TAX AUDITS AS SIGNALS: DESIGNING SMARTER ENFORCEMENT IN PAKISTAN

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Tax audits have always been at the center of the tax enforcement debate. A popular opinion held by many is that the Federal Board of Revenue (FBR) lacks the technical capacity (and sometimes willingness) for true tax enforcement. Another, less popular opinion, is that no matter enforcement capacity, taxpayers, in particular large corporate taxpayers, will inevitably plan their way out of increased tax liability. While both these narratives hold merit, they oversimplify what is a complex paradigm of tax enforcement, especially in a country like Pakistan. Foundational to this claim is recent empirical evidence from Pakistan that suggests that tax enforcement is not simply a question of whether the state is enforcing tax laws, but integral to that discussion is how those laws are being enforced and on whom. Additionally, it is most important to know what the state is learning about taxpayer behavior and what the taxpayer is learning about state capacity as a result of these enforcement activities.

To form a near complete picture as to how taxpayers respond to tax audits, both in the short and long term, this article pulls insights from two different tax audit studies based on Pakistan: one that looks at the impact of randomized Value-added Tax (VAT) audits (Waseem, 2021) and the other that looks at the impact of randomized income tax audits (Farooq, n.d.) on corporate firm behavior. Given Pakistan's specific context, a conclusive result from these studies is that while firms may respond to audits, the inclination to become more compliant or more evasive will depend greatly on what firms learn about state capacity as they undergo the audit process. Audit, then, serves as a signal to the taxpayer in addition to serving (in some cases) as a deterrent to tax evasion.

While this is not new knowledge, for a country that already grapples with persistent tax evasion, this reframing of tax audits is especially important. The deterrent effect of tax audits is well grounded in public finance theory and states that if there is a positive probability that, one, any tax evasion will be detected, and two, tax evasion once detected will result in financial penalties, tax audits will deter evasion. However, evidence points to the fact that the deterrent effect of audits is not guaranteed and if detection fails, is partially successful, or is perceived as superficial, audits may not deter evasion at all. In fact, firms may upgrade their tax planning with the knowledge gained from audit and become more sophisticated in their non-compliance over time.

This is not to say that enforcement is failing; quite the contrary. It points to the growing need to reimagine how enforcement is measured and how enforcement tools should be designed. While used as a strong tax enforcement tool around the world, static one-off tax audits will not be enough to deter tax evasion as enforcement is no longer just about detection, but about what taxpayers think is the state's capacity to detect. The two strands of tax audit research shed light on exactly this.

So, does an increase in the number of audits lead to more deterrence? The first research that looks at a series of randomized income tax audits spanning seven consecutive years using a sample of 55,000 firms in Pakistan, finds that while audits impacted firm behavior, the effects were divergent by size of firm. The research reveals the small and medium sized firms responded to tax audits immediately by increasing their compliance (filing their tax returns and paying their taxes on time). However, the effects for large firms, those with generally a greater access to more sophisticated tax planning resources, behaved differently; in fact, three distinct behaviors emerged. While some firms responded by becoming more compliant, for most firms the deterrent effect was short-lived, and was followed by a decrease in reported income in the years post audit. Then again, for some firms, compliance in the immediate term (resulting in higher reported incomes) was immediately followed by an increase in indirect evasion where firms failed to deposit the full amount of taxes owed to the government exchequer including taxes collected by them as withholding agents. And finally, for some large firms, audits had no effect on compliance at all. These behaviors suggest that going through the process of audit, firms are able to assess a "safe" level of evasion for them, fueled by the perception that it will go undetected.

That this is in fact firm behavior in response to tax audits is also reinforced by the findings of the second research. The second study looks at randomized VAT audits across the entire tax population and finds that while audits do uncover a substantial amount of evasion (in fact an evasion rate of 80%), they had virtually no effect on taxpayer behavior at all. That is to say, taxpayers that were audited continue to file the same way in the years post-audit with no meaningful change observed in their reported net sales, input taxes, output taxes or overall tax liability.

Taken together, these two studies challenge the assumption that more audits, even those that detect and penalize evasion, will lead to an increase in compliance. To the contrary, they demonstrate that audits carry transferrable knowledge and that firms interpret that knowledge, learn from it, react to audits based on what they learn, and eventually recalibrate their behavior. But the question arises: what are firms learning about the tax administration? What are audits signaling about the capacity of the state to detect tax evasion, and as a result, how are firms perceiving future evasion risk? Determining answers to these questions are critically important not only because they determine compliance levels today, but also because they establish the credibility of tax enforcement in the future.

These results are not surprising because firms are only reacting to enforcement. And as they undergo audits, they create mental models of whether the state is or is not able to detect evasion. For instance, if audits only skim the surface of taxpayer declarations, and fail to probe into areas where certain taxpayers are consistently evading taxes, such as overstatement of purchases, declaring large amounts of transactions in cash, or consistently failing to pay due taxes, then the firm may believe that such behavior has a low risk of detection. This is perfectly in line with what literature refers to as "detection probability": a model of tax compliance where taxpayers' decision to evade is directly proportional to their perceived probability of detection.

What this tells us is that in Pakistan's context, where tax officers have nearly 3,000 tax returns falling within their jurisdiction and a skeletal team of support staff, conditions that as good as guarantee limited audit coverage and often partial detection, it is the signal of audit that matters more than the number of them. It is important to note that this revelation does not imply that all firms are inherently malicious and noncompliant, for they are reacting rationally to what are signals from the tax environment in which they operate. If they perceive detection to always be partial, it will result in compliance being partial as well.

This is exactly the tipping point, where tax audit policy in Pakistan now needs to shift towards a targeted, informed, and dynamic enforcement design; because if audits are signals, it is not their quantity that will matter, it is their credibility. Both research studies have shown us that much! When audits are used as an enforcement tool but without the capacity for enhanced real-time detection, the returns to audit can diminish quickly. In both VAT and income tax audits, we saw that despite detection of evasion, firms that had gained enough knowledge of the system either remained steadfast in their reporting patterns or found new margins of evasion. In both cases, the behavior was led by the perception that their reporting behaviors will go undetected by the tax administration during, what they will begin to perceive as, procedural rather than substantive audits.

The good news is that this recognition has started to shift Pakistan, in particular FBR's approach to tax audits[1]. Although public discourse is saturated with critiques on what the tax administration has failed to do, it is worth paying attention to the measures that it is getting right, slowly but surely. In the past year alone, the design of tax enforcement has evolved through a set of reforms that are grounded not in hyperbole but in actual data and empirical insights, viewed through a behavioral lens. This shift demonstrates that institutional understanding now recognizes that for enforcement to be stronger, it must be smarter. One of the most significant developments that flow directly from empirical evidence discussed earlier is the adoption of a Compliance Risk Management (CRM) system. This system is built not just to catch non-compliance but to effectively allocate limited enforcement resources. Accordingly, it uses the universe of tax data that spans years, to define behavioral markers and risk indicators. Based on these flags, the system then segments taxpayers by their filing behavior and risk profiling to determine when to audit, when to simply nudge, and when not to do anything at all. This segmentation happens at various levels starting within the same industry, within the same city, or even with the same tax office. With the adoption of this system, the FBR now moves beyond blanket enforcement and is geared to effectively target taxpayers for whom risk of non-compliance is the highest.

The past year has also seen FBR experimenting with behaviorally informed nudges. A lot has been written about the positive effect of nudges on tax compliance behavior, and they do stand out as the most cost-effective instrument for increasing tax compliance, favored by many tax administrations around the world[2]. Nudges are designed as a move away from standard tax notices and consequently long periods of compliance. Instead, nudges rely on targeted dispersion of tax compliance information that considers historical filing patterns, performance amongst peers, and identified risk factors. This makes the communication between the tax authority and the taxpayer more credible and tailored, thereby inducing not just a quick response but a strong signal that the state is keeping an eye. There are other reforms that have quietly taken shape in the past year. This includes an increased scrutiny in all registrations into the tax net, informed by the conscious decision that screening out what might be non-genuine registrations at an early stage will reduce the risk of fraud in sectors with a high risk of non-compliance or a higher rate of fraudulent refund claims. While these subtle reforms may not be a full-scale transformation of Pakistan's tax administration, they certainly mark a shift in how tax enforcement is now being viewed. It is evident that the trajectory of tax reform is focused on building credibility and in designing an enforcement framework that is grounded in evidence and developed to continuously evolve.

Having said that, in a country where tax compliance will always remain a challenge and the tax culture formidable, it is inviting to judge enforcement in binaries: absent or present; success or failure. But the foregoing discussion is evidence of that fact that tax enforcement is complex and without a clear understanding of this complexity, it is impossible to judge enforcement fairly. It is often quoted that "FBR has failed to enforce taxes". Given that we continue to have a low tax-to-GDP ratio, and the problem of tax gap continues to linger; this statement, prima facie, may seem just. However, when we frame it this way, we ignore two harsh realities: first, that tax enforcement operates in an environment that has structural limitations such as limited human resource, lack of data integration, legal processes, and a fragmented tax base; and second, enforcement needs to be forward looking – it is important to catch evasion in the present but it is even more important to design systems that prevent it in the future.

1. https://fbr.gov.pk/taxpayers-audit/142257/131272#:~:text=Taxpayers%20are%20selected%20for%20audit,be%20included%20in%20risk%20register.
2. https://academic.oup.com/ej/article-abstract/135/668/1033/7810274?redirectedFrom=fulltext

A similar statement is "audits just don't work"! This statement, again, cannot be viewed in isolation. It is clear via the evidence presented that taxpayers respond to audits and may even become more compliant, but only according to what they believe about the capacity of the state. It is also clear that this belief is not formed by numbers but instead, is shaped through a consistent dynamic stream of intelligent interactions between the taxpayer and the tax administration; ones that foster trust whilst at the same time create deterrence. The point here is not to defend enforcement but to demonstrate that viewing enforcement measures with narrow metrics such as the number of tax audits or the amount of revenues recovered, overlooks the broader agenda of a reform. Every notice, every audit, every enforcement action feeds into the taxpayers' perception, and this demands that true reform becomes an on-going interaction rather than a one-off measure.

Reforming tax enforcement in Pakistan will have to be a rolling conversation and the tax administration must focus on three key things to add weight to it. First, intentional investment in data and analytics, not just to ensure compliance in the short-term but to use data, behaviors and reporting patterns to understand taxpayers at a deeper level. Second, to purposefully build an enforcement framework that extracts feedback from enforcement models and dynamically upgrades its risk algorithm, thereby allowing the system to adapt to changing patterns of reporting. And third, to recognize that building a compliant tax culture is a slow process, and consistency will far outweigh swift gains when it comes to long term success. This includes recognizing that reform fatigue exists and perpetuates not just within institutions but also within societies. Therefore, intelligent communication and on-boarding of stakeholders throughout the evolving enforcement landscape needs to be a constant feature.

The future of tax enforcement in Pakistan is not written in the number of tax audits closed or the amount of penalties levied; it will depend on whether firms believe in the capability and consistency of the tax system. It is this belief that will shape tax compliance, and tax reform must earn this belief to be successful.

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