LSE Asia Research Centre

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Pakistan: Design of Tax Reforms and Financing of Social Programs—rent seeking and informality

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Outline

- Tax reforms, distribution and rent seeking: Insights from the models
- Pakistan context
- A way forward?

Insights from the models

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Some research questions

- Should a single tax address distributional and efficiency/revenue considerations?
- What combination of instruments would be appropriate in given contexts?
  - VAT
  - Income taxes
  - Social spending
- How to minimize incentives for informality and evasion/rent-seeking?
- How to sequence and implement reforms: political-economy perspectives

Interactions with social policy

- Can social policy tools and transfers make it easier to compensate "losers" and sell tax reforms?
  - Political economy of maintaining "growth" versus "redistribution"
- Can more effective tax structures remove distortions with design and financing of social policies?
  - Removing kinks and high marginal tax rates
    - Improve incentives for firms and workers
    - Enhance growth prospects
    - Improve distributional outcomes

Design of intergovernmental transfers?

- Transfer design affects incentives at the local level
  - Gap-filling “fiscal dentistry” is the worst…all responsibility moves to higher levels
  - Can local governments be held accountable? Role of “yardstick competition?”
  - Diversion of earmarked transfers, especially if there are no clear responsibilities and own-source revenues?
- Can equalization transfers be treated as “lump-sum”?
  - Importance of own-source revenues and interactions with transfer design

Sequencing and political economy

- How would one sequence combinations of policy reforms?
- Modeling and simulations of interactions and introduction of measures

Insights from modeling exercise

- Interactions between taxes and social benefits matter
- VAT could provide information for “formality”, if:
  - Simple structure without exemptions
  - Administered by arms length body
- Interact with “efficient” corporate income tax
  - Levels important for investment (cross country comparisons)
  - Enhance incentive to hire formal labor /declare outputs
- Need single administration for VAT and CIT
  - Intergovernmental issues handled by “piggy-backing” or sharing

The Pakistan context

RENT SEEKING AND CLIENTELISM

Major problems

- Split bases for the main taxes
  - Agriculture assigned to provinces
  - Provides a useful "tax avoidance" mechanism
  - Holes in the CIT (taxation of capital gains)
- GST
  - Split base (goods vs services)
  - Riddled with exemptions and special provisions (Statutory Regulatory Orders, SROs)
  - Administered largely on presumptive basis (with tax administration fixing assumed sale prices)—backward shifting
- Social programs:
  - At behest of friendly MP
  - "Clientelism" if not outright "capture" (Bardhan and Mookherjee)
- Huge incentive to informality; rent-seeking by administrators; politicians trying all means to get returns on investment…..

Split base for the GST—tax on services administered by provinces

- Legacy of Government of India Act 1935
  - Sales tax and income tax on agriculture assigned to states/provinces
  - Sales tax centralized after independence
  - 1973 constitution gave "Service component" back to provinces
- Situation in Pakistan inverts India
  - Split based problematic in both cases (Ahmad and Poddar, 2008 for Indian Finance Commission)
  - Disastrous in Pakistan
- Sindh insisted on administering (reversing Musharraf agreement on joint collection)
  - Effectively becomes an import duty imposed by Sindh on transactions for other provinces
  - Others could retaliate by "fraudulent invoices" [Brazilian invoice sight seeing]; denying credits would hurt business
- Makings of an interprovincial tax war : will damage growth prospects

GST productivity—declining and low in comparison with competitors

	Standard rate	Revenue/GDP	Productivity
Pakistan (1990s)	15		.39
Pakistan (2005)	15	3.4	.30
Pakistan (2009)	16	3.1	.26
Sri Lanka	15	6.7	.47
Philippines	12	4.3	.45
Turkey	18	7.1	.48
Lebanon	10	5.1	.50
Jordan	16	10.1	.62
Korea	10	6.7	.67
Singapore	5	1.8	.63
New Zealand	12.5	8.9	.93

Reforms promised—VAT plus….

- How does one raise an additional 4.5% of GDP in 5 years
  - Without hurting the pro-business and export strategy or the poor
  - Most has to come from the VAT
  - Concomitant improvements in the income taxes
  - Arms length administration, building on self assessment with cross-checking of information and audit
- Mangled administration since 2003, despite TARP ($135m World Bank project)
- Attempts to bring back on to track since 2008, not particularly successful
- Stiff resistance from administration to removal of SRO powers
  - Was the draft VAT law deliberately sabotaged?….what was submitted to Parliament was not what had been agreed….
- Sidetracked by Services issue—and when solution was found with Sindh, outright opposition to the proposal of a VAT
  - despite the fact that we already have one and it is not a very efficient one
  - Removal of distortions would not affect the poor, or even proper exporters
  - Even if we cannot be China, can we measure up to Sri Lanka?

Rent seeking—perennial curse

- Cozy relationships with "important sectors"
- SRO culture by passes Parliamentary oversight
- Resistance to arms-length administration
- Tax administration reforms completely reversed 2011
  - Greater discretion to field officials
  - Especially for audit—non existent previously, having been abandoned in 2004
- Are implicit subsides still needed by geriatric infant sectors unable to compete? Negative value added?
- Why are input subsidies needed for efficient agriculture, with highest commodity prices in memory?

SRO 283—FBR's April Fool's Gift to Nation

- Very confused—mixes up final and intermediate goods
- Makes arms length administration almost impossible
- Bestows lower effective taxes for the rich
- Marginal revenue changes due to induced cascading – antithesis of GST reforms
- Reinstates the primacy of SROs for 185 items—rag bag of items #185 anything the FBR can think of in the future
- Kills arms length administration
- Destroys tax reforms for foreseeable future
- Overrides tax policy primacy of parliament….!!!!

Collusion and rent-seeking?

- Consumers and producers of luxury carpets and textiles
  - Is it a disguised subsidy to producers who cannot compete in international markets?
  - Way to get around WTO rules?
- Certainly not the poor and middle classes!!!
- Collusion between tax administrators and vested interests

Table 1 Pakistan: ranks for λ_i

ε	0	0.5	1.0	2.0	5.0
1. Wheat	10	4	1	1	1
2. Rice	7	7	6	6	7
3. Pulses	8	5	3	2	2
4. Meat Fish, Eggs	13	13	13	13	13
5. Milk and Products	11	11	10	10	11
6. Vegetables, fruits and spices	12	12	11	11	9
7. Edible Oils	1	1	4	4	4
8. Sugar	3	3	5	5	5
9. Tea	5	2	2	3	3
10. Housing, fuel and light	2	6	8	9	10
11. Clothing	6	8	9	8	8
12. Other foods	9	9	7	7	6
13. Other non-foods	4	10	12	12	12

Source: Ahmad and Stern (1991)

Notes: The welfare loss for commodity *i*, λ_i, represents the effects on all households (using Household Survey data on consumption, and estimated demand responses) of an increase in the tax on the i^{th} good sufficient to raise a rupee of government revenue. The β^h are welfare weights on households, and ε is the inequality aversion parameter ranging from 0 to 5. A good ranked 1 would be such that a switch of taxation from it to any other good would increase welfare at constant revenue.

$$\lambda_i = \frac{\sum_h \beta^h x_i^h}{X_i + \sum_j t_j^e \frac{\partial X_j}{\partial t_i}}$$

Policy implications of domestic zero-rating

- Removes taxation from clothing and carpets
- λ_i not particularly high at any level of inequality aversion
- Certainly not high priority for peoples' party with a concern for the poor, and $\varepsilon>1$
- Has to be due to "special interests", and GST in excise mode with incidence on producers
- With proper arms' length GST/VAT would not affect producers
- Tax administration would like to keep it the old way….

A way forward

TOWARDS EMPLOYMENT GENERATION AND INCLUSIVE GROWTH

What should be an appropriate growth strategy?

- Define the role of the state?
  - Need for public infrastructure spending? Do we have enough roads, transport facilities, airports?
  - With inefficient public provision, will the private sector provide without state guarantees? If latter, what provisioning is to be made?
  - Effective social protection and household protection?
  - Public and national security
- Need to rely on efficient private sector
  - Where is the efficient private sector to carry out the needed investment spending?
  - Will 60-year old geriatric infants on life support subsidies be able to provide?
- Spending rationalization and prioritization within a multi-level governance structure
- But what does this imply for the public finances?

National consensus needed on tax policy agenda

- 15% for tax/GDP ratio in Stabilization Plan, 2008, too unambitious for the medium-term
- Reconsider revenue assignments—need for effective own-source revenues at provincial and district levels
- More effective management/ arms length administration
- Consolidate bases—shared or joint occupancy (next lecture)
- Distributional concerns addressed by public spending and more effective income taxes
- Main sources of revenues: VAT and income taxes
- VAT and arms length administration needed to expand tax base and encourage formal sector activity

Towards a global income tax?

- All income, regardless of source, to be subject to PIT
  - Capital gains on property, with standard exemption for owner-occupied property; property tax levied by localities
  - Three or four brackets, top marginal rate kept in line with lower CIT rate;
  - Adjust exemption limit with inflation—main impact on distribution—minimizes disincentive effects of high marginal rates
  - Remove “notch problem”, applying relevant marginal rate to a respective bracket
- Piggy backing options for provinces, with consolidated bases
- Corporate tax: consolidate to reduced single rate, together with creditable minimum tax (GAT)

GAT?

- GAT
  - Quite common in Latin America
  - Mechanism to force collection of CIT—creditable
  - Fixed assets, adjusted for depreciation
  - Accounts receivable
  - Bank deposits and cash
  - Exclude
    - assets with less than two years of acquisition
    - debt
    - Financial sector and trusts
- Pakistan 2009, 47,000 corporate taxpayers with SECP
  - 13,000 returns filed
  - Of which 8,000 did not declare income or assets; 3,000 reported profits
- Revenue potential additional +0.25 to 0.3 percent of GDP
  - With further reduction/rationalization of CIT

Assets Declared by Corporate Taxpayers in the Returns for Tax Year–2008 (as on 12/01/2009)

Total Assets (in Rs)	Taxpayers	Total Assets (in millions of Rs)	Percentage of Total Assets
Up to 1 Million	1,339	467	0.00
1 to 10 Million	2,217	9,083	0.08
10 - 25 Million	957	15,692	0.14
25 - 50 Million	743	26,388	0.23
50-100 Millions	643	46,108	0.40
100-500 Millions	1,161	271,472	2.34
500-1000 Million	394	283,880	2.44
1 to 5 Billion	547	1,187,840	10.23
Above 5 Billion	261	9,770,044	84.14
Not Declared	4,571	-	-
Total	**12,833**	**11,610,973**	**100%**

Additional Collection for Various CIT and GAT Rates

CIT Rate	Additional Collection (in Percentage of GDP)		
	1%	**0.75%**	**0.50%**
35%	0.52	0.41	0.30
25%	0.41	0.30	0.18
20%	0.36	0.24	0.13

NO Alternatives to VAT/GST!!

- Additional tax items
  - Income taxes—PIT; CIT/GAT; property;
  - 1- 2% of GDP
- Still need the 3% of GDP from VAT/GST in medium-term
- More importantly need the information to be able to implement arms-length administration
- Simple VAT will require compensatory mechanisms for the poor
  - Revamp the cash transfer/employment programs for this purpose

Pakistan: Setting the Stage for Empirical Work

Progress and Next Steps

Taxes, Social Policy and Labour Markets

- Political economy work on tax reform; using ongoing research (IDEAS)
- Growing social program evaluation literature
- Joint assessment with labour market interactions

Progress to Date

- Required data variables identified
- Data gathering exercise initiated
- Background work initiated with collaborators

Next Steps

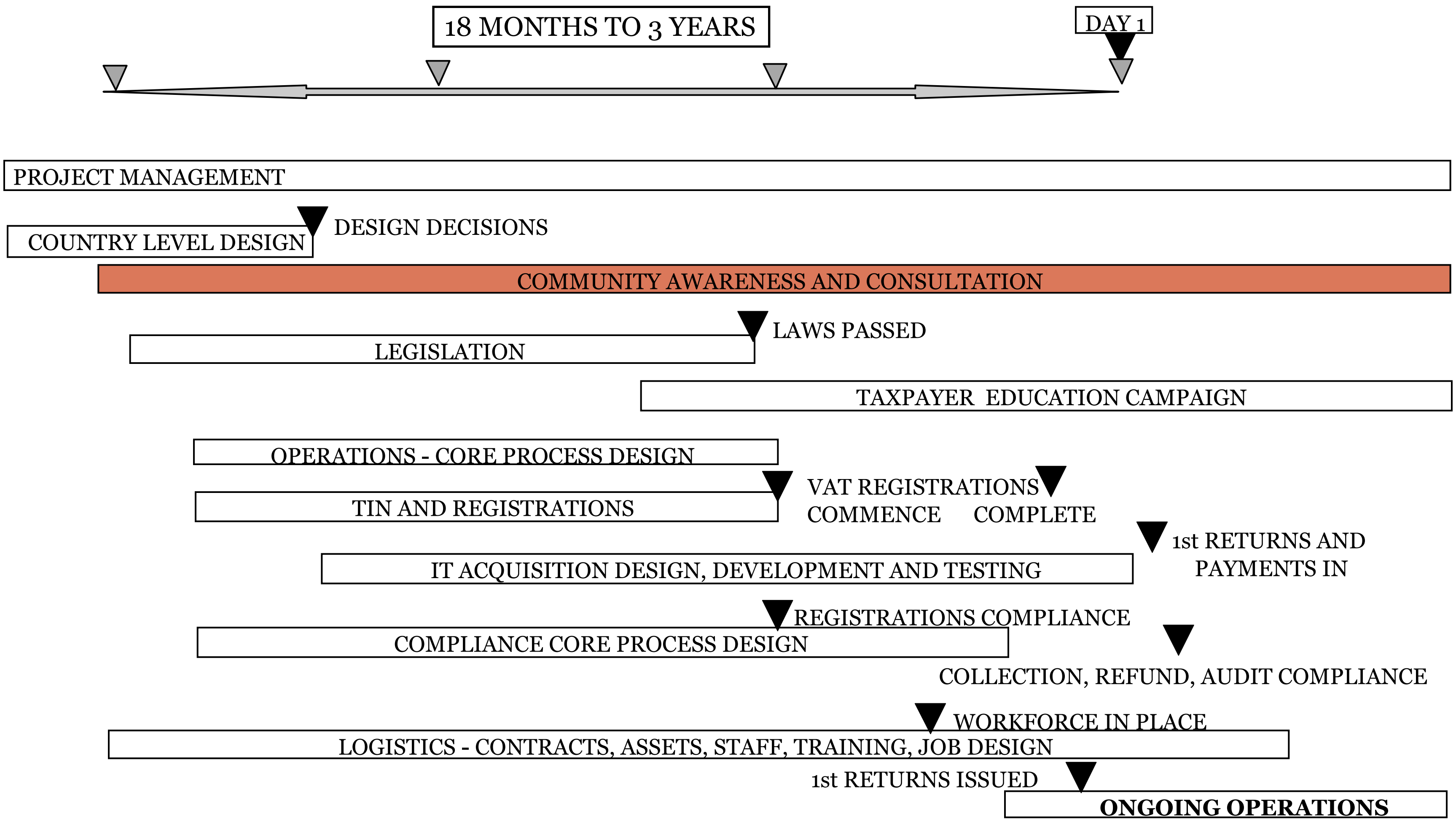
- Complete data gathering, clean data
- Empirical assessments

Data	Status	
Labor force survey		DONE – last five years ending 2011
Household survey		DONE – two years – sub-national data for 2005 and 2011
BISP recipient		REQUESTED – in accordance with dissemination policy
Tax		IN PROGRESS - timeliness may be issue
Other		Other Sub-national and firm-specific data being explored

New tax administration

- Impossible to fix FBR
- Set up new administration for "shared taxes"
- Independent agency, on private sector rules
- Report to CCI? PM?
- Alternatives:
  - Peru: SUNAT (under Finance Minister): Fire staff and start again?
  - Iran: New VAT administration within administration—old administration and staff handling other taxes

VAT Timeframes and Major Activity



Concluding thoughts

- Better transparency on who spends what; PFM and TSAs
- Urgent tax measures needed, plus spending rationalization; careful design and implementation of social safety nets
  - 5% of GDP on revenue side in 5 years, remains an achievable target
  - Must include the VAT
  - Careful about jettisoning the improvement in the investment climate from the Musharraf years
- Remove clientelism in social policy design; minimize "capture"
- Rent seeking in administration and special interests remain the main constraints