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Policy Brief

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Simulating the Impact of Indirect Tax Reforms in Pakistan

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REVENUES FROM DIRECT VS INDIRECT TAXATION IN PAKISTAN

Taxation systems in developing countries usually suffer from a narrow tax base, complex rate structure, and high compliance costs. Achieving goals related to progressivity and redistribution thus become more difficult due to the challenges related to the narrow structure of earning population. In a country like Pakistan, where 68 percent of the population lives in rural areas and around 30 percent of households are below the poverty line, the scope of direct (income) taxes is not attractive.

To meet the government's needs in terms of operational and development expenditure, indirect taxes account for a major part of overall revenue collections. However, tariffs, excise duties and surcharges are being gradually phased out due to their distortionary impacts (declining trend since 1992). Among indirect taxes in Pakistan, today, the general sales tax (GST) in VAT mode now contributes the most to the national exchequer - even compensating for the losses recorded following reduction of other tax revenues, especially tariffs (or custom duties).

Meanwhile, contributions from (direct) income taxes have been stagnant, and those collected from duties under provincial domain (agricultural incomes, capital gains on tangible assets, services, and urban property) are negligible.

With this particular PEP-supported study, local researchers sought to analyse the effects of possible reforms in indirect taxes on household welfare and the national economy in Pakistan.

SIMULATING THE IMPACT OF INDIRECT TAX REFORMS ON WELFARE

Four main simulations of tax policy changes were conducted - using a CGE (computable general equilibrium) model of the national economy - and linked to micro data from the country's Household Survey Budget (2001-2002 prices).

Simulation	Fiscal (Tax) Policy Change
1	Increasing GST rate by 33 percent
2	A 10 percent GST added on presently zero-rated goods
3	Increasing GST rate by 33 percent + bringing services into the tax net
4	Increasing GST rate by 33 percent, + bringing services into the tax net + levying a 5 percent flat tax on agricultural incomes

GST : General Sales Tax

Results from these simulations, and related policy recommendations, are described in the text box below; the impact of these experiments should be seen in terms of their socio-economic costs and benefits in 2002 prices

Sim-1) A 33% raise of GST rate, leads to:

Increases in	Decreases in
Government income, + 15,4 %	Firm incomes, - 1,5 %
Wages for skilled labor + 8,9 %	Wages for farm labor, - 6,5 %
Prices of industrial goods	Exports of textile, - 6,2 %
Poverty headcount, + 2,1 %	Prices of agricultural goods
Inequality, + 0,6 %	Return to factors:
	land - 7,1% & capital - 1,5%
	Overall investment, - 5,6 %

POLICY: A differential GST rate may be (relatively) more equitable. A structure encompassing further reduction in rates for pro-poor consumption items could make the existing GST relatively more progressive.

Sim-2) A 10% GST added on presently zero-rated goods, leads to:

Increases in	Decreases in
Government income, + 39,4 %	Firm incomes, - 4,1 %
Returns to factors for skilled labor	Overall returns to factors of production
Prices of exports	Real investment, - 10,3 %
Poverty headcount, + 4,7 %	Nominal investment, - 8,5 %
Inequality, + 1 %	

POLICY: Instead of full removal of the zero-rating facility, a more prudent approach would be gradual removal that may take the form of: a) introduction of a reduced GST in the beginning, or b) introduction of GST commodity by commodity over a medium-term period. Gradually removing the zero-rated facility will make the sectoral adjustment in the export-oriented sectors less "arduous".

Sim-3) A 33% raise in GST rate + including services in tax net, leads to:

Increases in	Decreases in
Government income, + 65,3 %	Firm income, - 4,6 %
Wages of skilled labor, + 28,8 %	Real investment, - 14,6 %
Prices of private services, + 17,7 %	Overall returns to factors of prod.,
Prices of public services, + 34,5 %	Exports of textile, - 14,5 %
Exports of rice, + 3.8 %	Exports of processed food, - 6,4%
Poverty headcount, + 5,6 %	
Inequality, + 1,3 %	

POLICY: As public services have direct incidence on socioeconomic well-being, this particular sector may be kept tax-exempt.

Sim-4) A 33% raise in GST rate + including services in tax net, + levying a 5% flat tax on agricultural incomes, leads to:

Increases in	Decreases in
Government income, + 77,6 %	Firm income, - 5,4 %
Wages of skilled labor, + 28,8 %	Real investment, - 15,8 %
Prices of private services, + 17,7 %	Wages for farm labor, - 22,3 %
Prices of public services, + 34,5 %	Returns to land factors, - 24,5 %
Poverty headcount, + 14 %	Exports of textile, - 16,4 %
Inequality, + 1,5 %	Exports of manufactured goods - 5,9%
	Rural household consumption, - 22,7%

POLICY: A flat agriculture tax will be relatively regressive. A basic income threshold may be adopted in order to bring some progressivity in the system.

This policy brief is based on the results from PEP-supported project MPIA-11062 and working paper 2010-12