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Tax Challenges Faced by Pakistani Governments

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Increasing tax revenues has proven to be a significant challenge for recent Pakistani governments. The stagnation of the tax to GDP ratio to around 10 percent has widely been attributed to a host of inter-connected factors including weak enforcement, fragmented revenue administrations, low compliance by taxpayers, generous and distortionary exemptions and concessions to entire sectors of the economy and narrow tax bases.

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I. Introduction

Although the tax to GDP ratio has risen over the last three years from 8.45 percent to 10.5 percent, Pakistan significantly lags below other countries with comparable levels of income. The country's tax capacity—the maximum level of revenue that a country can collect— is estimated to be 22.3 percent of GDP, which implies a revenue gap of around of 11.8 percent of GDP.

II. Tax Compliance and Potential

Around 7 million out of an estimated total population of around 202 million Pakistanis are estimated to be eligible to pay income tax, but only around one-tenth do. Approximately, 2 percent of the total population or 60 percent of the potential tax base is registered for income tax. However, in tax year 2015, only 0.45 percent of the total population filed a tax return, corresponding to 15pc of the potential tax base. Only two-thirds of those registered—constituting just above 0.3 percent of the population—actually paid income tax as part of the tax-filing and assessment regime. This is one of the lowest ratios in the world. Less than a tenth of taxpayers paid more than 500,000 rupees in personal income tax for the year (US$4,800 plus).

The bulk of the income tax collection is from the corporate sector, which contributed over two thirds of total income tax receipts in 2015-16, while personal income tax receipts made up the remainder. Out of over 65,000 companies registered with the Securities & Exchange Commission of Pakistan, around 25,000 filed a tax return (approximately 38 percent of the total). Of these, 40 percent did not declare a profit. One percent of all companies accounted for 79 percent of corporate income tax collection.

A similar pattern is borne out in sales tax, which is a value added tax charged on the sale of goods: out of 1.4 million retailers and 3.5 million commercial and industrial electricity users, only 178,190 are registered for sales tax.

A. Challenge Facing the Government's Policy-makers

While on the one hand the above statistics paint a picture far from satisfactory with regards to compliance by taxpayers and resource mobilization by the government, on the other they demonstrate the vast potential

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for increasing tax revenues. The gap between present tax collection and the capacity of the economy to pay taxes is even greater when the fact that major sectors of the economy are presently exempt or nominally taxed by Federal and Provincial Governments is taken into account.

B. Collection in Tax Year 2016

In spite of the current situation it is laudable that the Federal Government met its tax revenue target (of 3.1 trillion rupees) in tax year 2016—a first in nearly a decade. A breakdown on the expenditure side reveals that, even after achieving the target, after accounting for transfers to the Provinces of their share of tax, 95.5 percent of the net receipts will be taken up by debt servicing and defence spending. The former accounts for 1.8 trillion rupees and the latter to 860 billion rupees. The remainder of the Federal Government's development expenditures (health, education, infrastructure, subsidies, etc.) and non-development expenditures (cost of running the civil government, pensions etc.) shall have to be financed from the remaining 4.5 percent of net federal revenues and further borrowing to the tune of 46 percent of net federal revenue (or 58 percent if the Provincial surpluses of 339 billion rupees are not taken into account).

C. Underlying Causes

The ever rising demands on the exchequer make it all the more crucial for the government to increase tax revenues by tapping into the potential revenue gap in a manner that does not penalize economic growth or exacerbate income inequality. Due to the state of public finances and the economy in general, the need to increase tax revenue has acquired dimensions that transcend the conventional objectives—namely, reducing budget deficit and increasing fiscal space for social and infrastructure development—and has implications on wider issues such as the exchange rate of the Pakistani rupee, documentation of the informal economy and governments' freedom from external players in formulating policy.

The general consensus among commentators as to the central flaws in the system of taxation in Pakistan has been that it relies too heavily on indirect taxation, leaves large sectors of the economy untaxed or taxed far below their contribution to the GDP, overly burdens compliant economic sectors while not enforcing tax law in others. It is also widely regarded as complex (relative to comparator developing economies) and cumbersome.

In tax year 2016, indirect taxes in aggregate constituted 62 percent of the Federal Government's tax revenues. Such heavy reliance on indirect taxes has given rise to a regressive tax system. Even in tax year 2016, in which the government met its tax revenue target, the increase in collection was caused by the higher than anticipated increase in indirect tax collection (sales tax and customs duty). The target for income tax was missed by 231.6 billion rupees. The taxation at source regime (withholding and advance tax) in Pakistan's income tax system, which contributes around 68 percent of total direct tax collection and is perhaps one of the widest ranging in the world, operates in many respects as an indirect tax. It is applicable also to those transactions in which the recipient (in cases of withholding) or payer (in case of advance tax) has a taxable income below the minimum threshold for income tax and in many cases is a final or minimum tax on the income to which it applies. In that respect, although the tax is levied as a tax on income, in practical terms it translates into a tax on consumption or transactions, irrespective of income, and is passed on to the end consumer. An illustration of the foregoing is that while the number of persons paying income tax in tax year 2015 was 1,074,418, tens of millions more paid advance tax on purchase of mobile phone credit: as of March 2015, Pakistan had a total of 134 million mobile phone subscribers. Some commentators have therefore described the tax as an indirect tax camouflaged as a direct tax. If the income tax collected as source is classified as an indirect tax, the proportion of indirect taxes in Pakistan's tax revenue will stand at nearly 86 percent—a testament of the extent of regressivity of the tax system

In recent years, the government has sought to increase tax revenue largely by further taxing already compliant sectors of the economy. Such measures exacerbate inequality, decrease tax morale and create further distortions in economic activity. Vast sectors of the economy, such as agriculture, continue to remain taxed far below their share in the GDP whereas others such as petroleum products have been taxed heavily. The challenge in bringing to tax such under taxed sectors is compounded by the fact that under Pakistan's Constitution, taxation of agriculture, services and immovable property, which represent a significant share of the GDP, is the exclusive domain of the Provincial Governments. The agriculture sector, for example, generates less than 0.1 percent of total revenues although it accounts for around 20 percent of the GDP. Although in recent years some Provincial Governments have increased tax collection largely by introducing and implementing a value added tax on supply of services, provincial tax revenues represent around 8 percent of the total revenue collection in Pakistan. The provincial governments finance the remainder of their expenditures through constitutionally mandated transfers from the Federal Government.

The tax system of Pakistan is also complex and places substantial demands on management time, making it costly to comply. In 2015, with respect to ease of paying taxes, the World Bank Group's Doing Business Survey ranked Pakistan at 171 out of 189 countries surveyed. The ranking was maintained in 2016. The average number of tax payments required to be made each year in Pakistan is 50 percent higher than the average for South Asia. Furthermore, the World Bank survey determines that a total of 594 hours are required to be spent each year on paying taxes; the regional average is around half that number. An already complex tax system is made even more complicated by the fragmentation of taxing powers between the Federal Government and the Provincial Governments; the Federal Government, each Provincial Government as well as local authorities have a number of revenue collection agencies. Any meaningful reform aimed at simplifying and streamlining the tax system will require consensus between all tiers of government to entrust their revenue collection to a single (or fewer) revenue collection agencies.

In recent years successive governments have put in place various measures to increase tax revenues. However, wide-ranging reforms aimed to document the informal economy and tax sectors of the economy that do not bear an equitable burden of taxation have either not been pursued or substantially diluted. For instance, in mid-2015, in order to clamp down on widespread evasion (as detailed above) by wholesale and retail traders, the government levied a withholding tax on banking transactions on traders who did not file their tax returns (non-filers). After several months, the government relented and offered an amnesty scheme to the traders, which neither yielded substantial tax revenue nor led to a noticeable increase in in filing of returns by traders.

III. Recent Developments

The Finance Act, 2016 was by and large a continuation of the government's policies in previous years: tax rates were increased, the scope of the withholding and advance tax regime under the income tax system was broadened to include further transactions, the differential in rates of income tax collected levied at source (withholding and advance tax) was increased, conditions for favorable tax treatment of new industrial undertakings were relaxed and certain exemptions were withdrawn. In doing so, the majority of commentators argue that the Finance Act, 2016 lacks imagination and failed to introduce measures to tackle the underlying problems with the tax system in Pakistan.

A summary of the main changes affecting businesses introduced by the Finance Act, 2016 is shown below.

A. Increasing Tax Revenues through the "Rate" Effect

The Finance Act, 2016 extended the application of the "super tax" introduced in 2015 for a further year. Such tax is chargeable at the rate of 4 percent of the income of banking companies and 3 percent of the income of companies with an income of over 500 million rupees. Furthermore, for the purpose of the computation of income for the purposes of the levy, depreciation and business losses have been specifically excluded. The extension of this levy, which was initially introduced as a one time levy, and the exclusion, will further burden taxpayers who already contribute the substantial portion of the corporate income tax receipts. The measure is therefore inequitable and will hamper economic growth of large companies.

The Finance Act, 2016 also removes an exemption on income derived from inter-corporate group dividend to companies eligible for group relief. Furthermore, the ability of companies to surrender business losses to holding companies has been restricted to an amount that is proportionate to the shareholding of the holding companies in the company surrendering the losses. Provisions for group taxation and group relief were introduced in 2007 after a detailed study and thorough deliberations between stakeholders. The curtailing of the benefit of such provisions discourages the formation of corporate group ownership structures in favor of direct ownership. Corporate group ownership structures had emerged in Pakistan after the introduction of reforms in 2007, which aimed to bring the tax system at par with international standards. After formation, many of these entities had listed on stock exchanges. A roll back, albeit partial, of such reforms will dent investor confidence in the continuity of governmental policies.

Companies that declare gross loss before depreciation and inadmissible expenses have now been made subject to the minimum tax regime under which income tax must be paid on turnover. The concept of a minimum tax militates against the principle that income tax is chargeable on the profits of a business and was introduced with the objective of taxing persons who were falsifying their accounts (in most cases by overstating expenses) in order to escape income tax liability. A necessary evil of minimum tax is that it would also be equally applicable to companies genuinely making losses. By expanding the scope of minimum tax as the government has done under the Finance Act, 2016, companies that undergo a cyclical downturn (e.g. due to a surge in prices of inputs) have been burdened with minimum tax. In some cases, the additional burden could mean the difference between survival and closure of businesses. However, the levy of minimum tax is not exclusive to Pakistan. A number of developing countries experiencing tax evasion by businesses have introduced the levy. Research suggests that minimum taxes can reduce evasion by up to 70 per cent of profits.

The rate of tax applicable to income from services rendered outside Pakistan and construction contracts

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executed outside Pakistan has been raised between 3.5-5 fold. Previously the tax rate was at par with that which continues to be applicable to income from export of goods. The measure represents yet another instance of the government attempting to resolve the problem of low collection of taxes under this head by increasing the rate of tax rather than effective enforcement through increased monitoring.

B. Encouraging Compliance

The present government has sought to encourage compliance with income tax laws primarily by introducing higher rates for collection of tax at source for persons who do not file returns. Such policy has been continued in the Finance Act, 2016, which increases the difference between the rates of such tax applicable to filers and non-filers. Furthermore, the Finance Act, 2016 levies advance tax on insurance and leasing of vehicles in the event that policyholder or lessee, as the case may be, is a non-filer. Although the unfavorable tax treatment of non-filers undoubtedly presents an additional burden on this group of tax-payers and yields additional revenue to the government, the measure has not resulted in a marked increase in the number of persons filing tax returns. Despite the vast expansion in the scope of collection at source provisions and imposition of higher rates, particularly for non-filers, collection increased by only 12 percent in tax year 2016. In many cases, people prefer to bear the additional burden and continue not filing tax returns, as doing so would increase their overall tax liability. Furthermore, due to a perception of high handedness on the part of tax collection agency, non-filers apprehend that if they file tax returns, they shall be exposing themselves to audits and recovery proceedings, and thereby face harassment as well as expend time, effort and significant costs.

The government's strategy of creating a distinction between tax filers and non-filers and setting up a regime of differential taxes is a short term measure which attempts to generate revenue without reforming the tax collection agency and documenting the economy. Many commentators state that it is providing the wrong incentive to non-filers—to continue to legally stay out of the tax net by paying a nominal differential.

Another measure to encourage overall compliance introduced by the Finance Act, 2016 is increasing the tax credit from 2.5 percent to 3 percent of tax payable for the year for those manufacturers registered under the Sales Tax Act, 1990 who make 90 percent or more sales to persons registered under the aforesaid Act. It is doubtful whether such measure really qualifies as an incentive: the ability of a person to make sales to registered persons is dictated for the most part by the norms of the relevant industry and the extent to which customers of a certain product are registered. Even otherwise, the increase in the tax credit could at best be described as nominal.

C. Broadening the Tax Base

One of the most significant changes introduced by the Finance Act, 2016 was with respect to tax on sales of immovable property. Whereas previously, the "fair market value" of the property was determined with reference to valuation tables for each area published by Provincial Governments, which were a fraction of the actual market value, the Finance Act, 2016 provided that fair market value would be determined by a valuer licensed by the central bank. Such a drastic change caused widespread panic within investors, particularly in light of the fact that immovable property is commonly used to store, (and in many cases) conceal wealth in Pakistan, and has paralysed the real estate market. In just over a month after the enactment of the Finance Act, 2016, the Federal Government notified revised valuation tables having rates higher than those under the tables published by Provincial Governments but significantly lower than actual market values. Although reports suggest that real estate prices have fallen on average by about 20 percent since the publication of the valuation tables by the Federal Government, it appears, at least for the time being, that the revised measures will remain in place.

Another measure introduced in the Finance Act, 2016 which would contribute towards broadening of the tax base is the introduction of a tax on the profits and gains of builders and developers of residential, commercial and other buildings and plots at specified per square foot rates for various parts of the country. The aforesaid measure is in the nature of a presumptive tax in that it applies irrespective of whether the builder or developer accrues taxable income. As is the case with such measures, those builders and developers who are compliant will suffer additional burden if their profits are lower than expected. However, given that construction and development activity is on the rise and that the sector does not contribute its share of income tax under the existing regime, the measure is justifiable. Tax liability under the new measure can be easily determined, without reference to income or expense, thus substantially reducing the revenue collection agency's cost of enforcement.

D. Incentives to Businesses

The Finance Act, 2016 extended the time period for application of existing incentives (in the form of tax credits) available to industrial undertakings, and in one case relaxed the conditions applicable thereto. However the legislation did not introduce new incentives but retained various exemptions already granted to a of number of sectors, including renewable energy, agribusiness, halal meat, industrial undertakings set up in Balochistan and Khyber Pukhtunkhwa, electricity transmission, manufacture of mobile phones, power generation, coal mining, export of software and IT services and LNG terminals.

The application of tax credit to companies investing in plant and machinery for replacement or expansion, setting up new industrial establishments, financing of plant and machinery by existing industrial establishments through equity financing, which was previously applicable to plant and machinery installed or industrial establishments set up until June 30, 2016 has been extended to June 30, 2019 by the Finance Act, 2016. Furthermore, the tax credit available to companies establishing manufacturing units generating employment has been extended to manufacturing units set up until June 30, 2019.

A tax credit equal to 20 percent of the tax payable which was allowed to companies in the year of their listing on a stock exchange has been extended to apply to the year after listing. Whilst the above measure incentivizes companies to offer shares to the public, in light of the restrictions on the exemptions available to companies eligible for group relief introduced by the Finance Act, 2016, in practice, the expansion in the scope of the tax credit may not attract companies to list on stock exchanges in the country.

Furthermore, the condition that a new industrial undertaking and plant and machinery of an existing company be financed entirely through equity in order to be eligible for tax credit has been relaxed to 70 percent equity. However, the amount of the tax credit has been pro-rated to the proportion of equity financing.

E. Streamlining of the Tax System—Recent Trends

1. Interplay between Federal and Provincial Taxes

Pursuant to amendments introduced by the Finance Act, 2016, sales tax on services paid to Provincial Governments under legislation imposing a sales tax on services will no longer be considered an input tax for the purposes of determining tax liability under the Sales Tax Act, 1990, the Federal legislation imposing a tax on the sale of goods. Indirect taxes paid to the Provinces shall not reduce the incidence of sales tax paid to the Federal Government. This has been one of the most roundly criticized measures introduced in the Finance Act, 2016 and is inconsistent with the value added regime adopted by the Federal and Provincial Legislatures for taxing goods and services respectively. The measure which amounts to dual indirect taxation will also increase reliance on indirect taxation and increase regressivity of the tax system. Shortly after enactment of the Finance Act, 2016, a number of litigants challenged the aforesaid measure before the High Court of Sindh and obtained interim relief, which remains in effect.

Furthermore, input tax adjustment will no longer be available to supplies which are not recorded in the return filed by the supplier or in respect of which the supplier has not paid tax. This will effectively penalize a recipient of a taxable supply for the acts of the supplier over which the former has no control. This measure, besides being inequitable by further burdening already compliant taxpayers, also marks a departure from the value added regime adopted in the sales tax laws applicable to goods and services.

The Finance Act, 2016 imposes an advance tax on persons who do not file income tax returns but file returns under the Provincial laws levying sales tax on services. The measure has been met with much resistance from the Provinces who view it as yet another instance of the Federal Government delegating to the Provinces its responsibility to collect income tax without paying any collection fee in return.

2. Taxes on an Inter-provincial Plane

Following a Constitutional amendment in 2010, which conferred on Provinces the exclusive right to tax the sale of services, the Provinces (in particular Sindh and Punjab) have dramatically increased tax revenues from such tax. However due to lack of coordination, competing objectives and mistrust between the provincial governments, the respective provincial taxing statutes are anomalous and inconsistent. Whereas Sindh taxes services on the basis of their origin, Punjab does so on the basis of their receipt. By doing so, each Province has sought to maximize its economic advantage by framing the law in a manner that will yield it the highest revenue. However, taxpayers are unjustly burdened in cases where services provided by taxpayers in Sindh to customers in Punjab.

3. Procedural Measures

One of the most significant changes that has recently been brought about with the objective of reducing evasion and minimizing delays in processing of refunds and interaction between taxpayers and the revenue collecting agency is the introduction of the Sales Tax Real Time Invoice Verification system. Under the system, registered persons will be required to electronically submit invoices for the previous month by the 10th of the next month and then file their returns by 18th of that month. The Federal Board of Revenue ("FBR"), the revenue collecting agency for the Federal Government, will be able to cross check and verify invoices submitted by various taxpayers to monitor

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compliance, reduce evasion and expeditiously process refund claims eliminating the need for post return interaction with taxpayers.

Through another measure with a similar objective, namely the Monitoring and Invoice Verification System, the FBR aims to compile and monitor data relating to sales by government vendors who, according to FBR officials, in many cases, charge the entire amount of sales tax but deposit only a fraction in the treasury. Given that the Federal and Provincial Governments spend significant amounts on goods and services, the measure will ensure a significant reduction in evasion.

IV. Looking to the Future

The Federal Government has sought to increase tax revenues by 16 percent in tax year 2017 and has set a target of 3.6 trillion rupees for that tax year. As of August 2015, the Federal Government was aiming to raise the tax to GDP ratio to 15 percent by tax year 2018. However, given that the tax to GDP ratio as of tax year 2016 stood at 10.5 percent instead of 11.5 percent then targeted, the timeline for achieving a tax to GDP ratio of 15 percent has been extended to 2020. Commentators are nearly unanimous that the target cannot be achieved without substantive and coordinated reforms to document the informal economy and broaden the tax base. Substantive reforms to the tax system are not expected to be introduced before the next general elections, which are due to be held in early 2018.

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