Taxation in Pakistan: taxing the untaxed elites

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Chris Matthews's famous quote "Paying tax is not a punishment. It's a responsibility". Most developed countries with a simple and efficient tax system enjoyed higher GDP growth, investment and employment than those with complex and inefficient tax systems.

According to Tax Competitiveness Index 2023, Estonia stood at the best tax code among OECD countries due to efficiency, simplicity, equity, and transparency. The tax-to-GDP ratio in Estonia was 33%while ranged from 18% in Mexico to 47% in Denmark among OECD countries in 2020. In developed economies, direct taxes (DTs) and indirect taxes (ITs) contributed 59-62% and 32-35% of total tax revenue, respectively.

The situation is reversed in Pakistan, because DTs and ITs varied between 18-46% and 54-82% of total tax revenue for decades. More than 70 types of taxes were collected through a complex tax system with the support of 37 tax collection agencies. ITs always led to tax composition. The share of ITs, including income withholding taxes, remained at its highest stage of 82% in recent years.

The share of DTs and ITs ranged between 36-40% and 60-64%, respectively, from FY18 to FY22. Albeit, DTs and ITs contributed 46% and 54% to total tax revenue, respectively, in FY23. The major reason is the ballooning fiscal deficit (FD) for decades. The average FD hovered around 6pc of GDP during 1970-2022 while the estimated FD remained at 7.4% for FY2024. The persistent rising FD diverted the economy's direction towards higher ITs.

The total tax collection was Rs.0.31bn in 1973 and levitated to Rs.7.164trn in FY2023. The tax-to-GDP ratio dwindled from 14% in the 1980s to 8.5% in FY23. The tax-to-GDP ratio remained between 8.4% and 9.8% during the recent past. At the federal level, Pakistan's tax potential is Rs.20trn and by including the undocumented economy it is projected to be Rs.34trn, 16% of GDP.

Heavy dependence on ITs meant that a significant portion of tax revenue is snatched from lower and middle-income groups. According to the World Bank document 2023, in cash terms, and relative to pre-tax incomes, the poorest 10% of the population pays a greater share of income in taxes than the richest 10%.

Moreover, the poor and rich are paying the same tax rate on goods and services, and the middle class shrinking from 42% to 33% is always sacrificed in the form of higher indirect taxes and inflation (17.4%), the incidence of poverty approached 43%.

Currently, over 103 million people are living below the poverty line. Because the current tax system is highly regressive and unsympathetically affects middle and lower-income groups through ITs. The tax structure is fragmented, exploitative, and anti-growth.

A research study by Lahore University of Management Sciences (LUMS) revealed that the government only received Rs.38 out of every Rs.100 of revenue collection, with the remaining Rs.62 distributed among taxpayers, tax collectors, and tax practitioners.

In Pakistan, income and wealth inequality are swelling, exacerbated by regressive taxation. Several research studies claimed that a major chunk of tax collected through ITs adversely impacts the unequal distribution of wealth and income. The 2% of elites own 95% of national resources.

About 5% of feudal possess 64% of farmland while 65% of small farmers hold only 15% of the total farmland. The average worth of an elite is more than US$1m, but their income tax contribution is less than 1% of total tax collection. Unfortunately, annual perks and privileges for elites are more than Rs 4 trillion (US$17.4 billion). Tax evasion is Rs 5.8 trillion, equivalent to 7% of GDP. The size of the informal economy is more than 40% of GDP while the estimated value of the black market and smuggling of goods remained at US$23bn in 2023.

Agriculture, industry, and services sectors contributed 22%, 20%, and 58% of GDP while their tax shares are 7%, 62%, and 31%, respectively. The estimated agricultural income tax (AIT) potential is Rs10bn to Rs 200 billion. The Pakistan Business Council (PBC) estimated tax revenue potential of wholesale, retail, real estate, agriculture, and property sectors is Rs 747 billion.

The foremost challenge to tax collection is the trust deficit among the public, tax administration, and policymakers. It intensifies when the middle and lower middle suffer from the cost of debt repayments through heavy indirect taxes while more than 60% to 70% of the public revenue goes into debt servicing and the elite enjoy the perks and privileges of more than Rs 4 trillion (US$17.4 billion) per year.

Trust deficit can only be restored through a simple, efficient, equitable, transparent, and digitised tax system with candid administration. So the big challenge is not achieving the tax target but restoring the trust deficit through taxing the 2% of untaxed elites who own 95% of national resources. Pakistan's tax-to-GDP ratio could rise to 20% of GDP if 3.5m ultra-rich individuals are brought into the tax net. No doubt it is difficult but not impossible. This will be done only through political will and effective tax reforms.

Implementing progressive tax rates for elites can lead to a fair tax system which can play an imperative role in restoring the public trust deficit. Among the top 2% of the elite, those not paying taxes should

be taxed, despite imposing a heavier burden on the remaining 98% of the general public who are already overburdened through taxes.

The proposed tax ratios of DTs and ITs are 59-62% and 32-35% of total tax revenue collection, respectively. Therefore, a big shift from ITs towards DTs can ensure that higher income groups contribute a fair share in total taxes. Moreover, the elite's privileges, and smuggling should be eradicated on a war footing basis.

The informal economy should be documented through digitisation to modernise the tax system. Furthermore, the focus should be on broadening the tax base by including the untaxed elites rather than increasing tax rates on the general public. Ibne-Khaldun's Theory of Taxation avows that high tax rates shrivel the tax base because they dwindle economic activity.

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