

Tax Structure in Pakistan: Fragmented, Exploitative and Anti-growth

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INTRODUCTION

Taxes are involuntary charges levied on individuals or corporations and enforced by a government entity—whether local, subnational or national—in order to finance government activities. As such, the prime objective of the taxes is revenue generation. However, for sustained stream of revenues, the tax policy also needs to be growth facilitating. These dual objectives can only be achieved if the tax policy reduces the deadweight loss resulting from imposition of taxes, and help transactions grow. Higher number of transactions is associated with higher economic growth and more employment. Increased growth enhances the taxable capacity of the economy and therefore generate sustainable streams of revenues.

Unfortunately, this has not been the case in Pakistan. The objective of the tax policy is reduced to only to collecting more revenues to achieve illusive targets of Tax—GDP ratio and to reduce fiscal deficit. Growth facilitation has not been the priority. Increasing the tax-to-GDP ratio even at the cost of violating the basic principle of taxation—fairness, certainty, efficiency, and convenience—has become the cornerstone of policy. Consequently, the tax structure has taken the shape of an exploitative and anti-growth design that kills transactions. The amplified share of indirect taxes in total collections, the increase dependence on withholding taxes accompanied by compliance cost, and the use of tariff for revenue generation instead of a trade facilitation instrument are some of glaring examples of a tax structure that would go for short-term revenue gains by sacrificing long-term growth.¹

In this brief note, we critically review the taxation structure of Pakistan and suggest some measures on making tax policy consistent with the established principle of good taxation.

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¹The objective of the policy is to first achieve a higher tax-to-GDP ratio no matter what is the cost, and then generate growth and employment through Public Sector Development Programmes (PSDP). There are, however, several issues with this paradigm of tax policy and growth which are discussed in this note.

LEGISLATIVE TAX STRUCTURE IN PAKISTAN

In Pakistan, resource mobilisation takes place at the federal and provincial government levels. Main taxes are broadly differentiated in direct and indirect taxes (with surcharges included in the indirect taxes). As per the constitution of Pakistan, the taxes for collection for different tiers of the governments are defined as shown in Table 1.

Table 1

Tax Structure by Legislation for Pakistan

Level of Government	Direct Taxes	Indirect Taxes
Federal Government	Income Tax	Sales Tax
	Corporation Tax	Excise Duty
	Wealth Tax	Import Duty
	Property Taxes	Export Duty
		Gas and Petroleum Surcharge
Provincial Government	Land Revenue	Foreign Travel Tax
		Sales Tax on Services
		Stamp Duty
	Urban Immovable Property Tax	Motor Vehicle Tax
	Tax on Transfer of Property	Entertainment Tax
	Agriculture-Income Tax	Excise duty
	Capital Gains tax	Cotton fee
	Tax on Professions, trades and callings	Electricity Duty

Source: The Constitution of Pakistan; Fourth Schedule-legislative List.

TAX STRUCTURE AND ITS IMPLICATIONS

Tax Composition

The share of indirect taxes (and surcharges) has been more than share of direct taxes in the consolidated (federal and provincial) revenue resources. This put excess burden on the economy as indirect taxes create distortion in the resource allocation. The share of direct taxes were just 25 percent of the consolidated revenues in 1949-50, 33 percent in 1959-60, and subsequently reduced to just 14-17 percent in the 1970s (Ahmed and Rashid, 1984). However, in the later periods efforts were made to cover for this deficiency. As noted by Fatima and Qazi (2001), the emphasis of fiscal policy in 1990s was to increase the share of direct taxes in tax revenue, which eventually did increase a bit, but the overall tax-to-GDP ratio could not be increased. As of fiscal year 2019-20, the ratio of direct taxes in the total taxes is 32 percent out of which 70 percent are collected in a withholding basis (which defies the Direct Tax claim).

Taxation Principles

A good tax system need to be least distortionary, has ease of collection, doesn't discriminate and is politically acceptable. Most experts are of the view that Pakistan's tax policy is not based on these well-known and clear principles.² Ad-hoc tax revenue

²See Haque, *Macroeconomic Research and Policy Making: Processes and Agenda* <https://www.pide.org.pk/pdf/Macroeconomic-Research-and-Policy-Making-Processes-and-Agenda-Dr-Nadeem-ul-Haque.pdf>

enhancing measures through SROs and mini-budgets have developed a complex tax system that confounds principles of rational tax policy. FBR sets an ambitious target and to chase that number arbitrary measures are taken which create uncertainty that eventually kills transactions. These unrealistic targets cannot be achieved without enhancing the taxable capacity of the country; instead these are stifling the economic activity.³

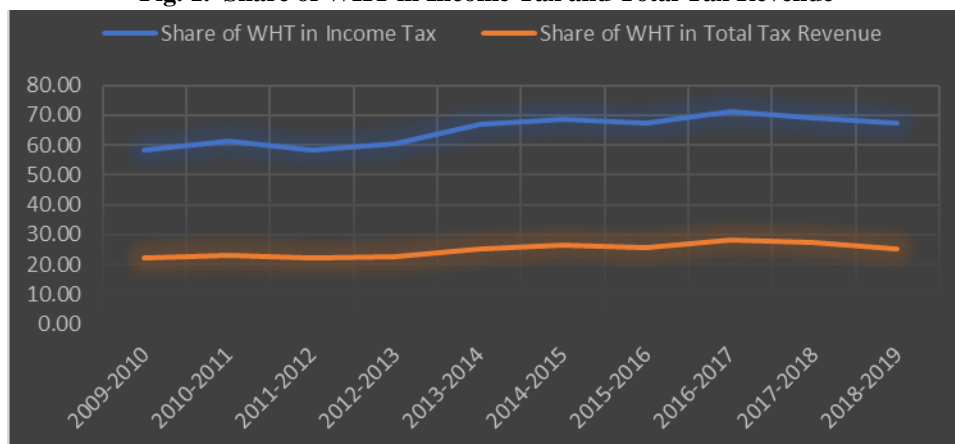
The current tax structure in Pakistan is regressive in nature and is in contrast to the fairness principle of tax policy. Frequent changes in policy and rates make the environment very uncertain especially for potential investors. The reliance on indirect taxation and withholding regimes increase the compliance cost for the tax payers (especially business). Similarly, excessive documentation requirements increase transaction cost. Together, these make the tax policy inefficient and inconvenient.

This situation calls for tax reforms. There have been 16 Tax Reforms efforts since independence. The unmet need for more reforms considering inelastic structure and low tax collection from the economy warrants a critical analysis of the history of reforms and the subsequent outcomes.

Excessive Withholding Regime

As an extractive practice FBR has been able to switch burden of collection to those doing transactions and can be forced to collect withholding taxes on behalf of FBR. About 70 percent of tax revenue is collected through withholding tax agents such as banks, utilities, telecom etc. placing the burden of collection on these businesses and increasing their business costs (Figure 1). While these withholding taxes may provide an easy source of collection for Federal Board of Revenue (FBR), they make the tax system incredibly complex for the taxpayers. This also questions the role of FBR as a tax collecting authority.

Fig. 1. Share of WHT in Income Tax and Total Tax Revenue



Source: Author's estimation based on data from FBR Website.

³See Haque, N. Kill Transactions, Kill Economic Growth <https://medium.com/@nadeemhaque/kill-transactions-kill-economic-growth-5b45ae75abc1>

A recent report titled “Growth Inclusive Tax Policy: A Reform Proposal” by the Macroeconomics Section of PIDE estimates that there are about 35 out of a total of 82 Withholding taxes in Income Tax, five hundred ninety-six out of total 821 in domestic sales tax lines; 42 out of 97 for sales tax on imports, 37 out of 95 in case of customs and 09 out of 37 in case of Federal Excise Duties which contribute less than 1 percent in their respective revenue heads. The report further estimates that about 11.14 Billion rupees of compliance cost of these taxes and 0.24 Billion FBR cost of collection is saved if these taxes are not levied. Further if these taxes are not levied, businesses would reinvest them to expand, then the overall impact would be more economic activity resulting in even more tax collections than that forgone. But unfortunately, while policies are made, no one notices the loss to economic growth and job creation due to these adverse tax measures.

High Compliance Cost

Current withholding regime and other documentation drives by FBR are counterproductive because of higher cost of compliance. This cost consists of the number of hours required for record keeping, tax planning, and forms completion and submission. It takes around 577 hours (per year) to complete the tax payment process in Pakistan compared to the world average of 108 hours. Adding this to the high number of payments (47) tremendously increases the average tax burden in the country (Nasir, et al. 2020). In such a non-conducive environment, any documentation drive would kill transactions and with it any hopes of increasing economic growth and sustainable revenue streams.

Fragmented Tax System and Growth

Tax basis are fragmented with services subject to taxes at the provincial level and goods at the federal level. There is also variation in rates (from 1 percent to 17 percent), in addition to several specific exemptions. The standard rates on services also vary between provinces. In Baluchistan and KPK it is 15 percent, in Punjab it is 16 percent and in Sindh it is 13 percent. Such fragmentation and exemptions also add to the existing uncertainty.⁴ This fragmented and contentious tax policy has resulted in decline of long term growth and productivity. These measures multiply as unrealistic targets are chased with mini budgets every quarter. The study further identifies that the policy priority has been to increase tax-to-GDP ratio thus leaving growth and employment to an outcome mainly produced from Public Sector Development Programmes (PSDP).⁵ Arbitrary and frequent tax changes have created an environment of uncertainty (Nasir, et al. 2020).

Complex Taxation Structures

Pakistan ranked 161st among 190 economies for “paying tax” indicator in the 2020 Doing Business Report. The low performance for this indicator is due to the complex tax system and high tax compliance costs (The World Bank Report, 2019). PIDE report (2020) identifies that the number of complaints received at FTO have been

⁴See Huzaima & Ikram, Overcoming fragmented tax system, *Business Recorder*, October 19, 2018.

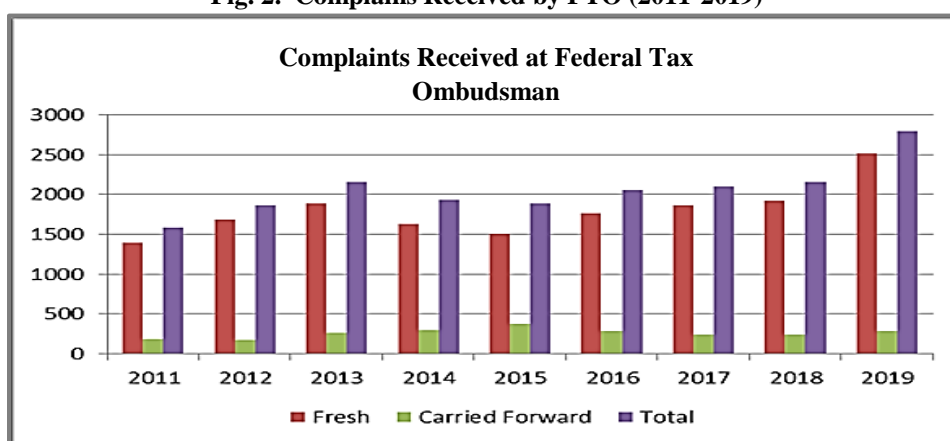
⁵PIDE has already developed a book (Haque et al, 2020) as well as a policy viewpoint on the subject to note that our growth policy remains framed in the now obsolete Haq/HAG model.

<https://forms.gle/UCqHjnwU4AZPPYXRA>

<https://pide.org.pk/pdf/Policy-Viewpoint-11.pdf>

increasing over time (see Figure 2 and Table 2). Out of the total cases decided in 2019 a total of 66 percent complaints were in fact accepted. Statutes and Regulation of FBR are provided in 34 documents besides the clarifications and notifications (15 Acts, 11 ordinances and 8 Rules). For example, only the Income Tax Ordinance 2001 Amended up to December 31st, 2019 have 634 pages of pure legal language. This makes businesses to rely on tax Accountants and lawyers which is costly; requires time and may result in double bookkeeping and prolonged process of rights claim.

Fig. 2. Complains Received by FTO (2011-2019)



The practice of refund claims is also not pervasive in Pakistan due to low refund payback rate and fear of getting audited if refund claim is presented. The Doing business report of World Bank for Pakistan states that 50-70 percent of all VAT refund cases are subject to an Audit.

Table 2

Number of Complaints for Each Tax Type

Category	Income Tax	Sales Tax	FED	Customs	Total
Refund Related Complaints	1172	381	1	127	1681
Maladministration	225	210	6	52	493
Unnecessary Notices	58	18	3	46	125
Others	125	30	4	52	211
Total	1580	639	14	277	2510

Source: FTO Annual Report 2019.

Tariff as Instrument of Taxes or Trade Policy

Openness is important for growth but in Pakistan there has been a policy of protection and that too on the basis of setting higher tariff. This has barred businesses to become competitive and rely on perpetual government assistance. Protectionism, especially for the manufacturing sector, is the standard policy of the government. Manufacturers enjoy exemptions and concessions on the import of these items which if imported by others are liable to duties etc. The local manufactures neither developed their

capacity nor upgraded technology to bring in quality for their captive market (Nasir, et al. 2020). The unprecedentedly high (52-90 percent) duties on raw material reduce the share of manufactured goods in Pakistan as compared to those of India and Vietnam.

Low Fiscal Resource Mobilisation

Due to complex laws, primitive mechanisms for tax collections and high degree of discretion with the tax collecting authorities, the revenue collection is low and an impression of corruption and inefficiency for the tax collection authorities has emerged. Further, the tax base for almost all the taxes are narrow due to the wide ranging exemptions,⁶ concessions and the presence of a black economy (Zaidi, 2005). The political economy angle of tax reforms reveals that vested interest groups at the helm of affairs and strong lobbies have been able to manage the tax-free ride at the cost of high deficits and others bearing the burden of higher indirect taxes. The lack of commitment by those making the policies, state capture by vested interest groups and wrong strategy of implementation of reforms have been the main reasons for such low fiscal resource mobilisation in Pakistan (Pasha, 1995).

Inefficient Tax Planning

As an example PIDE report (2020) states that Income Tax code considers incomes in separate blocks. Further all types of incomes, required to have an advance tax, considers some these as fixed and final which is fundamentally wrong because the actual liability may be even much more. The actual tax liability should be evaluated at the end of the year where the returns will reconcile all advance payments. All incomes should be treated as income and should not be differentiated.

Increasing the number of filers has also become an obsession with FBR. Limited research is available on data of filers. Often the ones filing are actually not paying significant taxes along with it. To increase the number of filers, for the last couple of years, FBR has developed numerous discriminatory taxes to segment filers from non-filers. From bank withdrawals to asset purchases non-filers are penalised through such transaction taxes. The Revenue collection has not increased but the distortion in transactions and asset prices have slowed down investment and the economy. The acceptance of transaction taxes and presumptive taxes from non-filers reduces the pressure to file. Overall distinction based on filer and non-filer through rate differential has not worked, rather it has established a premium for being non-filer.

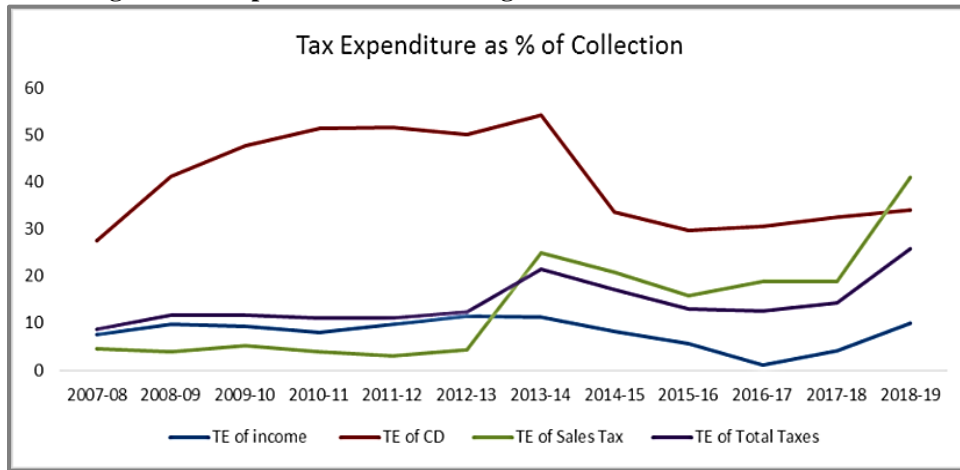
Tax Expenditures

There is a significant revenue loss from SROs based and under 5th, 6th, and 8th Schedules of tax codes. There has been hardly any economic appraisal of these waivers. The recent Tax Expenditure report by FBR identified that as much as Rs. 1.15 trillion

⁶Still agricultural sector, which contributes around 20 percent of the GDP, is not fully considered for agricultural income tax. Further, there are 0-rated industries/sectors such as textile industry, which enjoys a tax holiday for quite some time now and lastly the packaged and unpackaged food items such as tea, pulses, vegetable oil, etc. are also tax-exempt. Although the reformed GST which was floated in 2011 was supposed to include these items also, but it was not implemented.

was provided as exemptions in FY 2020, which was Rs. 972.4 billion in FY2019. These exemptions are increasing over time and are almost one third of the total revenues collected otherwise (Figure 3).

Fig. 3. Tax Expenditure as Percentage of Collection for Various Taxes



THE WAY FORWARD

There is a clear need to have a transaction-facilitating policy rather than having one that kills transactions. The economy is shrinking because of this policy of suspicion on all transactions. Some measure that should make the policy growth-facilitating are as follows:

- A tax system must be simple and clear.
- It should not seek to tax different goods and services differently to allow all consumer and investment decisions to be based on market realities.
- Tax rates and policies should be stable and not changing in minibudgets every few months forcing all to speculate on tax policy.
- Those withholding taxes that contribute only meagerly but have higher cost of collection (compliance cost) should be abolished.
- The culture of SROs should be completely abolished.
- Tax expenditure are forgone revenues due to exemptions, concessions, and preferential treatments to particular industry, sector, or activity. Research is needed to assess which industry need such exemption and why? And for how long? Whether those that have been given these exemptions/concessions have achieved the desired results such as jobs creation and economic growth.

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