

The Center for Peace and Development Initiatives, (CPDI) is an independent, non-partisan and a not-for-profit civil society organization working on issues of peace and development in Pakistan. It is registered UNDER SECTION 42 of the Companies Ordinance, 1984 (XLVII of 1984). It was established in September 2003 by a group of concerned citizens who realized that there was a need to approach the issues of peace and development in an integrated manner. The CPDI is a first initiative of its kind in Pakistan. It seeks to inform and influence public policies and civil society initiatives through research-based advocacy and capacity building in order to promote citizenship, build peace and achieve inclusive and sustainable development. Areas of special sectoral focus include promotion of peace and tolerance, rule of law, transparency and access to information, budget watch and Legislative Watch and Development.



Centre for Peace and
Development Initiatives

409-B, Nazim-ul-Din Road, F-11/1, Islamabad

t: +92 51 210 82 87, 211 23 15

f: +92 51 210 15 94 e: info@cpdi-pakistan.org



Centre for Peace and
Development Initiatives

Policy Brief

Broadening the Tax Base

October 2011

Budget Study Centre

Policy Brief

Broadening the Tax Base

October 2011

A Publication of Budget Study Centre

Centre for Peace and Development Initiatives (CPDI)



Supported by

Center for Peace and Development Initiatives (CPDI) would welcome reproduction and dissemination of the contents of the report with due acknowledgments.

Centre for Peace and Development Initiatives (CPDI)

409-B, Nazim-ul-Din Road, F-11/1, Islamabad
t: +92 51 210 82 87, 211 23 15, +92 51 431 94 30
f: +92 51 210 15 94
email: info@cpdi-pakistan.org
www.cpdi-pakistan.org

Disclaimer:
Every effort has been made to ensure the accuracy of the contents of this publication. The organization does not accept any responsibility of any omission as it is not deliberate. Nevertheless, we will appreciate provision of accurate information to improve our work.

Table of Contents

BACKGROUND

1

STATISTICS

3

POTENTIAL AVENUES

5

HOW TO GO ABOUT IT ?

6

BACKGROUND

In modern state system, revenues of a state have the status of fuel which runs the engine of a state. It is in fact the backbone for running the administrative affairs of a state ranging from defence to development and security to social welfare. Historically, taxes have been the main source of revenues of any state, the levy and collection of which has refined into the present day modern taxation system.

With the growing state structures, resulting in the establishment of regular armed forces and bureaucratic administrative setups, supplemented by growing need for infrastructure development and social demands for provision of basic utility services, levy and collection of taxes by the state has become an important public policy aspect in the modern day governance.

Tax in real terms is parting of one's money for the state which will be used for running the administrative affairs of the country and for general welfare of the citizens. The determination of priorities to spend this money is made by the elected representatives of the people. The element of volunteerism in payment of taxes has been a rare phenomenon and, therefore, the same has evolved as a legal obligation upon the citizens by the state, with penal measures for the violators. This resulted in the development of legislation for the taxation measures so as to make it obligatory upon the citizens to pay taxes with provisions to punish the violators.

The level of compliance in payment of taxes increased due to the legal framework, but still, in states where the citizen-state trust is low, the level of compliance is also lesser as compared to the states having a higher degree of citizen-state trust. Other way round, it can also be termed that there is a high level of compliance in the developed countries in contrast to developing and under developed countries.

Another reason for a low degree of compliance has been the inequitable distribution of taxation measures i.e., some sectors are heavily taxed while others are either exempt or nominally taxed due to political or pressure groups. In such an inequitable tax scenario, the taxed sectors opt for avenues to avoid taxes through pressure groups or attainment of political power.

Broadening the Tax base

Yet another cause of low compliance is the phenomenon of excessively higher rate of taxation. This works as a disincentive for the business growth as the incentive to growth is stalled by the simple business economics that all the fruits of the expanding business will be lost in the form of taxes. So, this results in the stalling of economic growth and the entrepreneurs either divert their profits to non-productive sectors or flight of capital from the country takes place.

On the government's side, inefficient or corrupt tax machinery also acts as a reason for low level of compliance by the taxpayers. If the tax administration is inefficient with lack of access to the relevant information and data, and has a low level of understanding of the business processes of their clientele, they will be easily deceived by the taxpayers resulting in low level of compliance. Besides, if there is a tendency of corruption in the tax machinery, which is a common phenomenon in most of the developing and under developed countries, tax-payer and tax-collector collusion is a win-win situation for both of them at the cost of state revenues making state and its citizens as the casualty in long run.

Keeping in view the above factors, Pakistan's taxation system needs to be analysed in the following parameters;

- i) Whether the distribution of tax is equitable in different sectors of the national economy. If not, which of the sectors are availing undue benefits and what are its repercussions on the overall receipts.
- ii) Whether the taxation rates are too high which cause regression in the economic growth resulting in diversion of capital to other non-productive sectors which are out of tax net.
- iii) Whether the tax machinery is capable, skilled and efficient with enough human and material resources to understand the business processes and their true potential of various industries in the country,
- iv) Whether the general perception that tax machinery is corrupt can be taken care of. What measures need to be taken to redress this important issue which is not only causing a perpetual financial loss to the state exchequer, rather it is also affecting the social norms of the society.

Broadening the Tax base

STATISTICS

During the last decade, there has been a quantum jump in the receipts from different taxes being collected by the FBR, the prime tax agency of the federal government. With a collection of just Rs. 392 billion in 2000-01, the receipts went up to Rs. 1596 billion in 2010-11. Though, the figure seems impressive, but the international scale for measuring the performance of tax machinery is the Tax to GDP ratio. Going by that parameter, the performance of the tax collection machinery has been dismally stagnant at around 9% throughout the last decade. This shows that the increase in the revenues has been due to the growth in economy with no additional gains by improving the working or efficiency of the tax machinery despite a large scale multi-million dollar tax policy and administrative reforms project being undertaken in the FBR.

The table given below gives an overview of the yearly tax collection during the last decade with a further bifurcation of the direct and indirect tax collection.

| Year | Total Federal Tax Revenue (Rs. in Billions) | Tax - GDP RATIO (%) | Direct Taxes | | Indirect Taxes | |
|---------|---|---------------------|--------------|------|----------------|------|
| | | | Amount | %age | Amount | %age |
| 2000-01 | 392 | 9.4 | 125 | 32 | 267 | 68 |
| 2001-02 | 404 | 9.2 | 142 | 48 | 262 | 64 |
| 2002-03 | 460 | 9.6 | 148 | 32 | 312 | 68 |
| 2003-04 | 519 | 9.2 | 165 | 32 | 354 | 68 |
| 2004-05 | 588 | 8.9 | 177 | 31 | 411 | 69 |
| 2005-06 | 713 | 9.4 | 225 | 32 | 488 | 68 |
| 2006-07 | 847 | 9.7 | 334 | 39 | 573 | 61 |
| 2007-08 | 1007 | 9.8 | 388 | 40 | 619 | 60 |
| 2008-09 | 1161 | 9.1 | 444 | 38 | 717 | 62 |
| 2009-10 | 1327 | 8.9 | 529 | 40 | 799 | 60 |
| 2010-11 | 1558 | 9.2 | 602 | 39 | 956 | 61 |

The taxes are broadly divided into two categories regarding the incidence of tax on the taxpayer. When the incidence of tax is directly on the individual, it is called Direct Tax e.g., Income Tax and Wealth Tax. On the other hand when the incidence of tax is passed on

Broadening the Tax base

to the end consumer, it is called Indirect Tax e.g., Sales Tax, Customs Duty and Federal Excise Duty. The Direct Taxes are considered as progressive as their basic principle is the more you earn, the more you pay, whereas the indirect taxes are considered as regressive because the incidence of indirect taxes is passed on to the end consumers irrespective of their financial status.

Till late 1990's, Pakistan's revenue base was heavily tilted in favour of Indirect Taxes as compared to Direct Taxes with a blend of 70-30. The modern day progressive taxation system in advanced countries is designed with a greater emphasis on the direct taxes. As an example, the contribution of direct taxes in UK is around 70%. In the Tax reforms in Pakistan in the last decade, an attempt has been made to reverse this indirect-direct tax receipts blend of 70-30 to introduce progressive taxation which has shown a nominal change in the proportion to 60-40. This is, however, still far from the ideal blend of 30-70.

In the Tax reforms, attempt was also made to broaden the narrow tax base which revolves around the same old manufacturing sector and imports. The Agriculture and Services sectors which form around 75% of the GDP, contribute only 10% to the total revenues, meaning thereby that 90% of the revenue is being collected from sectors having 25% share in the GDP. In this inequitable distribution of taxes, the sectors which are documented are an easy prey for the tax machinery to tap them such as Importers (who have no other choice but to document their imports for entry in the country), Corporate entities (Telecom Companies, Banks, Insurance Companies, Oil Companies, etc), Large Scale Manufacturers, Salaried individuals, etc, whereas the sectors which avoid formal documentation get an easy escape from the tax net.

The lesson learnt over the years is that apart from equitable distribution of taxes at the policy level, documentation is also one of the key factors at the implementation level to develop a successful tax policy and administration. The documentation factor helps to determine the capacity of a certain individual, entity or sector as well as the revenue to be realized from it. Despite a countrywide exercise of documentation through Tax Survey in 2000, the government failed to show a strong political will to implement a fair tax distribution policy and an effective collection system which caused whole of the exercise to go down the drain. Still, the way out is to take effective measures to document the financial transactions which will in the long run help in realizing the true revenue potential from the economy.

Broadening the Tax base

POTENTIAL AVENUES

An analysis of the tax statistics in Pakistan shows that tax spread is erratic. Agriculture and Services contribute 21% and 53% respectively to the GDP, but their combined contribution to tax revenues is a paltry 10% of the total taxes. Petroleum sector alone is contributing around 27% of the total tax revenues with Telecom, Tobacco, Auto and Auto parts and Edible oil sectors as the other major revenue spinners. This unequal spread needs to be balanced by an equitable distribution of taxes in different sectors of economy.

A two pronged approach needs to be adopted to explore the potential revenue avenues which are either out of net or availing undue concessions, i.e., tap new sources and plug the leakages. The former is a policy issue whereas the latter relates to effective implementation. This approach then needs to be followed in various economic sectors with Agriculture and Services as the main priority areas.

The Agriculture sector is taking advantage of the lack of legislation to tax the agriculture income which is a policy issue. The successive governments have shown a lack of political will to tax agriculture income due to strong political resistance by the agriculturists lobby which has a strong representation in the political corridors of the country. Taxing agriculture income requires legislation at the respective provincial legislatures as it is a provincial subject. A simple theory needs to be propagated that anyone who earns beyond a certain threshold of money in a year needs to be taxed, irrespective of his source of earning. This will not only make the idea simple rather will also help allay the fears of small farmers. A soft start with a lower rate of taxation or fixing higher income thresholds for tax needs to be introduced in the initial phase to avoid resistance.

On the other hand in the Services sector, Wholesale, Retail and Transport are the sub-sectors which account for 20% of the GDP, but are still out of the tax net. This is due to lack of effective implementation which is partly because of the lack of political will of the government due to its political compulsions and partly due to the lack of capacity of the tax machinery to determine the actual potential of the individuals working in these sectors. So, to exploit the full potential of taxes, the government needs to give full backing to the tax drive with no interference in the form of concessions or exemptions and the tax machinery needs to be fully equipped with the data and understanding of the business processes to bring them in the tax net.

When a comparison of tax collection by the Provincial governments vis a vis Federal government is made, the performance of Provincial governments is extremely poor. The provinces are dependent upon the federal government for funding and no serious efforts have ever been made by the provincial governments to generate their own resources. Although, Agriculture and Services fall in their ambit, but no initiative in this respect has been taken so far, except by the Sindh government which has levied sales tax on services this year but its effective implementation is yet to be seen. The Provincial governments have a comparatively broad tax net in the urban areas in the form of property tax, CVT and motor vehicle tax, which if implemented scientifically with proper documentation and data bank, can generate reasonable amount of revenue.

Besides the above, stock market brokers, jewellers, money changers, property dealers, doctors and architects also need to be focused to explore major individual entities in these sectors to tax them as per their actual potential. The overall objective should be to bring the major business entities in the informal sector in the tax net.

HOW TO GO ABOUT IT?

As a first step, provincial governments need to legislate on agriculture income tax. For this purpose, across the board political consensus needs to be developed followed by proper laws and collection procedures to ensure its effective implementation. For this purpose all the stakeholders need to be on board especially the representative bodies of farmers to determine the standard parameters of expenses and receipts on production in different areas for different crops in different types of land. For this purpose the existing infrastructure and human resource base of the land revenue department should be utilised which should also be simultaneously reformed with new young blood entrants with proper training to run the department on modern lines through automation of record and making it transparent to reduce the elements of forgery and fraud.

Secondly, Retail, Wholesale and Transport sectors need to be focused by defining parameters for determination of their volume of business in a transparent manner. For this purpose, standard parameters of each sector for determination of business volumes should be arrived at through mutual consultations with the stakeholders such as major business entities, their representative bodies, lawmakers, Chartered Accountants, tax lawyers, etc. Once the parameters have been determined, individual business entities in these sectors should be identified by tax offices. In the initial phase, this exercise should be conducted in only 4-5 major cities of the country with rest of the cities to be taken up in the second phase after successful results in the first phase. This phase splitting will also help in

avoiding a country wise resistance by these sectors which normally causes problems for the political governments.

Thirdly, the tax department needs to be properly trained and equipped before any of the above exercises are initiated. Special trainings for the taxmen to make them understand the business procedures should be arranged so that they should be able to work out the business volumes, expenses, receipts and profitability of the business sector under review. The tax department should also document these parameters which should be widely circulated so that tax payer should also have a fair idea about parameters for determination of his tax liability. This would not only help in reducing discretion of the taxman, rather will also increase the transparency of the taxation system.

Fourthly, a data warehouse should be established by the tax department with access and linkages to the major public sector urban development authorities (CDA, IDA, KDA, PDA, PDA, Cantonment Boards and other associated authorities), private sector housing authorities (DMAs, Bahria, Falcon Housing, Naval Housing, etc.), land revenue departments, Excise and Taxation Departments, Auto Manufacturers, Airlines, Clubs, private schools/colleges/universities, etc. A proper system should be developed in which all these entities should have an online access to the said data warehouse with a legal obligation to enter every transaction made by these entities. For this purpose, a simple e-form should be designed by the tax department which should be filled by the organization making such transactions and be forwarded online to the tax department immediately on conclusion of such a transaction to be stored in the account of individual or entity making the transaction. This will help develop the transaction data .of each individual/entity which will be used in determination of his tax liability at the end of the year. Till the time such an online system is developed, the tax department should make manual arrangement with all such departments/organizations for collection of data of major transactions to enter in their system. This data should be collected by all the tax offices in the country with input access to the central data warehouse of the tax department which should be used for desk audit and tax assessment.

Fifthly, a transparent system should be developed to determine the actual value of goods at import stage because sizeable revenue is generated at the import stage in the form of Customs Duty, Sales Tax, With olding Tax/Advance Income Tax and Federal Excise Duty. The trend of under invoicing of goods results in loss of revenue to the state which needs to be checked by ensuring declaration of correct value of goods. For this purpose imports should be made obligatory through banking channels and cash transactions for commercial activities should be curbed through strict policies of the State Bank. To check movement of

cash to foreign countries, effective enforcement at the airports and on illegal channels such as Hawala and Hundi needs to be made. In addition, the government should go for mutual agreement with major trading partners such as China, Dubai, etc, for sharing of import/export data which should help in determination of actual import value of goods for realization of the real revenue.

The above mentioned measures need to be implemented in letter and spirit to establish an effective and efficient taxation system in Pakistan. This will certainly give a boost to the revenue collection to offset the scarcity of resources.

.....