

A Study of the Informa Economy in Pakistan

By

Fouz Khalid Khan

THESIS

Submitted to

KDI School of Public Policy and Management

in partial fulfillment of the requirements

for the degree of

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ABSTRACT

The informal sector plays an important and quite inevitable part of the complex landscape that characterizes urban economy. Although part of the overall environment, it has its own unique characteristics and nuances that shape the lives of almost half of urban population in developing countries. With a contribution of almost 40% in GDP and employing about half the unskilled and semi skilled labor force, informal economic entities remain one of the most vibrant – and understudied- features of modern societies. While it may be argued that their basic structure belies the formal procedures, evades taxes, induces illegality, flays regulations and escapes any attempts to document, they remain one of the most visible and inherent feature of cityscape. Providing jobs to millions, making a family-based, community-oriented social safety net and helping (though formally unappreciated) in the growth and development process, it can be argued that informal economy – especially in today’s economic climate – is a relevant and forceful appendage to formal structures.

A study of the *raison d’etre*, characteristics and unique nature of informal economy in Pakistan has been undertaken in this paper and attempt has been made to recommend alternative tax initiatives in order to nurture and help the same towards eventual formalization with a view to enhance the tax base and revenue in future.

These recommendations/initiatives include reducing the cost of compliance for formalization by reducing the registration fees and accounts documentation formats; waiver for mandatory need for National Tax Number for making bulk purchases;

acceptability of property documents for obtaining bank credits and soft loans; simplifying bureaucratic hassles; identifying the problems created by street vendors (which constitute a huge portion of urban informal economy) and allowing them to ply their trade in makeshift “Night Bazaars”; insisting upon expansion of economy through increased consumption rather than merely focusing on tax collection, especially the VAT which has huge enforcement and acceptability problems in Pakistan; and perhaps more importantly, the tax regulation to realize that informal economy needs to be treated separately and in a growing economy like Pakistan where huge agricultural sector goes untaxed for income, a strict and equal tax regime for overall economy might not be the solution in the short run.

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CHAPTER I: INTRODUCTION

Developing countries invariably have an economic structure that incorporates a huge and visible informal sector. Although the term was used loosely in various economic reports, its origin as an acceptable terminology can be traced back to the 1970s. It is also referred to by various names such as black, shadow and underground economy. Informal sector may not necessarily be illegal although evading regulatory framework puts it in that ambit. We cannot pinpoint the exact definition but it is usually accepted that people working in the informal sector are “...independent, self-employed producers in urban areas some of whom employ family members and some of whom hire non-family workers or apprentices.”¹

Since it involves informality to a high degree of disregard for corporate and/or fiscal regulation, informal sector is often defined to be “...the sector of economy where firms engage in tax evasion”². However, it may not necessarily entail lowered productivity; in-fact the opposite might be the case in many developing countries where this sector contributes to major productivity. ³ This is important in light of the fact that according to World Bank estimation for developing countries, the informal sector employs between 35 and 65 percent of the labor force and contributes between 20 to 40 percent as its share in the GDP.⁴

¹ Centre for International Private Enterprise, *Barriers to Participation: the Informal Sector in Emerging Economies*, 2000, p4.

² Al Makrîzî Institut D'économie, *Informal Sector and Taxation*, Jellal Mohamed. August, 2009, Online at <http://mpira.ub.uni-muenchen.de/17129/>

³ Ibid, p 8.

⁴ The World Bank Policy Research Working Paper No 1334, *Taxation, Public Services and the Informal Sector in a Model of Endogenous Growth*, August 1994, p2.

It has also been argued that the informal sector owes its presence and continued existence to over-regulation of the general economy --such as the incidence of high tax rates and transaction costs of formalization-- and inefficiency of the compliance control system.⁵ While public services such as transportation, the road network, government health and education programs, and utilities are financed only by the formal sector through their tax contributions, the informal sector makes use of some of these services and gets away with paying for none of them. Conversely, it may not be able to enforce its property rights through the judicial system or (in some case the police service) for fear of disclosure of income and wealth accumulation; nor can it benefit from the capital / insurance market or government credit agencies for want of regulatory requirement such as tax registration. But since the informal sector requires little capital and moderate skills for operation, it continuously uses the infrastructure provided by the government.

Measurement of the informal economy can be undertaken through direct as well as indirect methods. The former uses voluntary survey of visibly non-regulated economic agents and tax audit reports which seek to assess differentials in declared and actual income. Examples of the latter method are the monetary approach to informal economy estimation based on transaction velocity of money; through data modeling from physical inputs such as electricity consumption as a proxy for economic activity; or using a complex Multiple Indicator-Multiple Cause (MIMIC) method which combines in a complex inter-dependent relationship, *inter-alia*, the tax/GDP ratio, the M2/GDP ratio with M2 and utility consumption to arrive at an estimation of the informal economy. Based on the above methods, the average estimates of the informal economy range from 23.2 to 27.3

⁵ Ibid, p2.

percent of the total economy of Pakistan for the years 2000~2010.⁶

Economic development in Pakistan is hindered mainly by insufficient revenue raised through its taxation system, which is both inequitable and ineffective, in that it distributes the tax burden disproportionately between the formal sectors of the economy (agriculture, services and industry) and by doing so, fails in providing enough funds for development. The Tax-GDP ratio is a dismal 9.8%, whereas the average ratio during the last 5 years for comparable middle-income countries is 19% and has registered a growth of almost 3% over the period 1994-2004.⁷ Institutional and structural failures of taxation and governance systems in Pakistan have rendered exclusion of the informal sector from the tax base and mitigated its potential as a significant source of tax revenue.

The research problem inherent in the incidence and growth of the informal economy is the fact that it is burgeoning without any containment within the regulatory regime and without paying its due share of economic contribution to the society in the form of taxes. Perhaps more critically, it seems to get away with using the resources paid for by the formal economy and especially the salaried middle class. It has been argued that the main reason for the non-inclusion of the informal economy – aside from its basic characteristics – is the stringent regulations and the cost of doing formal business in the economy. The purpose of the study, therefore, is to establish a link between formation and persistence of informal economies and stringent tax regimes in Pakistan; and propose a

⁶ State Bank of Pakistan Working Paper Series No 33, *The Size of Informal Economy in Pakistan*, May 2010, p11.

⁷ The International Monetary Fund, Fiscal Affairs Department, *Revenue Mobilization in Developing Countries*, March, 2011, fig.11, p29. <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>.

framework of policy measures and institutional / structural re-alignment in the existing regulations that will ensure recognition, measurement and development of informal sector in the context of over-all economic growth and development

HYPOTHESES

This research seeks to address the following hypotheses:

- a) There is a correlation between the present structure of tax regime --along with related social and economic environment-- in Pakistan and continued disincentives to formalization by the informal sector.
- b) Economic growth and development are related to a process of recognition, encouragement and development of the informal sector along with a differential tax and continued strategic efforts for formalization.

Based on the above hypotheses, this paper seeks to answer the following question:

- a) What, if any, structural re-adjustments and policy measures can be effected in general and particularly by the Tax administration that will ensure inclusion of the informal sector in the tax net?
- b) What kinds of enforcement elements will be needed to obtain a higher degree of control over the informal economy?

RESEARCH AGENDA

This research will use both primary and secondary sources which will include tax and general economic data of Pakistan such as those available from the State Bank of Pakistan and Federal Board of Revenue websites. Reference will also be made to reports

on the subject compiled by the World Bank (WB), International Monetary Fund (IMF), and other research agencies. Although the research is Pakistan-centric and has a significant practical orientation in that context alone, theoretical aspects of the role of the informal sector in other developing economies will also be included by making reference to standard material and authorities on the subject. In addition, the author will also draw from his own practical exposure to tax administration in Pakistan.

Based on the above, this research paper seeks to construct a framework of policy measures helpful in designing and implementing specific issues related to the overall management of the informal economy. That in itself is a daunting task and requires analysis of the socio-political and environmental issues that shape the informal sector; such matters will be dealt with briefly, where necessary. However, since the scope of this paper is limited to resource mobilization, emphasis is placed on the tax regulation and formalization aspect.

Academic and institutional studies on informal economy generally take the regulatory philosophy as an exogenous variable and focus on devising policy measures within that context only. However, the developing world is entering a phase of burgeoning informal economy which makes it a practical impossibility --not to mention, economically ineffective-- to treat the same at par with the formal economy. This research will highlight issues in that context and will seek to formulate policy design to optimize resource mobilization through a sustainable and focused tax treatment of the informal economy

CHAPTER II: LITERATURE REVIEW

Literature relevant to the definition, extent, analysis and treatment of the informal sector mainly consists of three broad categories. Firstly, there are academic books on economics, taxation and sociology which are limited mostly to, and are helpful in, laying a theoretical foundation of the subject; secondly, institutional reports by international (and local) agencies such as the IMF, WB, Organization for Economic Cooperation and Development (OECD), United Nations (UN) and State Bank of Pakistan (SBP) which collate quantitative indicators, analyze effects of various regulatory measures and suggest policy guidelines based on desired economic objectives; and finally, articles in professional journals are available which undertake case studies in field through which comparison of cross-country data and policy implications can readily be made.

Being a subject which has been of interest to economists only recently, the informal sector has yet to achieve a solid theoretical grounding. However, Michael Todaro in his widely acclaimed book provides a comprehensive definition of it as a part of a mostly urban developing economy which is "...characterized by small competitive individual or family firms, petty retail trade and services, labor-intensive methods, free entry, and market-determined factor and product prices." Despite government policies which encompass "benign neglect and even outright hostility,"⁸ Todaro affirms the continued important role of this sector in developing countries. He also provides a micro-economic framework within which classification of the informal sector is made through its competition policy, entry-exit barriers, labor productivity, profitability and effects on rural-to-urban migration. The latter characteristic is linked with the overall size and activity of

⁸ Todaro, Michael P., and Stephen C Smith. 2011. *Economic Development*, 11th ed., Addison-Wesley, Boston, p327.

the rural sector since it contributes to adjustment of excess rural labor and, *ipso-facto*, to poverty reduction. Another important aspect of the informal sector is its ability to absorb a semi-skilled urban labor force at substantially lower wages and thus ease pressure on the formal sector which --by definition in developing countries--has a small base of output and employment rate. This correlation may prove to be effective in directing the future course of policy action towards a focused development of this sector which at present is suffering from what the UN-Habitat, 2011 report calls “anti-urban bias of development agencies.”⁹

A significant, and to date the most comprehensive and reliable, contribution to measurement of the informal sector in Pakistan has been made by a recent publication of the State Bank of Pakistan. We know that standard economic indicators of growth such as GDP, unemployment rate, consumption and investment rates are not truly reflective of the total economic activities since a significant part of them escapes documentation; and hence policy measures, most importantly tax-base estimation and income-tax rate criteria, are highly likely to be misaligned vis-à-vis economic realities on the ground. Therefore, estimating the size of the informal economy is of utmost importance. This task has been undertaken in the above- mentioned report through usage of a modified monetary approach, by analysis of utilities consumption patterns, most notably that of electricity, and by a complex Multiple-Indicator Multiple-Cause model, the latter two being used for the first time in Pakistan. Hence, this estimation is more indicative of the actual informal economy than the earlier studies which were undertaken using only the monetary approach. The report estimates the size of the informal economy in the period 2000-2010 at 23.2% to 29% of the total GDP with a declining trend from 30% exhibited through 1970's

⁹ Ibid, p330.

onwards.¹⁰

A synopsis of the Kenyan informal economy is given in Arne Bigsten, Peter Kimuyu and Karl Lundvall's article "What To Do With The Informal Sector?," *Development Policy Review*, (November, 2004) where the authors provide an overview of the economic and other factors which led to the evolution, persistence and growth of the same in line with the Dual-Economic Sectors model established by Arthur Lewis.¹¹ The case study of Kenyan "jua-kali" (literally, *Hot-Sun* in Swahili; figuratively, informal) sector is relevant, since Pakistan shares the same sub-sectors such as artifacts, food processing and unskilled general labor, comprising its informal economy along with almost the same degree of lax government regulation. Inasmuch as the development efforts have been concerned, we find the factors listed in the article including lack of human capacities, poor governance, low demand, poor infrastructure, inadequate capital, reliance on labor intensive techniques and dual industrial structure to be generally applicable to Pakistan as well.

A debate on the role and character of the informal sector regarding its growth potential and its integration or otherwise with the formal sector is also a separate study in itself; presently due to lack of a strong and generally accepted theoretical framework, empirical evaluation of policy measures such as the one carried out in the above-mentioned article fill this gap. This is also the approach taken in the present paper; hence the importance of such case studies cannot be over emphasized, as they provide a relevant

¹⁰ The State Bank of Pakistan, *The Size of the Informal Economy in Pakistan*, Working Paper Series No 33, p11.

¹¹ Arne Bigsten, Peter Kimuyu and Karl Lundvall, 2004. *What To Do with the Informal Sector?* *Development Policy Review*, Blackwell Publishing, Oxford, UK, November, 2004.

and comparable bench-mark through which various policy outcomes in other developing countries might be studied for modified replication in the local setup.

A specific model of tax effects on the informal sector is also provided in another paper, “Taxes, Inequality and the Size of the Informal Sector,” *Journal of Development Economics* (February, 2003) where the authors assess the role of tax (which can be thought of as a formalization fee) and its effects on the income of the informal sector which are then proven to be complimentary to each other. It is also argued that the effects of tax are “ambiguous,” and it is suggested that “...caution is needed when using such simple minded [tax reduction] policy, often recommended in the literature as the solution to informalization.”¹² This issue is the central theme of the present author’s paper and will be dealt with in some length in the succeeding chapters with specific reference to Pakistan and the present economic paradigm where, *inter-alia*, the cost of documentation has sharply declined due to innovations in technology; and where a renewed emphasis on regulatory measures are now vigorously being advocated to pull out Pakistan’s economy from an imminent collapse.

From the above, one may be tempted to conclude that informal sector is only limited to transitional or developing countries; but that is not strictly the case. Although, worsening social and economic conditions are often the instigator to informalization, this trend also exists in the developed country. The sweatshops that flourish in New York are a good example of such kind of alternative economic mode.

¹² Sylvain Dessy and Stephane Pallage, 2003. Taxes, Inequality and the Size of the Informal Sector, *Journal of Development Economics*, Elsevier Science B.V., February, p233.

Another aspect that seems to automatically associate itself with the informal economy is a negative connotation of its activities, the processes and the extent of its subsequent effects on the “positive economy.” This view point has resulted in a trend where the informal economy has been predominantly depicted as composed of negative attributes whilst the formal economy has been portrayed more positively as the path to ‘progress’, ‘advancement’ and ‘modernization’.¹³ The two economic models are thus viewed not only as sequential but also in a hierarchical perspective: that not only the informal economy precedes the formal one, but the latter is far more legitimate than the former. In a sense, the informal economy is considered a remnant of pre-capitalism era, which is a discrepancy within the immutable framework of formalization and needs to be corrected; or itself will be corrected due to pressures from market forces and increasing government regularization of economic and business activities.

A slightly more forgiving ‘post-Fordist’ perspective acknowledges the presence of the informal economy as a necessary adjunct to the modern organization but still views it negatively. This is in no small measure due to the fact that in recent years the informal economy has expanded, effectively negating the belief in formalization as something inevitable and natural. One of the reasons, afforded by the so-called ‘Post-Fordist Theory’ cites the advent of the informal economy as a “direct by-product of the advent of a de-regulated open world economy” and the result of businesses employing creative strategies to reduce costs by out-sourcing labour – often hoodwinking over the strict regulations that inevitably accompany their formal counterpart. A classic example of this can be seen in the sweatshops run by garment manufacturers¹⁴.

¹³ *Ibid* p237

¹⁴ Colin C Williams and John Round, 2008. A Critical Evaluation of Romantic Depictions of the Informal Economy, *Review of Social Economy*, Vol. LXVI No.3, September, 2008

However, the paper cites various sources which have, in recent years, begun to view the informal sector as an alternative route to progress and development and evaluates these simplistic and binary depictions of economic dualism. One such viewpoint depicts the informal economy as a 'chosen-alternative' and a complement to the formal economy and thus, arguing the fact that "nurturing the informal economy is just as important as developing the formal economy". Then, again, some neo-liberals view informal sector as a form of "popular resistance to an unfair and excessively intrusive state" and informal workers as "heroes casting off shackles of an over-burdensome state". However, it has been argued that their actual intention is not so much as praising the virtues of informality than to condemn the strict regulations imposed by the barriers to entry in the formal regime. Yet another view of informal economy is grounded in the so called 'radical green' aspect of the now-maligned 'export-oriented mode of production' which is 'ecologically unsustainable'; therefore, the informal economy with its reliance on indigenous production methods utilizing local goods and services and meant for domestic consumption is a move towards a more environmentally friendly direction. This argument can be stretched to include a more political colour in the post-colonialist era where formalization was seen as being subjected to authoritarian regulations while serving the needs of a capitalist regime; informal sector thus provides a sort of liberation from these forces, a mandate to carry on self sustainable economic activity without the need to be regulated by government¹⁵.

It is apparent from the above that the economists are having a second look at the importance, viability and future prospects of the informal economy. While the dual economy thesis was prevalent during the latter half of the last century, post modernistic

¹⁵ Ibid, p 303

economies (especially after the disintegration of USSR and the formation of new, regional centric economic blocs), the role of informal economy is being appreciated anew. A fresh approach to regulations needs to be undertaken and we may ask this question: is formal economy the only means wherefrom economic growth and development can be achieved or is there some alternative way to jump-start the same?

While on the subject of political economics, it is hard to refute the theory that the informal economy and non-representation are related through a cause and effect phenomenon. This is very evident in the presence of the rules of the games, the requirements to formalization, which effectively, prevent the informal economy from assimilating. Informal economic actors are, by the very fact, entrepreneurs: they have no infrastructure to build on except their own homes or public land; no technical or vocational skills except those learnt through tradition or practice, or at times only the manual labor; no capital and loan opportunities except what they can borrow from friends and family. On the other hand, formal sector has all the ways and means to carry out business within the defined ambit of governmental regulations.

It is also evident that having a clout in the form of active political representation, they are the ones whose interest are best served by the existing economic regime including tax cuts for the affluent of the society and levying across the board consumption taxes on basic necessities. This, then, is a phenomenon evident more on account of political turf rather than any social or economic reason and the presence of informal economy is largely due to poverty, injustice and other inequalities in the society. Indeed, “to the extent that excessive regulations are created to benefit particular interest groups and not society in general, the presence of the informal sector is a result of the failure of political institutions

to protect and promote an efficient market based economy”¹⁶.

One of the major barriers to entry that are erected in the face of the informal economy is the prohibitively high cost of doing business. This effectively inhibits both democratic and economic transitions by imposing a high premium on transaction costs such as “obtaining a business license; acquiring land titles or leases; hiring employees; knowing and complying with applicable government laws and regulations; obtaining information about the price, quality and quantity of particular goods and services, about sources of goods and services and about potential customers; obtaining a loan; buying supplies; hooking up and maintaining electricity and telephone services; paying taxes; enforcing contracts, and so forth.”¹⁷

Finally a word about the agriculture sector which constitutes the third largest sector of the country in terms of GDP contribution i.e 21% (after services and industrial sectors) and the largest in terms of labour force employment which is 45% and having 60% of rural population depending upon this sector. Decline in agriculture growth rate resulted mainly from decrease in surface water availability (in Million Acre Feet) to a dismal -13.4% over the average which resulted in lower crop production ¹⁸. With a growth rate of 3.13% in the fiscal year 2012 against 2.8% in the previous year¹⁹, the agriculture sector’s performance is not upto the mark mainly because of natural calamities and shortage of

¹⁶ Catherine Kuchta-Helbling, *Barriers to Participation: The Informal Sector in Emerging Democracies*, Centre for International Private Enterprise, Nov 2000.

¹⁷ Ibid, p 2

¹⁸ http://www.finance.gov.pk/survey/chapter_12/02-Agriculture.pdf

¹⁹ http://www.finance.gov.pk/survey/chapter_12/highlights.pdf

electricity which had a growth of -1.62% in the FY 2012. Agriculture is therefore not taxed for Personal Income Tax in Pakistan and although instances of huge accumulated wealth through agricultural means are rampant, the government is still reluctant to include this sector within the tax bracket mainly due to pressures from legislators who mostly belong to feudal and landed gentry. Although it has been argued²⁰ that taxing agriculture would be one of the ways to achieve potential annual revenue of Rs.250-300 Bn and to tap the “structural shift of income towards untaxed sectors” and to create tax equity, it is still a debate whether or not to tax this sector where inefficiencies abound and practical on ground situation demands a gradual shift in the policy. It has been counter-argued that due to decreasing land holding sizes, already existing provincial tax regimes and the possibility of burdening poor farmers instead of big land lords, imposition of any agricultural tax will not be efficient.²¹ It is due to this reason that agriculture has not been discussed in this rudimentary paper as a possible solution to Pakistan’s tax inequities and the focus has been kept fixed on the policy treatment to informal sector of the economy.

²⁰ <http://www.pildat.org/publications/publication/EcoFinance/BP42-TaxingtheAgricultureIncomeInPakistan.pdf>

²¹ *ibid*

CHAPTER III: PAKISTAN'S INFORMAL ECONOMY

The informal economy in Pakistan, like any other developing country, is a mix of many different elements, social, political and environmental. Liberated from the British Raj only 64 years ago in the year 1947 and dismembered after 24 years in the year 1971, Pakistan's economy has seen both good and worst times. In recent times, the economy has taken a downturn mainly due to the devastating consequences of natural calamities, huge expenditure (both social and fiscal) on being a strategic partner in the Afghan War, huge electricity shortages and a general inflationary trend in the country. In such times, the informal economy of the country is receiving a mixed blessing with its labor-intensive dependency and dual linkages with the formal economy.

The characteristics of the country's informal economy are multifold and comprise both the 'informal by compulsion' and 'informal by design' classes. The former is the poor, uneducated and mostly urban individual or households who are compelled to make their living through employments and entrepreneurships that is classic informality: they make use of the public goods and services and yet, do not contribute to the public exchequer in the form of regulation fees and taxes. This is not surprising because with a Poverty Gap of 18.74 (at \$2/day, PPP) escalating poverty is one of Pakistan's biggest economic problems. The Kuznet's ratio is (Top20% / Bottom 40%) is $\{42.1 / (9.0+12.8)\} = 1.93$ (coupled with the Gini coefficient of 0.33²²) which is a significant indication of inequality distributed throughout the society. Similarly, considering the present minimum wage for monthly unskilled labor is about \$ 70, amounting to a mere \$2.3/day, this aggravation of informal sector employment is not surprising. The major fields of such players are restricted to

²² Todaro, Michael P., and Stephen C Smith. 2011. *Economic Development*, 11th ed., Addison-Wesley, Boston

traditional cottage industries which used to comprise power looms for making textiles, handicrafts, street food and other goods vendors, domestic help, brick-kiln making, transport sector, small scale manufacturing, whole sale and retail trade, construction workers, corner shops, sweetmeat packaging, home based dairy supply, cooking services, sanitary workers, home based beauty parlors, auto mechanics, etc. Since informal work is not classified by any moral connotations, smugglers, drug traffickers, sex workers, gamblers, extortionists and all sorts of other mafia can also be classified in this category. This class of economy can reasonably be said to have no choice except to continue with their employment in the face of rising economic pressures and major disincentives to formalize.

The latter class of informal economy comprises of the rising middle class and affluent tax evaders which have gained a major foothold in the politico-economic framework of the country. Not all disincentives to formalization can be based solely on poverty and economic hardship considerations, though: greed and the get-rich-quick fixation play perhaps a greater role in evading taxes and continuing the informal structure of business and employment. Thus, the tuition centres in urban areas catering to the mass of school and college students are a classic example of a middle class rip off: they presumably cater to a noble and rather necessary goal – that of filling the gap of strict standardization requirements and the dismal teaching level at many educational institutions. Yet in doing so, they very conveniently avoid paying any kind of due taxes by keeping the documentation non-existent and operating strictly on cash basis to avoid any indication of their income and expenditure.

Similarly, in urban areas of the country there is a proliferation of the so-called

“Baara Markets” – a haven of smuggled goods mainly from neighboring China. These markets are filled with garments, consumer electronics, cosmetics and house hold crockery and utensils which are either brought in through ‘khaypias’ or smuggled in from the porous borders of neighboring Afghanistan, China, etc. ‘Khaypia’ is a specialized messenger service wherein a person goes offshore, usually to such places as Dubai, Far-east, China, etc, and brings in huge number of consumer goods as baggage to be exclusively sold in those markets. Of course, without the active involvement of Customs officials, this practice is not possible. Such goods are also blatantly displayed at many departmental stores around the cities in open defiance of the country’s import regulations. This is also evident in the insistence of many shops to have cash as their primary and preferred means of transactions in order to avoid documentation of their sales.

Another case of such blatant exploitation is the one carried out by a class of people who should be most honest – the religious preachers. Pakistanis are a deeply religious people and preaching, especially in the holy months of Ramadan, Moharram and Rabi-ul-Awwal is a thriving business. Preachers and religious hymn-singers earn in thousands of Rupees *per hour* and yet no tax at 6% is deducted at their payments in stark violation of section 153 of the Income Tax Ordinance, 2001. The fact that this blatant violation is made for a religious service is all the more shameful.

Shameful indeed is yet another class of informal economy, which though is relatively small in number but perhaps outstrips the major players in formal economy in respect of profit and accumulated wealth. This is the black and underground economy sector comprising of high stakes stock market plays, illegal money transfers, smuggling, drug trafficking and extortionist activities. It can be rightly termed the criminal side of

informal economy as opposed to mere irregular one, mentioned above. The Big Hawala networks, an alternative remittance transfer system operated mainly from the Gulf countries where South Asian labour is located, which were active a few years back have now been somewhat curbed by the State Bank's policy of requiring the banks to know their customers. The threat of money transfer for terrorist activities has also clamped down this attitude to some extent; however, 'Hawala' (or Hundi, as it is alternatively known) is still a vibrant business and a major contributor to tax evasion by setting up a shadow banking system.

Another manifestation of evading taxes by using the very means meant for inducing formalization is the widespread usage of banking system. This trend can be seen in the dismal ratio of taxpayers vs. bank account holders (which is almost 1:30²³); it can be argued that many people have more than one bank account, some are not subject to direct taxation and many are exempt (such as those having agriculture income). However, even with all such justifications, the ratio is too huge to merit waiver of any wrongdoing involved.

It is also apparent that tax evasion in the informal economy need not be invisible although many activities, mostly criminal, are by that very fact disguised. One example of that is the tacit government allowance of providing subsidy on electricity; a fact which has helped the mushroom growth of informal economy. Spurred on by the multifaceted problems besetting the electric generation politics (such as no bills for the tribal areas adjacent to water dams, huge line losses, corruption in allocating rental power plants, reliance on costly furnace oil rather than exploiting coal reserves, political bribery of oil

²³ M. Munir Qureshi, Pakistan's Informal Economy.

marketing companies, privatization of State owned enterprises, stoppage of cheap Saudi oil, etc), a subsidy on the already inefficient electricity generation is tantamount to increasing disposable income of the consumers.

It is well known that an effective method of estimating the size of the economy is the electricity consumption ratio vis-à-vis the GDP growth. An almost unit elasticity is maintained that can be made from between the two indicators so that electricity requirement can be practically measured by estimation of a country's GDP. Another important indication that can be gauged from this analysis is the size of the informal economy which is the differential between the electricity consumption (per capita) and the consequent GDP. In other words, the amount of electricity needed to produce the GDP is subtracted from the actual electrical production and the rest is attributed as the consumption made by the informal sector²⁴. The electric power consumption (kWh per capita) in 1980 was 132 and the corresponding GDP per capita was 357 US\$; in 2008, the most recent figures available, the figures were 433 kWh/capita and 1,007 US\$ respectively. Based on the percentage change every year for the 28 years (1980~2008), the following graph depicts the high proportional change in electricity consumption vis-à-vis GDP per capita change and is a good indicator of the increasing size of informal economy in the country.

²⁴ Ahmed Gulzar, Novaira Junaid, Adnan Haider: What is hidden in the hidden economy of Pakistan? Size, causes, issues and implications.

<http://www.pide.org.pk/psde/25/pdf/agm26/day2/Ahmed%20Gulzar.pdf>

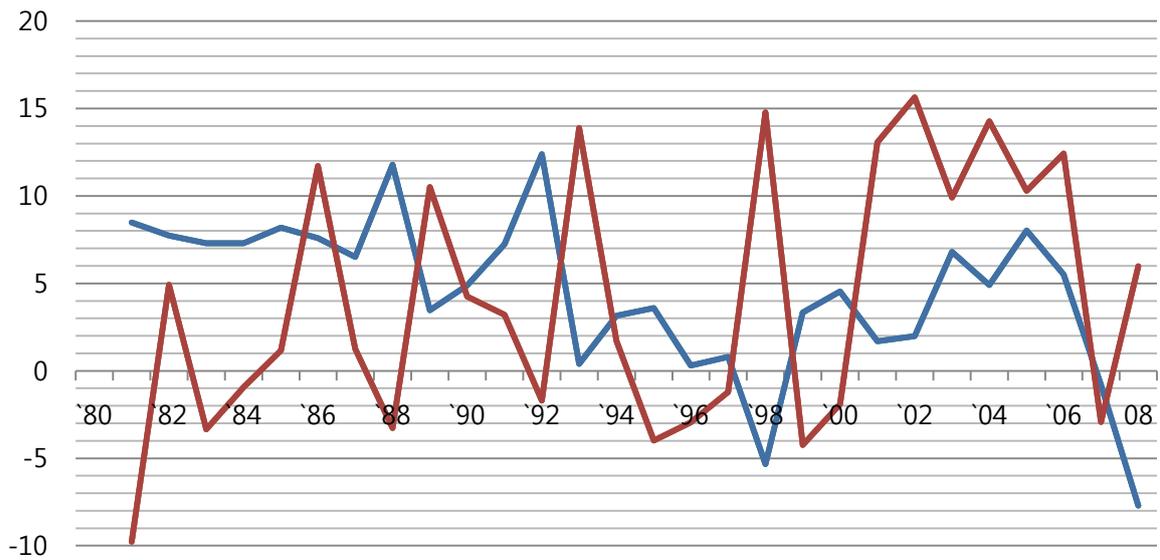


Fig 1: Percentage change comparison in Electricity Consumption & GDP. (The blue line is Electric Power Consumption per capita (% change) and the red line is GDP per capita (% change)).

Based on this approach, estimates of the informal economy in Pakistan have been made²⁵ at 30.67 for the year 1974 to 47.62% of the GDP for the year 2010. As a comparison, on average the Asian countries exhibit an informal economy at 41% of their GDP. The estimation, of course, depends upon the indicators and the model used. Based on the above, a graph of the estimations is as follows. It can be seen that the informal economy has been fluctuating about the mean of a little less than 50% of GDP. This implies that the economy of the country has been under-reported by almost half of the amount throughout the years. This has grave repercussions for efficiency of tax collection, tax-actual-GDP ratio and other major macro-economic indicators which help the policy makers in devising strategies for the country's growth and development.

²⁵ Ibid p 39.

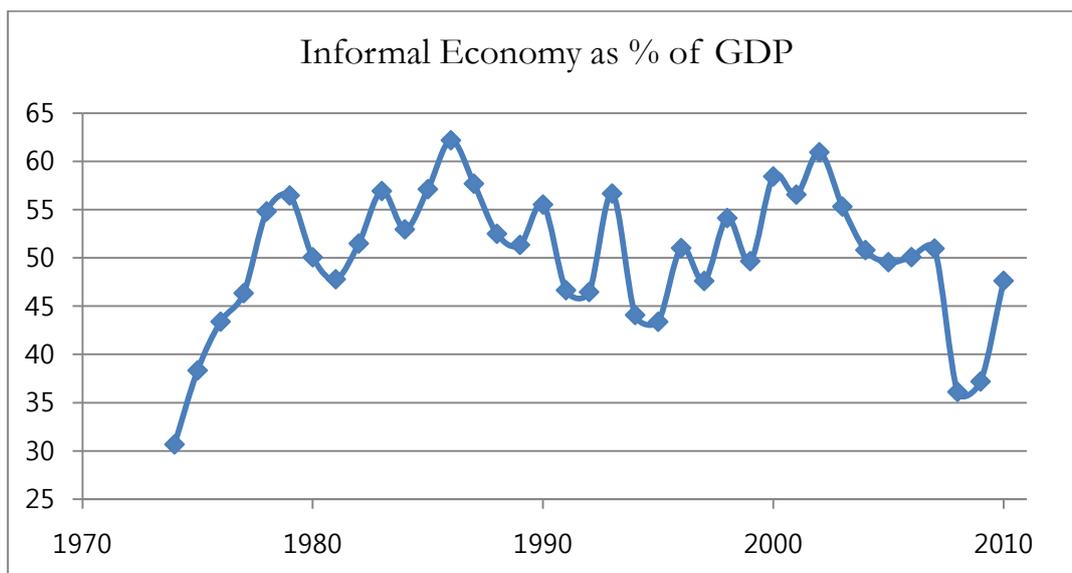


Fig 2: Estimation of the informal economy as % of GDP throughout the years

The size of the informal economy is only an indication of the causes and problems inherent in the continued existence of informal sector. All the factors listed above have been instrumental in creating disincentives to formalization. Besides, we can list many other social and environmental reasons that are prevalent in the country. Pakistan has a very dismal Tax-GDP ratio of 9.8 and only about 3 million taxpayers, a large chunk of which are salaried taxpayers. Besides, a low literacy rate, continuous devaluation of currency and low growth rate of public sector development expenditures have also been cited as major impediments to formalization. Potential reasons which may see increase in the informal sector include rise in cross border smuggling, decreasing arte of general purchasing power, price hike of petroleum and electricity, weak law enforcement and increasing corruption²⁶.

There are many social and economic reasons for the flourishing of the informal

²⁶ Ibid p 21.

economy besides the above mentioned. One of them seems to be the huge wage differential between the formal and the informal sector. Recent²⁷ surveys indicate that almost 60% of employees work in the informal sector and only 30% of them are regular; the rest of the employees are either contractual or daily wage workers. Non-regular female workers in the informal sector are almost 80% of the labour which accounts for 54% of all female employment in the country. During the past decade, cross classification of enterprise type (formal, informal) with wages show a wide differential with the informal sector suffering a fall in average wage. As is expected, female employees in the informal sector have continually been registering the lowest money wage growth²⁸. This situation is indicative of two major cause of concern for the policy makers: the low status, and literacy rate, of women in the society coupled with the fact that formalization requirements are so strict as to effectively persuade entrepreneurs to back out. While sociologists might agree that the entry of women in labor force is a welcome move and even lower wages are better than nothing, Pakistani society has yet to incorporate women as an active and equally productive wage earner.

As an example of the formalization requirements, we can cite the requirement to register the firm for number of employees exceeding 10 and to accordingly pay social security contribution in their respect. Another reason which is perhaps the biggest contributor towards ineffective documentation of records is the fact that before the Income Tax Ordinance, 2001, the previous (repealed) Tax code had no specific provision for requiring a taxpayer to keep any sort of standard accounting documents. Documentation of

²⁷ Dr. Muhammad Irfan: Pakistan's Wage Structure: During 1990/91 to 2006/07, Pakistan Institute of Development Economics, December 2008, p 8.

²⁸ Ibid, p 16

business in Pakistan at the small business/partnership or individual level followed the traditional book-keeping from the pre-independence days which were non-standardized and often written in local languages. It was the responsibility of the tax authorities to translate and transcribe the same and make whatever sense they can out of it to extract taxable income from it. More often than not, they resorted to making an educated guess for tax incidence and subsequently levied tax on the same. This practice and experience has resulted into the time honored tradition of the tax authorities in Pakistan to resort to calculating Gross profit ratios for individual sectors based on previous averages and escape the burdensome task of annual assessment. The taxpayers, obviously, had no objection to this practice which requires no effort on their part for documentation and regularized their tax payments to a comfortable average. This lacuna on part of the previous tax code is perhaps the single most technical reason for the proliferation of informal economy. The mistake has now been corrected but the damage it did flourishes on and is resultant in the continuation of informal activities in the country.

Urbanization is another important factor that caters to the huge growth of informal economy. With 36% of total urban population and a rapid annual change rate of 3.1%²⁹, Pakistan is fast running out of urban space to cater to the surplus labor force which is naturally absorbed in low-paid, semi-skilled, non-regular employment. Most of such labor is illiterate, have a family to support back in village and are employed in fields which do not increase their vocational skills such as domestic help, transportation and general labor. However, a substantial number of them with some luck choose relatively better jobs as auto-mechanics, cooks, factory apprentices and house painters which vocation can assure a substantial income from what they were making at the villages.

²⁹ <http://www.indexmundi.com/pakistan/urbanization.html>

CHAPTER IV: ISSUES IN TAXING INFORMAL ECONOMY

Now that we have a somewhat clear idea of the nature, characteristics and extent of the informal economy, we can begin to see some of the issues that plague the regulator in making an assessment of, and subsequently, capture the informal economy for formalization. As expected, the size of the informal economy is positively correlated with tax burden and labor market restriction (in effect, barriers to formalization); it is also negatively related with proxies for quality of governance, institutional strength and rule of law along with related peripherals of corruption, security (economic and otherwise), cultural inclinations and ideological attachments of the people³⁰.

Therefore, it is imperative that at the first instant we decide whether or not to tax the informal economic activities. We first analyze the reasons for not taxing the same. Economic hardship, poverty and general level of income in the country result in taxation being unfair to the masses. Since the government is providing no substantial services to the poor people, and they have almost little or no representation in the political field, slapping them with direct taxation is almost illogical. Coupled with the fact that indirect taxation in the form of the Sales Tax ranges from 10% to 17% on goods and services that include basic necessities, any move towards stringent enforcement of direct taxation in its present stage will only be counter-productive.

Federal government expenditure has recently shown an increasing trend towards non-development expenditure including defense expenditures for the on-going war on terror. Similarly, the natural calamities such as recent floods and earthquakes have resulted

³⁰ See Sangeeta Pratab, Erwan Quintin: The Informal Sector in Developing Countries: Output, Assets and Employment. P 8

in decreased government capacity to incorporate new development initiatives that increase employment in general. Resultantly, the government has to resort to inefficient schemes such as the Benazir Income Support Program (BISP) whereby US\$10 per month are given to the selected poor families. Obviously political favoritism and corrupt practices cannot be ruled out while practically wasting millions of rupees in non productive activities; this also results in a lack of confidence in government's ability and subsequently no desire to pay any taxes.

On the other hand, totally exempting the informal sector from any kind of taxation is also not a viable option. The revenue needs of the government are increasing and the macro-economic indicators do not post a healthy trend. Combined with the fact that the informal economy has shown a persistent increased trend and phenomenal growth over the decades implies that under-taxing the same results in substantial loss of revenue to the exchequer. It has also been argued that a tendency to under-tax the informal economy is a disincentive for the formal sector to pay taxes. There is an indication from Latin American countries regarding increase in the tax compliance of formal sector if the informal sector is relatively small. Thus, ignoring informal sector activities will result in lower morale and general non compliance of Tax regulations.³¹

Yet, another reason for not completely roping-in the informal sector while devising tax policies is of State legitimacy. Informalization has been perceived as a negative reaction to the State failure and a proxy for lack of confidence in the

³¹ Joseph R A Ayee, 2007; Building Tax Compliance through Reciprocity with Government, Paper presented at the Foreign Investment Advisory Service (FIAS) of the World Bank Group Regional Conference on the theme "Enterprise Formalization in Africa", held at the Alisa Hotel, Accra on January 10 – 11, 2007

government's ability to provide for the protection of life and property. With some dissatisfaction at the country's federal character, especially in the troubled province of Baluchistan, this is the sort of question the government would wish to avoid at all costs. In such times, the writ of the State is equated with its ability to enforce regulations across the board and not being able to tap the huge resource of untaxed income is abject failure on part of the State. It may even be argued that the players in the informal economy are willing to discharge their duty in lieu of recognition of their legitimacy and gaining a clean slate for their past assets. Indeed, this is one of the powerful arguments and experience has shown its feasibility: tax authorities have regularly issued tax amnesty schemes whereby illegal money can be 'whitened' simply by paying a nominal surcharge, without any fear of ever invoking questions of its origin and penalties thereof.

After delineating the arguments both for and against tax treatment of the informal sector, it is clear that the policy choice is difficult at best. No clear theoretical foundations exist, which guide us towards the basic questions, which is whether or not to treat the informal sector any different than the formal one. Practical considerations and the ground politico-economic reality suggests that prudence, coupled with long term strategy and immediate need for enhanced revenue mobility, should guide our policies towards the informal sector. This paper is concluded by outlining the following policy recommendations categorized within Political Perspective, Capacity Constraints, Tax Policies and Institutional Framework.

Political Perspective: The political perspective involves political favoritism by parties promising tax exemptions to certain sectors of the economy in lieu of votes and campaign contributions. Pakistan has a long history of political bribery and political

parties can readily be identified with their economic support groups. Not only is there an effective blockage of the possibility of any tax measure affecting the ruling elite, such as the much needed agriculture income tax, but the Federal Board of Revenue, the apex tax collecting agency in the country, is highly politicized as well. The Chairman of the FBR is usually the first officer to be changed whenever a new government takes office and the length of his tenure in the coveted posting is an indication of his loyalty – and therefore, acceptability – by his political masters.

Tax has increasingly been seen in Pakistan as a negative connotation – not as a responsibility and duty of citizenship but more of a burden to avoid. The main reason for this is the lack of trust in government priorities evidenced by out-of-control negative economic and social indicators and increasing non-development expenditure. The inability to bring about peace in security situation is also a challenge that the government seems quite incapable to deal with.

Capacity Constraints: Taxing the informal economy is altogether different than applying regular tax laws to formal sector. Informal economy is undocumented which effectively means no accounting mechanism exists to help assess the income level. Since informal economic activities are spread over the entire urban landscape (residential houses, lands, streets, slums, etc) rather than in a limited and readily identifiable space (such as factory and offices in case of formal economy), identification and location of specific activities is a daunting task for any tax administrator. It is also far more difficult on an institutional and personal level to develop linkages with the players of informal sector and gain knowledge of the practices, constraints, trends and Gross Profit ratios of those sectors. In Pakistan, the tribal belt is one such area where the laws are not applicable and most of

the smuggling and drug/arms trafficking is taking place in those areas. Here, the constraints of the tax machinery are very much evident since it is not equipped with security measures to effectively combat such situations. In urban areas, many towns are effectively no-go areas where even the Police have trouble enforcing the law. The Inland Revenue Service does not have any such protection, which, for instance, the Pakistan Customs has for protection against border smugglers.

The usual constraints of the tax machinery such as low morale, high corruption, no institutional training system and a lethargic approach towards enforcing penal provisions of law are also responsible towards possible failure in effectively taxing the informal economy.

Tax Policies: The Presumptive Tax regime has been instituted by the government precisely to avoid having to assess the informal sector in the face of all the constraints mentioned above. It has been argued that “Taxation based on formal systems of income calculation, accounts and payment options is not appropriate to much of the informal sector. Direct presumptive taxation may be more promising.”³² It was perhaps this motive to increase the tax base through targeting the informal economic activities that, in Ghana in 1986, a new experiment to collect tax through the members of associations was instituted. This tax collection relied specifically on a scheme called Identifiable Grouping Taxation (ITG) and was implemented in the transport sector where a huge gap existed between the tax actually paid (which was close to nothing) and the tax due. The gist of the scheme was to make the association as a sort of a withholding agent for tax collection from and within its members. This scheme relied on the immediate knowledge of the

³² Ibid, p 5

association of its members and which would serve to rectify the inability of the country's Revenue department to collect due taxes. The tax collected in terms of the overall potential of payment was obviously small, given the fact that the association was not eager to punish its members severely or to remit the total amount to the government. This also underlined the sometimes illegal and mafia-like attitude displayed by informal economy players in developing country – a problem that is no less severe in Pakistan as well. But a culture of tax payment was established in Ghana through this experiment although it could no longer be kept at a viable pace due to various politico-economic considerations. Nevertheless, the experiment can be successful in Pakistan because informal sector associations are rampant and tax can easily be collected from them at the detriment of not auditing the individual member. The experiment in Ghana was in late 1980s when not only the technological knowhow nor a political will along with capacity of tax officials was developed to optimal extent; in the 21st century, we can hope to tap this huge resource of untaxed revenue by applying the same policy design, although perhaps localized procedures, to work in Pakistan.

It is also appropriate to question whether or not the tax administration is capable of taxing the illegal activities which abound in the society. This is more of philosophical question rather than a practical one since the tax code does not distinguish between immoral or illegal activities for the purpose of taxation of income. However, for obvious reasons, neither proper documentation of the same has been made (hence no reliable data available) nor any substantial categorization has been undertaken to determine the tax incidence from this sector.

Another tax policy design that can be implemented in specific response to the

characteristics inherent in, challenges posed by and needs determined of, the informal sector is what I would term “Taxation for Development” paradigm. The salient features of the said paradigm follow the arguments to determine why taxing informal economy is inefficient, impractical and imprudent and makes the following claims:

Claims on Inefficiency:

- i) Tax revenues are not significantly raised through increase in tax base of informal economy.
- ii) The low capacity of tax administration to effectively detect informal economy tax “Avoision”.
- iii) The increased chances of malpractices and corruption.

Claims on Impracticality:

- iv) Tax machinery in Pakistan is not equipped to recognize, detect and bring into tax net all informal economic activities.
- v) No documentation will result in huge un-detected economic transactions.
- vi) Tax machinery is understaffed and ill equipped with the ways and means to cover all such economic activity.

Claims on Imprudence:

- vii) Informal economy constitutes a huge voter-base and hence cannot be taxed regularly or with significance due to political pressures.
- viii) Past failure of administration to rope in the tax evaders

Therefore, in order to eventually include informal economy within the overall formal framework of the economy, the following measures need to be undertaken:

Short term:

- i) Deregulate the informal economy from ambit of regular tax laws.
- ii) Improve sustainability of security, utility and civic services provision.
- iii) Soft loans for entrepreneurial initiative should be given. Consolidation of all such government led organizations into a central body to provide sector specific guidance and loans.
- iv) Evaluation of specific sector studies to determine average Gross profit ratio to assess profitability margin.
- v) Income Tax holiday to be provided. Reduced or No Sales Tax rate to be implemented and no requirement of Return filing for 5 years except nominal Return for monitoring purposes till the entrepreneur achieves the threshold Gross Profit ratio for a continued period of 3 years.

Long term:

- i) Improving the capacity of the Tax machinery to recognize and evaluate the informal economic sectors through better training facilities, sector notes preparation and coordination with other regulators.
- ii) Bringing the informal economy gradually into the regular Sales Tax and Income Tax regime only after self sufficiency and sustainability of the taxpayer and the sector as a whole is achieved as per above criteria.

Institutional Framework: We need to see harmony in achieving objectives of the government by all departments. Economic management is not worked out by any one agency in isolation. It is a collective effort for which proper roles should be defined and

incentives laid out. Public sector institutional reform is the key to building bridges with the citizens and making them aware of their rights and duties as responsible partners in development.

There is also a need to make tax evasion a criminal act which should be a cognizable offence by law enforcement agencies. However, it can also be argued that given the huge trust deficit accompanied by rampant corruption and peripheral capacity of the Police and the Judiciary to dispense justice to the people, this move would perhaps be more resisted than complied with. Arming the FBR, seen by many as the usual corruption suspect, with even more penal provisions would be more counter-productive when the agency has yet to utilize any of the provisions already present in the law.

At present we see a myriad of institutions engaged in the same goal of bringing development assistance to the poor economic sectors but ending up being inefficient due to lack of a shared and common goal and too much bureaucratic hassles.

CHAPTER V: FORMALIZING THE INFORMAL ECONOMY

Perhaps the biggest challenge in informal economy management is to have sustainable and continued compliance by the players with the market rules of the game and the only way to ensure that is to bring formalization to the sector. This activity is not only vastly difficult but it has all sorts of difficulties and inherent dilemmas attached with the characteristics of informal economy.

As a first step we may recognize that the informal sector needs to be treated differently than the formal one and therefore, in order to help the former on the way to eventual formalization, it has been argued that to “design an ad-hoc regulatory system, different existing regulatory schemes...involv[ing] the adoption of dual or preferential regimes.”³³ But this is usually opposed on grounds of fairness and the complications associated with duality of economic systems. It is also argued that such a regime may lead to stagnation of the very enterprise it is meant to liberate. However, this does not preclude the possibility of having on ground differential treatment for instance in tax procedures, an example of which is the Presumptive tax regime. In Pakistan, many retailers and wholesalers (essentially belonging to a very visible informal sector) avail this facility through tax rates that may be as low as 0.5% of their total turnover.

A second option can very well be having a non-exclusionary regime and lowering the barriers to formalization by reducing costs of compliance such as registration fees and requirements. Another way of looking at this arrangement is to consider the informal sector as a client rather than a regulated player and to adapt the formalization requirements

³³ Victor E. Tokman, Integrating the informal sector in the modernization process.

to the ground realities and capabilities of the players. This can be done in either striking down some requirements (such as National Tax Number requirement for purchases); lowering the fees for incorporation or accepting practical arrangements for a more legal one. An example of the latter can be the acceptability of property documents as a valid way to obtain a bank credit; at present a host of other documents are usually called for including Income Tax Returns and Sales Tax Registration, etc. In-fact, this example is more than relevant since more often than not a lack of capital, and not entrepreneurial abilities, hampers the growth of a home-based cottage industry or a family shop. This may be within the spirit of the law although examples can be found of government adopting such methodologies for a specific purpose. The relaxation of the State Bank's recent prudential regulations amendment regarding collateral requirement to accept any documented property including their inventories, moveable property, and receivables is therefore, a welcome step on this direction.³⁴ This reactionary spirit is evident in the numerous tax amnesty schemes approved by FBR for the precise purpose of whitening the black economy. For a mere 2% of the tax to be collected, the whole concept of economic fidelity was given away.

Perhaps, the biggest impediments to making an economic sense of all this is the current tax administration trend which is focused on expanding tax base and relying more and more collection from Value Added Taxation (VAT). Evidently, any attempt to be lenient on the informal economic sectors can be seen to be exempting a huge potential of tax revenue while giving a "soft" impression of the government in terms of implementation. However, as has been argued above, it will benefit the economy in the long run through real growth which may, paradoxically, remain undocumented due to the

³⁴ <http://www.cipe.org/blog/?p=9834>

nature of such transactions.

Building trust regarding the government's ability to perform its stipulated duty and only *then* assume the moral and legal right to collect due taxes through lawful means is also very important. The political dimension of creating such a trust is beyond the scope of this treatise; however, simplifying procedures through less bureaucratic hassles and providing a one-window operation of registration and tax issues will certainly go a long way in improving the services to the people and hence, having them realize their citizenship duties.

Another way to increase facilitation for a sizeable number of informal sector player who ply their merchandize on street (street vendors and small shops encroaching upon public spaces) is to provide for a balanced strategy for providing the citizens their right to enjoy public space, as well as letting the vendors sell their inexpensive stuff. In Pakistan, as in most developing countries, street economy is a major part of a thriving urban business where the right to occupy a particular corner is often paid for by heavy bribes to the Police and/or town administration. One way of doing that is to create "Night Markets" where vendors can have their regular trade carried out in makeshift arrangements of tents and portable cubicles; in fact this recommendation is workable because most of the goods sold on streets are perishables, eatables, toys, stationery items and cloths which can be easily accommodated. Aside from Night Markets on streets on stipulated days, the local administration can also arrange to have local play grounds, parking areas and parks converted to instant bazaars for this purpose. In this way, the usual daily traffic in the morning and afternoon will not be hampered by the presence of vendors and the vendors will also be assured of their livelihood for the day. This suggestion is of

course not applicable for beggars, drug peddlers or sex workers or any other sector creating public nuisance.

A look at the business environment of formal and informal organizations may also be relevant here. With the advent of faster means of supply chains and increasing competitiveness, large formal organizations are adopting flexible productive systems to cater to “the supply-side fluctuations: by producing goods upon request and by getting closer to customers before and after delivering the goods. This is the kind of approach traditionally followed by small businesses. [Therefore] a new opportunity is opening up.”³⁵ This presents a challenge where through a culture change in the informal sector, a more comprehensive and success oriented strategy will result in better profits and hence, by dint of necessity, a need to incorporate in the main stream economic regime.

It is important to our understanding that a vibrant informal economic sector is in the larger interest of the country’s economic growth, though its persistence is also an indication of growing consumer demand and imperfect market conditions along with the usual inherent reasons such as barriers to entry and strict taxation regime. Perhaps the biggest change for the policy makers is to start viewing the informal economy as a partner in progress; an extra-legal arm of the formal economy which needs to be nurtured and brought into the fold rather than be abandoned and left to wander along the murky corridors of illegality.

³⁵ Victor E. Tokman, Integrating the informal sector in the modernization process, p 11

CHAPTER VI: PROPOSED TAX REGIMES

Pakistan's tax structure is highly skewed towards the formal sector in the sense that it taxes every income that is documented and netted within the economy. Since the country is not highly industrialized, many financial transactions also take place within the old system of cash and/or indigenous methods of borrowing and transfer of money. Often these methods are illegal such as *hawala*, which employs transfer of money without movement of money thus bypassing the normal banking channels. It is largely based on an honour code which is recognized within the industry and, contrary to popular belief, works within the country as well as outside it. The unique feature of *hawala* is that the system generates no financial documentation and therefore, escapes regulatory detection.

In the absence of such evidence, it is indeed very difficult for an equitable tax regime to undertake policies which might evenly distribute the national burden on various taxpayers. The IMF report³⁶ on revenue mobilization contends that small businesses may not be the best revenue generators since they have fixed tax revenue potential. It also points out a fundamental dilemma of regulators in that they devote huge resources to extract taxes out of this segment but often the costs are too high to justify the results. The report further states that the tax treatment of such businesses may have an important role, which is above and beyond any revenue mobility in that it has employment generating capabilities and, consequently, political importance. In fact, it goes on to suggest that such taxes ease competitiveness and eases distortions even if the revenue impact is inefficient.³⁷

Another area in which tax regimes are deficient is the use of VAT which is hardly

³⁶ International Monetary Fund, Revenue Mobilization in Developing Countries, 2011, p.39

³⁷ Ibid, p.40

efficient in that the compliance may not be made properly given the non-documentation of economy in general and the reluctance of people in particular to evade any taxes they deem to be discriminatory. In Pakistan, recent attempt by the government to introduce VAT in the nomenclature of Reformed General Sales Tax (RGST) has been met with resistance and effective boycott by the trade associations especially in the post 2011 flood scenario in the country.³⁸

Contributing to this dismal economic scenario is the fact that domestic taxation specifically the Personal Income tax (PIT) shows the most unfavorable growth potential among the major tax streams i.e. PIT, Sales Tax, Excise Duty and Customs Duty. The Federal Board of Revenue (FBR), the apex tax regulator in Pakistan, released the figures³⁹ of tax collection for the penultimate quarter of the FY 2012 according to which, the growth in domestic taxes is estimated at 25.1% as compared to the previous period; however, that is largely due to the Sales Tax (33.3%) and not the PIT.

GOVERNMENT OF PAKISTAN REVENUE DIVISION FEDERAL BOARD OF REVENUE ***** Tax collection figures (Net) for and upto March, 2012 (Rs. in million)						
Revenue Head	For March, 2012			Upto March, 2012		
	2011-12	2010-11	Growth (%)	2011-12	2010-11	Growth (%)
A. DOMESTIC TAXES (1 TO 3)	135,452	125,785	7.7	1,118,014	893,376	25.1
1. DIRECT TAXES	68,266	66,674	2.4	473,648	381,617	24.1
2. SALES TAX (a+b)	59,674	48,495	23.1	563,324	422,671	33.3
a) ST on Import	33,696	23,502	43.4	312,901	211,979	47.6
b) ST on Domestic	25,978	24,993	3.9	250,423	210,692	18.9
3. FEDERAL EXCISE(c+d)	7,512	10,616	-29.2	81,041	89,088	-9.0
c) FED on Import	637	1,756	-63.7	6,605	12,359	-46.6
d) FED on Domestic	6,875	8,860	-22.4	74,436	76,729	-3.0
B. CUSTOMS	20,473	18,387	11.3	148,025	126,773	16.8
Total Taxes	155,925	144,172	8.2	1,266,039	1,020,149	24.1

Coupled with the fact that these figures should also be offset against the rising

³⁸ http://www.dailytimes.com.pk/default.asp?page=2010%5C11%5C22%5Cstory_22-11-2010_pg7_31

³⁹ <http://www.fbr.gov.pk/Docs/201249144024563TaxCollectionFigure.pdf>

inflation estimated⁴⁰ at 11.3% for April 2012 in the country (as shown below) speaks of not only the unwillingness of taxpayers to pay the PIT but also the failure of regulators who rely on rising price of goods to generate positive indicators of Sales Tax increases.



Another reason for low PIT collection is the low number of Returns filed by the taxpayers themselves. Already the dismally small figure of about 2.2 Million taxpayers are showing a declining trend of filing of Income Tax Returns with the filers dwindling from 1.965 Million in FY 2010 to 1.3 Million for the FY 2011⁴¹.

One more reason for decline in direct taxation is the cut in Public Sector Development Program (PSDP) which results in huge withholding taxes on development projects contracts. This trend seems to persist as direct taxation touches 39% of the total revenue realization and PIT contributes minimally to that basket.⁴²

Coupled with the worsening socio-political conditions of the country and low

⁴⁰ <http://www.tradingeconomics.com/pakistan/inflation-cpi>

⁴¹ <http://dawn.com/2012/02/27/enforcing-tax-compliance/>

⁴² <http://www.fbr.gov.pk/Docs/201215151230514Final%20Yearbook%202010-11.pdf>

prestige in the eyes of international donors, it seems imperative that a tax regime is introduced which caters to the peculiar nature of informal economic sectors, provides relief to the players and seeks to formally induct them in regular economic structure in a progressive, gradual and practical way. Delineated below are some of the recommendations which, *inter-alia*, may outline and define the broad scope and extent of such a tax regime:

i) The tax regime should first and foremost realize that the purpose of taxation in a developing country is not just revenue collection but to provide a conducive economic environment for players of various categories and orientations. Informal economy exists in the region for centuries and no regulatory framework will be able to net it within the normal environment fully. Leakages will always be present either by legal failure (lacunae in the law by which tax is effectively evaded), corruption or simply inability to regulate everything. Poverty, lawlessness, political patronage and adherence to traditional way of life (including barter transactions, non maintenance of records, etc), distrust in State agencies all contribute towards a societal attitude in which tax is seen as a burden to be avoided rather than a duty to be performed.

ii) The informal sector is already subject to various taxation regimes such as Sales Tax on general consumption, property taxes by local governments and withholding taxes on electricity, telephone, gas and water bills. These taxes are unavoidable and contribute towards cost escalation of their life style maintenance as well as low profit margin for their products. It must be remembered that informal sector goods and services have a limited scope and extent due to their low quality and limited shelf life.

iii) For the numerous reasons discussed above, subjecting the informal sector to PIT is counterproductive as far as the present structure of the country and income distribution is concerned.

iv) The players of such sectors may be identified through a broad based survey aimed at recognizing pockets and clusters of areas where such economic activities are taking place. In Pakistan, that means slums and other underdeveloped habitats usually engaged in a particular trade *en bloc*. For instance, Karachi's cattle colony engages in buffalo milk trade where almost every house is a mini dairy farm. Similarly, in other areas people develop cottage industries such as those of bangles (women's ornamental accessory) in Hyderabad in order to have economies of scale and local expertise.

v) The next stage to identification of such players is the realization and calculation of economic impact of their activities including downward linkages to other informal sectors, mainly general labor, which is affected by every activity formal or otherwise. Employment generation potential must be one of the most important yardsticks by which a sector be evaluated in terms of future tax potential and formalization process.

vi) The informal sector players may be encouraged to form an association where it is feasible and further negotiations regarding tax treatment should be made within that forum. This strategy has worked well with the formal sector in Pakistan and can also be successfully replicated in the informal sector.

vii) For a period of three years, all the players of a particular sector may be granted exemption/waiver from PIT initially for a period of 3 years.

viii) Gross Profit Ratio of the sector may be determined through analysis of

business and the taxpayers may be required to file nominal PIT Returns during the period of waiver. This will not only ensure correct determination of income potential in the sector but will also induce a habit of keeping documentation and records of all transactions by the taxpayer. Strict vigilance in this regard is required from the FBR so that the taxpayer, while enjoying the benefits of waiver, should not remain lax of his national duty by providing valuable information regarding the business income potential.

ix) During this period the FBR must determine a threshold Gross Profit Ratio for the particular sector over and above which the taxpayer may be taxed as per Provisional Tax Regime. This scheme envisages a tax at a fixed percentage of Gross Sales rather than Income of a particular taxpayer because of various reasons such as huge number of taxpayers, non documentation of transactions, economic and accounting illiteracy of taxpayer and practical difficulties in keeping transaction records, etc.

x) When the Gross Profit Ratio is achieved for a continued 3 year period, the household/informal enterprise may be registered as a regular taxpayer i.e. formalized.

xi) Normal taxation may be undertaken once the business is formalized. Obviously, there would be a crystallization period during which time the practical realities of the policy will have to be incorporated in a rationalized way in order to achieve an optimum level of efficiency in implementation of this scheme.

CONCLUSION

Informal sector taxation is a sensitive topic. On the one hand, there is the realization that extreme poverty, hardship and challenges to survival warrant exemption from any form of taxation. On the other hand, principles of economic justice and equality demand that any form of income must be taxed especially that of the informal sector (which sometimes include illegal sectors as well such as drugs and smuggling). Political patronage to slum dwellers also means that the government is never really serious about introducing a long term strategy for taxing the poor properly and relies on stop gap arrangements. One of these methods is provision of subsidy on various goods such as electricity and petroleum which policy is self defeating in that it raises the price of every other commodity and the lot of the poor is not ameliorated.

It is therefore, of the utmost importance that the extent, scope and economic value of the informal enterprise may be estimated thoroughly and measures devised to formulate it effectively within the mainstream. One of those ways is suggested in this dissertation which deals with the practical realities of informality in Pakistan. If the concept is incorporated in government policy, it can have a substantial impact on formalization efforts in the country and may help to bring a large number of taxpayers within the ambit of income taxation.

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