Tax Policy in Pakistan: An Assessment of Major Taxes and Options for Reform

Wayne Thirsk
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International Studies Program
Andrew Young School of Policy Studies

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The FBR team was headed by Mr. Ahmad Waqar, Secretary Revenue Division and Chairman FBR, and Mr. M. Abdullah Yusuf, former Chairman FBR, and included Mr. Mumtaz Haider Rizvi, Member Fiscal Research and Statistics, Dr. Ather Maqsood Ahmed, former Member Fiscal Research and Statistics, Mrs. Robina Ather Ahmed, Chief Fiscal Research and Statistics, Mr. Umar Wahid, Secretary Fiscal Research and Statistics, Mr. Mir Ahmed Khan, Second Secretary Fiscal Research and Statistics, and Mr. Naeem Ahmed, Second Secretary Fiscal Research and Statistics.

The final report was prepared by Kaspar Richter (World Bank), and Jorge Martinez-Vazquez (AYSPS). The background studies (listed below), were drafted by Robina Ather Ahmed, James Alm, Roy Bahl, Musharraf Cyan, Mir Ahmad Khan, Jorge Martinez-Vazquez, Geerten Michelse, Mark Rider, Wayne Thirsk, Umar Wahid and Sally Wallace. The tax revenue simulation results in the report are based on micro-simulation models developed by Mark Rider and Sally Wallace with Harini Kannan. The GST chapter draws extensively on a review of Pakistan’s sales tax by Rebecca Millar and Christophe Waerzeggers from June 2008. The final report also benefited from the Pakistan tax administration review by Carlos Silvani, Edmund Biber, William Crandall, Wyatt Grant, Orlando Reos and Geoff Seymour from September 2008. Peer reviewer comments from Kai-Alexander Kaiser, Senior Economist, World Bank; Michael Keen, Advisor, International Monetary Fund; Dr. Ahmad Khan, former Member FBR; Russell Krelove, Senior Economist, International Monetary Fund, and Eduardo Ley, Lead Economist, World Bank greatly enhanced the quality of the report. Dr. Ahmad Khan and Dr. A. R. Kemal reviewed the background studies, and Ehtisham Ahmad commented on the concept paper. Anjum Ahmad, Shamsuddin Admad, Mihaly Kopanyi, Hanid Mukhtar, and Saadia Refaat from the World Bank provided useful feedback. Mirafe Marcos helped greatly by providing the draft chapter of the provincial background study. The team would like to thank Satu Kahkonen, Lead Economist, Miria Pigato, Sector Manager, Ijaz Nabi, former Sector Manager, Yusupha Crookes, Country Director, and Ernesto May, Sector Director, for continued support and guidance throughout all stages of this report. Muhammad Shafiq, Nimanthi Attapattu, and Irum Touqeer handled with great ease all arrangements for the missions and for the processing of the report.

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Background Papers for the Pakistan Tax Policy Report


08-08 Thirsk, Wayne. *Tax Policy in Pakistan: An Assessment of Major Taxes and Options for Reform*.


08-10 Alm, James and Khan, Mir Ahmad. *Assessing Enterprise Taxation and the Investment Climate in Pakistan*.


08-12 Sally Wallace and Harini Khan. *Pakistan: Comprehensive Individual Tax Reform: Round 2*

08-13 Wahid, Umar and Wallace, Sally. *Incidence of Taxes in Pakistan: Primer and Estimates*
Tax Policy in Pakistan: An Assessment of Major Taxes and Options for Reform

Wayne Thirsk
International Studies Program, Andrew Young School of Policy Studies, Georgia State University
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EXECUTIVE SUMMARY

This paper undertakes a critical evaluation of the strengths and weaknesses of all of Pakistan’s major sources of tax revenue: the individual income tax, the corporate income tax, the sales tax, excise taxes and trade taxes on imports. For each major tax it describes the nature of the current tax base and the rate or rate structure that is applied to that base. After that exercise the paper identifies certain features of each tax that raise significant concerns for tax policy and constitute the beginning of an agenda for future tax reform. In each case the tax policy issues that have been flagged are discussed within a policy framework that appeals to the broadly accepted norms of “good” taxation and international experience in grappling with these issues. The concluding section of this paper sets forth for consideration an array of tax reform proposals that attempt to address the most important flaws and problems that have been detected in Pakistan’s tax system.

(1) Issues Surrounding the Individual Income Tax (IIT)

- The current IIT is complicated. It operates with two basic schedules for recipients of wage and non-wage or business income each having different zero rate brackets for men and women and with anywhere from fourteen to twenty-one different tax brackets.
- The current IIT collects relatively little revenue as a consequence of tax evasion and the use of a large zero rate tax bracket or high income tax threshold.
- The current IIT unwisely applies higher marginal tax rates to the total amount of a taxpayer’s income. This notch problem can result in punitively high effective
rates of marginal taxation and create perverse incentives to accurately report additional amounts of taxable income.

- The current IIT allows no deductions to reflect differences in family circumstances but instead provides for a package of personal tax credits that are on the whole poorly designed and of dubious merit.
- The current IIT contains far too many tax exemptions and concessionary tax rates.

(2) Issues Emerging from a Review of the Corporate Income Tax

- The basic design features of the corporate income tax match well against standard international practice but two important problems remain in this tax area.
- One problem is the poor compliance that is observed for this tax so that even a good tax on paper can cause significant distortions in resource allocation and have inequitable effects if in practice it is not implemented effectively.
- The other problem arises from the tax treatment of small corporations and, in this case, there are two major issues. One is the failure to tax small corporation taxable income in an incremental manner and to subsequently target the benefits of the lower tax rate on small corporations to only small companies. Under current treatment a small corporation that grows beyond the turnover threshold for a small business faces a confiscatory tax regime. The second issue is the exemption of small corporations from any withholding obligations and the damage this exemption can inflict on the entire system of tax withholding.
(3) Issues Regarding the Sales Tax

• The registration threshold for the sales tax is relatively high in comparison with the choices made in other countries.

• The current Sales Tax Act has some legal gaps and lapses and allows the Federal Board of Revenue to determine how the tax is to be applied as it sees fit. This legal discretion has resulted in marked instability in the way this tax has functioned.

(4) Issues in Excise Taxation

• An excessively large number of different rates apply to petroleum products and their derivatives.

• A few of the excise tax exemptions open the door to wide scale tax evasion.

• Pakistan has not considered the scope that exists for applying “green” excise taxes.

(5) Policy Issues Regarding the Tariff Structure

• Although Pakistan has compressed its tariff structure in recent years and currently operates with a much narrower band of tariff rates than before, some consideration might be given to further rate compression and moving towards a single uniform tariff.
<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Current Base</th>
<th>Rate Structure</th>
<th>Reform Issues</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Income</td>
<td>Mainly the wage and business earnings of individuals and AOPs; separate schedules for most forms of capital income; four tax credits for pensions, new shares, charities and housing; extensive withholding and use of presumptive taxes</td>
<td>Two rate schedules for wage and non-wage income; different zero rate brackets for men and women; 14-21 rate brackets; marginal rates apply to total income; flat rates for capital income; low withholding rates on a large range of transactions</td>
<td>Income Tax threshold too high; tax credits too generous; serious notch issue; too many tax brackets and too many exemptions and rate concessions; co-existence of gross and net income taxation invites tax evasion</td>
<td>Lower the tax threshold and move to a simpler system with a smaller number of tax brackets (3-5) and replace the zero bracket with personal tax credits; apply progressive rates to separate slices of taxable income; develop administrative measures to reduce reliance on gross income taxation</td>
</tr>
<tr>
<td>Corporate Income</td>
<td>Active and passive income of large and small corporations after allowance of normal business deductions; generous investment allowance; power cos. exempt</td>
<td>35 per cent for all large corporations and 20 per cent for small corporations</td>
<td>Weak tax compliance generates investment distortions and inequitable tax burdens; serious small business notch problem; small businesses not withholding agents</td>
<td>Review power co. exemption; strengthen enforcement and audit activity; remove small business notch along US or UK lines and require withholding by small businesses to repair the hole in the tax net</td>
</tr>
<tr>
<td>Sales Tax</td>
<td>Final consumption of imports and domestic manufacturing; services and most of agriculture exempt</td>
<td>15 per cent although higher rates have been used to encourage taxpayer registration; exports zero rated</td>
<td>Relatively high registration threshold; administrative instability in applying the law; weak and incomplete Sales Tax Act</td>
<td>Introduce a new Sales Tax Act to both guide and constrain administration of the law; consider a lower registration threshold</td>
</tr>
<tr>
<td>Excise Taxes</td>
<td>Six conventional categories: vegetable oils, carbonated beverages, cigarettes, cement, 17 oil and fuel products, toiletries and cosmetics; some services taxed under VAT mode</td>
<td>Mixture of in rem and ad valorem rates; services taxed at the 15 per cent VAT rate</td>
<td>Excessive rate proliferation of oil and fuel products; some questionable exemptions for particular users; absence of any “green” taxes</td>
<td>Simplify the taxation of oil and fuel products by developing a smaller number of broader categories; move to a universal system of indexed in rem tax rates; consider the introduction of new “green” taxes</td>
</tr>
</tbody>
</table>
The public finances of Pakistan’s federal government rely on five major sources of tax revenue, the income tax on individuals and associations of persons, the corporate income tax, the sales tax, excises and customs duties. This paper examines in some detail the contents of the tax laws that, together with the current tax administration apparatus, govern how each of these revenue sources operate to generate revenue and the impact they have on the distribution of tax burdens in the economy and the allocation of resources to different economic activities.¹ Precise calculation of the distributive and allocative effects of Pakistan’s tax system is left as a task for other papers that, along with this one, form a package of studies for the Pakistan Tax Policy Project sponsored by the World Bank. Sub-national taxes are also ignored in this paper as these too are the topic of another paper commissioned by this project.

To establish some context and a framework for the discussion of different federal taxes, this paper begins with a brief description of the sectoral composition of Pakistan’s economy, recent revenue performance of the major taxes, and the broad macro-economic parameters within which tax policy plays itself out. From there the paper considers, in turn, the legal foundations of the two income taxes, the sales tax, excises and customs duties. The base of each of these taxes is described first followed by a description of the

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¹ For a recent appraisal of Pakistan’s tax system that voices many of the same concerns expressed in this report see Martinez (2006).

### Table ES-1: Policy Matrix for Tax Reform in Pakistan (continued)

<table>
<thead>
<tr>
<th>Tax Type</th>
<th>Current Base</th>
<th>Rate Structure</th>
<th>Reform Issues</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Import taxes</td>
<td>Imports of all types</td>
<td>Zero to twenty five per cent range for most imports; higher rates on finished products</td>
<td>The negative allocative effects and administrative complexity of an escalated tariff structure</td>
<td>Move over time to the adoption of a uniform tariff on all imports</td>
</tr>
</tbody>
</table>
tax rate structure that is applied to each base. In each case this description precedes an
evaluation of the main weaknesses and problems that have been detected for each tax.
This evaluation is made drawing upon what are generally considered to be the norms of
“good” taxation and international experience in applying these norms. This paper
concludes with a set of tax reform options intended to address the tax policy
shortcomings that have been identified.
A Brief Snapshot of Pakistan’s Economy

The following features of Pakistan’s economy provide some useful economic benchmarks against which many aspects of current tax policy can-and will be-evaluated:

- Pakistan’s economy has enjoyed robust rates of economic growth over the period of 2003-2007 at an average annual rate of seven per cent. With a current population of 158 million these growth rates have translated into per capita GDP growth rates of 5.5 per cent.

- The overall inflation rate is presently around eight per cent but core inflation rates (non-food and non-energy) rates are lower at six per cent. Food prices, however, are rising at a ten per cent rate.

- Pakistan has been receiving substantial capital inflows from abroad: in 2006 foreign direct investment was $6.5 billion while remittances from other countries amounted to $5.5 billion.

- The exchange rate has been relatively stable and the current rate is about 60 Rupees (Rs) per US dollar.

- Per capita income is currently $925 or 55,500 Rs. However, the minimum wage is presently 4,500 Rs per month or 54,000 Rs annually. The daily wage for unskilled

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1 Almost all of the information presented below has been gleaned from the most recent Ministry of Finance Overview of the Economy, posted on the web site of the central-now federal-board of revenue located at www.cbr.gov.pk.
construction workers is, with some regional variation, about 250 Rs which, assuming an annual work spell of 260 days, translates into an annual wage income of 65,000 Rs. Skilled construction workers earn about fifty per cent more than this amount or 97,500 Rs.

- With a work force of approximately 44 million, agriculture accounts for about 43 per cent of this labor force while formal non-agriculture employment contributes a much smaller share of about 15 per cent. These two numbers imply the existence of a large informal work force within the non-agricultural sector accounting for 41 per cent of total employment.

- In terms of the sectoral shares of GDP agriculture accounts for 21 per cent, services for 53 per cent, manufacturing for 17 per cent and others (mainly oil, gas, mining and quarrying) for the residual 9 per cent. The size of these shares is important because of the implications they have for the scope of federal tax policy. Pakistan’s Constitution exempts agriculture from all income taxation while at the same time assigning the right to tax services to Provincial governments. Further on in this report, in the section dealing with federal excise duties, it will be seen how the federal government has tried in recent years to circumvent this constitutional constraint on taxing services.

- For several years, the ratio of taxes to GDP has hovered around the ten per cent mark. These revenues, when combined with non-tax revenues and borrowing support a fiscal deficit of about four per cent of GDP and have permitted total government spending of a little over seventeen per cent of GDP. Almost all of this
expenditure is attributable to the federal government; sub-national government spending has consistently been around .5 per cent of GDP.

- The share of direct taxes-mainly income taxes-in total tax revenue in 2006 was 38.5 per cent with corporate income tax revenues outweighing revenues from the individual or non-corporate income tax by a ratio of five to one. Indirect taxes comprise the remaining tax share of 61.5 per cent and, within that particular share, sales tax contributes 60 per cent of the total with the remainder attributable to excises (15 per cent) and customs duties (25 per cent).

**Income Taxes Levied on Individuals and Associations of Persons**

Taxpayers are defined as individuals-workers and small unincorporated business-and associations of persons (AOPs). The latter group of taxpayers is defined as a firm in which a profit sharing agreement exists-a partnership arrangement in other parlance-or a business body formed under a foreign law as well as Hindu undivided families.

a) The Tax Base

Taxable income consists of income derived from five different sources, wages and salaries, property (rental) income, business income, capital gains, and other sources of income. While at first glance, it appears this tax is imposed on a comprehensive concept of income, appearances in this case are deceiving. Although the tax is in principle global in its reach, stock market capital gains are, for the time being at least, exempt and property, or rental, income is taxed under a separate schedule as are dividends, interest and lottery earnings. Income that is described as taxable in one part of the law is often
excluded in another part and, as a result, this income tax contains many schedular elements. For instance, rental income is now taxed at a flat five per cent rate with no allowance given for any costs of earning income or for any other taxes that may have been paid on that income. Dividends are also taxed at a flat ten per cent rate (five per cent prior to 2007). Taxable wages in principle include all manner of employee perks, interest on repayable loans and any transferred property or shares. In practice, however, many forms of non-monetary compensation and income received in the form of transfers appear to escape the income tax net.

Income tax is imposed on the world-wide income of a resident and three year averaging is permitted. AOPs are not taxed per se but partners, or beneficiaries from the business dealings of the AOP, pay tax on their share of the business profits. However, if the income of an AOP has been subject to the six per cent withholding tax on services, this tax is considered to be a final tax and no further tax is paid on distributions of income from the AOP. The extensive web of withholding taxes employed by Pakistan on a wide variety of different purchases are described further on in this report. Otherwise, the income received from an AOP is subject to the graduated rate schedule of part 1 of the First Schedule of the Income Tax Ordinance 2001. Any losses incurred by an AOP can be absorbed in other types of taxable income.

Other sources of income include dividends, interest income, royalties, annuity or pension income, gambling proceeds, grants received for the right to explore or use a natural resource, consideration for vacating a building (less any amount paid in rent, spread out over ten years), loans, advances and gifts. Losses arising under any head can be offset against income from another other head with a one year carry forward and the
proviso that business losses must be set off last. There is a six year limitation on loss carry forwards from business income while so-called speculative business losses can only be offset against speculative business income.\textsuperscript{2} If stock market related capital gains were taxable, as they might become in the future, capital losses could be set off only against these gains but a carry forward of unused losses for six years would be allowed. Income splitting is also disallowed if it involves either a revocable or family transfer of an asset.

b) Exemptions from the Income Tax Base

The Second Schedule of the Income Tax Ordinance 2001 presents an extensive list of exemptions and tax concessions that take up seventy pages of the Income Tax Manual. This package of exemptions and concessions acts to make Swiss cheese out of the income tax base for both individuals and AOPs. Rather than attempt to list all of them, this report documents those that are most notable and represent the largest departures from a comprehensive income tax base. Exempted from taxation by the Second Schedule are the following components of income:

- Any non-military pension (if a person receives two or more pensions, the largest is exempt);
- All Armed Forces pensions;
- Any annuity payments;
- Any payments from the Workers Participation Fund (the operation of this fund is explained in the next major section of this report);

\textsuperscript{2} A speculative business is defined as one in which there is no transfer of a commodity from one party to another but it does not apply to hedging activities or forward contracts.
• Any fringe benefits provided to employees of transportation companies, schools, hospitals, hotels and restaurants;
• Any income earned by mutual fund or investment companies;
• Any income derived from holding federal securities;
• Any income earned by foundations or institutes;
• Rents and entertainment allowances paid for the President, Governors or Generals.
• All agricultural income unless the taxpayer also earns more than 80,000 Rs of non-agricultural income.
• Capital gains enjoy a partial exemption. Capital gains on the sale of share listed on any of Pakistan’s three stock exchanges are exempt until June 30, 2008. However, capital gains realized from the sale of unlisted shares are fully taxable with a tax rebate of 25 per cent if the shares have been held for longer than a year. Capital losses can only be set off against capital gains and any unused losses can be carried forward for six years. Capital gains arising from the sale of real estate, unless they are the main business activity of the seller, are totally exempt.

c) Concessionary Tax Rates

The Second Schedule also provides for preferential tax rates for select groups of taxpayers. Specifically, the following groups enjoy a reduction in tax liability:

• Senior citizens of 50 per cent of ordinary tax;
• Teachers and researchers of 75 per cent of ordinary tax;
• Distributors of domestic cigarettes of 80 per cent of the minimum tax (this tax is elaborated upon in the next major section);

• Importers who meet certain conditions are exempt from withholding taxes.

d) Tax Credits

The size of the income tax base is additionally whittled away by a generous array of tax credits. These tax credits come in four varieties:

• A tax credit for charitable contributions to a wide range of sports, religious, cultural, welfare, medical and technology promoting organizations. The amount of the tax credit is limited by a formula which multiplies the ratio of tax liability to taxable income by a tax credit coefficient which is the lesser of the amount of the donation or thirty per cent of taxable income for a person or AOP. Thus, for example, if a person had taxable income of 100 and a tax liability of 20 he or she could make a contribution of 30 units and received a tax credit of 6 units which would reduce their tax liability by thirty per cent. It might also be noted that companies are also eligible for this credit although the limitation is smaller, at fifteen per cent of taxable income.

• A tax credit for investment in new shares (IPOs). For persons, but not companies, the credit is limited once again by the product of tax liability to taxable income and a tax credit coefficient that is the lesser of the cost of share acquisition, ten per cent of taxable income and 300,000 Rs. If the shares are sold within a year of purchase the value of the credit is added back to taxable income.
A tax credit for contributions to an approved pension fund. Here the familiar formula is the product of tax liability to taxable income and a tax credit coefficient equal to the lesser of the premium paid, twenty per cent of taxable income and 500,000 Rs. Transfers of existing pension balances to a fund are ineligible for this credit.

A tax credit for any interest in, share in rent, or a share in appreciation of a house paid for by a loan from a recognized lending institution. This de facto mortgage interest credit is limited again by the ratio of tax liability to taxable income multiplied by the lesser of total interest paid, forty per cent of taxable income or 500,000 Rs.

A wealthy or high earning taxpayer able to take advantage of all of these credits in a single tax year would have little difficulty in reducing his or her income tax liabilities to zero.\(^3\)

Another worrisome feature of these credits is that, since their value rises with the value of the taxpayer’s average tax rate, they will have a regressive impact on the distribution of tax burdens conferring larger tax saving benefits on those with higher incomes. As a means of stimulating certain types of spending considered to be socially meritorious, tax credits are often preferred to tax deductions because they provide equal amounts of tax relief regardless of the income status of the taxpayer. In Pakistan,

\(^3\) A simple numerical example can illustrate this outcome. Suppose, as in the example given for charitable contributions, that the taxpayer has a tax liability of 20 and taxable income of 100. Suppose further that the binding limit on the tax credit is the percentage of taxable income allowed for each credit. This means that our hypothetical taxpayer pays interest on his home mortgage in excess of 40 per cent of taxable income, makes a pension contribution exceeding 20 per cent of taxable income and a donation to charity equal to 30 per cent of taxable income. Under these circumstances, assuming the nominal limits are non-binding, the total tax credit available to the taxpayer is
\[
\frac{1}{5}(0.3+0.1+0.2+0.4)\times 100 = 20
\] which is sufficient to erase all tax liability.
however, tax credits have been designed in a way that causes them to resemble tax deductions whose value increases with the size of the taxpayer’s marginal (and average) tax rate.

A somewhat peculiar feature of the individual income tax system is that a taxpayer’s liability is not at all sensitive to the taxpayer’s family circumstances that in most other countries are considered to be an important determinant of the ability to pay taxes. In Pakistan, however, it does not matter for tax purposes if the taxpayer is single or married or either has no or possibly six children. Elsewhere, income tax laws have recognized that two cannot live as cheaply as one, and that children are expensive to raise and nurture, and, accordingly, permit the taxpayer to take either a deduction from taxable income or a tax credit to reflect these differences in tax paying ability.

e) The Tax Rate Schedule

Given the calculation of taxable income, tax is payable at the rates established in Part 1 of the First Schedule. Taxpayers, except salaried or wage earning workers, face a fourteen bracket rate schedule with an initial zero rate for taxable incomes of less than 100,000 Rs.4 Beyond the zero rate, rates rise gradually from .5% to 25% when taxable income exceeds 13,000,000 Rs. A highly unusual feature of this rate schedule is that it does not apply to discrete slabs of income. Instead, when a taxpayer passes from one rate bracket to another he is taxed at a higher rate on the total amount of his or her taxable income. The consequences of this severe “notch” problem are discussed in detail in the next section of this report. Here it is important to point out that if a taxpayer earns more

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4 Of interest is the fact that the upper limit for the zero rate bracket in the case of female taxpayers is 125,000 Rs. This limit climbs to 200,000 Rs in the event more than fifty per cent of taxable income consists of wages and salaries.
than fifty per cent of his or her income in the form of wages and salary, he or she is subject to a separate rate schedule. This rate schedule has a more generous zero rate bracket for incomes less than 150,000 Rs and a less steep graduation of rates with a top rate of 20 per cent for incomes in excess of 8,400,000 Rs.

**Tax Policy Issues Concerning the Taxation of Individuals and AOPs**

The description of the legal system for taxing individuals and AOPs raises a number of tax policy concerns. Among them are the following:

- The zero rate bracket, which establishes a tax free income threshold is unusually large for wage earners. If the average monthly wage in Pakistan is about 6,000 Rs, as noted in the first section of this report, and this monthly wage translates into an annual income of 72,000 Rs, workers earning an average wage are exempt from income taxation. Even workers earning twice the average wage are liable for no income tax.

  There is no scientific method for determining what the “right” level of income tax exemption should be except the general notion that income taxes should not burden the poor in any economy. A useful rule of thumb, frequently encountered in the international tax literature, is that exemption levels should be set somewhere in the vicinity of twice a country’s level of per capita income. In the case of Pakistan, application of this rule would generate an upper bound for the zero rate bracket of about 111,000 Rs, or about 26 per cent lower than the present amount of 150,000 Rs for wages earners (or 45 per cent lower in the case of female wage earners).
The relatively high income tax threshold also has a wider implication in terms of good governance practices. Low and middle income groups are the primary users of basic public services and pay no income taxes. High income groups that do pay income taxes are much more likely to use private sector alternatives to basic public services such as health and education. A healthy linkage between payment of taxes and consumption of basic public services is by and large absent in Pakistan resulting in weak monitoring and accountable mechanisms that contribute to the problem of ineffective public service delivery.

- The application of progressive marginal tax rate to entire slabs of income, rather than on increments to taxable income creates severe “notch” problems that discourage incentives to provide accurate documentation of earnings.\(^5\) There are two interesting ways of looking at this notch issue. One is to ask what happens to the tax bill of a taxpayer who just trickles into the next highest tax bracket. The third column of table 1 below indicates the additional tax a male non-wage taxpayer faces when growth in his taxable income pushes him ever so slightly into the next highest tax bracket.\(^6\)

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\(^5\) As will be seen in the next section, company taxation also suffers from a similar “notch” problem.

\(^6\) Wage earners, those whose wage income exceeds 50 per cent of taxable income, face a similar “notch” problem.
### Table 1: Marginal Tax Burdens Resulting from Entry into a Higher Tax Bracket

<table>
<thead>
<tr>
<th>Income (Y) Bracket</th>
<th>Tax Rate</th>
<th>Inter-bracket Marginal Tax Burden (Rs)</th>
<th>Marginal Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Y &lt; 100,000</td>
<td>0</td>
<td>not applicable</td>
<td>not applicable</td>
</tr>
<tr>
<td>100,000 &lt; Y &lt; 110,000</td>
<td>0.5%</td>
<td>500</td>
<td>5.5</td>
</tr>
<tr>
<td>110,000 &lt; Y &lt; 125,000</td>
<td>1%</td>
<td>550</td>
<td>4.7</td>
</tr>
<tr>
<td>125,000 &lt; Y &lt; 150,000</td>
<td>2%</td>
<td>1,250</td>
<td>7</td>
</tr>
<tr>
<td>150,000 &lt; Y &lt; 175,000</td>
<td>3%</td>
<td>1,500</td>
<td>9</td>
</tr>
<tr>
<td>175,000 &lt; Y &lt; 200,000</td>
<td>4%</td>
<td>1,750</td>
<td>11</td>
</tr>
<tr>
<td>200,000 &lt; Y &lt; 300,000</td>
<td>5%</td>
<td>2,000</td>
<td>7</td>
</tr>
<tr>
<td>300,000 &lt; Y &lt; 400,000</td>
<td>7.5%</td>
<td>7,500</td>
<td>15</td>
</tr>
<tr>
<td>400,000 &lt; Y &lt; 500,000</td>
<td>10%</td>
<td>10,000</td>
<td>20</td>
</tr>
<tr>
<td>500,000 &lt; Y &lt; 600,000</td>
<td>12.5%</td>
<td>12,500</td>
<td>25</td>
</tr>
<tr>
<td>600,000 &lt; Y &lt; 800,000</td>
<td>15%</td>
<td>15,000</td>
<td>22.5</td>
</tr>
<tr>
<td>800,000 &lt; Y &lt; 1,000,000</td>
<td>17.5%</td>
<td>20,000</td>
<td>27.5</td>
</tr>
<tr>
<td>1mn. &lt; Y &lt; 1,300,000</td>
<td>21%</td>
<td>35,000</td>
<td>32.7</td>
</tr>
<tr>
<td>Y &gt; 1.3 mn.</td>
<td>25%</td>
<td>52,000</td>
<td>77</td>
</tr>
</tbody>
</table>

The first two columns in table 1 display the rate schedule and bracket limits for the current tax law. In the third column the additional tax payable on crossing by one Rupee from one bracket to the next is indicated. By any standard, a one Rupee bracket crossing results in a punitive and unreasonable, not to mention unfair, marginal tax burden. Even if his taxable income were rising over time, a taxpayer has a strong incentive to “stay put” by resorting to whatever means are available to disguise and conceal any amount of higher income from the tax collector. In an economy which is trying to encourage greater taxpayer honesty in declaring income and more extensive documentation of the taxpayer’s circumstances this approach to taxing individual and AOP incomes is counter-productive.

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7 The marginal tax burdens displayed in column three are calculated in a straight forward manner. Consider a taxpayer whose income increases from 109,999 to 110,000 Rs. His previous tax bill, to a close approximation was .5% of 110,000 and his new tax bill is 1% of 110,00 or a difference of .5% of 110,00 or 550 Rs. Similar calculations apply throughout.
An alternative, and softer, view of this notch problem is obtained by measuring the marginal tax rate of a notional taxpayer who earns enough additional income to shift entirely towards the end of the next highest tax bracket. This measurement provides the minimum marginal tax rates facing a taxpayer who progresses into the next highest tax bracket. Because the graduated tax rates are initially fairly modest in size and increase only in small increments, this alternative view implies a less serious notch problem exists. As show in the final column of table 1, the marginal tax rate calculated in this manner rises smoothly from a level of about 5 per cent to nearly 33 per cent in the penultimate tax bracket. Note, however, that an extra 100,000 Rs after the final tax bracket is reached faces a marginal tax rate of 77 per cent.

Even if Pakistan were to return to a conventional method of progressive taxation, by imposing higher marginal tax rates on incremental slabs of income, it would still be an outlier in this tax area by international standards. For the past several decades the rest of the world has been moving towards the adoption of much flatter rate structures imposed on only a handful of tax brackets. Canada, for example, has operated with only three tax brackets since the 1980s. Many developing and transitional economies, from Jamaica to Latvia and Ukraine, have gone farther and adopted flat or single rate personal income tax systems.

Finally, it is standard tax policy advice to advocate aligning the top marginal income tax rate with the corporate income in order to secure organizational neutrality in the choice of whether a business should operate in corporate or non-corporate form.

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8 A few years ago Pakistan operated a conventional progressive income tax and only recently switched to the unconventional practices noted here. Why this switch occurred remains a bit of a mystery.
9 See a recent paper by Sabirianova, et al (2007) which clearly demonstrates the international trend toward flatter, and, in some cases, flat personal income tax schedules.
Failure to align these rates, for example, having a top marginal income tax rate less than the corporate tax rate may give undue encouragement to non-corporate forms of business activity. In Pakistan, the incentives governing the choice of business form seem to run in this direction as the corporate rate of 35 per cent is significantly higher than the top marginal rate of 25 per cent for individuals and AOPs. However, the small business corporate rate is probably more relevant in determining this choice and this rate, at 20 per cent, is more closely aligned with the higher marginal rates of tax on individual and AOP incomes.

- Pakistan is somewhat unique in that it does not have a national social security system that is financed primarily by payroll taxes. Instead, it has a patchwork quilt of private and public pension schemes. At the federal and provincial government levels, employees make a compulsory contribution to a pay-as-you-go public pension fund with matching contributions made by the government. Contributions, as mentioned above, are within limits creditable against taxable liability and future pension payments are non-taxable. In addition, public sector employees contribute to a benevolent fund paying benefits to families with children and to a group insurance fund that provides lump sum death benefits.

In the private sector there are three separate sources of social security support. One is a Workers Welfare Fund (WWF) funded by a two per cent tax on the after-tax income of companies that is paid to the Ministry of Labor which administers a wide range of benefits to workers in the private sector. Another is the Workers Profit Participation Fund (WPPF) that collects five per cent of the after-tax income of large companies and multi-national enterprises and distributes
the proceeds primarily for the benefit of low wage workers. Any residual not distributed is transferred to the WWF.

Many private sector companies also operate their own pension schemes in the form of Provident Funds approved by the income tax department of the Federal Board of Revenue (FBR). Contributions are creditable against tax liability, within the limits discussed before, and benefits are non-taxable when paid out.\(^{10}\)

In most other countries that have pension programs, pensions receive favorable tax treatment but not on the scale enjoyed by pensions in Pakistan. Ordinarily, pensions are treated for income tax purposes in one of two ways. Either pension contributions are not tax deductible and the ensuing benefits are non-taxable or, more frequently, pension contributions are deductible and the benefits received are taxable. Because of the tax deferral they permit, both treatments provide for favorable treatment of pension income viv-a-vis other kinds of income but nowhere to the same extent as that seen in Pakistan where pensions are a highly subsidized form of income.

- Compliance with the income tax laws for individuals and AOPs is relatively weak in Pakistan.\(^{11}\) Only 1.8 million taxpayers file an income tax return. Within this group of filers, one million are represented by employees who have been withheld

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10 Some restrictions, however, do apply. Pension benefits paid before retirement age are considered to be taxable income as are any amounts withdrawn at retirement that exceed one-quarter of the pension balance. In addition, employers’ contributions should not exceed ten per cent of a worker’s salary nor should interest accumulated on pension balances exceed one-third of a worker’s salary. Anything exceeding these limits is also considered to be taxable income.

11 Because of rampant concern over the degree of taxpayer-tax collector connivance, Pakistan adopted a universal self-assessment system in 2003 under which returns were accepted at face value and almost no taxpayers audits were carried out at the field level. At the time of this writing, however, a new selective field audit program was about to be launched.
by their employer. Another half million represent sole entrepreneurs with the balance made up mainly by AOPs. The income tax law contains penalties for non-filing but enforcement by the FBR is not robust. If no response is obtained from a non-filer the FBR is empowered to issue an estimated (or “best judgement”) tax assessment based, among other things, on the location and number of clients of a business. Faced with such an assessment the taxpayer can choose to either pay up, not pay or appeal. Most choose to appeal because the appeals process is tilted heavily in favor of the taxpayer. When appeals are made the taxpayer is under no obligation to settle any amount of assessed tax until the procedure has been exhausted which, in the case of Pakistan, may go on for several years.

In light of its large informal sector and the low compliance rates that are observed, Pakistan’s tax laws have resorted to elaborating an extensive network of withholding measures that include many forms of presumptive taxation. Designated withholding agents include the federal government, a company other than a “small” company, an AOP, a foreign contractor or consultant, a consortium or joint venture and an exporter or export house. Any purchases of goods and services by these agents is subject to withholding at the following rates: 1.5 per cent for the sale of rice, cotton seed or edible oils, 3.5 per cent for other goods and

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12 Until the Finance Bill of 2007 was introduced, employees who had taxes withheld at source needed to file a return in order to claim any of the tax credits that they were eligible for. Starting in 2007 employers will be able to take these credits into account in determining the amounts to be withheld and the frequency of filing would be expected to decrease in future years.
six per cent on services including professional services.\textsuperscript{13} In addition to these, the value of contracts is also withheld at a rate of six per cent.\textsuperscript{14}

About twenty other types of payment are also subject to withholding tax (WHT). The leading sources of revenue generation under these arrangements are shown in Table 2 below.

\section*{Table 2: Withholding Tax (WHT) by Source of Payment, 2006-07}

\begin{table}[h!]
\centering
\begin{tabular}{lrrr}
\hline
Source & Amount (Billions of Rs) & Percent of WHT Revenue & WHT Rate (%) \\
\hline
Contracts & 60.7 & 35.6 & 6 \\
Imports & 26.1 & 26.9 & 5 \\
Wages, salaries & 16.5 & 15.6 & variable \\
Exports & 13.1 & 9.9 & 1 \\
Telephone Bills & 10.9 & 7.6 & variable \\
Bank Interest & 8.1 & 6.5 & 10 \\
Electricity Bills & 5.3 & 5.1 & variable\textsuperscript{15} \\
Dividends & 4.2 & 3.2 & 10 \\
Other & 25.8 & 18 & – \\
Total & 170.8 & 100 & \\
\hline
\end{tabular}
\end{table}

Source: Federal Board of Revenue, Islamabad

The category “other” in Table 2 includes WHT on bank deposit withdrawals (.2 per cent of daily withdrawals exceeding 25,000 Rs), on automobile purchases (5 per cent), on purchases and sales of listed shares (.01 per cent in 2006/07 but increased to .02 per cent in 2007/08), on prizes and winnings (10 per cent), on gross rents (5 per cent), on the commission income of petrol station operators (10 per cent), on brokerage and

\textsuperscript{13} A small company is defined to be one with turnover of no more than 250 million Rupees and a labor force of less than 250 employees. In the case of services, withholding on transportation services occurs at a lower rate of two per cent.

\textsuperscript{14} A contract is defined to be anything other than the sale of a good or service. In practice, contracts appear to refer to the value of construction contracts.

\textsuperscript{15} For electricity and telephone bills, the amounts withheld increase in nominal terms with the size of the bill. Withholding on electricity bills applies only to commercial and industrial consumers. In the case of a mobile phone subscriber, or purchaser of a pre-paid card, the WHT is ten per cent of the subscriber’s bill or the sales price of a card.
commission fees (10 per cent) and on royalties and management fees paid abroad (15 per cent). Also included in this category are levies on the transportation business of fixed amounts depending on seating capacity for passenger vehicles and on laden weight for vehicles hauling freight.

Given the extensive array of withholding devices, it is not surprising that this method of tax collection contributes slightly less than half of all income tax revenue raised although this share has fallen slightly in the last 4-5 years.\textsuperscript{16} What is of greater interest is whether these taxes constitute final taxes or, alternatively, are considered to be advance tax payments against which credit can be taken in the calculation and submission of a final tax return. The picture on this score is a mixed one. Withholding on interest, dividends and rents is meant to be a final tax on these sources of capital income and signify a departure from a global income tax.\textsuperscript{17} Withholding on goods, services, and contracts on the other hand is designed to tax the hard-to-tax residents of the informal economy who are loath to submit a tax return. Thus for individuals and AOPs these taxes are deemed to be final taxes. But in the case of companies, that are more likely to file a return, these taxes are creditable, or “adjustable” in the terminology used in Pakistan. For listed companies on the stock exchanges all of these taxes are adjustable while for unlisted companies only the withholding made against contracts is not adjustable.

\textsuperscript{16} A peculiar, even illogical, feature of the WHT is that, in the case of goods and services, the value on which withholding occurs includes the value of any sales tax.

\textsuperscript{17} As is happening in a number of other countries, comprehensive income taxation is giving way to a dual income tax system that treats labor income and capital income as separate tax bases and taxes many types of capital income at lower tax rates than most labor incomes. For a discussion of how dual income tax systems have been recently applied in Nordic countries see Genser (2006).
The withholding tax of one per cent on exports is also intended to be a final tax as is the five per cent advance tax on imports with certain exceptions to this rule.\(^{18}\) Withholding taxes that are deemed to be final taxes become another form of presumptive taxation and Pakistan’s tax system is replete with many different kinds of presumptive tax regime.\(^{19}\) As is true in many parts of the world, small businesses are the primary target of presumptive taxation in Pakistan. Besides those already indicated, presumptive taxes are also employed to reach the taxable income of small retailers in Pakistan.

Retailers, other than a company, having a turnover of less than five million Rs are subject to a tax on their turnover of .5 per cent that is considered a final tax against which other taxes that may have been paid cannot be deducted.\(^{20}\) Larger retailers, other than companies, pay tax on their turnover at graduated rates. For turnover values of more than five million Rs, but less than ten million, a small retailer faces a tax on turnover equal to 25,000 Rs plus one per cent on the value of turnover exceeding five million Rs.\(^{21}\) For retail sales in excess of ten million Rs, turnover is taxed at 75,000 Rs (50,000 in income tax and 25,000 in sales tax) plus 1.5 per cent on the amount of turnover greater than ten million Rs.

\(^{18}\) The exceptions are importers purchasing business inputs for their own use, importers who import fertilizer for the manufacture of fertilizer, importers who import motor vehicles for the production of motor vehicles and larger import houses meeting several criteria including annual import volumes of more than 500 million Rs, a paid-up capital of more than 100 million Rs, assets of at least 100 million Rs, a record of presenting accounts for tax audit every year and registration with the Sales Tax department. Importers meeting these criteria are withheld at the reduced rate of one per cent.

\(^{19}\) As discussed in the next section of this report, presumptive tax measures also apply to the corporate sector of the economy.

\(^{20}\) This rate was reduced from .75 per cent in the 2007 Finance Bill to the current level of .5 per cent.

\(^{21}\) The law makes an awkward, and completely arbitrary, distinction between rates of sales tax and income tax that are applied to the value of a retailer’s turnover. In this case, the total tax rate of one per cent is divided evenly between the rate of sales tax and the rate of income tax.
In the end, Pakistan’s income tax laws strike an uneasy balance between withholding taxes that are considered to be final and those that considered to be advance or adjustable taxes. Advance taxes as enumerated in the law consist of withholding against cash withdrawals, car purchases, brokerage fees, stock market transactions, transportation services, and electricity and telephone bills. Yet even here withholding against brokerage fees and transportation services is deemed to be a final tax. And for individuals, AOPs and small retailers who are subject to final withholding on their sales of goods and services, there is no opportunity to claim any advance tax that may have been paid on cash withdrawals, car purchases or the use of electricity or telephone services. For this group of taxpayers advance taxes have been converted into de facto final taxes. However, since 2007 even an individual taxpayer with income tax liability less than the amount of adjustable tax paid on electricity consumption is not entitled to claim any refund of tax.

The Income Tax on Companies

Corporate income tax is imposed on the world-wide profits of resident companies and the Pakistan source income of non-resident companies. Resident companies are those whose control and management are located in Pakistan at any point during the tax year. Thus a branch operation is normally considered to be a non-resident entity. An incorporated subsidiary of a foreign company is deemed to be a resident company but is taxed only on its Pakistan source income.

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22 Pakistan’s source rules, as set out in Chapter VII of the Income Tax Ordinance 2001, are reasonable ones found in the income tax laws of many other countries. The foreign source income of resident companies is exempt if foreign tax has been paid on that income; if that income is chargeable in Pakistan a foreign tax credit is allowed and the company pays the lesser of the foreign tax paid and the tax payable in Pakistan on that income.
a) The Tax Base

The base of the corporate income tax is conventionally defined as active business income earned from the sale of goods and services, and any passive income received in the form of rents, interest, management fees or royalties. Dividends received by a company are exempt but a five per cent tax applies to any dividend received from any public or other resident company.\textsuperscript{23} Capital gains on assets other than immovable property are included in regular income and, if held for longer than a year, receive a 25 per cent tax rebate.\textsuperscript{24} A ten per cent capital gains rate applies to the sales of shares or assets by a private company to a venture fund or a private equity fund. Capital losses can only be set off against capital gains and any unabsorbed losses can be carried forward for six years. Net operating losses also can be carried forward for six years but there are no carry backs.

From chargeable income the following deductions are allowed:

- Interest expenses on company debt;
- Expenses for research and development;
- Expenses for employee training;
- Dividends paid to State financial corporations that have lent funds to the business;
- Bad debts (if felt to be “irrecoverable”);\textsuperscript{25}
- Cost of sales (using FIFO methods for closing inventory)

\textsuperscript{23} Dividends received from a non-resident company are taxed at ten per cent unless reduced by tax treaty.
\textsuperscript{24} Exempt are the capital gains obtained by insurance companies and those arising from the sale of ships and corporate reorganizations. At least until June 30, 2008 capital gains arising from the sale of publicly listed shares are also exempt. Thus only capital gains attributable to the sale of private, unlisted, companies are currently taxable.
\textsuperscript{25} In the case of consumer loans, losses are limited to less than three per cent of taxable income.
• Depreciation allowances for tangible fixed assets;
• Compulsory contributions to WWF and WPPF
• Expenses for rents, repairs and royalties
• Amortization of the cost of intangible assets

b) Depreciation Rules

Pakistan employs a declining balance schedule of depreciation allowances along with an investment allowance (IA) of fifty per cent allowed as an initial deduction from the original cost of asset acquisition, including second-hand plant and machinery used in Pakistan for the first time.\textsuperscript{26} Road transportation vehicles (unless for hire), furniture and used capital goods are ineligible for the IA. However, intangible assets and pre-commencement expenses such as the costs of tests, trials and feasibility studies, are written off on a straight-line basis at a rate of twenty per cent for pre-commencement expenditures and according to the cost per year of estimated lifetime in the case of intangible assets.

In 2005/06 Pakistan streamlined its depreciation schedule and reduced the number of categories from thirteen to four. Tangible assets can now be amortized at the following rates:

• all types of buildings at 10 per cent
• furniture (including fittings), plant, equipment and machinery, motor vehicles, ships and technical or professional books at 15 per cent;

\textsuperscript{26} With a corporate tax rate of 35 per cent the investment allowance is equivalent to an investment tax credit of 17.5 per cent.
• computer hardware, machinery and equipment used to produce IT equipment, aircraft and aero parts at 30 per cent;
• for the mineral and oil sectors, under-ground installations at 100 per cent and off-shore drilling platforms at 20 per cent.

If an asset is disposed of, any excess of disposal value over depreciated value is considered as “income from business”. Conversely, if disposal value is less than depreciated value, the difference is deductible from “income from business”. However, there currently are no “put in use “ rules in Pakistan so a company could defer purchase of capital equipment until the end of the tax year and claim a depreciation deduction for the entire tax year.\(^{27}\) No depreciation deduction is permitted if an asset is disposed of in the same tax year in which it was acquired.\(^{28}\)

c) Tax Rates

Pakistan, with one important exception, has moved recently towards the adoption of a uniform corporate tax rate of 35 per cent on taxable profits for both public and private sector companies. Previously, banks and private sector companies were taxed at somewhat higher rates than public sector companies. The main exception to this uniform rate approach is small companies which are taxed at a lower rate of 20 per cent on their taxable profits. Small companies are defined to be those with annual turnover of less than 250 million Rs and no more than 250 employees at any time during the tax year.\(^{29}^{30}\)

\(^{27}\) Until it was dropped in the 2004 budget Pakistan employed a reasonable “put in use” rule for tangible assets. Curiously, such a rule remains in effect for intangible assets.
\(^{28}\) In the case of leasing companies, depreciation can only be claimed against lease rental income.
\(^{29}\) Besides the turnover and employment limitations, a small company must pass two other tests, that its paid-up capital plus undistributed reserves does not exceed 25 million Rs and that it has not been formed as a result of fragmentation of an existing business.
An unusual feature of corporate taxation is the absence of a smooth graduation from small to large company status. If a small company’s turnover exceeds the turnover limit of 250 million Rs. by one Rupee, the entire amount will be taxed at the much higher rate of 35 per cent. Thus, as discussed in the next section of this report, a serious “notch” problem is also present in the corporate income tax law.

d) Tax Payments and the Treatment of Losses

Companies are required to make quarterly advance tax payments based on the amount of tax paid in the same quarter of the previous year. In 2005-06 of the 250 billion Rs collected in corporate taxes, 165 billion Rs was obtained through voluntary compliance in the form of advance payments and filed returns. The remainder was garnered through the extensive withholding system and a small amount of collections on demand including arrears (seven per cent of the gross amount collected). Of this total amount of revenue, the banking sector contributed 18 per cent, the private non-banking sector 45 per cent and the rest, 37 per cent, by public sector companies.

As noted before, net operating losses can be carried forward for a period of six years. The same carry forward period applies in the event two companies amalgamate as long the newly amalgamated business carries on the same business for at least five years. A subsidiary of a public listed company can transfer up to three years worth of losses to its parent holding company which can use these losses against any of its taxable profits for the next three years. Consolidated returns of this kind have been allowed since 2006.

30 The other exception is Modaraba companies-management companies for closed end mutual funds- that enjoy a tax rate of 25 per cent.
e) Presumptive Taxation of Companies

Pockets of the corporate sector are taxed under presumptive tax regimes. For non-resident entities, income from shipping is taxed at a rate of eight per cent on turnover and at three per cent on income from air freight operations. For residents, a presumptive tax on shipping is imposed at a rate of one US dollar per gross registered tonnage.

Compressed Natural Gas (CGN) operators are taxed at six per cent of the gas bill they are charged by a gas distributing company. These charges are a final tax on the income of the CGN station arising from the sale of gas. Income earned by a Pakistan company supplying construction services abroad is taxed at a rate of one per cent of the gross receipts received provided the foreign exchange earned is brought back to Pakistan through normal banking channels. Insurance companies, other than life insurance companies, pay a presumptive tax on their premium income of five per cent.31

Finally, a minimum company tax applies either where no tax is paid or where it is less than .5 per cent of turnover. In these cases, the minimum tax is .75 per cent of a company’s recorded turnover.32 This minimum tax applies even to tax holiday firms and firms posting either a loss or a carry forward of an earlier loss. In the 2004/05 budget the minimum tax was allowed to be carried forward for five years set off against any future tax liability. Exempted from this tax are individuals, small companies, non-profit organizations, venture capital corporations, retail petroleum dealers, some power companies, non-resident companies and real estate investment trusts.

31 This rate was raised from 3 per cent in 2006.
32 Another form of presumption is a thin capitalization rule which restricts the debt-equity ratios of foreign controlled resident companies to be no more than 3:1.
f) Income Tax Incentives and Exemptions

Certain types of economic activity have been exempted from the purview of the company income tax. These include the income earned by micro-finance banks provided no dividends are paid out and all profits are reinvested in micro-finance operations. In addition, the profits or gains of a venture capital company are exempt until June 31, 2014. Profits or gain on the sale of immovable property to a real estate unit trust up to June 30, 2010 enjoy a similar exemption. Any profits earned by a computer training or vocational institute also escape any income taxation.33

Except for electrical power companies, which enjoy unlimited income tax exemption, and perhaps oil and mining companies that benefit from both depletion allowances and expensing, Pakistan’s corporate tax laws do not discriminate among different sectors of the economy in terms of concessionary rates or special tax breaks. Pakistan does, however, offer attractive incentives for firms that set up operation either in an export processing zone (EPZ) or a special investment zone (SIZ). In the former zone firms receive a five year tax holiday and a 75 per cent tax exemption after the holiday expires. Firms operating in the latter type of zone enjoy an unlimited income tax rebate of 75 per cent.

g) Income Tax Compliance

The record of corporate income tax compliance in Pakistan is not encouraging. In 2006 there were about 47,500 companies registered with the Securities and Exchange Commission of Pakistan (SECP). However, only a much smaller number of companies,

33 Inter-corporate dividends are also exempted according to the Second Schedule of Exemptions and Concessions but as mentioned in the text a separate 5 per cent tax applies to dividends received from any public or other resident company.
23,090, were registered for tax purposes with the FBR.\textsuperscript{34} And of those registered with the FBR, just slightly more than half, 12,526, filed a tax return in 2006.\textsuperscript{35} Of some concern is the fact that of the group that filed, only 3,888 declared any taxable income; the majority of filers either declared losses or reported no taxable income. The record for foreign companies is even more dismal. Only 17 of 494 foreign companies filed a return in 2006.

\textbf{Policy Issues Concerning the Taxation of Companies}

The major issues surrounding the reform of corporate taxation relate not so much to the current law but rather to its administration. The rules for determining the size of the tax base are reasonable ones for the most part and the rates that are applied to that base are not unreasonably high by international standards. Apart from electrical power companies and companies operating in the oil and mining sector, the tax rules do not discriminate among investments in different corporate activities. The tax incentive regime, favoring firms located in export processing and special investment zones and small start-up companies, is also relatively modest in scale by international standards. Nonetheless, some legal anomalies remain.

- The Tax Treatment of Small Business

A triad of policy issues rises to the fore in the tax treatment of small business. First, a small business, defined as having turnover less than 250 mn. Rs ($4,166,666.7) and fewer than 250 employees, is not “small” when compared with the legal definition of

\textsuperscript{34} This comparison is somewhat misleading because many of the companies registered at the SECP are known to be defunct entities and insufficient effort has been made to clean out the deadwood and bring the registry up to date.

\textsuperscript{35} This information can be found in a recent article by Wahid (2006).
smallness in other countries. Elsewhere, “small” almost never describes firms with more than USD one million in turnover and more than fifty employees (if an employment restriction exists at all).36

A second concern is the exemption of small business from any withholding requirements. This exemption opens up a large tax avoidance seam in the fabric of the withholding system. It predisposes other businesses to concentrate the sale of their products to small business as a way of minimizing their tax bills and results in a revenue loss of unknown magnitude. It also implies that small businesses are not required to withhold income taxes from the wage and salary incomes paid to their employees.37

The lower statutory rate of 20 per cent that applies to the taxable income of small business is of a more controversial nature. On the surface, it appears to represent an obvious tax distortion biasing investment decisions toward small business. In the tax literature, however, this preferential treatment has been justified as an important means of offsetting another distortion, the failure of credit markets to channel adequate financial resources to small business because of information asymmetries.38 Potential lenders to small business may overlook them because their business prospects are more difficult for lenders to evaluate.

It is on these grounds that many countries, for example Canada and the USA, offer concessionary tax rates to small business. Nevertheless, the countries that adhere to

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36 For example, Ukraine’s unified tax taxes the turnover of physical persons employing fewer than ten persons and having turnover of less than about USD 50,000 and, in the case of legal entities, firms with fewer than fifty employees and turnover of less than about USD 200,000.
37 See Mark Rider, “Estimates of Pakistan’s Tax Gap”, Georgia State University, 2008, who finds that current withholding on wages and salaries brings in slightly less than half of what would be collected if there were perfect compliance with the income tax law.
38 This is an example of second best tax policy, in which tax decisions try to take into account non-tax factors that affect resource allocation. The optimal approach is always to deal with any distortion directly, rather than indirectly, but that is often easier said than done.
this practice do so in a more rational manner than Pakistan does. Other countries tax an initial slab of business income at a lower rate and anything in excess of that at a higher rate. Pakistan does not. Instead, all turnover exceeding the small business threshold is taxed at the higher corporate rate of 35 per cent creating a significant “notch” issue.

The nature of this problem can be depicted by a simple numerical example. Consider a small company with a turnover just below the threshold of 240 mn. Rs. and a profit margin of 10 per cent on that turnover. Under current legislation, its profits of 24 mn. are taxed at 20 per cent yielding 4.8 mn. in revenue. Assuming this company increases its turnover by 20mn. and now exceeds the threshold by 10 mn., it would be taxed on profits of 26 mn. at a rate of 35 percent and face a new tax bill of 9.1 mn. Two million Rupees of additional profit would encounter an additional tax of 4.3 million, or more than confiscate the extra earnings of the company. Conclusion: far better to remain a small business than try to grow into a larger one.

The decision to remain small could impose avoidable costs on the economy of Pakistan. To the extent there are economies of scale in production, the tax constraint on small business growth may prevent firms from exploiting these economies to the detriment of both the level and rate of growth of GDP.

- Vulnerability to Over-invoicing

Different businesses in Pakistan are subject to different tax regimes. Because the methods for determining tax liability differ from one regime to another, it is possible for nimble taxpayers to take advantage of these differences in the tax rules. When some businesses are taxed on a net income basis and others are taxed on their gross incomes or
turnover, one widely used trick is to resort to over-invoicing in order to shift taxable income towards more lightly taxed regimes. In a Pakistan context, a few examples can illuminate these tax planning opportunities. Taxes on transportation services, for example, are a fixed amount per passenger seat or per unit of vehicle weight. If a company supplying these services to a corporation over-invoices the value of these services it will not raise its own taxes but will save taxes for its customer. Similarly, a presumptive tax of a firm of 3.5 per cent on gross sales also encourages over-invoicing by that firm in its sales to corporations. If such a presumptively taxed firm over-invoices its corporate client by 100 Rs it will pay 3.5 Rs in additional tax but it will save its client 35 Rs in corporate tax, a net gain of 31.5 Rs which the two parties can split by prior agreement.39

What might be done to combat this type of behavior? The FBR already has the legislative mandate that would allow it to control over-invoicing and other forms of transfer pricing. Chapter 8 of the Income Tax Ordinance 2001 outlines a conventional set of anti-avoidance measures available to the FBR which allow the Commissioner to recharacterize income and deductions and impose arms length values on transactions. However, in practice the FBR lacks the administrative capacity to effectively employ these compliance tools.40 41 This observation underscores a final concern over the efficacy of corporate tax policy.

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39 Over-invoicing of imported capital goods, to secure a larger investment allowance, is another tax dodging avenue.
40 Pakistan is not unique in having to deal with challenges of this kind. Other developing countries have grappled with the same problem and have adapted their presumptive tax regimes to reduce the rewards attached to over-invoicing. In the case of Mexico, it changed its approach to presumptive taxation for precisely these reasons. See Gil-Diaz and Thirsk, 1997 for a discussion of how Mexico attempted to change the taxation of small business from a gross to a net income basis.
41 To control international transfer pricing practices Pakistan has resorted to applying stringent rules limiting the deductibility of inter-corporate income flows. Thus interest on loans from head offices to a
• Weak Compliance Measures

Countries can design and adopt reasonable corporate income tax laws but, if they are unable to administer them properly and apply them uniformly, the pattern of tax liabilities that emerges across the corporate sector is highly unlikely to score well in terms of either neutrality or equity. Pakistan appears to fit this description. As noted in the preceding section of this report, barely half of all registered companies file a return. And of those that do file, only about one-third declare any taxable income.\(^{42}\) Perhaps three interlocking steps are required by the FBR to support the current system of universal self assessment.

First, more stringent penalties need to be imposed in the event of non-filing, perhaps buttressed by the option of third-party intercepts if the penalty goes unpaid.\(^ {43}\) Secondly, non-filers should continue to be assessed best judgement presumptions but with the proviso that, while the presumption is both rebuttable and appealable, the assessment must be paid in advance of any attempt to rebut or appeal it. Third, taxpayers need to be more aware that that any effort on their part at tax deception will face a significant probability of detection. This is where the new program of field audits comes in. But its potential for improved compliance should be bolstered by a modified appeals process. Any additional tax assessment arising from an audit should be immediately payable before any appeals process can be launched.

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foreign company permanently established in Pakistan is not a deductible expense and neither are royalties, and fees for management services and the use of assets paid to a head office. See the Economist Intelligence Unit, 2007, for a further discussion of these transfer pricing restrictions.

\(^ {42}\) As on FBR official has put it, how can companies that consistently report losses year after year manage to survive for so long?

\(^ {43}\) Section 140 of the Income Tax Act allows for the imposition of third-party tax collection.
Sales Tax

Sales Tax (ST) is imposed on all traders, other than those involved in providing services, having a turnover above the registration threshold of 5 million Rs. ($83,373). This is a relatively high threshold by international standards. Although service providers are excluded from the scope of the tax for Constitutional reasons, the FBR may impose a tax on services on behalf of the provinces and collect it for them. The tax is structured along traditional value-added tax (VAT) lines, relying on a credit-invoice mechanism for its administration. It was introduced in 1990 but experienced a difficult birth, facing fierce opposition from the business community despite the insistence of the IMF that it be adopted. Business feared the record keeping requirements of a VAT and the possibility of more harassment and corruption by tax officials. VAT supporters, on the other hand, viewed an undocumented business sector as an untrammeled avenue for tax evasion. As discussed below, the VAT in recent years has been accompanied by single stage retail sales taxes applied to the informal retail sector of the economy.

About 130,000 traders were registered for the sales tax in 2007. Among those registered, 98,840 filed a regular monthly tax return for the tax. Within the group of filers, about 3,000 accounted for ninety per cent of all tax payments while another 32,000 contributed only about 1-2 per cent of all sales tax revenue. Seventy-six per cent of all domestic sales tax revenue was attributable to returns from ten sectors: telecoms,

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44 In 2004-05 the threshold was raised to this level from a lower level of one million Rs for retailers and .5 million Rs for manufacturers respectively.
45 Jamaica for example has a threshold of $5000 and recommendations have been made to double it. See Bird and Edmiston (2007) for a discussion of the Jamaican case. When Australia and New Zealand introduced their VATs, thresholds were set at $50,000 and $40,000 respectively.
47 Sales tax may be paid through the banking system in Pakistan.
petroleum, oil and lubricants, gas, electric energy, sugar, cement, cigarettes, beverages and auto parts. After refunds, electric energy was a negative contributor to total revenue.

a) The Legal Tax Base

The Sales Tax Act of 1990 outlines the basic features of the tax but in many ways is an empty legal vessel remarkable more what it doesn’t say than for what it does say. The Act clearly establishes that the base of the tax is sales price inclusive of any federal excise duty and/or customs duty. It also specifies the accrual date for tax liability as either payment for, or delivery, of a good, whichever comes first. However, much of the normal language of a traditional VAT, such as the place of supply or the time of supply, is missing from the Act. An obvious intention of the Act is to grant enormous discretion to the FBR in administering the provisions of the tax. Many of the articles in the Act begin with a “notwithstanding” clause proclaiming that, whatever may be the content of the article, it may be overturned at any time by a decision of the FBR. As shown below, the result is a constantly changing set of ad hoc rules that govern how the tax is applied in practice.

The Act also contains a number of unusual provisions including the following:

- Article 3.B: any excess tax is payable to the government;
- Article 7.A: the government may prescribe any minimum value addition;
- Article 8.1: the government can deny any input credit claim it chooses to disallow;
- Article 2: the procedure for pro-rating input credits for businesses selling both taxable and exempt goods is not spelled out;
• Article 1a: input credit is automatically denied if no sales tax is deposited in the Treasury;\textsuperscript{48}
• Article 8.A: if a buyer “suspects” a seller will not remit tax paid both are liable for any non-payment;
• Article 8.B: no input credit is allowed in excess of ninety per cent of the output tax payable;
• Article 13: the FBR may exempt any good it chooses to exempt;
• Article 10.1: excess tax credits are to be carried forward for six months after which a refund is to be paid within 45 days unless the claim looks suspicious in which case this period can be extended to seven months although the FBR could also mandate a permanent carry forward at any time during this process.

b) Exemptions from Sales Tax

Exemptions to the sales tax, as found in the Sixth Schedule, are too numerous to be included in the body of this report. Instead, they are listed separately in an appendix. A reading of the Sixth Schedule suggests that the exemptions are aimed at reducing the sales tax burden on unprocessed and unpackaged goods, inputs used mainly in the production of exempt goods, such as feed, seed, fertilizers and tractors, medical products, reading materials, public sector transport vehicles, transportation means such as buses and ships, imports purchased by hospitals, non-profit organizations, imports for disaster

\textsuperscript{48} This provision is sensible if the seller fails to remit tax that has been received; however, if the purchaser is in arrears and fails to pay tax to the seller, the sales tax is perversely transformed into a tax on business income.
relief and by international agencies and plant and machinery listed in the official Gazette. The list is a fairly long one but is also fairly standard.\footnote{A recent, and careful, study by Refaat (2003) concludes that the impact of these exemptions is to impart a mildly progressive pattern of tax burdens.}

c) The Operational Tax Base

To understand how the ST works in Pakistan, one has to carefully read and digest the Sales Tax Notifications and Statutory Regulatory Ordinances (SROs) published regularly in the Gazette that reflect FBR decisions on how the ST should take effect any point in time. Such a reading leaves no doubt that the ST is, by and large, whatever the FBR says it is.\footnote{The sales tax provides a classic example of the dictum, sometimes attributable to Milka Casanegra de Jantscher and Richard Bird (1992), that “tax administration is tax policy.”} Many of the Notifications and SROs are relatively innocuous involving clarifications of payment procedures, previous SROs and changes in the tax forms. Others, however, engage in fine tuning of the Sales Tax Act and initiate sales tax policy changes. Table 3 below offers a flavor of the 2007 policy changes that have been introduced up to September of that year.

Up to the end of September, 2007 about 75 changes in the tax law occurred through issuing new SROs. For the entire year of 2006 about 136 such changes were introduced. By comparison, a much smaller number of SROs affected the income and excise tax laws. By the end of September, 2007, there were 20 new SROs for the income tax and 15 for the excise tax.
Table 3: A Sample of Some SROs in 2007

- 1/9/07: exemption granted to 63 kinds of diagnostic kits;
- 24/8/07: zero rating provided for all dairy products, stationery items; refunds to be given for all such supplies to both registered and unregistered traders; tax collectors shall accept a taxpayer’s declaration if the input-output ratio accords with the industry average;
- 27/6/07: sales tax rates of 20 per cent to apply to a list of 70 products and 17.5 per cent to a list of 9 products;
- 8/6/07: zero rating extended to bicycles, sewing machines, trailers and uncooked poultry meat; amnesty given to those with a default surcharge;
- 9/6/07: restrictions applied to input claims of cotton ginners for electricity and diesel fuel; in 2006 zero rating was applied to textiles, leather products, carpets, sporting and surgical goods-that list now extended to 47 other items including a large number of chemicals and chemical agents;
- 28/4/07: a number of companies qualify for zero rating of sales tax on their electricity and gas bills;
- 14/2/07: assessable value of locally produced sugar fixed at 24 Rupees/gram

It is hard to discern any consistent trends in the long list of SROs that have been issued in recent years but there does seem to be a tendency towards granting more extensive zero-rating under the sales tax. Besides the more widespread zero-rating noted in table 3, in 2006 buses and taxis were zero-rated for both imports and local supply. In 2005 zero rating was applied to tractors and all inputs used to produce tractors. In addition, zero rate treatment was given to all raw materials, components and parts used in manufacturing plant and equipment which itself was zero rated.51

Much of the recent wave of zero rating appears to have been inspired by administrative considerations. The primary factor behind the zero rating of textiles, carpets, leather goods and sports and surgical equipment was the large refund claims associated with these activities that were difficult for the FBR to substantiate. Zero rating these activities and most the inputs used by these activities was a way of removing some troublesome taxpayers from the sales tax circuit, at least for value-added tax

51 A curious SRO of 30/6/05 stipulates that a zero rate will apply to all taxable sales of M/S Pakistan PTA ltd., Port Qasim having registration number 1200800600164.
purposes. In lieu of VAT treatment, the FBR has resorted, at least until 2007, to taxing these sectors with a three per cent single stage retail sales tax.

Another observable tendency is the greater reliance on presumptive methods of collecting sales tax. Besides the element of presumption noted in the last item appearing in table 3, an SRO in 2005 stated that pesticides were to be taxed with a thirty percent fixed value addition. Also, in the same year, the FBR fixed the price of potassium fertilizers, both domestic and imported, at 4,610 Rupees per ton. Because wholesalers and retailers were felt to be evading sales tax on a large scale, the FBR began to impose sales tax on the “printed” retail price set by a manufacturer, thus pre-collecting tax that would-or should-have been paid at later stages. In 2005-06 this method of tax collection was applied to toiletries, tea, confectionery and footwear.

d) Sales Tax Rates

A zero tax rate applies to exports and, as just mentioned, to a number of other sectors and activities. Originally, the standard rate was 23 per cent but it was subsequently reduced to 18 per cent and then 12.5 per cent in 1997. Currently, the rate stands at 15 per cent.

Pakistan has also experimented with multiple rates as a strategy for encouraging better taxpayer compliance. In the 1990s a two per cent rate was offered to small scale manufacturers and retailers if they opted to register for tax and a 20 per cent rate was imposed on imported raw materials as an incentive to register an unregistered business.

52 See Ahmed Khan (2006) for an analysis of the revenue impact of these changes that suggests these changes were nearly revenue neutral. The reduction in refunds claims closely matched the revenue foregone from the imposition of a zero rate.
53 In some sense, this tendency is a reversion to earlier ways of administering the tax. When it was introduced in 1990 it took the form of a fixed tax on twenty seven industries.
Previously, sales to non-registered buyers were made at 18 per cent as a registration incentive. As already noted in table 3, this incentive approach has been resuscitated in 2007.

**Policy Issues Relating to the Sales Tax**

- The Efficiency of the Sales Tax

A standard measurement of a country’s sales tax efficiency is the so-called “C efficiency ratio” defined as the share of VAT revenues in consumption to the standard rate. This measure uses the reference point of a uniform tax on all private consumption which would have an efficiency rating of 100 per cent. Higher or lower values indicate the degree to which a country’s sales tax deviates from this norm either through over or under-taxation of total consumption.

When this calculation is performed for Pakistan, the result is a rating of 38 per cent which is relatively low in terms of international comparisons. The reasons behind this weak performance relate to the relatively small size of the domestic tax base. In 2006 imports and domestic tax collections were approximately the same size, 176 billion Rs and 171 billion Rs respectively. Data from the 2006-07 Pakistan Economic Survey indicate that about 55 per cent of all imports are consumption related. Given an import-to-GDP ratio of 17 per cent these numbers imply that the import base for the sales tax is 0.086 of GDP. From the same source, the ratio of private consumption to GDP is 73 per cent. If the agricultural sector, 20 per cent of GDP, is factored out of this base the maximum size of the domestic tax base is about 45 per cent of GDP. Given the near equality in revenue collections from imports and domestic activity, implying nearly equal

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54 See Ebrill et al (2001) for an expanded discussion of this efficiency criterion. According to the findings in this volume, Pakistan’s efficiency rating would place it at the regional average for Sub Saharan Africa.
tax bases, it appears that only about 20 per cent of domestic consumption (.086/.45), primarily from the manufacturing sector, is included in the current sales tax base after taking into account exemptions, zero rating and evasion. In other words, the relatively low efficiency rating reflects the relatively small amount of domestic consumption that is captured in the tax base.

- Complexity and Instability in the Sales Tax Regulations

Pakistan badly needs to amend and overhaul its existing sales tax legislation with the objectives of eliminating many, if not most, of the questionable provisions alluded to earlier and providing a more coherent picture of how the tax is supposed to operate. Continuous tinkering with, and tweaking of, the tax laws through a steady barrage of SROs over time causes the legislation to lose shape and focus, not to mention undermining the efforts of taxpayers to comply with the laws that are in force at any point in time.

It is also highly doubtful whether Pakistan has applied the appropriate policy medicine to some of its sales tax headaches. In particular, the important textiles sector has proven itself to be a hard-to-tax sector that has caused vexatious refund problems. In such cases the standard policy prescription is to grant an exemption to such a sector and tax it indirectly by denying any credit for the input taxes it pays. This would be equivalent, but administratively much easier, than the alternative option of zero rating the sector and denying any claims for refunds.
Federal Excise Duties

Taxpayers are domestic producers of excisable goods and services and purchasers of excisable imports of goods as set forth in the Federal Excise Act of 2005. Unlike the Sales Tax Act, the Excise Tax Act is a state-of-the-art piece of legislation that clearly and comprehensively defines all of the important excise tax concepts and the procedures for complying with the tax. An interesting feature of this Act is that it repealed the earlier system of physical excise control and replaced it with a new system in which all clearances are now self-assessed.

For 2006-07 excise taxes are expected to yield about 72 billion Rs or about one-quarter of the yield anticipated from the sales tax. As a share of total taxes, excises which accounted for 22.5 per cent of the total in 1990/91 now account for only about 8 per cent.

a) The Tax Base

The excise tax base consists of 48 goods and, until recently, 8 services that are described in the Excise Tax Act. Although the number of goods seems large in fact the 48 commodities can be conveniently grouped into six categories, vegetable oils, carbonated beverages, cigarettes, cement, seventeen different types of oils and fuels, toiletries and cosmetics. Excisable services include TV advertising, inland air travel, inland air freight, first class or air conditioned train travel, shipping agents, a broad array of telecom services, and all types of insurance services except life. In 2006-07 additional services were added to the excise list including cable TV, services of money changers, non-fund or fee related banking services and international air travel. The latter excise is meant to
apply to travel both to and from Pakistan but it is not clear how tax can be collected on inward travel if the ticket is purchased abroad.

An interesting feature of excise taxation in Pakistan is that in a number of instances it mimics the behavior of a value-added tax. The Second Schedule of the Excise Tax Act stipulates that in the case of vegetable oils the excise tax is to be collected under sales tax mode and any tax paid by a sales tax registrant is entitled to an input tax credit. The excise tax rate on vegetable oils is also the same as the standard sales tax rate of 15 per cent. Many of the excisable services are also taxed at this rate. Moreover, section 5 of the Act provides for zero rating of all excisable goods that are exported. In addition, section 6 of the Act allows a producer of any excisable goods to deduct from tax liability any amount of excise that may have been applied to the inputs used by the producer. Finally, a sales tax SRO issued in 2006 allows the excise duty applied to most services to be treated as if it were a sales tax, and it therefore becomes a creditable charge to any sales tax registrant.

**Policy Issues under the Excise Tax**

- Proliferation of Excise Tax Rates

The First Schedule of the Excise Tax Act prescribes a somewhat bewildering mixture of in rem and ad valorem tax rates. The highest ad valorem rate is on high priced cigarettes, at 63 per cent of the retail price, followed by carbonated beverages at 50 per cent. With one or two exceptions all of the excises on oil and fuel products are levied on an in rem or quantity basis. In rem excises are easier to administer but have the defect that they are susceptible to inflationary erosion. Even on an in rem basis, the proliferation of different rates on seventeen different kinds of oil and fuel is a source of concern.

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55 The reason behind this tack is, of course, the Constitutional restriction on the sales taxation of services.
because of the ease with which misclassification can occur. Too many fine distinctions within a commodity category pries open the door for the type of tax evasion that is hard for tax administrators to detect. Most countries operate with a much simpler system of tax rates for petroleum products and their derivatives.

- Some Questionable Excise Tax Exemptions

The Third Schedule of the Excise Tax Act outlines a moderate list of exemptions from excise tax. Many of them are sensible ones, for example the exemptions given to international agencies and organizations and to purchases made by outbound ships and planes. Others, however, are more questionable as they represent the exemption of particular purchasers for particular uses that potentially open up large avenues for tax evasion. Examples found in the Act are the exemption for hydraulic cement imported or purchased by petroleum or energy sector companies and the exemption for carbon black if imported by National Petrocarbon Ltd., Pipir, Karachi.

**Wealth Taxes in Pakistan**

Pakistan used to have a general wealth tax that generated very small amounts of revenue and was abolished in July of 2001. Puny amounts of tax continue to trickle in from this tax as a result of unsuccessful appeals. However, selective wealth taxes continue to exist in the form of capital value taxes applied to the ownership and purchase of cars, stocks and real estate. These taxes are imposed at the time these particular assets are acquired. Currently, these taxes contribute only about seven per cent of total direct tax revenue.
A capital value tax of .02 per cent is currently attached to the purchase price of any shares listed on the stock exchanges. Car purchases are taxed at five per cent of their sales value. In the case of real estate, a two per cent tax is charged on the sales value of immovable urban property larger than 500 square meters. A fixed value of 50 Rs per square meter kicks in if no value can be attached to the property or if the purchaser has no national tax number.

From a policy perspective, the question arises as to whether this group of assets is too lightly taxed. A number of other developing countries impose heavier taxes on these assets, for example Turkey, and generate more revenue from these sources.

**Customs Revenue from Imports**

The government of Pakistan has made a conscious, most would say wise, decision to reduce revenues obtained from tariffs on a wide range of imported goods and replace the lost revenue from other sources. Over the period 2005/06 to 2006/07 revenue collected from customs duties declined by 4.4 per cent. Because sales and excise tax apply to the tariff laden value of an import, lower tariffs also contribute indirectly to lower yields from both sales and excise taxes. Despite the trend towards lower tariff levels, tariff revenues account for a significant fraction of indirect tax revenue, about 25 per cent or 1.5 per cent of GDP in 2006-07.

Ten years ago, tariff levels in the neighborhood of 150 per cent were not uncommon. In 2006-07 the policy intent is to operate with a tariff structure in the zero to 25 per cent range with lower rates applied to raw materials and higher rates on finished goods. Within the FBR the focus is on trade facilitation rather than revenue generation.
with the expectation that a lower set of tariffs will ultimately spur higher levels of economic activity and result in revenue gains showing up elsewhere in the economy.

The main issue regarding tariffs is what the longer term objective of tariff policy should be and whether further reform of the tariff structure is warranted. This topic is addressed in the next section of this report.

**Options and Directions for Tax Reform in Pakistan**

Each of the preceding sections of this report has flagged certain blemishes and imperfections of the major taxes in Pakistan that, taken together, constitute a reasonably robust tax reform agenda. Based on the findings contained in this report that agenda should be comprised of the following elements:

1) **A Thorough Review and Examination of the System of Personal Tax Credits.**

   Among the questions that should be answered by this review of tax reform options is whether Pakistan has too many credits and that are too complex and regressive in their design and too generous in the amounts of tax relief they offer.

   Pakistan offers tax credits for charitable and pension contributions and purchases of new shares and housing. Most counties provide either a credit or a deduction for charitable donations and the only issue here is whether the current definition of a charitable institution is too wide and should exclude, for example, sports and cultural activities. The other three credits are of a more doubtful nature.

   In light of the non-taxation of pension benefits a tax credit for contributions effectively subsidizes this form of income and supplements the after-tax income of a
pension contributor. Conventional tax treatment of pensions, one that allows a deduction for pension contributions and taxes pension benefits when received, more or less effectively exempts pension income from income taxation.\(^5^6\) To see this outcome, let “D” denote the size of a contribution, “t” the taxpayer’s marginal tax rate and “r” the taxpayer’s discount rate. If tax rates remain unchanged and the discount rate approximates the earnings rate of the pension fund, a contribution of D saves taxes in the amount \(tD\) and generates future tax payments having a present value of \(tD(1+r)^t / (1+r)^t\) or \(tD\). Pakistan’s tax treatment goes beyond this and provides only a tax saving through the tax credit with no offsetting flow of future tax payments.

The tax credits for buying new shares and housing operate in a similar manner in Pakistan and provide only a tax saving for the taxpayer and no corresponding tax obligations at some future point. This happens because capital gains reaped from holding shares and the implicit rental income of housing are both exempt from taxation.

Regardless of any changes Pakistan might make in the number of tax credits it offers, an argument can be made for simplifying their structure. Credits are frequently preferred to the alternative of tax deductions on the grounds that they deliver the same amount of tax relief regardless of the taxpayer’s marginal tax rate. But credits found in other countries typically have a much simpler design and provide a credit that is a percentage of the amount spent on the tax preferred item. A credit for charitable donations, for example, might allow a credit equal to ten per cent of the donation. Taxpayers making the same donation would be able to claim the same amount of tax saving no matter what their taxable income status. This outcome cannot happen in

\(^{56}\) Another way of looking at this result is to note that the conventional treatment of pensions provides for “consumption tax” treatment in that savings devoted to pension funds are removed from the income tax base.
Pakistan at the moment because the value of the credit increases with the taxpayer’s average tax rate and, in effect, converts the credit into the form of a deduction.

2) A Reassessment of the Tax Thresholds pertaining to the Personal Income and Sales Taxes

As noted in the body of this report, wage recipients earning twice the average wage fall under the threshold set for the zero rate tax bracket. Consequently, Pakistan reaps little tax revenue from labor income and, as noted elsewhere, most of the current income tax burden falls on recipients of capital income. Tax thresholds and exemption levels found in other countries tend to be less generous than those in Pakistan and are more likely to be geared to a measurement of the minimum wage or some notion of a minimum level of subsistence.

It is also anomalous, and cumbersome, to have three separate tax schedules, a standard one, one for taxpayers whose major source of income is from labor, and another one for women. If the policy intent behind having three separate schedules is to offer some modest tax relief to wage earners and women, perhaps because the latter also have important household responsibilities, it would be far simpler and better targeted to have a single schedule accompanied by modest tax credits for earning labor income or for female labor force participation.

The current threshold for the sales tax, approximately US$ 83,000, is also high by international standards. Choosing the “best” threshold, however, requires a judicious balancing of administrative and compliance costs and the social value of an additional Rupee of tax revenue. Ultimately, it is an empirical question of whether lowering the
threshold to say US$ forty or fifty thousand would generate sufficient revenue to justify the extra administrative and compliance costs that would be incurred.

3) A Reversion to the Previous, and Conventional, Method of Imposing Tax Progression

Conventional approaches to progressive taxation tax incremental slabs of taxable income at higher marginal tax rates. Pakistan, on the other hand, has recently opted to apply higher marginal tax rates on the total amount of taxable income as it increases in size. The result is a serious “notch” problem in the pattern of effective marginal tax rates. A taxpayer whose growth in taxable income pushes him or her into the next highest tax bracket by the amount of one Rupee faces marginal tax rates that are astronomical. Punitive marginal tax rates such as these create strong and perverse incentives to disguise and conceal income gains from the tax collector.

It is clear, however, that if Pakistan were to return to a conventional method of taxing personal incomes progressively, it would lose revenue if it also retained the current structure of tax brackets and marginal tax rates-14 in all. In this respect, however, Pakistan is out of step with the rest of the world which, beginning in the 1980s, has moved steadily towards a much smaller number of tax brackets and a reduction in marginal tax rates at the top of the income ladder.

Pakistan might do well to consider reforming its personal tax system in the direction of having far fewer tax brackets and a flatter rate schedule while also addressing the need for low income relief and the overly generous tax threshold that currently exists. A simple numerical illustration shows how this might be accomplished.
This proposal would eliminate the device of zero rate bracket and replace it with a personal income tax credit that would have the same effect of providing low income relief. A zero rate bracket generates its own “notch” issues which can be avoided only by having low initial marginal tax rates and numerous rate brackets to accommodate the desired degree of tax progression.

In this numerical example, suppose the decision has been taken that no personal tax will be levied on average wage income but some tax will apply to wage income higher than the average. In Pakistan the current average wage is 6,000 Rs per month or 72,000 Rs per year. For the sake of argument assume the tax schedule that is adopted has the following features:

- the first 50,000 Rs of taxable income is taxed at 10 per cent;
- the next 50,000 Rs of taxable income is taxed at 20 per cent;
- anything over 100,000 Rs is taxed at 30 per cent

According to this schedule, the average wage earner, without benefit of any tax relief, would be taxable in the amount of .1x50,000 + .2x22,000 or 9,400 Rs. Thus the personal income tax credit should be set at about the same level, say 10,000 Rs or 13.9 per cent of the average income of 72,000 Rs. By contrast, a taxpayer with 140,000 Rs of taxable income would calculate tax owing as 32,000 Rs – .1x50,000+.2x50,000+3x40,00- and claim the personal income tax credit of 10,000 Rs resulting in a net tax obligation of 17,000 Rs. The average tax rate for this particular taxpayer would be 12.1 %.

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57 In the interests of achieving greater taxpayer equity, child and spousal tax credits might also be considered for adoption.
This example is meant to be suggestive only, outlining the main structural features of a reformed individual income tax. More realistic reform proposals would examine the effects of choosing different rate structures and credit levels and compare these results to the distribution of tax burdens under the current income tax system.

4) Adoption of a Totally Different Approach to Taxing Small Business

There are two major problems with the current method of taxing small business in Pakistan. Small business taxation also encounters a “notch” problem, one that is particularly vicious. In addition, the tax treatment of small business causes a serious rupture in the network of withholding taxes. Both matters are elaborated upon below.

Small businesses in Pakistan, those having a turnover smaller than 250 million Rs and employing no more than 250 workers, are subject to a lower rate of 20 per cent on their taxable income. At higher volumes of turnover the corporate rate of 35 per cent applies to the total amount of taxable income generated by a higher amount of turnover. Whatever profit was earned on the turnover below the turnover threshold would face a jump in tax rates of fifteen percentage points and the additional profits earned on turnover above the threshold would be effectively taxed at more than confiscatory rates. No small business would rationally choose to grow its turnover and face the dire tax consequences of crossing the turnover threshold.

This penalty on small business growth could be removed by adopting measures along the lines of the reform proposal for the personal income tax. To avoid this severe “notch” problem Pakistan could tax discrete slabs of business income at different rates and the simplest reform would charge tax at 35 per cent only on profits generated by
growth in turnover above the small business threshold. Firms operating above the threshold would be allowed to pro-rate their taxable income by the ratio of threshold turnover to total turnover and pay tax at the lower rate of 20 per cent on the amount of pro-rated income.

While this proposal would correct the “notch” problem it is inadequate in the sense that it offers the benefit of the small business tax to larger businesses. The purpose behind the preferential tax treatment of small business is to use the tax system to compensate for credit market imperfections by enhancing the retained earnings of small business as a source of finance. But it makes no sense to also extend this benefit to larger businesses that have access to alternative sources of finance.

There are a number of options Pakistan could turn to in order to address the “notch” issue and simultaneously target the small business preference to benefit only small businesses. Two are discussed here. In the US, where the normal corporate rate is 35 per cent, the first $50,000 of taxable income is taxed at 15 per cent, the next two $25,000 amounts at 25 per cent and 34 per cent respectively. These stacking rules apply to both large and small business but in the case of large businesses these benefits are clawed back through higher rates imposed on additional slabs of taxable income. Larger businesses are taxed at a higher rate of 39 per cent on additional taxable income between $100,000 and $335,000 to eliminate the benefits of the lower 15 and 25 per cent rates.58

Canada utilizes a different approach for what is labeled as the “small business deduction”. This tax preference for small business is limited to Canadian controlled

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58 A similar type of claw-back system is employed in the United Kingdom. There the first 300,000 pounds of taxable income are taxed at a rate of 20 per cent. For taxable incomes between 300,001 and 1,500,000 pounds the rate jumps to 32.5 per cent so the average tax rate increases gradually from 20 per cent to the regular rate of 30 per cent.
private corporations and is therefore unavailable to large public corporations. The preference is given in the form of a 16 per cent tax credit applied to the lesser of active business income, taxable income and the small business limit of $300,000. Larger private corporations with paid up capital in excess of $10 million are also ineligible to claim this “deduction”.

Tax authorities in Pakistan might also want to reconsider the criteria of what constitutes a small business. The current turnover threshold of US$4.3 million is expansive by international standards. Direct comparisons are difficult to make because other countries typically define small business in terms of taxable income. To establish some orders of magnitude, if taxable profits are assumed to be 20 per cent of turnover, the comparable threshold in the US would be $.5 million and in Canada $1.5 million.

The other aspect of small business taxation that requires some attention in Pakistan is the exemption of small business from the list of withholding agents. Apparently this step was taken as part of a misguided effort to create a more level tax playing field and encourage the corporatization of large businesses operated by individuals and partnerships that are currently outside the grasp of all regulatory agencies. The argument was that since individuals and partnerships are not required to withhold any tax on their business purchases, this exemption privilege should extended to small business as well in order to enhance the benefits of adopting a corporate business form. However, the logical conclusion of this argument is a race to the bottom and no withholding anywhere.

This exemption potentially threatens the integrity of the withholding system and the current regime of presumptive taxation. Both large and small businesses that would
be subject to withholding on their sale of output to other large businesses can escape the withholding web by structuring their sales to small businesses. Although little is known about the extent to which this tax avoidance practice may be occurring in Pakistan, it seems unlikely that tax planners in Pakistan are unaware of this loophole and have not acted on it. This is all the more likely to be true given the generous definition of a small business noted above.

If the policy goal is to entice small business out of the informal economy and document its activities by inducing it to act as a corporation, there are better instruments for achieving this objective than a withholding exemption. Pakistan might consider, for example, establishing a new lending institution along the lines of the Small Business Administration (SBA) in the United States that would cater to the borrowing needs of small business and make loan eligibility conditional upon providing the same types of documentation that a corporation would be expected to provide.\textsuperscript{59} A specialized lending facility such as this addresses directly the credit market imperfections that are used to justify special tax breaks for small business.

5) Elaboration of a New Sales Tax Act

The 1990 Sales Tax Act currently in existence has by and large been superseded by a wave of annual regulations and ordinances issued by the FRB with the result that the current sales tax is whatever the FRB says it is and what was said yesterday may, or may not, be in force today. Countries with well performing sales taxes invariably have a strong legal foundation for these taxes that constrain the ability of tax administrators to alter the basic principles and concepts of sales taxation. This is not the case in Pakistan.

\textsuperscript{59} In the US some world class firms, such as FEDEX, started out with an SBA loan.
where the FRB has taken on the role of both policy maker and tax administrator. To note this outcome is not to necessarily criticize the decisions undertaken by the FRB but rather to emphasize that these decisions should be made with reference to solid legislation that shapes and defines the character of sales taxation.

Pakistan’s tax authorities would do well to study, and, in many respects, emulate the sales tax legislation found in other countries, such as New Zealand and Australia, that are generally recognized as having well designed VAT laws. Of course, what works well in these countries may not work as well in Pakistan and these laws would need to be adapted in some respects to suit Pakistan’s current economic circumstances.

6) Fine Tuning of the Federal Excise Tax Act

For the most part the Excise Tax Act sets out a sensible approach to selective commodity taxation. With one exception, noted below, this legislative framework serves well the conventional excise tax goals of raising revenue, discouraging undesirable types of consumption, pricing some public services such as roads, and improving the overall progressiveness of taxation. The list of excisable products, consisting of vegetable oils, carbonated beverages, tobacco products, petroleum derivatives and natural gas and some toiletries, is a standard one found in most other countries. Moreover, the decision to extend the reach of excises to include a number of services and give them VAT type treatment also seems appropriate given the sales tax restriction that applies to services. However, the rate structure and some of the exemptions that have been granted do raise some concerns. The current pattern of excise tax rates is a somewhat confusing array of in rem, or specific, rates and ad valorem, or price related, ones. While both methods of
determining tax rates have their strengths and weaknesses, it is generally conceded that in rem rates are much easier to administer and Pakistan might consider moving to a general system of in rem rates. However, if that step were taken, it would also be desirable to index these rates and adjust them for the rate of inflation in order to forestall any inflationary erosion of real revenues that might occur with the changeover to in rem rates.

Inflation is not yet a serious economic problem in Pakistan but it is getting there. If current rates of inflation persist for several more years, it will also be desirable to index other nominal magnitudes in the income tax system, in particular the size of the income tax brackets in order to prevent “bracket creep” from occurring.

It could also be asked whether too many fine distinctions exist in the treatment of petroleum products and their derivatives. At the moment twenty different products are singled out for different tax treatment and more uniform treatment, which could be achieved by developing broader tax categories, may be desirable for both revenue and tax administration reasons. At the same time, however, it does not appear that the choice of the petroleum rate structure has been motivated by any consideration of so-called “green” tax principles. In fact, green taxes are missing entirely from the roster of excise taxes in Pakistan.

Green taxes are taxes on “bads” and represent the only “good” taxes that have ever been invented by mankind. The “bads” in this case are environmental externalities representing unwanted by-products and wastes from production processes that reflect differences between the social and private costs of producing goods and services. These

60 Many countries, for example, impose higher excise taxes on leaded than on unleaded gasoline for environmental reasons.
differences arise because private producers have no cost incentives to take into account the environmental degradation, for example lower air and water quality, that may be associated with their production activities. Green taxes are designed to make producers aware of the social costs they impose on the economy and to impart incentives to generate lower levels of pollution. Taxes on water and air effluents are intended to make it privately profitable to generate less pollution and have two benign effects on the economy: they improve air, water and ground quality and, at the same time, generate revenue that can be used to reduce the revenues collected from other taxes that typically impair economic efficiency. In other words, green taxes are virtuous twice over and yield a so-called “double dividend”.

European countries have frequently been in the vanguard of effectively applying green taxes. Sweden is a case in point. Its Environmental Protection Agency began phasing-in environmental taxes in 1984 and these revenues currently account for about six per cent of the country’s total tax revenue. Over the period 1989-1995 Sweden’s pollution charges on emissions of sulfur dioxide have reduced the amount of acid rain by thirty per cent and stimulated power generation companies to install abatement equipment and switch to fuel oils with a lower sulfur content. Not all of the revenues have swollen government coffers as a portion of them has been used to provide subsidies to green investments. Sweden is a useful green tax laboratory as it may offer the best case studies of how green taxes can work in practice.

Despite their advantages, green taxes may prove to be difficult to implement in practice. Because information about the cost and ease of abating pollution is not easy to

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61 In neighboring Norway green taxes represent slightly more than four per cent of total revenue but still are equivalent to 1.6 per cent of GDP compared to .8 per cent of GDP for all of Pakistan’s excise taxes.
obtain, it is difficult to predict how much pollution will be reduced at any given green
tax rate. It is for this reason, among others, that policy makers in many countries prefer
environmental regulation as an alternative to green taxation. Regulation, however, is a
particularly blunt instrument to control pollution and usually has high efficiency costs.
The EU, and to some extent the US, have been experimenting with “cap and trade”
systems of regulation that promise to reduce the efficiency costs of regulation. Under
these systems the environmental regulator sets a limit to the total amount of emissions
but allows polluting firms to buy and sell pollution permits that in the aggregate are
limited to the amount of allowable pollution. Active trading of these permits establishes
an effluent fee for pollution and a firm will sell its permit to another firm if its abatement
costs are less than the amount of the effluent fee.

Environmental levies should not be confused with carbon and other energy related
taxes intended to address larger issues such as global climate change and long term
environmental sustainability. Instead their target is much narrower and, in the case of
Pakistan, would involve, for example, imposing higher excise taxes on leaded gasoline
products and lighter taxes on cleaner diesel fuels in the interests of securing a cleaner,
and presumably safer, local environment.

The last issue arising from the review of excise taxes is the questionable nature of
some of the exemptions that have been granted. Exemptions of particular purchases for
particular uses, such as those for carbon black and hydraulic cement, are frequently open
invitations for tax abuse and evasion. Exemptions of this kind should be removed from
the Federal Excise Act.
7) Adoption of a More Uniform, if not Uniform, Tariff Schedule

Strong economic arguments can be made for Pakistan to consider altering its tariff schedule in the direction of more uniform rates and possibly even a single uniform rate. With the current escalated tariff structure effective rates of tariff protection are much higher for final goods than the nominal tariff rates indicate. Effective protection rates measure the extent to which the tariff structure permits value-added in import substitution activities to diverge from value-added that is recorded at world market prices. Assume, for example, that an import substituting final goods producer relies on imported intermediate inputs worth one-half of gross output value. Domestic value-added measured at world prices is therefore also one-half of gross output value. If the tariff applied to final goods is 25 per cent and that payable on imported inputs is only 5 per cent, domestic value-added measured in domestic prices can increase to .725 per unit of output. The effective rate of protection in this case is 45 per cent \((.725/.5)-1\).

A uniform tariff applied to all imports would remove differences in effective protection rates within the import substituting sector and provide broad based protection to the entire manufacturing sector. Infant industry protection would be replaced by infant economy protection providing equal treatment for all activities engaged in import substitution. If a uniform tariff rate of ten per cent were in place, the effective rate of protection in all parts of the manufacturing sector would also be ten per cent.

A further advantage of a uniform tariff is that it reduces the pressure of special interests who would otherwise lobby for preferential tariff treatment. This reduction in rent seeking opportunities would not only save resources directly due to the lower reward
for lobbying activity but would also be expected to result in less public sector corruption both in the customs office and elsewhere. Misclassification of imports at the border entry would no longer be an issue and customs clearance procedures would be simplified and less costly due to the need for fewer inspections.

What might a reasonable uniform tariff for Pakistan look like? Presumably it should be revenue neutral as it would be difficult to make up any lost tariff revenue from other revenue sources. The current batch of tariffs generate revenues in the amount of 1.5 per cent of GDP. If, as mentioned earlier, imports as a fraction of GDP are 17 per cent and a rough adjustment of one percentage point is made for the duty free imports of international agencies and the like, a revenue neutral uniform tariff would be 9.4 per cent (1.5/.16). This rate could be rounded up to ten per cent without causing any real economic harm.62

8) Should Capital Gains be Subjected to Taxation?

The taxation of capital gains raises difficult conceptual and administrative issues in any country. In principle, real capital gains should be taxable under an income tax as they accrue. Unfortunately, no country in the world has figured out how to do this in an administratively elegant and completely sensible fashion. Instead, capital gains are taxed, if they are taxed at all, on the basis of when they are realized and often at preferential rates to compensate for the bunching that occurs when gains accrued over several years are realized in a single year and for the possibility that gains reaped in the stock market may have been previously exposed to corporate level taxation.

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62 Chile, for example, has operated with a uniform tariff of 11 per cent for several years.
Debate over taxing stock market related capital gains taxation inevitably brings out the thorny issue of the double taxation of capital income earned by corporations. If dividends and capital gains are taxable at the individual investor level, corporate earnings would be subject first to the corporate income tax and again upon the distribution of after-tax income to corporate shareholders in the form of either dividends or capital gains. A corporation’s decision to retain its after-tax income will ordinarily produce a higher stock market valuation, or capital gain, in the amount of the retention.63 An alternative method of distributing a capital gain is through corporate stock repurchases of shares.

To avoid double taxation a capital gain arising from corporate retentions should not be subject to individual tax and neither should dividends be taxable to individuals. Primarily for reasons of vertical equity, however, due to the typical concentration of stock ownership at higher income levels, many, if not most, countries impose a tax on dividend distributions and, in that case, some tax on capital gains is warranted in order to avoid distorting corporate distribution polices in the direction of a greater amount of retentions. This line of reasoning suggests, that since Pakistan imposes a modest rate of tax on dividends, it might also want to consider imposing a similarly modest tax on long term stock market related capital gains i.e., those that have been more than a year in the making.

If all of Pakistan’s neighboring countries in the region imposed significant taxes on stock market related capital gains, it would be attractive for Pakistan to consider doing

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63 This is the position taken by the so-called “old” view of dividend taxation in the tax literature. A “newer” view challenges this position and argues that as long as dividends are taxed at higher rates than capital gains, a dollar of retained earnings will result in a higher stock market valuation of less than a dollar. This new view also has the striking implication that, if marginal investments are financed from retained earnings and dividend taxes are expected to remain unchanged, dividend taxes have no effect on investment decisions but capital gains taxes do. According to the older view both dividend and capital gains taxes act as an investment deterrent by raising the pre-tax rate of return required by investors.
the same. But in fact the converse is true. As shown in Table 4 none of Pakistan’s neighbors expose long term stock market related capital gains to positive levels of taxation and in a world of mobile capital resources this state of affairs makes it problematic for Pakistan to contemplate breaking this mould.

<table>
<thead>
<tr>
<th>Country</th>
<th>Tax Rate on Long Term Gains</th>
<th>Short Term Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sri Lanka</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>India</td>
<td>zero</td>
<td>10%</td>
</tr>
<tr>
<td>Indonesiaa</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>Malaysia</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>Philippinesb</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>Thailand</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>Vietnam</td>
<td>zero</td>
<td>zero</td>
</tr>
<tr>
<td>Turkey</td>
<td>zero</td>
<td>Taxed as normal income</td>
</tr>
</tbody>
</table>

**Table 4: The Treatment of Capital Gains in Indo-Asian Countries**

Notes:

a. Indonesia imposes a final withholding tax of .1% on the sale of stock market shares and .5% on the sale of new shares, whether sold or not. India also has a similar securities transaction tax.

b. Philippines taxes only the capital gains of non-resident aliens at rates of .5% for listed shares and 5-10% on unlisted shares.

Two questions require solid answers before the consequences of taxing stock market capital gains in Pakistan can be properly understood. One question is how a new capital gains tax would affect where these gains would be realized. Introducing a capital gains tax in Pakistan would create an incentive for listed companies in Pakistan to register their shares on neighboring stock exchanges and take their capital gains on these alternative stock exchanges where they would not be taxed. How easy would it be for companies currently listed on the Pakistan exchanges to make this shift in trading location? Secondly, if such shifts were not easy to make, a new capital gains tax would increase the cost of capital in Pakistan since capital gains form an important part of the
investment return earned by investors. A higher cost of capital would deter real investment in Pakistan but what would be the expected size of this negative impact?

Since there are no good answers to these questions at the moment and little is known about the strength of these taxes induced reactions, Pakistan, in light of the existing international investment environment, should tread extremely cautiously in the area of taxing long term stock market capital gains. As for short term capital gains, those derived over the course of a single year, there is probably little harm, and probably not much revenue potential, in taxing them as is currently done in India and Turkey.

The other aspect of capital gains taxation concerns the prospects for taxing the gains on immovable real property. Because, at least in the short run, real property is immobile, the prospects for taxing these capital gains may be more promising. Some, but not all, countries in the region currently assess capital gains tax against the sale of land and/or buildings typically with an exemption in the case of a primary or principal personal residence. Indonesia taxes real estate related capital gains as part of the normal taxable income of both individuals and companies. Malaysia levies a separate capital gains tax on the disposal of real property at sliding rates depending on the length of holding (30 per cent for assets held less than two years and zero per cent for assets held longer than five years). The Philippines imposes a six per cent withholding tax on the higher of the gross sales price of a property or its estimated fair market value. The experience of these and other countries should be carefully studied to determine the best approach to taxing this income source in Pakistan.
APPENDIX

APPENDIX A: Sales Tax Exemptions

According to the Sixth Schedule of the Sales Tax Act the following commodities are exempt from sales tax:

- live animals including poultry, bovine meat, sheep and goats;
- fish, excluding live fish;
- eggs;
- live plants;
- pulses, excluding those that are bottled, canned or processed;
- red chiles, tumeric and ginger unless sold in retailing packing bearing brand names;
- seeds, fruits and spores used for sowing;
- cinchone bark;
- sugar beet and sugar cane;
- edible oils on which excise duty is levied and collected from a registered manufacturer;
- fruit juices unless canned, bottled or packaged;
- milk preparations whether or not packed for retail sale;
- ice and water unless bearing brand names;
- poultry and cattle feed;
- table sale unless retailed under a brand name;
- ultrasound gel;
- adult diapers;
• Quran;
• newspapers, journals, magazines etc. excluding directories;
• currency notes, stocks and bonds;
• bricks;
• gold or silver in unworked condition;
• incinerators;
• computer software;
• ambulances, fire trucks and maintenance vehicles;
• ships larger than 15 tons unless pleasure craft;
• imported goods of international agencies;
• dextrose and saline infusion;
• imports of household effects by rulers of Gulf Sheikdoms;
• goods imported by public hospitals and non-profit organizations;
• dialysis and angioplasty equipment and supplies;
• goods produced in Pakistan, exported and then re-imported within on year;
• national defense equipment and supplies;
• spare parts and equipment for aircraft, air navigation and marine pilotage;
• plant and machinery listed in the official Gazette;
• tractors, bulldozers and harvesters;
• CNG Euro-2 buses;
• supplies consumed in-house for manufacture of goods subject to sales tax;
• all breads and canteen as well as in-flight foodstuffs;
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