UNDERSTANDING FEDERAL SALES TAX EXPENDITURES IN PAKISTAN

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Introduction

Tax policy is a fundamental driver of economic development in any nation. Governments worldwide utilize tax policies to shape economic activities. These policies determine how taxes are levied, in what quantities, and to whom they apply. Generally, tax policies establish a standard tax code applicable to all economic activities, along with exceptions known as 'tax expenditures.' These exceptions include preferential tax rates, exemptions, deductions, allowances, rebates, deferrals, and credits, and they are employed to provide different tax treatment to various economic activities. This report, by documenting the history of statutory changes in sales tax expenditures, provides a thorough analysis of federal sales tax expenditures in Pakistan. It explores the historical trends in the statutory changes, offering insights that can contribute to discussions about their rationalization.

Studying tax expenditures in Pakistan holds paramount significance due to its multifaceted implications. Firstly, tax expenditures substantially influence the nation's fiscal health and economic landscape. Tax expenditures can alter investment decisions, distort market behaviors, and impact resource allocation by providing special tax benefits to certain sectors or activities. This, in turn, affects overall economic growth, productivity, and employment patterns. Secondly, as Pakistan grapples with fiscal challenges and the need for sustainable revenue sources, comprehending the extent and impact of tax expenditures becomes crucial. These expenditures can substantially erode government revenues, leading to budgetary imbalances and hindering the country's ability to meet essential public needs.

Additionally, studying tax expenditures facilitates informed policy-making, enabling the government to refine and optimize its tax regime. By assessing the effectiveness of these expenditures in achieving their intended goals, policymakers can tailor tax policies to better align with economic objectives and equitable resource distribution. A comprehensive understanding of tax expenditures ultimately empowers Pakistan to enhance revenue efficiency, promote economic stability, and make informed decisions for sustainable development.

One of the reasons for the limited literature is the lack of well-organized data on tax expenditures. This project addresses this bottleneck by compiling the history of statutory exemptions and reductions in Pakistan for sales taxes. In Pakistan, sales tax on goods and services is the biggest beneficiary of tax expenditures, forming the central focus of this project. We are compiling the history of legal changes regarding tax expenditures in the

[1] We acknowledge the excellent research assistance provided by Bilal Ayaz Siddique.

sales tax acts via Finance Acts, SROs, and Tax Ordinances since 1990 at a granular level of item or category. The unlocking of this data source will enable the exploration of various vital questions related to sales tax expenditures in Pakistan.

In a recent report on tax expenditures in Pakistan, the Federal Board of Revenue (FBR) assessed federal tax expenditures at PKR 1,482.3 billion, equating to 31.2 percent of federal tax revenues during the fiscal year 2020-21 (Federal Board of Revenue, 2022). These expenditures were distributed across various categories: sales taxes accounted for 49.9 percent, income taxes constituted 27.0 percent, and customs duties represented 23.1 percent. It's essential to note that these calculations primarily consider the direct consequences of tax modifications, assuming that economic activities and taxpayer reporting behaviors remain unaffected by shifts in tax policy. However, including behavioral effects—such as changes in economic activities and differences in taxpayer reporting—can potentially alter the scope of these estimates significantly. Nonetheless, these evaluations underscore the considerable impact of tax expenditures on Pakistan's tax revenue landscape. Given the dominant role of sales tax expenditures, this report focuses on sales tax, with income and excise taxes reserved for future exploration.

Background

History of Sales Taxes in Pakistan

In Pakistan, sales taxes were initially implemented in a complex multistage system, which led to widespread dissatisfaction and significant tax evasion issues. In 1949, this multistage approach was complemented by a single-stage tax on specific items like textiles. In 1950, a sales tax committee recommended replacing the multistage system with a single-stage tax applied at the initial point of sale, either at customs for imports/exports or at the manufacturer's stage for domestically produced goods. This recommendation was largely adopted in the Sales Tax Act of 1951, effective from July 1951.

Under this act, a single-stage sales tax was imposed on imported and domestically produced goods, including those intended for export. Manufacturers were required to pay tax based on the selling price, with an exemption for sales tax on raw materials. Some items, such as cotton, locally made furniture, sports goods, writing ink, penholders, paint and color boxes, ice, washing soap, kerosene stoves, and certain export items, were exempt from this tax. The standard tax rate was set at 15 percent, while luxury goods were taxed at a higher rate of 20 percent, and different rates were applied to other categories. During these times, the sales were also subject to other surcharges, such as a 1 percent rehabilitation surcharge starting in 1964 and a defense surcharge of 25 percent starting in 1965/66. (Ojha & Lent, 1969)

In response to various problems created by the turnover tax (such as the cascading effect that results in distortions and tax evasion) and due to the decline in revenues caused by decreasing import tariffs, in the 1990s, Pakistan introduced the Value Added Tax (VAT). Guided by the International Monetary Fund (IMF) recommendations, adopting a broad-based consumption tax seemed like a sustainable solution to bridge the fiscal gap. The legislative framework for implementing VAT was established in July 1990. (Waseem, 2022).

However, due to difficulties in enforcing VAT due to a lack of well-documented value chains, Pakistan adopted a hybrid system in which many items are taxed on retail price. In fact, ninety percent of Pakistan's sales tax revenue is collected outside the value-added system and still relies on the historical system of turnover taxes (Sarwar, 2023).

Data

Tax and tax expenditure policy in Pakistan is administered through three legal instruments: annual finance acts/ordinances, amendments to the annual legislation through acts/ordinances, and statutory regulatory orders (SROs).

The annual Finance Act is legislation passed by the Parliament that outlines the country's financial policies and changes to taxation and other financial matters for the upcoming fiscal year. The act is typically presented alongside the federal budget and is essential to the government's economic management.

The Finance Act includes provisions related to taxes and other revenue-generating measures, as well as changes to tax expenditures and other expenditure allocations in the budget. In Pakistan, the fiscal year runs from 1st July to 30th June of the following year. The Finance Act is usually introduced by the government just before a new fiscal year starts and is debated and approved by the Parliament. In fiscal years when there has been no sitting parliament, the legislation has been enacted through executive ordinance and is referred to as the Finance Ordinance.

In addition to the annual Finance Act, changes in tax legislation are also made, as needed, through amendments and supplementary acts. Similar to the annual Finance Act, the Parliament or executive ordinance also introduces and approves Amendment Acts.

Finally, tax policies can also be changed through statutory regulatory orders (SROs). SROs are legal instruments used by the government to make rules without going through the regular legislative process. The Federal Board of Revenue (FBR) in Pakistan has the authority to issue Statutory Regulatory Orders (SROs) related to tax matters. This authority in itself has been granted through legislative acts. As SROs do not require parliamentary approval, they are a faster way to make tax law changes; however, as a result, they may need more transparency and political buy-in from various stakeholders.

We compiled and organized all statutory changes to sales tax rates and expenditures to build our database from these three sources. As mentioned above in the history of sales taxes, Pakistan started transitioning to a value-added tax system in 1990, and the first amendment to that act was introduced in 1996. Therefore, we track all changes to the federal sales tax expenditure policies from 1996 onwards.

Data Labeling

To understand the distribution of tax expenditures by industries and sectors, every provision in the database was categorized into the following labels: **group**, **industry**, **sector**, **end-stage beneficiary sector**, **beneficiary,** and the **intended policy objective** of the sales tax expenditure.

Group refers to a broad categorization based on the type of good or service receiving preferential tax treatment. To determine the groups of all the goods in the database, the Harmonized System (HS) was used. The Harmonized System is a global system administered by the World Customs Organization (WCO) and used to classify essential goods for exporting products. Customs departments also use it worldwide to determine taxes and duties for all goods. Each product has a specific HS code, and similar products are classified into one broad group with a double-digit code. Each good in our database was classified according to these broad classifications, and a double-digit code was attributed to each observation. For example, stainless steel, alloy steel, or iron products were all classified under HS Code 72: “Iron and Steel,” while all types of rubber and its products are classified under HS Code 40: “Rubber and articles thereof.” The purpose of this group-wise classification was to gain some idea of what types of products are subject to tax expenditures.

In the second step of the categorization process, each item was classified into an **industry**, a **sector**, and an **end-stage beneficiary sector**. The **industry** is a more specific subset within the **sector**, which is a broader category. The International Standard Industrial Classification of All Economic Activities (ISIC), Revision 4, was used to ensure consistency. The United Nations Statistics Division endorses this classification, and is globally accepted for comparing economic statistical data.

The focus was on categorizing goods, utilizing Part Three of ISIC, which details 22 sectors, numerous industries within each sector, and examples of associated activities. This detailed breakdown facilitated locating the specific activity a product is linked to, simplifying classification at the industry and sector levels. For instance, goods under "components or sub-components of energy saver lamps" were placed in the manufacturing sector due to their role in lamp production. The exact match was found by examining industries within the sector: "manufacture of electrical lighting equipment," confirmed by activities listed therein.

The **end-stage beneficiary sector** refers to sectors benefiting from a product's manufacturing, supply, or import. Occasionally, goods fall into one industry and sector, but their ultimate beneficiary is a different sector. For example, "raw materials for manufacturing syringes and infusion giving sets" are used to create medical equipment. While they are categorized under "manufacture of medical and dental instruments and supplies" and "manufacturing," they also contribute to the "human health and social work activities" sector by aiding healthcare. To avoid such confusion, an end-stage beneficiary sector, determined by ISIC, was introduced.

Next, we classified the database by **beneficiary,** which refers to the part of the population most directly benefiting from this particular good. This is different from the end-stage beneficiary sector since that refers to the economic sector while this refers to the population group. The Global Tax Expenditures Database's data visualization was used to follow a conventional, widely followed classification. This lists possible beneficiaries, including Businesses, Households, the Public sector, International/Regional/Multilateral organizations, Non-profit organizations / NGOs / Philanthropic organizations/foundations, and churches / religious organizations. Using this list, each one of the goods was assigned a beneficiary.

The last step of classifying the database entailed attributing **policy objectives** to each good. This was vital to understand the intentions behind the tax expenditures for all the goods in the dataset. For this purpose, again, the Global Tax Expenditure Database was used. This database has seven broad categories of policy objectives: Attract/promote investment, Develop a priority economic sector or activity, Increase access to/demand for goods and services, Promote environmental sustainability, Support specific subgroups of the population, and Provide disaster relief. These policy objective categories are then further divided into more specific subcategories. For example, "attract/promote investment" has sub-categories referring to all different types of investment, including domestic, foreign, and portfolio, while the category "develop a priority economic sector or activity" has sub-categories catering to all major sectors and activities, including manufacturing, extractive, agricultural and so on. Collectively looking at the Global Tax Expenditure Database, our database of goods, and their corresponding legal references alongside the contexts in which they were passed, two policy objectives were assigned to each group: the first corresponding to the broader category and the second to the specific subcategory.

Types of Tax Expenditures

The sales tax expenditure provisions are determined by the standard tax rate that has historically varied in Pakistan, as shown in Figure 1. Here are some common types of sales tax expenditures in Pakistan:

Reduced Tax Rates:

This refers to applying lower-than-standard sales tax rates to specific goods or services. These reduced rates aim to encourage consumption or investment in those sectors.

Exemptions:

Exemptions involve excluding certain goods or services from being subject to sales tax. This can be done to promote affordability, support specific industries, or encourage the consumption of essential items.

Zero-Rated Supplies:

While not technically an exemption, zero-rated supplies involve imposing a sales tax rate of zero percent on certain goods and services. When a zero rate applies, sales are exempt from tax, and the firm is also entitled to a credit for taxes paid on purchases so that no tax element is included in the final cost of goods and services. A tax credit may result in a tax rebate or offset against tax on taxable sales.

Tax Credits or Refunds:

These mechanisms enable the reimbursement of sales tax paid on inputs used to produce goods or services. They are intended to help reduce the tax burden on businesses and encourage production.

Special Schemes:

Some sectors or industries might be granted special tax schemes that offer unique rules or calculations for sales tax. These can include fixed rates or simplified methods for calculating tax.

Threshold Exemptions:

Certain small businesses might be exempt from sales tax if their annual turnover falls below a specified threshold. This is intended to reduce the administrative burden on small enterprises.

Special Circumstances:

Some tax expenditures might be applicable under specific conditions, such as disaster relief, emergencies, or other extraordinary situations.

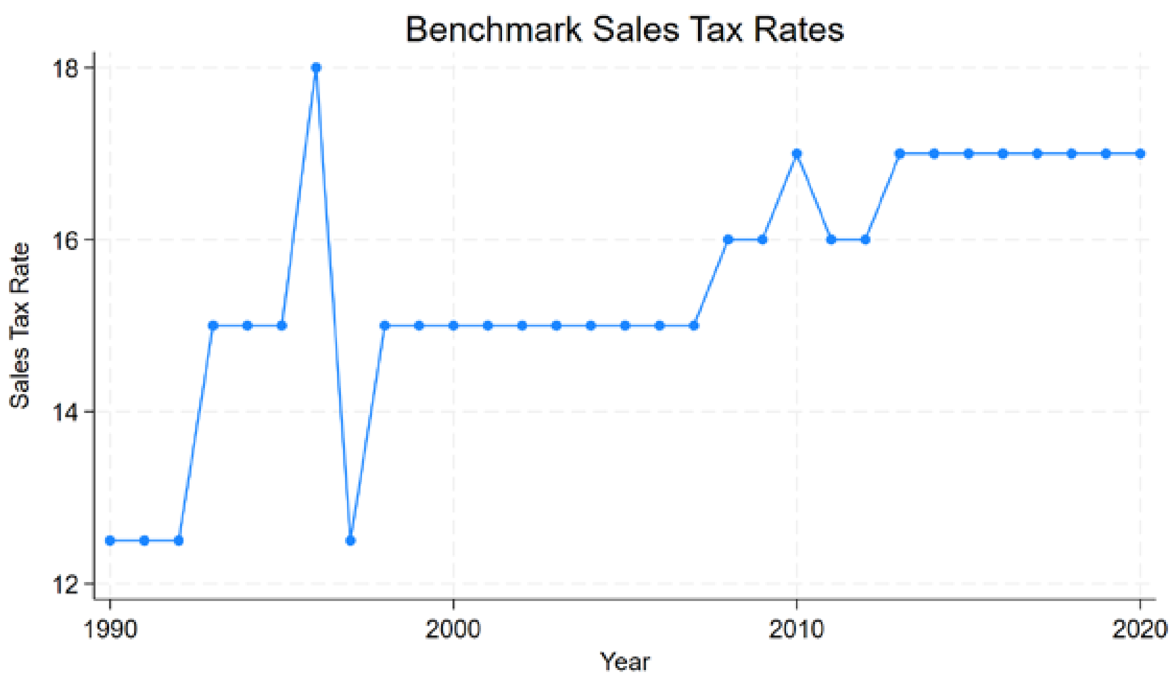

Figure 1: Standard Statutory Sales Tax Rate in Pakistan

Findings

Statutory Changes in Sales Tax Expenditures

Figure 2 illustrates the chronological evolution of statutory modifications in sales tax expenditures from 1996 to 2021. The graph clearly shows that the most prominent expenditures are related to exemptions, followed by reduced and zero rates. Additionally, each year, there is a higher frequency of tax expenditure additions than omissions. This trend shows that over the last two decades, there has been a progressive surge in provisions facilitating tax expenditures.

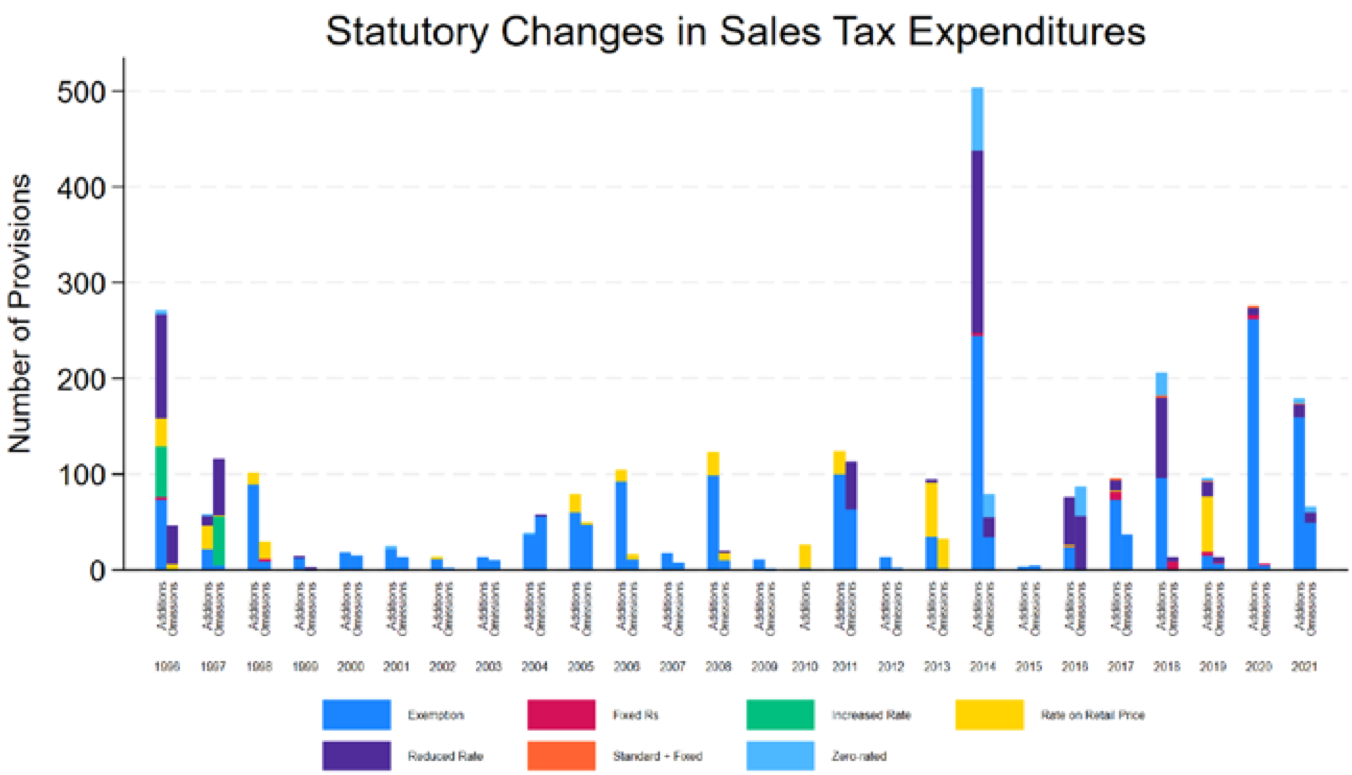

Figure 2: History of Changes in Sales Tax Expenditures

Sales Tax Expenditures on Domestic Supply and Imports

As previously noted, Pakistan stands among the select nations that heavily rely on taxing imports to generate sales tax revenue. Consequently, sales tax expenditures play a dual role in shaping the country's fiscal policy and trade dynamics. The importation and local production of diverse goods can be influenced by granting exemptions or reducing sales tax rates.

Figure 3 depicts the historical distribution of statutory sales tax expenditures, differentiating between domestic supplies and imports. The data reveals a consistent pattern of these expenditures being equally directed toward domestic supplies and imports. Once more, exemptions emerged as the predominant provision employed throughout the years, targeting domestic supplies and imports alike.

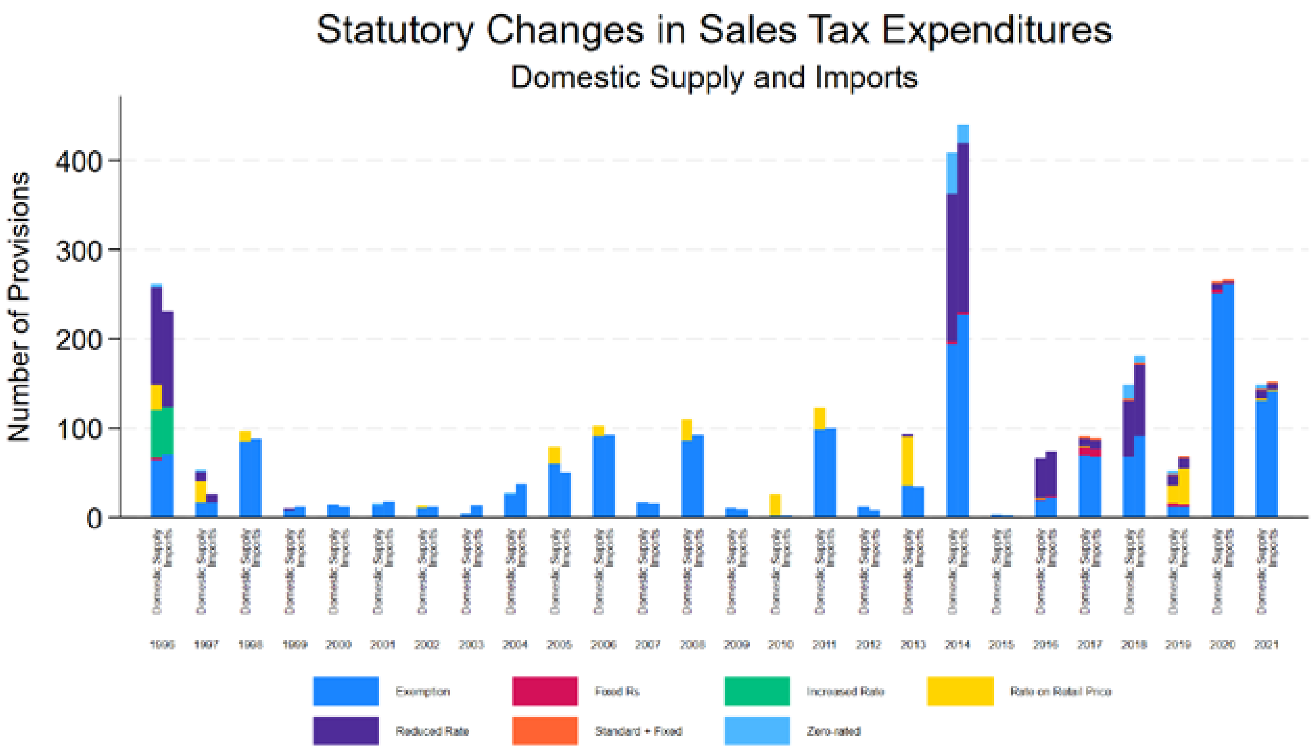

Figure 3: Sales Tax Expenditures on Domestic Supply and Imports

Sales Tax Expenditures by Legal Instrument

Tax expenditure policy in Pakistan is administered through three legal instruments: annual finance acts/ordinances, amendments to the annual legislation through acts/ordinances, and statutory regulatory orders (SROs). While a legal change can be achieved through any of these instruments, the choice of instrument carries significant political-economic implications. Each instrument requires support from a unique set of stakeholders and interest groups. It is, therefore, instructive to analyze the choice of legal instruments used for tax expenditures.

Figure 4 shows the distribution of tax expenditure provision over time by type of legal instrument. Tax expenditure policy has been predominantly established through finance acts/ordinance and their amendments. However, SROs have also been consistently used as a tool to implement tax expenditures, in some years surpassing finance acts and modifications in terms of the number of tax expenditure provisions implemented. Most notably, in 2020, SROs were extensively used to implement tax exemptions and reductions, including healthcare-related ones, in response to the Covid 19 pandemic.

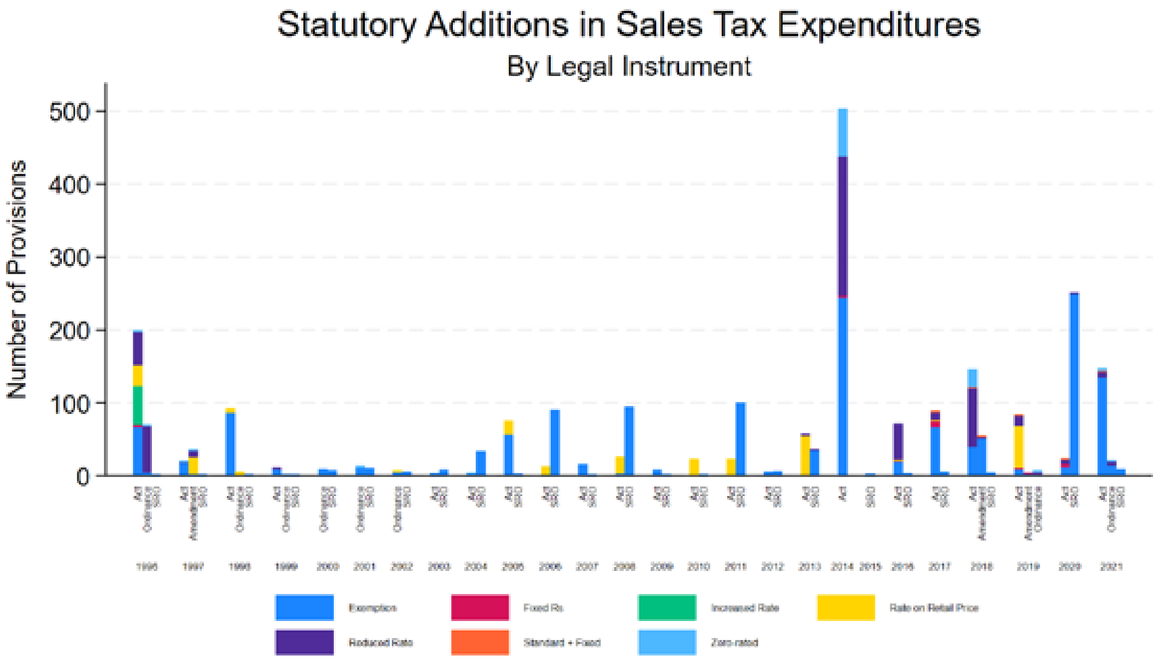

Figure 4: Sales Tax Expenditures by Legal Instrument

Sectoral Distribution of Sales Tax Expenditures

Figure 5 portrays the allocation of sales tax exemptions and reductions across various sectors in the country. From the data presented, wholesale and retail trade encompasses the most significant share of provisions related to sales tax expenditures, followed by health, agriculture, and manufacturing as other dominant sectors. In the following subsections, we present the dynamics of provision within each of these major sectors.

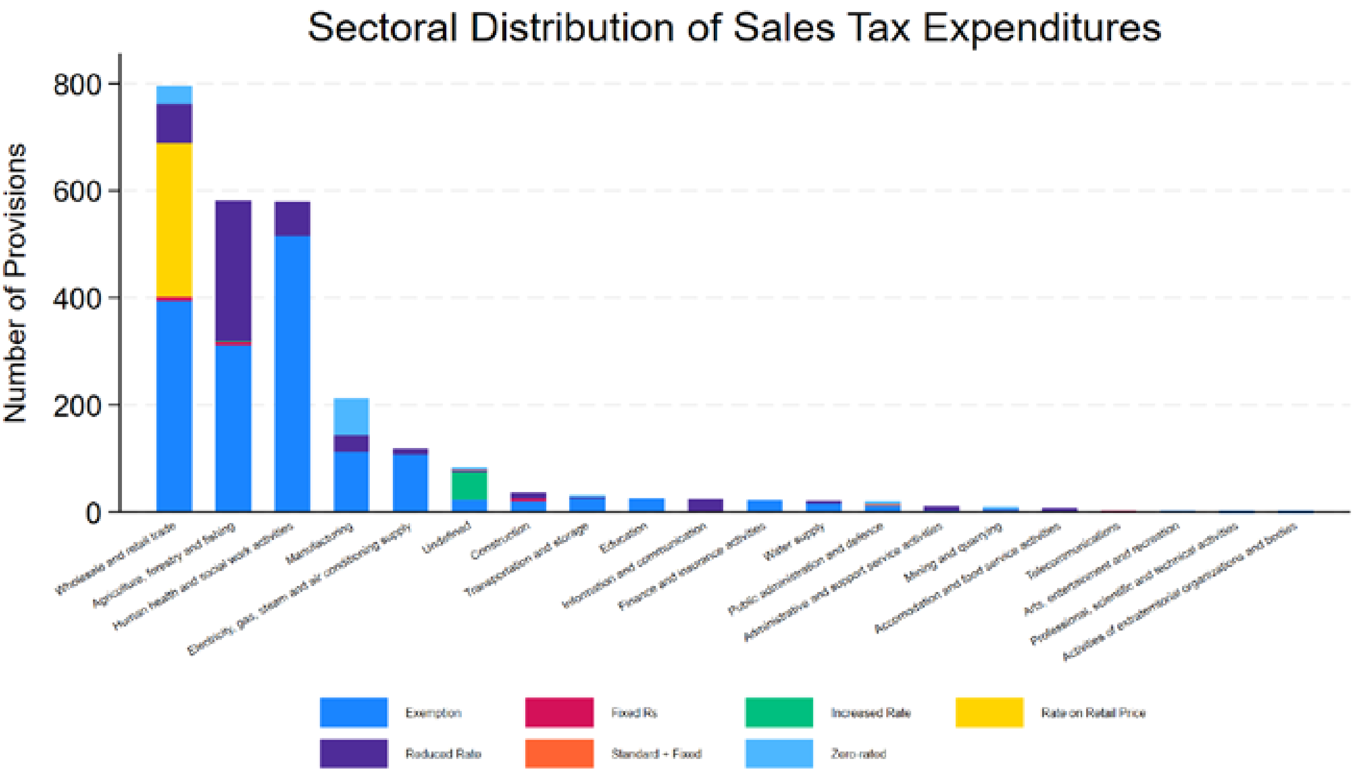

Figure 5: Sectoral Distribution of Sales Tax Expenditures

Wholesale and Retail Trade

Pakistan's wholesale and retail trade (WRT) sector is marked by numerous small and medium-sized enterprises functioning within the formal and informal economy. The WRT sector is the fourth largest employer in the country, accounting for 32% of the services sector and contributing 18% to the total GDP.[2] According to data from the Economic Census, a staggering 98% of all WRT enterprises employ five or fewer workers, with 90% reporting an annual turnover of less than PKR 1 million.[3] Javed et al. (2023) estimate that the revenue potential from the sector could be as high as PKR 277 billion, out of which only 43 billion is currently collected.

Tracking the supply chain in the wholesale and retail trade sector in Pakistan can be a complex task due to various factors, including formal and informal businesses, limited technology adoption, and challenges related to documentation and record-keeping. Considering these challenges, the sales tax is collected entirely at the retail stage as a percentage of the retail price for most items.

Fruits, vegetables, meat, and edible oils have remained widely exempt in Pakistan. At various times, the government has taken steps to exempt certain fruits and vegetables from sales tax or impose a reduced rate to promote their consumption and support the agriculture

[2] Economic Survey of Pakistan, 'Pakistan Economic Survey 2022', 2022, https://www.finance.gov.pk/survey/chapter_22/PES01-GROWTH.pdf.
[3] Economic Census of Pakistan, Pakistan Bureau of Statistics, 2005

sector. The rationale behind such policies is usually to make essential food items more affordable for the general public and to provide relief to farmers and producers.

Stationery items such as pencils, erasers, sharpeners, books, and newspapers have also been beneficiaries of sales tax exemptions and zero ratings. These exemptions are provided to increase the affordability of these items and promote literacy and education.

Manufacturing Sector

The manufacturing sector has been another significant beneficiary of sales tax expenditures. The following industries have benefited both at the retail and manufacturing stages; therefore, we summarize the provisions at the industry level.

Under the WRT and manufacturing sector, the **dairy industry** has received the most exemptions, zero ratings, and reduced rates throughout the study period. The items include milk, cream, butter, yogurt, cheese, and derived products. The dairy sector has also enjoyed zero ratings on raw materials and inputs for manufacturing dairy produce. Some exemptions are offered directly to individual companies such as Nestle Milkpak Limited. The individualized exemptions are typically handed through SROs. The perceived policy objective of these exemptions is to develop the dairy sector.

The **sugar industry** has been another major recipient of these expenditures. Figure 4 presents the range of exemptions and reduced rates offered to this industry during the study period. Not only has the sugar industry received exemptions on sugar sales, but agricultural inputs such as harvesters and planters for sugarcane have remained exempted and then changed to a reduced rate.

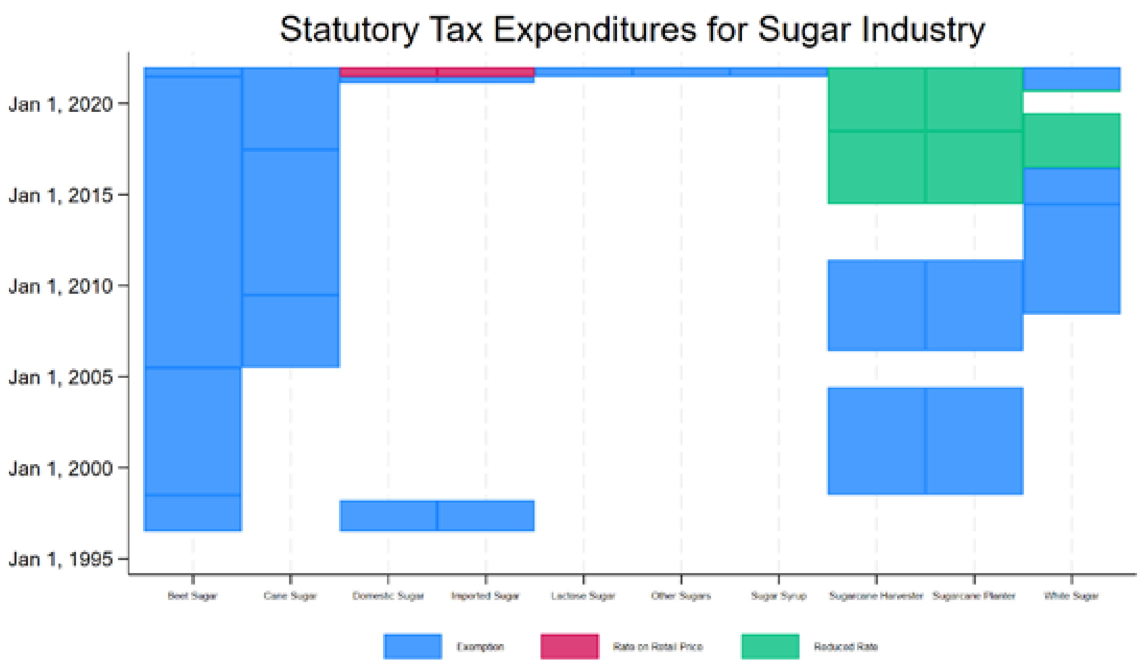

Figure 4: Statutory Tax Expenditures for Sugar Industry

The **automotive industry** in Pakistan has also received various benefits in the last few decades. Sales tax on imported vehicles was exempted during 1999 through the Finance Act. However, the exemption was removed shortly after that via an amendment ordinance. The exemption was reintroduced in June 2017 and has since continued. Sales tax on locally assembled vehicles was exempted from 2001 to 2004 via an SRO. Recently, hybrid and electric vehicles (and their complete knock-down (CKD) kits) have been beneficiaries of exemptions and reduced rates to promote environmental sustainability and mitigate greenhouse gas emissions. The sector has also benefited from various exemptions and reductions on auto parts and imports of plants and machinery.

Agriculture, Forestry and Fishing

Agriculture is one of the largest sectors of the Pakistani economy. In 2022, agriculture accounted for 22.9 percent of the GDP and 37.4 percent of employment[4]. The sector enables food security, provides raw materials to the industrial sector, and generates the country's major exports.

While government support for the sector in the form of federal income tax exemptions for agricultural income is well known, the sector also extensively benefits from sales tax expenditures. Tax expenditure provisions for the agriculture sector are split between exemptions and reduced rates, accounting for 53% and 45% of all preferential provisions, respectively.

The most significant number of exemptions in this sector fall into the **support activities to agriculture** and post-harvest crop activities industry. This includes exemptions on agricultural equipment such as harvesting, threshing, tilling, seeding, and storage equipment.

The agriculture sector is extensively supported through tax expenditures on agricultural inputs. The manufacture of **pesticides** and **fertilizers** has received exemptions and reduced rates during the last two decades. This includes exemptions for the manufacturing process's chemicals, machinery, and output.

Human Health and Social Work Activities

A close third highest number of tax expenditure provisions belong to the Human Health and Social Work Activities sector. This sector includes preferential tax treatment for the **pharmaceuticals**, **medical equipment,** and **hospital activity** industries. Most of these provisions (89%) are sales tax exemptions, while the remaining are reduced rate provisions. These provisions reflect a policy prioritizing public health and welfare to ease the financial burden on individuals seeking necessary medical supplies, equipment, and medications. At the same time, these provisions support the manufacturing industries of pharmaceuticals, medical, and surgical equipment.

The figure below shows the timeline of preferential tax provisions for the health sector. A significant portion (42%) of these exceptions and reduced rates were implemented in 2020 to address the urgent public health crisis of the COVID-19 pandemic. All pandemic-related

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[4] Economic Survey of Pakistan, 'Pakistan Economic Survey 2022', 2022, https://www.finance.gov.pk/survey/chapters_23/02_Agriculture.pdf.

exemptions were implemented through S.R.Os. These exemptions aimed to facilitate the availability of essential medical supplies such as personal protective equipment (PPE), ventilators, masks, sanitizers, and other critical items.

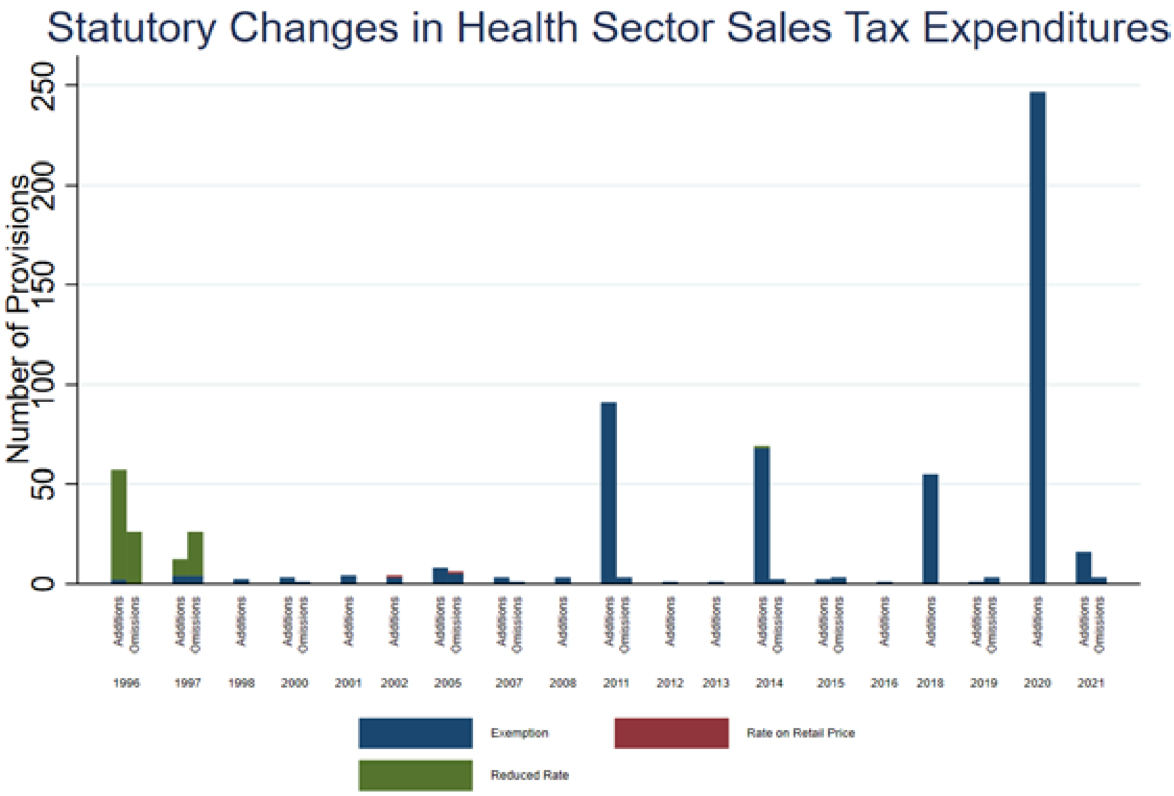

Figure 5: Statutory Tax Expenditures for Health Industry

Challenges and learnings from the digitization exercise

One of the significant issues faced while classifying goods into "groups" was due to provisions meant for a particular use. For example: "raw materials used in the manufacture of insecticides and pesticides meant for agricultural purposes," "raw materials, packing materials, sub-components, components, sub-assemblies and assemblies for the manufacture of cream," and "supplies" to the business to be established in the Gwadar Free Zone. These examples and similar observations include products of many categories used for one particular activity. So, while the industry and sector were determinable, such observations could not be categorized in a singular group and were instead labeled as "undefined."

Initially, our database did not have the "end-stage beneficiary" categorization. The problem was that while some goods were imported, supplied, or manufactured for further processing and fit into the “manufacturing” sector, their purpose was served in another sector. For example, “plant and machinery for the manufacture of fertilizer” and “plant and machinery for the manufacture of insecticides and pesticides” are both used by the Manufacturing sector. However, their end-stage beneficiary is not manufacturing but rather the “Agriculture, forestry, and fishing” sector because both those products are used in this sector after production. Similarly, while toothpaste is manufactured and hence can be categorized to be in the “Manufacturing” sector, in the end, it is sold as a tertiary good. Therefore, the beneficiary of the tax expenditure is the “Wholesale and retail trade; repair of motor vehicles and motorcycles” sector as per the ISIC. So, to erase the confusion of what sector the good is initially a part of versus the sector it is benefitting, it became imperative for a categorization catering to the end-stage beneficiary.

Conclusion

This report aims to document the history of statutory changes in federal sales tax expenditures in Pakistan. This understanding is a starting point in a debate to rationalize these expenditures. As noted, these expenditures are widespread in Pakistan (as in other countries); however, there needs to be more evidence of the effectiveness of these expenditures. On the one hand, tax expenditures enable achieving respective efficiency or distributional goals. Still, on the other hand, they may introduce significant distortions in the tax system that may increase the deadweight loss on the economy. Future research should explore the effectiveness of these expenditures and compare those to its cost vis a vis revenue leakages and distortions in economic activities.

In addition to understanding the impact of tax expenditures, it is equally important to know how these expenditures arise in the political economy context of a developing country such as Pakistan. Again, the evidence could be more extensive.

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