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Reform Issues in Tax Policy and Tax Administration for Self-reliant Development

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INTRODUCTION

Similar to most countries, objectives of the taxation system in Pakistan are not well-defined. The stated objectives include resource generation, promoting area/sector-specific economic activities, discouraging undesired imports/production, and encouraging savings and investment. These objectives have been met through a variety of tax concessions and exemptions, rebates and credits, and differentiated tax rates and tariffs. The revenue short falls/leakages resulting from preferential tax treatment of the desired activities were offset through appropriate changes in various fiscal instruments, e.g. high tax rates and tariffs, regulatory duties, extended withholding and presumptive taxes, excise duties on services, and many more. These measures, in turn, have complicated the taxation system and adversely affected the equity, neutrality and progressivity thereof.

Consequent to the pursuit of above conflicting objectives, Pakistan's taxation system is characterised by a number of structural problems. These include:

(i) The overall level of fiscal effort is low and the Tax-to-GDP ratio remains, more or less, stagnant at between 12 to 13 percent.

(ii) There is over dependence on indirect taxes notwithstanding that the share of direct taxes has increased from 16 percent in 1990-91 to over 35 percent during 1997-98. This has increased the regressivity of the taxation system and imposed a higher excess burden of taxation.

(iii) Within indirect taxes, dominant share continues from taxes on international trade (both customs duties and sales tax) which has promoted inefficiency, distorted resource allocation and encouraged illicit trade.

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(iv) Effective tax bases of most taxes is narrow due to wide ranging exemptions/concessions and rampant tax evasion.

(v) The tax administration is characterised by conventional and inefficient work distribution, out-moded procedures, lack of appropriate skills, dependence on manual rather than automated functioning, considerable arbitrariness and discretion. The common perception about the taxation system underlines of corruption, inefficiency and arbitrariness.

In the background of above structural problems and growing institutional decline and erosion of fiscal, financial and administrative discipline, low economic growth and high fiscal deficits, Government have ventured on serious structural reforms. The fiscal component of the Economic Reforms Package of March 1997 and the subsequent policy announcements through 1997 and 1998 Budgets are part of series of steps in this direction. Notwithstanding these major policy initiatives, adequate expansion of effective tax bases and increase in revenues as percentage of GDP still remains a dream unfulfilled.

The present paper examines within the overall macro-economic setting, salient features and structural problems of taxation system underlying the complexities and dynamics, assessment of previous tax reforms, and key issues in tax policy and administration. Specific recommendations for improving the resource mobilisation, both in short term and long term, have been made. Policy and administrative aspects are separately discussed.

MACRO-ECONOMIC SETTING

While Pakistan has generally witnessed a satisfactory level of economic progress in terms of growth in GDP and structural changes in composition of out-put, and the performance in key sectors up to 1980s has been reasonable, the problems of structural imbalance in the public finances have been noticeable since the mid 1970s. The over all fiscal deficit remained in excess of 6 percent of GDP until 1992-93 which was subsequently brought down to less than 6 percent. The rapidly growing interest payments on high level of borrowings in early years, however, exerted a strong upward pressure on current expenditure which, overtime, has increased from 13.6 percent of GDP in 1980-81 to 18 percent of GDP in 1997-98. Increase in debt servicing and defence expenditure has kept public expenditure at a high level, i.e. 69.65 percent of total expenditure in 1997-98 as against 42.7 percent in 1979-80. As percentage of federal revenues, such expenditure has increased from 64.56 percent in 1979-80 to 78.48 percent in 1997-98, thereby scaling down of public sector development expenditure from 9.3 percent in 1980-81 to 3.1 percent in 1997-98.

Improvements in the resource mobilisation were observed until the year 1991-92. After that, it is a story of continual decline i.e. total revenues as percentage of GDP went down from 19.1 percent in 1991-92 to 16.1 percent in 1997-98. Tax-to-GDP ratio declined from 14.3 percent in 1988-89 to 12.7 percent in 1997-98 (11 percent in 1998-99). Direct Taxes-to-GDP ratio, during this period, increased from 2.2 percent to 4.1 percent. The indirect Taxes-to-GDP ratio declined from 10.0 percent to 7.5 percent—the major declined being in customs duties. The ratio of non-tax revenues to GDP has, however, been moving up. In absolute terms, the increase in tax and non-tax receipts in relation to GDP was almost equal. The minimum target for the Tax-to-GDP ratio is to increase it by about one percentage point every year until it reaches 17 percent of the GDP.

As to the level of total fiscal effort, wide divergence is observed between the federal and provincial Governments. The federal Tax-to-GDP ratio has remained between 13 percent to 14 percent declining to 11 percent for 1998-99. The provincial Tax-to-GDP ratio, however, declined from 0.9 percent in 1980-81 to 0.6 percent in 1997-98. Several explanations have been offered for the poor performance of the latter, such as limited fiscal space and narrow and inelastic tax base. The gap between provincial expenditure and revenues has now become so large that a radical rearrangement of taxation powers between the federation and the provinces is required.

In terms of international comparisons, level of tax revenues in Pakistan is lower than similarly-circumstanced developing countries. Against the average Tax-to-GDP ratio of around 18.5 percent in case of several developing countries, Pakistan's Tax-to-GDP ratio is 11 percent (for 1998-99). Further, share of direct taxes to the overall tax revenues in Pakistan has historically remained between 2.68 percent to 3.8 percent of GDP as against an average of 7.2 percent for other developing countries. Tax-to-GDP ratio in respect of indirect taxes is around 9 percent in Pakistan as against 5.2 percent in case of other developing countries. The overall cost of revenues collection has generally remained around 1 percent for Pakistan which is modest in comparison with other developing countries.

The improved performance in direct taxes is largely due to the extension of the withholding tax regime during '90s. Payments accompanying corporate tax returns have also continued to grow despite some fall in tax rates. Major additions in revenue were observed in 1997-98 (around 104 percent) consequent to the changed basis of computation of advance income tax payments under section 53 of the Income Tax Ordinance, 1979. One the contrary, indirect tax revenues declined due to changes in customs tariffs and the resort to capacity taxation, and fixed sales taxation have led to a loss in revenues. The broadening of the tax base of excise duties by its extension to telephone and banking services has only partially compensated for these losses.

The tax base for most of the taxes in Pakistan has been growing faster than the GDP, particularly in respect of direct taxes and sales tax. However, these tax bases have not been fully captured and the effective tax bases remain narrow and skewed. Thus, even though the buoyancy of the tax system has increased over time, the tax revenues have not grown adequately (partly due to distortions in tax policy and partly due to failure of tax administration). In consequence, the low elasticity coefficient remains depressed.

The elasticity of taxes has remained low. It is observed that high tax rates, pursuit of secondary economic and social objectives (through variety of tax concessions), non-taxation of agricultural income and an inefficient tax administration contributed towards the low elasticity in direct taxes. The story has been repeated in case of indirect taxes, especially the import duties. Introduction of fixed sales tax in some industries tended to reduce elasticity of GST. On the country, levy of ad-valerom taxes of capital incomes (which are growing relatively rapidly in the economy), the extension of ad-valorem excise duties to services like telecommunication and the switch-over from specific to ad-valorem duties are some of the factors responsible for enhancement in the elasticity of taxation system. It is of interest to note that tax expenditure due to exemptions from direct taxes and custom duties for the year 1990-91 has been estimated at around 116 percent and 55 percent of the total revenues respectively. Tax expenditures related to excise duties are relatively limited although the study carried out by the Resource Mobilisation and Tax Reforms Commission shows that the tax expenditure on cottage industries amounted to over Rs 3.2 billion in 1991-92.

It has been observed that the taxation reforms still do not focus adequately on efficiency. While the fixed taxes on agriculture and on capacity in industry, reduction in maximum tariffs and introduction of a VAT type of sales tax, particularly its extension to retail stage, is likely to improve efficiency in industries and contribute to a better allocation of resources, the process of reforms being still in the implementation phase, it is not possible to assess its contribution to greater efficiency.

As to 'progressivity of taxation system', it is observed that the increase in the share of direct taxes in federal tax revenues from 18 percent in 1991-92 to over 35 percent in 1997-98 has, *prima facie*, contributed to greater progressivity of the tax system. It is, however, important to note that the switch-over from several withholding to fixed taxes in the form of presumptive taxes has imparted the features of indirect taxes to the major component of direct tax. The fact that almost 40 percent of income tax receipts are collected via presumptive taxes and are passed on to the consumers as cost, it substantially dilutes the progressivity element. The progressivity of the tax burden may have further deteriorated with the levy of minimum tax under section 80 D of the Income Tax Ordinance, 1979 and the enhanced probability of selection for tax audit of small taxpayers in self assessment scheme. Relatively low revenue increases out of the tax audit of corporate and personal income returns, coupled with reduction in income tax rates, has benefited the upper income groups. The introduction of scheduler basis of income taxation in respect of most investment ('passive') income and several business income has rendered the taxation system least neutral.

While examining the progressively of taxation system in the context of sectoral incidence of taxes, the studies conducted by the Resource Mobilisation and Tax Reforms Commission for 1990-91 indicate the highest effective tax rates on cigarette and tobacco (86 percent), perfumery and cosmetics (48 percent), beverages (46 percent), soap and detergents (42 percent), electrical machinery (38 percent), tea blending (35 percent), paints and varnishes (34 percent), cement (33 percent), silk and synthetic textile (27 percent) and Gas (27 percent). Most of these sectors were subject to excise duties. The sectors which were found to be relatively under-taxed relate primarily to agricultural and services activities, catering to the upper income group. This discrepancy reflects lack of horizontal equity.

However, in terms of incidence of taxation by household income, the overall burden of federal taxes (during 1990-91) was regressive upto a household monthly income level of Rs 4,600. It became some what progressive on higher incomes because of income tax payments by upper income households. On the contrary, import taxes and excise duties were found to be markedly regressive. Incidence of sales tax, by and large, has been neutral with respect to the level of household income. Overall, the indirect taxes are significantly regressive and the tax burden was found to be around 13 percent on the lowest income groups which fell to less than 9 percent for the uppermost income group. Given the continuation of more or less same pattern of taxation, there are reasons to believe that the equity aspect of taxation, as observed for 1990-91, has undergone no significant changes.

On the compliance side, it has been observed that while the tax bases have improved overtime, the effective tax bases continue to be narrow and skewed. Major revenue leakages have been observed both in direct and indirect taxes. Smuggling of goods at massive scale continues unhindered from the established sea and land routes. Quantitative misdeclaration of imports are also very common. Evasion of sales tax, particularly at the manufacturing and whole-sale stage, is rampant. Compliance level for direct taxes is extremely low. For assessment year 1998-99, only 9,781 corporate tax returns were filed out of around 40,000 companies registered with the Corporate Law Authority. Similarly, around 600,000 income tax returns were filed by around 2.5 million persons engaged in business, profession and vocation. Only 300,000 wealth tax returns were filed for assessment year 1998-99. These represent no more than 20–25 percent of the persons otherwise liable to wealth tax. Large number of transactions subject to withholding taxes and capital value tax escape taxation for reasons of misdeclarations and/or inadequate monitoring. This explains the existence of large underground economy which is estimated at Rs 1115 billion in 1996. Sarfraz and Zafar have estimated the total tax evasion for 1996 at Rs 152 billion. It has also been observed that incomes from underground activities in the foreign trade tax sector have been higher than the domestic tax sector and non-tax sector and that the evidence suggests that the rate of growth in the black economy has been higher than the rate of growth of the formal economy.

SALIENT FEATURES OF THE TAXATION SYSTEM

Under the Constitution of Pakistan, 1973, the **federal government** is empowered to levy and collect taxes on income other than agricultural income, workers welfare fund, taxes on capital, i.e., wealth tax, capital value tax, capital assets tax, customs duties on international trade, excise duties on goods and services (excluding duties on alcoholic liquors, opium or other narcotics), and sales tax on imports, production and sale of goods.

The provincial governments are empowered to levy and collect taxes in respect of items other than those reserved for the federal government. These taxes include water tax, tax on trade and profession, stamp duty, duty on excises not included in the federal excise duty, electricity duty, entertainment duty, taxes on motor vehicles, tolls on roads and bridges, urban immovable property tax, betterment tax, capital gains tax, taxes on cinemas and hotels, and arms licence fees, court fees, cotton fees and various cesses. The provincial governments are not authorised to assess and collect entertainment tax and urban immovable property tax in cantonment areas within the provinces.

Local bodies, like municipalities and district and local councils, may levy and collect taxes falling in the jurisdiction of the provincial governments subject to the prior approval by the provincial government. The list of taxes, rates and fees livable by the local bodies is contained in the local governments Act which includes the urban immovable property tax, taxes on value of land, animals, toll taxes and octroi duties.

The most noticeable dimension of the taxation powers under the Constitution is that the provincial taxation powers relate to low tax bases. Even where the provinces have the powers to tax certain products, federal government has at times encroached upon their jurisdiction. The obvious examples include capital value tax and excise duties on services instead of sales tax which was part of the divisible pool.

TAX POLICY DEVELOPMENTS AND STRUCTURAL DISTORTIONS

Income Tax, Wealth Tax, Capital Value Tax

The income tax law has historically followed the global basis of taxation of income at flat rates for corporate income and progressive rates for personal income until 1990 when fixed tax for smaller tax payers was introduced. There was poor response notwithstanding its simplicity and low tax rates. Hence, this concept was discarded. The next major conceptual distortion in the taxation system in 1991 with the introduction of scheduler basis of taxation and conversion of several withholding taxes to presumptive taxes. The scope of withholding and presumptive taxes was expanded overtime with the result that presently more than two dozen economic activities are subject to these taxes as against 11 in FY 1990-91. Altogether, presumptive taxes constitute around 40 percent of the total income tax receipts. The third distortion was introduced through 1997 Budget by changing the basis of computation of prepayments u/s 53 of the Income Tax Ordinance, 1979, which although more than doubled the tax receipts on this account but created unnecessarily cash flow and future adjustment problems for taxpayers. The sum total of these developments was that during 1997-98 over 86 percent of the income tax receipts were generated via withholding/presumptive taxes and advance tax payments, about 4 percent from payments made along with corporate tax returns, and 2.5 percent from payments along with non-corporate tax returns. The policy emphasis on prepayments, as a major component of income tax receipts during the '90s adversely impacted the tax audit functions with the result that on the average additional tax receipts consequent to tax audit varied from 6–8 percent of the total amount of income tax receipt. Audit of non-corporate tax returns contributed only 0.2 percent to the total income tax receipts. The reduction in tax rates, particularly the non-corporate tax rates, has not improved tax-compliance. Exclusion of agricultural income from the federal income tax base has not only diluted the effective income tax bases, but also served as an instrument of tax-evasion and avoidance. Continuation of liberal tax exemptions has also contributed to the regressivity of income tax.

Generally, wealth tax has not been considered as a major source of revenues. Until 1994, wealth tax was levied only on non-agricultural assets. Self-occupied residential houses (in lieu of Rs 1 million basic exemption) and assets created through foreign remittances were/are exempt from wealth tax. Wealth tax was extended to agricultural assets through the 1994 Budget. The legislation provided for separately taxing agricultural and non-agricultural assets with Rupees one million exemption limit for each. Buildings appurtenant to agricultural land and motor vehicles were excluded from the taxable base. Produce index unit served as the basis of valuation for agricultural land. Altogether, it has compromised progressivity and equity of taxation system. There has been marginal revenue contribution (around Rs 6 million during FY 1997-98) from the agricultural sector. Valuation basis of taxable assets is questionable, particularly for the immovable properties as it is based on values adopted for stamp duly purpose rather than the market value. Minimum wealth tax on plots, buildings and motor vehicles introduced through 1997 budget on a notional basis is also debatable. The methodology for collection of pre-payments via advance taxes is inefficient as it leaves much to the voluntary compliance by tax payers.

Capital value tax, in its present form, has very limited scope as it applies only to the transfer of immovable properties, air tickets and imported/old motor vehicles. CVT collections being direct function of the valuation basis and monitoring arrangements, and it being adjustable against wealth tax payments reduces its efficacy as revenue generating instrument. Notwithstanding that CVT collections increased by over 110 percent during 1996-97 and remained at the same level inspite of across-the board 50 percent reduction in CVT rates in 1997-98, it can not qualify as a major source of federal revenue.

The present organisation of income tax and wealth tax department, in its relatively well-defined form, has successfully performed over the years. In an environment of shifting emphasis on withholding taxes and other pre-payment as a major means of revenue collection, the advantage of a traditional administrative organisation under which a tax unit encompasses all tax-related functions has become a disadvantage in handling of diverse functions. Specialised character of trade and industry no more permits handling of tax audit by generalists, as it requires trade and industry specialisation. Similarly, the system and procedures for filing of tax returns, assessment and payment of taxes, record keeping, monitoring of withholding taxes and other pre-payments, booking of tax-defaulters, and access to market information are inefficient and time consuming. Use of automation is limited to data-entry of tax-payment challans and simple tax computation of salary and business tax returns. Management information system for better tax audit and expansion of effective tax bases is not in place inspite of around Rupees one billion investment in computerisation of CBR.

The practice of the same tax unit having jurisdiction over income tax and wealth tax returns has led to a lopsided emphasis on the former at the expense of wealth tax returns which can be a major source of additional revenues. Similarly, allocation of personnel dealing with corporate and non-corporate income tax payers has historically been disproportionate to their revenue generating capacity. The selection basis for tax-audit continues to be random balloting rather than an objective parametric approach based on some kind of discriminant functions. Coupled with inadequate tax audit skills, such a selection basis has rendered the tax audit function marginally effective.

There is no well defined monitoring arrangement for capital value tax. CVT collections, being no more than 1.5 percent of the overall direct tax revenues, the assessing officers are not expected to make much contribution in this regard unless major functional re-arrangement is made.

In brief, the Department lacks the requisite professional specialisation otherwise available to most of the tax administrations in the developed countries. This situation is definitely not expected to enable the Department to capture the protential tax bases.

Central Excise Duty

Central Excise duties are charged on selected commodities and services. Commodities are charged to ad-valorem duties on value, specific rates based on weights/volumes, and as percentage of retail price. Services are charged to ad-valorem duties, and/or on charge basis. The concept of capacity taxation is very limited as of now. More than 70 items are subject to excise duty but a handful of these items; i.e. cigarettes, cement, sugar, natural gas and petroleum products, telephone services, and beverages are the major duty spinners contributing around 70 percent of tax revenues.

There are immense leakages of excise duties both in respect of supervised and non-supervised clearance of goods and services. The later are particularly prone to tax evasion. Revenue leakages are primarily due to mal-practices and collusion of central excise officials with the taxpayers, their complacent attitudes and lower-than-optimal tax audits, particularly in respect of services, lack of integrated data base on manufacture of taxable commodities/services and over-reliance on the major duty spinners.

The Central Excise Department continues to have a narrow focus only on major excise duty spinners. Large number of small excise duty contributors and services remain inadequately attended notwithstanding that their large tax bases can be converted into affective tax bases. The composite Customs and Central Excise Collectorates have the inbuilt disadvantage of lesser administrative focus on the excise duties. The staff assignment at units other than major excise duty spinners as well as those monitoring services sector are considered less preferred and the staff spend most of their energies on their transfer to greener pastures.

Customs Duties

The existing structure of levies on imports is fairly complex. The basic duty structure is supplemented with a host of SROs allowing general/specific exemptions. The overall effect is neither visible to the economy nor do they serve as indicators for correction to policy-makers. Cumulatively, tariff and paratariffs create substantial distortions in the structure of tariff schedule. The duty concessions/exemption have led to substantial reduction in tax base and provided opportunities for mischaracterisation of dutable goods in the tax-exempt/low duty regimes. Tariff reforms initiated in recent years have also not led to surge in dutable imports. On the contrary, it has resulted in reduction in revenue collection. The major areas of tax leakages are ineffective anti-smuggling efforts, misdeclaration of quantities and value of imports, management of ware houses, mis classification of goods for the assessment of custom duties, and collusion of custom officials with the importers. The job specialisation recently initiated in the Custom Department is capable of producing positive results. The general perception that customs duty collections are function of value/quantities of imports and the affective duty rate is disputed, particularly because the factors mentioned above strongly influence revenue collection.

Sales Tax

Sales tax regime, in its present form, is restrictive in so for as it applies to the retailers. The narrow base leads to frequent breaks in production-distribution-consumption chain. Wide range of exemptions, including the linkage with annual turnover in case of retailers, provide adequate room for tax evasion. In the presence of such exemptions, zero-rating of exports is not possible. Similarly, verification of the precision of transaction values is also difficult. Inadequate institutional capability and absence of full political support leading to Government succumbing to the pressure of trade associations has handicapped the GST implementation. The recruitment of audit personnel has been inordinately delayed and shortages of required funds frequently observed. Taxpayers education/assistance programmes are inadequate.

In years to come, GST is expected to convert into consumption type VAT encompassing purchase/sales transactions at all levels and all commodities and services. The scope of work is, therefore, going to be immensely increased. The present level of political and administrative support is grossly insufficient to muster the full advantages of GST, both in terms of tax collection as well as help in creating necessary data base for improving the direct tax efforts.

KEY ISSUES IN TAX REFORMS

The key issues in tax reforms as emerging from the foregoing analysis concern both tax policy and tax administration. While equity and progressivity of the taxation system are important considerations, resource, mobilisations appears as the most important item on Government agenda. The Government of Pakistan, as part of ESAF/EFF Agreement with IMF, is committed "to achieve a significant enhancement of the revenue effort while promoting a more equitable distribution of the tax burden and greater documentation of the economy. To this end, the tax base will be broadened by including un-taxed income and under-taxed sectors, and tax administration improved in order to provide scope for a lowering of statutory tax rates. Further, administration of the GST in the textile sector will be improved and the GST extended to services, petroleum products, electricity and agricultural inputs. Government will fully implement agricultural income taxation and ensure achievement of 1998-99 budget revenue target of Rs 2.5 billion. An action plan will be developed to strengthen the system of agricultural income taxation which will broaden the base as well as increase the rates. Revenues from agricultural income taxation are targeted atleast at 0.3 percent of GDP over the medium term. Reform of tax administration will aim at improving taxpayer compliance, reducing compliance costs and broadening the tax base in order to achieve a sustained growth of tax revenue. CBR will be converted into an independent and autonomous Pakistan Revenue Service and a comprehensive institution building programme for PRS will be implemented with the assistance of the World Bank. Introduction of a unique tax identifier number which will replace all previous numbering systems in use in the tax and customs administration will be completed by May 1999 and will form the basis for harmonisation of the operations of major tax departments. The number of registered taxpayers will be increased to 1.6 million by December 31, 1998 and to 1.8 million by May 31, 1999. Number of GST non-filers will be reduced to 10 percent by June 1998. To strengthen the audit function within the CBR the separate audit department established in the CBR will develop a joint audit programme for all tax liabilities which will cover 10–15 percent of taxpayers by September, 1999 and 20–25 percent by December, 1999". In addition, major reductions in the customs duty rates (from 45 percent to 35 percent) and corporate income tax rates are anticipated in medium term. The reduction in customs duty rates, to be implemented by June 30, 1999, will adversely affect the declining customs revenues unless the resulting revenue losses are offset by adequate increases in imports and additional revenues consequent to changes in other policy instruments and administrative improvements.

Pakistan's experience in recent years does not support the Lafer's Curve as the necessary conditions therefor were never met. The reduction in rates of customs duties, corporate and personal income tax during 1997-98 did not improve the tax compliance/revenue yield. But for the conditionalities incorporated in the 1997 Self Assessment Scheme, tax revenues for 1997-98 from non-corporate sector were lower than the previous year. Similarly, there were no improvements in corporate revenues except for the additionality of over Rs 8.5 billion (100 percent increase) arising out of quarterly advance taxes payable under section 53 of the Income Tax Ordinance, 1979. Compliance level also did not improve in the area of indirect taxes.

While the Government has already reduced customs tariffs, the next major tax policy issue concerns broadening of the tax base, particularly for income, wealth and sales tax. Taxation of agricultural income and assets, and phasing out tax exemptions are key issues on the tax reform agenda. The areas of concern relate both to tax policy and administration. First, whether to continue with the taxation of agricultural income by the provinces or to bring it into the federal tax net, and in the process, improve the equity and revenue yield. Second, whether to continue with separate taxation of agricultural assets or to include these assets with non-agricultural assets for wealth tax purposes. Third, to what extent and over what period of time the existing exemptions and differentiated tax rates should be phased out to remove the inequities. Fourth, over what period of time the presumptive taxes should be converted into return based taxes. Fifth, to what degree and in what manner PIUs as the basis of determination of agricultural income and valuation of agricultural assets may be replaced by a more realistic basis. Sixth, how should the sales tax be extended to services sector and various exemptions removed so as to eliminate the breaks in production-distribution-consumption chain. These are important questions which deserve serious debate before arriving at an optimal choice. The World Bank studies generally recommend a phased approach while retaining the taxation of agricultural income within the jurisdiction of provinces. This approach is debatable on various grounds including the efficiency of provincial tax administration, equity and progressivity of taxation system, revenue leakage, etc.

Importantly, the decision on the above tax policy reform issues must take into consideration both economic and political realities. On economic grounds, there is a definite need to bring about above changes in the medium term. Full taxation at the federal level, as practised in similarly-circumstanced countries like Philippines, Malaysia, Indonesia and Thailand, will bring agricultural incomes and assets under a global tax regime, reduce the tax avoidance and evasion practices associated with mis-characterisation of taxable income/assets and substantially increase the revenue receipts. Politically, these are sensitive issues involving powerful interest groups who would be reluctant to assign full taxing rights on agricultural income and assets and on services to the federal government. However, given the powerful political mandate of the present government, it should generally be possible to make necessary constitutional amendments as required for this purpose.

The next major tax policy issue concerns reversion of presumptive taxes to normal taxation. This deserves special attention. When introduced in 1991, it was clearly understood that presumptive taxes will be a temporary phenomenon. Government will, in the meantime, undertake necessary steps to improve quality of income tax audit and will gradually phase out presumptive taxes. Interestingly, while the improvements in the personnel skill level and the relevant procedures and practices has been marginal, the ease in higher revenue generation through presumptive taxes has served as an incentive for expansion in the presumptive tax regime. Presently, over 40 percent of income tax revenues are generated via presumptive taxes. It is, therefore, necessary that a period thresh-hold may be fixed for adequately improving tax compliance and tax audit level during which all presumptive taxes should be phased out. Continuous reliance on these taxes will serve as a disincentive for improving the tax audit effort. June 30, 2001, for instance, could be fixed as the date by which all presumptive taxes should be phased out.

The next important tax policy reform issue concerns the delineation of taxing jurisdiction of federal and provincial taxes. The Commission on Tax Reforms, headed by Saeed Ahmad Qureshi, in its report submitted in July, 1998 has comprehensively examined this matter. It was observed that under the present revenue-sharing arrangement, there is an increasing dependence of the provinces on federal government for meeting their financial requirements. This arrangement undermines the provincial autonomy in fiscal matters, enfeebles incentives for expenditures by provinces, discourages provinces in their resource mobilisation efforts and creates uncertainty in transfer of resources to the provinces. After carefully considering the deficiencies in the present system of distribution of revenues between the federal and provincial governments, the Commission has recommended far-reaching fiscal decentralisation to bring provincial resources in line with their expenditures. It has been proposed that wealth tax, capital value tax and excise duties be transferred to the provinces. In addition, about half of the withholding taxes on domestic transactions should belong to the provinces-not by transfer but by bifurcating the liability. Alternatively, the entire direct taxes may be transferred to the provinces and indirect taxes retained by the federal government. Also that an independent Commission may be constituted to look into the present arrangement of distribution of revenue resources between federal, provincial and local governments and suggest mechanism for reduction in vertical and horizontal fiscal imbalances including equalisation payments to the provinces and local governments on the basis of deficiencies in their per capita resource basis. Commission's recommendations deserve careful consideration by the government and a decision thereon taken along with the issues concerning taxation of agricultural income and levy of sales tax on services.

The major reform issues concerning tax administration broadly orbit around the inadequate institutional capacity to deal with a modern economy, lack of motivation and accountability. The institutional inadequacies concern procedures and practices for filing of tax documents, valuation of goods and services, assessment of income, information handling, work distribution, personnel skills and taxpayers-tax collector relations. The concerns regarding lack of accountability and motivation stem from public perception of the tax administration beset with mal-practices, arbitrariness, harassment and corruption. There generally exists an adversorial relationship between taxpayers and tax officials which renders tax collection efforts marginally productive. Therefore, while there is a need to address the performance related issues and improve the infrastructure, efforts are also required to ensure a closer association of the taxpayers' representatives for improved tax compliance. Use of modern technology in document processing and putting in place an appropriate MIS is expected to curtail arbitrariness and also improve the tax effort in a taxpayer-friendly environment.

Institution re-building requires qualitative improvements in tax administration, strengthening the policy-making role of CBR, modernising the tax systems, and aligning the tax administration to the tax reforms. These measures must aim at taxpayers convenience, simplified procedures for filing and processing of tax documents, increased reliance on voluntary compliance, establishing a comprehensive MIS, improved quality of tax audit which finally improves revenue generation. Commission on Tax Reforms has made comprehensive recommendations in the critical areas of improvements in the tax administration. These recommendations cover restructuring of the CBR and its subordinate departments, documentation of economic transactions, establishing a comprehensive management information system and training for tax officials.

Government is considering establishing an independent, autonomous Pakistan Revenue Service replacing CBR/Revenue Division. The proposed restructuring of revenue administration envisages independence in recruitment of professional manpower and expenditure budgeting. A high powered policy board headed by the Prime Minister will determine the broad policy direction while an operational board comprising the Chairman and the Members of Pakistan Revenue Service will ensure the implementation of policy decisions and collection of revenue targets assigned by the Government.

Conceptually, the idea of an independent, autonomous PRS has been borrowed from third world countries like Spain, Jamaica, Peru, Argentina, Columbia, Ghana and Zambia. Except for Singapore, which has otherwise a corporate out look/structure in government matters, no country in North America and Europe has an independent, autonomous revenue organisation. Revenue being the sovereign function of the state has been entrusted to the highly trained, capable civil servants. In Pakistan's context, an independent CBR/Revenue Division with high degree of flexibility in spending and recruitment of professionals to augment the regularly recruited tax personnel could be considered as an alternative to an independent, autonomous PRS. Autonomy, *per se,* does not guarantee quality performance. WAPDA is an example in point.

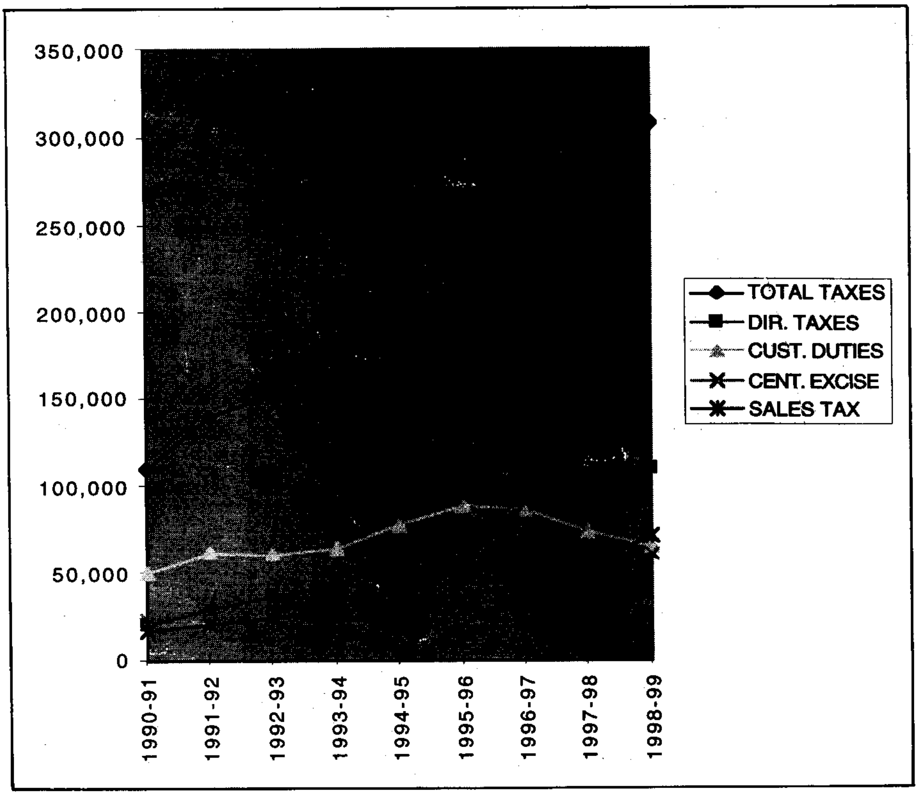
Appendices

Appendix Table 1

Federal Tax Revenue in Pakistan (Year 1990-91 to 1998-99)

(in Million of Rs)

Years	Total Taxes	Dir. Taxes	Cust. Duties	Cent. Excise	Sales Tax
1990-91	110,493	19,870	50,528	23,087	17,008
1991-92	139,776	28,851	61,821	28,305	20,799
1992-93	153,238	36,771	61,400	31,546	23,521
1993-94	172,591	43,452	64,240	34,520	30,379
1994-95	226,578	61,660	77,653	43,691	43,574
1996-96	268,037	78,165	88,916	51,115	49,841
1996-97	282,087	85,060	86,094	55,265	55,668
1997-98	293,631	103,182	74,496	62,011	53,942
1998-99	308,530	110,402	65,292	60,904	71,932

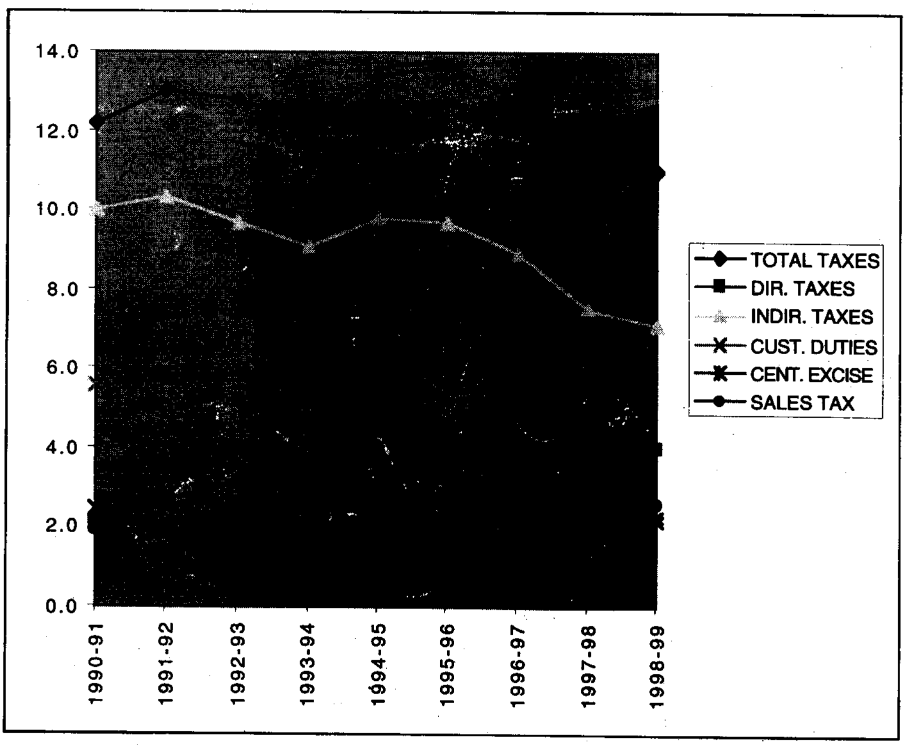


Appendix Table 2

Federal Tax—GDP Ratio in Pakistan (Year 1990-91 to 1998-99)

(in %)

Years	Total Taxes	Dir. Taxes	Indir. Taxes	Cust. Duties	Cent. Excise	Sales Tax
1990-91	12.2	2.2	10.0	5.6	2.5	1.9
1991-92	13.0	2.7	10.3	5.7	2.6	1.9
1992-93	12.8	3.1	9.7	5.1	2.6	2
1993-94	12.2	3.1	9.1	4.5	2.4	2.2
1994-95	13.4	3.7	9.8	4.6	2.6	2.6
1996-96	13.7	4.0	9.7	4.6	2.6	2.6
1996-97	12.8	3.9	8.9	3.9	2.5	2.5
1997-98	11.6	4.1	7.5	2.9	2.4	2.1
1998-99	11.0	4.0	7.1	2.3	2.2	2.6



Comments

The writer deserves compliments for attempting a comprehensive paper on reform issues in taxation policy and tax administration. It covers macroeconomic setting salient features and problems of taxation policy and key issues in tax reforms. The paper could be certainly of great use for the practitioners in Central Board of Revenue as the writer has drawn heavily on his practical experience of three decades in dealing with the taxation issues. The structural adjustment and stabilisation reforms have been launched in the country since early 90s and the area of the taxation policy is its integral part. The reforms have already taken too long time to be completed. During this period a number of measures have been implemented in improving the tax administration/machinery and reforming the tax structure. Contrary to that the tax GDP ratio has slipped during this period. A number of factors account for lacklustre performance of the taxation policy in the country which the author should have also covered. The taxation reforms have not been debated in advance either at the public fora or in the legislature. Confidence of the tax payer in these reforms has not been fostered. The taxation system, despite a number of reform measures, continued to be complex. A large number of SROs have been issued which allow exemptions in specific tariff and tax measures and that provides loopholes for corruption and tax avoidance. The way the tax reforms are implemented has generated some kind of uncertainty and distorted the principle of continuity which is often required for the investor in making the long term investment decisions. The rapid tariff reduction, albiet part of the tariff reforms, has eroded significantly the tariff protection to the national industry while the whole industrial base had grown under long time protection. This has adversely affected industrial base and has ultimately led industry into a recession. The industrial growth which had remained in the earlier period above 8 percent a year is now on a declining trend.

Congenial rapport between tax collector and tax payer has all along been lacking and the new tax reforms had made no improvement in this regard. The next point which should have been highlighted in the paper is that there is no central coordinating authority for taxation system as a whole. At present a number of government departments/agencies deal with the different aspects of tax system. For example these are ministry of finance dealing with the budget, ministry of commerce with trade and tariff policy, Board of Investment dealing with the fiscal incentives for new investment, and National Tariff Commission dealing with the anomalies and protection to the industries. There is a need to have a central authority to coordinate and integrate the activities of all these bodies into one operational set up so that the synergised efforts of these could be geared to an ultimate aim of fiscal stability. Taxation policy needs to be adequately integrated into the national development strategy which is aimed to achieving the goals of higher resource mobilisation, sustained economic growth, economic stability and equity. There is also a strong need to ensure a political will to take politically harsh but economically sanguine decisions in implementing different taxation measures. Governance has been a persistent problem in implementing taxation policy and that has to be attended to under the new reforms.

The author found that the relationship between tax rate and tax collection in Pakistan has not been governed under the Laffer Curve. The Laffer Curve indicates three stages of correlation between tax rate and tax collections. Had the author analysed the complete series of the data he would have certainly found a clear application of this curve. Professor Richard G. Lipsey has revealed in his book on "Introduction of Positive Economics" (7th Edition) that the Laffer curve was empirically identified six hundred years before the discovery of curve Laffer by a muslim philosopher, Ibne Khuldun, in his famous book "Muqaddimah: An Introduction to History". If the data is properly analysed the application of the Laffer curve to Pakistan could be statistically established as well.

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