**[Stubborn taxation regime](http://www.dawn.com/news/1092349/stubborn-taxation-regime)**

[Ishrat Husain](http://www.dawn.com/authors/274/ishrat-husain)

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SUCCESSIVE governments have been confronted with the issue of a stagnant or declining tax revenue stream. Many reforms of the Federal Board of Revenue, tax policy and tax administration have been attempted but the results have been painfully disappointing.

To analyse the reasons for the tax regime’s intractable nature we have to adopt a more systemic approach by dissecting the economy into sectors including rural and urban; formal, informal and illicit; agriculture, industry and services; and income distribution groups.

Of Pakistan’s potential labour force of 75 million, 18 million are not participating, five million are unemployed and 52 million employed. The rural labour force accounts for approximately 70pc of the total. Aside from the income of land holdings over and above 12.5 acres of irrigated and 25 acres of non-irrigated land, the labour force mostly consists of landless peasants, unpaid family help, casual workers, subsistence farmers, small vendors, etc. These categories are largely exempt from direct taxes and bear only indirect taxes on inputs and consumption. The main burden falls on urban incomes earned by 30pc of the labour force.

Direct evidence and hard facts regarding the formal, informal and illicit economy are difficult to gather. Casual empiricism or anecdotal evidence points to a gradual expansion in the informal sector’s share through workers’ remittances, understated property income, proliferation of unregistered enterprises operating out of residential areas such as boutiques, tuition centres, schools, clinics, beauty salons, restaurants and small and medium enterprises. Their common feature is that they are all outside the tax net.

In the last five to six years, illicit incomes earned through corruption and bribery by public office holders, extortion, robberies, ransom, extractions by land, water and other mafias, prostitution, gambling dens and other illegal and criminal activities have multiplied manifold. But the formal economy has remained stagnant or declined. Therefore, the taxable base even in urban areas is shrinking because of the transfer of incomes from the formal to the informal/illicit economy. The best estimates indicate that formal-sector employment isn’t more than 25pc of the total urban employment.

The number of those who qualify for the minimum threshold of taxable income — if properly assessed, audited and enforced — could stretch to some four million. Presently, only 1.5 million individuals and firms file tax returns. Leaving aside the salaried class, many of the filers do not fully disclose their income.

Less than 1.1pc of GDP is collected as actual direct income tax. Most of the additional yields would therefore accrue from the top 20pc who receive 50pc of the national income. Some 118,000 firms are registered in the sales tax system but only 15,000 actually pay any tax. As much as 82pc of the total sales tax and federal excise duty is collected from only 100 companies.

It is apparent that in this environment the traditional tools of rate changes, assessment, compliance, audit etc will remain blunt unless the share of income in the formal sector rises, and exemptions, concessions and waivers within this sector are eliminated and new assessees are added.

Studies on sectoral incidence show that industry bears more than two-thirds of the tax — while the services sector bears about 21pc and agriculture 3pc. About 90pc of farm families have subsistence holdings. Of the remaining, only a third holding more than 50 acres of land would cross the threshold of taxable income. To expect the agricultural sector (20pc of GDP) to make an equi-proportional contribution to national tax revenues is unrealistic. The yields from farm income are unlikely to exceed 1pc or 2pc of the current tax revenue collection. The filing of tax returns by agriculturists will, however, stop the leakages from non-agricultural incomes.

In the services sector, transportation and trade together account for one-third of GDP. Most transport movement takes place via roads and except for a few companies the sub-sector is dominated by small- and medium-size operators. Only air and shipping yield some revenues. Similarly, out of 1.5 million wholesale and retail trade units (employing a population of nine million) 85pc are small family-run stores. The entire direct and sales tax collection from the trade sub-sector constitutes 0.5pc of federal taxes. The scope from the services sector also remains limited.

As two-thirds of the tax collected is in the form of indirect taxes and one-fourth of the entire amount comes from petroleum and petroleum products at various stages (which is passed on to consumers) the overall incidence is regressive. Even where direct taxes are concerned, two-thirds consist of withholding taxes which are deemed to be the full and final settlement of tax liability. So, in terms of the impact on different income groups the burden falls disproportionately on the poor and middle-income groups.

On top of this, policymakers, in their attempt to attain revenue targets, impose additional levies on existing taxpayers. This disincentive leads to the quest for various loopholes in the complex tax code — saddled with enormous discretionary regulations — to understate incomes, claim exemptions and avoid paying full taxes.

The analysis here shows that the present taxation regime that is highly skewed towards the urban, industry and formal sectors is narrow, inequitable, regressive and distortive. Unless a structural transformation of the economy takes place — one that expands the formal sector, makes the rural sector and agriculture more efficient, raises middle-class numbers and makes taxes more progressive and less patronage-ridden — attempts to reform the tax regime will continue to produce unimpressive results.

The writer is a former governor of the State Bank of Pakistan.