

Pakistan's informal economy: the way forward

Outline

1. Introduction

Thesis statement: Informal economy impedes the development of a country. The informal economy of Pakistan is a root cause of some serious evils leading to socio-political rifts and peace crisis. There is a dire need of restructuring the revenue department and process of formalizing informal economy.

2. Concept of informal economy.

3. Reasons of informal economy.

a. Ambiguous channels of transaction

(3rd party, un-registered money exchangers and no record)

b. Incompatible currency change and charges.

(less than the un-registered + Bank charges and duties)

c. Excessive tax burden and lack of motivation.

(40-50% of amount in taxes, Tax scams)

4. Impacts of informal economy.

a. Causes currency devaluation and increases fiscal deficit. (Current high inflation)

b. Burden of tax increases on salaried class
(Increases in every budget)

c. No possible check leads to dangers (Terror financing)

5. How informal economy can be formalized

a. Tax incentives, limited and compatible charges.

(Iterative method to mobilize people)

b. Transaction should be directed through Banks

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e. E-commerce and online transaction should be promoted.

(Easy to record money trail)

d. Progressive tax regime and mandatory returns file.

e. Strict provisions to restrict tax evasion and curb defaulters.

f. Awareness about the benefits of tax.
(Seminars, Advertisements)

g. Transparent and digital mechanism for audit. (would reduce corruption)

h. Free floating currency compatible with unregistered exchangers.

G. Conclusion.

"Mysterium tremendum et fascinans" (Mysteries that we simultaneously fear and admire), Rudolf Otto. The case of Pakistan's informal economy is something like this phrase. Government wants to have a relationship of benefit by utilizing this large chunk of economy, but is afraid of the cost that would be paid to acquire possession of these resources. The ambiguous channels of transaction due to incompatible and excessive charges and currency exchange rate are the reason of this informal economy. This informal economy leads to devaluation of currency, which burdens the salaried class in terms of tax to bridge the

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fiscal deficit and it is further used for illegal actions. To formalize this informal economy it is necessary that people should be given tax incentives, and a cut in taxes in terms of duty. Furthermore, the transactions should be directed through banks, e-commerce and online transactions should be promoted. Progressive tax regime can provide help in formalizing the informal economy. Strict provisions of law and awareness among the people will further strengthen the initiative. ~~last~~ but not the least transparent digital mechanism and free floating currency can provide drastic changes in the process. Informal economy impedes the development of a country. The informal economy of Pakistan is a root cause of some serious evils leading to socio-political rifts and peace crisis. There is a dire need of restructuring the revenue department and process of formalizing informal economy.

Concept of informal economy revolves around the undeclared income of an individual that is not in the records of the state. State institutions are unaware of such incomes, and therefore they can not be taxed. Majority of transactions that an individual performs in his daily life are part of such informal economy. From buying groceries from unregistered shop to paying fare to a taxi driver, all these are the part of an

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informal economy, but situation worsens when the elites become part of this informal economy, to save their money from being taxed. They divert this amount through different channels to minimize the amount of tax. The concept of informal economy deals with the untaxed amount being circulated in the market and their ownership, and the way they opt to keep it, is an informal economy.

Reasons of informal economy include the ambiguous channels of transaction. These unclear paths of transaction are the major hurdle in formalizing the informal economy. The tax authorities are unable to cope with such a situation where there are millions of transactions ~~are~~ taking place in a day, but there is not a single record of such transaction. It is therefore one of the major reasons of informal economy. Moreover, the money sent through un-registered money exchangers negatively impact the reserves, but due to their covert operations they are not prosecuted.

Then, the motivation for informal economy is the 'incompatible currency change, that is less than of the un-registered money exchangers'. The reason of this gap is the taxes and burden on an individual that official way has for the one

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who sends money. The cherry on top is the duties and Bank charges.

The last reason in the row is the excessive tax burden and lack of motivation. It is not less than a misery for an individual that his hard earned money may be heavily invested in taxes. Moreover, the utilization of those taxes is the major concern for tax payers. Previously, the result of schemes, such as "Qarz utaro milk Sansaro", have a ^{got} negative impact on the society and there exists a trust deficit that hinders the people from contributing to the tax system. On average the amount earned by an individual abroad after taxes remains 50-60% of the value of pre-taxed income. This is the result of double tax regime. First, he is taxed on remittances, then after all the taxes and duties, further sales tax and withholding tax plays its part in demotivating people.

One of the major impacts of this informal economy is that it causes currency devaluation and increases fiscal deficit. Informal economy misrepresents the potential of nation's economy, which creates an impression of less reserves and subsequently the currency devalues. This further increases the inflation and life of an average income household suffers. Fiscal deficit due to

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less income than expenditure ruins the equilibrium and state suffers to manage its budget, it borrows from other countries.

The burden of tax on salaried class is another impact of informal economy. The increase in informal economy increases the burden of taxes on salaried class. This phenomenon is the result of bridging the targeted tax revenue to income through revenue. If there would have a proper formal economy this burden could have been averted. The budget study provides insights that, in previous all the budgets the trend of imposing tax regressively increased. This increasing trend negatively impacts the life of a common man.

Lacunas of informal economy have serious concerns for the state as well. The lack of availability of checks leads to a dangerous situation. In most of the criminal activities, this informal economy plays its role. Activities such as corruption, terror financing, election rigging and murders etc are financed through this uncontrolled and unregulated economy. This is a serious threat to peace of the society, and law and order situation of the country. From resurgence of TTP to increasing aggression of ISAF, every act that is now attacking the peace of Pakistan is result of this

Informal economy.

Though, informal economy is embedded in the core of economic system of Pakistan, but it is possible to formalize it through some structural reforms.

The first step in formalizing the economy could be tax incentives, and limited and compatible service charges. In history of Pakistan, there is a long list of amnesties to bring informal economy in tax nets, but they have costed loss of revenue that could have been anticipated by the collection of tax. Therefore, instead of providing amnesty, a certain portion of tax may be rebated in form of tax incentives. Other than this, the amount that directly comes from other countries in remittances or revenue of services should be provided to beneficiaries at minimum possible charges to increase the decreasing influx of remittances. This method can mobilize people to pay their due share of taxes.

Then, there should be a proper mechanism for directing transactions through Banks. The major contributor to the increasing informal economy is the lack of direct mechanism that may provide people a regulated pattern for their transactions. By this single step a major chunk of informal economy could be tracked by the authorities, as there would be transaction

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historics facilitating the tax enforcing authorities.

The banking sector can play its role in an important way, that would result in aligning the informal economy with the rules and regulations set by the state.

As formal economy relies on the record of the economy, in this view e-commerce and online transaction should be promoted. E-commerce being cost efficient saves the resources, while the online payment method tracks the flow of money in economic system. As US senator said; "Entrepreneurs and their small enterprises were the reason of economic growth of USA" through the same method by promoting e-commerce the economic growth of Pakistan's economy and formalization of informal economy could be guaranteed.

Then, there is a dire need of progressive tax regime to motivate people for filing their returns and be part of formalization of informal economy. IMF and other economic, financial institutions also recommend such method to increase the revenues of an state by applying limited burden on the salaried class. It should be a binding principle for every citizen to file his returns. to ascertain exact amount of resources that Pakistan acquires. Moreover, this will provide the breeding

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space to the people struggling due to increased taxes and expensive electricity.

As the quote¹ already has described this mystery as something that one admires and fears, simultaneously. The part of fear is important, here. It is necessary that there should be strict provisions to restrict tax evasion and curb the defaulters. As of FBR's latest press release, out of 750,000 super rich Pakistanis, only 25,000 are registered with FBR, while the others are not even complying the national tax policies. This irregular behaviour shows the importance of strict provisions that may bring this distracted economy again on the track.

It is necessary, that people should be aware of the benefits of their taxes. They need to be on the ^{one} platform and support the efforts of government, designed for their future. Through seminars at Universities, colleges, workplaces and advertisements the utilization of taxes should be defined. The role of transparency for a democracy is of inevitable importance. The more transparent mechanism of spending tax amount would be like far-reaching positive message it will take. In result, a sense of trust will be built among the people for the state.

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A common man avoids the intricacies of indulging into audit matters. The prevalent corrupt practices have demoralized the law abiding citizens. Therefore it is necessary that there should be a transparent and digital mechanism for audit. This would reduce the human touch, mainly responsible for corruption, and increase trust for the tax effective government among the citizens. It is necessary that the voice of people should be heard and their demands should be transformed into reality.

In view of overseas Pakistanis, the major hurdle of informal economy could be the currency rate. It was noted by the leading nations that the currency of Pakistan was virtually manipulated by showing its value constant. This created a trust deficit among the people. The overseas Pakistanis chose unregistered money exchangers to send their remittances through Hawala-hands. If the rate and charges would be compatible to the unregistered money exchangers a huge chunk can be brought in the net of formal economy.

The existing, dwindling economy of Pakistan is the result of many economic experiments. It is the demand of time that some serious steps should be

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taken to address this serious issue. As ex. PM of Japan had said "Economy is the start and end of everything". Therefore it is necessary that the Government may take some sound decisions for the better future of Pakistan. By bringing the informal economy of Pakistan in formal net, a major life line could be acquired. It would have far reaching positive impact on the exchequer and foreign reserves of Pakistan. Through this Pakistan would be one step closer to the escape from IMF bailout packages. This critical hour requires, that every stake holder should play his part with love and respect for the motherland.