

Pakistan: Using third party information to plug tax gaps: need for a comprehensive tax reform

Ehtisham Ahmad, Michael Best

October 2012



Asia
Research Centre



Zentrum für Entwicklungsforschung
Center for Development Research
University of Bonn

Presented at a Seminar at the LSE on October 17, 2012, as part of a Research Program on the Design and Financing of Social Policy in the Presence of Informality. Support from the IGC is gratefully acknowledged.

Outline

- Tax reforms, distribution and rent seeking: Insights from the models
- Pakistan context
 - Case of repeated failures
- Can one rely on third party information to plug gaps?
 - Some experiments to modify announced FBR strategy
- Need for policy reforms?

Insights from the models

Some research questions posed in February, 2012 LSE meeting

- Should a single tax address distributional and efficiency/revenue considerations?
 - Mistake to build in distributional objectives, say into VAT
 - Combination of “efficient tax” and social policy advisable
- What combination of instruments would be appropriate in given contexts?
 - VAT
 - Income taxes
 - Social spending
 - Own-source revenues for sub-national accountability (see Brazil paper)
- How to minimize incentives for informality and evasion/rent-seeking?
- How to sequence and implement reforms: political-economy perspectives

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/revamped tax administration
- 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?
 - Subnational revenue bases: local business tax? Property taxes?
- Lessons from research on Mexico:
 - Need to worry about people outside the tax net; but also about stopfilers and
 - Misreporting by those in the tax net—due to holes in the system

The Pakistan Context

Ending 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...

Consequences: poor tax collections

Years	FBR Collection (Billion PKRs)	Tax / GDP Ratio (%)
2007-08	1,008	9.8
2008-09	1,161	9.1
2009-10	1,327	8.9
2010-11	1,558	8.6
2011-12	1,883	9.1

Tax filers

Country	Taxpayers
Pakistan	0.9 %
India	4.7 %
Argentina	16.5 %
France	58.0 %
Canada	80.0 %

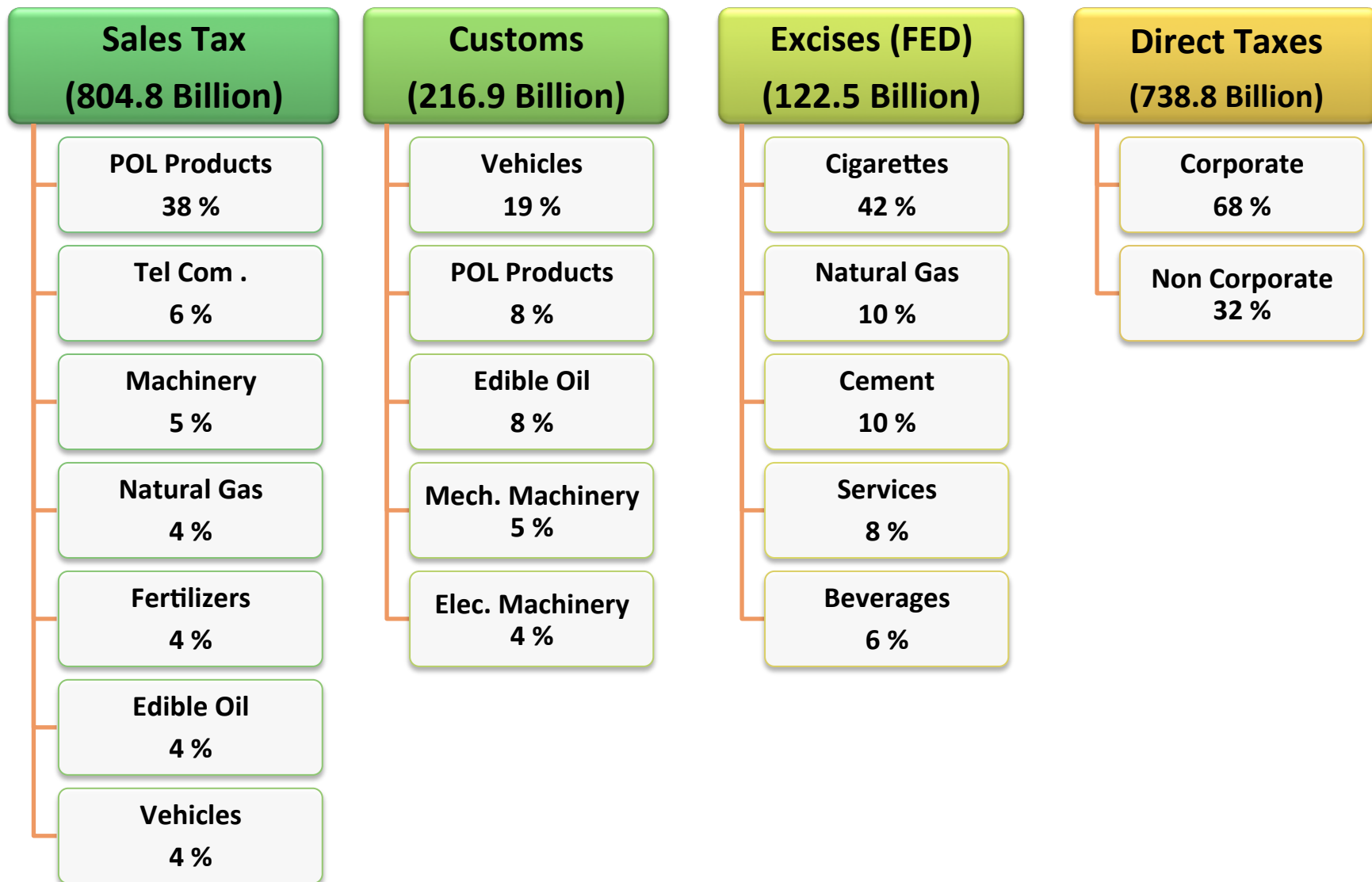
NADRA presentation at LSE: taxpayers as % of population

Tax Registration and Filers

Types	TY 2012 Registration	TY 2011 Filers	Compliance
Company	50,840	22,068	43%
AOP	150,281	38,312	25%
Business Individuals	1,830,555	512,903	28%
Salaried Individual	1,356,442	928,347	68%

Source: FBR

Major tax heads



GST productivity—declining and low in comparison with competitors

	Standard rate	Revenue/GDP	C-efficiency/ 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

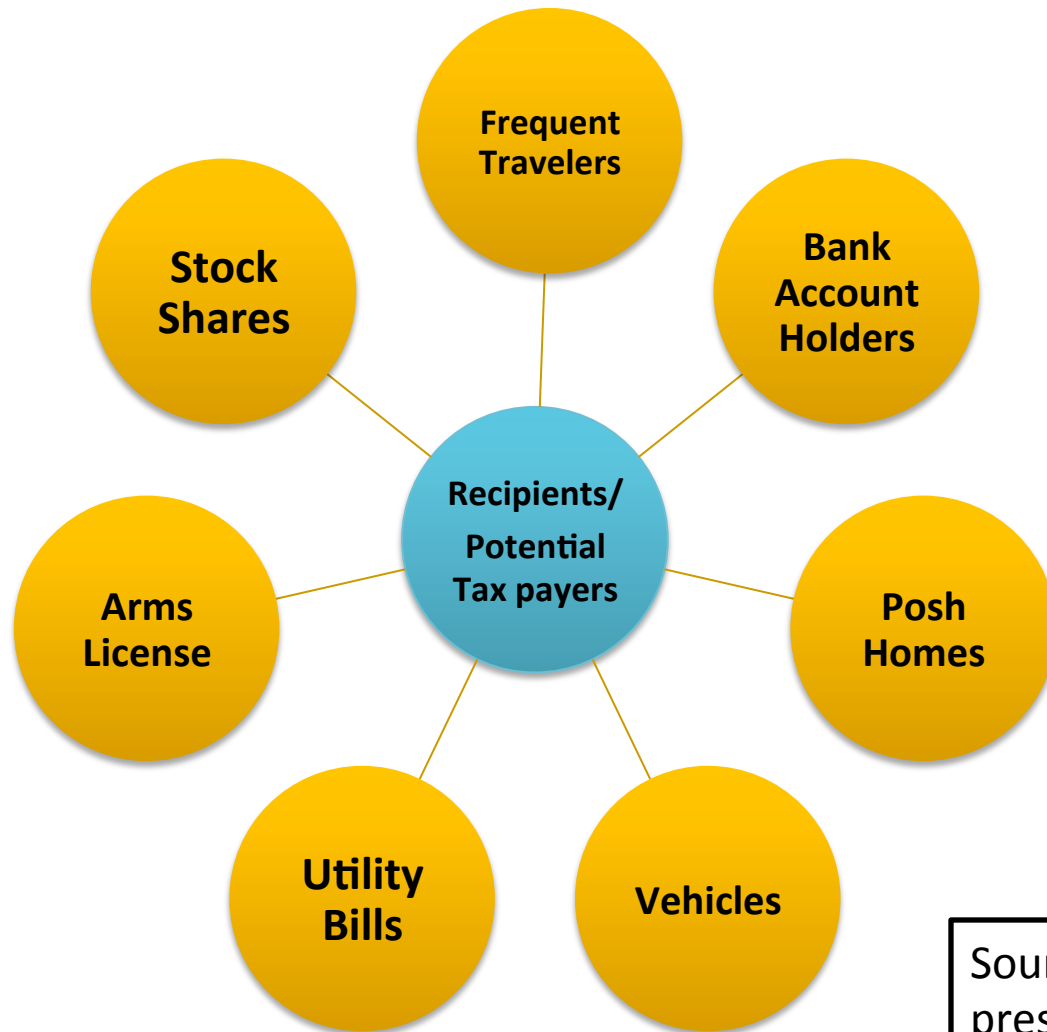
Policy agenda

- **Persistent failure to address “holes” in tax system:**
 - Collapse of IMF program
 - Tax/GDP ratio stagnating below 10%
 - Unsustainable recourse to domestic borrowing
 - Potential collapse of the agreement underlying the NFC and the 18th Amendment
- **No political appetite to address the “tax” holes and preferences**
 - SRO remains a useful tool
- **Tax administration expansion strategy:**
 - Build picture on the taxpayer’s balance sheet
 - And monitor changes (flows, e.g. through the GST)
- But, can the “base broadening exercise substitute for fundamental tax reforms?

Excellent database on individuals— family networks

- NADRA (National Database Registration Agency)
 - Building up profiles (post 9/11)
 - Households, major linkages
- Can reach individuals accurately
 - Use of mobile phone technology: tracking of recipients (NADRA based information)
 - BISP (Conditional cash transfers)
- Accurate access does not preclude “clientelism” (Barhan and Mookherjee)

FBR strategy: identifying “gaps”



Source: FBR; NADRA
presentation at LSE

Identification of gaps using third party information

- 1.3 million non filers with tax IDs (NTNs)
- 2.5 million potential taxpayers without tax NTN

Non- NTN Holders:

1,611,153 frequent travelers
584,730 individuals having multiple Bank Accounts
56,421 residents of Posh localities
19,149 owners of expensive vehicles
66,736 heavy consumers of utility services
13,201 individuals having arms licenses
25,133 people in top professions

Source: FBR, NADRA presentation at LSE

FBR proposes

- Notices to identified individuals
- Payment of lump-sum “registration”
 - Rs 40,000 (approximately \$400)
 - No questions asked about previous “gaps”
- Else escalating charge (+50% in three months)
- Followed by sanctions
 - Blocked travel and ID cards
 - Freezing bank accounts
 - Attaching property

Assessment

- Use of third party information very positive
- But some dangers:
 - How do taxpayers or potential taxpayers react?
 - Does this constitute another amnesty?
 - Can the information be misused?
 - Rent seeking by a perceived “corrupt agency”?
 - Political suasion in a pre-election period?
- Overall vigilance required for taxpayers as well as tax administrators; and may still need policy reforms

Some risks: existing taxpayers

- Taxpayers:
 - Incentives to stop paying and elect for the amnesty/future amnesties
 - Evidence from Mexico on small taxpayer regime
 - Pay minimum to get tax administration off their backs: induce race to the “bottom” for the honest taxpayers
 - Could this create yet another “loophole” and distortion?
- Very hard to get people to pay “right amount”
 - Distortions and complexities created by loopholes and exemptions

Potential taxpayers?

- Could threat of sanctions push them further into “informality”?
 - Cash economy
 - Illegal and contraband activities
 - Slipping across porous borders
 - Who will tackle FATA, Waziristan, Baluchistan?
- How to prevent and manage “reactions”?

One-off or Repeated game?

- **If FBR drive is seen as an “amnesty”**
 - May generate one-off payments
 - But could encourage existing taxpayers to stop paying and wait for the next amnesty
 - Could lead to an implosion of the tax system
- However, if the registration drive is seen as bringing people/firms into the tax net; then ***verifying the base and returns becomes a priority***
 - Need to step up the audit function
 - Some of the experiments described below show the potential of changing expectations and incentives
 - ***Could turn a vicious circle into a virtuous one***

Assessment and Making it Work

Efficient use of third party information

General issues

- **Credibility:** Drive to broaden base should not be seen as politically motivated;
- **Corruption** of FBR officers will undermine any good intentions
- How to use wealth of 3rd party information?

Evaluate incentives for non-compliance

- **Experiment on subsets of taxpayers with alternative policy options**
 - including a “control” group that stays in the status quo
- **See what works well:**
 - careful design produces credible evidence on behavioural responses; draw lessons from that
- **Re-design and implement amended policies**
 - after gathering sufficient data (six months to a year) to evaluate impact, continuing the cycle
- **Policy experiments are much like “A-B split testing” in website design**
 - visitors assigned to different homepages and then subsequent behaviour tracked to see which options work better

Experiment 1. How to Bring Taxpayers into the Tax Net and Keep Them There?

- NADRA and wealth of linked 3rd party information permit identification of potential taxpayers.
- Policy Questions:
 - How to raise revenue from identified potential taxpayers?
 - **“Carrots” or Amnesties**
 - Do they demoralise “honest” taxpayers?
 - Do they raise compliance by non-compliers?
 - What is their “price” in terms of foregone revenue?
 - **“Sticks” or Audits**
 - How effective at increasing compliance? (c.f. experiment 2)
 - Does it drive people completely off the radar?
 - Needs to be part of regular “arms-length” tax administration

Experiment 1. How to Bring Taxpayers into the Tax Net and Keep Them There?

- Recent public announcement on identified individuals makes evaluation difficult: no comparison group... but
- Can focus on firms instead and glean insights:
 - Identify all actual and potential taxpayers: filers, stop-filers, non-filers and non-registered firms using third party information
 - Make monthly GST declarations so higher frequency feedback
- Assign each firm to one of three groups
 - Amnesty regime. Send letter informing
 - Audit regime. Send simultaneous letter and then actually audit
 - Status quo. (comparison group)
- Analysis of subsequent returns (CIT, GST etc.) identifies answers to questions posed above

Experiment 2. How to Exploit Third-Party Information fully?

- **NADRA & 3rd party information allow analysts to draw a “web” of connected individuals, firms, sectors**
- **Key Questions:**
 - How to maximise the “bang” for the audit “buck”?
 - **What observable characteristics of firms/individuals are associated with low compliance? “Weak Links”**
 - Sales to final consumers?
 - Sectors exempted from GST?
 - Both have low incentives to report sales (purchases) truthfully.
 - **How big are enforcement spillovers? “Strong Links”**
 - Interconnected tax bases (GST-CIT for example)?
 - GST incentives along production chains (receipts generate tax credits - incentive to report truthfully)?

Experiment 2. How to Exploit Third-Party Information fully?

- As above, focus on GST where monthly declarations generate quick feedback
- **Use historical GST/CIT declarations to**
 - **Identify weak links**
 - Final sales
 - Exempted status
 - **Identify strong links**
 - Graph theory/economics suggest “eigen vector centrality” measure of connectedness
 - Availability of 3rd party information
 - Identify clusters of firms that are connected
- **Assign firms in clusters to one of three groups**
 - Audits targeted at weak links
 - Audits targeted at strong links
 - Uses status quo audit targeting rule (comparison group)

Experiment 3. The policy regime: Does it encourage cheating and how to prevent it?

- Differentiated tax rates and split bases generate opportunities to cheat
- **Key Questions:**
 - How easy is it to misclassify taxable sales into lower taxed or untaxed sales?
 - How easy is it to misclassify purchases as GST-liable to claim input credit?
 - How do these effects vary across sectors? (easy to reclassify a semi-finished textile as a finished textile; not so easy to misclassify a car as a bus)
 - How sensitive is this margin of evasion to the probability of detection?
 - How sensitive is this margin of evasion to the size of the incentive (the difference in the tax rate)?
- **Provides agenda for short to medium-term policy reforms to buttress base expansion reforms**

Experiment 3. The policy regime: Does it encourage cheating and how to prevent it?

- Analysis of existing tax structures and CIT/GST data to identify
 - Key exemptions/sectors that are vulnerable to this sort of cheating
 - Key exemptions/sectors that may respond favourably to increased scrutiny
- Target audits
 - At transactions that have large incentives to cheat
 - At transactions where misclassification is relatively easy
 - According to status quo audit targeting strategy (comparison group)

Experiment 4. How Can the Performance of FBR Officials be improved?

- Performance of FBR officials is notoriously poor
 - Perception of corruption (opportunities and incentives for rent seeking)
 - Lack of capacity (requisite skills, pay, incentives to perform well)
- Policy Questions:
 - How to improve effectiveness of FBR officials?
 - Punish misbehaviour: “*Sticks*”
 - How effective can (the threat of) internal audit be in improving performance?
 - Applying third party information to tax officials!
 - Internal audits very costly, both financially and in terms of morale
 - Reward good performance: “*Carrots*”
 - What are the available rewards?
 - Pay (problematic to make pay contingent on performance)
 - Assignment of future postings and promotions very powerful incentive
 - Potential to be much more cost effective way of improving performance

Experiment 4. How Can the Performance of FBR Officials be improved?

- Design objective measures of performance:
 - GST refunds department where performance is relatively easy to measure and current performance poor?
 - Customs officials?
- Assign officers to one of three groups
 - increased internal audit scrutiny
 - Promotion/posting decisions contingent on measured performance
 - status quo (comparison group)

Experiment 5. How do Public Perceptions Affect Tax Compliance?

- Currently, public perception of FBR is overwhelmingly negative
- Questions to address:
 - How will the current base expansion drive affect perceptions of FBR?
 - What impression do taxpayers have of their routine interactions with FBR officials? Are some interactions more favourably viewed than others?
 - What can FBR do to improve its public image?
 - How does public perception of FBR affect tax compliance?
 - By those with direct experience of interacting with FBR officials
 - By those with only indirect exposure to FBR

Experiment 5. How do Public Perceptions Affect Tax Compliance?

- Phone interviews of FBR “clients” on a large scale are now technologically feasible.
 - This sort of approach can provide a direct measure of perceptions of FBR by its users.
 - For example, this could be implemented at customs points and/or amongst firms claiming GST refunds.
- Can be used to measure effect of perceptions
 - A: assign some taxpayers with good perceptions to audit and some taxpayers with negative perceptions to audit to compare detected evasion.
 - B: Design and evaluate direct tools to improve perception of FBR and look for effects on compliance.

A Way Forward

Need for parallel policy reforms

Reforms promised--GST 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 closing holes in the GST
 - Concomitant improvements in the income taxes
 - Arms length administration, building on self assessment with cross-checking of information and audit
- Mangled tax administration since 2003, despite TARP (\$135m World Bank project)
 - Attempts to bring it back on track since 2008 not particularly successful
 - Stiff resistance to removal of arbitrary SRO powers

Towards a global income tax?

- Corporate tax: consolidate to reduced single rate, together comparable with trading partners
- 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
- Scope for a minimum gross assets tax towards CIT and PIT liability?
- Piggy backing options for provinces, with consolidated bases

No alternatives to fixing the holes in the GST!!

- Additional revenue from:
 - Income taxes—PIT; CIT/GAT; property
 - Will not raise more than 1- 2% of GDP
- Still need the 3% of GDP from GST in medium-term
- Fixing the holes in the GST remains critical
 - 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
- Revisit the split base for the next NFC
 - Piggy backed options for the provinces; property taxes for local governments