



TAX POLICY ISSUES IN PAKISTAN

PIDE RESEARCH 2000-2020

Compiled by

**MACROECONOMICS RESEARCH SECTION
PAKISTAN INSTITUTE OF DEVELOPMENT ECONOMICS**

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PREFACE

The policy makers in Pakistan predominantly use tax policy to increase the Tax-to-GDP to stimulate the economic growth and public investment. Despite several attempts at reforming the tax policy, the objectives of sustainable growth and employment could not be achieved. This raise an important question that whether our tax policy support growth.

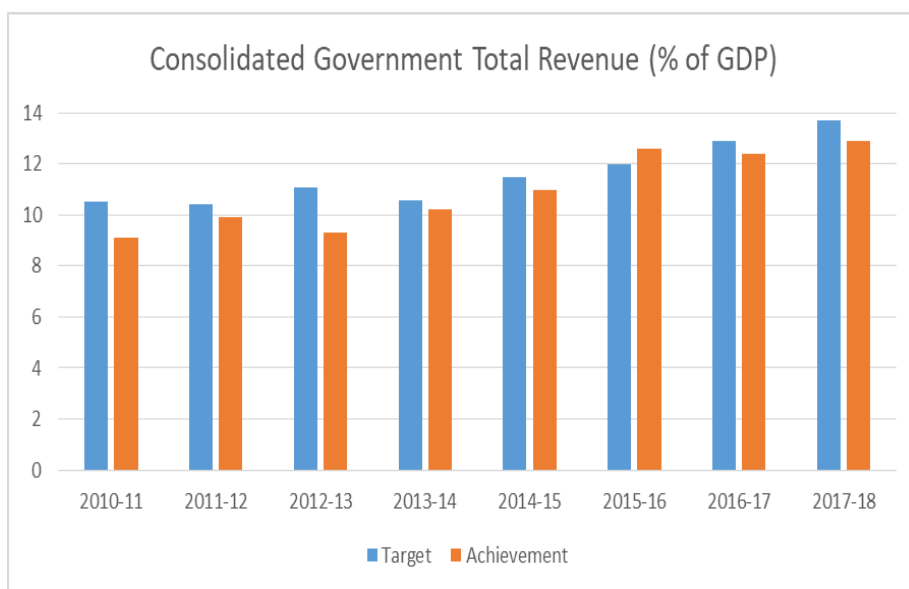
Before we make another attempt at reforming the tax system, we need to identify the key issue with our tax system. Several studies have been conducted by the experts and organisations to identify these issues. The Pakistan Institute of Development Economics (PIDE) has also been involved in exploring these issues through various research studies. While PIDE work on tax policy issues extends over several decades, this document is an attempt to summaries the studies that have been completed by the PIDE researchers and students in the last two decades. It is worth mentioning here that this report heavily draws on the studies that are being reviewed as the main purpose was to convey the actual messages emerging from these studies. This scholarship identifies several issues including, but not limited to, regressive tax policy, overestimation of revenue forecasts by the tax authority, low tax elasticity, and capacity issues in the Federal Board of Revenue (FBR). We hope that the readers will find this document helpful in getting a sense of the tax policy issues in Pakistan.

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1. INACCURACY OF REVENUE FORECAST

The effective management of resources, physical, financial or natural, is the key for success and prosperous life of an individual as well as nations of the world. Governments prepare plans so as to materialise their short and long term goals needed for the peace and prosperity of the country. The plans are implemented through the effective use of human, natural and financial resources available to the country. The expenditures, either for development purposes or for current need, depend upon the resource envelope of the country. The resource envelop of a country consists of two major components namely internal resources and external resources. The availability of total internal resources depends upon tax and non-tax measures.

For any government of a country, accuracy of tax revenue forecasting is important for materialising its projected programs. Otherwise the degree of deviation from accurate forecasting would eventually cause government to lose its esteem among the public. In Pakistan, historically there has been a shortfall in actual revenue receipts against the projected values. The shortfall in revenue receipts causes cuts mainly in capital /development expenditure which lowers the pace of future growth of the country.



The budget preparation is annual feature and is being practiced by each country of the world. The first and the most important step towards budget preparation is the determination of resource envelop available to the country. Serious efforts are made to determine the appropriate level of revenue receipts which constitute major portion of internal resources. Apparently, the annual budget in Pakistan is also prepared on the principles being followed by most of the countries of the world. The targets for government receipts are determined and the expenditures are made accordingly. However, these targets are hardly achieved in any fiscal year. The graph contains the consolidated government targets for total revenue receipts as a percentage of GDP for the last Eight years. The targets lay down for revenue receipts did not materialised for most of the period. If we do the same for absolute targets, then this situation further exacerbates. Missing the revenue target clearly indicates that either the targets are based on inaccurate forecasts or the tax collection machinery is inefficient. The accuracy of revenue receipts of Federal Government has become important, especially after 18th constitutional amendment, because any shortfall in federal revenue receipts would has two important effects: one it will jeopardise federal government's development plan and secondly the provincial governments would have lesser resources at their disposal because more than 80 percent of provincial resources depend upon the transfers made by the Federal Government.

In their study Qasim and Khalid (2016) have noted that as per Accounting Policies and Procedures Manual, Government of Pakistan, the revenue forecasting is defined as:

“Forecasts of revenue are to be prepared on a cash basis that is, based on what can reasonably be expected to be paid and collected in the financial year. This will be calculated from prior year collection figures, adjusted for changes in revenue collection policy. The forecasts will be provided in gross amounts (e.g. revenues will not be shown net of any related costs). This is also consistent with the related accounting policy for the recognition of revenues”.

The above stated revenue forecasting procedure is very simple and it is not based on any forecasting model/procedure/technique which usually takes into account all economic agents that are likely to play key role in the determination of revenue for the coming year. The reason for over or under estimation is due to non-adoption of proper model/procedure to determine the revenue forecasts. The study further notes that FBR (Federal Board of Revenue) is the major tax collecting authority of the country and is collecting about 90 percent of tax revenue. It has its own procedure/method for setting the revenue targets for the coming year (or next year). The procedure/method adopted by FBR to set the next year revenue target is not available in the documented form. However, the discussions with the officials of FBR reveal the following combination of procedure/method adopted by FBR to set the revenue targets for the coming year:

Table 1.1

Levels of Revenue Forecast Error

Description	Proportion of Percentage Error in Total at Various Level (in Absolute Term)			Standard Deviation
	≤ 1%	> 1% But ≤ 5%	> 5% and Above	
Federal Total Revenues	8.89	37.78	53.33	11.04
Federal total Taxes	6.67	26.67	66.66	10.79
Federal Direct Taxes	6.67	31.11	62.22	29.14
Federal Indirect Taxes	8.89	35.55	55.56	10.88
Sales Tax	4.44	20.00	75.56	30.66
Custom	8.89	35.35	55.56	12.21
Fed Excise	11.11	17.78	71.11	12.93
Surcharge	9.52	14.28	76.20	32.79
Federal Non-Tax Revenues	4.44	20.00	75.56	23.26

- Buoyancy based revenue forecasts: Government Ministries (such as Finance, Planning etc.) prepare the Macroeconomic Growth Framework for the next year identifying the sectoral growth rates. Based on Buoyancy measures for respective taxes, revenue forecasts for each tax are calculated.
- Reforms based revenue forecasts: Based on tax reforms for respective taxes each year, revenue projections are made.
- Administrative Efficiency measures based revenue forecasts: Based on certain administrative reforms of the FBR itself certain revenue projections are made for the overall taxes.
- SRO based revenue shortfall estimates: Based on the SROs, revenue reduction is estimated and deducted from the above revenue forecasts.

Their analysis for the period of 1970-2014 for federal government total revenues reveal if the acceptable level of accuracy i.e. forecast is said to be accurate, is measured when the percentage of error is less than or equal to one the highest number of accuracy is recorded for federal excise where 11.11 percent of the total period, actual revenues were close to the predicted revenues by a margin of less than or equal to one percent. However, it also has recorded its estimates to be out of target by margin of 5 percent plus 71 times out of 100. The lowest times for this highest error is for the customs. In terms of overall variability federal indirect taxes have been better as compared to indirect taxes. Federal non-tax revenue is also more volatile in terms of inaccuracy as compared to the taxes.

The picture is no different for the provincial resource generation position as well. In her study Jabeen (2014) for the KPK, Sindh, Baluchistan and Punjab province concluded that ex-ante revenue generation plans are formulated very ambitiously or over ambitiously due to political factors and government myopia. The structural drawbacks such as fiscal deficit, inflation, faulty projections of revenue/outlays and fiscal indiscipline are show a habit persistence. The budget estimates of the provincial governments are quite dependent on the revenue released from the federal assignments as per the National Finance

Commission Award, thus the inaccuracy of the federal government's revenues estimates translates into the forecast errors of provincial governments.

Recommendations

- The persistent forecast error during the period of study indicates that targets are not set on the basis of econometric model/CGE type models.
- Better Forecasts of basic macro variables, such as national income, price level etc., and estimates of key parameters such as tax and expenditure elasticity should be made.
- Besides these quantitative measures, budgetary processes and assumptions such as FRDLL and PFM Act etc. may also be considered in the determination of accurate revenue receipts.

2. IS TAX POLICY REGRESSIVE IN PAKISTAN?

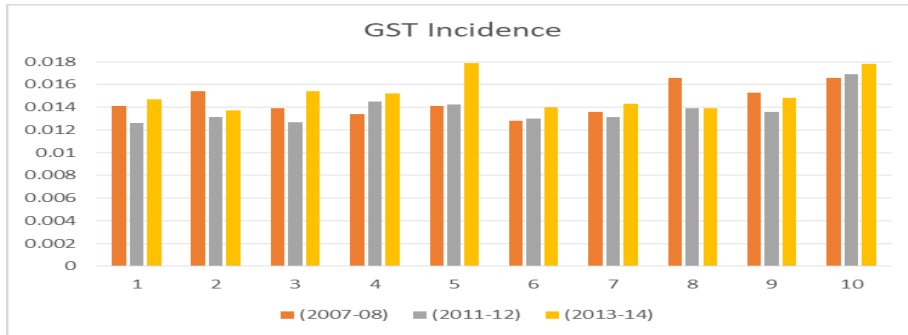
Pakistan thoughtfully lacks in tax culture, although many say it comes as an alien conception. The real tight spot of country is that rich and poor equally are not ready to pay the taxes on the ground of overall insecurity and absence of basic necessities. Government is of the opinion that in deficiency of revenue, demands of the public cannot be satisfied systematically. In this miserable consequence the only accessible possibility to the Government is to mend its internal revenue/tax collection mechanism because how long the donor's agencies will help us when we are not interested to improve our own revenue structure. In this regards the debate on tax incidence becomes of prime importance as it helps both to understand the effectiveness of the system as well as shed light on redistributive property of a good tax system. There are studies which suggest that public services such as Education are not pro-poor. For example, Asghar and Mudassar (2012) found that the public spending at the primary and secondary level is progressive, while higher education spending is regressive. Either the public service delivery model has to improve or the tax system has to take into account the redistributive context for uplifting the middle and low income class.

Tax incidence has long been a topic of debate considering the negative welfare impact on the poor relative to the rich. Any tax irrespective of its target group affect both the consumer and the producer and, hence, change the production as well as consumption decisions on the part of the private sector. To avoid regressivity authorities have to preview in deep detail, all those commodities which are poor concentrated goods. Less tax on poor concentrated good is beneficial for them so they can afford them easily. As Progressiveness shows the equity consideration vice versa of regressive taxation, so to find that Pakistan is having a progressive tax regime or regressive taxation is critical in that sense.

An old but comprehensive definition is:

“The term incidence refers to the pattern of the distribution of the burden of the tax; tax burden means the reduction in real income (consumption goods purchased,

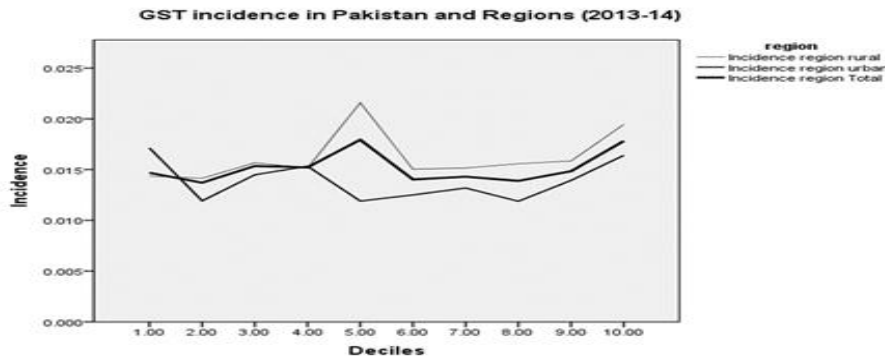
valued at given prices, plus savings) which occurs as a result of the imposition of the tax.' The tax burden may thus be considered to rest on various persons to the extent that their real income is reduced as a result of the tax". (Due, 1953, p.254)



The study by Asghar (2016) estimates the incidence of Indirect Tax-GST system of Pakistan. Tax incidence is estimated for three waves and for the regional differences. The paper utilises [Pakistan (2007-08); Pakistan (2011-12); Pakistan (2013-14)] Household Integrated Economic Survey collected by the Pakistan Bureau of Statistics. There are different methods and definitions of measuring middle class. This study follows relative approach. Here middle class is defining as Expenditure quintiles two to four.

No doubt that GST is the most essential tax in the country and in years to come its ascendancy is likely to rise. The study finds incidence fairly balanced in the first nine deciles and it only slightly increased for the last decile. From the perspective of equity, GST is known to be a regressive tax, which hurts poor more.

The study discovers that poor households confronting a very comparable level of GST tax incidence matched to the richer households even though clear dissimilarities in consumption exist mainly due to letdown (failure) of the government to bring more services such as real estate, legal services, financial services and recreational activities inside GST net. Further the study estimates the incidence for Rural-Urban context and it appears that the GST affects these disproportionately. Rural sector of the economy pays relatively more as compared to the urban.



In another study by Khalid (2006) overall tax incidence in Pakistan is calculated using various rounds of HIES and secondary data from FBR year books. Since the estimations were carried out using the HIES, which has the self-reported direct tax payments the estimates appear to be on the lower side. However, the relative picture appears to suggest that we have a regressive tax system. Except for the last income group in pre-reforms period, which was also the case in Asghar (2016) in later estimations. Secondly overtime also the system doesn't seem to be elastic hence unable to capture additional taxes with increase in relative incomes. Withholding tax regimes, more focus on trade sector and weak tax surveillance and enforcement mechanism have dragged our tax system to become less potent. Access to information for research can play a pivotal role in designing effective and efficient tax policies.

Table 2.1
Aggregate Tax Incidence

Income Groups (as reported in HIES reports)	1987-88	1988-89	1989-90	1990-91	1999-00	2000-01	2001-02	2002-03	2003-04
I	7.24	8.1	8.54	7.61	6.53	6.39	6.16	6.32	6.16
II	7.9	8.55	8.82	8.19	7.61	7.47	7.22	7.46	7.29
III	8.1	8.6	8.92	8.17	7.43	7.3	7.07	7.33	7.17
IV	8.06	8.58	8.8	8.13	5.07	5	4.86	5.06	4.98
V	8.06	8.49	8.65	8.09	4.68	4.63	4.52	4.76	4.69
VI	8.1	8.5	8.66	8.1					
VII	7.84	8.21	8.32	7.78					
VIII	8.02	8.32	8.37	7.87					
IX	7.62	7.93	8.01	7.58					
X	8.52	8.87	8.93	8.49					
XI	7.57	7.97	8.09	7.49					
XII	10.99	11.19	10.62	10.64					

Recommendations

- There is lack of empirical evidence, which requires further research on tax incidence for each tax to have efficient as well as equity based tax Policy reforms.
- The studies suggest our tax system is not progressive. Reforms such as application of non-uniform GST rate is one way to make this happen.
- These studies consider the equity approach only, however other analyses including efficiency through measuring tax incidence can also be considered.

3. TAX STRUCTURE IN PAKISTAN: ELASTICITY AND BUOYANCY LENS

Tax elasticity and buoyancy measures reveal the revenue generating capacity of the tax system with respect to changes in economic activity. High elasticity and/or buoyancy of taxes are pivotal for a healthy public financial system. But in developing

countries the taxation structure both from the tax rates and administration side are suboptimal and inefficient. Tax to GDP ratios is low which indicates either the high levels of tax erosion (under-ground economy) or low revenue capture of economic growth in the system. Major taxes have a very low elasticity due to inherent weaknesses in the economic structures as majority of the people remains out of the tax net due to low average income levels and non-formal nature of most of the economic activities. Nevertheless, an equally important factor has been the provision of massive tax incentives and exemptions to the industrial sector over longer periods of time in most of the developing countries. As a result, the level of budget deficits and borrowing becomes unsustainable over time-same has been the case for Pakistan.

The estimates of tax elasticity are essential element for assessing revenue productivity of a tax system, budget making, fiscal projections and long term plans of development. The response of tax revenues to changes in income has often been singled out as a vital ingredient in considering a criterion for a tax system. This response is measured by the concepts of elasticity and buoyancy. The elasticity measures the automatic response of revenues to income changes i.e. revenue changes excluding the effects of discretionary policy changes. High tax elasticity is always desirable as it allows growth in public expenditures. Higher elasticity means that growing development expenditures will be financed by automatic increase in the tax revenues due to high economic growth without raising tax rates. The target of increased revenue can be met with the growth in the base only. However, the if major tax revenue sources have a low elasticity then in this case the governments must introduce discretionary changes to accrue additional funds. Thus, tax revenue growth may be caused by higher buoyancy.

The tax elasticity with respect to its base is determined on the basis of the tax structure. It can be progressive if elasticity value is more than one, regressive if less than one and proportional if equal to one. If the taxes are by definition proportional, such as an indirect tax (here in the case of Pakistan custom duty (CD) and general sales tax (ST)), then the elasticity should be one. But since the tax bases are proxy bases and the tax implementation is also weak with many taxable commodities in the tax base being exempted from tax.¹ Hence the elasticity coefficient needs to be estimated and may turn out to be very low. Further, income taxes, at least theoretically, should be progressive for a good tax structure but in case of developing countries where the tax system has many caveats, exemptions and proxy bases, it may turn out differently. Even for per unit flat taxes such as Federal Excise duty (FED) in case of Pakistan, the elasticity value will turn out to be much less than one. The value of the base improves over time due to inflation but since the tax is specific and not changed over time hence it may look like a regressive system.²

¹E.g. in case of Pakistan's ST, clothes and apparel are exempt from ST, meat and dairy products are also exempt, educational services are not charged with taxes although it is legally due on the user of these.

²The cyclically-adjusted fiscal position is also affected by ad-hoc factors which are not directly referable to the economic cycle, which includes one time revenues such as broadening of taxable base, e.g.

In Public Finance Literature Ex-Post Tax Elasticities are estimated. However, the Tax-Laws/SROs may show completely different picture if elasticities are measured Ex-Ante. Individuals through their tax compliance behaviour can result in suboptimal (regressive instead of a progressive tax system) outcomes. Pakistan's tax behaviour is typical in this case as most of the tax-return based studies identify tax-notches.³ So it becomes an interesting question to see the difference in ex-ante and ex-post elasticities. Both direct taxes and indirect taxes had been less elastic in Pakistan as estimated by Khalid (2014). The following table shows tax wise elasticity estimated for the period of 1971-2010.

Table 3.1

Tax Elasticities

	Tax to Base $\alpha_{i,b}$	Tax Base to Total Income $\alpha_{b,y}$	Tax to Total Income $\alpha_i = \alpha_{i,b} * \alpha_{b,y}$
FDT	1.15	0.77	0.88
CD(with Imports only)	0.84	0.77	0.65
CD(with total trade)	0.90	0.49	0.44
FED	0.77	0.24	0.18
ST	0.27	1.20	0.32
SUR	0.87	0.42	0.36
PDT*	0.92	1.00	0.92
PIT**	0.84	0.75	0.63

* Since the provincial government can levy agricultural income tax, hence their base was taken to be the total income

** Trade taxes are administered by Federal Government only

FDT is Federal Direct Taxes, CD is Custom duty, ST is General Sales tax, SUR is Surcharges, PDT is Provincial Direct taxes and PIT is provincial indirect taxes.

Performance of the taxes in relation to economic activity have been dismal. The tax system in Pakistan is poised with weak structure and implementation mechanism (existence of large underground economy and corruption), therefore we find very low revenue elasticities. All of the taxes have less than unity value except for federal direct taxes in case of tax to tax base elasticities, so the system is quite regressive and is unable to take care of sudden shocks either towards improvement or degradation. The situation is worse in case of tax to total income elasticities, where all taxes have less than unity elasticity values. Although both the federal and provincial direct taxes are

in case of Pakistan withholding taxes (on the assumption of post realisation) are applied on various billing instruments such as TV license, utility bills, car/financial assets purchase, or others.

³This is a situation when tax payers reveal their incomes to be close to the upper limit of the taxable income bracket. As marginal income increase will shift them into the higher tax bracket which will may result into a lower net of tax income.

somewhat better with elasticity estimates close to one (0.88 and 0.92 respectively), all other taxes show a very dismal picture. The federal excise duty shows just a value 0.18, which is due to the fact that most of the excise taxes are on per unit basis, hence with the advent of inflation although the value increases but since the volume does not increase by the same proportion hence the resulting revenue generated is less.

The study further calculated three sub categories of aggregate tax elasticities i.e. federal government indirect tax elasticity, federal government direct tax elasticity and the total provincial government's tax elasticity. However among each of these categories respective bases were used to calculate elasticities such as elasticity of general sales tax or federal excise duty etc. Then these sub categories were aggregated on the basis of their respective weights in total tax revenues. Table below show the weighted tax elasticities calculated from elasticities estimated in the last section. Since the values of α_{tx} would vary over time due to the variations in ratio $\frac{T_i}{T}$, average of the sample period (1971-2010) is taken.

Table 3.2

Weighted Tax Elasticities (Average of 1971-2010)

Federal Indirect Tax Elasticity	0.42
Federal Direct Tax Elasticity	0.88
Federal Total Tax Elasticity	0.52
Provincial Total Tax Elasticity	0.66
Consolidated Total Indirect Tax Elasticity	0.43
Consolidated Total Direct Tax Elasticity	0.88
Consolidated Total Tax Elasticity	0.53

The Consolidated Total Tax Elasticity (TTE) value of 0.53 is very low representing peculiar characteristics of tax structure in Pakistan. The low tax effort, large tax gap and huge tax credits have resulted in a tax to GDP ratio which is abysmally very low. Similarly for other sub categories the elasticity turns out to be very low, in which Federal Direct tax elasticity is relatively better (0.88).

Now on the other hand if we see the longrun elasticity and buoyancy measures as estimated by Bilquees (2004), it is still evident that elasticity coefficient were much less than 1 and buoyancy coefficient are also around just 1 which is considered dismal interms of revenue generation. These are show in Table 3.3.

Lastly as discussed above the difference in ex-ante and ex-post elasticities help us understand the behavioural response of the tax payers. In their study Khalid et.al. (2020) estimates for the Elasticity of income slabs for the period 1984-2015 is presented. There were two main taxation regimes used in the reference period. Namely, fixed and proportional and only proportional tax policies. The fixed tax rate+proportional policy showed progressive elasticities from lower income group to higher income group but in the case of proportional taxation policy, the elasticity was

Table 3.3
Elasticity and Buoyancy of Consolidated Federal and Provincial Taxes
(with GDP Base)

	Total Tax	Income Tax	Customs Duty	Excise Duty	Sales Tax
Short run 1974-2003					
Buoyancy	0.44	0.40	-0.06	0.48	0.42
Elasticity	0.33	0.31	-0.20	0.06	0.38
Long run 1974-2003					
Buoyancy	0.92	1.23	-1.19	0.48	1.41
Elasticity	0.88	1.21	0.43	0.44	1.50

even higher than that. However, those elasticities were coming from the lower income group. Which is not in line with the progressive taxation theory. Overall the Income Tax system was progressive over the years but within the income slabs, it was regressive. Further there is also a very interesting result of the study that as we moved from lower income groups to higher income group in the proportional tax with no fixed rate the elasticity of the slabs decreases. This may cause the income inequality to rise in the country as the lower income group is paying higher percentage on their additional income as compared to higher income group.

Recommendations Based on Above Studies

- Overall taxes are inelastic and does not capture the marginal returns from economic activity and requires the policy makers to resort to new measures which creates an uncertainty for businesses and fiscal planning.
- Government should prefer to adopt the fixed basic amount of tax plus a percentage of the amount exceeding the minimum limit policy as the results of the study show that this kind of tax policy results in lower difference in income elasticity between different income groups. Thus lower the income inequality.
- Government must establish an integrated database for the tax payers and build capacity of FBR for analysis and adopting evidence based reforms.

4. TARIFF, TRADE LIBERALISATION AND FREE TRADE AGREEMENTS

It is well accepted in the literature that the trade liberalisation policies can affect the economy in several ways. These policies can lead to pave a path for growth and development or in some other cases these policies may turn out to be abhorrent. The literature posits several questions in this backdrop. For example, how these policies impacted the export, import and trade balance of the countries? How trade restrictions, tariffs and other trade restrictions effect import smuggling? How these policies

resulted in the desired outcome of improving the economic conditions, structural imbalance and income distribution in countries like Pakistan? What is the role of Free Trade Agreements (FTAs)?

A plethora of research can be found at international level. However, there is no general consensus among the researchers on the above mentioned questions. There are few studies available in the case of Pakistan as well. This research brief will summarise some of studies which are based on above research questions and conducted by Pakistan Institute of Development of Economics (PIDE).

Impact of Trade Liberalisation on the growth of Imports and Exports

Haq (2011) analyses the impact of reduction in export duties, import duties and trade liberalisation policies on the import and export growth for SAARC countries. The study uses econometric methodology (see Box 1) for the analysis. It is found that the reduction in export duties and import duties significantly increase the import and export growth (see a_4 and b_4 in Table 1). However, the study observes that the effect of duties on import growth exceeds the effect of duties on export growth. This implies that if there is a simultaneous decrease in export and import duties in SAARC, this would contribute in export and import growth, but import growth impact would be larger than export growth.

Box 4.1: The Methodology of Haq (2011) Study

Haq (2011) analysis the sample of South Asian Association for Regional Cooperation (SAARC) countries, that is, Bangladesh, Bhutan, India, Nepal, Pakistan and Sir Lanka for the time period from 1982 to 2012. The study utilises Generalised methods of Moments (GMM) for estimating the export growth and import growth regressions. The export growth regression is specified as follows.

$$x_{it} = a_i + a_1 px_{it} + a_2 w_{it} + a_3 x_{it-1} + a_4 dx_{it} + a_5 lib_{it} + a_6 (lib * px)_{it} + a_7 (lib * w)_{it} + \varepsilon_{it}$$

Where x is export growth, px is export price, w is world income, dx is revenue from export duties as a percentage of GDP, lib is a dummy of liberalisation policy and e is error term.

The import growth regression is specified as follows

$$m_{it} = b_i + b_1 pm_{it} + b_2 y_{it} + b_3 m_{it-1} + b_4 dm_{it} + b_5 lib_{it} + b_6 (lib * pm)_{it} + b_7 (lib * y)_{it} + v_{it}$$

Where m is import growth, pm is import price, y is domestic income, dm is revenues from import duties and v is error term.

Table 4.1

Effects of Trade Liberalisation measures on Import and Export Growth

	Coefficient
Effect of duties on Export growth (a_4)	-0.112*
Effect of duties on Import growth (b_4)	-0.315***
Effect of liberalisation on Export growth (a_5)	0.957***
Effect of liberalisation on Import growth (b_5)	2.021**
Effect of Liberalisation on Income elasticity of Exports (a_7)	0.416***
Effect of Liberalisation on Income elasticity of Imports (b_7)	0.782***

Note1: *, ** and *** show 10 percent, 5 percent and 1 percent level of significance.

Note2: Parentheses show the coefficients of the export and import growth regressions

Furthermore, the trade liberalisation policy in the SAARC region has increased export growth by 0.95 percent and import growth by 2.02 percent. Therefore, we can infer that trade liberalisation has increased imports as well as exports, but a thing to notice is that this policy has produced more favourable effects in import growth. The effect of trade liberalisation on the income elasticity of export and import is calculated by the interaction terms in the model. The income elasticity of export and import takes a positive sign and the values of 0.416 and 0.782 respectively. We observe that the income elasticity of exports is lower than the income elasticity of imports. This shows that an increase of one percent of the income of the trading partners would increase exports of the SAARC region by 0.416. On the other hand, if the income of SAARC nations increases by the similar amount, import growth would increase by 0.78 percent. This comparison shows that in the SAARC region, there is more inclination towards importing goods as income rises.

The findings of Haq (2011) suggest the reductions in tariff and trade liberalisation will increase the transactions of imports and exports. If the tariffs are high, then the traders may see the alternative illegal ways of trade. This issue is highlight by Mahmood and Ahmad (2015). The study of Mahmood and Ahmad (2015) find that the tariffs and other restrictions on imports are the major factors for illegal imports. Liberal trade practices are supposed to decrease the cost associated with formal trade, making it attractive. More specifically, the study finds that import smuggling between FY1973 and FY2010 is at an average annual of around 3.5 per cent of GDP according to estimates of Mahmood and Ahmad (2015). Therefore, the trade liberalisation policies may give more revenues through increased economic and documented activity which is crucial for problem of budget deficit in the economy.

The Impact of Tariff Reduction on the Economic Conditions, Structural Imbalance and Income Distribution

One of pioneer studies is conducted by Kemal et al. (2001) on the impact of tariff reduction on income distribution of urban and rural households in Pakistan by using computable general equilibrium model (see Box 2) in the background of Structural Adjustment Program (SAP).

Box 4.2: Computable General Equilibrium Model (CGE)

CGE model is an economic model which is employed for analysing the government policy changes, change in technology and environment etc. using real economic data. It is multi-sectoral model that explains the explicit information about the behaviour of economic agent. It treats households as utility maximising agents and firms as cost minimising and profit maximising agents of the economy. The model assumes that agents' decisions about the production and consumption are based on prices which are determined by the equilibrium conditions of demand and supply. The model allows for obtaining the numerical values of the coefficients that are estimated using the base data.

Kemal et al. (2001) examines the impact of reduction in tariff on industrial imports across households and on other broad macro aggregates. The simulation exercises suggest that the impact of tariff rate reduction lowers the price of imported goods, which affect the domestic relative output price and input price structure. It affects supply and demand of all commodities.

More specifically, the immediate impact of tariff rate reduction by 80 percent on industrial imports is to lower the import price of industrial imports by 16.37 percent. The reduction in import price leads to decline in domestic price of industrial goods. The resulting decline in domestic industrial goods prices leads to decline in supply of industrial products by 0.58 percent, and releases labour from industrial production. The results show that labour demand in industrial sector declined by 1.9 percent. The released labour is absorbed in other sectors. Demand for labour increases in agriculture, health and education sector by 1.21 percent, 3.52 percent and 3.16 percent, respectively. The tariff reduction increases the gap between the rich and poor as the results show that share of capital and labour in GDP has increased and declined, respectively. Consequently, Gini coefficients- the measure of income inequality, show that income distribution has worsened. But impact on income distribution is very marginal. The results also reveal that consumption of each household group has increased. This implies that tariff reduction has welfare enhancing impact on households.

Welfare Effect of Free Agreements

Pakistan has signed various regional trade agreements including preferential trade agreements and free trade agreements, both bilateral and multilateral in composition.⁴ A recent study of Shahzad (2018) measure the welfare gains which are derived from free trade agreements (FTAs). The net welfare gains from FTAs depend on the amount of trade creation (welfare gains) and the trade diversion (welfare loss). Shehzad (2018) analyses the welfare implications of bilateral FTAs of Pakistan with

⁴ <https://aric.adb.org/fta-country>

three countries, namely, Sri Lanka (PSFTA), China (PCFTA) and Malaysia (PMFTA). This analysis extends the welfare analysis to the manufacturing and agriculture sectors to obtain meaningful evidence with regards to sector level welfare. The evidence on sector and industry level analysis is intended to guide and aid the formulation of trade policy, which may ensure net welfare gains for the country as we undertake and sign the FTAs.

The evidence from Poisson Pseudo Maximum Likelihood method [see Box 3] suggests the existence of net welfare gains from all the FTAs undertaken since the signing of PCFTA, causing significant trade creation from the manufacturing sector worth USD 76.84 million. However, trade creation from PSFTA is worth USD 0.15 million only. PMFTA has produced negative trade creation, amounting to USD 0.56 million. PCFTA has made a positive change in trade of 793 product groups and an adverse change in trade of 240 product groups all because of the agreement. PMFTA has caused a positive change in the trade of 131 product groups and an adverse change in the trade of 117 product groups. The negative change outweighs the positive change resulting in an adverse net change. Despite the improved terms of trade with Malaysia, Pakistan saw an adverse net change in trade volume. Overall, Pakistan gains from these FTAs, as none of the FTAs caused a welfare loss due to non-diversion of trade. Findings are robust at the sectoral, industry and product level.

Box 4.3: Methodology of Shehzad (2018)

Shehzad (2018) analyses the welfare implications of bilateral FTAs of Pakistan with three countries, namely, Sri Lanka (PSFTA), China (PCFTA) and Malaysia (PMFTA). Based on the objectives of the study at hand, the study specifies the following gravity model:

$$\ln E_{pj} = \alpha + \beta_1 \ln Y_p + \beta_2 \ln Y_j + \beta_3 \ln D_{pj} + B_{pj} + O_{pj} + \mu_{pj}$$

Where E_{pj} is the trade between Pakistan and j th country, Y_p is the GDP of Pakistan, Y_j is the GDP of j th country, pj is the distance between the centres of Pakistan and j th country. B_{pj} and O_{pj} are dummies to capture trade creation and trade diversion.

The regression is estimated by using Poisson Pseudo Maximum Likelihood method (hereafter PPML) to estimate the gravity equation. The method is capable of tackling the issues like having some zero values of the dependent variable and to tackle the different patterns of heteroscedasticity along and measurement error. PPML can cope with different gravity modelling issues and biases such as elasticity bias, zero trade values, exaggerated estimated parameters and multilateral resistance term.

Two different indicators for quantifying the welfare effects: *the trade volumes and terms of trade*, and *the extrapolated values for trade volumes and terms of trade* are used.

Furthermore, Shehzad (2018) confirms, based on a counterfactual analysis, that trade volume would be lower, and terms of trade would be unfavourable in the absence of the FTAs. The results are robust in all three FTAs. Based on the product group level analysis, Shehzad (2018) concludes that the countries with a high concentration of exports and imports do not gain much from the FTAs. It is necessary for Pakistan to diversify trade to reap the fruits of the FTAs fully. In addition to this the study finds that the consumers in Pakistan gain from these FTAs because of the reduction in the prices of several import products after the preclusion of tariff; and so, the import demand for the products available in the particular FTA is enhanced. The consumer gains from PSFTA and PMFTA are not that significant.

The producers, however, are worse off due to the high competition because of the trade liberalisation brought about by the FTAs. The availability of a variety of goods available at cheaper rates causes lower local production. However, we conclude that overall the producers have gained from these FTAs. The estimates of Shehzad (2018) show that the FTAs have increased Pakistan's industry-level imports by USD 52.97 million, meaning there has been trade creation. The Chinese and Malaysian FTAs account for trade creation worth USD 27.69 million and USD 24.73 million, respectively. Out of the three PSFTA has not shown an impressive trade performance. The exports to Sri Lanka have increased sluggishly, and at the same time, the imports have decreased. Alarmingly, the FTA partner countries do not import from Pakistan in proportion to their expanding economic abilities.

Conclusion

This research brief concludes that the reduction in tariff and increase in trade liberalisation increases both the export and imports. Furthermore, the reduction of tariff will reduce the smuggling of imports as well. Indeed, this will lead to enhancement of legal transactions and a good source of revenue from the imported goods. In addition to this the reduction of tariff has a welfare effete according to Kemal et al (2011). Therefore, this policy brief suggests further rationalisation of tariff and trade liberalisation.

Welfare effect of FTAs are also analysed. As mentioned earlier, Shahzad (2018) suggest that, overall Pakistan gains from these FTAs, as none of the FTAs caused a welfare loss due to non-diversion of trade. However, the producers, are worse off due to the high competition because of the trade liberalisation brought about by the FTAs. Hence, there is a recommendation of re-negotiating the currently active FTAs to address the concerns of producers and other stakeholders. More specifically, there is a dire need to grant tariff concession from either side on the top trading products, along with high trade potential products.

5. CAPACITY ISSUES IN TAX ADMINISTRATION

It is not only the tax policy and overall design of the tax system that lead to sustainable streams of revenue generation, the capacity of the tax administration also

matters. Even in the presence of a *fair, simple and efficient* tax policy, the desired results may not be achieved if the *convenience* principle is not followed. Besides enlarging the size of the underground economy, a complicated tax system accompanied by weak implementation and governance can also deter payment of taxes thereby resulting in sub-optimal revenue collection. In Pakistan, the Federal Board of Revenue (FBR) is assigned with duties related to tax administration. The constitution mandates the Federal Board of Revenue to administer, manage, conduct and supervise the execution and implementation of the country's taxation laws and related statutes. In addition to smaller tax base and tax evasion, Pakistan also faces the capacity and administrative constraints that prevent the country from having an efficient and convenient tax system. Although, over the years some efforts were made to reform and improve the tax governance and stakeholder confidence, the overall taxation capacity of the FBR could not be upgraded. Tobacco taxes also operate in this realm and their effectiveness may be understood in the overall context of tax administration in Pakistan.

Box 5.1: Key Informant Interview 1

“We used to have supervised sales [until the 2000s] and the system was working perfectly, and we have the capacity, but the lobbying convinced the policy makers that the person sitting at the factory is exerting rent seeking behaviour” - Investigation and Intelligence Unit Hyderabad.

... Our assignment requires a team of ten, but we are just two ... and those too with limited mobility in the field.

In ad valorem we are linked to price and currently there is no price regulation in Pakistan...The [tobacco] industry used to see their own liability and did changes in price [at their advantage]. At the FBR, we did not know their prices and thus cannot project revenue without depending on whatever they set. So, if we increased the taxes, they decreased the prices, so the net incidence was that. If duties decrease, the prices were increased by the companies, so this was the issue here.

A federal FBR official

In order to understand the political economy of tobacco taxation and the relevant capacity issues in the tax administration, Nayab et al. conducted a qualitative study in 2018. The study was primarily based on interviews with FBR officials, cigarette distributors, middlemen engaged in marketing of the unprocessed tobacco, and tobacco farmers and other stakeholders. One of the major finding of the study was that despite stringent regulations, in practice, the collection from Federal Excise (FED) Duty is sub-optimal. The FED on cigarettes is collected following the Specific Tax regime (i.e. on a fixed basis per 1000 cigarettes). Despite the fact that only two cigarette companies own the 98 percent of the market share, the FBR follows Specific Tax regime on self-declared production instead of imposing it on supervised sales. No matter how surprising this looks, the capacity constraint of the FBR is the reason for

this. According to a FBR official (Key Informant), the tier-based Specific Tax is manageable given the existing administrative capacity of the FBR, all in terms of the limited number of personnel and other resources.

These resource and governance constraints impact the fundamental structure of the tax administration. Consequently, instead of establishing designated departments singularly tasked for tax collection, enforcement, audit and other compliance issues, a sectoral formation approach is followed. Hence, in this system, a single official is responsible for every dimension of the taxation related to the industry assigned to him. How this, coupled with the FBR's revenue focus, becomes a problem and impacts other dimensions of tax administration is as follows. A field office would be informed about the revised FED targets. The officer in charge would negotiate with cigarette manufacturers. Normally, the companies would agree on the amount of funds demanded by the FBR subject such that the enforcement, audit and other compliance protocols would be set aside de facto. In certain cases, the FBR official may request the tobacco manufacturers for advance tax submissions even though, by law, the FED is payable only when manufactured goods exit factory premises or are in warehouses. So, a sense of collusion exists at the FBR-execution node with the tax base, certainly with intimation to high-ups. Thus, a tax official, and for that matter, the entire taxation system, is appreciated if the revenue targets are achieved. The enforcement, audit and compliance issues then become secondary issues for persons or teams involved.

Box 5.2: Key Informant Interview 2

The field formations are assigned with sector level taxes... [This means that] a grade 18 level officer [deputy commissioner] would be tasked to manage [not only] tax collection [all sort of taxes such as FED, VAT and Income Taxes from a sector] and would also manage enforcement, audit and other compliance protocols [of the sector assigned to him/her].

A federal FBR official

In addition, there are other capacity issues as well. For instance, the Investigation and Intelligence Unit in the FBR has enforcement authority. However, they too rely on third-party information. With an extremely low probability of detection through banderole-based identification, even those who are caught are rarely penalised. This increases the probability of defiance again, as the cost of detection is only paying the amount that is due. Hence, the tax-paying entity would cheat again to avoid any potential tax implications.

Similarly, due to lack of comprehensive information-sharing platform, the efficacy of the rules related to registration has also been called into question. Given the importance of tobacco excises for the country's revenues and regulation, the FBR needs to register and license all producers (both at GLT and cigarettes manufacturing stage), importers, distributors and retailers. The rules contain procedures for

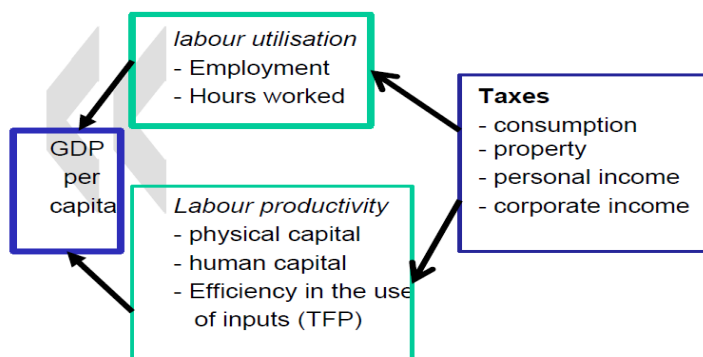
compliance with sales and purchase from a registered supplier only. However, capacity constraints in terms of limited or no information-sharing platform, many loopholes and voluntary non-compliance issues emerge.

Recommendations

- There is an overarching framework for reforming the tax administration in Pakistan that could break the existing field formation on sectoral lines and re-organising the FBR operations along functional lines, i.e., tax revenue collection, monitoring, audit and compliance should be the responsibility of different departments. This will break the responsibility hubs, discourage discretions among field officials and introduce positive checks and rewards in the system that may result in reducing the leakages, improving efficiencies and changing reward and punishment mechanisms.
- For efficiency enhancement, technological solutions should be introduced for monitoring, enforcement and compliance, and which may also include e-tagging and tracking systems.
- A single-tier tax structure should be in place, which would lower the administrative effort required for implementation as well as give fewer incentives to tobacco companies for tweaking prices and increasing the overall tax rate.

6. TAX RATES AND GROWTH

The question that does tax stimulate growth or the opposite is an ongoing debate. Taxes in an economy are always a distortion as they affect the decisions of the households and the investors at the same time. For a household these decisions pertain to saving, supply of labour and investing in human capital. For an investor the tax affects the decision of the firms to produce, create jobs, invest and innovate. Interestingly, the implications of these decisions then affect the living standards and hence growth of the economy. These decisions are not only affected by the level of taxes but also by the kind of tax that is imposed. Thus designing the tax structure that could promote growth should also be the one of the main objectives of the tax reforms.

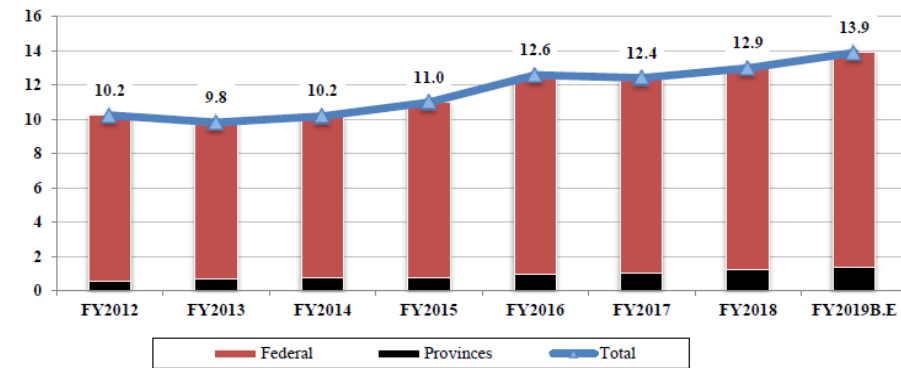


In Pakistan, the tax system is too complex. Broadly speaking there are two broad categories of taxes in Pakistan but the excessive reliance on indirect taxes has made the entire system regressive and procyclical. The major chunk of revenues from indirect taxes is generated from the sales tax on petroleum products that remain sensitive to global prices and regulatory duties.

The exemptions and SROs further complicate the tax structure. As a result of exemptions provided by these SROs the general sales tax can't be implemented in VAT mode. Instead it adopts the excise tax mode. The corporate taxes are also high in the country. The corporate taxes adversely affect investment and productivity growth and is especially detrimental to the new startups that are emerging in Pakistan. If these taxes are lowered the firms will have more finances to invest in research and innovation which enhances productivity and hence growth.

In direct taxes, the collection on demand is minimal. The government relies heavily on the withholding taxes that are collected by the banks, telecom companies etc. This combined with nonexistent rebates of the withholding tax increase the burden of taxes on low income segment of the economy, further curtailing their transactions and investment in human capital through education. The existence of withholding taxes also questions the very existence of the tax machinery which is the operational tool of the tax policy.

The picture that the tax structure paints is pretty simple. Pakistan has witnessed a consumption driven growth in this decade and on the other hand, the share of indirect taxes in the composition of total taxes in Pakistan is all time high. Still a persistently low tax to GDP ratio and resetting of a lower revenue target demonstrates that tax reforms should shift the paradigm from tax payer to the tax policy and the tax collecting agency.



Amongst the indicators of tax policy, tax to GDP ratio is a very commonly used indicator to gauge the tax policy effectiveness. There are several factors that affect the tax to GDP ratio. A study carried out by Butt (2009) analysed the impact of public domestic borrowing on the tax-GDP ratio, along with other conventional variables for

lower middle income and upper middle income countries using data of 11 developing countries from 1985-2010. The study findings are very interesting. The governments resort to domestic borrowings to bridge the huge budget as it does not involve “transfer problem”. But this borrowing crowds out the economic activity in the private sector thus engendering a further low tax to GDP ratio. The attractive domestic saving schemes can make up for some of this adversity but this seems a bleak possibility. Another interesting finding reveals that non tax revenue adversely effects the tax GDP ratio. Thus more reliance on the tax revenues is recommended for developing countries.

Empirically there is prodigious variation in the effects of different tax instruments across studies. The interpretations are complicated by the different measures of tax revenues/rates, different measures of government spending and different control variables, methodologies etc. In case of Pakistan a study was conducted by Shafi (2012). The authors believed that the use of appropriate variable leads to more accurate analysis of the impact of tax policy on economic growth. The authors estimated average marginal tax rate (AMTRs) following Seater (1982) using data from 1991 to 2010 for five developing countries.

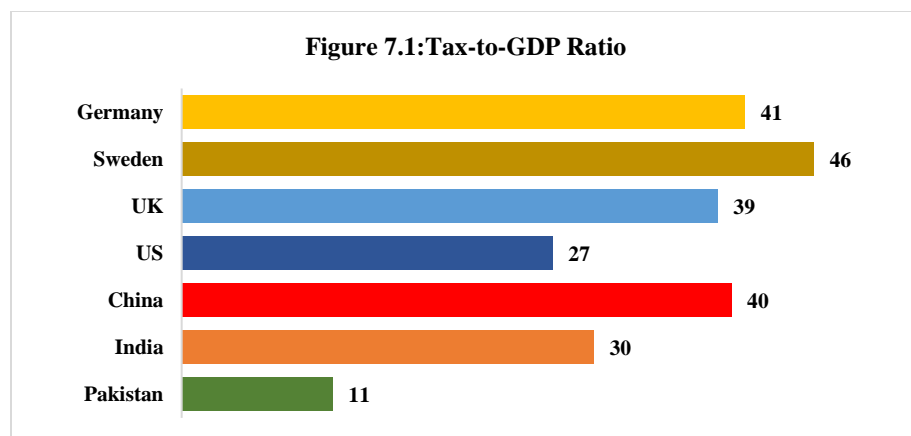
The AMTRs is calculated by dividing the change in tax revenue by the change in total income before tax. Their findings suggest that there is a nonlinear effect of tax policy on economic growth. The increase in average marginal tax rate at the lower level of taxation, effects more adversely, than at higher levels of taxation. The prevailing level of taxes in the economy is thus very crucial. Generally, the tax rates are high in developing countries, thus minor tax cuts won't translate into growth. The tax reform should consider lowering taxes if growth is the primary objective.

7. HAQUE'S PERSPECTIVE ON TAX POLICY IN PAKISTAN

This chapter reviews Dr. Nadeem Ul Haque perspective on the tax policy in Pakistan. His research articles cover a range of issues in tax policy in Pakistan. We briefly discuss his views to highlight the issues with the state of tax policy in Pakistan.

Tax-to-GDP Ratio Paradox

Policymakers in Pakistan perceive that the resolution of all economic problem revolves around increasing Tax-to-GDP. The increased Tax-to-GDP ratio perhaps could help in stimulating the sustainable economic growth. The Tax-to-GDP ratio sustained at 11 percent which is lower than the international standards. The Tax-to-GDP ratio is more than 30 percent in India and 40 percent in China. Whereas in advance countries, US sustained 27 percent, UK with 39 percent, Sweden with 46 percent, and Germany with 41 percent. Does this imply that all countries should have the same ratio? Is there any theoretical underpinning that tells us that all tax-to-GDP ratios should be the same?



The research briefs by Nadeem Ul Haque (2020) discusses this concern that policymakers compare higher tax-to-GDP ratio without establishing a basis for a comparison. If we want to compare our tax performance, perhaps we should go back in the economic history and see how the advanced countries did when they were at the early stages of level of development. In 1901 the US and UK had a per-capita income of about \$4500 and \$3700 respectively. Their tax-to-GDP ratios were 7 percent and 10 percent respectively. This research also emphasises that Pakistan has a per capita income of around \$1500 which is fairly low compared to other developing countries. Given the low GDP per capita, should we really be aiming for US and OECD tax rates? Why then has our focus been on the tax-to-GDP ratio for the last few decades and not on growth?

Box 7.1: Tax-to-GDP Ratio and Tax Buoyancy

The strong tax buoyancy of the economy is needed to have higher tax to GDP ratio. The stronger tax buoyancy is observed when the share of tax revenue rises in synchronisation with the rise in the country's GDP.

For instance, if our tax-to-GDP ratio went up to about 15 percent, at this stage it would not increase the economic growth and generate more employment opportunities for people. The successful tax policy involves the tax cut as a policy instrument for stimulating growth. To simulate the economic growth in Pakistan needs the tax policy that persuade the investors will invest more, workers will work harder, and savers will save more because taxes increase.

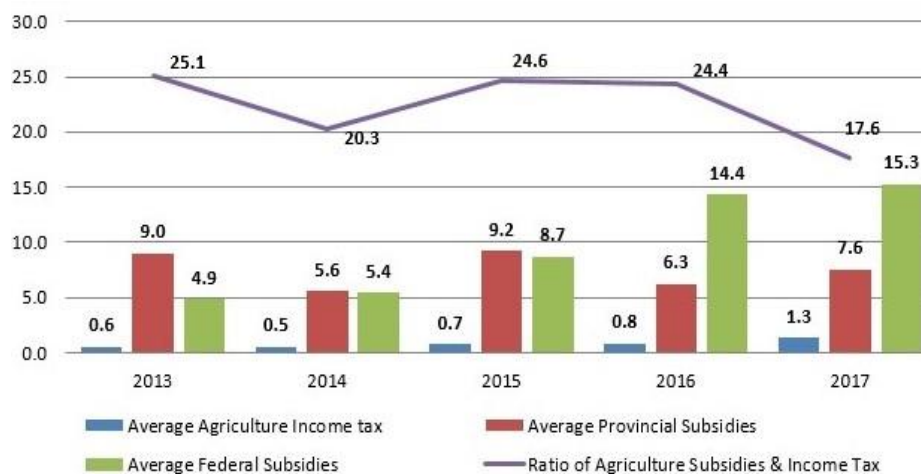
Missing Tax Grid

The tax policy remains silent on extensive list of tax exemptions and concessions. Haque (2018) highlighted that agriculture sector, largest second

contributing sector in GDP, avails the biggest exemption of income tax which is outside the income tax regime based on artificial Produce Index Units (PIU). Similarly, we incur approximately Rs. 600-900 billion loss from the tax exemptions which is given to the favourites in the famous SROs.

In agriculture sector, the tax performance of both the federal and provincial governments have historically been unsatisfactory. The federal and provincial governments' increasing reliance on indirect and withholding taxes is an indicator of the state's failure to tax higher income groups and privileged lobbies to generate revenue. The sub-national governments' fiscal approach is to substitute taxation with federal transfers, which remains the primary determinant of insufficient provincial and local tax collection today. This has resulted in perpetual deficits and low tax capacities. As shown in above Figure 2, agriculture sector is as under-taxed and over-subsidised, also large farm owners benefitting disproportionately. This is because subsidies are applied per unit consumption, so small farm owners who consume less get less subsidy while large farm owners consumer more units and gets a larger share of the pie. Agricultural taxation in Pakistan is a clear example of the country's flawed taxation system.

Figure 2: Agriculture Sector: Taxes and Revenues



Source: Asim B Khan (2017).

Taxation for Dead Capital and Subsidies

Government spend best efforts in collection of revenue, and the efficiency of revenue requires it must be utilised productively. It must be reallocated productively for the welfare of the country. However, the waste of the revenue has never been reviewed in Pakistan. Haque (2019) research discusses that revenue waste in Pakistan is exemplary. It includes, the large number of spending on the government houses made for officials; the real estate developments made to provide plots to favourites;

the wasteful and needless road widening for the cars of the rich; the expansion of sui gas pipelines even though we have run out of gas; whimsical projects that MNAs are allowed to direct for vanity reasons; wasteful expenditures on the Premiers directives that are non-productive or too expensive; and ill thought out subsidies to the rich or political favourites. Regardless of government of a particular political party, the government in Pakistan is full of waste and the cost-benefit analysis of this waste is never been accounted. Instead, we focus on the extraction of more money through a bad tax policy.

Study highlighted that government has lost more than 3 trillion rupees in energy over the last 10 years. Government has also signed sovereign guarantees without thought or planning to build more and more energy. As a result, both the circular debt and energy cost are increasing to impose a huge cost on the economy. Yet, economists think that a wasteful inefficient and thoughtless government's mistakes must be covered by more increased oppressive or regressive taxation.

The unproductive use of revenues kills the economic growth and productivity. Growth and productivity must be the centre point of taxation, but unfortunately it is missing in policy. At most there will be the usual plea for industrialisation and export promotion, for both of which the only instrument seems to be more subsidy in one form or another group emerge to collect revenue.

Taxes and Transactions Tradeoffs

Taxation is a strong economic tool of social justice, reducing income inequality, and economic development. The share of direct taxes in Pakistan has gradually gone down. Currently, transaction taxes such as the withholding tax, sales tax, FED taxes are the major revenue, these taxes are regressive and unrealistic. This taxation is creating distortions by reducing economic transitions at the marketplace. It hampered the distortionary effect in Pakistan where tax system is and complicated tax system.

Box 7.2: Taxes Kill Transactions

The share of direct taxes in Pakistan has gradually gone down. Transaction taxes such as the withholding tax, sales tax, FED taxes are the major source of revenue. These taxes are regressive and kill the economic activity Haque (2018).

Haque (2019) suggested that government needs to change their analysis and make it more evidence based. First, they must understand that an economy is a set of transactions and more transactions means higher economic growth. Second, it is a fallacy to think that the government knows which transactions are better. Third taxing transactions beyond a simple GST or VAT is inefficient and counterproductive. It will kill transactions and slow down growth.

It is time that the government stopped making policy on rhetoric alone. There are no good and bad transactions. Nor is documentation a tax on transactions. The

primary reason for much of the legal framework and government machinery is to facilitate transactions. There is a clear need to be a *transaction-facilitating* government rather than a *transaction blocking* government. The economy is shrinking because of this policy of suspicion on all transactions. If the government wants to revive the economy, they should carefully review all policies to weed out those that are impeding transactions. Policy should remember: kill transactions, kill economic growth.

Distortionary Policy?

The study of Haq and Bukhari (2019) have noted the problem is more that we have a mindless and grabbing tax policy that does not conform to any principles of taxation. Tax policy is distortionary and has negative impact on the economy.

How negatively it impacts the economy:

- *SROs* are affecting industrial organisation in Pakistan and preventing entry and development of market.
- *Withholding income taxes* on goods and services are transaction taxes which are both regressive and distortionary. In most countries, withholding tax only applies to incomes. Here withholding taxes are applied as income tax on many services such as utility bills, school fees, mobile telephone payments. And in most cases this is done with no intention to refund the money. The withholding regime that FBR now relies on for revenue needs serious review and thought. There are now over 60 withholding taxes and about 70 percent of revenue comes from withholding taxes. Banks, utilities and many other enterprises have become revenue collection agencies, increasing their costs and weakening the collection chain. So if business establishments are collecting taxes for FBR, what then is the FBR doing? Withholding income tax as practiced in Pakistan operates like a regressive transaction tax affecting the poor the worst. The system is set up such that this income tax is withheld from the poor with no chance of getting who a refund. Withdrawal of *SROs* and the withholding regime in an orderly manner but relatively soon will give the economy more breathing room.

Second, tax policy must develop a vision of what a good tax policy is and figure out path to go there. This study proposed three simple taxes.

- (a) *Income tax* should be low progressive all-inclusive and clear. For the middle class graduated to 15 percent for very high incomes (say over a Rs 300 million annually) could go from 20–40 percent with no exception. (For agriculture will require constitutional amendment)
- (b) *Corporate tax* can be set at about 20 percent.
- (c) *Simple capital gains* on short term speculative investments of less than a year. Equivalent to income tax, Long term investments can apply flat 5 percent, the inheritance tax can be restricted to 40 percent above 10 billion nothing below.

- (d) *Sales tax* in VAT mode starting at 8 percent. (requires constitutional amendment). Collection must be unified, split of revenues is a political decision and should be maintained.
- (e) *Property tax* as local but low flat rates and government should pay as well as it is different jurisdictions that benefit. For example, federal government must pay Lahore for Staff college and civil service academy or relocate.

Third, tariffs structure should be simplified into 3 lines that we had developed in early 2000s First, 5 percent all goods. Second, 10 percent intermediates, Last, 15 percent on the finished products.

Recommendations

Haque research briefs make following recommendations for a good tax policy:

- All exemptions to be removed in 3-year period and all powers to place exemptions withdrawn. All tax changes to go through the budget. We need a constitution amendment quickly to make fix the revenue system to achieve the following:
- To bring agricultural income into the income tax system.
- To ensure that service and goods are unified for collection at the federal level. This will allow the collection system to be unified for collection. Of course, the federal government will share the revenue with provinces as per the law and constitution.
- As an aside this constitutional amendment could also be used to introduce and strengthen much needed local government as well as putting in place more provinces for better governance and a balanced policy.
- Lastly, FBR and MOF both must develop some research capacity, so they can study these issues and develop a learning attitude rather than rely on donor consultants.
- The proposals roaming around on wealth tax and minimum asset tax are wrong and need to be reviewed carefully in the light of the following.
- It taxes the saver twice and rewards the profligate. It will lower saving rate. It will fall disproportionately on the old as they are mainly wealth holders.
- It will fall disproportionately on the middle class who are forced to hold wealth on their name. The business owners have a several ownership levels that will allow them to get a break.
- Valuation of some assets is very disputable and difficult to assess.
- Most people will be holding wealth in the form of real assets or real assets, which will be full of disputes and hardship.
- Most wealth holders will have locked wealth in real estate which has appreciated in value. Will they have the liquidity to meet the tax obligation. In that case are we going to make them vulnerable to sharks and dispossess the

saving middle class. It will give an added impetus to capital flight. It will further lower our saving rate. Wealth tax may not be the best way to go.

This then is a minimum agenda for tax policy reform. It will have the advantage of simplification as well as predictability. Alongside this we must have tax administration reform. For that, the solution will be getting of good human capital in FBR with appropriate technology. Let an independent service well versed in technology and modern auditing techniques run the place. Let a responsible and accountable tech savvy group emerge to collect revenue.

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