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6th Youth Parliament Pakistan

A Report on

Tax Reforms in Pakistan

March 2015

PILDAT
Pakistan Institute of Legislative Development And Transparency
Secretariat Youth Parliament Pakistan

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PREFACE

After the successful completion of 5 terms since 2007, the 6th Youth Parliament Pakistan was launched in June 2014. The specific objectives of the Youth Parliament Pakistan (YPP) programme are to inculcate democratic culture and spirit of tolerance for others views among the youth; to expose them to the political and parliamentary processes; to facilitate youth to express their views on various national, international, regional and local issues thereby helping the government and society at large to better understand the concerns of the youth; to groom the leadership potential of the youth of Pakistan by exposing them to peaceful and democratic resolution of differences especially at a time when various parts of Pakistan are suffering from conflict and extremism. Finally this provides a forum to the youth of Pakistan to understand how the Parliament works as the supreme public representative institution in a democracy.

The YPP has its own 2-party system, Leader of the House and Opposition, as well as an augmented system of Parliamentary Committees with Committee Chairpersons, Vice Chairpersons and Secretaries.

The Youth Parliament Standing Committees of the 6th Youth Parliament Pakistan (2014), as a part of the learning process, have been tasked with conducting reviews of national policies through research based analysis and with developing cogent policy alternatives for the Parliament and the Government of Pakistan. The six Youth Parliament Standing Committees for the current term are:

- Youth Parliament Standing Committee on National Security
- Youth Parliament Standing Committee on Foreign Affairs
- Youth Parliament Standing Committee on Energy
- Youth Parliament Standing Committee on Law, Justice & Human Rights
- Youth Parliament Standing Committee on Education & Youth Affairs
- Youth Parliament Standing Committee on Finance, Economic Affairs & Planning

The Committees have gone through a process of intensive research, consultations with policy experts and internal review within Committees before putting together their proposals. The initial findings were shared with the Secretariat Youth Parliament Pakistan and the Steering Committee Youth Parliament Pakistan who gave their comments on these drafts. After incorporating these inputs, the reports are finalized by individual Committees and thereafter presented on the floor of the House for further recommendations and feedback from the entire strength of the YPP. Going through this rigour the participants not only experienced the process of drafting policy in a democratic fashion but also formulated useful recommendation in the form of this report,

The reports are compiled and finally published for the purpose of dissemination through media briefing and report launch event at the closure of third YPP Session of the 6th YPP term. More importantly all the reports will be presented by the Members of YPP to the corresponding Standing Committees of the National Assembly and Senate, in the effort to incorporate the voice of the youth in the national policy making process. The authors of the reports, the MYPs, are to take the lead in lobbying for the recommendations they have devised, to civil society, media and to a greater audience. The reports are also available online at www.youthparliament.pk.

The 6th Youth Parliament Pakistan (2014-2015) is supported by the Danish International Development Agency, Government of Denmark, as recognition of the importance of young people's development in democracy and democratic practices.

Disclaimer

The Secretariat of Youth Parliament Pakistan has provided unbiased feedback in a timely manner on the research reports and the scientific value of the work done by MYP's. The Secretariat has given guidance in ensuring the content is clear, concise, and relevant to the current pool of knowledge in regard to originality, and interest to the readers. The opinions, findings or recommendations expressed in this report belong to the authors and do not reflect the views of PILDAT or DANIDA.

Secretariat of the Youth Parliament Pakistan
Pakistan institute of Legislative Development and Transparency
March 2015

Executive Summary

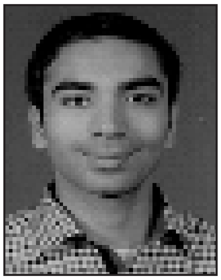
Pakistan has one of the lowest tax-to-GDP ratios in Asia and the country faces serious budget deficits despite levying high indirect taxes which are regressive in nature and impose higher burden on the low income groups disproportionately. This report explores various problems and their reasons pertaining to tax at federal level in Pakistan and it offers recommendations for their solution.

In the existing situation, several problems are identified in the report that result in low tax collection including SROs, inefficient direct taxes, administrative issues of FBR, low tax incentives for taxpayers, trust deficit in tax collectors, and others.

This report recommends increasing incentives for taxpayers and imposing strict penalties for tax evasion. Top management of FBR should include honest and competent professionals with regular training programs. Devolution of tax collection and its monitoring by multiple bodies to ensure honesty and professionalism is also recommended to make the system more efficient. The relations between tax officials and taxpayers also need to be improved significantly. Tax payment should be convenient and simple, for this online payment of tax is recommended alongside promoting use of eTax. Tax payment certificates to be issued to taxpayers to avail benefits of tax payment as well as evidence of tax payment. Tax should be made fairer, value added tax should be promoted and GST should be lowered instead sales tax should be increased on luxury items, proportion of indirect taxes should be lowered, service sector's contribution in tax is disproportionately low and should be increased, corporate taxes should be lowered, tax base should be increased and tax slab limits should increase and be tied to CPI. Gross annual rental values should be revised. SROs should be reduced and their issuance should involve rigorous scrutiny process. Special tax evasion courts should be established to facilitate legal problems between tax department and tax payers. Cheque guarantee system by banks should be promoted for proper documentation of the economy as well as fixed tax liability to be imposed on non-taxpayers which should be proportionately high rate of tax, for small scale firms a low but fixed tax should be imposed where tax accounting difficulties persist. Information sharing between government departments should be encouraged for efficient identification and collection of taxes. Awareness of tax payment, calculation and payment process as well as transparency measures is imperative, details of receipts and expenditures of taxes should be made public to reduce the trust deficit.

This research was conducted using both primary data in the form of interviews with relevant officials and secondary research in the form of research articles and government publications. The topic was divided into subtopics and a group of 2-3 members was given a subtopic each. Their findings were presented to the committee and then compiled. The committee is thankful to Mr. M. Ali Kemal, a research economist at PIDE , Mrs. Ayesha Noor, Secretary HR, FBR Headquarters and Mr. Rashid Mehmood, Assistant Manager Corporate Compliance & Reporting, Ernest & Young Pakistan.

Members of Youth Parliament Standing Committee on Finance and Economic Affairs and Planning



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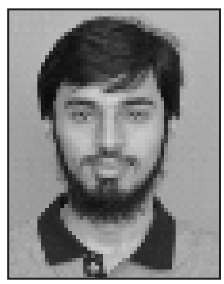

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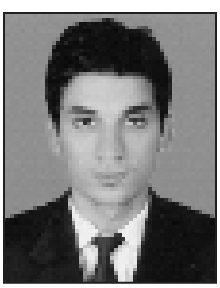

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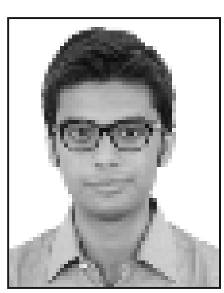


Muhammad Furqan Khan
Youth Minister for Finance, Economic Affairs and Planning
(YP55-SINDH08)

Tax in Pakistan

Federal taxes are imposed in Pakistan through the 4th Schedule of the Federal Legislative List of the Constitution of Pakistan. Major federal taxes include Income tax, Sales tax, Custom duties and Excise duties.

Direct Taxes:

a. Income Tax: It is levied under the "Income tax Ordinance 2001".

Indirect Taxes:

a. Sales Tax: It is levied under the "Sales Tax Act 1990"
b. Custom Duties: It is levied under the Customs Act 1969"
c. Excise Duties: It is levied under the "Federal Excise Act 2005"

In the article Tax Reforms in Pakistan (1990-2010) the author discusses the importance of tax and suggests that tax is the major source of revenue for any country. They also point out the main problems in the taxation system of Pakistan majorly being a narrow tax base for the low tax to gdp ratio. For a developing country like Pakistan to successfully meet its recurring obligations and invest in development, it should ideally have a tax to GDP ratio of around 20% . The slow growth in collection of taxes in Pakistan in consecutive governments suggest extensive tax reforms to be under taken in tax policy and tax administration .

43. Duties of customs, including export duties.
44. Duties of excise, including duties on salt, but not including duties on alcoholic liquors, opium and other narcotics.
[4][45.] Omitted
[4][46.] Omitted
47. Taxes on income other than agricultural income.
48. Taxes on corporations.
[5][49. Taxes on the sales and purchases of goods imported exported, produced, manufactured or consumed 6[, except sales tax on services].]
50. Taxes on the capital value of the assets, not including taxes 7[****] on immovable property.
51. Taxes on mineral oil, natural gas and minerals for use in generation of nuclear energy.
52. Taxes and duties on the production capacity of any plant, machinery, undertaking, establishment or installation in lieu of the taxes and duties specified in entries 44, 47, 48 and 49 or in lieu of any one or more of them.

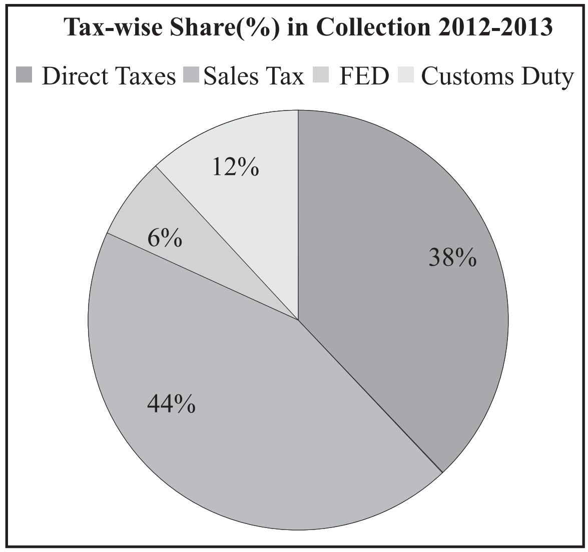
(Source: http://pakistanconstitutionlaw.com/4thschedule-legislative-lists/)

The Government of in the final report of National Taxation Reform Commission suggests tax aversion as one of the major source of leakage in system due to vague policy and weak implementation. In Pakistan we are heavily reliant on in-direct taxes like General Sales Tax (GST) which is easy to manipulate and should be reformed to a Value Added Tax (VAT) which has been successful in similar developing countries .

(SDPI 2013) Sustainable Development Policy Institute reported very few Pakistanis pay income taxes. Out of a total work force of 58 million less than 2 million are registered taxpayers and last year only 0.7 million people actually paid income tax. When the Government finds it difficult to collect direct taxes like income tax than it resorts to rely on the easy way out of in-direct taxes.

(Waseem 2013) discusses reduction in corporate tax rate to encourage partnership businesses to move towards limited companies which is generally avoided by small to medium scale businesses to as they require detailed financial audits, compliance and Security Exchange Commission regulations.

Tax is the major source of income for any country to funds its development. While direct taxes are progressive; in-direct taxes are regressive as applied uniformly. It is clearly visible from the data above that we have a heavy reliance on in-direct taxes whereas the case should be vice versa.



Consecutive governments have failed to increase tax to GDP ratio and effectively develop measuring mechanism to gauge Income Tax. For the fiscal year 2012-2013 FBR was not able to meet its target and achieved only 3 percent increase in their tax collection. The single largest contributor of direct taxation in Pakistan is Income tax. Unfortunately, it has been difficult to tap the full potential of this tax due to leakages in our tax system and lack of FBR's ability to match a person's income with his tax receipts.

Of the three major in-direct taxes applied by the Federation, the largest contributor is Sales Tax. We would have to move towards a value added tax (VAT) or Reformed General Sales Tax (RGST). VAT will ensure that the tax is applied at input and output rather than just taxing the output in the case of General Sales Tax. This way it will be easier to gradually tax the value addition rather than applying a uniform tax at the output and final stage. It should be applied to both local and imported products.

The corporate income tax rate is 35% for Pakistan which is on a higher side when compared to other emerging economies of the world especially SAARC countries. It is proposed to revise the rate of 35% to 25%. The reduction in tax rate will encourage corporatization, a concept Pakistan is far behind its

Comparison of Net Revenue Collection (Rs. Billions)

Revenue Heads	FY: 2012-13	FY: 2011-12	Growth (%)
Direct Taxes	739.7	738.4	0.2
Sales Taxes	841.3	804.9	4.5
FED	119.4	122.5	-2.5
Customs	239	216.9	10.2
Total Taxes	1939.4	1882.7	3

(Source: FBR Year Book 2012-2013)

Rationalization of Tax Rates:
List of Countries by Tax Rate

	Corporate Tax	Individual Tax	Individual Tax	Payroll Tax
Afghanistan	20%	-	-	
Bangladesh	45% - 0%	0%	25%	
Bhutan	30%	0%	25%	
India	30%	0%	33%	12.5% - 2%
Maldives	15% - 0%	-	-	
Nepal	5%	10%	25%	
Pakistan	35%	7.5%	35%	

(Source: http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx) neighboring India and will motivate business to expand.

Proposed Tax Reforms:

- Focus on progressive taxation instead of regressive taxation.
- Focus on direct taxation rather than in-direct taxes.
- It is suggested to develop bench marks for different sizes of small sized business and introduce a fixed tax. It is difficult to assess small business where many times informal book keeping is being done. So having a fixed tax liability will not only raise tax collection but will also encourage small businesses to promote as credible tax payers.
- Majority of direct tax is collected from the industry where as service and agriculture sector do not contribute as per their share in the GDP. As agriculture income tax is a provincial subject after the 18th amendment in the constitution of Pakistan. The federation should consider a stronger focus on matching the tax collection from the service sector as per its contribution in the GDP. The Telecom companies are the only major contributor of tax in service sector.
- Tax payers need to be encouraged by schemes where the tax payer is benefited and appreciated for his due contribution. Unfortunately the tax payer already in the tax net is neither appreciated but rather feels harassed due to the behavior of tax collection agency.
- Stronger penalties need to set for tax evaders to discourage them from this practice.
- The most comprehensive database in the country is operated by NADRA. Hence, it is proposed to make CNIC number into tax number for individuals and centralizes different available databases for example data of Capital Development Authority (CDA) and Motor Registration Department so FBR could track non-filing high income individuals.
- The law of the land dictates that it is mandatory for every person owning a vehicle above 1000cc to file a tax return. Enforcement of this needs to more rigorous.
- Mr. M. Ali Kemal, a research economist at PIDE wrote in his article “Monetizing Perks” published in (The News, 2014) that we do not need more taxes but need to increase our tax base/net.
- During research Mr. Rashid Mehmood, Assistant Manager Corporate Compliance & Reporting, Ernest & Young Pakistan recommended the following points for this report:
  - Income Tax Ordinance is ambiguous. The ordinance needs to be revised to ensure effective compliance implementation.
  - Filing an income tax return is very complex for a layman. The filing needs to be simplified and welcoming.
  - It is generally difficult to collect tax on voluntary basis. Hence it is suggested to ensure tax filing for every professional.
  - Bridge trust gap between the Tax collector and Tax payer.

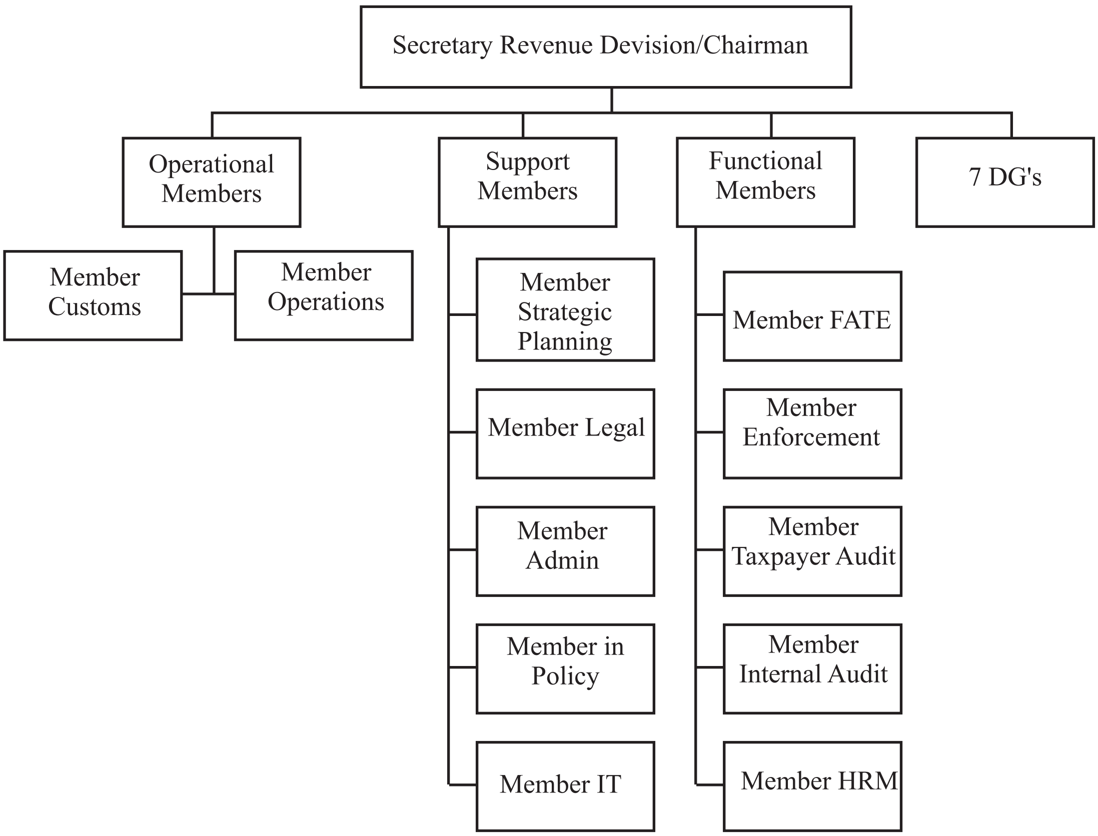
Mr. Mehmood was of the opinion that FBR has very limited data hence the narrow tax net. More sources of data need to be introduced for effective tracking of every taxable individual.

Structure of FBR

Federal Board of Revenue (FBR) is the federal agency for tax policy, auditing and collection for Pakistan. Taxes that fall under FBR are sales taxes expect sales tax on services, income taxes excluding tax on agriculture income, excise duties and custom duties primarily. The Secretary of Revenue Division is Chairman of FBR. His responsibilities are formulation and administration of fiscal policies, levy and collection of federal taxes, quasi-judicial function of hearing of appeals relating to taxes and coordination with President, Prime Minister and relevant Ministers. Under the chairman come three types of members, operational, support and functional as well as the seven director generals as shown in the figure below.

The operational members are department heads who are directly responsible for tax collection. They are divided into Customs and Inland Revenue members. Inland Revenue members are responsible for all other taxes except Customs, and therefore include sales tax, income tax and excise duty. Inland Revenue is further divided into North and South regions. Then there are functional members who are responsible for Inland Revenue policies, Information Technology, administration, legal issues and strategic planning. The support members fall under Facilitation and Taxpayer Education, enforcement, taxpayer audit, internal audit and Human Resource Management. The seven director generals include intelligence and investigation for Inland Revenue, intelligence and investigation for Customs, internal audit, post clearance audit, withholding taxes, training and research for Customs and training and research for Inland Revenue. Operational members, functional members, support members and the seven director generals, all separately report to Chairman FBR. There are three Large Taxpayer Units for Inland Revenue collection namely Karachi, Lahore and Islamabad and a chief commissioner is the head of each LTU. The role of the chief commissioner include administration, collection

FBR Organizational Chat



(Source: http://www.fbr.gov.pk/ShowArticle.aspx?actionID=59)

of revenue, taxpayer facilitation, legal issues as well as any other assignment by Chairman FBR. The chief commissioner of each LTU is aided by commissioners, additional commissioners, deputy commissioners and assistant commissioners also known as tax officers. In Customs there are chief collectors of North and South divisions, the chief collectors supervising the many Model Customs Collectorates.

Recently, eTax has been introduced by FBR on its website where records of income are filed and the website calculates the tax due objectively given the income declarations with the end of making tax payment convenient for taxpayers. However, online collection of taxes is not available and tax payments have to be made in National Bank of Pakistan by means of conventional methods of payments which are time consuming and inconvenient.

Tax Evasion

Tax evasion is the failure of individuals or entities to comply with their tax obligations deliberately. It is a phenomenon that has become of crucial importance in Pakistan. According to a 2008 study of State Bank of Pakistan curbing tax evasion in Pakistan would lead to the generation of revenue equivalent to 2.5% of GDP.

Reasons for Tax Evasion

Before trying to recommend how to curb tax evasion it is necessary to find out why tax evasion takes place. Mughal and Akram (2012) conducted a study in 92 cities of Pakistan and found that all ten of his hypothesized reasons for tax evasion were significant. These include absence of tax morality, high tax rates, poverty, proliferation of taxes, illiteracy of tax calculation, lack of adequate enforcement for default, lack of adequate tax incentives, non-existence of equitable & efficient tax system, no public enlightenment campaign, and poor relationship between taxpayer and tax authority.

He further ranked them in descending order of importance which is shown in the table below Table 1.

The most common reason is poor relationship between taxpayers and authority, followed by lack of adequate tax incentives, then proliferation of taxes, then illiteracy of tax collection and then comes no public

Table 1: Top Five Reasons of Tax Avoidance and Evasion

Sr.	Particulars	Factor Loadings	Rank	Mean (M)	Rank	Standard Deviation
1	No public enlightenment campaign	0.508	1	3.68	5	1.09
2	Lack of adequate tax incentives	0.493	2	3.80	2	1.06
3	Poor Relationship of Tax Payer and Authority	0.464	3	3.91	1	1.08
4	Proliferation of taxes	0.456	4	3.78	3	1.08
5	Illiteracy of tax calculation	0.395	5	3.77	4	0.99

enlightenment campaign. However, if factor loadings are taken into account which is a better measure as it is adjusted with the weighted effect of the reason, the ranking is from no public enlightenment campaign, lack of adequate tax incentives, poor relationship between tax payers and authority, proliferation of taxes and lastly illiteracy of tax calculation.

Recommendations

- Lower corporate tax rates so that they match rates of other developing countries, increase tax revenue from increasing tax base instead of increasing tax rates.
- In the case of income tax, tax base should be widened and tax slab should be increased and made adjustable to CPI annually according to an agreed upon formula.
- Fixed taxes such as turnover tax should be levied in the situation when proper documentation of income is not made available by any company, this rate should be higher than the tax rate to be charged otherwise.
- There should be incentives for paying taxes such as priority in public services, in government contracts, etc.
- Details of tax receipts and expenditure should be made available and debated upon for transparency purposes.
- High income services such as credit cards, travel agents, consultancies, etc. should be levied higher taxes to reduce general sales tax to make tax more progressive.
- Tax base could be increased by information sharing between different government departments such as electricity connections for commercial or industrial units should be matched with filing of tax returns.
- Tax should be based on value addition, on input as well as output so that the tax rate at output position is reduced and it becomes more progressive.
- Revise gross annual rental values of properties, very often these values are extremely outdated.
- Tax should be imposed on assets at 1% of total asset value exceed a certain level of asset range.
- To avoid tax collector corruptions tax payment certificates be issued to taxpayers by an independent audit body.
- Special courts for tax evasion should be established that deliver verdict within a year's time after filing of the case.
- Awareness of tax payment importance, its payment procedure and its transparency mechanisms should be made widespread.
- It should be ensured that the top management team of FBR should comprise of both honest as well as competent members.
- Online transfer of taxes from all banks should be permitted to ease the payment of taxes.
- Bank cheque guarantee system should be introduced as in many developed countries, banks issue customers cheque books in accordance with their transactions and any cheque issued from that account should be guaranteed by banks so the documenting of the economy becomes easy and switching from cash transactions to bank based transactions becomes easier, with the effect of promoting documentation in the economy, cash transactions should be penalized.
- Devolution of tax collection and expenditure powers to municipal governments, with fixed proportions for provincial and federal levels would promote transparency as well as ease in spotting of tax evaders.
- Monitoring of these municipal tax authorities by multiple authorities would make bribery an expensive option for taxpayers and promote tax payments.

These recommendations cover all the five areas reasons for tax evasion and are likely to significantly reduce the tax evasion problem with effective implementation.

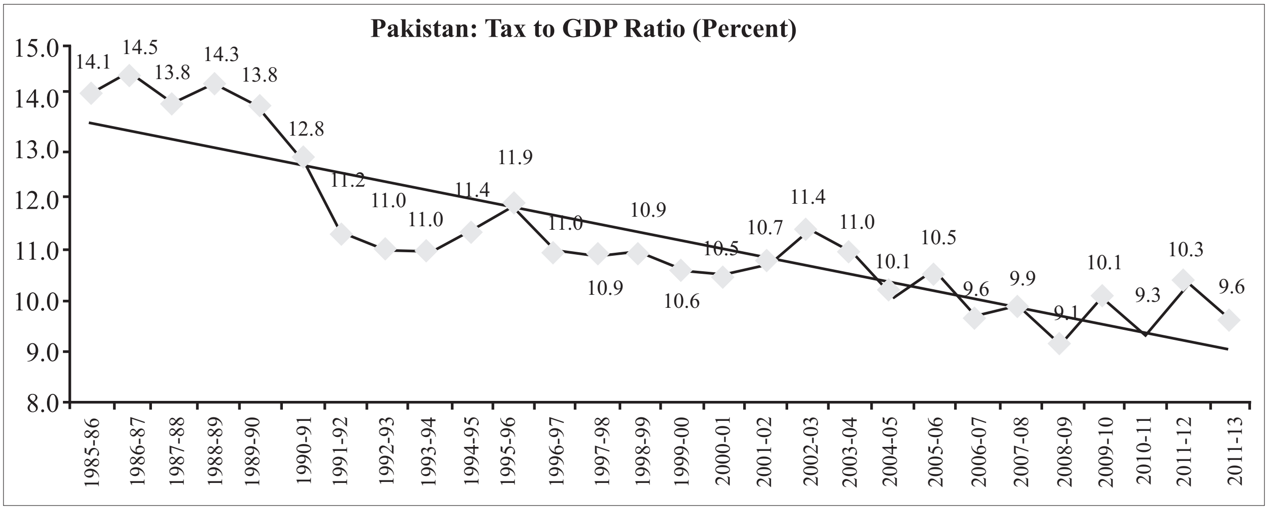
Low Tax to GDP Ratio
Exempted or zero-rated tax sectors: The eminent reason behind the low tax to GDP ratio in Pakistan is the tax exemption given to powerful political figures, capitalists and various industrial sectors. " The exemptions now amount to Rs477.1bn- nearly 2pc of the country's gross domestic product(GDP) in fiscal year 2013-14- compared to Rs239.535bn in the last year, an increase of Rs237.57bn"(M.Khan 2014). The major tax exemptions include the income tax exemption, sales tax exemption and custom tax exemptions. "An amount of Rs96.634bn was lost due to exemption in income tax in 2013-14" (M.Khan 2014), whereas, Sales tax exemptions and Custom tax exemptions have increased by Rs211.564bn and Rs131.451bn, respectively. These exemptions have decreased the revenue by Rs.200bn and the tax to GDP ratio to 8.5 percent.

Structural Flaws in FBR
A) - Incompetent Tax Officers: Work efficiency of the tax officers is a matter of significant importance in reference to the narrow tax base. In FBR, over the course of time, it has been witnessed that many officers were inducted without the relevant background or expertise. "The system through which the non-officers are inducted is highly politicized" (Inam, 2014 P.112) and "current training and development practices do not expose the staff to best practices in tax administration" (Inam, 2014 P.112). There exists a structural flaw in the working of FBR, where the competent employee has a lesser chance to get promoted and "the inadequate compensation system fails to attract and retain highly qualified professionals" (Inam, 2014 P.112).

B) - Lack of Proper Database: Despite the fact that FBR has introduced a mechanized system, there still exists the need to improve the database, so that tax evasions and frauds could be tracked down easily..

Exemption of Agricultural Sector: Agricultural sector contributes nearly 22 percent to Pakistan's GDP, whereas, its contribution to taxes is no more than 2.5 percent. This overdue exemption from tax has adversely affected the economy of Pakistan since long. There is no proper implementation of agricultural income tax, the main reason of which is the on-going political power enjoyed by the feudal lords. " The agro lobby has allegedly prevented the Federal Government from bringing about any change in the Constitution, while also restraining provincial governments from utilizing their authority effectively to impose AIT" (S.Khan).

Trade Liberalization: This involves the removal or reduction of the restrictions or barriers on the free exchange of goods between the nations- which includes both; the tariff and non-tariff obstacles. By reduction of these tariffs, not only the local market is affected but it also negatively affects the trade revenues that could be earned. The idea of trade liberalization is viable for countries which have other sources to recover these revenues from. "For low income countries, in contrast, a steady reduction in trade tax revenues over the last twenty years has been accompanied by a reduction in total revenues" (Baunsgaard, 2014 P.3), and recovery of these revenues from other sources is uncertain, so despite the fact that trade contributes towards the



(Pakistan: Representation without Taxation, Nyda Mukhtar) economic growth of a country, trade liberalization beyond a certain limit, decreases the trade taxes which remains a huge barrier in the economic growth of a country.

Trust Deficit- Low tax Filings: The existence of trust deficit among the public is one of the major reasons behind the low tax to GDP ratio. People have a general conception that the state is unable to manage their taxes well, so they are not motivated to give taxes. In nations like Sweden, "public trust is supported by tax procedures and transparency on tax collection, tax invoices can be received even on cell phones" (Sindhu, 2014 P.17). These measures, if taken in Pakistan, can contribute towards increasing the tax base and enhancing the tax to GDP ratio. The reflection of this trust deficit can be seen in the fact that contribution of income tax "to total tax revenue stands at 28 percent" (Inam, 2014 P.101), whereas, the "number of active tax-filers in Pakistan is about 1.05 million, which is 0.07 percent of the population" (Inam, 2014 P.102).

Lack of Tax Facilitation Policies: In this context, we could take the example of Sri Lanka, where, "for the facilitation of the tax payers, tax is collected in five installments, while in Pakistan, under the law, tax payers have to pay the tax in lump sum".(Sindhu, 2014 P.13). Moreover, there are no incentives associated with taxes in Pakistan, unlike Sri Lanka, "where there is noticeable provision of incentives in the form of discounts and privilege cards". (Sindhu, 2014 P.13). This could be an eminent initiative to increase the tax to GDP ratio.

Flawed Taxation Policy and Lack of Enforcement Mechanism: In Pakistan, rich are exempted from the tax net due to which "government is constrained to pounce upon the poor with regressive taxes- sales tax and presumptive taxes under the income tax code" (Sindhu, 2014 P.21). Whereas, the "countries with high tax to GDP ratio, follow a policy with focus on progressive taxes" (Sindhu, 2014 P.21). To increase the tax to GDP ratio, the government should focus on progressive taxes, which would also deal with the problem of income inequality.

In Pakistan, the mechanism of tax enforcement is flawed, which gives exemption to ruling class, creating economic and social disparity among the citizens. Considering the example of India, the foremost thing which they did while reforming taxation system was to ensure the strong enforcement of taxes and make sure that nobody is exempted from the tax net. In Pakistan, irrespective of the fact that there are policies related to the tax system, the major issue remains the enforcement of these policies.

Recommendations

- Improvement in tax administrative structure – qualified and competent tax officers
- Transparency in recruitment process
- Simplification of tax filing processes.
- Education of tax payers.
- GST to VAT transition
- Expansion of e-taxation system to replace manual tax systems– Increases efficiency
- Removal of Trust Deficit-Confidence building measures to encourage taxation (targeting the health and education sector to build confidence among people that their taxes are not being wasted, rather spent on development projects)
- Improving governance.
- Autonomy of Tax administration
- Advance training program for tax officials

Tax Exemptions and the SRO regime

Introduction

The GDP of Pakistan as shown graphically hints to a steadily increasing economic activity in Pakistan. The study of GDP per Capita (approximately 41% growth) also provides a hint of increasing wealth as opposed to the increasing population. The positive trend in the GDP signals the enhanced scope of foreign direct investment to give further boost to the economy.

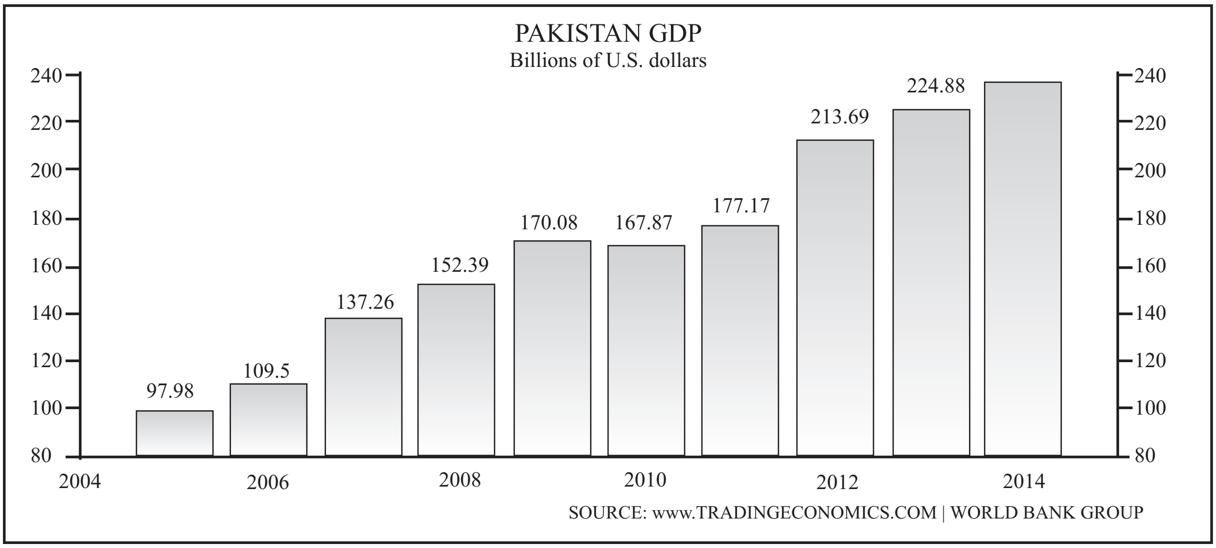
Studying Pakistan's economic activity from the dynamic of the rising revenues of major businesses in Pakistan we can conclude that Pakistan's economic outlook is at the very least good. The revenues of almost all the major companies have been rising and many of the companies have been posting revenues exceeding 1 billion USD.

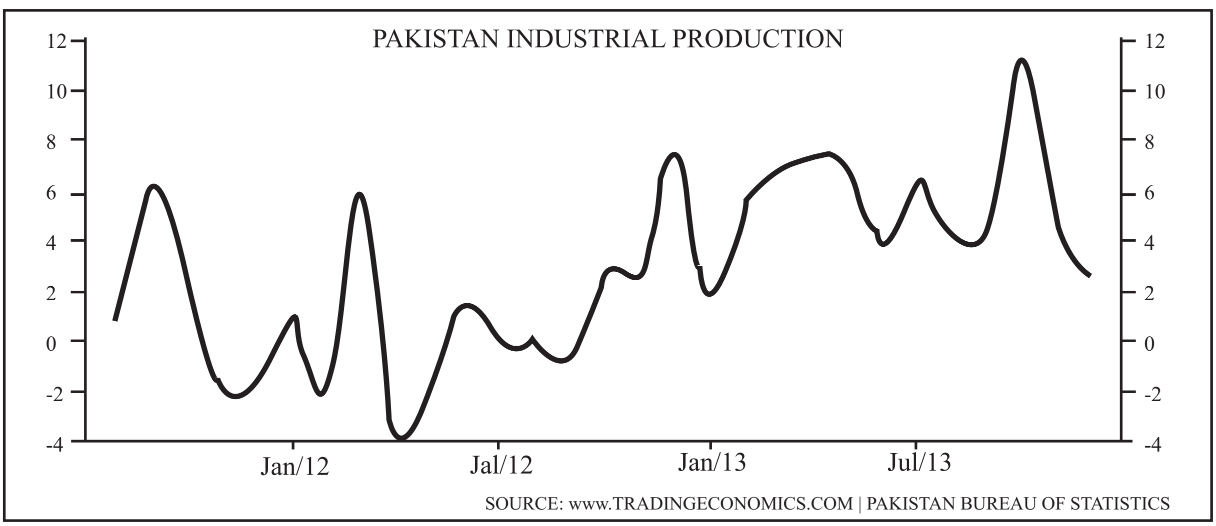
The Industrial Production in Pakistan has also cast an overall upward glance, augmenting the fact that the economy is experiencing an overall upward trend.

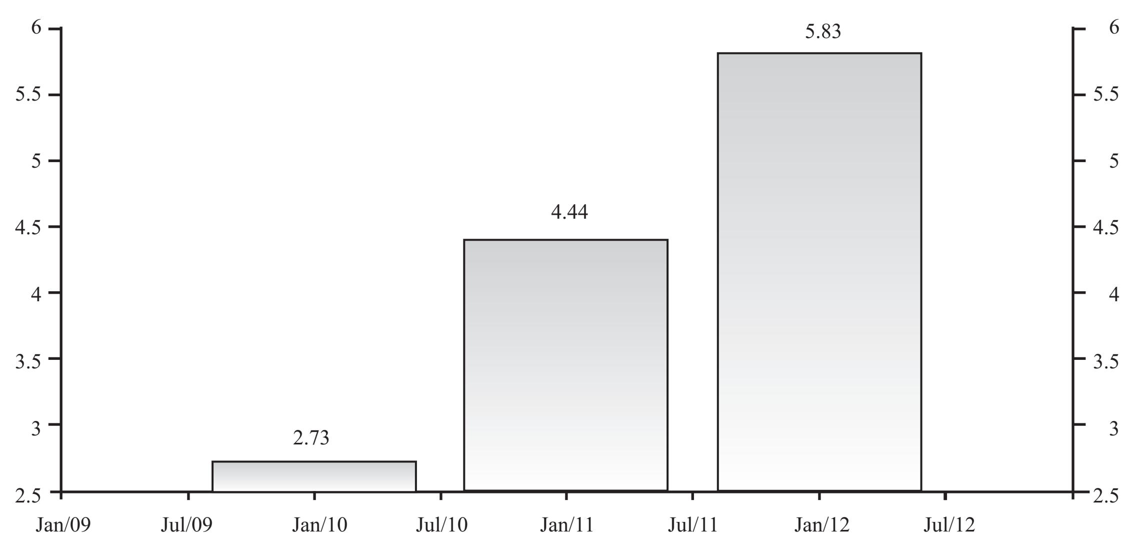
The household consumption has also been looking up in the last four years with consumer's confidence in the economy strengthening.

Background of the Problem

Despite all these positive outlooks the position of Pakistan's fiscal development has more or less been stagnant or worsened. The government agencies seem to have lost any interest in the documentation of this increasingly large economy. The Pakistan Economic Survey of each


PAKISTAN GDP
Billions of U.S. dollars
97.98
109.5
137.26
152.39
170.08
167.87
177.17
213.69
224.88
80
100
120
140
160
180
200
220
240
2004
2006
2008
2010
2012
2014
SOURCE: www.TRADINGECONOMICS.COM | WORLD BANK GROUP


PAKISTAN INDUSTRIAL PRODUCTION
-4
-2
0
2
4
6
8
10
12
Jan/12
Jal/12
Jan/13
Jul/13
SOURCE: www.TRADINGECONOMICS.COM | PAKISTAN BUREAU OF STATISTICS


2.73
4.44
5.83
2.5
3
3.5
4
4.5
5
5.5
6
Jan/09
Jul/09
Jan/10
Jul/10
Jan/11
Jul/11
Jan/12
Jul/12

year starts with an optimistic vision of the future and reviews the situation after the situation to be gloomy. The collected tax as a percentage of GDP has been decreasing which indicates that our agencies have not been able to keep track of the increased activities. The shortfall in the tax collection creates dents in the budget of the government, which as a result requires auction of 3G / 4G licensing and similar activities in order to generate ample revenue.

The decreased potency of the enforcement agencies is not the only factor that explains the dip in the fiscal development performance. Another aspect has been the increasing tax exemptions in the face of difficult fiscal situation.

In spite of the increased government expenditure and increased economic activity the tax exemptions for FY 2013-14 as revealed in the economic survey went up to 477.1 billion rupees. The tax exemptions for the previous fiscal year were a mere 237.6 billion rupees, which represents an increase of 100% into the next year. The major cause behind the drastic rise in these exemptions is the sales tax SROs issued which has collectively caused the national exchequer 230 billion rupees, which is equal to the amount of exemptions of the previous year. The six export sectors that have been given a zero-rated scheme have caused the loss of 65 billion rupees to the revenue collection.

The annexure 2 of the Economic Survey FY 2013-14 states the areas of major exemptions. The zero percent rated tax exemptions can be seen to be causing the biggest losses. Some of the exemptions have been given as a result of long-standing agreements with independent power production companies (IPPs) and those have caused 52.1 billion rupees as lost revenues.

The issuance and legality of SROs is also in doubt because some court rulings have cast serious doubts on the practice. The Article 77 of the constitution solely vests the authority of taxation in the Parliament and does not allow the executive to interfere in the matter. In a judgment of Supreme Court, *Engineer Iqbal Zafar Jhagra and Senator Rukhsana Zuberi v Federation of Pakistan and Others,* it has been explicitly held that:

*"*It is well settled proposition that levy of tax for the purpose of Federation is not permissible except by or under the authority of Act of Majlis-e-Shoora (Parliament). Reference in this behalf may be made to the case of *Cyanamid Pakistan Ltd. V. Collector of Customs (PLD 2005 SC 495),* wherein it has also been held that such legislative powers cannot be delegated to the Executive Authorities."

The SRO regime is also in violation of the commitments made to external stakeholders for the use of their lending facilities. IMF has been strongly recommending to the government to take back the SROs system, as it is not helping Pakistan improve its deficit. The government has also ensured IMF on certain occasions of its intentions to root out the system but has not been able to do anything in that regard.

Recommendations – Discussion and Implementation

Based on the identification of the issue and discussion

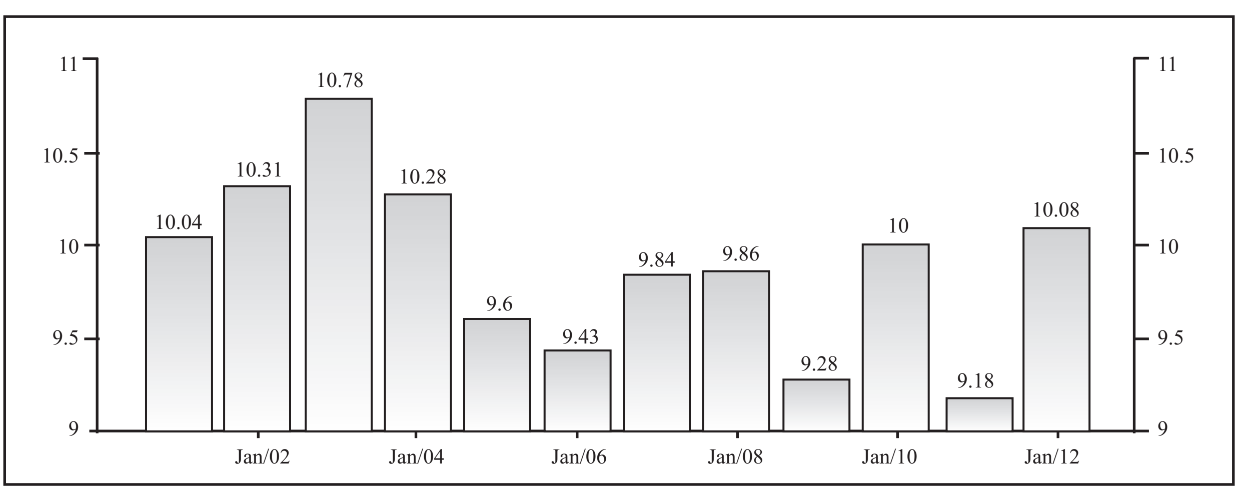


Table 2: Tax Expenditure of Sales Tax for 2013-14 **(Rs. Billion)**

SRO	Loss of Sales Tax Due
i. export facilitation schemes	
SRO 450(I)2011(DTRE & MB)	14.0
SRO 326(I)2008(EOU)	1.0
SRO 492(I)2009(Temp. same State)	4.0
Sub-Total	**19.0**
ii. General and Sector Specific SRO's	
SRO 727(I)2011(Plant & Machinery)	14.0
SRO 1125(I)2011(concessionary rate of sales tax on raw materials, intermediary inputs and finished goods relating to Textiles, Carpets, Leather, Sports and Surgical sectors)	65.0
SRO 549(I)2008(zero% on specified goods)	94.0
SRO 575(I)2006(Machinery, Equipment, Apparatus and Items of Capital Goods)	30.0
SRO 551(I)2008(Exemption from ST on import and supply of certain items)	26.0
SRO 69(I)2006(levy of ST @ 14% on rapeseed)	1.0
Sub-Total	**230.0**
Group Total (I+II)	**249.0**

of the problem, following are the recommendations, which are proposed by this report. It should be noted that where appropriate, implementation strategies are also discussed along with suggestions for improvements.

Structural Changes in the Tax System
The non-active taxpayers need to be scrutinized stringently. The government should not only limit their bank accounts but should also focus on the overall portfolio i.e. assets, business activities, registered and non-registered accounts et cetera. The principle of tax at source should be applied to all the industries, which will generate appropriate sales tax revenue. Utilities should have a strict team, which should ensure that despite of proper collection full amount of total tax collected should reach the authorities.

Incentives for the Tax Payers
Majority of the non-tax payers are of the opinion that what they will get in return. Of course the government cannot give monetary benefits for every single tax amount received however, there can be certain schemes introduced which can act as fruitful for the tax payers e.g. free membership of respective chambers of commerce and industry, free access to airport business lounges across the country, full refund of one international business expo trip per single person per financial year, interest free loan for first five years on new projects and et cetera.

Improvising the Tax Exemption Parameters
Major loss of the tax revenue is incurred due to the inadequately structured tax exemption parameters. The officials need to form much tighter parameters for those individuals with heavy bank accounts but do not hold an NTN. While those who hold a registered NTN but are not paying tax, should be made to make tax payments for the missing years and asked to follow a regular tax payment schedule. The senior citizens should be exempted from tax on their savings in fact the rate charged to the regular citizens and especially those involved in business activity should be increased.

Improvements in the SRO Regime
Based on the pressure through the external aid providers e.g. IMF and World Bank, the government needs to make major structural changes in the SRO regime in the form of diminishing the rate of tax rebates. Checks should be placed on the export activity of individual companies based on the total revenue collected through them over the years; they should be

given leverage only if they fulfill the criteria of successively paying a high tax amount. SRO 450 needs to be improvised since it dented the government exchequer with a loss of PKR 14.0 billion. SRO 1125 along with SRO 549 needs to follow a tighter criterion.

Institutional Changes in FBR
The strength of an institution is the backbone of successful operations. FBR needs to create high profile requirements for the officers designated at crucial positions. The policy makers need to have an international perspective of LDCs and should be trained locally or internationally in order to properly equip them with appropriate measures which are in fact the need of the hour with respect to Pakistan's economy.

Recommendations SROs
The Ministry of Finance should discourage the practice of issuing SROs immediately because the practice is extremely detrimental to the fiscal development in Pakistan. The average number of SROs issued in the previous five years should be taken as the ceiling for issuance in following year. The practice must be completely phased out in a period of five years.

The issuance of an SRO should be followed by the submission of a report on the probable implications of the SRO on tax collection and motives of extending it in the first place to the Standing Committee on Finance, Revenue, Economic Affairs, Statistics and Privatization National Assembly and Senate by the Ministry of Finance. The submission must be made within a period of 15 days from the issuance date of the SRO.

The volume of tax exemptions extended as a result of SROs or any other form should not be more than those extended in the previous period. In the case it is so the matter will be put forward in the National Assembly for approval with the reasons of excess by the government along with the Budget and Finance Bill. The excess allowable is 25% at most from the previous years.

A combined meeting of Standing Committees on Finance, Revenue, Economic Affairs, Statistics and Privatization of Senate and National Assembly will be held semi-annually to review the tax collection situation and target achievement progress. The meeting must be attended by Minister of Finance accompanied by Secretary Finance Division, Secretary Planning, Chairman FBR and Secretary Economic Affairs Division. President of SBP will also be encouraged to attend.

The Minister of Commerce must be present in the National Assembly and Senate the government's policy on Industrial development. The areas possibly requiring government attention must be clearly mentioned. The government must only try to incentivize the areas in its broad development agenda by giving them partial tax exemptions through SROs or any other mode. Arbitrary and random tax exemptions must be discouraged.

The government should make available the same report submitted to the standing committees to the general public on demand and online within one month of the issued SROs to increase transparency.

The issued SRO must be time bound and the time period of its effectiveness must be stipulated clearly on the issued SRO. No SRO under any conditions would be effective for a period of more than 90 days. In case, government wants to extend the period it must get a prior approval from both the Standing Committees of National Assembly and Senate. The approval will be extended by a majority of members in the committee approving the government's proposition. All the existing SROs will automatically become ineffective within 6 months of the implementation of this new policy.

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