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Black...Grey...White.

Tax collection by the Central Board of Revenue has picked up significantly in the first half of the current fiscal year. The CBR has exceeded its tax collection target by almost 10%, collecting taxes worth Rs. 409.2 billion in the first six months of FY 07. These tax receipts have demonstrated a growth of 26.3% since the corresponding period of the previous year, contributed primarily by a healthy increase in direct taxes that accounted for 42.2% of the total tax receipts against the historical level of 30%. Despite this healthy growth, the tax to GDP ratio continues to hover around the 10% level.

This issue seeks to analyze the causes of the historically low levels of the tax to GDP ratio that fails to reflect the healthy growth of the economy and consequently the low contribution of the direct taxes to the total tax revenue.

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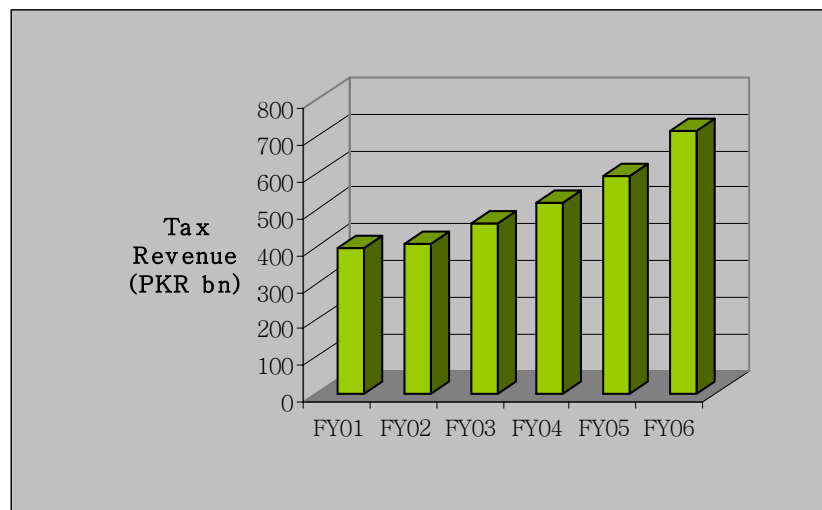
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Reaching Heights

Tax collection by the Central Board of Revenue has picked up significantly in the first half of the current fiscal year. Remarkably high domestic demand and high development expenditure has helped the CBR exceed its tax collection target of Rs. 372 billion, by almost 10%, collecting taxes worth Rs. 409.2 billion in the first six months of FY 07. These tax receipts have demonstrated a growth of 26.3% since the corresponding period of the previous year, contributed primarily by a healthy increase in direct taxes that accounted for 42.2% of the total tax receipts against the historical level of 30%. The growth witnessed in contribution of direct taxes to total tax receipts is the result of increased corporate profitability, especially of the banking, oil and gas, and telecom sectors.

This is not the first time that the CBR has exceeded its tax collection target. For the second consecutive year, the CBR crossed its target by a healthy margin of Rs. 22.5 billion, as it amassed tax receipts of worth Rs. 712.5 billion, against the target of Rs. 690 billion for FY 06. It is interesting to note that over the years, tax receipts collected by the CBR have followed a healthy growing trend. Since FY 01 the CBR tax collection has grown by almost 81.6% to Rs. 712.5 billion in FY 06.

Figure 1
Tax Revenue Collection by CBR (FY 01- FY 06)



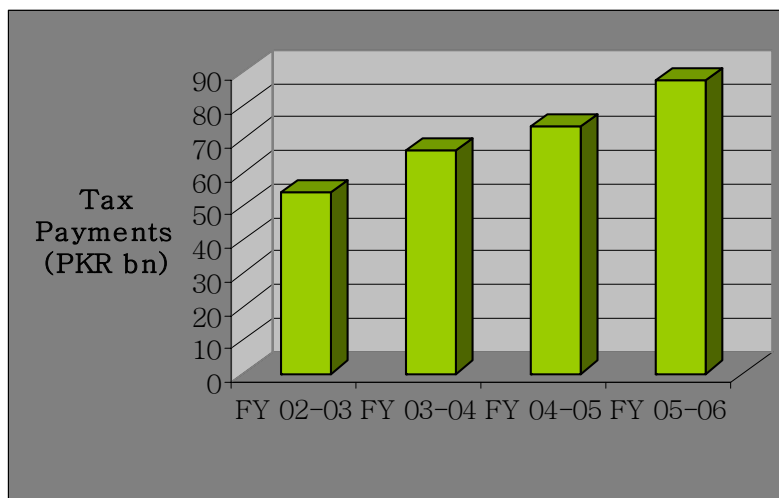
The increase in tax receipts collection has been the result of determined efforts by the CBR since 2000 to revamp the entire tax structure of the economy so that it is compatible with the modern tax regimes of the developed world.

One of the most significant of these reforms has been the introduction of the Universal Self-Assessment Scheme in 2002-03 that currently applies fully to the income tax, customs and sales tax. The scheme allows the taxpayers to assess the tax applicable to

their own incomes. Before the advent of the Scheme, the assessment was made by the tax collectors who were infamously known to connive with tax evaders and coercing businessmen to pay them bribes in return for lower tax assessment. With the self assessment scheme in place the taxpayers now realize that the Scheme has replaced assessment by collectors and hence it lies with the taxpayers as a trust. This has significantly improved voluntary compliance as the voluntary income tax gross receipts have increased by 18.3% to Rs. 87.3 billion in FY 06 since the previous year.

Figure 2 shows the trends in voluntary payments since FY 03 when the Self Assessment Scheme was implemented for the first time in its present shape. The rising trend reflects the confidence of tax payers in the Universal Self Assessment Scheme which is additionally highlighted by the increased number of returns and statements filed by tax payers voluntarily. The first six months of FY 07 witnessed a huge number of returns amounting worth Rs. 1.5 million that was roughly equivalent to the number of returns received in the twelve months of FY 06.

Figure 2
Trends in Voluntary Payments (Rs. Billion)



To complement the Self-Assessment System, a system of Computerized Payment Receipts has been developed in association with the State Bank and the National Bank of Pakistan and sanctioned by Ministry of Finance and Accountant General Pakistan Revenues. This automation is aimed to ensure efficient and transparent service to the taxpayers on one hand and on the other provide prompt revenues for the government.

Additionally as part of revising the tax structure, the CBR has established regional tax offices to move away from the centralized tax structure, while enabling the provinces to reduce their dependence on resource transfers. The Large Taxpayer Units (LTUs), Medium Taxpayer Units (MTUs) and Tax Facilitation Centers (TFCs) are being

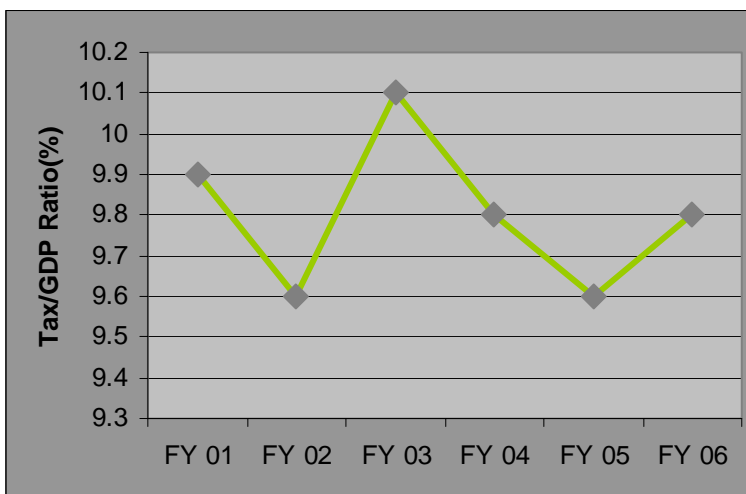
established as a part of the reform plan. LTUs have been established at Karachi and Lahore as well as six Medium Taxpayers Units in major cities where a home-grown computerized Tax Management System has been implemented.

All that glitters is not gold!

What is more important to note than the absolute increase in tax receipts is the total tax to GDP ratio and the composition of tax revenue in terms of direct and indirect taxes.

The sparkly picture presented by a growth of 20.7% in tax collection by CBR for FY 06 since the preceding year, fades when viewed in terms of the tax to GDP ratio that continues to hover around the 10.0% level for the past few years as shown in figure 3.

Figure 3
Tax to GDP Ratio (FY01- FY06)



The tax to GDP ratio for FY 06 was recorded at 9.8% which is well below the ratio for not only the developed OECD countries like Sweden, USA and the UK but also the emerging economies like South Korea and India. Figure 4 shows the tax to GDP ratio for various economies as of 2005.

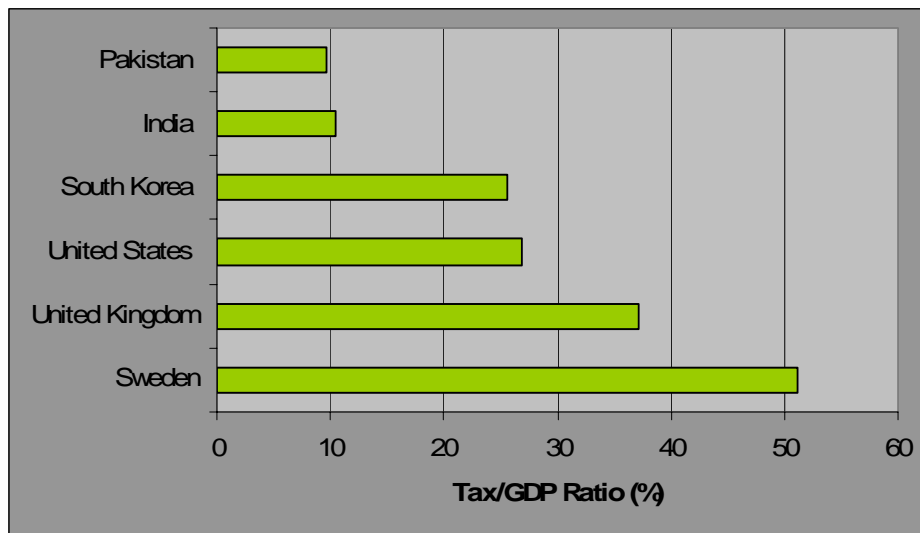
Another important feature of the current tax structure that cannot be ignored is the composition of the tax revenue in terms of the direct and the indirect taxes. The Federal tax receipts have two primary components: direct taxes and indirect taxes. The direct taxes being progressive in nature help maintain the overall proportionality of the taxation system. These constitute income and corporate taxes, capital value tax and the workers' welfare fund. Conversely indirect taxes are regressive in nature as their burden falls on the final consumer. These include the General Sales Tax, federal excise and customs duties.




It is interesting to note that more than half of the tax revenue came from indirect taxes as they accounted for almost 68% of the total tax revenue for FY 06. The direct tax receipts grew by 22.5 % to Rs. 224.6 billion exceeding the target by Rs. 9.4 billion. Despite this significant rise the share of direct taxes to total tax revenue increased only slightly to 31.5% for FY 06.

This composition of taxes is in sharp contrast with that of most advanced countries where the share of direct taxes in total tax collection has always been higher than indirect taxes. For example in countries like USA, Belgium, Sweden, Japan, Austria, Germany, the Netherlands, France and Norway the share of direct taxes to total tax receipts is more than 60%. On the other hand in emerging economies like Korea, Brazil, Turkey and Mexico the contribution of direct taxes has been increasing steadily and has reached the 45% mark. This implies that Pakistan, where the direct tax contribution has been hovering around 30% for the past few years, has a huge scope for generating revenues from this source.

Figure 4
Tax Revenue as % of GDP (as of 2005)



The first half of the current fiscal year has already realized this scope as it witnessed a commendable increase in total tax revenues and contribution of direct taxes to the tax receipts. As mentioned earlier, the direct taxes accounted for 42.2% of the total tax revenue for 1HFY 07. Though this may raise hopes for tax authorities who would expect the rather low contribution of direct taxes to total tax receipts and the low tax to GDP ratio to register meaningful increases by end of the current fiscal year, it is important to note that the expected slowdown in imports and POL prices can shrink the growth of tax collection and cause the tax to GDP ratio and the contribution of direct taxes to continue to float at its low levels. This certainly calls for new administrative measures to broaden




the narrow tax base and further increase compliance as a cause for increasing the tax to GDP ratio and the share of direct taxes to total tax revenue.

The Darkness Beneath

Despite healthy growth of tax collections, rampant tax evasion and tax avoidance by a major proportion of the population has caused the present tax structure of Pakistan to lag significantly behind the modern tax regimes in terms of adequate revenue generation, efficient resource allocation and equity. Tax evasion is defined as the illegal way of avoiding taxes while tax avoidance is a lawful arrangement or planning in an attempt to reduce tax liability. For instance a physician who fails to declare the income he earns from his services is said to indulge in tax evasion. On the other hand a physician who does declare his income but exaggerates various expenses incurred to acquire relief from tax payments is said to avoid taxes. Whether its tax evasion or tax avoidance, the two are reflective of the existing corruption in our tax structure. Additionally the system is characterized by the dominance of indirect taxes and has many exemptions and concessions.

Witnessed in terms of under declaration of incomes, tax avoidance is strongly prevalent in the economy. For instance those subject to taxation, with the exception of wage and salary earners pay only a fraction of their share. The distributional analysis of the income tax return filers for 2005 showed significantly low ratio of return filers in the upper slabs as the majority of the corporate and non corporate entities declared their income below Rs. 150,000. Out of 1,065,044 returns filed for the year 2005 only 2% taxpayers declared their annual income above Rs. 1 million. This suggests that in the current ambience of corruption in terms of tax avoidance, any significant dependence on voluntary compliance can actually cause the tax to GDP ratio to decline.

Besides rampant tax avoidance, huge levels of tax evasion accounts significantly for the low tax to GDP ratio. The 2005 report of the Punjab Anti-Corruption Establishment stated that the taxation unit accounts for extensive institutional corruption. The report declared that the economy's taxation system was typified by widespread tax evasion resulting from lack of documentation, the non-serious tax collection policies and their lukewarm implementation by the government. In Pakistan a large unorganized black economy exists as several economic activities are not reported to the formal economy and hence remain out of the tax net. Often defined as the *underground* or *off-the books* economy, the transactions in the black economy are made in cash and banks are scrupulously avoided. Though the term *black economy* usually conjures up images of illegal or illicit activities what we are pointing out here are black transactions that are for activities that are legal but concealed from the tax authorities in an attempt to evade taxes. Thus the existence of a large black economy results in low tax collections, reduced government services, unfair competition and an uneven playing field for the documented businesses.



Defining the current tax regime as administratively deficient to collect taxes, the Anti-Corruption Establishment report stated that as much as fifty percent of the total urban income goes unreported, while estimating the annual tax evasion to be nearly Rs. 218 billion. This calls for a stringent need for widening the tax base as well as making the existing tax base an effective one in order to improve the tax to GDP ratio.


Despite all the reforms that have been introduced in the sector over the last several years, CBR has failed to record any significant improvement in its capacity to collect what is due from the existing tax base as evasion and avoidance continues to go unchecked. Continued corruption in the collection agency allows the unscrupulous among the taxpayers to evade and avoid taxes to significant levels. Consequently the reforms have failed to broaden the tax base to any significant levels as only an extremely small proportion of the population continues to pay the taxes. Thus broadening the tax base does not imply deepening the tax burden for those who are already contributing significantly to the tax receipts like the documented corporate sector but rather taxing the sectors that are either outside the tax net or are lightly taxed.

The Black River goes Grey

Realizing that huge amount of tax revenue accrues to the existing underground economy, the CBR has often declared its intention of taking appropriate measures to bring the informal sector into the formal sector with the help of the business community but most efforts have been futile. The government of Pakistan has a strong interest in knowing the size of the black economy to gauge the portion of revenue they are losing to tax evasion. But since these transactions are hidden there is no straightforward tool to measure them.

However it is interesting to note that the black economy of Pakistan has entered a grey area with the development of the financial sector. The healthy growth in the banking sector has reduced the scope for the cash economy as the black economy businesses are in one way or other channeling their transactions through the financial sector. Though these transactions are not reported to the CBR, their record is present at the financial institutions. Additionally with the introduction of CNIC, the central data warehouse holds record of 78 million individuals with 140 million additional records stored as part of the data collected from the last census. The submission of a CNIC of an individual is now compulsory before he/she enters into any relationship with the financial institutions. Hence with this system in place the government now has the ability to access the records of individual's holdings in the banks. If this recorded information is accessed, it is likely to reduce the chances of anyone's wealth going completely unchecked unless hoarded at homes.

Despite these advancements, the CBR has not been able to meaningfully raise the tax to GDP ratio. This is largely because it is strictly prohibited from accessing the data available at the financial institutions and the CNIC data warehouse. This implies that



keeping the undocumented sector of the economy out of the tax net is a choice of the government rather than a compulsion.

Draining Grey from the Black River


The government has so far avoided placing any checks and balances on the incomes generated within the underground economy, which are being channeled through the documented financial sector. This is primarily because the flows of incomes from the unreported transactions contribute significantly to the development of the financial sector that accounts for a robust growth of the economy. If the government decides to crack down on these flows and extract records from the banking sector in order to bring more people into the tax net, it may drive away the general public from the financial sector. Paranoia may lead to people withdrawing their money from the financial sector and hoarding huge sums at home or investing them outside the country. This will certainly push the financial sector back to where it stood before the boom. Hence faced with this catch 22 situation the government has so far restrained itself from taking drastic actions against the underground economy despite having access to the records of such transactions with the advanced data warehouses in place. It is instead concentrating on more voluntary measures of compliance such as the Universal Self Assessment Scheme to encourage development of a healthy tax culture.

So although the government is often viewed critically regarding the low levels of tax to GDP ratio, considering the administrative deficiencies and the corruption within the taxation departments, it is not difficult to rationalize the logic of the government. It is imperative that the black to white transition be as painless as possible for the economy as a whole and even for the individuals involved. We say this because this is not a question of a small number of tax evaders but of a huge chunk of the general public.

What we suggest is a status quo for the time being to let the tax reforms take their course. This would allow the natural conversion from black to white to continue. At the same time it is imperative for the government to continue the internal reforms of the CBR to set it up as an efficient organization whose job is not to scare but to facilitate the taxpayer.

But we imagine that one day down the line the government would have to use the gun it is holding over the general public's head and go for the complete documentation of the economy by allowing the CBR to access financial sector records and act upon them. But before acting upon this, some sort of formal documenting incentive would be imperative to allow a painless transition to a documented economy.

One such incentive would be a general one time tax amnesty scheme to be offered to the general public. Under the scheme people voluntarily declaring their assets and enrolling themselves as taxpayers must be allowed to pay a nominal tax rate on the declared assets



as opposed to the full income tax rate that would be paid normally. Currently any such assets if declared to the tax authorities are treated as an income and would be taxed at the applicable income tax rate which creates a disincentive, preventing people from declaring their assets and coming into the tax net. The tax amnesty would pave way for the black economy to enter the tax net without much pain. Though to the government this would mean foregoing the income tax on assets that were earned previously, it would also mean that the undocumented businesses and assets enter the documented sector, and become a significant source of direct taxes from then on.

Wrapping Up!

Wrapping up we suggest that it is highly imperative for the government and the CBR to take note of the historically low level of tax to GDP ratio that has been hovering around the 10% mark for past few years despite a healthy growth in tax collection. Additionally the direct taxes fail to contribute significantly to the total tax receipts. As explained earlier, the low tax to GDP ratio and the insignificant contribution of the direct taxes is certainly the result of narrow tax base, low compliance of tax, the non serious attitude of tax payers in filing their return and fulfilling tax obligation and most importantly the existence of a large undocumented black economy that indulges heavily in tax evasion. It has, therefore, become imperative for the government to revise the tax structure by turning the current tax base into an effective one and bringing the black economy into the white sector. However before introducing any drastic reforms, what is more important for the government is to revamp the administrative infrastructure and frame policies that create a disincentive for corruption on part of the taxpayers and the tax officials. This shall increase the tax to GDP ratio significantly, reducing the economy's dependence on international lenders to finance its long term borrowing needs.



Economic Snapshot

Fiscal year 06														
	Units	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov
<u>Inflation</u>														
Headline Inflation	%	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07
Core inflation	%	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62
Food inflation	%	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62
Non-food inflation	%	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27
<u>T-bill (Wgt Avg)</u>														
3 month	%	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64
6 month	%	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81
12 month	%	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00
<u>External Sector</u>														
Export	Mln US\$	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420	1290	1380
Import	Mln US\$	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450	2191	2773
Trade balance	Mln US\$	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)	(901)	(1393)
Remittances	Mln US\$	309	336	391	339	444	401	507	464	376	435	422	410	448
Forex reserves	Mln US\$	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460
n.a = Not Available														



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