Policy Report

REFORMING PAKISTAN'S TAXES FOR SUSTAINABLE AND INCLUSIVE GROWTH

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Acknowledgments

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Introduction

Increasing tax revenues has been a major challenge for Pakistan. It has one of the lowest tax-to-GDP ratios, especially in comparison to countries with similar development levels. Low tax collection combined with high public expenditure has led to a chronic fiscal deficit and a rising debt burden for Pakistan leading to an unprecedented economic crisis such that the country is on the verge of default. To ensure macroeconomic stability, the government needs to substantially enhance revenue collection while ensuring that taxes result in minimum distortions and encourage economic growth. A well-designed tax system can be a catalyst for growth and competitiveness.

The Consortium for Development Policy Research (CDPR), in partnership with the UK government's Foreign, Commonwealth & Development Office (FCDO) funded, Revenue Mobilization, Investment, and Trade (REMIT) programme, hosted two consultative workshops titled Reforming Pakistan's Taxes for Sustainable and Inclusive Growth, with key stakeholders to generate a dialogue on tax reforms focused on improving the performance of various federal taxes. Recommendations, including specific action points, were presented to the Federal Board of Revenue (FBR) to provide input to the federal budget 2022-23. These recommendations are disseminated in this brief for the benefit of a wider audience and to encourage debate on the tax policy and administration of Pakistan.

Methodology

The first workshop was held on 13th April 2022 in Lahore and the second on 25th April 2022 in Karachi. The workshops were divided into four sessions, starting with a 30-minute introductory session where representatives from CDPR and REMIT and (additionally in the Karachi session), from FCDO and Pakistan Business Council set the stage for the discussion. The remaining three sessions were of 1.5 hours each. The first session was on Enhancing the Income Tax Base, the second on Addressing the Challenges in Sales Tax Performance and the third and final session focused on Reforming the Customs Tariff.

The primary objective of the workshops was to have a consultative dialogue on the state of tax policy and performance in the country to:

a. build a narrative on the nature of reforms/ changes that are required and must be encouraged

b. incorporate input from various private sector representatives and relevant academic, accounting, and legal experts to generate recommendations specifically for the Federal Board of Revenue (FBR) (but also including other important policy stakeholders) for policy reform and action, and

c. to inform the government's upcoming deliberation for the annual budget 2022-2023.

Workshop planning began by drafting a concept note that provided a brief background of the taxation system in Pakistan and the main context and objectives of the workshops. An appropriate moderator was engaged as a resource and to facilitate the discussions and synthesize the key takeaways and policy messages from the discussions. Dr. Sher Afghan Asad, Assistant Professor at the Economics Department at the Lahore University of Management Sciences (LUMS), was requested to facilitate. He is currently engaged in research with both the provincial and federal tax authorities on tax reforms. One of his foremost tasks was to frame the discussion for each session. With support from the CDPR team, he prepared a slide deck for each session, highlighting the context, and important information about tax legislation and policies, while tracing the performance of the different types of taxes.

Following confirmation of the date for each workshop, the panels for each session were finalized. The aim was to include representation from academia, the private sector, and the government. Some of the panelists included the British Deputy High Commissioner, Chief Executive Officer of the Pakistan Business Council, various advisors to the provincial and federal governments, senior representatives from corporations, senior government officials such as the Chairman of the National Tariff Commission, and FBR Members, and prominent academics from the Institute of Business Administration (IBA) and the Lahore University of Management Sciences (LUMS). Once locked, specific questions were tailored in accordance with each panel's composition, and each panelist's experience and expertise. The questions were researched and internally discussed with both CDPR and REMIT teams to ensure they cover the relevant themes and highlight policy concerns/issues in the discussion that would help achieve the objectives of the workshop. The Lahore workshop helped hone the questions for the Karachi workshop. These questions were shared with each panelist ahead of the event to allow them ample time to prepare.

The audience was to have a critical role in contributing to the discussion. Thus, it was imperative to have interactive sessions that would allow the audience to engage with the panelists and highlight ground realities, problems, and recommendations. To ensure a fruitful discussion, specific stakeholders (academia, private sector, representatives from relevant government departments amongst others, labor associations, sector associations, industrialists, legal firms, and accountants) were identified and invited to attend the workshop. Invitations were sent via email, phone calls, and messages. In addition, the workshops were extensively advertised on social media to ensure maximum traction and turnout.

Limitations and Lessons

The entire exercise of hosting these workshops was a good learning experience. A few imperative lessons are listed below:

1. The timing of the event remains a crucial factor. Due to certain constraints, the workshops had to be scheduled within a specified window and given the time sensitivity due to the upcoming budget, these ended up being held in Ramadan. This adversely affected audience attendance and made panelist confirmations particularly challenging. Additionally, given the recent change in government, the socio-political climate of the country was extremely volatile, and the associated uncertainty impacted both availability of panelists (as many politicians and government officials were unable to attend) and a willing attendance. This problem became most evident when planning the Islamabad workshop, which had to be postponed indefinitely due to the aforementioned political volatility. Media presence was also weak as its focus was on the ongoing political and economic situation including the crucial IMF negotiations. When planning future events, special attention must be paid to the scheduling of the event to account for all foreseeable impediments.

2. Audience engagement was impacted due to Ramadan. The workshops' audience engagement was lower than expected due to Ramadan timings. These workshops were planned as full-day events with long sessions. Although this model in itself is not unusual, full-day events during Ramadan adversely affected audience participation. In order to ensure the full-day event wrapped up in time for Iftar, sessions ended up being rushed to ensure all discussion points were covered. This was especially critical as each type of tax included in the discussion had its own context, relevant stakeholders, set of problems/policy concerns, and distinct recommendations. Overarching takeaways/action points were seldom common. Due to this minimal overlap in content and interest, target audience for each session had to be selected for each session separately. This limited time to probe deeper into certain issues to derive recommendations. An alternative and perhaps more efficient way of organizing these sessions could have been to organize them as parallel sessions with a common introductory and closing session.

3. Each city presents its own dynamics, and the discussions have to be tailored accordingly. For example, Karachi has a strong presence of the private sector that needed to be leveraged for the workshop. Similarly, Lahore has a wide academic network and Islamabad remains the hub for policymaking and engagement with development partners. Thus, in order to improve the quality of discussion the target audience, the structure of the panel, and the nature of the discussion should be tailored for each city, keeping in mind the business climate of the city.

4. Local partnerships strengthen engagement through events. It is beneficial to partner with local private sector counterparts as was done in Karachi with the Pakistan Business Council (PBC). This was a lesson quickly learned after the first workshop in Lahore where no such partnership was sought. However, the Lahore Chambers of Commerce and Industry (LCCI) could be a potential partner. To overcome the challenges faced when planning the Lahore workshop, CDPR co-hosted the joint Karachi workshop with PBC. PBC helped identify and invite panelists as well as relevant stakeholders as part of the audience. It also ensured a more meaningful and contextualized engagement.

5. Ownership of the event by the lead stakeholder, the Federal Board of Revenue (FBR) was weak. FBR's presence at the event should have been more central (as opposed to peripheral). One way to achieve this could have been through a formal collaboration with FBR which would have lent a greater degree of legitimacy and garnered greater traction for the event. Additionally, engagement of other key stakeholders, such as the International Monetary Fund's (IMF) local office, and provincial governments, was also missing. For future workshops, such collaborations can prove beneficial.

6. Engagement with the chambers of commerce was low - this might be attributed to the timing of the workshops, but it is worth looking into when planning future events.

7. The focus on inclusivity and sustainability could have been more pronounced in the content of the discussions. While full effort was made to ensure gender representation, future engagements should have a clear and significant inclusivity angle, centering gender, and poverty dimensions within the discussions on tax policy and administration.

Recommendations

The following sections outline the main challenges in the policy and administration of each of the three taxes and list recommendations from the workshops to address some of the challenges.

Income Tax

01

1.1 Make taxation a national rather than FBR specific issue

1.2 Collect and examine data of non-compliant taxpayers

1.3 Penalize non-compliant taxpayers

1.4 Rationalize tax laws

1.5 Bring importers into the tax net

1.6 Improve overall administration of taxes

1.7 Ensure accountability of tax officials

1.8 Streamline the withholding tax regime

1.9 Rationalize Corporate Income Taxes

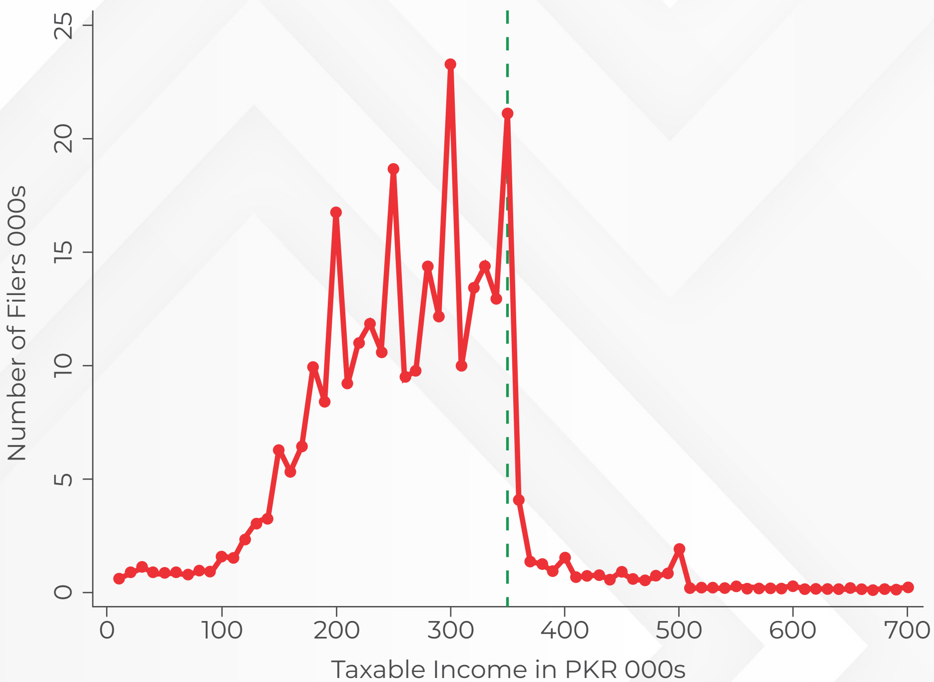
1.10 Tax agriculture income more effectively

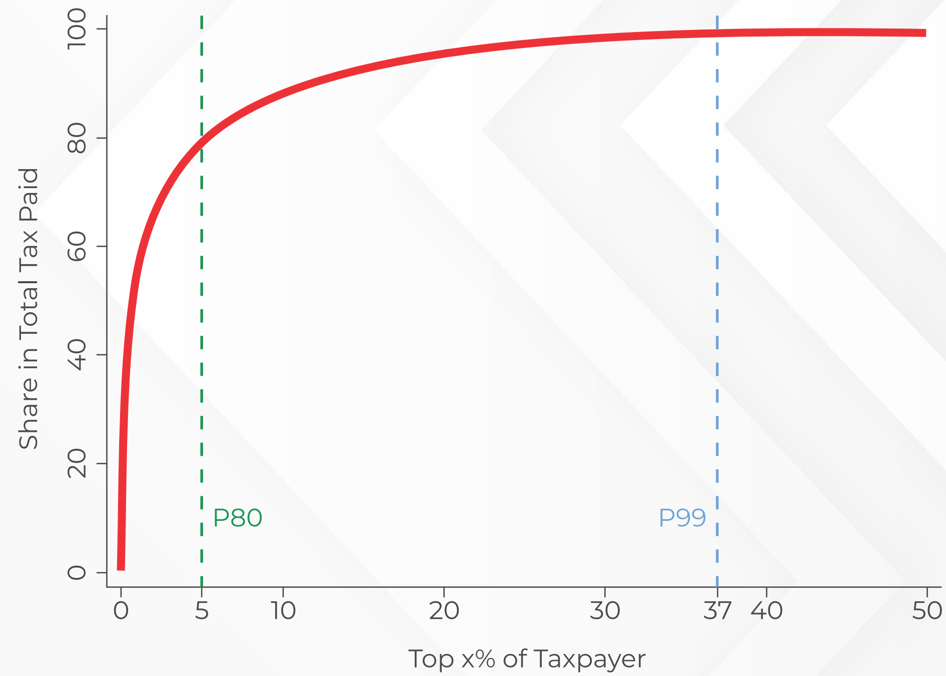
1.11 Tax agriculture income more effectively

1.12 Improve audit procedures

Income tax serves the purpose of distributive justice by ensuring that each individual pays their due share in proportion to their actual income. Pakistan collects only 38% of its federal taxes using direct taxes (much lower than countries with comparable levels of development) and remains heavily reliant on indirect taxation, which can be distortive and regressive. It is important that to ensure fairness income tax is levied and collected in accordance with the taxpayers' true ability-to-pay.

Compliance to income taxes is low in Pakistan. During FY21, just over 3 million individuals/ companies filed their income tax returns. While this number has shown impressive growth over the last few years, a closer inspection reveals that the additional filers are not adding substantially h to overall income tax collection. Many of these are reporting either zero income or income below the exemption threshold. Based on reported income of filers in 2018[1], the figure below shows that taxes remain top-heavy in Pakistan, as the top 5% of the taxpayers paid 80% of the income tax in 2018, while the top 37% paid 99%.





Here are some of the recommendations to improve income tax compliance in Pakistan.

[1]Source: FBR's tax directory of all taxpayers for tax year 2018.

1.1 Make Taxation a National Rather Than FBR Specific Issue

There is a need to bring other stakeholders into the discussion on tax reforms as the issue concerns federal and provincial stakeholders beyond FBR. All entities, government departments, financial institutions, and revenue authorities such as banks, board of revenues, Securities and Exchange Commission of Pakistan (SECP), power companies, that have taxpayers' data, should collaborate and co-ordinate efforts to raise revenues. For example, SECP can consider canceling the registration of companies that are not tax compliant.

1.2 Collect and Examine Data of Non-compliant Taxpayers

1.2.1 To encourage documentation, there should be a requirement to present the CNIC for every transaction above a certain threshold in addition to the transactions for which this requirement is already in place. In contradiction to this recommendation, the Finance Bill 2022 has removed the condition of CNIC/NTN in case of sales to unregistered persons.

1.2.2 There are many transactions such as land and vehicle sales/purchases that collect the CNIC of potential taxpayers. This data can be examined to identify and target high-worth non-compliers.

1.2.3 FBR must prioritize compliance by the large consumers of utilities such as electricity and gas. Utility companies must facilitate FBR by updating their users' details, such as CNIC and NTN, for effective targeting of enforcement efforts.

1.2.4 Data sharing between FBR and NADRA to construct profiles of potential taxpayers is a welcome step. This should be complemented by engaging a firm with expertise in data handling, machine learning, and artificial intelligence and be assisted by a team of IT experts, accountants, tax experts, and lawyers. A task force can be constituted, composed of independent officials to oversee the implementation of this initiative. Data from third parties can be used to reap the true potential of this initiative.

1.2.5 The FBR should act on non-filers through information on withholding deductions. Currently, FBR lacks the incentive to make the effort to encourage the filing of returns from these non-filers that have essentially become a source of revenue for the government by being double charged. Such taxes can become distortionary unless the government brings the non-filers paying these taxes into the tax net.

FBR & NADRA

Collaborate for Data Sharing

1.3 Penalize Non-compliant Taxpayers

1.3.1 A higher penalty can be levied on taxpayers that do not appear on the active taxpayers' list (ATL). The tax rate on such persons can be increased from the current hundred percent increase to more stringent levels. These higher advanced income taxes on non-compliant taxpayers can be levied at the consumption stage such as at the time of purchase/transfer of land, vehicles, jewelry, and at the time of business/first-class travels. In accordance with this recommendation, the budget 2022-23 has increased the tax rate on purchase of property and vehicles for non-active taxpayers.

Higher Tax Rate
Suggested For
Non-active Taxpayers

1.4 Rationalize Tax Laws

1.4.1 Tax evasion is a criminal offense and over time Pakistan should move to a tax system that does not make provisions for criminals that evade taxes by acknowledging non-filers in the tax law. Expediency in converting non-filers into filers is required as per the rules outlined in the tenth schedule of the income tax ordinance.

1.5 Bring Importers into The Tax Net

1.5.1 Importers' income should be assessed, and efforts made to document and tax the chain after the import stage. This can be challenging due to a strong lobby of importers. However, this is where the most potential for documentation and revenues lies.

1.6 Improve Overall Administration of Taxes

1.6.1 FBR should streamline entry into the active taxpayer list (ATL). Currently, no mechanism is in place to ensure that filed return is consistent with the potential income of the filer. The present system allows entry into ATL even when the filer does not report any income in their returns. FBR should implement automatic checks to verify consistency of reported income with available withholding and third-party information on taxpayers.

1.6.2 The government should establish its serious-ness and commitment to increasing tax compliance. To ensure compliance it needs a holistic approach that includes addressing human resource problems (such as recruit-ment and training of staff), building trust in the government, and making it hard for citizens to live beyond their reported means.

1.7 Ensure Accountability of Tax Officials

1.7.1 Processes should be in place to ensure accountability of tax officials and discourage harassment of taxpayers

1.8 Streamline the Withholding Tax Regime[2]

1.8.1 The withholding tax regime should be streamlined such that a person who is not liable to pay any income tax is not liable to pay withholding tax either. FBR should remove all withholding taxes that do not proxy for income. For example, withholding tax on bank transactions is not a proxy for income and therefore should not be charged.

1.8.2 No withholding tax should be charged as a final or a minimum tax. Multiple minimum taxes lead to a large increase in the tax liability of taxpayers. The budget 2022-23, against this recommendation, has introduced restrictions on carry forward of minimum tax in subsequent years, which may cause excessive burden on taxpayers and create distortion of economic activity.

1.8.3 Businesses with small profit margins in the range of 1% to 2% cannot afford to pay higher withholding taxes and are thus encouraged to stay out of the tax net. The withholding rates should be rationalized and brought down to encourage more widespread compliance.

1.9 Rationalize Personal Income Taxes[3]

1.9.1 It is an unfair practice to increase taxes on salaried individuals while undocumented individuals continue to remain untaxed. Higher tax rates can in fact make it harder to expand the tax base. The increase in tax rates should be considered once most potential taxpayers are brought into the tax net. In accordance with this recommendation, the budget 2022-23 has increased the exemption threshold for salaried and business individuals while introducing two percent extra tax (for poverty alleviation) on higher earning persons. This is likely to raise more revenues from the salaries class without putting extra burden on lower income salaried individuals.

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[2]Withholding taxes are considered the bedrock of income tax enforcement. More than 90% of income tax in developed countries is collected through withholding taxes. Withholding taxes are a source of information and revenue for the government. These taxes are non-distortionary if the withheld tax is adjustable, and the excess withheld amount is refunded costlessly. However, with imperfect enforcement, the withholding tax acts as a combination of an income and an excise/indirect tax. Such an environment may distort the economy by raising consumer prices and disproportionately affecting poor households.

[3]Pakistan's contribution of personal income taxes (PIT) to overall tax revenues is lower than other countries at a similar level of development. Revenues from PIT as a percentage of GDP in Pakistan have hovered at a mere 1%. One explanation for low PIT collection is the low income-tax rates on the middle class. However, there is also the perception of a high burden on the salaried class that does not have opportunities to evade income. This can lead to negative sentiments towards the state. Also, heavily taxing the salaried class can further encourage undocumented work.

1.10 Rationalize Corporate Income Taxes[4]

1.10.1 The effective tax rate for corporate income is higher than the individual income which creates a strong disincentive for corporatization and encourages firms to stay small or to create multiple small firms. To reduce the effective tax rate on firms, corporate income tax, capital gain tax, tax on dividends, and super taxes should be curtailed. In fact, to further incentivize corporatization, effective corporate tax rate may be brought below the rate faced by the Association of Persons (AOP) and small companies. However, this was not addressed in the budget 2022-23, rather, retrospective imposition of super tax on selected sectors has created an environment of uncertainty and deteriorated investor confidence.

1.10.2 In the current regime, corporatization is disincentivized while investing in real estate is encouraged. This is partly due to low capital gain taxes in real estate and under assessment of land values by FBR. These taxes need to be brought at par to encourage investment and growth in the productive sectors of the economy. Budget 2022-23 has incorporated encouraging measures in this direction such as tax on deemed income from unutilized property including luxury farmhouses and increase in tax rate on sale and purchase of property. The budget has also taken steps to synchronize the capital gain tax on disposal of securities and real estate.

1.10.1 The effective tax rate for corporate income encourages firms to stay small

1.10.2 Corporatization is disincentivized while investing in real estate is encouraged

[4]Corporate income tax (CIT) in Pakistan is the single largest contributor to the country's direct tax revenues. The CIT rates have been brought down substantially since the 1990s to attract international business in an increasingly globalized world. The single largest contributors to corporate income tax remain local private-sector corporations, followed by the public sector and banking companies. Small companies and the Association of Persons (AOPs) pay a much lower tax. The difference in tax rates applicable to small companies/AOPs and to large corporations creates incentives for small companies/AOPs to stay small or at least legally small.

1.11 Tax Agriculture Income More Effectively[5]

1.11.1 The first step is to ensure that the federal and provincial governments are serious about taxing agricultural income. Due to vested interests of elected representatives and large agricultural landowners, efforts to reform agriculture income tax remains on the backburner. Without commitment of the top political leadership, it will be difficult to tax agricultural income at par with other incomes. considered once most potential taxpayers are brought into the tax net. In accordance with this recommendation, the budget 2022-23 has increased the exemption threshold for salaried and business individuals while introducing two percent extra tax (for poverty alleviation) on higher earning persons. This is likely to raise more revenues from the salaries class without putting extra burden on lower income salaried individuals.

1.11.2 The rate of tax on agriculture income should be brought at parity with non-agriculture income. Provinces must be brought together to form a consensus on tax rates on agriculture income in line with rates in the income tax ordinance.

1.11.3 Collection of agriculture income tax should be outsourced to the federal government as it has better enforcement capacity. The federation can collect these taxes on behalf of the provinces and transfer the proceeds back to the provinces. It will be efficient to have only one authority to collect income tax in Pakistan.

1.11.4 The government must ensure that agricultural income tax collected from a particular area is spent on the development of the same area. This will incentivize compliance at the local level.

1.11.5 Agricultural supply chains that include wholesale and retail of agricultural products remain untaxed despite being under the ambit of the federal government. The agents in the supply chain such as wholesale commission agents or aartis, should be brought into the tax net as they engage in transactions worth millions of rupees on a daily basis.

1.11.6 Determining the true level of agriculture income can be challenging due to the nature of the agriculture production process. Therefore, most of the tax collected from agriculture income is land-based which does not represent the true liability of agriculture landholders and farmers. Methods such as geoprocessing and remote sensing along with refined land ownership records can help provide accurate estimates of such income.

1.11.7 The wealth statements must be reconciled with the payment of agriculture income taxes on a regular basis in line with rules outlined in the Income Tax Ordinance 2001.

[5] Agriculture income has historically remained undertaxed in Pakistan. Agriculture output constitutes 19.2 percent of GDP, and another 20 percent of economic activity is concentrated in the wholesale and retail supply chains of agriculture produce but agriculture's contribution to tax revenue is less than 2 percent.

1.12 Improve Audit Procedures[6]

1.12.1 The purpose of an audit should be to support voluntary compliance. It should not be employed as a tool to raise revenue.

1.12.2 Given limited audit resources, it is important that audit efforts are well targeted to achieve maximum impact (that is to detect and deter evasion). FBR should engage experts from the field of public finance to design risk parameters that use cutting-edge methods to identify taxpayers for audit. These parameters should be relatively sophisticated, so it is not easy for taxpayers to deceive or bypass the system. FBR should explore using machine learning and artificial intelligence to select high-risk taxpayers. These algorithms can be trained on existing audit data to detect and predict high-risk cases.

1.12.3 FBR's capacity to audit should be enhanced. Given the magnitude of detected evasion via audits, it makes economic sense to expand the scope of audits to a larger number of taxpayers.

[6]The tax system in Pakistan is operating on a self-assessment basis aimed at promoting voluntary-compliance, documentation, and self-policing. Ultimately voluntary compliance comes from credible threats of audit and penalty. Audits should have two purposes: i) detection of misreporting, and ii) deterrence of future misreporting. Since audit firepower is scarce, it must be utilized to detect and deter maximum evasion. According to a recent study, auditing in Pakistan uncovers a substantial amount of evasion, however, it does not deter future cheating (Best, Waseem, and Shah; 2021). Also, once the audit is complete, recovery of the detected amount is an additional challenge and according to one estimate, around 2.5 trillion worth of legal cases are pending in the courts.

Sales Tax

2.1 Harmonize the sales tax regime

2.2 Bring the informal sector into the tax net

2.3 Improve the uptake of Point of Sales (POS) Devices and Track & Trace Systems

2.4 Improve audit and litigation

02

Sales taxes are the biggest contributor to the national exchequer contributing close to 40% to the overall federal revenue. As a proportion of GDP, sales tax collection is roughly equal to 4%. Given the standard sales tax rate of 17%, a simple back-of-the-envelope calculation indicates that the vast majority of the consumption is going untaxed while the potential is estimated to be around four times the current collection. There are important challenges in Pakistan's sales tax regime that must be addressed to increase compliance, efficiency, and ease of doing business.

Here are some of the recommendations to improve sales tax compliance in Pakistan.

2.1 Harmonize the Sales Tax Regime[7]

2.1.1 There should be a single revenue authority that administers sales tax collection on goods and services across Pakistan. This revenue authority should have provincial representation on its board and be considered an agency that collects taxes on behalf of all provinces. Provinces and federations should agree on the distribution of the revenue between the province and federation.

2.1.2 The decision on the principle of origin versus destination needs to be made at the earliest to reduce compliance burden on the businesses. expand the scope of audits to a larger number of taxpayers.

Single Revenue Authority to Administer Sales Tax Collection is Suggested

[7]Pakistan is a federation with taxation powers shared between the federal government and provinces. The sales tax base is fragmented, with services subject to taxation at the provincial level and goods at the federal level. As a result, taxpayers face different taxes across multiple jurisdictions, and in addition to FBR, they need to deal with four separate sales tax administrations—one in each province. The fragmented GST system as it stands now has a cascading effect since there is no systemic mechanism to ensure that all taxes paid on input can be credited against a final sale (the output tax). This results in the cumulative taxation of intermediate inputs of production and distorts the prices that producers face in buying and selling from one another. The current GST system creates an incentive for low value-added production and hampers integration into the global value chains (GVC).

2.2 Bring the Informal Sector into the Tax Net[8]

2.2.1 Bridge the trust deficit between businesses and tax officials

2.2.1.1 Trust deficit between businesses and tax officials prompts businesses to stay undocumented in order to avoid potential audits and harassment by tax officials. The ground-level staff of FBR at RTOs and MTOs should be trained in soft skills and how to interact with potential taxpayers. Staff's behavior creates an environment of distrust and conflict between the taxpayers and tax officials.

2.3 Improve the Uptake of Point of Sales (POS) Devices and Track & Trace Systems

2.3.1.1 Taxation of retail is mainly a case of enforcement failure in Pakistan. Large wholesale markets in big cities remain untaxed even though they run transactions worth millions of rupees on a daily basis. IT-based solutions such as point of sale (POS) machines, and track and trace systems can help bring the retail sector into the tax net. Efforts in this direction need to be sped and scaled up[9].

2.3.1.2 Incentives for retailers to adopt POS devices and pay sales taxes are not going to be effective unless the parallel un-documented economy is brought into the tax net. The government therefore must ensure all businesses operating within the same market are competing on a level playing field.

Enforcement Failure:
Taxation of Retail

[8] In Pakistan, countless unregistered small, home-based, and online businesses are running successful/profitable operations but continue to escape the tax net. By one estimate, the retail market accounts for around 18% of the GDP while its contribution to the national exchequer is a meagre 1%. The presence of undocumented businesses creates disincentives for documented businesses to stay formal and may push them into the informal economy.

[9] This has successfully been implemented in restaurants in Punjab where customers making card payments are charged 5% GST vis a vis 17% GST imposed on cash transactions.

2.3.2 Reduce the sales tax rate

2.3.2.1 The GST rate should be reduced from 17% to a lower amount that would help incentivize businesses to come into the tax net. This will lead to some revenue losses in the short run but over time it is likely to bring more retailers into the tax net and thereby increase overall sales tax collection.

2.3.3 Encourage documentation

2.3.3.1 Government should incentivize the use of card payments. Currently, retailers have to pay a bank fee if they accept card payments which encourages the cash economy and people continue to prefer using ATMs to withdraw money and pay with cash than pay directly using the card. This leads to further non-documentation of economic transactions of retailers. Introduction of advance tax on credit/debit card payments in the budget 2022-23 is antithetical to this recommendation.

2.4 Improve Audit and Litigation

2.4.1 The current audit methods such as the STRIVE system are unable to detect under-stating of sales. There is a need to incorporate data from track and trace and to reinforce investigative audits to detect under-invoicing of sales and over-invoicing of inputs.

2.4.2 Data analytics can be employed to monitor business transaction activities. In the past, such investigation wasn't undertaken because it would have deterred adoption but now with relatively high adoption of POS devices among large retailers, analytics can facilitate enforcement efforts and improve tax compliance. However, this should be done in a way that does not lead to an extra burden on adopters of these machines vis-a-vis non-adopters. The primary focus has to be on bringing more retailers into the documented sector.

2.4.3 FBR should review all cases under litigation and expedite their resolution. The disputes need to be linked with tax payments and settled with taxpayers as per their payment capacity. In a recent IGC-funded research project, the research team is working with the FBR on addressing the large backlog of income tax cases which are pending because they are sub-optimally allocated among the officers leading to low productivity and longer waiting times. Through the use of cutting-edge research techniques, the research team is developing a Machine Learning (ML) integrated app to optimally allocate cases to smooth-out caseload across officers to help reduce tax evasion and improve efficiency and quality of justice. This project is at the initial stages of development.

2.4.4 There is also a need to reduce the number of frivolous notices from FBR. This will significantly reduce the number of cases that have to go to litigation.

Custom Tariffs

03

3.1 Use tariffs to promote economic activity rather than to raise revenues

3.2 Ensure the cascading of the tariff rates

3.3 Streamline anomalies in the tariff rates

3.4 Employ non-tariff measures to promote exports

3.5 Any tariff protection should be time-bound

3.6 Limit illicit trade

2.7 Reduce the dwell time at the customs stage

3.8 Support the growth of SMEs in the current tariff regime

Pakistan's tariff history shows excessive reliance on import tariff revenues close to 50%. The country's customs duties are almost twice as high as the world average and three times higher than East Asia and the Pacific. It also has one of the highest weighted average tariff rates globally in the region. Under the Federal Government Rules of Business, 1973, the tariff policy and protection regime are the mandate of the Commerce Division. However, the role of tariff setting has been gradually assumed over the years by the FBR, which has employed it as a revenue instrument, thereby creating multiple layers of policy distortions, adversely affecting export competitiveness.

Import tariffs, if employed effectively, can play a vital role in the optimal allocation of resources, protection of domestic industry, improving competitiveness, attracting, and protecting investments, improving the balance of payments, and serving as a source of revenue. On the other hand, if employed excessively, the tariffs can erode competitiveness of the industry by increasing the cost of inputs, breed incompetence by protecting the inefficient producers, impose costs on consumers by making industrial products expensive, and create anti-export bias by making the domestic market more attractive than exports. The workshop discussed some ways to rationalize the tariff structure in Pakistan.

Here are some of the recommendations to improve the customs regime in Pakistan.

3.1 Use Tariffs to Promote Economic Activity Rather Than to Raise Revenues

3.1.1 Tariffs should be employed to promote economic activity rather than as a tool to raise revenues. The heavy reliance on custom tariffs is detrimental to economic growth. To become an export-based economy, there is a need to drastically decrease tariff rates (including custom duties and regulatory duties) on intermediate inputs and raw materials. This will allow our industries to compete globally and attract domestic and foreign investment. The government should speed up efforts to reduce the cost of doing business by lowering tariffs at the import stage.

3.1.2 To reduce anti-export bias, the tariff rates on final goods should be brought down so that businesses are forced to compete globally and not just in the local market.

4.1.3 There are a number of products that have different tariff rates (including sales taxes and withholding tax rates) depending on whether the importer is commercial or industrial. These differential rates are distortionary, incentivize misdeclarations, and increase costs for small businesses that cannot import directly. The tariff structure should be simplified by reviewing these products and considering them as industrial inputs irrespective of the type of importer. For example, the paper should be considered as input irrespective of who is importing it as that would be its most likely use.

3.1.4 FBR's practice of issuing Statutory Regulatory Orders (SROs) causes significant distortions in the tariff structure and should be eliminated on an urgent basis.

3.1.5 Ad-hoc changes in tariffs lead to misallocation of resources and make business investment decisions challenging. Policies should be predictable and consistent. The separation of policy and administration of tariffs, as per the National Tariff Policy 2019, should be sustained over the long term.

3.2 Ensure the Cascading of The Tariff Rates

3.2.1 While cascading of tariff rates has increased domestic economic activity over the last few years, there are significant limitations in the tariff rates where the concept of cascading is still being violated. To incentivize the domestic industry, the government must rationalize the tariff structures to ensure that it is in the best interest of the businesses to produce locally rather than import the finished products. In accordance with this recommendation, the government has encouragingly reduced or exempted duties on imports of raw material for various industries in the budget 2022-23.

3.3 Streamline Anomalies in The Tariff Rates

3.3.1 There are significant differences in tariff rates at 8-digit HS codes within the 4-digit level which creates strong incentives to mis declare goods in the lowest rate 8-digit HS code. The tariff rates should be brought to the same level within the 4-digit code.

3.3.2 There is a need to add more goods and 8-digit HS codes so that fewer items are declared in the “Others” category within the 4-digit HS code.

3.4 Employ Non-tariff Measures to Promote Exports

3.4.1 Non-tariff measures such as facilitating certification and labeling should be employed to meet world standards and encourage exports.

3.5 Any Tariff Protection Should be Time-bound

3.5.1 The tariff protection should be time-bound with a clear outline of how the protection will be removed and phased out. This will help businesses plan better and incentivize competitiveness. Contrary to this recommendation, in the budget 2022-23, the government has provided protection to a few more industries, however, there is no clear indication of the length of protection and how the relevant duties will be phased out.

3.6 Limit Illicit Trade[10]

3.6.1 Illicit trade via transit trade agreements can be further reduced by increasing enforcement efforts and fencing of the borders.

3.6.2 Tariff rationalization will play a major role in reducing incentives for misdeclaration and smuggling, hence efforts should be made to rationalize tariffs and encourage the legal economy.

3.6.3 One of the major challenges for customs is to optimize monitoring of cargoes while ensuring facilitation of trade. Technological solutions such as hundred percent scanning of cargoes can help in improving the efficacy of monitoring efforts while ensuring legitimate trade is not disrupted.

3.7 Reduce The Dwell Time at The Customs Stage[11]

3.7.1 Currently, 90% of port regulators are operating on a completely manual paper-based system. There is a need to reform the port regulators such that the documentation requirements for the traders are streamlined and the excessive burden of documentation is significantly reduced. According to a recent study by IFC, a typical vessel in Pakistan has to submit more than 54 papers to various departments with 22 additional documents that are collected during various stages of import clearance. In line with this recommendation, the Finance Bill 2022 has incorporated changes to align the Customs Act, 1969 with the Pakistan Single Window Act, 2021.competitiveness. Contrary to this recommendation, in the budget 2022-23, the government has provided protection to a few more industries, however, there is no clear indication of the length of protection and how the relevant duties will be phased out.

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[10] Illicit trade leads to crowding out of the legal economy, loss in revenue for the government, and erosion of trust in public institutions. Pakistan is losing a significant proportion of customs tariffs every year due to illicit trade. Trade restrictions and tariffs incentivize traders to engage in smuggling and misdeclaration. The workshop discussed how to limit such trades.

[11] The dwell time from the birth of vessels is more than seven days. The clearance from the green channel is 51 percent for imports and 75 percent for exports.

3.7.2 There is a need to move to post-payment of duties and taxes from the current practice of pre-payment which can lead to significant liquidity issues for the businesses.

3.8 Support The Growth of SMEs in The Current Tariff Regime

3.8.1 SMEs are unable to directly import inputs and are therefore reliant on high tariff commercial importers for provision of inputs. SMEs should be facilitated by either reducing tariff rates on commercial importers or ensuring SMEs are able to import directly.

3.8.2 Trade facilitation is substantially lower for SMEs and needs to be improved to encourage growth of SMEs.

3.8.3 SMEs are not part of negotiations on tariff rates as they do not have access to FBR and the ministry of commerce. They are therefore discriminated against in terms of tariff rates they face for their inputs. There need to be active efforts to identify issues that SMEs incur and accordingly rationalize the custom regime to support their growth.

Conclusion

The tax regime in Pakistan suffers from various challenges that create hurdles for the country's economic development. The economy is in a dire state due to insufficient domestic resources and there is little sign of recovery in the absence of substantial reforms to improve domestic resource mobilization. The recommendations outlined above can nudge Pakistan towards sustainable and inclusive growth. The budget 2022-23 has taken some steps in the right direction (as mentioned above) however there are other areas where there is room for considerable improvement.

REFORMING PAKISTAN'S TAXES FOR SUSTAINABLE AND INCLUSIVE GROWTH

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