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Taxing the Agriculture Income in Pakistan

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PREFACE

Pakistan faces abysmally low tax-to-GDP ratios varying between 9-11%. Presently calculated at 9.2%, and especially compared to peer countries and to the region, this percentage is the lowest in the world. This scenario has led to the need for urgent re-thinking and reforms in current tax policies as well as addressing deficiencies in the tax administration system.

The need to tax agricultural income, just like any other income in the country, has also fuelled the debate on how to tax the agricultural income. Because rural income is growing, the demand for taxing agricultural income has gained new importance. However, taxing agricultural income remains a divisive issue in the country. Most agriculturists, including the current Prime Minister of Pakistan, oppose introduction of a new agricultural income tax while proponents of agricultural income tax point out that while the sector constitutes around a quarter of the GDP, its contribution to tax revenues hovers at a minimal 1 per cent.

Since the right to collect agricultural income tax lies exclusively with the provinces, provincial legislators need to lead an informed discourse on taxing the agricultural income in Pakistan. Like most divisive issues, there is an urgent need to develop a political consensus on this issue which needs to be led by public representatives. This is only possible through an informed debate following which the provincial legislators can recommend and oversee practical reforms required in taxing the agricultural income.

This Briefing Paper on **Taxing the Agricultural Income in Pakistan** is aimed at crystallizing the issue and its various facets so as to facilitate an informed discourse among MPAs. The paper is based on the principle that all income needs to be taxed in Pakistan and the anomalies, distortions and issues relating to taxing the agricultural income must be resolved urgently through political consensus. Provincial Legislatures should lead the discourse on reforms in the existing tax system that should be based on expert input.

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Lahore
November 2011

INTRODUCTION

The agriculture sector is the mainstay of Pakistan's economy. It accounts for around a quarter of the Gross Domestic Product (GDP) and provides employment to 45 per cent of the population.[1] Furthermore, it has provided much-needed momentum to economic growth in the 2010-11 fiscal year as a result of higher prices of agricultural produce and a subsequent rise in rural incomes, and is expected to continue to do so in coming years.[2]

Because rural income is growing, the demand for taxing agricultural income has gained new importance.[3] Between 2001-2008, Rs. 329 billion were transferred to rural areas due to higher prices of major crops. However, in 2010-2011 *alone*, an additional Rs. 342 billion were transferred to the rural areas due to major price spikes of agricultural produce.[4] Proponents of agricultural income tax point out that while the sector constitutes around a quarter of the GDP, its contribution to tax revenues hovers at a minimal 1 per cent. Any move to impose agricultural income tax is, however, heavily opposed mostly by political parties/public representatives with agricultural background and organizations such as the Farmer's Associates Pakistan (FAP).

The issue of tax reform has been on the table for at least the past decade. During this time, the tax-to-GDP ratio has remained stunted and has varied between 9-11%. Presently, it is 9.2%. Compared to peer countries and to the region, this percentage is the lowest.[5] Therefore, re-thinking current tax policies as well as addressing deficiencies in the tax administration system is crucial at this time.

This paper aims to clarify the main issues that surround the debate on agricultural income tax in order to provide objective insight into how it may be effectively tackled in the future.

The section of the paper stipulates basic constitutional and legal provisions regarding agricultural income in Pakistan. In order to place the current debate within historical context, the evolution of the legal framework surrounding the taxation of the agricultural sector is also discussed. The main problems with the current system are also shared. This is followed by outlining the chief points made by proponents and opponents to either support or reject agricultural income tax.

The major conclusion drawn from these sections is that the current system of taxing the agriculture income is an inefficient and inequitable set-up and that some form of restructuring is necessary. Finally, the paper outlines recommendations for the framing of a new tax policy as well as recommendations to amend existing legislation. While the former presents what should be done ideally, the latter provides practical guidance for what may be achieved now.

1. Pakistan Economic Survey 2010-11, p. 15
2. Ibid.
3. Nasir Jamal. *Time to tax farm incomes*. http://www.dawn.com/2011/05/30/time-to-tax-farm-incomes-2.html (May 30, 2011)
4. Pakistan Economic Survey 2010,11, p. 15
5. Pakistan Economic Survey 2010-11, p. 50

History and Legal Framework

Basic Constitutional and Legal Provisions on Agricultural Income

The 1973 constitution defines "Agricultural Income" in Article 260(1) in the following words: "*Agricultural income" means agricultural income as defined for the purpose of the law relating to income tax."*[6]

Income Tax Ordinance 2001 defines agricultural income under Part VII ("Exemptions and Tax Concessions"), number 41, in the following words:

"(1) Agricultural income derived by a person shall be exempt from tax under this Ordinance.
(2) In this section, "agricultural income" means,-

(a) any rent or revenue derived by a person from land which is situated in Pakistan and is used for agricultural purposes;
(b) any income derived by a person from land situated in Pakistan from
(i) agriculture;
(ii) the performance by a cultivator or receiver of rent-in-kind of any process ordinarily employed by such person to render the produce raised or received by the person fit to be taken to market; or
(iii) the sale by a cultivator or receiver of rent-in-kind of the produce raised or received by such person, in respect of which no process has been performed other than a process of the nature described in sub clause (ii); or
(c) any income derived by a person from
(i) any building owned and occupied by the receiver of the rent or revenue of any land described in clause (a) or (b);
(ii) any building occupied by the cultivator, or the receiver of rent-in-kind, of any land in respect of which, or the produce of which, any operation specified in subclauses (ii) or (iii) of clause (b) is carried on, but only where the building is on, or in the immediate vicinity of the land and is a building which the receiver of the rent or revenue, or the cultivator, or the receiver of the rent-in-kind by reason of the person's connection with the land, requires as a dwelling-house, a store-house, or other out-building."

In the Fourth Schedule to the Constitution, Entry 47, Part 1 gives the Federal Government the authority to levy "taxes on income other than agricultural income."[7] Constitutionally, therefore, the right to collect agricultural income tax lies exclusively with the provinces.

Historical Context: The Evolution of Laws Regarding the Taxation of Agriculture

Under the British rule in the sub-continent, income taxes with wide coverage (i.e. including taxes on agricultural income) were imposed in 1860, which was much earlier than in other countries such as Canada (1917) and Australia (1915-16).[8] This was at a time when agriculture was already heavily taxed through land revenue. However, agricultural income was only taxed for 9 years before it was exempted from taxation, and has since then remained almost tax-free for over a century. One reason for this exemption was that land revenue raised a considerable amount of funds (in 1860, they constituted almost 45% of the total central and provincial tax revenues). Later, the Government of India Act 1935 officially barred the central government from imposing tax on agricultural income. It gave provincial authorities to impose and collect such a tax if they wished. Although some provinces in the undivided India levied a form of agricultural income tax, none of these areas fell into present-day Pakistan.[9]

The longest-standing tax on agriculture in Pakistan is the land tax/land revenue. Although the land revenue systems in the four provinces were dissimilar in 1947, the **West Pakistan Land Revenue Act of 1967** put into place a standardized system.[10]

In the **Finance (Supplementary) Act of 1977**, the land revenue/tax was replaced by an agricultural income tax by

6. As quoted in: Huzaima Bukhari & Ikram-ul-Haq Pakistan: Provinces and Agricultural Income Tax. http://www.opinion-maker.org/2010/12/pakistan-provinces-and-agricultural-income-tax/ (December 31, 2010)
7. Ibid.
8. Findlay G. Shirras, The Science of Public Finance (London: Macmillan, 1924), 635.
9. B. A. Azhar, "Taxation of Agricultural Income: A Holistic View," The Pakistan Development Review 30: 4 Part II (Winter 1991): 1065 1067.
10. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 2

the Pakistan Peoples Party (PPP) government of Mr. Zulfikar Ali Bhutto, but this move was suspended and eventually reversed by the military government that came into power after the *coup d'etat* of July 1977, who exempted agricultural income from taxation once more through the **Income Tax Ordinance of 1979**.[11]

As time went on, revenue from taxes on non-agricultural sectors increased and those from land revenue fell. Today, land revenue comprises a minimal percentage of total tax revenues (see Table 3). Because land revenue does not impose any significant burden on the agricultural sector, agricultural income tax has been suggested repeatedly over the years as a way to raise additional revenues and to bring the agriculture sector under the tax net.

In the 1990s, under pressure from foreign donors such as the World Bank and the International Monetary Fund to bring the agriculture sector into the tax net, some efforts were made to reform the system.[12] The 1992 caretaker government directed provinces to levy a new land tax at a flat rate of Rs. 2 per Produce Index Unit (PIU) on any landholdings above 4,000 PIUs. The exemption limit proved too high, and the resources and effort mobilized too low to collect any significant revenue.[13]

All four provinces also promulgated their own "Agricultural Income Tax" Ordinances in the 1990s. These measures are often "confusingly" described as agricultural income taxes.[14] ***"Agricultural income" as defined collectively by the Constitution and the Income Tax Ordinance 2001 was not taxed under these Ordinances***.[15]

In the Northwest Frontier Province Agricultural Income Tax Ordinance of 1993, for example, the term "agricultural income" was not even defined and the tax itself is a land tax on the basis of produce index units.[16]

These Ordinances have been amended since, most notably in 2000. The First Schedule of each of these Ordinances contains rates of land taxes (henceforth referred to as the "acreage tax"). The Second Schedule of each province stipulates agricultural income tax rates which are to be levied on income exceeding Rs. 80,000. For example, in the ***Punjab Agricultural Income Tax Act of 1997*** (First Schedule), cultivated land was taken to be agricultural income, and therefore agricultural income tax was actually land revenue based on acreage.[17] Later, the Second Schedule of 2001 introduced progressive rates on net income through Section 3(3) of the Act. However, the older system was also retained and farmers/agriculturalists were required to pay **whichever of the two taxes was**

Table 1: Land Revenue Rates (Punjab)

Land Ownership	Tax
Up to 12.5 acres	No Tax
12.5 - 25 acres	Rs. 100/acre
26 - 50 acres	Rs. 250/acre
50 acres or more	Rs. 300/acre

Table 2: Progressive Tax Rates Levied by Punjab Agricultural Income Tax Act (Second Schedule)

Income Level	Tax
If total income is less than Rs. 80,000	No Tax
If total income does not exceed Rs.100,000	5% -5,000
If total income is more than Rs. 100,000 but does not exceed Rs. 200,000	Rs. 5,000 + 7.5% on over Rs. 100,000
If total income is more than Rs. 200,000 but does not exceed Rs. 300,000	Rs. 12,500 + 10% on over Rs. 200,000
If total income is more than Rs. 300,000	Rs. 22,500 + 15% on over Rs. 300,000

Source: Farmers Associates Pakistan, 2011 (Available at: http://www.pakissan.com/english/articles/agriculture.income.tax.shtml)

11. Ibid: 7
12. M. Ghaffar Chaudhry, "The Theory and Practice of Agricultural Income Tax in Pakistan and a Viable Solution," The Pakistan Development Review 38: 4 Part II (Winter 1999): 757
13. Ibid: 9
14. Ibid: 7
15. Huzaima Bukhari & Ikram-ul-Haq, Taxing Agricultural Income, http://www.agricorner.com/taxing-agricultural-income/ (December 20, 2010).
16. Ibid.
17. Huzaima Bukhari & Ikram-ul-Haq Pakistan: Provinces and Agricultural Income Tax. http://www.opinion-maker.org/2010/12/pakistan-provinces-and-agricultural-income-tax/ (December 31, 2010)

higher.[18] Table 1 and 2 show the two kinds of taxes levied by the Punjab Agricultural Income Tax Act.

All four provinces of Pakistan have now incorporated the progressive tax rates (Table 1.2) into their Ordinances, and farmers are required to pay whichever is higher. However, the enforcement and collection of agricultural income tax as stipulated in the Second Schedule of each provincial Ordinance has been ineffective. Because farmers are required to pay whichever tax is higher, it is easier to not declare net income and to pay the acreage tax instead.[19] Furthermore, the amount of money collected under this tax is so minimal as to not even be recorded separately. The only data available is for the total receipts of provincial agricultural land taxes (i.e. receipts from the "acreage tax"), which are also minimal and can be seen in Table 3.

of these problems in order to highlight why there is a need for re-thinking the present set-up.

1. The amount of revenue raised is minimal. Table 3 carries the amount of revenue collected by each province in the last ten years. Table 4 shows how much each sector contributes to the GDP, growth in the economy, and revenue respectively. Although the prices of agricultural commodities have increased, the contribution of the sector to taxes has hovered around 1% for over a decade.

2. These taxes are collected through provincial revenue departments, which employ local 'patwaris' to administer tax returns.[20] Local officials are poorly paid,

Table 3: Provincial Agricultural Tax (in Millions of Pakistani Rupees)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Punjab	671	556	623	768	615	658	760	670
Sindh	547	359	218	221	197	198	158	189
Khyber Pakhtunkhwa	19	47	44	58	137	18	23	20
Balochistan	2	5	0	___	___	___	6	1
Total	1239	967	886	1047	949	874	947	880
Total as % of Total Provincial Revenues	0.54	0.42	0.32	0.38	0.28	0.19	0.20	0.13
Total as % of Total Tax Revenue	0.28	0.20	0.16	0.17	0.14	0.12	0.11	0.08

Source of Data: Ministry of Finance Fiscal Operations Reports

In conclusion, although all four provinces do have laws regarding "agricultural income tax," these laws do not in practice actually tax "agricultural income" as defined by the Constitution and the Income Tax Ordinance. The Second Schedule(s) of the provincial Agricultural Income Tax Act(s)/Ordinance(s) does attempt to tax net agricultural income, but highly ineffectively.

Problems with the Current System

The current system of taxing agriculture has numerous drawbacks. This section lists some of the most persistent

Table 4: Sources of Growth and Tax (for 2009-10)

	Contribution to (in %)		
	GDP	**Growth**	**Taxes**
Agriculture	22	10	1
Industry	25	30	63
Services	53	60	26

Source: Federal Bureau of Statistics, Federal Board of Revenue

18. Punjab Agricultural Income Tax Act: http://punjablaws.gov.pk/laws/398.html
19. Huzaima Bukhari & Ikram-ul-Haq Pakistan: Provinces and Agricultural Income Tax. http://www.opinion-maker.org/2010/12/pakistan-provinces-and-agricultural-income-tax/ (December 31, 2010)
20. Usman Mujib Shami. The Mystery of Agriculture Tax. http://jinnah-institute.org/issues/126-usman-mujib-shami-the-mystery-of-agriculture-tax- (October 11, 2010)

trained, and supervised.[21] Because these departments lack the capacity and expertise to efficiently handle the collection of these taxes, there is considerable room for corruption and mismanagement.

3. Although progressive rates on net income have been implemented, the tax based on acreage has not yet been abolished instead, whichever is higher is to be paid. This system leads to tax evasion as it is easier to not file a return for net income and instead pay the acreage tax by fraudulently claiming it is higher.[22]
4. The current system treats agricultural income differently from other sources of income and therefore creates inefficiency and distortions in the economy. The perception of tax inequity leads to a low level of tax compliance overall. It provides an easy route to engage in tax arbitrage, i.e., the practice of profiting from differences between the way transactions are treated for tax purposes. In other words, taxpayers engaged in the non-agricultural sector declare their income as earned from agriculture in order to escape paying taxes. Furthermore, money laundering is made much easier for drug dealers and corrupt government officials who buy agricultural wastelands.[23]
5. Land revenue has a relatively generous size based limit this encourages sub-division of larger landholdings (by, for example, dividing it between close relatives at least on paper) in order to avoid payment of the land tax by staying under the limit.
6. Land records are highly localized, and therefore there is no efficient system to determine the total size of landholdings owned by one person. If a person's landholdings fall in another records area, they can avoid the real tax rate on their total landholdings because of the graduated rates of the land tax.[24]
7. Because the tax is on cultivated land, this also creates an incentive not to cultivate marginal land.[25]
8. Due to inheritance laws, the size of the average farm is expected to keep dropping over time, which will decrease land revenue even further.[26]

Given the **corruption, tax-evasion** and **unavailability of accurate records detailing total landholdings owned by one person,** it is difficult to calculate the total potential of revenue under the current system. **However, for the same reasons, it is reasonable to expect that if the capacity and expertise of provincial revenue departments is increased, revenue collection will be higher than what is presently the case**. Regardless, this will not fully solve the problems of the distortions created by this form of taxation. Such a state of affairs has led many to suggest that agricultural income be brought directly into the tax net, i.e., agricultural income tax in the true sense should be implemented.

21 World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 11
22. Huzaima Bukhari & Ikram-ul-Haq Pakistan: Provinces and Agricultural Income Tax. http://www.opinion-maker.org/2010/12/pakistan-provinces-and-agricultural-income-tax/ (December 31, 2010)
23. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 10
24. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): Exec. Summary, p. iii.
25. Ibid: 11
26. M. Ghaffar Chaudhry, "The Theory and Practice of Agricultural Income Tax in Pakistan and a Viable Solution," The Pakistan Development Review 38: 4 Part II (Winter 1999): 761

Agricultural Income Tax - The Debate

Several arguments have been put forth for and against the introduction of agricultural income tax. The first two parts of this section list these popular arguments, whereas the final part analyzes the arguments from both sides in order to provide a bias-free picture of the main issues involved. The purpose of this section is to clarify which points of disagreement between the two camps need to be genuinely addressed by an expert body in order to move forward.

Argument for Agricultural Income Tax

Proponents of agricultural income tax argue that:

1. The present bleak economic situation requires the government to raise more revenue in order to lift the low tax-to-GDP ratio and in order to meet revenue and fiscal targets, which it has missed for the past four (4) years. In order to break the cycle of low growth and high inflation, more funds are essential. An oft-quoted estimate of the revenue potential of the agricultural sector is **Rs. 250-300 billion**,[27] which is calculated on the basis of the agriculture sector's contribution to the GDP and the income tax rates that are currently applied to non-agricultural sectors. However, the Beacon House National University's Institute of Public Policy (IPP) estimates the revenue potential to be much lower around **Rs. 40 billion**, whereas Mr. Sakib Sherani, former Principal Economic Advisor to the Ministry of Finance, places his estimate **at Rs. 60 billion**. Varying estimates are in part a result of different assumptions on which the estimate is based.
2. There has been a "structural shift of incomes towards untaxed sectors," which requires a broadening of the tax base. Because rural incomes have been rising, a window is now open to tax farm incomes to fund development. [28]
3. Agricultural income tax can be made progressive, i.e., those who earn more, pay more. This is tied to the fact that many rich and influential landlords do not significantly contribute to tax revenues, and so their incomes may be targeted through a progressive tax rate that is comparable to income tax rates for financially similar individuals earning from non-agricultural sectors of the economy.
4. Agriculture should not be given special treatment as the exemption from income taxes for this sector is not supportable on the grounds of equity.
5. Discrimination against the agriculture sector through the imposition of low prices has diminished in the past decade due to the implementation of structural adjustment programme and the sector now has an untaxed potential because of the decline in implicit taxation.[29]
6. Cultivation intensity has been shown to vary inversely with farm size in Pakistan, i.e., as farm size increases, the efficiency with which it is cultivated decreases. Therefore, at least theoretically, higher tax rates on larger farms could provide the incentive to rich landlords to more efficiency use their land.[30]

Revenue generation and **equity** are therefore the chief concerns of most proponents of agricultural income tax.

Argument against Agricultural Income Tax

Opponents of agricultural income tax argue that:[31]

1. The agriculture sector is already taxed through the provincial agricultural income tax ordinances.
2. Rich landlords are not in a majority, and therefore the revenue potential from the sector is not as high as claimed.
3. Agricultural income tax will only burden poorer farmers and in turn adversely affect the performance of the agricultural sector.

27. See for example: Usman Mujib Shami. The Mystery of Agriculture Tax. http://jinnah-institute.org/issues/126-usman-mujib-shami-the-mystery-of-agriculture-tax- (October 11, 2010)
28. Nasir Jamal. Time to tax farm incomes. http://www.dawn.com/2011/05/30/time-to-tax-farm-incomes-2.html (May 30, 2011)
29. Mahmood Hasan Khan, "Resource Mobilisation from Agriculture in Pakistan," The Pakistan Development Review 30:4 (1991); World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 1.
30. M. Ghaffar Chaudhry, "The Theory and Practice of Agricultural Income Tax in Pakistan and a Viable Solution," The Pakistan Development Review 38: 4 Part II (Winter 1999): 758
31. Note that many of these arguments are taken from a statement issued by the Farmer's Associates Pakistan (FAP), which is taken for the purposes of this paper to represent the opponents of agricultural income tax. The statement is available here: http://www.pakissan.com/english/articles/agriculture.income.tax.shtml

4. The percentage of larger land holdings has decreased due to inheritance laws, conversion of agricultural land into residential colonies, etc. Between 1970 and 1990, for example, the average farm size fell from 13.0 to 9.4 acres.[32] Table 5 carries more recent figures.

Table 5: Agriculture Land Ownership in Punjab (in %)

Land Ownership	Less than 5 acres	5 -12.5 acres	12.5 -25 acres	25 -50 acres	50 acres and over
	90.73	7.4	1.2	0.28	0.05

Source: Statistics Punjab, 2007

5. Collecting direct taxes on agricultural income is a complex, burdensome task that is too difficult for developing countries to administer.
6. In addition to current direct taxation, the agriculture sector also pays indirect and implicit taxes. Indirect taxes include the sugarcane cess and the cotton cess. The cost of agricultural inputs has gone up due to diminishing/withdrawal of subsidies and the imposition of 17% RGST/VAT on agricultural inputs and machinery (fertilizers, tractors, etc). At the same time, prices are not fully allowed to fluctuate in order to reach international market prices, resulting in continuing implicit taxation.

Key Issues

Now that both sides of the debate have been outlined, it is important to address some of the key points raised by both sides. The above sections demonstrate that there are several unresolved issues that must be addressed before a decision is made on agricultural income tax. The following questions must be answered:

1. When implicit and indirect taxation is accurately taken into account, what is the real tax burden on the agriculture sector and how does this compare to the tax burden on non-agricultural sectors? Although implicit taxation through overvaluation of the exchange rate and imposition of low prices was seen to relatively diminish in the late 1990s and early 2000s, recent figures on the extent of indirect/implicit taxation on the agriculture sector are not available. Without such an estimate, it is difficult to make any claims regarding the actual tax burden of the agriculture sector. However, it should also be noted that non-agricultural sectors also face indirect taxation.
2. What is the true revenue potential of agricultural income tax? Although this is listed as an unresolved issue due to the varying estimates present in the literature, it should be noted that even a conservative estimate of Rs. 40 billion is a sizeable amount of revenue compared to current collection. Furthermore, the equity argument still stands even if the potential revenue is not as high as 250-300 billion.

It should also be noted that the popularly-used argument that landlords are a minority of farmers and poorer farmers will be burdened is not a valid argument against reforming the current system. Figures showing average farm sizes may not accurately depict how much land is actually under the control of rich landlords. They may have sub-divided their property amongst close relatives, or may own lands in different records areas. Regardless of whether or not rich landlords are a minority, there is no reason why the tax burden on their income should be lower than that on other comparable incomes, even if the revenue potential from their combined incomes is not a monetarily significant contribution to total revenues. Furthermore, a progressive system of taxation would seek to not burden poorer farmers.

Another argument about lack of administrative capacity to collect agricultural tax, however, deserves serious attention. As is shown in the next section, experiences from other developing countries provide at least one concrete lesson: the imposition of agricultural income tax requires a certain level of administrative expertise, oversight, and capacity which is seldom fully found in sub-national levels of government in countries like Pakistan.[33]

Although the 17% RGST/VAT (value added tax) is expected to raise government revenues and is theoretically a viable way to tax agriculture, there are some genuine concerns about such a tax. The VAT is a tax levied on inputs and outputs along a chain of production. This requires effort to

32. Government of Pakistan, 1990 Census of Agriculture: All Pakistan Report. Vol I. Lahore (1993).
33. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 32

make sure that the tax is only on value added and does not arbitrarily affect final goods prices. Because this requires accurate documentation at each stage of production, the World Bank suggests that levying such a tax is too administratively difficult for developing countries. Although steps can be taken to improve the quality of documentation in order to handle the considerable record burden, an additional concern is that a VAT is difficult to make progressive.[34] Because the VAT is uniform across all buyers of agricultural inputs, poorer farmers may be adversely affected.[35] If the VAT is to be retained, agricultural commodity prices must be allowed to fluctuate freely so that the productivity of the agriculture sector does not suffer.

Despite the unresolved issues regarding real tax burden/real revenue potential, it is clear that some form of change in the current system is absolutely necessary. The current system is inefficient, creates confusion about actual practices, and produces inequity and distortions in the economy. The next section provides an outline of what a good tax policy is and lists recommendations on what considerations must necessarily be a part of reform package in this regard. However, it must also be acknowledged that the framing of a new tax policy is a lengthy and complicated procedure that may potentially face several roadblocks. For that reason, the final section presents concrete changes to current legislation that it may be possible to implement in the near future.

Framing the Ideal Tax Policy

It is clear that the current tax policy on agriculture requires some form of restructuring or reformation. It is also clear, however, that replacing it with agricultural income tax requires resolving certain unaddressed questions that have been listed above. In order to resolve the conflicting claims about the potential of the agricultural sector, as well as the extent of implicit and indirect taxation on the sector, an expert panel consisting of economists specializing in taxation must be consulted in order to gain an accurate depiction of the present state of affairs.

The Goals of a Good Tax Policy

Before deciding how the issue of reforming agricultural tax policy should be tackled, it is important to outline what the goals of this reformation are i.e., to determine the features of a good tax policy.[36]The following three are prime features of a good tax policy:

1. It should create as little distortion as possible. All taxes cause distortions (i.e. change in economic behaviour as a result of the tax) but the effort should be to minimize distortions. Apart from change in underlying economic behaviour, a tax can also provide incentives to modify how income is received in order to avoid or minimize taxation. This type of distortion is most probable when tax policy treats income from one source differently from income from another source, as is currently the case.
2. It should be equitable, i.e., it should treat taxpayers in comparable financial positions in a similar way. Secondly, the tax system should be progressive in order to promote any re-distributional goals the government may have.
3. It should be simple to administer. If the cost of administering the tax is too high, little revenue may be generated from it once costs are subtracted from returns. It is important to practically consider whether the institutional capacity and expertise required to administer a tax is available/could be developed over time. Simply changing the policy on paper without considering such practical issues will not solve the current problems.

34. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 1
35. Muhammad Hussain Khan, Taxes on Farm Inputs Pinch Small Growers. http://www.dawn.com/2011/06/20/taxes-on-farm-inputs-pinch-small-growers.html (June 20, 2011)
36. These have been taken from the following two sources: M. Ghaffar Chaudhry, "Theory of Optimal Taxation and Current Tax Policy in Pakistan's Agriculture," The Pakistan Development Review 40:4 Part II (Winter 2001); World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999)

Therefore, in reforming a tax policy on agriculture, it should be determined what kind of tax and what percentage of tax would be most optimal in promoting efficiency and equity, while at the same time considering the current and future constraints on the resources and expertise available to provincial governments to administer such a tax policy. Reforming policy would require addressing the unresolved questions as no concrete step should be taken before the appropriate facts and figures on implicit taxation and taxation potential are available through an expert body specializing in economics.

Lessons from International Experience

This sub-section aims to draw on international experience to provide some lessons for Pakistan. The countries briefly examined are Bangladesh, India, and Uruguay.

Bangladesh

Bangladesh taxes agriculture through land revenue (called the Land Development Tax or LDT). The LDT was introduced in 1976 and the tax rates have since then been revised so that larger land holdings are charged more per hectare. However, the administrative problems of not being able to determine the total land holdings of an individual owner have persisted, as they do in Pakistan. Revenue generated from the LDT is minimal whereas the administrative costs of the tax are estimated to be two-thirds of the collected revenue.[37]

India

In India, agricultural income is exempt from taxation under the Indian Income Tax Act. Here also a form of land revenue is the primary way of directly taxing agriculture. The simple land area tax has every so often been changed on an ad hoc basis, but today remains an insignificant contributor to total central and provincial revenues.[38] Drawing from the experiences of India, Pakistan, and Bangladesh, it is safe to conclude that the graduated tax on land area is not efficient at raising revenue in these countries, and comes with a myriad of administrative problems and costs. This further supports the point that the current system requires reform. A majority of underdeveloped states do not provide exemptions to agricultural income from taxation. In these countries, the norm is that either a majority of farm incomes fall below the exemption limit, or tax evasion is extremely high. This has led governments to concentrate mostly on the collection of non-agricultural income, except where agricultural incomes are easier to target in the cases of agricultural businesses/large-scale plantations.[39] What is important to note about agricultural income tax in developing countries is that it is not viable to tax actual income because of the unreliability/unavailability of accurate records of transactions, home consumption, etc. Therefore, countries that use this form of income tax rely on some method of calculating presumed income.

Uruguay

One relatively successful story is that of Uruguay, which adopted a gradual transition from land-based taxes to a form of agricultural (presumed) income tax. One lesson that is particularly applicable to Pakistan is that this transition began by targeting large/more commercial farmers and then moved to a wider presumptive income tax. The agricultural tax reforms in Pakistan must be paced appropriately so that the benefits of a more gradual process of reformation may be availed. What is also clear from the experiences of most developing/underdeveloped countries is that sub-national levels of governments are usually ill-equipped to administratively handle taxation. This is currently the case with Pakistan as well, where the expertise of the FBR outstrips that of provincial revenue departments. Because the constitution bars the collection of any taxation of agricultural income by the federal authorities, it is necessary to build the administrative capacity of provincial revenue departments. It is also important to note that before undertaking any reforms, implicit taxation of the sector must be removed if direct taxation is to be implemented.[40]

In summary, whatever reforms of the tax policy are adopted in Pakistan, the following lessons from international experience must be kept in mind:

1. The administrative capacity and oversight of provincial revenue departments must be increased to meet the requirements of the new tax.
2. The tax reform should preferably be gradual.
3. Before implementing any reforms increasing direct taxation, implicit taxation on agriculture should be removed.

37. Jonathan Skinner, "Prospects for Agricultural Land Taxation in Developing Countries," The World Bank Economic Review 5: 3 (September 1991): 502-505.
38. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 27
39. World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 28
40. Experiences of developing countries taken from: World Bank Report, "Agricultural Taxation in Pakistan," (June 21, 1999): 30-34

Findings and Recommendations

This section outlines recommendations that should be considered urgently for implementation while the process of reforming the tax policy continues in the background.

The paper has so far argued that:

1. The current system of taxing agriculture through land revenue/land-based income taxes is inefficient, creates confusion about actual practices, and produces inequity and distortions in the economy.
2. A reform in tax policy for taxing agriculture should be undertaken. Effort should be made to make this policy efficient, equitable, and administratively practical. This does not necessarily mean the imposition of agricultural income tax. For example, one researcher has suggested a two-tier system of proportional land tax and a tax on marketed surplus. However, only an expert panel hired specifically to reform a tax policy can appropriately weigh the options and decide what form of taxation is most desirable.

While the Provincial legislatures can encourage framing of new/reformed tax policies by the Provincial Governments, efforts must be made by all provinces to properly and efficiently administer the taxes already in place. A few practically feasible amendments should be introduced to current legislation on agricultural income tax. Some recommendations to be considered by provincial legislators are:

A) The tax rate per acre is very low (Rs. 150-250 per acre). This amounts to only around 1 % of the estimated net income per irrigated acre of Rs. 25,000-30,000. The BNU Institute of Public Policy (IPP) recommends that these rates should be enhanced to Rs. 750 per acre (for up to 25 acres) and Rs. 1,250 per acre (beyond 25 acres) with a minimum exemption limit of 12.5 acres.

B) The penalties on non-compliance with taxation procedures are extremely low. For example, the penalty for failure to file a return is a maximum of Rs. 1,000. The IPP recommends that this should be raised to Rs. 10,000 in order to enforce compliance. It is expected that if a penalty is lower than the tax amount being evaded, this creates an incentive to pay the penalty instead of the tax. Similarly, the penalty for default in payment should be charged at 15 % per annum instead of the current 5%.

C) 50% of the tax collected from any individual should go directly to the Zila Council of the individual's district. Such a policy may have the effect of improving tax payer compliance.

D) The IPP estimates that if changes A and C are incorporated into current legislation, and collection efficiency is improved, the taxation potential of the sector could rise to Rs. 10-15 billion.

E) Any rise in tax rates, however, should come with the removal of implicit taxation such as price controls. This is especially pertinent given the imposition of RGST on agricultural inputs.

F) Regardless of whether agriculture is taxed through land revenue, RGST/VAT, or in the future through agricultural income tax, it is absolutely necessary to increase the administrative capacity of provincial revenue departments. This is the most important recommendation of all, as many tax options are only made viable if the government is actually able to administer the collection of the tax. This is made especially evident by the fact that although a form of taxing net agricultural income has been imposed in provincial laws, there is little enforcement or collection of this tax.

In conclusion, it is imperative to reiterate that the reforms in tax policies must be urgently considered by the Provincial Legislatures and the Provincial Governments while these reforms must be guided by expert opinion. An exploration of past incidences of ad hoc reforms to agricultural taxation has revealed that policies that are not well thought-out and implemented are neither effective nor useful.

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