Reforming the Taxation Structure

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An essential component of a programme for structural readjustment is a reform of the taxation system so that it supports the basic thrust of the reform package. Although the system of taxation in Pakistan is supposedly based on the principles of equity and has a progressive character it has not actually functioned in this manner. This is so because the system has evolved as a result of changes made at different moments in time in response to the exigencies of the government’s revenue needs and the pressures exerted by different lobbies. The attempt to use the taxation system to serve a variety of social and economic objectives has created distortions and made the structure rather complex and non-transparent, thereby weakening its potency as a revenue generation instrument, while adding unnecessarily to costs. The structure is, therefore, characterised by direct taxes not being paid by those who should be paying them, indirect taxes being largely paid by those who are otherwise considered too poor to pay taxes and subsidies and exemptions being cornered by those who should not get them.

There are limits to which expenditures can be compressed without hurting the economy, unless there is a decline in defence expenditure and the debt servicing obligations can be reduced by using the proceeds from privatisation for debt retirement. Therefore, revenues must rise for the long term sustainability of the economic and taxation reforms. Hence, the prime objective of the tax reform should be to enhance the revenue buoyancy of the system by overhauling the structure and administration while facilitating compliance and enforcement.

The package of reforms being designed by the government is also expected to address the basic issue of the inadequacy of the federal government's revenue receipts, which currently stand at a mere 17 per cent of GDP. At Rs. 211 billion in 1993-94 they fell short by Rs. 32 billion to cover the government's revenue expenditure. The gravity of the problem confronting the state should be apparent from the fact that it is unable to meet even its annual running expenditure from the taxes it levies on its citizens. If the government has to borrow to satisfy its recurring obligations it is understandable that all development expenditure has to be financed from loans.

With this introduction, we examine below the government’s strategy on reforming the structure of income tax, customs duties and sales tax.

Income Tax

Largely because of some innovative taxation measures introduced during Nawaz Sharif's tenure, revolving around presumptive taxes and greater reliance on withholding taxes, the government's revenue from income taxes has shown a robust growth of 30 per cent per annum during the previous three years. The extension of the systems of withholding and presumptive taxes has facilitated both revenue generation from the hard-to-tax sectors as well as detection of tax evasion (especially in respect of capital incomes), to such an extent that withholding taxes now represent over 65 per cent of gross income tax revenues. The revenues from these sources has grown at a remarkably healthy rate of over 40 per cent per annum during the period 1989 to 1993. These instruments have simplified the taxation system, thereby reducing the cost of compliance for tax payers.

However, although the share of direct taxes in the total tax revenue of the federal government has grown from 12.7 per cent in 1990-91 to nearly 17 per cent in 1993-94 (having risen from 2 per cent of GDP in 1990-91 to over 3 per cent of GDP) the level of direct taxation still compares rather poorly with the 5.5 per cent of GDP in the case of other developing countries and 7 per cent of GDP for similarly placed economies.

Even rough estimates suggest that the difference between actual receipts from direct taxes and potential revenue is still quite large. If we, for instance, assume that 70 per cent of incomes are from non-agricultural activities then in 1993-94 the income liable for taxes was around Rs. 1,100 billion. If 50 per cent of this income had accrued to the richest 20 per cent households then the potential base for income tax would have been Rs. 550 billion. Even a 15 per cent tax would have yielded over Rs. 82 billion whereas total receipts from income tax were Rs. 45 billion. In other words only 55 per cent of potential incomes are being taxed. If this base were to be taxed almost 28 per cent could be shaved off the budgetary deficit.

The base of tax payers is small, partly because of the exemptions granted to different types of income. Despite the improvements referred to above, the government has been unable to adequately exploit the instrument of income tax. There is, therefore, a need for a further widening of the base (bringing more tax payers into the net), particularly the withdrawal of the numerous tax exemptions. According to one estimate the cost of exemptions is as high as 2 per cent of the GDP, between Rs. 35 to Rs. 40 billion today.

Furthermore, the growth in tax revenues from the corporate sector has been disproportionately lower compared with the increase in turnover or, even, paid-up capital. It is instructive that of the 330 companies listed on the Karachi Stock Exchange in 1991/92 only 90 were paying income tax, of which only 20 companies had paid income tax every year since 1981. Several companies that seem to be doing well and paying decent dividends are not paying taxes because of liberal tax exemptions/provisions.

Therefore, the exemption or concessionary provisions, particularly those applying to incomes from agricultural activities (wealth in the form of agricultural assets) should be withdrawn and the level of income at which the maximum rate would apply should be raised. The raising of the level of income for the application of the maximum rate would neutralise the impact of inflation in pushing money incomes into the higher tax brackets, while the elimination of exemptions would not cause any revenue loss.

For the corporate sector we could retain the requirement of a minimum tax introduced in the shape of a turnover tax introduced earlier. However, without compromising on the principle of a minimum tax paid by all tax payers, we should replace the turnover tax by a levy – a fixed percentage – on gross profits or by a tax on depreciated business assets (book value of assets adjusted for inflation). Such a tax would put pressure on less efficient companies to use their assets more productively.

Furthermore, in view of domestic socio-economic and political realities and the weak administrative structure, there should be greater recourse to withholding and presumptive taxes; the fact that withholding taxes form a predominant part of income tax revenues indicates the weakness in the administrative areas of taxation.

The purpose of a presumptive system is not to absolve the tax department of the responsibility to identify those liable for taxation but to make it convenient for the marginally taxable, who are not able to maintain regular accounts, not to have to maintain elaborate records for tax purposes. An example frequently cited as evidence of failure of the presumptive system relates to the fixed tax for shops. However, the reasons for the poor response of the presumptive scheme introduced for shops includes fear of being caught in the clutches of the tax department, having once filed a statement with them, and the perception that the chances of being caught and penalised are, as things stand today, low anyway. The presumptive tax at the rate of x rupees per sq. ft. for different types of shops needs to be modified to reflect the location of the market and the nature of the business conducted from the outlet (this information is readily available in the records maintained by the Provincial Excise and Taxation Department for the purposes of property tax). This rate should be indexed to inflation and the GDP growth rate.

The maximum rate of tax can be further lowered but after all tax exemptions and incentives-related provisions have been withdrawn. The Nawaz Sharif government's political strategy in this regard was faulty, it reduced tax rates without simultaneously withdrawing all the major exemptions, thereby making it politically difficult for the successor government to remove the many remaining exemptions without offering anything in return.

At the level of an individual tax payer, there is need to tighten tax provisions regarding the value of fringe benefits like furnished accommodation, free use of company cars (in many cases these are luxury cars), free provision of utilities, servants, etc. This could even be achieved by instituting a separate tax for fringe benefits.

To encourage tax payers to maintain records the government could legislate that those with a turnover in excess of a specified level would have to maintain records (the level of detail varying for different kinds of activities, sectors or industries) with a penalty of say 10 per cent to 20 per cent throughout the period the tax payer is in default. Other penalties could include disallowance of interest charges as an expense or disqualification from entering into contracts with the government.

Small scale enterprises with a turnover below this specified limit should only be subjected to a presumptive tax (a surcharge on electricity consumed was introduced as a proxy for income three years ago).

We could also introduce a system whereby the income tax number should become a requirement for gaining access to telephone and gas connections, credit facilities, etc. To make this condition easier for farmers this requirement may be exempted for facilities extended in rural areas.

The poor administration of taxes challenges the principle of equity because actual recovery depends upon the conscience of the potential tax payers. Also, as a consequence of weak management there is a tendency to rely on the taxation of easy-to-tax sectors thereby creating intersectoral inequity in tax incidence.

To ensure workability of the system some deterrents have to be introduced. But then, if mere documentation, stricter laws and warnings of reprisals could frighten the tax evader and produce the desired results, the black economy would have disappeared long ago. The tax dodgers have known all along that the various policies introduced and the threats issued by governments from time to time have had a hollow ring to them. A variety of government-sponsored measures have had a great deal to do with these impressions on the minds of the tax evaders. As long as the tax evader perceives, and in fact experiences, that the cost of evasion (government attitude, extent of penalty, probability of being caught out, etc.) is low and that in most cases he will get away with it, how can he be expected to mend his ways? For him a simple calculation of costs and benefits of non-compliance are far in excess of the costs. Along side the ultimatums of far reaching consequences there have been a number of promises of turning a blind eye to past evasion if investments are made in government black money whitener schemes (whitener bonds, foreign exchange accounts, bearer schemes and in public sector enterprises that the government wishes to dispose off) and promises are made that they will become good, honest tax paying citizens in the future. Strong words and repeated warnings on the government's determination to bring to book offenders, cannot seriously be expected to force recalcitrant tax evaders to disclose all and repent, especially if these warnings are supplemented with tax cuts and "all will be forgiven" incentives.

The behaviour of tax officials towards tax payers also influences the climate for compliance. If they act as facilitators they are likely to be more successful than if they act as policemen hunting down tax evaders. Ultimately, however, compliance depends upon the socio-cultural environment within which taxes are administered. Although cultural change only takes place slowly, it will only come if there is an environment conducive to change, which is currently rather poor considering that tax evaders continue to enjoy the hospitality and friendship of those holding the highest offices in the land. Tax evaders rank among the who's who of the land who, even when they do not stalk the corridors of power, command respect from the ruling elite. It is instructive that since the birth of the country no one has ever been convicted of tax evasion, despite it being widespread. The government's commitment to check evasion can only be taken seriously if tax evaders are not only prosecuted but also barred from holding any public office.

The Nawaz Sharif government had achieved notable success in opening up the budget formulation process to those most affected by these decisions – the business community. Unlike the past practice of budget-making in secrecy, representatives of trade and industry were members of a high powered committee on the budget. This positive development was reversed by this government. There is an urgent need to revive this committee and open up the budget making process again.

Finally, all the measures discussed above need to be supported by a system of rewards and penalties for tax administrators.

Indirect Taxes – Import Tariffs

The present package of reforms in the indirect taxation structure is centred around the lowering and rationalisation of import duties and the introduction of a broad-based general sales tax to be levied at the rate of 15 per cent.

Under the taxation reform package the maximum tariff rate for customs duties will be brought down to 35 per cent by the beginning of 1996-97. In the past the high tariffs encouraged smuggling. According to one estimate this was to the extent of 5 per cent of GDP, Rs. 80 billion in today's prices. Although tariff rationalisation may lead to an overall reduction in tax revenues, by radically altering the protection levels currently available to a number of sectors and manufacturing units, industrial efficiency would be expected to improve.

In principle, the revised structure should discourage smuggling while facilitating and giving direction to the process of industrialisation in the country. For instance, it should permit duty free imports of inputs to support the export-oriented industry. It should also be simple to supervise and regulate (an objective that will be largely achieved through a reduction in the number of duty slabs and in the number of classification of goods) and make more transparent the discretionary powers granted to the administration to give or cancel fiscal concessions through SROs, should be withdrawn.

Another key area of reform relates to exemptions. There is a myriad of exemptions which has resulted in 40 per cent to 45 per cent of imports entering the country duty free. The consequence of these exemptions can be illustrated by an examination of the import data for the nine months to March 1995. During this period customs duty collection was a bare Rs. 35 billion against the potential collection of Rs. 65 billion, giving an effective rate of import duty of only 24 per cent. In other words, if all exemptions were to be abolished and a flat rate of 24 per cent were to be imposed on all imports, the government would have, at the very least, collected as much as it is collecting now.

The other harmful effects of these exemptions have included rate structure distortions, extension of discretionary powers of officials, enhancement of the vulnerability of the duty structure to the pressures of special interest groups and, finally, encouragement to rent seeking.

However, there could be political costs if all concessions were removed. Today some public sector agencies such as WAPDA and PTC have access to imports at preferential duty rates. The impact on utility tariffs after the elimination of these advantages could have daunting political consequences.

Also, to effect the changes envisaged under the tariff reform package, greater consultation with the parties likely to be affected is urgently required. Unfortunately, the workings of the Ministry of Finance continue to be shrouded in unnecessary, and perhaps suicidal, secrecy.

General Sales Tax

A key component of the package has been the introduction of a broad-based General Sales Tax (GST). GST grew by 29 per cent in 1993-94 and 41.5 per cent in 1994-95 and the share of sales tax in total tax revenues increased from 7.6 per cent to 14.4 per cent, while sales tax receipts from domestic production as a percentage of total sales tax receipts were 46.5 per cent in 1994-95.

The primary purposes underlying the introduction of the GST was to a) neutralise the revenue loss that would arise from the reduction in import duties as a result of the tariff reforms, b) tax consumption; and c) to create an incentive for documentation, through the institution of a system of invoices for raising claims for tax refunds.

The generalised sales tax is obviously preferable to a straight forward sales tax because it helps avoid the cascading effect of a tax on turnover and the snowballing incidence of a tax on tax as the taxed product passes from one manufacturer to the other and then onto the wholesaler and from the latter to the retailer. It would be in the interest of a firm to account for the taxes that it has paid on its inputs otherwise it would have to bear the cost of this tax. Any firm attempting to understate its output would be caught by the disclosures of those who purchased inputs from this firm. This cross-checking and cross-auditing would also enable the tax authorities to check tax evasion.

Such a tax would also support efforts to improve efficiency as a firm would not be exempted from its tax liability even if it were to make a loss. It would, therefore, facilitate the release of resources for use by the more efficient producers.

The GST is in the process of being extended to the retail level. The shifting of GST to the sales point will allow sales tax collection even on smuggled goods – a yield of around Rs. 156 billion – thereby also protecting industries hit by smuggling. Value added in trading activity will also become taxable (value added at wholesale and retail level is 20 per cent).

The broad basing of the tax to include small units is being welcomed by the larger enterprises. Greater documentation will also facilitate the assessment of income tax. However, the cost of compliance will increase with the need for maintaining a more elaborate accounting and documentation system. It is difficult to estimate the associated administrative and compliance costs as well as the potential for overstated claims for tax credit.

The GST, based on principles of VAT, is a rather sophisticated tax which has not been introduced even in developed economies such as the US. Hence, it seems to run contrary to the objective of greater simplification of the taxation system. Therefore, there should be an incentive to maintain records. The government could decide either to levy a lower, say a 12 per cent GST for those maintaining records or it could impose a punitive presumptive GST (over and above the lack of a facility to such assesses to adjust for the GST paid by them on their inputs) for those reluctant to have a set of records for an assessment of their liability on account of GST.

On the face of it, the extension of the system of general sales tax, the replacement of specific customs duties by *ad valorem* duties, the elimination of different tax rates for the same commodity according to use, the reduction in rates and categories of duties, etc., all seem desirable and overdue.

However, in the view of this writer, a greater reliance on presumptive taxes is desirable both on the grounds of practicability (because of the simplicity it introduces by reducing the discretionary element in taxation), considering the characteristics of Pakistan's socio-economic structure, and the capacity (as well as the credibility) of the tax collection machinery. Such taxes enable the government to broaden the tax base. In the case of the extension of the GST to retail outlets, it will be difficult to monitor the turnover of shops in view of the proliferation of 'with bill or without bill' practices. A rate as high as 15 per cent will also open up avenues for corruption. A presumptive tax on the area of the shop (taking into account its location in the city) would at least for the foreseeable future, be a better option.

Another area that requires urgent attention relates to sales tax exemptions. Exemptions, as argued earlier, are the biggest curse in the taxation structure, as a result of which the average rate of sales tax on imports and domestic output in 1991/92 was 5.6 per cent and 5 per cent respectively, although GST was 12.5 per cent. The various exemptions with regard to sales tax, particularly for those settling in lesser developed areas, are also burdening tax revenues heavily. Sales tax exemptions to those locating in Hattar and Gadoon Amazai are not achieving much by way of objectives of development and industrialisation of the backward regions as they have encouraged 'border hopping' – manufacturing units are being merely established on the borders of the exempted areas to be as close as possible to Islamabad, the non-exempted area. As an illustration take the cases of an existing unit in Hattar manufacturing polyester fibre and another similar sized enterprise being set up. The net loss of sales tax revenue from these two units alone will be Rs. 1400 million per annum. Large revenue losses are also being incurred as a result of exemptions to manufacturers of cement, plastic goods and iron and steel products in Hattar and Gadoon Amazai.

The sales tax is being supported by the provincial administrations, as 80 per cent of the revenues from it will flow to the provinces. However, a tax rate of 15 per cent will practically extract all the surplus available at the local level, which local governments would like to tap to finance their activities. A 15 per cent GST, unless it is shared with the local bodies (of which there is little hope), is an anti-decentralisation move. In Pakistan, decentralisation is the only viable solution now left to efforts directed at improving the access of the population to social welfare services of reasonable quality. It, therefore, runs contrary to the spirit of the much touted 'social contract'.

In the context of the GST, greater effort needs to be directed at the development of mechanisms for tax collection and the training of both tax administrators and tax payers.

Conclusions

In the early days of the implementation of the package of tax reforms the overall elasticity and progressivity of the tax structure in Pakistan is rather low, just 0.3; the elasticity of customs duties is 0.31 and even direct taxes are inelastic, although at a more respectable 0.61.

Our review suggests that the problem of the ownership of the reforms and their acceptability among both tax payers and tax collectors and the institutional arrangements for their effective execution continue to be areas of weakness which could end up scuttling the whole process of the reformation of the taxation structure.