

# Addressing Pakistan's Chronic Fiscal Deficit

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# Recent Economic Outcomes

- Pakistan's GDP growth rate has been lower and more prone to steep falls
- Since 2000, four BOP crises and IMF programs, severe expenditure shrinking.
- This happened under a military government (Musharraf, 1998-2007), democratically elected governments (2008-2018), a left leaning government (PPP 2008-13) or a pro-market one (PMLN, 2013-18).
- There has been considerable erosion in the value of the Rupee which represents substantial loss of wealth.
- Remittances have held steady at about 6 percent of GDP, and largely account for the continued fall in poverty.
- Roller coaster economy: anxiety about sustaining living standards and poor investment climate.

# Deepening Structural Weaknesses

- Taxing imported inputs, overvaluation of the rupee, high freight and other costs of doing business, have eroded **international competitiveness**.
- Sustained high expenditure and poor revenue collection, and therefore high **fiscal deficit**, remain unaddressed.
- Episodic recovery of growth and macro instability do not shore up business confidence: the **investment** has remained flat, hovering between 15 and 20 percent throughout this period (half that of India and Bangladesh).
- **IMF programs thus did not address the core structural weaknesses**. So why the IMF? Catastrophic cut backs politically infeasible, international capital market very costly, pockets of “Friends” shallow.
- Widespread political unrest has been avoided because remittances, urbanization, adequate food production and a modern government social safety have helped reduce inequality and poverty. However, without addressing the structural problems that have stunted investment and economic growth, citizen frustration with poor quality jobs will be hard to contain.

# Tax and Expenditure: Overview

- Pakistan's tax revenues as a percentage of GDP was 12.9% in 2018. It compares with the average of 12% of central governments' tax revenues in lower middle income countries in 2017.
- Overall revenue (tax and non-tax) was 15.1% of GDP and budgetary expenditures 21.6% of GDP.
- Most budgetary expenditures are inflexible. Interest, defense and pensions account for over 60% of federal government expenditures.
- There is considerable scope for:
  - strengthening Fiscal Responsibility and Debt Limitation Act (FRDLA)
  - better targeting of subsidies (tariff equivalence subsidy; consumers other than lifeline consumers also benefit; one third of the poorest households are not connected to the grid)
  - governance reform of SOEs
  - reform of public investment management (PIM)
  - improvement of operation and financial management systems (e.g. POPs in Punjab)
  - better expenditure outcomes (e.g. cash grant vs. asset transfers; skills development program; incentives to tax-inspectors; teachers, bureaucrats; use of IT to monitor the monitors).
  - shifting some of the burden of development expenditure onto the private sector through greater public-private partnership
- While these efforts should be ongoing, the gap between budgetary expenditures and revenues (tax and non-tax), which was 6.5% in FY2018 and about 9% in FY2019 (provisional estimates), must be addressed simultaneously through major effort to increase tax revenues on a sustainable basis.
- Fenoehietto and Pessino (IMF, 2013) calculate Pakistan's tax capacity – the maximum level of tax revenue that it can collect controlling for demographic, economic and institutional characteristics – to be 22.3 percent of GDP in 2011. There is thus a potential for raising an additional 9.4% of GDP as tax revenue and therefore bridging the revenue expenditure gap.

# What Impedes Tax Collection?

Mukhtar and Nasim (2016)

- **Constitutional and Legal Aspects**

- Constitution makes unwarranted bifurcation between income and sales taxes.
- At the legislative level the tax law allows large exemptions from payment of all major taxes (see below for further elaboration).
- Several loopholes and lacunae that make it impossible to bring culprits of tax evasion to justice.
- Tax laws and tax rates are dated (e.g. AIT, UIPT).

- **Structure of the Economy**

- Most of the taxes collected in Pakistan are from the manufacturing sector, which has shown sluggish growth over the last decade.
- GDP growth during this period has come primarily from the services sector which is very lightly taxed.
- Hence, additional revenue measures are taken each year just to keep the tax-to-GDP ratio from falling.
- Changes in the fiscal federalism paradigm have eroded incentives for greater revenue collection efforts at both the federal and provincial levels.

- **Large informal sector**

- Arby et al. (2010) estimated the informal economy (unmeasured and untaxed) to be in the range of 20% to 30% of the total economy in 2008.
- FBR embarked upon the Broaden the Tax Base (BTB) scheme, which uses third-party data to identify potential taxpayers.
- These and other efforts have resulted in the number active income taxpayers to increase from 0.98 million in FY2014 to 1.46 million in FY2018 and reported to have gone up to 2.154 million in FY2019.

- **Administrative Limitations**

- FBR has tried to tap into the informal sector by expanding the scope of withholding taxes and applying a higher tax rate on those who do not file their tax returns.
- But it has failed to exploit the transaction and consumption database on filers and non-filers to expand the income tax base or to make major tax recoveries from the public.

# What Impedes Tax Collection?

## **Tax Exemptions**

- The bases of all major taxes are badly perforated by a large number of tax exemptions and tax concessions granted to various sectors, sub-sectors and economic activities.
- A number of exemptions relate to bilateral and multilateral agreements (e.g. Independent Power Producers, Free Trade Agreements, etc.)
- Exemptions and concessions are also outcomes of ad hoc policy decisions of the government to provide incentives for accelerated industrialization, attract foreign investment or to afford security to some segments of the population.

## **Poor Tax Audit**

- Although self-assessment is encouraged for most federal taxes, the number and quality of tax audits remain insufficient to encourage correct assessment by taxpayers.
- Tax demand generated from the tax audit process and additional tax collected from revamped audits remains woefully small.

# Tax Reform Options

# Tax Incentives and Investment

## **Alm and Khan (2008), World Bank, Pakistan Tax Policy Report (2009).**

- The tax rate on companies (other than banking companies) is 29 percent. (Singapore (17%), Taiwan (20%), Turkey (22%) and Malaysia (24%)).
- The tax rate is only one part of the overall tax and incentive structure for investments in Pakistan. The overall tax burden is captured by Average Effective Tax Rate (AETR – total taxes paid as a fraction of gross corporate income) and the Marginal Effective Tax Rate (METR – additional tax paid by a firm when it invests one more unit of capital).
- Estimates of METR and AETR suggest that tax burden differs by sectors and by type of assets.
- Good tax policy would suggest that policy makers should not discriminate between sectors and assets for investment purposes unless there are very good reasons for encouraging investment in particular sectors, e.g., for reasons of export growth or greater employment.
- The emerging consensus is that more important than tax incentives (lower tax rates or tax holidays) are other elements of investment climate, such as macroeconomic stability, quality of infrastructure, skill level of the workforce, location, size of the domestic market, regulatory environment and the rule of law.
- A tax system which tries to meet multiple objectives, including progressivity, promotion of FDI and domestic investment, small business enterprises, export industries, employment etc., will become necessarily complex: adds greater administrative discretion, greater contacts with tax payers and scope for graft and corruption, distorts incentives and resource allocation, increases scope for tax evasion, and compromises the distributional objectives of the tax system.



# Informality and Turnover Taxes

- A key result of the optimum tax theory that there should be no taxes on intermediate inputs including imported intermediate inputs, is based on the assumptions that there is no tax evasion and there are no administrative costs in tax enforcement.
- Turnover tax violates the principle of production efficiency that requires that inputs should not be taxed.
- This loss in efficiency has to be weighed against revenue efficiency (compliance) that the minimum tax schemes make possible.
- Best et al (2015) explore this tradeoff theoretically, and empirically in the context of Pakistan.
- The authors show that uniform turnover taxes reduce evasion by up to 60-70 percent of corporate income compared to profit taxes.
- A switch from profit taxation (35%) to pure turnover taxation (0.5%) can increase corporate tax revenues by 74% without decreasing aggregate after-tax profits (hence representing a welfare gain).
- The authors do not estimate the general equilibrium effect of such taxation, which has an offsetting effect.

# Agricultural Income Tax

- Mukhtar and Nasim (2016) have estimated potential tax revenue based on ITO 2001 that farmers in Punjab would have paid if agricultural incomes were taxed at rates comparable with incomes in non-agricultural sectors.
- The authors estimate that in FY2014, the tax yield would have been Rs54 billion compared with less than Rs1 billion collected in that year.
- The tax implementation capacity of the provincial BOR, which is responsible for collecting agricultural land/income tax, has deteriorated over time.
- Some degree of tax coordination and information sharing between the FBR and BOR can raise revenue yield but the scope of tax farming is fairly limited.
- Changing the current form of tax collection from a land tax to an income tax will require building a modern income tax machinery, which could take many years
- In the interim the provincial government can consider alternative forms of agricultural taxes that are easier to implement.
- Land tax rates could be revised in a way that the tax collection from land (as a proxy for income tax) is comparable with income tax collection in other sectors of the economy.
- Alternatively, taxation of presumptive income based on revised PIUs can be considered.
- These tax measures will not only hold an important symbolic value in terms of fairness and equity but will also substantially supplement provincial government finances.

# Property Tax

- Urban land and property taxes contribute 2% of GDP in OECD countries compared with 0.018% of GDP in FY2019 in Pakistan.
- Collier et al (2018) list following key reasons for taxing urban land and property:
  - *These taxes yield substantial revenues for governments and can have a large impact on the ability of municipal governments to deliver public infrastructure and services.*
  - *These taxes are fairer than other forms of taxes. Taxing land and properties allows governments to capture some of the increases in land and property prices that result from forces outside of the owner's control and are in part the direct result of public investment.*
  - *These taxes provide self-sustaining return on investment. Annual land and property taxes can allow governments to obtain returns on their investments in public services and infrastructure that raise the value of nearby land and/or property. These taxes enable a virtuous cycle where appreciating urban land and property values finance the public investments which make the city more productive.*
  - *Implementing these taxes therefore provide governments with higher future income streams, on the basis of which it may be possible to finance current projects through capital markets.*
  - *These taxes are more efficient than other form of taxes. The fixed supply of land in a city means that taxing this asset does not negatively affect urban investment and in some cases can encourage more efficient land use. This is unlike taxation on work or savings that can incentivize individuals to work or save less. Taxing land and property, though less efficient than taxing land alone, has been found to be less harmful to investment and growth than other taxes such as income and corporate tax.*

- For property tax purposes, policy makers can either tax property (excluding land) or land (excluding property) or a combination of land and property.
- Pure land taxation is considered most desirable from an efficiency point of view but a combination of land tax and low property tax may be more desirable if distribution considerations are also important.
- Property tax revenue can be affected by the exemptions which can be based on land/property use, value and ownership.
- Generous use of exemptions can seriously erode tax revenue or shift the burden on to a narrower base.
- It is best to keep the tax rate low but have a broad tax base to adequately provide urban public services.

# Property Tax

## Recent Property Tax Studies

### **Nabi and Sheikh (2011)**

- The authors report some of the property tax reforms and their impact based on the recommendations of a task force on tax reform set up in 2008 by the then Chief Minister of Punjab.
- The task force tackled both issues of tax rates and differential between tax liability of self-occupied versus rented property (tax rate on rented properties was 10 times the rate on owner-occupied properties).
- By applying new valuations (from Rs12 per square yard/feet to Rs60 per square yard/feet), reducing tax rate to 10% (from their rate of 20% to 25% at the time) and the differential down to 1:5 (from 1:10 at the time), the revenue demand jumps from the Rs.2.8 billion in 2008 to over Rs.5.0 billion
- Complete elimination of the differential would have resulted in revenue demand increasing nearly four times at over Rs. 8.0 billion.
- As in any reform process, some categories stood to gain whereas for others there was an increase in the tax burden but the increases were highly affordable
- Despite the low impact on household budgets, there was resistance to the proposed reforms by important players in the ruling PML-N.

### **Khan et al (2016)**

- Results based on an RCT experiment in Punjab
- When a three person team of property tax collectors was *given bonuses for tax collection* above a historically-predicted benchmark, the growth in collection was greater by 46 percent compared with those tax circles where such bonuses were not given (controlled group).
- The authors show that this was predominantly because of increase in assessed value of property rather than through increased recovery or changes in exemptions granted.
- They also find that the increase in tax revenue was not accompanied by any decline in a typical taxpayers' perception about the quality of service of the tax office.
- The increase in the value of the assessed property in any one year, implies not only an increase in that year but in all subsequent years. Thus the potential benefit of incentive payments is spread over several years.

**Khan et al (2019)** considered *non-monetary benefits* in the form of postings to preferred locations.

- The authors find that the promise of performance-based postings substantially raised revenues. The revenues were about 5 percentage points higher in treatment groups than in control groups in the first year and 9 percentage points higher in the second year. This amounts to an increase in the growth rate of tax revenues of 41 percent in the first year and of 30 percent in the second year.
- Ongoing research is assessing the *willingness to pay* property tax based on service delivery

# Proposed areas of tax policy research

## Personal Income tax

**BTB:** *huge tax gap. 3-4 million people should be paying taxes. Research will:*

- collate different data sources to identify non-filers and under-reporters
- will develop algorithms for compliance notices that increase the probability of success
- implement and evaluate alternative designs of communication with potential taxpayers
- identify and develop solutions to operational bottlenecks for the successful implementation of BTB programme

**Withholding:** *65% of income tax revenues; worldwide applies mostly to salaried employees; in Pakistan withholding on salaried employees represents only 11% of the withholding revenues. The research will assess whether:*

- the withholding system increases income tax filing and compliance by those who file
- it is regressive; change design to minimize its impact on the poor
- withholding taxes are treated as indirect taxes and passed on to consumers
- reforms can be implemented to increase the revenue it raises

**Customs under-invoicing:** *Effective risk management detects under invoicing and recovering lost revenues. Also, it deters future taxpayers from under invoicing. Unique collaboration opportunity. Researchers will help FBR:*

- Improve the risk management algorithm.
- Implement Remote Clearance to reduce the scope for revenue eroding collusion
- Anonymize data by using the electronic clearance system to reduce collusion

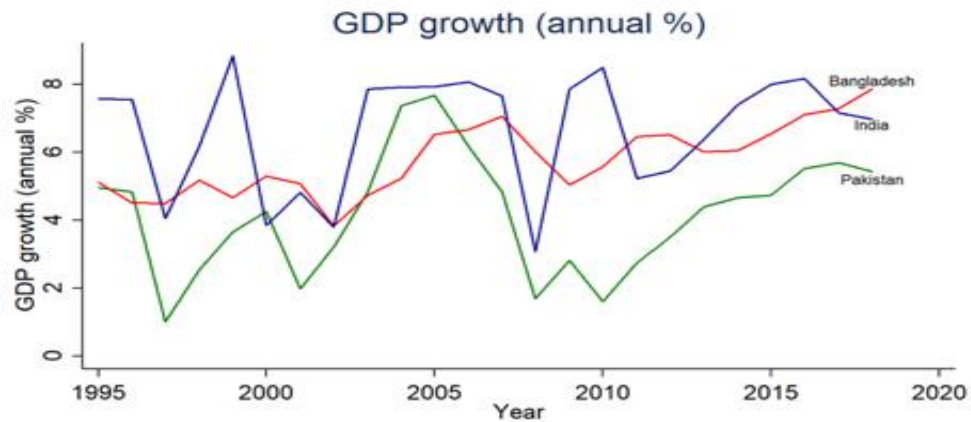
**Sales tax enforcement:** *GST largest source of FBR revenue; information on detailed transactions. Researchers will:*

- Perform comprehensive evaluation of GST enforcement to identify gaps by sectors
- develop algorithms to detect misreporting, particularly fraudulent refund claims



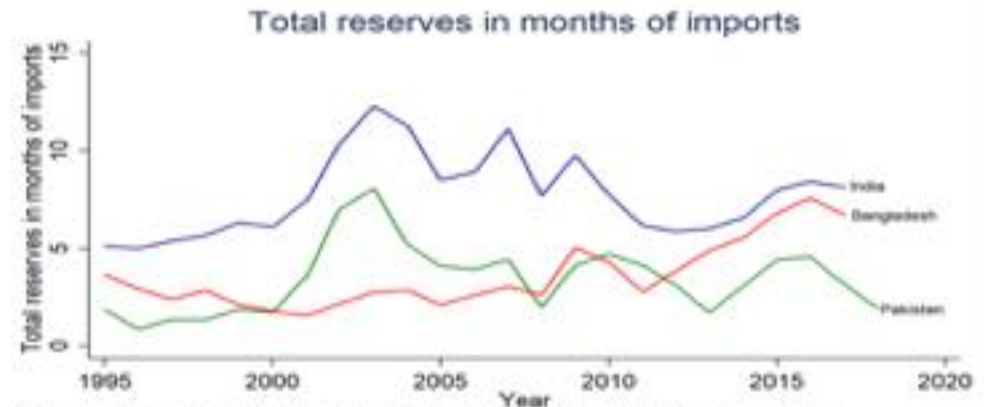
# Conclusion

- Addressing fiscal deficit of the order of 9% of GDP requires effort be made for expenditure reduction as well as revenue generation.
- In this presentation we have focused on taxation as a revenue generation measure.
- We have reviewed some recent literature on taxes in Pakistan at the federal and provincial levels, and how these taxes may be designed for greater revenue generation.
- The proposed tax design will only go part of the way to address Pakistan's chronic fiscal deficit.
- Improvement in expenditure management to cut out waste, introduce more flexibility and efficient delivery of services are important to increase willingness to pay taxes
- Other factors that explain poor revenue collection have also been identified. Addressing all of these must go in tandem if fiscal deficit is to be addressed on a sustainable basis.



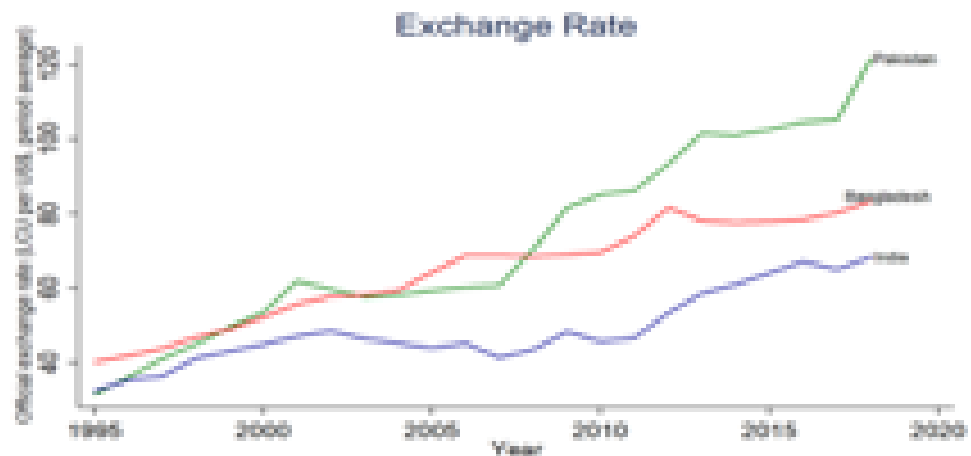
Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2010 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Data Source: World Bank National Accounts Data



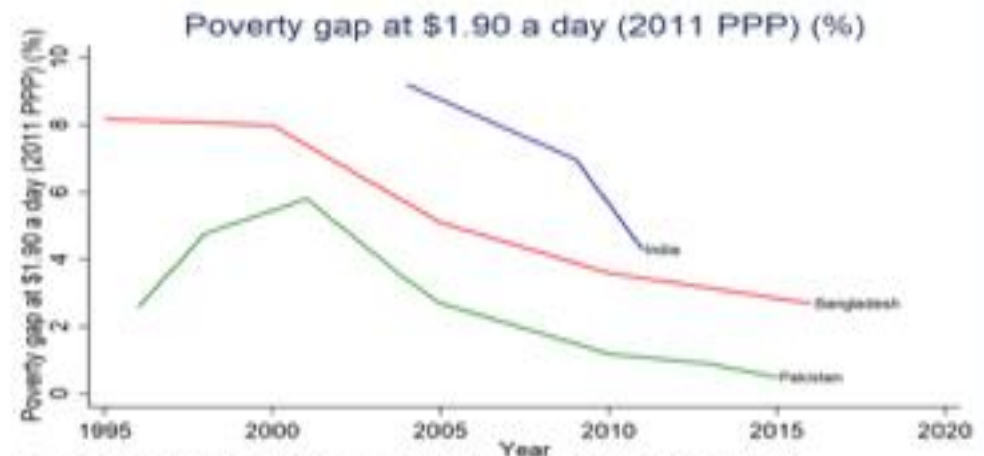
Total reserves comprise holdings of monetary gold, special drawing rights, reserves of IMF members held by the IMF, and holdings of foreign exchange under the control of monetary authorities. The gold component of these reserves is valued at year-end (December 31) London prices. This item shows reserves expressed in terms of the number of months of imports of goods and services they could pay for [(Reserves/Imports)\*12].

Data Source: IMF International Financial Statistics (and data files)



Official exchange rate refers to the exchange rate determined by national authorities or to the rate determined in the legally sanctioned exchange market. It is calculated as an annual average based on monthly averages (local currency units relative to the U.S. dollar).

Data Source: World Development Indicators



Poverty gap at \$1.90 a day (2011 PPP) is the mean shortfall in income or consumption from the poverty line \$1.90 a day (counting the nonpoor as having zero shortfall), expressed as a percentage of the poverty line. This measure reflects the depth of poverty as well as its incidence.

Data Source: World Development Indicators



Current account balance is the sum of net exports of goods and services, net primary income, and net secondary income.

Data Source: World Development Indicators



Gross capital formation consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on), plant, machinery, and equipment purchases, and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." Net acquisitions of valuables are also considered capital formation.

Data Source: World Development Indicators



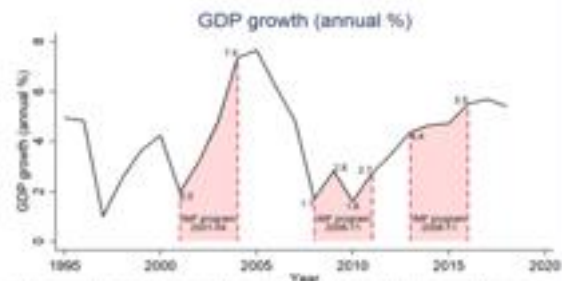
Fiscal deficit is calculated by subtracting total central revenue from central expenses. This deficit is then divided by nominal GDP and multiplied with 100 to obtain fiscal deficit as a percentage of GDP.

Data Source: IMF International Financial Statistics (and data files)



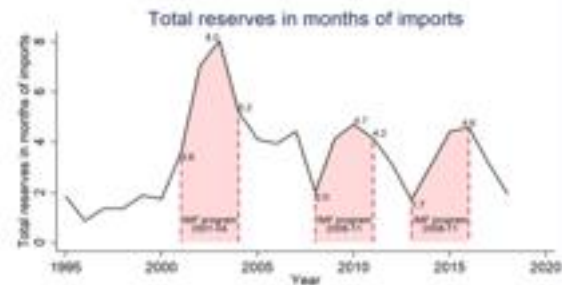
Tax revenue refers to compulsory transfers to the central government for public purposes. Certain compulsory transfers such as fines, penalties, and most social security contributions are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative revenue.

Data Source: World Development Indicators



Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2010 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Data Source: World Bank National Accounts Data



Total reserves comprise holdings of monetary gold, special drawing rights, reserves of IMF members held by the IMF, and holdings of foreign exchange under the control of monetary authorities. The gold component of these reserves is valued at year-end (December 31) London prices. This item shows reserves expressed in terms of the number of months of imports of goods and services they could pay for (Reserves/Imports\*12).

Data Source: IMF International Financial Statistics (and data files)



Exports of goods and services represent the value of all goods and other market services provided to the rest of the world. They include the value of merchandise, freight, insurance, transport, travel, royalties, license fees, and other services, such as communication, construction, financial, information, business, personal, and government services.

Data Source: World Development Indicators