

## **Pakistan: Withholdingisation of the Economic System—A Source of Revenue, Civil Strife, or Dutch Disease+?**

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The paper takes an incisive shot at the systemic inadequacies that have tiptoed into the economic order of the state over time via the apparently innocuous mechanism of withholding taxes. Withholding tax—a legitimate instrument of preponing the state revenues on clearly identifiable chunks of incomes—has historically been resorted to by most states, and to that extent it should be normal with Pakistan, too. However, what has happened in Pakistan is that the tool of withholding taxation has been used as a source of revenues way too large in scale, size, scope and intensity. In addition to the pulling forward of tax collection on clearly demarcated chunks of *incomes*, a large number of *transactions* have also been roped into its nexus and then charged to tax by presumptivising gross receipts as income—a withholdingisation of the sorts not only of the tax system but of the entire economic system as a weighty portion of ubiquitous withholding taxes gets stuck into the pricing structure of the final goods and services produced in the economy rendering them price-incompetitive in the international market. This overwhelming withholdingisation of the economic system, it is argued, has been brought about by a numb state continually operating under, using a Freudian framework, the “pleasure principle” instead of the “reality principle” with political governments complacently choosing to continue harvesting quick bucks into the exchequer, pushing the extractive system into a total disarray, the society into burgeoning civil strife, and the economy to the Dutch Disease effect.

*JEL Classification:* H1

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### **I. INTRODUCTION**

*“The central dilemmas of collective life are embodied in the question of taxation.”*<sup>1</sup>

Historically, the state has raised extractive structures, inter alia, to meet its expenditure needs with taxes availing centrality and forming foundational pillars of most public finance systems. Tax defined as “a compulsory contribution to the government, imposed in the common interest of all, for the purpose of defraying the expenses incurred in carrying out the public functions...without reference to the special benefits conferred on the one making the payment,”<sup>2</sup> manifests itself in multiple forms and models. In order to achieve cardinal objectives, that is, equity, neutrality, and certainty, states have

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<sup>1</sup>Evan S. Lieberman, *Race and regionalism in the politics of taxation in Brazil and South Africa*, Cambridge studies in comparative politics (Cambridge; New York: Cambridge University Press, 2003).

<sup>2</sup>R.W. McGee, *The philosophy of taxation and public finance* (Springer US, 2011). 16.

experimented with differing taxing models. Since different taxes have varying yield times—Income Tax, Wealth Tax, and Capital Gains Tax being annual levies; Value Added Tax including its variants like Sales Tax, General Sales Tax, and Excise duties being monthly or activity-based levies; Gift Tax and Inheritance Tax (Estate Duty) being occurrence-dependent charges—governments are always striving to find ways and means to reduce the lag between the point at which revenues become *due*, and the point at which those can actually be *collected*—that is, by advance payment of taxes.

This objective is generally achieved through two modes i.e. *advance taxes*<sup>3</sup> and *withholding taxes*.<sup>4</sup> In the sub-continental context, the fiction of advance tax was introduced during 1940s purely as a war measure to harvest quick bucks into the exchequer, “combat inflation and to withdraw a part of the unprecedented amount of currency in circulation.”<sup>5</sup> To be exact, “‘advance tax’ popularly styled as ‘pay as you earn’ scheme was introduced in 1944,” and it covered “all types of taxable income (except salaries and interest on securities where provision already existed for deduction at source) exceeding twenty-five thousand rupees.”<sup>6</sup> It was observed that though “like many other innovations in taxation legislation, this innovation also has outlived its used by date which gave it birth,”<sup>7</sup> over time, the payment of advance tax in instalments has become a necessity; an important ingredient of most public finance systems across the globe.

Withholding tax, on the other hand, has rather deeper roots in time. Not only that its origins can be traced as far back in history as 1512, but also that “most forms of direct taxation during the 16th, 17th and 18th centuries contained taxation at source, and that its use increased with the passage of time.”<sup>8</sup> The importance of withholding taxation continued to increase throughout “the nineteenth century as the income tax evolved into a major form of direct taxation.”<sup>9</sup> During the British period, the mechanism of withholding tax, for the first time, was introduced in 1861, and salary income of government employees was brought under its scope.<sup>10</sup> It was argued that due to the application of withholding tax, the contribution of government employees “to the fisc rose from 14 per cent in 1860, to 21 percent in 1864.”<sup>11</sup> Over the past one and a half century since, the withholding regime has considerably expanded in most countries eliciting arguments both for and against its application, and expansion.

In Pakistan’s context, justifying the need and efficacy of withholding regime, Khan posits that “since withholding taxes are transaction related, they are easy to

<sup>3</sup>“Advance tax” implies approximation and payment by a person in monthly or quarterly instalments of his total annual tax liability worked out on the basis of estimated total annual taxable income.

<sup>4</sup>“Withholding tax” refers to deduction of certain percentage of various types of incomes at the very payment or release stage.

<sup>5</sup>This observation was made in *Prushottamdas vs. Commissioner Income Tax*, 48 ITR 206(2011).

<sup>6</sup>GOP, “The Taxation Enquiry Committee Report (Volume 1)” (Karachi: Ministry of Finance, 1960), 150.

<sup>7</sup>*Prushottamdas vs. Commissioner Income Tax*.

<sup>8</sup>P. E. Soos, *The origins of taxation at source in England* (Amsterdam: IBFD, 1997).

<sup>9</sup>Stephen Dowell, *A history of taxation and taxes in England* (London: Frank Cass & Co. Ltd., 1865).

<sup>10</sup>C. L. Jenikens, “Legislative comment—1860: India’s first income tax,” *British Tax Review* XX, no. 87 (2012).

<sup>11</sup>*Ibid.*

collect.”<sup>12</sup> He also asserts that “in a country like Pakistan where the economy is predominantly un-documented and outreach of the department is limited,” withholding “taxes easily cover some otherwise difficult sources of income.”<sup>13</sup> He goes on to maintain that taxpayers also “find it convenient as their annual tax burden is spread over the year, helping them discharge their tax liability in instalments,” and that “withholding tax regime provides considerable documentation to the economy and effective control to...escapement of income being all pervasive in the economy.”<sup>14</sup> Withholding taxes have also been credited as being able to “provide a clear picture to the other economic partners and prospective investors about the taxation regime and serves as important source of policy initiatives of a country.”<sup>15</sup> It is logical that, given its wide-going merits, at-source withholding is worldwide recognised as a legitimate tool of fast-forwarding of revenue collection.

However, what has happened in Pakistan in this context is completely different. What happened in Pakistan was no preponing of tax collection on clearly demarcated chunks of revenues that, as per accepted accounting norms, have attained the character of *income* in the hands of their recipients or are likely to do that; it is rather tantamount to withholdingisation of the entire tax system; perhaps the entire economic system. Withholdingisation could operationally be defined as the process of envelopment of economic market whereby at every single stage in the economic chain the state chooses to expropriate a chunk of the value of each transaction—a sort of *Chinacutting* of transactions.<sup>16</sup> The state’s ostensible journey from withholding to withholdingisation—intense and all-pervading as it has been, inter alia, was marked by a brutal sprawl of tentacles of withholding regime aggressively grabbing more and more areas of economic activity into its fold with every year passing over the past three decades. When disaggregated, withholdingisation appears to have been attended by and evidenced in an increase of withholding tax provisions being legislated into the fiscal code; tally of withholding provisions brought within the purview of Presumptive Tax Regime (PTR); application of withholding regime to transactions as against incomes; extension of withholding regime to admit of collection at source (CAS) as against deduction at source (DAS);<sup>17</sup> share of withholding taxes as percentage of total revenues; reallocation of resources by the revenue administration to intenser and deeper monitoring of withholding regime; stringency and toughness being brought into the punitive and prosecutive implications for defaulting withholders; number of

<sup>12</sup>Sardar Aminullah Khan, “Standard operating procedure for monitoring of withholding taxes,” (Islamabad: FBR, 2011).

<sup>13</sup>Ibid.

<sup>14</sup>Ibid.

<sup>15</sup>Ibid.

<sup>16</sup>“*Chinacutting*” is a term that is specifically used in Pakistani journalistic circles and refers to a process whereby land grabbing goons known as “land mafia” surreptitiously occupy, cut, build, and usurp parts (generally nooks and corners) of precious private and public lands lying unattended for a time. The phenomenon being a major governance challenge is quite prevalent in cities like Karachi, Lahore, and Quetta.

<sup>17</sup>The DAS mode refers to the process whereby tax is withheld at source by a fixed percentage on the release of payments that are in the nature of INCOME. On the contrary, the CAS mode implies application of almost the same process but on PAYMENTS undertaken in the economy for sale/purchase of goods and services—including intermediary ones.

economic transactions being made to suffer withholding taxes at both ends; and transference of cost of collection from the state exchequer to the citizenry. The paper premises that withholdingisation being applicable at each joint in the transaction chain cumulatively enhances the end-price of goods and services being produced in the economy—triggering a process that could operationally be dubbed as taxflation<sup>18</sup>—inflation (increase in prices) due to taxation—much of which is neither due, nor adjusted nor refunded.<sup>19</sup> The data of a select set of withholding provisions, year-wise tax withheld thereunder during T/Ys 2012 to 2016, total tax claimed and percentage of tax withheld remaining unclaimed is presented in Table 1.

In all categories, the tax claimed in tax returns far exceeds the tax withheld. In fact, out of the total tax withheld at Rs. 451.6 billion under just 10 withholding provisions only 101.9 i.e. 77.4 percent was claimed.<sup>20</sup> This is what makes the economic outputs overpriced in both production and consumption markets of the economy, and uncompetitive internationally and unaffordable domestically for the lower rung consumers. Since economics is the basic most ingredient of any social fabric, withholdingisation of the economic system (national web of economic transactions) can have far-reaching implications for the economy, the society and the state. To make things worse and worrisome both the society and the polity are quite oblivious of the negative dimensions of withholdingisation.

Table 1

*Withholding Provisions—Tax Withheld, Claimed & Unclaimed*

Year/ WHT Provision <sup>21</sup>	2012	2013	2014	2015	2016	Total Tax* Withheld	Total Tax Claimed	Total Tax Unclaimed (%-age)
Section 236	36.9	27.1	51.9	44.6	47.6	208.1	19.9	90.4
Section 231A	12.2	12.0	18.6	23.2	28.6	94.6	43.5	54.0
Section 231B	1.2	1.1	3.2	7.4	7.5	20.4	10.7	47.5
Section 234	3.3	3.6	6.3	6.5	8.9	28.6	8.4	70.6
Section 236A	X	X	13.6	3.0	3.6	20.2	7.3	63.8
Section 236C	X	X	0.7	1.5	2.1	4.3	1.4	67.0
Section 236K	X	X	X	4.0	6.2	10.2	3.2	67.0
Section 236D	X	X	0.7	0.6	0.7	2.0	4.7	335^
Section 236I	X	X	1.2	1.9	2.5	5.6	1.1	80.0
Section 236P	X	X	X	X	21.6	21.6	1.7	92.0
<b>Total</b>	<b>53.6</b>	<b>43.8</b>	<b>96.2</b>	<b>92.7</b>	<b>129.3</b>	<b>451.6</b>	<b>101.9</b>	<b>77.4</b>

\*Source: FBR/DRS/PRAL; X = Withholding tax provision was not yet legislated. ^Implies excess tax claims.

<sup>18</sup>“Taxflation” has been used in the paper in a sense slightly different from the one that is generally associated with it whereby an inflation-related increase in income pushes its recipient into higher applicable tax brackets off-setting the impact of increase in income—something also known as “bracket-creep.”

<sup>19</sup>This is because, theoretically speaking, all direct taxes are supposed to be borne by a payer of the tax himself.

<sup>20</sup>For an in-depth analysis see Faisal Mushtaq Dar, “Unjust taxation in Pakistan,” (Peshawar: National Institute of Management, 2017).

<sup>21</sup>Section 236 deals with CAS mode taxation on mobile phone cards; section 231A with DAS mode on cash withdrawals; section 231B with CAS mode on vehicle registration; section 234 with CAS mode on token tax renewal; section 236A with CAS mode on auction of property; section 236C with CAS mode on sale of immovable property; 236K with CAS taxation on purchase of immovable property; section 236D with CAS mode on marriage halls; and section 236I in CAS mode on educational institutions.

The paper, by adopting narrow-to-wide angle approach, explains the process of withholdingisation in Pakistan in detail, and brings out its implications in different domains—extractive system, economy (and its various sectors), and the polity. It argues that withholdingisation has perverted the extractive system of the state, disengaged it from the macroeconomic framework and resultantly contributed towards enhancement of the extant economic status quo. The process of withholdingisation has occurred at the same time as the process of defanging, stunting and weakening of the (traditional) tax system—the hallmark of all well-functional states. The state's mad rush into withholdingisation has a method in madness and may have been undertaken with a purpose and under a grander design of things. This is what makes withholdingisation an elitist enterprise in Pakistan. In this sense of the matter, withholdingisation becomes the parameter of Pakistan tax system, and therefore, a highly worthy and intriguing subject of enquiry. The paper looks to peg withholdingisation and all what it stands for the state in the elitist framework already developed, and dissect and lay bare its various dimensions with a view to seeing if it really is an abundant source of revenue, or Dutch Disease? This is the cardinal two-pronged overarching research question that the paper looks to answer in some depth.

The paper is divided into 7 sections. After Section 1 has introduced the subject, Section 2 develops the requisite theoretical framework within which to analyse the process of withholdingisation in Pakistan. While Section 3 critically traces its evolution through the nation's history, Section 4 unravels the underlying mechanics and nuts and bolts of withholdingisation and expands its concept to cognise it as the new normal of Pakistan's economic system. Section 5 lays bare the relationship between withholdingisation and tax collection cost, and seminally develops the concept of *national* tax collection cost and modifies that of taxflation to fit the spatial context. Section 6—the very core of the paper—dissects withholdingisation in three separate parts i.e. as a source of revenue, civil strife, and Dutch Disease, and without being monocausal, argues that this may perhaps be the most critical pull-back factor operating on the economy impelling its underperformance in most critical areas—including receding exports, home remittances, and foreign investment. Section 7 summarises the debate with forebodings for the future.

## 2. THEORETICAL FRAMEWORK

Although, the elitist framework has long been exploited to interpret Pakistan's power and politico-economic structures,<sup>22</sup> yet Ahmed contrived the convenient conceptual vehicle of Elites Ltd, crystallised the elitist model, and expanded its scope to systematically analyse the monopolisation of Pakistan's extractive function, and disaggregated it to comprehend various mutually reinforcing dynamics and cross-cutting

<sup>22</sup>See, for instance, Asaf Hussain, "Elites and political development in Pakistan," *The Developing Economies* 14, no. 3 (1976); Hamza Alavi, "The state in post-colonial societies: Pakistan and Bangladesh" *New Left Review* 1, no. 74 (1972); Saeed Shafqat, *Political system of Pakistan and public policy: Essays in interpretation* (Lahore: Progressive Publishers, 1989); Ishrat Husain, *Pakistan: The economy of an elitist state* (Karachi: OUP, 1999); Stanley A. Kochanek, *Interest groups and development: Business and politics in Pakistan* (New York: Oxford University Press, 1983); Hamza Alavi, "Pakistan and Islam: Ethnicity and Ideology," in *state and ideology in the Middle East and Pakistan*, ed. Fred Halliday and Hamza Alavi (Hong Kong: Macmillan Education Ltd., 1988).

mechanics at work by way of an explanation of its historically embedded low performance.<sup>23</sup> The state's political crust, it is argued therein, is essentially underpinned by Elites Ltd which, in turn, is composed of seven effective elite groups i.e. industrial elite, business elite, religious elite, feudal elite, military elite, and sundry (judicial, media, non-profits, and professional) elite; that while elites enter into zero-sum transactions on the political chessboard, they resort to non-zero-sum transactions in the economic realm; that elites face a rational actor dilemma in that they need a state to govern but they also want to maintain it at least cost to themselves; that in order to resolve this dilemma, the elitist state takes to optimally extract from international sources; and that since an infinite international extraction is not possible, it descends down to undertake internal extraction through six unwholesome and perverse modes by way of domestic resource-match<sup>24</sup>—withholding taxes being one such mode. Ahmed reckons extraction as a critical variable of state-building, and in Pakistan's context, lays bare the level of importance which various societal agents accord to it, and enquires into how elites, after effectively monopolising the *infrastructure* of the state i.e. means of production,<sup>25</sup> take to exploit the *superstructure* of the state to numb and opiate the citizenry to conveniently rig the extractive policy formulation process and weaken the extractive arm.<sup>26</sup> This position is based on the premise that only a weak extractive system can help elites underwrite full control over their riches that they amass over time through monopolisation and manipulation of the infrastructure, and maintenance of the economic status quo. He further posits that in order to achieve their spurious agenda of maintaining and enhancing the economic status quo, at strategic level, Elites Ltd forms alliance with the Generalist Juggernaut—generalist cadres of Pakistan civil services—an elites-generalist duopoly of sorts.<sup>27</sup> The paper looks to operationalise the conceptual framework recapitulated hereinabove, by lowering down its focus to one elitist tactical ploy—withholdingisation—and by breaking it into its elements, and seeing how it pans out in the overall scheme of statecraft in Pakistan, and by gauging its implications for the people, the economy, and the system.

The paper seeks to induct Freud's competing psychological concepts of "the pleasure principle" and "the reality principle" into this political economy analysis of the extractive function to supplement the theoretical underpinnings and explain the state's submissive descend into withholdingisation with all its wide-going destructive potential. The pleasure principle implies the drive through which a person seeks pleasure and looks to satisfy his or her biological (and other) needs simultaneously avoiding pain, suffering and hard work—say, for instance, adolescent phase of human life. However, as one attains maturity, spontaneous pleasure-seeking is overtaken by the reality principle.—operating conditions of the real world. Once dominance of the reality principle is established, the search for fulfilment of needs and satisfaction does not take the most

<sup>23</sup>Muhammad Ashfaq Ahmed, "Pakistan: Extraction, elites and state autonomy: A theoretical configuration," *The Pakistan Development Review*, 56(4), (2017).

<sup>24</sup>Ibid.

<sup>25</sup>For a detailed analysis see Husain, *Pakistan: The economy of an elitist state*: 133.

<sup>26</sup>Muhammad Ashfaq Ahmed, "Pakistan: State-building, extraction, and (misplaced) societal preferences," *Journal of International Stability Studies* 2, no. 1 (2016).

<sup>27</sup>Muhammad Ashfaq Ahmed, "Pakistan's governance goliath: The case of non-professional chairman, F.B.R.," *The Pakistan Development Review*, 55(4) (Winter) (2016).

direct route, but instead defers attainment of its goal in accordance with the conditions imposed by the external world and operating realities.<sup>28</sup> It has been remarked that both “the reality principle and the pleasure principle pursue personal gratification, but the crucial difference between the two is that the reality principle is more focused on the long-term and is more goal-oriented while the pleasure principle disregards everything except for the immediate fulfilment of its desires.”<sup>29</sup> At some level, Freud knew and underscored “the potentially destructive aspects of the blind quest for pleasure,”<sup>30</sup> when he posited “that the pleasure principle seems actually to serve the death drives.”<sup>31</sup> It has been asserted that “unconscious persistence of the pleasure principle turns the mind’s internal state of nature into a looming threat, and ever-present potentiality of chaos...justifying a tyranny in the mind as necessary to prevent disastrous and pathological potentialities from turning into overwhelming eventuality.”<sup>32</sup> Moreover, excessive zealotry to pursue pleasure produces “an unpleasurable and wasteful situation,” in the longer run.<sup>33</sup> The study borrows from Freud to argue that Pakistani state, for most part of its history, has operated under “the pleasure principle” at the expense of the “the reality principle” although most functional states operate or aspire to operate under the latter principle. By way of aside, it could be remarked that Pakistani state’s below par performance on most fronts could well be interpreted in terms of its preference for and gravitation toward the pleasure principle—always repressing the reality principle for a later day; into the future—that has never come.

In order to examine the state’s constant drift into withholdingisation, Anuj Desai’s work that he undertook to explore into the intrusion of withholding tax into the US system with its grit and stubbornness to stay there despite efforts aimed at its elimination, would be insightful.<sup>34</sup> Desai brings in a couple of powerful legalese, namely, “Entrenchment” and “Superstatute,” and examines the impact of the Current Tax Payment Act, 1943, through which, withholding tax on Wages was introduced in the US in the wake of World War II-induced increase in public expenditure. Desai borrows Eskridge & Ferejohn’s notion of Entrenchment<sup>35</sup> which no longer means “simply an unelected judiciary overriding an elected legislature or executive”<sup>36</sup> but an expanded concept under which “entrenchment becomes a more complex phenomenon, whereby statutes—the product of legislatures themselves—can in turn act to bind future legislatures.”<sup>37</sup> A Superstatute, on the contrary refers to a law or a legal convention “that seeks to establish a new normative or institutional framework for state policy and that has a broad effect on the law due to its cultural influence, in such a manner that

<sup>28</sup>David Rook, “The buying impulse,” *The Journal of Consumer Research* 14, no. September (1987).

<sup>29</sup>Ibid.

<sup>30</sup>J.A. Brunner, *Freud and the politics of psychoanalysis* (Piscataway NJ: Transaction Publishers, 1999). 73.

<sup>31</sup>S. Freud, *Beyond the pleasure principle* (Dover Publications, 2015).

<sup>32</sup>Brunner, *Freud and the Politics of Psychoanalysis*: 75.

<sup>33</sup>Ibid., 77.

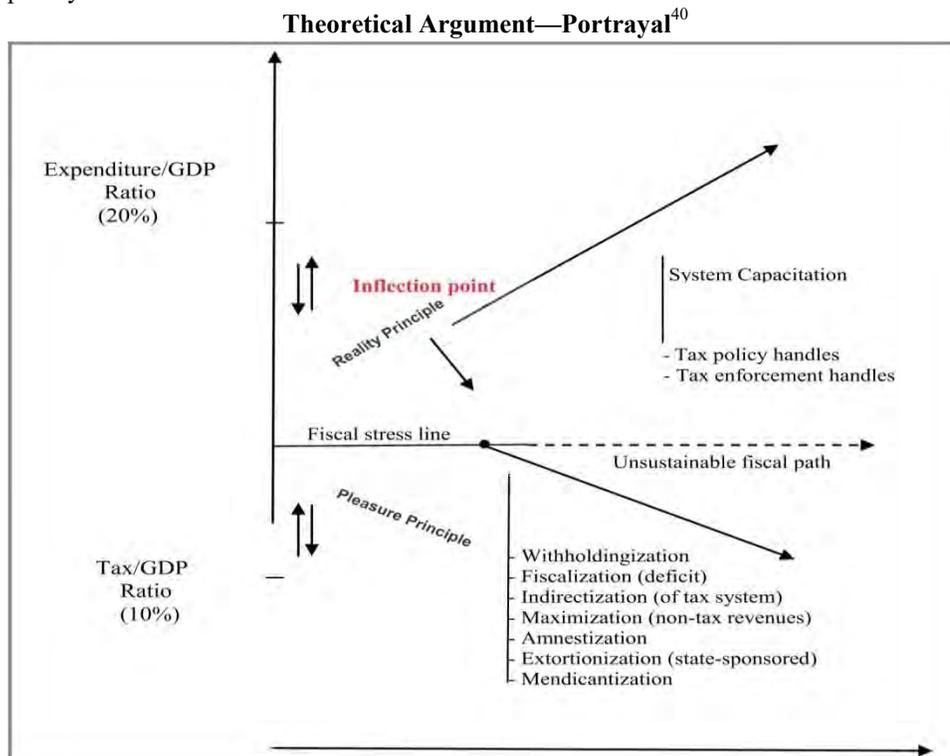
<sup>34</sup>Anuj C. Desai, “What A History of Tax Withholding Tells Us About the Relationship Between Statutes and Constitutional Law,” *Northwestern University Law Review* 108, no. 3 (2014).

<sup>35</sup>W.N. Eskridge & J.A. Ferejohn, *A republic of statutes: The new American constitution* (Yale University Press, 2010).

<sup>36</sup>Desai, “What a history of tax withholding tells us about the relationship between statutes and constitutional law,” 861.

<sup>37</sup>Ibid.

even constitutional provisions are interpreted with reference to it.”<sup>38</sup> In order to better comprehend the exact contours of Superstatute, Desai explores into the history of withholding taxes in the post-WWII scenario in the US, “explaining in turn how that history sheds light on the underlying notion of a superstatute.”<sup>39</sup> The paper admits both Entrenchment and Superstatute—essentially counter-majoritarian concepts—into the analytical framework to throw light on the withholdingisation in Pakistan under all regime types—democratic, authoritarian, and hybrid, and its innate ability to be ever-winner, ever on the expansion. Thus, while Ahmed provides theoretical platform shedding light on how the institutional infrastructure of the state is occupied, monopolised, and mobilised by Elites Ltd into action towards the achievement of its objectives using withholdingisation as a tested too, the Freudian pleasure principle and reality principle help explain how an elitised state conveniently and comfortably walks into withholdingisation—an obvious exhibition of the pleasure principle, and Desai provides a conceptual closure as to how it may not perhaps be possible to reverse the process of withholdingisation, and that the system is there to stay and get more and more perverted with time if the underlying political settlement continues to hold its ground. The theoretical premise developed hereinabove can as well be diagrammatically portrayed.



<sup>38</sup>H.A. Hamoudi, *Negotiating in civil conflict: Constitutional construction and imperfect bargaining in Iraq* (University of Chicago Press, 2013). 29.

<sup>39</sup>Desai, “What a history of tax withholding tells us about the relationship between statutes and constitutional law,” 859.

<sup>40</sup>Muhammad Ashfaq Ahmed, “Pakistan: Economy under elites—Tax amnesty schemes, 2018,” *Asian Journal of Law and Economics* 10, no. 2 (2019). In this particular paper “Amnestisation” was operationalised.

What the picture portrays is that at any given point in time, Pakistan is found operating under significant amount of fiscal stress, that is, its expenditures exceed its revenues. This means that Pakistani state every now and then finds itself at the inflection point—the crossroads—at which it has two choices i.e. either to strengthen the extractive system enough to undertake sufficient taxation like all functional states, which is also good enough to meet its expenditure needs or to resort to the easier yet perverse extraction through the seven domestic resource-match ploys. The Freudian analytical concepts of *reality principle* and *pleasure principle* amplify and illuminate option exercised by the state. The paper operationalises the above theoretical framework by juxtaposing withholdingisation therein and critically analysing it from all essential angles.

### 3. WITHHOLDINGISATION—EVOLUTION IN HISTORICAL CONTEXT

While it has already been observed that the roots of withholding taxation are anchored as far back in time as early 16th century England, and mid-19th century British India, this section undertakes a brief rundown of withholdingisation-related developments that took place on this account in the post-1947 period. The evolution of withholdingisation in Pakistan is primarily traced by exploring into the development of the tax laws alongside a thorough analysis of various studies and reports that were conducted with the objective to reappraise and redesign the tax system to render it more responsive to fiscal imperatives of the state. But all, instead, ended up achieving diametrically the opposite—more withholdingisation. At independence, Pakistan conveniently adopted the pre-partition tax code with minimal changes.<sup>41</sup> Since the British India government had already imposed withholding tax on Salary, Interest-on-Securities, Dividend, and (Super-tax) on Bonus Shares,<sup>42</sup> it could safely be assumed that Pakistan's withholding regime continued to stay confined to these very sources throughout 1950s. Under the system, the withholder was responsible to provide a certificate of deduction to the withholder that the latter could furnish to the revenue service alongwith his return as a valid claim for payment of tax or that of refund. Naqvi had observed that the “essence of this system was the recovery of tax from the person who disburses income instead of from the person who receives income.”<sup>43</sup>

In 1959, contract receipts were made liable to withholding tax in order to alleviate mounting pressure on the exchequer.<sup>44</sup> This betrayed seeds of withholdingisation starting to germinate under the pleasure principle. The Taxation Enquiry Committee (TEC), 1960, affirmatively observing that the “principle of source deduction has been extended to supply of goods, contract payments etc. by the Finance Ordinance 1959”<sup>45</sup>—expressed oblique skepticism about its faithful implementation. It was around that time that the punitive implications for defaulting withholders also started to become more stringent.

<sup>41</sup>The tax code adopted was The Income Tax Act, 1922.

<sup>42</sup>S. M. Raza Naqvi, *The income tax act, 1922* (Lahore: Taxation House, 1963).

<sup>43</sup>*Ibid.* 619.

<sup>44</sup>GOP, “Budget speech 1959-60,” in *Budget Speeches 1947-48 To 1984-85 (Volume 1)* (Islamabad 1984).

<sup>45</sup>GOP, “The taxation enquiry committee report (Volume 1) “ 149.

TEC normatively asserted that “If the person responsible for making a payment from which tax should have been deducted, fails to deduct it or having deducted tax, fails to deposit it in a Government Treasury, he is deemed in default in respect of such tax and personally held liable for its payment.”<sup>46</sup> TEC also grappled with the cardinal question of “extending the principle of source deduction to other incomes,” that is, “to interest, rents, royalties, payments to contractors etc.”<sup>47</sup> But then noting that contractual receipts had already been roped into the nexus of withholding scheme a year ago, TEC, teetering on the edge of withholdingisation, observed:

We are of the view that, despite the effectiveness of the system in reducing opportunities for tax evasion, its extension is beset with certain obvious difficulties. It will, for instance, be difficult to ensure that the persons or agencies deducting tax at source will promptly deposit it in the Treasury. Again, in a large number of cases, the tax deducted at source will be in excess of the actual tax payable by the assessee. This will increase claims for refunds and put both the Administration and the taxpayer to considerable inconvenience. The verification of the payment of tax into Government Treasury will delay the disposal of these claims. These are serious bottlenecks which have to be taken into consideration before extending the system to other sources of income. We have considered the question in its various aspects and would not recommend the extension of the system of source deduction to other items.<sup>48</sup>

However, this muted and muffled resistance was not to last long as right at the onset of the 1960s, the state started to pursue the pleasure principle rather recklessly as withholdingisation spread its tentacles far and deep into the economic system. The Commission on Taxation and Tariff (CTT), 1966, remarked that a provision had already been “made for withholding a prescribed amount on account of income-tax out of payments made to contractors by Government and other public bodies mentioned in the Act.”<sup>49</sup> CTT deliberated upon the matter at length and sought to consolidate withholdingisation gains stipulating that “necessary rules should be framed without further delay so that the relevant law relating to deduction of tax at source in the case of contractors is put into operation.”<sup>50</sup> The reality principle, it appears, had started to lose ground very much during 1960s.

The Taxation Commission (TC), 1974, defended and justified the systemic bathos into withholdingisation under the pleasure principle noting that in “a country where evasion takes place on a large scale, provisions relating to deduction of tax at source have to be properly implemented.”<sup>51</sup> It was for the first time that *tax non-deduction* was imperceptibly equated with *tax evasion*. TC also significantly focused non-implementation of various withholding provisions, and vehemently harangued that the “provisions relating to deduction of tax at source, are not as effectively implemented as the law requires,” as in “many cases employers do not act upon these provisions,”

<sup>46</sup>Ibid.

<sup>47</sup>Ibid. 150.

<sup>48</sup>Ibid.

<sup>49</sup>Ibid. “The commission on taxation and tariff (Second Report),” (Islamabad: Ministry of Finance, 1966), 14.

<sup>50</sup>Ibid., 50.

<sup>51</sup>Ibid. “The taxation commission report (Volume 1),” (Islamabad: Ministry of Finance, 1974), 203.

whereby in quite a few such “cases tax is evaded by persons who are responsible for deducting tax at source,”<sup>52</sup> and expended substantial amount of energies to beef up the punitive regime. Thus, observing that the existing law pertaining to deductions at source was not being implemented fully, TC ended up recommending that penal provisions should be invoked in all such cases, and that every “notice or form which requires the deduction of tax at source should also bear a warning at the bottom, indicating the liability that a person incurs in failing to make deduction at source.”<sup>53</sup> In 1976 imports were also made to pass under the withholding axe thereby introducing the CAS mode for the first time, and expanding the net of transaction-taxing in Pakistan. It is also about this time that the state’s focus starts to shift from *the tax-payer to the tax-withholder* as the one ultimately responsible to carry the state’s fiscal burden.

The National Taxation Reform Commission (NTRC), 1986, looked to justify relentless withholdingisation, which by now had begun to emerge to the state with all its perverse potentialities as the only “viable” source of revenue repressing the reality principle deep down into its sub-consciousness. “The growing emphasis on current payments of tax,” it was remarked, “happens to be one of the most pervasive and significant world-wide trends in income tax administration,” and of “all current payment devices, withholding is the most common and generally the most significant in terms of its contribution to revenue collections.”<sup>54</sup> Recognising and propagating withholding as *the tool* of tax policy—particularly that of curbing tax evasion and promoting tax compliance with reference to taxation of import-based transactions, NTRC stipulated that this “provision was incorporated in the law to enable the tax administration to reach the ever-increasing number of delinquent importer-taxpayers, who traditionally operate without any easily locatable business premises.”<sup>55</sup> NTRC eulogising the process of withholdingisation argued that “the system of deduction at source has enabled the income Tax Department to bring a large number of taxpayers on its records,” and therefore “withholding net may be extended further” to brokerage and commission payments, and public transport owners.<sup>56</sup> Interestingly, NTRC did recommend certain other measures to strengthen and capacitate the system but all such measures were conveniently ignored for implementation.

The GOP-sponsored Study of Direct Taxation (STD), 1989, stands out in its rule-based and empirical appraisal of withholdingisation in Pakistan. STD took note of Pakistan’s irresistible slide into withholdingisation and asserted that if NTRC’s prescription to bring brokerage and commission payments into the ambit of withholding regime had been accepted, it would “have taken the wide-ranging system of withholding of tax in Pakistan as far as it can go.”<sup>57</sup> STD while making this comment absolutely had no idea that it was merely a tip of the iceberg and that worse was yet to come. It was also cautioned that “Low withholding rates which were final—favoured in a number of countries—have the advantage of simplicity and

<sup>52</sup>Ibid.

<sup>53</sup>Ibid.

<sup>54</sup>Ibid. “The national taxation reform commission report (Part 1),” (Islamabad: Ministry of Finance, 1986), 69.

<sup>55</sup>Ibid., 73.

<sup>56</sup>Ibid., 132.

<sup>57</sup>Ibid. “Study of direct taxation,” (Islamabad: CBR, 1989), 64.

certainty but seem...to be unsatisfactory as a payment solution, since they produce a structure which favours the better off recipients.”<sup>58</sup> The Committee on Tax Reforms (CTR), 1991, cast its vote unequivocally in favour of pushing withholdingisation further. CTR observed that “a large number of contractors and suppliers are getting their payments split into amounts below Rs. 50,000 to avoid the deduction limit,” and recommended that “the present limit of deduction at Rs. 50,000 under section 50(4) be reduced to Rs. 20,000 for all classes of recipients i.e. goods and services.”<sup>59</sup> The change was readily effected through Finance Act, 1991 giving traction to CAS mode and the process of withholdingisation as all critical economic indicators were seen going into downward spiral. If one were to pick a point at which withholding regime started to get fundamentally transformed from a standard tool of preponing of legitimate government dues to withholdingisation of the entire system, it was at the turn of 1990s.

The Resource Mobilisation and Tax Reforms Commission (RMTRC), 1991, was established in continuation of and as a sequel to CTR right in the midst of extreme economic chaos and politico-strategic unrest chiefly generated by a waning US interest in the region in the wake of Soviet withdrawal from Afghanistan. The country’s appetite for revenues was insatiable and a fledgling democratic dispensation resurrected after a decade-long military rule was all willing to pursue the pleasure principle regardless of its consequences. RMTRC being an elitist initiative stands out for five significant points. One, RMTRC in innuendos claimed credit for and revelled in the success of withholdingisation when it argued that “the success of this regime is that the discretionary powers of the tax collectors have been reduced—for the simple reason that when ‘deductions at source’ predominate as they do now, the incidence of ‘collection of demand’ declines.”<sup>60</sup> It was remarked that “while between 1984-85 and 1992-93 the ‘deductions at source’ increased from 41.5 percent to 68.1 percent of total income tax collection, the ‘collection of demand’ fell from 25.2 percent to 9.1 percent during the same period.”<sup>61</sup>

Two, RMTRC provided legitimation to income-presumptivisation of receipts for the first time assigning an entirely a new dimension to withholdingisation. “Initially, as a measure of reform, an attempt has been made,...to convert withholding taxes into presumptive taxes, representing fixed and final settlement of tax liabilities,” of which, “primary objective is to simplify the tax collection and to reduce the compliance cost of taxpayers.”<sup>62</sup> Three, RMTRC provided politically loaded but theoretically misplaced justification for the inequity that was now grossly entrenched into the system. It was argued that the “tax system in Pakistan is by and large inequitable and violates the dictates of horizontal and vertical equity,” and while “horizontal equity is violated because agricultural income and service activities are inadequately taxed, or escape taxation altogether,” in fact, vertical equity was “also compromised because direct taxes contribute no more than 2.7 percent to the GDP; and this despite the fact that the recent

<sup>58</sup>Ibid., 80.

<sup>59</sup>Ibid. “The committee on tax reforms report,” (Islamabad: Ministry of Finance, 1991), B-29.

<sup>60</sup>Ibid. “The resource mobilisation and tax reforms commission report,” (Islamabad: Ministry of Finance, 1994), 48.

<sup>61</sup>Ibid.

<sup>62</sup>Ibid., 52.

introduction of withholding and presumptive taxes has dramatically increased the direct-to-indirect tax ratio to 23 percent or so.”<sup>63</sup> RMTRC ill-argued that withholdingisation had “probably contributed to a greater (horizontal) equity of the tax system,” as it had led to “a more effective taxation of capital incomes, levy of withholding tax on income proxies, the introduction of taxes on agricultural wealth and the levy of excise duties on services like telephones consumed by the upper income groups.”<sup>64</sup> This was quite an oversimplification of the complex equity concept already well-developed in the realms of political philosophy and political economy elsewhere in the world.

Four, RMTRC looked repressing the reality principle. On the one hand, it candidly noted that “the switchover from withholding to fixed (presumptive) taxes in the case of contractors, importers, etc. has imparted the characteristics of indirect taxes to a component of the income tax,” and that “the regressivity of the tax burden has been accentuated by the introduction of the minimum tax,” whereby “the reduction in income tax rates has mostly benefited the upper income groups.”<sup>65</sup> On the other hand, it argued that “overemphasis on the deduction of the tax collected at the source can take away the very pressures that are necessary to improving the administrative machinery by generating information about the tax-payer's taxable capacity, by spreading greater tax awareness among the public, and above all, by inculcating a “tax culture” among the people,” and as such, “taxation, based on self-assessment, must be according to the ability of the tax-payers to pay.”<sup>66</sup> The capacitation of the revenue system as a viable alternative was deferred stating that “after the first phase of development of withholding and presumptive tax regimes, the focus in the second phase will have to shift to improvements in management and information system; assessment practices, speedy and fair disposal of appeals and more effective enforcement generally.”<sup>67</sup> Not only that no roadmap or timelines were set out for the promised “second phase” but also that the same has never been realised even after a lapse of over two and a half decades. Five, RMTRC, in combine with TRC proved phenomenal towards extension and expansion of withholding net in Pakistan. In 1991, the system of deduction/withholding of tax at source for adjustment against tax as subsequently determined were converted into a presumptive tax. Likewise, a fixed tax at a flat rate of ten percent was imposed on Interest from financial institutions and on Dividend. In 1992 a nominal withholding tax in CAS mode was enforced on exporters to be collected by State Bank of Pakistan (SBP) at the time of the realisation of foreign exchange proceeds.<sup>68</sup> RMTRC perhaps played the most important role in putting the economic system on the scaffolding of withholdingisation.

The Task Force on Fiscal Reforms (TFFR), 1996, substantially helped consolidate the expansion of withholdingisation. TFFR observed that presumptive tax was “being charged on various types of income including profit on bank accounts and deposits; value of contracts and supplies; imports and exports; proceeds of bearer certificates; dividends; auction of the lease of rights to collect octroi and duty; prizes on prize bonds, and profit

<sup>63</sup>Ibid., 37.

<sup>64</sup>Ibid., 75.

<sup>65</sup>Ibid.

<sup>66</sup>Ibid., 48.

<sup>67</sup>Ibid., 51.

<sup>68</sup>Ibid., 52.

on bonds, certificates or securities.”<sup>69</sup> TFFR did engage into an apparently innocuous debate as regards oppressive implications of the presumptive regime, but then throwing the gauntlet on the tax administration, charge that it was because of CBR that switch-over from the fixed presumptive tax to adjustable withholding tax was not feasible.<sup>70</sup> It was further posited that till the “time that the economy is completely documented and the income tax department is fully computerised duly backed by constant updating of software for assessment and collection of direct taxes, the proposed switching over may be postponed.”<sup>71</sup> TFFR also noted that extension of withholding scheme had “substantially curtailed the oft-spoken discretion of the assessing officers and brought to an end the complaints about discrimination in the matter of assessments,” and that this “has made the collection of tax easy and prompt and settled once for all the complaints against officials of the income tax department regarding malpractice associated with the issuance of refunds.”<sup>72</sup> This was the most dangerous, self-defeating and self-contradictory narrative of the state’s revenue function that was built by none other than the very initiative that had been put in place to strengthen and capacitate it. The same narrative was then on-transmitted and propagated by a number of studies.<sup>73</sup> This was withholdingisation at its crescendo but not quite—the worst was yet to come.

The Task Force on Tax Reforms (TFFR), 2000, after observing that “income and corporate tax revenues have increased from 2 percent of the GDP in 1990-91 to 3.6 percent of the GDP in 1999-2000,” held that the “two-percentage point increase in income tax (as a share of GDP) is largely attributed to an increase in withholding taxes,” which, in fact, accounted “for approximately 70 percent of total income tax revenue.”<sup>74</sup> At the turn of the century, out of the total withheld taxes, “about 54 percent were non-adjustable or treated as final discharge of liability.”<sup>75</sup> The TFTR went on to candidly remark that “within this category, some taxes, such as tax on dividends and on interest income, can properly be regarded as income taxes but there are several others, which are in the nature of export duties, import levies, turnover or other indirect taxes,” and that once adjustment had been made for these “indirect taxes,” the performance of the revenue agency became highly questionable.<sup>76</sup> This was quite perfunctory analysis of the revenue drawing-board of the nation as TFTR was ignoring the simple fact that revenue was a zero-sum affair between the functional tax system and a withholdingised one in that if the charge had already been collected at the transaction stage, there would be no or nominal revenue left to be collected at the declaration stage or even at the audit (post-declaration) stage, and the shift there could not solely be ascribed to the revenue administration’s efficacy or effectiveness; this being the state’s deliberate choice to time collection of dues. After holding that “about 42 percent of the withholding taxes” were “in the nature

<sup>69</sup>Ibid. “The task force on tax reforms report,” (Islamabad: CBR, 1996), 29.

<sup>70</sup>Ahmed, “Pakistan: Extraction, elites and state autonomy: A theoretical configuration.”

<sup>71</sup>GOP, “The task force on tax reforms report,” 30.

<sup>72</sup>Ibid.

<sup>73</sup>See, for instance, Hafiz A. Pasha, “Political economy of tax reforms: The Pakistan experience,” *Pakistan Journal of Applied Economics* vol. 11, no. n1-2 (1995); Saadia Refaqt, “Social incidence of indirect taxation in Pakistan (1990-2001),” (Bath: University of Bath, 2008).

<sup>74</sup>GOP, “The task force on reform of tax administration report,” (Islamabad: Ministry of Finance, 2001), 7.

<sup>75</sup>Ibid.

<sup>76</sup>Ibid.

of indirect taxes,”<sup>77</sup> TFTR should have gone on to make some suggestions to rein in the fast-sprouting withholdingisation; it instead, ended up proposing a few insignificant steps geared to strengthening the very process of withholdingisation. TFTR-proposed new-look tax system had “universal self-assessment, selective audit, functional specialisation, a centralised information system, strong audit capacity, survey and research capability, and taxpayer education and assistance programs,” as its main prongs, which would have expected to “increase voluntary compliance, improve the quality of tax audits, make tax audits fair and non-discriminatory, and strengthen the ability to detect and punish evasion and fraud.”<sup>78</sup> However, what TFTR did not realise was perhaps that withholdingisation was like the tail-eating snake—once let loose it was to gulp the envisioned egalitarian tax system, howsoever, good it might be or wholesome. In fact, withholdingisation stood in-between TFTR-contrived utopia and in reality fast panning out dystopia of a tax system.

The Tax Reform Commission (TRC), 2016, succinctly observing that FBR was “collecting 95 percent of taxes by imposing more and more tax obligations on organisations and individuals in the form of withholding tax provisions,”<sup>79</sup> viewed withholdingisation in a negative light chiefly for two reasons. First, it was reckoned that withholdingisation was per se spurious because, inter alia, it (a) had “reduced the tax base rather than realistically expanding it, eroding the administrative efficiency as against improving it;”<sup>80</sup> (b) had obliterated “the concept of maintaining the full sets of books of accounts...from the taxpayer’s mind due to taxation of its gross receipts on Presumptive basis;” and (c) was “fraught with the possibilities of ultimately complicating the system more than simplifying it.”<sup>81</sup> Second, withholdingisation has afforded the revenue administration an opportunity to “hide behind the façade of withholding taxes to show overall tax collection of their unit,” and that this misrepresented their “actual effort...in tax collections.”<sup>82</sup> Against such a backdrop of avowed disapproval of withholdingisation in Pakistan, TRC, 2016 recommended developing a much-touted mechanism of “rationalisation of differential withholding taxes for compliant and non-compliant tax payers”<sup>83</sup> initially in 2014. While TRC was proposing gradual phasing out of FTR, the polity resorting to an extensive use of withholdingisation as a tool of tax policy over the period that TRC was well in position, brought about a dozen new withholding provisions onto the tax code.

It could be argued that states engage their societies, inter alia, in two important ways i.e. extractive engagement and distributive engagement. Distributive engagement is not only the most desired one sans any upper caps; but extractive engagement has strict principles and parameters. In Pakistan, the extractive engagement has not only been insufficient but also perverse and roguish, and its triggers and, at times, even its theoretical and ideological explanations, howsoever off-mark and misplaced, were supplied by various tax reform commissions and committees as explained above. It is obvious that tax reform commissions and

<sup>77</sup>Ibid.

<sup>78</sup>Ibid., 31.

<sup>79</sup>Ibid. “Tax reform commission report,” (Islamabad: FBR, 2016), 1.

<sup>80</sup>Ibid., 44.

<sup>81</sup>Ibid.

<sup>82</sup>Ibid., 31.

<sup>83</sup>Ibid., 28.

committees were extensively used for surrogate insemination of elitist policy options.<sup>84</sup> Even worst of tax policy prescriptions when processed through and stamped by a tax reform commission or committee, governments got them legislated and implemented with ease and without resistance. Not surprisingly, as also shown in Figure 1, currently Pakistan has by far the widest withholding regime in the world. It could be observed that withholdingised extractive engagement between the citizen and the state effectively neutralises and dilutes the impact of the distributive engagement whatever little of it is undertaken by the latter.

#### 4. WITHHOLDINGISATION—INFRASTRUCTURAL NUTS & BOLTS

Given its multiple merits, at-source withholding of taxes is worldwide recognised as a legitimate and important source of fast-forwarding of revenue collection and to that extent it should be normal in Pakistan. However, in Pakistan withholding regime has been used as a source of revenue way too large in scale, size, scope and intensity. In addition to the preponing of tax collection on clearly demarcated chunks of *revenue* that, as per accepted accounting principles, have attained or are at the verge of attaining the character of *income* in the hands of the recipients, a large number of *transactions* were also brought into its nexus and then charged to tax by grossing up and presumptivising receipts as income—a withholdingisation of sorts. Withholdingisation, at a greater length, as already pointed out, refers to the process of wrapping of the entire economic system whereby at every single stage in the economic chain the state subtracts a part of the value of each transaction. Marginal subtraction of the value of each transaction—a part of it being picked by withholdee and part of it being passed on—when aggregate, inflate the end-value or price-tag of the goods and services produced in the economy. The elitist state’s mad rush into withholdingisation took a raw turn when towards the onset of the present century after perhaps reaching a saturation point in identification of any new incomes or transactions that could be slapped withholding taxes, started to tax transactions at both ends—first in DAS mode and then in CAS mode under two different provisions of the law. The number of transactions falling victim to dual-end withholdingisation is increasing every year.

Since withholdingisation emanates from, is under-grid by, and lies in the trifurcation of tax system into Normal Tax Regime (NTR), Minimum Tax Regime (MTR), and Final Tax Regime (FTR), brief description of each would set the stage for the ensuing analysis and debate. NTR comprises standard set of rules and regulations whereby a taxpayer makes out a solemn declaration of his income or loss at a specified date in respect of a statutorily defined accounting period, whereupon the revenue administration, depending upon the operating procedures, and within the parameters of bounded rationality, either accepts the declaration as such or frames its own assessment after investigations as it may consider necessary. The tax withheld at source on various counts is added up and after

<sup>84</sup>Muhammad Ashfaq Ahmed, “Elites, extraction, and state autonomy: Pakistan and U.S in comparison,” (Islamabad: Quaid-e-Azam University, 2015).

giving credit of the same, the resultant tax or refund is worked out and communicated to the taxpayer. MTR implies an arrangement put in place by the state whereby the tax withheld at source is considered a minimum tax liability in lieu of normal tax liability, if normal tax liability is less than the minimum tax liability. FTR, on the other hand, is based on the underlying principle of income-presumptivisation of receipts which, in turn, originates from the legal fiction of deeming gross receipts as income and charging them to tax at a specific reduced rate.<sup>85</sup> Under FTR withholding taxes deducted or collected at source, if done at the applicable rate, are adjusted against the total receipts deemed as income and the taxpayers' tax affairs to the extent of that accounting period are considered finalised. A taxpayer fully covered under FTR does not necessarily need to have his accounts finalised, get them audited and file a comprehensive tax declaration. In fact, the treatment of withholding taxes is not only at the bottom of all three tax regimes, it is also their distinguishing feature.

The transition of the system from withholding to withholdingisation—though slow yet steady—has been marked by the spread of tentacles of withholding regime aggressively grabbing more and more space of economic activity into its fold. Such an ingress of withholding scheme into the economic system was, *inter alia*, evidenced by an ever-increasing (i) number of withholding provisions in operation at any given time; (ii) tally of withholding agents; (iii) number of withholding provisions being legislated year after year; (iv) extension of withholding regime in FTR mode; (v) modification of withholding regime to admit of collection at source (CAS) as against deduction at source (DAS); (vi) application of withholding regime to transactions; (vii) share of withholding taxes' share as a percentage of total tax revenues; (viii) compliance requirements for tax withholders; (ix) reporting requirements for tax withholders; (x) punitive implications for tax withholders; (xi) application of withholding regime at both ends; (xii) lopsided resource allocation for withholding monitoring operations.

The foregoing variables when come into play with and reinforce each other, cause to unleash an oppressive trigger that percolates from top to bottom and back in the economy resulting in massive negative fallouts for all economic agents, sectors and stakeholders except perhaps the state itself, which thrives on easy bucks—but only in the short run. In the long run, however, it is not only the active economic agents who suffer, but also the state and its underlying society, as the TRANSACTION gets shackled and gridlocked in a withholdingised economic system not only because of the withholder's unlimited choice to pass on the tax withheld but also because part of the tax so withheld gets stuck and reflected inside the price-tag of the final product. A brief analysis of factors of withholdingisation will help galvanise the debate and the thesis.

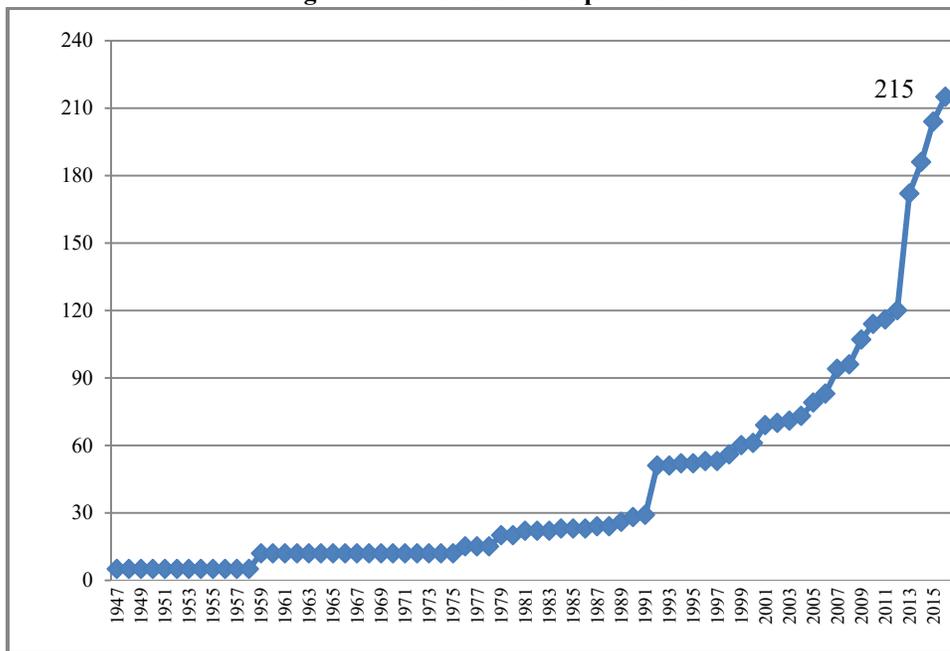
#### **4.1. Withholding Provisions in Operation**

During its first one hundred years i.e. between 1860 and 1960 withholding tax regime faired quite conservatively admitting into its fold only three revenue sources, namely, Salary, Interest-on-Securities, and Dividend. Even Profit-on-Debt that otherwise

<sup>85</sup>FTR replaced Presumptive Tax Regime (PTR) in the wake of promulgation of the Income Tax Ordinance, 2001.

had all the traits of income was not brought into the ambit of withholding net. Between 1960 and 1990, when the economy industrialised, its revenue yielding capacity was punctured through wide-going exemption and repeated amnestisation. Pakistan being an expensive state to maintain, revenue needs were attempted to be met through an enhanced dependence on withholding taxes as not only Profit-on-Debt and Rent-on-Property were placed under it, but also receipts from contract execution and supplies met the similar fate. Simultaneously, withholding regime for non-residents also expanded at a rapid pace. However, the real rot started towards the onset of the 1990s. This was also the time when democracy returned to Pakistan after a prolonged hiatus. The Soviet withdrawal from Afghanistan almost diminished the US interest in the region and caused a decrease in opportunities of international rents for Pakistan. The resultant pressure for extraction from domestic sources needed to be deflected. The elites' rational actor dilemma looked to resolve as modes of withholdingisation started to reproduce at an exorbitant pace.<sup>86</sup>

**Fig. 1. WH Provisions in Operations**



Source: FBR/PRAL.

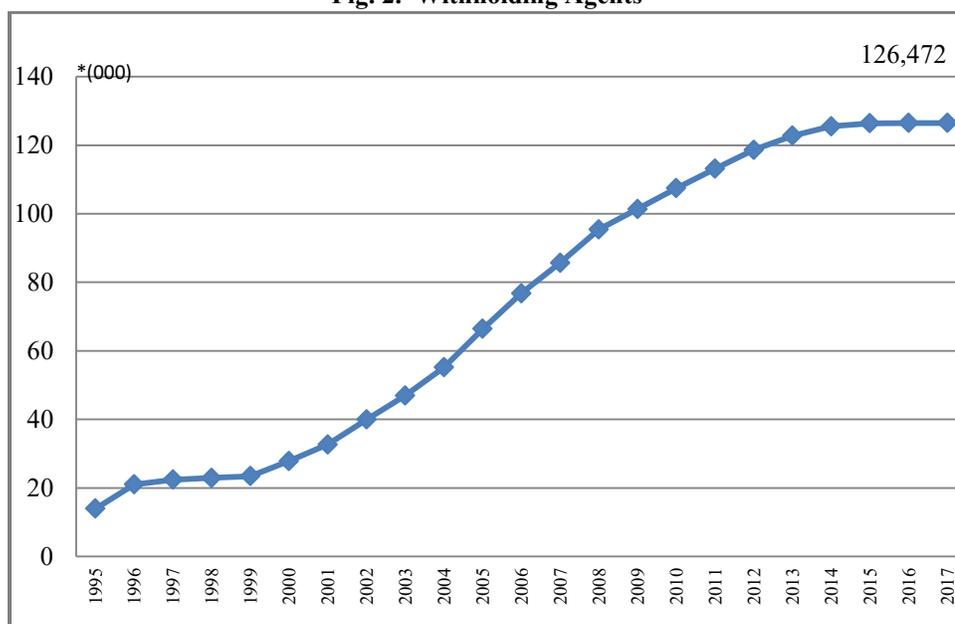
Figure 1 depicts time series data of withholdingisation of Pakistan's economy, that is, the number of withholding provisions being in operation at any given time. It may be noted that within the context of this study each withholding tax rate variation has been reckoned as a separate withholding provision. This is because each withholding tax rate variation represents an economic class or creates a new economic class or an economic interest group—denoting, by implication, some notches of added pressure on the polity in terms of lobbying or interest articulation for favourable “group taxation” policy options.

<sup>86</sup>See, for a detailed analysis, Ahmed, “Pakistan: Extraction, elites and state autonomy: A theoretical configuration.”

#### 4.2. Number of Withholding Agents

Overtime, number of withholding agents has also steadily gone up. Unlike the initial 100 years of withholding regime when only the payers of Salary, Dividend and Interest-on-Securities were withholders, now practically in Pakistan every other participant in economic activity or transaction is a withholder. The time series data of withholding agents since 1995<sup>87</sup> is plotted in Figure 2, which shows that till about 2013 the number of withholders with every passing year was increasing steadily, but then the line tends to straighten up around 2014 onwards. It implies that while new withholding provisions continued to be added to the code, the tally of withholders did not go up having reached a near-saturation point. It can safely be inferred that the same set of withholders were now implementing even a larger number of withholding provisions, deepening the oppressive impact of withholdingisation on its frontline victims.

**Fig. 2. Withholding Agents**



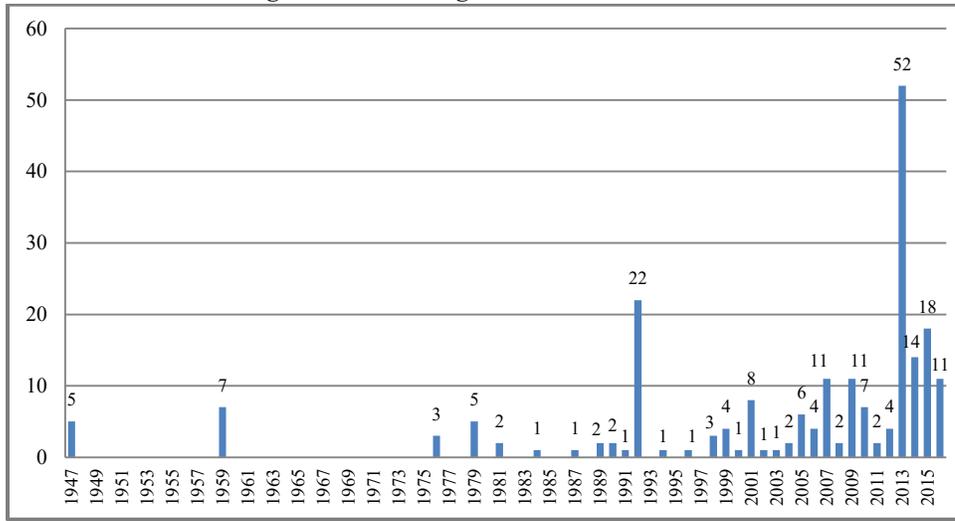
Source: FBR/PRAL.

#### 4.3. Withholding Provisions Introduced

Although, the primary purpose of the expansion of withholding regime as always claimed was to collect data of potential taxpayers and net them into the tax system, yet in reality, withholding has been used as a favourite tool of tax policy—particularly since mid-1970s. Figure 3 exhibits the number of withholding provisions promulgated each year and leads one to an irresistible conclusion that this prong of withholdingisation has been resorted to rather with vengeance since early 1990s. It conversely also means that while the polity remained adrift into withholdingisation, in the process, it continued to have the system weakened and incapacitated.

<sup>87</sup>Withholders' data for the years prior to 1995 is not available in a reliable form.

**Fig. 3. Withholding Provisions Introduced**

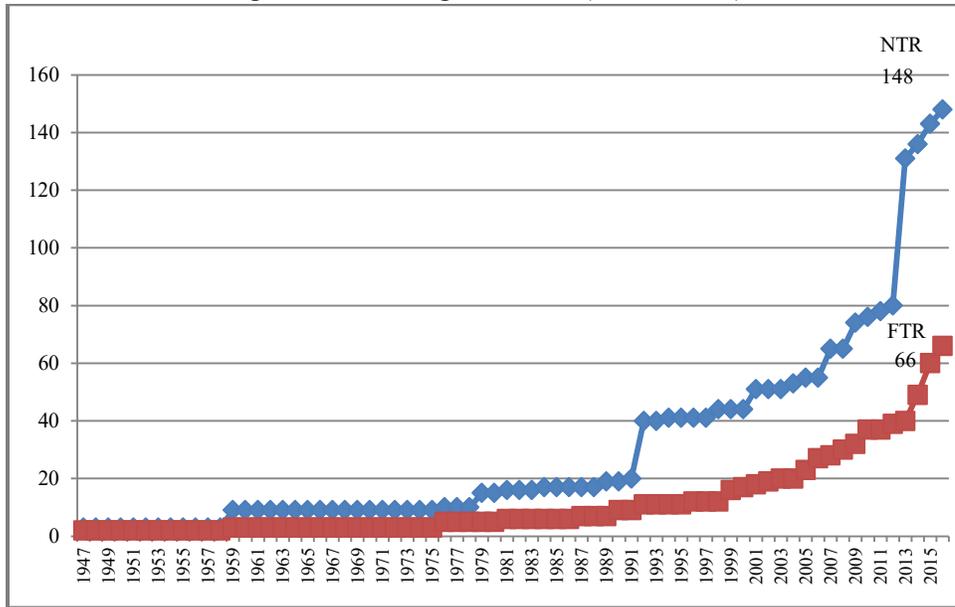


Source: FBR/PRAL.

**4.4. Expansion of FTR**

With time the tally of withholding provisions being brought into the purview of FTR has been increasing by the year. What it plainly implies is that while the state is increasingly extricating itself from the process and effort of reaching out to the correct tax base on its citizens in a differentiated manner, in the process, it is de-capacitating its tax administration continually.

**Fig. 4. Withholding Provisions (FTR & NTR)**



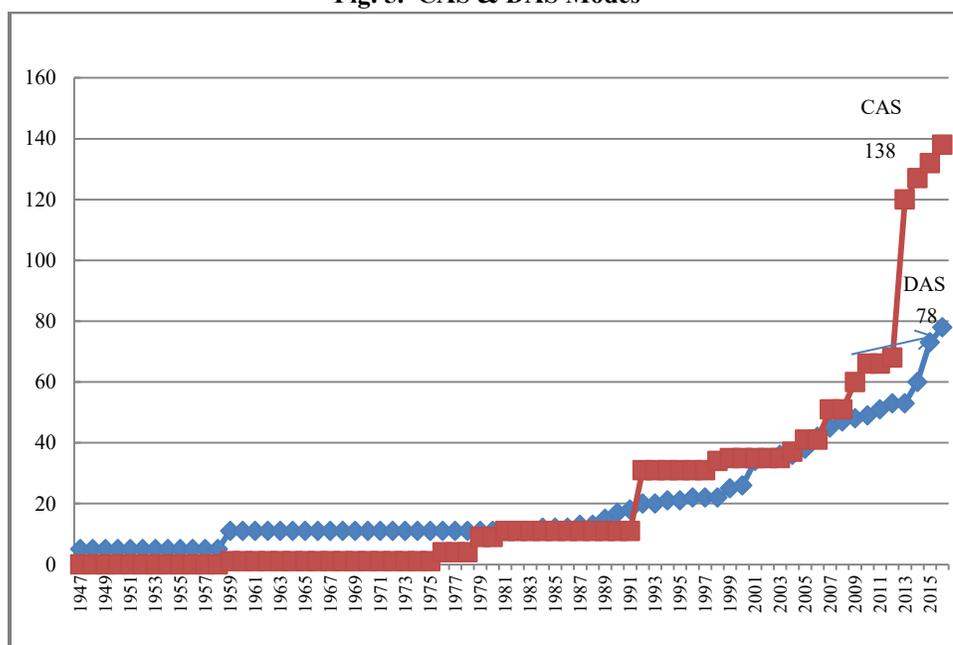
Source: FBR/PRAL.

It is evident that there visibly exists a positive correlation between withholding tools being legislated on the taxing statute and expansion of FTR as portrayed in Figure 4. Although, the number of withholding provisions under FTR is still less than that under NTR, yet the latter set of provisions also contains those extortionary legal tools where—under the option of adjustment is available, but in actuality, the claims of adjustment of tax withheld are never or only negligibly filed.

#### 4.5. Shuffle from DAS to CAS Mode

Similarly, a homegrown innovation on the withholding regime has been to apply it to CAS mode as against DAS mode, which is an internationally accepted mechanism of preponing of government revenues. Data plotted in Figure 5 shows relative movement of CAS and DAS modes overtime. While even the total number of DAS points at 78 may be taken as too high in an international comparison, yet the fantastic number of 138 CAS points may be reckoned as a bizarre Pakistani exceptionalism. This may be taken as the key variable and expression of brute withholdingisation in Pakistan.

Fig. 5. CAS & DAS Modes

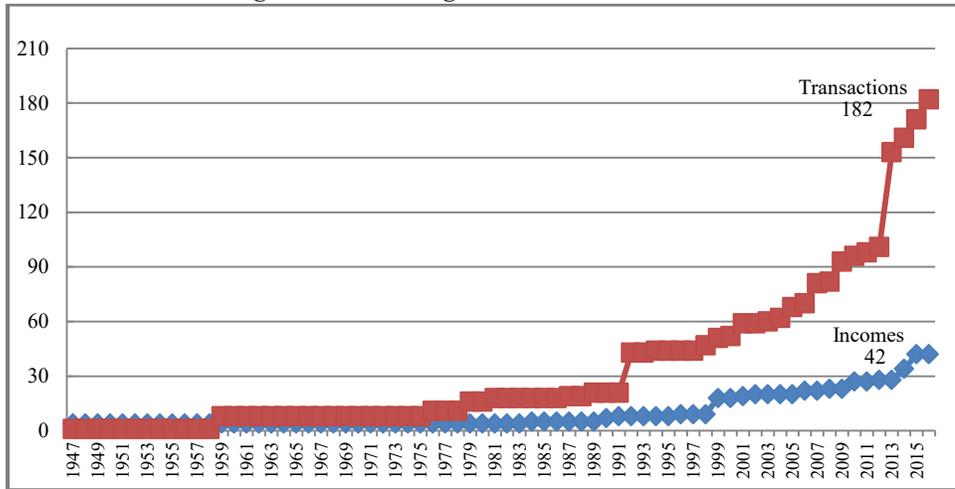


Source: FBR/PRAL.

#### 4.6. Withholdingisation of Transactions

While application of withholding scheme to incomes has long history and wide coverage internationally, its application to transactions is not too common. Figure 6 exhibits a consistent trend of upward increase in withholding regime's application to the value of gross transactions at 182 as against 42 incomes. This coercive *Chinacutting* of transactions when aggregated at the national level turns to be of serious size and implications for the economy.

**Fig. 6. Withholding Incomes & Transactions**

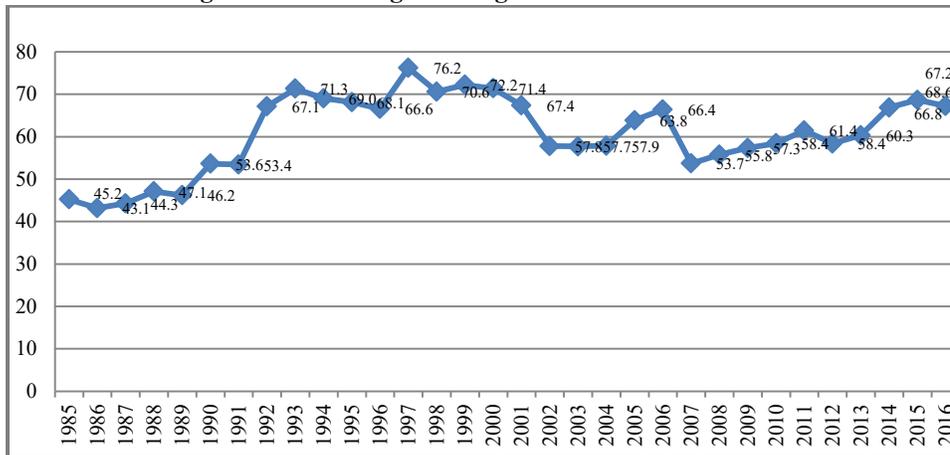


Source: FBR/PRAL.

**4.7. Withholding Share in Total Taxes**

The relative share of withholding taxes in the overall national tax take can be a meaningful gauge of how quickly and effectively the economy is falling into the shackles of withholdingisation. Data plotted in Figure 7 vividly reveals that continually share of tax collection through withholding has gone up. Likewise, the average rate of tax of deduction at source—particularly the one pertaining to transactions—execution of contracts, supplies, and imports—has also steadily moved up the ladder. This indicates the polity’s preference for and dependence on withholding mode and there too on taxation of gross transactions. It is apparent that such a perverse preference exercised under the pleasure principle effectively scuttled the continuum and aggregate of economic transactions—banking and real estate sectors being its vivid examples.

**Fig. 7. Withholding as %-Age of Income Tax Revenue**

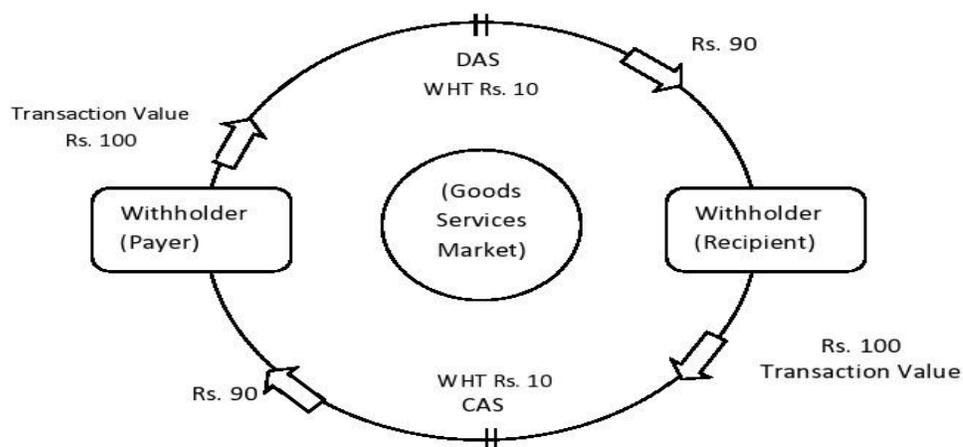


Source: FBR/PRAL.

#### 4.8. Dual-end Withholding Taxes

Although, the impact of dual-end withholdingisation on transactability in the economy—at least, in the recorded economy—is still to be systematically analysed and gauged, yet the same cannot be expected to be halcyon by any standard. Figure 8 is the graphic representation of dual-end withholdingisation simultaneously operating under DAS/CAS modes. Illustratively, while impact of withholding tax for a transaction in DAS mode is Rs. 10, but when the same transaction undergoes identical taxation also in CAS mode, the net impact gets doubled to Rs. 20, as reduced by each withholders' ability to absorb the tax withheld by the other. Such aggressive taxation can have reverse-multiplier effect on the economy.

Fig. 8. DAS/CAS Coupling Scenario



#### 4.9. Withholders' Compliance Requirements

According to law, the tax collected or deducted is held by the withholder “in trust for the Federal Government,”<sup>88</sup> and thereafter the same is “paid to the Commissioner” within seven days...in the manner” prescribed.<sup>89</sup> It has been ordained that in case “a person fails to collect tax...or having collected...fails to pay the tax to the Commissioner as required under” law, he “shall be personally liable to pay the amount of tax to the commissioner.”<sup>90</sup> Albeit the fact that in case “a person fails to collect tax as required under” the law, the Commissioner has the powers to “recover the amount not collected or deducted from the person from whom the tax should have been collected or to whom the payment was made,”<sup>91</sup> yet it would “not absolve the person who failed to deduct tax...from any...legal action in relation to the failure, or from a charge of default surcharge or the disallowance of a deduction for the expense to which the failure relates.”<sup>92</sup> The withholder is also duty-bound under the law to issue to the withholdee “a

<sup>88</sup>Section 166(1)(a) of Pakistan, “The income tax ordinance, 2001,” (Islamabad: FBR, 2001).

<sup>89</sup>Section 160 of *ibid.*

<sup>90</sup>Section 161(1) of *ibid.*

<sup>91</sup>Section 162(1) of *ibid.*

<sup>92</sup>Section 162(2) of *ibid.*

certificate setting out the amount of tax collected or deducted and...other particulars.”<sup>93</sup> Still, to top all, a withholder has to be ready and brace for withholding monitoring audits for an indefinite period of time. One can spot a steady trend of increase in compliance compulsions for economic agents (withholders) over time surreptitiously rendering their operationalisation more and more difficult in a withholdingised economic system.

#### 4.10. Withholders’ Reporting Requirements

An identical trend can be spotted in the reporting regime for withholders. Having deducted and paid off the required amount of withholdable tax to national exchequer, the withholder is supposed to “furnish to the Commissioner a monthly statement in the prescribed form setting out” complete particulars about his own person, those of the withholdee, the transaction, and its payment to the treasury.<sup>94</sup> It used to be an annual withholding reporting return which each withholder was obliged to furnish to the tax administration. Subsequently, it became a quarterly requirement in 1982, and it was not until 2011 that the submission of withholding statements was rendered a monthly requirement. The prescribed withholding statement requires of a withholder to fill in and supply a great amount of information apart from reproducing his entire cash book and bank book, which makes it quite a cost-intensive affair. Moreover, since withholding statements are to be furnished online, a withholder needs a substantial in-house capacity to timely meet the reporting requirements, which factor pushes the compliance cost for an enterprise further up. It will not be out of place to mention that withholders who happen to substantially contribute to the exchequer have been negotiating and getting selective reporting waivers e.g. banks in the case of interest-bearing depositors. But, in overall terms, the withholders’ reporting requirements have increased—including the withholding audits.

#### 4.11. Withholders’ Punitive Regime

Something that may have started as a regulatory vigilantism on the withholders towards the onset of the withholding regime has, with time, evolved into a full-blown parallel stream of taxation with its own operating coercive mechanisms duly supported by well laid down punitive and prosecutive implications. The minimum penal action that a withholder is subjected to in case of a default is that such “person shall be personally liable to pay the amount of tax to the Commissioner who may pass an order to that effect and proceed to recover the same.”<sup>95</sup> Moreover, the defaulting withholder would pay “default surcharge at the rate of twelve percent per annum from the date he failed to collect or deduct the tax to the date the tax was paid.”<sup>96</sup> Non-furnishing of monthly withholding statements calls for imposition of penalty at the rate of Rs. 2,500 per day (subject to a minimum penalty of Rs.10,000).<sup>97</sup>

The icing on the cake comes in the shape of prosecutive implications as the law stipulates that “Any person who, without reasonable excuse, fails to...comply with the

<sup>93</sup>Section 164(1) of *ibid.*

<sup>94</sup>Section 165(1) of *ibid.*

<sup>95</sup>Section 161(1) of *ibid.*

<sup>96</sup>Section 161(1B) of *ibid.*

<sup>97</sup>Section 182(1)(Table Sl.1A) of *ibid.*

obligation...to collect or deduct tax and pay the tax to the Commissioner,...shall commit an offense punishable on conviction with a fine or imprisonment for a term not exceeding one year, or both.”<sup>98</sup> Yet another highly penalising implication for withholders comes in the form of a stipulation that “no deduction shall be allowed in computing the income of a person...for...any expenditure from which the person is required to deduct or collect tax..., unless the person has paid or deducted and paid the tax as required by” law.<sup>99</sup> The imposition of penalty for non-filing of withholding statements has of late become a major preoccupation of the revenue administration. Illustratively, only during May and June, 2017, DC, IRS, Cantonments, Rawalpindi, imposed a penalty of Rs. 1.3 billion for non-filing of monthly withholding statements. Likewise, AC, IRS, exercising jurisdiction over Rawalpindi City, levied a penalty of over Rs. 2 billion on non-filers of monthly withholding statements. The amount of penalty so imposed far outweighed the total tax imposed under the normal law by the entire Regional Tax Office, Rawalpindi. Accordingly, pending appellate cases at given point in time resulting from the imposition of penalty for default of withholding taxes far outnumber those under the normal regime.

#### **4.12. Resource Allocation for Withholding Regime**

Betraying the polity’s pronounced preference for withholdingisation of economic system at the expense of capacitation of the tax system, a corresponding historical shift in resource allocation from the latter to the former can be spotted—particularly since 1991. The narrative used for the purpose was “effective monitoring” of withholding taxes. During 1990s, the focus of tax administration increasingly shifted from normal taxation to withholding taxation as revenue numbers began to avail primacy over how they were being generated. In this sense of the matter, the polity reflected the society and its mores to look at private wealth and its means. A specialised Directorate General (Withholding Taxes) was created in 2001, which intensified the process of withholdingisation. About two dozen specialised Commissionerates (Withholding Taxes) were established in February 2013 all over the country—with maximum resources—both in men and means—being placed at their disposal. In fact, withholdingisation of the system has occurred at such a rattling pace that FBR in routine has started to pick up sundry procurement and tender notices published in various newspapers, caption them as “Real Time Proactive Monitoring of Withholding Taxes,” and circulate them to field formations prospectively stipulating “that all due taxes, in these procurements, as and when became due, are properly withheld (as per law) and timely deposited (as per procedure).”<sup>100</sup> One wonders if FBR also ever collects information on massive money laundering ploys, illegal remittances, beneficial transactions and cases of mega tax evasion and shares it with field collectors for proper adjudication. Since bulk of the revenue comes from withholding, understandably maximum resources in each tax organisation tend to be allocated for monitoring and collection of withholding taxes leaving normal taxation to backburner, sapped, and stunted. Thus, it is not astonishing that the best human resource and maximum means get allocated for withholding function at the expense of normal taxation.

<sup>98</sup>Section 191(1)(c) of *ibid.*

<sup>99</sup>Section 21(c) of *ibid.*

<sup>100</sup>FBR’s Memorandum No.7(73)C(WHTM-)/2017/5983-R, dated June 15, 2017.

Since the premise is that withholdingisation is essentially an elitist enterprise, it would be an interesting question to pose as to how do elites then wriggle out of its concomitant adverse fallouts—for instance, excessive-deductions. The paper posits that elites have both pre- and post-withholding escape clauses kept available to themselves. In the pre-withholding domain the elites have exemption that they resort to as and when required, which is of two types i.e. general exemption and specific exemption. General exemption refers to exempting provisions that are brought to bear down on the tax system through both legislative and bureaucratic processes e.g. Statutory Relief Orders (SROs). Specific exemptions are issued by Commissioners on request. In the post-withholdingisation scenario, elites resort to exercise of political muscle to get their refunds cleared.<sup>101</sup> In case of non-sanctioning of exemption requests and refunds, elites resort to invoking writ jurisdiction under Article 199 of the Constitution with substantial degree of receptivity. Elites Ltd has also put in place Federal Tax Ombudsman (FTO)—an institution that is effectively utilised to get their refunds of all shades and hues processed. It can be argued that excessive deductions also serve some other purposes. First, the government gets free funds to finance its operations. Second, “getting a tax refund fosters the notion that the government is benevolent.”<sup>102</sup> Many a times over the recent past, at especially arranged functions, Prime Minister, Finance Minister, and Chairman, FBR, have been seen bestowing upon citizens refund cheques that anyway legitimately belonged to them. Thirdly, the elitist state uses excessive deductions as bargaining chip while negotiating settlements with various interest groups. Lastly, excessive deduction creates opportunities for convenient rent-seeking. In a withholdingised economic system, elites also resort to amnestisation as an effective tool of advancing their economic agenda. In addition to the above strands which converge on the point that Pakistan’s polity, under the preponderant impress of the pleasure principle, systemically withholdingised the tax system which steadily took the entire economic system into its shackles.

The oppressive implication of withholdingisation was further accentuated by other unconnected but related measures e.g. a robust withholding regime being put in place under sales tax in 2007.<sup>103</sup> Likewise, in early 2010s, when provinces established their own independent revenue agencies in the wake of 18<sup>th</sup> amendment to the Constitution, withholding of sales tax was enforced as the central pivot of the provincial revenue systems. Similarly, an upfront Infrastructure Cess on all imports and exports by land or sea was imposed by Sindh with other provinces constantly looking to tap new sources of easy and quick revenues. If all that was not enough, the state opted to fix some of its other malaise (that had nothing to do with taxation or tax system per se) through withholdingisation e.g. T.V. Surcharge, Neelum Jehlum Surcharge, and compulsive contributions from employees’ salaries at the time of natural calamities.<sup>104</sup>

<sup>101</sup>Ahmed, “Pakistan: Extraction, elites and state autonomy: A theoretical configuration.”

<sup>102</sup>Lawrence M. Vance, “The Curse of Withholding Taxes,” Mises institute: Mises daily articles (2005), <https://mises.org/library/curse-withholding-tax>.

<sup>103</sup>The Sales Tax (Special Procedure) Rules, 2007, enforced vide SRO, 660, of 2007.

<sup>104</sup>See, for a detailed analysis, Ahmed, “Pakistan: Extraction, elites and state autonomy: A theoretical configuration.”

## 5. WITHHOLDINGISATION & NATIONAL TAX COLLECTION COST

Withholdingisation, inter alia, achieves a couple of distinct objectives of the elitist state. One, it helps underfinance the revenue administration, which as a result thereof gets incapacitated over time and weak enough to pose taxing questions. It has been argued that Elites Ltd's control "on the revenue function helps the former keep the latter under-financed and, thus stunted, and constrained on its operations."<sup>105</sup> It thus is not astonishing that against the world-average of 2.5 percent, Pakistan's tax collection cost is 0.73 percent, which when further divided between IRS and PCS works out at 0.23 percent for the former—the agency which is exclusively responsible to conduct state's inland extractive operations and collect good about 90 percent of its total tax revenues.<sup>106</sup> It has also been observed that "such was not the scenario at the time of independence when the colonial state allocated full required amount of resources to its extractive arm so as to undertake optimal revenue generation," as there is evidence to suggest that it was only after independence that "post-colonial elitist state had started to cut on its revenue function's expenditure."<sup>107</sup> Vakil, as far back as 1950, had commented that "the cost of collection of various taxes," in "proportion to total revenue in India is higher than that in Pakistan."<sup>108</sup> Likewise, TEC had observed in 1960 that for "the Central Government the cost of collection of taxes is roughly 3 percent," and as a "proportion of total expenditure, the cost of collection of taxes has declined from 3.77 percent in 1949-50 to 3.12 percent in 1957-58,"<sup>109</sup> to adequately establish that "corrosive degenerative process that had seemingly taken roots by then—finally bringing it down to such ridiculously low levels as at present."<sup>110</sup> NTRC after observing that "the cost of collection of taxes has been kept below one percent of the total revenue collected which compares favourably with the cost of collection not only in the developing countries but also with the developed world," harangued that "this has been achieved at the cost of ignoring certain basic elements necessary in a sophisticated taxation system."<sup>111</sup> It is not that a sane voice has never been raised; there have been, but those were completely ignored. CTR noting that the "cost of collection (in respect of Sales Tax) went down from 0.71 percent in 1986-87 to 0.62 percent during 1988-89,"<sup>112</sup> argued "that expenditure of CBR should be treated as development expenditure, and that it be allowed to spend a fixed percentage of revenues collected."<sup>113</sup> Similarly, it was suggested that the present level of CBR's expenditure should be raised by 0.5 percent of revenue collected and also that it should be given complete financial autonomy.<sup>114</sup> The elitist state's response, however, has been more and more withholdingisation thereby keeping the revenue system incapacitated and cost of collection transferred to citizens.

<sup>105</sup>See Ahmed, "Pakistan's Governance goliath: The case of non-professional Chairman, F.B.R.," 30.

<sup>106</sup>These estimates are based on the actual budgetary allocations made by the Government of Pakistan to FBR and its various departments.

<sup>107</sup>Ahmed, "Pakistan's Governance Goliath: The Case of Non-Professional Chairman, F.B.R.," 30.

<sup>108</sup>C. N. Vakil, *Economic consequences of divided India; a study of the economy of India and Pakistan* (Bombay: Vora, 1950).

<sup>109</sup>GOP, "The taxation enquiry committee report (Volume 1)" 24.

<sup>110</sup>Ahmed, "Pakistan's Governance goliath: The case of non-professional Chairman, F.B.R.," 30.

<sup>111</sup>GOP, "The national taxation reform commission report (Part 1)," 325.

<sup>112</sup>GOP, "The committee on tax reforms report," D2.

<sup>113</sup>*Ibid.*, B46.

<sup>114</sup>*Ibid.*

Two, the elitist state conveniently shifts (outsources) its fiscal function to private entrepreneurs—by directly cutting on the cost of collection of taxes. But is it really so? Probably, it cannot be; and it is not. In 2016-17, Pakistan saw its position sliding down to 85th in terms of “effects of taxation on incentives to invest” from 66th in 2015-16.<sup>115</sup> Moreover, Pakistani entrepreneurs pick exceptionally higher compliance costs vis-à-vis tax administration. Is it just because of the standard tax filing of routine nature? Perhaps not; much of it is because of withholdingisation of economic system and what it means to an entrepreneur being a withholder. No doubt, sparse grievances are aired by various economic agents suggesting that cost of withholding taxes was becoming unbearable for the private business. But it is yet to be systematically posited that, in fact, what the state had done was, it had tactfully contracted out its extractive function, and that if the official cost of collection was on lower side, it was due to the deft cost shifting by the state to the entrepreneur. In Pakistan’s context official cost of collection was markedly different from the national cost of collection, which, in addition to the official cost of collection, also included the cost of withholding—borne by private entrepreneurs. Thus, Pakistan’s tax collection cost may be notationally written as under:

$$X = W + Y$$

$$X = Z$$

While  $X$  represents standard tax collection cost;  $W$  represents *official* tax collection cost (picked by the state);  $Y$  represents withholding tax collection cost (picked by the entrepreneur); and  $Z$  represents *national* tax collection cost (picked both by the state and the society); hence dubbed as national tax collection cost. An empirically-based approximation of national tax collection cost being outside the purview of the present study, yet what can hypothetically be stated is that, all put together, Pakistan’s national tax collection may be between 3.5-4 percent—probably highest in the world. Now if the developing countries average of 2 percent is taken as an acceptable measure of tax collection cost, the excess being spent by Pakistani society between 1.5-2.0 percent could be dubbed as national deadweight loss. This amount, if saved through capacitation of the tax system, could easily be diverted to better the service delivery and improve state’s performance in other functions like coercive, regulative, and distributive, apart from arresting withholdingisation-induced anarchy, and neutralising its Dutch Disease effects on the economy.

### 5.1. Taxflation

Now, the exaggerated cost of collection as worked out above that both the economy and the society are compulsively made to suffer on account of withholdingisation can be analysed within the context of how it actually plays out with prices of goods and services transacted in the market. It is stipulated that withholdingisation being applicable at each meeting-point in the transaction chain cumulatively enhances the end-price of goods and services being produced in the economy—triggering a process that could operationally be dubbed as taxflation—inflation (increase in prices) due to taxation<sup>116</sup>—much of which is neither due, nor

<sup>115</sup><http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017.pdf>

<sup>116</sup>“Taxflation” has been used in the paper in a sense slightly different from the one that is generally associated with it whereby an inflation-related increase in income pushes its recipient into higher applicable tax brackets off-setting the impact of increase in income - something also known as “bracket-creep.”

adjusted nor refunded.<sup>117</sup> While on the one hand, such aggressive extortionist taxation contributes to taxflation owing to its inherent ability to get passed on, on the other, it tinkers with equity and efficiency principles, and adds to social anarchy and chaos. Taxflation, when disaggregated, can be notationally written as under:

$$TF = CC + WHT^1 + WHT^2 + WHT^3 + LL + VAT$$

In the equation, while TF denotes taxflation; CC exaggerated compliance cost in a withholdingised economic system;  $WHT^1$  withholding tax deducted on intermediary inputs stuck in the final output prices;  $WHT^2$  withholding tax applied in CAS mode and likely to be added to the price;  $WHT^3$  fixed cost paddings like withholding tax on building rent, and utilities e.g. electricity, gas and telephone that the supplier has to pass on; LL line-losses like withholding tax on banking and other transactions; and VAT represents the federal and provincial sales tax or its variants, which are an inevitable additionality to the final price of goods and services transacted and produced in the economy.

## 5.2. Perverse Quid Pro Quo

This tax collection cost sharing arrangement between the contractor (state) and the contractee (withholder) may have under-grid a larger perverse quid pro quo in the economy. Entrepreneurs, as withholdingisation expanded its tentacles on the economic system, made adjustments to their business systems, in the process internalising the withholding tax collection costs into their pricing structure—both upstream and downstream. The entrepreneurs picking up these additional withholding collection costs were duly compensated and rewarded by the state in the form of recurrent amnestisation, general and specific exemptisation, generous audit waivers, deterrence-free self-assessment regimes, relaxation in information declarations, and diluted regulatory and oversight frameworks—even bordering on keeping the tax collectors at bay. In fact, Pakistani entrepreneurs may have quite happily picked up the withholding tax collection cost. This lowly, perverse, and degenerative arrangement between the state and the society realises a tax system that effectively undertakes undifferentiated, extortionist, and unequal extraction in a society wherein economic resources are already highly unevenly dispersed. In this sense of the matter, withholdingisation may have operated as an effective pull-back factor on the forward march of the society, the state, and a bonding between the two that continues to be thread-thin at any rate.<sup>118</sup>

## 6. WITHHOLDINGISATION OUTCOMES

While the preceding sections argued and established that Pakistan tax system had been thoroughly withholdingised as evidenced by a dozen of its underlying prongs, this section ventures to normatively analyse, in the succeeding three sub-parts, if its output—collection of easy bucks—has had a wholesome outcomes and impacts on the polity; if it caused or contributed towards an ever-increasing disruption in the society; and if it generated an adverse impact on the economy closer to that of Dutch Disease? What could

<sup>117</sup>This is because, theoretically speaking, all direct taxes are supposed to be borne by the payer of the tax himself.

<sup>118</sup>Ahmed, “Pakistan: State-building, extraction, and (misplaced) societal preferences.”

be predicted upfront is that the state's blindly pursuing the pleasure principle at the expense of the reality principle was bound to have consequences; and looks like chickens have come home to roost.

### 6.1. Source of Revenue?

It is abundantly clear, as also depicted in Figure 7, that withholding taxes' contribution which was about 45 percent of total direct tax revenue starts to shoot up at the start of 1990s; this was due to the introduction of PTR. The contribution of withholding taxes consistently kept climbing up till it touched its historic highest in 1996-97;<sup>119</sup> then steadied at around 60 percent. The curve again starts to get steeper at the start of 2010s and touches 70 percent mark before again slightly declining at around 2014-15, which decline is really difficult to explain.<sup>120</sup> Is it fatigue of the withholder with the coercive outsourcing of the extractive function or fudging of facts on part of the state to make the numbers look acceptable enough to form a reasonable basis for further international extraction? It is reiterated that the exaggerated contribution of a withholdingised extractive system is unwholesome with far-reaching adverse fallouts for the state to extract from other sources. In the succeeding paragraphs some of the systemic fallouts will be explained.

Firstly, tax system's uprooting from its normative foundations may be one of the most carcinogenic effects that withholdingisation has had on the state and its extractive operations.<sup>121</sup> Adam Smith normatively desired to base a tax system on (a) equity—fairness in regard to relative tax burden borne by various segments of society; (b) certainty—assurances against arbitrariness in regard to the procedure of working out of tax liability and the timing of its discharge; (c) convenience—with regard to the mode, manner and the timing of tax defrayment; and (d) efficiency—deriving maximum output from the input supplied, that is, cost of collection, and with minimum negative externalities.<sup>122</sup> Although, this classical prescriptive model of a tax system has ruled the roost for centuries, yet a couple of more attributes may also be desirably added, namely, is the tax system good enough to extract at a sufficiently required level, and if the tax system, in overall terms, adds to the process of state-building or undermines it? A compulsive cynic may, however, retort that if a given tax system has all four Smithsonian attributes, should it not be assumed that it also has inbuilt the two aforementioned

<sup>119</sup>This can, inter alia, be explained in terms of the prevailing political uncertainty that brought the normal revenue operations to a perceptible slow down.

<sup>120</sup>It may be pertinent to point out that if at-source deduction of sales tax is also added to the equation, the impact of withholdingisation on the economy would appear even intenser.

<sup>121</sup>Mahnaz Fatima and Q. Masood Ahmed, "Political economy of fiscal reforms in the 1990s," *The Pakistan Development Review* 40, no. 4 (2001); Ahmed, "Pakistan's governance goliath: The case of non-professional Chairman, F.B.R.," Ahmed, "Pakistan: State-building, extraction, and (misplaced) societal preferences.," Ahmed, "Pakistan: Extraction, elites and state autonomy: A theoretical configuration.," Pasha, "Political economy of tax reforms: The Pakistan experience.," Hafiz A. Pasha & Aisha Ghaus-Pasha, "The future path of tax reforms in Pakistan," in *Pakistan: Moving the Economy Forward*, ed. Rashid Amjad & Shahid Javed Burki (New Delhi: Cambridge University Press, 2015); Musharraf R. Cyan and Jorge Martinez-Vazquez, "Pakistan's enduring agenda for tax reforms," in *The role of taxation in Pakistan's revival*, ed. Jorge Martinez-Vazquez and Musharraf R. Cyan (Karachi: Oxford University Press, 2015).

<sup>122</sup>Adam Smith, *The wealth of nations*, ed. C. J. Bullock, vol. X, The Harvard Classics (New York: P.F. Collier & Son, 1909-14).

additional traits. “Yes” and “no.” The paper stipulates that a tax system howsoever utopian in its outlook, if it does not collect revenues enough to maintain the state, it is not a good tax system as the state under compulsion would have to resort to other sources of extraction with adverse implications in the long-run, which scenario reinforces the sufficiency and state-building attributes into the equation.

Like the debate on equity is central to the debate on a tax system, the debate on tax incidence is central to a debate on equity. Equity is of two types i.e. horizontal equity and vertical equity. While horizontal equity asserts that there ought to be “equal treatment of equals,” that is, individuals enjoying identical wealth, or in identical income brackets, must suffer equal tax impact, vertical equity canon stipulates that wealthier persons and those in possession of larger economic resources must pick larger tax incidence. David Elkins argues that “violation of horizontal equity, while not necessarily fatal, is nevertheless considered a fatal flaw in any...tax arrangement.”<sup>123</sup> Tax rates that underlie equity principle can be of three types, namely, progressive, regressive or proportional. In case, the effective tax rate increases as income increases, the overall tax system would be considered as progressive; in case, the tax rate decreases with income, the tax system would be regressive; and finally, if it remains constant, it is a proportional tax system. The most important concept inside equity debate may be that of tax incidence, which is of two types i.e. statutory incidence and economic incidence. While statutory incidence of tax indicates who is legally responsible for the tax, economic incidence of a tax is the change in the distribution of private real income induced by a tax. The mechanism through which statutory incidence of a tax is transferred from those who are legally responsible to collect to those who actually bear the economic burden is dubbed as “tax shifting.” In case, the tax is shifted to consumers through higher prices of goods and services, the tax is said to be “shifted forward;” if the tax is borne instead by workers or other input suppliers, then the tax is said to be “shifted backward.” Wahid & Wallace undertook an enlightened empirical study on Pakistan, which despite limitations and shaky assumptions, held that “two most important sources of horizontal inequities are the unequal treatment of different taxpayers through exemptions and tax evasions.”<sup>124</sup> Without touching upon vertical equity, which may perhaps be a bigger bane in Pakistan’s context, they go on to controversially hold that “while all households bear part of the burden of taxes in Pakistan, the higher income households bear a larger share of the burden than low-income households.”<sup>125</sup> They also adjudge that “direct taxes have a much more progressive distributions,” which may be “due to the high threshold for the individual income tax and the concentration of capital income in the higher income groups.”<sup>126</sup> They end up making highly provocative statement that “the system of direct taxes in Pakistan is very progressive at the top income end.”<sup>127</sup>

<sup>123</sup>David Elkins, “Horizontal equity as a principle of tax theory,” *Yale Law & Policy Review* 24, no. 1 (2006).

<sup>124</sup>Umar Wahid and Sally Wallace, “The equity debate in tax policy,” in *The Role of Taxation in Pakistan’s Revival*, ed. Jorge Martinez-Vazquez and Musharraf Rasool Cyan (Oxford University Press: Karachi, 2015), 313.

<sup>125</sup>*Ibid.*, 319.

<sup>126</sup>*Ibid.*

<sup>127</sup>*Ibid.*

These rather positive summations come against the general perception that Pakistan tax system having been excessively withholdingised is highly lopsided. Theoretically speaking, progressivity—the ability to extract from people according to per their capacity, becomes the first casualty of withholdingisation. Tax system’s surreptitious indirectisation through withholdingisation, as already also pointed out, has been done and achieved on purpose. Haq pertinently remarked that “determination of a tax base capable of measuring an individual’s ability-to-pay is a major problem of our tax system,” since elsewhere “this rule is achieved by adopting progressive rate schedule for personal income tax and property tax,” but “we have moved from this policy to unequal sacrificial rule where the mighty...political elite are paying meager taxes and actual incidence is shifted to the less-privileged.”<sup>128</sup> He goes on to state that “businessmen are offered presumptive tax regime, even under income tax law, to pass on burden on the customers,” whereas “masses are overburdened with oppressive indirect taxes, ever rising costs of public utilities and petroleum products.”<sup>129</sup>

Secondly, sustained ruthless withholdingisation has effectively neutralised and disengaged the tax system from the overall macroeconomic framework. Government’s role in the economic domain has broadly been seen in terms of (a) overcoming inefficiencies of market system and allocation of economic resources; (b) reordering of distribution of income and wealth in the society along “just” and “equitable” lines; and (c) smoothing out of cyclical economic fluctuations with a view to ensuring employment and inflation rates at desired levels.<sup>130</sup> One of the prime harms that withholdingisation may have done is neutralisation of tax policy as an effective tool of macroeconomic management. A standard Keynesian stipulation is that through an effective utilisation of fiscal policy, aggregate demand levels can be increased or decreased while balancing the act between unemployment and inflation. In Pakistan’s case withholdingisation has defanged tax policy as a mechanism of tinkering with macroeconomic management. In a withholdingised economic system the standard tool of reduction in tax rates cannot be expected to increase output through raising the aggregate demand, as the actual tax rate is diluted into hundreds of tax rates applicable to sectors, sub-sectors and even single business lines.<sup>131</sup> Withholdingisation may have also neutralised taxation as a reliable tool of conducting social policy. Historically, taxation has been used to encourage home ownership, investment, family formation, and even environmental protection. In Pakistan, of late, tax policy has become synonymous with and confined to fine-tuning of withholding tax provisions, rates, and operational mechanisms. Likewise, withholdingisation may have also negatively impacted economic development in not

<sup>128</sup>Ikramul Haq, “Undoing unjust tax system,” *Daily Times*, June 4, 2017.

<sup>129</sup>Ibid.

<sup>130</sup>R. A. Musgrave, *The theory of public finance* (London: McGraw-Hill, 1959); Ahmed, “Pakistan: state-building, extraction, and (misplaced) societal preferences.”; Ahmed, “Pakistan’s governance goliath: The case of non-professional Chairman, F.B.R.”; Wahid and Wallace, “The equity debate in tax policy.”; Jorge Martinez-Vazquez and Kaspar Richter, “Pakistan’s short and medium term reform options,” in *The role of taxation in Pakistan’s revival*, ed. Jorge Martinez-Vazquez and Musharraf Rasool Cyan (Karachi: Oxford University Press, 2015).

<sup>131</sup>Excessive withholdingisation, it has been argued, can also cause, incentivise and increase smuggling.

too-well-known but important ways. It was observed that imposition of withholding tax on banking transactions “resulted in the slowdown of bank deposit growth, and forced medium- and small-sized banks to offer returns above the market rates to raise deposits.”<sup>132</sup> In Pakistan where rates of savings and investment are already much below the desired threshold, such negative latent policy biases are bound to adversely affect economic growth and development.

Thirdly, withholdingisation may have created more economic distortions than generally ascribed to it. When withholding regime started to expand in Pakistan during 1980s and 1990s, one of the major advantages, at least for public consumption, was reckoned to be data collection about potential taxpayers so they could be roped into tax net. However, the current levels of withholdingisation have started to produce diametrically opposite results. Illustratively, SBP in reference to the imposition of withholding tax on bank deposits, in 2016, observed that “withholding tax on deposits is halting the deepening of the banking services,” and that the same was “acting against the goal of achieving financial depth,” and further that “for the first time since 2009-10 the monetary expansion came more from currency in circulation than the bank deposit growth,” as “private sector deposits increased by Rs.149.4 billion during July-March FY16 — less than half of the rise recorded during the corresponding period of FY15.”<sup>133</sup> In the same vein, business community “also tried to find other modes of payment to avoid it,” and “particularly retailers and medium-sized businesses, started using dollars to make payments while they kept dollars in their bank lockers.”<sup>134</sup> Resultantly, surplus liquid funds either flee the country or get invested in the real estate—a dead sector for all practical purposes.<sup>135</sup> It is also commonly believed that excessive application of withholding taxes on the real estate sector has significantly brought down the number of transactions therein causing a definite dent in the aggregate revenue. Thus, Pakistan’s official savings rate staying stagnant around 16 percent may also partly be explained in terms of brute withholdingisation of the economic system.

Fourthly, withholdingisation has rendered much of the fiscal system unreformable. This can be seen from five different standpoints. One, the entire tax administration—IT systems, underlying rules and procedures, the human resource—and even the Parliament, have all adjusted to at-source mode and methodology of revenue-collection within their respective roles. Two, because of the ever-emerging special regimes, the tax statute has gotten more and more complex and complicated with every year passing particularly since 1991 onwards. Three, the case law that has developed over the past three decades having been cast in the same dye, has significantly added to the complexity of the system rendering it more and more unreformable. Four, the state’s overdependence on at-source taxation leaves little room for successive governments to undertake any risky and meaningful reforms in

<sup>132</sup>Shahid Iqbal, “Withholding tax slows down bank deposit growth: State bank,” *Dawn*, July 2, 2016.

<sup>133</sup>*Ibid.*

<sup>134</sup>*Ibid.*

<sup>135</sup>This may be reckoned as dead sector as any investment in real estate, inter alia, does not create jobs; does not generate substantial amount of revenues through taxaton of gains resulting from its appreciation over time, and creates bubble crowding genuine buyers out of the market causing slow down in the construction industry - and directly and indirectly associated industries and sectors.

that no government finds itself in a position to let go of sure easy bucks into the kitty. “The necessary work to address these contortions and the costs of tax revenues likely to be lost during such a transition,” it has been averred, “will now need three to four budget cycles to carry out.”<sup>136</sup> Last, the system due to relentless retrofitting over the past three decades has gone beyond a repairable condition—an “entrenchment” of sorts; in that withholdingisation operates as the “Superstatue”—an inescapable reality.

Fifthly, withholdingisation has also triggered heightened interest group activity in the country. Elsewhere elaborated also, heightened groupnessisation has taken the entire public policy formulation process into its shackles. In fact, interest group activity has attained such a pace that it is beginning to have a rattling effect on the polity. Trade unionisation of the economy, when above-normal, creates distortions and produces substantial negative externalities. An interest group gets formed and rolled out as soon as another group has gotten its withholding rate or regime favourably adjusted. It goes without saying that an economic group operates as a rational actor readying to optimise on any opportunities to safeguard and promote their particularistic interests. In a withholdingised economy, when the interest groups also contribute to the exchequer substantially, their voice proportionately becomes more vibrant and audible. In fact, in T/Y 2016, while banking sector “paid total taxes of over Rs. 140 billion,” it “collected and paid to FBR over Rs. 134 billion as withholding tax.”<sup>137</sup> Not surprisingly then the sector got away with significant relaxations on their reporting requirements in quid pro quo from the state.

Lastly, since by their very nature, withholding taxes happen to be indiscriminate in target and impact, they tend to nudge and hurt marginalised segments of society rather seriously. Although “vulnerable groups such as widows, pensioners, retirees, students etc., receive very low compensation or income that falls below the taxable threshold and...are not liable to pay tax,” yet “withholding tax is deducted on their savings whenever they make withdrawals, which is unfair as they cannot claim credit for the deducted amount.”<sup>138</sup> The state which is already failing on its functions in terms of providing necessary public goods like education and health to its citizens must be doubly cognizant of citizen groups that statutorily are not to be taxed—short of that state-society relations would be as weak as in the present-day Pakistan. Further, such deductive extortions from the impoverished or not well-to-do citizens pushes them away from financial inclusion process effectively barring them from economic mainstreaming.<sup>139</sup>

In all fairness, withholdingisation apparently may have added an element of certainty to the tax system, but it is essentially artificial in that, in the long run, it is not sustainable being unjust, arbitrary, and perverse. Withholdingisation also betrays sham convenience as if both the withholder and the withholdee are over with tax component of doing business, but in reality it has complicated the system as can be seen from the ever-increasing compliance and reporting requirements, and the stringency of the punitive and prosecutive regimes for withholders. There is no doubt

<sup>136</sup>Shahid Kardar, “Amplified policy distortions,” *Dawn*, July 4, 2017.

<sup>137</sup>M. Arshad, “F.B.R urged to Amend ITO 2001 provisions to stop tax evasion,” *Customs Today*, April 5, 2017.

<sup>138</sup>Ibid.

<sup>139</sup>Ibid.

that in Pakistan an entrepreneur allocates a substantially high number of man-hours to comply with tax system's requirements, which really dislodges both the convenience and efficiency arguments in support of withholdingisation. Summing up, it may, however, be that withholdingisation has done well by maintaining a tax/GDP ratio of under or around 10 percent but in the process, it could have done more harm than good to the economy, the society, and the polity at a deeper and wider level; a better understanding of which would continue to be gained by all three in the years and decades to come.

## **6.2. Source of Civil Strife?**

Ron Cruse's observation that many of the countries that he "visited in the late 1980s were veritable incubators of repression, civil strife, and war," but Pakistan was the place "where violence was a part of daily life," holds water even today.<sup>140</sup> Pakistan historically has been in the throes of civil strife of varying shades and hues starting with the independence-time mass-migration (and its aftermath) to linguistic, ethnic, sectarian, regional, and ideological civil strife. Not that all these causes have been neutralised or that economically-oriented civil strife did not exist earlier but lately economic civil strife appears to have overtaken as the most abundant and powerful source of civil strife in Pakistan. People have, of late, protested on roads and gone violent, killed, pelted stones, burnt private properties, fired, staged sit-ins, splayed deadbodies refusing burials, resorted to hunger strikes, carried-out mock hangings to articulate their demands; express their angst; exhibit their powerlessness. The state has responded to the protests and protestors with killings, *lathi* charges, arrests, lay-offs, tear-gassing, wickedly negotiations, but rarely with robust and solid policy interventions. Protests, in turn, more typically, have sprung against joblessness, unfavourable job conditions, load-shedding,<sup>141</sup> perceived grievances of exclusion (say, under CPEC),<sup>142</sup> unscheduled power failures and outages, drone attacks, ethnically-oriented cleansing, honor-killings, media clamp-down, perceived unfavourable fiscal, agricultural, religious, export and other policies. But at some level, the social anomie has deeper roots and appears stemming from governance structures that produce, sustain and promote massively iniquitous and unjust socio-economic order.

Although economic civil strife started to make manifestations over the past couple of decades, yet it had its seeds sown in the very way the state structure was contrived during initial phase of its establishment. Groupnessisation along pecuniary lines, riot politics, agitational demand articulation, exploitation of violence as a means of pursuing objectives, and commercialisation of politics may be the most important manifestations of economic civil strife. There is hardly any disagreement as to its causes, which include widespread economic injustice, concentration of national economic resources in few

<sup>140</sup>R. Cruse, *Lies, Bribes & Peril: Lessons for the real challenges of international business* (Universe, 2008). 47.

<sup>141</sup>Hassan Farhan, "One dead as protests against loadshedding turn violent in K.P.," *Dawn*, May 29, 2017.

<sup>142</sup>Imtiaz Ali Taj, "Thousands protest government's negligence of Gilgit Baltistan under CPEC," *Dawn*, May 15, 2017.

hands, state's structural faultlines that have pro-rich in-built bias, extant political settlement that is out of sync with the operating realities—and, of late, withholdingisation. Withholdingisation breeds groupnessisation in that it creates new economic identities and groups, reactivates the ones gone into hibernation, and resuscitates the dead ones by prompting them an economic threat or splaying before them an economic opportunity vis-à-vis another economic group. A withholdingised economic system is bound to brace for hyper group activity where economic agents get unleashed to haggle with other interest groups. In order to analyse withholdingisation and study its actual oppressive implications for the system, the paper draws upon Colin H. Kahl's theory of Demographic and Environmental Stress (DES), and modifies it to fit the topical, the temporal and the spatial.<sup>143</sup>

The theory of DES stipulates that demographic and environmental stress can bear down significant amount of pressure on societies and polities in the developing world and, over time, test their harmony, robustness and survivability.<sup>144</sup> To Kahl “ecological, economic, and social effects, population and environmental pressures reverberate into politics” and potentially produce two pathways to civil strife i.e. *state failure* and *state exploitation*.<sup>145</sup> It follows that “state failure conflicts occur when DES substantially weakens state authority,” whereby the state's conventional monopoly over violence gets diluted and shared with non-state actors “increasing the opportunities and incentives for anti-state and intergroup violence via the logic of the security dilemma.”<sup>146</sup> On the other hand “State exploitation conflicts...occur when threatened state elites seize on natural resource scarcities and related social grievances to instigate conflicts that advance their parochial interests.”<sup>147</sup> The theory further “contends that two key intervening variables, *groupness* and *institutional inclusivity*, play decisive roles in determining which countries are most prone to state failure and state exploitation conflicts.”<sup>148</sup> Kahl believes that “violence is particularly likely in the context of high degrees of groupness (i.e., societies that are sharply cleaved along ethno-cultural, religious, or class-based lines) and low degrees of institutional inclusivity (i.e., countries with highly...and repressive political systems).”<sup>149</sup>

Now, if Kahl's theory is tailored by replacing demographic and environmental stress with economic stress brought about by high degree of economic injustice, extreme concentration of wealth, inequitable tax system, and a withholdingised economic system, it can not only explain the origins and roots of economic civil strife but also the way the state looks at them, repressing every notion to confront them per dictates of the reality principle. Kahl's theory of DES is modified to induct Withholdingisation Induced Economic Stress (WIES) into the analysis as depicted in Figure 9 below.

<sup>143</sup>C.H. Kahl, *States, scarcity, and civil strife in the developing world* (Princeton University Press, 2006).

<sup>144</sup>*Ibid.*, 29.

<sup>145</sup>*Ibid.*

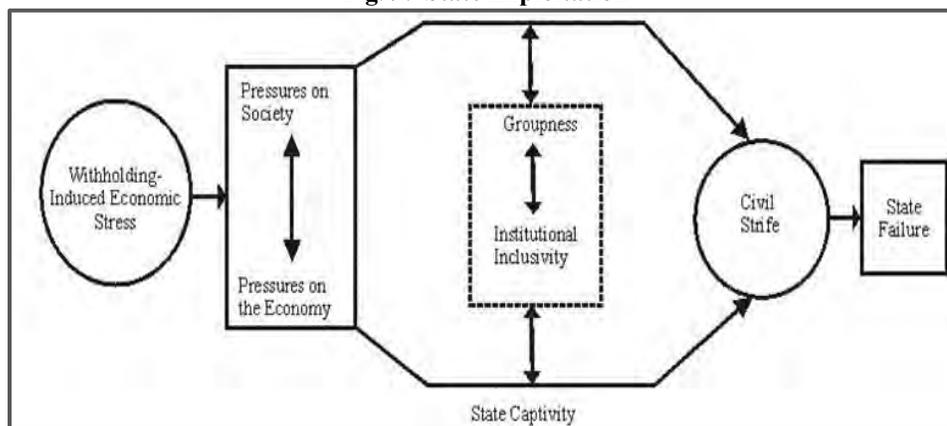
<sup>146</sup>*Ibid.*

<sup>147</sup>*Ibid.*

<sup>148</sup>*Ibid.*

<sup>149</sup>*Ibid.*, 29.

Fig. 9. State Exploitation



What it stipulates is that WIES partly borne by active economic agents (producers) on account of coercive withholding liabilities and higher input costs resulting from state-sponsored *Chinacutting* of economic transactions (a good portion of which gets stuck in the pricing structure), and partly by passive economic agents (consumers) on account of higher prices of final goods and services consumed—operates on the society, the economy, and the polity as a domineering factor cyclically resulting in further taxflation. Groupness and Institutional Inclusivity get into an intense interplay and take either of the routes i.e. State Exploitation or State Captivity leading to civil strife, which, if not arrested anytime at initial stages, can potentially create a specter of State Failure. In a scenario of higher groupnessisation, the state is put to direct exploitation and enhancement of economic agenda. In other situations, the state is brought to a captive condition to rig the policy formulation process to achieve economic goals. Predictably, whatever path is taken, it would lead to, and end up preservation and promotion of the extant economic status quo. Over the past three decades, while PML(N)-led coalitions ravished Pakistani state through State Captivity mode, those led by PPP adopted State Exploitation mode. It may be noted that State Captivity mode, since it can involve tinkering with policy formulation in critical areas of statecraft, can have more far-reaching effects as compared with State Exploitation mode.

*A la* under DES, when WIES starts operating on the people with shared economic interests, they form groups, relate and organise themselves, evolve effective interest-articulation channels, and start behaving like living organisms obsessed with instinctual self-preservation, self-reproduction and growth. In fact, all economic dispensations do help create economic group identities, but withholdingisation, by its very nature, does so at an exorbitant pace—in the process, generating living economic identities, sub-identities, and even mini-sub identities. How does it actually happen? No sooner a withholding provision is brought onto the tax statute, or a withholding tax rate is altered or its attendant filing regime is adjusted, the pre-existing economic environment being essentially zero-sum, the change is definitely going to be a bane for some and boon for some. Immediately, all economic interest groups affected by the change get into gear with their own interests to protect vis-à-vis others. All economic identities then start to

exert pressure on the polity, which since has put no mechanism of interest group articulation in place, gets to entertain them selectively—that is, only those that are connected politically or those that can buy an access bureaucratically or those that can apply a combination of both. This very phenomenon may have politicised commerce and commercialised politics in Pakistan as all interest groups strive to get heard in the state's policy-making structures.<sup>150</sup> It would be seen that withholdingisation has unionised the entire economy with every single economic sector being hit by a single withholding tax rate becoming a group; hence, the greater the level of withholdingisation in the economy the greater the level of economic groupnessisation.<sup>151</sup>

While DES primarily deals and is concerned with *groupnessisation of scarcity*, WIES deals with *groupnessisation of affluence*, *groupnessisation of economic interests*, and *groupnessisation of deprivation*. Firstly, the *groupnessisation of affluence* represents the primordial economic order extant in Pakistan. This groups tries to and does exercise its influence at the strategic level e.g. abolition of taxes on capital gains, wealth, gifts, inheritance and agricultural income etc.<sup>152</sup> Secondly, *groupnessisation of economic interests*—chiefly the product of a withholdingised economic system—represents currently the most wide-spread and most effective factionalisation when weighed in terms of its ability to impact policy formulation at the tactical level e.g. change in withholding regime. In this connection, real life illustrations could be that of traders protesting against imposition of withholding tax on banking transactions; realtors resisting valuations prescribed by the government; young doctors and paramedics demanding job security; teachers and clerks protesting against unjustifiable service conditions having been—all having been indirectly hit by withholdingisation-induced taxflation. Thirdly, *groupnessisation of deprivation*—that represents the dregs and the marginalised of the withholdingised economic order—are the societal residue, who are yet to be organised, get cognition and learn to do interest-articulation. They are the most dangerous set of souls for three reasons. One, they are made to pay tax through taxation of transactions although they are not liable to pay any. Two, they being on the lower rung of the economic stratification, bear the major brunt of taxflation. Three, the state having withholdingised the economic system, is neither able to generate enough revenues to undertake effective distributive engagement with them nor are they able to muster enough capital to enter a highly taxflated economic market.

Given the current state of affairs, Pakistani polity must brace for the time when groupness of deprivation would acquire its cognition. Groupness of deprivation may still be nested in time, but there are definite symptoms that already betray gathering of the clouds. Its real-time exhibition would occur when the marginalised millions of Pakistan having absolutely no stakes in the system would throw in the towel, and take to streets and start articulation their interests in agitational mode at mass level. In fact, that is the

<sup>150</sup>For an extensive discussion on groupness, see S. Bailey, *Legacies of race: Identities, attitudes, and politics in Brazil* (Stanford University Press, 2009).

<sup>151</sup>For instance, withholdingisation treats imports under eight different categories denoted in eight district tax rates thereby creating eight groups who are constantly striving to engage tax policy making circles in Islamabad and out-negotiating one-another for ever-more favourable group taxation regimes.

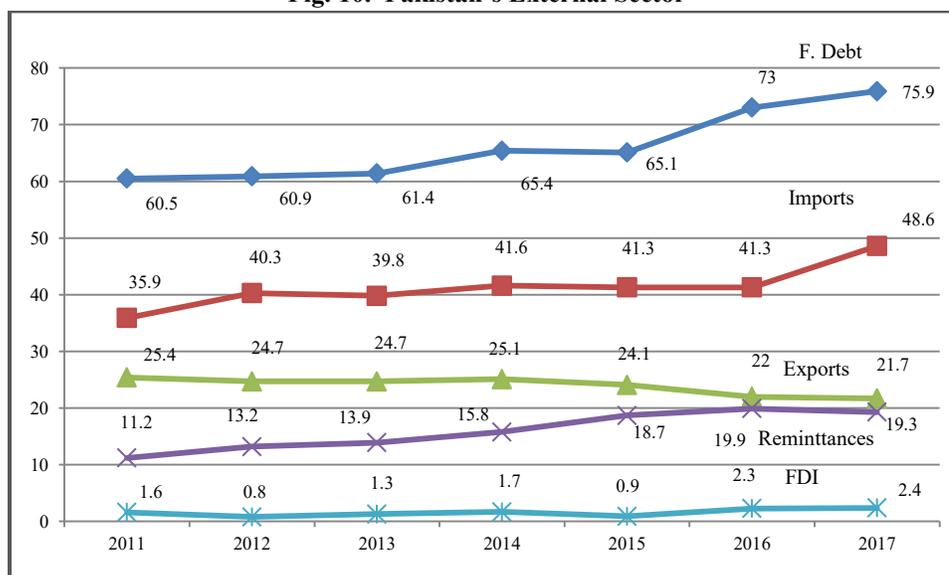
<sup>152</sup>For further and in-depth analysis see Husain, *Pakistan: The economy of an elitist state*; Kochanek, *Interest groups and development: Business and politics in Pakistan*; Ahmed, "Pakistan: Extraction, elites and state autonomy: A theoretical configuration."

specter that could possibly be equated with the scenario of tax war. It is not that a war is necessarily fought between two regular militias pitted against each other across a clearly demarcated line; it can take multiple manifestations. A tax war could potentially occur when the polity tries to acquire or regain its (relative) autonomy by making a desperate effort to improve its extractive system; the groupness of affluence, and groupness of interest resist the specter resulting in violent protests which is a tested ploy of industrial elite and business elite towards achieving their economic agenda. It could even be reverse of it, that is, when groupness of deprivation—completely excluded and isolated from the system—out of desperation, take the process of economic equalisation in their own hands. Without being monocausal, it is reasonable to believe that WIES can seriously impact and be a determining factor of the forward march of all three, the society, the economy and the polity in the years and decades to come.

#### 6.4. Source of Dutch Disease?

In this part, it would be seen how withholdingisation eats into the very vitals of the economy at the macro level with all the spurious outcomes. Like also shown in Figure 10, somewhere around 2013 and onwards, something curious appears to have happened to the economy. While the similarly-circumstanced nations—particularly those with substantial oil import bills—were having a bonanza in the wake of nose-diving petro-prices in the international market, Pakistani exports started to decline; FDI that, in fact, had never been impressive in good times, did not pick up even in the wake of much-touted CPEC-induced inflows; home remittances began showing signs of stress; and industrial productivity dwindled notwithstanding uninterrupted power supply at the expense of other sectors. Intriguingly, around that very time the process of withholdingisation starts to culminate—coming to full bloom.

**Fig. 10. Pakistan’s External Sector**



Source: SBP.

Simultaneously, however, revenue numbers were claimed to have risen steeply; FBR was painted a champion organisation; and Finance Minister was lionised as “the best” in the business.<sup>153</sup> This, on the very face of it, looked bizarre as tax revenues being a function of economic activity with an unquestionably established direct relationship could not have taken a surge while the rest of the economy was depressed. This paradox though earlier identified, yet has rarely been resolved. Like already posited withholdingisation inflicts the economy with something akin to Dutch Disease.<sup>154</sup> The Dutch Disease could be defined in a variety of ways keeping in view the contextual imperatives, but in its simplest conception, it means an outgrowth of one particular sector or side of the economy in relation to others, say, large hydrocarbons or mineral reserves, inducing substantial sharp inflows of foreign currency causing exchange rate appreciation, and in the process, stunting other sectors and industries, and rendering them less price-competitive in the international export market—thereby having a negative influence on the economy in overall terms.

When broken down Dutch Disease is attended and evidenced by an appreciation in real exchange rate due to abnormal inflows of foreign exchange; decline in exports; surge in imports; resource-shift from the lagging to the booming sectors; and erosion of industrial productivity and competitiveness. All these factors are not only interdependent but mutually reinforcing, too. The paper ascribes the standard role associated with hydrocarbons in the Netherlands’ context to withholdingisation in Pakistan’s and analyses Dutch Disease effect within this framework.<sup>155</sup>

Pakistan’s exchange rate is admittedly overvalued by as much as 22 percent in overall terms, and since 2013, around 27 percent. Interestingly, the exchange rate is overvalued not because of any excessive inflows of foreign exchange into Pakistan but because of (a) non-devaluation of rupee *vis-à-vis* other currencies, and (b) relative devaluation of Pak rupee’s rival currencies. Since 2013, while Pakistan rupee devalued by a meager 3 percent, the Malaysian, Indonesian, Indian, and South Korean currencies have devalued by 38, 47, 30, and 7 percent, respectively. In Pakistan, devaluation of currency has traditionally been a function of non-monetary and political factors. The most important factors discouraging the government from devaluation of currency are a consequential sudden jump in debt-stock which is denominated in rupee, and an aggregated national ego overly associated with the value of the currency. While rupee non-devaluation may not be a direct result of withholdingisation, the phenomenon had an identical impact—increased price of exportable goods. This could well be called the Dutch Disease effect with a plus sign in that the currency does not appreciate as there are no exaggerated inflows of foreign exchange, but still cost of production goes up substantially due to withholdingisation. Ahmad & Mohammad have argued that foreign aid inflows also have had a Dutch Disease like effect on the economy.<sup>156</sup>

<sup>153</sup>Shahbaz Rana, “Ishaq Dar declared “Finance Minister of the year,” *The Express Tribune*, October 9, 2016.

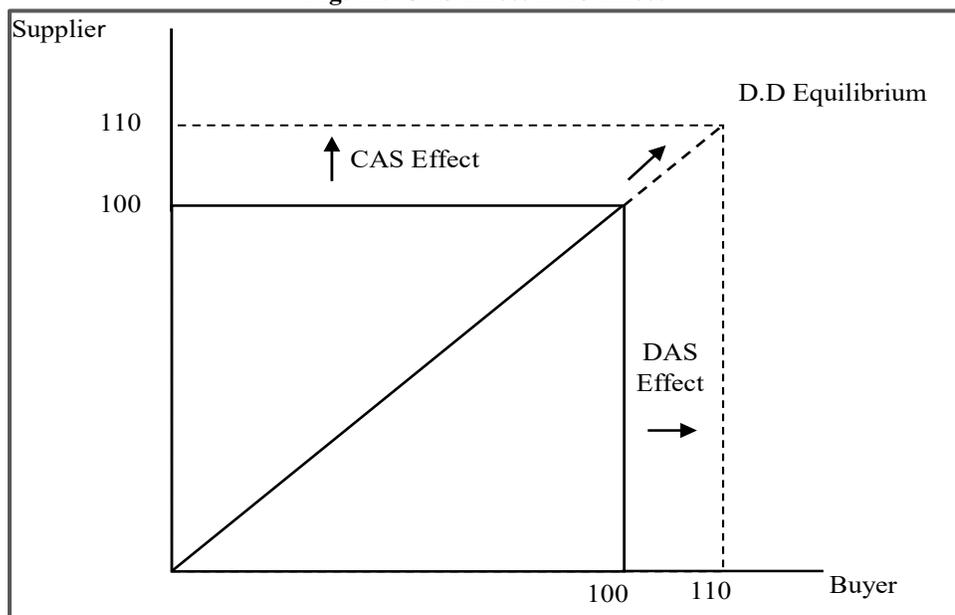
<sup>154</sup>The concept of Dutch Disease was originally developed by W. Max Corden & J. Peter Neary in 1982 in the context of the Netherlands in reference to large discoveries of hydrocarbons in the 1960s and 1970s.

<sup>155</sup>Khaleeq Kiani, “Energy sector contributes over Rs. 1 trillion to national kitty,” *Dawn*, September 7, 2017.

<sup>156</sup>Ehtisham Ahmad & Azizali Mohammed, “Pakistan, the United States and the I.M.F: Great game or a curious case of dutch disease without the oil?,” in *Working Papers* (London: Asia Research Centre, 2012).

The goods and services produced in a Dutch Diseased economy are not price-competitive in the international market. This is exactly what happens in a withholdingised economy. It is argued that withholdingisation negatively impacts the economic system by pushing up the transaction cost thereby causing taxflation of sorts. Wahid & Wallace point out that in Pakistan, while “most taxes are passed forward, taxes on inputs will ultimately rest in the prices of final goods,”<sup>157</sup> Dissecting Pakistan tax system, they go on to posit that “if goods produced in the corporate sector were largely sold on the world market, it would be difficult to shift the tax burden onto the price of the good,” and since “Pakistani goods would simply not be competitive and in the medium term, industries would suffer and eventually die off without government intervention.”<sup>158</sup> On the basis of industrial output data for the F/Y 2006-07, they also argued that “the manufacturing sector was projected to account for approximately 36 per cent of the income tax,” whereby “the ability to shift the corporate tax forward into output prices is hindered to some extent by the competition in the world market.”<sup>159</sup> Figure 11 is the simplest illustration of withholdingisation-induced Dutch Disease effect. The picture exhibits the economic market at an equilibrium point where supplier is ready to sell his product at 100, and buyer is ready to buy it at 100. Now, the government imposes a withholding tax of 10 on buyer to be collected by supplier, and since the tax has a near-full potential of being passed on, the price jumps to 110. Likewise, when government also imposes a tax of 10 on the supplier to be collected by the buyer—his price also goes up to 110; hence, the new Dutch Disease Equilibrium, which is taxflated and expensive not by 10 but by 20.

**Fig. 11. CAS Effect-DAS Effect**



<sup>157</sup>Wahid and Wallace, “The equity debate in tax policy,” 297.

<sup>158</sup>*Ibid.*, 281.

<sup>159</sup>*Ibid.*

The withholdingised economy is essentially an import economy as an overvalued exchange rate renders exports less competitive externally and imports more competitive internally resulting in even daily consumables cheaper in the domestic market. This is particularly true of Chinese products flooding Pakistani markets unfavourably sustained by Pak-China FTA and CPEC-sentiment. When an overvalued exchange rate spurred imports, instead of fixing the fundamentals of the economy—the tax system or the exchange rate—purely under political considerations, SBP ended up enforcing cash margins @ 100 percent, and FBR imposing a regulatory duty on so-called non-essential imports. The resultant unabated import onslaught has triggered a process of deindustrialisation whereby not only that industry is being shut down but it is also being relocated to China, Bangladesh and the Middle East for production of export goods as well as for import and consumption back in Pakistan.

Without being monocausal withholdingisation may be at the roots of fast-waning competitiveness of Pakistani industrial sector. Energy costs have gone up for the industry chiefly because of upfront load of withholding taxes, making industrial energy most expensive in the region as an industrial input. It was reported that energy sector alone contributed a hefty sum of Rs. 650 billion during F/Y 2017 mainly on account of upfront withholding taxes.<sup>160</sup> Likewise, gas as an industrial input is 37 percent cheaper in Europe as compared to Pakistan majorly because of tax-padding at production and distribution stages. Transportation costs are about 25 percent higher in Pakistan vis-à-vis the regional countries—due majorly to upfront withholdingisation. A wide-going withholdingisation occurring over the past three decades may have “distorted incentive structures in Pakistan, and weakened the desire for self-reliance.”<sup>161</sup> Pakistani tariff levels are above par and serve “as a major impediment to integration in global supply chains, hampering the diversification of exports.”<sup>162</sup> Kardar, amplifying this point, posits that “Policies, transactional processes and import tariff structures are critical in enabling firms to participate effectively in global value chains based on core competencies—manufacturing of different components and services like design, logistics, marketing and distribution,”<sup>163</sup> but withholdingisation is inimical to all these.

In a Dutch Diseased economy market forces drive resources from the lagging to the booming sectors reinforcing the fundamental malaise and reproducing its negative effects. This is what also occurs in a withholdingised economy and could be explicated from three different perspectives. One, resource-shift from industry to import, real estate and other non-productive sectors as in Pakistan. Two, resources travel from formal to informal sectors because of price competition between goods and services produced in the formal and informal sectors. Further, “if more substitutes that exist in the informal sector, the more difficult it would be for firms in the legal, tax-paying, formal corporate sector to pass off the corporate tax in the form of higher output prices.”<sup>164</sup> It is believed that Pakistan’s black economy, at any given time, may be equal to the size of the formal

<sup>160</sup>Kiani, “Energy sector contributes over Rs. 1 trillion to national kitty.”

<sup>161</sup>Mohammed, “Pakistan, the United States and the I.M.F: Great game or a curious case of dutch disease without the oil?.”

<sup>162</sup>Kardar, “Amplified policy distortions.”

<sup>163</sup>Ibid.

<sup>164</sup>Wahid and Wallace, “The equity debate in tax policy,” 281.

economy. Three, intra-institutional resource-shift also takes place as more and more resources are diverted to withholdingisation (booming sector) at the expense of the traditional tax system (lagging sector) reinforcing all of its negative fallouts.

Moreover, high taxes and duties in a withholdingised economic system compulsively induce complicated regulations and procedures to manage trade,” whereby regulatory burden further raises “the cost of steering trade, besides incentivising smuggling.”<sup>165</sup> However, excess deduction or collection is attendant fallout of withholdingisation. Since government is constantly striving for revenues, it chooses to withhold refunds so desperately needed by the exporters. The exporters then compulsively have to approach banks for working and export finance capital. While mark-up paid by industrialists gets added to product cost, the government successfully propagates loans so taken as industrial credit off-take to score points in media and the parliament and paint halcyon picture of the economy. All said over-deduction further holds back exporters’ potential to compete internationally.

To sum up, the ultimate disturbing consequence of withholdingisation “is a polarised, dichotomous economic edifice,” which “is characterised by heavily protected sub-segments of industry, that essentially serve the domestic market enjoying relatively high profit levels while those operating in global markets find survival difficult,” whereby “the pattern of industrialisation is fast changing for the worst; it is one which is not viable without high walls sheltering it from competitors.”<sup>166</sup> To make things worse, withholdingisation comes down hard with its blunt blade of *Chinacutting* of transactions and taxflation completely sapping competitiveness of the industrial sector. It is in this context that Pakistan’s sluggish economy, deindustrialisation, sprawling black economy, sickly revenue generation, receding exports, FDI and home remittance may be seen, analysed and framed in for policy refinement. The foregoing debate as regards the paradox of plenty created by brute withholdingisation by generating easy and unhealthy revenues for the elitist state, and the way it eats into the very vitals of the economy, opens new vistas for future research particularly as to how it would affect the societal processes—social cohesion.

## 7. CONCLUSION

One can draw curtains on the withholdingisation debate and its fallouts by posing, and if possible, answering, five inter-related and mutually interdependent questions, namely, is the system really fettered enough to justify the epithet of withholdingisation with all its hard-sounding connotations; if the system is effectively withholdingised, is it generating revenues *sufficient enough* for the state in quantitative terms and *healthy enough* in qualitative terms; is withholdingisation constructive or destructive to the citizen-state relations—so very important a dimension of statecraft in yet evolving states; is withholdingised system supportive or disruptive to the aspirations of economic development and prosperity of the nation; and, if a withholdingised system—with all its down- and upsides—sustain itself and hold the state and society together—futuristically.

<sup>165</sup>Kardar, “Amplified policy distortions.”

<sup>166</sup>*Ibid.*

The first question being relatively less subjective is perhaps the easiest one to answer. What one knows now is that the elitist state has increasingly shifted its extractive liability onto the withholding machine; added more and more withholding provisions to the tax code brining in increasingly larger tracts of gross economic activity and greater number of economic agents into its fold; innovated to optimally scavenge on tools like FTR and MTR regimes, CAS mode and DAS mode, and transaction-taxing to earn easy bucks; improvised the coercive (punitive and prosecutive) diktats to deal with delinquents—defaulting withholders. All these insights—as empirically explicated in section 3, lead one to an unmistakable conclusion that it is not only the extractive system but the economic system that has now been effectively withholdingised. There is a complex preponderance operating on the entire economy at any level generating vast amounts of dissonance amongst both its passive and active agents repelling any potential new entrants.

Turning to the next question, that is, if the withholdingised system capable of generating revenues *sufficient enough* for the state in quantitative terms and *healthy enough* in qualitative terms, the plain answer would be in a trite negative. What one already knows is that the system is generating under 10 percent of GDP in tax revenues and the state has to compulsively borrow roughly the same amount every year to sustain itself with all the adverse fallouts for the economy and its long-term sustainability. If the entire body of scholarship created so far on the fiscal function of the state has any relevance or meaning for Pakistan, brutally withholdingised system renders it completely irrelevant as it defies all logic and commonsense, in that, it is completely uprooted from standard normative foundations; disengaged and extricated from the macroeconomic framework; has created mega economic distortions, and sapped self-healing (corrective) ability of the system apparently beyond recuperation.

The third question—if withholdingisation's role towards the building of state-citizen relation in Pakistan is constructive or destructive has to be reckoned destructive. Heightened groupnessisation triggered by withholdingisation constantly reproducing new economic identities, which then ferociously hover and converge on the embittered state for exercise of favourable policy choices, can hardly ever induce a halcyon influence for the bonding between the citizen and the state. This deduction gets further strength from the fact that about half of the total tax generated from withholdingisation remains unclaimed, and still almost 90 percent of claimed excess deductions are never refunded; hence extortion; hence unjust; and therefore, can no way be taken to contribute positively to the processes of state-building. This factor operates in addition to the wide-spread taxflation for both the producer and the consumer. The penultimate question—is withholdingisation good for the economy in overall terms—can only elicit an immediate negative response. The fragility of the macroeconomic indicators when coupled with external sector's downward slide—if not a plunge—and viewed from the prism of taxflation-induced incompetitiveness of the economy vis-à-vis the rest of world leaves no room to doubt there is a trade-off between withholdingisation and competitiveness.

Lastly, the question if a withholdingised economic system, in general and extractive system, in particular, can undergrid the state and hold it together futuristically. This subjective stipulation though empirically intractable yet can be best understood through circumstantial evidence to prove that a withholdingised system being

anachronistic in nature does not belong to the present times, at least. The political settlement underlying the institutional configuration of the state—perhaps any state or any institutional framework for that matter—cannot be expected to have design capacity enough to manage negative externalities of the magnitude that as brutally withholdingised a system as that of Pakistan is currently producing. Withholdingisation, with time, may have *entrenched* too wide and too deep into the system attaining the status of a *Superstatute* of sorts. This is further evident from the fact that over a dozen reform efforts that have been made to improve the revenue system have miserably failed producing counter-results—as having been sponsored and steered by Elites Ltd—counter-results being more withholdingisation; more (extractive) system incapacitation; more debt accumulation.

In a nutshell, the paper first gleans and then hammers home the point that there is absolutely no escape from having a capacitated and functional revenue system in place to operate the state's extractive function—capacitated enough to generate both *healthy* and *sufficient* revenues for the state. This is simply because the cost of running the state has to be picked up by the underlying society itself. This cost can be preponed, paid at par and time, or postponed (for a time), but a permanent deferral is not possible—not even theoretically. The cost of maintaining the state could, however, be internally shifted; that is, transferred from those who ought to bear it to those who ought not to bear it or bear it only marginally; the latter scenario can occur when the state falls captive as in Pakistan.<sup>167</sup> It is further driven home that consistently meeting the cost of maintaining the state operating under the pleasure principle—brute withholdingisation, incessant borrowing, and endless harvesting of rents at the international level—has a certain price-tag for the society and the state perpetuating both intra- and intergenerational distortions and inequities. Likewise, perverse internal transference of tax burden by power-wielding oligarchs (including via withholdingisation) to the not-so-lucky, yet un- and disorganised, and unrepresented marginalised millions, has its implications for the economy like legitimisation of extortion, extension and expansion of inequitable taxing structures, inducing of the Dutch Disease into effect, creation of macro-economic distortions, and uprooting of the tax system from its normative foundations.

This is because states even when in adolescence cannot afford to shun on the reality principle. Pakistani state having operated on the pleasure principle for too leisurely and too long has now gone into a state of double jeopardy in that it is bearing even above-par *national* cost of tax collection and yet does not have an effective and functional revenue administration in place—the one capable of generating both *sufficient* and *healthy* revenues. Thus, the choice eventually rests with the state as to whether it intends continuing with its leisurely ways by out-contracting its extractive function to private collectors—withholders, or corrects the wrong done—to itself and its people—by putting in place a capacitated, functional and effective extractive system. This may be added that some facade of a tax system has to be there—as part of the state structure. If not a properly functional tax system—capable and capacitated enough to undertake across-the-board, rule-based, comprehensive, and differentiated taxation; it would

<sup>167</sup>See, for a detailed analysis, Ahmed, "Pakistan: Extraction, elites and state autonomy: A theoretical configuration."

undertake undifferentiated, perverse, and pro-elite taxation as done so far—with respective outcomes of both taxation types ostensible, it is up to the society to decide as to what kind of revenue system it wants in place. The prognosis, however, is that capacitation of extractive system would continue to hover on the conscience of the polity as an unfinished agenda of state-formation keeping the economy under duress, the society under stress and the state on sedatives. In the final analysis, Withholdingisation is not, and must not be taken as some paltry sub-subsystem of some system of the state; it has, in fact, over time, grown into an economic system unto itself as much as Slavery was the economic system of the American South, Mercantilism the economic system of the Colonial Europe, and Hydrocarbons the economic system of the Middle East, and needs to be approached and understood in that very context.

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