

**TAX POLICY AND ENTERPRISE
DEVELOPMENT IN SOUTH ASIA
RESEARCH DESIGN DOCUMENT
ON PAKISTAN**

Submitted

By

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Beaconhouse National University, Lahore
June 2012

TAX POLICY AND ENTERPRISE DEVELOPMENT

Contents

- 1 Format of Research Design document
 1. Institutional Information
 - 1.1.Name of Institution
 - 1.2. County of Origin
 - 1.3.Research Themes
 - 1.4. Institution Focal Person/ Member, Steering Committee
 - 1.5.Team Leader

- 2 Literature Review
 - a. Data sources
 - i. Theme 1
 - ii. Theme 2
 - iii. Theme 3
 - b. Reports and Articles
 - i. Theme 1
 - ii. Theme 2
 - iii. Theme 3
 - c. Key Knowledge Gaps
 - i. Theme 1
 - ii. Theme 2
 - iii. Theme 3

- 3 Conceptual and Theoretical Framework
 - a. Research Questions
 - i. Theme 1
 - ii. Theme 2
 - iii. Theme 3
 - b. Definitions of Key Concepts
 - i. Conceptual Framework

- ii. Definition of Concepts
 - c. Hypothesised Relationships Among Parameters
 - i. Economics of Compliance vs Non-Compliance
 - ii. Impact of tax expenditure on Profitability
 - iii. Option of Payment of Fixed/ Presumptive Tax or the Withholding Regime
 - iv. Choice Between Registering or Not Registering
- 4 Analytical Framework
 - a. Policy Analysis Framework
 - i. Theme 1
 - b. Level of Analysis (National, Sub-National)
 - c. Analytical Approach and Evolution Criteria
- 5 Data Collection Methodology
 - a. Research Methods
 - i. Key Informant Interviews
 - 1. List of Key Informant Interviews
 - 2. Instrument (Semi-Structured Questionnaire Outline)
 - ii. Survey Research
 - 1. Sample Frame
 - 2. Sampling Design and Rationale
 - 3. Survey Instrument
 - 4. Action Plan
 - 5. Data Collection Protocols
 - 6. Data Entry and Verification Protocols
- 6 Reporting Format for Year 1,2 and 3 Deliverables
- 7 Team Composition
 - 1. Focal Person
 - 2. Team Leader
 - 3. Research Associates/ Survey Supervisor
 - 4. I.T Specialist
- 8 Technical Annex

ACRONYMS

AERC	Applied Economics Research Center
AJ&K	Azad Jammu & Kashmir
AOP	Association of Persons
BNU	Beaconhouse National University
CIDA	Canadian Indian Development Agency
DPRC	Development Policy Research Center
FATA	Federally Administered Tribal Areas
FLL	Federal Legislative List
FBR	Federal Board of Revenue
GDP	Gross Domestic Product
GINI	Governance Institutes Network International
GIZ	Gesellschaft für Internationale Zusammenarbeit
GST	General Sales Tax
HIES	Household Integrated Economic Survey
IBA	Institute of Business Administration
IDRC	International Development Research Center
IPP	Institute of Public Policy
ITO	Income Tax ordinance
IT	Information Technology
K-PK	Khyber-Pakhtunkhwa
LUMS	Lahore University of Management Sciences
LTU	Large Taxpayers Units
MOA	Memorandum of Agreement
MDGs	Millennium Development Goals
NEPRA	National Electric Power Regulatory Authority
NGO	Non- Governmental Organization
OGRA	Oil and Gas Regulatory Authority

PBS	Pakistan Bureau of Statistics
PFC	Provincial Finance Commission
PJAE	Pakistan Journal of Applied Economics
PID	Punjab Industries Department
PSDE	Pakistan Society of Development Economists
PSIC	Punjab Small Industries Corporation
RGST	Reformed General Sales Tax
RTO	Regional Tax Offices
SBP	State Bank of Pakistan
SID	Sindh Industries Department
SME	Small and Medium Enterprises
SMEDA	Small and Medium Enterprises Development Authority
SRO	Statutory Rule and Order
SPDC	Social Policy Development Center
UIPT	Urban Immoveable Property Tax
UNDESA	United Nations Department of Economic and Social Affairs
UNDP	United Nations Development Program
USAID	United States Agency for International Development
UK	United Kingdom
VAT	Value Added Tax

TAX POLICY AND ENTERPRISE DEVELOPMENT IN SOUTH ASIA RESEARCH DESIGN DOCUMENT

1. INSTITUTIONAL INFORMATION

1.1. NAME OF INSTITUTION

The research partner is the Institute of Public Policy, (IPP), Beaconhouse National University, Lahore, Pakistan. IPP is an independent, academic thinktank for research on economic, social, political and foreign policy issues. Its mission is to “work in the areas of importance for improving the welfare of the citizenry. Its work focuses in particular on public policies in areas of economics, social and political development, as well as on foreign policy”.

Key activities of the Institute include: independent and objective analysis of the economy; strategic analysis of the concepts and doctrines in selected areas of public policy; research in the areas that are important for regional cooperation; seminars and workshops to bring together policy makers, experts and other members; funded research projects and dissemination of research findings with the view to enhance public awareness and contribute to debate on issues of public policy.

The IPP Executive Council consists of eminent personalities devoted to improvement of public policy in Pakistan.

1.2. COUNTRY OF ORIGIN

The Islamic Republic of Pakistan is located at the crossroads of Central Asia, Middle East and South Asia with a geographical area of 796096 sq. kms. The territory of modern Pakistan was the site of the ancient Indus valley Civilization. Pakistan is a federation with a parliamentary system. With a population approaching 180 million, it is the sixth most populous country in the world. It is an ethnically and linguistically diverse country with predominantly Muslim population.

The federation of Pakistan consists of four provinces- Punjab, Sindh, Khyber- Pakhtunkhwa and Balochistan. The jurisdiction of the federal government includes the Islamabad Capital Territory, Federally Administered Tribal Areas (FATA), Azad Jammu and Kashmir (AJ&K) and Gilgit- Baltistan. There are altogether 130 districts.

Punjab is the largest province with a population share in Pakistan of 55.6 percent according to the last Census of 1998, followed by Sindh with population share of 23.0 percent, Khyber-

Pakhtunkhwa with 13.4 percent and Balochistan with 5.0 percent. Areas under the administrative control of the federal government have a combined population share of 3.0 percent.

The allocation of fiscal powers to different levels of government is given in the Constitution. Fiscal powers of the federal government are explicitly defined, (See Box 1). Other taxes fall in the fiscal domain of sub- national governments.

BOX 1:

FISCAL POWERS OF THE FEDERAL GOVERNMENT AS PER THE CONSTITUTION OF PAKISTAN^a

Item No in FLL-1	Included	Excluded^b
43	Duties of customs, including export duties	-
44^c	Duties of excise, including duties on salt	Duties on alcoholic liquors, opium and other narcotics
47	Taxes on Income	Agriculture Income
48	Taxes on Corporations	-
49	Taxes on the sale and purchases of goods imported, exported, produced, manufactured or consumed	Sales tax on services
50	Taxes on the capital value of assets	Taxes on Property
51	Taxes on mineral oil, natural gas and minerals used in generation of nuclear energy	-
52	Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation	-
53	Terminal taxes on goods and passengers carried by railway, sea or air; taxes on their fares and freights	-

^a following the 18th Amendment

^b fall in the domain of fiscal powers of provincial governments

^c items no 45 and 46 have been excluded. Item No 45 was Duties in respect of succession to property and Item No 46 on Estate duty in respect of property.

FLL = Federal Legislative List

Source: Constitution of Pakistan (as updated upto the 20th Amendment)

1.3 RESEARCH THEMES:

As per the Memorandum of Agreement (MOA) signed between GINI and IPP, studies will be conducted on the following Research Themes pertaining to Pakistan:

- Theme 1: The Impact of Tax Exemptions and Concessions on Enterprise Development
- Theme 2: The Impact of the Value-Added-Tax (VAT) on Enterprise Development
- Theme 3: The Impact of Property Tax on Enterprise Development

1.4 INSTITUTION FOCAL PERSON / MEMBER, STEERING COMMITTEE

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1.5 THE TEAM LEADER WILL BE:

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2. LITERATURE REVIEW

2.1 DATA SOURCES

The data sources respectively for the three themes are as follows:

2.1.1 THEME 1

Small Enterprises in Pakistan

The following data sources will be used to determine the overall size, composition and growth of small enterprises in Pakistan:

- ***Pakistan Bureau of Statistics - Labor Force Surveys***

8 surveys available from 2001-02 to 2010-11

Information on:

- ~ Share and characteristics of employment in the informal sector* by economic sector
- ***Economic Census, 2005, PBS***
 - ~ Distribution of establishments by location, sector, size of employment, enterprise status, employment status, gender, year of commencement, level of investment (excluding land and building), level of sales, pattern of ownership
- ***Banking Statistics, 2010, SBP***
 - Growth in deposits of sectors with a large share of SMEs and by size of deposits
 - Growth in advances to sectors with a large share of SMEs and by size of advances
- NEPRA
 - ~ Number and growth in industrial and commercial consumers and consumption of electricity
 - ~ Rate of application for new connections and numbers energized
- OGRA
 - ~ Number and growth in industrial and commercial consumers and consumption of gas.

* The informal sector is defined by the LFS as ‘

- (i) All household enterprises
- (ii) Enterprises owned and operated by employers with less than 10 persons

- FBR
 - ~ Numbers of tax returns filed by type of taxpayer (upto 2008-09).
 - ~ Level and growth of domestic sales tax revenue from industries with substantial presence of SMEs (FBR year Books).
- SBP
 - ~ Exports, level and growth, by sectors with substantial presence of SMEs.

Tax Laws

The income Tax Ordinance, 2001,¹ Sales Tax Act, 1990 and SROs issued by the Customs Department will be studied to identify tax expenditures on small enterprises and large companies respectively. The initial identification of these tax expenditures is given in Box 1.

Quantification of Tax Expenditures

The basic sources for information on the magnitude of tax expenditures in the federal tax system is given in the Annex to the Pakistan Economic Survey on **Tax Expenditure in Pakistan**.

Level of Compliance

Data on level of compliance by different types of tax payers is given in the following publications of FBR:

- FBR Year Books
- FBR Quarterly Reviews

Also, key indicators of tax compliance are given the data base, **World Development Indicators** of the World Bank.

2.1.2. THEME 2

GST² Revenues

- The level, composition and growth of GST revenues is given in FBR statistics, especially the Year Books
- Provincial³ revenues from the Sales Tax on Services is available in the budget document.

¹ Including rules thereof

² The General Sales Tax (GST) is the Name of the VAT in Pakistan

³ GST on goods is a federal tax while the Sales tax on Services is a provincial Tax

BOX 1
DIFFERENTIAL IN TAX TREATMENT
OF SMALL AND LARGE ENTERPRISES

INCOME TAX

In favour of Small Enterprises

- Exemption limit of Rs 400,000 annually and lower tax rate on incomes than large companies , including lower tax rates on property income
- Flat rate of 25 % on income of a small company*as compared to 35% for large companies
- Lower effective tax rates for particular economic activities like retail trade, transport services, etc, which are largely in informal economy.
- Special investment allowance of up to Rs 1 million. **
- No wealth statement required if income less than Rs 1 million.
- Minimum tax on turnover not payable by individuals or AOPs with turnover below Rs 50 million.

In favour of Large Enterprises

- Accelerated depreciation allowance on investment (of 50% in the first year)
- Low presumptive tax on exports of 0.5% to 1 % on turnover
- Tax credit for balancing, modernization and replacement (of 20%)
- Tax credit for enlistment in the stock exchange (of 15%)
- Tax holidays for particular sectors (energy generation) and locations (Special Economic Zones, backward and rural areas)
- Lower fixed rate on industrial importers as compared to commercial importers (mostly imports for small enterprises)
- Option to file a return and pay a lower fixed tax rate on supplies and exports (more likely to be availed by companies)
- Tax credit on investment financed by equity
- Lower withholding tax rate(as %of bill) on electricity bills
- Capital Gains Tax exemption on trading of shares in the stock market and in properties

GENERAL SALES TAX

In favour of small companies

- Exemption limit of upto Rs 7.5 million of turnover (in taxable supplies)
- Sales tax on services exemption on many services in the informal economy including

wholesale and retail trade, community, personal and social services

In favour of large companies

- 2 ½ % reduction in income tax liability if 90% sales to registered persons

CUSTOMS DUTY

In favour of large Companies

Examples including the following :

SRO 565 (1) /2006: Exemption from customs duty on import of raw materials, sub-components, components, sub-assemblies, for manufacture of specified goods (Survey based)

SRO 567(1)/2006: Exemption from customs duty on import of specified goods (non-Survey based)

SRO 575(1)/2006: Exemption from customs duty an machinery and equipment

SRO 809(1)/2009: Exemption from custom duty to textile industry for import of machinery and equipment

SRO 666(1)/2006: Exemption from customs duty for OEMs in automobile Sector

* Under Companies Ordinance 1984, with paid up capital of less than Rs 25 million, 250 employees or less, and annual turnover not exceeding Rs 250 million

** Same limit for large companies

Input-Output Ratios

- Available from the Census of Manufacturing Industries, 2005-06, of the PBS.
- Revised Input-Output Table prepared by FBR

Consumption Patterns

- Given in the **Household Integrated Economic Surveys (HIES)** of PBS.

Tax Laws

The sets of laws which govern the VAT in Pakistan are as follows:

- Sales Tax Act, 1990, of the Federal Government
- The Sales Tax Ordinance, 2000, of the provincial governments of Punjab, Khyber-Pakhtunkhwa and Balochistan
- The Sindh Sales Tax Act, 2010
- Value Added Tax (VAT) Bill 2010, presented to the National Assembly of Pakistan (not passed yet)

THEME 3

Property Tax Revenues

The revenues from different property taxes including the Urban Immoveable Property Tax (UIPT), Land Revenue, Stamp Duty and Tax on Transfer of Property are available in the provincial budget documents for the four Provinces.

The revenue assignment of property taxes is given in the awards of the provincial Finance Commissions (PFCs)

Laws

The collection of different property-related taxes is governed by the following legislation in each Province:

- Urban Immoveable Property Tax Act, 1958
- The Stamp Act, 1899
- Land Revenue Act, 1967
- Agricultural Income Tax Act, 1997

The laws/ regulations governing land zoning and use are given in the Building Bye-Laws of the different Development Authorities, especially in the metropolitan cities of Pakistan.

2.2 REPORTS AND ARTICLES

We indicate here primarily reports and articles that focus on the Pakistan context and not on the standard international literature on each theme.

2.2.1 THEME 1

On tax expenditures, the following papers will be reviewed:

- Pasha, H.A, ‘ Fiscal Reforms in Pakistan’, paper presented at the Regional Conference on Tax Reforms , Singapore, GINI-IDRC.
- Pasha, A.G, ‘Can Pakistan Get out of the Low Tax-to-GDP Trap?’ Paper presented at the Sixth Annual Conference of the Lahore School of Economics, 2011.
- Shah, Z.,’Fiscal Incentives, the Cost of Capital and Direct Foreign Investment in Pakistan’ presented at the annual PSDE Conferences, 2003.
- Ahmed, Q.M, The Influence of Tax Expenditures on Non-Residential Investment, PhD dissertation, University of Bath, 1997.
- Ahmed,Q.M.,’ The Study on the Quantification of the Tax Expenditure in Income Tax’ Research Report No 8, AERC, 193.

- Pasha, H.A and K. Bengali, ‘Impact of Fiscal Incentives on Industrialization in Backward Areas: A Case Study of Hub Industrial Estate,’ PJAE, Vol 4, No1, 1985.
- Ministry of Finance, Government of India, Statement of Revenue Foregone, Union Budget, 2012-13.

2.2.2. THEME 2

- FBR Quarterly Review, ‘Economic Analysis of the Reformed GST in Pakistan,’ July – September 2009.
- FBR Quarterly Review, ‘Efficiency of the GST in Pakistan,’ July – September 2008.
- FBR Quarterly Review, ‘Vying for the Services Sector: Taxation of Services in Pakistan,’ January – March 2009.
- FBR Quarterly Review, ‘Acknowledging the Compliant Taxpayer,’ October-December 2007.
- FBR Quarterly Review, ‘FBR Reform Program: the Outcome of the Perception Survey,’ July-September, 2006.
- FBR Quarterly Review, ‘Sectoral Analysis of Taxes and GDP,’ January-March 2007.
- Social Policy and Development Center, ‘The cost of Exemptions in the VAT on Goods,’ report prepared for FBR, 2010, Karachi.
- Institute of Public Policy, The VAT on Services, report prepared for FBR, 2010, Lahore.
- Robina Athar Ahmed and Mark Rider, Pakistan’s Tax Gap: Estimates by Tax, Working Paper 08-11, International Studies Program, Andrew Young School of Policy,
- IPP, Perception of Federal Taxes in Pakistan, report prepared for GIZ and FBR, May 2012.

2.2.3. THEME 3

- World Bank, Property Taxes in the Punjab, Pakistan, June 2006.
- World Bank , Property Taxes in the Large Cities of Punjab, November 2006.
- I. Nabi and Hina Sheikh, Doing Business: Registering Property in Pakistan, World Bank.

- I. Husain and Sumbul Rana, 'Fiscal Effort by Provincial Governments in Pakistan,' Pakistan Development Review, 2012.
- DPRC, LUMS, 'Reforming the Urban Property Tax in Pakistan's Punjab,' March 2011.
- H.A.Pasha and A. Ghaus, 'Municipal Finance in Small Cities,' Conference Paper No 17, Social Policy and Development Center, 1995.
- H.A Pasha and A.Ghaus, 'Development of Megacities,' Paper No 18, SPDC, 1995.
- A.W.Khan, 'Development of Property Taxation,' Conference Paper No 9, SPDC.
- SPDC, Social Development in Pakistan: Devolution and Human Development, Annual Review No 8, 2007.
- H.A. Pasha, 'Land Densities in Karachi,' Pakistan Journal of Applied Economics, 1986.
- Applied Economics Research Center, Cost- Benefit Analysis of Regularization and Improvement of Karachi Abadis , Report prepared for Karachi Development Authority, 1988.
- A.G.Pasha , 'Buoyancy of Provincial Tax Revenues in Pakistan,' Pakistan Economic and Social Review, 1988.
- A.G.Pasha, 'Municipal Finance: A case Study of Karachi,' Pakistan Economic and Social Review, 1989.

2.2 KEY KNOWLEDGE GAPS

2.2.1. THEME 1

Quantification of Tax Expenditure

Research has not been adequately undertaken on tax expenditures in Pakistan and the Annex in the Pakistan Economic Survey on Tax Expenditure covers only a few tax expenditures and not by size of enterprise.

Quantification of many of the tax expenditures listed in Box 1 has not been done in the Pakistan Economic Survey. It is not clear at this stage if requisite data is available for primary research to be undertaken on estimating the size of tax expenditures which benefit small and large enterprises respectively.

Compliance Levels

Published data by FBR does not indicate the compliance levels by size and type of taxpayers. It will also be extremely difficult to determine if a taxpayer is compliant or not from the proposed survey. It is unlikely that a respondent taxpayer will declare himself/herself as being non-compliant. This will constitute a serious limitation of the proposed research.

Ownership by Gender

Small enterprises owned by women are extremely infrequent in Pakistan, probably less than 1 % of enterprises. The likelihood of finding many enterprises owned/ managed by women during the survey is very low. As such, it will be difficult to answer research questions relating to such enterprises.

Emigration

While some national data is available on levels of international migration by Pakistani workers it is unlikely that this is directly linked to the tax regime. Security, law and order and power load shedding are far more important in influencing the flight of capital and workers currently.

However, in the proposed survey (described in section 5) questions will be included if there are any plans to migrate or if any workers have been lost due to migration.

2.2.2. THEME 2

Input-Output Table

The last Input-Output table prepared by the Pakistan Bureau of Statistics (PBS) dates back to the 80s. FBR has estimated a more recent I-O table as part of the TARP, but its reliability is not known.

Transactions in the Informal Economy

The survey is expected to reveal the differences between compliant and non-compliant taxpayers. Given the expected biases in responses, especially between exempt taxpayers and non-complaint taxpayers who are engaging in tax evasion, the likelihood is that the latter type of taxpayers will claim that they are not registered because they are below the GST exemption limit of turnover of Rs 7.5 million. This will render difficult the tax incidence analysis of VAT on small complaint and non-complaint enterprises.

Determinants of Growth

The TOR for the study expects that econometric analysis will be undertaken to test the degree to which the VAT burden is a significant determinant of the ability of small enterprises to grow. The difficulty in quantifying the VAT burden at the individual enterprise level has been highlighted above, especially in the case of transactions between firms that are not registered taxpayers of GST.

Furthermore, there are a multiplicity of factors currently which are impacting on the growth of small enterprises in Pakistan. These include, as indicated above, security and law and order conditions, power loadshedding, gas shortages, etc. Isolation of the impact exclusively of GST will be difficult.

2.2.3. THEME 3

Coverage of Rating Areas

‘Rating areas’ are jurisdictions within which the Urban Immoveable Property Tax can be levied. Data on the coverage of rating areas within metropolitan cities is difficult to obtain. In particular, settlements at the periphery of such cities have frequently not been annexed into the rating areas by extension of the metropolitan boundaries. It is in these settlements where squatting mostly takes place and informal land markets emerge. As such, it will be difficult to quantify the extent of presence of such markets.

Small Enterprises in Informal Land Markets

There is not much information on the location of small enterprises in cities/towns of Pakistan. The typical pattern, especially in Province of Punjab, is for small-scale industrial units in particular sectors to agglomerate together in clusters usually in the central and older parts of cities, proximate to residential locations of owners and markets. Given the absence of basic infrastructure like a quality road network, water supply, electricity and gas connections in informal settlements, the significance of industrial activity in such locations is likely to be limited. As such, the role of informal land markets in influencing the growth of small-scale industrial enterprises may not be substantial.

‘Benami’ Transactions

The pattern of land acquisition is complicated in Pakistan by the presence of ‘benami’ transactions. These are arrangements where (a) a property is held by a person (other than in fiduciary capacity) on behalf of another person who has paid for it or (b) the transaction is made

for property in a fictitious manner or (c) the owner of the property is not aware or denies knowledge of such ownership. As such, it may prove problematic to identify the process of land acquisition by small enterprises.

Property Tax Underregistration or Evasion

The Provincial Excise and Taxation Departments of the Provincial Governments, characterized by relatively poor quality of tax administration, do not have a comprehensive record of properties, especially in the central city with high housing density. As such, the compliance with property tax payments may not only be a function of taxpayer behavior but also due to lack of issuance of ‘challans’, following assessment, for tax payment by the department.

3. CONCEPTUAL AND THEORETICAL FRAMEWORK

3.1. RESEARCH QUESTIONS

3.1.1. THEME 1

- What is the extent to which small enterprises face biases in tax exemptions and incentives?
- What is the extent to which these biases disproportionately impact on small enterprises operated in the undocumented economy and/or those owned/managed by women?
- What are the impacts of the exemptions and concessions on entrepreneurs and SMEs in terms of enterprise performance and productivity?
- What are the impacts of biased tax regimes on emigration of entrepreneurs and skilled labor?

3.1.2 THEME 2

- What are the progressivity impacts of VAT burden on small enterprises (particularly those operating in the undocumented economy)? How do they affect enterprise performance and productivity?
- How are small entrepreneurs treated by VAT administration, against indicators of compliance costs and taxpayer friendliness?

3.1.3. THEME 3

- What are the weaknesses in Property Tax systems that create and/or sustain informal land markets?
- What is the nature and magnitude of impacts of land informality on entrepreneurs of small enterprises operating in the undocumented economy?

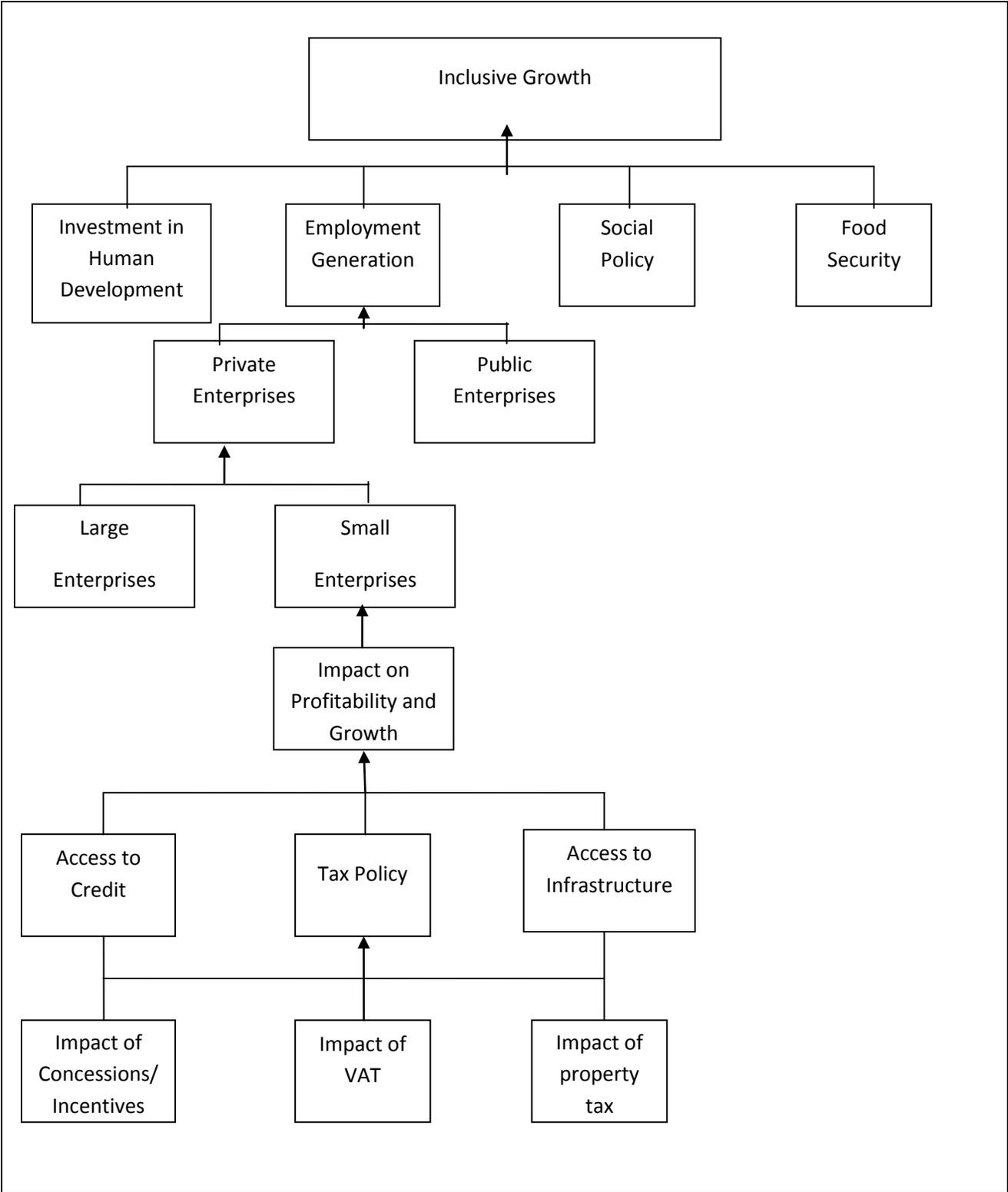
3.2. DEFINITIONS OF KEY CONCEPTS

3.2.1. CONCEPTUAL FRAMEWORK

The conceptual framework for the study is presented visually in Chart 1. ‘Bottom-up’ the relationships are as follows:

- i. The impact of key elements of tax policy.viz, differential in tax expenditures, the system of VAT and property taxation, on the performance, profitability and growth of small enterprises.
- ii. The resulting contribution to employment generation of growth of small enterprises.
- iii. The contribution of employment generation to the process of ‘inclusive growth’ in the economy.

Chart 1
Conceptual Framework of the Study



3.2.2. DEFINITION OF CONCEPTS

The following concepts/terms will be clearly defined⁴:

- Association of Persons
- ‘Benami’ Transaction
- Company
- Compliant Taxpayer
- Compliance Costs
- Enterprise
- Employer
- Informal Growth
- Informal Economy
- Informal Land market
- Non-Complaint Taxpayer
- Own- Account worker
- ‘Person’ in the ITO
- Penalties
- Registered Taxpayer
- Risk-based Audit
- Small- Scale Industry
- Small Enterprise
- Small and Medium Enterprise (SME)
- Small Company
- SRO/ Customs General Orders
- Self- Employment
- Self- Assessment Scheme
- Tax Expenditure
- Tax Deductibility
- Tax Credit
- Tax Allowance
- Tax Incidence (Nominal)
- Tax Incidence (Effective)

⁴ Wherever possible, as defined in the tax laws.

In particular, it will be necessary to decide on a definition of ‘small enterprises,’ SMEDA defines small and medium enterprises, as approved in SME Policy 2007, as follows:

SME:

Employment: Up to 250

Paid up capital: Up to Rs 25 million

Annual Sales: Up to Rs 250 million

The other definitions used by various institutions in Pakistan are as follows:

Institution	Definition
SME Bank	Total Assets of up to Rs 20 million
PBS	Less than 10 employees (Factories Act)
PSIC	Fixed Investment up to Rs Million (excluding land and building)
PID	Fixed Assets of up to Rs 10 million (excluding cost of land)
SID	Fixed Capital Investment of up to Rs 10 million (including land and building)
SBP (Prudential Regulations)	An entity- ideally not a publicly limited company-, which does not employ more than 250 persons (manufacturing) and 50 persons (trade/services), and also one of the following. <ul style="list-style-type: none"> i. Trade/services- total assets (excluding land and buildings) of up to Rs 50 million. ii. Manufacturing-total assets (excluding land and buildings) of up to Rs 100 million. iii. Net sales not exceeding Rs 300 million.

It is proposed that the study will use the definition given in the **SME Policy 2007** of

Employment: Up to 250

Paid up capital: Up to Rs 25 million

Annual Sales: Up to Rs 250 million

3.3. HYPOTHESISED RELATIONSHIPS AMONG PARAMETERS

3.3.1. Economics of compliance vs Non-Compliance

Technical Annex 1 derives the relationship between different parameters in determining the decision of an enterprise (with income above the exemption limit) to comply or not with the tax laws.

In the simple case, the decision depends on the probability of being audited and the size of the penalty in the event the assessor finds income that has not been declared in the return filed.

3.3.2. Impact of Tax Expenditure on Profitability

Technical Annex 2 derives the relationship between pre-tax income, different types of tax expenditures including tax deductibility, tax credit, concessionary tax rate, final/presumptive tax, and post-tax income.

3.3.3. Option of Payment of Fixed/ Presumptive Tax or the Withholding Regime

Technical Annex 3 identifies the parameters which influence the choice of a firm to opt for the final/ presumptive tax regime versus a withholding tax payment followed by the filing of a return with the expectation of receiving a refund.

3.3.4. Choice between Registering or Not Registering

Technical Annex 3 indicates the parameters which influence the decision of an enterprise to register or not in the GST regime.

4. ANALYTICAL FRAMEWORK

4.1 POLICY ANALYSIS FRAMEWORK

4.1.1 THEME 1

Income Tax

The focus will be on making recommendation on rationalizing tax expenditures, considering the costs and benefits, accruing to small enterprises, from the viewpoint of impact on productivity, profitability and growth.

At this stage, the following tax policy measures have been identified for study:

- The pros and cons of greater public investment, especially in power generation and distribution, gas supply, roads, etc. for small enterprises, versus tax expenditures on these units.
- Equalisation of the highest marginal tax rates of income tax on individuals, AOPs and companies in order to compel small companies to enhance their corporate status as they grow.
- Fiscal incentives for conversion from AOP to small company according to the Companies Ordinance.
- Reducing competitive advantage from tax expenditures to large companies by the following policy measures;
 - ~ Limiting the duration of tax holidays to a maximum of five years
 - ~ Reduction in the accelerated depreciation allowance on the acquisition of non-productive physical assets (like buildings)
 - ~ Higher accelerated depreciation allowances on acquisition of locally manufactured machinery (50%) versus 25% on imported machinery
 - ~ Elimination of the presumptive tax differential between commercial importers (who mostly supply small companies) and industrial importers
 - ~ Making the withholding tax rate on electricity bills proportionate to the size of the bill
- Introduction of incentives for higher compliance by small enterprises. The proposed scheme is described in Box 2.

**BOX 2:
INCENTIVES FOR COMPLIANT TAXPAYERS**

Incentives could be given to tax payers who satisfy the following criteria:

- (i) Regular filing of returns for the last two years
- (ii) No under declaration or short payment.
- (iii) Such taxpayers should receive a special certificate which entitles them to some or all of the following benefits, as long as they fulfill the above criteria:
 - (i) Some preference in contracts for supplies to government departments
 - (ii) Guaranteed refund within the stipulated time
 - (iii) Access to a bank loan over a certain limit
 - (iv) Provision for carry forward of losses
 - (v) Partial or full exemption from withholding taxes, contributing thereby to improvement in the cash flow position
 - (vi) Preferential treatment in getting access to public services like issue of passport; electricity or gas connections, etc.
 - (vii) A tax credit

Sales Tax

- Allowing voluntary registration by small enterprises, which are below the exemption limit
- Extension of the withholding tax net to cover sales by registered units to unregistered units
- Bringing uniformity in the GST rates on imports (in view of no output tax)
- Simplifying the tax system with more tax payer friendly returns, less frequency in filing of returns for small enterprises and availability of forms in local languages.

Customs Duty

- Rationalisation and / or elimination of SROs which confer a competitive advantage on large enterprises, along, with a downward cascading of the overall statutory customs tariff structure.

Property Tax

- Simplification of the method of assessment of tax liability and making a transition to a self-assessment system
- Computerisation of property records, following a comprehensive survey

- Reducing tax differential between different types of properties
- Rationalization of the overall tax incidence on property transactions
- Decentralization of collection of UIPT to large local governments.

4.2 LEVEL OF ANALYSIS (NATIONAL, SUB-NATIONAL)

Research for the first two themes will be conducted at the national level while the study for theme 3 will be at the sub-national (provincial, local levels).

4.3 ANALYTICAL APPROACH AND EVALUATION CRITERIA

Each of the above policy options will be evaluated (in a static framework) on the basis of the following criteria:

- ~ impact on the level of compliance of small enterprises
- ~ impact on the relative competitive position of small and large enterprises (especially the relative tax incidence)
- ~ impact on the profitability and growth of small enterprises
- ~ impact on revenues, extent of revenue loss or gain
- ~ Identification of gainers or losers

On the basis of the above criteria, the policy options will either be recommended or not recommended. Overall, an effort will be made to present a package of policies which are either largely revenue- neutral or do not involve significant tax revenue losses, given the extremely low tax-to-GDP ratio of Pakistan (at 9 % of the GDP). It is also likely that revenues may be enhanced by rationalization of tax expenditures on large companies.

5. DATA COLLECTION METHODOLOGY.

5.1. RESEARCH METHODS

Besides secondary data analysis, research will also be based on primary data collection. We are proposing to conduct key informant interviews and a primary survey for the three themes as described below.

5.1.1. Key informant Interviews

Key informant interviews spanning civil servants, elected officials and other non-state actors will be undertaken for the three themes as follows:

5.1.1.1. List of key Informant Interviewees	Theme 1	Theme 2	Theme 3
Civil Servants (Derving & Former)	✓	✓	–
1. Member Inland Revenue, and Member Customs FBR	✓	✓	
2. Former Chairman, FBR	✓	✓	✓
3. Provincial Small Industries Corporation, Punjab	✓	✓	✓
4. Chairman, SMEDA	✓	✓	✓
5. Secretary, Excise and Taxation, Punjab	✓	–	✓
6. Chairman, Sindh Revenue Board	✓	✓	–
7. Director General, Excise & Taxation, Sindh	✓	✓	✓
Elected Officials			
8. Members Parliamentary Committee on Finance in the National Assembly	✓	✓	– –
9. Members Parliamentary Committee, Punjab Provincial Assembly	✓	✓	✓
Non- state Actors			
10. Real Estate Agents,	✓	–	✓
11. First Women’s Bank or SME Bank	✓	–	–
12. One Trade Associations (Pakistan Carpet Manufactures and Exporters, Pakistan Handicraft Manufactures Association)	✓	✓	✓

5.1.1.2 Instrument (Semi-Structured Questionnaire Outline)

Questions to be asked will be divided into the following 13 modules. Modules 1 to 6 are more relevant to theme 1, Modules 7 to 9 to theme 2 and Modules 10 to 12 to theme 3.

1. The institutional setting for SME sector, especially focusing on institutions working for development and promotion of the SMEs.

2. Constraints to improved productivity, growth and employment generation ability of small enterprises including regulatory constraints, fiscal policy constraints, infrastructural constraints, human resource constraints, market constraints, macro policy constraints and financial constraints.
3. Biases in tax exemptions and incentives for small enterprises, their potential impact and effectiveness.
4. Political economy considerations affecting tax policy and considerations.
5. The role of the undocumented sector in Pakistan's economy, particularly in times of macroeconomic instability and rising poverty and unemployment and impediments to formalization.
6. Biases and their impact on small enterprises owned and managed by women.
7. Impediments to entry/ exit of small firms and impact of tax regime in emigration of entrepreneurs and skilled labour.
8. Current Sales Tax/ (RGST) Pakistan, its structure and administration and observations on reform.
9. The impact of VAT on small enterprises performance and productivity.
10. Treatment of small enterprises by Tax administration agencies and taxpayer friendliness.
11. Structure of urban immovable property taxation in Pakistan.
12. Key issues in property taxation.
13. Impact of taxation on land markets.
14. Impact of land markets, tax structure and tax administration on small enterprises.

The interviews will be administered by the project research team, including the Team leader in Islamabad, Lahore and Karachi. About 70 percent of the small enterprises are located in Punjab, so the concentration of the interviews will be in cities of Punjab.

5.1.2. SURVEY RESEARCH

The research will be complemented by a primary survey of small enterprises. The detail design of the survey is given below:

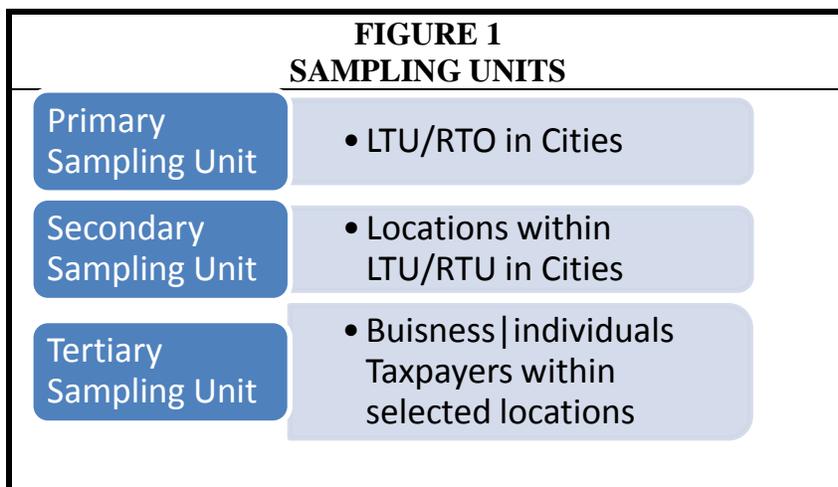
5.1.2.1. Sample Frame

IPP has recently completed a tax perception survey. A similar approach of a three stage sampling methodology will be used to select a nationally representative sample of

respondants for the survey. As illustrated in Figure 1, in this survey, the primary sampling units will be selected from following

cities:

- Hyderabad
- Islamabad
- Karachi
- Lahore
- Faisalabad
- Peshawar
- Quetta
- Rawalpindi
- Gujranwala
- Sialkot



Small cities generally are covered by the RTOs. At the second stage, within each primary sampling unit, a number of secondary sampling units (corresponding to circles) will be selected. In the third stage the random sample will be drawn from the list of taxpayers. The resulting distribution of the sample will largely achieve a nationally representative sample.

The proposed sample distribution is given in Table 1.

**TABLE 1:
PROPOSED SAMPLE DISTRIBUTION**

City	Type of Establishment		
	Small Companies	AOPs and Proprietorships	Total
Karachi	30	66	9
Lahore	16	22	3
Faisalabad	13	28	41
Peshawar	5	20	25
Total	65	136	200

The sample size has been fixed at 200 given the limited funds available in the study for primary survey.

5.1.2.2. Sampling Design and Rationale

A structured questionnaire will be designed to assess the impact of income, customs and sales tax exemptions and concessions, RGST and property taxes on enterprise development. The survey instrument will be pre-tested on small businesses in Lahore. Senior (M.S/ M.Phil) BNU students

will be involved in the project both in the pre-testing and the actual survey. BNU already has a network of students from various universities across Pakistan. This network will be used to conduct surveys in Karachi, Peshawar and Faisalabad. To ensure high quality work, students will be interviewed for required knowledge and skills and further trained on the basics of taxation, current taxation structure in Pakistan, especially RGST and property taxes and small and medium enterprise development issues in Pakistan.

To allow for the possibility that same sample units may have moved to other locations or have shut down, a larger sample will be given to the surveyors when they go to the field.

5.1.2.3. Survey Instrument

A structured pre-coded questionnaire will be given to the surveyors. The questionnaire will have the following modules:

- 1) Information on the sample unit, relating to names, address, ownership pattern, legal status, type of business etc.
- 2) Information on business, relating to employment, turnover, markets accessed, exports etc.
- 3) Constraints to improved productivity, growth and employment generation including regulatory framework, infrastructure, human resources, market access, macro policy and financial.
- 4) Applicable taxes, tax concessions and incentives and their impact.
- 5) Perceptions about taxes, tax administration procedures and tax administrators and Compliance costs.
- 6) Impediments to formalization of business and willingness to formalize.
- 7) Biases and their impact on businesses owned/ managed by women.
- 8) The impact of RGST on performance in terms of production, sales, employment generation and productivity.
- 9) Problems created by multiplicity of taxes.
- 10) Property related taxes paid and their impact on business development.
- 11) The land market and its impact on their business.
- 12) The process of land acquisition.
- 13) Ranking of issues/challenges related to each theme.

Modules 1-7 focuses on theme 1, modules 8-9 on theme 2 and modules 10-12 on theme 3. In each module, specific emphasis will be on issues/challenges and what needs to be done both in terms of change in policy and procedures/mechanisms. At the end of the questionnaire, the

respondants ranking of issues/challenges will be asked to get a handle on the intensity and severity of each problem and to prioritize the policy recommendations emanating from the research.

5.1.2.4: Action Plan

Action Plan- 2013												
Tasks	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
1. Finalization of Questionnaire [Key Informants]	✓	✓										
2. Interviews of key informants, Civil Servants Others				✓	✓							
3. Synopsis Report on Key Informant Interviews						✓	✓	✓				
4. Finalization of Questionnaire [Primary Survey of firms]		✓	✓									
5. Selection of Survey Teams		✓	✓									
6. Training of Surveyors Lahore/ Karachi				✓								
7. Pre- Test of Questionnaire				✓								
8. Finalization of Questionnaire/ Data Entry program Survey Logistics					✓	✓						
9. Survey of Small Enterprises							✓	✓	✓			
10. Data Entry of firms' Questionnaires									✓			
11. Data Cleaning verification										✓		
12. Report on Survey											✓	

5.1.2.5. Data Collection Protocols:

As mentioned earlier, the project team will be complemented by senior university students (MS/MPhil) in Lahore, Karachi, Peshawar and Faisalabad to undertake the survey. Senior students will be inducted from universities in Karachi, Peshawar and Faisalabad while BNU

students will undertake the survey in Lahore. The students will mostly be with economics, finance and business background. They will be interviewed before recruitment.

A comprehensive training program will be held for the surveyors which will include:

- 1) Lectures on:
 - a) Pakistan taxation structure.
 - b) Structure and administration of RGST.
 - c) Property taxation in Pakistan.
 - d) Small enterprises- their role and challenges.
- 2) Walk through the questionnaire.
- 3) Survey Methods and Design and survey logistics.
- 4) Data Entry Program.

The surveyors will interact with their supervisors who will be the staff members of IPP assigned to the project. This method of conducting survey is chosen as it minimizes costs with no compromise on quality. Also, it exposes senior students to real world challenges facing Pakistan and, therefore, contributes to the dual purpose of imparting knowledge and giving first hand experience to young Pakistanis on the verge of starting their professional lives.

The supervisors will allocate samples, manage logistics in the field, monitor the survey and will conduct random reliability checks. We propose a random reliability check of 20 percent of the surveyed questionnaires.

5.2.6. Data Entry and Verification Protocols:

The questionnaire will be pre-coded and a data entry program will be developed on the institution's website with restricted access. Wherever the data is entered it will be submitted to the same website. The person entering the data will be identified alongwith details like time and date etc. We propose that surveyors enter the questionnaire themselves in the computer and that also as soon as possible so that they do not forget details. Space will be provided for open-ended responses and insights provided by the respondents during the survey. Surveyors will be encouraged to let the survey respondent provide insights/experiences in the field, particularly those related to recommended policy/ procedure changes and to record them in the data base.

Data Analyst, who will be part of the project team will undertake a stratified random verification of the accuracy of the information fed into the computer for 10 percent of the entered questionnaire.

6. REPORTING FORMAT FOR YEAR 1,2AND 3 DELIVERABLES:

Deliverable	Due date
Year 1	
1) Research Design Document	30 th June, 2012
2) Literature Review	31 st October, 2012
3) Conceptual and Theoretical Framework	30 th November, 2012
4) Analytical Framework	31 st December, 2012
Year 2	
5) List of key Informants interviewed	29 th February,2013
6) Semi structured key Informant Interview outline	29 th February, 2013
7) Synopsis Report on Key Informants	30 th August, 2013
8) Sample frame for Survey	31 st January, 2013
9) Sampling design and Rationale for survey	31 st March, 2013
10) Pre- Tested and finalized Survey Questionnaire	30 th May, 2013
11) Database of data collected (cleaned and verified)	30 th October, 2013
12) Report of Monitoring and Reliability Mechanism	31 st November, 2013
13) Descriptive analysis of Survey Data	31 st November, 2013
Year 3	
14) Analyzed data in accordance with analytical Framework, Research Design Document	31 st March, 2014
15) Findings and conclusions	31 st April,2014
16) Policy Implications and recommendations	31 st June, 2015
17) Final Report of the country study with incorporation all the above Deliverables	31 st August, 2015

7. Team Composition

1). Focal Person

Dr. Hafiz A Pasha, Vice Chairman, Institute of Public Policy and Dean SLASS, BNU will be the institutional Focal Person. He will provide overall guidance and methodological advice to the project.

The Principal Investigator and Head of the Research Team has the following credentials.

- i. Dr. Pasha has a PhD from Stanford University, USA. He has over thirty five years of teaching and research experience.
- ii. Dr. Pasha has served earlier as Vice Chancellor of the University of Karachi, one of the largest public universities of Pakistan. Earlier he served as Dean and Director of the Institute of Business Administration (IBA) Karachi. Currently. He is Professor and Dean, School of Liberal Arts and Social Sciences of the Beaconhouse National University.. He is also the Vice Chairman of the Institute of Public Policy.
- iii. Dr, Pasha has held a number of important public positions including Commerce Minister, Finance Minister, Education Minister and Deputy Chairman, Planning Commission in three governments.
- iv. Dr. Pasha is currently providing high level policy inputs to the Government of Pakistan in his capacity as Convener of the Prime Minister's Economic Advisory Council. Earlier, he served as Chairman of the Revenue Advisory Council of the Ministry of Finance. He also served on a number of Tax Reforms Commissions and is considered as one of the architects of major tax reforms since early 90s.
- v. Dr Pasha has published over 150 books and articles in leading national and international journals

2) Team Leader:

Dr. Aisha Ghaus-Pasha has twenty-six years experience in teaching, undertaking research and consulting assignments in social policy and development, governance, public finance and urban and regional economics and in advocacy work on social and economic issues. She has a Ph.D. from the University of Leeds, United Kingdom. She is Director of the Institute of Public Policy, Beaconhouse National University, Lahore, Pakistan. She has served as the Deputy/ Acting Managing Director of the Social Policy and Development Centre, Karachi, Pakistan, a leading non-governmental think tank.

Dr. Ghaus-Pasha has been a member of several Task Forces, Committees and Commissions on public finance, social sectors, poverty alleviation and institutional reforms constituted by Governments in Pakistan. She has represented NGO's on the management boards of a number of important institutions like the Pakistan Poverty Alleviation Fund.

She has undertaken consulting assignments for a number of international multilateral and bilateral agencies like UNDESA, UNDP, The World Bank, The Asian Development Bank, Canadian International Development Agency (CIDA) and the United States Agency for International Development (USAID).

She has published over 75 books, journal articles and reports

3). Research Associates/ Survey Supervisors:

a) Muhammad Imran

Muhammad Imran will be one of the data analysts and survey supervisors.

He has nearly five years of experience in research and consulting in the fields of public policy analysis, public finance, project/programme evaluation, governance, and social sector economics. This includes both individual work and working as team member for assignments. He has undertaken a number of studies for multilateral aid funding agencies including the United Nations Development Programme, International Growth Centre, and the Department for International Development, UK. He has over 20 publications in public finance, social sector economics, governance, project monitoring & evaluation, and urban and regional planning.

b) Wasim Saleem

Wasim Saleem, Research Associate of Institute of Public Policy. He has done his Masters in Economics from Punjab University, Lahore and M-Phil Business Economics from Beaconhouse National University, Lahore. He assisted the Vice Chairman for 5th annual report of IPP. He coauthored a paper on analysis of Budgetary Allocations for Poverty Reduction, Social Sector, Human Development and MDGs published by SPO 2011.

c) Qasir Abbas

Qasir Abbas, Research Associate of Institute of Public Policy. He has done his MSc in Economics from Punjab University, Lahore and M-Phil in Development Economics from Beaconhouse national University, Lahore. He assisted the Vice Chairman for 5th annual report of

IPP. He served as lecturer in Govt. Gulberg College for Boys, Lahore and Govt. College Model Town, Lahore.

4) IT Specialist:

Muhammad Rizwan

Muhammad Rizwan. IT Manager Institute of Public policy, will be the institutional IT analyst. He will take care of all the Data analysis. Muhammad Rizwan has done Masters in Computer Sciences and almost 5 years of experience in Computer Programming, Networking and Data Analysis. He has the following responsibilities at IPP ,Maintaining and timely update IPP's Web Site, Troubleshoot DSL problems, Managing and resolving the networking issues over the LAN and wireless network, Procurement of IT hardware, software and maintenance products & services, Data Analysis, Assisting Chairman, Vice Chairman and Director in timely completion of project reports, Assist users and technical staff by providing technical support in resolving network related problems and providing software support. He is proficient in tools like C sharp.Net, Vb.Net, PHP, Microsoft ASP.Net and SQL, Microsoft Office, SPSS, EViews, Visual Studio, QuarkXpress.

Technical Annexes

TECHNICAL ANNEX I: ECONOMICS OF COMPLIANCE VERSUS NON-COMPLIANCE

We designate the following:

Suppose that the tax payer declares a portion θ of his income, $0 < \theta < 1$

π = pre-tax profit, π_T = post-tax profit, α = probability of audit, t = tax rate, β = rate of penalty on income not declared.

If he is not audited then

$$\pi_T = \pi - \theta\pi t$$

If he is audited then

$$\pi_T = \pi - \pi t - (1 - \theta)\beta\pi t \qquad 1 < \beta$$

Suppose that the audit probability is α , the expected post-tax profit is

$$E(\pi_T) = (1 - \alpha)[\pi - \theta\pi t] + \alpha[\pi - \pi t - (1 - \theta)\beta\pi t]$$

$$\frac{\partial E(\pi_T)}{\partial \theta} [(1 - \alpha) + \alpha\beta]\pi t$$

$$\frac{\partial E(\pi_T)}{\partial \theta} < 0 \quad \text{if} \quad \alpha\beta < 1 - \alpha$$

Therefore if the $\alpha(\beta + 1) < 1$ then non-compliance, which implies

If α is small, he has an incentive not to be compliant

If β is not too large, he has an incentive to evade.

For example suppose $\alpha = \frac{1}{3}$, $\beta = 2.5$ then $\alpha(\beta + 1) = \frac{1}{3} \times 3.5 > 1$ and he fully declares.

Technical Annex 2: IMPACT OF TAX EXPENDITURES ON PROFITABILITY

Suppose that y = pre-tax income, y_T = post-tax income. If the tax function is given by

$$T = t(y) \quad \text{where } \frac{\partial t}{\partial y} > 0 \quad \frac{\partial}{\partial y} \left(\frac{\partial t}{\partial y} \right) > 0 \text{ and}$$

y_e = exemption limit on incomes.

Then under the following provisions:

Type I: Tax Deductibility

Suppose that the tax deductibility under various provisions is D . Then in the presence of these concessions, the tax liability is T' where

$$T' = t(y - D) \quad y_T = y - T' \dots \dots \dots (1)$$

and the implied tax expenditure is, TE , where

$$TE = T - T' \dots \dots \dots (2)$$

Type II: Tax Credit

Suppose that the amount of tax credits that can be claimed is C . Then the amount of tax paid is given by

$$T' = t(y) \cdot \left[\frac{y - C}{y} \right] \quad y_T = y - T' \dots \dots \dots (3)$$

and the tax expenditure is given by (2).

Type III: Concessionary Tax Rate

Suppose that the extent of concession is c , then

$$T' = (1 - c)t(y), \quad y_T = y - T' \dots \dots \dots (4)$$

and, as before, the tax expenditure is given by (2).

Type IV: Fixed and Final Presumptive Tax

Suppose that the presumptive rate applied and total income is p , then

$$T' = p(y + y_e)$$

$$\text{and } TE = t(y) - p(y + y_e) \geq 0$$

It is possible in this case that the tax payer is over taxed, implying negative tax expenditure. However, in this case there is the possibility of forward shifting of the tax implying less reduction in post-tax income.

Technical Annex 3:

OPTION OF FIXED TAX VERSUS WITH HOLDING TAX

Should a company opt for the final tax option or file a return and claim a refund?

π = net profit

T = turnover

f = fixed tax rate

Post-Tax profit with fixed tax

$$\pi_T = \pi - fT$$

Suppose he files a return and fully declares his net profit, t is the tax rate on π .

$$\pi_t = t\pi$$

$$\pi - fT > \pi - t\pi$$

$$t\pi > fT$$

declared

$$\pi \rightarrow \left(\frac{\pi}{T}\right)t > f$$

In this case he does not file a return

This depends on

how high $\frac{\pi}{T}$ is

how high t is

Therefore, interestingly the larger firm has a stronger incentive for opting for the fixed tax regime, since it is likely to face a higher t , given the same $\frac{\pi}{T}$.

Technical Annex 4:

DECISION TO REGISTER OR NOT BY ENTERPRISES

When is a small enterprise better off not being registered for sales tax (even though it may be required by law to do so)?

Suppose that o is the value of output, i is the value of inputs and s is the share of inputs from registered persons, t is the VAT rate:

If registered

$$T = to - tsi = t(o - si)$$

If not registered

$T = ti$, Tax paid all inputs,

$$ti < to - tsi$$

$$i < o - si$$

$$(i + si) < o$$

$$(1 + s)i < o$$

$$\frac{i}{o} < \frac{1}{1 + s} \quad \text{If } s = 1$$

$$\frac{i}{o} < \frac{1}{2}$$

This condition may be satisfied in many industries.