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The tax test

For the past 10 months of the PTI's rule, the economy has remained on the centre stage of our media discourse. The reason for that is very simple – the battering that our economy got since this government came into power has been unprecedented.

So even though the current focus is on political matters including video / audio tapes and the implications surrounding them, I think it's important not to ignore the serious nature of our economic downfall.

Today's article is exclusively on tax matters as this is perhaps the most important economic indicator, reflecting in a way the health of the national economy.

In terms of total tax collection as well as tax-to-GDP ratio, Pakistan continues to be among the worst in the world. During the period 2013-2018, significant improvements were made by the PML-N government. Total tax collection went up from Rs1946 billion in 2013 to Rs3850 billion in 2018. In four out of the five years of the PML-N, tax revenues increased 20 percent per annum while the slowest growth was 13 percent.

This massive growth was achieved despite extremely low inflation and without significant exchange rate movements. High inflation and devaluations contribute to higher tax revenue collection without any additional effort on the part of the tax authorities. The tax-to-GDP ratio also went up to more than 11 percent from less than 9 percent in 2013. When the current government took over, it was expected that the momentum would continue. But rather than capitalizing on the successes, the government reversed the gains in its first year.

We witnessed the slowest revenue growth in 21 years. Tax revenue actually went down compared to last year. This probably is the foremost failure of the current government.

Let's now look at how the actual performance has been against its own set targets. The original target set by the PML-N government in May 2018 was Rs4435 billion. There was every reason for the PML-N government to set a reasonably high target since it had consistently achieved high revenue growths during its five-year rule. However, after coming into power, the PTI government revised this target to Rs4398 billion during the supplementary budget presented in September 2018. Pakistanis in general and PTI supporters in particular were surprised that instead of increasing the tax revenue forecast, the government was now projecting a lower tax revenue. This was the first real test, and the government didn't do well in it. This was a clear reflection of the fact that claims made prior to elections were all based on hearsay and without any proper homework. The commitment was to increase tax revenues to Rs8000 billion within 1-2 years.

Against the first target set by the government itself in September, the actual collection is short by Rs578 billion – a staggering amount by any standard. Around March this year, the target was revised once again bringing it further down to Rs4150 billion. Even this target was missed by Rs330 billion – significant enough in the overall context. Even though the tax revenue target was being revised downwards, surprisingly expenditure was going up rather than being contained to ensure fiscal discipline.

The more worrisome aspect is the decline in the tax-to-GDP ratio which has come down from over 11 percent to 9.9 percent in one year. While this ratio consistently went up during the PML-N tenure, the current ruling party could not manage to keep the upward trend.

Consistently changing targets and still missing by huge margins is a reflection of bad planning, lack of understanding of Pakistan's taxation system, lack of preparedness, poor selection of people to manage the FBR (took more than nine months before the new FBR chairman was replaced and that too just two months before the end of the fiscal year) and false assumption about Prime Minister Imran Khan's pull of credibility (the notion that people will simply line up to pay taxes or that tax collection will go up because people trust Imran Khan).

The poor tax collection resulted in several negative implications for our economy. These include significantly lower distribution to provinces as part of the NFC award and very high fiscal deficit – one of the areas that the PTI had promised to bring in control. About 58 percent of the total tax revenue is distributed among the provinces. The provinces in turn spend that money on the welfare of the people such as education, healthcare, water management, public transportation, road network etc. So, the lower tax collection directly impacts our ability to spend on the welfare of the people.

During the five-year PML-N period, the amount given to provinces almost doubled as a result of higher tax collections. The impact on the fiscal deficit is even worse. In the supplementary budget announced in September, fiscal deficit was targeted at 5.1 percent but due to significantly lower tax collection and higher expenditure spending, fiscal deficit is now expected to be around 8 percent – one of the highest in recent history. The higher fiscal deficit has directly contributed to significantly higher borrowings during the year – in fact the highest in our history in a single year.

For the next fiscal year, the present government has proposed tax revenue of Rs5550 billion – an increase of almost 40 percent. This is the most ambitious revenue target set by any government in our history. With the same party in power, the same FBR (except a new chairman, but having removed the revenue minister without any explanation) and the same IT infrastructure, how is it possible that the revenues will start coming in record numbers?

Of course, this target has been forced on us because of an IMF agreement which makes the whole process even more uncertain. As a result of IMF requirements, fiscal deficit is projected at Rs3200 billion which is Rs1000 billion more than where we closed in the last year of the PML-N government. Imagine a slippage of even Rs500-600 billion in revenue numbers plus expected overshooting of expenditure by Rs500 billion. This will add another Rs1000 billion in our fiscal deficit number which is unsustainable. Within two years of the current government, we would have doubled the amount of fiscal deficit.

There are two possible ways to increase your tax revenues. The first and better option is to increase economic activity, which will then ensure higher taxes. The other and more regressive method to increase tax revenues is by increasing rates (income tax, sales tax, excise duty etc.). The present government has chosen the latter method. If it does achieve its target or close to it, businesses would be completely destroyed in the process leading to consistent double-digit inflation, more people below the poverty line and mass scale unemployment.

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