Getting Over Under-Taxation

By

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Introduction

The persistence of a low tax to GDP ratio has been frequently mentioned as a key reason underlying an unimpressive development trajectory; successive governments in Pakistan, both elected and militarily appointed, have struggled to gain the fiscal space necessary to drive inclusive and durable economic growth. . Though a number of remedial measures are suggested in the literature, these tend to operate on the assumption that the issue in Pakistan is one of under-taxation, rather than over-taxation. This paper will argue the focus of tax reform in Pakistan has disproportionately fallen on the former, rather than the latter.

The limited extent of the academic output on tax policy in a Pakistan specific context is surprising and has allowed for the proliferation of a flawed understanding of the issue. This tends to be fixated with selected aspects of the present regime; primarily the ratio of indirect to direct taxes, the conspicuously narrow tax base, and the related issue of regressivity. This simplistic focus has obscured the debate and crowded out scholarly expertise in an area that is generally, as evident from the material on other countries, addressed by a substantial literature.

A contribution that this paper will make is to present an overview of the current state of understanding on taxation in the context of a developing country. This will provide a more relevant framework for understanding the issue of a low tax to GDP ratio in Pakistan. It will be argued that the ascendancy of indirect taxation, a narrow tax base, and a large informal economy are all an outcome of poor administration, which has lead to dependence on a small number of contributors. As a result, those contributing to revenue collection in Pakistan may be considered over-taxed, rather than under-taxed, as a low tax to GDP ratio might imply.

The remainder of the paper is organized as follows; the subsequent section addresses the issue of indirect taxes, arguing that it is the circumstances that are associated with developing countries in general, rather than Pakistan in specific, that are responsible for the ascendancy of indirect taxation. Dependence on this as a source of revenue is unlikely to change unless there is a dramatic shift in the way that tax administration and compliance is approached. Following that, there is a discussion on the issue of the narrow tax base and the suggestions that it can easily be overcome. As a result, the role of administration is once again emphasized. The next section discusses a central point of this paper; that the nature of the informal economy is such that recommendations for simply widening the tax base must be taken with a pinch of salt and that the focus of policy should be on facilitating the formal, rather than restricting the informal sector. The final section concludes and offers recommendations.

The issue of indirect taxes is more complex than perceived.

The dominance of indirect taxes is a common objection when concerns about equity are articulated. There are two components of the hostility towards indirect taxation. One is that it is considered regressive, and the other is that shifts the burden of taxation away from more affluent segments. Despite this, indirect taxes tend to be dominate revenues in developing countries. So, a high ratio of indirect to direct taxes is not a Pakistan specific tendency. Furthermore, there is an argument to be made for the relative ease of collection of indirect taxes when the informal economy is sizeable.

Gordon and Li (2009) make three observations about the differences in tax structures between richer and poorer countries. One, that the corporate income tax is a more important source of revenue among poorer countries (19.3% of revenue, compared with 9.7% in richer countries). Two, that tariffs are also important (16.4% of revenue, compared with a trivial fraction in richer countries). And three, that seignorage represents a major nontax source of revenue among the poorest countries (21.8% of tax revenue, compared with 1.7% in richer countries).

Nevertheless, in a global context over recent years there has been a shift towards direct taxation. This may be attributed largely to the shrinking volume of trade taxes as countries increasingly adopt more liberal trade regimes (Martinez-Vasquez, Vulovic, Liu, 2011). Despite this there is still a stark difference between the direct to indirect tax ratio in developed countries relative to developing countries. Martinez-Vasquez et al. (2011) find that in developing countries, the choice to opt for a low direct to indirect tax ratio indicates a preference for economic growth and FDI over income redistribution and macroeconomic stability.

Such a choice is related to the ascendancy of endogenous growth approaches over supply side economics. According to the latter, patterns of taxation are not relevant to growth from a long term standpoint. This is in contrast to endogenous growth models which incorporate the effects of human and physical capital accumulation. So, externality effects can arise even from stable tax structures and have effects on growth (Martinez-Vasquez et al. 2011)

The case of Pakistan is not unique in the context of indirect taxation. Particularly, the reliance on trade taxes is a common phenomenon. Besley and Persson (2013) note that shifts in patterns of taxation tend occur as states develop; broader tax bases are thus emphasized and exemptions are limited with indirect taxes diminishing in importance. Hence, developing countries differ in this regard from their developed counterparts where "taxes on income and value added do the heavy lifting in raising sufficient revenue to support the productive and redistributive functions of the state" (Besley and Persson, 2013).

Data shows that Pakistan's reliance on indirect taxes is higher than its regional counterparts. Pasha and Ghaus-Pasha (2015) note that indirect taxes[i] in Pakistan account for 65% of revenues. This may be compared to 43% in India, 78% in Sri Lanka, and 51% in Egypt. In these three countries, tax to GDP ratios are 9.7%, 12.4%, and 14.1% respectively. This indicates that a higher ratio of direct taxes is likely to result in higher revenues; this contention is supported by ratios in other developing nations. Gordon and Li (2009) find that "On net, poorer countries collect on average only two-thirds or less of the amount of tax revenue that richer countries do, as a fraction of GDP." This is so even though poorer countries require heavier investments in infrastructure and education, implying that the contrast in taxation patterns might be indicative of differing tastes and preferences related to public vs. private goods.

What then might be the reason for the dominance of indirect taxation? The literature reveals that there are a number of instances when indirect taxation might be preferable to direct taxation. Atkinson (1977, cited in Martinez-Vasquez, Vulovic, Liu, 2011) observes that indirect taxation may be preferred on the grounds that it offers choice. Related to the matter of choice is the ease of collection. Besley and Persson (2013) note that tax to GDP ratios in developed countries today are remarkably similar to those 100 years ago in the countries that are now classified as developed. They attribute this to endogenous fiscal capacity, the enhancement of which underlies shifts from indirect to direct tax reliance (Besley and Persson, 2013).

An emphasis on rates shifts the focus to administrative difficulties. What is eventually gathered reflects the combined effects of the informal sector as well as inefficiencies in the administrative machinery. "Thus an additional rupee could be raised as easily by enhancements in the administrative capabilities as it would from raising the tax rates while keeping administration constant" (Ahmad, 2010).

This observation may be related to the issue of revenue targets. Joshi et. al note that the recent literature indicates that an emphasis on revenue targets, by governments as well as donors, is a part of the problem as revenue targets tend to focus on short-term and often coercive collection to the detriment of investments in endogenous fiscal capacity.

Such a view lends support to the over-taxation hypothesis where revenues are sought from a limited segment of potential sources, rather than a wider net which would entail a more long term approach. From the standpoint of future policy, there is a case to be made for increasing the share of direct taxes in total revenue collection. This is of course a standard prescription and has been suggested before (Pasha and Ghaus-Pasha, 2015). However, it is worth noting that much of the emphasis on direct taxation is based on a notion of regressivity whereby it is argued that direct taxation is preferable because it carries out a redistributive function.

Vasquez (2008) points to the lack of information pertaining to the fairness of the tax system in Pakistan. His analysis indicates that even though poorer groups are responsible for contributing a large share of revenue, the tax system is proportional to mildly progressive for the lowest 60% of the population and progressive for the remainder, with the richest 20% responsible for 40% of taxes. Despite this the general perception is that the system is regressive and this view has probably weakened compliance.

Additionally, it may be argued that the persistence of informality is inconsistent with the regressivity view. As noted by La Porta and Shleifer (2014), informality is the outcome of poverty. Based on this, any attempts to reign in informality to widen the tax base imply a more regressive structure where poor people are regarded as a source of taxes. This point is further discussed later in this paper.

The issue of a narrow tax base is less complex than perceived

The narrowness of Pakistan's tax base is mentioned repeatedly in news reports as well as academic studies; this is not surprising because the low tax to GDP ratio may be directly attributed to the fact that out of a total population of 180 million, active filers barely exceed the 1 million mark. This situation can be improved quickly through administrative measures that entail a combination of political will and technology

In their critique of budgetary measures proposed by the federal government of Pakistan for FY14, Bukhari and Haq (2013) dismiss claims that relatively low revenue collection may be attributed to a narrow tax base. As one example, they point to the tax potential of the 100 million plus base of cellular phone users, emphasizing the need to distinguish between taxpayers and return filers. The latter are only 1.2 million in number but this number may be increased to 50 million if with the assistance of the National Database and Registration Authority, information on bank accounts, car ownership, and energy consumption, is utilized by the FBR to assign NTNs.

Here it is worth mentioning that the issues of tax evasion and avoidance are often conflated. Whereas evasion may be seen in the instance of non registration, the issue of avoidance in Pakistan is closely related to a culture of exemptions. Exemptions, also known as tax expenditures, are defined by Atshuler and Dietz (2008), cited in Pasha and Ghaus-Pasha (2015) as “revenue losses attributed to tax laws which provide for a special exclusion, exemption, deduction, tax credit, preferential rate of tax or a deferral of tax liability”. A summary of the of the tax expenditures in Pakistan is available in Pasha and Ghaus-Pasha (2015) and more detailed analysis in Ahmed and Ather (2014). Tax expenditures reinforce the political dimension of revenue collection, particularly since the FBR has the authority to issue Statutory Regulatory Orders (SROs) to grant concessions, waivers and exemptions, without parliamentary approval.

This is of course directly related to the issue of administration which was discussed earlier. For this reason, an overhaul of the FBR with a view to establishing an autonomous revenue authority has been suggested in a number of studies (Pasha and Ghaus-Pasha, 2015; Ahmed and Ather, 2014; Vasquez, 2008). At present, the role of the Ministry of Finance in revenue collection is to set annual targets for the FBR. So, the former evaluates the latter on the basis of how much it collects. As mentioned earlier, this practice promotes short terms measures instead of incentivizing investments that have a long term impact.

The issue of the informal economy is central to the issue of over-taxation

The complexity of the role of the informal economy is evident from the revival of the tendency to see development as dualistic. This perspective emphasizes the role of the formal economy in controlling spread of informal economy.

Dualistic views are centered on developing countries, and hold that development flows from the formal to the informal (Lewis, 1954). Clement (2015) contends that this standpoint, in which a subsistence economy coexists with a modern economy has more validity than the notion of a continuum where a “distinct informal sub-economy is encapsulated within the formally accounted economy”. The dualistic approach has also been endorsed by La Porta and Shleifer (2014) who find that empirical evidence supports the dual view of informality. They observe that the informal economy is extremely large, and characterized by low productivity, which keeps it persistently separate from the formal economy, with informal firms rarely transitioning into formal firms. Informality shrinks only when the overall economy grows and develops. These characteristics are consistent with the dual view of development.

La Porta and Shleifer (2014) caution against steps to formalize the informal, suggesting that structural policies designed to promote formality should be viewed with prudence, taking care to distinguish between those policies that encourage formalization, and those that discourage informal activity. The simplification of registration as endorsed by De Soto (1989) is consistent with this approach even though the evidence suggests that it is unlikely to have huge benefits. Skepticism may be directed to those policies that seek to tax or regulate informal firms. Such policies may have the effect of driving informal firms out of business, rather than making them formal. The outcome of this will be poverty and destitution of informal workers and entrepreneurs. This is based on the observation that informal firms are fundamentally different from their formal counterparts. Since the formal are extremely inefficient, it is advisable to avoid policies that impose additional costs.

Evidence indicates that the size of the informal sector in poor countries reflects the low productivity of uneducated entrepreneurs, who generally run small and inefficient firms (La Porta and Shleifer, 2014). The growth of this inefficient sector may be thus only be curtailed by the development and expansion of formal firms that are managed by educated entrepreneurs, who have the capacity to run larger and more efficient firms. A shortage of educated entrepreneurs is thus a strong impediment to the formalization of the informal economy, as it is these entrepreneurs who form and manage businesses with which informal firms cannot compete, despite the advantages they enjoy through the evasion of taxes and regulation. The facilitation of these educated entrepreneurs should thus be the focus of policies that seek to limit the size of the informal sector.

In its present state, Pakistan's informal economy shares the traits of those described above; it is largely unproductive and run by entrepreneurs who do not have the capacity to manage large and efficient enterprises. Given these characteristics, it is unlikely that drawing such firms into the tax net simply through administrative or regulatory measures will raise tax revenues. Instead, it is likely that the costs of taxation and regulation will drive many such firms out of business, thus having a harmful impact on overall economic growth.

Conclusion

Under-taxation then is clearly not the main issue that restricts the improvement of Pakistan's very low tax to GDP ratio. Further, the perception that this may be rectified through simply bringing the large informal economy into the tax net, reveals a fundamental misunderstanding of not only how informal economies may be formalized, but also of how the formal economy contributes to growth.

In the absence of measures that offer a long term opportunity for informal firms to become formal, Pakistan will continue to rely on indirect taxes. These are of course prone to regressivity but given the alternative of raising the tax burden on existing filers, these are one way to avoid further over-taxation. Another is to utilize consumption information to increase the number of registered tax payers.
At the core of non-compliance is weak administration. Investments in improving compliance another means to raise collection while keeping rates unchanged. Such an approach calls for an overhaul of the FBR, as well as its relationship to the Ministry of Finance.

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[i] All taxes except those levied on incomes and profits.