

Simplifying the taxes

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IN contrast with the frequently repeated statements of government spokesmen that Pakistan is a low-taxed country — with a tax to GDP ratio of 13 per cent that is significantly lower than the average of 20 per cent in the case of similarly placed countries — even Islamabad's mentor, the IMF, accepts that Pakistan's revenue performance is not out of line with the experience of other countries with similar per capita GDPs.

An IMF cross-country comparison shows that: a) none of the countries with per capita GDP below Pakistan's raise as much revenue as Pakistan does; b) revenue from the three main tax instruments (customs duties, income tax and sales tax) is higher than that raised from similar taxes by comparatively rich countries like Egypt, Mexico and Sri Lanka; and c) the efficiency of Pakistan's customs duty collection is higher than that of richer countries like Philippines, Morocco and even South Korea.

Countries with tax-to-GDP ratios of 20 per cent and above, unlike Pakistan, run and manage social welfare systems for their populations. Also, compared to tax rates worldwide, our tax rates are higher. Although at 35 per cent the present highest rate of income tax does not compare unfavourably with rates in other countries (that range from 30 to 35 per cent in most developing countries and in excess of 45 per cent in European countries), the mismatch is stark in the visible returns that developed societies and citizens get from the state on the taxes they pay. The fact that we have too many taxes in the country, if we include all provincial and local taxes (although in totality they generate only a small fraction of nation's revenues), adds to the inconvenience of the taxpayers and raises the 'cost of doing business' in Pakistan. This is another matter that needs to be dealt with separately which I propose to do some other time.

Having debunked official claims on the subject, let us

imperatives of the political economy of tax reform.

This problem can best be illustrated by the recent decision to lower interest rates on different instruments floated by the National Savings Schemes (a perfectly sensible and long overdue decision) without simultaneously announcing a scheme that addresses the concerns of pensioners and simply promising to devise one soon. A mistake as elementary as this has been a costly public relations failure. It may even force a partial roll-back or dilution of this or some other equally important agenda item in the reform programme.

Through taxation the state reduces the spending capacity of its citizens. Therefore, any effort to raise tax revenues evokes criticism and protest, even resistance. What is less important is the inherent merit of any proposal. It is its voter, and media, acceptability which carries more weight, since tax reform cannot benefit all citizens. The more vocal the losers the less likely that a proposal will be accepted, unless the overall package distributes the burden fairly and equitably. Therefore, the then decision to raise the threshold of incomes exempt from taxation to Rs. 60,000 should have been followed by a decision to withdraw the bulk of the exemptions for perquisites to salary earners.

The resulting higher taxation of salaries of professionals was criticized in the press as a measure that could evoke an exodus of high quality human capital, although what attracts people to migrate to the West is not low levels of taxation, but more opportunities of earning higher incomes. In any case, the

ation of dividends as a result of this income being fully taxed, an imputation system would have to be introduced — through the provision of a tax credit to shareholders on a portion of the tax, say, 20 per cent out of the corporate tax rate ranging from 35 to 43 per cent. Ideally, however, incomes derived from savings should be exempted from taxation. Taxing them creates a bias against saving because of the double taxation of savings — first as part of the income after taxation from which it has been saved and later as an investment on the return from the instrument in which this income has been saved. This bias can be removed by either deducting the savings from the taxable income or by exempting the return from tax. Another way of removing the bias against savings could be to give relief on income earned from long-term saving instruments.

There is no such thing as voluntary compliance. Only effective enforcement can serve as a good deterrent to evasion. In our case tax administration weaknesses with regard to enforcement arise because of an ineffective legal system and the lack of effective accountability of government employees.

Greater publicity should be given to cases of tax evasion (only those upheld by courts or conceded to by taxpayers) in the hope that public shame would serve as one of the deterrents to tax evasion. Good governance in a structure of transparent taxation cannot be achieved with the same ease as computerization of the taxation system through purchase of equipment and supporting software. These essentials will continue to elude us as long as

the governing political system nurtured and supported by the elite is financed by black money through institutionalized instruments and mechanisms for evading taxes. How does one overhaul such a system through the transformation of the political structure is a million-dollar question that defies easy answers as to the need for tax reform built around transparent and simpler systems of taxation.

However, the reality is that there are no quick fixes. Exercises to simplify tax laws and to ensure effective enforcement can take several years, as the experience of even developed countries

The existing tax structure should be replaced by the one that has lower rates but with very few exceptions (to check discretion), remembering that the principle of horizontal equity is violated through both exemptions and defective definitions of 'taxable income'. To this end, the personal income tax structure can be further simplified by having just a handful of rates to minimize the impact of 'bracket creep'.