

## Agenda for tax reforms – III

Pakistan also faces the herculean task of providing jobs to millions-on an average we need to create 1.2 million jobs annually for young people alone. For achieving this task, we will have to ensure that economy grows at the rate of 8% to 10% per annum over a long period of time-for this we need investment of 20% of GDP. This challenge is also our great opportunity for economic progress. Majority of job-seekers are young people, which are our greatest asset-impacting education and skills to them and creating matching jobs is the real challenge. This can be met successfully by assignment of taxes for productive investment and employment generation-our real engine of growth.

The prevalent pessimism is due to the attitude of rulers and financial managers, who cannot think beyond what they are "commanded" or "trained" to think. They keep on telling us about the symptoms of an ailing economy but never try to cure the real causes of illness. Unfortunately, no serious effort has ever been made in Pakistan to devise a rational tax policy for encouraging industrialisation through corporatization of business leading to economic growth and documentation of economy. The sole stress on irrationally-fixed revenue targets-with main incidence on weaker sections of society-has created an ugly fiscal mess.

The persistent failure of successive governments to broaden the tax net, crack down on untaxed assets and ill-gotten wealth, spend public money prudently and remove socio-economic imbalances has pushed the country into a 'debt prison'. We can get out of it provided there is leadership having competence and unshakeable determination to pursue a pragmatic reform agenda to transform Pakistan into an egalitarian state-true social democracy with justice for all.

Pakistan is one of those very fortunate countries of the world that has an abundance of resources and a climate that is fit for simply any activity throughout the year. But thanks to donors' agenda of overemphasis on retrogressive taxation and incompetence of our economic wizards, Pakistan's dependence on imported products has increased manifold, whereas value-added exports have not been given any attention, let alone promoting high-tech industries capable of technological innovations-modern economies are knowledge-based and future is for those people who can develop them as quickly as possible.

For technological transfers, rapid industrial growth and employment generation, foreign direct investment (FDI) is desirable. In Pakistan when local investment is dying, expecting FDI is like living in a fool's paradise. Tax incentives play an important role in attracting FDI, which has nosedived in Pakistan during the last decade. Tax policy constitutes an important factor for favourable investment behaviour. Unfortunately, our budget-makers have always been preoccupied with revenue targets and have never bothered to provide some long-term investment-oriented tax incentives for infrastructure development, investments and employment generation, without which sustainable growth is not possible.

Foreign investors will not come to Pakistan until law and order situation and energy shortages exist. Due to these and other negative factors, even the existing industrial units are closing down or working at a low capacity. Nobody is willing to invest in special economic zones, where tax incentives are available. The main reason is lack of proper infrastructure. The result is unprecedented decline in foreign direct investment during the last ten years. Pakistani industrialists-fearing loss of life and property, acute power shortages, rising costs of doing business and hostile tax policies-are shifting their capital abroad. Investors, both domestic and foreign, prefer a place that characterises stability, consistency and requisite infrastructure facilities-we lack all these.

Tax incentives do matter but not as first priority. Any feasible growth-oriented project can be profitable after paying reasonable taxes. In Pakistan, corporate taxation in 2016 is still as high as 42% (company tax rate plus tax on dividends). The corporate sector is the worst sufferer of FBR's designed policies and widespread corruption-top management of FBR has very myopic outlook as evident from over-emphasis on withholding taxes. With low tax rates, we could have promoted corporate growth. On the contrary, in 2015 FBR imposed 'Tax on undistributed reserves' [section 5A of Income Tax Ordinance, 2001] ignoring the fact that reserves are created from already taxed income. Minimum taxation on service sector companies was another wrong move. In 2014, FBR imposed 'Alternative Corporate Tax' [section 113C of Income Tax Ordinance, 2001]. Such erratic, arbitrary and expropriatory taxation would further retard corporate sector and discourage future growth.

We need to incentivize corporatization of business. At present there are about 80,000 companies registered with the SECP out of which 24,000 filed tax returns. There are numerous anti-corporate provisions in the tax codes. Companies are maltreated by FBR-after collecting billions as 'withholding tax agents' of the state without any compensation; they are penalised for small lapses that may neither be intentional nor willful. Taxation of notional benefits eg concessional loans in the hands of employees, high corporate tax rate and double taxation of dividends and reserves out of already taxed profits are some examples of anti-corporate provisions-the list is not exhaustive. In these circumstances, no one would like to conduct business through a company, especially when audited accounts by independent and credible auditors are rejected on mere whims and without bringing any material on record, by taxation officers. Litigation is imposed on the companies and they have to hire costly professionals to get justice. It is thus no surprise that in the World Bank's 'Doing Business 2016' data for Pakistan, our ranking has gone down to 138 from 136!

Devising an efficient tax model for rapid economic growth in Pakistan requires an analytical study of all the irritants prevailing in tax codes, procedures and implementation processes. The main irritant is highhandedness, corruption and unprecedented high level of maladministration in tax apparatuses-both at federal and provincial levels. We need public debate for suggesting solutions to remedy

the situation and to promote taxation and business growth attracting domestic and foreign investment and ensuring much-needed jobs.

On our part and for initiating such a debate, we are identifying some main maladies that need to be fixed through holistic tax reforms aimed at incentivising rapid growth and voluntary tax compliance.

**Collection dilemma: flat-taxation is the answer** At present, both the centre and provinces are not collecting taxes according to their respective potential due to weak enforcement and inherent problems of an out-dated tax system. Total tax potential of Pakistan is around Rs 12 trillion if agricultural income tax and other provincial and local taxes are also collected efficiently. As shown below, at federal level, income tax alone can be collected to the tune of Rs 7 trillion provided the entire undocumented economy is brought into tax net. So far, all efforts to achieve this objective have miserably failed. The existing tax system itself is the root cause for encouraging parallel economy, the reform of which is a fallacy. Patchwork here and there is just an exercise in futility and no matter how many tax reform commissions or committees are constituted the consequence would be attempting to cure the incurable. Remedy lies in dismantling the existing oppressive tax system and shifting to a flat-rate that is pragmatic, growth-oriented, workable and acceptable to all stake-holders. Under this flat rate taxation, those not coming into tax net or avoiding true disclosures would opt to pay voluntarily as rate would be minimal and compliance cost almost nil. Tax system is meant to incentivize growth and not otherwise as the present one is doing.

After levying all kinds of oppressive taxes, the federal government has failed to bridge the ever-increasing fiscal deficit that is creating a greater debt burden-at present 65% of tax revenues are going towards debt servicing alone. On the other hand, provinces are critical of inefficiencies of FBR due to which their share in the overall divisible pool is insufficient to meet their annual budgetary requirements. Since the share of every province in federal taxes under the National Finance Commission (NFC) is dependent on how efficiently taxes are collected by FBR, it is important that the centre and federating units actively participate in tax collection apparatus/processes/efforts. No serious debate has ever been initiated on the issue as to how we should increase the size of the cake to ensure that both the centre and provinces flourish as sufficient funds are made available to run the governments and fulfill the needs of the people.

**Tax system in perspective** The ever-growing size of parallel and undocumented economy, has much to do with the way taxes are being administered for the last many decades-from a tax-compliant public to a tax rebellious one, from high tax-to-GDP ratio to an obnoxiously low one, from greater revenue from fewer taxpayers (2 million) to very low revenue from a broad-based population (approximately more than 20 million), from a relatively thriving economy where debts were at their lowest to an apparent prosperous one where share of debts is

68% of the GDP, from a comparatively greater reliance on direct taxes to a complete turn-around towards indirect ones (even in the garb of income tax law which is essentially a form of direct tax), from relative simplicity of compliance to complicated procedures both at the federal and provincial levels especially in the aftermath of the Eighteenth Constitutional Amendment for which the earlier government takes immense pride. Even the Inland Revenue Service has transferred a major portion of its responsibilities of collecting tax, on withholding tax agents leaving very little to justify its own existence.

In short, all that could have been done has been done to make the life of a compliant taxpayer as miserable as possible and snatching from him that little iota of motivation that was egging him on to be an obedient citizen of this country. The helplessness of seeing one's hard-earned money going down the drain has compelled many to look for greener pastures around the world where their taxes would trickle down in the form of some benefit coming back to them. With this in mind, it becomes imperative at this stage to rethink and devise a scheme that would alleviate the sufferings of the common man and help generate substantial revenue for governments to function comfortably. Our country is rich in resources and its people are very generous. There is no doubt that a logical scheme of things capable of sucking in large revenues without disrupting the common man's life would be a welcome respite from the constant lashing by tax collectors.

Another important factor that discourages compliance with tax laws is the extremely complicated and cumbersome nature of procedure involved in being registered with the revenue authorities. Even the corporate and educated class finds it difficult to comprehend, follow and observe the simultaneously applicable innumerable legal obligations, what to talk of the illiterate and ordinary man on the street. If a survey is conducted with respect to merely the advance tax provisions (almost 75 in number), it would reveal how a person is supposed to be aware of so many avenues where either tax is being withheld or he is himself paying income tax and the consequences of these taxes, the credit of which he may or may not be allowed to take while filing his return. In the first instance, a highly meticulous record of all such transactions that invoke taxes would have to be maintained and secondly, an even higher level of grasp over the law would be required to apply it.

Considering the present level of inflation and the high cost of living, the minimum threshold of income (Rs 400,000) where no income tax is to be paid nor a return needs to be filed is within reach of an overwhelming population, including people who are earning income from simple employment, trade and vocations. With the prevailing standards of literacy in the country how can it be expected that the common man has any cognizance about tax laws let alone complying and then tackling the authorities who are perpetually ready to whip anyone-innocent or guilty. Had it been restricted to simple arithmetic, things could have improved but the cruel methods adopted to teach the nation lessons in paying taxes have only proved detrimental rather than motivating.

People take pride in beating the authorities, no exemplary punishment has been meted out to confirmed evaders, no effort has been made at the grass root levels to educate the public about its obligations and instead of serving the nation, officials of the revenue department are poised to pounce upon the first stray taxpayer to squeeze him dry. Revenue officers are trained to look suspiciously at every registered taxpayer-their motto being "guilty until proven innocent." Even though law requires that officers should counsel and guide the taxpayer with respect to his duties and rights, he is conveniently forced to engage a tax consultant who, if professionally unethical, is capable of causing much more financial damage to his client than the amount of tax in question.

**Black economy and tax losses** Tackling the twin menaces of black money and tax evasion has always been a failure in Pakistan. The study, What is hidden, in the hidden economy of Pakistan? Size, causes, issues and implications, by Ahmed Gulzar, Novaira Junaid and Adnan Haider, shows that corruption and tax evasion are not only causing an expansion in the size of the informal economy but also hampering the growth rate, thereby adding more to economic uncertainty, income inequality and poverty. Successive governments, instead of dealing with these issues have been pardoning and appeasing tax evaders through various laws and amnesty schemes.

The result is obvious-there is an ever-growing informal economy, which is ironically declared as The Secret Strength of Pakistan's Economy. Only 25 percent of the economy is taxed if the undocumented sector is taken into account. It means that tax gap in Pakistan is 75%. The tax-to-GDP ratio is much less than what is claimed by FBR. They do not take into account informal (untaxed) part of economy. Former Finance Minister Shaukat Tarin said in 2010 that "Pakistan loses 800 billion rupees a year in tax evasion". The tax collection of each year, after blocking refunds and taking advances of billions of rupees is not enough to bridge the budget gap, which last year was over 5 percent of GDP. The present accumulated size of informal (untaxed) economy is estimated at Rs 50 trillion. If tax at flat rate of 10% is offered to all who have failed to pay in the past, in just one year FBR will collect Rs 5 trillion and then in future this figure would be much higher compared to what is collected at present-in fiscal year 2015-16 FBR collected merely Rs 3.1 trillion against documented GDP of around Rs 24.7 trillion.

**The new paradigm** Under the afore-stated situation of imbalances, a fresh approach and a renewed policy are urgently needed to replace the entire taxation system for fiscal stabilization. The equation is simple. Federal government needs at least Rs 7 trillion of revenue (for meeting all development and non-development expenditure along with retirement of expensive loans), for which determination of a fair tax base is imperative. The current complex system, only favours a few thousand officers and their staff along with people having money power and who can blatantly flout the law. It is possible to suggest a simple flat rate tax that is neither burdensome nor difficult to implement but it would deprive the bureaucracy and some vested interests who would be most likely to oppose it.

Nonetheless, there is no option but to dismantle the existing, out-dated and anti-growth tax system if we have to overcome the twin but inter-related malaises of fiscal deficit and debt burden.

Arthur B. Laffer and Stephen Moore in their book "Return to Prosperity," have expanded upon a theory that meets our existing conditions. While elaborating upon the practicality of flat rate of tax, they write:

"Excessive taxation is detrimental to labor and capital, poor and rich, men and women, old and young. Excessive taxation is an equal opportunity tormentor. Businesses locate their plant facilities in order to make higher after tax returns for their owners. In the short run, higher taxes on labor or capital lower after tax earnings. During depressed times, businesses are often desperate to reduce costs because of a shortfall in revenues. Increased taxes in one location can be the final straw leading to businesses' relocating to more tax friendly locations or making the ultimate decision to close down operations. In the longer run, immobile factors (such as low wage workers and commercial and residential real estate) are left to suffer the tax burden."

Referring to the significance of mode of taxation, the writers draw justification from a noted nineteenth century American economist Henry George who wrote in his book, "Progress and Poverty" (1879):

"The mode of taxation is, in fact, quite as important as the amount. As a small burden badly placed may distress a horse that could carry with ease a much larger one properly adjusted, so a people may be impoverished and their power of producing wealth destroyed by taxation, which, if levied in any other way, could be borne with ease."

There has to be a source of motivation for taxpayers to comply voluntarily and to some extent eagerly in contributing towards the national exchequer. Whenever the governments resort to high-handedness in collecting taxes, the people term it as broad daylight robbery, instrumental in encouraging tax evasion. As propounded by the eminent authors of "Return to Prosperity" on pg. 174:

"The theory of incentives provides the basis for the concept of a flat-rate tax, which is so called because a tax applies equally to all sources of income and does not change as a result of taxpayer's volume of income. Any exemptions, deductions, differential rates, or progressivity would, as a matter of linguistics, preclude the name flat tax. They also represent a deviation from the principles of efficient taxation. Such exemptions to the even application of a single narrow tax base, lead to a higher tax rate, make for greater complexity, and increase tax avoidance."

**They further say that:** "In the realm of economics taxes are negative incentives

and government spending entails positive incentives, subject to all the subtleties and intricacies of the general theory of incentives. People attempt to avoid taxed activities-the higher the tax, the greater their attempt to avoid."

The tax system that will work smoothly for Pakistan, keeping in view our peculiar socio-economic circumstances and mind-set of masses, must be a flat rate with no compliance hassles. All taxes should be merged into one single tax with complete assurance to the masses that they would be free from any kind of harassment; and money collected would be spent towards their welfare. The agenda of fair taxation cannot succeed if wastage of public funds and its abuse by the rulers continue unabated. The quid pro quo for paying taxes is as important as the system to collect tax. Where the public is blamed for not paying their due share, public authorities are equally, if not more, responsible for indulging in corrupt means taking cover of complicated procedures that eventually lead to poor collection of revenue. As mentioned by the writers:

"A flat rate eliminates much of the inefficiency in a convoluted tax system by broadening the tax base and sharply reducing marginal tax rates. Many of the distortions that exist with the current tax system are minimized. A flat tax rate reduces the collection cost per dollar of tax revenue and eliminates much of the bureaucracy necessary to monitor and enforce numerous taxes. Its adoption leads to a surge in growth and creates a more competitive economy."

The tax base with respect to direct tax vis-à-vis fair distribution of incidence can be achieved by imposing 10% flat rate tax on net income of individuals and reducing corporate tax rate to 20%. This kind of simple taxation would induce voluntary compliance provided all the citizens are aware of the fact that competent and effective tax machinery exists having a tax intelligence system that can easily detect tax avoidance. Without this deterrence even the new system which is a great deal simpler, will be unworkable. Nowhere in the world is proper collection of taxes possible without a strong enforcement apparatus. However, the apparatus should be friendly and firm-friendly, to the extent of educating and guiding the people for fulfillment of their tax obligations, and firm to the extent of punishing willful defaulters.

As far as sales tax is concerned, it has been emphasized time and again that Pakistan needs harmonized sales tax (HST) which should be single-stage and single-digit. This envisages collection through a National Tax Authority which should replace all existing authorities at both federal and provincial levels.

**The National Tax Authority (NTA)** National and provincial assemblies should pass a law agreeing on establishment of NTA responsible for collecting all taxes imposed by the federal and provincial governments. This would facilitate people to deal with a single revenue authority rather than multiple agencies at national, provincial and local levels. The mode and working of NTA can be discussed and finalised under Council of Common Interest [Article 153] and its control can be

placed under National Economic Council [Article 156].

The provinces should also feel responsible for better and efficient tax collection. Presently they are isolated and rely on distribution from the divisible pool whereas the Federal Board of Revenue annually collects less than the assigned revenue target. The responsibility to collect revenues should be joint and several giving a participative sense to all federating units.

The NTA should consist of officers and staff representing the federation of Pakistan as in taxes, both the centre and provinces have equal stakes. If the size of the pie grows every federating unit will get more and the Centre will also have more money at its disposal. For NTA, an all Pakistan Tax Service should be established. Recruitment for All Pakistan Tax Service must be independent of the present Central Superior Services structure. Competent people having knowledge in accounting, law, IT and administration should be selected through a special Board, comprising members from the existing Federal and Provincial Public Service Commissions.

**Determination of direct tax/income-based method** According to available data, total number of persons having taxable income of more than Rs 400,000 is between 10 to 12 million and tax base is around Rs 50 trillion (after taking into account informal economy). Flat rate taxation of just 10% with strong enforcement system will yield Rs 5 trillion under income tax alone.

**Determination of the indirect tax base** All existing indirect taxes should be replaced both at the federal and provincial levels with Harmonized Sales Tax (HST). There are multiple tax collection authorities now, rendering the life of the ordinary citizen miserable since he is unable to comprehend complex laws without having to pay heavily to professionals.

If the present indirect taxation is replaced with HST as in a comparable federation like Canada, it would not only improve revenue collection but would also help to alleviate the sufferings of taxpayers who have suddenly been bombarded by multiple tax authorities.

In the Pakistani milieu if a single-stage 5% HST is levied, it would yield at least Rs 3 trillion both at federal and provincial levels. A comprehensive study, courtesy Tax Reform Commission (TRC), is already with FBR. In this study, prepared by a sub-committee of TRC, even the matter with respect to cascading of prices has been addressed and dealt with satisfactorily.

**Conclusions** 1. If we want optimum collection of taxes fairly and without hampering growth, it is imperative to abolish the present tax laws and enact new ones.



2. Collection of taxes through a single national authority as suggested above.

3. Establishment of a Tax Intelligence System sending quarterly information to potential taxpayers about their economic activities so that they can be informed in advance as to how their incomes and expenditure should finally look like in their tax declarations.

4. Prudent spending of public money through a transparent process enjoying the confidence of the people.

**(Concluded)**

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