TAXATION – WHERE DOES PAKISTAN STAND?

PART II

TO TAX OR NOT TO TAX AGRICULTURE

INFONALYSIS

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Executive Summary

Valued readers will recall that the first part of the series of reports titled "Taxation – Where Does Pakistan Stand?" discussed a high prevalence of indirect taxation in the country as compared to direct taxation and compared Pakistan's existing tax structure with many other countries. It also recommended a reduction in the General Sales Tax rate by 5% to reduce tax burden on ordinary citizens, which could be offset by reforming income taxation from a regressive model to a progressive one.

The second part, "To Tax or Not to Tax Agriculture" highlights the fact that the agriculture sector, in spite of its representation in the national GDP of 21%, and in spite of having an income of an estimated PKR 3.89Tn annually contributes next to nothing as taxes. On the contrary, the industrial sector, though also having the same share of 21% in GDP contributes a mammoth 60% to the exchequer as taxes. This surely is an anomaly given the fact that Pakistan is a leading producer of agri commodities like wheat, rice, cotton and sugar cane, and that huge incomes are derived from its fertile and rich soil.

So what makes the agri sector virtually go tax free?

Why are not laws made to correct this long pending demand of the business community? The answer probably lies in the reluctance of Pakistan's political landholding elite to have their own farm incomes taxed. Imposition of agricultural tax is even ingrained in the manifesto of the current ruling party and key members of the incumbent govt's federal team also acknowledge its importance in backroom discussions. Estimates of the govt's finance experts suggest that such a tax can help generate at least PKR 20Bn for the exchequer, other estimates range from PKR 40-60Bn, while aggressive estimates put the figure at PKR 250Bn.

Effectively, there exist two types of provincial taxes: the land tax and the agriculture income tax. However, the respective provincial laws require the farmer to pay a single tax, which is the higher of the two. The actual problem lies in correct enforcement of the law and proper monitoring of revenue collection as current collection methods provide enough loopholes to save upon applicable taxation.

By virtue of low tax applicability, the agriculture sector often becomes a tax shelter for other forms of income as taxable income from non-agricultural sectors is often declared as income earned from agriculture. The World Bank even goes to the extent of saying that tax arbitrage opportunities provided by the agriculture sector makes money laundering easy for drug lords and criminals.

What could be possibly done to increase agri taxation?

- A measure that can be taken to increase agri tax is the imposition of a 1% flat tax rate on all agricultural revenues, which could yield a sum above PKR 30Bn if implemented in letter and spirit.

- Another step could be that minimum tax on land in Punjab can be increased to PKR 750 per acre from PKR 150 while that in Sindh can be increased to PKR 1,000/acre from PKR 200 for irrigated and PKR 500/acre from PKR100 for un-irrigated land, respectively.

- Thirdly, the payment of support prices to farmers in a crop year can be tied to actual payment of taxes and filing of returns by the farmer for the previous fiscal year.

- Further, the administrative capacity of provincial tax departments needs to be increased drastically to match the requirements of the new tax measures, while ensuring that the incremental administrative costs of the new measures do not overshadow the gains achieved by them.

Pakistan can also take cues from countries like Turkey and Uruguay, who have successfully implemented agricultural reforms and incorporated wide ranging measures to bring agriculture into the tax net. The Turks tax treat agri income the same as income from all other sources, and attracting tax rates of 15-35%. Uruguay follows a much simpler form of agri taxation as net income is taxed at a flat rate of 25%.

Leaving the huge agri wealth untaxed while taxing each and every penny from salaried individuals, entrepreneurs and businessmen is akin to breeding inequality and injustice while also fostering the black economy. To create a level playing field, every source of income must be indiscriminately taxed at even grounds, whether it be from agriculture or non-agriculture.

Agricultural Tax: To reform or not to reform

While deliberating on tax reforms, one should not forget that a very crucial sector of Pakistan's economy with a share of 21% in the GDP and employing about 43% of the available labor force has been allowed to remain virtually tax free – that sector is agriculture. This leaves the majority of Pakistan's tax burden to be carried by the industrial sector which though constituting about 21% of the economy (same as agriculture), pays more than 60% of the nation's taxes.

So what makes the agri sector virtually go tax free?

Efforts to bring the agri sector into the tax net have been made in the past many a times but have failed to see the light of the day.

Taxing agriculture has always been a contentious issue. Efforts to bring the agri sector into the tax net have been made in the past many a times but have failed to see the light of the day. With a majority of the parliamentarians belonging to agrarian backgrounds and having strong influence in the country's politics, endeavors to bring in regulation for expanding the tax net by including agriculture have probably faced stiff resistance at every instance; landholding politicians reportedly have a practice of exercising their clout whenever this issue is raised in the legislatures, with the result always being the same – no enhancement in agricultural taxes.

Reluctance of federal govts.

Landholding politicians have a practice of exercising their clout whenever issue of taxing agriculture is raised in the legislatures

Imposition of agricultural tax is even ingrained in the manifesto of the current ruling party and key members of the incumbent govt's federal team also acknowledge its importance in backroom discussions. Estimates of the govt's finance experts suggest that such a tax can help generate at least PKR 20Bn for the exchequer, other estimates range from PKR 40-60Bn, while aggressive estimates put the figure at PKR 250Bn. But at budget formulation time, the same old rhetoric comes into play: "agriculture is a provincial issue and its taxation is solely the prerogative of the provinces, while the center can only suggest an improved system for its collection."

Reluctance of provincial govts.

To mention a recent event, before the budget for FY15 was presented in the Sindh provincial assembly, there was a whiff that agricultural taxes in the form of a Minimum Income Tax (MIT) and Agriculture Income Tax (AIT) would be enacted through amending the Sindh Agriculture Income Tax Act 1994. It would range from PKR 100 to over PKR 1Mn depending on the nature of cultivable land and size of income made by the farmers. MIT was to be applicable on cultivated land of more than 16 acres while AIT was to be charged at different rates on different slabs of income from a minimum of PKR 0.4Mn to above PKR 6Mn.[1] Not so surprisingly, there was no mention of the tax when the budget was announced and the issue was pushed to the back burner, yet again.

Agri tax can help generate at least PKR 20Bn for the exchequer (other estimates range from PKR 40-60Bn, while aggressive estimates put the figure at PKR 250Bn)

Improper imposition and application of tax laws

It is not that laws do not exist for taxing agricultural income. In fact, there exist two types of taxes: the land tax and the agriculture income tax. However, the

[1] *Daily Dawn. Sindh: Draft agriculture income tax law ready. Jul 2014.*

There exist two types of taxes: the land tax and the agriculture income tax. Farmers are required to pay a single tax, the higher of the two.

respective provincial laws require the farmer to pay a single tax, which is the ***higher*** of the two. The actual problem lies in correct enforcement of the law and proper monitoring of revenue collection; as applicable tax on land is lower than that on agricultural income, landowners find it very convenient to pay the land tax by either showing tax from income to be lesser than that from land by way of manipulation, or not to declare one's agri income at all. The amount resultantly collected is so miniscule that one is compelled to conclude that agriculture is effectively tax free.

Presence of loopholes and absence of centralized land records

Further, land based tax is calculated according to different slab rates depending upon the size of the land. This gives the landowner incentive to sub-divide his land into much smaller portions amongst close family members on paper, and save taxation due to lower applied tax rates. Furthermore, the absence of centralized land records provides the landowner the opportunity to own small chunks of land in different jurisdictions and save up on his land tax bill.

Obsolete system providing an easy conduit to corruption

Lack of centralized records and obsolete methods of tax calculation and collection allow many loopholes to be created for tax evasion and avoidance.

Agriculture or land tax, being a provincial domain, is collected by employing rural accountants called Patwaris who report to provincial revenue departments. As the patwaris have minimal training and supervision and have a tendency to be easily intimidated by the land owner, the whole system is prone to corruption and mismanagement. [2]

Non–taxation making agriculture a haven for crime

It should be borne in mind that by virtue of tax exemptions given on agriculture income, the country's agriculture sector often becomes a tax shelter for other forms of income. To avoid income taxes, taxable income from non-agricultural sectors is often declared as income earned from agriculture. To top it, an early World Bank report suggests that tax arbitrage opportunities provided by the agriculture sector makes money laundering easy for drug lords and criminals. Buying of agricultural lands acts as a safe stash for ill-gotten wealth, without the worries of paying taxes on it.

To avoid income taxes, taxable income from non-agricultural sectors is often declared as income earned from agriculture.

Proactivity by Punjab; but a lot more needs to be done

Although agriculture is a provincial issue, Punjab is the only province that has made efforts (if any) to impose higher tax on agriculture, although there remains a lot to be desired. Even with its amended tax laws, it could only manage to collect PKR 830Mn in FY14. Sindh could however muster only about half of this amount, as collection was recorded at a mere PKR 427Mn. Cumulatively, the collection of a paltry PKR 1.3Bn from the country's two large provinces amounts to only 0.05% of FBR's collection during the year, while the whole sector was responsible for generating wealth in excess of PKR 3.89Tn!! Clearly much needs to be done to rectify this long pending anomaly.

[2] *Usman Mujib Shami. The Mystery of Agriculture Tax. Oct 2010*

Taxation – where does Pakistan stand?

Collection Trend of Agriculture Income Tax (PKR Mn)				
Province	**FY11**	**FY12**	**FY13**	**FY14***
Punjab	717.21	762.44	827.34	830.00
Sindh	210.16	122.81	406.46	426.56
KP	17.53	20.08	22*	22
Balochistan	-	0	0	0.5
Total	**944.90**	**905.33**	**1,255.80**	**1,279.06**
As % of Pakistan's Total Tax Revenue	0.06%	0.04%	0.06%	0.05%
As % of Total Provincial Tax Revenue	1.46%	0.84%	0.83%	0.59%

** Figures are Budget Estimates; - N/A* **Source:** *KCCI Research; Ministry of Finance; Budget Statements of Provinces*

What say the opponents of the agri tax?

Opponents of the agricultural tax argue that:

- The sector is already taxed implicitly as the government allows farmers to charge only government-fixed prices for their produce, which is actually quite low than what they would have received under a free market mechanism.
- The sector already pays indirect taxes i.e. the sugarcane cess and cotton cess, and direct tax in the form of land tax or agriculture income tax, and the farmer will be burdened further with increase in the taxes or introduction of a new tax; this would negatively affect the performance of the sector.
- In the rural economy, payments are mostly made in cash or kind and are hence not properly documented as would have been had they undergone through the banking system. Therefore, it is not possible to calculate agricultural income and the tax on it, as is being done with other sectors.
- As land record is stored locally, it is quite easy for influential landlords to understate their landholdings to misappropriate payable tax in the absence of a centralized system.
- The revenue collection mechanism does not have the capacity to efficiently handle tax on agriculture, while it is also plagued by incompetence and corruption.

Punjab is the only province that has made efforts (if any) to impose higher tax on agriculture, although there remains a lot to be desired.

Why should a higher tax be imposed on agriculture?

The following sections try to cast some light on the reasons the arguments given by those opposing a higher tax on agriculture stand little ground, and why the tax should effectively be enhanced.

Higher commodity prices resulting in higher rural income

Since 2008, the govt. has been fixing commodity support prices of major commodities in consultation with stakeholders which are deemed to be fair. The prices are decided keeping in view the ground realities like cost of inputs and impact of natural hazards. Determination of commodity prices in this manner has reportedly ensured that the farmer gets a fair reward for his endeavors and has resulted in substantial flow of wealth to the rural economy from the urban areas.

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Agri tax needs to be at par with taxes on other sectors

Leaving this huge wealth untaxed while taxing each and every penny from salaried individuals, entrepreneurs and businessmen is akin to breeding inequality and injustice at the whims of a few influentials. To create a level playing field, every source of income must be indiscriminately taxed at even grounds, whether it be from agriculture or non-agriculture. Thus, it has become utmost necessary to bring all rural income in the tax net.

To create a level playing field, every source of income must be indiscriminately taxed at even grounds, whether it be from agriculture or non-agriculture.

The doors of tax evasion by virtue of declaring non-agri incomes as agri income must be closed once for all, so that the non-agri earners do not have to bear the burden of uneven taxation.

The govt. must end this disparity in taxation given the high level of inequality in income distribution across the country. 51% of the country's population lives below the poverty line ($2 per day); on the contrary, 40% of the national income is shared by the 20% high earners.[3] A majority of these high grossers are land lords who pay minimal taxes by reporting their incomes as received from agriculture. Though these landlords have permanent residences in rural areas, their lavish lifestyles are evident too in major urban centers by virtue of their residences in high end localities and ostentatious display of wealth in the form of luxurious automobiles and security apparatus. Should not their income be taxed so that the under privileged get access to better living standards?

51% of the country's population lives below the poverty line ($2 per day); on the contrary, 40% of the national income is shared by the 20% high earners. A majority of these high grossers are land lords who pay minimal taxes by reporting their incomes as received from agriculture.

Issue of land mis-declarations can be resolved by technology initiatives

As far as the issues of centralization of land records are concerned, the state needs to urge provinces to create a centralized database which could enable the tax collector to identify the actual land holding and hence the tax payable on the total holding within the province. This could have been best done as part of a bigger plan of land reforms, as bringing in land reforms is crucial at this juncture when govt. is letting no stone unturned in increasing its revenues.

Unfortunately, wide ranging land reforms were declared un-islamic by a Supreme Court Shariah Appellate Bench in 1989 on the basis of several jurisprudential technicalities; so until a review of the case is filed in the courts on the grounds of change in agriculture dynamics during the last 26 years or any other better reason, the least that could be done at present is the centralization of provincial land records in the whole of Pakistan.

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Possible measures to tax the nation's agri economy

The above reasons must clearly have emphasized that it is high time that concrete measures are taken to reform the current policy on agricultural taxation, and that agricultural income is properly taxed in line with other forms of income like business, property, capital gains etc. The problem that remains is the manner in which tax from agriculture can be significantly increased so as to have some meaningful impact on the national exchequer.

[3] *World Bank data, 2011*

One measure that can be taken is the imposition of a flat tax rate on all agricultural revenue, say 1% initially. This could yield about PKR 39Bn on an income of PKR 3.89Tn.

The sections below put forth some empirical suggestions on the probable application of different modes of taxation on agriculture, while also dwelling on the models followed by other countries. Policymakers in the echelons of power may consider any of the proposed measures or a combination thereof to serve the purpose.

A flat tax can be imposed on all agri income

One measure that can be taken is the imposition of a flat tax rate on all agricultural revenue, say 1% initially.[4] This could yield a sum above PKR 30Bn on an agri revenue of PKR 3.89Tn quoted above, if implemented in letter and spirit. Working on the pattern of Minimum Turnover Tax, the tax would side step the cumbersome process of calculating the net income of the farmer, while also curbing the practice of manipulating the net income figures to make the applicable agri income tax lesser than the land tax.

Current Agriculture Income Tax Rates	
Level of Income	**Current Tax (Punjab & Sindh)**
If total income is less than PKR 80,000	No Tax
If total income is less than PKR 100,000	5% of total income
If total income is more than PKR 100,000 but is less than PKR 200,000	PKR 5,000/- plus 7.5% of the amount exceeding PKR. 100,000/-
If total income is more than PKR 200,000 but less than PKR 300,000	PKR 12,500/- plus 10% of the amount exceeding PKR. 200,000/-
If total income is more than PKR 300,000	PKR 22,500/- plus 15% of the amount exceeding PKR. 300,000/-

Source: *KCCI Research; Govt. of Punjab & Sindh*

Proposed Agriculture Income Tax Rates	
Level of Revenue	**Proposed Tax (Punjab & Sindh)**
If total revenue is less than PKR 500,000	No Tax
If total revenue is more than PKR 500,000	1% of total revenue

Source: *KCCI Research;*

Another measure could be that tax on land in Punjab can be increased from PKR150-250 per acre to say PKR 750 per acre (up to 25 acres) and PKR 1,250 (more than 25 acres) while exempting 12.5 acres from such tax. While that in Sindh can be increased to PKR 1,000/acre for irrigated and PKR 500/acre for un-irrigated land.

Land revenue rates can be increased significantly

Another measure could be that tax on land in Punjab can be increased from PKR150-250 per acre to say PKR 750 per acre (up to 25 acres) and PKR 1,250 (more than 25 acres) while exempting 12.5 acres from such tax.[5] While that in Sindh can be increased to PKR 1,000/acre for irrigated and PKR 500/acre for un-irrigated land.

The reason that a 5 times increase is being recommended in the rates of land tax is that the current level of land taxes are even less than 1% of the net agri income per acre, and that they should at least be 5% of the net income. Secondly, support prices of major commodities like wheat, rice, cotton and sugarcane have risen by

[4] *Said Asif Khan. Agriculture Income Taxation (AIT) in Pakistan. Oct 2013*
[5] *BNU Institute of Public Policy*

at least 300% in the last decade, giving the large and middle sized farmer significant space to contribute his fair share in the national exchequer, which may have not been possible when the laws were last revised in 2003 for Punjab and year 2000 for Sindh.

Current and Proposed Land Revenue Rates for Punjab		
Land Ownership	**Current Tax (Punjab)**	**Proposed Tax (Pakistan)**
Up to 12.5 acres	No Tax	No Tax
12.5 – 25 acres	PKR 150/acre	PKR 750/acre
Above 25 acres	PKR 250/acre	PKR 1,250/acre
Mature Orchards (Irrigated)	PKR 300/acre	PKR 1,500/acre
Mature Orchards (Un-irrigated)	PKR 150/acre	PKR 750/acre

Source: *KCCI Research; Govt. of Punjab (Year 2003)*

Current and Proposed Land Revenue Rates for Sindh		
Land Ownership	**Current Tax (Sindh)**	**Proposed Tax (Pakistan)**
Up to 4 acres (Irrigated)	No Tax	No Tax
Above 4 acres (Irrigated)	PKR 200/acre	PKR 1,000/acre
Up to 8 acres (Un-irrigated)	No Tax	No Tax
Above 8 acres (Un-irrigated)	PKR 100/acre	PKR 500/acre
Mature Orchards Banana/ Betel Leaf (Irrigated)	PKR 700/acre	PKR 3,500/acre
Mature Orchards Banana/ Betel Leaf (Un-irrigated)	PKR 350/acre	PKR 1,750/acre

Source: *KCCI Research; Govt. of Sindh (Year 2000)*

FBR can be tasked to help the provincial govts. with overhauling the existent provincial taxation setup and to build their capability to enforce the new measures.

The progressive nature of this tax (i.e. the high earning farmer paying higher amount of taxes) would inherently tax more from the high earning rich landlords. This would bring at least some measure of uniformity in taxation amongst similar earners of both the farming and non-farming sectors, which at present is non-existent.

Help of FBR can be sought to boost provincial taxation capability

The administrative capacity of provincial tax departments needs to be increased drastically to match the requirements of the new tax measures, while ensuring that the incremental administrative costs of the new measures do not overshadow the gains achieved by them. The case of Bangladesh can be taken as an example where cost of administering the Land Development Tax was about 2/3 of the revenue generated from it.

FBR can be tasked to help the provincial govts. with overhauling the existent provincial taxation setup and to build their capability to enforce the new measures. Until the provinces develop self-sustainability in agri tax collection, the task can be outsourced to FBR which can charge the province for its services.

The payment of support prices to farmers in a crop year can be tied to actual payment of taxes and filing of returns by the farmer in the previous fiscal year.

Payment of support prices can be linked with filing of tax returns

The payment of support prices to farmers in a crop year can be tied to actual payment of taxes and filing of returns by the farmer for the previous fiscal year. The govt. can pass a law making it mandatory for the Trading Corporation of Pakistan (TCP), sugar millers, flour millers, cotton ginners or any other buyers/ agents/ middlemen who buy the agri commodities directly or indirectly from the farmers to pay the govt. announced support price if and only if the farmer submits a copy of his last year's tax return while collecting his payment.

In Turkey, income from agriculture is taxed in the same manner as income from commercial and professional services, salaries, income from moveable property, dividends, interest income, capital gains and royalties.

This measure would serve to entice the farmer to maintain proper records of his taxes, and enhance documentation of the agri economy. However, it would only serve its purpose when the support prices remain competitive with the market determined prices.

Taking cues from other countries

Many countries have successfully implemented agricultural reforms and incorporated wide ranging measures to bring agriculture into the tax net. We look at Turkey and Uruguay as two such examples:

Turkey

In Turkey, income from agriculture is taxed in the same manner as income from commercial and professional services, salaries, income from moveable property, dividends, interest income, capital gains and royalties. Agriculture is a broad term which entails any activity performed in land, sea, lakes and rivers in forms of cultivating, planting, breeding, fishing, hunting etc.

Only small farmers are exempt from tax if a farmer's gross revenue or operational size of his farming enterprise is less than an amount specified by the Income Tax law.[6]

Agri income attracts tax rates of 15-35%. Additionally, an indirect tax of 1% is applicable on the sale of agricultural products sold as raw materials.

The farmers who are not exempt from the tax fall into two categories in determining their agricultural income. The income of farmers, whose annual proceeds or yields are less than an amount specified by the Council of Ministers for each year, is determined on a lump-sum basis. In this method, only the gross revenues of farmers are calculated on the actual basis, while expenses are determined simply by applying an estimated expense rate (70%-80%) to the gross revenues, depending upon the type of agricultural activity.

If the income exceeds the threshold specified by a Council of Ministers, then both revenues and expenses are computed on their actual amounts. Such farmers need to keep accounting books to record their revenues and expenses incurred in the relevant year.

[6] *Revenue Administration Dept. of Turkey*

The income thus computed attracts tax rates of 15-35% (the following table illustrates the applied rates). Additionally, an indirect tax of 1% is applicable on the sale of agricultural products sold as raw materials.

Agricultural Income Rates in Turkey	
Level of Income (Turkish Lira)	**Tax Rate (%)**
0-11,000	15%
11,000 – 27,000	20%
27,001 – 60,000	27%
Over 60,000	35%

Source: *KCCI Research; Deloitte*

Uruguay

Uruguay follows a simple form of agri taxation as income from agriculture is taxed at a flat rate of 25%.

Pakistan can also learn from the Uruguay's example. Uruguay underwent a gradual transition from land-based taxes to agricultural income tax, starting from large landowners. It follows a simple form of agri taxation as income from agriculture is taxed at a flat rate of 25%, after allowing for deductions. For small farms however, rate is lower, as farms with income below UYU (Uruguayan Peso) 4.1Mn per year have a maximum tax of UYU 102,500 (upto 2.5%).[7]

With 21% contribution to GDP, doesn't agriculture deserve a higher tax??

Imposition of an agricultural income tax on large and medium farmers would significantly increase revenue collection while it would also undoubtedly reduce poverty in the country.

Applying tax on agricultural incomes on the pattern of other sectors would yield substantial revenues and would offset to a large extent the expected decline from the proposed cut on GST (stipulated in Part 1 of this series of reports). Clearly, exempting agriculture from taxation imposes a heavy burden on the rest of the economy and causes significant revenue loss for the govt.

Imposition of an agricultural income tax on large and medium farmers would significantly increase revenue collection while it would also undoubtedly reduce poverty in the country. Poverty reduction would be made possible by higher spending on public welfare projects, and a perceived reduction in indirect taxation due to higher direct tax collection.

Enhanced agri taxation would make the provinces more self-sufficient with their revenue requirements and reduce the burden on the federal govt.

Enhanced agri taxation would make the provinces more self-sufficient with their revenue requirements and reduce the burden on the federal govt. Now it is up to the provincial governments to realize the gravity of the matter and pass laws to strengthen the existing agriculture taxation laws in the assemblies. Not only this, the governments need to take measures to aggressively implement these laws in letter and spirit. They can conduct media awareness campaigns to educate the farmers on this issue and ensure that the same attitude regarding agri tax needs to be instilled amongst their own rank and file.

[7] *Fischer & Schickendantz - www.uruguayinvest.com*

** Report has drawn freely from PILDAT Briefing Paper No. 42. Nov 2011*

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