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Is tax evasion always bad for economic growth?

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Tax evasion is a big problem in Pakistan. Owing to the less-than-adequate revenue collection, as evident from the tax-to-gross domestic product (GDP) ratio of only 12.4 per cent, the fiscal deficit was 6.8pc in 2017-18.

In fact, the tax-to-GDP ratio remains within a narrow band of 9.8pc (2012-13) and 12.4pc (2016-17). The ratio of non-tax revenue to GDP has also decreased from 3.5pc in 2012-13 to 3pc in 2016-17. In view of the extremely low and dwindling non-tax revenue, tax revenue remains the leading source of funds for the government to balance the budget.

The tax-to-GDP ratio remains low despite an increase in real GDP growth in recent years mainly because of a wide tax gap, which is as large as 9.8pc of GDP or almost Rs3.2 trillion. In other words, potential tax revenue is much more than the actual tax collection. Given the same level of tax enforcement, the tax gap will be further enlarged in coming years due to a substantial increase in the income tax exemption threshold for individuals, including salaries persons, from Rs400,000 to Rs1.2 million effective from July.

A benign attitude towards tax evasion may be warranted if it results in greater economic growth

With this enhanced threshold, about 521,597 income tax return filers will be out of the tax net in the current tax year. That will also cause a reduction of revenue by Rs35.2 billion. Furthermore, a reduction in corporate income tax rates will further decrease tax collection. The income tax rate for companies, excluding banking and small companies, for tax year 2019 has been reduced to 29pc from 30pc. This will be further reduced by one percentage point for each of the following years until tax year 2023.

In view of the increasing trend in the fiscal deficit, it is inevitable to mobilise additional tax revenue. This is possible by reducing the tax gap, which is the difference between anticipated and actual tax revenue. For bridging the tax gap, strict enforcement through audits and penalties is being recommended.

Nonetheless, there are different approaches towards tax evasion. An important perspective is to see whether tax evasion reduces economic growth. A benign attitude towards tax evasion may be warranted if evasion results in greater economic growth by leaving more resources in the private sector for investment that could otherwise be wasted due to corruption or inefficiency in the public sector.

There are no two opinions that tax evasion increases disposable income, which is important from the growth perspective. Savings increase due to greater disposable income. Saved income increases the economy's capital stock, thereby pushing economic growth.

Alternatively, evaded money invested abroad reduces the economy's capital stock. Moreover, higher tax evasion results in lower revenue for the government that places greater constraints on government spending on public goods and services, which hurts economic growth as well.

To overcome the revenue shortfall due to greater evasion, the government may be forced to raise tax rates or devote more resources for enforcement to curtail tax evasion. Higher tax rates create more distortions in the economy, resulting in lower economic growth. Higher resource allocation to enforcement reduces resources available for more productive purposes, which reduces economic growth.

Tax evasion also has an associated excess burden in the form of anxiety costs of hiding income that reduces welfare. Additionally, tax evasion may result in the allocation of resources towards non-productive purposes, as illicit money may be shifted to the underground sector. Tax evasion also imposes an externality on honest taxpayers as they must compensate for the evaded revenue from their own income.

The large shortfall in revenue compels the government to seek loans. In recent years, Pakistan has experienced a significant increase in public debt from 64pc of GDP in 2012-13 to 70pc in 2017-18.

The accumulation of public debt beyond 60pc of GDP is a violation of Fiscal Responsibility and Debt Limitation Act 2005, which has been amended to provide legislation for bringing down the federal fiscal deficit to 3.5pc by 2017-18 and overall debt to 50pc of GDP within the next 10 years. On the contrary, the debt-to-GDP ratio reached 70pc in 2017-18.

In view of growth effects of tax evasion, the economic growth-maximising government needs to make more informed decisions regarding compliance factors, such as audit rates and any potential trade-offs with growth. For example, increasing the audit rate may result in higher tax revenue. But if higher rates result in lower economic growth, the government may revisit the enforcement policy and may forgo the additional tax revenue that higher audits bring.

Similarly, if the private sector is unable to use proceeds of evasion productively or shifts them abroad, the government may resort to strict enforcement measures in a bid to use that revenue for more productive purposes to boost economic growth.

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