Independent studies have pointed out that as a result of this legislation there is a double taxation on several services, as the Federal Government has been slow in withdrawing from its jurisdiction.\textsuperscript{21} At least two provinces have also imposed their own forms of excise and regulatory duties. This multiplicity of taxes is further contributing to the regressive image of the overall tax framework.

The Tax Reforms Commission, established by the federal government in September 2014, has already noted (in the case of indirect taxes) the existence of smuggling, fake invoices, under invoicing, illegal adjustments and delays in tax refunds. These issues are leading to higher transaction costs for formal businesses, which are being passed on to clients, ultimately leading to a loss of consumer welfare.\textsuperscript{22}

There are case studies from other economies where governments have bridged the revenue gap arising from a reduction in indirect taxes through broadening of direct tax base. A key example comes from Turkey which was able to double its tax-to-GDP ratio between 1995 and 2006, while also achieving a reduction in share of indirect taxation. In 2002 the Turkish Government abolished 16 indirect taxes and introduced a special consumption tax which was levied on items most consumed by higher income groups. Taxes on wealth, such as property, inheritance and high-value gifts, were increased. An environmental tax was imposed in order to finance expenditure in social sectors.

3. Equal tax contributions by all sectors

Under a fair tax system, all sectors pay their due share of taxes according to their contribution towards national income; however, under the current system, some economic sectors pay more tax than others. Currently, the industrial sector is taxed disproportionately high in comparison to agriculture and services sectors. The various exemptions allowed to agriculture and some other sectors should be revisited. New sub-sectors of the services industry, such as private educational institutions, IT establishments and electronic media outlets, should also be considered for sharing tax burden.

The prevalence of exemptions is one of the contributing factors to the low tax-to-GDP ratio. And where exemptions and concessions are granted to certain sectors and organizations, the benefits have not been passed to the end consumer.\textsuperscript{23} The overall exemptions in 2013-14 were reported to be PKR 477 billion, equivalent to two per cent of GDP (Figure 1). In 2014, sales tax exemptions (PKR 211 billion) and customs duty exemptions (PKR 131 billion) also increased against the previous year.\textsuperscript{24} The gradual removal of exemptions allowed to large-scale operators in the agriculture and livestock sector could provide an additional PKR 115 billion to the government.

Figure 1: Exemptions from indirect taxes (PKR billions)

![Exemptions from indirect taxes (PKR billions)](image)

Source: Multiple Inequalities and Policies to Mitigate Inequality Traps in Pakistan, Oxfam and LUMS\textsuperscript{25}

The services sector accounting for over 60 per cent of GDP is vastly underestimated
according to the tax gap survey conducted by the FBR. There has been a growth in new services which can only be brought into the tax system if a new survey of services establishments is conducted by both the provincial and federal boards of revenue.

The government may also decree through the Finance Act a requirement for any future exemption or concession to be comprehensively debated in parliament or in the relevant standing committee, with the overall aim to discourage exemptions. Their endorsement should be necessary for creating new tax exemptions, which themselves should only be enacted where there is evidence that they will reduce incidence of inequality and poverty. The standing committees should have the provision to consult economists and legal experts before a Statutory Regulatory Order (SRO) is endorsed.

4. Tax administration reforms

Tax policy formulation and tax collection should be made separate. The responsibility for policy formulation should rest with parliament (or its relevant committee). Tax policy should originate from the overall fiscal policy vision with the aim of creating a fair and just society with a strong focus on redistribution and pro-poor spending. The tax administration should be an autonomous body to implement this vision.

The mandate of the tax administration is not supported by strong enough legislation to establish a social contract between citizens and the state. There is a need to look into open budget initiatives and citizen oversight of the tax system as seen in several Commonwealth countries.\(^{26}\)

It is recommended that FBR and provincial tax authorities should be allowed greater autonomy. This should allow the tax entities to have their own human resource and management structures. There should be no political intervention in the recruitment, promotion and reward structures of revenue authorities. These authorities should be helped in developing functional expertise. This is only possible once these tax departments put in place medium-term strategic plans and monitoring of key performance indicators. Provincial tax authorities should now develop better databases and forecasting capacities to carry out regular assessments of revenue that may accrue from agriculture, services and real estate.

There is also a need to look into taxes rendering nominal revenues with high administrative costs.\(^{27}\) Such taxes should be merged with a uniform rate and gradually phased out. Any lost revenue can be compensated through progressive increases in direct taxes.

**Conclusion**

The tax system in Pakistan in its current state is both inefficient and unfair. The revenue-to-GDP ratio in Pakistan remains unacceptably low. The redistributive potential of the tax system has not been realized, both because the tax system overburdens the poor through direct taxes, while providing privileges to a wealthy few, and because it does not generate sufficient revenue for public services, such as health, education, safe drinking water and sanitation. This paper outlines four elements of a just and fair fiscal policy that would help make the Pakistani tax system both more efficient and more equitable: broadening the tax base through expanding direct taxes; reducing the number of indirect taxes that primarily affect the poor; redistributing the tax burden more fairly between various sectors of economy; and implementing a number of tax administration reforms. When implemented, these changes in the tax system would help reverse the trend of growing economic inequality in Pakistan.
References

5. IMF’s Seventh Review document reveals that the debt-to-GDP ratio stands at 62 percent. Forty percent of total federal spending goes for repayment of debt and interest payments (followed by defence at 22 percent and the Public Sector Development Programme at 17 percent).
7. For details: FBR Chairman’s interview, Business Recorder, 7 June 2011.
8. WHT is the amount of an employee’s pay (or expenditure) withheld by the employer (or supplier) and sent directly to the revenue authority as partial payment of income tax. In 2013 the growth of revenue from WHT was 3.7 percent.
22. Consumer welfare (surplus) in this case implies the reduced difference between: a) the price which consumer is willing to pay and b) the price actually paid by the consumer.
23. This also implies that the structure of exemptions is not progressive.
27. For example, cess on crop sectors, excises on hotels and cinemas.