Full length article

The determinants of tax morale in Pakistan

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A B S T R A C T

This paper examines the determinants of tax morale in Pakistan, a country that has struggled with low tax effort over the past decade. We exploit novel data for individual taxpayers collected in 2014 by Pakistan's Federal Board of Revenue to estimate a binary probit regression model. Our results are generally in line with the findings of the modern empirical literature on tax morale in other countries. Overall, groups with lower labor force participation show more positive attitudes toward tax compliance. Educated respondents exhibit higher tax morale than the illiterate, but only for those with very low or very high educational attainment is tax morale higher than for those with bachelor's degrees. Tax morale is highest in major industrialized population centers that serve as seats of government. Females show generally higher tax morale than males, however, their attitudes tend to worsen with age to such an extent that elderly females have lower tax morale than elderly males. Our findings on gender suggest potential gains from increasing female labor force participation rates. More generally, addressing the current failures of tax administration and dealing with horizontal inequity arising from administrative weaknesses may contribute materially to improving voluntary compliance.

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1. Introduction

Pakistan with its 200 million population has exhibited an ongoing struggle with low tax collection. With tax collections at 11% of GDP in 2015, Pakistan has a low tax effort for its current level of development and its needs in public infrastructure and basic services (IMF, 2016a, 2016b).[1] Moreover, its tax collection effort, as a percent of GDP, has seen a downward trend for most of the last two decades. At present it is 1.4% points below its peak level of collection at 12.6% of GDP in 1996 (IMF, 2016a, 2016b). Low revenue collections have been reflected in the large federal government deficit which has fluctuated around 6% of GDP over the past decade. Large expenditures needs in the shape of public expenditures on major improvements in service delivery and public infrastructure remain on the planning horizon as the country aims to pursue its developmental agenda. Improving tax collection therefore has remained a key item on the policy agenda of different Pakistani governments but despite its immanence not much has being accomplished so far.

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  [1] Tax effort is an index measure of how well a country is doing in terms of tax collection, relative to what could be reasonably expected given its economic potential.

Other than a slightly higher than average reliance on "taxes on international trade" and an extensive list of excisable commodities, Pakistan's tax structure is not very different from the international norm nor at great variance with comparable Asian countries. The low tax to GDP ratio largely arises out of the low tax effort exerted by the Pakistani tax authority (Martinez-Vazquez & Cyan, 2015), characterized by putative corruption and administrative weaknesses.[2] At the same time, the tax base has not grown significantly over time, indicating low levels of voluntary compliance. Despite the introduction of tax facilitation measures such as assistance in tax-filing, taxpayers' behavior remained largely unchanged. What shapes tax morale in Pakistan, the main theme of this paper, and what prevents people from voluntarily complying with their tax obligations, thus, comes up as an important question with wide ranging implications for tax policy and administration refom in Pakistan. The mere identification of groups of taxpayers with relatively higher tax morale does not directly improve voluntary tax compliance. But, when tax administration is informed by this knowledge, the implications for tax policy and administrative reform are twofold. Knowledge of the determinants of tax morale can, first, guide tax enforcement to achieve more cost-effective interventions and, second, maximize the impact of the tax authority's communication strategy. On the one hand, this information helps create profiles of tax compliance behavior among the population that can inform the auditing selection process. Before committing resources to an audit, tax authorities typically conduct some risk analysis to narrow-in potential tax evaders. Focusing the attention of the auditors to the least-likely to comply slivers of the population can lead to more effective tax enforcement and, in turn, improve tax compliance. By highlighting the most relevant characteristics of taxpayers' attitudes toward tax compliance, our findings could assist the tax authority's assessment of individual risks of tax evasion. On the other hand, associations of tax compliant behavior with individual characteristics can be exploited to increase the effectiveness of the tax authority's communication strategy through informed targeting. A rigorous analysis of taxpayer perceptions will serve as the first step toward designing taxpayer engagement campaigns to further enhance voluntary tax compliance. In fact, this was another reason for fielding the baseline perception survey. Policy makers in Pakistan were also interested in obtaining public conception, perception and views of eligible individual taxpayers regarding key aspects of tax return filing or non-filing to optimally design a subsequent tax filing encouragement campaign. Clearly, a targeted communication campaign was likely to bring about a larger behavioral shift than a campaign that remained uninformed of the architecture of the taxpayer population's tax morale. Thus, we believe that the identification of tax morale determinants is useful from the tax authority's perspective because it can lead to more cost-effective deterrence of tax evasion or better-targeted communication when appropriately used.

At the outset, it should be pertinent to mention that Pakistan faces a number of structural challenges to its tax and revenue collection systems. To some extent, these are the cumulative results of repeated past failures at reform that have taken place since 2004. Potentially, these features of the tax system could also be affecting tax morale. We briefly recount these to place our discussion of tax morale in the current institutional perspective and assess their expected impact on tax morale. First, the bases of the most important taxes, namely, corporate and personal income tax, and general sales tax (GST) remain narrow. The availability of exemptions and deductions to only some income groups is likely to deteriorate tax morale of those who bear the tax burden. However, a broader income tax net in developing economies would not necessarily yield larger tax revenues and cannot be reliably used for re-distributive purposes due to corruption (Bird & Zolt, 2005). Second, high levels of tax evasion, estimated at 7% of GDP, are also significant contributors to the tax revenue shortfalls (Kemal, 2003) while also creating severe horizontal inequities between compliant taxpayers and tax evaders, which undermines tax morale. Third, Pakistan continues to experience difficulties recovering the revenue losses incurred with customs reform as indicated by the low buoyancy rate (below unity overall) of the tax system. Revenue variability of the most important tax instruments is also low which reduces the ability of the tax system to operate as a built-in stabilizer over the business cycle. Income taxes and the GST (value-added tax) are relatively elastic (1.2 and 1.9, respectively) but the excise and international trade taxes are extremely inelastic (Martinez-Vazquez & Cyan, 2015). This feature of the tax system does not directly affect tax morale but limits tax administration's capacity to rely on alternative tax revenue sources which indirectly increases the importance of voluntary tax compliance. Fourth, Pakistan has a large underground economy, which Kemal (2003) estimates around 35–40% of GDP; this, in turn, translates into a small number of registered taxpayers. To make things worse, the Federal Board of Revenue (FBR), the country's primary tax collection agency, has been incapable of collecting from the "hard to tax" and, largely, relies on "easier" tax handles instead (Alm, Martinez-Vazquez, & Schneider, 2004). Gangl, Kirchler, Lorenz, and Torgler (2015) examine non-filing dynamics in Pakistan by comparing rich, self-employed individuals who do not file tax to tax-filers with similar socio-economic characteristics. They find that less knowledge of taxpayers' rights and a perception of widespread corruption in the tax administration are significant predictors of tax non-filing behavior. As earlier, unequal treatment by the tax system in the preseence of a large number of non-filers is expected to worsen tax morale of those who file. Sixth, efforts in improving tax revenues by the federal government have not been complemented by those made by the provincial

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[2] More conceptually, Pakistan's low tax effort may be explained by the presence of corruption its tax adminsitration system and the low voice and accountability of its political system (Bird, Martinez-Vazquez, & Torgler, 2008).