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TAXATION REFORMS IN PAKISTAN

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I. Taxation Reforms in Pakistan

Macro economic imbalances in Pakistan, caused by the burgeoning budget deficit and a large trade deficit, have created strong pressures for stabilisation and structural adjustment involving wide ranging reforms in different sectors of the economy. Given downward rigidities in public expenditure, resulting from the growth in defence and debt servicing liabilities, it has become essential to reduce the budget deficit primarily by action on the revenue side. Following the largest ever budget deficit in 1990-91, the newly inducted government constituted a Tax Reforms Committee (TRC) to study the problems in the taxation system and to make recommendations for improvement. The Committee submitted its report in early 1991. Most of its proposals were accepted by the government. The Resource Mobilisation and Tax Reforms Commission (RMTRC) was constituted to implement the recommendations of the TRC and to contribute directly to the budget making process.

Over two years have elapsed since setting up of the RMTRC and three budgets of 1991, 1992 and 1993 respectively have been announced incorporating significant changes in the taxation system. However, taxation reforms remain one of the least publicised areas of reforms as compared, for example, to steps taken towards liberalisation, privatisation and deregulation of the economy. This paper attempts to identify the major tax reforms that have occurred in recent years and evaluate them from the viewpoint of impact on revenue and the efficiency and equity aspects of taxation.

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The paper is organised as follows: Section 2 highlights the major elements of tax reform observed in developing countries that have already gone through this process. This provides a yardstick for evaluating the nature and extent of reforms undertaken in Pakistan. Subsequent Sections 3 to 6 highlight the major reforms in different federal taxes. In Section 7 we make an overall assessment of the reforms. This is followed by identification of potential areas of reforms in coming years in the last section.

II. General Features of Tax Reforms

Burgess and Stern (1993) have recently completed an exhaustive review of tax reforms undertaken by countries like Korea, Mexico, Colombia, Turkey, Jamaica, Indonesia, Sri Lanka and Malawi during the decade of the '80s. Prior to this, Ahmed and Stern (1991), Gillis (1989) and the World Bank (1991) had attempted to distil and derive lessons from the experience of tax reforms in developing countries.

The most commonly observed pre-reforms conditions of tax systems include, first, *over-reliance on particular sources* such as taxation of mineral resources (primarily oil) or of imports, second, *narrow tax bases*, especially of income tax, due to exemptions, loopholes, lack of clarity of laws and evasion, third, generally *weak tax administration*, characterised by inefficiency and corruption. In 1991, all these problems were visible in Pakistan. There was over dependence on taxes on foreign trade, with a share in federal tax revenues approaching 60 per cent. This had exposed revenues to the vagaries of the international market and had been one of the major reasons for the dramatic worsening of the budget in 1990-91 in the aftermath of the Gulf war. All taxes in Pakistan, including the income tax, import duties and excise duties were characterised by narrow tax bases, due largely to wide ranging exemptions. Low priority had been attached to the development of federal and provincial tax administrations, which were manned largely by generalists with little exposure to innovations in tax systems. Total cost of collection was about 0.5 per cent of revenues, which highlighted the low level of remuneration, under-staffing and lack of access to facilities and equipment. There was a general perception of high levels of evasion and corruption in the tax system.

Reforms in direct taxes in most developing countries have primarily included measures to promote taxation of incomes in a less distortionary way by using broader bases with more even distribution of liabilities. This has involved withdrawal of deductions and exemptions, removal of loopholes and taxation of different types of realised income like capital gains, interest, rents, dividends, etc., in addition to labour income and corporate profits, frequently by the use of withholding and presumptive tax mechanisms.

Simultaneously, alongwith the broadening of the tax bases, effective tax rates have generally been reduced in order to curb evasion and to reduce the deadweight

losses associated with taxation. Some countries have attempted to integrate the corporate and personal income tax systems to encourage investment and to prevent possibilities of tax arbitrage.

Within indirect taxes, the primary thrust generally has been towards effective taxation of domestic goods and services, especially through introduction of value added tax (VAT) systems. In addition, as countries have moved towards liberalisation of the trade regime, there has been an emphasis on tariff reforms, with reduction in levels of protection, leading to a change in orientation from import substitution towards export promotion.

In the Pakistani setting, one of the primary objectives of taxation reforms is resource mobilisation, given the need to reduce the budget deficit. The tax to GDP ratio in Pakistan is low in comparison to other developing countries (see Table 1). This indicates that significant scope exists for generating higher revenues by broad-basing the tax system, removing exemptions and modernising the tax administration. Also, the tax system appears to be more imbalanced, with a very low share of only about 14 per cent of revenues in 1989-90 from direct taxes, as compared to the average of 35 per cent for developing countries at a comparable level of development. This indicates that one of the first priorities in tax reform must be to develop direct taxes.

Given this overview of the features of tax reform in developing countries and the imperatives of reform in Pakistan, we now proceed to describe the major changes that have taken place in each federal tax during the last three years.

III. Income Tax

Income tax revenues constituted only 1.75 per cent of the GDP in 1989-90. This is very low in comparison to over 5 per cent on the average for developing countries (see Table 1). Also, revenues had grown less rapidly than total tax revenues, as shown in Table 2.

Basic reasons for the low yield of the income tax in Pakistan have been, first, the plethora of deductions and exemptions which have traditionally been justified as incentives for investment, saving, exports, regional development, etc. In 1991, the Second Schedule of the Income Tax Ordinance (ITO) contained a large number of specific exemptions alongwith other concessions embedded elsewhere in the Ordinance. Second, there is widespread evasion in income reporting. The total number of income tax payers [with national tax payer number (NTN)] is only about 1.5 million while the revenue yielding number is about 900,000. According to Ahmed, M., (1993) over 50 per cent of the income generated in the urban areas is in the black economy. The result is that the collection of income tax has remained restricted largely to the industrial and financial sectors, to public limited companies and multinationals, to corporate profits and salary income and to the metropolitan

cities of Pakistan.

Reforms in income tax have focussed on measures to achieve greater documentation of the economy and create incentives for higher level of declaration, broaden the base of taxable incomes primarily through introduction of withholding and presumptive tax mechanisms and across-the-board cuts in tax rates to discourage

TABLE 1

Level and Composition of Tax Revenues in Developing Countries and in Pakistan

	(as % of GDP)				
	Developing Countries			Pakistan	
Tax	With per capita income of less than $360	With per capita income of $360 to $750	All	1989-90	1992-93
Direct Taxes	**3.91**	**6.84**	**7.26**	**1.83**	**2.71**
Income Tax	3.27	5.53	5.11	1.75	2.58
Wealth and Property Tax	0.24	0.31	0.45	0.08	0.13
Social Security Taxes	0.21	0.79	1.30	-	-
Others	0.19	0.21	0.40	-	-
Indirect Taxes (Domestic)	**4.55**	**4.74**	**5.21**	**4.81**	**4.33**
Sales, Turnover, VAT	2.44	2.30	2.46	2.17	1.74
Excises	1.55	1.95	2.07	2.64	2.59
Others	0.46	0.49	0.68	-	-
Indirect Taxes (Foreign)	**5.30**	**7.58**	**5.13**	**5.68**	**4.52**
Import Duties	4.05	6.70	4.32	5.11	4.46
Export Duties	1.09	0.64	0.62	0.57	0.06
Others	0.16	0.22	0.20	-	-
Others	**0.26**	**0.41**	**0.45**	**0.51**	**0.70**
Total Taxes	**14.02**	**19.66**	**18.05**	**12.83**	**12.26**

Sources: Burgess and Stern, (1993), Pakistan Economic Survey, 1992-93.

TABLE 2

Trend in Federal Tax Revenues by Type in Pakistan,
1988-89 to 1992-93

Tax	1988-89	1989-90	1990-91	1991-92	1992-93
	Level (Rupees in million)				
Direct Taxes	**13,920**	**15,637**	**19,868**	**28,851**	**36,760**
Income Tax	13,407	15,000	19,079	27,913	35,018
Wealth Tax	326	419	496	632	1,195
Capital Value Tax	-	64	106	140	313
Others	187	164	188	166	234
Indirect Taxes	**77,100**	**89,498**	**92,275**	**112,954**	**120,179**
Sales Tax	14,700	18,574	17,008	20,799	23,610
Excise Duties	20,038	22,341	24,739	30,334	35,169
Import Duties	37,879	43,706	46,441	57,121	60,536
Export Duties	4,484	4,879	4,087	4,700	864
Total Taxes	**91,020**	**105,135**	**112,143**	**141,805**	**156,939**
	Annual Growth Rate (%)				
Direct Taxes	**17.5**	**12.3**	**27.1**	**45.2**	**27.4**
Income Tax	16.3	11.9	27.2	46.3	25.5
Wealth Tax	68.9	28.5	18.4	27.4	89.1
Capital Value Tax	-	-	65.6	32.1	123.6
Others	55.8	- 12.3	14.6	- 11.7	41.0
Indirect Taxes	**20.2**	**16.1**	**3.1**	**22.4**	**6.4**
Sales Tax	68.1	26.4	-8.4	22.3	13.5
Excise Duties	15.2	11.5	10.7	22.6	15.9
Import Duties	9.1	15.4	6.3	23.0	-6.0
Export Duties	36.3	8.8	- 16.2	15.0	- 81.6
Total Taxes	**19.8**	**15.5**	**6.7**	**26.5**	**10.7**

Sources: Central Board of Revenue, Year Book, 1991-92, Pakistan Economic Survey, 1992-93, Directorate of Research and Statistics, CBR.

evasion, improve the investment climate and reduce distortions in the allocation of resources. Some of the major steps taken are described below.

a) Documentation

Tax audits have been rendered extremely difficult in Pakistan by the wide prevalence of cash transactions and the lack of proper book keeping and accounting. It is clear that proper documentation of the economy is a basic pre-requisite for reforms in the income tax system. This requires enforcement of a system of tax numbers, shift from cash to transactions by cheque and improvements in the accounting practices of taxpayers.

A number of approaches have been adopted in recent years to achieve the objective of greater documentation. As part of the computerisation of the income tax department , an attempt is being made to establish a system of unique NTNs so that no individual tax payer has multiple numbers. Widening of the withholding tax net and introduction of tax invoicing in the general sales tax (GST) also potentially increase knowledge of economic transactions by taxpayers. However, the Central Board of Revenue (CBR) has not yet exploited this information in any significant way in order to detect evasion.

The last (caretaker) government took a number of steps in August 1993 towards greater documentation of the economy like instituting the requirement for making transactions of above Rs.25,000 (previously Rs.50,000) by cheque and maintaining of proper accounts by tax payers with annual turnover in excess of Rs.500,000. A number of incentives are also being offered for proper documentation. In the Finance Act of 1993, medical expenses have been made tax deductible. Conversion of legal status from a private company to a public company (with greater financial reporting obligations) is accompanied by a sizeable reduction in the applicable income tax rate.

b) Mechanisms for Higher Declaration

Given the limited capability of the income tax department to detect evasion, the strategy adopted has been to induce higher compliance by taxpayers by giving incentives for higher declaration which lead to immunity from audit and save small taxpayers, in particular, from any harassment by tax officials. According to the Finance Act of 1993, a taxpayer who has been subjected to audit in the previous three years and pays 20 per cent higher tax than the tax paid in any of the preceding three years will automatically have his return accepted. This scheme appears to be superior either to the last immunity from audit scheme which was linked to previous declaration[1] (with or without assessment) and as demonstrated by Arby (1993)

[1] According to the original immunity from audit scheme, a taxpayer would have his return accepted as final without assessment if he showed a growth rate of 20 per cent over the previous year's assessed income (if audited) or declared income (if not audited).

had led to base-dropping behaviour implying higher, not lower, level of tax evasion or to the panel-audit scheme[2] for tax payers with income above Rs.100,000, which has been shown to be defective by Pasha (1993) as it motivated tax payers to declare income below Rs.100,000. However, the new immunity from audit[3] scheme increases the gains to a taxpayer from a favourable assessment and is, therefore, likely to lead to larger bribes in the tax system.

The caretaker government had also announced a basic modification in the self assessment scheme[4] whereby the probability of being selected randomly for audit has been increased from one in twenty to one in three. The higher probability of audit will induce higher declarations by tax payers. However, over six times as many returns will have to be examined by the income tax department. This is likely to lead to a deterioration in the quality of assessments in the absence of any major increase in staff in the short run. A better policy might have been to increase the percentage of returns audited gradually.

c) *Reduction in Tax Rates*

Major reductions have been made in income tax rates in recent years. The primary objectives have been to reduce evasion, encourage investment and reduce the overall burden of taxation. In the Finance Act of 1991, personal income tax rates were brought down significantly (see Table 3). Table 4 gives the resulting change in marginal and average tax rates at different levels of income. Prior to the assessment year 1992-93, the maximum marginal rate was 45 per cent which is now 35 per cent. However, the exemption limit has been maintained at Rs.40,000 for salaried taxpayers and at Rs.30,000 for the self-employed. Consequently, much of the benefit from the decline in personal income tax rates has accrued to upper income taxpayers. For example, there has been an over 29 per cent fall in the tax liability of a taxpayer with total annual income of Rs.300,000.

In a bold step, the government announced in the Finance Act of 1992, a five year schedule for reduction in the income tax rate of companies. The decline envisaged

[2] This scheme was introduced in 1988-89 whereby taxpayers declaring income below Rs.100,000 were required only to submit a simplified return while those with income above Rs.100,000 were subject to more intensive audit by a panel of officers including an Inspecting Assistant Commissioner (IAC).

[3] Immunity from audit scheme has been reintroduced in 1993-94, according to which a taxpayer, who has been subjected to audit at least once in the previous three years, will be immune from selection for audit if the tax paid for the assessment year 1993-94 is higher by at least 20 per cent as compared to the maximum tax payable in any of the preceding three years.

[4] Taxpayers who are eligible to file returns under the self assessment scheme in 1993-94 must have the following characteristics: declared income of less than Rs.200,000 this year and the previous year, income tax paid at least 10 per cent higher than the previous year, refunds of less than Rs.30,000 and no legal issue pending in an appeal/reference in respect of previous assessment.

by 1997-98 is from 66 per cent to 55 per cent in the case of banking companies, from 44 per cent to 30 per cent for public companies (other than banking companies) and from 55 per cent to 40 per cent for other companies. In addition, the super tax or surcharge on companies has been withdrawn. This measure is likely to contribute greatly to reduction in uncertainty about future tax rates and facilitate investment planning. Annual reductions in tax rates, however, have been kept sufficiently small (at two to three percentage points) to prevent any tendency for inter-temporal transfer of profits or postponement of investment decisions.

Changes in income tax rates have, however, failed to address the issue of tax rate differentials. The rate on banking companies will continue to be substantially higher than that on public companies, despite the fact that interest rates have been deregulated and the banking sector is undergoing the privatisation process. Also, the maximum personal income tax rate will remain lower than the corporate tax rate at least upto 1995-96. This will continue to discourage development of the equity market and permit some tax arbitrage.

TABLE 3

Personal* Income Tax Rates** in Pakistan

Income	Applicable from Assessment Year 1992-93
Rs.Zero to 40,000	Zero
Rs.40,01 to 100,000	10%
Rs.100,001 to 200,000	Rs.7,000 + 20% of the amount exceeding Rs.100,000
Rs.200,001 to 300,000	Rs.27,000 + 30% of the amount exceeding Rs.200,000
Rs.300,001 and above	Rs.57,000 + 35% of the amount exceeding Rs.300,000
Taxable Income	**Applicable from Assessment Year 1988-89 to 1991-92**
Rs.Zero to 60,000	10%
Rs.76,000 to 100,000	Rs.11,500 plus 25% of the amount exceeding Rs.76,000
Rs.100,001 to 200,000	Rs.17,500 plus 35% of the amount exceeding Rs.100,000
Rs.200,001 and above	Rs.52,500 plus 45% of the amount exceeding Rs.200,000

* On salaried tax payers.

** There is a 10% surcharge on taxpayers with total income above Rs.200,000.

Sources: Finance Act, 1991 to 1993, Income Tax Ordinance.

TABLE 4

Marginal and Average Tax Rates on Different
Levels of Personal Income in Pakistan

Total Income (Rs.)	Applicable from Assessment Year 1988-89 to 1991-92	Applicable from Assessment Year 1992-93
	Marginal Tax Rate (%)	
below 40,000	0	0
40,000	10	10
100,000	25	20
124,000	35	30
200,000	35	30
224,000	45	30
above 300,000	45	35
	Average Tax Rate (%)	
40,000	0.0	0.0
60,000	3.3	3.3
100,000	6.0	6.0
124,000	10.9	9.5
200,000	19.3	13.5
224,000	23.0	16.8
300,000	29.2	20.9
500,000	37.3	27.9

Source: Finance Act, 1991 to 1993, Income Tax Ordinance.

d) Removal of Exemptions

Ahmed et al., (1993) have demonstrated that exemptions, exclusions, deductions and concessions have implied major tax expenditures in the income tax system of Pakistan. Substantial revenue has been foregone due to the exemption of agricultural income, interest income on government savings instruments, income of public corporations like Water and Power Development Authority (WAPDA) and Pakistan Telecommunications Corporation (PTC), capital gains on financial assets, tax holidays and the favoured treatment to income from exports and income in the form of allowances, salary perquisites, pensions, etc. Altogether, a conservative estimate is that the total tax expenditure is over 70 per cent of the revenues generated by the income tax.[5]

Some attempt has been made during the last three years to reduce the coverage of exemptions allowed in the Second Schedule of the ITO. Exemption has been withdrawn on income from preservation of food grains, income from renting out of agricultural machinery, income of National Investment Trust (NIT), income of Investment Corporation of Pakistan (ICP), gratuity, donations to particular trusts/foundations, etc. More recently, the caretaker government promulgated ordinances at the provincial level for introduction of the agricultural income tax from the assessment year, 1994-95, onwards.[6] This is a major step forward in broad-basing the income tax, although the tax has been introduced in a schedular and presumptive manner with a high exemption limit and potentially low revenue yield. Nevertheless, it is likely to remove a major loophole in the tax system and improve perceptions of equity.

Much less has been achieved on other fronts. The major exemptions/concessions continue either because the different governments have lacked the political will to take on powerful interest groups or because of the fear that a policy of withdrawal of exemptions might have an adverse effect on other vital macro economic magnitudes like investment, saving, exports, etc.

e) Withholding and Presumptive Taxes

Withholding taxes essentially represent, more or less, ad-hoc deductions at

[5] Estimates by Ahmed, et al., (1993) of tax expenditure in the income tax in 1991-92 are as follows: exemption of interest income from government savings instruments (Rs.4,900 million), statutory exemption of income of public corporations (Rs.4,900 million), favourable tax treatment of salary perquisites (Rs.4,100 million), exemption of agricultural income (Rs.3,000 million), rebate on export income (Rs.1,600 million), exemption of capital gains on financial assets (Rs.1,200 million), tax holidays (Rs.600 million), etc.. The aggregate tax expenditure is over Rs.20 billion.

[6] The agricultural income tax has been introduced essentially as a presumptive tax on land holding, with the value of produce index units (PIU) acting as the proxy of income. Accordingly, the exemption limit has been set at 4,000 PIUs, beyond which the tax is chargeable at rupees two per unit.

source at the point of accrual of income with subsequent adjustment at the time of filing of statement of income from all sources. In this sense they have the obvious merit of preventing leakage of income from the tax net. However, collection responsibility of withholding taxes is potentially decentralised and there exists the possibility of collusion between the withholding tax authority and the taxpayer. Therefore, there is a tendency to restrict the role of tax collector to government agencies, public corporations and large companies. Another problem is that if withholding tax rates are set at very high levels then they can create the problem of refunds by the tax department. These refunds are prone to misuse and corruption. Initially, in the reform process in Pakistan there was a tendency to convert withholding taxes into presumptive taxes, representing fixed and final settlement of tax liabilities. This led to problems of greater inequity, both horizontal and vertical, in the tax system.

Withholding and fixed taxes have primarily been used to extend the coverage of income tax to various forms of capital/unearned income. Traditionally, Section 50 of the ITO which covers such taxes was restricted largely to salary income with deduction at source on a monthly basis by employers. In the '80s this was extended to cover other forms of income like interest income of financial institutions, from government securities, income of non-residents, income of contractors, suppliers and importers. From 1991 onwards, there have been significant developments in the withholding/fixed tax regime (See Table 5). In the Finance Act of 1991, a fixed tax at the flat rate of 10 per cent was levied on interest income from financial institutions and on dividends and at 5 per cent on rental incomes above Rs.100,000. This was followed in the Finance Act of 1992 by the extension of a fixed tax (0.5 to one per cent of value) on exporters to be collected by the State Bank of Pakistan at the time of realisation of foreign exchange proceeds.

A number of criticisms have been made of fixed, presumptive taxes on income. Not only are these taxes seen as arbitrary and bearing little relationship with actual income at the individual taxpayer level but also as fundamentally contrary to the concept of income taxation. It is argued that fixed income taxes levied on the value of sales, output or inputs are actually in the nature of indirect taxes and, therefore, as opposed to direct taxes, the effective burden does not fall on the taxpayer. For example, the 2.5 per cent tax on suppliers is likely to be shifted forwards and lead to a cascading of the tax burden. Similarly, the 2 per cent tax on the value of import or the 3 per cent tax on the value of contracts look very much like sales taxes.

Use of withholding/fixed taxes has not remained restricted only to deductions at source in Pakistan. Increasingly, these taxes have been levied at points where it is possible to get a proxy of the income of a taxpayer. This innovation in the tax system is largely attributable to the desire to catch evasion in the economy. For the first time a withholding tax was levied on commercial and industrial consumers of electricity in the Finance Act of 1992. The objective was to net in the large number

TABLE 5

Deductions at Source under Section 50 of Income Tax Ordinance

Sub-Section	Type	Year of Introduction	Final Tax Liability	Tax Collecting Authority	Coverage	Prescribed Rates
50(1)	Salary	1979	No	Employer	Annual Salary above Rs.40,000	Rates given in Table 3
50(2)	Securities	1982	No	Payer of Interest	Interest on Securities issued by federal and provincial governments	30%
50(2A)	Interest	1991	Yes	Payer of Interest or Profit	Interest or Profits on Deposits with Financial Institutions	10% before deduction of Zakat
50(3)	Non-Residents	1982	No	Payer	Income of Non-Residents	30% [a]
50(3A)	Technical Fees	1987	Yes	Payer	Technical Fees payable to Non-Residents	20%
50(4)	Contracts	1981	Yes	Government, companies and registered firms (with paid up capital not less than Rs.1.5million) etc.	Payments for execution of contracts	3%
	Supply of goods		No		Payments for supply of goods	2.5%
	Services rendered [b]		Yes		Payments for rendering of services	5%
50(4A)	Brokerage	1989	No	Same as 50(4)	Payments for brokerage including advance payments	10%
50(5)	Imports	1979	Yes	Customs Authorities	All imports on duty plus sales tax paid value	2%
50(5A)	Exports	1992	Yes	Authorised Dealers in Foreign Exchange	Foreign Echange proceeds on export of goods	0.5% to 1.0% [c]
50(5B)	Foreign Exchange	1993	No	Same as 50(5A)	Fgn. Exch. for travel abroad	5%

TABLE 5 (*continued*)

Sub-Section	Type	Year of Introduction	Final Tax Liability	Tax Collecting Authority	Coverage	Prescribed Rates
50(6)	Public Transport	1979	Yes	Provincial Excise & Taxation Department	Trucks, Buses, Minibuses	Trucks: Rs.300 to Rs.5,000 [d] Buses: Rs.20 to Rs.25/seat
	Private Motor Cars	1992	No	- do -	Private motor cars with capacity above 1000 cc	Rs.500 to Rs.1,500
50(6A)	Dividends	1991	Yes	Principal Officer of Company	Dividends to non-resident shareholders	10%
50(7A)	Auctions	1981	No	Same as 50(4)	Value of property auctioned	3%
50(7B)	Rent	1989	No	Government, Company or a Diplomatic Mission	Annual Value of rental payment of Rs.100,000 or above	5% of total payment
50(7BB)	Builders	1993	No	Building Control Authority at time of granting permit	Commercial builders	2% of estimated cost
50(7C)	Prize Bonds & Winnings	1990	Yes	Payer	All recipients of money from prize bonds, raffles or lotteries, etc.	7.5%
50(7D)	Bonds	1991	Yes	Payer	Profits or Interest on Bonds and Certificates	10%
50(7E)	Electricity Bills	1992	No	Electricity Company	Value of electricity bills of commercial and industrial consumers	Rs.30 to Rs.360 [e]

a = @ 12% for exploration companies

b = Withholding tax provisions also exist for supply of agricultural commodities and transport of goods.

c = Rates vary by commodity depending upon the extent of income tax rebate.

d = On the basis of carriage capacity.

e = Depending upon the value of electricity bill.

Source : Income Tax Ordinance.

of small to medium-sized taxpayers[7] into the income tax net on the basic assumption that broadly there is a relationship between electricity consumption and income. The magnitude of the withholding tax was linked progressively to the value of the electricity bill,[8] with collection responsibility resting on power utilities. A similar concept has been applied to justify the imposition of withholding tax in 1992 at the time of granting/updating registration of private motor vehicles,[9] in 1993 at the rate of five per cent at the time of issue of foreign exchange for travel abroad and at the rate of two per cent of estimated cost at the stage of issue of building certificate to developers.

Altogether, there has been considerable success in reducing evasion by extension of the network of withholding and fixed taxes. Total revenues under Section 50 have grown very rapidly during the last two years with a cumulative increase of almost 150 per cent in 1991-92 and 1992-93 (see Table 6). This is the major factor responsible for the unprecedented growth in income tax revenues in recent years. Simultaneously, it may be noted that the component of refunds has been largely eliminated from the tax system (see Table 7). These were equivalent to over 18 per cent of net revenues in 1989-90 but were down to only about 4 per cent by 1992-93. Tax deductions at source currently account for over 70 per cent of total income tax revenue.

f) Minimum Tax

Another innovation that has been introduced in Pakistan is that of a minimum tax on corporate entities. This is largely motivated by the fact that less than half of companies pay any income tax. A surprising statistic is that almost 45 per cent of the turnover of publicly quoted companies escape income tax either because of tax holidays, accelerated depreciation allowances and other tax credits or due to under declaration of profits. Over 75 per cent of companies have a tax to turnover ratio of less than 0.5 per cent. This erosion of the tax base provided the basis for introduction of a minimum tax on companies in the Finance Act of 1991 at the rate of 0.5 per cent on turnover or gross receipts. This was extended to registered firms in 1992.

[7] According to estimates from Water and Power Development Authority (WAPDA) and Karachi Electric Supply Corporation (KESC), the total number of industrial and commercial consumers who will be paying the withholding tax, following the withdrawal of the exemption limit in 1993, is almost 200,000 and 1.5 million respectively. This will lead to a major expansion in the income tax net.

[8] The withholding tax is levied on the value of the electricity bill. For commercial consumers, bills upto Rs.400 were exempted. For a bill of between 401 and Rs.600, the tax is imposed at Rs.30. The maximum tax of Rs.360 is charged on bills in excess of Rs.3000. In the case of industrial consumers, exemption was given on bills of upto Rs.500. The maximum tax of Rs.360 is applied on bills above Rs.5,000. In the Finance Act of 1993 all exemptions have been withdrawn.

[9] The withholding tax rate is Rs.500 per annum on private motor vehicles with capacity of 1,000cc to 1,200cc, Rs.750 per annum on 1,201 to 1,300cc cars and Rs.1,500 on above 1,300cc cars. Half rate is applicable on cars registered five to ten years before July 1, 1992. Older cars are exempt.

TABLE 6

Trend in Revenue from Withholding and Presumptive taxes under Section 50 of Income Tax Ordinance

Section	Type of Income	1988-89	1989-90	1990-91	1991-92	1992-93	ACGR (%)
		Rs. in million					
50/1	Salary	705	930	1,395	1,732	2,431	36.3
50/2	Interest on Securities	1,836	1,850	1,673	4,609	7,072	40.0
50/2A	Interest	-	1	14	1,020	1,963	-
50/3	Income of Non-Residents	264	232	494	2,077	539	19.5
50/3A	Technical Fees	-	-	-	3	42	-
50/4	Income from Contracts	2,286	2,833	3,822	5,080	6,846	31.5
50/4A	Brokerage Fees	-	-	335	55	47	-
50/5	Importers	931	1,952	2,071	3,039	3,556	39.8
50/5A	Exporters		-	-	-	1,190	-
50/6	Transporters	60	106	121	128	286	47.8
50/6A	Dividends	-	-	3	100	124	-
50/7	Bonus Shares	-	27	75	117	63	-
50/7A	Auctions	90	84	139	138	157	14.9
50/7B	Rental Income	-	-	2	12	39	
50/7C	Winnings from Lotteries	-	-	21	47	110	
50/7D	Interest on Bonds	-	-	-	20	68	
50/7E	Electricity Bills	-	-	-	-	334	
Total		6,172	8,015	10,166	18,175	24,865	41.7

Sources: CBR Year Book, 1991-92, Resource Mobilisation & Tax Reforms Commission.

TABLE 7

Trend in Income Tax Revenue by Type, 1988-89 to 1992-93

	1988-89	1989-90	1990-91	1991-92	1992-93
Total Income Tax Revenue (Rs. in million)	13,407	15,000	19,079	27,913	35,018
	Share (%)				
Collection of Demand	26.0	22.8	25.3	12.1	9.5
Payment with Returns	38.8	42.4	35.8	28.0	23.4
Deductions at Source	46.0	53.4	53.3	65.1	71.0
Miscellaneous	0.2	0.2	0.1	2.0	0.3
Less Refunds	- 11.0	- 18.8	- 14.5	- 7.2	- 4.2
Total	100.0	100.0	100.0	100.0	100.0

Sources: CBR, Year Book, 1991-92, Directorate of Research and Statistics, CBR.

Initial estimates were that the minimum tax would have significant revenue-raising potential of over Rs.1.5 billion. Actual results have been very disappointing, due to problems of litigation in the courts. This tax has generally been seen as very inequitous due to the lack of a link with profits, whereby even loss making firms are required to pay the tax.

IV. Customs Duties

Customs (import and export) duties have traditionally been the principal source of tax revenue in Pakistan. In 1989-90, revenues from this source were equivalent to 5.68 per cent of the GDP which is somewhat higher than the average for all developing countries of 5.13 per cent (see Table 1). Bulk of the revenue is from import duties (inclusive of surcharges). Export duties represent a highly variable source of income depending upon the size of the exportable surplus in major agricultural commodities, especially cotton, and international prices. In 1992-93, because of the steep decline in the cotton crop and the resulting fall in exports, export duty revenues fell to less than Rs.1 billion.

Table 8 indicates that import duty was paid on 59 per cent of imports in 1992-93. Due to the presence of a large number of Statutory Rules and Orders (SRO),

TABLE 8

Total Import Value*, Dutiable Import and Import Duty at Different Statutory Rates of Duty, 1988-89 and 1992-93

Statutory Rate of Duty**	1988-89 Total Imports	1988-89 Dutiable Imports	1988-89 Import Duty	1992-93 Total Imports	1992-93 Dutiable Imports	1992-93 Import Duty
	Rupees in million					
Zero	16,818	-	-	6,478	-	-
10%	2,109	1,559	236	10,615	2,185	375
20%	13,569	9,479	1,656	38,971	13,453	3,357
30%	-	-	-	154	77	26
40%	10,017	8,149	2,923	17,829	15,951	6,209
50%	4,841	1,492	688	22,285	16,890	8,092
60%	2,188	1,635	841	4,699	3,561	2,112
80%	12,289	9,362	5,105	25,282	15,626	5,612
90%	-	-	-	10,616	8,336	3,571
100%	4,049	3,067	1,573	2,708	1,510	890
125%	2,056	1,546	846	105	90	30
150%	407	362	525	3,422	898	1,371
225%	98	67	104	1,851	110	186
445%	358	205	175	1,412	612	673
Specific	41,537	31,644	10,027	53,390	38,549	9,143
Total	110,268	68,568	24,699	199,812	117,849	41,647

* At Karachi Port only.
** Only Import Duty.
Sources: CBR, Year Book, 1991-92, Directorate of Research and Statistics, CBR.

imports of a number of commodities or by particular types of importers (public sector, industry, etc.,) enjoy duty-exempt status or pay only concessionary rates of duty. Therefore, although the import tax base is large, it has been effectively eroded by exemptions and concessions. The resulting tax expenditure is estimated at Rs.54 billion in 1991-92, which is 90 per cent of actual revenues. In 1992-93, only one SRO relating to public transport (the yellow cab scheme) is estimated to have cost the exchequer almost Rs.12 billion.[10]

Given the wide ranging duty concessions, it has been necessary to levy relatively high rates of duty of upto 125 per cent. For automobiles, the rates are even higher of upto 445 per cent.[11] On the effective tax base, the average rate of duty works out at 35.3 per cent, while the modal statutory rate is 80 per cent. In 1992-93 about 27 per cent of imports were subject to specific rates and the remainder, 73 per cent, to ad valorem rates of duty. The high rates of duty have not only implied high levels of protection to domestic industry but have also led to a large volume of smuggling. Pakistan Institute of Development Economics, (1993) estimates the magnitude of smuggling into the country at over Rs.100 billion. Also, the average rate of duty does not appear to vary significantly by the stage of processing. On raw materials it is 34 per cent, on intermediate goods, 38 per cent, and on finished goods, 36 per cent. Therefore, there is effectively no cascading in the import duty structure. This has discouraged establishment of high value added industries within Pakistan.

Table 2 highlights the uneven path of growth in import duties. For example, in 1991-92, revenues showed rapid increase of 23 per cent. In 1992-93, however, there was moderate growth of only 6 per cent. This fluctuation in revenues in the principal tax has greatly increased the uncertainty in government budgeting and highlighted the need for diversification of revenues.

Reforms in import duties have included the following:

a) Fixation of International Trade Prices (ITP)

From 1991 onwards, the customs department has adopted the practice of fixing on a quarterly basis, international trade prices (ITP) of a large number of imports. Duties are no longer assessed on the declared c.i.f. prices in the bills of entry but on

[10] Other import duty SROs involving major tax expenditures are as follows : SRO 495 (I)/87 on components for local manufacture of vehicles (Rs.7,900 million), SRO 480(I)/92 with general exemption of import duties (Rs.5,400 million), SRO 484(I)/92 to plant and machinery for rural areas (Rs.4,500 million), SRO 791(I)/91 for goods and machines for textile industry (Rs.2,300 million), SRO 460(I)/88 on raw material for local manufacture of two or three wheelers (Rs.1,180 million), SRO 349(I)/85 on raw material and packing material used in the manufacture of pharmaceutical products (Rs.1,200 million), SRO 858(I)/92 on specified construction machinery (Rs.1,000 million), etc..

[11] The rates of import duty on automobiles ranged from 110 per cent to 445 per cent upto the year 1992-93. In the budget of 1993-94, these rates have been lowered. They now range from 70 per cent to 250 per cent.

the ITPs. The primary motivation is to check under-invoicing of imports and in some cases to discourage dumping. These ITPs are set by price fixation committees, with representation of the private sector. By now it is estimated that ITPs apply to almost 62 per cent of imports.

The ITP system appears to have worked moderately well initially but has tended to break down more recently. The underpinning of an information system on international prices in major exporting countries to Pakistan is weak and there are allegations by traders that they are not adequately involved in the price fixation process. Also, it is felt that significant scope exists for corruption in the setting of ITPs.

b) *Reduction in Maximum Tariffs*

As an initial attempt towards trade liberalisation and with the objective of bringing down excessively high levels of protection to some industries, the maximum tariff rate has been brought down from 125 per cent in 1991-92 to 80 per cent in 1993-94. However, inclusion of iqra surcharge at 5 per cent, import licence fee at 6 per cent and flood relief surcharge at one per cent implies that the overall maximum rate is still relatively high at 92 per cent. The reduction achieved in the tariff rates does not appear , as yet, to have met with any significant resistance from industry.

c) *Specific to Ad Valorem Duties*

A transition is being made slowly from specific to ad valorem duties[12] in the case of items which are recognised as not being vulnerable to under-invoicing or dumping. This is expected to increase somewhat the built-in elasticity of customs duty revenues.

d) *The Duty Drawback Regime*

Pakistan has been attempting to zero rate exports by operating a duty drawback regime which involves rebates to exporters equivalent to the value of taxes (import duty, excise duty and sales tax) paid on inputs. The largest component of these rebates is of import duties. For example, exports of textiles receive significant rebates against duties paid on imported inputs like dyes and chemicals. These duty

[12] The tariff on a number of major items in the Pakistan Customs Tariff has been changed from a specific to an ad valorem rate. This includes milk and milk preparations and some chemicals. In addition, some items which originally were subject to specific tariff now have a composite import duty. This includes some POL products, man made and synthetic fibres and yarn, iron scrap, vessels for breaking, etc..

drawbacks have sometimes been manipulated and there is perception of over payment (hidden subsidy) and corruption in the system. A basic indicator of leakage is the fact that the quantum of duty drawbacks exceeds the duty actually collected, as demonstrated by Ismail (1992). Also, the growth in the magnitude of rebate payments has significantly outpaced the growth in value of rebatable exports.[13]

The caretaker government took steps to rationalise the duty drawback rates. The rates have been brought down significantly from October 1, 1993 onwards, on the average by about 35 per cent, and in some cases by as much as 60 per cent. This is expected to reduce the component of arbitrage on the part of exporters and curtail misuse of this facility. It is also likely to encourage the use of bonded warehousing facilities for exports. However, the timing does not appear to be propitious in view of the stagnation in exports. Also, the payment system remains to be streamlined and there are complaints of long delays. Future reforms ought to explore the possibility of duty free imports of raw materials which are largely used for exports. This will obviate the need for duty drawbacks.

V. Excise Duties

Excise duties have historically been the second largest source of revenue after customs duties. In 1989-90, revenues were equivalent to about 2.5 per cent of GDP which is somewhat higher than the average for developing countries (see Table 1). Excises are levied on only a limited number of goods and services. However, these include some of the largest industries of Pakistan like sugar, tobacco, cement and textiles. The pattern of revenues is highly skewed. In 1989-90, four industries, viz., tobacco, sugar, cement and POL products accounted for over 73 per cent of revenues (seeTable 9). Most of the tax rates are specific in character and have been revised infrequently. Consequently, the buoyancy of revenues is low.

During the '90s, major reforms undertaken in excise duties are as follows:

a) *Introduction of Capacity Taxation*

One of the terms of reference of the RMTRC was to explore the possibility of introducing capacity form of excise taxation in major industries like cigarettes, yarn, cement, sugar, etc.. Pakistan's earlier experiment with capacity taxation in the late '60s had largely been a failure. The system had tended to break down because of the need to give relief for unanticipated events like power load shedding, strikes, machinery breakdown, etc.. This had led to litigation in the courts and pending

[13]Total amount of duty drawback to exporters against payment of customs duty, excise duty and sales tax has increased from Rs.4.4 billion in 1988-89 to Rs.16.5 billion in 1992-93, showing an annual growth rate of almost 39 per cent. During this period, the value of manufactured exports has increased by 26 per cent.

arrears had accumulated. However, in 1991, the government found capacity taxation attractive because it had the potential for stimulating production as the marginal tax rate in this system with respect to output is zero. Also, corruption was rampant in the department and it was felt that industry would welcome this system as a means of avoiding harassment by excise officials. Consequently, a special Capacity Taxation Committee was constituted to implement this system.

TABLE 9

Commoditywise Collection of Excise Duties

	1988-89	1989-90	1990-91	1991-92	1992-93
	Rupees in million				
Beverages	747	733	1,093	1,134	1,233
Sugar	3,205	3,747	3,669	4,789	4,879
Tobacco	7,015	8,307	8,072	8,732	8,505
Cement	2,363	2,501	3,084	3,699	3,601
Crude Oil	222	253	402	381	411
Natural Gas	1,035	1,130	1,189	1,272	1,333
POL Products	1,839	1,784	2,147	2,430	2,318
Paints and Varnishes	236	171	198	250	297
Soaps and Detergents	457	485	358	427	477
Cotton Yarn	782	954	1,915	2,971	2,680
Man-made Yarn	211	253	632	1,047	1,027
Hotels and Restaurants	138	218	259	328	367
Telephone Services	-	-	-	1,046	3,487
Domestic Travel	-	140	206	240	278
Bank Advances	-	-	-	-	2,503
Others	1,788	1,665	1,516	1,588	1,773
Total	20,038	22,341	24,740	30,334	35,169

Sources: CBR, Year Book 1991-92, Directorate of Research and Statistics, CBR.

The Committee discovered that it was extremely difficult to arrive at a consistent formula for fixing the tax base at the individual unit level in different industries. The approach actually adopted was closer to presuming the production rather than assessing the rated capacity. It was hoped thereby to reward the more efficient units in the industry and to penalise the inefficient. Also, in this approach there was no need for incorporating an explicit *force majeure* clause for interruptions to production as a normal allowance for this was to be built into the formula for determination of the tax base.

In practice, arriving at the presumed production in the sugar industry was complicated by the large variation observed among units in the length of the crushing season and in the recovery rate. In cigarettes, there was a large differential in the levels of productivity per machine by size of unit and in retail prices which were substantially higher for established brands. In yarn, the basic problem was one of merging different counts into one composite measure. Also, in industries where the effective tax rate is high, like tobacco, individual units are averse to making a commitment in advance to paying a fixed amount of tax. Small fluctuations in demand are likely to drastically affect profitability, given the fixed tax burden.

The only industry where success was achieved was cement, with substantial homogeneity in output. Capacity tax was introduced in this industry in 1991-92. It, however, involved a substantial redistribution in the tax burden between public sector and private sector units,with the latter enjoying substantial tax breaks, while the overall transition was revenue neutral.

The caretaker government, however, withdrew the capacity tax on cement and brought back the production based system. This was motivated by the fact that the former reduces elasticity of revenues greatly, as there is no automatic increase in revenues in line with increased production in existing units. This was demonstrated by the virtual constancy of revenues from the industry in 1992-93 although production grew by about three percent. Altogether, the experience over the last two years indicates the lack of success in reintroducing capacity taxation in Pakistan.

b) Broad-basing of Excise Duties

Given the emphasis on resource mobilisation and in the light of the fact that many of the service sectors of the economy with potentially large and growing tax bases were undertaxed, a major effort has been launched to extend the coverage of excises to services. For the federal government there has also been the consideration that excise duties (excluding those on gas, tobacco and sugar) are outside the divisible pool and, therefore, any additional revenues generated from this tax do not have to be shared with the provinces.

In the Finance Act of 1991, an excise duty at the rate of 25 per cent of billing was introduced for the first time on telephone services. This was expected to be a

major revenue spinner with bulk of the incidence falling on the upper income groups. Simultaneously, an excise duty was also levied on banking services at the rate of 1/12th of one per cent of the advance outstanding on the last working day of each calendar month. The justification was that in a regime of regulated interest rates, the cost of capital is artificially low and scope exists for mopping up some of the difference with respect to market rates through taxation. Advances below Rs.50,000, loans for fixed investment, housing, agriculture and exports were initially exempted from this tax. Subsequently, in the Finance Act of 1992, the rate of excise duty on telephone services was increased to 60 per cent and was doubled on bank advances, alongwith withdrawal of exemptions.

The jump of the tax rate on telephone services from 25 per cent to 60 per cent was expected to yield substantial additional tax revenues of over Rs.5 billion. This did not happen. Demand appears to have been elastic with respect to price and the high tax rate encouraged revenue leakages. This is a classic example of overtaxation leading to a severe contraction in the tax base such that revenues show little increase. It is not surprising that based on this experience the Finance Act of 1993 has brought down the rate of excise duty on telephone services from 60 per cent to 35 per cent. Also, interest rates are extraordinarily high currently in Pakistan, at 20 to 22 per cent. This argues for a withdrawal of the excise duty on bank advances.

VI. General Sales Tax

General sales tax (GST) revenues were equivalent to 2.17 per cent of the GDP in 1989-90. This is somewhat lower than the developing country average of 2.44 per cent (see Table 1). Revenues had shown considerable buoyancy in the late '80s as major base-broadening of the tax took place. Since then revenues have tended to show only modest growth.

Sales taxes are collected largely at the import and manufacturing stages in Pakistan. In 1989-90, the share of the import sales tax was 47 per cent, with the remainder, 53 per cent, collected at the manufacturing stage. Almost 400 domestic industries pay the sales tax currently. Major revenue contributors are auto parts, cement, cigarettes, cotton fabrics, iron and steel products, jute products, lubricating oils, man made fibres and yarn, metal containers, motor cars and cycles, paper products and wires and cables.

GST exemptions are pervasive at the import stage. The potential tax base consists of dutiable imports plus import duty. This is estimated at Rs.147 billion in 1991-92. With the standard tax rate of 12.5 per cent, the potential revenue yield is Rs.18.4 billion, whereas the actual revenue in the year was Rs.10 billion. This implies an erosion in the tax base of almost 46 per cent due to specific SROs containing GST exemptions.

A number of significant reforms have been attempted in the GST in the last few years, as follows:

a) Introduction of Tax Invoicing

Input tax invoicing was introduced in 1990 following the promulgation of the Sales Tax Act. This has imparted some of the features of a VAT to the tax and partially removed problems of cascading.[14] The Act contains provisions not only for tax invoicing but also for zero rating of some sectors (especially exports). Detailed procedures have been laid down for monthly payment of the tax and the method for computing tax liability. As opposed to excise duties, all goods are subject to GST, unless specifically exempted. The list of exemptions currently contains industries mostly producing food items, basic consumer goods, construction material and machinery. Therefore, the GST is potentially a broad-based tax. In 1990 some of the initial steps required for introduction of the VAT appear to have been taken in Pakistan.

However, there are some basic problems with the large scale introduction of VAT in Pakistan. First, in the absence of proper accounting and documentation of transactions, especially by smaller manufacturing and trading entities, enforcement of the tax becomes difficult. Also, there appears to be some reluctance on the part of large-scale units to accept tax invoicing of inputs and outputs because of the fear that furnishing of this information will also enable better determination of income tax liabilities and thereby limit possibilities of evasion. Second, there is a degree of political reluctance to levy GST on the consumption of goods like tea, vegetable ghee, etc. Third, there is a constitutional restriction on the extension of sales taxes to services by the federal government in Pakistan. This implies that the GST cannot be levied on major service inputs like power, gas, transport,[15] etc., and as such it is impossible to make GST correspond to a true value added tax in the absence of an appropriate constitutional amendment.

These problems have been resolved in practice in a number of ways. First, by imposition of fixed, flat rate sales tax, in a number of industries.[16] Alternatively, manufacturers have been given the option of paying a five per cent tax on value of output without tax invoicing of inputs. Both these improvisations have eliminated the VAT feature of the tax in a number of industries.

[14] The component of tax invoicing against input tax in the gross revenue on output from the domestic GST was 26 per cent in 1991-92. It has remained, more or less, constant in 1992-93.

[15] According to the Input-Output Matrix for 1990-91 prepared by the AERC, the share of service inputs like electricity, gas, road transport, railway transport, etc., in the total value of intermediate inputs is over 11 per cent.

[16] Industries with a fixed, specific GST include processed fabrics, marble tiles, cement blocks, paper board, iron and steel ingots and billets, mild steel re-rolled products, power looms, plastic goods, electric fans, washing machines, PVC and RCC pipes, plastic ropes, tin containers, aluminium utensils, desert coolers, sanitary ware, gas appliances, etc.. The fixed rates are revised annually on an ad hoc basis by 5 per cent to 10 per cent.

b) Extension to Wholesale and Retail Level

Some tentative attempts have also been made to extend the GST on some items to the wholesale and retail level and give it increasingly the character of a consumption tax. These goods are primarily consumed by the upper income groups. In the Finance Act of 1991, the sales tax was extended to wholesale/distribution stage of locally manufactured goods and the stage of local retail supply of nine items, viz., air conditioners, deep freezers, T.V. sets, ceramic tiles, sanitary wares, carpets (synthetic and woollen), foam and foam products and paper board. In the Finance Act of 1992, sales tax was extended to the retail stage in the case of the nine items. In addition, another 21 items were subjected to GST at the wholesale and retail stage.

However, the government has retreated under protest from the traders. Instead, a simplified procedure has been introduced whereby retail sales tax on locally manufactured goods shall be collected by manufacturers on behalf of the retailers at 2 per cent of the ex-factory price (including the amount of sales tax). No adjustment for input taxes shall be allowed for the sales tax collected under this procedure. This retreat by the government has jeopardised any future large-scale introduction of a VAT type of sales tax at the wholesale and retail level in Pakistan.

c) Enhancement in Rate

Given the constraints to broad-basing of the GST, the government has adopted a pragmatic approach to resource mobilisation by enhancing the standard rate. In the budget of 1993-94, this rate has been enhanced from 12.5 per cent to 15 per cent. This is expected to yield substantial additional revenues of over Rs.4 billion. Escalation of the GST rate across-the-board raises the issue of incidence. Given the nature of the tax, it has been argued that the incremental burden will largely fall on the poorer sections of the society. This may not necessarily be true because, as highlighted earlier, bulk of the revenue is collected from intermediate goods. However, a high standard rate is contrary to the long run goal of a low rate, broad-based VAT in Pakistan.

VII. Assessment of the Impact of Reforms

Following the description of the major reforms in federal taxes we now make an overall assessment of the impact of these reforms.

a) Revenues

As highlighted above, one of the major imperatives behind tax reforms in Pakistan has been to mobilise additional resources in order to contain the size of the

budget deficit. Cursory analysis reveals, however, that the reforms have failed to yield a breakthrough in terms of a quantum jump in the federal tax to GDP ratio, which has remained trapped at between 11 to 12 per cent during the last few years. However, the performance has been different in direct and indirect taxes respectively. The former have shown extreme buoyancy during the last three years and there has been close to a one percentage point increase in the direct tax to GDP ratio. As opposed to this, the reforms have not been able to remove the stagnation in indirect tax revenues, especially in the GST and customs duties. Consequently, the indirect tax to GDP ratio has fallen by about one percentage point.

The extraordinary performance in direct taxes is largely due to the extension of the withholding and fixed tax regime (under Section 50) in income tax, which now accounts for over 70 per cent to revenues. As a consequence, while income tax was the smallest source of revenue in 1989-90, after customs duties, excise duties and sales tax, by 1992-93, it has emerged as the second largest source of revenue after customs duties.

It is also of some interest to note that 'supply-side' economics appears to have worked in the case of income tax in Pakistan. Despite the sizeable reduction in personal income tax rates, tax deductions at source on salary income have shown rapid growth of 24 per cent in 1991-92 and over 40 per cent in 1992-93. Similarly, payments with returns by companies have continued to grow despite some fall in tax rates and introduction of withholding/fixed taxes on export income, etc.. Altogether, it appears that lower tax rates have been successful in inducing higher income declaration/generation.

In the case of indirect taxes, reforms that have led to a loss in revenues are the reduction in the maximum tariffs and the resort to capacity taxation and fixed sales taxation. Also, initially the introduction of input tax invoicing in GST adversely affected revenues. The broadening of the tax base of excise duties by its extension to telephone and banking services has partially compensated for these losses. It is expected that in 1993-94 scaling down of duty drawbacks and enhancement of the standard GST rate will yield significant net additional revenues.

b) Elasticity

It is likely that the reforms have contributed to some modest enhancement in the elasticity of the tax system, especially of income tax and excise duties. Factors responsible for this are the levy of fixed (ad valorem) taxes on capital incomes which are growing relatively rapidly in the economy, the extension of ad valorem excise duties to services characterised by a high income elasticity of demand like telecommunications and the switchover from specific to ad valorem duties. As opposed to this, the introduction of fixed sales tax in some industries has tended to reduce elasticity of the GST.

c) *Efficiency*

There are a number of elements in the tax reforms which could contribute to greater efficiency. First, fixed taxes on agriculture and on capacity in industry are likely to be non-distortionary in character. Second, reduction in maximum tariffs may create greater incentive for efficiency in industries which have hitherto enjoyed high levels of protection. Third, the introduction of a VAT type of sales tax is likely to contribute to a more efficient allocation of resources. As opposed to this, the resort to high tax rates in sectors like telephone services has led to major behavioural responses. Similarly, enhancement in the standard GST rate will have distortionary effects on demand.

d) *Equity*

At the broadest level, while the tax reforms have been largely revenue-neutral, they have led to a fundamental change in the composition of revenues. The share of direct taxes in federal tax revenues has increased dramatically from 14.9 per cent in 1989-90 to 23.5 per cent in 1992-93. This has probably contributed to greater progressivity of the tax system. Specific examples of this are the more effective taxation of capital incomes, levy of withholding tax on income proxies, introduction of the agricultural income tax and levy of excise duties on services like telephones consumed by upper income groups. However, the switchover from withholding to fixed taxes in the case of contractors, importers, etc, has imparted the characteristics of indirect taxes to a component of the income tax.[17] In addition, regressivity of the burden has been accentuated by introduction of the minimum tax and the recently enhanced probability of audit of small taxpayers in the self-assessment scheme. Further, the reduction in income tax rates has mostly benefitted the upper income groups. Altogether, the impact of the reforms on equity remains unclear and will have to await more in-depth analysis.

In summary, we conclude that the reforms have been broadly revenue-neutral, although they have contributed to a substantially improved performance of direct taxes. In addition, the reforms have probably meant some enhancement in the elasticity of the tax system and in the overall level of efficiency in the economy. However, the impact on equity is ambiguous.

VIII. Future Directions of Reform

We finally compare the nature and extent of tax reforms already implemented

[17] The share of fixed taxes on imports and contracts, which are likely to be shifted forward, in total revenue from income tax is about 17 per cent. Therefore, the degree of conversion of the income tax to an indirect tax is not very pronounced. Other fixed taxes, e.g., on interest income, are unlikely to be shifted.

in Pakistan with those generally observed in other developing countries. On this yardstick, tax reforms in Pakistan appear to have been limited in character. Major structural changes remain to be brought about in the tax system. Measures that have been taken to date are essentially those which were politically feasible and did not require any major improvement in the quality of tax administration. Wherever political will was required, this has generally been missing. For example, the retreat from a limited imposition of VAT type of GST at the wholesale and retail level has adversely affected prospects for significant revenue gains in the medium run from large scale introduction of VAT in Pakistan. Also, it has not been possible to withdraw exemptions in income and other taxes in the face of strong pressures from vested interests. The solitary exception to this is the introduction of agricultural income tax by the caretaker government which was probably able to take this radical step only due to lack of any political interest. However, the future of the agricultural income tax ordinance remains uncertain.

Future directions of reform may include the following:

i) stronger measures to enforce proper documentation of the economy;

ii) introduction of a large-scale VAT preceded by proper registration of tax payers, removal of exemptions, strengthening of the tax administration and constitutional change;

iii) a move towards greater simplicity of the tax system and lower compliance costs by reduction in the multiplicity of taxes charged by different levels of government;

iv) a more rational policy towards exemption of small-scale industry to prevent continued erosion of the tax base by loss of competitiveness by large-scale industry; and

v) improvement in the quality of income tax staff to achieve substantially better assessments of corporate returns.

The paper has highlighted that major revenue gains will only be achieved if the wide ranging concessions and exemptions in income tax, customs duty and sales tax are phased out. These currently account for a total tax expenditure roughly equivalent to two-thirds of the tax revenues generated in Pakistan. This can be coupled with a policy of further reduction in tax rates.

Comprehensive tariff reforms must also remain high on the national agenda if the economy is to make a transition from an inward looking, import substitution strategy to export promotion and if a fundamental change is to be made in the taxation system, with less dependence on foreign trade taxes and more reliance on taxes on domestic income and consumption. Also the ambit of tax reforms will have to be extended to cover provincial and local governments.

The unfinished task of tax reforms, however, requires a level of political commitment and willingness to improve the quality of tax administration which has hitherto been lacking.

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