WHERE DO THEY SPEND MY TAXES?

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Pakistan economy has been trapped into stagflation since the last three years amid low growth prospects, persistent macroeconomic imbalances, and enlarged vulnerabilities of a sizeable fraction of the populace. Among these, growing fiscal deficit is one of the fundamental causes of Pakistan's structural economic woes. Pakistan is faced with a fiscal deficit of around 7.6% of GDP for financial year 2023-24, calling for more borrowing in the current fiscal year and enlarging the future liability. Persistence in fiscal deficit is caused by both a flawed tax system and unproductive spending behavior of the successive governments. Pakistan's tax system is regressive, complex, and inefficient which is not only costly but also encouraging a wider tax evasion and informality in the system. Likewise, Pakistan's public expenditure system is characterized by a huge volume of current outlay exacerbated mainly by a huge size of the public sector, excessive interest payments, loss-making State Owned Enterprises (SOEs), and burgeoning circular debt, all implying little fiscal space for development spending. This setup has cumulatively caused the country's debt to GDP ratio to reach to around 80% of GDP, which is much higher than the limit of 60% as is fixed by the Pakistan's Fiscal Responsibility and Debt Limitation Act of 2005. In nutshell, we need fiscal sustainability which can be attained with broader structural reforms like enhancing efficiency of the tax and expenditure system, removing exemptions and distortions in tax policy, and rationalizing public spending etc. One specific but very relevant question in this regard would be to think over where do we spend our meagre resources or taxes. In this essay, we are focusing on this aspect but, before going to that point, let us briefly explain the basics of our tax structure.

As far as the current tax structure is concerned, all individuals, unregistered firms, association of persons, etc. are liable to pay tax, at rates ranging from 10 to 35 percent. Likewise, all public companies (including banking companies) incorporated in Pakistan are assessed for tax at different corporate rates. The effective rate for each type of company is likely to differ on account of allowances and exemptions related to industry, location, exports, etc. Based on the data from 2022-23, overall, direct taxes contributed around 40 percent of the total tax revenue (40.7% in 2022-23 of Rs. 7470 billion). Income tax is 98.8% of direct taxes, with three types of income tax are currently in practice (4.4% is out of demand, 29.7% is voluntary payments, 67.5% is withholding tax). The corporate tax rate currently stands at 29 percent, averaging at 33.51 percent from 1997 to 2023. It was all time high at 43 percent in 2000 and a record low of 29 percent since 2021. In addition, for banking companies, the standard corporate tax rate is 39% (raised from 35% effective from July 1, 2022). Tax is levied at increased rates ranging from 39% to 55% on the taxable income of banks attributable to investment in federal government securities. For small companies meeting certain conditions, the tax rate is 20% (reduced from 21% effective July 1, 2022). A total of 50,000 companies are filing their annual income tax returns out of over 100,000 entities registered with the SECP as is stated in World Bank financed Pakistan Raises Revenue Project (PRRA). In addition, there is also a super tax which applies at different rates for different levels of income. For 2023-24, the super tax applies at a higher rate of 10% for banking companies where income exceeds Rs. 300 million. A minimum tax is payable at 1.25% of

turnover. An alternate corporate tax (ACT) also applies, where the minimum tax liability of the company is determined as the higher of 17% on accounting income or the corporate tax liability including the minimum tax on turnover. Despite these high tax rates, Pakistan has been facing persistence in fiscal deficit for most of its history, with having one of the World's lowest tax-to-GDP ratio (around 10.4% for financial year 2022-23). In other words, our tax system though comprehensive but is inefficient.

Inefficiency directly stems from the tax system, which is characterized by complexity, narrowness in base, low compliance, inefficient administration, and declining provincial tax revenues. It has led to widespread discretion and corruption, with inequitable exemptions and preferential treatments, low tax registration, and massive tax evasion. The outcome is a regressive tax system (indirect taxes make up around 60% of total taxes), with too much dependence on withholding taxes. Indirect taxes combined with a corporate income of around 29% create anti-growth bias by shaping distortions in resource allocation. Likewise, tariff policy has strangled competition and growth, with the average effective tariff rate (11.2%) being the highest in the region. Moreover, as stated earlier, 68% of direct taxes are derived from withholding taxes, with the share of direct taxes in total revenue decreases significantly if we exclude withholding taxes. Along with these issues, Pakistan's tax collection is costly; excessive documentation raises the cost of compliance too; PIDE estimated, on average, for each business the annual compliance cost is more than Rs. 250,000, irrespective of the business size. While on the exemptions side the system has been extravagant; from around Rs. 35 billion in 2000, tax expenditures have been swelled to Rs. 2.24 trillion in financial year 2022-23.

With regard to spending, Pakistan has been a spendthrift economy, especially with regard to current expenditure which are increasing consistently. Over time, Pakistan has experienced spread in size of the government, with proliferation of ministries, government departments, and various agencies, which has imposed a substantial cost in terms of salaries, benefits, and pensions. In addition, interest payments, defense spending, and subsidies has been ballooned. If we look at the budgetary figures for financial year 2024-25, of the gross revenue of Rs. 17.815 trillion, the federal government will have a net amount of Rs. 10.377 trillion after transferring Rs. 7.438 trillion to the provinces under the National Finance Commission (NFC) award. Given an allocation of Rs. 9.775 trillion to debt-servicing, it implies that almost all other heads like defense spending, pensions, running of the civil government, Public Sector Development Program (PSDP) etc. are to be financed by borrowing. This in other words implies that around 45% of the total budgetary outlay is financed through borrowing. Second, there is a sizable footprint of the government in the economy, with around 212 State-Owned Enterprises (SOEs) are operating in various sectors. Overall, the government's footprint in the economy exceeds 60% of the GDP as is estimated by PIDE. It has also puts a significant drain on the budgetary resources, with their annual losses reaches to around Rs.1.8 trillion for the financial year 2022-23. The budgetary impact of SOEs has climbed from 9.2% of the budget in 2000 to 46.2% in 2022-23 because of payments to Independent Power Producers (IPPs). Third, Pakistan's power sector, dominated mainly by public limited companies, is facing severe financial crisis as their circular debt, the amount of money that the government owes to power producers and fuel suppliers, has reached to Rs. 2.6 trillion by the end of October, 2023. With regard to its budgetary impact, the ministry of energy has recently demanded Rs. 1.234 trillion power subsidies for the next fiscal year (2024-25) which is 26% higher than the original allocation of Rs. 976 billion for the current fiscal year (2023-24). This regime of subsidies is not limited to the power sector but extends beyond to extensive exemptions and concessions, tax breaks, cheap input prices or higher output prices, preferential access to land, capital, and services etc. For instance, tax expenditure mentioned above can broadly be defined as the revenue foregone due to various exemptions and concessions in tax laws constitutes to be Rs. 2.24 trillion for financial year 2022-23 amounting around 24% of the gross tax revenue for the same financial year. Mostly, these exemptions are awarded to the elite section of the society. Overall, around Rs. 2.6 trillion are spend each year on the privileges and benefits enjoyed by the powerful interest groups in Pakistan as is estimated by the United Nation Development Programme (UNDP) in the National Human Development Reports (NHDR), 2020. This is close to 7% of the GDP compared to the spending of 5.4% of the GDP on debt-servicing, 4.1% on defense, and just 3.5% on the provision of social services. All these add to the wasteful expenditure that Pakistan has been incurring persistently since its inception. Finally, regulatory mechanism in the country is faulty which has been eating a handful of budgetary resources. PIDE, in its Sludge Audit, has estimated that cost of regulations in the country is around 45% of the GDP.

What needs to be done? I would like to posit that introducing structural reforms in true letter and spirit is the need of the hour, with clear goals of fiscal sustainability and macroeconomic stability in the short and medium terms, receptively, and sustainable economic growth in the long run. First, besides looking for additional revenue streams as also desired recently by the IMF, measures such as removing preferential tax credits and exemptions, enhancing tax base and registration by simplifying the mechanism, introducing agricultural income tax, harmonizing the sales tax regime, and rationalizing public spending would serve the purpose. Second, circular debt of the power sector and losses of the SOEs must be curtailed. Reducing generation cost and capacity charges, cost-effective pricing, improving transmission and distribution mechanism, introducing competitive practices in energy market, ensuring energy efficiency along with corporate governance would ameliorate the circular debt. Likewise, reforms like

corporate governance, market-based induction of CEOs, joint ownership structure, and privatization of irremediable SOEs would eliminate leakages in SOEs. For sustainable growth in the long-run, we need investment, especially Foreign Direct Investment (FDI), which can raise our labor productivity and overall growth capacities. Likewise, we need exports which, along with upscaling our growth potentials, can cope with our external sector shortages. In this regard, reforms that can guarantee external sector liquidity, maintain market determined exchange rate, improve our sovereign credit rating, and mobilize domestic revenues are of upmost importance. Most of these reforms, however, need a certain political will. In other words, economic viability of the country needs to be the fundamental theme of political discourse. Reforms in political market must be initiated that can enhance the accountability of our political elite, on one hand, and solve the problems of collective action and free riding with regard to unbridled subsidies, Statutory Regulatory Orders (SROs) and several other forms of regulatory abuse, on the other.

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