REFORMING SALES TAX ON SERVICES IN KHYBER PAKHTUNKHWA

Sustainable Energy and Economic Development Programme

Improved Economic and Urban Planning in Khyber Pakhtunkhwa

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About the work

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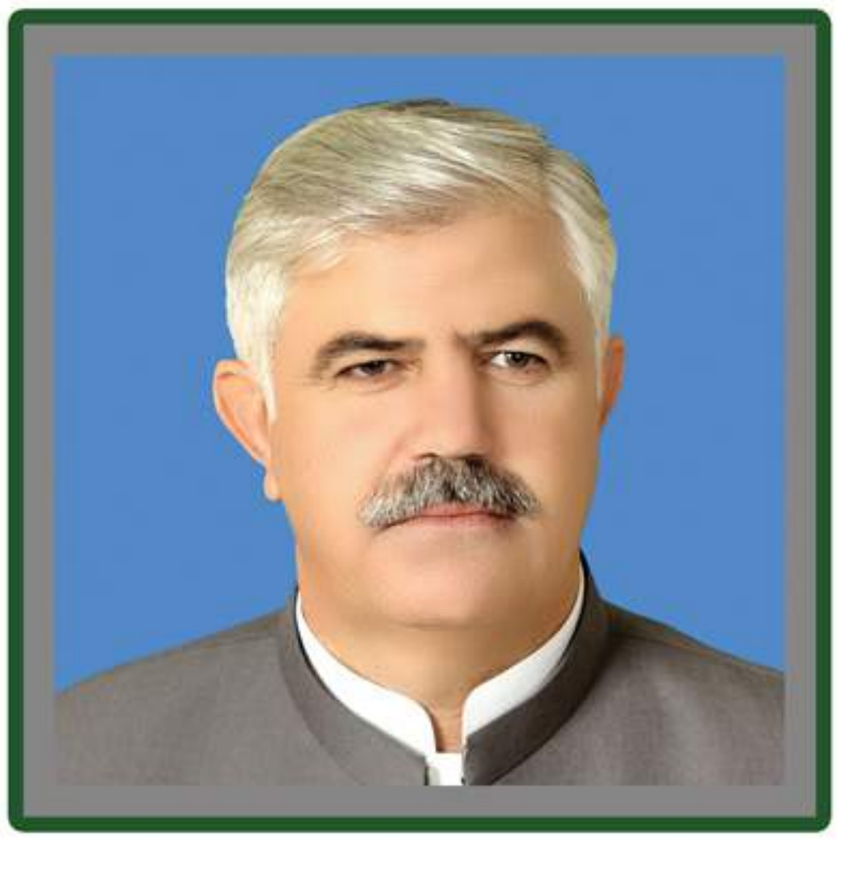


Mahmood Khan

Provincial own source revenue is a pivotal component of Khyber Pakhtunkhwa's total receipts and enables the government to provide services to the citizenry and undertake public investments. Sales tax on services has emerged to be the largest single source of provincial revenues and has exhibited a phenomenal growth during the year 2019–20. It goes without saying that Khyber Pakhtunkhwa Revenue Authority (KPRA), which has the sole mandate of collecting Sales Tax on Services, lies at the heart of the government. We, at Khyber Pakhtunkhwa, envision KPRA to be a premium revenue collecting entity capable of undertaking data analytics, system-supported detection of new taxpayers and smart enforcement.

I would like to compliment KPRA for the reform agenda it has embarked upon and the achievements it has accomplished. It gives me immense satisfaction seeing KPRA supporting economic activities during the COVID-19 pandemic through rationalization of tax rates and taking steps to increase ease of doing business in the province. While we consolidate the earlier reforms, our journey does not stop here but we will embark on new initiatives that improve revenue collection in the service sector.

We are committed to taking all measures that will help us optimize our revenue collections so that we can serve the province and the country in a befitting manner. This policy note highlights areas where KPRA can initiate steps and adapt others to further enhance the quality and quantity of Sales tax on Services collection.

Message from Finance Minister, Government of Khyber Pakhtunkhwa

Taimur Jhagra

Tax policy is an important tool of fiscal policy which has a direct bearing on the revenues of the government of Khyber Pakhtunkhwa. A forward-looking tax policy which takes into consideration the context and dynamics of the economy can prove to have far reaching consequences for revenue generation. Sales tax on services is an increasingly important source of Khyber Pakhtunkhwa's tax revenues. The year 2019-20 has been historical in the collection of Sales Tax on Services as collections increased by a historic proportion of 64% over the preceding year. Had it been for business-as-usual policy, this would have been hard to realize. But some bold policy and tax administration reforms were initiated that catalyzed the revenue growth under the constrained economic conditions. Rationalization of sales tax rates on services, generally provided by small and medium enterprises, helped capture the tax base of the semi-formal sector; tax collectors incentives were aligned with performance targets with setting up of meaningful performance indicators and a strong oversight and monitoring mechanism was put in place. My heartiest facilitations to KPRA for its achievements and forward-looking efforts for strengthening the system of sales tax on services in the province.

However, the path to reforms does not end here. In a continuum, the first generation reforms pave the way for refinement and lead to second generation reforms. It is our priority to make Sales tax on Services a buoyant tax, stimulate voluntary compliance and re-calibrate the organizational structure of KPRA to make it a 'well-functioning' tax administration. I envision for KPRA to gain the capability of informing integrated tax policy; be on the cutting edge of data analytics; have improved audit, processes and tools and be run by professionals whose motivation does not falter. This policy note complements our government's vision and highlights not only key reform areas, but also gives instances of where some of the reforms have worked.

Message from Secretary Finance, Government of Khyber Pakhtunkhwa

Atif Rehman

Primarily, Finance Department has a regulatory role for resource management. However, it has a limited role in revenue generation in as much as policy setting where sales tax on services is concerned. KPRA, being an attached department of the Finance Department has two-fold significance; it helps the department in better revenue forecast; and it serves as a repository of technical information and advises the department on technical aspects of the services' sales tax regime. In this latter role, the Finance Department leverages on the services' sales tax proposals for feeding into the annual budget.

Government of Khyber Pakhtunkhwa has initiated a tax reform process that gives salience to businesses and taxpayers but at the same time, is revenue augmenting. While a number of initiatives have already been undertaken by the provincial government like reduction in services' sales tax rates and rationalization of taxes within services sector as well as other sectors, more efforts will be required to further strengthen the policy and tax administration functions of KPRA. A tax system that is buoyant to capitalize on economic growth will be able to ensure flow of revenues that are stable and long lasting. Applying a systems approach for improving enforcement capacities, simplification and automation of business processes and payments, integrating the tax databases and building a high-performance organization can have a persistent impact on revenue generation of KPRA. The policy note highlights these issues and provides key recommendations for the government of Khyber Pakhtunkhwa to reinforce its sales tax on services' reforms agenda.

Message from Director General, Khyber Pakhtunkhwa Revenue Authority, Government of Khyber Pakhtunkhwa

Syed Fayyaz Ali Shah

KPRA is cognizant of the pivotal role it can play in providing a basis for the socio-economic uplift and prosperity of the province. It goes without saying that KPRA has been fast aligning its administration strategy characterized with taxpayers' persuasive facilitation, soft enforcement measures, efficient settlement of disputes and consistent engagement with trade associations using their platform to persuade and motivate businesses towards conformity of sale tax obligations. Measures have been initiated including efficient compliance-aimed handling of non-filers, late-filers or short-filers, selection of food outlets for the purpose of installation of RIMS, rationalization of regional jurisdictions, expansion in registration base by using available third party data, formalization of audit plan and monitoring of its implementation, and introducing measurable key performance indicators for each important activity. The shift in administration paradigm coupled with policy reforms has been instrumental in KPRA achieving a record revenue of PKR 17 Billion during FY20.

Reflecting on my experience of handling the reforms at KPRA, I am of the view that KPRA is at a stage where each additional reform measure can have increasing returns to scale. I do believe that reforms that encourage voluntary compliance, improve enforcement capabilities and builds taxpayers' trust in the tax system can have lasting impact on revenues. This policy note provides an objective assessment of KPRA's current functioning and suggests ways and means to improve it.

Message from Team Leader, Sustainable Energy and Economic Development Programme

Hasaan Khawar

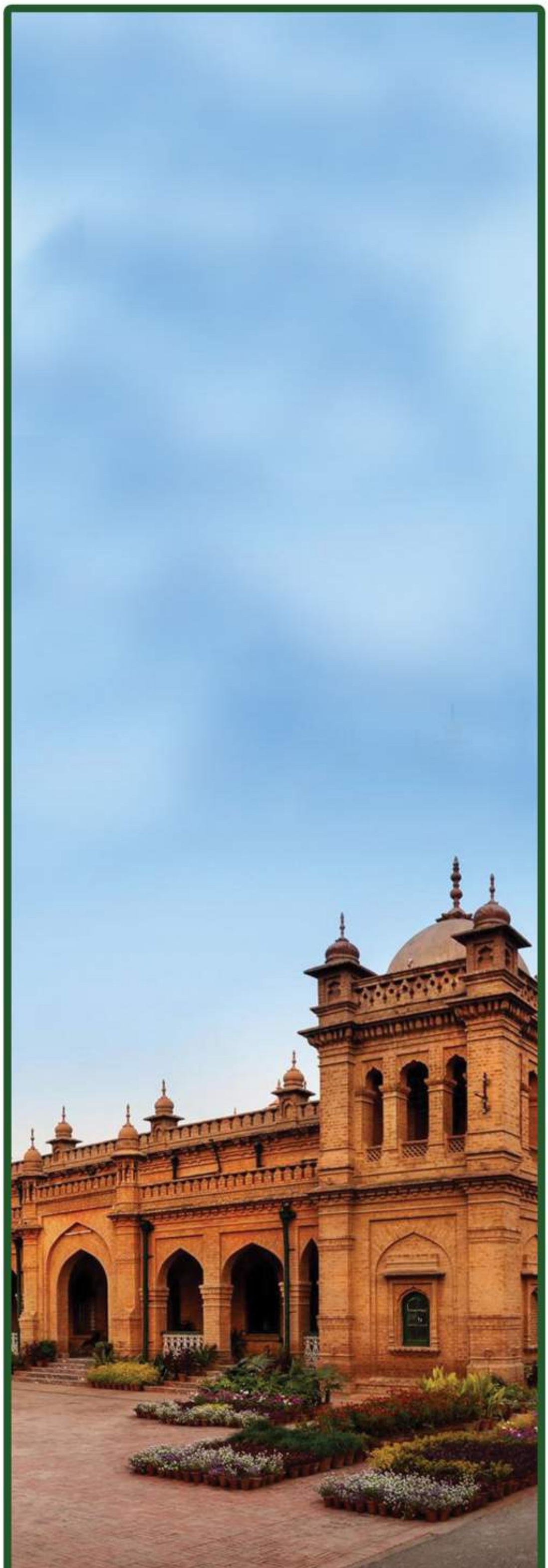
Sustainable Energy and Economic Development (SEED) Programme, funded by UK's Foreign, Commonwealth & Development Office (FCDO), is aimed at generating higher levels of public and private investments. In the post-COVID scenario, there is an even more pressing need for greater public investment, but the fiscal space is now highly restricted. This means that if public investment has to increase, SEED will have to work with the government to increase the available fiscal space. This in turn is dependent upon helping government in optimizing its revenues but the revenue mobilization effort should not lose sight of the private sector development and improved urban planning goalposts.

The provincial government presently relies heavily on federal transfers, while KP's own source revenues remain limited. In this context, the Sales tax on Services (STS) constitutes over 50 per cent of the total provincial tax collection. In recent years, KPRA has been working relentlessly to expand the tax net, simplify the procedures and increase the tax returns' filing ratio. But there is a realization in the government that if KPRA has to keep the momentum going and excel further, it needs to improve its organizational structure, enhance quality of its human resources, refine regulatory regime and most importantly make full use of IT systems and solutions. SEED remains committed to supporting the Government of Khyber Pakhtunkwa and KPRA in this journey towards excellence.

SEED has collaborated with the Consortium for Development Policy Research (CDPR) and the International Growth Center (IGC) to produce this policy note on STS. This note acts as a policy guide for the provincial government to carve out a framework for future reform to improve the performance of sales tax on services in KP.

I hope that SEED will be able to help the Government of Khyber Pakhtunkhwa in reforming the sales tax on services regime, leading to increased public investment, ultimately contributing to achieving the growth and prosperity agenda of the province.

Executive Summary



Sales tax on services is an indirect tax on supply services. Sales tax on services has undergone a major transformation since FY11 which was the last year in which the tax was collected by the Federal Bureau of Revenue (FBR) on behalf of all provinces. An amount of PKR 65.98 billion, equivalent to 0.36% of GDP was transferred to provincial governments on account of sales tax on services in FY11. This had increased to PKR 223.9 billion or 0.65% of GDP in FY18 after establishment of provincial tax collection agencies.

Each province in Pakistan has promulgated its own legislation for sales tax on services whereas sales tax on goods, which is a federal levy, is administered by the FBR. There are differences among provinces on the basic principle for levy of the tax. The Sindh Government uses the origin principle which implies that sales tax on services is the right of the province where services originate. Other provinces primarily argue for use of destination principle, implying that sales tax on services is the right of the province where their final consumption takes place. Different tax rates are used by provincial governments which creates difficulties in input tax adjustments. Similarly, there are a number of disputes over classification of goods and services between FBR and provincial revenue authorities. Taxpayers are required to file multiple returns which also imposes additional compliance costs. quite clearly, fragmentation of sales tax in Pakistan seems to be resulting in significant production inefficiencies for businesses.

At the same time sales tax on services is extremely important for provincial revenue generation in Pakistan as it contributes more than 50% of the total provincial tax collection. Reforms to sales tax on services are, therefore, extremely important for provincial governments with a view to generate more resources at a time when provincial governments are feeling a resource crunch due to slow-down in FBR collection and resultantly lower Federal Divisible Pool Transfers. At the same time businesses need to be protected from impact of COVID-19.

Pakistan inherited the Government of India Act, 1935 which assigned collection of sales tax on goods and services to the provincial government. Soon after independence, the power to levy sales tax on goods was assigned to the federation. However, the power to levy the tax on supply of services still remained with the provinces. Exercising its powers, the Federal Government promulgated sales tax acts in 1948 and 1951. Up till 1990s, sales tax was a minor and unimportant tax in Pakistan. It started with a narrow base, and between 1996 and 1999 the scope was expanded sequentially to include all economic activities except services, because services were in provincial domain. The Federal Government got provinces on board and all four provinces levied tax on supply of services through respective sales tax ordinances and delegated the power to collect it to FBR. This arrangement meant that Pakistan had a broad base of sales tax and only one revenue authority was collecting it.

This arrangement was, however, changed after 7th National Finance Commission (NFC) Award and 18th Constitutional Amendment as the provinces were allowed to collect sales tax on services themselves, if they desired so. The major shift was the result of the demand of the Sindh government. The government was apparently aggrieved by the population-based distribution of the sales tax on services between provinces and also the taxation of some major services as part of the Excise Duty by the Federal Government. Thereafter,

provinces passed new sales tax legislations and established their own tax collection authorities in the light of decisions made by 7th NFC. Pakistan moved from an integrated system of sales tax to a fragmented system where a number of authorities are levying and administering this tax.

Sales Tax on Services in KP

Under the KP Sales Tax on Services Ordinance, 2000, only thirteen services were liable to pay the tax. By FY19, the number of taxable services increased to 94. Khyber Pakhtunkhwa Revenue Authority (KPRA)'s collection has been increasing steadily. The collection had touched PKR 17.0 billion in FY20 which translates into an increase of approximately 64% over the previous financial year. This growth rate could have been around 35% if the collection in FY19 had not restricted due the Supreme Court of Pakistan's decision to suspend collection of sales tax on telecom services. Sales tax on services collected by KPRA is important for Government of KP as it constitutes over 50% of the total provincial tax collection. KPRA has also done well by reducing its dependence on telecom services. Their share in total sales tax collection decreased from approximately 92% in FY14 to almost 40% (excluding FY19 when the share of telecom services was only 24%). KPRA is also working hard to increase its filing ratio and take it above 90%. KPRA had a total of only 37 personnel in FY19 but the authority is increasing its HR capacity through fresh recruitments. With stronger ownership of KPRA by the Finance Department, the government's support for its accelerated strengthening of KPRA has visibly increased.

Key Reform Ideas

A. Expansion in scope of sales tax on services

The Government of Khyber Pakhtunkhwa has done well by bringing a total of 46 services within the scope of sales tax on services. The number of taxable services in KP in FY19 was 94. However, during FY20, the Schedule of taxable services was revamped, and classification of services was reorganized in light of international practices. Still there are many services that remain outside the tax domain.

B. Study to assess tax gap

KPRA's revenue growth has been impressive in the last financial year. There is a plausible need to undertake a tax potential study covering the potential from the entire services sector. Punjab Government, with the assistance of the World Bank and FCDO (Ex-DFID), UK, undertook a tax gap study which revealed a tax gap of 70%. A similar study for KP will tie in very nicely with the move to negative list. The study would not be a mere diagnostic as it will identify areas with major untapped potential/ tax gaps and lead the authority's efforts to develop a strategy to plug the tax gap.

C. Organizational development/ restructuring of Khyber Pakhtunkhwa Revenue Authority

There are a number of areas of organization development/restructuring where KPRA can benefit from the experience of other revenue authorities in Pakistan. KPRA was initially established in the Directorate of Excise & Taxation. KPRA has recently moved from the administrative control of Excise Department and assigned to the Finance Department. After this move, KPRA

has started to use functional roles and needs undergo a functional review to be organized on functional basis in future.

Several measures have been undertaken on HR and incentives within KPRA to boost collections. Tax collectors' incentives are now aligned with performance targets moving towards more meaningful performance indicators. In FY19 KPRA's manpower was also enhanced from 37 to 79. At the strategic management level KPRA is moving towards creating in-house capacity for tax policy formulation and tax audit administration.

However, lack of capacity of tax collectors is a major challenge for KPRA. KPRA like other provincial authorities has been relying, to a great extent, on officers of In-land Revenue Service working at these authorities on deputation, causing serious capacity constraints for revenue authorities. KPRA must recruit young, qualified officers of its own and build their capacity over time to fill important positions through targeting training. In addition to exposing the trainees to conceptual dimensions of the tax regime, training content needs to include practical dimensions of tax collection and administration. These trainings could be imparted by establishing KPRA's own training facility (as done in Punjab) or by collaborating with major academic institutions in the country.

D. Use of Information Technology

Use of information technology is vital for taxpayer facilitation, effective administration of sales tax and audit of taxpayers' returns. Provincial revenue authorities are ahead of other provincial tax collection agencies/departments in the sense that their tax collection systems are fully automated. Process of registration, filing of return, generation of tax challan etc. are performed electronically. In Punjab, the E-Pay system is also functional for ten taxes which includes sales tax on services. So, taxpayers can also make payment of sales tax on services using E-Pay. Government of KP is also in the process of automating process of payment of taxes by the taxpayers. KPRA has undertaken a number of initiatives to make use of information technology systems for collection of sales tax on services. These initiatives include Restaurant Invoice Monitoring System (RIMS), e-courts and a system to develop pre-populated returns of taxpayers.

KPRA has also joined e-Strive system of FBR which will help with improvements to the system of input tax adjustments with FBR.

KPRA can further benefit from reviewing the use of information technology in other provinces and experiences to date. PRA, for example, has developed a number of systems to facilitate taxpayers and directly collect information of transactions involving service provision. These include development of PRA Mirror and PRA eye (for efficient monitoring of staff), e-courts, Restaurant Invoice Monitoring System (RIMS), e-IMS (system that captures real time information of invoices generated by target sectors), pre-populated return, e-proceeding module, and database integration and data scraping (for identification of new taxpayers).

E. Mass Audit

The officers recruited in the audit and compliance unit of PRA have been trained on tax laws in Punjab. Using the compliance requirements set in the tax legislation and rules, the officers have developed risk criteria to review tax returns submitted by taxpayers. This can be done electronically.

KPRA is aware of the PRA's experience on establishment of this unit and has started to undertake mass audit of taxpayers. Development of this area can help overcome tax evasion.

F. Taxpayer Awareness/ Communication Strategy

Non-compliance of tax laws/rules, in many cases, is an outcome of lack of awareness of taxpayers especially the small and medium level businesses. The experience in other provinces has shown that taxpayer awareness campaigns can help increase voluntary tax compliance.

G. Harmonization of Sales Tax

Lack of harmonization of sales tax between Governments in Pakistan is causing major production inefficiencies and costs for businesses/taxpayers. The Federal Government has agreed with the International Monetary Fund (IMF) to create a National Tax Council to harmonize and integrate sales tax on services. The provincial Government / KPRA may start to work on integration by working with Sindh Revenue Board, Balochistan Revenue Authority, PRA and FBR. This can perhaps be the biggest reform in the system of sales tax in Pakistan. If there is consensus among the provincial and federal government, the remaining work could be completed quite quickly.

Concluding Remarks

KPRA has made significant progress on developing a system of collection of sales tax on services in KP. In order to further develop its tax collection systems, KPRA needs to improve its organizational structure, quality of human resources and its audit policies/plans. Effective use of IT can also go a long way towards improving quality of tax administration in KP. Further, efforts towards harmonization of sales taxation in Pakistan remains the most important area of reform.

1. Introduction

What is sales tax on services and what is the context of its evolution over time?

Sales tax on services is an indirect tax on supply of services. As per the Constitution of Islamic Republic of Pakistan, 1973 provincial governments have the power to levy and collect this tax.[1] Accordingly, provincial governments in Pakistan have established their respective revenue authorities/boards to collect this tax whereas Federal Board of Revenue (FBR) is collecting this tax in the federal territories.

Introduction

Sales tax on services has undergone a major transformation since FY11[2] which was the last year in which the tax was collected by the FBR on behalf of all provinces. Thereafter, Sindh Revenue Board (SRB) was established in 2011, Punjab Revenue Authority (PRA) in 2012, Khyber Pakhtunkhwa Revenue Authority (KPRA) in 2013 and Baluchistan Revenue Authority (BRA) in 2015. In this fashion provincial authorities gradually took over collection from FBR. An amount of PKR 65.985 billion, equivalent to 0.36% of GDP was transferred to provincial governments on account of sales tax on services in FY11[3]. The collection from sales tax on services had grown to PKR 223.9 billion or 0.65% of GDP in FY18. The collection, however, dropped to PKR 202.9 billion (0.52% of GDP) in FY19 as collection of this tax from telecommunication companies was suspended by a decision of Supreme Court of Pakistan. The suspension was vacated in April 2019.

Each province in Pakistan has promulgated its own legislation for sales tax on services. The legislations have resulted in differences in scope of the tax, multiplicity of tax rates and even differences in principles (origin principle vs. destination principle) for levy of the tax. The matter is further complicated by the fact that sales tax on goods, which is a federal levy, is administered by the FBR. The Sindh Government uses the origin principle to levy sales tax on services which implies that sales tax on services is the right of the province where services originate. Other provinces primarily argue for use of destination principle, implying that sales tax on services is the right of the province where the final consumption takes place. Similarly, there are a number of disputes over classification of goods and services between FBR and provincial revenue authorities. Revenue authorities have also been unable to come up with a fail-safe system of input tax adjustments. Businesses do not get input tax adjustments for transactions relating to more than one tax collection authority. Multiplicity of tax rates also renders it difficult to allow input tax adjustments. Quite clearly, fragmentation of sales tax in Pakistan seems to be resulting in significant production inefficiencies for businesses. Further, businesses operating across the country are required to file monthly tax returns to all tax authorities which also adds considerably to cost of doing business in the country.

Sales tax on services is extremely important for provincial revenue generation in Pakistan as it contributes more than 50% of the total provincial tax collection. Reforms to sales tax on services are, therefore, extremely important for provincial governments with a view to generate more resources at a time when provincial governments are feeling a resource crunch due to slow-down in FBR collection and resultantly lower Federal Divisible Pool (FDP) Transfers. At the same time, in the post COVID-19 scenario, it is very important to protect businesses and provide stimulus for greater economic activity. Therefore, the provincial governments in Pakistan including the Government of Khyber Pakhtunkhwa are trying to reform sales tax on services in a way that it generates optimum amount of revenue, without adversely affecting economic activity in the country.

[1]Serial No.49 of Part I of Federal Legislative List, Constitution of Pakistan, 1973
[2]FY11 refers to FY 10-11
[3]Budget in Brief 2011-12, Finance Division, Government of Pakistan, Islamabad (Page 48)

This policy note is an attempt to review the current system of sales tax on services in KPRA and other provincial revenue authorities (particularly Punjab Revenue Authority) with a view to identify if there are lessons that can be learnt for improvements in the system for levy and collection of sales tax on services in KP. This section provides the historical context of sales tax on services in Pakistan with a special focus on the period post 7th National Finance Commission (NFC) Award when provinces started to establish their own revenue collection agencies. Section 2 summarizes the state of collection of sales tax on services in the provinces of Khyber Pakhtunkhwa. Section 3 is the key part of this policy note as it identifies reforms and initiatives that can be implemented by Khyber KPRA for improvements in the system of collection of sales tax on services in the province and emphasizes the need for harmonization / integration of sales tax in Pakistan in order to reduce production inefficiencies and cost of doing business. Section 4 marks the end of the note with concluding remarks

Historical Context

At the time of independence, Pakistan inherited Government of India Act 1935.[4] The Act was based on federal structure, with powers demarcated between federation and provinces. The authority to levy sales tax on supply of goods and services was with the provinces. Soon after independence, Pakistan changed this in the sense that the power to levy sales tax on goods was assigned to the federation. However, the power to levy the tax on supply of services still remained with the provinces. Exercising its powers, the Federal Government promulgated sales tax acts in 1948 and 1951. Up till 1990s, sales tax was a minor and unimportant tax in Pakistan. In 1990, the Government of Pakistan decided to reform it along the lines of Value Added Tax (VAT). However, implementation of these reforms took a long time. It started with a narrow base, and between 1996 and 1999 the scope was expanded sequentially to include all economic activities except services, because services were in the domain of provincial taxation authority. The Federal Government got provinces on board and all four provinces levied tax on supply of services through respective sales tax ordinances and delegated the power to collect it to FBR.[5] The proceeds of this tax were distributed among provincial governments in proportion to their share in population. Most of the major services such as telecom, banking and insurance were being taxed by the Federal Government under Excise Duty. This arrangement meant that Pakistan had a broad base of sales tax and only one revenue authority was collecting it. This arrangement was, however, changed after 7th NFC Award and 18th Constitutional Amendment when power to administer sales tax on services was explicitly devolved to provinces and they were also allowed to collect this tax by establishing their own revenue collection agencies. This major shift was the result of the demand made by the Government of Sindh to 7th NFC to collect its tax through its own authority/board. Sindh Government was apparently aggrieved by the population-based distribution of the proceeds proceeds of sales tax on services between provinces and also the taxation of some major services as part of the Excise Duty by the Federal Government. Provinces passed new sales tax legislations and established their own tax collection authorities in the light of decisions made by 7th NFC and explicit authorization in the Constitution through the 18th Amendment. Thereafter, Sindh Revenue Board (SRB) was established by Government of Sindh in 2011, followed by establishment of other provincial revenue authorities. In this way, provincial

[4] Government of India Act, 1935, General Sales Tax Act, 1948, Sales Tax Act, 1951
[5] NWFP Sales Tax Ordinance 2000.

authorities gradually took over collection of sales tax on services from FBR. Thus, Pakistan moved from an integrated system of sales tax to a fragmented system where a number of authorities are levying and administering this tax.

The collection of sales tax on goods and services by different revenue authorities has its own complications. First, classifying transactions as either purely goods or services is difficult in some economic activities. Second, this affects production efficiency. The production efficiency requires that the tax should not ir