Policy Brief

THE TAX SYSTEM OF PAKISTAN AND THE AGENDA OF TAX REFORMS

Hafiz A. Pasha, Hafsa Tanveer, and Fatima Malik

(CGP # 06-008)

(This document is unedited author's version submitted to RASTA)

INTRODUCTION

The policy brief aims to conduct a thorough analysis of Pakistan's tax system at both the federal and provincial levels. The tax revenue as percentage of GDP of Pakistan is not only low but is also declining during the last few years as it stands at 10.5% of GDP in 2023-24. Not only it is abysmally low but high.

The brief examines the decline in tax to GDP ratio by decomposing the tax ratios into 'base' and 'rate' effects The brief also navigates through the determinants of tax to GDP through a cross-country regression analysis and identifies the potential for Pakistan for the year,2022- 2023. A representative tax system and bottom-up approach are used to estimate tax gap. Both approaches estimate a significant tax gap of above 3% of GDP.

Moreover, a substantial tax gap is also revealed at the provincial level. In addition to this, a detailed analyses of incidence of each federal tax reveal a mild progressivity of Pakistan's tax structure. In view of the identified problems of the tax structure, enormous potential for tax reform exists at provincial and federal level.

The brief focuses on a detail proposals of tax reforms aiming at creating a buoyant tax system that promotes equity across different income groups as well a balanced sectoral tax incidence. It aims at broadening the tax base while protecting the savings, investment and employment in the economy. Moreover, the measures suggested also intend to increase the integration of provincial and federal tax system to make it simpler and transparent.

FEDERAL TAX REFORMS

The reform agenda proposed in the report outlines a comprehensive suggestion for the federal income tax particularly focusing on the personal income tax and corporate income tax.

Personal Income Tax

- The reform recommends merging unearned income (like interest and rental income) with earned income, featuring a higher exemption limit and progressive tax rates.
- The tax structure suggested proposes an exemption on income up to Rs. 1,000,000, while suggesting an increasing rate for higher income brackets, peaking at 35% for incomes above Rs. 5,000,000.

- Reintroduction of an investment allowance of up to 15% of taxable income, applicable to specific national savings schemes.
- Reducing small withholding taxes and enhancing withholding tax rates for electricity bills for commercial consumers.
- Implementing a flat 10% income tax on pensions exceeding Rs. 2,500,000.

Corporate Income Tax

- Introduction of a progressive corporate income tax based on pre-tax return on equity and withdrawal of the super tax, with rates varying from 29% to 45%.
- Levy of a Federal Capital Value Tax on assets minus liabilities of a public or private company.
- Introduction of a tax rate of 5% additional tax on pre-tax profits of commercial banks if the credit share is below 20% of the socially preferred sectors.
- Extending a tax credit for investments in plant and machinery and offering a five-year tax holiday for new industrial investments.
- Continuation of tax credit of 10% of the amount invested in acquisition of plant and machinery for purposes of balancing, modernization and replacement (BMR)
- Tax Holiday for new investment in industry anywhere in Pakistan of five years.
- Taxing capital gains on property at a flat rate of 20% based on real gains, adjusted for inflation.

Federal Sales Tax

- Under items 24 and 27 of the Federal Legislative List the management of all imports is a federal responsibility. The sales tax on imported services should be levied on the 'reverse charge principle', whereby the tax payment is made by the domestic recipient of the service and charged accordingly from the foreign provider of the service.
- Extending sales tax to the retail price of various consumer goods and durables to increase the tax base and revenue from this sector.

Customs and Excise Duties

- Increased customs duties on high tariff slabs, from 16% to 20% and from 20% to 25% respectively to address revenue shortfalls.
- A need for effective protection for the farmers is suggested by increasing the tariff rates on wheat and cotton by increasing them to 11%.
- Implementing higher excise duties on industries contributing to environmental pollution. This will be an effective measure in the light of alarming issue of smog especially in Punjab.

PROVINCIAL TAX REFORMS

Agricultural Income Tax

- A major reform involves aligning the Agricultural Income Tax (AIT) with personal income tax structure on other incomes. This comes as an integral part of the IMF bailout package 2024 and aims to commence from January 1, 2025.
- This reform is expected to unlock a revenue potential of Rs. 880 billion, although it may face some resistance from large landowners.

Sales Tax on Services

- There is need to focus over the next few years on the process of the integration of the Provincial sales tax on services with the Federal sales tax on goods to facilitate move to a proper VAT.
- Consequently, increase in the sales tax rate on services to 18%. This is likely to be progressive as the demand for services rises disproportionately with income of households.

Urban immovable property Tax

- Upgrading the Gross Annual Rental Values (GARVs) of residential and commercial properties in the Provincial Excise and Taxation departments, based on the Survey of Properties by the FBR down to the individual locality level in the cities and towns of Pakistan.
- The tax policy ought to be exemption of small properties up to 8 Marlas in size. Thereafter, the recommended formula for deriving the GARV is 4% of the property value.

The recommended tax rates are 15% for a rented property and 10% for an owner-occupied property.

Capital Value Tax on Property

- Encourage provinces to implement a yearly capital value tax on real estate, replacing the inefficient transfer/ sales tax system with yearly assessments determined by the market value of property.

The comprehensive agenda of tax reforms both at the federal and provincial level could generate Rs 2395 billion of additional revenues on the 2023-24 tax base, equivalent to 2.1% of the GDP.

This potential increase in the revenue has significant features that indicate the presence of underdevelopment of provincial taxes, especially, the urban immoveable property tax and the agricultural income tax.

- The recommended tax reforms can potentially increase the provincial tax-to-GDP ratio from 0.8% of the GDP to 2.2% of the GDP. The federal tax-to-GDP ratio could rise from 9.7% of the GDP to 10.6% of the GDP. Combined, the national tax-to-GDP ratio could rise from 10.5% of the GDP to 12.8% of the GDP.

- Income tax on all incomes, including agricultural income could increase by Rs 14.85 billion, equivalent to 65.5% of the total increase from the reforms. This will make the tax system m of Pakistan markedly more progressive.

In conclusion, it needs to be said that the Agenda of Tax Reforms is comprehensive and progressive in character. Already, the reforms in the Budget of 2024-25 should raise the tax-to-GDP ratio from 10.5% in 2023-24 to 11.7% of the GDP.

Added on to this there will be another 2.3% of the GDP following implementation of the Agenda of Reforms. Pakistan's tax-to-GDP ratio could rise to 14% of the GDP. This will represent an overall increase of 3.5% of the GDP.

Consequently, the present 'tax gap' quantified in report will be largely closed by implementation of the proposed agenda of reforms.