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# Corporate Tax Reforms in Pakistan

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## Abstract

Tax policy plays an important part in inclusive growth, incomes and wealth redistribution. Owing to a narrow tax base in Pakistan, the ability of taxes to alter distribution of incomes in favour of the poorest income quintiles has been limited. This paper specifically makes a case where private sector has been realizing anticipated profits however their rising incomes did not result in progressive changes in tax contribution. The ability of tax administrative machinery to check evasion has also remained weak.

Another important matter is how a distortive tax policy is preventing entry of new firms and investments which can potentially create greater competition and enhance consumer surplus. Since 2007 Pakistan's economy has been witnessing low levels of investment. Despite low interest rates, the private sector credit has not picked up. The exports have declined during a period when Pakistan enjoys preferential market access from the European Union and the United States. While large firms operating domestically continue to growth, the survival and growth of new firms is weak.

According to several recent studies, part of the answer to this problem may lies in the way taxes are helping cartelization through exemptions and preferences in the direct (corporate) tax structure. We discuss this view in the light of recent tax directory published by the Federal Board of Revenue. Making use of the key informant interviews and focus group discussions involving the business community, tax officials, trade and consumer associations, we present some recommendations for the reform of corporate taxation in Pakistan.

# 1. Introduction

A key driver of socio-economic development in medium and low income economies is public sector investment in human capital. Public sector expenditures for social welfare will be increasingly important for countries to successfully meet their commitments under the Sustainable Development Goals (SDGs) framework. Public investment in turn is dependent on resource mobilization efforts by the government. Gupta (2007) explains that in developing economies, key determinants of revenue performance are per capita GDP, trade openness and foreign aid. There are institutional factors as well that can influence the tax effort. For example, corruption in a country has a significantly negative effect on revenues collected by the government.

To legitimately broaden the tax base and widen the tax net, it is important for a state that a macroeconomic milieu should be created in which the economy can achieve a path of stability and growth. Under periods of sustained growth, implementation of tax reforms is relatively less painful for all economic agents. Pakistan's economy has experienced satisfactory level of macroeconomic stability in recent past securing a stable rating from leading rating agencies. The foreign exchange reserves which had fallen to below two weeks of import payments in mid-2013 have increased manifold since then owing to timely procurement of debt, remittances and other inflows from abroad. This has stabilized the exchange rate and foreign exchange reserves held at the central bank. The low commodity prices, particularly the stable and low oil prices, have also resulted in low domestic inflation.

However, the revival of economic growth remains a challenge. According to several studies, the current economic growth remains below the economy's potential rate in agriculture and industrial sectors (Table 1). A key factor in low growth is stagnant investment to GDP ratio (Table 2) which is one of the lowest in South Asian region. Though poor law and order situation and energy shortages have contributed to low interest of domestic and foreign investors, there are policy and regulatory barriers that need to be redressed.

The World Bank's cost of doing business ranking placed Pakistan 138 out of 189 countries in 2015. Pakistan was cited as one of the most difficult countries in terms of paying taxes, enforcing legal contracts, getting credit, carrying out property transactions, getting utilities connection (e.g. electricity) for commercial purposes, and dealing with permits (e.g. for construction and trade).

The distortive and regressive changes in the tax regime are also adding more to the constraints faced by the small and medium enterprises, which constitute 97 per cent of all enterprises in the country. Most taxpayers today are complaining less of the actual financial burden of taxes but more with regard to the costs associated with compliance with various taxes. In a bid to increase tax revenues, Finance Bill 2015 has burdened the existing taxpayers (e.g. salaried class).1

The regressive withholding taxes (on utilities, traded goods, ICT, banking transactions, remittances, asset transfer, real estate transactions, etc.) have increased the informal sector of the economy, as a large number of small-scale manufacturing and services sector entities are reluctant to formalize their business. Pakistan in 2015 ranked 171 out of 189 countries in tax related difficulties faced by businesses.

Local interest to expand business in key exporting sectors also declined due to lack of energy, non-processing of tax refunds (of exporters) by Federal Board of Revenue (FBR), and reluctance of banking sector to lend for working capital. Though the budget had claimed to lessen the red-tape for businesses, 'one-window' operations have not been 'functional' till now. Pakistan was ranked 122 out of 189 countries in difficulties faced by businesses in starting their business.

There are some barriers to growth which fall under regulatory sphere. For example, the Ministry of Finance needs to assess why fiscal policy is a hindrance in investment inflows.2 Some studies have pointed out that the current fiscal policy regime is hurting investment in energy sector. The study highlights that (a) FBR may be asked to look into the unnecessary 'differentiated' slabs of corporate taxation, (b) the part of the Finance Act that discourages investment in the renewable and alternative means of energy generation should be removed, (c) business community should be taken into confidence regarding the utilization of levies such as Gas Infrastructure Development Cess, (d) procedures in the import of petroleum products for raw material should be rationalized, and (e) the issue of circular debt, untargeted/hidden/cross subsidies in energy sector should be resolved. The management of circular debt needs to be made more transparent with real time losses posted online.

A weak dispute resolution system has also painted a bleak picture for future investments in Pakistan. The delay in dispensation of justice in corporate cases along with a culture of stay-orders and weak implementation of court orders weaken the investors' confidence in rule of law and property rights.

Table 1: Sectoral Growth (%)

| Sector/Industry | 2013-14 | 2014-15 | Target 2015-16 | Tax Revenue Contribution (%) |
|---|---|---|---|---|

[1] Also see: Ahmed and Wahab (2015)

[2] IPRI (2015).

| | | | | |
|---|---|---|---|---|
| Agriculture | 2.7 | 2.9 | 3.9 | 2.7 |
| Industry | 4.5 | 3.6 | 6.4 | 76.4 |
| Services | 4.4 | 5.0 | 5.7 | 20.9 |
| GDP | 4.0 | 4.2 | 5.5 | 100.0 |

*Source: PBS, Planning Commission Annual Plan, revenue share from Pasha et al. (2013)3

Table 2: Pakistan's Macroeconomic Indicators

| Indicators | Units | 2012-13 | 2013-14 | 2014-15 | 2015-16 |
|---|---|---|---|---|---|
| GDP | % | 3.65 | 4.03 | 4.24 | 5.5 (T) |
| Investment | % of GDP | 15.0 | 14.9 | 15.1(P) | 17.7(T) |
| National Savings | % of GDP | 13.9 | 13.7 | 14.5 | 16.8(T) |
| Per Capita Income | US $ | 1333 | 1384 | 1512 | - |
| CPI-Inflation | % | 7.4 | 8.6 | 4.5 | 1.86* |
| Remittances | US $ Billion | 13.92 | 15.84 | 18.45 | 8.10* |
| Current Account | % of GDP | -1.1 | -1.3 | -1.0 | -0.5** |
| Reserves | US $ Billion | 11.0 | 14.1 | 18.7 | 20.7^ |
| Fiscal Deficit | % of GDP | 8.2 | 5.5 | 5.4 | 1.1@ |
| LSM | % | 4.2 | 4.0 | 3.4 | 3.9@ |

*:July-November **:July-October @: July-September ^:As on December 11,2015

Source: Fiscal Update, Ministry of Finance, December 2015

[3] Pasha et al. (2013).

Staying with the subject of this paper, Pakistan's narrow direct tax base remains a challenge for the government whose public expenditure needs are fast expanding. There is an added pressure from the International Monetary Fund (IMF) to further reduce the fiscal deficit. This could result in a slashing down of public spending on social sectors and infrastructure (Table 3). Despite the narrow direct tax base, there is a preferential treatment for some sectors and entities which get tax concessions from the government. These privileges hamper a level playing field and put a higher pressure of increased tax rates on sectors, entities and individuals already paying their due share of taxes.

Table 3: Pakistan's Fiscal Position

| **Items** | **FY 15** | **Target FY 16** | **Prov. Actual FY 16 (Jul-Sep)** | **Prov. Actual FY 15 (Jul-Sep)** | **% Change** |
|---|---|---|---|---|---|
| FBR Tax Revenue | 2588.2 | 3104 | 600.2 | 537.8 | 11.6 |
| Other Revenues | 1074.3 | 1210 | 265.6 | 248.4 | 6.9 |
| Gross Federal Revenue Receipts | 3662.5 | 4313 | 865.8 | 786.2 | 10.1 |
| Transfer to Provinces (Net) | 1538.7 | 1849 | 288.9 | 311.3 | -7.2 |
| Net Federal Revenue Receipts | 2123.8 | 2463 | 576.9 | 474.9 | 21.5 |
| Total Federal Expenditure | 3667.9 | 4089 | 912.5 | 857.0 | 6.5 |
| Current Expenditure of which | 3165.7 | 3166 | 840.8 | 816.8 | 2.9 |
| *Interest / Mark-up Payments* | 1303.8 | 1280 | 415.9 | 394.5 | 5.4 |
| *Defence* | 697.8 | 781 | 145.6 | 164.6 | -11.5 |
| *Others* | 1164.1 | 1105 | 279.2 | 257.7 | 8.3 |
| PSDP | 502.2 | 700 | 71.7 | 40.2 | 78.4 |
| Federal Budget Deficit | -1544.0 | -1626 | -335.5 | -382.2 | 12.2 |
| % of GDP | -5.6% | -5.3% | -1.1 | -1.3 | - |
| Provinces Surplus | 87.3 | 297 | 7.4 | 45.3 | -83.7 |
| Overall Fiscal Deficit | -1456.7 | -1328 | 328.2 | 336.8 | 2.6 |
| % of GDP | -5.3% | -4.3% | -1.1 | -1.2 | - |
| Financing | 1456.7 | 1328 | 328.2 | 336.8 | 2.6 |
| External | 181.0 | 346 | 55.3 | -13.5 | - |
| Domestic | 1275.7 | 982 | 272.9 | 350.3 | -22.1 |
| Nominal GDP | 27384 | 30672 | 30672 | 29078 | - |

*Source: Fiscal Update, Ministry of Finance, December 2015

The corporate taxes imposed on a narrow range of taxpayers, and existing tax exemptions, concessions and holidays, distort production and consumption behaviour. Such revenue losses also have implications for rising inequality and slow growth in public expenditure for social sectors.4 Going forward the challenge for FBR will be to make corporate taxes a key driver of revenue growth and also keep these taxes as progressive as possible to lessen the burden on small and medium enterprises. A related challenge for FBR is to strengthen the audit function. In a culture of tax non-compliance, incentives to come under tax net are often not a sufficient condition to increase a number of tax filers. It is only through transparent and effective audit that potential taxpayers will know that their wealth and income growth is being monitored.

Taking lead from the above-mentioned discussion, our key objective in this paper is to conduct an in-depth review of information on corporate taxes given in the FBR tax directory. Furthermore, based on our discussions with the government officials, business community and civil society organizations we provide a strategy for reform of corporate tax regime in Pakistan.

The remaining sections in this paper will focus on the key features of Pakistan's corporate taxation (section-2), exemptions provided in the corporate tax regime (section-3), and a strategy to make corporate taxation in Pakistan a tool for redistribution of incomes and wealth (section-4).

## 2. Methodology

There is a limited literature on the incidence of corporate taxes in Pakistan. While this study, due to time and resource constraints, does not carry out an in-depth incidence analysis, however we try to update the knowledge regarding corporate tax regime, based on three sources of information.

First is the analysis from the tax directories published by the FBR for fiscal year 2013 and 2014. Second, based on our key informant interviews and focus group discussions, we provide a strategy for reform of corporate taxes. The recommendations that find their way in this paper are those upon which there was some degree of consensus among both government officials and the representatives of the business community. Third, we also validate our recommendations from the available literature on this subject.

## 3. Analysis of Corporate Tax Information in FBR Directory

A tax directory was published in 2013, after a gap of almost 15 years. This exercise was repeated for 2014. A number of key findings emerge from these directories.5

[4] Burki et al. (2015).

[5] This section draws from our research work in Ahmed et al. (2015b).

First, the number of corporate return filers is relatively small. As shown in Table 3, a total of 23,530 companies filed returns in 2013 while 24,186 in 2014. There are over 62,000 companies registered with Security Exchange Commission of Pakistan (SECP). The number of individual taxpayers was 726,987 and 791,456 in 2013 and 2014 respectively. This is a small fraction of the potential taxpayers of over three million.

Second, the distribution of revenues is very skewed. In the case of corporate taxpayers, over 44 per cent filed a zero return in 2014 showing no profits. There are only 1.4 per cent of the companies, paying their due share of taxes, and contributing as much as 82 per cent to revenues.

An analysis of the tax directory published by FBR (Table 3) explains that the companies with a turnover between PKR 5-10 million are paying the big share of taxes (not necessarily their due share). In the absence of a strong audit mechanism at FBR, one can question as to why the share of taxes paid by companies with higher levels of turnover is low. We, of course, understand that the number of companies decreases as the level of turnover increases.

In the case of smaller companies, the government has also been increasing the threshold level due to which one observes a relatively smaller growth for companies having turnover less than PKR 5 million and reduction in number of taxpayers for companies having turnover less than PKR 1 million. We recommend that such thresholds should be calculated in real terms as well so that a true value of exemptions can be assessed.

Table 3: Tax contribution by companies

| | **2013** | | **2014** | | **Growth Rate** | |
|---|---|---|---|---|---|---|
| **Groups**<br>**Tax Paid** | **No. of Taxpayers** | **Total Tax paid** | **No. of Taxpayers** | **Total tax paid** | **No. of Taxpayers** | **Total tax paid** |
| | | **Rs in million** | | **Rs in million** | **%** | **%** |
| 0 | 10,492 | - | 10773 | - | 2.7 | - |
| 1- 1,000,000 | 8,158 | 2,015 | 7756 | 2,038.30 | -4.9 | 1.2 |
| 1,000,001 - 5,000,000 | 2,557 | 6,057 | 2906 | 6,847.20 | 13.6 | 13 |
| 5,000,001 - | 1,447 | 16,495 | 1768 | 20,012.00 | 22.2 | 21.3 |

| | | | | | | |
|---|---|---|---|---|---|---|
| 25,000,000 | | | | | | |
| 25,000,001 - 100,000,000 | 577 | 27,989 | 646 | 32,049.00 | 12 | 14.5 |
| 100,000,001-500,000,000 | 220 | 46,364 | 239 | 50,625.00 | 8.6 | 9.2 |
| 500,000,001+ | 79 | 215,633 | 98 | 229,604.20 | 24.1 | 6.5 |
| **Total** | **23,530** | **314,553** | **24186** | **341,171.90** | **2.8** | **8.5** |

Source: FBR, Ahmed et al. (2015b).

In the case of AoPs (table 4), the number of taxpayers in the highest turnover category has fallen between 2013 and 2014. The total tax paid by this group has also declined by over 22 per cent. Similarly, due to the increased threshold level (and absence of thresholds calculated on real prices) the total tax paid by AoPs having up to PKR 1 million turnover has also declined. The data indicates a major increase in taxes paid by the group between PKR 5 to 100 million. This also indicates a disincentive to corporatize.

SDPI (2015) had analyzed that the current structure of taxation is a disincentive to corporatize. FBR's own report co-authored with a consortium of economic experts states:

*"Public and private limited companies pay the same tax rates, though the former have slightly more reporting requirements than the latter. The public limited company pays out its entire net income in dividends. The shareholders will thus not only pay a corporate income tax, but also a tax on the dividend income. The effective tax rate in the case of an incorporated business comes to 41.5%. In the non-corporate sector there are two sub-sectors: Association of Persons (AoPs) and Business individuals. An AoP does not have the limited liability protection but does face a significantly lower tax rate than a company. In addition, an AoP's income tax represents the full and final income tax liability for the individual partners, who then do not need to make any additional payments for personal income tax. The effective rate of taxation is 25%. In respect of business individual, it may be said that they are simply persons who does business as a sole proprietor and does not incorporate their enterprise. This person does not get any legal protection from liability, and in turn faces tax rate much lower than either an AoP or a company, since they are taxed only at the individual income tax rate. Their actual rate comes to 7.25%".6*

[6] SDPI (2015).

Table 4: Tax contribution by Association of Persons (AoPs)

| | **2013** | | **2014** | | **Growth Rate** | |
|---|---|---|---|---|---|---|
| **Groups**<br>**Tax Paid** | **No. of Tax Payers** | **Total Tax paid** | **No. of Tax Payers** | **Total tax paid** | **No. of Tax Payers** | **Total tax paid** |
| | | **Rs in million** | | **Rs in million** | **%** | **%** |
| Less than zero | 6 | 0 | | | | |
| 0 | 15,930 | - | 14,721 | - | -7.6 | |
| 1- 1,000,000 | 19,914 | 4,075.80 | 20,478 | 4,042.50 | 2.8 | -0.8 |
| 1,000,001 - 5,000,000 | 3,808 | 8,314.00 | 4,313 | 9,611.00 | 13.3 | 15.6 |
| 5,000,001 - 25,000,000 | 835 | 7,813.20 | 1,103 | 10,866.50 | 32.1 | 39.1 |
| 25,000,001 - 100,000,000 | 93 | 3,894.30 | 129 | 5,931.50 | 38.7 | 52.3 |
| 100,000,001 - 500,000,000 | 20 | 4,663.90 | 18 | 3,606.50 | -10 | -22.7 |
| 500,000,001+ | | | 2 | 1,109.00 | | |
| **Total** | **40,606** | **28,761.20** | **40,764** | **35,166.90** | **0.4** | **22.3** |

Source: FBR, Ahmed et al. (2015b).

The point about disincentive to corporatize is further endorsed when one observes the largest growth in number of taxpayers and taxes paid by entities registered as 'business individuals' and not companies of AoPs (Table 5). The significant growth in number of tax payers in the group having turnover above PKR 1 million indicates the potential of this group to come under rules applicable for companies or AoPs if due facilitation by FBR and SECP is available.

Table 5: Tax contribution by Business Individuals

| | 2013 | | 2014 | | Growth Rate | |
|---|---|---|---|---|---|---|
| **Groups**<br>**Tax Paid** | **No. of Taxpayers** | **Total Tax paid** | **No. of Taxpayers** | **Total tax paid** | **No. of Taxpayers** | **Total tax paid** |
| | | **Rs. in million** | | **Rs. in million** | **%** | **%** |
| less than 0 | 325 | -0.6 | | | | |
| 0 | 304,004 | - | 297,002 | - | -2.3 | NA |
| 1 – 2,000 | 48,402 | 51.3 | 50,747 | 56.4 | 4.8 | 9.9 |
| 2,001 – 10,000 | 121,095 | 634.3 | 143,687 | 756.8 | 18.7 | 19.3 |
| 10,001 – 20,000 | 54,408 | 782.4 | 61,231 | 894.6 | 12.5 | 14.3 |
| 20,001 – 25,000 | 14,464 | 324.7 | 17,723 | 398.7 | 22.5 | 22.8 |
| 25,001 – 50,000 | 49,467 | 1,788.80 | 58,912 | 2,123.10 | 19.1 | 18.7 |
| 50,001 – 100,000 | 44,200 | 3,132.50 | 52,205 | 3,710.90 | 18.1 | 18.5 |
| 100,001 – 500,000 | 57,964 | 12,583.70 | 73,111 | 16,500.10 | 26.1 | 31.1 |
| 500,001 – 1,000,000 | 16,488 | 11,493.90 | 16,036 | 11,309.10 | -2.7 | -1.6 |
| 1,000,001+ | 16,170 | 58,611.20 | 20,802 | 79,017.80 | 28.6 | 34.8 |
| **Total** | **726,987** | **89,402.20** | **791,456** | **114,768** | **8.9** | **28.4** |

Source: FBR, Ahmed et al. (2015b).

The findings of the tax directory clearly demonstrate the high level of tax evasion in the country. Almost 62 per cent of companies and 75 per cent of individuals do not file returns. This is also the position with AoPs. A sectoral analysis of this directory reveals that sectors which have witnessed relatively faster growth in recent times have few number of taxpayers (owing to various exemptions and tax evasion). For example, Pakistan's leading export sector, i.e. textile only has 1,135 tax paying entities. Similarly, the booming construction sector having backward and forward linkages with several other industries has 720 tax paying entities. A large part of construction activity still continues in the undocumented sector (table 5). The legal cover provided to some sectors allowing them not to pay taxes is resulting in a substantial tax leakage. For example, independent power plants have been allowed a life-time tax exemption, which needs to be reconsidered by parliament.

Table 5: Taxpayers in Select Sectors7

| Sectors | Number of tax payers |
|---|---|
| Agro-based industries | 791 |
| Construction | 720 |
| Energy | 2,839 |
| Small and medium enterprises | 2,945 |
| IT & Telecom | 1,451 |
| Textile | 1,135 |
| Media | 225 |
| Insurance | 63 |
| Banking | 107 |

*Source: FBR Tax Directory 2014

The total number of business taxpayers stood at 39,456 (break-up by major industries in Table 5) total income by companies and AoPs has increased by 9 per cent. However the companies and AoPs who have paid taxes only increased by 4 per cent. Sectoral share in overall tax paid shows that energy sector remains the highest taxpayer (Table 7) followed by banks, agro-based industries (including fertilizer, food processing and beverages), construction and telecom sectors.

Table 7: Sectoral share in total tax paid

| Sectors | Share in Tax Paid | Share in Total Number of Tax Payers |
|---|---|---|
| Textile | 1.9 | 2.9 |
| Agro-based Industries (Fertilizer, Food, | 7.4 | 2.0 |

[7] Source of 'tax from business' can accrue from companies, AoPs and business individuals.

| | | |
|---|---|---|
| Beverages, etc.) | | |
| Banks | 12.1 | 0.3 |
| Construction | 3.6 | 1.8 |
| CGS0 (Cotton/Ginning/Sugar/Seed Oil) | 2.3 | 3.4 |
| Energy (CNG, Power, Petroleum, etc.) | 33.0 | 7.2 |
| Media (Broadcasting, Communication, Cable operators, etc.) | 0.1 | 0.6 |
| Insurance | 0.7 | 0.2 |
| Telecom & IT | 3.7 | 3.7 |
| Other manufacturing enterprises | 0.8 | 7.5 |
| Others | 34.4 | 70.6 |
| TOTAL | 100 | 100 |

*Source: FBR Tax Directory 2014

## 4. Exemptions under corporate tax regime

Pakistan is known to have higher corporate tax rates than other major Asian countries (Table 6). The basic issue is why despite high tax rates, Pakistan has a very low tax-to-GDP ratio. The answer lies in wide ranging exemptions and concessions along with high levels of tax evasion.8 This again confirms the perceptions of people regarding the tax system in Pakistan, described earlier.

Table 6: Key Tax Rates Across Select Asian Countries, 2013

| **Corporate Tax Rate %** | | **Standard Sales Tax Rate %** | | **Average MFN Tariff Rate %** | |
|---|---|---|---|---|---|
| India | 34 | Turkey | 18 | Bangladesh | 14.4 |
| Pakistan | 32 | Pakistan | 17 | Pakistan | 13.9 |

[8] Also see: Ahmed and O' Donoghue (2009).

| | | | | | |
|---|---|---|---|---|---|
| Philippines | 30 | China | 17 | India | 12.6 |
| Sri Lanka | 28 | Bangladesh | 15 | Sri Lanka | 10.2 |
| Bangladesh | 27.5 | India | 12.5 | Turkey | 9.8 |
| China | 25 | Sri Lanka | 12 | Thailand | 9.8 |
| Indonesia | 25 | Philippines | 12 | China | 9.6 |
| Malaysia | 25 | Indonesia | 10 | Indonesia | 7.0 |
| Thailand | 20 | Malaysia | 10 | Malaysia | 6.5 |
| Turkey | 20 | Thailand | 7 | Philippines | 6.1 |

Sources: KPMG, WTO, Ahmed et al. (2015b).

The future tax reforms must avoid escalations in tax rates and focus on reduction in tax expenditures (revenue cost of exemptions and concessions) and address the problem of high levels of tax evasion.

Currently, there is a narrow pool of income taxpayers. Based on a 2008 study by Athar and Rider (2008), the overall tax gap was estimated at 7.5 per cent of GDP.9 The share of direct taxes is boosted by the withholding tax (WHT) regime, under which tax is deducted at source for a long list of payments (such as against contracts, rent, consultant fees, commercial imports, etc.).10 Withholding taxes account for approximately 63% of direct tax collection. If the WHT receipts are not classified under direct taxes, as these are primarily indirect taxes, the share of direct taxes is even lower – at an estimated 16% of the total (or 1.5% of GDP).

Within the main sectors of economy, industry – manufacturing in particular – accounts for an overwhelming share of the tax collection. With a share in GDP of around 18 per cent, industry's contribution to taxes is 76 per cent (Table 7). Agriculture on the other hand, contributes around 3% of the tax collection despite being the second-largest sector of the economy with a share of 21%. There is a similar asymmetry between the share in GDP and contribution to taxes in the case of almost all other important sub-sectors of the economy. Retail and wholesale trade is another glaring example, as are real estate and the equity markets.

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[9] Ahmed and Rider (2008).

[10] Direct taxes in Pakistan include the following categories: Personal as well as Corporate Income Tax; Worker's Welfare Fund (WWF); Workers Profit Participation Fund (WPPF); and, Capital Value Tax (CVT).

Table 7: Relative tax incidence across sectors

| Sector | Contribution as a % of GDP | |
|---|---|---|
| | GDP | Tax Collection |
| Agriculture | 21 | 3 |
| Industry | 18 | 76 |
| Services | 54 | 23 |
| **Wholesale and Retail Trade** | **17** | **1.2** |

Source: FBR, Ahmed et al. (2015b).

Even within the same sector, there are issues of horizontal inequity with only the larger, more formalized entities paying taxes. An indication of the skewed nature of the collection from an extremely narrow base is that over half of the total income tax collection is from 5 sectors of the economy, while over 80% of the sales tax is collected from around 100 registered payers.

A number of factors partially explain the narrow corporate tax base (and exemptions) in Pakistan. These include:

- The semi-industrialized structure of the economy, with agriculture, dominated by small land holdings, and an unorganized services sector accounting for the bulk of the economy
- Lack of documentation of the economy
- Widespread tax exemptions by law
- Weak enforcement amid high levels of corruption in the tax machinery, and political interference
- The split assignment in the Constitution of tax bases between the federal and provincial governments
- Weak incentives for provinces to tap into their tax bases in the presence of progressively higher transfers from the federal divisible pool under the National Finance Commission (NFC) Award
- Citizens are not considered an important player and nor sensitized and encouraged to play their role
- Pakistan’s fiscal resources base is locked up in low revenue-less spending-lower human development and lower GDP growth
- Social accountability mechanisms are weak and people are not demanding equal access to better public services.

## 5. Key Recommendations

### 5.1. Simplify corporate tax regime

Corporate taxes in Pakistan have three different rates which allow for misuse by companies. A public company or 'any other company' will be charged a rate of 33%.11 A banking company will be charged a rate of 35%. A small company will be charged a rate of 25%. There is an incentive for companies not to openly declare their growth and save taxes. A lower rate of 20% would apply for the companies in industrial sector set up between July 2014 to June 2017 for a period of five years, provided their 50% equity is through foreign direct investment. Remittance of profits to head office is also treated as dividends, subject to 10% withholding taxes.

If tax payable is less than 1% of the turnover, and the company is reporting profits, the company will pay a minimum tax equivalent to 0.5% of the turnover. Such taxes in excess of normal corporate tax liability will be adjusted against future liability. However, this adjustment can only be against liability of the five tax years immediately succeeding the tax period for which the amount was paid.12

An alternate corporate tax (ACT) has been introduced since 2014. The minimum tax liability will be higher of 17% of accounting income or the tax liability. ACT applies to all companies except small companies, or companies dealing in the business of insurance, exploration, petroleum, and banking.

The current structure of taxation has been termed as a disincentive to corporatize.13 FBR's own assessment realizes this distortion. However we now need to move towards a strategy to correct such anomalies.

### 5.2. Eliminate unfair exemptions and concessions

There are several exemptions and concessions in Pakistan's corporate tax regime which strengthen drivers of vertical and horizontal inequality. Profits from an electric power generation project, information technology services, export of software and IT enabled services are exempt from tax.

Small firms also face reduced tax rates of 25%. Such companies have been defined as those having paid-up capital plus undistributed reserves not exceeding PKR 25 million, having an

[11] A public company is listed on stock exchange. A public company is also an entity in which not less than 50% of the shares are held by the government or a public trust (source: http://taxsummaries.pwc.com).

[12] Source: http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Pakistan-Corporate-Taxes-on-corporate-income

[13] SDPI (2015).

annual turnover not exceeding PKR 250 million, and have not been formed by splitting up or the reconstitution of an already existing business.

Companies are also allowed a tax credit of 20% of their taxable income if they provide donation to educational institutions, hospitals, government relief funds and non-governmental organizations.

If a resident taxpayer derives income from abroad on which income tax is paid in a foreign country, the taxpayer can claim a tax credit equal to the lower of income tax paid in foreign country or tax payable in Pakistan on that income.

Under a recently announced Prime Minister's Tax Administrative Package, taxpayers have been granted exemption from the audit proceedings if the tax paid is 25% higher than previous tax year. Furthermore, the sources of investment will not be probed for investment in greenfield industrial project, expansion project, construction industry in corporate sector, housing construction in corporate sector, livestock development projects, new captive power plants and mining in Thar, Khyber Pakhtunkhwa and Baluchistan.14

In the case of a modaraba, income, except relating to trading activities, is exempt from tax, provided that 90% of its profit is distributed to the certificate holders as cash dividends.

It has been recommended in the past that the government may promulgate through Finance Act, a requirement of explicitly debating any future exemption or concession in parliament or the relevant standing committee. Their endorsement should be necessary for creating new tax expenditures. The standing committees should have the provision to consult economists and legal experts before a proposed concession is endorsed.15

### 5.3. Broaden the corporate tax base

The Eighth review of IMF for Pakistan noted in October 2015 that 'the number of personal income tax filers, corporate income tax filers and retailers registered for general sales tax remains still well below the potential, informality remains high, and tax-to-GDP ratio, at 11 per cent, remains much below that of most emerging market and developing countries".16

According to the World Bank (2015), a key reason why Pakistan's corporate income tax rate is one of the highest in the world, compared with 24% global average, is because there are not enough sectors or companies to tax. High rates prevent corporatizations and force firms not to register for corporate or sales taxes. Small-scale firms often find conducive to operate out of the

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[14] FBR (2015).

[15] Ahmed et al. (2015).

[16] Source: http://www.imf.org/external/pubs/ft/scr/2015/cr15278.pdf

tax net given high rates and a weak audit arm of Federal Board of Revenue (or provincial revenue authorities). Higher rates on narrow set of production activities also prevent domestic and foreign investment in these sectors.

The inability of the state to broaden the tax base has come under critical inquiry. This has led to greater reliance on Withholding Taxes (WHT). The voluntary tax return filing regime has not met much success due to difficulties in calculating tax liability, lack of adequate incentives to file taxes, lack of adequate punitive measures, and poor relationship between taxpayer and payee (Mughal & Akram 2012; Ahmed & O' Donoghue 2009).17

There are varying estimates of shadow or undocumented economy in Pakistan (Ahmed et al. 2011).18 However there is a consensus among experts that this segment of the economy is on the rise. The use of ICT tools, biometric information and a data warehouse that links banking information with NADRA's database can help the efforts of tax authorities to earn revenue from untapped sources.

## 5.4. Expedite tax administration reforms

The ongoing tax administrative reforms have not met the desired level of success on account of lack of political will, frequent turnover of leadership at FBR, weak audit machinery and frequent changes in tax schedule. In a 2013 firm-level survey by SDPI, respondents had demanded that human interaction in corporate taxation should be reduced at FBR so that rent-seeking can be avoided and a stronger grievance redressal mechanism may be put in place. The respondents had further noted that initiatives such as taxpayers' facilitation units and one-window operations should be made effectively operational.19

Weak tax administration has economic costs for the corporate sector. The World Bank's doing business database explains that a Pakistani firm faces 47 tax payments annually which require 594 business hours per year. This ranks Pakistan 171 out of 189 economies in the paying taxes rank.

## 5.5. Ensure peoples' participation and oversight

Through strengthening of appropriate social accountability mechanisms, government and civil society organizations can put in place systems of citizen participation and oversight which will lead to more transparency, better governance of tax administration and better utilization of

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[17] Mughal and Akram (2012).

Ahmed and O' Donoghue (2009).

[18] Ahmed et al. (2011).

[19] Ahmed and Adnan (2014).

available revenue. Open Budget Initiatives such as one practiced in several commonwealth countries can strengthen fiscal transparency and overtime enhance taxpayers' confidence. The civil society organizations on their own can also ensure (through open budget surveys) if governments provide the public transparent access to information on fiscal affairs and opportunities to participate in the budget process at the national and sub-national level.20

Regular public-private dialogue on tax issues can also result in a reduction in the incidence of tax avoidance in Pakistan. Mughal and Akram (2012) explain that government needs to innovatively communicate tax policy and administrative reforms to the public. According to the authors, key reasons for tax avoidance and evasion in Pakistan include: lack of public advocacy, poor working relationship of taxpayer and authority, proliferation of taxes (without broadening of tax base), and lack of knowledge regarding tax liability calculations.

## 6. Conclusion

Pakistan, under the ongoing IMF programme, has committed to improving the tax to GDP ratio. The case for increased revenue mobilization is gaining importance as provincial governments realize their increased responsibilities (post 18th amendment) and a growing population is demanding improved and expanded public services. In such a milieu, the government will need to look in to increasing direct tax base, remove exemptions and concessions in the current tax code, strengthen audit mechanisms, and streamline judicial reforms that can help expedite punishments in case of tax evasion.

a. The corporate taxes form a major chunk of government revenues however, 62% of companies still do not pay any taxes. This paper has discussed a four-pronged strategy to increase corporate taxes through: simplification of corporate tax laws,
b. eliminating unfair exemptions from corporate taxes,
c. broadening of corporate tax base, and
d. Expediting the tax administration reforms, which in turn will reduce taxpayers compliance costs, bring down harassment complaints from tax-payers and automate the filing, appeal and grievance redressal mechanisms.

Until the time government is successful in broadening the corporate tax base and effectively making companies pay their due taxes, the rate of taxation on the corporate sector will continue to remain high (in comparison to peer economies) and the burden will disproportionally fall on a small number of sectors which are already heavily taxed.

[20] For an example of such a process, see International Budget Partnership's Open Budget Initiative. Web link: http://www.internationalbudget.org/opening-budgets/open-budget-initiative/

We also find research gaps in existing literature on corporate taxes in Pakistan. Going forward, FBR and academia should conduct research on the incidence of corporate taxes through a sectoral and welfare lens. Addition ally, research is also required on how the current corporate tax regime affects investment behavior of local and foreign investors.

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