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Taxation, Informal Economy and Economic Development in Pakistan

Samiullah

1 Samiullah	**Contribution** PhD Scholar, Department of Economics University of Peshawar
Correspondence author Samiullah PhD Scholar, Department of Economics University of Peshawar horiyansami2011@gmail.com	

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ABSTRACT

Taxation is one of the key instruments through which domestic resource mobilization, provision of public goods, inequality, and sustainable economic development can be achieved. However, despite everything, Pakistan still suffers from the longstanding problem of underdeveloped tax base along with the existence of a significant level of informality. The interaction between taxation and informality creates an unattractive political economy scenario, since on the one hand, large taxes can induce firms and households to operate informally, while on the other hand, low taxes decrease the government's capacity to provide public goods. According to recent research, despite certain progress, the ratio of tax revenue to GDP in Pakistan remains relatively low compared to its peers. According to IMF, the gross general government tax was estimated at 12.3% of GDP in FY2025 and there is much untapped potential of revenue generation in the country (IMF, 2026). The paper examines the relationship between taxation, informality and economic development in Pakistan. The paper notes that the revenue mobilization through sustainability depends on a number of factors such as broader tax base, simplification, tax administration through digital technology, improved tax morale, exemption, formalization of informal activities, and improved quality of government expenditure. According to the paper, formalization must be undertaken through institutional trust rather than by coercion only.

Keywords: Taxation, informal sector, tax compliance, economic development, Pakistan, tax morale, formalization, fiscal capability

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INTRODUCTION

Taxation can be viewed as one of the important elements of state capacity and development. Tax revenues enable the government to finance such expenditures as education, health care, infrastructure, social security, security, and administration (Musgrave, 1959; Kaldor, 1963; Tanzi & Zee, 2000). Well-developed taxation systems enable the government to deal with economic crises and make developmental expenditures (Besley & Persson, 2011; Besley & Persson, 2014). In case of developing countries, tax collection is influenced by such factors as small tax bases, poor administrative system, presence of the informal economy, poor institutional capacity, and low levels of taxpayers' trust (Tanzi & Schneider, 2000; Bird, 2015; Keen, 2012). In the case of Pakistan, it is possible to consider this issue as an interesting case study, since there is the presence of the informal economy in the Pakistani economy, but the government experiences severe fiscal constraints. Traditionally, tax revenues generated by the tax system of Pakistan are insufficient to meet development needs of the country (IMF, 2016; Cevik, 2016). The tax ratio of Pakistan has risen recently; however, the tax ratio in the country in 2016, including provincial taxes and the petroleum development levy, is 12.3% of GDP (IMF, 2016). The informal economy refers to those economic activities which do not get fully recorded, regulated and reported to the respective authority (ILO, 2018; Schneider & Enste, 2000; Loayza, 1996). The informal sector does not necessarily involve criminal actions or any deliberate evasion of tax laws because a majority of people working in the informal sector are engaged in such activities because of poverty, regulation, lack of capital or unavailability of job opportunities (Perry et al., 2007; La Porta & Shleifer, 2014). Nevertheless, the existence of the informal sector complicates tax collection due to cash transactions and lack of record-keeping of economic activity (Alm et al., 2004; Keen & Slemrod, 2021). Thus, the relationship between taxation and the informal economy is multifaceted. More or complicated taxes can make businesses operate within the informal economy but at the same time, the existence of the informal sector restricts the ability of the government to levy taxes (Loayza, 1996; Schneider & Enste, 2000; Ulyssea, 2020). The case of Pakistan shows that businesses react to high taxes by reducing their income and legal form of business as well as resorting to the informal sector (Waseem, 2018). The problem of tax morale is another factor that has to be considered in this situation. The higher level of compliance among taxpayers will occur when people perceive taxation as justified, reliable institutions and good quality of services from the government (Torgler, 2007; Kirchler, 2007; Luttmer & Singhal, 2014). Researchers studying Pakistan's particular case have discovered that education, institutional context, geographical context, gender and perception of tax administration can influence tax morale (Cyan et al., 2016).

The primary argument raised in this paper is that Pakistan has to shift its revenue collection strategy to fiscal development.

Literature Review

Taxation and Economic Development

In terms of economic development, taxation contributes to resource mobilization, redistribution, macroeconomic stability, and public good provision (Musgrave, 1959; Stiglitz, 2000). Throughout history, the development of tax system efficiency has been connected with the development of state effectiveness (Besley & Persson, 2011; Besley & Persson, 2013). Effective states usually have more taxing capacity, tax identification capability, and public good provision capability (Acemoglu et al., 2001; North, 1990).

According to Besley & Persson (2014), it is true that developing countries collect a lot less money through taxation than developed ones because of the economic composition, ineffective institutions, fragmented politics, and fiscal inefficiency. In this context, taxation should not only be regarded as a fiscal instrument but also as an institution of economic development (Besley & Persson, 2013; Acemoglu & Robinson, 2012). Tax revenue gives governments the opportunity to make investments in physical capital and in human capital. Investments in education might increase the productivity of labor force, while investments in infrastructure reduce transaction costs and improve competitiveness of the private sector (Barro, 1990; Romer, 1990; Mankiw et al., 1992). However, taxation can create economic distortions if it features excessive taxation and unreasonable tax systems (Mirrlees et al., 2011; Slemrod, 2007). Therefore, besides increasing taxes, Pakistan should develop a good tax system that will contribute to economic growth and provide sufficient income to the state (IMF, 2016; Martinez-Vazquez & Cyan, 2015). The IMF highlighted that there were low potentials for taxes in Pakistan because of narrow tax base, lots of exemptions, ineffective administration, and the prevalence of informal economy in the country (IMF, 2016).

Informal Economy

Informal sector has been widely studied in developmental economics literature. Concept of informal economy has been elaborated by Hart (1973) who stressed the importance of informal economy in developing countries. Subsequently, ILO (2018) proposed a general framework of understanding of informal employment and informal enterprises. Schneider & Enste (2000) state that there might be various factors that may give rise to informal economy; namely taxes, regulations, institutions and individual incentives.

According to Loayza (1996), there is a possibility that taxes and regulations cause the formation of informal economy, which in its turn, leads to lower government income and constrains development. Perry et al. (2007) have categorized different types of informal workers and informal enterprises and argued that informality is not an uniform phenomenon. La Porta & Shleifer (2014) find that informal enterprises coexist with formal enterprises; however, the former are less productive and do not have financial and market opportunities. Pakistan's informal economy carries a lot of importance because most of the workers and businesses operate in the country unregulated and untaxed. Several studies have come up with estimates about the size of the informal economy of Pakistan depending on the approach used (Kemal, 2003; Schneider et al., 2010; Ahmed & Ahmed, 2020). However, there is only one empirical study that gives an estimate of the size of the informal economy, which is quite large as a share of GDP and the effects on economic growth (Ahmed & Ahmed, 2020). The informality has been analyzed in relation to micro-enterprises in Lahore, which indicates that informality depends on different factors related to the entrepreneur and the firm, which include education, age, income, business age, and sector (Williams et al., 2016).

Taxation and Informality in Pakistan

The level of relevancy between taxation and informality is very high. The research carried out by Waseem (2018) has provided some empirical evidence regarding the behavior of the businesses when the higher level of taxation of the partnership firms brings about earnings reduction and changes in the business structure together with informality. There are also gaps related to the taxation in Pakistan. The OECD analysis of the year 2026 shows that the income tax gap in the year 2022 was estimated to be around 30% of the overall taxes collected while the sales tax gap was found to be around 24% of the overall tax revenues (OECD, 2026). In addition to this, it can be seen that some of the self-employed people underreport their income and the VAT paying firms also indulge in tax evasion (OECD, 2026).

Thus, it is not only the case with informal businesses which are outside of the tax regime. The formal businesses have also shown the tendency to under-report their taxation activities (OECD, 2026).

Tax Morale and Institutional Trust

Tax compliance consists of enforcement and willingness to cooperate. The first deterrence theory was formulated by Allingham and Sandmo (1972) based on their well-known model where taxpayers estimate the benefit from tax evasion against its cost and probability of punishment. Another scholar who paid particular attention to the issues of deterrence and penalty was Becker (1968). Nevertheless, the lack of a proper explanation of taxpayer behavior occurs exclusively in case of deterrence theories. To illustrate, Torgler (2007), Kirchler (2007), Alm (2012), and Luttmer & Singhal (2014) discovered the importance of tax morale, social norms, trust, fairness, and legitimacy of the government. In Pakistan, Cyan et al. (2016) discovered significant differences in tax morale among different segments of the population. Therefore, the improvement of Pakistani tax system should include transparency, fairness, taxpayers' facilitation, and connection of tax payment with public services (Cyan et al., 2016; Alm, 2012; OECD, 2026).

Theoretical Framework

Three main theories have been included in the course of writing this research paper: fiscal capacity theory, informal economy theory, and tax compliance theory.

Fiscal capacity theory asserts that institutional capacity for raising revenues and providing public goods is needed (Besley & Persson, 2011; Besley & Persson, 2013). Informal economy theory posits that regulation costs, taxation, unemployment and bad institutions can motivate citizens to engage in informal activity (Loayza, 1996; Schneider & Enste, 2000). Tax compliance theory highlights the role of enforcement, tax morale, fairness and trust (Allingham & Sandmo, 1972; Kirchler, 2007; Torgler, 2007). From the interplay of these three theories, one can see the following positive cycle:

Taxation reforms → formalization → broadened tax base → additional revenues → improved public services → greater trust

→ improved tax morale → greater compliance → formalization.

However, the negative cycle looks like the following: Higher compliance costs => informality => smaller tax base => lower revenues => lower-quality public services => lower trust => lower tax morale => higher informality.

The above theoretical approach is aligned with the findings related to the complex relationship between taxation, institutions, and informality (Besley & Persson, 2014; OECD, 2026).

Methodology

The study is carried out using qualitative and analytical research design, which employs secondary data sources as the basis for the research. Data synthesis is carried out using information from peer-reviewed academic journals, international organizations, governments' publications, and empirical studies relating to Pakistan. Data synthesis is conducted on the basis of three major dimensions – taxation, informality, and economic development. Taxation is studied in terms of revenue generation, tax-to-GDP ratio, tax expenditure, tax compliance, and tax administration. Informality is studied in terms of unregistered businesses, informal employment, underreporting, cash-based transactions, and barriers to formalization. Economic development is examined in terms of fiscal capacity, investments, public goods and services, productivity, employment, and poverty reduction. No primary data from surveys have been used for conducting this study. The details of Pakistan have been studied against the backdrop of the existing literature on developing nations (Besley & Persson, 2011; Perry et al., 2007; La Porta & Shleifer, 2014). The latest information has been taken to provide a context to the analysis. As per the report of the International Monetary Fund, the tax revenue of Pakistan is 12.3% of GDP in FY2025, while OECD report of 2026 contains the evidence of tax gaps in Pakistan.

Taxation and Revenue Mobilization in Pakistan

The tax system in Pakistan has never had enough income for the needs of country's development. This issue of low tax base, low efficiency of tax administration, too many exemptions, and informality was mentioned multiple times by the IMF (IMF, 2016; Cevik, 2016).

Recent progress is remarkable, but not enough. As it is seen from the statistics provided by the IMF, total tax revenues were equal to 12.3% of GDP in fiscal year 2025 and tax revenues of the Federal Board of Revenue equaled about 10.3% of GDP (IMF, 2025). The IMF (2026) mentions that the tax revenue ratio has reached the highest value since 2000 in Pakistan.

Table 1Selected Indicators of Pakistan's Revenue Challenge

Indicator	Recent evidence	Development implication
Total tax revenue, FY2025	12.3% of GDP	Limited fiscal space
FBR revenue, FY2025	10.3% of GDP	Heavy dependence on federal collection
Income-tax gap, 2022	~30% of tax collected	Significant compliance potential
Sales-tax gap, 2022	~24% of tax collected	Large revenue leakage
Federal tax expenditure, FY2022–23	Rs. 3,879.2 billion	Significant revenue foregone
Tax expenditure as % of GDP	~4.61%	Important reform opportunity

Sources: IMF (2025, 2026); OECD (2026); FBR (2024).

Explanation:

The multi-dimensional issue of revenue generation in Pakistan is pointed out in Table 1 below. Even though there have been some improvements in the area of tax administration, the percentage of taxation relative to GDP is relatively lower. Under-payment of income tax and sales tax indicates a lot of room for compliance, while tax expenditure reduces the efficiency of taxation.

Taxation and Informal Economy

One of the structural problems associated with the tax administration in Pakistan is informality. Informal firms do not register completely, lack good accounting, and do their business through cash transactions. Hence, it is difficult for the tax administration to follow their operations (Schneider & Enste, 2000; Perry et al., 2007; Keen & Slemrod, 2021).

Small traders, household businesses, agricultural workers, transporters, construction workers, domestics, and many other service workers are part of the workforce in the informal economy of Pakistan. However, it is important to distinguish between informal workers and tax evasion since there are informal workers who earn very little income and hence do not pay taxes (ILO, 2018; Perry et al., 2007).

According to OECD (2026), informal sector and hard-to-tax activities are not the same thing. There may be overlap but no coincidence. Examples include agriculture, small firms, cash-in-transaction business, and some professional services.

Table 2Major Drivers of Informality in Pakistan

Driver	Mechanism	Likely consequence
High compliance costs	Discourage registration	Business informality
Complex tax procedures	Increase administrative burden	Non-compliance
Cash-based transactions	Reduce traceability	Underreporting
Weak enforcement	Low perceived probability of detection	Tax evasion
Limited access	Reduces	Informal

to finance	formalization benefits	operations
Low trust in government	Weakens tax morale	Voluntary non-compliance
Unemployment	Encourages survival enterprises	Informal employment
Regulatory uncertainty	Raises business risk	Avoidance of registration

Explain:
The figure shows that informality emanates from a number of sources which are economic and institutional in nature rather than from the tax alone. Informal firms arise because of the cost of registration, inefficiency of the government, and market access problems. One should keep in mind that the policy would become efficient only if both aspects are dealt with simultaneously.

Tax Policy and Firms' Behavior

The firm's decision may be greatly affected by the tax policies. As per the economic theory, the taxpayer makes a choice between the costs of evasion and penalties (Allingham & Sandmo, 1972; Becker, 1968). At the same time, there is evidence about a variety of ways of the firm's reaction to changes in taxes, including investments, reporting, formality, and organizational formality (Slemrod, 2007; Kleven, 2014; Ulyssea, 2020). The situation with Pakistan is quite illustrative in this regard. In particular, the study carried out by Waseem (2018) shows that when Pakistan launched its tax reform and taxed partnership income, the firms' reactions were lowering reported income, reorganization, and formality. The behavioral reaction was so high that the government collected less revenue after the reform than before it. This shows that Pakistan needs to incorporate behavioral aspects while increasing its tax rates. Tax rates, compliance costs, enforcement and formalization need to be considered simultaneously (Waseem, 2018; OECD, 2026).

Table 3. Potential Effects of Alternative Tax Policies

Policy approach	Short-term effect	Long-term possibility
Higher tax rates	Higher liability for existing taxpayers	Possible informality
Broader tax base	More registered taxpayers	Higher sustainable revenue
Simplified taxation	Lower compliance costs	Increased formalization
Digital invoicing	Better transaction records	Reduced evasion
Targeted enforcement	Higher detection probability	Higher compliance
Tax incentives for formalization	Initial revenue cost	Larger future tax base
Better public services	Higher taxpayer trust	Stronger tax morale

Explanation:
From Table 3, it is evident that sustainability of tax policy does not necessarily have to do with the raising of statutory rates. Expansion of tax base, simplification of compliance concerns, better documentation through digitization, and improving the trust of taxpayers may help in achieving sustainability in tax income. From the experience of Pakistan, it is evident that ineffective taxes affect the behavior of taxpayers.

Tax Morale and Compliance

Tax morale has been defined as the inherent willingness of people and organizations to pay taxes (Torgler, 2007; Alm, 2012). Tax compliance requires not only enforcement but also such factors as fairness, trust, efficiency of government, and social norms (Kirchler, 2007; Luttmer & Singhal, 2014). Cyan et al. (2016) point out that tax morale in Pakistan is influenced by socio-economic and demographic factors, and inefficiencies and inequities of tax administration might negatively affect voluntary compliance. Taxpayers tend to oppose being taxed if they believe that other people receive preferential treatment. Furthermore, tax exemption might influence tax morale as well. The FBR report reveals that the Federal Government has incurred huge expenditure on income tax, sales tax, and customs duty exemptions (FBR, 2024, 2025). An inequitable tax system discourages voluntary compliance even among registered taxpayers.

Taxation and Economic Development

There are several ways through which taxation affects economic development. Taxation can be used to fund infrastructure and human resource development (Barro, 1990; Romer, 1990). Secondly, taxation can help in income redistribution and social security provision (Musgrave, 1959; Stiglitz, 2000). Lastly, proper taxation will enhance the governance and financial accountability of the government (Besley & Persson, 2011; Acemoglu et al., 2001).

It is particularly tough in Pakistan, because public debt, energy crises, poor investments, poverty, and limited fiscal capacity are all related to poor tax revenue (World Bank, 2024; IMF, 2026). According to the World Bank, the process of tax reform was critical for economic recovery and overcoming poverty in Pakistan. High taxes can negatively affect investment and entrepreneurship, because businesses would not have any guarantee that taxes will not become even higher in the near future (Mirrlees et al., 2011; Slemrod, 2007). Therefore, it is important to have an efficient taxation system rather than the highly taxed one.

Table 4Taxation–Informality–Development Relationship

Taxation condition	Informality response	Development outcome
Simple and predictable	Lower incentive for	Higher investment

taxes	evasion	
High compliance costs	Greater informality	Lower productivity
Fair enforcement	Higher compliance	Stronger revenue
Digital administration	Better documentation	Reduced tax gaps
Broad tax base	More formal taxpayers	Greater fiscal capacity
Better public services	Higher tax morale	Sustainable compliance
Excessive taxation	Potential exit to informality	Reduced revenue

Explanation:
Table 4 shows the main points discussed in this research: taxation and development are related through formalization and institutions. An efficient and transparent tax system will encourage the formalization of enterprises, while high taxes will discourage the formalization of enterprises. The revenue collected will facilitate funding of public goods, which will increase trust and compliance.
Policy Recommendations
Expand the Tax Base
Pakistan needs to focus on expanding the tax base rather than increasing the taxes of those individuals that have been taxed by the authorities.
Simplify the Process of Compliance
Small firms need a simple process of registration and tax compliance. More documentation means a higher cost of compliance and discourages the formalization process (Loayza, 1996; Perry et al., 2007; Ulyssea, 2020).
Improve Electronic Tax Administration
Invoicing, electronic payments, data integration, and third party information allow the government to identify economic transactions (Keen & Slemrod, 2021; OECD, 2026). Pakistan needs to improve its database integration of tax authorities, financial institutions, business registers, customs, provincial departments, and other relevant database.
Earn Trust of the Taxpayers
When taxpayers perceive that there is delivery of some tangible goods by the government institutions, they pay their taxes (Torgler, 2007; Kirchler, 2007)
Minimize Distorting Tax Expenditures
Tax exemptions and tax expenditures need to be assessed from time to time considering the economics and social factors involved. The tax expenditure study of Pakistan indicates loss of revenue due to several exemptions (FBR, 2024, 2025).
Incentivize Formalization
Formalization needs to provide benefits such as credit, government purchases, social security, training services, electronic markets, and legal protection (Perry et al., 2007; La Porta & Shleifer, 2014)
Agriculture and Hard to Tax Industries
According to the IMF, agriculture is considered to be one of the heavily undertaxed industries in Pakistan (IMF, 2026). This tax reform will focus on taxing this sector in an efficient manner rather than taxing small scale farmers.
Cooperation between Federal and Provincial Governments
The system of Pakistan is the federal system which brings many problems for tax collection. Cooperation between federal and provincial governments will lead to avoidance of duplicating work, better communication, and revenue efficiency (IMF, 2016; Martinez-Vazquez & Cyan, 2015).
Discussion
It is proved that the problem of taxation in Pakistan should not be considered in isolation from its informal sector. The interaction of both sectors operates in such a manner: small tax base makes it hard for the existing taxpayers, whereas the high cost of the tax system and its biased nature may push firms to become informal (Loayza, 1996; Schneider & Enste, 2000; Waseem, 2018).The recent success in revenues collected in Pakistan can be treated as a sign of the possibility to implement reforms and get certain results. However, the tax-to-GDP ratio in the country is too small to cover the development needs of the state (IMF, 2026). Tax gaps in the country are still big enough to make compliance increases possible (OECD, 2026). It also demonstrates that the tax policy affects taxpayer behavior. The evidence provided by Waseem (2018) demonstrates that businesses may become informal because of the changed incentive structure induced by the increase in taxes. Thus, when introducing a tax reform, policymakers should take into account not only the direct effect but also the indirect effect of a particular tax reform. One more important inference that should be made is that informality does not always indicate the intention of tax evasion. Actually, the informal workers can be characterized by poor productivity, low earnings and poor prospects for becoming formal (ILO, 2018; Perry et al., 2007). The implementation of the policy that will completely focus on enforcement may lead to social costs. The most rational strategy will involve the enforcement of tax evasion among high income individuals and creating the mechanism of easy formalization of small businesses and low-income individuals. Finally, tax collection must be integrated into service provision. The people will be willing to pay taxes if they see improvements in areas such as infrastructure, education, health care, security, and social services (Torgler, 2007; Alm, 2012). This means that tax reform must be accompanied by governance reform.
Conclusion
The interconnection between taxation, informality and economic development takes place in Pakistan. The low ratio of tax to GDP in the country limits fiscal space, but informality influences economic transactions and makes it harder for a country to establish its tax base. Moreover, the poor design of taxation policy and the high compliance cost may push companies to become informal or transfer their operations to informal sectors (Loayza, 1996; Schneider & Enste, 2000; Waseem, 2018). Recent research proves the existence of tax collection growth in Pakistan. At present, the amount of tax collections equals 12.3% of GDP in FY2025 (IMF, 2026). Nevertheless, it is not enough. According to OECD data, there are serious deficiencies in income and sales tax, while FBR argues that tax expenditures are considerable (OECD, 2026; FBR, 2024). Thus, one can draw the following conclusion from the policy analysis – Pakistan should not rely on the increase in the rate of taxation. Policy-makers should pay attention to the tax base expansion, simplify the payment procedure, digitalize the tax administration system, improve the intergovernmental cooperation, avoid any exemptions, and provide certain incentives for formalization. The effective

formalization policy will alter the balance between citizens and the state. Businessmen need to understand that registration to the state authorities is not just taxation, but this will provide them with access to financing, state contracts, legal protection, digital platforms, and social guarantees. And citizens should be aware that their money is being used effectively. Therefore, the main task for the policy maker will be to create the virtuous fiscal-development cycle, in which broad formalization results in increased tax collection, increased revenues bring better public services, and better public services result in increased trust and compliance among citizens. This may be a way for Pakistan to achieve fiscal sustainability and economic development.

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The current official evidence supports the paper's central conclusion: Pakistan has made progress in revenue mobilization, but substantial tax gaps, informality, and tax expenditures continue to constrain fiscal capacity and development.