Policy Brief

ANALYSIS OF TAX EXPENDITURES IN PAKISTAN

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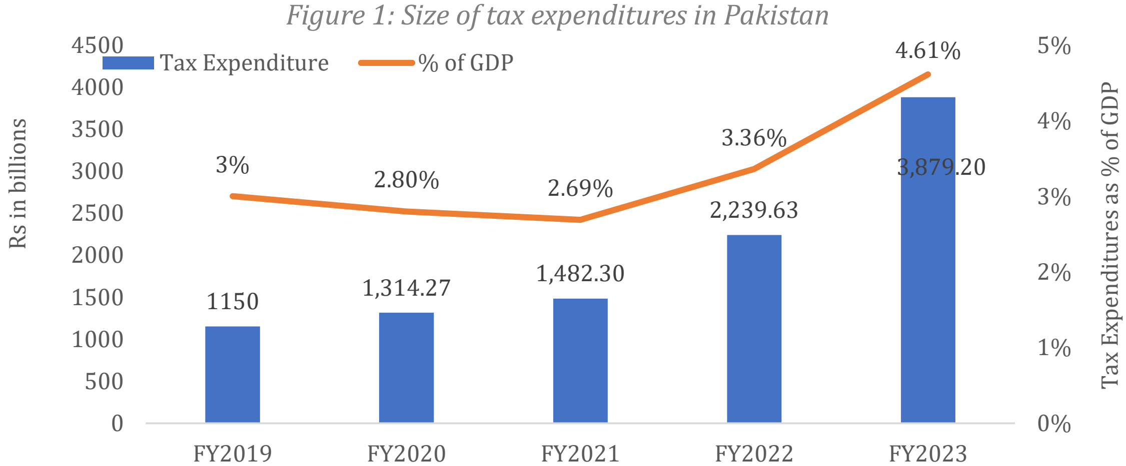
INTRODUCTION

Tax expenditures are the tax revenue loss resulting from those preferential provisions of the law that provide certain taxpayers/class of taxpayers or certain sectors with concessions that are not available to other taxpayers or sectors and that results in the collection of less tax revenue than would be the case otherwise.

According to this definition, if a concession or exemption is available to all the people then the revenue loss due to it will not qualify as tax expenditure. However, if a concession, exemption, or preferential treatment is available to some specific people, sectors, businesses, sources of incomes, areas, certain goods or services etc. then the revenue foregone due to this provision will be recorded as tax expenditures.

Figure 1: Size of tax expenditures in Pakistan



Source: GOP. (Various issues). Tax expenditure reports (2020, 2021,2022, 2023, 2024). Federal Board of Revenue.

According to economic theory, for optimal utilization of resources, it is necessary that all the economic agents or sectors of production should be treated equally so that market forces may work freely to lead to optimal resource allocation and maximize the welfare of the people in society. However, if some activities or groups receive special treatments which alter their cost of doing business, then the role of market forces in allocation of resources is limited which may lead to misallocation of resources and loss of welfare.

Tax expenditures are also a kind of distortion which adds complexity to the tax system, narrow the tax base, makes compliance more difficult, leads to decreasing the government revenues and fuel the inequalities. In this background, we present the key insights and recommendations from our study on tax expenditures in indirect taxes in Pakistan. The tax expenditures in income tax could not be studied because of the data availability challenges.

KEY FINDINGS

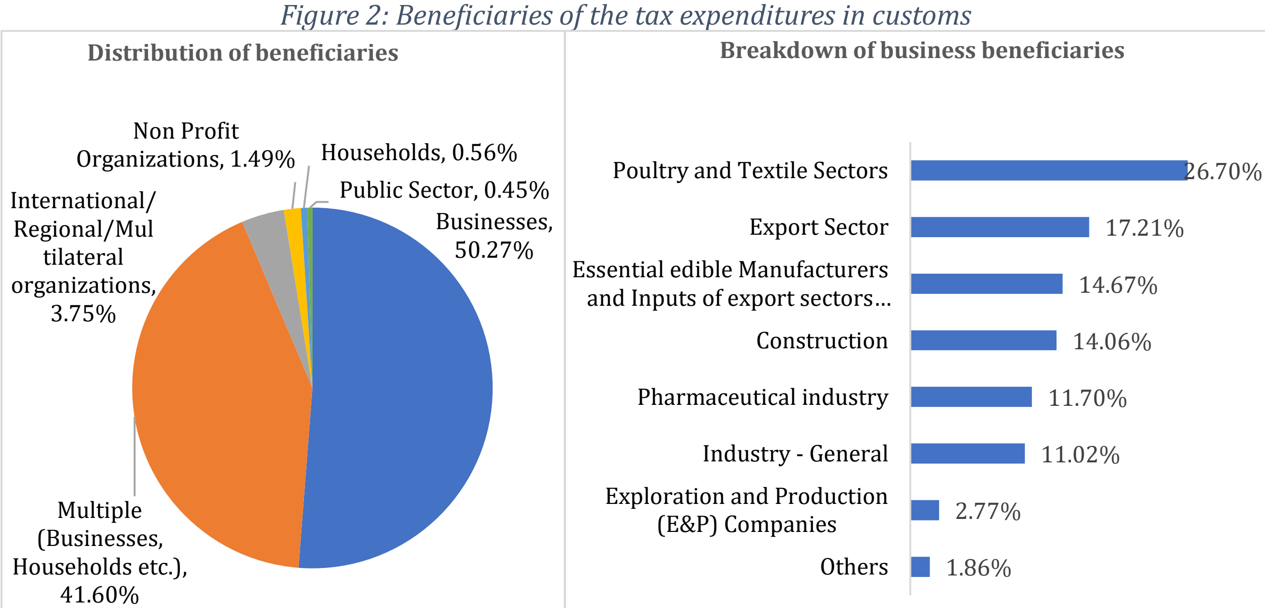
To calculate tax expenditures under customs, we utilized data from Pakistan Customs and used statutory rates as benchmarks and the difference between the tax at statutory rate and effective rate is noted as tax expenditure. We used the same data for calculating tax expenditures in sales tax at the import stage whereas for domestic sales, we used Input-Output matrix to calculate sales tax expenditures. Our findings reveal that tax expenditures in the customs duty and sales tax continue to grow.

Table 1: Tax expenditures under customs (Rs in billion)

	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023
Tax Expenditures under Customs	253.11	287.8	342.89	521.7	599.02
Percentage of FBR Collection	6.60%	7.20%	7.20%	8.50%	8.50%
Percentage of the total Tax Expenditures	22%	21.90%	23.10%	23%	...

Source: GOP. (Various issues). Tax expenditure reports (2020, 2021,2022, 2023, 2024). Federal Board of Revenue.

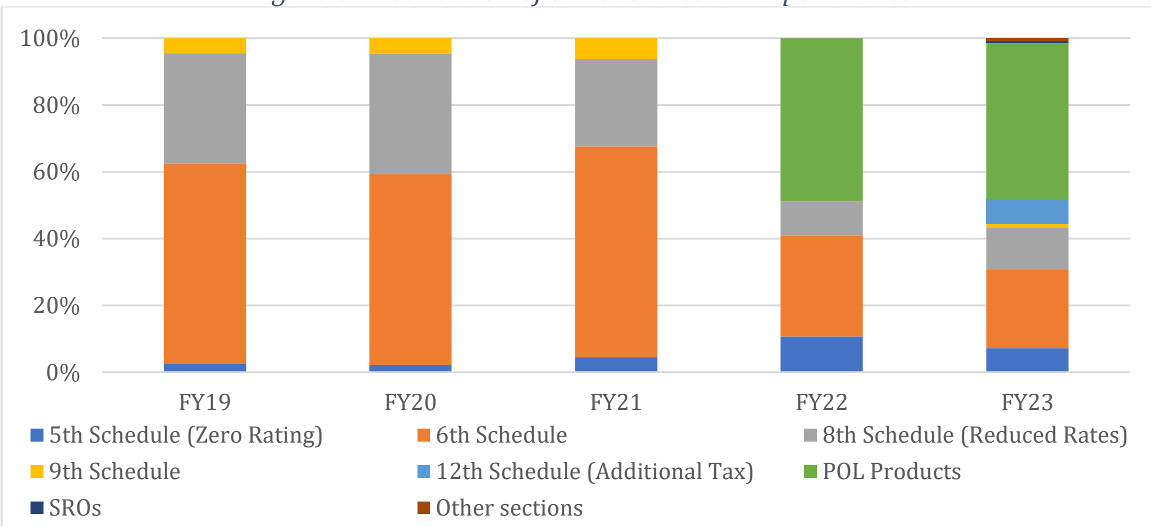
Figure 2: Beneficiaries of the tax expenditures in customs



Source: Authors' calculations.

The sales tax expenditures (including additional sales tax expenditures as well) calculated from the import data are Rs 872.96 billion. This includes Rs. 638.81 billion worth sales tax expenditures and rest are the expenditures in additional sales tax at import stage. Whereas for domestic production and selling, using I-O table data and RA-Gap model, we find that the sales tax expenditures on domestic goods is Rs. 2,663.71 billion.

Figure 3: Distribution of various sales tax expenditures



Sources: Authors' calculation and GOP (various issues).

To study sales tax expenditures on services, we studied the tax structure of tax authorities in Punjab and Sindh. Both these authorities deviate from the FBR practice as then positive list, that is, only the activities described in the act will be taxed at the specified rate. Therefore, the activities that are exempted are fully exempted without any discrimination between the participants on those activities. The reduced rate is, however, optional in some cases. Where available, the taxpayer has an option to avail it provided no input tax adjustment will be given, or (s)he may pay the tax at statutory rate and claim the input tax adjustment. Therefore, following the definition of the tax expenditures used in the study, such treatments do not fall in the tax expenditures.

RECOMMENDATIONS

Following our analysis, we present the following policy recommendations:

I. Data must be made public for better research and analysis.
II. SRO based exemptions should be discouraged as they not only impact tax collection negatively but also makes the system complex.
III. The tax expenditures introduced in any form, concession, exemption, reduced rate etc., should state clearly the purpose of their introduction. This will make it possible to evaluate the given expenditure and do a cost-benefit analysis.
IV. The industries or businesses to benefit from the tax expenditures should be selected based on some productivity benchmarks with clear targets and sunset clauses.
V. The tax exemptions for the sectors that have been enjoying the protectionism since years and are still lacking behind in the productivity (for example automobile), must be withdrawn immediately.