cdpr

TAXING INCOME IN PAKISTAN

PDPS
PAKISTAN DEVELOPMENT POLICY SERIES
پاکستان کی ترقیاتی پالیسی سیریز

A BRIEF HISTORY OF INCOME TAXES IN PAKISTAN

TAX STRUCTURE

Pakistan inherited the tax structure of pre-partition India as per the Government of India Act

CENTRAL TAX AUTHORITY

FBR is the central tax authority in Pakistan and is affiliated with the Revenue Division of the Ministry of Finance

All non-agriculture income tax is collected by the federal government, through the Federal Board of Revenue (FBR) while agriculture tax is collected by provinces

TAX COLLECTION

The Income Tax Ordinance, 2001, replaced the previous one (1979) and has thus far been amended over 2500 times.

TAX ORDINANCE

KEY HIGHLIGHTS OF INCOME TAXES IN PAKISTAN

TAX GAP

Pakistan's mid-term tax gap stands at around 4% while its long term tax gap stands at 10.4% of GDP

10.4%

GDP

In FY20 income taxes were 32.1% of Pakistan's total tax revenue and 3.7% of its GDP

32.1%

TAX FILER

Only 2.74 mn (4.1% of the labor force or 1.3% of the population) files personal income tax

1.3%

ZERO TAX

35% of individual filers pay zero income tax

35%

CORPORATE

64% of all income tax is derived from corporate taxes

64%

URBAN CENTERS

86% of all corporate income tax is collected from Islamabad, Lahore & Karachi as most businesses are headquartered there

86%

Sources: FBR Income Tax Directory (2018) cdpr

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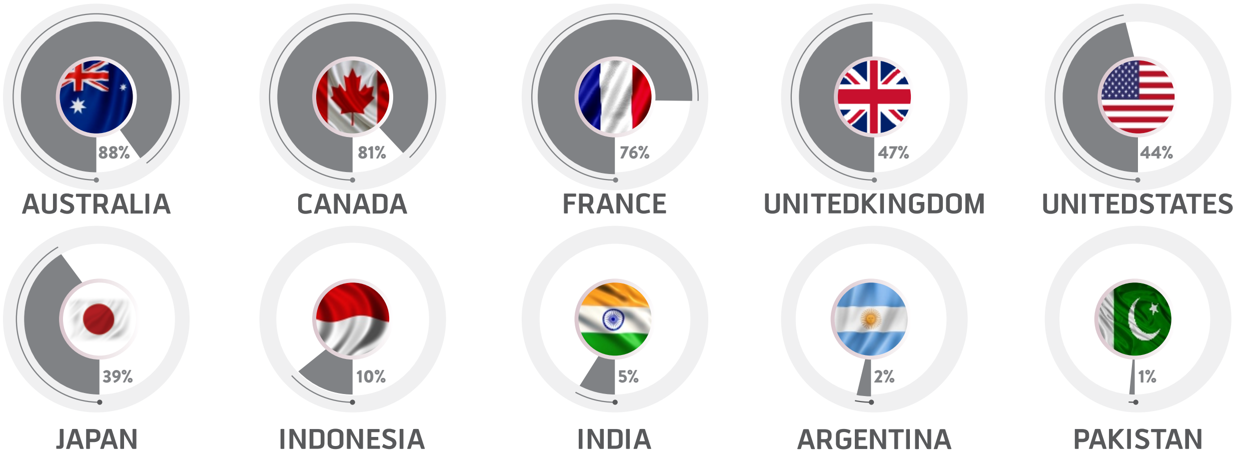
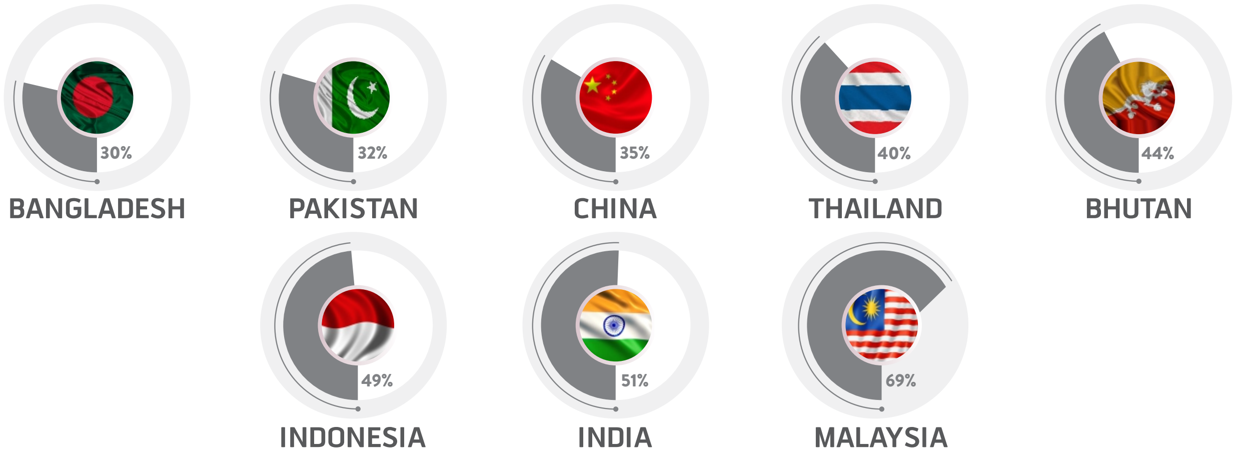
HOW WELL HAS INCOME TAX PERFORMED IN PAKISTAN?

PROPORTION OF ACTIVE TAX PAYERS IN THE POPULATION



INCOME TAX AS A PERCENTAGE OF TOTAL TAX REVENUE (2017-2019)



INCOME TAX IN FY20

Rs.1.5 tn

Total Income Tax Revenue

57%

Tax-gap Against Potential

33%

Tax Expenditure as a Share of Overall Income Tax Collection

Figure Sources:
Figure 1: Addressing Pakistan's Chronic Fiscal Deficit, 2020
Figure 2: World Development Indicators (2017-19)

DETERMINING AN INCOME TAX POLICY IS NOT SIMPLE

- How to Ensure compliance ?
- Who to tax? i.e determining the tax base
- Who to grant exemptions & concessions ?
- How to incentivize collection ?
- How to determine tax rates for different income slabs?

WHAT CONSTITUTES AN INCOME TAX POLICY?

WHAT TO TAX?

- Income from Agriculture
- Salary
- Income from Property
- Income from Business
- Income from other sources
- Capital Gains

WHY TAX?

- Revenue Collection
- Equity
- Promoting Economic Growth
- Productive Investment
- Price Stability
- Promoting Employment

COLLECTED INCOME TAX OF PAKISTANIS MUCH LOWER THAN ITS POTENTIAL WHY?

ADMINISTRATIVE ISSUES

1. Weak and slow enforcement leads to opportunities for rent-seeking
2. Weak capacity to audit large number of firms and individuals.
3. Over-reliance on withholding taxes to meet revenue targets impacts progressivity of the tax structure

POLICY ISSUES

1. Fragmented tax base between agriculture and non agriculture income creates room for tax evasion
2. Excessive reliance on exemptions and concessions, leading to distortions
3. Larger minimum tax thresholds and lower marginal tax rates regionally lead to a narrow tax base
4. A complicated tax system adds significantly to the cost of tax compliance by firms & individuals

WHAT CAN BE DONE?

A. HARMONIZE INCOME TAX

CHALLENGE

1. A fragmented tax base: Agriculture Income Tax (AIT) is collected by provinces at a lower rate than non-agriculture income tax which is collected by the FBR

2. This results in loss of revenue as citizens evade taxes by declaring non-agriculture income as agriculture income

3. Provinces have remained reluctant to revise AIT rates

Rs. 69.5 BN

Agriculture Income tax gap (FY20)

WHAT NEEDS TO BE DONE?

1. Agriculture and non-agriculture income should be taxed on the same principles, preferably by FBR

2. All collection by FBR may be sent as straight transfers to provinces to reduce provincial administrative costs

3. Use 'Presumptive income taxes' with appropriate tax rates applied on the difference of estimated value of agricultural outputs and cost of production.

4. Frequent revision of AIT rates to capture value added

B. RATIONALIZE INCOME TAX

CHALLENGE	WHAT NEEDS TO BE DONE?

CHALLENGE

1. Generous income tax thresholds and rates to make tax structure progressive have led to extensive loss in tax collection
   - i. Led to Narrow Tax Base
   - ii. Encouraged Tax Evasion at the Margins

WHAT NEEDS TO BE DONE?

1. An analysis of the potential loss in tax collection
2. Adjustment of tax structures in line with regional comparators
3. Tax rates should be stable and not change with every finance bill to avoid speculation on tax policy
4. Consider flat rates versus multiple tax rates

C. REFORM TAX ADMINISTRATION

CHALLENGE

1. Slow enforcement and audit practices allow rent-seeking opportunities
2. Number and quality of tax audits insufficient for correct self-assessment by taxpayers
3. Excessive reliance on withholding taxes.
4. Collection on demand is just 4%. Rest reliant on enforcement.

WHAT NEEDS TO BE DONE?

1. Automation of tax systems
2. Strengthening of tax enforcement procedures
3. Instituting risk-based audits
4. Strict monitoring measures to improve performance of FBR

SOME RECENT REFORMS

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Promotion of tax compliance through strengthened audit and enforcement capacity system

REFORM 2004-2011

IMPACT

Tax-to-GDP ratio fell from 9.4% to 8.8%, FBR failed to introduce an effective automated tax intelligence system and sales tax base remained entirely unchanged

FUNDED BY

Improvement of fiscal revenues and expenses by limiting the authority to grant tax concessions or exemptions as part of Finance Bill, merging NTN system with CNIC data base, launching initiatives to enhance revenue administration for sales tax, excise and customs similar to income tax.

REFORM 2013-2016

IMPACT

Tax policy and administration reforms fostered revenue mobilization and progress was seen in raising the revenue-to-GDP ratio and strengthening compliance

FUNDED BY

Use of third party data to identify potential taxpayers and send notices to non-filers

REFORM 2014

IMPACT

Increased number of active income taxpayers from 0.98 mn in FY2014 to 1.46 mn in FY2018 and 2.154 mn in FY2019

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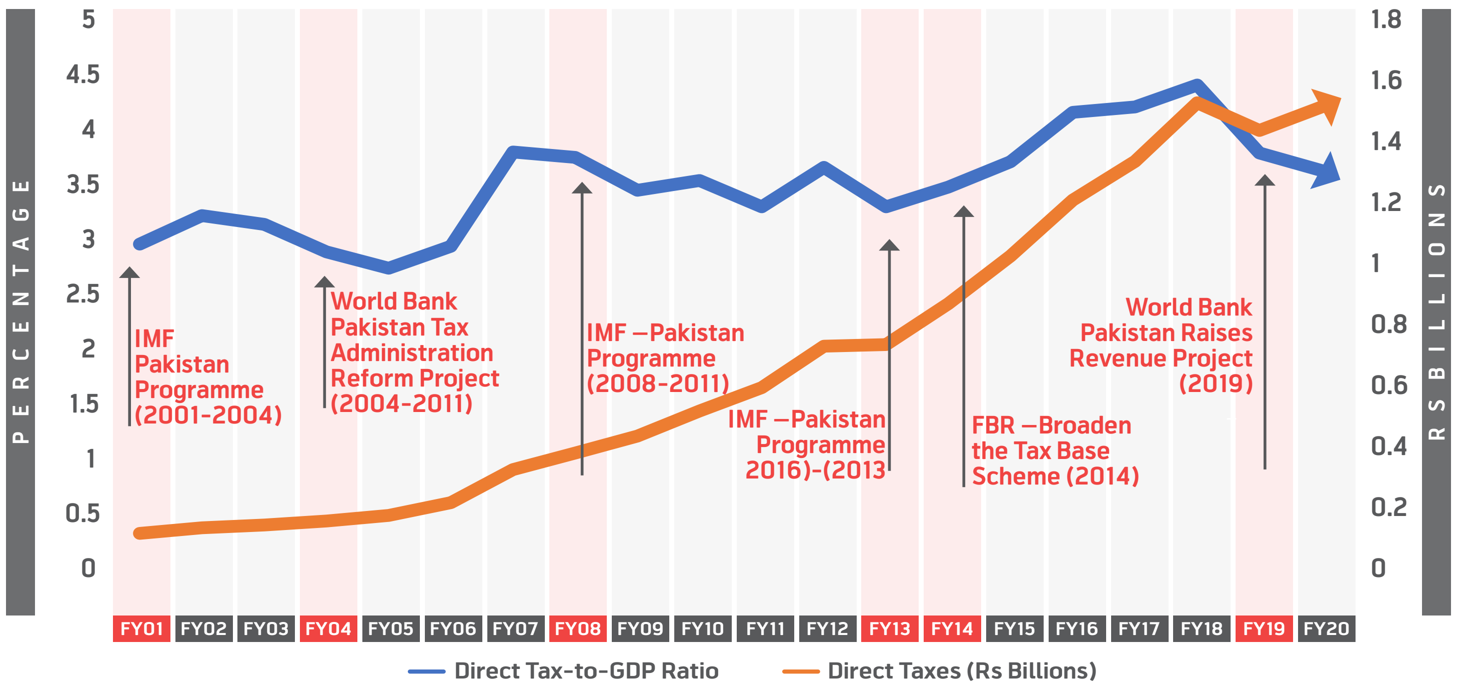
Introduction of a simple and transparent tax system, compliance facilitation, FBR officer's performance awards and upgrading FBR's Information Technology system

REFORM 2019

IMPACT

Tax-to-GDP ratio slipped from 13% in June 2018 to 11%, number of income taxpayers increased from 1.27 mn to nearly 2 mn but average tax paid decreased, time to file return and pay tax remained unchanged, number of entities automatically sharing taxpayer data improved significantly, no progress seen in training of FBR officers



Note: Income Taxes constitute more than 90% of Direct tax revenues

Source: Pakistan Economic Survey 2019-20 and FBR Year Books