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Reforming Pakistan's tax system: Evidence-based suggestions

As Pakistan fails to collect a decent proportion of own-source revenue, it has little choice than to take on debt or depend on more creative means, such as a recent crowdfunding campaign, to fund public projects.

Where does Pakistan stand?

Pakistan tax-to-GDP ratio is about 12% . In comparison, OECD countries raise taxes equivalent to about 34% of their GDP. This limits Pakistan's capacity to fund public investment. Where it does collect taxes, it principally relies on indirect taxes on goods and services, which account for 6.3% of GDP. The other 4.2% of the GDP that make up direct taxes are collected mainly by businesses withholding a percentage of economic transactions for the government. Hence, they do not require voluntary tax compliance from individuals, which, as a result, remains extremely low.

Start with improving enforcement

There is a relatively strong consensus that effective enforcement can lead to more tax revenue. Weak enforcement ranges from a property tax collector taking a bribe to not enforcing the tax, or a just a simple lack of capacity of the tax authority.

Improving enforcement may also result in more productive firms in Pakistan. Ilzetzki and Lagakos (2017) created a model of Pakistan's economy to understand the impact that increased enforcement could have. They find that increasing enforcement will not only allow Pakistan to raise more tax revenue from firms in the short-run, but it would also result in higher growth by bringing these firms into the formal sector. By formalising, they would be able to make productivity enhancing investments and as a result be able to grow.

Enhancing enforcement requires Pakistan to do two things. First, hire better trained staff who have access to the right technology and resources. Piracha and Moore (2015), using a case study of Punjab, Pakistan's largest province, find that each property tax circle needs to collect on average about $350 a month themselves to cover operational costs of their offices.

Furthermore, Pakistan will also have to focus on aligning the incentives of the bureaucrats associated with tax collection, with the incentives of the government. This is the classic principal-agent problem: politicians delegate tax collection power to bureaucrats, but cannot monitor them perfectly. At the same time, the front-line bureaucrat will most likely have better information. Due to this information asymmetry, tax collectors need to be effectively incentivised to fully and fairly enforce taxes. To this end, Khan et al. (2016) collaborated with the Punjab government to run an experimental study by assigning different incentive schemes to property tax collectors. They found that over two years of the study, performance incentives encouraged tax collectors to add new properties to the tax collection roster, significantly increasing revenue.

Information is the key

Most developing economies have large proportion of their economies based on informal, cash-driven transactions, which means they are not captured by the tax base. There are a few ways Pakistan can attempt to create better information. Evidence suggests that implementation of a value added tax (VAT) helps raise more revenue by generating a paper trail between firms through cross-reporting of liabilities. This is evident in the paper by Pomeranz (2015) in the case of Chile. Building on this line of thought, Pakistan's VAT structure has certain challenges. First, intuition suggests that VAT should be applied uniformly by a single agency. In Pakistan, it is however split between federal and provincial governments, creating administrative and coordination challenges.

Second, by providing extensive exemptions in the VAT, Pakistan distorts the information trail; VAT is levied at 17% on the majority of goods, however, several goods have a either a lower rate or are exempt. One example is the exemption of red chillies but not green chillies.

Empower cities to tax

About 38% of Pakistanis live in cities, yet they contribute to about 55% of the GDP. This means that if Pakistan effectively manages the tax collection in these cities, there is further revenue potential.

Presently, Pakistan does not have financially empowered local urban governments, instead, most urban taxes are implemented by one of Pakistan's four provincial governments. These provincial governments have large jurisdictions, with populations ranging from 12 million to over 110 million. As managing cities is not the central function of these governments, most of them have not developed effective urban administration mechanisms.

As noted through the synthesis of research conducted by the IGC's *Cities that Work* initiative, land and physical properties are a major source of untapped revenue for most developing country cities. Punjab, for example, despite being home to nine cities home to over a million people, collected only Rs. 10

billion, or about 6% of its total tax revenue, from property taxes. Other parts of Pakistan have not fared better. Sindh, which is home to Karachi, Pakistan's largest city, has not had a revaluation of land and property since 2001.

Yet there is large potential to increase this. For example, an estimate from the IGC (2011) shows that Punjab can raise Rs 25 billion in property taxes if it undertook comprehensive reforms.

Hope for the future

Reforms passed earlier this year granted government the power to forcibly acquire any property that a citizen holds by paying 100% over the price they have declared in their tax returns (hence creating incentive for them to declare the true value of property). However, it is unclear whether these reforms will be implemented in practise.

Increasing taxation is possibly the most fundamental challenge Pakistan faces today, not only to adequately finance public investment and services, but also to establish a fairer society. To do so, it is useful to bridge the gap between research and policymaking by integrating research findings into policy decisions. This article points towards three avenues which can act as a point of departure for such a discourse.

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