

## *Special Invited Lecture*

# **Political Economy of Tax and Digital Transformations in Pakistan**

EHTISHAM AHMAD

## **1. THE NEED FOR A COORDINATED TAX AND SUSTAINABLE GROWTH STRATEGY I**

The 1985 National Tax Reform Commission (NTC) recommended a coordinated set of policies on tax policy, administration, and digital transformation to take the tax/GDP ratio from around 14 percent as it was then, to 20 percent by 1990, to underpin a sustainable growth path.<sup>1</sup> The interim report of the NTC called the CBR “the most corrupt of Pakistani institutions.” The final report paid a great deal of attention to the interrelationships between tax evasion, smuggling and corruption.<sup>2</sup> The report emphasised a coordinated approach to reforming all taxes and administration, and that a tax-by-tax approach with tax administration determined separately would not do.

Unfortunately, the report was shelved as Pakistan extracted geographic rents from the war against the Soviets in Afghanistan. While the NTC could not have imagined that the tax/GDP ratio would decline after three decades of interactions and support from the IFIs, that the country would find itself on the brink of default consequently, or the depths to which rent-seeking and corruption might plumb.

A coordinated approach to multilevel tax policy and administration should also address key political economy challenges if Pakistan is to overcome the current economic crisis and move towards resilient and sustainable growth in the medium term. This is especially critical given the unprecedented “perfect storm” of the pandemic, climate shocks and once in a century floods, and ongoing disruptions in global value chains. The contrast with India is striking. With a general government tax/GDP ratio well above “the tipping point” of around 15 percent, India has been able to run a greater general deficit and much higher overall debt level than Pakistan (see Table 1 and Chart 1), without running into a potential debt crisis. It is important to stress that India by a Constitutional Amendment to harmonise the VAT across subnational jurisdictions has begun to address faults inherited from the pernicious 1935 Government of India Act, that still influences revenue assignments in Pakistan. The increasing geo-political importance of India, and the country’s greater resilience and attractiveness for FDI provide important contrasts and lessons for policy makers in Pakistan.

Ehtisham Ahmad <s.e.ahmad@lse.ac.uk> is Independent Researcher and Former Staff member, International Monetary Fund (IMF) and London School of Economics (LSE).

*Author’s Note:* This paper benefitted from a Webinar arranged by the PIDE in January 2024, and comments from participants are greatly appreciated. The work on Pakistan dates to the 1980s, when the author along with Nicholas Stern made presentations to the 1985 National Taxation Reforms Commission. Insights on political economy and digital transformations are based on research directed by the author at the LSE on China and Mexico.

<sup>1</sup>1985-86 National Taxation Reforms Commission, *Final Report*, December 31, 1986.

<sup>2</sup>Qamar-ul Islam, 1986.

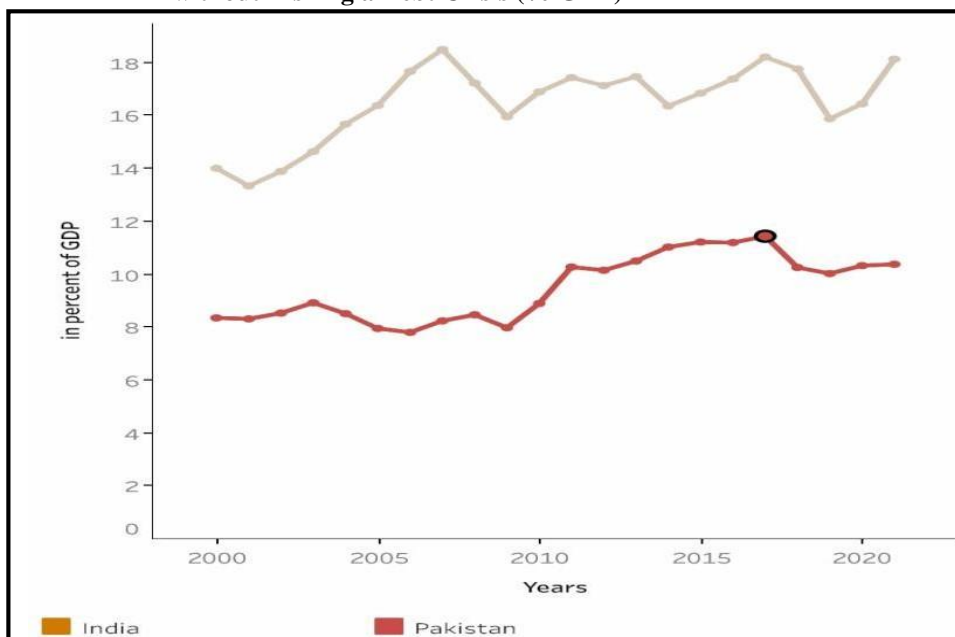
Table 1

*Macro-fiscal Consequences of the Pandemic Responses:  
Why Pakistan Faces a Debt Crisis and India Does Not?*

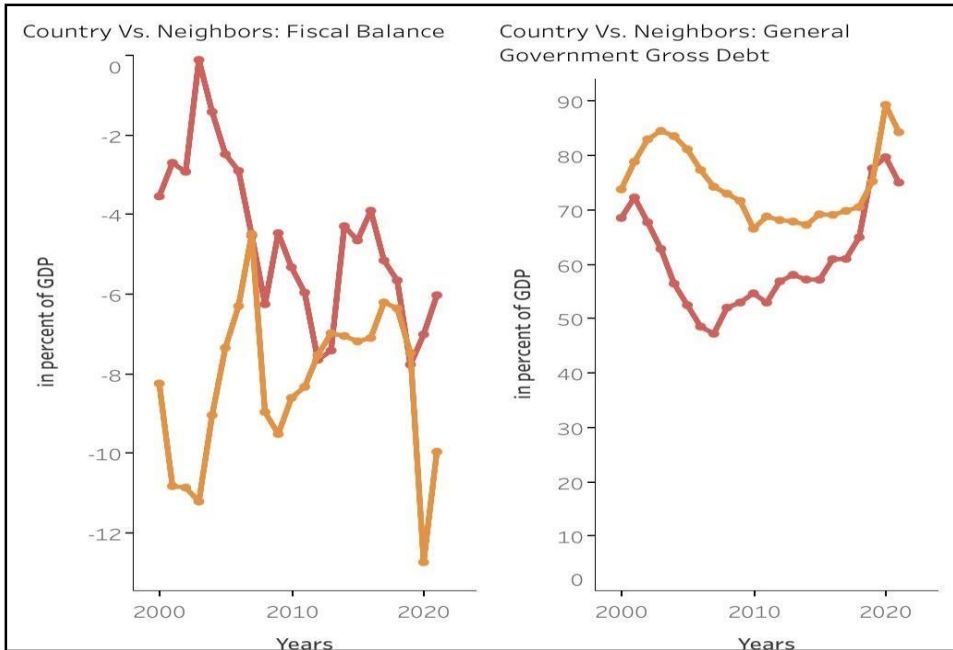
	General Government Balance						Gross General Government Debt					
	2015	2018	2019	2020	2021	2022	2015	2018	2019	2020	2021	2022
Singapore	2.9	3.7	3.8	-6.8	1.2	0.4	102.2	109.5	127.8	149	147.7	134.2
Indonesia	-2.6	-1.8	-2.2	-6.1	-4.5	-2.3	27	30.4	30.6	39.7	41.1	39
India	-7.2	-6.4	-7.7	-12.9	-9.6	-9.6	69	70.4	75	88.5	84.7	83.1
Pakistan	-4.7	-5.7	-7.8	-7	-6	-7.8	57	64.8	77.5	79.6	73.6	75.8
Philippines	0.5	-1.5	-1.5	-5.5	-6.3	-5.2	39.6	37.1	37	51.6	57	57.5
Sri Lanka	-6.6	-5.1	-7.5	-12.1	-11.6	-10.4	76.3	83.6	82.6	93.7	102.2	117.7
Thailand	0.4	0.1	-0.8	-4.7	-7	-5.5	42.6	41.9	41.1	49.4	58.4	60.5
Bangladesh	-3.3	-4.1	-5.4	-4.6	-3.8	-3.8	28.2	29.6	32	34.5	35.5	39.1
Cameroon	-4.2	-2.4	-3.2	-3.2	-3	-1.8	31.1	38.3	41.6	44.9	48.6	46.4
Lao PDR	-5.6	-4.7	-3.3	-5.6	-1.3	-1.6	53.1	60.6	69.1	76	92.4	126.5
Ghana	-4	-6.8	-7.5	-17.4	-12.1	-9.9	53.9	62	58.3	72.3	79.6	88.8

Source: IMF Fiscal Monitor, April 2023.

**Chart 1. India vs. Pakistan: Stronger DRM Performance Permits Greater Ability to Manage Higher Deficits and Debt to Respond to Crisis without Risking a Debt Crisis (% GDP)**



Note: India is the orange bar and Pakistan is shown in red.



Source: World Bank Tax Dashboard.

Note: India is the orange bar and Pakistan is shown in red.

This paper builds on earlier work on Pakistan during the 1980s (see Ahmad & Stern, 1991),<sup>3</sup> including for the 1985-86 NTRC. This paper also draws on the experiences of other multilevel countries, such as China<sup>4</sup> and Mexico, in deriving feasible policy options for Pakistan. Both these countries have recently reformed their VATs and digital transformation to make the tax system more resilient and conducive to investment, *but paid attention to the political economy of gainers and losers across states/provinces through the use of multiple tax and transfer instruments.*

A sustainable domestic resource mobilisation (DRM) strategy entails much more than raising revenues. A great deal depends on what measures are taken, and how these are implemented in a multilevel/federal framework; and must encompass measures for:

- Achieving balanced and equitable growth.<sup>5</sup>
- Addressing corruption and smuggling, a key concern of the NTRC 1985, in a manner that tackles informality and limits rent-seeking opportunities.
- Leveraging the comparative advantages of Pakistan in terms of location and skills.

<sup>3</sup>See Ahmad, E. and N. Stern (1991). *Theory and Practice of Tax Reforms in Developing Countries*, Cambridge University Press, and a number of papers published in *PDR*.

<sup>4</sup>China introduced a VAT in 1994 to bolster DRM, and the political economy involved multiple instruments, including special purpose and equalisation transfers to offset provincial gainers and losers. The reform took the tax/GDP ratio to around 20 percent from 10 percent in 1993, and a VAT with similar rates as Pakistan generated almost 11 percent of GDP prior in 2019, as opposed to 4 percent in Pakistan (see Ahmad, "Rebalancing in China: Fiscal Policies for Sustainable Growth. *Singapore Economic Review*, 2017).

<sup>5</sup>Haque, Nadeem Ul (Various Issues). Emphasis on the importance of a growth strategy to anchor public policy.

- Addressing political economy constraints of provincial interests and spatial imbalances.
- Achieving greater resilience to health and climate shocks, including at the national and local levels. There is no strategic or geopolitical stability without fiscal resilience. A debt ridden and aid dependent country cannot be resilient.

Digital innovations open significant enhancements in creating a new multilevel tax administration as well as more efficient and equitable policy options. These should also generate conditions for foreign direct investment in sustainable employment hubs, and help create clean, compact, and connected cities. The tendency in recent years to computerise processes, procedures and institutional structures based on existing arrangements has proved to be ineffective. Effective change management requires a joint reform of policies, institutions and procedures in a multilevel context, and the political economy of reforms takes centre stage.

A coordinated national and local agenda for tax policy and administration is also needed to take full advantage of the opportunities created by the global exchange of information and level playing field generated by the BEPS agenda. BEPS Pillar 2 with a minimum global CIT would have implications for the design and operation of SEZs, even for countries that have not acceded to the agreement, as investments from source countries would still be liable to minimum tax under Pillar 2. But taking advantage of BEPS requires a more conducive domestic fiscal system, involving an efficient VAT to facilitate domestic linkages and reflect a country's comparative advantage.

Thus, a new approach is needed to the design of SEZs, and to limit potential tax leakages.

Political economy considerations require that own-source provincial and local tax handles are available to strengthen accountability and access to private finance. This is to ensure stable provision of basic services and access to private financing for infrastructure. Such investments are preconditions for sustainable growth.

This paper addresses a broad strategy for the medium-term, and outlines some of the short- term building blocks that would not require Constitutional Amendments to correct underlying imbalances in assignments or institutional arrangements.

## **2. PERNICIOUS COLONIAL LEGACY**

Pakistan's current difficulties are deeply linked to an inability to break away from its colonial legacy. The Government of India Act 1935 (GOI, 1935) was an attempt by the colonial power to accommodate growing unrest by permitting elections at the provincial/state level but hobbling the "elected" subnational governments with overlapping responsibilities and unworkable split revenue bases. Splitting the main tax bases (income and excise/sales) and controlling trade taxation, was designed to protect colonial commercial and industrial interests and British households from taxation by "native" provincial governments. The main tax handles assigned to "native" subnational jurisdictions were landed assets and income from these sources, and the final point sales tax on goods. By exclusion, the sales tax on services, excises on production, and non-agricultural incomes were left in the hands of the crown/centre, along with the taxation of trade/customs.

The main principles of tax policy in the Colonial period were aptly summed up by Dharma Kumar (1982, p. 905)<sup>6</sup>—“market for British manufactures, source of raw materials and field for profitable investment. The government was particularly chary of taxing those groups which it regarded as its allies, mostly landlord. India’s first Viceroy commented on a proposal to impose income tax—“danger for danger, I would rather risk governing India with an army of 40,000 Europeans than I would risk having to impose unpopular taxation.” While the GOI 1935 Act ostensibly accommodated elected provincial assemblies in recognition of growing resistance to Colonial rule, it created fissures that resonate to this day.

The expectation on the part of the colonial masters was that by facilitating landed interests to control provinces, ostensibly handing them tax powers that affected them directly, that most would choose not to tax themselves. They would continue to rely on largesse from the crown. For this purpose, the GOI 1935 created a divisible pool to share centrally collected revenues. While ostensibly seeming to be fair, this arrangement created incentives not to use assigned revenue bases, and to press the crown for more funding for what should be central responsibilities. This resulted in yet another area of conflict between the centre and the provinces. The consequence of the inherent incentives was that land revenue, which had generated 53 percent of combined central and provincial revenues in 1900 (other important sources of revenue included taxation of salt, customs, and excises), had fallen to 7 percent by 1946. Although there was an increasing contribution to revenue generation by customs and excises, the proportion of land revenue to gross agricultural output fell from 5 percent to 2 percent over the same period (Dharma Kumar, 1982, p. 918).

The split revenue bases and revenue sharing carried over to the succeeding Pakistan constitutions. The revenue sharing was seen as arbitrary and generated disincentives to raise and use resources efficiently, and dissatisfaction, especially in East Bengal, and was to contribute to the dissolution of Pakistan, as discussed below.

#### **(a) Inadequacy of Colonial and Normative Governance Models**

At independence, Pakistan had little in the way of an industrial base, hence the production-based excises were insignificant relative to the importance this tax head had in India. Other than customs, the only other tax base was the final point sales tax on goods, and this had been assigned to the provinces under GOI 1935. This base was centralised after independence, given the parlous state of federal finances. The revenue sharing compensation followed the pattern of the GOI 1935 revenue sharing, but implied that the provinces would get much less than they gave up—immediately sowing the seeds of conflict.

The lop-sided revenue sharing/compensation was codified and made worse by the Raisman award, implemented in 1947 and formulated as the Finance Commission Award in 1951 had the following components:

- 50 percent of net proceeds of the income tax, but only 45 percent of shared tax to more populous East.

<sup>6</sup>Dharma Kumar (1982). *The Fiscal System*. In Dharma Kumar and Meghnad Desai (1982). *Cambridge Economic History of India*, Vol II, 1757-1970. Orient Longmans & Cambridge University Press.

- 50 percent of net sales tax collection of sales tax on origin basis to originating province.
- 50 percent of excise duty on tobacco, betel nuts and tea (grown entirely in the East).
- 62.5 percent share in duty on jute to the East (grown entirely in “East”).

The resources generated went largely to investments to the West (Indus basin, defense excluded) as well as definition of investments. This was accompanied by a huge focus on tariffs and QR protection for infant industries mainly in the West, especially in Karachi and the Punjab—sowing seeds of mistrust among the Western provinces. The dissatisfaction among provinces was so great that none of the Finance Commissions until the separation of Bangladesh were conclusive (see Table 2).

The split revenue bases and tax by tax administration, following the GOI 1935 model, including at subnational levels, formed major constraints for establishing a modern tax system that relies of information sharing and management. These issues have not been adequately addressed in post-independence South Asian countries, and in Pakistan are a major cause for creating “rents” and incentives to cheat. After the secession of Bangladesh, the 1973 Constitution doubled down on the GOI 1935 assignments—with the difference that the sales tax on goods was retained by the Federal Government, while that on sales was passed on to provinces. This split proved even more of a constraint to the VAT, than the assignment of the taxation of sales to the centre, and the 1935 assignment of the final point taxation of goods to the states (provinces) did in India.

Table 2

*Revenue sharing/Finance Commission Awards in United Pakistan.*

Chronology				
Awards Listing Order (s)	Raisman Award Listing(s)	Presented by	Tests, Results, and Status	Projected Fiscal Year
First	Raisman Award, 1951	Liakat Ali Khan	Conclusive <sup>[3]</sup>	1951–55
Second	NFC Award, 1961	Ayub Khan	Inconclusive <sup>[3]</sup>	1961–64
Third	NFC Award, 1964	Ayub Khan	Inconclusive <sup>[3]</sup>	1964–67
Fourth	NFC Award, 1970	Yahya Khan	Inconclusive <sup>[3]</sup>	Terminated <sup>[3]</sup>

*Source:* Government of Pakistan.

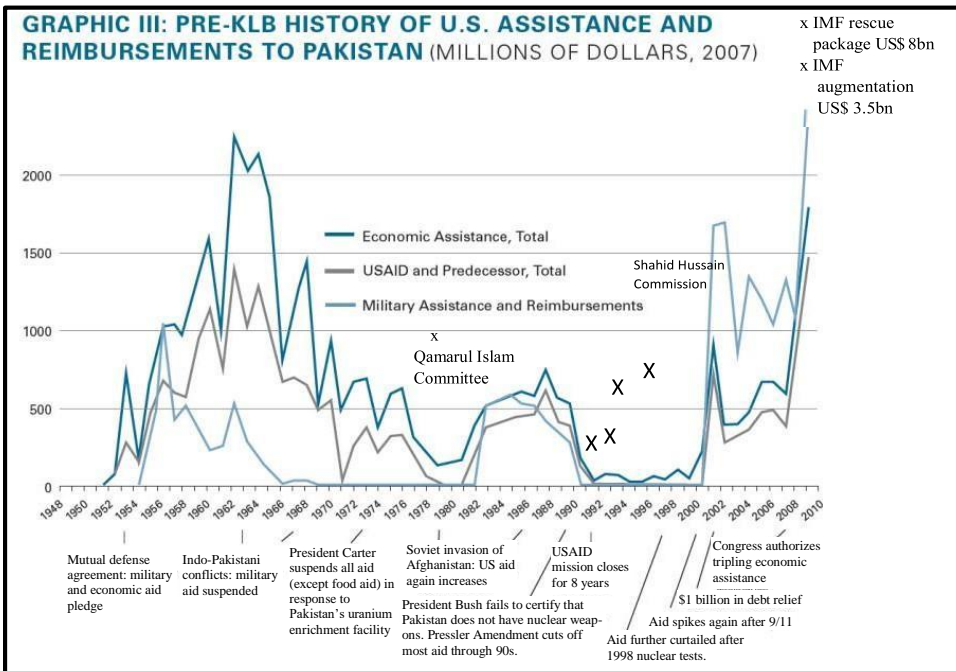
### (b) Aid Dependency or the Great Game?

One of the main reasons that Pakistan has never been serious about domestic resource mobilisation is the geographic rents that have accrued from time to time. In the 1950s and 60s, the focus on Pakistan was largely to contain the threat posed by the USSR. As argued in Ahmad and Mohammed (2018),<sup>7</sup> the stop-go nature of the support from the Western powers, especially the US, has had much to do with periodic sanctions due to the development of the Pakistan nuclear program (see, Chart 2) and periodic usefulness in a dangerous part of the world. The resumption of aid in the mid-1980s for the bulwark against the Soviet invasion of Afghanistan is one of the main reasons that the Qamar-ul Islam

<sup>7</sup>Ehtisham Ahmad and Azizali Mohammed (2018). Pakistan, the US and Bretton Woods Institutions: A continuing Great Game. *Routledge Handbook of Contemporary Pakistan*.

NTRC 1986 report was buried and forgotten. The aid dried up with the fall of the USSR, and resumed again in the post-9/11 period from 2001-7 but the IMF and the World Bank stepped in to fill the breach when the largesse was no longer forthcoming. The VAT/GST was forced on the then government in 1990, but was not well understood and was badly implemented, effectively as a “production excise”. This negated the purpose of the VAT—to reduce the cost of doing business, facilitate exports, facilitate domestic integration of value chains, generate information to stop cheating, and of course to raise revenues. The Pakistan GST failed on all counts, despite a huge quantum of technical assistance from the IMF, and the World Bank, accompanied by hundreds of millions of US\$ to finance the modernisation of the tax administration (TARP and its successors).

Chart 2



Source: Ehtisham Ahmad and Azizali Mohammed (2018). Pakistan, the US and Bretton Woods Institutions: A continuing Great Game. *Routledge Handbook of Contemporary Pakistan*.

Unfortunately, successive governments in the 1990s, and since then, have not understood the difference between exemptions in excises and the income tax, and the very different implications of exemptions under a VAT/GST. Under a GST/VAT, exemptions signify “input taxation,”<sup>8</sup> and are far from desirable. Exemptions destroy the information generation aspects of the GST/VAT, introduce cascading that the tax was meant to eliminate, and make it impossible to correctly determine export refunds in a timely manner. The VAT with myriad exemptions stops generating revenues, adds to the cost of doing business and vitiates the efficiency gains that has led the tax being implemented with great success in developing countries, including in China in 1993/4 (three years after Pakistan).

<sup>8</sup>Input taxation is the term used in more modern VAT legislation, rather than exemptions, as in the 2000 Australian VAT legislation.

The *removal of GST exemptions was structural benchmark* for mid-1994 under ESAF 1993 (entered into by the Moeen Qureshi interim government and ratified by Benazir Bhutto's PPP government). The exemption removal condition was reported met to IMF (Staff Report, August 1994), but nothing of the sort actually took place. The exemptions were used to garner support and bonanza for the "parties" in power by all administrations since then. In the 2008 IMF Standby Program, fixing holes in the VAT was the core proposal of the newly formed PPP Government. Despite commitments by the then President to the Friends of Pakistan and to the IMF, again there was no real intention of removing exemptions, and as a matter of fact the administered doubled down on exemptions with SRO 283. This was the cause of failure of 2008-12 SBA. In 2012, and the IMF Mission chief, Adnan Mazarei, famously is reported to have said: "no VAT no money." However, in subsequent programs regrettably "fixing the VAT" has not been on the table. This had led to trying to extract income tax revenues from a narrow formal sector wage base; or taxing assets the majority of which are not under the jurisdiction of the Federal government. Given the continuing fiscal crises, the alternative involves unpalatable including effectively cutting the revenue shares of provinces agreed under NFC awards, that risks unwinding the federation, if the history of Pakistan is any guide.

**(c) Constitutional Guarantees and Unfunded Mandates—  
"Good Intentions, Bad Outcomes"**

The 1973 Constitution had very advanced, almost Bismarkian, social ambitions. Its guarantees:

- "Compulsory and free" education till secondary level #37(b), but "within minimum possible period" (after 50 years, standards have not really improved, and even more modest SDG targets appear out of reach at the present time);
- Full access to technical and higher education for all on "merit" #37c—this is not subject to the minimum possible period and should have been prioritised from 1973 on.
- Social benefits for the unemployed or incapacitated: a very Bismarkian objective to "provide basic necessities of life, such as food, clothing, housing, education and medical *relief for all such citizens*, as are permanently or temporarily unable to earn their livelihood on account of infirmity, sickness or unemployment" #38d. This very clear, and no additional targeting, or score cards, that are favoured by many international agencies, but open to "capture" or "clientelism". *These are Constitutional basic rights and should be actionable in court.*

While it makes political sense to focus on functional responsibilities in a constitution, it is important to keep in mind the "economic implications" or preconditions for each of these rights or guarantees. Thus, compulsory and free education till secondary level has implications regarding the availability of teachers and school buildings, but also other functional inputs, like books and equipment, electricity, clean water and sanitation. The cost implications are a function of all the economic components. And if a function is assigned to a lower level, the accountability for a function also depends on whether or not a jurisdiction has the ability to raise taxes at the margin to cover incremental spending and additional liabilities (Ambrosanio & Bordignon, 2006, 2015).



The problem in Pakistan is that the social policy aims of the Constitution have not been supported by the domestic resource mobilisation agenda. The NTRC 1985 agenda to raise the tax GDP ratio from 14 percent towards 20 percent would have helped if it had been accompanied by a shift from distortive trade taxes to a more investment and growth friendly regime. The GST implemented under IFI duress in the early 1990s was implemented in production excise mode and imports, neither generated efficiency gains nor additional revenues expected from a VAT. Falling revenues led to various capacity-based schemes that increased cascading, disadvantaging exports, leading to further demands for exemptions. While there were many positive aspects to the 18th Amendment, the split of the GST was formalised, and both policy and administration for the taxation of services devolved to the provinces.

Again, this has had no impact on overall tax revenue collection that has stagnated at around 10 percent of GDP for general government. Note that to reduce the cost of doing business, and better integrate the domestic economy, including the high tech Special Economic Zones, China consolidated the taxation of services and goods under a single administration in 2015, and with similar rates as Pakistan, the VAT alone generated 11 percent of GDP. India is moving in the same direction with a Constitutional Amendment to harmonise the VAT base. Multiple administrations remain and are a constraint to business efficiency.

The anaemic performance of the Pakistan tax system at all levels of government implies that even the SDGs cannot be financed, let alone the ambitious Bismarkian guarantees under the Constitution. Just to meet the SDGs, Pakistan was estimated to need an additional 16 percent of GDP to meet the SDGs, and this was prior to the Pandemic (Brollo, et al. 2021).<sup>9</sup> While this includes both public and private resources, often the private funding for public spending cannot be unlocked without a resilient own-source tax base, especially at the subnational level. The tax system has had a disastrous impact on the real economy, growth and export performance as well as social indicators. The “good intentions” under the Constitution and the 18th Amendment have degenerated into unfunded mandates and “bad outcomes.”

### **3. LURCHING FROM CRISIS TO CRISIS—UNABLE TO BREAK THE BEGGING BOWL**

Pakistan finds itself in a precarious situation with a tax/GDP ratio that has declined from 14 percent in 1985 to around 10 percent in 2022. Geo-political rents had periodically sustained the country, followed the Soviet invasion of Afghanistan, but created disincentives to address serious fiscal imbalances. Despite multiple IMF programs and FAD technical assistance missions, and extensive support from the World Bank (see Ehtisham Ahmad and Azizali Mohammed, 2018<sup>10</sup> for an assessment) various vested interests prevailed in a version of “Dutch Disease” without oil. These interests have prevented the efficient operation of modern tax instruments, especially the GST/VAT introduced under duress in the early 1990s.

<sup>9</sup>Brollo, Fernando, Emine Hanedar, & Sébastien Walker (2021). Pakistan: Spending Needs for Reaching the Sustainable Development Goals. (IMF Working Paper, WP/21/108).

<sup>10</sup>Ahmad, Ehtisham & Azizali Mohammed (2018). Pakistan, the US and Bretton Woods Institutions: a continuing Great Game. In Aparna Pande (2018). *Routledge Handbook of Contemporary Pakistan*. NY.

As noted above, the Pakistan tax system generates much lower levels of revenue than India despite similarities in starting points. This has led to a much lower counter-cyclical capacity to address shocks, such as the pandemic, maintain essential investments and run higher deficits and debt without running the risk of a debt crisis. The split GST/VAT in Pakistan, reiterated by the 18th Amendment, virtually vitiates all the advantages that a VAT was designed to create. The shift to harmonisation of the GST/VAT in India, through a Constitutional Amendment, while not complete, increases India's attractiveness as a destination for FDI, adding to economic and strategic resilience relative to Pakistan.

The Pakistan Tax System also does not perform well in relation to any of the major objectives of public policy for sustainable and resilient development. With the second highest PSBR in the world (approaching 30 percent of GDP in 2023/24, see IMF Fiscal Monitor, April 2023), Pakistan faces stark choices to get its domestic resource mobilisation (DRM) on a sustainable footing as quickly as possible, almost four decades after the NTRC 1985/6, and business as usual just will not do.

### **(a) Overview of the Major Problems**

Among the main problem areas facing a coherent DRM strategy in Pakistan, some the result of long-standing political economy issues, including the following:

- *Split tax bases reflect fissures between the centre and the provinces, and the pernicious influence of the colonial 1935 Government of India Act.* The crown retained the major tax handles—especially on trade and excises on production and the main sources of income (that were also related to colonial interests), and assigned taxes on agricultural and property incomes, and hard to tax sales to newly elected “native” governments in provinces.
- *The post-independence centralisation of the sales tax,* given the absence of tax handles in the newly independent republic, was accompanied by an inadequate transfer/revenue sharing. This contributed to dissatisfaction in provinces, including in the most populous province that contributed to the subsequent separation of Bangladesh.
- *The central-provincial tensions continue* despite the 1973 Constitution that did not significantly depart from the 1935 GOI fiscal straitjacket. An inefficient design of tax assignments and sharing of revenues remains a fundamental problem and was reinforced under the 18th Amendment that sought to provide “own-source revenues” for devolved functions. While the motivation was correct, the wrong instrument was assigned to the provinces deepening the split in major tax bases and administrations.
- *The GST/VAT was introduced under duress under an IMF program in the early 1990s* (after the Soviets withdrew from Afghanistan, and there was a hiatus in support from the usual bilateral funders).
  - It was designed and administered like a production excise on an increasingly narrow base, including imports. This led to backward shifting of the tax, cascading, and difficulties with export refunds. Consequently, there was pressure from vested interests to exempt firms (often 50-year old infant industries) and even sectors.

- *The GST/VAT C-efficiency is among the lowest in the world* at around 0.2. This can be contrasted with 0.8 achieved in countries in East Asia, such as PR China, which introduced the VAT a few years after Pakistan, or Thailand.
  - Extensive exemptions and split bases vitiate the efficiency advantages of a VAT that should have reduced the cost of doing business and facilitated exports but have managed to have the opposite effect. The exemptions also remove the ability of the VAT to generate information for other taxes, especially the income taxes, or to stop cheating. The split bases and exemptions also prevent the free flow of goods and services that are a component of creating an integrated economic space. Furthermore, it fails to raise revenues.
  - Closing the gap in C-efficiency of the VAT/GST with other Asian countries could generate significant additional revenues (up to 4-5 percent of GDP), and improve the investment climate.
- *Capacity- based schemes during the 1990s*, to address budget crises following nuclear-related sanctions, further destroyed the logic of a VAT/GST, created production distortions, and spectacularly failed to achieve revenue objectives.
  - *Recent third-best proposals to move to a turnover basis for assessing tax* to raise revenues, would generalise the capacity-based schemes, and destroy what is left of efficient production or export-based sectors (see IGC-funded proposal by Best, et al. 2015).<sup>11</sup> Fortunately, these proposals have not had much traction.
- *PIT collections are low*. This is not unexpected given the levels of development in Pakistan and the heavy reliance on formal sector wages, as argued in Tanzi (1987).<sup>12</sup> Recent attempts in the current (suspended) IMF program to shift the focus from fixing the VAT to raising additional PIT revenues have not generated revenues. Since PIT revenues arise largely from withholding taxes on formal employment and non-wage income is hard to tax, the income tax paradoxically becomes regressive. While the PIT will eventually play its role as the prime instrument for redistribution, a premature emphasis is likely to be counterproductive and is not likely to raise revenues significantly. This may also prevent a reform of the other main taxes, such as the VAT.
- *The coverage of the CIT is pessimal*, with only a fraction of the companies listed registered for tax, and an even smaller percentage making any positive payments (see Chart 3). An industrial sector that has evolved around protective barriers and a distortionary tax system is at increasing risk as the macroeconomic situation deteriorates.
- *The urban property tax is dysfunctional*. The attempt by the FBR to set property values centrally is a pointless exercise. If a US-style ownership-

<sup>11</sup>Michael Best, Anne Brockmeyer, Henrik Kleven, Johannes Spinnewijn, & Mazhar Waseem (2015). Production versus Revenue Efficiency with Limited Tax Capacity: Theory and Evidence from Pakistan. *Journal of Political Economy*, 123, 6.

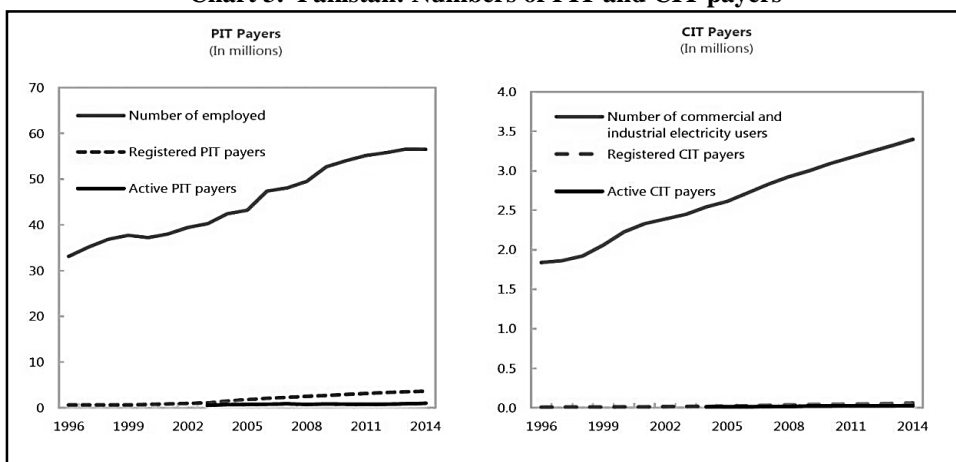
<sup>12</sup>Vito Tanzi (1987) Quantitative Characteristics of the Tax Systems of Developing Countries. In David Newbery and Nicholas Stern. *The Theory of Taxation for Developing Countries*. Oxford University Press for the World Bank.

valuation property tax model is being developed, then values need to be determined by market rates, and these will vary within cities and over time, depending on demand and supply, and the quality of public services being financed. For reasons outlined below, the property-valuation model has not worked very well in any developing country and was also abandoned in the UK by Margaret Thatcher. This paper develops proposals for a beneficial property tax for greater local accountability for the SDGs, and access to private finance for needed infrastructure.

- *The agricultural land tax collapsed after the Government of India Act 1935* (Dharma Kumar, 1982)<sup>13</sup> and far from being one of the main sources of revenues, has almost completely dried up (along with the payments for scarce water), but has spawned a large bureaucratic establishment that derives more in rent-seeking and extortion than actual revenues collected.

The FBR has been progressively “modernised according to prevailing wisdom”, on a functionally designed tax administration model with significant World Bank support over the past two decades, but faces significant problems, including a static and declining revenue performance. Even the best administration in the world would have struggled to raise revenues with the policy framework that has evolved in Pakistan.

**Chart 3. Pakistan: Numbers of PIT and CIT payers**



Source: Serhan Cevik (2016). Unlocking Pakistan's Revenue Potential. (IMF Working Paper).

Recent attempts to move towards digital point of sales registers for small taxpayers were not successful due to the absence of a parallel policy shift away from lump-sum taxation that leads to backward shifting of the tax burden and reduces incentives to participate in a digital chain. Similarly, the extensive use of exemptions and SEZs increases both the incentives and the ability of taxpayers to avoid paying taxes to the state. Qamar-ul Islam's *prescient observation remains that tax avoidance, smuggling and corruption are closely linked and feed on each other* (NTRC, submission letter 1986).

<sup>13</sup>See Dharma Kumar (1982). *The Cambridge Economic History of India*. Volume II, Cambridge University Press.

It is important to heed Qamar-ul Islam's advice that the reform of the tax administration must be linked to the reform of the tax policy agenda to have any chance of success. Unfortunately, that dictum has been ignored by successive governments, as well as foreign advisors, including the IFIs.

### (b) Recent External Support for DRM

Over the past three decades, there have been attempts to reform various taxes in a largely static tax administration model, e.g., supported by a very large number of IMF technical assistance missions. Many have been led by the IMF's leading tax policy and administration experts but have yielded little in the way of enhancements to the tax policy agenda. Ad hoc measures taken by the recipients of the technical assistance, as mentioned above, have amounted to further distortions in the tax policy framework and revenues have continued to decline.

The IMF missions were supplemented by the World Bank's administrative reform projects—or successive TARP's from around 2003, and the hundreds of millions of dollars have amount to little more than balance of payments support. The failure of the TARP's was largely due to the disconnect between a computerisation program without a clear “Conceptual Design” linked to a coherent tax policy reform agenda.<sup>14</sup>

More recent IFI efforts since the 18th Amendment have supported the establishment of new provincial tax administrations<sup>15</sup> mainly to administer the unworkable provincial assignment of the GST on services. These have also not had any appreciable impact on revenues or the overall efficacy of the tax system, and have clearly added to the cost of doing business.

Following the collapse of the 2008-10 SBA, the IMF engaged in “defensive lending” (see Ahmad and Mohammed, 2018),<sup>16</sup> and dropped the reform of the VAT that had been a contentious cornerstone of all programs since the early 1990s. Instead, the more recent programs have focused on raising revenues through the income tax. This is in ignorance of Vito Tanzi's seminal work in 1987,<sup>17</sup> that in most developing countries, the personal income tax is largely paid by formal sector wage earners. This would make it regressive, as it missed out non-wage income, and raises little prospect of additional revenues.

Recent proposals to establish electronic point of sales (POS) machines for e-invoices, and harmonising GST bases and rate structure *are sensible*. However, these are unlikely to be successful without additional policy measures and administrative rationalisation—reinforcing the observation of the 1986 NTRC that a comprehensive approach to tax reform is indispensable.

The IFI proposals to harmonise rates and bases of the GST, as India has almost managed under a Constitutional Amendment, is *eminently appropriate, but unlikely to work without additional policy measures to assure that provinces have “own-source” tax handles*. With harmonised rates and bases, there is no need for multiple administrations for the GST. Indeed, dealing with one administration for the GST (and the major taxes) would

<sup>14</sup>Review by the author in 2008 in preparation for the 2008-10 IMF Standby Programme.

<sup>15</sup>These were distinct from the Provincial Revenue Boards set up in colonial times to administer land-related issues and were broader than revenue collection offices.

<sup>16</sup>Ahmad, Ehtisham and Azizali Mohammed, 2018, *op cit*.

<sup>17</sup>Vito Tanzi, 1987. Quantitative Characteristics of the Tax Systems of Developing Countries. In Newbery, D. M. G. & Stern, N. H. (eds.) (1987). *The Theory of Taxation for Developing Countries*. Oxford University Press for the World Bank.

considerably reduce the compliance burden on firms—which has increased considerably since the 18<sup>th</sup> Amendment endorsed multiple administrations.

The harmonisation turns the provincial GST into a shared tax (with or without multiple administrations) and indistinguishable from the revenue shares under the NFC award. For accountability and access to private finance for investments, own-source revenue handles are needed with subnational ability to determine rates at the margin and can be achieved with a piggy-back or a surcharge on the income tax or excise tax base (including the petroleum surcharge). *Again, no separate subnational tax administration is needed.*

- The provincial tax administrations established for the GST on services would become redundant. Collections would be more efficient with a single tax administration and considerably lower compliance costs on businesses.
- Revenue distributions can be efficiently handled with a single tax administration, with the sharing proportions as determined under the 18<sup>th</sup> Amendment. This ensures that there are no relative revenue effects, other than hopefully a larger “pie” to be shared.

The IFI proposal to establish electronic POS machines is also appropriate, but not sufficient per se. This is largely due to the incentive systems under a simplified policy framework. Under lump-sum taxation of retailers and SMEs in lieu of GST, they would have no incentives to use the POS machines, as they would see no benefits with the change. This then breaks the value chain facing large taxpayers. Full implementation of e-invoicing is also important in generating information to stop cheating in all taxes and will require a coordinated amendment in tax policy and overall design of the administration, as highlighted by the Qamar-ul Islam Commission in 1985. The big difference today is that the reform options are greatly enhanced by the possibilities with digital transformations of the fiscal framework.

Beyond the numerical targets on tax/GDP ratios and levels of debt, it is important that the DRM should focus on incentives facing firms, workers, households, and governments at different levels of administration, to generate sustainable and resilient growth. This also would better position Pakistan to take advantage of opportunities in the wake of global supply chain disruptions due to the pandemic, climate shocks, as well as tensions between major trading partners. It is critical to anchor the tax design and administration within a strategy for sustainable transitions. A direct linkage with perceived benefits is also essential with respect to certain types of taxes, such as those on property—leading to a “beneficial approach to local taxation” (Ahmad and Brosio, 2022).<sup>18</sup> Such direct linkage is not possible with the broad-area taxes such as the GST.

#### **4. APPROACH TO TAX MULTILEVEL TAX POLICY AND ADMINISTRATION REFORMS WITH LESSONS FROM MEXICO**

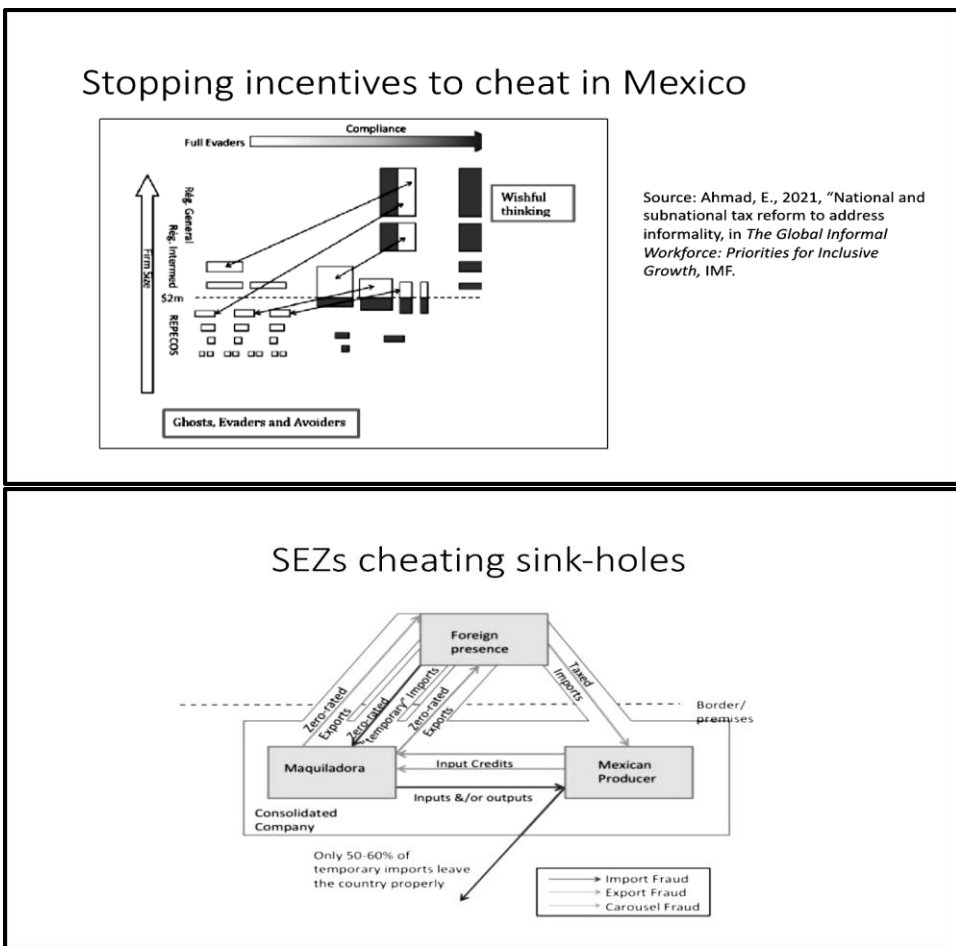
A meaningful sustainable tax policy and administration reform must incorporate more than just a revenue-generation objective. Exemptions and special provisions for income distribution purposes, or to attract investment, especially in the VAT, break the information chain on BTB transactions and are generally counterproductive. VAT was

<sup>18</sup>Ahmad, Ehtisham & Giorgio Brosio (2022). *Beneficial property taxation for emerging market countries—addressing climate change and post-pandemic recovery*. Palgrave MacMillan.

devised with the objectives of removing cascading and encouraging exports and *creating a level playing field for investments and workers*. This can leverage FDI and domestic linkages, as well as reduce the cost of doing business. VAT information from the full BTB value chain and digital transformation also *reduces the incentives of firms to “cheat” in their income taxes, and their ability to do so*.

Two standard policy recommendations relating to the registration threshold for VAT/CIT Chart 2a) and SEZs (Chart 2b) open the door to “cheating” in multiple taxes.<sup>19</sup> In the first case, the ability to hide transactions between large firms and those below the threshold, or out of the net, facilitates “cheating” on VAT, wages, and profits. In the second case, the SEZ facilitates import fraud, export fraud and carousel fraud—as well as income tax fraud with firms hiding domestic profits in the tax-free zone. In both cases, the solution is through VAT applied to all transactions, including in SEZs—the coverage of the full value chain permitting immediate refunds on export.

Charts 2a and 2b



<sup>19</sup>Ahmad, Ehtisham (2021). National and Subnational Tax Reforms to Address Informality. In C. Deléchat and L. Medina (eds.) (2021). *The Global Informal Workforce*. International Monetary Fund, Washington, DC.

Distribution and political economy considerations are best addressed through a joint consideration of tax-on-tax interactions that improve the income taxes, intergovernmental transfer design given multilevel assignment of functions, and tax- benefit linkages, especially at the local level.

A tax reform agenda to support resilient and sustainable growth should not only focus on revenues, but also:

- create incentives for *minimising environmental damage*,
- generate *greater spatial equality* given disparities and centrifugal tendencies,
- lead to greater *local accountability*, especially for the SDGs and form the basis for sustainable access to private finance, and
- utilise *technological transformations to ease the cost of doing business* while reducing incentives to evade taxes.

A more robust multilevel tax system, including at the local level, should be designed with appropriate weights given to human, social, and natural capital, and of course revenues. The broader focus is needed to anchor the SDGs for greater resilience to shocks. Local own-source revenues are also needed for accountability and to ensure sustainable local access to private capital to finance investments. Thus, the *tax system should provide signals to firms, workers, and households on decisions to invest, seek employment (including domestic and cross-border migration options), and patterns of consumption*. This would include taxation/public sector pricing of carbon- related activities and emissions at the national and local levels.

Coordinated actions at national and local levels will be needed to ensure financing for minimum service delivery levels across the country and achievement of SDGs, and for responding to shocks like the Pandemic. These actions will influence incentives to migrate from lagging regions, and orderly policies for mitigation and adaptation in metropolitan areas. The creation of sustainable employment opportunities in clean, compact, and connected cities should also begin to address the huge problems with informality, especially in the crowded metropolitan slums.

Own-source sources of revenue at the local level are necessary to create greater “accountability” for the enhanced spending responsibilities. The greater devolution of resources under the last NFC award was designed to finance the SDGs as well as disaster management. However, the failure of DRM has resulted in unfunded mandates for the provinces, and unsustainable fiscal deficits for the federal government.

Own-source revenues at the subnational level would also anchor sustainable access to private finance, including provincial/municipal bonds, PPPs, and attract private capital for infrastructure financing. In parallel, there will be a need for tighter monitoring of uses of earmarked transfers and external assistance and ensuring envisaged outcomes.<sup>20</sup> The use of PPPs (including) at the subnational level requires the liabilities to be recorded in the balance sheets at the appropriate level of government with associated provisioning (IPSAS rules governing the management of PPP liabilities).

With digital transformations, the administration for most taxes does not have to be local. This arrangement applies to several policy options, such as piggy-backs or surcharges on a national base, or the proposed use of blockchain for asset transactions that

<sup>20</sup>Examination of the PFM/treasury options is beyond the scope of this paper.



might be subject to taxation by more than one level of administration. Local control can be established by setting rates at the margin, including on bands legislated by the centre. However, assigned subnational funds collected by FBR must be promptly credited to the appropriate local treasury accounts.

A key lesson from the effective management of the Pandemic in Pakistan was local identification and provision of support, including for the informal sector and the “new poor,” together with national, information management, coordination, and financing. For tax purposes, there needs to be coordination between the national ID numbers (NIC) and the FBR TIN.

The integration between the NID and TIN is critical for successful digital transformation that depends on the efficient flows and management of consistent information. This flow of information is central for the digital transformation of tax policies and rationalising fiscal institutions, including the tax administration and treasury functions and institutions. Digitisation of existing (semi-automated) processes and procedures is common.

Unfortunately, this is like pouring concrete over the fiscal system and preventing the desired transformation. Effective change-management will entail a joint reconsideration of policies and institutions to maximise the advantages of digital transformation of the fiscal system.

Digital transformations create significant new options for reforming DRM. These depend on timely and accurate information generation that facilitate tax-on-tax interactions and potential to change both policies and supporting institutions. Changes in the policy framework are an essential component in a digital transformation. This is seen in the resistance to adoption of point of sales measures by small businesses subject to lump sum taxation in the Pakistan case, as the tax regime did not change. Changes in institutional design are also needed, e.g., with the use of AI and big data. A very different structure of a national tax administration for all taxes emerges, as seen in the case of China. *More work would be needed to redesign the tax administration in the Pakistan case to take advantage of digital transformations.*

An application of an integrated VAT is observed with the need to generate full information on the BTB value-chain. This will permit electronic invoice matching leading to integration of small firms and businesses into the regular tax net. The more effective tax-on tax interactions will be made possible by digital enhancements, with significant improvements in the operations of the income taxes. The implications for the design of SEZs follows—e.g., the borders around the Shenzhen SEZ following the integration of the VAT in 2018 were removed to permit a better establishment of linkages with the domestic economy, leading to the creation of the Greater Bay Area High Tech Zone (Ahmad, 2021).<sup>21</sup>

Blockchain use to record asset transactions, including at the local level, provides a basis for establishing an arm’s length tax administration that assists all levels of government. Local autonomy depends on setting of rates at the margin by the sub-national governments and immediate and full access to the funds generated and deposited in their Treasury accounts.

<sup>21</sup>Ahmad, E. (2021). Multilevel financing of sustainable infrastructure in China—Policy options for inclusive, resilient and green growth. *Journal of Infrastructure, Policy and Development*, April 2021.

BEPS can play an increasing role in creating a level playing field and prevent “beggar-thy-neighbour” policies by trading partners and competitors. The effects of BEPS, even if a country has not formally acceded to the global treaties, are important for investment and resilient growth and should encourage FDI if the domestic linkages and business climate are sufficiently attractive. But taking advantage of the BEPS agenda will require transforming the investment climate to reduce the cost of doing business, and a streamlined system of SEZs. For this, a reformed VAT will play a major role. Enhanced domestic linkages should be among the core attractions of SEZs in Pakistan, including with CPEC related projects. Some preconditions for the effective utilisation of BEPS include the following:

- Immediate and timely refunds of the VAT on exports.
- Essential infrastructure investments for “agglomeration” effects, including “clean energy”.
- High-quality basic services, including health and education, including in the SEZs/CCCs.

The implications for specific tax instruments at the central and local levels, and potential for digital transformation follow.

## **5. TOWARDS AN AGENDA FOR TAX REFORMS IN PAKISTAN**

In keeping with the advice of the Qamar-ul Islam 1985 NTRC, given the history of failed tax reforms in Pakistan, and drawing on the experiences of relevant countries, it is possible to derive a set of coordinated multilevel tax policy and administrative reforms for the short-to-medium term. These build on Ahmad and Stern (1991) and can be linked with the more recent work by Haque, et al. (PIDE, 2024) on a sustainable growth strategy.

### **(a) Multilevel Tax Policy Options**

The design and management of national and provincial taxes in Pakistan could be improved in several respects. Some of the reforms would be facilitated by the planned digital transformation, and others depend on a political economy linkage with other taxes or inter-governmental transfers and should be considered as part of a coordinated “package”.

#### **(1) VAT and Digital Transformation**

A modern and simple VAT with minimal exemptions not only generates significant revenues but also helps with creating a level and integrated economic space, reduce the cost of doing business, and generate information that facilitates the broadening of the income tax base and reduce “leakages” and “cheating”. As seen in China and Mexico, VAT introduction and reforms generate gainers and losers among provinces/states, *and political economy considerations require the use of a “package of taxes and transfers” to offset the likely resistance to the reforms.*

Digital transformations depend crucially on generation of timely and verified information that simplify both tax/spending design as well as institutional

arrangements, policies, and procedures. Thus, to anchor a digital transformation the VAT will involve:

- Full information for digital transformation with coverage of BTB value chain and the components of wages and profits at each stage, requires integration of SMEs into the VAT value chain. This will require both policy and administrative reforms along with digital transformations.
- Removal of exemptions and special provisions to encourage investments or distribution for BTB transactions. This applies to a significant portion of the tax base, leading to one of the lowest C-efficiency estimates in the whole world (OECD, 2022).
  - Exemptions in the VAT are tantamount to “input taxation” that prevent input tax offsets being carried further in the value chain. Hence this introduces “cascading” that the VAT was invented to eliminate, adds to the cost of doing business, and discourages exports.
  - Exemptions in a VAT lead to breaks in the information chain that prevent the use of information from the VAT for other taxes, thus making it easier to avoid income tax liabilities. An integrated VAT has the potential to stem “cheating” in the income taxes and hiding of transactions and value added (wages and profits), including by large taxpayers.
  - VAT can be applied to mining and drilling and would force the disclosure of activity levels, including with production-sharing contracts, even if the activities are mainly for export.
  - A VAT that covers the full value chain and facilitates immediate export refunds/credit could also transform the design and operations of SEZs that could better leverage domestic linkages.
  - A critical element in the digital transition is to ensure that the TIN is consistent with the NIC. The revised TIN/NIC would also need to be mandatory for any public transactions, especially customs, but also other public activities such as contracts and procurement, and registration of labour or companies.

With an integrated VAT and complete coverage of the BTB value chain (with C-efficiency rising from 0.2 to above 0.8, or levels achieved in PRC or Thailand), there should be a significant enhancement in the tax/GDP ratio taking it towards the 15-18 percent levels and form the main element in enhancing DRM resilience targets. This would also help in creating a level playing field and ensuring that Pakistan is able to take full advantage of greater global efforts to harmonise corporate taxation (BEPS Pillar 2 in particular).

- Sequencing of measures for a “package of reforms” including VAT and tax administration
  - In the short run, an integrated VAT would require agreement between the Centre and the Provinces for a single administration, perhaps with a board of directors representing all federating entities. Revenues would continue to be distributed according to the 18<sup>th</sup> Amendment. The new administration would also administer an integrated income tax and allocate revenues according to current laws.

- In the longer run, a Constitutional Amendment would be needed to reassign revenue functions, taking account of the efficiency and revenue gains of digital transformations, along with new own-source provincial revenues for accountability. A new fiscal equalisation component would also be needed to avoid exacerbating spatial imbalances.

## **(2) Political Economy of Distributional and Environmental Concerns**

Distributional and environmental concerns should be met through other taxes, such as the income tax or excises on goods consumed primarily by the rich. While it is not appropriate to integrate distributional concerns into a VAT, excluding non-processed foods from the VAT goes a long way in protecting the poor without jeopardising the flow of information from the full value chain.

Political economy considerations influence environmental taxation, such as a carbon tax. Reforms should be based on a broad perspective on gainers and losers, especially in a country such as Pakistan with lower-than-average per capita emissions in relation to other Asian countries as well as the global average. Yet, *appropriate carbon pricing is needed to tax the rich users of energy and petroleum, and to reduce pollution and congestion especially in large metropolitan areas*. This can be achieved through a piggy-back local surcharge on the petroleum levy<sup>22</sup> that would be higher in Karachi or Lahore, than in remote and less densely populated regions. This would reduce migrations and informality and help shift investment and employment to clean, compact, and connected cities (CCCs), and SEZs with domestic linkages.

More precise estimates for distributional or environmental concerns could be based on a system of additional petroleum excises. These would require systems of demand and supply estimates using household and production data (see Ahmad and Stern, 1991 for method and examples from South Asia, or Ahmad and Viscarra, 2016 for Chile; and Ahmad and Viscarra 2021 for Mexico). While static micro-simulation estimates, often used by the IFIs to establish gainers and losers in policy reforms are a useful starting point, a full assessment would also incorporate the impact on employment generation and the environment, that also lead to improvements in health and living conditions.

For Pakistan, drawing lessons from other countries would suggest the following options:

- Excises on carbon, emissions; taxing “bads” (including e.g., plastics, cigarettes, and alcohol)—the suggested relative rate structures would depend on the inequality aversion of the policy makers and weights on human, social and natural capital.
- Local piggy-backs or surcharges, e.g., on excises for health externalities and environmental damage would provide significant additional revenues and also appropriate (dis)incentives in more polluted or congested areas. A higher piggy-back in Karachi or Lahore, than in CCCs/SEZs, would generate incentives that support the spatial transformation for sustainable growth.

<sup>22</sup>This was originally called the petroleum tax but was changed to petroleum levy to avoid sharing the revenues with provinces.

*Local/subnational tax administrations are not needed for surcharges or piggy-backs, and sub-national autonomy and accountability depend on the ability to set piggy-back rates at the margin.*

### **(3) CIT, BEPS and Redesigned SEZs**

In a rapidly globalising world and especially strengthened competition from neighbouring S and SE Asian countries, there is a case for reducing the standard rate of the CIT to bring the rate structure in line with the regional standard, especially since some of these countries are competing for FDI. Revenues would be protected by rationalising CIT exemptions and preferences, and making better use of BEPS, especially Pillar 2.

- CIT—rate setting with BEPS –would effectively establish a minimum tax on profits, even if generated in a SEZ, or in a country that has not signed on to the global treaty. It would make not sense for Pakistan to subsidise the Finance Ministries of investor source countries.
  - Consideration should be given to shifting to full loss carry forward rather than exemptions to tax the effective profits over the life cycle of the investments. This would reduce the incentives to cheat. It would also eliminate a bias in favour of short-duration projects.
- SEZs should concentrate on agglomeration effects and better linkages with the domestic economy. Implementing the VAT in SEZs would enhance domestic linkages, increasing the attractiveness of Pakistan for FDI, provided there is immediate and full refunds/credits for exports. This would depend critically on the planned digital enhancements of the FBR and procedures that directly credit the accounts of the relevant taxpayers.

### **(4) PIT and Tax-on-tax Linkages**

PIT coverage in most Emerging Market Countries is often driven by formal sector wages. Non-wage income, including from the very extensive informal sector, agriculture, and assets, is typically difficult to capture with traditional tax administration methods. The options expand as the economy develops, and digital transformation takes hold, especially with a fuller coverage of the value-added base. The latter provides information on wages and profits (components of value added) at each stage, as is important in expanding the base of the income taxes.

- PIT enhancements depend on the effective use of big data, and full coverage of BTB value added by the VAT is a huge advantage.
- A critical precondition for the improvement in information flows is the linkage between the NIC and the TIN. This is a cornerstone of the digital transformation and needs to be examined carefully.
- Generating information from blockchain on financial and real asset sales will assist in expanding the base significantly beyond taxing formal sector wages.

Own-source revenues, where the sub national jurisdiction sets the rate at the margin (including within a band in unitary states) are essential for accountability. This is particularly important in countries that have devolved spending to the sub national level. Thus, for sub-national administrations:

- It is important to align incentives of subnational jurisdictions/local governments and the national tax administration by permitting a piggy-back on an integrated national PIT base. This would also encourage sub-national governments to provide information that is more readily available to them, especially third- party data on living standards. However, the more developed cities, where the rich live, would likely benefit disproportionately.
- A full reform that addresses political equalisation and spatial equity concerns would involve a fiscal equalisation system in which a subnational piggyback on the income tax (and property taxes—see below) should be a factor determining standard revenue capacities, and hence the amount of transfers received.
- The piggy-back would also count as “own-source revenue” for subnational access to local government bonds or other access to private finance. Shared revenues are not under the control of a sub-national jurisdiction and are thus not appropriate in determining local borrowing or capacity to service liabilities.

##### ***(5) Tax-benefit Linkages and Political Economy of Local Taxation***

A huge area of concern is the absence of effective own-source revenues at the local level in Pakistan, given a dysfunctional property tax, and major push to devolve spending. While higher revenue-shares are needed given the large vertical imbalance in the country, these do not ensure accountable use of revenues or appropriate decisions concerning financing the SDGs or associated investment design.

The potential piggybacks on national taxes provide a convenient tax handle that can be implemented quickly, can unlock bond issuance as well as private finance, and do not require a new local tax administration, three other elements would help in overcoming a potential “race to the bottom”:

- The piggy-back could be subject to a floor;
- Access to private funds and borrowing could be made subject to generation of own-source revenues, including the piggy-back; and
- The fiscal equalisation could include a standardised estimate of what the jurisdiction should raise from the own-source taxes, that would be taken into consideration in the determination of the equalisation transfer. This however applies to all local own-source taxes, and not just the “piggy-backed” arrangements.

Property taxes are visible, “onerous” and generate political opposition, as Alfred Marshall noted in the 1890s. This seems to have been borne out in most emerging market countries, and Pakistan is one of the worst examples in this regard with negligible collections (see Annex charts). Alfred Marshall correctly pointed to the importance of

linking a simple property tax to basic services to overcome political resistance and turn an onerous tax into a beneficial one (Ahmad and Brosio, 2022).<sup>23</sup>

Three distinct cases apply with respect to urban property taxes:

- (a) The recurrent tax on non-commercial properties. This provides the bulk of property tax revenues in most countries and is the most difficult to address largely because of a potentially “onerous” character of the tax. A major stumbling block in emerging market countries from China to Colombia to India, has been the political economy constraint of income constrained households living in potentially expensive areas.
- (b) A recurrent tax on commercial properties. The political economy constraints faced under Case 1 do not apply, and there are far more transactions than for non-commercial properties. It would be appropriate to continue to apply the traditional market-based valuation-ownership model.
- (c) Property sales. All property sales, whether for commercial or non-commercial properties, should be taxed at the prevailing market. Such sales can be taxed at both central and local levels and would benefit greatly from the digital transformation that is underway in many countries.

The ongoing work to establish property values by FBR can be used to establish relativities in a simple area-based system of bands based on location and size, with simple establishment of rates by the local authorities for the recurrent taxation of non-commercial properties. This has considerable potential (up to about 2 percent of GDP). It is possible to pilot some of the “Marshallian” linkage with local service delivery. But for commercial properties and all property sales, it is important to apply the accurate market rate, and a blockchain system can go a long way in establishing this. A significant area of work remains to be done in Pakistan on local taxation, urban transitions and achievement of the SDGs and greater accountability and resilience. Some key points follow:

- (a) Use existing work on national valuation to establish rankings for “potential bands” for an area/location- based recurrent property tax on non-commercial properties; use of satellite technology (national tax administration) with low-tech local verification.
- (b) Use of blockchain for all property sales at market values, would become a key element in the capital gains tax, and provide information on assets for the proper working of the income taxes.
- (c) Market valuation for recurrent taxation of commercial/business properties is important, as more regular markets exist and more robust information generation. Central government/FBR determination of property values is not appropriate in this context.
- (d) An effective “fiscal equalisation system” is an essential complement to this reform.

<sup>23</sup>Ahmad, Ehtisham & Giorgio Brosio (2022). *Beneficial property taxation for emerging market countries—financing sustainable development and post pandemic recovery* (with). Palgrave Macmillan.

## **(6) Taxation of Agricultural Land**

Size/location and irrigation status could also be used to revamp agricultural taxation linking to local public services for accountability purposes—was presented to the 1986 NTRP and is outlined in Ahmad and Stern (1991, op cit). The Ahmad-Stern simulation of acreage-based land tax was linked to a percentage of gross output (7.5 percent) above a generous exemption limit of 12.5 acres of operational units (also graded by PIUs) for insurance purposes. The exemption leads to an increasing marginal tax rate for larger holdings, so is equitable, and would have generated around 1 percent of GDP or more revenue than the total provincial revenues at the time, or federal development grants to provinces. The crucial link with “ushr” and local public services: health care, basic education, and social protection for the locally identified needy, is needed for political acceptability and could transform rural local governments towards better accountability and social service delivery.

### **(b) Towards a New Tax Administration Paradigm with Digital Transformation and Local Autonomy**

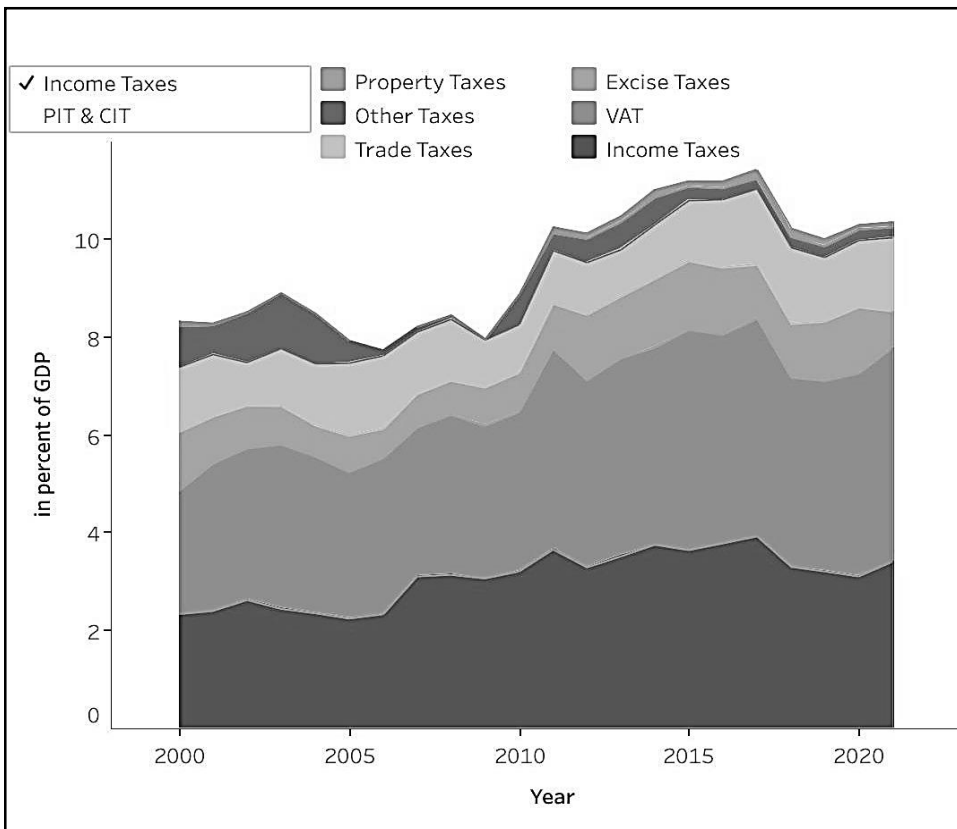
A digital tax administration is all about efficient information generation and management, and this involves both policy and processes and procedures. As seen in the recent less than successful attempts to roll out point of sales machines that issue electronic invoices to small taxpayers and wholesalers, there is not much enthusiasm for this as long as these taxpayers are subject to “lump sum taxation” and do not see any benefit to joining the scheme as the burden is shifted backwards.

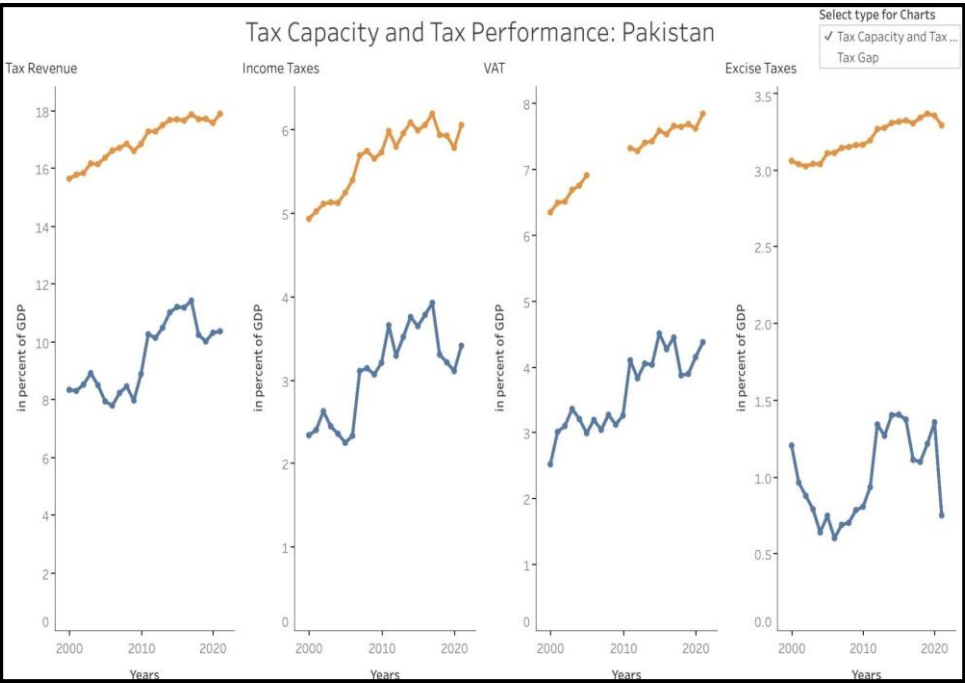
It is important not to computerise existing processes and procedures without thinking through what a policy and institutional arrangement might look like in a digital world. While there is considerable work needed in this area before more specific recommendations can be drawn, the following issues need to be kept in mind.

- Use and management of big data and artificial intelligence can shift the determination of tax liabilities to an automatic basis from the audit evading taxpayers, with a more arms’ length role for the tax administration. *It would also change the options for the design of tax administrations from the standard TADAT model.*
- Invoice matching was not recommended in the typical structure and functions of an administration that relied on firms to maintain records and conduct (scarce skilled) audits—with the attendant focus on large taxpayers and increasing the registration threshold for VAT and income taxes. This led to ability and incentives to cheat, with incomplete information.
- With big data, it is much easier to integrate small businesses into the automatic invoice matching system—with detailed audits focused on very large and complex taxpayers, building on the Large Taxpayers Unit. This involves a potential shift in the role and functions of the tax administration to a more arm’s length basis, with implications for tax policy and administration. The more efficient integration of small taxpayers is key to addressing informality and stop cheating (by large taxpayers).



- Simplification of procedures, reconciliation, and information by use of blockchain, as well as management of returns and liabilities, would need to also examine that interface with the treasury/PFM system.
- Digital transformation permits easier exchanges of information between domestic and foreign firms, facilitating FDI. This will transform the role of the tax administration, with most assessments carried out electronically and presented to taxpayers. An additional benefit is the exchange of information between tax administrations needed for a closer evaluation of transfer pricing, electronic services, and prevention of the cross-border leakage of revenues.
- There is considerable potential for an integrated arms' length tax administration for all levels of administration, that sidesteps capacity constraints at the local level—but
  - Rate setting at the margin is critical;
  - There needs to be a complementary equalisation system (administered within provinces/regions; or centrally).
  - Automatic transfer of funds to local accounts is essential, so PFM and TSA issues are also involved.

**Annex Chart 1 Pakistan Tax Performance.**



Source: World Bank Tax Revenue Dashboard.