Pakistan's Tax Woes & the 'Notch' Issues

Pakistan is grappling with a plethora of economic challenges ranging from low economic growth, high unemployment, high inflation, and current account crisis, to name a few. Consequently, the country performs poorly across a range of economic indicators with significant room for improvement. Taxation is one such area.

The tax regime of Pakistan is marred by economic inefficiencies and bureaucratic red-tape. Over the past 70 years, policymakers have focused more on deepening—rather than broadening—the tax base, resulting in an inefficient arrangement, whereby indirect taxation comprises 65% of the aggregate tax revenues, as they are easier to collect in the form of General Sales Tax (GST), and surcharges. The remaining 35% of the revenue comes from direct taxes, of which the share of withholding taxes is roughly 70%.

Like the GST, the withholding taxes are also relatively easy to collect, as they are automatically deductible from the salaries of the professional class, giving the latter no discretion over its payment. This inefficient tax arrangement puts a disproportionate burden on the salaried class and average consumers, while the landed elite and business classes —especially traders—routinely evade their fair share.

Small wonder then that the tax collection in Pakistan is abysmally low and way below its actual potential as reflected in an average Tax-to-Gross Domestic Product (GDP) ratio of 7%, which is lower than the regional average of 10%, and far lower than the Organization for Economic Cooperation & Development (OECD) average of 15%. Moreover, in the Ease of Doing Business Index for 2020, Pakistan's tax system was ranked 161 out of 200, with an aggregate score of a meager 53 out of 100 points. Furthermore, owing to the complexity of the tax code, it took businesses 283 [corporate] hours to complete the filing process, which is the highest in South Asia.

In addition to economic inefficiencies, bureaucratic inertia and corruption add to the slowing down and inefficacy of our tax system. Consider for example the fact that the Federal Board of Revenue (FBR), which is Pakistan's premier tax collection agency, accounts for only 5% of the total collection of tax revenues.

To put it another way, if FBR had to close today, the Federal Government would still be able to collect 95% of the present tax revenues! Furthermore, there are gross inefficiencies and maladministration in the operations of FBR. A report prepared in 2015 revealed that out of 21 field offices of the FBR, 15 were incurring costs that were greater than the tax revenues that they collected from their respective regions.

Of all the ills that confront Pakistan's tax system, the issue of tax 'notch' is perhaps the most unique as it is a complex hotchpotch of both the economic and bureaucratic problems discussed above. This issue was best highlighted by the American academic Wayne Thirsk in a 2008 paper titled *Tax Policy in Pakistan: An Assessment of Major Taxes and Options for Reform*. According to Thirsk, the marginal tax system of Pakistan creates distortionary lacunas due to the following reason: when a person moves up the income ladder, s/he is charged an amount equivalent to the tax rate of the new income bracket, rather than being charged on the *increment* in income.

Thirsk called this phenomenon a ‘notch’ issue that has prevailed in Pakistan’s tax system for a long time.

Let me illustrate this intricate issue with a simple example. Assume a Robinson Crusoe economy with one person, one government, and only two income tax brackets. The first bracket is for the income slab of PKR 1-100 with a 5% tax rate, while the second bracket is for the slab of PKR 101-200 with a 10% tax rate. Also, assume that this individual in our simple economic model is earning an income of PKR 100 and paying PKR 5—at a 5% rate—in taxes.

Now also assume that this individual gets a PKR 1 raise making her earn a gross income of PKR 101. This raise puts this individual in the higher income slab of PKR 101-200, and therefore subject to the higher tax rate of 10%. At this rate, the individual will be paying PKR 10.1 in taxes—10% of 101—as opposed to Rs 5 that she paid before. So, while her income has increased by a meager PKR 1, her tax burden has disproportionately increased by PKR 5.1 due to the ‘notch’ issue present in this tax system.

It is easy to see that the ‘notch’ issue acts as an economic distortion by lowering the incentives to work and move up the career ladder. In the context of Pakistan, the ‘notch’ issue has magnified the already entrenched economic inefficiencies prevalent in our tax system. Besides, this issue is also pervasive in the business world, and especially affects the small and medium enterprises (SMEs).

While the ‘notch’ issue was first highlighted by Wayne Thirsk about a decade ago, unfortunately, no concrete steps have been taken by the FBR so far to resolve it. This is primarily because calculating taxes for incremental income and profits is tedious work and requires a great deal of individual and company data to deal with and process. In this context, then, the ‘notch’ issue also partly becomes a bureaucratic issue that is lingering on due to the inefficiency and sluggishness of our taxmen.

However, resolving the ‘notch’ issue is of utmost importance as it is increasingly creating disincentives to work and other economic distortions, particularly for the salaried middle-class—a societal segment that is already overtaxed.

While dealing with the ‘notch’ issue may be technical and involve complex problem-solving, its resolution, nevertheless, will be a major step towards creating a fair and just tax regime besides paving the way for the rectification of other economic and bureaucratic problems that afflict our tax system.

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