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How Pakistan's Unfair Taxation System Fuels Inflation

OXFAM

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Abstract

In the past few years, Pakistan has experienced a period of high inflation by historic standards, especially in terms of food inflation. While a super-spike in global commodity prices provided the initial trigger for a rapid increase in the price level between 2008 and 2012, structural weaknesses such as high fiscal deficits caused by abysmally low tax revenue collection, have fuelled inflation since. Even though Pakistan has been experiencing declining inflation in the past few months, without addressing the fiscal roots of inflation, the poor and vulnerable will continue to be disproportionately burdened.

Policy Brief

Since 2008, Pakistan has experienced a period of unprecedentedly high inflation. Food price inflation, in particular, recorded a historic peak during this period. The period 2008-12 was also among the most sustained episodes of above-trend inflation in the country's history.

Between July 1, 2008 and end-June 2014, consumer price inflation has recorded a cumulative rise of 119 percent, with food prices more than doubling in aggregate, recording an increase of 150 percent. This protracted episode of above-trend inflation has had severe adverse consequences for large parts of the population and imposed substantial economic as well as social costs.

In overall macroeconomic terms, this period of historically high inflation in Pakistan coincided with declining fixed investment and almost-flat real growth in incomes and employment. In terms of welfare consequences, high food inflation has imposed a disproportionately greater burden on poorer and vulnerable households - given the higher share of spending on food in their budget as compared to better-off households. Because of this reason, food inflation in particular is regarded as amongst the most highly regressive forms of "taxation".

As a result of the unprecedented increase in food prices during this period, millions of Pakistanis have been made food-insecure – with some estimates placing the number at nearly 60 percent of the total population, or some 100 million people. Recent estimates on the incidence of poverty place the headcount poverty ratio at 54 percent, based on a poverty line of US$ 2 a day (PPP), a sharp increase from the last official number of 17.2 percent for 2008; simulations done earlier by the Asian Development Bank suggest food inflation as a probable leading cause for the sharp increase in poverty.

Unfortunately, but hardly surprisingly, the period under review has also recorded a sharp increase in the level of child malnutrition to alarming levels. Perhaps most perniciously, persistent food inflation and any resulting nutritional deprivation that is not easily reversible, may have had a lasting effect on the economic and social marginalisation of a significant part of the vulnerable population – as being indicated by national nutrition surveys.

Inflation in Pakistan has generally been associated with commodity price and/or supply shocks, and less so with monetary factors such as money supply. However, excessive money creation, which has fiscal roots in Pakistan, caused by the failure of successive governments to collect taxes combined with inefficient and bloated public sector spending, is a leading structural cause for inflation in Pakistan.

[1]Using a compounded measure.
[2]Based on the national poverty line.

Pakistan's tax system is characterised by widespread exemptions, low compliance and weak enforcement. Successive governments have failed to address the weaknesses in tax policy and the corruption-ridden administration – mainly to the benefit of their elite constituents.

The scale of tax non-compliance (tax evasion as well as avoidance) in Pakistan is staggering. Some dimensions of the country's tax situation throw a light on the magnitude of the problem:

- The overall "tax gap" has been estimated by a World Bank-FBR study at nearly 80% for 2007-08 (or approximately 7.5% of GDP). The tax gap refers to the difference between actual collection and the estimated potential, and is a useful indicator of the extent of tax non-compliance.
- The Federal Revenue Board (FBR) has approximately 4 million people on its tax register. However, around 3.2 million of these are estimated to be inactive or non-filers.
- In total, less than 800,000 taxpayers filed a tax return (or 0.4% of the total population), while nearly 40% of these tax filers paid zero tax.
- The source of tax revenue is heavily skewed towards indirect taxation (approximately 65% of total collection), instead of from direct taxes. Direct income tax collection is only around 3.5 percent of GDP. Approximately 70 percent of what is recorded under direct tax collection is generated by the withholding tax regime, a form of indirect taxation.
- Taxation of energy (petroleum products, electricity and natural gas) is a major source of revenue for the government, generating nearly 50% of the sales tax.
- Underscoring the scant respect of the elite for the "rule of law" in the country, 35% of members of Pakistan's national assembly (NA) paid no tax in 2012-13, according to the Parliamentarians Tax Directory 2013 published by FBR.
- The average tax paid for members of the national assembly, excluding the highest taxpaying MNA who contributed 20% of the amount of tax paid by the entire NA, amounted to the equivalent of US$ 1,186 in 2012-13.

Not surprisingly, one of the longest periods of historically-high inflation in Pakistan between 2008 and 2012, coincided with one of the weakest fiscal performances in the country's history. With the tax-GDP ratio averaging 8.9%, the fiscal deficit climbed to an average of over 6.8% during this period.

The causality of fiscal performance and inflation works through the following channels:

- A sharp increase in money supply and/or the monetary base caused by the monetisation of large and persistent fiscal deficits;
- A heavy reliance on indirect taxation;
- The resort to taxation of petroleum products, electricity and natural gas;
- Inability of the government to absorb subsidies in the budget, resorting to adjustments in administered prices usually in response to an IMF adjustment loan;
- The debasing of the Rupee caused by excessive growth in the money supply – which results in the transmission of a domestic price shock from the sharp

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[i] Using a compounded measure.
[ii] Based on the national poverty line.

increase in the landed cost of imports, especially in the case of petroleum products.

As a result of poor collection of tax revenue, successive governments have been finding it increasingly difficult to fund public mandates such as delivery of basic as well as essential services. More often than not, this hurts vulnerable households and communities the most.

The pervasive environment of "fiscal domination" during this period, where financing the government's ever-larger needs trumped all other objectives, also severely undermined the central bank's anti-inflation monetary policy and other measures to combat inflation.

The recent collapse of international oil prices has brought the distributional consequences of Pakistan's inequitable and unfair tax system into sharp relief. World oil prices have fallen by 50 percent since June 2014; the government, fearing a huge revenue loss, had transferred only 23 percent of the benefit to Pakistani consumers by end-December.

If the entire decline in international oil prices had been passed on domestically, consumers would have benefited to the extent of over Rs 500 billion (the impact on transportation fuel alone). By passing on a lower reduction, and increasing the sales tax, the transfer to consumers has been trimmed to Rs 175 billion, a significant welfare "loss" of over Rs 300 billion at current prices.

Hence, the roots of inflation in Pakistan are pre-dominantly institutional as well as structural – centred in a weak fiscal framework. The unwillingness and/or inability to correct an unbalanced and unjust fiscal system that benefits the elite of the country – either via an inequitable and unfair tax system, or via disproportionately skewed expenditure on the upkeep of the well-off – places an inordinate burden on the poor and vulnerable.

It also goes to the heart of the governance issue in Pakistan.

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