Taxation System of Pakistan and its Impact on Economy

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Introduction

There cannot be two arguments that taxes are important for an economy. Taxes matter for variety of reasons as they not only directly affect citizens and businesses through a system of incentives or disincentive framework but also influence governance mechanisms and even they are vital in shaping political cohesion between different tiers of the Government. Effective tax policy design provides the basis for strong economic development. Inability to generate sufficient tax revenues actually limits governments’ abilities to finance public goods and services, and invest in infrastructure to stimulate economic growth.

In developing countries like Pakistan there is always a quest for revenue to finance government expenditures. However, in this pursuit equity implication and redistribution aspect of a tax system remains equally important especially when a high percentage of population lives below the poverty line. The tax system of Pakistan can be analyzed or evaluated in various dimensions from different perspectives. It may be evaluated in terms of its economic or administrative efficiency, with respect to its fairness or with regard to its adequacy or transparency. This policy brief tries to shed light on some of these aspects.

The Taxation System of Pakistan

The taxation arrangement of Pakistan comprises of taxes on different sources of income, consumption, wealth, profits, and capital gains. It also makes use of custom duties, excise duties, levies and surcharges for revenue collection. The first source of information through which we can draw a line between federal and provincial level taxes is Constitution of Pakistan. For instance, within the Constitution of Pakistan, Part I of the Federal Legislative List (FLL) provides information regarding key taxes that can be levied at the federal level and indicate the areas where the federal government can legislate.

<table>
<thead>
<tr>
<th>Item no. (FLL-1)</th>
<th>Major Federal Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>43</td>
<td>Customs duties, including export duties</td>
</tr>
<tr>
<td>44</td>
<td>Excise duties, including duties on salt (exclusive of Duties on alcoholic liquors, opium, and other narcotics)</td>
</tr>
<tr>
<td>47</td>
<td>Taxes on income (exclusive of Agricultural income as it falls in the domain of fiscal powers of provincial governments)</td>
</tr>
<tr>
<td>48</td>
<td>Taxes on corporations</td>
</tr>
<tr>
<td>49</td>
<td>Taxes on the sale and purchase of goods imported, exported, produced, manufactured, or consumed (exclusive of Sales tax on services which now falls in the domain of fiscal powers of provincial governments after Sales Tax ordinance 2000)</td>
</tr>
<tr>
<td>50</td>
<td>Taxes on the capital value of assets (exclusive of Taxes on property which falls in the domain of fiscal powers of provincial governments)</td>
</tr>
<tr>
<td>51</td>
<td>Taxes on mineral oil, natural gas, and minerals used to generate nuclear energy</td>
</tr>
<tr>
<td>52</td>
<td>Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation</td>
</tr>
<tr>
<td>53</td>
<td>Terminal taxes on goods and passengers carried by rail, sea, or air; taxes on their fares and freights</td>
</tr>
</tbody>
</table>

Note: Previously items no. 45 linked to succession to property and 46 linked to estate duty with respect to property were also part of list but now excluded


All the taxes shown in Table 1 are currently levied by the federal government with the omission of capacity taxes. Moreover, it is quite obvious from the above table that fiscal powers of the provincial governments enable them to collect revenue from agricultural income tax and property-related taxes in addition to the taxes on some of the excluded parts of the federal tax bases. Following the 18th Amendment, the sales tax on services has been declared provincial subject. Moreover, all residual taxation powers are in the domain of sub-national governments and therefore provide the basis for the imposition of taxes such as stamp duty, motor vehicle tax, and entertainment tax by the provincial governments. Furthermore, Article 163 of the Constitution enables provincial governments to levy a tax on persons engaged in trades, professions, and callings.

Situation Analysis:

Share of revenues from different taxes during last three years (2013-2016): Nominal and Real Changes

Majority of the revenues come from federal taxes that make up about 92% share in total revenue collections of 2015/16. Sales tax stimulates 36 percent of total tax revenues and is the leading federal tax, followed by income tax that generates 33% revenues. Contribution of custom duties and excise duties stands at 11% and 5% respectively in year 2015-16. The share of revenues from these sources has remained more or less the same in preceding two years 2013-14 and 2014-15. The share of provincial taxes is not that significant and stays nearly just around 7% in all these years. When we draw comparison with countries like India where contribution of state taxes comes out to be over and above 35% it seems quite meager. The sales tax on services and stamp duties has emerged as the two major provincial tax contributors.

Federal taxes on income, goods, and international trade structures nearly two-third of total revenue collection whereas it fetches the residual one-third collections through non-tax revenue sources like petroleum and gas levies and by the provincial governments tax and non-tax sources.

Federal Government Tax revenue showed an increase of around 32% in real terms and 41% in nominal terms during last three years (2013-2016). Adjusted against inflation, FBR revenue increased by 29% whereas this increase was 37% in nominal terms in the same period. Last three years also witnessed an overall increase (both in real and nominal terms) in collection on custom duties (58% real & 69% nominal), federal excise duties (28% real & 37% nominal) and sales tax (24% real & 32% nominal).

There has been an increase of around 40% in real terms and roughly 50% in nominal terms in overall provincial government tax revenues over the same period i.e. 2013-2016. Under the umbrella of provincial revenue collections, excise duties registered a positive growth of 17% in real and 25% in nominal terms and stamp duties 52% in real and 63% in nominal terms. Other taxes that include sales tax on services too showed 48% increase in real and 58% in nominal terms in the same time period. However, the most disappointing was 61% decrease in property tax collections in real terms and 58% in nominal terms for the same time frame.

Major Issues:

The overall taxation picture is not that pleasing as there are some structural problems in Pakistan’s tax system. First, it is characterized by an overall low level of fiscal effort where the tax-to-GDP ratio has remained trapped in the neighborhood of 9 to 10 percent. Tax base is also quite narrow. This can be extended as a major reason that why high deficit budgets were seen even in excess of four percent of the GDP growth.

Second, over the years the competence of tax authorities to collect revenues from the direct tax apparatus has reduced and there is over dependence on indirect taxes which has enhanced regressivity in the tax system. If we dig deeper on this issue the state of affairs gets quite gloomy as on one hand more than 50 percent of government tax revenue comes from a few key taxes and on the other hand the capacity of tax authorities to collect these revenues is not up to the mark.

Third, the tax system is quite unbalanced both within regions as well as between federal and provincial governments. Article 251 of the Constitution empowers the provinces to levy taxes on their share of revenue collections without any specific limits, resulting in the provinces’ reliance on federal taxes and non-tax revenue sources like petroleum and gas levies. Tax autonomy, thus, remains an issue that is still to be tackled.

Finally, the recent tax reforms have created major challenges for revenue collection as well as for the effective implementation of new tax laws. The tax reforms in 2017 included a significant increase in the rates of various taxes, which led to an increase in the number of compliance demands and potential arrears, thereby affecting the revenue collection efforts.
government revenue comes from indirect taxes, and on the other nearly 70 percent of the collection presented under direct taxes is in the form of withholding tax (WHT) or presumptive taxes. Predominantly it is applied on income tax but there is also a system of WHT on sales tax too.

WHT is primarily applied on income tax but there is also a system of WHT on sales tax. The WHT collection has indicated a further growth of around 20.3% during FY 2015-16. As per the FBR year book 2015-16, the nine major components of withholding taxes that contributed around 85% to total WHT collection are: contracts, imports, salary, telephone, export, bank interest/securities, cash withdrawal, dividends and electricity.

Within there, the highest contributor is contracts with 27.9% share, followed by imports (22.8%) and salary (11.7%) in last fiscal year. FBR’s own exertions resulted in only around 13 percent of yearly tax collection. On top of it there is large scale tax evasion both by individuals and businesses. Different independent studies indicate that there is vast majority of tax non-filers even within the business community and roughly less than 25 percent of registered companies actually pay income tax.

Third, when it comes to indirect taxation, there is domination of taxes on international trade in the form of custom duties and sales tax on imports that has distorted the allocation of resources and has encouraged the illicit trade and has promoted inefficiency in the economic system. In addition to it, the collection of sales tax domestic is concentrated in few commodities. This is confirmed by the fact that four commodities i.e. petroleum products, electrical energy, cement, fertilizers, and cigarettes throw in around 60% total sales tax domestic.

Fourth, wide ranging exemptions and concessions and extensive tax evasions has limited the capacity of the state to extract taxes, leading to the narrow effective tax bases of most taxes further leading to revenue leakages of 3 to 4 % of GDP. Consequently, informal economy has grown and compliance ratios are reducing.

Lastly, the overall state of tax revenue collections by major sectors of the economy is also depressing. Tax collections from agriculture sector are very limited as it represents 21 percent of GDP but the proportion of tax collection in this sector is less than 1 percent. The majority of the tax revenue collections are from the manufacturing sector as there we see variety of taxes imposed such as corporate taxes, income taxes on workforce, and other presumptive taxes. The corporate tax rate of 34 percent is amongst the highest in the world. Hence, the overall contribution of manufacturing to GDP is 13% but its contribution to tax revenue is 52%. Tax collection from services sector also remains below potential as services contribute 58% to GDP but its input to tax collections are 37% and that too mainly comes from financial services and telecommunication. Likewise, provincial taxes also portray a picture that is not encouraging at all as property tax fetch only 0.11% of total tax revenue, and sales tax on services represents 0.5% of income generated in services sector.

**Decomposition of changes in Tax-to-GDP Ratio**

Next, there is need to scrutinize the factors that have contributed to increase in tax collection of FBR in last three years. Should it be attributed to increase in tax net or increase in percentage of taxes levied? Following the standard methodology in literature, it can interestingly be done by isolating the “base” and “rate” effects on the change in the tax-to-GDP ratio. Pasha, H., & Ghaus-Pasha, A.(2015) states that the “base” effect arises when the relevant tax base rises faster/slower than GDP, while the “rate effect” comes into play

The methodology used to identify the two effects is given below:

Here the descriptions are as referred

- \( T \) = actual tax revenue
- \( t \) = effective tax rate
- \( b \) = tax base
- \( Y = GDP \)

That is, \( T = tB \)

Subscripts 0 and 1 designate the base and terminal years, respectively and the change in the tax-to-GDP ratio is given by

\[ \frac{T_1}{Y_1} - \frac{T_0}{Y_0} = \frac{t_1B_1}{Y_1} - \frac{t_0B_0}{Y_0} = \frac{t_1B_1 - t_0B_0}{Y_1} \frac{Y_1}{Y_0} \]

That is

\[ \frac{T_1}{Y_1} - \frac{T_0}{Y_0} = t_1 \left( \frac{B_1}{Y_1} - \frac{B_0}{Y_0} \right) + \frac{B_0}{Y_0} \left( t_1 - t_0 \right) \]

First term on R.H.S is base effect and second is rate effect.

The tax bases for different taxes are as follows:

**The Tax Bases for Different Taxes**

<table>
<thead>
<tr>
<th>Tax</th>
<th>Tax base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct taxes</td>
<td>Nonagricultural GDP</td>
</tr>
<tr>
<td>Sales tax</td>
<td>Imports + large-scale manufacturing + banking and insurance + telecommunications</td>
</tr>
<tr>
<td>Customs duties</td>
<td>Imports</td>
</tr>
<tr>
<td>Excise duties</td>
<td>Large-scale manufacturing</td>
</tr>
</tbody>
</table>

The analysis spans the period 2013/14 to 2015/16. The main reason for the increase in the FBR’s tax-to-GDP ratio (by over 1.5 percent of GDP) is the large positive Rate effect. The Base effect is actually negative in all cases that may be due to the reason that large-scale manufacturing and imports, the two primary tax bases in the economy, raised a little or even remained more or less static during these years.

**Base and rate effects and Change in tax-to-GDP ratio, 2013/14 to 2015/16(%)**

<table>
<thead>
<tr>
<th>Tax</th>
<th>Base effect</th>
<th>Rate effect</th>
<th>Change in tax-to-GDP ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct taxes</td>
<td>-0.01</td>
<td>0.52</td>
<td>0.51</td>
</tr>
<tr>
<td>General sales tax</td>
<td>-0.15</td>
<td>0.63</td>
<td>0.49</td>
</tr>
<tr>
<td>Customs duties</td>
<td>-0.23</td>
<td>0.64</td>
<td>0.41</td>
</tr>
<tr>
<td>Excise duties</td>
<td>-0.11</td>
<td>0.19</td>
<td>0.08</td>
</tr>
<tr>
<td>Total</td>
<td>-0.50</td>
<td>1.98</td>
<td>1.48</td>
</tr>
</tbody>
</table>

Note: Federal taxes only are considered here in tax-to-GDP ratio

Source: Authors’ Calculations

**Suggestions for Reforms:**

In developing countries like Pakistan, governments typically struggle to raise sufficient tax revenues in face of narrow tax base, widespread tax evasion, rent-seeking among tax collectors, distrust in public institutions and weak administration to provide essential public goods and services. Particularly in case of Pakistan presence of huge informal sectors, dominant cash economy, weak enforcement mechanisms, tendency to hide taxable economic activities, lack of data and records, poorly administered and targeted tax audits etc, makes it really difficult to catch tax evaders. Given this, a comprehensive tax policy framework and tax administration is very much needed to optimize the revenue collections from different sectors. The government and tax collection authorities should play a very important role in ensuring level playing field for all the sectors.

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1. A certain percentage under this arrangement is withheld as an advanced tax on certain transactions (e.g. on withdrawal of cash from banks or purchase of a vehicle etc.). The withheld tax (called the Withholding Tax or WHT) is likely to be claimed against the final tax liability owed after a financial year. The withholding tax regime that rests on the postulates that the individual has enough earning capacity to be taxed, has seen rapid increase since 1990s.

2. It is pertinent to mention that the methodology of Pasha, H., & Ghaus-Pasha, A.(2015) for decomposing the change in the FBR’s tax-to-GDP ratio into “base” and “rate” effects respectively is followed.
- There is not only a need to stimulate, empirical and evidence-based discussions but also a need to establish the importance of inclusive and participatory process in tax policy making to reduce rationality deficit, create better synergy between private and public sectors and to achieve a more responsive policy propositions.

- Tax reform in this country needs to be sequenced properly keeping in view the local context and its particular constraints.

- Widening of tax net is important but equally important is that there should be direct tax on all incomes coming from all sources; be it be income from agriculture sector or manufacturing sector or services sector. Moreover, reforms in the taxation system are not possible unless tax avoidance and evasion is not controlled in the non-taxpaying elites. This is very important as we are living in a world that responds to signals.

- Wide-ranging, credible and meaningful reform of the FBR would be an important step to improved tax administration. FBR needs organizational and functional overhauling in its structure to align itself with its mission and goals. Additionally, ICT capabilities also need considerable upgrading.

- Trust Deficit needs to be reduced by giving citizens a feeling of reciprocity by the government. Moreover, intrinsic motivation and social incentives could also improve tax compliance.

- In order to improve collections in terms of custom duties and taxes on international trade there should be effective measures to control illegal sector including the use of local illicit, smuggled and counterfeit products.

- One suggestion would be to introduce taxes on turnover rather than on profits in case of business or production related activities. For instance, Best, Brockmeyer et al., (2015) are of the view that developing economies like Pakistan which are typically characterized by low tax revenue and widespread tax evasion firms underreport their tax liability. Analyzing administrative tax records from Pakistan, the study shows that the use of production-inefficient turnover taxes sharply reduces tax evasion and increases tax revenue.

- In case of property taxation currently many developing countries are experimenting with ‘performance pay’. Evidence presented in Adnan et al., (2016) uses a two-year randomized evaluation of incentive schemes for tax officials in Punjab, Pakistan, it suggests that additional revenue can be generated when performance of tax officials is linked to their pay because then they tax the previously untaxed properties at their true values. This scheme works well in case of developing countries where property evaluation and assessment is on their discretion and where tax inspectors are poorly compensated, corruption is considered rampant, and there is limited and only partial administrative and third-party data to draw on (e.g., Carillo, Pomeranz and Singhal, 2014).

**Concluding Remarks:**

Substantial efforts are needed to improve system of taxation in Pakistan as currently it is characterized by primitive procedures, complex laws and considerable arbitrariness and discretion. Tax-policy and tax-administration are the areas where there is considerable room for improvement. There is need to enhance tax base which is currently narrow and even greater need to make it fair by removing the preferential treatments available to certain segments of the society leading to negligible collected amounts through taxes on agriculture, immovable property and capital gains. There is also a need to eliminate culture of corruption and inefficiency from the tax administration landscape. These problems are at manifest for a long time in Pakistan and have hindered the tax reforms process.

**References:**


Federal Board of Revenue Year Books, 2014-15 and 2015-16


Reforming Tax system in Pakistan (2013). Sustainable Development Policy Institute, draft study.


**Punjab Economic Research Institute**

The Punjab Economic Research Institute is a statutory body attached with Planning and Development Board, Government of the Punjab, with a mandate to carry out socio-economic research on issues of provincial and national importance and to support planning and development work of Punjab Government. It is the oldest economic research institution in the country. The Institute was reorganized by the Punjab Government in 1975 in order to reactivate the Board of Economic Inquiry which had an unbroken record of economic research going back to 1919. The Institute became a statutory body in November 1980.