How does Pakistan's shamelessly unfair and inadequate tax system fuel inflation and burden poor and vulnerable households?

An Equitable Tax System
For a
Educated, Healthier & Prosperous Pakistan

TAX JUSTICE COALITION
PAKISTAN

The lack of a fair and equitable taxation system, and the unwillingness and inability of successive governments to fix it, is placing an increasing burden on poor and vulnerable Pakistani households.

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.**

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.

In an equally direct manner, though not as visible as the impact of high taxation of energy and petroleum products or non-delivery of basic public services, is the effect of the "inflation tax" on the poor and vulnerable imposed by the skewed and unfair tax system in Pakistan.

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. Since 2008, 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 welfare consequences for large parts of the population and imposed substantial economic as well as social costs, imposing a disproportionately greater burden on poorer and vulnerable households via increased poverty and rising malnutrition.

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.

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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[i] Pakistan Tax Policy Report, World Bank 2008.
[ii] Source: FBR Tax directory for TY2012-13.
[1] Using a compounded measure.

Sakib Sherani

"Former member of the Prime Minister's Economic Advisory Council,
Ex-Principal Economic Advisor to Ministry of Finance, Government of Pakistan.
Chief Economist Pakistan for a Leading Foreign Bank.
Columnist for a Leading National Daily Dawn and a Commentator on the Economy."

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