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The phenomenon of tax evasion and avoidance in Pakistan: an exploratory approach

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ABSTRACT

Governments all over the world rely on revenues majorly generated from variety of taxes in order to meet their numerous fiscal expenditures. The practice of tax evasion and tax avoidance has bedeviled the tax system of Pakistan since 1947. So this research is conducted in order to identify the nature, causes and magnitude of tax evasion and tax avoidance along with their social, economic and political impacts especially in context of economy of Pakistan. The integrated approach has been used in order to answer the objectives of this study. Study reveals that tax evasion and avoidance both leading to fiscal deficit and foreign debt in Pakistan; however, tax evasion is most important. The estimations of tax evasion and tax avoidance are not reliable on account of different assumptions and ambiguous methodologies. Our research deals only with the conditions prevailing in Pakistan so results cannot be generalized. Moreover, instead of using estimates of tax evasion or avoidance we have used indicators of tax evasion an avoidance to determine their magnitude.

Introduction

Governments all over the world rely on revenues, majorly generated from variety of taxes, in order to meet their numerous fiscal expenditures on defense, education, health, infrastructure, industry, agriculture and safety of general public etc. Developed countries generally receive taxes, direct and indirect, from majority of people as well as corporations. In contrast, developing countries and third world countries are confronting for many tax compliance difficulties i.e. social and administrative in building a stable system of public finance.

Tax evasion and tax avoidance are universal phenomena, prevailed since the existence of taxation itself, which are being practiced by each social class, each industry and each economic system and it is the function of various factors i.e. level and type of income, political structure and social behavior etc. This phenomenon has a history of about two thousand and five hundred years ago mentioned by Plato. The ducal palace of Venice (Italy) had a stone with a hole, through which people cautioned the state about tax offenders. Although this problem has always been a critical issue, despite of utmost significance of this phenomenon, a very little attention has been paid to this, especially in Pakistan, until recent years.

However, in this century, concerned efforts have been made in order to establish sound self-financing capacities in developing countries and domestic revenue mobilization plays a key role in development of any economy on account of following three reasons. Firstly, it is indispensable for any Govt. in order to ensure sustainable process of development. In developing countries, unfortunately, tax-revenues' collections are generally not sufficient. Secondly, governments which are characterized with broad based taxation compelled to consider tax payers demands which results in good governance and accountability. Finally, as tax revenues involve entire population so it represents a direct influence on people as well as their disposable incomes. In order to achieve above mentioned goals, there should be effective tax system and tax compliance. However, there is a strong need to alleviate the practices of tax evasion as well as avoidance as they are counter-productive and attenuates the purpose of tax system.

The Problem in Pakistan

The practice of tax evasion and tax avoidance has bedeviled the tax system of Pakistan since 1947. After 1991, Govt. of Pakistan experienced consistent reduction in tax revenue as a percentage of Pakistan's annual gross domestic products (GDP). The current issue in public finance of Pakistan is that the collection of Govt. revenue in Pakistan composed of income tax, sales tax, property tax, corporate tax and administrative fees etc. are insufficient to meet the desired fiscal expenditures. The fiscal deficit of Pakistan was 6.3 % of total GDP in 2010 (Economic Survey of Pakistan 2010); whereas, Martinez-Vazquez (2006) mentioned that Govt. of Pakistan has failed to offset fiscal deficit despite of desperate efforts through adjustment in fiscal expenditures.

The ineffectiveness of current tax system in Pakistan is the basic reason of government revenue inadequacy in Pakistan. The Central Board of Revenue (CBR) institution, converted into Federal Board of Revenue (FBR), is responsible for government revenue collection. CBR has the authority to formulate fiscal policy and it administers more than 90 percent of total taxes in Pakistan. Tax revenue is the chief source of revenue for the government of Pakistan as it accounts for about 80% of the total government revenues. Average tax revenue to GDP ratio in low income countries was about 12% of the GDP as compared to developed world which was about 35% in 2005 (Fuest and Riedel 2009). Martinez-Vazquez (2006) revealed that after 2003 tax revenue to GDP ratio in Pakistan consistently followed declining trend which is very alarming along with growing fiscal

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deficits as well. In 2010, Tax to GDP ratio was about 8.9 % of the GDP in Pakistan.

Many researchers blamed about government's failure to administer tax efficiently as the root cause of the problem in tax collection whereas there are also arguments that the tax gap arises as a result of tax avoidance and evasion as a result of social attitudes of unpatriotic citizens. So this research is done in order to identify the causes of tax evasion, a phenomenon in which people do not fulfill their tax obligations intentionally by reporting fake income or several other illegal ways, and tax avoidance, a situation in which individuals and companies take advantages of the loop holes in tax system within legal boundaries, in Pakistan. Although tax evasion has been studied extensively in the past but this research aims to include tax avoidance in context of Pakistan in order to study tax non-compliance as well as tax gap in Pakistan. Moreover, the factors causing such phenomenon have also been explored extensively along with its political, economic and social impacts in Pakistan.

Objectives

Although, problem of tax evasion and avoidance is crucial for both developed as well as developing countries of the world; however, there is lack of research literature and data regarding this issue. Difficulty in observing the practice of tax evasion or avoidance and accurate data is also an important obstacle. Most importantly, there is scarce research on the relative significance of tax avoidance as well as tax evasion with a special perspective of Pakistan. Thus, basic objectives of our study are as follows:

❖To define the terminology, characteristics and forms of tax evasion as well as tax avoidance in Pakistan.

❖To find out the estimates and reflectors of tax evasion and avoidance in Pakistan.

❖To analyze the social, political, legal and economic factors contributing towards problem of tax evasion and tax avoidance in Pakistan.

❖To critically evaluate the impact of tax evasion and avoidance on the economy of Pakistan.

❖Policy recommendations and measures in order to combat and alleviate the phenomenon of tax evasion and avoidance in Pakistan.

Review of related issues

Tax compliance provides more resources to finance government expenditures without imposing tax burden on taxpayers (Hogye 2000). The estimation of tax non-compliance either in form of tax evasion or avoidance is essential for any Govt. in order to make better fiscal policy. Moreover, it should be noticed that both quantitative and qualitative analysis of tax evasion or avoidance are important in this regard.

Terminology Characteristics

Tax evasion and tax avoidance are multi-dimensional issues. As there is no clear cut line of distinction between tax evasion and avoidance but following definitions will be helpful in this regard

"If you get away with it, it was tax avoidance otherwise tax evasion"

Tax avoidance is defined as, legally use of tax laws in order to reduce the tax liability of an individual or a corporate; this generally involves use of permissible deductions. Hogye (2000) said that the change in behaviors of taxpayers to use the loop holes in the current tax law in order to reduce their tax liability is known as tax avoidance. They adopt purely legal procedures but which are against the purpose of tax law and that's why it is said that it is that form of tax non-compliance which is protected by tax law.

Any illegal activity in which a person or company avoids its due tax liability intentionally is known as tax evasion and is subject to criminal charges. Jayasinghe (2007) defined tax evasion in a sense that it is form of tax non-compliance in which people and corporations do not report their taxable income, profits subject to tax exactly and fairly. He referred this to underground economy, non-reporting of accurate income due to high tax rates etc. It also includes activities misrepresentation of income source and overstated exemptions intentionally (Alm and Vazquez 2001; Chiumya 2006).

A detailed debate and controversies regarding tax evasion and tax avoidance is discussed by Fuest and Riedel (2009), Global financial integrity (2008) and Torgler and Schneider (2009). According to estimates, developing countries are losing about $ 1 trillion per year due to illegal financial flows of money earned through illegal ways (Global financial integrity 2010). Baker (2005) also estimated corporate capital flows and fake transactions done in developing countries just to avoid or reduce taxes amounted to $ 350 billion a year. Jayasinghe (2007) mentioned that it is difficult to measure the level of tax avoidance in any economy that's why tax evasion, which can be identified and measured, is mostly used as measure of tax non-compliance. Although there is difference between tax evasion and avoidance but sometimes the loopholes in tax law are ambiguous that's why most often both the issues are addressed jointly.

Forms of Tax Evasion & Tax Avoidance

This section is devoted to disclose prevalent instruments used for tax evasion and avoidance. Tax payers' non-compliance has been broadly divided into three parts, which are as follows (Jayasinghe 2007):

❖Unfilled tax returns forms;

❖Misrepresentation of income; and

❖Underpayment of tax.

However, following table is also summarizing major relevant techniques and forms used for tax evasion and avoidance explicitly in developing countries.

Table: 1 Different Form of Tax Evasion and Tax Avoidance

TAX EVASION	TAX AVOIDANCE
1. Non-Declaration of income/ profit/ financial assets	1. Profit Shifting
2. Trade Mispricing	2. Bargaining of Tax incentives
3. Sales Tax Fraud	
4. Bribery and Corruption	
5. Abuse of tax incentives	

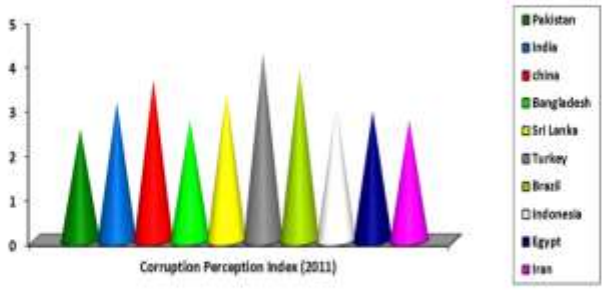
Source: The International Tax Compact (ITC) (2010)

Instruments for Tax Avoidance

The table 1 listed the various modes of evading tax against national tax laws. The most prevalent method for tax evasion is either misrepresentation or non-declaration of accurate income or profit from business or financial assets by individuals and corporations. Some businesses are involved in holding offshore financial accounts, exploiting bank secrecy, in order to conceal income (ITC 2010). Trade mispricing is another illegal activity resulting in tax evasion. It refers to faked invoicing between exporter and importer in order to transfer money from less developed economies to bank accounts in developed countries solely for the purpose to evade taxes (Global Financial Integrity 2010). Keen and Smith (2007) mentioned in their study some other important modes of tax evasion involving falsified records of sales, overstating purchases in order to claim tax refunds.

They also disclose carousel fraud resulting from zero - rating exports between countries. Misclassification of goods along subject to different tax rates in order to truncate tax liability or to claim tax refunds is another major way of evading tax in Pakistan. Smuggled goods and underground economy result in not only sales tax evasion but also income tax and import duty evasion. Developing countries including Pakistan are exposed to bribery due to inefficiency in enforcement of law. Following graph 1 will show the rank of Pakistan in corruption as compared with other selected countries.

Figure: 01 Comparison of Pakistan with Other Developing Countries in Corruption



Source: CPI [Corruption Perception Index] (2011), Transparency International. Scale: 0 (highly corrupt) to 10 (very clean).

Pakistan is ranked at 134 among all nations in the world (Transparency International's Corruption Perception Index 2011) and index for corruption for Pakistan is 2.5 in 2011 as compared to other selected developing countries (i.e. India, 3.1; china, 3.6 and Bangladesh, 2.7 etc.) which means that Pakistan is highly corrupt nation and that contributes major factor in tax evasion in Pakistan.

Instruments for Tax Avoidance

The strategies adopted for tax avoidance involves profit shifting which refers to exploitations of loop holes in tax law in order to form tax base. As subsidiaries of multinational corporations are taxed only once so MNC's shift profits from high tax to low tax countries in order to reduce overall taxes. MNC's also manipulate tax liability by transfer pricing of commodities traded within their group and through selection of allocation of intangible assets. MNC's set higher transfer prices for commodities send to countries with high tax while they use low transfer prices for commodities send to low tax countries. In that way, input cost deliberately shown as overstated in order to alleviate taxable profit in high tax countries.

Companies also involve in barter trade internationally results in artificial decrease in prices to reduce the sales tax (Buettner and Wamser 2007; Dischinger and Riedel 2010).Mutual loans by MNC's to their subsidiaries also results in reduction in tax to the extent of interest paid and this decreases the tax obligation of these corporations in high tax countries. The selection for location of registration of intangible profit generating assets like copyrights and patents etc. are also important in this regard and normally given to subsidiaries in countries with less tax while, R&D and other highly costly departments are established in countries with huge tax in order to reduce overall tax liability within legal framework (Simpson 2005).

Govt. often uses tools of tax exemptions and subsidies in order to achieve specific social and economic goals in the form of lower tax rates and time concession etc. Unfortunately, only some people or companies get benefits from it due to nepotism, lobbying and corruption with an official cover. For example, effort of developing countries including Pakistan to attract FDI will result in tax incentives to foreign companies but local companies will also evade tax by mentioning their investment as foreign investment as well. Easson (2004) has clearly revealed the practice and consequences of tax incentives.

Reasons for Tax Non-Compliance in Pakistan

In this section, we deal with the reasons associated with the multidimensional problem of tax evasion and avoidance in developing countries with a special focus on Pakistan.

The phenomenon of tax evasion and tax avoidance is based on various underlying causes which have been explored by number of researchers.

Tanzi and Shome (1993) have studied to explore the factors affecting tax evasion and avoidance. They mentioned that this issue depends upon sectors i.e. manufacturing, trade and agriculture etc., scale of production, type of earning activity (salaried or entrepreneur etc.), social ethics and taxpayer's attitudes toward risk of tax evasion and avoidance.

Moreover, the revenues collection in developing countries are constrained by underground economy, poor administration of tax, political pressures and low capacity to pay tax (Bahl et al. 2008). Chaudhry and Munir (2010) found that trade openness; foreign debt and political stability are the major determinants of tax efforts. They also mentioned that reasons for low tax revenues in Pakistan are underground economy, small business sector which is hard to tax.

The transfer of resources from various sectors to agriculture in Pakistan, due to tax exemption, is another major cause of tax shelter. Public non-awareness regarding benefits of paying due taxes is also contributing factor towards tax evasion as well as tax avoidance. Complicated and ambiguous tax regulations results in tax avoidance, by taking advantages of loopholes in tax law, and tax evasion. Furthermore, frequent tax law changes also cause tax avoidance (ITC 2010).

A study by ITC (2010) has mentioned the core reasons for tax non-compliance issue in developing countries. It broadly categorized four reasons for this phenomenon:

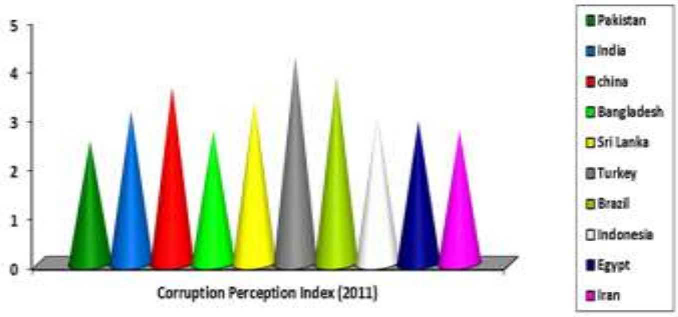
- Low tax morale;
- High compliance cost;
- Inefficiencies in tax collection; and
- Weak enforcement of law.

Tax morale is the factor which can improve the tax efforts even beyond feasible levels. Developing countries are characterized with culture of non-payment of tax which results is low tax morale. Torgler et al. (2007) has found out significant relation between tax morale and tax compliance. The factors which influence taxpayer's morale to pay tax are govt. failure to provide sufficient and quality public goods and services in return for taxes (Brautigam et al. 2008), high tax rates (Chipeta 2002), people perceptions about the unfairness of tax system (ITC 2010) and corruption and lack of transparency is govt. institutions (Kirchler et al. 2007).

Costs involved in gathering essential information for reporting taxable income and submitting tax forms are also important reason for tax evasion and avoidance.

As costs and time required for preparing and paying taxes in Pakistan and other developing countries is higher so, it results in tax evasion and avoidance. This can be better explained with the help of "time to prepare and pay taxes" indicator prepared by World Bank (2010).

Figure: 02 Time to Prepare and Pay Taxes



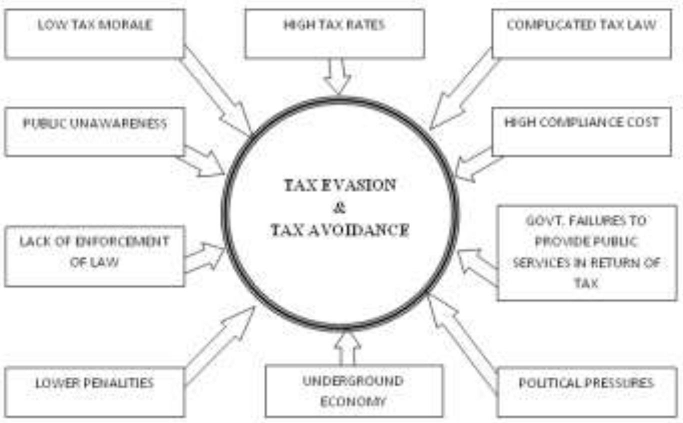
Source: World Bank Indicators: time to prepare and pay taxes (2010)

"Time to prepare and pay taxes" is given in hours needed to report and pay corporate tax, sales tax and labor taxes prepared by the World Bank (2010). As we can see clearly that the time required to report taxable income and to pay tax in Pakistan is far more than other countries i.e. it requires 560 hours for the year 2010 in Pakistan to pay tax as compared to India in the same year, which was just 258 hours. Time to prepare and pay taxes in other selected developing countries, mentioned in the graph, are also less i.e. it requires 398 hours in China, 266 hours in Indonesia and just 200 hours in South Africa to prepare and pay taxes.

Major developing countries are facing with the dilemma of poor administration of tax system. In Pakistan, there is a problem to identify individuals and firms liable to pay tax due to lack of tax administration. Fjeldstad and Moore (2009) mentioned that administration and collection by finance department in developing countries are subject to corruption. Additionally, lack of well qualified and motivated tax officers also results in insufficient tax collection. Finally, large scale underground economy in Pakistan also leads to insufficiency and inefficiency in tax collection.

Fishlow and Friedman (1994) found the consequent legal penalties size after tax evasion is positively related to tax compliance. Moreover, Frequent changes in tax law in developing countries and complicated tax regulations leads to tax avoidance (Mo 2003). Sometimes in developing countries it becomes inevitable to evade taxes when tax laws are too complex to comprehend and follow. Pakistan is characterized with low literacy rate along with current universal self-assessment compliance system dissuading people from reporting accurate taxable income. Due to lack of proper documentation, manufactures do not pay due tax in Pakistan (Chaudhary and Hamid 2001). We can summarize the above discussion as follows:

Figure: 03 Reason of Tax Evasion and Avoidance



Background of Tax-Gap in Pakistan

Since 1971, after the separation of East and West Pakistan, Pakistan has been facing fiscal deficit. Tax efficiency has been questioned for the last 25 years. Unfortunately, despite of all the efforts in order to boost revenues, tax to GDP ratio in Pakistan remained fairly constant during last years. During the Russia-Afghan war huge aid was given to Pakistan which adversely affects the performance of Govt. of Pakistan and made it largely dependent on external recourses rather than reforming and enhancing internal revenues. The revenue collected from excise duties fell drastically in 1990's due to WTO regulations but on the other hand Govt. of Pakistan imposed high sales and income tax in order to follow the conditionality of International monetary Fund (IMF). However, after 1991 Pakistan faced increased pressure in order to improve the efficiency of tax system and this problem received much attention from researchers as well as govt. of Pakistan. Under universal self-assessment (USAS) and through income tax ordinance 2001, a voluntary tax compliance system has been introduced in Pakistan by CBR. Previously, tax officers were responsible to access tax liability within different geographical "circles". This amendment in tax system on one hand reduced corruption by tax officers. Which was basically due to personal involvement in tax assessment, but on the other hand this was considered as a catalyst for noncompliance and unethical behaviors of taxpayers and resulted in increased tax evasion and avoidance due to lack of wide scale auditing and scrutiny required under self-assessment system. Jayasinghe (2007) in his study also mentioned this as a dominating cause for tax evasion and avoidance in Pakistan.

Magnitude of Tax Non Compliance in Pakistan

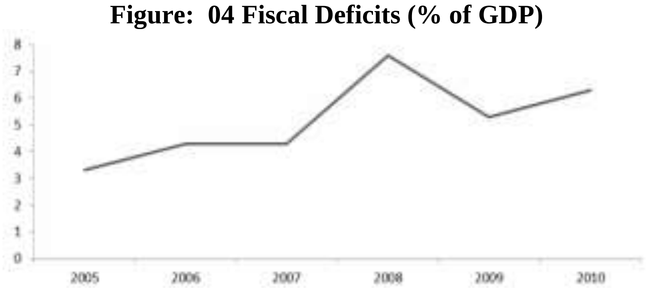
In this section, the severity of tax evasion and avoidance in Pakistan has been analyzed critically. Pakistan has been facing fiscal management problem since 1971. Pakistan is facing the dilemma of constant low tax revenue to GDP ratio over the last decade. Increasing government expenditures along with stagnant tax revenue to GDP ratio is leading to higher and higher Fiscal deficits in Pakistan. Tax gap can be used as an indicator of tax evasion and avoidance. But one should be careful while using it as a determinant of tax evasion and avoidance because tax gap may also arise due to other factors like capacity of tax administration etc. Fiscal deficit of Pakistan over the last few years presents a grim picture of economy and administrative inefficiencies which is summarized in the following graph.

Table: 02 Fiscal Indicators as Percentage of GDP

Financial Year	Total Revenues	Total Expenditures	Fiscal deficit	Real GDP Growth
2005	13.8	16.8	3.3	9.0
2006	14.1	18.4	4.3	5.8
2007	14.9	20.8	4.3	6.8
2008	14.6	22.2	7.6	3.7
2009	14.5	19.9	5.3	1.7
2010	14.2	20.5	6.3	3.8

Source: Economic survey of Pakistan 2010-11

Figure: 04 Fiscal Deficits (% of GDP)

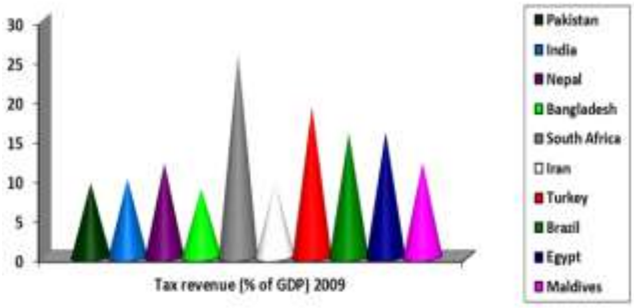


Source: Economic survey of Pakistan 2010-11

As it is depicted by the above given graph 3, lower tax revenue collection has caused Pakistan high fiscal deficit as well as drastic fluctuation as well as reduction in GDP growth. According to Economic survey of Pakistan (2010) there is not a hope that Pakistan will get rid of this fiscal deficit trap soon. Government expenditure has been projected about the 18.0 % of GDP where expected revenues for the same year are just 14.6 % of GDP which is nonetheless a overstated value.

Pakistan tax revenues as % of GDP as compared to various developed and developing countries is very low showing the magnitude of tax non-compliance as compared to other countries. Aslam and Hamid (2001) argued that as Pakistan is a developing country so it must have higher tax revenue to GDP ratio as compared to developed economies. Following graph will show the comparison of tax revenue to GDP ratio for the year 2009.

Figure: 05 Tax Revenue (% of GDP) Comparison 2009



Source: Tax revenue (% of GDP), World Bank Indicator (2009)

The above given chart 4 overtly mentioned the huge difference between tax revenue (% of GDP) in Pakistan as compared to other developing countries. Pakistan is way behind in tax revenues i.e. its tax revenues (% of GDP) in 2009 was just 9.3% where as it was 9.8 % in India, 11.8 % in Nepal,18.9 % in Turkey and 25.5% in south Africa in the same year.

Table: 03 Tax Revenue to GDP Ratio in Pakistan (2000-2011)

YEAR	TAX REVENUE TO GDP RATIO	COMPONENTS OF TAX REVENUE (% OF GDP)	
		INTERNATIONAL TRADE REVEUES	DOMESTIC REVENUES
2004-05	9.1	4.6	4.5
2005-06	9.4	4.6	4.8
2006-07	9.8	4.0	5.7
2007-08	9.8	3.9	5.9
2008-09	9.1	3.2	5.9
2009-10	8.9	3.3	5.7

SOURCE: FBR Quarterly Review, January – March 2011

The table 3 clearly shows the constant tax revenue to GDP ratio in Pakistan which consistently remained below 10% of GDP over the last decade. Estimates of finance ministry showed that regardless of desperate efforts made by FBR Pakistan cannot raise its revenue to double digit figure as a percentage of GDP until 2013-14 (The News, June 15, 2011).It is also said in the news that tax evasion, corruption and poor tax collection system is the basic cause for this abnormally low tax revenue to GDP percentage. The table also shows the significant change that govt. tax revenues from international trade sector has been reduced to approximately 3% from 4.6% of GDP in the year 2004-05. Those international regulations reforms in international trade, regarding lower trade restrictions in the form of tariffs and custom duties etc. resulted in increase in GST rates in Pakistan, because of the difficulty in direct tax collection arising from tax evasion as well as avoidance in Pakistan. Following are the statistics regarding trends in composition of Tax revenues in Pakistan.

Table: 04 Targets and Net Revenue Receipts: A Comparison (Rs. in billion)

REVENUE ITEMS	JULY-MARCH 2010-11		ACHIEVEMENT %
	TARGET	COLLECTION	
Direct Tax	377.5	381.6	101.1
Sales Tax	426.5	422.7	99.1
Federal Excise	88.6	89.1	100.6
Custom Duty	123.9	126.8	102.3

Source: FBR Quarterly Review, January – March 2011

Comparison of potential to actual tax revenue can be used as an indicator for fiscal effort and management (Tanzi 1981). Tax efforts in Pakistan however showing positive results as elucidated by the report of FBR (2011) as given above. FBR in Pakistan has achieved all targets successfully except sales tax projected revenues for the period July- March 2010-11. That was basically due to huge refunds paid by the FBR to the claimants i.e. nominally PKR 36 billion as compared to PKR 15 billion in 2009-10.

Revenue potential can also be viewed by analyzing the tax revenue lost as a result of concessions and tax exemptions. As most of the resources are moving towards tax exempted industries as well as tactical tax avoidance by major businessmen in Pakistan. Most of the time, these concessions are due to political influence as well as pressure from various lobbies. The table given below clearly illustrates the pattern of cost of such relaxations in tax to Pakistan. Ghaus-Pasha (2010) estimated that inclusion of only service industry under tax net could increase tax revenues approximately 1.5 % of GDP of Pakistan.

Table: 05 Estimated Revenue Losses of Federal Taxes

TYPE OF TAX REVENUE	2009-10 (PKR Billion)	2010-11(PKR Billion)
INCOME TAX	46.53	46.51
SALES TAX	27.41	25.32
CUSTOM DUTIES	76.35	94.94
TOTAL	150.29	166.77

Source: Economic Survey of Pakistan (2010-11)

The maximum loss caused by tax exemption or zero tax rates is done to the revenues collected from imports or international trade sector. However income tax loss of PKR 46.51 billion is also important with regard to policy reforms in order to raise Govt. revenues. Govt. can utilize this much potential of revenues by eradicating tax evasion and avoidance in income tax. Mukarram (2001) also mentioned in her study that direct tax and sales tax have much more potential to be effectively utilized and they will contribute most to the revenue in near future if proper strategy will be used.

- The researchers however suggest following ways in order to estimate the size of underground economy in any country and called it as an unobservable variable, which includes:
- Tax survey or use of tax non-compliance data as a measure of tax evasion;
- Using various variants of monetary approach;
- Comparing national income and national expenditure statistics; and
- Comparing actual and official data on labor force.

Ahmed (2009) in his comparative analysis of empirical studies done in order to estimate underground economy of Pakistan has concluded that all these studies are not satisfactory because they assume arbitrarily as well as different ambiguous methodologies have been used. Results of all the studies done in order to find out size of underground economy in Pakistan (Aslam, 1998; Kemal, 2007) are not reliable and thus Government should special care is required by policy makers while using these estimates which may lead to ultimately different results (Ahmed, 2009).

Facts about tax evasion in Pakistan

Pakistan has around 2.7 million NTN (National Tax Number) holders. Unfortunately, out of these NTN holders only 685000 people pay tax (Dawn News, January 17, 2010).The magnitude of Non tax filers in Pakistan has risen to 47.3% in the year 2010-11 as compared to 42.5 % in the last year 2009-10 (FBR 2011). Recently, Dr. Abdul Hafeez Shaikh (Federal Finance Minister) has said that tax base in Pakistan will be broadened and notices have been sent to 300000 NTN holders who have not submitted their tax return forms (Business Recorder, December 24, 2011). FBR, with the help of NADRA, have identified 700600 potential tax payers who own more than one house and other valuable property but didn't register themselves as taxpayer. FBR planned a mission against these offenders and expected to raise revenue about PKR 2 billion from them (The Express Tribune, March 22, 2011). According to a reported by World Bank corruption in tax is causing PKR 796 billion loss annually.

Govt. of Pakistan has promoted numerous tax officers from Grade 18 to 21 in order to cope with corruption and improve the efficiency in tax collection (The Express Tribune, 09 February, 2011). The FBR chairman also said that soon Govt. of Pakistan will reduce the income tax rate for corporations in order to alleviate tax avoidance (The Express Tribune, 20 March, 2011).

Discussion

In most of the developing countries, especially with the perspective of Pakistan, increased rate of taxes required to finance budget deficit and a weak economic activity resulted from relatively higher inflation has put many questions in the mind of compliant taxpayers, on the working, productivity and legitimization of the administration of taxation system. Lack of trust as per taking stock off government' non serious response regarding tax evasion and avoidance has resulted in even low voluntary tax payments in Pakistan than ever. Low tax- to- GDP ratio, and a weaker financial system, is hindering the process of sustainability of infrastructural development, causing parity of wealth between lower and high income class and reservations on government's efficiency in most of the developing countries.

Tanzi and Shome (1993) argued that tax evasion lowers productivity, results in biased views and behavior of people about public sector in most of developing countries. Unbalanced horizontal and vertical equity creeps in. In Pakistan, badly administrated tax system is providing opportunities to tax avoiders to avail the discrepancies of legislation as only 2% people pay tax in Pakistan. However intensity of tax evasion can be controlled through penalties. Cost- benefit analysis of tax collection cost of compliance, Forms of collection like cross controls, withholding etc., major revenues generating sectors have significant impacts on magnitude of tax evasion. Another startling, rather reciprocal impact on less government revenues is of corruption that may result either from pension receipts due to so-called disability or from fake illness receipts or subsidies provided to ghost workers and so on. This is equivalent to tax evasion. Moreover, tax evasion and avoidance also leads to resentment among honest tax payers and will cause further increase in tax non-compliance.

The constant revenue level over the last decade resulted in enormous public debt about 90% of GDP and fiscal deficit of about 6.3% of GDP in 2010. The problem of huge external debt also has repercussion effects on the increased tax burden and high tax rates in future. Moreover, foreign inflows in the form of foreign debt also lead to increased money supply and in turn causing galloping inflation in Pakistan. The increased inflation is, in itself, reducing the tax payment capacity of people and resulting in increased tax evasion and avoidance. Low level of revenues in Pakistan is also creating severe problems for Govt. to fund necessary pro-poor programs which have strong implication on national level of welfare. Tax noncompliance thus need to be eradicated in order to utilize the full capacity of revenue generation otherwise, there is no exit way from this vicious circle of international dependence. In the following section we have given some of the recommendations which will prove to be helpful for government policy making in order to address tax evasion and avoidance in Pakistan.

Limitations and recommendations

This research study, like any other study also, subjects to number of limitations. Firstly, in this study we primarily focus on tax evasion and avoidance via tax system, social and economic environment specific to Pakistan. So, the results of our study cannot be generalized. Secondly, instead of laborious calculations we have roughly estimated the magnitude of tax evasion and avoidance in Pakistan as there is no agreed method developed in order to estimate tax evasion and avoidance due to various complications. Thirdly, as this is not a quantitative research, we tried our level best in order to avoid any possible biasness with regard to subject matter of study. However, we cannot ensure to eliminate the probability of biasness. Finally, the effects of the issue of tax non-compliance i.e. tax evasion and tax avoidance has been discussed above only with respect to Pakistan. The problem of tax evasion and avoidance may have altogether different effects on other economies depending upon their social economic and political environment and tax legislation.

We have provided numerous recommendations in order to improve the situation of tax compliance in Pakistan. The issue of tax evasion and avoidance need to be addressed very carefully while keeping in mind the repercussion effects of tax policy on the economy. Following are the advised policy options which should be considered by Govt. of Pakistan in this regard:

1. It is strongly recommended to establish semi-autonomous revenue authorities as a tax reform for efficient tax collection system. In addition, reduction in the no. of tax officers dealing tax returns also leads to better tax administration.
2. There Govt. of Pakistan must bring the agriculture sector of Pakistan under tax net, as it is major contributor of GDP of Pakistan, still exempted from federal tax causing shift of resources into agriculture. This exemption is resulting in tax avoidance as majorly agriculture sector in Pakistan is owned by either politicians or influential personalities. Chaudhary and Hamid (2001) also mentioned that even at a very low tax rate it can contribute Rs. 15 billion in Govt. Revenues.
3. Law reforms are required by declaring the proper documentation and business records mandatory for manufactured products. In this way tax non-compliance can be minimized in excise duty as mentioned by Chaudhary and Hamid (2001).

4. Government of Pakistan needs to encourage and motivate tax officers against corruption through awarding awards and incentives for efficient performance. Training should be provided to tax officials regarding detection of illegal money transfer, by individuals and companies, and tax fraud. Moreover, it should take strict legal action against corrupt officers involved in assisting tax evasion and avoidance.
5. It is also recommended that Govt. of Pakistan should restrict to the smuggling effectively because black economy as prevailing in Pakistan caused formal economy in Pakistan as found by Kemal (2007).
6. Most importantly, it should be noted tax policy affects tax administration directly and tax administration on the other hand also affects the efficiency of tax policy. Therefore, both tax policy and tax administration must be given equal importance by the Government of Pakistan to resolve the issue of tax non-compliance.
7. Government should provide quality public services, ensure transparency of the tax system in order to gain the confidence of people and raise their morale. However, these fundamental reforms require sustainability in the long run to materialize in form of increased tax compliance.
8. Revenue authorities in Pakistan should be service oriented. Attention should be given towards lowering the cost as well as reducing complexities and red-tapism involved in filing the tax returns. FBR should carry out taxpayer surveys annually in order to find the taxpayers ratings for tax facilitation centers as suggested by World Bank.
9. Direct tax base in Pakistan should be increased due significant income inequality in Pakistan which is causing tax evasion.
10. Reducing the income tax rates as well as number of tax brackets may also prove to be a good option to enhance voluntary tax compliance by the people.
11. As FBR initiated online tax payment system, but in order to reduce the magnitude of tax evasion and avoidance inter-departmental exchange of adequate data along with up to date information technology (IT) and technical staff is required.
12. We strongly recommend the strict enforcement of law, quick case processing in court and higher penalties to tax offenders will definitely alleviate the scope of tax evasion and avoidance as found by Fishlow and Friedman (1994).
13. Finally, International co-operation is highly advised regarding tax matters through participation in international forums which will facilitate the government of Pakistan through exchange of tax practices by other countries and their outcomes.

Conclusions

Study concludes that Pakistan is facing crucial problem of both tax evasion and avoidance. However, tax evasion is most important as majority of population is involved in evading tax whereas the magnitude of the phenomenon of tax evasion and avoidance in Pakistan is difficult to estimate due to complications and ambiguity involved in developing methodologies. It is relatively more significant to analyze the underlying causes of lower tax compliance and effective strategies to counter them rather than concentrating just on the nominal amount of tax evasion or avoidance. We have found that there are numerous reasons e.g. political influences, tax exemptions, low quality services provided by government against tax, high tax rates and poor enforcement of law and inefficient and inequitable tax system etc. causing tax evasion and avoidance in Pakistan. Although, FBR have done desperate efforts and sincerely working for the solution of tax gap but still extensive efforts are required to eradicate this problem.

It would highly suggest that further research should be conducted to find out the determinants of tax payments on micro level along with pilot study on the impacts of different tax reforms in other developing countries and their impacts on these economies would be highly beneficial. Political, social as well as economic good governance is indispensable in the current scenario. Our research also invites other researchers to further explore and develop a reliable method to estimate tax evasion and avoidance so that the estimates could be effectively utilized in policy making.

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