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WHY HAS THE TAX-TO-GDP RATIO FALLEN?

SOCIAL POLICY AND DEVELOPMENT CENTRE

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Pakistan's tax*-to-GDP ratio stands today at just above 11 per cent. It has been falling steadily from the peak of 12½ per cent attained in 1995-96, with the first signs of some recovery in 1999-2000. As a whole over the ten year period, 1990-91 to 2000-02, there has little improvement in the tax-to-GDP ratio. The time path of this ratio during the 90's is an inverted U-shape, with a significant increase in the first half of the decade upto 1995-96, followed in the second half by a sharp fall.

The fall in tax-to-GDP ratio in recent years has come at a time when government's efforts have been increasing focused on macroeconomic stabilization, under the impetus of various on-going IMF programs. Greater emphasis has been placed on budget deficit reduction in order to contain the rate of inflation and restore a measure of fiscal sustainability by arresting the increase in the debt-to-GDP ratio. But the fall in the tax-to-GDP ratio has made this task increasingly difficult, necessitating sharp cutbacks in public expenditure, especially on development, thereby affecting the growth momentum of the economy. In addition, the falling share of divisible pool** taxes in the GDP has implied lower growth in inter-governmental transfers to the provincial governments, leading to a less of dynamism in social sector expenditures.

What has caused the fall in the tax-to-GDP ratio? A number of explanations can be put forward in this regard. The first is the loss of growth momentum of the economy, especially of large-scale manufacturing and imports, which constitute the primary tax bases in the economy. This has implied a low marginal tax-to-GDP ratio, which has resulted over time a fall in the average tax-to-GDP ratio. The second explanation is related to revenue losses resulting from the on-going tax reforms in the country during the decade of the 90's,

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especially the process of trade liberalization which has involved major reductions in statutory rates of import tariffs. Finally, there is a strong perception that there has been a systemic decline in the quality of tax administration and in the face of growing evasion and corruption, it is argued the incidence of taxes has effectively declined.

The objective of the paper is to disentangle the various effects on the tax-to-GDP ratio during the 90s. Part II describes the trend overall and in individual taxes. Major changes observed over the period are highlighted. Part III describes the methodology used to decompose the change in tax-to-GDP ratio. Part IV presents the results. Finally, Part V gives the key policy implications of the research.

II THE TRENDS

Table 1 gives the tax-to-GDP ratio overall and for individual taxes from 1989-90 to 2000-01. The analysis is restricted to federal taxes, which constitute the bulk (over 90 per cent) of the tax revenues in the country. Therefore, we concentrate on taxes collected by the Central Board of Revenue (CBR).

Major changes are observed during the period in the structure of tax revenues. First, the share of direct taxes has increased dramatically from about 15 per cent at the end of the decade of 80s to almost 33 per cent in 2000-01. Second, within indirect taxes, there have been significant changes in the importance of different taxes. The contribution of customs and excise duties has declined sharply while that of sales tax has risen.

Looking at the time path of individual taxes, we have that the tax-to-GDP ratio of direct taxes doubled between 1989-90 and 1995-96 and has since remained, more or less, constant. The earlier dynamism is attributable primarily to the extension of the net of withholding and presumptive taxes to a wide variety of transactions. This tax reform was apparently successful in curbing evasion and thereby leading to a major jump in revenues. In the second half of the decade, corporate profitability has been adversely affected by the on-going recession in the economy. Consequently, direct tax revenues have exhibited less buoyancy.

TABLE 1
TAX-TO-GDP RATIO, 199-90 TO 2000-01

Year	Direct Taxes	Excise Duties	Customs Duties	Sales Tax	Total Indirect Taxes	Total Taxes
1989-90	1.8	2.5	5.9	1.8	10.3	12.1
1990-91	1.9	2.3	5.0	1.7	9.1	11.0
1991-92	2.4	2.5	5.1	1.7	9.3	11.7
1992-93	2.7	2.6	4.7	1.8	9.1	11.8
1993-94	2.8	2.2	4.1	1.9	8.2	11.0
1994-95	3.3	2.3	4.1	2.3	8.8	12.0
1995-96	3.6	2.4	4.2	2.3	8.9	12.5
1996-97	3.5	2.3	3.5	2.3	8.0	11.5
1997-98	3.9	2.3	2.8	2.0	7.1	11.0
1998-99	3.5	2.1	2.7	2.4	7.1	10.6
1999-2000	3.4	1.8	2.0	3.7	7.5	10.9
2000-01	3.7	1.4	1.9	4.4	7.7	11.4

Source: CBR Year Book, Economic Survey, various issues.

The tax-to-GDP ratio of excise duties showed only minor change upto 1997-98. During the last three years, however, the ratio has fallen significantly. This is partly a reflection of the stagnation of the larger-scale manufacturing sector in the late 90s and partly the consequence of on-going tax reforms involving the replacement of excise duty by sales tax in a number of industries and services.

The most visible decline in the tax-to-GDP ratio during the 90s is in the case of customs duties. The process of trade liberalization has implied major reforms in the area of taxation of international trade. In the first phase, export duties were eliminated in the early 90s. This was followed in the mid-90s by the abolition of various forms of para tariffs, primarily import surcharges. The momentum for scaling down import tariffs picked up in the second half of the 90s. The maximum import tariff is down from 125 per cent in the early 90s to 30 per cent currently. Simultaneously, there have also been changes in the exemptions and concessions policy, as reflected in the various Statutory Rules and Orders (SROs) promulgated during the period.

The tax-to-GDP ratio of the sales tax rose modestly upto 1998-99, and more rapidly during the last two years, such that it is now the largest source of revenue. The recent jump is attributable to major broad-basing of the tax to cover sectors like cement; petroleum, oil and lubricants; electricity and other services. In most cases it has substituted for other sources of revenue like excise duty and petroleum development surcharge. Therefore, in terms of the impact on total revenues, tax plus non-tax, this reform is probably largely neutral.

III DECOMPOSITION

The next stage of the analysis is to decompose the impact of different factors on the changes observed above in the tax-to-GDP ratio for individual taxes and for CBR as a whole. We are interested, in particular, in isolating the 'base' and 'rate' effects respectively. The former essentially identifies to what extent the change in tax-to-GDP ratio is due to change in the ratio of the tax base to GDP. That is, if the tax base of a tax is stagnant/buoyant in relation to the GDP then the 'base' effect will be negative/positive, implying, other things being equal, a fall/rise in the tax-to-GDP ratio.

The 'rate' effect is meant to primarily capture the change in the 'effective' tax rate on the tax base. Effective rates can change either if statutory tax rates are altered or if, given unchanged statutory rates, there is a change in the efficiency of tax collection. For example, if statutory rates fall, as happened in the case of import duty during the 90s, then the 'rate' effect will be negative.

The methodology for attributing any change in the tax-to-GDP ratio to the 'base' and 'rate' effects respectively is described below.

We designate the following:

T	=	actual tax revenue
t	=	effective tax rate
B	=	tax base
Y	=	GDP

That is, T= tB

Subscripts 0 and 1 designate the base and terminal years respectively.
The change in the tax-to-GDP ratio is given by

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = \frac{t_1 B_1}{Y_1} - \frac{t_0 B_0}{Y_0}$$

$$= \frac{t_1 B_1}{Y_1} - \frac{t_1 B_0}{Y_0} + \frac{t_1 B_0}{Y_0} - \frac{t_0 B_0}{Y_0}$$

That is,

$$\frac{T_1}{Y_1} - \frac{T_0}{Y_0} = t_1 \left[\frac{B_1}{Y_1} - \frac{B_0}{Y_0} \right] + \frac{B_0}{y_0} \left[t_1 - t_0 \right] \qquad \ldots\ldots\ldots\ldots [1]$$

² base effect ÷ ² rate effect ÷

Equation (1) gives the expressions for the base and rate effects respectively. Results of the analysis are presented in the next section.

IV RESULTS

The results are highlighted first for individual taxes.

Direct Taxes

Ideally, the tax base for a tax should consist of that part of the economy which actually pays this tax. Therefore, exempted sectors should not be included in the tax base. However, precise measurement of the tax base is frequently rendered difficult by data limitations.

Given data constrains, the tax base chosen for direct taxes is the non-agricultural GDP. Value added by the agricultural sector has been excluded from the tax base because, as per the Constitutional provisions, agricultural income is exempt from federal income taxation. In addition, there is limit upto which personal incomes are exempted from the income tax. Ideally this component of income should also be excluded from the tax base. But such information is not available on an annual basis. Beyond this, there are a number of special income streams, identified in the Second Schedule of the Income Tax Ordinance, that also do not carry any income tax liabilities. But information on the extent to which these special provisions erode the direct tax base is also not available. Therefore, as a somewhat crude proxy, the tax base for direct taxes is taken as non-agricultural GDP.

Table 2 gives the tax-to-GDP ratio, tax base-to-GDP ratio and effective tax rate for direct taxes. The 'base' effect appears to be small, as indicated by the modest improvement in the tax base-to-GDP ratio. The change in direct taxes-to-GDP ratio is due primarily to the 'rate' effect. During the period, 1989-90 to 1995-96, when this ratio rose rapidly, the effective tax rate showed a corresponding large increase. Beyond this, the effective rate has shown little change.

What explains the rise in the effective rate of direct taxes in the first half of the decade of the 90s? The answer cannot be found in enhancement in statutory rates, which have actually tended to decline. The marginal rates of personal income tax and the corporate tax rates have generally been brought down over the period. The explanation for the major increase in the tax-to-GDP ratio of direct taxes in the first half of the 90's has to be found initially in the

extension of the withholding / presumptive tax net to a large number of income flows, especially capital and unearned income, and subsequently in enhancement in withholding presumptive tax rates.* It is clear, however, that much of the gains from such reforms had been obtained by the mid-90s. The second half of the 90s saw some loss of momentum in direct tax revenues because of non-implementation of the second phase of reforms involving development of a better system for the declaration and assessment of the global income of tax payers.

TABLE 2
DIRECT TAXES: TAX-TO-GDP RATIO, TAX BASE-TO-GDP RATIO AND EFFECTIVE TAX RATE, 1989-90 TO 2000-01

(%)

Years	Tax-to- GDP Ratio $\left(\frac{T}{Y}\right)$	Tax Base-to-GDP Ratio $\left(\frac{B}{Y}\right)$	Effective Tax Rate (t)
1989-90	1.8	65.7	2.8
1990-91	1.9	66.2	2.9
1991-92	2.4	65.7	3.6
1992-93	2.7	67.3	4.1
1993-94	2.8	67.1	4.1
1994-95	3.3	66.5	4.9
1995-96	3.6	58.2	5.4
1996-97	3.5	67.6	5.1
1997-98	3.9	67.4	5.7
1998-99	3.5	67.9	5.2
1999-2000	3.4	68.4	5.0
2000-01	3.7	69.0	5.3

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

We apply equation (1) to estimate the magnitude of the base and rate effects in the case of direct taxes for two sub-period- 1989-90 to 1995-96, 1995-96 to 2000-01. Results are given in Table 3 below.

TABLE 3
DECOMPOSITION OF CHANGE IN TAX-TO-GDP RATIO
DIRECT TAXES

(% of GDP)

Period	Change in Tax-to-GDP Ratio	Base Effect	Rate Effect
1989-90 to 1995-96	1.8	0.1	1.7
1995-96 to 2000-01	0.1	0.1	0.0
1989-90 to 2000-01	**1.9**	**0.2**	**1.7**

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

As expected, the improvement in the tax-to-GDP ratio is primarily due to the rate effect, with most of the change taking place in the first half of the decade. Tax reforms during this period appear to have yielded additional revenues of almost two percent of the GDP.

Excise Duty

The tax base of excise duty consists primarily of value added in large scale manufacturing. Major consumer goods industries like cigarettes, sugar, cement, etc., have traditionally been subject to excise duty. Most excises are specific and not ad valorem in character. During the early 90s, the tax net of excise duty was extended to cover some services, e.g. an excise duty was levied on bank advances. In addition, telephone services are liable for excise duties, alongwith a range of other professional services. Given the incremental coverage, therefore, the tax base for excise duty has been extended to include value added in banking and insurance, and transport and communications.

In the second half of the 90s, however, tax reforms have led to a contraction in the tax base for excise duty. The excise duty on bank advances has been withdrawn. A number of

industries and services have been subjected to sales tax in lieu of the excise duty. These changes are incorporated in our estimates of the tax base. As can be seen in Table 4, the tax base-to-GDP ratio for excise duty expanded in the early 90s and has since contracted sharply, especially in the last three years.

TABLE 4
EXCISE DUTY: TAX-TO-GDP RATIO, TAX BASE-TO-GDP RATIO AND EFFECTIVE TAX RATE, 1989-90 TO 2000-01

(%)

Years	Tax-to- GDP Ratio $\left(\frac{T}{Y}\right)$	Tax Base-to-GDP Ratio $\left(\frac{B}{Y}\right)$	Effective Tax Rate (t)
1989-90	2.5	20.5	12.2
1990-91	2.4	21.3	11.4
1991-92	2.5	21.6	11.6
1992-93	2.6	22.7	11.5
1993-94	2.2	23.4	9.4
1994-95	2.3	22.7	10.2
1995-96	2.4	22.4	10.7
1996-97	2.3	22.6	10.0
1997-98	2.3	23.0	10.1
1998-99	2.1	20.7	10.0
1999-2000	1.8	18.4	9.7
2000-01	1.4	16.6	8.7

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

The effective tax rate has shown a secularly declining trend. This is essentially a reflection of incomplete adjustment of the specific tax rates to inflation. Also, some statutory tax rates have been revised down as a counter evasion measure. The consequence is a fall in the effective tax rate from over 12 per cent in 1989-90 to below 9 per cent in 2000-01.

Altogether, the significant fall in the tax-to-GDP ratio of excise duty appears to be a reflection both of negative 'base' and 'rate' effects, as shown in Table 5.

TABLE 5
DECOMPOSITION OF CHANGE IN TAX-TO-GDP RATIO
EXCISE DUTY

(% of GDP)

Period	Change in Tax-to-GDP Ratio	Base Effect	Rate Effect
1989-90 to 1995-96	-0.1	0.2	-0.3
1995-96 to 2000-01	-1.0	-0.6	-0.4
1989-90 to 2000-01	**-1.1**	**-0.4**	**-0.7**

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

Much of the decline in the tax-to-GDP ratio of excise duty is in the second half of the 90s. This is, more or less, evenly distributed between the 'base' and 'rate' effects. During this period, it appears that the withdrawal of excise duties from a number of sectors has led to a revenue loss of about 0.5 per cent of the GDP.

Customs Duty

As highlighted earlier, the sharpest drop of four per cent of the GDP is observed during the period in customs duty. We have also hypothesised that this is probably due mostly to a fall in the level of import tariffs. To test this, we first specify the relevant tax base for this tax. The chosen tax base is dutiable imports, that is, total value of imports minus imports of items which are exempt from import duty like food, fertilizer and pharmaceuticals. There are, of course, other types of exemptions and concessions also which need to be considered. Such special treatment is embodied in the various SROs. But data is not available on the value of imports covered by the SROs and, therefore, we are unable to exclude such imports from the tax base.

Trends in the tax base-to-GDP ratio and the effective tax rate of customs duty are presented in Table 6. The former appears to vary year-to-year depending, in particular, on fluctuations in international prices. But in the second half of the 90s, the level appears to be noticeably lower. This is probably a reflection of the depressed demand for imports of raw materials and capital goods in the economy due to the prevailing recession and lack of buoyancy of the manufacturing sector.

TABLE 6
CUSTOMS DUTY: TAX-TO-GDP RATIO, TAX BASE-TO-GDP RATIO AND EFFECTIVE TAX RATE, 1989-90 TO 2000-01

(%)

Years	Tax-to- GDP Ratio $\left(\frac{T}{Y}\right)$	Tax Base-to-GDP Ratio $\left(\frac{B}{Y}\right)$	Effective Tax Rate (t)
1989-90	5.9	11.3	52.6
1990-91	5.0	10.9	45.4
1991-92	5.1	13.5	37.9
1992-93	4.7	13.1	35.9
1993-94	4.1	11.3	36.3
1994-95	4.1	11.3	36.6
1995-96	4.2	12.1	34.2
1996-97	3.5	12.1	29.0
1997-98	2.8	10.5	26.5
1998-99	2.7	10.4	25.6
1999-2000	2.0	10.2	19.8
2000-01	1.9	10.6	17.5

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

The effective tax rate of customs duty has fallen dramatically during the decade of the 90s. At about 17 per cent currently, it is less than one thirds of the level prevailing in 1989-90. This is clearly the consequence first of withdrawal of para tariffs followed by substantial cascading down of import tariffs generally. It appears, therefore, that the collapse of customs duty revenues is a reflection of tariff reforms undertaken as part of the process of trade liberalisation in the economy.

Application of equation (1) leads to the estimates of the 'base' and 'rate' effects given in Table 7. The fall in tax-to-GDP ratio of customs duty emerges clearly as a rates-driven story. It appears that tariff reforms, involving a general scaling down of tax rates, have implied a very sustainable revenue loss of as much as four percent of the GDP.

TABLE 7
DECOMPOSITION OF CHANGE IN TAX-TO-GDP RATIO
CUSTOMS DUTY

(% of GDP)

Period	Change in Tax-to-GDP Ratio	Base Effect	Rate Effect
1989-90 to 1995-96	-1.7	0.6	-2.3
1995-96 to 2000-01	-2.3	-0.5	-1.8
1989-90 to 2000-01	**-4.0**	**0.1**	**-4.1**

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

Sales Tax

Sales tax is levied both at the import and domestic production stages. During the decade of the 90s it has acquired the characteristics of a value added tax. Therefore, the tax base initially chosen for the sales tax is the value of dutiable imports plus revenue from import duty plus value added by large-scale manufacturing. In recent years there has been a major broad-basing of the sales tax and it has increasingly substituted for customs and excise duty and the petroleum development surcharge. The size of the tax base has been extended accordingly to reflect this reform.

Magnitude of the tax base-to-GDP ratio and the effective tax rate for the sales tax are presented in Table 8. The former had shown a declining tendency upto 1998-99 primarily due to lack of rapid growth in taxable imports. The major broad-basing initiative recently has, however, led to a big once-and-for-all jump in the tax base to GDP ratio. Effective tax rates have shown a rising tendency throughout the period. However, since we are unable to fully quantify the broad-basing effort, it is likely that the 'rate' effect is somewhat overstated while the 'base' effect is correspondingly under stated.

TABLE 8
SALES TAX: TAX-TO-GDP RATIO, TAX BASE-TO-GDP RATIO AND EFFECTIVE TAX RATE, 1989-90 TO 2000-01

(%)

Years	Tax-to- GDP Ratio $\left(\frac{T}{Y}\right)$	Tax Base-to-GDP Ratio $\left(\frac{B}{Y}\right)$	Effective Tax Rate (t)
1989-90	1.8	28.1	6.5
1990-91	1.7	26.9	6.2
1991-92	1.7	29.3	5.9
1992-93	1.7	28.4	6.2
1993-94	1.9	26.3	7.4
1994-95	2.3	26.2	8.9
1995-96	2.3	26.9	8.8
1996-97	2.3	26.0	8.7
1997-98	2.0	23.9	8.4
1998-99	2.3	23.6	9.9
1999-2000	3.7	32.2	11.3
2000-01	4.4	37.1	11.8

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

Results of decomposition are presented in Table 9 below. As expected, the big increase in the tax-to-GDP ratio in recent years is primarily due to the 'base' effect, which has contributed to additional revenues of almost 1.5 per cent of the GDP. However, for the period as a whole the contribution of the two effects is, more or less, the same.

TABLE 9
DECOMPOSITION OF CHANGE IN TAX-TO-GDP RATIO
SALES TAX

(% of GDP)

Period	Change in Tax-to-GDP Ratio	Base Effect	Rate Effect
1989-90 to 1995-96	0.5	-0.1	0.6
1995-96 to 2000-01	2.1	1.4	0.7
1989-90 to 2000-01	**2.6**	**1.3**	**1.3**

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

Total Taxes

We are now in a position to summarise our principal findings for the tax system as a whole, based on the overall decomposition of the change in the aggregate tax to GDP ratio given in Table 10. The following conclusions can be highlighted:

(i) The improvement in the total tax-to-GDP ratio in the first half of the decade of the 90s is due largely to favourable 'rate' effects on direct taxes and sales tax and 'base' effect on customs duty which were able to more than neutralize a large unfavourable 'rate' effect on customs duty. In other words, tariff reforms adopted over the period were more than balanced by successful reforms in direct and sales taxes.

(ii) The significant deterioration in the total tax-to-GDP ratio in the second half of the decade of the 90s is the result largely of unfavourable 'rate' effect on customs duty and 'base' effects on customs duty and excise duty which collectively exceeded favourable 'base' and 'rate' effects on sales tax. This implies that in the second half of the 90s revenue losses due to the phasing out

of import tariffs and excise duties were not fully compensated for by broad-basing and rate enhancement efforts in the case of the sales tax.

TABLE 10
DECOMPOSITION OF THE CHANGE IN TAX-TO-GDP RATIO
TOTAL TAXES

(% of GDP)

Tax	Change in Tax-to-GDP Ratio	Base Effect	Rate Effect
	1989-90 to 1995-96		
Direct Taxes	1.8	0.1	1.7
Excise Duty	-0.1	0.2	-0.3
Customs Duty	-1.7	0.6	-2.3
Sales Tax	0.5	-0.1	0.6
Total Taxes	**0.5**	**0.8**	**-0.3**
	1995-96 to 2000-01		
Direct Taxes	01	1.4	0.0
Excise Duty	-1.0	-0.6	-0.4
Customs Duty	-2.3	-0.5	-1.8
Sales Tax	2.1	1.4	0.7
Total Taxes	**-1.1**	**0.4**	**-1.5**
	1989-90 to 2000-01		
Direct Taxes	1.9	0.2	1.7
Excise Duty	-1.1	-0.4	-0.7
Customs Duty	-4.0	0.1	-4.1
Sales Tax	2.6	1.3	1.3
Total Taxes	**-0.6**	**1.2**	**-1.8**

Source: Estimates based on CBR Year Book and Economic Survey, various issues.

V POLICY IMPLICATIONS

The analysis above has enabled quantification, perhaps for the first time, the revenue consequences of the major tax reforms pursued during the decade of the 90's, as follows:

(i) Reforms in the income tax system in the first half of the 90s involving imposition and enhancement of withholding and presumptive taxes on different income streams (especially capital and unearned income) have contributed additional revenues of almost two per cent of the GDP, equivalent to almost Rs 70 billion.

(ii) The phasing out of excise duties in the second half of the 90s has implied a revenue loss of about 0.5 per cent of the GDP, amounting to over Rs 17 billion.

(iii) the process of trade liberalization during the 90s, involving abolition of para tariffs and substantial scaling down generally of import tariffs has implied cumulatively by 2000-01 a large revenue loss of as much as four percent of the GDP, equivalent to Rs 140 billion.

(iv) The substantial broad-basing of the sales tax in the second half of the 90s, primarily as substitution of other sources of revenue like customs and excise duty and the petroleum development surcharge, has mobilised additional revenues from the tax of almost 1.5 per cent of the GDP, in excess of Rs 50 billion.

The basic conclusions, however, from the analysis of factors contributing to the change in the overall-tax-to-GDP ratio is that, in the second half of the 90's, there were serious problems with the process of sequencing of tax reforms in the country. From a revenue viewpoint, the pace of reduction of import tariffs was too rapid in relation to efforts at development of the income tax system and broad-basing of the sales tax. While sizeable revenue losses were being incurred in the customs duty, CBR was unable to simultaneously make a transition to a modern income tax system based on assessment of the comprehensive income of tax payers and extend the sales tax to sectors like wholesale and retail trade and small-scale manufacturing. The result was that by the end of the decade, tax revenues had fallen by over 1.5 per cent of the GDP in relation to the peak level attained in 1995-96.

What are the policy implications of the analysis? One obvious implication is that the process of trade liberalization, involving further reduction in import tariffs, needs to be slowed down. This process has not yet contributed to any major upsurge in exports. Instead, the fall in the tax-to-GDP ratio has translated into a corresponding reduction in the level of development expenditure, which has reduced the growth rate of the economy. But with the maximum import tariff already down to 30 per cent, the scope for further reform appears to be limited. The government has, however, committed to the IMF a further reduction to 25 per cent next year. This will not only contribute to some further losses of revenue but will also carry protection to Pakistani industry down to dangerously low levels.

Meanwhile, top priority will have to be attached by CBR to pursuing reforms of the income tax and sales tax. This will require a systemic improvement in the quality of tax administration. In the area of income tax, the large number of exemptions will have to be phased out coupled with a withdrawal of some of the withholding and presumptive taxes to enable taxation of the total income of tax payers on the basis of filing of returns and greatly improved assessment procedures. The sales tax will have to be effectively extended to sectors like domestic trade and small-scale manufacturing which have hitherto proved difficult to tax. This will require demonstration of greater political will and major strengthening of the sales tax administration.

Otherwise, given the ambitious target for enhancement of the tax-to-GDP ratio in the next three years which the government has committed to the IMF as part of the conditionalities attached to the PRGF, some unpopular and potentially regressive measures will have to be undertaken.

This includes the taxation of food items by the imposition of GST on agricultural inputs and its extension to basic items like vegetable ghee, medicines and domestic consumption of electricity. In addition, there is the strong likelihood that pressure will be put of Pakistan to raise the standard rate of the sales tax from the present 15 per cent to perhaps as much as 20 per cent. Overall, the next round of tax reforms will determine whether the tax-to-GDP ratio rises significantly once again and in ways which do not place an undue burden on the poorer sections of society.

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